

## **Chapter C.5**

### **ESTABLISHING TRANSFER PRICING CAPABILITY IN DEVELOPING COUNTRIES**

#### **C.5.1. Introduction**

##### **C.5.1.1.**

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C.5.3.2. In addressing the issue of developing transfer pricing capability it is important, first of all, to determine the actual level of existing knowledge and the best organizational approach. The focus in this Manual is on countries with little or no existing experience in transfer pricing, so there are initial start-up issues. There is also a recognition that not everything can be achieved at once and that the system and the administrative capability will need to evolve over time, as part of a capability building plan - what is often termed a “life cycle approach”. A possible approach is outlined below in Figure C.5.1:<sup>2</sup>

**Figure C.5.1: Audit Process**

C.5.3.3. Factors to consider when assessing the level of development/capability of the tax administration include:

- Levels of education and expertise;
- The legal environment or framework (as addressed in Chapter B.8 \*\*including the characteristics of the transfer pricing legislation and responsibilities for and the scope of regulations – a clear and transparent legal framework is important to the functioning of the administration as a whole,<sup>3</sup> and perhaps especially in a difficult and legally complex area such as transfer pricing;

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- Networks of comprehensive bilateral tax treaties including articles relating to Associated Enterprises (usually Article 9), the Mutual Agreement Procedure (usually Article 25) and Exchange of Information (usually Article 26). Additionally, any more limited Exchange of Information agreements - especially with the countries of residence of key participants in the economy and their related parties;
- Availability of information within the country/tax administration; and
- Availability of information technology systems that allow for the most effective strategies to encourage compliance, develop and support audit strategies and facilitate collection and litigation where necessary, as well as those skilled in using them.

#### **C.5.4. Developing the Mission, the Vision and the Culture of the Unit**

##### **C.5.4.1. Objectives**

C.5.4.1.1. The goals of the team should be clear, both to team members and to others that they are engaging with. This includes others in the administration and stakeholders such as taxpayers and their advisors. Often this is put in terms of developing a “mission” representing what the unit will do in its daily operations and a “vision” representing what an ideal future will look like when the unit carries out its mission properly. Many tax administrations also have a “Taxpayer’s Charter” which reflects what taxpayers can expect from the administration, and what is expected from them in the relationship.

C.5.4.1.2. Documents reflecting the mission and the vision should become part of the culture and be “lived out” by the unit on a daily basis rather than merely being framed and put on the wall. This will be assisted by, for example, developing a team charter aligned with the wider organizational charter agreed by senior managers in the unit and key persons in the organization as a whole, preferably after conversations with stakeholders. This could usefully draw upon the experience of other countries though it must be tailored to each country’s own realities. It is of course necessary to keep under review whether the mission and vision are being achieved in practice and, if not, why they are not being achieved.

C.5.4.1.3. An important part of defining the unit’s objectives involves identifying, and recognizing the limitations of, available resources. Clearly determining what is inside and outside the competence of the unit will help clarify what resources are needed to meet the objectives of the unit and encourage the best use of such resources.

##### **C.5.4.2. Client/Taxpayer Orientation**

C.5.4.2.1. A central consideration to be borne in mind is that a transfer pricing unit will have important taxpayer service and education functions as well as a central enforcement function. These functions are interrelated: better education and taxpayer service reduces the cost, resource-intensiveness and “pain” of compliance. This, in turn, helps increase compliance (those wanting to comply find it easier to do so) and allows the administration to focus enforcement measures on the greatest risk areas (in particular, those who have no intention of complying with their obligations).

C.5.4.2.2. Understanding the functions and environment of MNEs will most effectively and efficiently further all these service, education and enforcement activities. Handling their taxation issues will inevitably lead to more contacts between MNEs and the unit. For instance, MNEs have to disclose their documentation and systems, while tax administrations have to be aware of the dangers of unnecessarily high administrative burdens, and therefore compliance costs, for MNEs. High compliance costs are

inefficient and may unnecessarily give a negative view of a country's investment climate, deterring potential investors.

C.5.4.2.3. On the other hand, increased focus on transfer pricing issues will inevitably lead to some disputes with MNEs and the possibility of double taxation. Another country may regard more of the profits of a transaction between related parties as subject to its tax jurisdiction in accordance with a bilateral treaty; resulting in fewer profits being (in that country's view) subject to tax in your jurisdiction. This is an increasingly common issue in transfer pricing and tax administrations need to devote resources to avoiding unnecessary differences. They need to ensure, where possible, that those differences do not lead to a dispute and they need to deal with formal dispute resolution procedures as expeditiously and effectively as possible when a dispute cannot be avoided.

C.5.4.2.4.

- Seeking to avoid disputes arising unnecessarily but also setting up clear and fair systems for addressing such disputes that do not unfairly deter taxpayers from pursuing legitimate grievances; and
- Advance rulings on specific issues of taxpayers.

C.5.4.2.9. Steps that could be encouraged among taxpayers and their advisors include:

- Being transparent and open about their risks, including by making voluntary disclosures to the tax administration;
- Requesting and obtaining advance rulings before embarking on activities with important tax consequences, or participating in Advance Pricing Agreements where they exist;<sup>4</sup>
- Making their transfer pricing policy available to the tax administration;
- Recognizing the resource limitations on Tw 4.261 0 Td [(e.6 ( [(R)4 (u (a)-1.6 (t)-4.6 (i)-4D4 (e)-1.0.9 (r)- 9

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C.5.4.3.3. As part of this risk management approach, even developed countries with long established transfer pricing regimes and administrations tend in practice to have criteria that define their areas of greatest or least current focus. This often includes thresholds below which they would generally not audit or adjust a controlled transaction for transfer pricing purposes, especially in relation to small and medium sized enterprises or for transactions below certain values.<sup>5</sup>

C.5.4.3.4. The criteria referred to above will have to be assessed for each country in the light of its own circumstances, and will have to be kept under review to make sure these criteria are not relied on abusively so that the risk profile has changed. Examples of factors that have often been given special prominence for further investigation by administrations (without of themselves implying any mis-pricing) include situations where the local entity has:

- Reported losses for a number of years or more, especially if the losses start to accrue close to the time when a “tax holiday” ends;
- A high value of related party transactions compared to the taxpayer’s turnover and operating profit;
- Significant transactions with major counterparts from low-tax or no-tax jurisdictions, non-treaty partners and countries from which information will not be readily available ;
- An economically unrealistic profit trend compared to industry trends, with no obvious explanation;
- Inconsistencies between inter-company contracts, transfer pricing policies and detailed transactional documents such as invoices and customs documents; or
- Significant royalty payments to related parties, especially if the intellectual property is not legally registered or appears to be in some part locally generated.

## **C.5.5. Organizational Structure for the Transfer Pricing Unit**

C.5.5.1. There are two basic types of structure that can be adopted for establishing transfer pricing capability: a centralized model, with a single transfer pricing unit operating across all industries and geographical areas, or a decentralized model, with separate transfer pricing units by industry or geography. Each has advantages and disadvantages, as follows.

### **C.5.5.2. Centralized Model**

- **Advantages:** coordination and adjustments to the transfer pricing approach are made easier in the start-up phase; knowledge is built up quickly; the model is in tune with a centralizing tendency in tax administrations (driven in part by the desire for all-encompassing technological developments and compliance strategies); there are clearer lines of authority, communication and reporting

guard against such an “ivory tower” mentality (and against being perceived as such) and ensure frequent interactions and exchanges of ideas and even personnel between such groups.

### **C.5.5.3. Decentralized Model**

- **Advantages**there are shorter lines of communication with tax inspectors; an easy diffusion of knowledge; combined industry and transfer pricing knowledge; and the model facilitates a long-term broader dissemination of transfer pricing awareness.
- **Disadvantages**there are risks that team members will not see their first loyalty as being to the transfer pricing unit but instead to the colleagues they most regularly work with, especially in the start-up phase of a multi-disciplinary, cross-functional team, with the danger of a lack of a single vision and coordination. Such coordination problems may lead(t)-2.7 (n )10.(ag)10.9.6 (i3b4.7 (o)10.9



monitoring key sectors of revenue while preserving relationships with taxpayers. This experience may also provide lessons that can be applied to the reform of the administration more generally.

C.5.5.8. Many countries adopt a highly centralized model for their transfer pricing unit at start-up. This reflects the importance of coordination and uniform approaches at that time; it also recognizes that a transfer pricing unit is not designed to have a specific lifespan but rather will become a permanent part of the tax administration's structure. Several models can be used to take transfer pricing capability further after this start-up phase. It is possible to create teams for every region that can exclusively deal with transfer pricing cases, for example. National coordination is then achieved by placing team members from each region on a rotation basis to work together and discuss the latest developments in transfer pricing.

C.5.5.9. Another model is to make all corporate income tax inspectors responsible for all transfer pricing cases. In that case it is sensible to appoint some regional focal points which have to be aware of all major issues and are responsible for contacting and informing policy makers.

C.5.5.10. As noted above, some countries also have a separate office dealing with MNEs because of their specific characteristics, their relevance in terms of investment and the tax revenue they may generate and the related tax issues that are of special importance. Such an office can be organized on a national level or within the regions, depending on the number of MNEs that are active in the country. As noted above, this unit should as far as possible act as a central contact point (or "one-stop shop") for responses on MNE issues and it will therefore need to contain transfer pricing expertise or at the very least work especially closely with the transfer pricing unit.

## **C.5.6. Building Team Capability**

### **C.5.6.1. General Human Resource Management Issues**

C.5.6.1.1. A new transfer pricing regime is probably itself related to major changes within a tax administration, such as recognition of the impact of globalization and international value chains on the particular country. As with most changes there are potential advantages and disadvantages. While the human resources management strategy for the unit needs to be integrated with the organization's wider human resources strategy, there are aspects that are likely to be of particular relevance in this area, including the importance of:

- The unit's "culture", focusing on achieving the organizational vision, mission, and objectives; motivating and providing incentives for performance; measurable goal setting; and mutually

- Officers who are keen to develop and to explore the most efficient and effective ways

C.5.6.1.4. There is, on the other hand, a risk that employees from the tax administration will become overly enthusiastic about transfer pricing as a “panacea” - a solution to all problems - and may accordingly propose unjustified or disproportionate tax adjustments leading to time consuming litigation and MAP proceedings. It is often stated that transfer pricing is not an exact science, and there is a broad range of possibilities to discuss and adjust tax returns. That inexact quality can be abused by authorities as well as by taxpayers. It is thus important to manage this process, and ensure that any proposed transfer pricing adjustment is justified on purely transfer pricing grounds; it is also important to show that the discretion implicit in such an inexact situation is properly exercised. This involves integrity issues and it is important that decisions taken having major financial impact are appropriately checked and “signed off” in a way that not only ensures (as far as possible) that they are made for the right reasons and consistently with the treatment of other taxpayers, but that they are also seen as doing so. **av0.1, Jav0.1;9dJ4 ( ho l (4 ( ho**

Having information available but being unable to properly interpret it may put an administration in a worse position, especially before the courts, than if it never had access to the necessary information.

C.5.6.2.4. Staff with a background in accounting have often been regarded as easy to train in transfer pricing as they are often enthusiastic about specializing in this field, but similar enthusiasm can be found in those with other skill sets. 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.

C.5.6.2.5. At the initial stages, specific transfer pricing expertise may not be generally available in the country (or at least within the administration) and will in large part have to be developed. At a later stage expertise from outside may be encouraged to join the tax administration by job gradings that reflect the scarcity of skills and good salaries – perhaps higher than usual salaries, although that can create resentment among other staff. Other non-financial incentives may be important, such as the ability to work on the governmental “side”, perhaps with greater policy or legislative exposure and improved lifestyle (by creating a more balanced work environment for those with children, for example). Developed .8 (e)-10Tc -0.0

helps to ensure that working arrangements are transparent, open and incorporate built-in checks and balances that will reduce the risk of temptation on both sides. It is also important to recognize that officers should be given protection from false accusations against their integrity, which may reduce their willingness to approach each case fairly and impartially. The checks and balances should be designed to support officers acting properly and maintain the effectiveness of the unit. A way for officers to bring issues of integrity to management attention through secure channels that will act on such intelligence without punishing the whistle-blower and discouraging such behaviour in future should also be considered.

C.5.6.2.10. Regular internal audits of the members of the unit can form part of the system of checks and balances. These audits could include reviews of quality, consistency and timeliness of decisions as well as, possibly, of personal assets of individual officers (such as by declarations of assets and interests and checks as to their accuracy). If resources allow, some form of double-checking of audits including rotation of fresh auditors into such roles can prove to be useful in this respect.

C.5.6.2.11. A review process of important cases by a formal panel or informal reviews by a senior group is suggested as a way towards achieving coherence, adherence to administration rulings, integrity, sound technical standards and effective case management. This can also, to some extent, form part of the on-the-job training. Those undertaking the review should ideally comprise not just officers from the unit, but also from other relevant areas. The group could include officers dealing with the type of business or industry (such as officers from the Large Taxpayer Office if it is separate), intelligence officers, officers from the economic unit (if there is a separate pool of economists working on transfer pricing issues but not part of the transfer pricing unit - an issue discussed below) tax treaty experts and those dealing with potentially related areas, such as thin capitalization. This need for checks and balances is likely to assume even greater importance in coming years, with greater scrutiny of transfer pricing issues by civil society and parliaments likely in most countries over the coming years.<sup>10</sup> The role of non-government organisations in pressing for country-by-country reporting as an outcome in the OECD/G20 BEPS project<sup>11</sup> is just one instance of this new reality.

C.5.6.2.12. A well-functioning transfer pricing unit needs both legal and economic expertise and it is not solely one or the other. Transfer pricing knowledge is about pricing, economic rationale, market conditions and tax law.

As with any specialist skill, having economists working in groups at the start-up phase may also be seen as promoting integrity and an “aligned” and consistent approach to the issues that arise.

C.5.6.2.15. Whichever approach is adopted, efforts will need to be put in place to ensure sufficient linkages and knowledge exchange between the “pool” of economists and their fellow economists in other areas, as well as other officials that will be part of multi-disciplinary transfer pricing teams.

### **C.5.6.3. Training**

C.5.6.3.1. In some countries the educational system provides a steady supply of accountants, auditors, economists and lawyers from which the tax administration can draw. In other countries the situation is more difficult either because the formal educational system does not produce enough qualified graduates or because there is more competition, especially on salaries, from the private sector. This will affect the type of training required and it is of the utmost importance to assess the knowledge, capabilities and competencies of officers.

C.5.6.3.2. In developing what might be called a “learning plan” for the unit and its individual officers, it is recommended to first develop an assessment of the existing capabilities. This cannot be done without a context, and that context must be the short, medium and longer term objectives of the unit, so it is essentially a “gap assessment”. Such an assessment considers what needs to be done to go from the current capability to the desired future capability. It will address how to achieve the objectives at various stages of the life of the unit and under various scenarios.

C.5.6.3.3. This assessment should be followed by setting up a training programme to operationalize its recommendations. For a start it is good to first have a group of experts with accountancy and legal backgrounds. The pioneer group to be trained should consist of senior tax officials from the administration (and preferably also from the policy making area). They are the pioneers and champions who should instil awareness in their colleagues of the importance of a transfer pricing capability. They will organize lectures and in-house seminars to train those officials who will become the next group of experts and to increase their skills and knowledge.

C.5.6.3.4. Specialist courses will be an important aspect of the training programme. As transfer pricing is a highly specialized expertise, in-country training from international experts and perhaps some training of experts overseas will be needed, with a plan to ensure they disseminate their new learning more broadly upon return (such as adopting a train-the-trainer approach). As with any training, it needs to be demand-driven, to respond to the needs of the transfer pricing unit, to speak to their current level of understanding and take it forward, and ensure commitment. Demand-driven training also requires that those demanding the training are made aware of such opportunities for improving their capabilities and performance (as well as job satisfaction) by undertaking targeted training. International development agencies, regional tax administration groupings, international organizations and training institutions may be willing to assist with this. Identifying opportunities and how to most effectively request such assistance is expected to be

discuss what is happening in other countries. The policy makers will see what the major issues are and have early warning of issues on the horizon that may need swift but considered policy responses.

C.5.6.3.6. In the meantime the same approach can be adopted to train the next generation of specialists. The ultimate aim is that all corporate income tax specialists are able to handle at least some aspects of transfer pricing cases. Before that is achieved, as large as possible a group of those dealing with MNEs need to be able to at least identify cases where there is a transfer pricing issue, for further consideration by specialist transfer pricing experts. Even though they may not know all the answers, they will be able to identify issues and will know where to go to find the answers. Additionally, their involvement in this process will help enhance their knowledge.

C.5.6.3.7. Training should not be merely on transfer pricing issues, of course, as expertise in how a particular industry operates, including the value chains it utilises, can be especially important if a transfer pricing expert operates predominantly in relation to that industry.<sup>12</sup> Training in management, negotiation and inter-personal/relationship building skills will also be very important. So too will be knowledge management, project planning, database and other IT skills. Ethics training can be helpful in ensuring that officers are aware of ethical considerations in their new role as well as more formal legal rules of conduct, and of the way in which these interact (especially as to the exercise of discretion).

#### **C.5.6.4. Research Materials/Databases**

C.5.6.4.1. The unit should have access to basic transfer pricing books and, if finances allow, a subscription to a dedicated transfer pricing journal dealing with current issues of interest to countries. As noted elsewhere in this Manual, databases are used by administrations, taxpayers and their advisers when searching for and evaluating possible comparables. They can be used to analyse materials such as:

- Company annual reports;
- Auditor's reports;
- Profit and loss accounts;
- Notes to the accounts;
- Balance sheets;
- Materials indicating the nature of related party transactions;
- Materials indicating the nature of the business; and
- Materials indicating profit margins.

C.5.6.4.2. Such databases can provide access to private company data not on the public record, as well as public company data. They can also be helpful in systematizing how the data is used, in keeping a record of what is looked at, who has looked at it, and what decisions have been taken, in serving as a way of ensuring documents are readily accessible and searchable, in providing regular backups, and in providing a help-desk function that may have an educative role.

C.5.6.4.3. Private databases tend to be expensive, although sometimes an introductory price can be negotiated that is much lower than the usual pricing. It cannot of course be presumed that the low price is a

adjusting the data to be more relevant to your cases may itself be very resource-intensive. That issue is addressed in more detail in Chapter B.2



C.5.7.2. A useful approach is to consider what other administrations do in similar circumstances, especially administrations in the same region, and to follow that guidance unless there are reasons why such guidance is not appropriate after a close examination of the options and the engagement of stakeholders. This approach of looking to what is being done elsewhere as a first point of reference will reduce compliance costs for taxpayers and contribute to a positive investment climate without impacting on the ability to deal with enforcement issues. In fact it should enhance that ability, as the user can draw upon the practice of other a



- Total administration costs of the unit as a percentage of gross collection;
- Improvements made to process, as well as legislative improvements that have arisen out of the areas of work;
- Training undertaken and given, and the measurable impact; and
- Evidence of sharing best practice with other government departments and other tax authorities as part of a continuous improvement strategy.

C.5.8.3.2. As with any such measurement process, if data that is collected is not being used by management to assess progress the reasons should be considered and the data requirements modified or the use of the data improved. In other words, the process of review should itself be reviewed for effectiveness on a regular basis.

### **C.5.9. Country Examples of Capacity Building in Transfer Pricing**

C.5.9.1. **Japan** started its transfer pricing administration with a small unit in the late 1980s. Once the National Tax Agency (NTA) identified the rapidly increasing needs for transfer pricing management it expanded a nationwide training course for international taxation step-by-step, now reaching approximately 100 trainees every year; and also reorganized and gradually expanded the national and regional examination division. Currently the headquarters has transfer pricing sections and the MAP office, while the four major regional bureaus have special divisions for transfer pricing (including two divisions specializing in APAs). Although some essential documentation concerning transfer pricing is required by statute to be translated into Japanese, transfer pricing specialists are generally equipped with sufficient language skills to conduct examinations of the original accounting books, documents, etc. in English.

C.5.9.2. In **India** capacity building has taken place mainly through on-the-job-training. The Directorate of Transfer Pricing has expanded given that the numbers of cases being referred for audit are increasing annually since 2004, when the Directorate was set up. The National Academy of Direct Taxes, the apex body responsible for training, has been conducting specialized training for off t eIn

Department into a full department of its own. The Multinational Tax Department, headed by a senior director, now reports directly to the Deputy Director General of Compliance. The department is still