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Submission File

22 February 2017

**World Bank Group and
Organisation for Economic
Co-operation and Development**

BY E-MAIL: GlobalTaxPlatform@worldbank.org

Dear Sir/Madam

COMMENTS ON THE DRAFT TOOLKIT FOR ACCESSING COMPARABLES DATA

1. We herewith present our comments on behalf of the South African Institute of Chartered Accounts (SAICA) Transfer Pricing Subcommittee (a subcommittee of the SAICA National Tax Committee) on the Draft Discussions on the Toolkit addressing difficulties in accessing comparable data for Transfer Pricing Analyses (Toolkit).
2. Our submissions attached in Annexure A, include comments on the questions specifically raised during the release of the Toolkit, as well as further input to simplify and clarify the Toolkit.
3. Given the various referrals to the Toolkit in the Discussion Draft addressing the Information Gaps on Prices of Minerals Sold in an Intermediate Form (Information Gaps), we have also included a short submission in this regard.
4. We have deliberately tried to keep the discussion of our submissions as concise as possible, which does mean that you might require further clarification. Should you require any further clarification on any of the matters raised please do not hesitate to contact us.

Yours sincerely

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CHAIRMAN
SAICA Transfer pricing subcommittee

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South African Institute of Chartered Accountants



ANNEXURE A

INTRODUCTION

1. The report is well written and provides a number of useful options for developing countries to address the lack of comparables, both from a revenue authority as well as taxpayer perspective.
2. Particularly useful are the examples and case studies provided, as well as the supporting information set out in the appendices.
3. The Toolkit was prepared by the Platform for Collaboration on Tax including the International Monetary Fund (IMF), Organisation for Economic Co-operation and Development (OECD), United Nations (UN) and World Bank Group (WBG) to assist developing countries applying local transfer pricing rules following the OECD Transfer Pricing Guidelines or the UN Transfer Pricing Manual, to overcome or at least mitigate problems arising from the lack of suitable local comparables.

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| 4. <u>Submission</u> : To avoid any misconception, it should be clarified that the OECD Transfer Pricing Guidelines, and the UN Transfer Pricing Manual must still be adhered to. |
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SPECIFIC COMMENTS TO QUESTIONS

- A. *Does this toolkit effectively help address the challenges identified by developing countries in finding the data needed to carry out a transfer pricing analysis as part of a tax audit?***

5. Generally, the toolkit seems comprehensive and helpful in addressing challenges faced by developing countries relating to the limitation or lack of comparable data for conducting benchmarking database searches.
6. Many revenue authorities in developing countries are still in the process of building transfer pricing capacity, and the majority of approaches set out in the toolkit requires significant theoretical and practical transfer pricing experience.
7. In addition, in order to ensure that taxpayers are able to comply with specific requirements and/or approaches to be followed where there is a lack of suitable comparables in respect of a specific developing country, taxpayers need to be provided with consistent clear guidance regarding the approach or approaches they need to follow.

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| 8. <u>Submission</u> : While the tool is very useful, it may not achieve the desired effect while revenue authorities do not have the man power and/or skill to implement it, |
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and until certain and clear guidance regarding what is required from a taxpayer in terms of comparables data has been made available.

9. The Toolkit does not specifically address approaches for benchmarking financial transaction such as loans and credit guarantees.
10. In practice, multinational groups often finance part of their operations in developing countries via intra-group financing arrangements. This could be between a developed country and a developing country, or between group companies in two different developing countries.
11. In the absence of safe harbour rules, some countries require that the interest rate applied in respect of a loan should be benchmarked, while other countries require that both the interest rate in respect of a loan, as well as the amount borrowed from a related party must be arm's length.
12. Currently, developing countries often rely on comparables from similar geographical markets based on information from databases that can only provide limited financial data.
13. Developing countries often have foreign exchange control rules in place, which impact the free outflow of capital. This may result in differences between on-shore and off-shore lending rates and guidance regarding the treatment of such differences would be helpful.

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| 14. <u>Submission</u> : More detailed guidance in respect of financial transactions should be included in the Toolkit. |
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B. *How can better use of administrative information, in a way that maintains taxpayer confidentiality, be effectively facilitated at a country and regional level?*

15. One way to maintain confidentiality of taxpayer information could be to only rely on comparable companies which publish financial information in any case.
16. However, as generally, only public companies and their subsidiaries are required to publish financial information, this approach may not be suitable as independent companies are often removed during a database search.

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| 17. <u>Submission</u> : Taxpayer information could be used to set and continuously test safe harbour rules. However, secret comparables should only be used in a transparent way, and authorities should be cautioned regarding the use thereof. |
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C. *How could the reliability of potential comparables from other geographic markets be tested?*



18. It may be challenging to test the reliability of comparables from other geographic markets depending on the location of the tested party and the type of transaction under review.
19. One possible solution could be a comparison of the performance of a local company (financial information would be available to the local revenue authority) with financial performance of a set of representative samples from the other geographic market.
20. For example, the results achieved by a company operating in a Sub-Saharan African country, could be compared to comparable East European companies with a functionally similar profile on the basis that political and economic circumstances in the East European and Sub-Saharan region are similar. In the example, information from a global database could be reviewed and filters applied to ensure comparability, for example based on industry classification, independence and revenue.
21. If a review of the potentially representative samples in the database, say at least 5 or 6 positive validations, reveals that the financial performance of the local company (tested party) is within the range of the East European comparables, then this would suggest that the comparables from the other geographical regions are reliable. Of course one would need to consider any adjustments, for example for foreign exchange differences.

22. <u>Submission:</u> It is recommended that revenue authorities should inform taxpayers which databases they regard acceptable and if specific search filters should be applied.
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D. Are there best practices or other reliable approaches for dealing with a lack of comparables not addressed in the discussion draft?

23. <u>Submission:</u> Instead of focusing on local or regional comparables, a different but useful approach could be to focus on regional comparables from a (different) region where the economic environment is comparable to the country/region where the tested party is based. For example, Eastern European comparables could be used to support a tested party in South Africa.

E. What other adjustments for geographic market differences could be made, and in what circumstances? How could the reliability of such adjustments be empirically tested?

24. Making adjustments often requires experience and judgment and this may result in subjective outcomes.



25. Submission: Generally, adjustments should be avoided to not overcomplicate matters, particularly if a developing country has not published sufficient reliable guidance.

F. Do the mineral pricing case studies accurately reflect market trading terms? Are there other adjustments that would be routinely made when these mineral products are sold?

26. The mineral pricing case studies generally reflect market trading terms and they are useful to revenue authorities and taxpayers. However, it should also be considered that multinational entities may reflect different contracts or processes.

27. Submission: It should be clarified that the Toolkit is not a complete guide.

ADDITIONAL COMMENTS

G. Part I: Introduction

28. The Toolkit, on page 6 states that “*in many instances, transfer pricing rules operate to consider whether a transaction has occurred at all, or has occurred in a way that is substantively different from that which is described in contracts or documentation*”.
29. This seems to stress that it should be considered whether a transaction needs to be re-characterised.

30. Submission: It is submitted that it should be made clear in the Toolkit that re-characterisation is a methodology that should only be applied in extreme circumstances.

H. Formulary apportionment

31. The Unitary Taxation/Formulary apportionment approach is briefly discussed on page 6.
32. It is stated in the Toolkit that formulary apportionment approaches are specifically excluded from the discussion in the Toolkit because “*they are unlikely to be implemented at global level in the foreseeable future*”.
33. However, the document then refers to the re-launch of the common consolidated corporate tax base (CCCTB) initiative in Europe, which incorporates “*an apportionment formula for the purposes of allocating taxing of rights between member states*”.



34. As the Unitary Taxation/Formulary apportionment approach still keeps coming up as an alternative method to applying the arm's length principle, the reference in the Toolkit may be confusing and send an incorrect message.

35. Submission: The reference to formulary apportionment should be removed as the purpose of the Toolkit is to provide alternative options where suitable local comparable data is not available, i.e. specifically where the arm's length principle is followed.

I. Part II: Issues arising when conducting a comparability analysis

I.1. Expanding existing commercial databases:

36. While expanding commercial databases to include more companies in developing countries is important, this would be a long term process.
37. In addition, many independent private companies in developing countries, which may be suitable comparables for transfer pricing benchmarking purposes, operate at a different scale when compared to the members of multinational entities that are subject to transfer pricing rules.
38. Therefore, even if financial information in respect of these companies is included in commercial databases, not many may pass qualitative or quantitative filters during the database search process and therefore not be helpful.

39. Submission: Comparables from different geographical regions are useful and the importance thereof and guidance on how developing countries should use this information, is important and should be emphasised.

I.2 Relevance of the geographic market:

40. The Toolkit addresses on pages 27 and 28 considerations in respect of the use of foreign comparables where sufficient suitable local comparables are not available.
41. The Toolkit suggests that "in some cases, the geographic market may be less relevant than other characteristics, meaning that the most reliable comparables available are those from a foreign market".
42. It is pointed out that while some developing jurisdictions, e.g. in Africa, apply a process in practice whereby the focus is on comparable functions, assets and risks as opposed to a focus on geographic proximity of comparables, other developing countries such as China appear to prefer a focus on regional geographic market.

43. Submission: Guidance for a coordinated approach regarding the selection of comparables would be helpful.



I.3 Access to commercial databases:

44. The suggestions set out in the Toolkit on page 24 are useful and could assist revenue authorities with obtaining access to the relevant commercial databases. Existing efforts to bring down costs and to broaden the number of options should be supported.

45. Submission: It should be stated in the document that revenue authorities should first review and consider benchmarking studies provided by taxpayers before performing their own benchmarking study, unless the taxpayer's documentation reflects significant shortcomings. This would simplify the process of a transfer pricing review.

I.4 Other sources of information:

46. The use of secret comparables are addressed on pages 31 and 32. Different countries apply different approaches regarding the use of secret comparables.

47. The UN Practical Manual on Transfer Pricing and the OECD Transfer Pricing Guidelines caution against the use of secret comparables, i.e. the use of information collected by tax administrations through tax filings or at customs for transfer pricing comparability purposes, "unless requisite information can be disclosed to the taxpayers within the limits of domestic confidentiality rules".

48. However, in practice, it is very difficult for revenue authorities to draw a clear line, and that the use of secret comparables by revenue authorities as a risk assessment tool often evolves into their use in supporting specific adjustments.

49. Submission: It is also submitted that the use of secret comparables makes resolving double tax cases more difficult under Mutual Agreement Procedure, and it is submitted that clarifying this in the Toolkit would be useful.

50. The Toolkit should make it clear that secret comparables should not be used by revenue authorities, even if suitable comparable data is not available, unless they are used to establish/confirm a safe harbour rule.

I.5 Working capital adjustments:

51. Submission: The guidance relating to working capital adjustments is in line with the guidance set out in the OECD Transfer Pricing Guidelines and is helpful.

I.6 Adjustments other than working capital adjustments:

52. While the guidance provided in respect of comparability adjustments other than working capital adjustments (pages 34 to 45) is useful, the different options of



adjustments and the methodologies available for making these adjustments may lead to uncertainty for taxpayers and revenue authorities alike.

53. This is specifically the case where broad experience and skills are limited within the relevant revenue authority. Also, the making of adjustments often requires judgment, which may lead to subjective results.

54. <u>Submission:</u> Adjustments should be avoided, or at least clear guidance should be provided by revenue authorities.

J. Part III: Approaches to applying internationally accepted principles in the absence of comparables

J.1 Negotiated settlements:

55. On page 52 of the Toolkit it is mentioned that one of the approaches to mitigate the issue of a lack of suitable comparables, particularly where a transfer pricing dispute has arisen, is through negotiated settlements between tax authorities and taxpayers.

56. While this is an approach often observed in developing countries, this may create several other issues.

57. <u>Submission:</u> To ensure consistency and to avoid double taxation, negotiations should be carried on in terms of a Mutual Agreement Procedure or a bilateral Advance Pricing Agreement, or any similar procedure, between a taxpayer and its domestic tax authority.
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58. It could be useful to include best practice guidance in the Toolkit regarding conducting negotiated settlements.
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J.2 Testing the benefits received:

59. On page 53 of the Toolkit, reference is made to a benefits test for intangibles. While the concept of a “benefit requirement” is not new in respect of services transactions, this may lead to confusion when considering the arm’s length nature of a royalty transaction.

60. In practice it is often difficult to determine the benefits in terms of a related party cross-border services transaction, and it could be even more difficult where the use of intangible property is concerned.

61. <u>Submission:</u> The concept of a “benefits test” for intangibles transactions to confirm arm’s length nature of any transaction is not useful as it complicates things, while not alleviating the lack of comparables in developing countries.



J.3 Safe harbours:

- 62. The Toolkit, on page 54, sets out the benefits of using safe harbour rules and it also sets out certain shortcomings and issues.
- 63. Safe harbour rules may constitute a simple method to address the lack of suitable local comparables, but there are certain limitations such as that unilateral application of a safe harbour may result in double taxation, and also that safe harbours often mean a deviation from the arm's length principle.
- 64. Regular review and update of the safe harbour rule would be important.
- 65. Submission: It should be clarified that the seeming recommendation for the use of safe harbours must be distinguished from using rules of thumb as set out in paragraph 2.9A of the OECD Transfer Pricing Guidelines.
- 66. Thus, it should be clarified that any safe harbour rules should be based on comparables, i.e. while simplifying the process, there would still be a reliance on comparables, to be determined by the relevant revenue authority.
- 67. The process of deriving the safe harbour rate should be transparent.

J.4 Transactional profit split method:

- 68. It is stated on page 61 of the Toolkit that “*valuable contributions most frequently derive from the utilisation of valuable scarce contributions, including those from intangibles and from the assumption (including the control and management) of the key business risks.*”
- 69. The term “*valuable scarce contributions*” appears to be new and not generally known.
- 70. Submission: It would be useful to clarify the meaning, e.g. by giving an example, to avoid confusion.
- 71. In addition, applying the profit split method still requires the use of comparables. It would appear that this method is not suitable where comparables are in fact not available.

J.5 Royalty caps and other anti-avoidance measures:

- 72. On page 63 of the Toolkit there is the introduction of a royalty cap, i.e. a top limitation of the royalty deductions that may be claimed by the licensee. This approach may lead to double taxation unless the relevant other Treaty Country applies the same rules. \



73. Furthermore, using a royalty cap approach could mean the end of the Transactional Net Margin Method (TNMM) based residual royalty approaches.
74. It is pointed out that some developing countries have exchange control restrictions in place which may lead to a similar result as royalty caps. However, there have been cases where exchange control authorities would consider a higher royalty deduction in a developing country on the basis of a transfer pricing study that suggests a higher royalty rate than the one set by that country.

75. Submission: It is submitted that a royalty cap together with the other anti-avoidance and tax base protection measures set out on pages 63 and 64, would not offer a solution to the lack of suitable comparables that a developing country may face, but rather an anti-avoidance mechanism.

K. Part IV: Summary, conclusions, and recommendations for further work

76. This section provides a useful brief summary of the Toolkit. The recommendations for further work seem appropriate.

CASE STUDIES

77. The case studies provided are useful and are welcomed.

78. Submission: It is suggested that more case studies dealing with specific issues experienced in developing countries should be included, e.g. management services provided to a multinational group entity in a developing country or regional distributor/limited risk distributor.

APPENDICES

79. The information contained in the appendices supports the information in the main parts of the Toolkit and appears to be very useful. Some specific comments relating to the appendices information is set out below.

L. Appendix 1 (functional and risk analysis):

80. The questionnaire provided in this appendix is very detailed and seems to aim to address a wide variety of scenarios.

81. Submission: We suggest that it should be clarified that revenue authorities should gain an understanding of the taxpayer's business from the transfer pricing documentation provided first, before embarking on a potentially lengthy exercise to gather the information as set out in this functional and risk analysis.



M. Appendix 20 (Safe harbours)

82. The OECD safe harbour for services in the table is reflected as 2% to 5%.
83. However, based on the 2005 OECD BEPS Actions 8 to 10 Report, the level is 5% (para 7.61).

84. <u>Submission</u> : We recommend that the percentage be corrected.
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DISCUSSION DRAFT

N. Addressing the information gaps on prices of minerals sold in an intermediate form

85. <u>Submission</u> : it should be clarified that the Toolkit is not a complete guide and multinational entities may reflect different contracts or processes other than those set out in the mineral studies.
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86. <u>Submission</u> : In addition, it would be useful if the case studies would, in addition to addressing extraction and refining phases, also include a discussion of other phases in the value chain such as exploration, marketing, logistics and restitution.
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87. The case studies included in the document refer to the application of the comparable uncontrolled prices (CUP) method for benchmarking purposes.

88. While this is often the most suitable methodology, there may be circumstances where suitable CUP method may not be available.

89. <u>Submission</u> : It would be useful if this could be clarified in the document and guidance/examples should be provided.
