

*Agenda Item 4*

*Working Draft*

**Chapter 4**

**Establishing Transfer Pricing Capability in Developing Countries**

*[This paper is based on a paper prepared by Members of the UN Tax Committee's Subcommittee on Practical Transfer Pricing Issues, but includes Secretariat drafting and suggestions not yet considered by them – the Secretariat takes responsibility for any relevant errors and omissions.]*

*[Note that there is currently some overlap between the introductory parts of many Chapters – Secretariat*

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

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

**i) Cooperation**

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

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

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

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

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

a) The tax authority by:

- Extensive and clear taxpayers' education;
- Making available to taxpayers tax guidance notes, information circulars and other literature on interpretation of tax laws to avoid misunderstandings and surprises among those willing to meet their

- Advance rulings on tax issues.

b) The taxpayers by:

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

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

- Secondment of tax administrators to the section

#### D. Setting up Policy Capacity

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

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

16. The tax systems of countries are at varying stages of addressing transfer pricing, and their governments maintain different policies and regulations toward companies

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- the tax administration that is responsible for the tax assessment and collection;
- the centralised policy makers;
- the Competent Authority for settling disputes under the MAP (that is, the official formally given this role).

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

25. In the start up phase, a clear centralised coordination is necessary. At this stage it is important that the policy makers have a clear view on the transfer pricing issues and their possible solutions. It is impossible to bring the tax administration at once to a high level of knowledge, especially across a large spread of, for example, industries. Centralisation gives a good overview of existing capabilities and needs for training. An expert group should be trained in the beginning. It is good to look for enthusiastic employees both from the Finance Ministry and the tax administration.

26. From experience there are two rTc0.5(n)10751 Tf2.mTT21Tf.22850TD.0001Tc[(adm)7.1.001T82.24

29. The pioneer group to be trained should consist of senior policy makers and senior tax officials. They are the pioneers and “champions” who should instil awareness in their colleagues on the importance of transfer pricing. This same group is responsible for setting up the policies in corporation with the business. They will organise lectures and in house seminars to train the officials who will become the next group of experts



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ii) **Model for Organisation**

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

§ Centralized, with one Transfer Pricing Part Area

*Advantage:* coordination, easy in start up phase, fast building up of knowledge

*Disadvantage:* risk of being in an "ivory tower" – out of touch with reality



assessment of MNEs to the other tax inspectors. This also helps ensure integrity in dealings with the MNEs.

44. The next stage is to

left. It also enhances consistency and helps highlight any difficulties with the policy or administration of transfer pricing..

- ii) To avoid loss of information and knowledge it is recommended that tax officials work together on a case and never alone. This has a positive side effect on integrity as well. It