

To The Platform for Collaboration on Tax

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Ref Comments on a draft toolkit designed to help developing countries address the lack of comparables for transfer pricing analyses

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KPMG International (“KPMG”) is pleased to provide comments on a report released by the Organisation for Economic Co-operation and Development (OECD) consisting of a *draft toolkit designed to help developing countries address the lack of comparables for transfer pricing analyses* (the Toolkit). The Platform for Collaboration on Tax (PCT) comprising the Organisation for Economic Co-operation and Development (OECD), the International Monetary Fund (IMF), the United Nations (UN) and the World Bank Group, developed this draft Toolkit in response to a request by the Development Working Group of the G20. The Platform Partners seek public comment on the draft Toolkit including the supplementary material on minerals pricing by 21 February 2017.

## **CONTENTS OF THIS RESPONSE DOCUMENT**

This response document is structured as follows:

### **A General**

This section of this response document includes general comments and suggestions.

### **B COMMENTS IN RESPECT OF THE SPECIFIC QUESTIONS RAISED**

Responses to the specific questions where KPMG believes it has relevant experience in respect of the Toolkit are set out in this section.

### **C ADDITIONAL COMMENTS**

This section contains specific comments to the various items discussed in Parts I to IV of the report as well as comments in respect of the case studies included and the appendices.

### **D DISCUSSION DRAFT ADDRESSING THE INFORMATION GAPS IN PRICES OF MINERALS SOLD IN AN INTERMEDIATE FORM**

Comments on the Discussion Draft are set out in this section.

## **E CONCLUDING REMARKS**

This section sets out concluding remarks.

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### **A GENERAL**

The report is well written and the Toolkit appears to be useful for developing countries, both revenue authorities as well as taxpayers. Particularly useful are the examples and case studies provided as well as the supporting information set out in the appendices.

However, while it is understood that the Toolkit is designed to merely provide different options on a high level for revenue authorities and taxpayers regarding how to address the lack of (suitable) local or regional comparables, it is submitted that in order for the suggested approaches to be effective, specific and detailed recommendations should be made regarding which approach should be followed in what case, e.g., if no local comparables are available, regional comparables should be used. If regional comparables are not available, foreign comparables from other markets should be used. Thereafter, recommendations in respect of adjustments, safe harbours etc could be applied.

The Toolkit was designed, in collaboration by the IMF, the OECD, the World Bank and the UN, 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. Therefore, and to avoid any misconception, it should be clarified that when applying the Toolkit, revenue authorities must also continue to follow the OECD Transfer Pricing Guidelines and the UN Transfer Pricing Manual.

### **B COMMENTS IN RESPECT OF SPECIFIC QUESTIONS**

We set out below comments in respect of the specific questions to the Toolkit as raised by the PCT:

- 1. 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?***

#### *General*

KPMG is of the view that the toolkit seems comprehensive and helpful for addressing challenges faced by developing countries relating to the limitation or lack of comparable data for conducting benchmarking database searches. The approaches set out give a broad range of options to revenue authorities to choose from when checking benchmarking searches provided by taxpayers to support cross-border controlled transactions entered into.

However, a major concern is that 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 experience on the side of the authorities.

In addition, in order to ensure that taxpayers are able to comply with any specific local requirements and/or approaches to be followed where there is a lack of suitable comparables in respect of a specific developing country, it should be made clear that the local revenue authority should publish clear, consistent guidance regarding the acceptable approach or approaches available to taxpayers.

Thus, while the Toolkit is very useful, it may not achieve the desired effect where revenue authorities do not have the manpower and/or skill to implement it. Further the Toolkit should make clear that, to the extent that local authorities adopt specific approaches to identifying suitable comparables, they must provide certain and clear guidance to taxpayers to facilitate compliance and minimize controversy.

#### *Financial transactions*

The toolkit does not specifically address approaches for benchmarking financial transactions such as loans and credit guarantees.

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.

In the absence of safe harbour rules, some countries require that the interest rate applied in respect of a loan should be arm's length, 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.

Currently, developing countries often rely on comparables from similar geographical markets based on information from databases that can only provide limited financial data.

Additionally, developing countries have often 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.

KPMG recommends that more detailed guidance in respect of financial transactions should be included in the Toolkit.

## ***2. How can better use of administrative information, in a way that maintains taxpayer confidentiality, be effectively facilitated at a country and regional level?***

KPMG is very concerned that sharing of taxpayer information between tax authorities for purposes other than a tax audit of the particular taxpayer or its related group will lead to loss of confidentiality.

In addition, as noted in the Toolkit, any use of such secret information by tax authorities will lead to unfair tax audits as taxpayers are challenged with information that they cannot analyze or even understand.

KPMG specifically recommends clarification that “use of administrative information” for development of secret comparable databases by tax authorities would not be appropriate as it would lead to the chaotic application and misapplication of the arm’s length principal. Further comments on secret comparables are included below in Part II of our Additional Comments.

**3. *How could the reliability of potential comparables from other geographic markets be tested?***

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. However, one approach would be to compare available data from local companies to that from candidate foreign geographic markets. While the number of local companies would be low (leading to the problem at hand) such comparison could pool that data and perform an economic / statistical analyses to determine the most appropriate similar geographies. Given the need to have access to global databases, assistance with this type of testing could be provided by the private sector as part of a joint revenue authority/taxpayer initiative.

It is recommended that revenue authorities should inform taxpayers which databases they regard as acceptable and if specific search filters should be applied.

**4. *Are there best practices or other reliable approaches for dealing with a lack of comparables not addressed in the discussion draft?***

Instead of focusing on local or regional comparables, a different but useful approach could be to focus on regional comparable from a 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.

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

In KPMG’s experience, making reliable adjustments is very specific to the particular circumstances of the analysis. KPMG does not have broad applicable suggestions in this regard.

**6. 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?**

It is KPMG's view that the mineral pricing case studies generally reflect market trading terms. More detailed comments relating to the mineral products studies are set out in section D below.

**C ADDITIONAL COMMENTS**

Below, we set out comments and suggestions relating to Parts I to IV of the Toolkit as well as the case studies and appendices.

***Part I: Introduction***

*Formulary apportionment*

Unitary Taxation/Formulary apportionment approach is briefly discussed on page 6. Although it is stated 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", the statement may be confusing in that this approach is still mentioned and the footnote mentions the re-launch of the CCCTB initiative in Europe. As the Unitary Taxation/Formulary apportionment approach continues to surface as an alternative method to applying the arm's length principle, the reference in the Toolkit may be confusing and send the wrong message. KPMG therefore suggests that 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.

***Part II: Issues arising when conducting a comparability analysis***

This part of the Toolkit provides a high level overview of how to perform a comparability analysis, considerations regarding comparability data, the availability data, adjustments and the interpretation of data collected and the determination of the arm's length remuneration. Below, specific comments and suggestions are set out:

*Other sources of information: secret comparables*

The use of secret comparables is addressed on pages 31 and 32. It is correctly pointed out that both the OECD and the UN state that secret comparables should not be used unless requisite information can be disclosed to the taxpayer. In KPMG's experience, the requisite information is not disclosed to the taxpayer as this would almost always breach local confidentiality rules. As a result, KPMG recommends that the Toolkit make it clear that secret comparables are not a fair or reasonable approach to benchmarking arm's length pricing or arm's length results. See KPMG's comments on the OECD Paper on Transfer Pricing Comparability Data and Developing Countries dated April, 11 2014. KPMG also notes that the use of secret comparables makes resolving double tax cases more difficult under Mutual Agreement Procedures.

Explicitly acknowledging this issue in the Toolkit would help developing countries understand why secret comparables are not endorsed by the OECD and the UN. KPMG further recommends that the Toolkit state that revenue authorities should first consider the benchmarking analysis provided by the taxpayer before considering any non-public data.

China is the only country quoted as an example in the Toolkit of a jurisdiction where the use of secret comparables is explicitly sanctioned by the transfer pricing legislation, and the Toolkit further points out that “most, but not all, countries either specifically prohibit the use of secret comparables or refrain from using them in practice.” Reference is made to SAT’s Circular 2, which includes a specific provision empowering tax authorities to use non-public information to analyse and evaluate the compliance with the arm’s length principle in the context of an investigation.<sup>1</sup>

In practice, however, KPMG’s member firm in China has observed a number of audit cases where tax authorities initially pointed to the existence of secret comparables but, after careful consideration of taxpayer’s arguments, then decided to rely solely on the publicly available data provided by the taxpayer. Thus, this supports the view that secret comparables cannot be used reliably or fairly in practice.

Accordingly, KPMG is of the view that the Toolkit should make it clear that secret comparables should not be used by revenue authorities even where there are reliability concerns with publicly available comparable data. Rather, alternative approaches or methods under the OECD Guidelines should be explored.

#### *Comparability adjustments*

While the guidance provided in respect of comparability 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. 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. It is therefore KPMG’s view that the Toolkit should clarify that the making of comparability adjustments requires clear guidance and consistent application. It would also be important for revenue authorities to publish local guidelines to set out what approach must be followed by taxpayers and revenue authorities to avoid uncertainty.

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<sup>1</sup> Implementation Measures of Special Tax Adjustments (Guoshuifa n° 2), issued in January, 2009 (“Circular 2”), Article 37.

### ***Part III: Approaches to applying internationally accepted principles in the absence of comparables***

#### *Negotiated settlements*

On pages 51 and 52 of the Toolkit it states that taxpayers and tax authorities need to be realistic with respect to the use of comparables. KPMG agrees that comparability is not an exact science and that all parties must reasonably utilize the available data.

KPMG strongly agrees with the Toolkit that the available data should inform any dispute settlements. To do otherwise would be an abandonment of the arm's length standard and lead to arbitrary tax results.

#### *Testing the benefits received*

On page 53 of the Toolkit, reference is made to a benefits test for services and intangibles. In KPMG's experience this area is one of the most contentious for multinationals operating in developing countries. In particular, it is KPMG's experience that revenue authorities demand extremely high levels of documentation and other types of proof in support of the benefit received by the local taxpayer for services rendered by a related party. KPMG suggests that the effort involved as part of these discussions is disproportionate to the level of risk of non-arm's length pricing. Consistent with the OECD Final Report on BEPS Actions 8-10's discussion of low value added services, KPMG recommends that the low value added services listed in paragraph 7.49 of the OECD Final Report be presumed to provide a benefit to the local taxpayer. The taxpayer and the revenue authority can then agree on the appropriate arm's length charge. This presumption of benefit is important because, in KPMG's experience, too often the revenue authorities refuse to recognize any benefit and determine that the arm's length charge is nil. In KPMG's view, these types of services are common and necessary for multinational groups to operate. The arm's length charge is not nil and guidance on the benefit provided would be very helpful.

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

KPMG believes that the concept of a "benefits test" for intangibles transactions to confirm arm's length nature of any transaction is not useful as it complicates and does not help in mitigating the issue of lacking comparables in developing countries. KPMG recommends focusing on whether the local taxpayer is making use of the intangible. This determination is generally simpler to make.

### *Safe harbours*

The Toolkit, on page 54, sets out the benefits of using safe harbor rules and it also sets out certain shortcomings and issues. KPMG supports the view that safe harbor rules may constitute a simple method to address the lack of suitable local comparables, but safe harbours can create a deviation from the arm's length principle unless there is regular review and update of the safe harbor,

The process of deriving the safe harbour rate should be transparent.

### *Transactional profit split method*

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.*” The term “valuable scarce contributions” appears to be new and not generally known. KPMG believes that it would be useful to clarify the meaning, e.g. by giving an example, to avoid confusion.

### *Royalty caps and other anti-avoidance measures*

Page 63 of the Toolkit discusses royalty caps, i.e. a top limitation of the royalty deductions that may be claimed by the licensee. KPMG strongly believes that this approach directly contradicts the arm's length standard and objects to its use as an anti-avoidance mechanism on the basis that it goes beyond any of the Base Erosion and Profit Shifting initiative related recommendations.

The Toolkit states that some developing countries have exchange control restrictions in place which may lead to a similar result as royalty caps. However, in KPMG's experience there have been cases where exchange control authorities have allowed a higher royalty deduction in a developing country on the basis of a transfer pricing study that supports a royalty rate higher than the standard rate approved by the exchange authorities is appropriate.

The Toolkit is entirely unclear as to its view on the various anti-avoidance and tax base protection measures set out on pages 63 and 64. In KPMG's view they do not offer a solution to the lack of suitable comparables that a developing country may face and will typically distort the arm's length standard in their application. KPMG recommends that the Toolkit unambiguously support the arm's length standard and admonish countries not to adopt short cuts such as royalty caps.

### ***Part IV: Summary, conclusions, and recommendations for further work***

KPMG finds this section of the Toolkit useful and agrees with the recommendations for further work to assist revenue authorities and taxpayers in developing countries from a transfer pricing perspective.

### *Case studies*

The case studies are useful. KPMG suggests 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, regional distributor/limited risk distributor.

### *Appendices*

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.

#### *Appendix 1 (functional and risk analysis):*

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

### **D DISCUSSION DRAFT: ADDRESSING THE INFORMATION GAPS ON PRICES OF MINERALS SOLD IN AN INTERMEDIATE FORM**

KPMG's specific comments relating to "addressing the information gaps on prices of minerals sold in an intermediate form" are set out below:

1. The case studies in the Toolkit provide detailed overviews of the typical processes for the extraction and refining of four categories of minerals into intermediate and finished products. In particular, the Toolkit focuses on the types of contracts entered into between industry players at several common stages in the extraction and refining processes for each of the four minerals. The Toolkit is a useful resource for both revenue authorities and taxpayers in terms of developing an understanding of industry dynamics. This type of analysis and discussion demonstrates some of the elements taxpayers should consider in their transfer pricing documentation. However, the application of the examples presented in the Toolkit should be applied with the recognition that MNEs may exhibit some differences to the examples and these differences can impact the overall value chain and transfer pricing. As discussed in the points below, the Toolkit should be used with caution as it does not provide a complete guide to application of the arm's length principle.
2. The Toolkit outlines the extraction and refining phases of the value chain. But, discussion of the exploration, feasibility assessment, mine development, marketing, sales and logistics processes would enhance the guidance contained in the Toolkit. These additional components of the value chain may be important to the transfer pricing analysis of the various transactions that occur throughout the value chain.

3. The Toolkit focuses on application of the CUP method, including identifying sources of public information where internal comparable uncontrolled transactions do not exist and contemplating various adjustments for comparability differences. While it may be possible to reliably apply the CUP method to price the sale of minerals, we recommend the Toolkit recognize there will be circumstances where there will be insufficient data on comparable uncontrolled transactions for the reliable application of a CUP or adjusted CUP method. The Toolkit should make it clear that another transfer pricing method should be considered when comparability differences between the controlled transaction and the uncontrolled transactions cannot be resolved.

4. Where the CUP method cannot be reliably applied, it may be more reliable to test the margins or results of one of the transacting parties, such as a processing or selling/marketing entity against the results for comparables that have a similar functional profile. We recommend the Toolkit include guidance on how to apply these other transfer pricing methods.

## **E CONCLUDING REMARKS**

KPMG welcomes this Toolkit as it is very useful, and commends the PCT for developing it. The Toolkit will provide, once finalized, relief to revenue authorities and taxpayers operating in developing countries alike.

Overall, KPMG notes that it would be good to include in the Toolkit a recommendation for developing countries to put in place specific guidance for revenue authorities and taxpayers regarding which approaches should be followed when facing a lack of suitable local and/or regional comparables, and in which order they should be applied. It is important that this guidance ensures clarity and consistency.

In addition, the Toolkit will only be successful to the extent that sufficient skilled transfer pricing teams are placed at the revenue authorities in the relevant developing countries to enforce transfer pricing. It is understood in this regard that various measures are currently in place to build skills at various levels.

## **About KPMG**

KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 152 countries and have 189,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.