

**UN-ATAF Workshop on Transfer Pricing
Administrative Aspects and Recent Developments**
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**AFRICAN TAX
ADMINISTRATION FORUM**

**COMPARABILITY
TOOLKIT**
**A Toolkit for Addressing Difficulties
in Accessing Comparables Data
in Transfer Pricing Analyses**

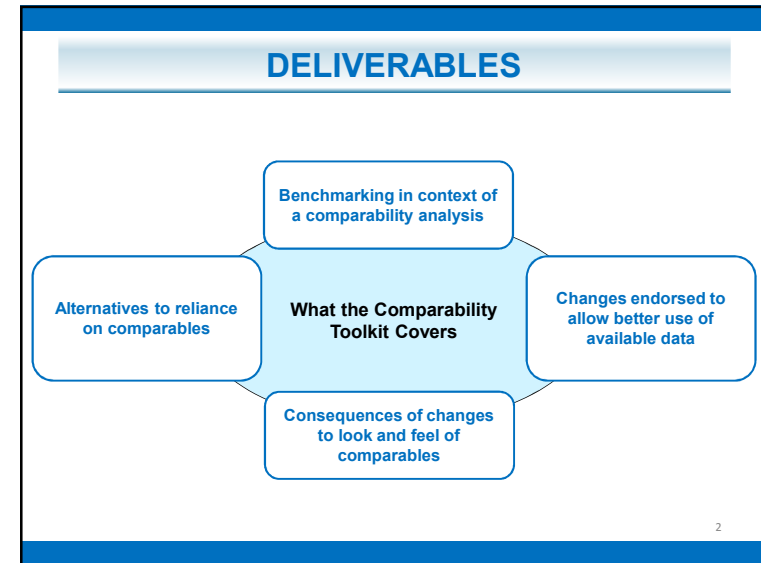
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The Platform for
Collaboration on Tax

A Toolkit for Addressing Difficulties in
Accessing Comparables Data for Transfer
Pricing Analyses

Includes a supplementary report on:
Addressing the Information Gaps on Prices of
Minerals Sold in an Intermediate Form

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**Comparability Toolkit:
Background, the Policy
Conundrum, and Scope**

COMPARABILITY TOOLKIT

*A Toolkit for Addressing Difficulties in Accessing Comparables Data for
Transfer Pricing Analyses*

Released June 2017 by The Platform for Collaboration on Tax (PCT)

PCT is a joint effort launched in April 2016 by the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD), the United Nations (UN) and the World Bank Group (WBG).

A major aim of the Platform is to better frame technical advice to developing countries as they seek both more capacity support and greater influence in designing international rules.

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COMPARABILITY TOOLKIT

Among the Platform's tasks are to deliver a number of publications designed to help developing countries implement the measures developed under the G20/OECD Base Erosion and Profit Shifting Project (BEPS) among other international tax issues.

Toolkits focus on the following areas:

- Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment (October 2015);
- Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses—including a Supplementary Report on Addressing the Information Gaps on Prices of Minerals Sold in an Intermediate Form (June 2017);
- Taxation of Offshore Indirect Transfers (comments by 20 October 2017);
- Transfer Pricing Documentation requirements;
- Tax Treaty Negotiation;
- Base Eroding Payments;
- Supply Chain Restructuring; and
- Assessment of BEPS risks.

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COMPARABILITY THE POLICY CONUNDRUM

The arm's length principle is not perfect, but is the global standard for transfer pricing.

It may sometimes feel that the arm's length principle is the worst form of allocating cross-border profits except for all those other forms that have been tried or suggested from time to time.

The arm's length principle depends crucially on comparisons with the conditions which would be made between independent enterprises.

In applying the arm's length principle, the majority of cases depend on analysing the financial data of comparable, independent companies.

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COMPARABILITY THE POLICY CONUNDRUM

However, around 80% of countries lack data from independent companies operating in their country to make the comparisons on which the arm's length principle depends (see Appendix 4 to the Toolkit, page 117).

So how can the global standard be implemented when comparables appear lacking?

That is what the toolkit seeks to address.

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THE TOOLKIT COVERS

- Making best use of available comparables data
- Approaches to applying the arm's length principle that reduce dependence on comparables

Is this relevant to you?

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Presentations at UN-ATAF Workshop on TP Comparability Analysis (Madagascar, November 2016)

Madagascar has no access to any comparables database yet. Similarly, the tool to gather information on benchmarks to be used as comparables with independent parties, has yet to be developed. Depending on the case in exam, we asked the assessed party to explain the price or margin applied with documentary evidence. By their responses, it was found that the pricing or margin benchmarks they used as comparables were taken from developed countries, having no similarities with African countries nor having negative results.

Zambia is using TP catalyst/CUFT/ORBIS provided by Bureau Van Dijk.

Challenge to obtain comparable companies from Africa as most companies are not on the Database.

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Comparability Toolkit: Benchmarking in Context

TYPICAL ISSUE AS SEEN IN TP REPORTS

The Transactional Net Margin Method (“TNMM”) was considered to be an appropriate method to assess whether Company A’s return for food manufacturing is consistent with arm’s length arrangements.

In applying the TNMM, we conducted a database search to identify companies engaged in the provision of food manufacturing services which can be considered comparable to those undertaken by Company A.

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TYPICAL ISSUE AS SEEN IN TP REPORTS

The table below shows the ranges of weighted average operating profit margins earned by the identified comparable companies over the period 2012-2014.

Minimum	First Quartile	Median	Third Quartile	Maximum
0.56%	1.35%	3.56%	4.05%	6.35%

Based on the above it is reasonable to conclude that comparable food manufacturers earned an inter-quartile range of operating profit margins of between 1.35% and 4.05%.

Therefore, the operating margin of 1.75% earned in 2016 by Company A with respect to its manufacturing activities is considered to be consistent with an arm’s length arrangement.

How do you approach a report like this?

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TP REPORTS IMPORTANCE VS LENGTH

Comparison, usually through benchmarking, is second aspect in a “comparability analysis” (see OECD Guidelines 1.33)

Benchmarking is entirely reliant on the first aspect which involves identifying the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated.

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TP REPORTS IMPORTANCE VS LENGTH

A typical TP report may devote, say, 6 pages to accurately delineating the transaction (often unsatisfactory), 2 pages (generally boilerplate text) to selecting the appropriate method, and 40 pages to the benchmarking search.

Length is not representative of importance.

The toolkit emphasises that inaccuracies in delineating the actual transaction, inappropriate selection of the tested party, and inappropriate selection of method are likely to have a far greater impact on the outcome than the accuracy of the data used in the benchmarking.

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TOOLKIT BOX 3 BOLPEN INC (PAGES 32-34)

Bolpen Manufacturing in Country X manufactures pens, which are sold to an associated enterprise, Bolpen Sales in Country Y. Bolpen Manufacturing purchases inputs from a number of arm’s length suppliers. Bolpen Sales sells finished pens to arm’s length customers. The table below summarises the key financial metrics for each entity before the application of the transfer pricing method to determine the price of the pens sold by Bolpen Manufacturing to Bolpen Sales.

	Bolpen Manufacturing	Bolpen Sales
Sales revenue	? (this is the transfer price)	1,500
Cost of inputs or Cost of sales	400	? (this is the transfer price)
Operating costs	50	220
<i>Total Profit</i>	<i>830</i>	

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TOOLKIT BOX 3 BOLPEN INC (PAGES 32-34)

Assume the TNMM is selected to benchmark the return to Bolpen Manufacturing using a PLI of mark-up on full costs. A search for comparables results in a benchmarked cost-plus mark-up of 10%. The table below provides simplified financial statements after the application of the Cost Plus TNMM with Bolpen Manufacturing as the tested party:

	Bolpen Manufacturing	Bolpen Sales
Sales revenue	495 (i.e. $(400+50) \times 10\%$)	1,500
Cost of inputs or Cost of sales	400	495
Gross profit	95	1005
Operating costs	50	220
Operating profit	45	785

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TOOLKIT BOX 3 BOLPEN INC (PAGES 32-34)

Assume Bolpen Sales is chosen as the tested party and a TNMM with a PLI of a return on sales is selected as the transfer pricing method. A search for comparables results in a benchmark return of 5% net margin on sales.

	Bolpen Manufacturing	Bolpen Sales
Sales revenue	1205	1,500
Cost of inputs or Cost of sales	400	1205
Gross profit	805	295
Operating costs	50	220
Operating profit	755	75 (i.e. 5% of 1500)

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IMPLICATIONS OF BOLPEN

What would be the result in either scenario if you devoted resources to challenging the comparables and attempted to increase (1) the mark-up by 50% to 15% or (2) the margin by 50% to 7.5%?

Note that the most significant difference depends on the appropriate method and tested party, with potentially around 700 of profit at stake.

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BENCHMARKING IN CONTEXT

The Bolpen examples illustrate why “the accurate delineation of the transaction, and from it, the selection of the most appropriate method (and the selection of the correct tested party where relevant), is so important to a reliable transfer pricing analysis: if this foundation is incorrect, irrelevant and inappropriate comparables may be used, making it more likely that the results of the analysis will not reflect arm’s length outcomes and could thus result in incorrect allocations of taxation between jurisdictions, double taxation or less than single taxation” (Toolkit page 34)

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BENCHMARKING IN CONTEXT

“Data quality and availability also matter, of course: imperfect or imprecise comparables applied to the correct tested party or using the most appropriate method will obviously lead to less accurate outcomes.

A key point, nonetheless, is that it is essential to consider the functional analysis (taking into account the assets used and risks assumed) of the parties to the transaction (Bolpen Manufacturing and Bolpen Sales) to determine which transfer pricing method is the most appropriate to the actual transaction, and how it should be applied, including – critically – what kind of comparables should be sought.

Neither taxpayers nor tax administrations can choose a method at will: the selection of the most appropriate method is a matter of fact and application of principle” (Toolkit page 34)

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IMPLICATIONS OF BOLPEN

What further information would you need to know in order accurately to delineate the actual transaction between Bolpen Manufacturing and Bolpen Sales, and as a result to determine the appropriate method?

The implications of a one-sided valuation method like a TNMM is that another party receives the profits or losses that are left over. How do you know which party that should be?

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Comparability Toolkit: Using Commercial Databases, Better Use of Available Data, Geographic Screening, and Financial Ratios Screening

USING COMMERCIAL DATABASES

Note: this course will not address how to perform a benchmarking search. This was outlined during the UN Course on Transfer Pricing Comparability and Transfer Pricing Methods Antananarivo, Madagascar 14-17 November 2016.

(See following two slides)

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3. THE COMPARABLES SELECTION PROCESS: A PRACTICAL EXAMPLE

Para. 5.3.4.12 of the Manual

- A typical comparable searching process may be divided into 3 screening phases, and namely
 - Database screening (primary screening)
 - Quantitative screening (secondary screening); and
 - Qualitative screening (tertiary screening)

- Only AFTER the searching process has been concluded any potential comparability adjustment may be performed

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3. THE COMPARABLES SELECTION PROCESS: A PRACTICAL EXAMPLE

Para. 5.3.4.12 of the Manual

- **Database screening** is generally applied with regard to industry and activity code and geographic market location
- **Quantitative screening** often involves screening of the financial information relating to the potential comparable for the period at stake
- **Qualitative screening** is mostly used by applying financial ratios (“diagnostic ratios”) to the final potential set of comparables

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USING COMMERCIAL DATABASES

The Toolkit contains useful material on the benchmarking process, including the typical process for screening for comparables from the universe of data points (Box 7 pages 43-44) and useful appendices on industry classification codes, independence criteria, and factors to consider when reviewing a search (Appendices 5-7).

Case Study 3 in the Toolkit (pages 100-103) is an example of a benchmarking process following the broad-based analysis of the taxpayer’s circumstances and the accurate delineation of the actual controlled transaction.

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USING COMMERCIAL DATABASES TWO KEY ISSUES

- Cost of access
 - Limited coverage
- Why spend money to obtain no or very limited local comparables?

Commercial database providers package publicly available data disclosed through regulatory reporting requirements imposed by countries. In the longer term a framework for registering companies’ financial information will improve coverage of commercial databases, and will also support more generally corporate financial reform initiatives (see Toolkit pages 67-68).

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USING COMMERCIAL DATABASES TWO KEY ISSUES

In the short term the Toolkit advocates widening or re-ordering the search criteria to “prioritise the features of the transaction which are the most economically relevant” (Toolkit page 43).

This involves abolishing or demoting the same geography screen and promoting financial ratios to achieve functional comparability.

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BETTER USE OF AVAILABLE INFORMATION: THE GEOGRAPHIC SCREENING BIAS

Although around 164 countries are unlikely to find local comparables in commercial databases, there are, nevertheless, 5-10 million potentially useable global records which meet the basic independence requirement (Toolkit page 37).

Using this global resource has been perhaps perceived to be discouraged by apparent precedence of one comparability factor: geographic market.

Practice has grown, perhaps because guidance has been influenced by countries with large data pools, to screen for geographic market at outset.

However, there are only 33 countries with over 10,000 potentially useable data points, and therefore that are likely to find comparables from their market.

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BETTER USE OF AVAILABLE INFORMATION: THE GEOGRAPHIC SCREENING BIAS

The Toolkit advocates demoting or even abolishing the geographic screening criterion so that comparables which in other respects show high comparability can be used (Toolkit page 43).

In such cases, "it will be important to examine whether differences in markets are likely to make a material difference to the condition being examined. Where the transaction occurs in a truly global market, geography may not make a material difference" (Toolkit page 41).

Even where local comparables exist, "an independent entity from a foreign market with highly comparable functions, assets, and risks may provide a more reliable comparison . . . than an uncontrolled entity from the local market with a lower degree of comparability in terms of its functional analysis" (Toolkit page 42)

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BETTER USE OF AVAILABLE INFORMATION: FINANCIAL RATIOS

Functional comparability can be enhanced by making better use of financial ratios as a screening tool, and using them as an alternative to industry classification codes.

The logic here is that classification codes are broad and do not attempt to align functions, assets, and risks, whereas certain financial ratios are likely to

- (1) better align functional similarities, and
- (2) more accurately define profit potential by focussing on what drives profit.

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BETTER USE OF AVAILABLE INFORMATION: FINANCIAL RATIOS

"For example, a distributor of pharmaceutical goods with a large sales force which outsources logistics and goods handling to a third party provider (and thus has no warehouses, logistics infrastructure or inventory risks) is unlikely to be comparable to entities falling within the industry classification of "pharmaceutical goods importer, wholesale" if typical companies within that classification in fact have significant warehousing and logistics functions, assets and risks, and smaller sales forces" (Toolkit pages 42-43).

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BETTER USE OF AVAILABLE INFORMATION: FINANCIAL RATIOS

Using financial ratios is sector agnostic. In this example, screening financial ratios of, say, fixed assets to turnover, inventory to turnover, and employee costs to total operating costs, may identify potential comparables (with low fixed assets, low or nil inventory, and large sales force) in, for example, the software sector.

How do you feel about comparing a pharmaceutical distributor with a software distributor?

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BETTER USE OF AVAILABLE INFORMATION: FINANCIAL RATIOS

Other examples of diagnostic ratios that are often used include:

- marketing and advertising expenses to sales,
- intangibles over total assets,
- days of inventory, receivables, or payables (average),
- turnover per employee,
- fixed assets over total assets,
- inventory over sales,
- operating assets to total assets,
- fixed assets to total sales,
- fixed assets to number of employees,
- operating expenses to sales,
- cost of sales to sales,
- and inventory to total assets. (Toolkit page 63)

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MAKING COMPARABILITY ADJUSTMENTS

Some countries accept pan-regional comparables (e.g. EU, Nordic, Iberian, Benelux), but this is likely to be because of economic homogeneity rather than simply proximity itself.

Turning to a comparable from a neighbouring country just because it is a neighbour has no logic in itself.

Similarities in macro-economic factors are likely to be more relevant than proximity. These might include regulatory systems, dominant industries, country credit ratings, interest rates, inflation.

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MAKING COMPARABILITY ADJUSTMENTS

The Toolkit provides examples of country risk adjustments (Appendix 12), but is sceptical about their reliability: "Careful consideration should be given as to whether such approaches can account for differences in risk and thus in expected profitability (to the extent that they exist) for commercial ventures in different countries" (Toolkit page 59).

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DIAMONDS AND ICE-CREAM

Would the guidance in the Toolkit endorse comparing the profitability of a diamond-cutter in Botswana (the tested party) with an ice-cream manufacturer in Thailand (potential comparable)?

What conditions are likely to be relevant in answering the question?

Does this affect your views about obtaining and using commercial databases?

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Comparability Toolkit: Alternatives to Reliance on Comparables

ALTERNATIVES TO RELIANCE ON COMPARABLES

Toolkit lists some alternatives to a reliance on comparables, including anti-avoidance measures, fixed margins, co-operative compliance including APAs, profit splits.

Main focus of Toolkit is on safe harbours, which provide “a mechanism for applying transfer pricing rules without the need for the taxpayer and tax administration to identify data on comparable transactions in each case” (Toolkit page 71).

The Toolkit in particular notes merit of:

Bilateral safe harbours

Regional co-operation in establishing unilateral sale harbours

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Comparability Toolkit: Some Conclusions and Status of Toolkit

SOME CONCLUSIONS

“For transactions in which the analysis concludes that a one-sided method is most appropriate, an evaluation of the economically relevant characteristics of the transaction will help to make the best use of any available comparables information (which may include information from foreign markets) to determine appropriate arm’s length outcomes.

Furthermore, in addition to being a simplification measure, carefully constructed safe harbours may be particularly useful in helping countries to address these kinds of transactions where there is a systemic lack of comparables information. Countries may, therefore, wish to consider developing safe harbour approaches to benchmark arm’s length returns to a tested party for relevant classes of transactions” (Toolkit page 82).

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AND ANOTHER REMINDER

“It is particularly noteworthy that the accurate delineation of the transaction (prioritising substance over form) and from it, the selection of the most appropriate transfer pricing method (and, where relevant, the selection of the appropriate tested party) will often be much more important in determining arm’s length prices and countering abuse than will the numerical level of the selected financial indicator, since the former are the necessary foundation to the analysis and will determine the basis for the calculation of the arm’s length price (often including consideration of which party will be entitled to any residual returns” (Toolkit page 81).

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STATUS OF TOOLKIT

Applying Toolkit may change look and feel of acceptable comparables.

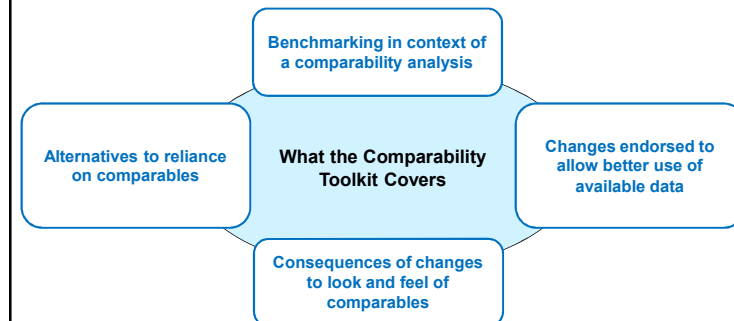
Will the Toolkit change your approach?

What is its status?

Will you issue guidance, internal or external?

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DELIVERABLES



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