

Chapter 4

Establishing Transfer Pricing Capability in Developing Countries

4.1. Introduction

4.1.1. This Chapter addresses issues of setting up a dedicated Transfer Pricing Unit in the tax administration. In setting up such a Unit for the first time there are important opportunities but also challenges on many fronts. The design of such a unit, its vision and mission statements and the measurement of its success will have to take into account factors widely recognized to be key features of modern tax administrations. These include factors such as:

- a) Relationships between tax policy and tax administration;
- b) The need to evaluate current capabilities and gaps to be filled;
- c) The need for a clear vision, a mission and a culture that reflects them;
- d) Organisational structure;
- e) Approaches taken to building team capability;
- f) The need for effective and efficient business processes;
- g) The advantages of staged approaches to reaching long term goals; and
- h) The need for monitoring to assess effectiveness and for fine tuning.

4.1.2. These points are a useful framework when consideration is given to setting up a transfer pricing unit, even though there is no “template” that will be suitable for all countries in every respect. These issues will all need consideration in the context of decisions taken at a wider policy and tax administration level.

4.2. The Tax Policy/ Tax Administration Relationship

4.2.1. The tax policy making function resides with the Ministry of Finance rather than the tax administration in most jurisdictions. The other revenue generating organs of government (e.g. the Customs Service)¹ are also separate from the tax administration in many jurisdictions. There is however a particular need to bridge the gap between the policy making function and the tax administration in order to implement an effective transfer pricing regime in practice, particularly due to:

- The complexity and resource intensiveness of administering a transfer pricing regime;
- The potential costs of compliance for taxpayers and of collection by tax administrations;

¹ relevant in relation to issues of valuation

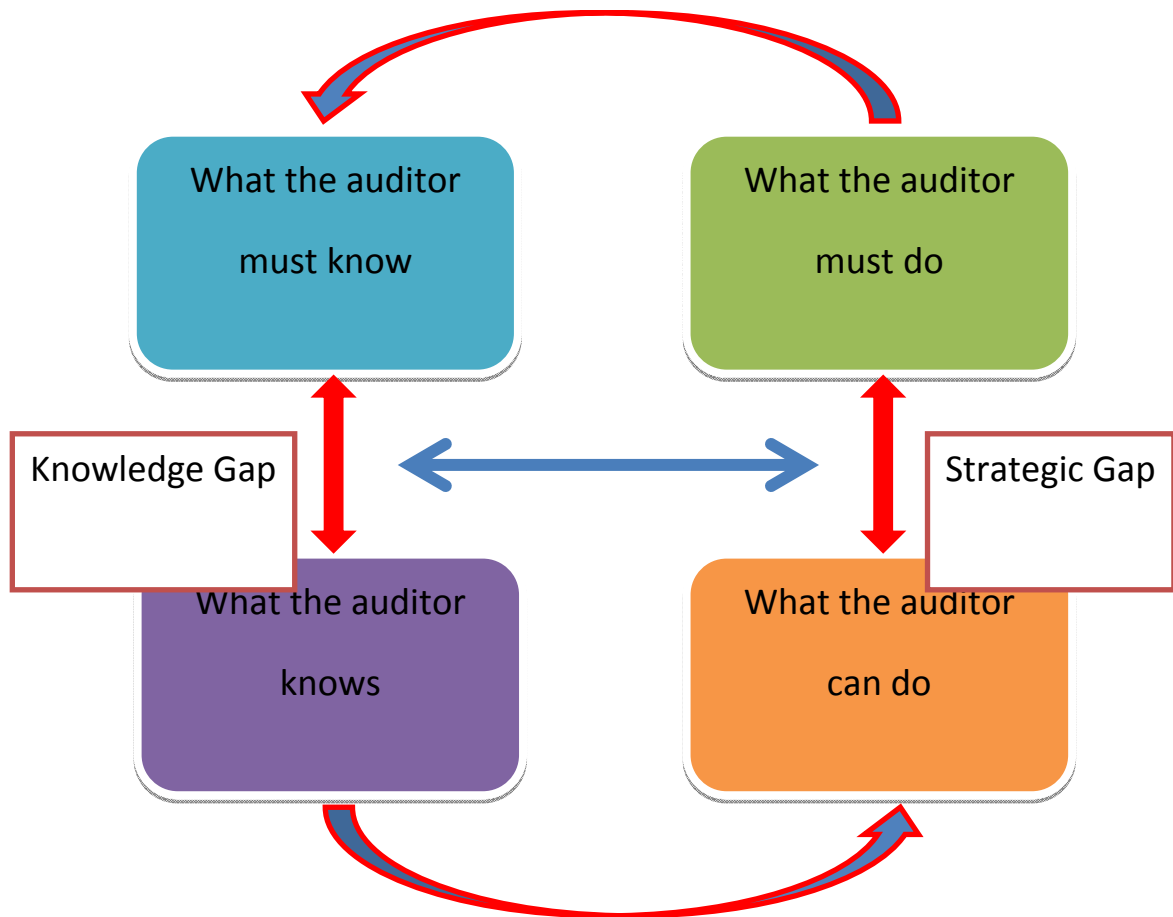
- The international dimension given the link to binding tax treaties through Art. 9 of the UN Model treaty, issues of potential double taxation and the interest of other countries; and
 - The large amounts of money that may be at stake.
- 4.2.2. An essential first step in improving cooperation is to review and clarify exactly what each agency's responsibilities and functions are and the mechanisms for contact and coordination. This review should be used to examine the scope for removing duplication and overlap of functions, and for streamlining and consolidating procedures.
- 4.2.3. Some factors that could improve this cooperation include:
- Recognition of the need to have a "policy feedback loop" so that the policy reasons for a transfer pricing regime are properly reflected in that regime and in its administration, but also that practical lessons from the administration of the regime can be fed back to fine tune policy. Examples are:
 - where aspects of the policy are expensive or otherwise very resource intensive to administer, and the likely revenue return is not commensurate with these costs;
 - where a wider treaty framework and strong exchange of information provisions would be beneficial; or where there is a need to ensure that the framework of thresholds, deterrence and penalties is effective and up to date;
 - Recognition, in particular, that the experience of the administration in taxpayer service, education and enforcement, including feedback from competent authorities (who liaise with competent authorities of other countries on double tax treaty matters) may be of particular benefit in fine tuning legislation or implementing regulations;
 - Cross secondment of tax administrators and policy makers to each other's teams. This will help ensure that administration officials understand the policy making process and the objectives of the legislation, and policy makers understand the practical issues of tax administration. Good tax policy must be able to be administered and good administration must have sound policy underpinnings;
 - Broader governmental policies to ensure that all investment policies with a tax dimension must have the involvement of the tax administration. For example, tax administrators should be involved in discussions about tax holiday policies that may affect transfer pricing and other aspects of tax administration; and
 - A recognition that policy makers should also not be limited in their training to economic effects of investment; taxation policy should be incorporated into the training. Conversely, tax officials should also recognise the importance of investment to development and the importance of, for example, seeking to avoid double taxation in accordance with applicable law.

4.3. Assessing Current Capabilities and Gaps to be filled

- 4.3.1. Different tax administrations require different types of administrative arrangements when it comes to implementing their government's transfer pricing policies. The level of

development/capability in the tax administration should be a key factor to consider when formulating policies, which is always not the case. Too much capability across too many areas is often sought in too short a time.

- 4.3.2. First, it is important to find out the actual level of existing knowledge and the best organisational approach. The focus in this Manual is on countries with little or no existing experience in transfer pricing, so that there are initial start-up issues. There is also a recognition that everything cannot be achieved at once and that the system and the administrative capability will need to evolve over time, as part of a capability building plan – what is often termed a “life cycle approach”. A possible approach is outlined below:²



² Adopted from: Developing Knowledge Strategy, Michael H. Zack m.zack@neu.edu; web.cba.neu.edu

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

- a) Levels of education and expertise;
- b) The legal environment (as addressed in Chapter 3) including the characteristics of the transfer pricing legislation and responsibilities for and the scope of regulations;
- c) Networks of comprehensive bilateral tax treaties including articles relating to Associated Enterprises (usually Article 9), the Mutual Agreement Procedure (usually Article 25) and Exchange of Information (usually Article 26). Also any more limited Exchange of Information agreements – especially with countries of residence of key participants in the economy and their related parties;
- d) Availability of information within the country/tax administration; and
- e) Availability of information technology systems that allow for the most effective strategies to encourage compliance, develop and support audit strategies and facilitate collection and litigation where necessary, as well as those skilled in using them.

4.4. Developing the Vision, the Mission and the Culture of the Unit

4.4.1. Objectives

4.4.1.1. The goals of the team should be clear, both to team members and to others they will deal with (including others in the administration and stakeholders such as taxpayers and their advisors). This is often put in terms of developing a “mission” (what the Unit will do in its daily operations) and a “vision” representing what the future looks like when it carries out that mission properly. Many tax administrations also have “Taxpayer’s Charters” which reflect what taxpayers can expect from the administration, and what is expected from them in the relationship.

4.4.1.2. Documents that reflect the mission and the vision should become part of the culture and be lived out by the Unit on a daily basis rather than merely being framed and put on the wall. This will be assisted by, for example, developing a team charter aligned with the wider organisational charter agreed by senior managers in the Unit and key persons in the organisation as a whole, preferably after conversations with stakeholders. This could usefully draw upon the experience of other countries though it must be tailored to your own realities.

4.4.1.3. An important part of defining the objectives involves identifying (and recognising the limitations of) available resources. Clearly determining what is inside and outside the competence of the Unit will help clarify resources needed to meet the objectives of the Unit and encourage the best use of such resources.

4.4.2. Client/Taxpayer Orientation

- 4.4.2.1. A central consideration to be borne in mind is that a Transfer Pricing Unit will have key taxpayer service and education functions as well as a central enforcement function. These functions are interrelated: better education and taxpayer service reduces the cost, resource-intensiveness and “pain” of compliance. This, in turn, helps increase compliance and allows the administration to focus enforcement measures on the greatest risk areas.
- 4.4.2.2. Understanding the functions and environment of Multinational Enterprises (MNEs) will most effectively and efficiently further all these service, education and enforcement activities. Handling their taxation issues will inevitably lead to more contacts between MNEs and the Unit. For instance, MNEs have to disclose their documentation and systems, while tax administrations have to be aware of the dangers of unnecessarily high administrative burdens, and therefore compliance costs, for the MNEs. High compliance costs are inefficient and may unnecessarily give a negative view of a country’s investment climate.
- 4.4.2.3. On the other hand, increased focus on transfer pricing issues will inevitably lead to some disputes with MNEs and the possibility of double taxation. Another country may regard more of the profits of a transaction between related parties as subject to its tax jurisdiction in accordance with a bilateral treaty; this results in fewer profits being subject to tax in the user’s jurisdiction. This is an increasingly common issue in transfer pricing and tax administrations need to devote resources to avoiding unnecessary differences. They must avoid, where possible, that those differences lead to a dispute and must deal with formal dispute procedures as expeditiously and effectively as possible when they cannot be avoided.
- 4.4.2.4. Most double tax treaties contain a Mutual Agreement Procedure (MAP) article to try to avoid double taxation, based upon the UN or OECD Model Tax Conventions, as noted in Chapter 1. Often this is Article 25 in bilateral treaties, as it is in both Models. However, the MAP conducted between competent authorities is very resource intensive and costly for both tax authorities and MNEs. As such, it is especially worthwhile to put sufficient energy and resources into risk assessment and establishing contact points between the tax administration, the competent authorities under tax treaties, and policy makers to avoid unnecessary adjustments in tax assessments.
- 4.4.2.5. Engagement with taxpayers, tax advisors and peak representative bodies is necessary to understand the transfer pricing system of MNEs, and for the MNEs to understand what is required from them in a new transfer pricing regime. This will help, in particular, to explore shared interests such as clarity and transparency, as much certainty as possible to understand and reduce the risks of tax positions, awareness of commercial realities, fairness and consistency between taxpayers and reduced costs of compliance and collection.
- 4.4.2.6. There will a need for considerable early investment in taxpayer education. The tax administration also needs to create professional and effective relationships with taxpayers as an element of taxpayer service. This is an area where the experience of other similarly placed administrations is likely to be especially helpful.

4.4.2.7. Overall, there needs to be a sustained commitment to this part of the “set-up” process, which is designed to maximise compliance and to assist in risk management (by helping differentiate non-compliance due to lack of understanding from more “deliberate” and therefore systemically risky, non-compliance). A fair amount of institutional patience and sustained commitment is required if the transfer pricing regime is to fully meet its medium to longer term goals. Some specific steps through which this can be achieved are recommended below.

4.4.2.8. Steps that could be taken by the tax authority include:

- Knowing its stakeholders and their commercial environment, as well as their main issues and concerns, and having in place a continuous dialogue with taxpayers, tax professionals, their associations or peak bodies on tax issues;
- Being reasonable and proportionate in its actions, and open and transparent with taxpayers;
- Being responsive to requests;
- Extensive and clear taxpayers’ education, including making available to taxpayers tax guidance notes, information circulars and other literature on interpretation of tax laws to avoid misunderstandings, confusion and surprises among those willing to meet their obligations;
- An informative and easy to navigate internet presence that is regularly tested for its effectiveness for users and is kept under review;
- Seeking to avoid disputes arising unnecessarily but also setting up clear and fair systems for addressing such disputes that do not unfairly deter taxpayers from pursuing legitimate disputes; and
- Advance rulings on taxpayer specific issues.

4.4.2.9. Steps that could be encouraged for taxpayers and their advisors include:

- Being transparent and open about their risks, including by voluntary disclosures to the tax administration;
- Requesting and obtaining advance rulings before embarking on activities with important tax consequences, or participating in Advance Pricing Agreements where they exist³;
- Making their transfer pricing policy available to the tax administration;
- Recognising the resource limitations on the side of the administration and not “playing games” to tie up those resources unnecessarily to the disadvantage of the administration and other taxpayers; and
- Complying with the requirements of the bilateral double tax treaty between the country they are operating in and their country of residence, and understanding the circumstances when the applicability of the tax treaty to them may be denied.

³ The issue of whether to institute an Advance Pricing Agreement programme is a complex one, addressed in Chapter 9 of this Manual. Some countries see this as a useful extension of the risk management approach even in the early days of a transfer pricing regime. Others think this is more appropriate once there is greater familiarity with and experience of transfer pricing issues, and prefer to focus limited resources in the start-up phase on the most serious instances of non-compliance rather than taxpayers likely to be in broad compliance.

4.4.3. The Enforcement Approach: Risk-Based Approach to Compliance

4.4.3.1. A “risk management” approach to the Unit’s work is recommended; this is true for the tax administration as a whole, but particularly when dealing with a new regime dealing with complex and resource intensive issues of transfer pricing, This means having robust processes in place for:

- Identifying transfer pricing risks;
- Analysing them (including ranking them in terms of their likelihood and the impact if they are realised); and
- Determining what can be done to avoid them or to limit their adverse consequences if they cannot be avoided.

The obvious risk is that the right taxpayers do not pay at the right time, but other risks, such as risks to public confidence in the system need also to be considered.

4.4.3.2. Ongoing issues of risk assessment and management are considered in more detail at Chapter 8 of this Manual. In setting up a Transfer Pricing Unit, however there is an important role for officers attuned to the organisation’s approach to risk management and able to implement it systematically for a new area and keep it under review. Consistent risk management strategies will often be developed in conjunction with other areas of the administration, such as those dealing with tax treaties or thin capitalisation, or those clustered around the relevant industries.

4.4.3.3. As part of this risk management approach, even developed countries with long established transfer pricing regimes and administrations tend in practice to have criteria that define their areas of greatest or least current focus. This often includes thresholds below which they would generally not audit or adjust a controlled transaction for transfer pricing purposes, especially in relation to small and medium sized entities or for transactions below certain values.⁴

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

- Reported losses for a number of years or more, especially if the losses begin about the time when a “tax holiday” runs out;

⁴ See, for example, *Multi-Country Analysis of Existing Transfer Pricing Simplification Measures*, OECD, 10 June 2011 at page 22.

- A high value of related party transactions compared to the taxpayer's turnover and operating profit;
- Significant transactions with major counterparts from low or no-tax jurisdictions, non-treaty partners and countries from which information will not readily be made available by tax authorities;
- An economically unrealistic profit trend compared to the industry trend, with no obvious explanation;
- Inconsistencies between inter-company contracts, transfer pricing policies and detailed transactional documents such as invoices and customs documents; or
- Significant royalty payments to related parties, especially if the intellectual property is not legally registered or appears to be in some part locally generated.

4.5. Organisational Structure for the TPU

4.5.1. There are two basic types of structure that can be adopted for the transfer pricing capability, a *centralized model*, with a single Transfer Pricing Unit operating across all industries and geographical areas, or a decentralized model, with separate transfer pricing units by industry or geography. Each has advantages and disadvantages, which are covered in the paragraphs below.

4.5.2. Centralized Model for the TPU:

- **Advantages:** coordination and adjustments to approach are made easier in the start-up phase; knowledge is built up quickly; the model is in tune with a centralizing tendency in tax administrations (driven in part by the desire for all encompassing technological developments and compliance strategies); there are clearer lines of authority and communication within the Unit; and communications with other areas can also be more coordinated.
- **Disadvantages:** there is a risk of being in an "ivory tower" – out of touch with realities on the ground; and a risk that over-centralization may create opportunities for corruption. As transfer pricing experts will need, in any case, to work with experts from outside that group, such as people with various auditing skills, and more general tax auditors with some transfer pricing experience, it is at the very least important to guard against such an ivory tower mentality (and being perceived as such) and ensure frequent interactions and exchanges of ideas and even personnel between such groups.

4.5.3. Decentralized Model for the TPU:

- **Advantages:** there are short lines of communication with tax inspectors; an easy spread of knowledge; combined industry and transfer pricing knowledge; and the model facilitates a long term broader spread of transfer pricing awareness.
- **Disadvantages:** there are risks that team members will not see their first loyalty to the Transfer Pricing Unit but to the colleagues they most regularly work with, especially in the start-up phase of a multi-disciplinary, cross-functional team, with the danger of a lack of single vision and coordination. Such coordination problems may lead to inconsistencies, lack of experience

sharing and issues “falling between gaps”; and some taxpayers may take advantage of a lack of coordination by, for example, “picking and choosing” who they approach for rulings.

- 4.5.4. Whatever approach is taken, it is important to have a clear and coordinated approach to transfer pricing issues and their possible solutions, especially as MNEs will generally be far more familiar with transfer pricing issues than individual tax officers in a start-up Unit. It is impossible to bring the tax administration at once to a high level of knowledge, especially for example across a large spread of industries. Measures need to be put in place to ensure good working relations with tax officials who are expert in particular industries, and tax officials in the various regions where transfer pricing issues may arise, including by regular meetings and formal “contact” points on both sides. This will help ensure the best realistic capability is achieved as soon as possible in terms of: educating taxpayers and the administration on transfer pricing; responding to taxpayer requests, identifying compliance issues and their links to other tax issues; and responding to those issues.
- 4.5.5. It is very important to bear in mind the taxpayer service aspect of the work: the taxpayer should be able to go to a “one-stop” contact point to deal with key issues. That contact point should do the internal coordination, rather than the taxpayer in effect being forced to act as coordinating agent for the administration; and this also helps promote consistency and coherence within the administration.
- 4.5.6. The facility of a “one stop” contact is also one reason why many administrations have Large Taxpayer Offices to handle relationships with MNEs and other large taxpayers, especially in key sectors of the economy, such as resource extraction. These offices can respond in an integrated fashion to diverse issues across different subject areas (for example: Income Tax, VAT and resource royalties) as well as related issues such as transfer pricing and thin capitalisation in relation to the same taxes. They usually have auditing, registration, tax accounting, collections, and taxpayer service roles and are sometimes seen as especially useful to implement new approaches, including major policy or administrative reforms such as self-assessment or computer modernisation of the tax office as an “incubator” for change elsewhere.
- 4.5.7. In a monitoring and intelligence gathering sense, this sort of approach can also enable more proactive analysis and action to deal with emerging issues, such as unexpected falls in revenue from key areas. Such falls may merely reflect economic conditions but could, alternatively, reflect new compliance risks, such as a rise in treaty shopping. Finally, if reform of the administration as a whole is likely to be a long term project, because of systemic skills or integrity issues for example, it is sometimes considered that assembling a well-functioning, trusted and skilled LTU is the quickest way of safeguarding and monitoring key sectors of the revenue while preserving relationships with taxpayers. This experience may also provide lessons that can be applied to the reform of the administration more generally.
- 4.5.8. Many countries adopt a highly centralised model at start-up. This reflects the importance of coordination and uniform approaches at start-up; it also recognizes that a Transfer Pricing Unit is not designed to have a specific lifespan but rather will become a permanent part of the tax administration’s structure. Several models can be used to take transfer pricing capability further after this start-up phase. It is possible to create teams for every region which exclusively deal

with transfer pricing cases. National coordination is then achieved by placing team members of each region on a rotation basis to work together and discuss the latest developments in transfer pricing.

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

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

4.6. Building Team Capability

4.6.1. General Human Resource Management Issues

4.6.1.1. A new transfer pricing regime is probably itself related to major changes within a tax administration, such as a recognition of the impact of globalisation and international value chains on the particular country. As with most changes there are potential pros and cons. While the human resources management strategy for the Unit needs to be integrated with the organisation’s wider human resources strategy, there are aspects that are likely to be of particular relevance in this area, including:

- The importance of the Unit’s “culture”, focusing on achieving the organizational vision, mission, and objectives, motivating and providing incentives for performance, measurable goal setting and mutually agreed and annually updated performance objectives and standards. In a new team, possibly with some reluctant but very capable members, the importance of this work and of good team leaders should not be underestimated;
- Recognising the importance of broadly developed officers who understand the importance of investment for country development (including the importance of avoiding double taxation) and understand the drivers and environment of business, but believe also in the crucial importance of collecting the country’s appropriate tax take and also of public confidence, the integrity of the system and of their actions;
- Internationally focused officers (including those familiar with the languages most used by international business) who meet routine business needs but are proactive, creative and adaptive to new ideas and challenges, seeing change as an opportunity;
- Officers who are keen to develop and to explore the most efficient and effective ways of doing their work and are patient in dealing with the large demands, complexity and often slow progress of transfer pricing cases rather than seeking to “cut corners”;

- A strategy for the identification and development of managers who are respected, have integrity and can motivate staff and help them share the vision of the Unit and the organisation;
- Recognition that not all will want to be, or be suitable as, managers. A strategy for recruiting and retaining technical leaders will also be necessary, as well as ensuring that their expertise is shared amongst their colleagues. This strategy can be furthered by discussions, rulings, meeting clients in teams and forming a database of experience – not to be used blindly, but to encourage ways of analyzing and reaching conclusions; and
- Clear career prospects and incentives (such as learning opportunities and secondments) for successful officers, based on performance assessments that are fair and based on objective criteria reflecting the objectives of a Unit. This means that good taxpayer service should be rewarded, not merely activity that appears to be more directly revenue generating. In particular there are clear dangers in incentives based mainly or wholly on the level of adjustments made, as this can encourage unjustified adjustments (and it may take years to establish whether an adjustment was justified or not, long after the Officer has moved on perhaps). Such unjustified adjustments are in fact counterproductive to the success of the Unit in establishing confidence in the system and providing taxpayer service, and that should be recognised.

4.6.1.2. Practice has shown two particular human resources-related risks at this stage. First, there is the possibility of resentment against those involved with transfer pricing policy and administration by others in more “established” areas. Because it is new, people within the organisation do not always know exactly what it is about and feel uncertain and can be unwilling or dismissive about taking up transfer pricing issues. Further, setting up such a Transfer Pricing Unit may require the recruitment of outside expertise in key roles. Existing staff may feel it is a “fashionable” area of work that draws resources and support away from their own equally important areas of work, or unduly rewards “outsiders” and “upstarts” who have not “paid their dues”. The interrelationship and equal importance of different aspects of the organisation’s mission and vision need to be emphasised and “buy-in” established with other parts of the organisation, but it has to be emphasised that building up capability in this area will involve new approaches and bringing in some fresh perspectives and new skill-sets. The Unit should not have a sense of superiority as part of its culture, but rather a sense of the importance of its work and of the opportunities to pursue broader organisational goals while furthering personal development.

4.6.1.3. The link can be established between an effective transfer pricing response and a more effective response by the organisation to more general tax issues and efforts can be made to have information and training sessions for officers in the organisation. This can reduce any impression that transfer pricing is a “black box” known only to members of the Transfer Pricing Unit (or, even more importantly, that the Unit and individual Unit officers want to keep it that way) and can emphasise natural linkages to the other work of the administration, such as thin capitalisation and treaty negotiation and administration.

4.6.1.4. Secondly, there is, on the other hand, a risk that employees from the tax administration will become overly enthusiastic about transfer pricing as a “panacea” – a solution to all problems -

and may accordingly propose unjustified or disproportionate tax adjustments leading to time consuming litigation and MAP. It is often stated that transfer pricing is not an exact science, and there is a broad range of possibilities to discuss and adjust tax returns. That inexact quality can be abused by authorities as well as by taxpayers. It is thus important to manage this process, and ensure that any proposed transfer pricing adjustment is justified on purely transfer pricing grounds; it is also important to show that the discretion implicit in such an inexact situation is properly exercised.

4.6.2. Competences/Skill Sets needed by the Unit – Putting Together the Best Team

4.6.2.1. Recognising the many aspects of transfer pricing and that the Unit will have educative and taxpayer service functions as well as an enforcement role, a transfer pricing Unit should ideally include, or have ready access to, the following skillsets:

- Team and Project Managers – people with demonstrated ability to put together new teams, whether or not they have specific transfer pricing expertise;
- Economists;
- Lawyers;
- Accountants;
- Auditors;
- Database-experts;
- Business Process experts (using IT to evaluate, automate, integrate, monitor and help improve business processes), and
- Those with special public relations and communication skills, including the ability to listen actively and effectively, solve problems, explain complex issues in terms that are readily understandable and act “diplomatically” with a view to longer-term productive relationships.

4.6.2.2. These various skillsets should be bound together by not just a technical knowledge and willingness to learn, but also a common identification with the Unit and wider administration’s objectives and ways of doing business. In addition, a deep understanding of what drives business and how it organizes itself to meet its own objectives needs to be developed.

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

4.6.2.4. At the initial stages, specific transfer pricing expertise may not be generally available in the country (or at least within the administration) and will in large part have to be developed. At a

later stage expertise from outside may be encouraged to join the tax administration by higher than usual salaries (although that can create resentments among other staff), the ability to work on the governmental side, perhaps with policy or legislative exposure and improved lifestyle (by creating a more balanced work environment for those with children, for example). Other countries may be willing to place one of their experts in your country as a component of Official Development Assistance or to sponsor a promising officer from your country in a placement within their administration.

- 4.6.2.5. A key challenge of working closely with taxpayers is that many of the best trained experts from the tax administration will eventually leave to join the private sector. As noted in more detail below, a system designed to capture and spread knowledge of transfer pricing issues within the Unit, which includes team involvement, effective management and regular review of cases, will help to minimise the effects of these departures, as will an effective system of recording and filing relevant transfer pricing opinions and material relating to particular cases. In any case, such interplay of “cultures” between the administration and the business sector over time can be useful for each of them to understand what drives the other and what the expectations are.
- 4.6.2.6. “Soft skills” are also important for the officers to perform their duties. Negotiation and communication skills are essential since transfer pricing demands a lot of interaction with MNEs. There is always a range of possible outcomes in transfer pricing and room for many discussions. Skills that help make these discussions as professional and effective as possible are an important component of a successful Transfer Pricing Unit.
- 4.6.2.7. Integrity issues may arise from the close contacts between business and the tax administration and the large amounts often at stake. This can be exacerbated by a trend of many tax officers engaged in transfer pricing issues later moving to the private sector,. The best way to deal with these issues is by having discussions with MNEs in teams, and ensuring that records are kept of those discussions. The records should be made available for checking internally to ensure that the proper policies and practices have been followed. This is to ensure that working arrangements are transparent, open and have built-in checks and balances that will reduce the risk of temptation on both sides. It is also important to recognise that officers should be given protection from false accusations against their integrity, which may reduce their willingness to approach each case fairly and impartially. The checks and balances should be designed to support good officers and the effectiveness of the Unit in this respect also. A way for officers to bring issues of integrity to management attention through secure channels that will act on such intelligence without punishing the “whistle blower” on integrity issues should also be considered.
- 4.6.2.8. Regular internal audits can form part of the necessary checks and balances, including reviews of quality, consistency and timeliness of decisions as well as, possibly, of individual officers (such as declarations of assets and interests and checks as to their accuracy). Although resources will no doubt be stretched, some form of double checking audits including rotation of fresh auditors into such roles is useful in this respect.

- 4.6.2.9. A system of review of important cases by a formal panel or informal reviews by a senior group is suggested as a way towards achieving coherence, adherence to administration rulings, integrity, sound technical standards and effective case management. This can also help to some extent, on-the-job training. This group should ideally comprise not just officers from the Unit, but also from other relevant areas. The group could include officers dealing with the type of business or industry (such as officers from the Large Taxpayer Office if it is separate), intelligence officers, officers from the Economists Unit (if that is not part of the TPU) tax treaty experts and those dealing with potentially related areas, such as thin capitalisation.
- 4.6.2.10. Transfer pricing knowledge and experience require both legal and economic expertise. It is not purely one or the other. Transfer pricing knowledge is about pricing, economic rationale, market knowledge and business and industry knowledge. But it is also important to understand international taxation and to understand the tax rationale underlying certain transactions.
- 4.6.2.11. There are sometimes questions as to whether a group with a specific professional specialism, such as economists, should be distributed within other teams or should comprise, at least in start-up mode, a separate unit. Some of the same issues arise as in structuring the Transfer Pricing Unit as a whole. The advantages of distributing the economic expertise more broadly are that economic issues are most clearly treated as just one aspect of transfer pricing issues, economic approaches are spread more broadly within the administration and economic perspectives are more easily integrated into the work of multidisciplinary teams.
- 4.6.2.12. The advantage of a separate economist unit (for example) is that greater “quality control” can be exerted, especially in the start-up phase, over the consistency of economic analyses and that the economists in a new area can discuss issues and learn from each other more easily. As with any specialist skill, having economists working in groups at the start-up phase may also be seen as promoting integrity. Here too, whichever approach is adopted, efforts will need to be put in place to ensure sufficient linkages between economists and their fellow economists as well as other officials that will be part of multi-disciplinary transfer pricing teams.

4.6.3. Training

- 4.6.3.1. In some countries the educational system provides a good supply of accountants, auditors, economists and lawyers from which the tax administration can draw. In other countries the situation is more difficult because of educational issues or more competition from the private sector. This will affect the type of training required and it is of the utmost importance to assess the existing knowledge, capabilities and competences in these areas.
- 4.6.3.2. In developing what might be called a “learning curve” for the Unit and its individual officers, it is recommended to first develop an assessment of the existing capabilities. This cannot be done without a context, and that context must be the short, medium and longer term objectives of the Unit, so it is essentially a “gap assessment” of what is needed to be done to achieve the objectives at various stages of the life of the Unit and under various scenarios.

- 4.6.3.3. This assessment will be followed by setting up a training programme. For a start it is good to first have a group of experts with accountancy and legal backgrounds, The pioneer group to be trained should consist of senior tax officials from the administration (and preferably also from the policy making area). They are the pioneers and “champions” who should instil awareness in their colleagues of the importance of a transfer pricing capability. They will organise lectures and in-house seminars to train the officials who will become the next group of experts and increase their skills and knowledge.
- 4.6.3.4. Specialist courses will be an important aspect of the training programme. As transfer pricing is a highly specialised expertise, in-country training from international experts and perhaps some training of experts overseas will be needed, with a programme to ensure they spread their new learning more broadly on return (such as adopting a “train the trainer approach”). As with any training, it needs to be demand driven, to respond to the needs of the transfer pricing unit, and to ensure commitment. Demand driven training also requires that those driving the demand are aware of the options and opportunities for improving performance through training. Training on the job will be critical also. There may be assistance for this, provided by international development agencies, regional tax administration groupings, international organisations and training institutions; this is dealt with in Appendix III to this Manual.
- 4.6.3.5. The next step is to extend this transfer pricing knowledge and expertise to the rest of the organization. A possible model is to train several employees in each region with the right skills and make them responsible for further training as well as operational activities. They can be given a high level of authority. However, the disadvantage is that other tax officials may resent this group, especially if they are given special pay or other conditions as sometimes happens. In this initial period it is expected that only a few cases will be dealt with. Nonetheless transfer pricing experience is being developed. These specialists should meet with the policy makers to share the latest developments. The policy makers will see what the major issues are and have early warning of issues on the horizon that may need policy responses.
- 4.6.3.6. In the meantime the same approach can be adopted to train the next generation of specialists. The ultimate aim is that finally all corporate income tax specialists are able to handle at least some aspects of transfer pricing cases. Before that is achieved, as wide as possible a group of those dealing with MNEs need to be able to identify cases where there is a transfer pricing issue, for further consideration by specialist transfer pricing experts. Even though they may not know all the answers, they will be able to identify issues and will know where to go to find the answers.
- 4.6.3.7. Training should not be merely on transfer pricing issues of course, as training in management, negotiation and inter-personal/ relationship building skills will also be very important. So too will be knowledge management, project planning, database and other IT skills. Ethics training may be helpful so that unintended mistakes are not made, even if ultimately good ethics cannot be taught.

4.6.4. Research Materials/ Databases

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

- Company Annual Reports;
- Auditor's reports;
- Profit and Loss Accounts;
- Notes to the Accounts;
- Balance Sheets;
- Materials indicating the nature of related party transactions;
- Materials indicating the nature of the business; and
- Materials indicating profit margins.

4.6.4.2. Private databases tend to be expensive, although sometimes an introductory price can be negotiated that is much lower than the usual pricing. One caution is that the public data is not available for many developing countries, and the relevance of databases based on other markets and environments has to be carefully considered – adjusting the data to make it relevant to your cases may itself be very resource intensive. That issue is addressed in more detail in Chapter 5 on Comparability.

4.6.4.3. Transfer Pricing resources tend to be expensive, and there should be a budget for such materials in seeking donor assistance for setting up a transfer pricing regime.

4.6.5. Information Strategies

4.6.5.1. The Unit will need to have access to the necessary hardware and software to enable them to deal with the complexity and volume of transfer pricing-related information, with necessary security for often very commercially sensitive taxpayer information.

4.6.5.2. An issue relating to “knowledge retention” is that of information strategies. Taxpayer files need to be held securely but centrally, so that it is clear what has been requested of taxpayers and when, as well as what has been received and when. It should also be clear when materials have been accessed and by whom among the authorised persons. It is important that documents are not lost or destroyed and that the large volume of paperwork that is a characteristic of transfer pricing cases is not overwhelming, but is securely held. The possibility of litigation on transfer pricing issues must always be borne in mind, even though it should be seen by both sides as very much a last resort.

4.6.5.3. Some countries require material to be provided in electronic form, and others require or encourage an index system for the documents provided and a description of the record-keeping system used. If such information is electronically searchable then, subject to the availability of the necessary software and skills, there are potentially great resource savings in dealing with potentially very large files. The cost to taxpayers of providing material in certain forms should always be considered in deciding what should be required under relevant legislation or regulations

4.7. Effective and Efficient Business Processes

4.7.1. Streamlining and simplification of procedures is part of tax administration reform to reduce compliance costs for taxpayers as well as collection costs for administrations. Any such processes being considered in a country should be internalised as part of setting up any transfer pricing capability. This is especially the case because overcomplicated procedures can lead to more informal processes, short-cuts or discretions being used with no legal basis and/ or inconsistently between taxpayers. They thus create a severe risk to the integrity of the system as well as increasing compliance and collection costs.

4.7.2. A useful approach is to consider the approaches of other administrations in similar circumstances, especially in your region, and to follow them unless there is a clear and transparent reason why they are not regarded as appropriate, after a close examination of the options and the engagement of stakeholders. This will reduce compliance costs for taxpayers and contribute to a positive investment climate without impacting on your ability to deal with enforcement issues. In fact it should enhance that ability, as you can draw upon the practice of your fellow administrations and probably deal with those administrations more effectively because of common starting points.

4.7.3. There may be discretion in the legislation or regulations of the transfer pricing regime in any case – they represent a trade-off between a flexible system that takes account of particular circumstances on the one hand, and the risk that discretion will be exercised inconsistently across similar cases on the other (thus favouring one taxpayer over another) and that there may be integrity issues in their exercise. Clear guidance for their exercise will be needed in any case.

4.7.4. Owing to the amounts at stake in many transfer pricing cases, and perhaps the fact that governmental transfer pricing experts often eventually leave for the private sector, strong checks and balances are required when decisions are made affecting taxpayer liabilities to tax. On the reverse side, it needs to be clear that the Unit is not anti-business, but recognises the way business inherently operates, the need to follow the law, and the need to recognise the duty to provide service to taxpayers, and exercise strong enforcement approaches only where warranted and on a fair basis.

4.8. Application of the above in implementing a Transfer Pricing Unit and enhancing capability

4.8.1. Initial Phase and Evolution over Time. Drawing upon the factors discussed above, the start-up phase of transfer pricing operations requires:

4.8.1.1. A critical look at the availability of human resources within the tax administration. Prioritisation is essential and choices have to be made concerning the attention to be given to different kinds of taxes. Policy on transfer pricing without sufficient resources in the tax administration will not achieve its objective;

4.8.1.2. Definition of the country's industrial characteristics. It will be useful to look for statistics on trading volumes and other indicators for cross border transactions. In a start-up phase many countries focus on their main industries (such as mining, pharmaceuticals, telecommunications, breweries, autos), and usually on the larger players in the industry in particular;

4.8.1.3. Good, professional relations with business. Acceptance and understanding of the policy will reduce compliance and collection costs. Meetings with all stakeholders will help in effectively building transfer pricing policy and capability. This also means less non-compliance is likely to be due to honest misunderstandings of the regime's requirements, and that there is more current intelligence on existing and emerging issues. This allows more focussed and efficient guidance and enforcement action;

4.8.1.4. Understanding of what other countries have done at a similar stage and also what they are doing now and where that represents an evolution. This can include:

- Representatives from other countries with a history of transfer pricing can be invited to give input and share their experiences.
- Reciprocal placements with countries that offer useful experience and who are willing to assist can be an excellent way to learn. It will be necessary to first prepare a clear plan of what knowledge is being sought, and why the other country willing to host a visit is the right country to learn from, its expected impact and flow-on effects.
- Seeking support from donors to arrange visits to such countries, with rigorous and strategic selection of participants, a strong work programme and an obligation to report on the outcomes and lessons learned. All this will help to ensure that it is not perceived, including by the other country or potential donors, as a mere "holiday" for participants. This can have important additional benefits in personnel management as those who are most open to learning new things and are judged likely to stay with the organisation for some time and take transfer pricing technical or managerial leadership roles may be offered such exposure.;

4.8.1.5. An ability to define, with policy makers and administrators involved in the process, the important areas of focus bearing in mind:

- The main characteristics of the country's industries, e.g. manufacturers or distribution activities;
- The main kinds of cases contained in the workload of the tax administration;
- The main types of activities to start with in developing policies, recognising the need for policy to be soundly based in reality; and

- Practical case studies that can provide input for policymaking and a focus for discussing administration issues.

4.8.2. After starting the transfer pricing Unit, areas of focus will evolve depending on factors including the stage of development of the transfer pricing policy and the administration. In the first years it is often considered helpful to focus on less complicated activities like contract manufacturing, intra group services, etc. When a higher level of experience is reached, the focus will often shift to more complicated areas like intangibles and business restructurings. The same journey has been undertaken by developed countries. The more complicated topics can be placed on the agenda after developing expertise with transfer pricing. That is not to say that particularly blatant examples of mis-pricing in these areas should not be addressed at an early stage.

4.8.3. It may be appropriate for a tax administration to set up a specific Transfer Pricing Unit that is *only* responsible for transfer pricing issues of MNEs. In such cases, the Transfer Pricing Unit has an advisory role and day-to-day work connected with the tax assessment of MNEs is done by other tax inspectors at this stage. This also helps ensure integrity in dealings with the MNEs; it is important, however, to define the relationship with other regular tax inspectors.

4.8.3.1. In such cases, it might be it is worthwhile to start simply with, for example, a Unit with one head and 4 – 5 staff. These staff should be trained in transfer pricing knowledge and skills. When there is a separate Transfer Pricing Unit,

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

4.8.3.3. The next stage in this process is to create an MNE unit, if it does not already exist. Tax treatment of MNEs requires a different approach and different knowledge compared to other taxpayers. Their tax assessment of MNEs is complicated because of the number of international tax issues that require specific knowledge. MNEs are run by highly trained and educated professionals. This calls for well trained professional counterparts on the side of the tax administration, and this is where you will put some of your best people. At this stage, the initial Transfer Pricing Unit can be integrated with the MNE unit because transfer pricing is a major part of the tax issues of an MNE. More staff will need to be trained on transfer pricing after the first stage.

4.8.4. Assessing Effectiveness and Fine Tuning

4.8.4.1. It is appropriate to set up a system of monitoring based on a performance measurement framework that establishes performance indicators and key outputs. While it is important not to overload staff, who will undoubtedly be much stretched for time and resources, possible areas of monitoring (some by raw data, some by questionnaires and interviews) include:

- a) The time schedules involved in transfer pricing disputes;
- b) Yield from risk based audits and the percentage of yielding audits;
- b) Adjustments in tax assessment;

- c) Ability to respond quickly to emerging issues – including measurable deterrent effects on taxpayer behaviour;
- c) The number of mutual agreement procedures;
- d) Effectiveness of education campaigns and ongoing contact with business groups and their advisers, as well as evidence such as increasing traffic to the website;
- e) Percentage of correspondence and telephone calls dealt with according to set customer service standards;
- f) Total administration costs of the Unit as a percentage of gross collection;
- g) Improvements made to process, as well as legislative improvements that have arisen out of the areas of work;
- h) Training undertaken and given, and the measurable impact; and
- i) Evidence of sharing best practice with other Government departments and other tax authorities as part of a continuous improvement strategy.

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

4.9. Country examples of capacity building in transfer pricing

4.9.1. Japan started its transfer pricing administration with quite a small sized unit in the late 1980s. Once the NTA identified the rapidly increasing needs for transfer pricing management, it: (1) expanded a nation-wide training course for international taxation step-by-step, now reaching 100 trainees every year; and (2) reorganized and gradually expanded the national and regional examination division. Currently the headquarters has transfer pricing sections and the MAP office, while the four major regional bureaus have special divisions for transfer pricing (including 2 special divisions specializing in APAs). Although some essential documentation concerning transfer pricing is required by statute to be translated into Japanese the TP specialists are generally equipped with sufficient language skills to conduct examinations on the original accounting books, documents, etc. in English.

4.9.2. In India capacity building has taken place mainly through on the job training. The Directorate of Transfer Pricing has expanded with the number of cases being referred for audit increasing every year since 2004, when the Directorate was set up. The National Academy of Direct Taxes, the apex body responsible for training, has been conducting specialized training for officers. The Government has also been sending officers for training and seminars abroad. The Directorate has organized seminars and conferences for experience sharing by officers engaged in audit and for capacity building of officers who join the Directorate for the first time.

4.9.3. In Malaysia, the Inland Revenue Board Malaysia (IRBM) responded to the rise in issues pertaining to cross-border related party transactions in audit and investigation cases by setting up the transfer pricing audit unit, known as the Special Audit Unit, on 1st August 2003.

- 4.9.3. 1. The unit began operations with five officers based in the IRBM headquarters, reporting to the Director of Compliance Department. Throughout 2004 to 2009 IRBM also had two auditors based in each of the Penang and Johor state office to deal with TP cases with the assistance of the Special Audit Unit. By 2007, transfer pricing cases became increasingly challenging and the Special Audit Unit grew to 12; however, it was found that TP issues were still being taken up by other branches resulting in lack of uniformity in the methods used to settle cases. IRBM then decided that transfer pricing audit activity needed to be centralised in order to increase officers' expertise as well as ensure a standardised approach.
- 4.9.3.2. The Multinational Tax Department came into existence with the introduction of Transfer Pricing regulations under Section 140A and Section 138C of the Income Tax Act 1967 which came into effect 1st January 2009. In 2008, efforts towards centralising TP activities was put forward and eventually came into force 1st March 2009 when the unit became separated from the Compliance Department into a full department of its own. The Multinational Tax Department, headed by a senior director, now reports directly to the Deputy Director General of Compliance. The department is still relatively small, as the intention behind the setup is to build expertise in a small group who will later be dispersed to provide assistance and knowledge to other branches within IRBM. In general the Department has four divisions, with individual division directors:
- Policy Division (1 auditor), responsible for matters pertaining to TP regulations and procedures
 - Multinational Audit Division (8 auditors), which conducts TP audit visits
 - Compliance Audit Division (4 auditors), which monitors TP compliance of cases previously audited, and
 - Advance Pricing Arrangement Division (1 auditor) which the application and processing of APA including Bilateral and Multilateral APA.
- 4.9.3.3. Auditors were sent to various training events both in and outside of Malaysia from the initial set up of the Special Audit Unit. The Department continues to send auditors to various courses to increase knowledge and expertise in TP issues, as well have the opportunity to share their own knowledge within the TP community.