Report by the Secretariat* on:

Informal Meeting on Practical Transfer Pricing Issues for Developing Countries

7 to 8 June 2011, UN Headquarters New York

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* The Secretariat has prepared this report and remains responsible for any errors and omissions. Participants were invited in their personal capacities and should not necessarily be taken as speaking for their organisations.

Introduction

The Informal Meeting on the Practical Transfer Pricing Issues for Developing Countries was co-sponsored by the Financing for Development Office, UN-DESA, the Friedrich-Ebert-Stiftung, New York Office, Center of Concern and Christian Aid. The objectives of the meeting were two-fold: 1) to assist the Subcommittee on Transfer Pricing - Practical Aspects of the UN Tax Committee (the Subcommittee) in ensuring that developing country perspectives, priorities and experiences were fully reflected in the Practical Manual on Transfer Pricing, which the Subcommittee is preparing; and 2) to familiarise the Permanent Missions of the UN Member States with the issue of Transfer Pricing and the costs to development of "improper pricing" by multinational enterprises (MNEs), which are widely considered to be extremely high. Expected outcomes included an informed discussion on the issues of transfer pricing in context of development, and specific new developing country input into the draft chapters of the Practical Manual on Transfer Pricing. It was therefore not necessary to reach a consensus on specific issues, though that would be noted where it was achieved.

This longer report is intended to assist the Subcommittee in its work by providing a detailed record of discussions. A shorter report on the meeting will be prepared and submitted to the annual session of the UN Tax Committee in October 2011.

60 participants from governments (including Permanent Missions to the UN), business, advisers, NGOs, international organisations and academia attended the meeting.

Mr Alexander Trepelkov, Director, Financing for Development Office, UN-DESA, and Mr Werner Puschra, Director, Friedrich-Ebert-Stiftung (FES), New York Office, opened the meeting and welcomed the participants. In his welcoming remarks, Mr Trepelkov thanked the Friedrich-Ebert-Stiftung, Center of Concern and Christian Aid for their strong support in organising the meeting. He noted that the involvement of such well established and respected bodies added an extra dimension to the discussions on international tax cooperation and on the UN role in that area.

Mr Trepelkov noted that the main purpose of the meeting was to help the Subcommittee in its task of fully reflecting developing country perspectives, priorities and experiences in the Transfer Pricing Manual. Mr Trepelkov gave a brief history of the Practical Manual project, including the need to give greater practical guidance in this area. He noted the mandate of the Subcommittee in assisting developing countries wishing to apply the arm's length standard to achieve that in a practical way. The need for a staged approach suitable to a country's stage of development, and to explore what flexibilities might be applicable for developing countries consistent with the UN Model, was also addressed.

Mr Trepelkov noted the links to the work of the Committee as a whole and to that of its other subcommittees, including those addressing dispute resolution and capacity building. He indicated that there had been great interest in this UN work on transfer pricing. It was important to work collaboratively with others active in the area, while recognising the deep need for globally inclusive approaches and a special UN role.

Mr Puschra, in his welcoming remarks, noted the background of the FES, and the particular role of the New York Office as a liaison office with special interest in issues of global economic governance and international peace and security. He noted the longstanding support of FES to the FfD process and the work of the FfD Office. He noted that issues of taxing and public finance had become high profile issues internationally and had become especially important because they relate to what people expected from their governments. He noted that not a great deal had been achieved so far in improving international tax cooperation and more needed to be done in this area.

UN-DESA Assistant Secretary-General on Economic Development Mr Jomo Kwame Sundaram also delivered a keynote address. In his remarks ASG Jomo emphasised the development context of transfer pricing issues - failure to price transactions in a way that truly reflects the profits earned in a country unfairly deprives the country of funds and opportunities for development. Likewise, a country taxing more than the fair share of profits generated in its jurisdiction could lead to possible double taxation which may result in negative effects on the investment climate and therefore also a country's development potential.

ASG Jomo noted that most countries (including developing countries) seeking to address transfer mis-pricing have adopted the "arm's length principle" as their response to the issue. He noted that the real difficulties and unfairness arise not so much from the theory in itself, but more from the practical application of the theory, especially since most transactions involving MNEs do not have any direct market analogies as multinationals create ever more complex business structures and become even more integrated in their operations. The complexity of transfer pricing comes from attempting to bridge the theory of arm's length transactions and the reality of increasingly integrated and unique transactions.

A special concern in the developmental context is that such complexities in the "rules of the game" lead to disproportional impacts on those countries least well equipped in terms of resources and information to deal with these complexities. The result is that developing countries, particularly the least well off, disproportionately bear the cost in practice of what are, at least in theory, fair solutions tailored to the facts and circumstances of individual cases.

In considering what could be done to redress these disparities, ASG Jomo emphasised the need for targeted and needs-responsive capacity building and for helping countries create investment environments that reduce compliance costs for those business interests seeking to enter mutually beneficial long-term partnerships for development. He noted that in order to best achieve these outcomes international institutions must work together cooperatively and developing countries must be engaged actively.

Addressing the issue of what the United Nations, with its limited resources in tax cooperation matters, can bring to the table in meeting these needs, ASG Jomo referred to the universal membership and legitimacy that characterises the United Nations and which gives the organisation a unique convening power, bringing the many viewpoints on these complex issues together in a respectful and constructive way. He also referred to the United Nations ability to

work cooperatively with other organisations, businesses, civil society stakeholders and with individual countries - because the UN Membership and mandate embraces all these viewpoints.

In concluding, Jomo noted that the United Nations can play a deeper role of helping to safeguard that all with an interest in the "rules of the game" will have a seat around the table in developing those rules. This can help ensure that such rules (i) address the real complexities of tax systems and international tax cooperation; (ii) respect the sovereign right of countries to determine their tax systems while also recognising the "spill-over" effects of such decisions internationally; and (iii) best meet the challenges of development.

Agenda Item 1: The Role of the UN in International Tax Cooperation, the Impact of Transfer Pricing on Sustainable Development and Possible Responses

Panel 1: Broader International Tax Cooperation Issues

The Chair of the session, Mr Armando Lara Yaffar, General Director, Ministry of Finance and Public Credit, Mexico, and Chairperson, UN Tax Committee, pointed out that the purpose of this session was to set the stage for discussing transfer pricing issues, and in particular to elaborate on the role of the UN in international tax cooperation issues.

In his presentation, Mr Alexander Trepelkov focussed on the proposals for conversion of the UN Tax Committee into an intergovernmental body. He briefed participants on the Secretary-General's report on "Strengthening of institutional arrangements to promote international cooperation in tax matters, including the Committee of Experts on International Cooperation in Tax Matters"[1], prepared in response to an Economic and Social Council (ECOSOC) request.

Mr Trepelkov noted the outline of the Report, including the views put by countries on these issues, and indicated that the Report identified three options for strengthening institutional arrangements for consideration by ECOSOC: (i) Strengthening existing arrangements, (ii) converting the Committee into an intergovernmental commission, and (iii) creating a new intergovernmental commission while retaining the current Committee. A first discussion on the report by ECOSOC on 26 April 2011 showed mixed support for converting the Committee. Informal consultations among Governments on a relevant draft resolution,[2] tabled by Argentina on behalf of the G77 and China on 1 June 2011, were noted as on-going.

Mr Peter Baumgartner, the Chairman of Swissholdings, underscored the role of the UN Tax Committee in supporting developing countries in international tax matters, as exemplified by the UN Model Convention. He noted business interest in the role of the UN in these areas, especially as the UN Committee was now considering transfer pricing issues. He noted that persons from both developed and developing countries working together could achieve rules that worked for all, recognising that there was not uniformity of developing country or developed country approaches. While OECD guidelines on the complex issue of transfer pricing existed, there was a need to provide practical guidance on dealing with transfer pricing issues and applying the arm's length principle to developing countries. He stressed that while the floor should not

[1] E/2011/76
[2] E/2011/L.13

entirely be left to the OECD in these areas, duplication in the work of different organisations should be avoided. He noted that virtually all tax treaties are predicated on sound arm's length approaches, but that the application of the arm's length principle could be very complex in practice. A sound approach, examining functions, assets and risks, could lead to sharing of tax revenues on an equitable basis. Mr Baumgartner noted that it was important that the UN work was consistent with the OECD Transfer Pricing Guidelines and did not duplicate the work of the OECD and others, but gave greater guidance on the practical application of the arm's length principle. In this respect, business needed legal certainty, including guidance that is consistently applied across countries.

Mr Kwame Adjei-Djan, Member of the Board of Directors of the Ghana Revenue Authority, stressed that the role of the UN in international tax cooperation was based on its universal acceptance and legitimacy. It was important to recognise that every country had the right to design its own tax policies and structures. Applying differing domestic rules led to international tax differences, however, and these needed to be addressed cooperatively. The UN was well-placed to support tax administrations in developing countries in cross-border taxation issues, including in minimising spillover effects to other countries, of regimes that encouraged international tax avoidance or gave over-generous tax incentives. In their tax policies, developing countries should strike the balance between revenue generation and creating an enabling investment climate. The key role of the UN in capacity building to build more effective tax administrations was also noted.

Mr Aldo Caliari, Coordinator, Center of Concern, highlighted the support of civil society organisations for a stronger role of the UN in international tax cooperation. The UN had a number of comparative advantages over other fora, such as the representation of developing countries, the nature of the UN as a political forum with convening power, and the possibility to address tax matters in an integrated way in conjunction with issues such as trade and investment.

He noted that there were two sides to any issue of "duplication of resources" and adverted to the risk of "mission creep" in other fora into areas where the UN had a legitimate role. Such "duplication of resources" arguments and "mission creep" should not be allowed to displace legitimate UN roles, however.

He noted that there are differences between developing countries being invited to a meeting to discuss issues, on the one hand, and having a seat at the table when key decisions were made, with voting rights and the ability to influence, on the other. The UN had a role as a political forum, and it was important to have discussions on "first principles" with a political aspect. The UN Tax Committee had a role of feeding in technical expertise into that political discussion. It is important in this respect that the UN is also the integrated forum for FfD matters, including tax issues in their broader context.

In the ensuing discussion, the Chair noted two particular issues: (i) what should the structure be of any intergovernmental commission if the Committee was transformed into such a body and (ii) what is the UN role in developing transfer pricing guidance, with business noting the difficulties if there are competing messages and developing countries seeking more practical guidance based on their realities.

In the general discussion, one participant who is a Member of the Committee noted that as there was a process considering the issues of a possible conversion of the Committee he considered it

best to leave the matter to that process. On the UN role in transfer pricing, he noted that the UN work is not seeking to create an alternative to the OECD guidelines. The UN Model Tax Treaty had, by design, enshrined the same "arm's length principle" as the OECD Model, and the UN work was seeking to make that easier to apply in practice. He agreed that there were important links with the UN Tax Committee work on capacity building and dispute resolution in particular.

A participant from a developing country noted that there can only really be "duplication" if the same countries are represented in the different fora, which often was not the case. Proposals for changes to the UN Tax Committee could give a wider sense of participation in the UN work than was possible at present. Another participant from a developing country noted that there could be no monopoly of ideas in these areas and that wider discussion of these issues in relevant fora should be welcomed. Another participant, also from a developing country, said attempting to have a single system in all countries was doomed to fail - flexibility and allowing for different approaches was necessary within a Membership as broad as the UN.

Panel 2: Specific Transfer Pricing Issues

The Chair, Mr Armando Lara Yaffar, Chairperson of the UN Tax Committee, introduced a range of specific transfer pricing issues to be addressed in this panel discussion, including the impact of transfer pricing on development, options for developing countries to tackle transfer pricing, and the role of the Committee in transfer pricing.

Mr Stig Sollund, Deputy Head of the Tax Law Department, Ministry of Finance, Norway, and Coordinator of the UN Tax Committee's Subcommittee on Transfer Pricing - Practical Issues, stressed that the impact of transfer pricing on development was a crucial issue. Transfer pricing had to be seen in the broader context of economic and tax policies. Developing countries needed to generate revenue for development purposes, while at the same time promoting business activities. Depending on the economic structure, developing countries might have different approaches towards transfer pricing. Also dispute settlement mechanisms were an important factor in addressing cross-border taxation issues.

Mr Jim Henry, Senior Advisor, Tax Justice Network, pointed out that identifying correct transfer prices was also a challenge within corporations. Following corporate globalisation, industry trends and the rise of secrecy jurisdictions, he said there had been increasing abuse of transfer pricing to avoid taxation. Transfer pricing abuse accounted for a significant loss of tax revenues worldwide. In order to improve the basis for decision-making, Mr Henry called for more empirical research and data collection on transfer pricing.

In his intervention, Mr Ricardo Barrientos, Advisor, Instituto Centro Americano de Estudios Fiscales, identified knowledge gaps among legislators and the private sector as major constraints in establishing transfer pricing regulation. Awareness-raising, international dialogue and education were therefore critical. To facilitate addressing transfer pricing in developing countries, there was a need to design easy, cheap and creative solutions. These would have to be explained to legislative bodies in a way that would allay any suspicions about the impact of complex provisions, including as to whether they would preserve appropriate taxing rights to the country.

Mr Jesse Drucker, Reporter, Bloomberg Business Week, provided participants with case studies on income shifting strategies by multinational enterprises (MNEs). Those strategies frequently

involved moving corporate profits from high-tax to no-tax jurisdictions through several stages. There was some discussion about the extent to which some such strategies were motivated by transfer pricing or other tax-related issues.

Mr Juan Carlos Campuzano Sotomayor, Economist, Internal Revenue Service, Ecuador, described some practical difficulties faced by tax administrations in dealing with transfer pricing. For instance, it was difficult to prove the relationship between a parent company and company units abroad. Also determining the specific function of MNE subsidiaries in a country might pose challenges.

Mr Francisco Bataller-Martin, Coordinator for Public Finance and Development Matters, Directorate General for Development and Cooperation, European Commission (EC), stated that taxation and development were high priorities in the work of the EC. One important objective was to enhance the capacity of developing countries in transfer pricing. To this end, the Commission had initiated a study on how to support developing countries to design and implement transfer pricing legislation. The forthcoming study included some country studies and experiences in reforming transfer pricing regulation. One preliminary finding was that introducing transfer pricing legislation typically led to higher tax revenues.

In the discussion, participants stressed the asymmetric information as between companies and developing country tax authorities in valuating intra-company transactions as a crucial challenge. Capacity-building in developing countries and improving data availability and information exchange on transfer pricing were seen as key action points.

Agenda Item 2: The Business Framework to Transfer Pricing

Mr Johan Müller, International Tax Manager, A.P. Møller-Mærsk Group, Denmark, addressed day to day issues for his group in dealing with transfer pricing issues. He noted that there was no one type of “firm” – they all differ: in being large and small, listed or unlisted, in their regions of operation and their corporate cultures, including appetite for risk. Individuals in the firm have their own targets of bonuses and will look at tax issues in that light. Some firms are more decentralised than others. If directors of separate companies are judged on pre-tax profits they may leave tax to the tax people, but they may not care about the tax issues. If they are judged on after tax profits they may try to do the tax planning themselves.

Mr Müller noted that part of the job is to maximise returns for shareholders, but to do so in a sustainable way. He discussed reputational risk and noted that some groups are more aggressive than others. Now there was more time spent by many tax managers avoiding double taxation and many did not have time for aggressive tax planning, in any case. He welcomed UN involvement in the transfer pricing work through the Manual, as his company dealt with people from many countries which were not OECD Members.

He said generally tax managers should not care where they pay tax as long as they only pay tax once. Most disputes were not technical; once the digging is done and the facts are established the answers are usually fairly simple (although another participant noted that in his country there were a lot of differences about what the law was saying). Mr Müller noted that administrations asking for relevant information to help analyse functions performed by particular parts of the

enterprise can form an important discussion and help resolve the issue, though it was not helpful when information about the group with no possible relevance was requested.

Mr Müller took the view that safe harbours can be good or bad from a corporate perspective, but once they were in place there was no obligation to *maximise* tax. Transfer pricing is complex, and simple responses often won't work, but a simple response that often works well in practice is that, once the governments get involved, tax managers can get out of the way and let the governments decide with a view to companies only paying tax once – hence the importance of good dispute resolution mechanisms.

As to arbitrage, Mr Müller indicated that there were legitimate opportunities for this, but one had to be practical and use common sense – if an advisor says "everyone does it" that is not enough to justify taking that course without a clear opinion as to its legality.

On the Business Framework Chapter of the Manual itself, Mr Müller noted that Para 2 talks about how business has evolved and could recognise more clearly the role of business in harvesting synergies. Paragraph 9 should recognise the need sometimes to use "kingdom builders" to e.g. develop a new business in a new country. Paragraph 14 should recognise more the staged approach to establishing presence in a country, such as starting up a joint venture then buying out the joint venture partner. Eventually you will have a subsidiary. Paragraph 16 of the Chapter should note that tax people think in legal entity level terms, where businessmen in the company think in terms of business units. The matrix structure exists, but causes PE nightmares. He was glad to see the recognition that cost contribution agreements could also be used to acquire services, and did not only relate to goods transactions. As to paragraphs 36 and following, it often doesn't help to outsource transfer pricing in his opinion, though that may vary from group to group. The reason is that you need to intimately know your own business.

Mr Stig Sollund noted the importance of the "Business Framework" chapter in setting the scene for the Manual. He noted the comment by Mr Müller of the role of firms in harvesting synergies. That naturally raised issues about how to apply an arm's length standard that did not easily account for such related party synergies. Those opposed to the arm's length principle sometimes used this as an argument against the relevance of the approach in principal and practice; however he believed this value creation could be appropriately taken account of in practice.

Mr Sollund noted that his major concern as a tax administrator is capturing the true value of functions and activities carried on in his country. Generally market pricing at independent market value would be an acceptable measure of value created in your jurisdiction, but sometimes that is not fully the case. For example, where there are globally integrated operations and pricing is based on the market (e.g. instances such as a captive insurance company in a low-tax jurisdiction with premiums that are deductible and are priced at market rates) there are nonetheless extra profits due to the joint operation of the related entities, some part of which fairly belongs to his country.

There are examples of aggressive tax planning and abuse, but transfer pricing is generally about day to day dealing with unavoidable transactions within the group. Transfer pricing is complex and difficult but not "unenforceable" and is a very important part of the tax environment.

Mr T.P. Ostwal of T.P. Ostwal and Associates, India, noted that different corporate groups had different models – companies in manufacturing may differ from services groups and more technology-driven companies. Also, developing country MNE models may be different – possibly they might be more family driven. He noted that countries should understand these issues and not just have transfer pricing regimes because it is the fashion. Some countries had chosen not to have specific regimes because of the compliance costs for business, he considered.

He said there is no clear international definition of the arm's length principle. The approach taken was the OECD approach, and in introducing the concept to developing countries such an approach to the arm's length principle may need to be modified. A more apportionment-based model could be developed in the initial stages and then the full-fledged arm's length model could be followed later as capacities develop – the beginning of this Chapter of the Manual could reflect that more. In view of the varieties of approaches, more MNEs could be asked to contribute their experiences to this work, he concluded.

Mr David McNair, Senior Economic Justice Advisor, Christian Aid, noted the potential of transfer pricing regimes to capture the value of operations of MNEs in developing countries, while recognising that there are also risks of hampering investment, double taxation, costs of compliance, uncertainty etc; all of these factors needed to be considered in a balanced way.

He noted that apportioning profit was so difficult because MNEs offered synergies and economies of scale to unlock value not available on a country-by-country basis. The UN work could help in ensuring effective legislation, and NGOs perhaps had a role in assisting parliamentarians to understand the issue in countries considering legislating.

He indicated that access to information and risk management were key issues and country-by-country reporting would help developing countries to identify high risk issues. He noted the reality of increasing scrutiny of not just company profits but also the ethics of their operations. He addressed the possible UN role in helping developing countries obtain information on company structures, and of host countries of MNEs in exchanging information on high risk transactions and the operations of MNEs.

He was of the view that the UN had a role as a forum where business administrations and civil society could come together to discuss these issues in a "safe space" that would further understanding of where they were coming from. Areas of transfer pricing focus will vary from country to country, including because of the scale and type of business, specialisations, and the business and legal environments. In his view, assisting developing countries in prioritisation of those issues would be a useful role, and there should be a discussion of step-by-step approaches to business models and whether that would be of value.

In the general discussion, one suggestion was to adopt a "Wiki" model for the Manual with designated editors, and to bring it alive with more case studies – including successful experiences and unsuccessful ones. Another comment was that there needed to be more consideration of whether there were relevant differences between common law and civil law approaches that should be addressed in this Chapter and beyond – was there a tension between these approaches? Also some companies were incorporated with an explicit State purpose, and this might need to be reflected in the Chapter.

On the issue of synergies and economies of scale, one participant considered that the consumer benefits from these factors, so there is in economic terms no "rent" retained by the MNE – so

that the arm's length approach can still operate fairly in such cases. Are there activities never sourced out in unrelated cases? that participant asked – maybe so, but you cannot assume that, and suitable comparables may be found in other economies than your own.

One representative from a developing country noted the difficulty in understanding the market structure in a case such as bananas, including determining what the relevant markets were.

Another participant noted that the basic rules for the Manual were the arm's length principle accepted in Article 9 of the UN as well as the OECD Model Tax Conventions and the OECD Guidelines recommended by the Commentary to Article 9 of the UN Model. The difficulty with comparability in practice is that MNEs can uniquely break themselves up into single-function entities for economic reasons, unlike unrelated parties, or may combine functions not normally combined in an unrelated party case – so the issue is: what are we comparing? Is the case mentioned of bananas, for example, was it a fruit and vegetable distributor case or a provision of services/ logistics entity cases – with quite different transfer pricing methods and results in either case. We have to look at what unrelated parties with the same functions assets and risks do. Do we use aggregated or segregated data and do we even have the relevant segregated data? At the end of the day it goes to the burden of proof. Are we looking for that one arm's length principle, or that overall profitability margins relating to the activities are within a range or that the company for its combined functions generates a certain amount within a certain range.

The same participant noted that the stricter you get, the more difficulties you get, and we need to recognise what MNEs do – they were historically encouraged to integrate in order to increase trade, investment and employment and to be efficient. We should be careful not to ask an MNE to be an unrelated party and to really break up and lose those efficiencies. The Chapter tries to talk about what the business does to try to maximise profits, and in this respect it should be noted that tax centres in MNEs are usually cost centres not profit centres.

Another participant said the Chapter needed a more explicit statement of the dilemma of transfer pricing policy – on the one hand wanting to maximise revenue and on the other hand the need to minimise impediments to business – that may be in the Chapter, but needs to be much more explicitly put. Another developing country participant noted that many transfer pricing cases in developing countries do not involve MNEs.

The Chair of this session, Mr Marcos Valadao, Coordinator-General of International Relations, Ministry of Finance, Brazil, commented that in looking at the form of a company the Chapter could (at para 14) look more at choice of company, partnership, LLC etc. and its tax impact. Paragraph 16 should also cover the treatment of companies and branches as separate or independent entities. Part 3 could mention more about the use of low tax jurisdictions. He thought the banana examples mentioned in discussions were useful to include at the appropriate place.

The Secretariat noted that it would be helpful for those commenting on the drafts to indicate the *types* of examples they thought would be helpful. The Secretariat was hoping a country or group of countries would assist in contributing funds for an editor who can make the Chapters more consistent, focussed, richer in examples, easier to read and visual, and comments would be helpful in respect of that editing task also.

Agenda Item 3: General Legal Environment:

Addressing India's experience in setting up a transfer pricing legal environment, Mr Prabhakar Reddy, Joint Director of Income Tax, said that India set up its transfer pricing unit in 2001 following a "more open economy" policy which resulted in more foreign direct investments. Acknowledging the need for policy design that fits the local realities, he gave an example of the IT sector in India where the trade within the same business or with a related company accounts for 60% of the total trade. In such a context he continued, authorities ought to design a policy that is appropriate to some type of industries and is more stable, as frequent changes in legislation or regulations may create uncertainty for businesses.

Mr Adjei-Djan focussed in his presentation on practical guidelines and noted the importance of double taxation agreements, particularly Articles 7 and 9, when dealing with the transfer pricing matters. The difficulties for developing countries in developing large treaty networks was also noted in the discussion, including the time and expense it takes and the fact that potential bilateral partner countries were not always willing to enter into negotiations or to do so as a priority.

Ms Monique van Herksen, Partner, Ernst & Young, Netherlands, presented a few key points she thought would help make the arm's length approach work effectively: (1) the existence and broad acceptance of international "rules" such as the OECD guidelines and the UN Transfer Pricing Manual; (2) specific domestic transfer pricing laws; (3) effective dispute resolution and avoidance of double taxation; (4) experience-based comparables.

When there is no local data for comparables, she argued, the taxpayer can make use of regional or global data to find comparables. In some cases, she continued, some types of objective and genuinely experience-based data might be used. She also suggested that in the case of developing countries, there is need to identify the type of data countries have to start with to build a database of comparables and an initial ramp up period before a full scale database is built may be necessary. Bodies such as the UN could have an important role in assisting that process in future.

Mr José Madariaga, Advisor, Internal Revenue Service, Chile, commented that transfer pricing regimes are not always a bad thing for business. He gave Chile's example where the Tax Administration had the support of the private sector to sensitise the Parliament to pass the transfer pricing law. Certainty was important to business.

On the quality and availability of data, Ms van Herksen noted the need for quality data for countries to benefit from an Advance Pricing Agreement (APA) program. The use of quality data, however, is hampered by the cost of obtaining such data from private entities, argued Mr Henry.

Mr Lara Yaffar commented on the benefit of using an APA for a certain timeframe so as to introduce changes later if need be. Mexico offers a good experience on how to set up an APA while building capacity. However this can be difficult to administer.

Mr T.P. Ostwal then mentioned the issue of lack of uniformity of databases. He also talked about the risk of disclosure of information for APA purposes that can later be used against the company.

Agenda Item 4: Establishing Transfer Pricing Capability in Developing Countries

The Session was chaired by Mr Kwame Adjei-Djan. Mr Julius Bamidele first addressed the problem of ensuring qualified staff for the application of a transfer pricing program and the data-deficiency issue. He suggested starting small and then as the program grows the tax administration would develop more general rules and regulations.

Presenting the Actionaid "Calling Time" report[3], Mr Martin Hearson expressed the view that in most cases small local businesses in developing countries end up paying corporate tax while big multinational companies pay little or no tax. It is very important, he continued, to make good policies for investment and not to offer excessive tax incentives. A public debate on concessions and tax incentives can only be a good thing.

Mr Prabhakar Reddy expressed the view that in many instances local companies do not know how to apply the arm's length principle as showed by a study done in India where, amongst 200 interviewed subsidiary companies, almost none knew how internal prices were determined. Thus the need to educate businesses. Customs officials also need training on how to identify transfer pricing risks.

Considering the issues of capacity-building and technical assistance, Ms Ute Eckhart, Senior Advisor, International Tax Compact Secretariat, noted that the International Tax Compact is an initiative started by the German government to strengthen international cooperation with developing and transition countries to fight tax evasion and avoidance. Among other aspects of its work, it helps capacity building in developing countries at a country level. She commented on the importance of a good judicial system as well as a receptive parliament to enact appropriate laws. She also argued for the balance between the benefit of implementing transfer pricing regimes and the cost of their implementation. For the country as a whole the benefit for transfer pricing implementation needs to be higher than its cost, she said. In that respect, she said, the Transfer Pricing Manual should reflect the situation of each country.

Mr Kiyoshi Nakayama, Adviser, Fiscal Affairs Division, International Monetary Fund, next gave his perspective on capacity building. He suggested that transfer pricing regimes are best introduced as part of broader tax policy reforms. He also remarked that the transfer pricing law should cover domestic transfer pricing as well as international transfer pricing, especially, in a country which offers tax incentives. He then reflected on the choice between: (a) making a small group of auditors, say, 10 percent of a large taxpayer office (LTO) auditors, a transfer pricing team to conduct a full-fledged transfer pricing audit while the rest of auditors conducting preliminary audit to verify transfer pricing risk during ordinary audits, or (b) making all (LTO) auditors conduct a full-fledged transfer pricing audit. Given a high level of expertise required for transfer pricing audits, a two tier (preliminary and full-fledged audits) approach would be more

[3] Available at http://www.actionaid.org.uk/doc_lib/calling_time_on_tax_avoidance.pdf

practical for developing countries where a limited number of transfer pricing experts is available. He also suggested a practical approach starting with small and less complicated cases such as an intra-group loan and expanding to more difficult cases once auditors obtained expertise and experience.

In the general discussion, participants agreed that the benefits of well focussed capacity-building outweighed the costs. It was important in the transfer pricing area, but such capacity building should not be at the expense of other pressing areas. The consistency of tax policies across different government entities was also considered important – the uncertainty for both government and taxpayers of lack of coordination within government had capacity building consequences. One developing country participant noted that if there was sufficient political will, including incentives with a tax impact in *tax legislation* only, was a useful way of ensuring consistency, and that this made it easier to ensure that the tax consequences of incentives were fully accounted. Capacity-building therefore needed to target the entire government structure.

One participant with experience in delivering capacity building noted that there were general issues in country coordination of capacity building, but that most countries had an overall structure of collaboration between governments and official development assistance providers, usually in line with the Paris Declaration on Aid Effectiveness. Under that structure, there was usually specific coordination working groups, such as on taxation matters. The goals were coherency, collaboration and supporting the government's reform agenda where needed.

Another participant from a developing country noted that investment promotion authorities had, as their main objective, encouraging investment, and in this there was sometimes an over-reliance on tax incentives, which could clash with the objectives of tax administrations. This was especially the case since the tax incentives were often not objectively needed to attract the investment, notably in resource extraction cases. Another participant noted that negotiators of trade and investment agreements also had different objectives, and seeking certain information would sometimes be argued as contrary to such agreements. Even limits on local purchase requirements under the WTO Trade Related Investment Measures had an impact on what would be available to tax authorities. Dealing with these inevitable inter-agency objectives required political leadership first and foremost.

The same participant noted that there were a host of tax collection problems for developing countries that needed to be addressed besides transfer pricing, including ensuring integrity in the collection agency. Some of the things that needed to be done were quite basic, such as defining what constituted "related parties" and putting in place workable documentation requirements. These constituted "low hanging fruit" that could be put in place as an important part of addressing transfer pricing. It was noted by several participants that capacity-building should address the particular needs of a country, should be premised on country ownership, and should not be limited to transfer pricing without reference to its wider context. It was also noted however that widespread reform was a costly and long term process, and early reforms in strategic areas, such as analysing and "sunsetting" tax holidays might be important, including in building support and credibility for longer term changes.

It was noted that one country had provided, when introducing transfer pricing, that if a taxpayer operates in a tax haven and an adjustment is warranted in relation to activities to which the tax holiday applies, the exemption otherwise available will be denied. In other words, the adjusted amounts do not receive the benefit of the tax holiday. Another participant addressed the skill

building aspects of capacity building, noting the ability to offer work-life balance that may not be available in consultancy firms – it was noted in this respect that most of the transfer pricing team in the South African Revenue Service (SARS) for example had left consultancy firms to join SARS – the exposure to high quality interesting work was also a way of attracting and retaining high quality staff.

The possibility of ensuring that officers could stay in the transfer pricing field after initial training (which would often take 2 years) was seen as important in many countries, even if other officials were moved from area to area more regularly than that. Moving promising transfer pricing examiners, often recruited from the best and brightest, to supervisory roles could keep them in the area for 10 or 15 years or more in the Japanese experience. Others noted, however, that keeping the same people in one area for a long time did raise integrity issues that had to be kept in mind.

One participant from a NGO noted that even where international standards were recommended it was ultimately a decision for particular countries as to what standards they adopted in transfer pricing. There was a recognised need for developing countries to be in a position to make those decisions and to play their part in developing the recommended standards also – and perhaps this Chapter of the Manual should address that key issue also in some fashion.

In this respect the Secretariat noted that the Manual was not, of course, intended to tell countries what to do, but to assist those that had chosen to follow the arm's length approach in doing so at the practical level – that was not to say discussions on broader and longer term issues should not be addressed in the context of the UN Tax Committee, including with a view to greater developing country involvement in setting what even de facto might become international standards. That would, of course, be an issue for the Committee itself. Another participant noted that the emphasis on a practical "here and now" approach was reflected in the draft Foreword available on the website and followed from countries adopting a UN (or OECD) version of Article 9, which incorporated the arm's length principle. The Secretariat further noted that perhaps a nuance that could be reflected in the next draft of the Foreword is that the Manual can also help countries to make the decision about what approach to follow.

Agenda Item 5: Methods of Achieving Arm's Length Pricing

The Panel was chaired by Mr Armando Lara Yaffar. Ms Monique van Herksen, Partner, Ernst & Young, Netherlands, introduced draft Chapter 5 on transfer pricing methods. The chapter presented different methods used to determine an arm's length price and discussed the strengths and weaknesses of each method. The chapter distinguished between traditional methods and transactional profit methods, although all would now be dealt with in one chapter.

She noted that the Chapter sought to stay as close as possible to the OECD Guidelines in substance. In dealing with traditional methods, the Chapter differed from the OECD Guidelines in how it addressed the strengths and weaknesses of each method, when they could be applied, examples and formula - trying to make it clear when and how the methods should be applied at a practical level. Aspects of transactional profit methods were also discussed in more practical detail than in the OECD guidelines.

She noted that there had been discussions about how to deal with lack of comparables. If they did not exist, something else was needed and we should help countries in that case. Some

countries already used hypothetical comparables or secret comparables for example, and there perhaps needed to be an exploration of a sunset provision where an objectively experience based range could be used on a taxpayer opt-out basis for simple functions. Obviously an issue would be where the data would come from, and organisations such as the UN may have a role here, including in helping put countries in a position to have sufficient local data to determine local comparables. It would have to be transparent and broadly indicative of arm's length dealings, and there would need to be a discussion of whether it should be on a global, regional or local basis for example.

The Chair noted that trying to apply transfer pricing methods without the necessary information would inevitably lead to failure and possible double taxation, so this issue was a very practical one for discussion.

Mr Roberto Schatan, Senior Advisor, OECD Centre for Tax Policy and Administration, recognised the need for transitional periods in developing countries to allow adoption of a full-fledged regime of arm's length pricing but, differing from what had been suggested by others, he did not believe that a fixed margins system could serve that purpose. A more appropriate concept of transition was to gradually lift the restrictive provisions of the previous closed economy regime. In relation to transitional down-graded or very simplified transfer pricing mechanisms, one needed to be aware, of the difficulty in removing them once they were in place, especially if they gave tax concessions.

On the issue of what conditions apply in developing countries that require specific guidance, he noted that the topics covered in Chapter One may not always meet that test. For example the conceptual problem of vertical integration, where allegedly no independent comparables can be found, besides being an issue that is simply taken for granted, was a more general conceptual issue, not particularly linked to *developing* countries. Intangibles are also given prominence, but the cases likely to be most usual for developing countries in his view were in the traditional industries where valuing intangibles (e.g. brands or trademarks) is not so difficult. The issues of privileged (asymmetric) information on the MNE side associated with research and development of new products was also not so much a priority issue for developing countries, in his view. The problems commonly associated with payments for services could be often dealt with by anti avoidance rules other than transfer pricing – a deduction could be denied on the basis that the legal requirements were not met and this was not a specific issue for developing countries.

Mr Schatan did consider, however, that there was a need to provide guidance on comparables to developing countries, given the frequent absence of local comparables and the need to make the necessary adjustments to foreign comparables, including for differences such as accounting principles. Countries can legislate as to which information should be made public by unlisted companies, which can help to build data sets of local comparables that are not secret.

Mr Chris Lenon, Group Strategic Advisor, Tax Policy, Rio Tinto plc., stated that determining corporate functions and valuing risks should be more fully featured in the methods chapter. He noted that when you ask people what they managed they naturally tend to say they manage more functions than they objectively do – putting them together in a room and questioning them closely was sometimes the only way of rigorously determining who really managed what functions. You need to ask if the people are capable of managing a function in the entity you are examining. There need to be consideration of not just the number of persons, but their skills and experience. More in the Manual on that would be useful.

At the level of a global function; procurement, he noted that for some special items, such as very large tyres for earthmoving equipment, the group-wide purchasing power may affect not just the price of them, but whether they could be procured at all – smaller entities may be unable to procure such items because they could not promise enough purchases. They would then be allocated within the group. These functions therefore have strategic value and allocating it between central procurement and the business was difficult but realistic, despite the cynicism sometimes expressed over procurement functions.

He noted the volatility since the global crisis and the recognition that risks had often been poorly valued. There needed to be more recognition that if there were risks in an operation, then there would be a price to pay for that risk, whether in cost of financing or otherwise. He noted that in considering the value chain, there needed also be an acknowledgement that a great deal of tax revenue could not be expected to eventuate if the functions in a country were genuinely only low value ones.

From a business perspective, Mr Lenon also emphasised that different transfer pricing standards applied in different countries will only operate effectively if a robust dispute resolution and arbitration mechanism was established to address the points where there is a clash that can lead to double taxation.

Mr David Spencer, Senior Advisor, Tax Justice Network (TJN) argued that the Manual should focus on simplifying and making transfer pricing guidelines enforceable for tax administrations in developing countries. The Manual should not only reflect the OECD Guidelines, but also take into account the circumstances of all UN Members. The main issues as TJN saw them were that: (i) it was too difficult for developing countries to apply the OECD Guidelines and perhaps the arm's length principle was in effect unenforceable – aligning with those Guidelines may not lead developing countries down the best path. The emphasis therefore needed to be on simplicity and enforceability; (ii) the Manual should be more objective about the problem of obtaining comparables; (iii) the difficulty of obtaining necessary information should be more directly confronted and the Manual should more explicitly support country by country reporting; (iv) other alternative methods, such as safe harbours, the residual profit split method, fixed margins and hybrid methods should receive more consideration; (v) the use of transfer pricing methods to direct profits to tax havens should be addressed, and responses such as the reversal of the onus of proof should be addressed in Chapter 5; (vi) many of those who were involved in this work had a vested interest in complexity and the continued use of the OECD Guidelines – NGOs and independent academics therefore should be more involved in the development of the Manual; and finally (vii) it needed to be recognised that the current rules were designed by developed countries and developing countries needed to be more involved in this process, as noted in the keynote address by Assistant Secretary-General Jomo. If the Manual only addresses the OECD Guidelines it could be criticised for that.

Mr Sollund remarked that the methods chapter was a core element of the Manual. It was important to provide a toolkit for administrations on how to apply the arm's length principle in practice, and to include a range of methods countries might choose from depending on circumstances and data availability. It would be a roadmap to reaching arm's length outcomes, but the choice of any particular transfer pricing method would depend on the circumstances and the information available, and anyone dealing with transfer pricing issues would need to be able to assess these issues, as a good tax auditor in any administration should be able to do. The

chapter will assist users in knowing what the methods are, how they are applied and how they relate to comparability.

Mr Valadao introduced the experience of Brazil in using fixed margins for transfer pricing. This would eliminate the need to find comparables and constitute a simple and low-cost system for both taxpayers and authorities, without the need to hire outside advisors on these issues. Fixed margins needed to be carefully established in the legislation and be sufficiently industry-specific and transparent in formulation. Mr Valadao proposed to include a section on fixed margins in the methods chapter or as a separate chapter. It would address different methodologies for simple resale versus sales based on imported inputs, as well as consideration of resale price (best for imports) and cost plus (best for export operations). The Secretariat and others noted that it was important that any ranges were grounded in real conditions if they were to be contended as an expression of the "arm's length principle".

In the ensuing discussion, participants exchanged views on which transfer pricing methods might be most suitable in different circumstances. Some participants were of the opinion that traditional methods might work best in a developing country context. There was a discussion about the nature of an "additional" method provided for in Indian legislation (and in other places such as Australia); it was suggested that if sufficiently defined as a way of finding arm's length principle it may be an experience that could benefit other countries.

On a related matter, one participant asked if the Chapter would support use of the "other methods" as outlined in paragraph 2.9 of the OECD Guidelines *only by taxpayers,* or would it instead support such use by *administrations* as well – if so that might be helpful. He noted that from his developing country's perspective, especially with exports of natural resources, CUP worked well, and putting all methods on the same level may not necessarily suit developing countries. He also noted the importance of effective dispute resolution in any 'fixed rate regime". In response a participant from a developing country noted that CUP is the most direct method in theory, but in 90% of actual cases TNMM is applied – mainly because of a lack of reliable data to confidently apply CUP.

Another participant noted that any "fixed" approach should recognise that some adjustments may be needed to take into account particular circumstances. He also noted the value of voluntary compliance programs with strong enforcement provisions. Another participant found it difficult to see how simplified margins could be consistent with the arm's length principle and there was a discussion of whether such approaches would only work in very competitive markets where profits tended to equalise among different competitors, a matter which could be left to the Subcommittee for further consideration.

The Chair, in summarising, noted the general concern at the frequent lack of reliable information and limitations on the ability to analyse and adjust it as necessary (including the need to adjust foreign comparables, such as in relation to geographical differences, country risk etc). He noted that this might be an issue where the UN Tax Committee could task the transfer pricing subcommittee to do some work in future, apart from the work on the Manual. That would be up to the Members of the Committee, of course. He noted that capacity building had been raised again, not only in terms of risk-management, but also on how to apply methods, including

measuring functions, assets and risks. Also, how should you transition into a transfer pricing regime in a way that they can be appropriately updated as the economy changes?

Agenda Item 6: Comparability

Ms Roselle Sakhoon, Transfer Pricing Expert, South African Revenue Service, elaborated on the frequent lack of comparability data. She said that while searching for comparable transactions the South African tax authorities had to use the AMADEUS and ORBIS European databases because there is no domestic alternative. The data was not fully comparable because of the differences between European and South African markets, however, and the authorities had not many great strides in making adjustments to align with the domestic market, but taxpayers had similar issues.

She noted that, with the lack of exact comparables, all parties made do with what was available. The statutory requirement for filing financials did not exist for private companies, and obtaining the information in the public domain would be very difficult at least. The Manual talks about making necessary adjustments for accounting practices relating to the tested party, but it was difficult to know how these practices bore upon the cost of goods sold and other aspects for example. There was also reference in the manual to customs implementation of the arm's length principle. In her experience customs implemented an almost real-time approach to establishing the arm's length price, while the tax authorities tended to be looking at the issue in an audit perspective, perhaps 5 years after the event. In determining the arm's length price, the customs areas noted that databases such as tax authorities used were based on past information and may not suit their needs. Also customs tends to use methodologies that do not exactly line up with CUP, RPM etc.

She noted that a problematic issue is that many developing countries do not have the funds to pay the fees for accessing these databases and the taxpayers themselves may not have access to these databases. One possibility might be implementing legislation requiring financial information to allow databases to be built up.

Mr Prabhakar Reddy focussed on functions, assets and risks analysis. Functions were particularly important, examining what persons are being recruited and their skills and profiles. In cases such as where the business develops high-end software, not just low-end software analysis, for example, the independent comparable companies often do not include high-end functions, and some profit must therefore be recognised over and above what is the case for the comparables.

He noted that market penetration strategies are an important issue for India. Who should bear the costs between subsidiary and parent? They will look at the nature of the business as a whole, and the relevant sector - and filters will be applied after the databases are searched to make it functionally and economically comparable. They will look for publicly available material including that required by other regulatory agencies internationally (such as the US Securities and Exchange Form 10-K). Sometimes in the form 10-K enterprises will say India is a R&D

centre, but they may tell Indian authorities that they only do routine software maintenance. On the issue of aggregation versus segregation, it could be very important.

In the cases of manufacturing, he noted that India expects the payment of royalties to be on an arm's length basis independently of other transactions, and should not just be aggregated with other transactions, such as export of raw materials. The OECD says the least complex entity should be taken as the tested authority, but in India the Indian party is usually taken as the tested entity, because of the difficulty of knowing the background to the situation of foreign tested parties, and lack of access to information on how the industry operates in that country. Others take similar approaches. India has two databases it uses; Prowess and Capitaline, which each cover over 30,000 Indian companies – they can usually find comparables.

Mr Reddy noted that Indian legislation mandates using single year data (of the year of the transaction), with earlier data able to be used in exceptional cases where it affected current year pricing. He noted the importance for litigation of "reproduceability" – meaning that anyone using particular keywords will end up with the same results. He noted that some of the adjustments that may be made are adjustments for differing accounting standards, working capital adjustments, rate of depreciation adjustments, capacity replacement adjustments and cost saving adjustments (including location savings). Loss making comparables are only accepted where there is an economic explanation for the losses. He noted, as others did, that there are no perfect comparables.

He noted that it was very important to understand processes in a particular industry for comparability purposes. In India, comparables could mostly be found in appropriate databases, but these products are often complicated and comparables can be hard to find.

Mr Müller said he liked the Chapter, as it takes you through the issues step-by-step. He had mixed feelings about comparability. It is essential and complex, but there were always excuses for arguing there was no comparability. This created uncertainty and led to use of TNMM so frequently. In addressing comparability, two parties needed to be convinced: the other side and, if you went to litigation, a judge. The problem is that whatever comparable was used, arguments could always be made against it. The key is that the issue of comparability has to be approached from a good faith approach. It is not just a case of documenting what you are doing, but also why you are doing it and also what you are *not* doing and why. That applied to governments as well as taxpayers. Sometimes even in a company it is not clear why something was done.

He noted that the down side is that few decisions are black and white, and honesty was needed in addressing those uncertainties. The Manual could deal more with such issues. Advisors have an important role in the techniques of comparability, but as to functional analysis and ultimate comparability, in-house knowledge was essential. An advisor can helpfully test the approach taken by the in-house experts as to why some comparables were used or rejected, however. That will ensure you have robust documentation. He agreed with the approach taken at pages 11-12 of the Chapter of not rejecting all losses. One example that might be used is cyclical losses – if your part of the industry is shown to be in a loss making cycle, that should be a reason to accept loss making comparables.

Mr Müller noted that the last paragraph of the Chapter addresses secret comparables, but business does not see them as ever being acceptable, and they are probably not likely to survive legal challenge in most cases. What the manual does not address, but may happen in practice is that if cost plus 15 is treated as the norm by the authorities, doing an analysis of comparables may not help, as the result will be expected to meet that cost plus 15 level anyway. While the UN Manual stood alone, the 2010 OECD Chapter was useful and could be referenced more in this Chapter.

One participant noted that a presumption, with a dynamic or shifting burden of proof, may help deal with the cost of complexity and information–gap issues noted before. The Manual could play a role in addressing this.

Summarising the discussion, the Chair, Mr Juan Carlos Campuzano Sotomayor, remarked on the benefits of harmonised approaches among countries in the same region. Through a concrete example he showed how a decision made by a country without considering its economic ties in the region might prove difficult to apply. He noted that a technically good case may not be understood by a judge, so attention had to be paid to making these complex issues as understandable as possible. "Possible", "reasonably", "sufficiently" and "trial and error" were key words in the Chapter, which could be illuminated more. Good documentation comes from good data, which may be difficult to come by, as the MNEs have more access to the information. The transfer pricing process begins with lawyers (in making the regulations) and ends with lawyers (in the courts). The economists are in the middle of the process, and maybe more on the nature of markets in the Manual would assist the lawyers involved in the process and bridge the gap between law and economics aspects of transfer pricing.

Agenda Item 7: Dispute Resolution

This agenda item was chaired by Mr David Rosenbloom, James S. Eustice Visiting Professor of Taxation and Director of the International Tax Program, New York University School of Law, and was introduced by Ms Carol Dunahoo, Partner, Baker and McKenzie LLP. She said that a draft chapter should be ready by summer and then spoke on various matters to be included in the draft chapter. She noted some of the questions that would be addressed in the chapter, including:

- Why do we need dispute avoidance and resolution mechanisms?
- What should the goal or goals of such mechanisms be?
- What special considerations do developing countries face?
- How can disputes be avoided through domestic mechanisms?
- Are there effective ways to avoid disputes through cross-border mechanisms?
- Where a dispute cannot be avoided, can it be resolved through domestic mechanisms?
- How can cross-border dispute resolution mechanisms best be designed and implemented, and what are the pros and cons of each?
- What are the goals of a Mutual Agreement Procedures (MAP) program?
    - What are the key features of successful MAP programs?
    - What are some of the common challenges encountered?
    - How can such challenges be addressed?

- What is the possible role of Advance Pricing Agreements (APAs) in avoiding or resolving disputes
  - How do APAs differ from MAPs?
  - When might APAs make sense for a developing country tax administration?
- What is the possible role of Mediation / Conciliation
  - How do mediation and conciliation work?
  - Are they effective compared to other mechanisms?
- What is the possible role of Arbitration?
  - How does tax treaty arbitration work and how does it differ from commercial arbitration?
  - What benefits can arbitration provide?
  - What are the challenges presented by arbitration from the perspective of developing countries?
  - Are there ways to address those challenges satisfactorily?
- What issues need to be addressed in coordinating domestic and cross-border dispute resolution mechanisms?
- How can the challenges identified best be addressed?

Ms Dunahoo, in commenting further on these issues, explained that dispute resolution under transfer pricing is very similar to dispute resolution in a general MAP sense, currently under discussion by the UN Tax Committee in the context of the UN Model Tax Convention. She then noted the importance of effective dispute resolution mechanisms and stressed that if they are properly and robustly designed and implemented, they benefit tax administrations (which need to collect the right amount of tax in an efficient manner), not just business (which need predictability and protection from double taxation).

She noted the resource shortages in many developing country tax administrations and suggested that practical and efficient dispute settlement mechanisms can assist them by improving their efficiency in this regard. She spoke on dispute avoidance and the benefits of guidance and effective use of Competent Authority (CA) functions under tax treaties in this respect. There may also be domestic mechanisms such as settlements, administrative and judicial appeals that can help deal with the issue domestically, although it was recognised that different countries were in different positions in this respect and also that domestic remedies may not prevent international double taxation.

In terms of the Mutual Agreement Procedure, Ms Dunahoo reflected upon the role of MAP in making sure the purposes of the double taxation treaty are furthered, including avoiding double taxation. The most successful MAP programmes exhibit characteristics of transparency, cooperation and independence from the audit function. Countries without a tradition of an independent CA would need to be supported in developing that role.

On APAs, she acknowledged that APAs may not be for everyone, and that some caution should be exercised in recommending them as first options for all developing countries, but noted that they had an important role for many countries.

She suggested that tax treaty arbitration was an important and efficient tool way of managing heavy dispute loads, to help make CA processes work more smoothly and give confidence in the system, and considered that it was probably much more effective than conciliation or mediation in practice. The challenges would, of course, have to be addressed in a practical way, including whether the costs of arbitration can be addressed in a way that assists countries to accept the approach more readily.

One participant insisted on the predictability of the tax liability and the need to avoid double taxation. The two issues are important for both the tax administration and taxpayers as this reduces the need for tax dispute and avoids surprises for both. It is important, he said, to have a domestic mechanism to avoid dispute or settlement on audit. Key features for such a system, he continued, are transparency, cooperation, and independence from the audit function. The Indian case can be a good example, APA is not for everyone, and mediation and reconciliation are not always successful, he said.

The Secretariat spoke of arbitration as an important approach in seeking greater certainty. However its cost and complexity can be a big challenge for many developing countries and may unduly weight the scales against them. If the cost was borne by the taxpayer, he argued, there would (even if such a close taxpayer involvement in the process was agreed by the countries) be a perception issue that this may encourage arbitrators to make decisions unfavorable to the tax administration, so that was no solution. Another possible perception, at least in the early years, may be that is that arbitrators may lack understanding of developing country realities and conditions. Extra-budgetary allocation for an arbitration (including costs of the judge, the room and secretarial services that need not be borne by the tax administrations in domestic court cases) would often be required, as well as considerable foreign reserves, and if that was difficult, there would be a concern that a country may have to agree to a position for practical reasons even though that might not be objectively the most appropriate and fair outcome.

The Secretariat suggested that there was room to explore the argument that arbitration may give more strength to developing countries in having the treaty goals met, but it should not be forgotten that the power to say "no" is an important right that should be used responsibly, in good faith, but should not be lightly given up. As for the APA, countries should only enter this system after careful consideration and when they feel they know the rules of the game what to do, and many countries may not feel they should at an early stage, be expending scarce resources on taxpayers more likely to be compliant. A staged approach to gaining confidence in the process was needed.

Mr Rosenbloom drew to the meeting's attention the issue of how much resourcing countries should devote to APA programs, dealing basically with compliant taxpayers. He said that a good arbitration provision should not be too costly, because a good provision is not used. Arbitration is, however a surrender of sovereignty, and has to be carefully sold to legislators. It can be good for countries with a lot of MAP experience but is not recommended for developing countries without sufficient MAP experience and expertise. It was easier to get acceptance if arbitration was seen as a small step beyond an established MAP procedure that is known and understood.

Mr Rosenbloom considered that too much emphasis was put on arbitration in a tax treaty context, which really meant MAP, but that developing countries did not have strong treaty networks, much less with arbitration provisions. He argued, therefore, that more emphasis should be put on the issues of arbitration and dispute resolution outside that context. He doubted that countries would have sophisticated arbitration procedures, but weak dispute provisions more generally. The UN may have an important role in developing a list of experts countries could confidently rely on in arbitrations.

On the domestic aspect of arbitration and dispute resolution, Mr Adjei-Djan gave the example of dispute settlement procedures in his country Ghana where there were few DTAs and they took a long time to be legislated – so that the issue was more one of domestic dispute resolution rather than arbitration under treaties in practice. The discussions with taxpayers in this context were often very protracted. Even where there is a DTA, the MAP is not used much, as from his experience the country and the tax payer in dispute have been able to find a solution without involving the other country party to the treaty. He informed the participants that in the case of Ghana a tax payer can always appeal to court in relation to an arbitration decision, in any case. He noted that many developing countries were hesitant to adopt arbitration and mediation in such a complex area, and he noted the tight budgetary circumstances for many of their administrations, which would make it difficult to obtain funding for an arbitration cases. He noted the concerns about the arbitrators lacking developing country experience and drew attention to the need for developing country experts. This is an area where the UN has a role in capacity building. In his view, most problems at the domestic level arise when the tax payer in dispute does not wish to provide all documents requested by the tax authorities. If the documents were provided in a timely manner, and the information could be relied on there would be minimal disputes, he concluded.

Responding to the issue of proper documentation not being provided by the taxpayer, Mr Rosenbloom wondered why developing countries do not establish strong presumptions in the lack of documentation, as the United States does. There could be a two tiered system so that if they did not provide the documentation, there was a strong presumption against them. It was noted that there may be strong pressures on a Commissioner not to invoke the strict legal provisions. Mr Rosenbloom responded that in cases where the Commissioner was given discretion it might be easier if companies wanting the application of a transfer pricing system without presumptions had to provide the information, otherwise the stricter regime with presumptions applied. This would be instead of the Commissioner having the discretion to impose a more onerous regime, though the possible political obstacles to such a regime were also noted.

Mr Prabhakar Reddy noted that in the developed countries litigation was more expensive than in developing countries, which leads to more transfer pricing litigation in developing countries. That litigation takes time to clear, so we should look to ways of avoiding or otherwise dealing with such disputes. Safe harbours are one possibility, but the practice is more difficult than the theory. Any guidance on how to go about achieving an effective safe harbour regime in the Manual would be valuable.

With reference to APAs, Mr Reddy noted that India does not have an APA mechanism yet, although one should be in place by next year. He noted that there is no power for transfer pricing officers to negotiate on transfer pricing matters under Indian law. He then said that India does not have Article 9(2) in all their treaties and that India takes the position that other countries cannot seek a corresponding adjustment without having Article 9(2) applicable. He noted that many MAP cases had been solved recently, against a framework of the authorities having sufficient expertise on transfer pricing. He noted that Indian legislation talks of the arithmetical mean, while other countries had differing domestic law – such domestic differences had to be put aside to reach a suitable resolution of MAP cases. He noted that arbitration is the next step after MAP, but a good deal of experience in MAP was required before agreeing to mandatory arbitration. Similarly, APAs take 2-3 years and a lot of resources for a maximum 5 year period, so they are quite resource intensive.

One participant indicated that transfer pricing legislation was introduced to Japan in 1986 and for almost 20 years there were no court cases because most disputes were resolved through mutual agreement procedures. For the MAP to be successful there was a need to have competent authorities that have real expertise and are empowered to reach a firm agreement without having to confer with field auditors. For developing countries there were conflicting pressures to use their scarce experts in the field audit or in the competent authority.

Mr Rosenbloom then noted that Competent Authorities were not abstract entities, but they were made up of flesh and blood people, and the MAP process works best where there is personal trust and a good faith attempt to avoid double taxation.

A business participant noted the strong business preference for the certainty and robustness of the investment regime which arbitration could give. As to cost, perhaps some of the funds used for capacity building could be used to support a Panel so that developing countries would not have to bear these costs. Often countries note the sovereignty issues, and say they could not agree to arbitration, but he considered that they should at least examine whether they were signing treaties with similar clauses in other areas, such as investment. He noted that in the practice of the European Union Arbitration Convention, one of the great benefits of an arbitration clause was to force MAP agreement. The Secretariat queried, however, whether the practice of Europe would be as applicable to a more imbalanced relationship, such as may exist between developed and developing countries, and there was a discussion about broader ways of addressing the imbalances.

Giving the example of India, one participant argued that litigation is perhaps not too costly (especially in many developing countries) but often takes too long to be resolved through the court systems. He also emphasised the point that transfer pricing is not an exact science and disputes usually stem from double taxation. In his view, it is important to try other methods for dispute avoidance – avoiding the double taxation. He described an Indian dispute resolution panel approach as more beneficial to the tax payer since the government cannot appeal it whereas the former can. However, he considered that so far the panel has not been as effective as it could be.

There was a discussion about possible “bogus” (i.e. deliberately excessive) adjustments whereby the adjusting tax authority made an obviously excessive adjustment in the hope that some reduction of their very high adjustment will still leave them with what they wanted. For Mr Rosenbloom, arbitration carries an advantage of punishing the party that is most unreasonable if the “baseball” approach is used. Arbitrators will pick one of the two positions put forward by the parties, and in rejecting a clearly excessive claim on one side, they would accept the other side’s proposed adjustment, even if it was not what the arbitrators would have chosen on their own initiative. This pushes the two parties to be as reasonable as possible before seeking arbitration and therefore brings them closer and eventually they should come to an agreement, he said.

Arbitration provisions, he commented, are robust and can be attractive to investors and could perhaps be modified for developing countries, by having the UN or other acceptable bodies choose arbitrators. He suggested that properly applied, arbitration can cost less than other mechanisms, avoid integrity concerns, and is less vulnerable to domestic process. Mediation, on the other area, involved pointing out the weaknesses in one side’s case in the light of jurisprudence, but as there was no relevant jurisprudence, it may not be appropriate in this area.

Mr Rosenbloom reminded participants that asking developing countries to negotiate a series of treaties with arbitration clauses was costly and might make double tax agreements less attractive – a far bigger issue was arbitration outside the treaty context.

Ms Dunahoo noted that, properly applied, arbitration should benefit developing countries, by reassuring investors, giving access to expertise, and eliminating the perceived need for high-level representations on a case-by-case basis to Ministers, for example.

A participant from a developing country talked about the differences between countries and observed that in some countries it would be impossible to agree to arbitration of tax disputes, as this implies giving up their sovereign rights; sometimes that may not be an option under the constitution. It was noted that, to avoid the lengthy battles through courts, Brazil has put in place a system in which if the tax payer is not satisfied by the transfer pricing decision taken by the tax authority, it can ask for reconsideration. If still not satisfied, it can bring the case before a body composed half of tax officials and half of business representatives. Even in this instance if the tax payer is not satisfied they can take the case to court.

Another participant from a NGO noted the efforts that the WTO made to ensure the imbalances referred to did not prevent developing countries from taking cases to the WTO, including the provision of advisors.

Another participant from a developing country noted the risk that too much emphasis was put on arbitration, to the exclusion of improving the MAP. Often legislators do not see the benefit of treaties already, so adding a mandatory arbitration provision might not assist in obtaining support for broadening treaty networks. Even if there are arbitration agreements, the resources may well be lacking to make them work effectively. In a final intervention from a developing country participant, the possibility for external arbitration to deal with court backlogs was again noted.

Agenda Item 8: Audit and Risk Assessment

This session was chaired by Mr. Stig Sollund. He noted that the issue would be dealt with before dispute resolution in the Manual.

Ms Roselle Sakhoon said that this area is very important for developing countries and strategies should be adopted to encourage efficiency and effectiveness. It was important that countries work out which cases they did *not* need to take further because they were not high risk, and which ones were high risk. Many countries did risk profiling, especially where the offshore related party is in a low-tax jurisdiction and scarce resources should be used as efficiently as possible, especially at the start of working on transfer pricing issues, where the "low hanging fruit" should be addressed prior to more complex high risk cases.

She said that in determining risk assessment strategies, an important issue to determine is whether you centralise or decentralise your transfer pricing units. South Africa has a hybrid model, with such units doing risk profiling and audits as well as some "head office" functions in assistance in drafting legislation and supporting materials – the pros and cons should be looked at, including in the Manual. She noted the possibility of introducing safe harbors at a risk assessment stage, rather than at an audit stage, which would provide taxpayers with some degree of certainty as to whether they are likely to be audited.

Ms Sakhoon indicated that another important way of achieving robust risk assessment is to ensure that relevant information is readily available. Income tax returns for corporations may be insufficient in what they require. One approach is to require taxpayers to indicate in their return whether they have a transaction with an offshore related party. If they do, they then have to list the transactions, including the type of service, nature of it, quantum and who they are transacting with. South Africa is currently considering whether to make such changes.

For Mr Julius Bamidele, it had to be recognised that every case has the potential to end in court and therefore tax administrations need adequate documentation to back up their position. The issue with arbitration, he continued, is that the outcome is not taken as final in many systems. It can always end up in court. He suggested that even though many multinationals have the capacity to litigate in court, it is in the best interest of both parties to settle out of court; it is faster and less costly and less corrosive of longer term relations. He then suggested finding a way within tax administrations to work on an enhanced relationship with the taxpayer so as to resolve disputes easily. That should help resolve lingering disputes, but such a relationship should have as its basis the application of the law in the proper fashion, reflecting the situation, rather than of not applying the law.

Mr Nakayama presented a few points that he saw as key to effective risk assessment. In assessing risk, the centralised approach will often be essential when a country is starting off in transfer pricing. This does not mean that one unit in Headquarters should conduct the whole audit, as it depends on the size of the administration and tax authorities. But supervision from Headquarters is recommended to ensure the quality of risk assessments and audits.

He proposed that obtaining the right information is essential and that tax returns should seek the key information about related party transactions, but sometimes taxpayers will argue that information such as major related transactions and functions and risks of the related partner is not available to them. Sharing information, as part of the risk assessment, with Customs authorities had been mentioned, but care must be taken with such information, which may be inaccurate and taxpayers may face a difficult situation that their argument to avoid anti-dumping actions could be used as a basis for transfer pricing adjustments.

Mr Nakayama noted that in relation to the transfer pricing system, developing countries can often learn from peers but a careful attention should be paid to domestic conditions that might be different between the two countries. A very robust audit approach in a country with a very large domestic market or which is very well endowed with natural resources may be successful, but a similar rigid approach in developing countries without those characteristics, may just result in scaring off foreign investment. When enacting new laws related to tax audit, he suggested tapping into knowledge of lawyers and tax practitioners who in some cases might have more experience than tax administrators. All cases could not be audited, so working with tax practitioners as partners is very important at the early stage especially, to disseminate good behaviours among taxpayers.

Ms Dunahoo indicated that administrations should think carefully about what they want from taxpayers in tax returns. Asking too much may result in information they cannot properly analyse, but asking the right questions can make risk assessment more informed and efficient. The idea of joint tax audits between different tax jurisdictions is being discussed in OECD circles. Any such discussion of a new procedure raises potential concerns, but the US is doing some such joint audits – it considers it can only do these with treaty partners, however, because of the information exchange (other speakers made the same point). It is mentioned briefly in the outline and is a creative idea that may help save resources. However, she continued, this can be more efficient in resolving any tax dispute that may exist. She said the use of target amounts of tax to be assessed by a tax official in a given period puts a lot of pressure on the officials, including other parts of the administration (for example it may lead to a large increase of cases in litigation), although it may be an approach taken by some countries for integrity reasons, for example. Finally, the use of secret comparables makes companies nervous, either because their information is being shared and they have competitiveness concerned, or because information is being used as a comparable that they do not have access to for the purposes of challenging it. There may be room for guidance on avoiding some of the difficulties.

Mr Sollund agreed that the issue of secret comparables is a very difficult one, and noted that it may not be able to be fully resolved by the Manual.

Addressing the use of data from other sources including customs, for comparability purposes, a participant from a developing country also concurred on the difficulty of the approach. He compared the examples of Japan, where tax administrations are not allowed to use customs data, and Brazil, where the tax administration and customs are part of the same administration and such data are frequently used. He noted the value of such data, and noted that even though customs administrations and tax administrations were looking for different things, they had

common interests. He wondered if, in cases where data is not shared, a company may end up having two invoices, one for the tax administration and one for the customs administration. Another participant noted that Customs data may be especially important to a developing country heavily involved in trading commodities and with a heavy investment in making sure trade data is accurate – especially as there may be little other data. Ms Dunahoo noted that if the data is accurate and categories match so that apples are not being compared with oranges, such information may be useful, but that was typically not the case, at least in the U.S. experience.

Another participant from an NGO suggested that auditing not just individual taxpayers but whole industries (such as brewing or tobacco, for example) was a useful idea as companies in the same industry tended to act similarly. Cross-country collaboration to develop an industry-wide view of compliance would help in building experience, developing a richer body of targets and economising on resources. On using customs data, there were some qualifications, but it is an invaluable resource – and there was value in sharing such information (as an additional tool to individual and industry audits) to determine what is going on.

For Mr Bamidele, the idea of a joint audit of industry had some difficulties. It was difficult to obtain information from one company in the presence of other companies, and some issues will be industry wide, but others are company specific. He considered that it might be more productive to audit all companies in the industry, ensuring common issues were treated in the same way, rather than auditing the industry as such. He noted that joint audits may involve information that is not yet tested, as there is nothing to be compared with at that stage, so he was not sure how effective it would be.

Another developing country participant noted that his country had started a joint audit program. He noted, though, that companies find it hard to see why income tax authorities will come and examine materials, and then others, such as VAT authorities, will come and examine similar materials later. On another point there was a dilemma of personnel who worked very closely with a taxpayer for some years potentially becoming compromised, and training tax auditors was expensive, so there was an issue of where to put those who had been compromised and how to replace them in that compromised role. Even when accountants were brought in from the private sector, they needed extensive retraining.

Another speaker noted on joint audits for clarification that they need not be real-time audits, which may deal with some of the concerns mentioned. A business participant noted that there was an issue in industry audits that for anti-trust/ competition law reasons, there were restrictions on what information could be shared between competitors – he could not meet with competitors and discuss anything but tax and even then had to record what he said. For example, in trying to establish what constitutes a comparable price for a mineral in a country, the information may be readily available in competitors but for anti-trust/ competition policy reasons it could not be sought.

Another participant noted that Her Majesty's Revenue and Customs of the UK had some relevant material on their website: http://www.hmrc.gov.uk/manuals/intmanual/intm461020.htm. The Chair noted that the comments on joint audit showed that the square brackets could be taken off that topic and some material added in the draft.

Close of Meeting

Michael Lennard of the Secretariat thanked all involved in making this event possible and noted that the meeting was important in the context of the convening power of the United Nations, and the important role of the NGOs in these debates. The debate had brought forth many very different but very valid viewpoints; they had been put forward in respectful and cooperative ways and could now be assimilated into the Manual in a way that meets developing country needs. The report would be forwarded to the Subcommittee drafting the chapters for consideration in its September meeting in particular.