

To OECD's Centre for Tax Policy and Administration

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From Sean Foley, Global Leader, Global Transfer Pricing Services

Ref Comments on the OECD Paper on Transfer Pricing Comparability Data and Developing Countries

cc Clark Chandler, KPMG in the U.S.

KPMG's Global Transfer Pricing Services professionals (KPMG) are pleased to provide comments on the Organisation for Economic Co-operation and Development's (OECD) *Paper on Transfer Pricing Comparability Data and Developing Countries* (hereinafter, The Paper), which was released by the OECD for public comment on March 11, 2014. The document was prepared in response to a request from the G8 "to find ways to address the concerns expressed by developing countries on the quality and availability of the information on comparable transactions that is needed to administer transfer pricing effectively."

## Introduction

The Paper presents some useful ideas for dealing with a number of practical difficulties in benchmarking returns for tested parties in developing countries. Specifically, the OECD outlines four possible approaches to address these concerns. The proposed approaches are as follows:

1. Expanding access to data sources for comparables;
2. More effective use of data sources for comparables;
3. Approaches to identifying arm's length prices without reliance on direct comparables; and
4. Advance pricing agreements ("APAs") and mutual agreement proceedings ("MAP").

KPMG welcomes the OECD's attention to the comparability data issue, which, along with broader resource and skill issues, is among the most critical facing developing countries in the transfer pricing arena. The document lays out a number of useful proposals for both enhancing developing countries' use of data sources, including existing commercial databases, and for exploring analytic approaches – such as using data from different geographic regions or countries,<sup>1</sup> and use of

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<sup>1</sup> Perhaps the OECD could sponsor the development of default appropriate regional comparable sets, beginning with an Africa wide one.

profitsplit methods or value chain analysis - that may essentially provide workarounds to a paucity of “in country” data.<sup>2</sup>

At the same time, however, one needs to recognize that comparable data issues exist in even the developed world<sup>3</sup>, and acknowledge that only quite imperfect solutions exist. The question, thus, becomes which actions by the OECD will have the highest return in terms of ameliorating the problem. KPMG believes that this is best accomplished by focusing on simple and practical ways of using existing comparables information (including the use of regional and “out-of-country” data; the use of safe harbors) more effectively. KPMG believes that it is simply not practical to expect, as an initial matter, that there will be substantial improvements in the availability of local comparable data (high quality comparables often simply do not exist), and that the use of complex transfer pricing approaches<sup>4</sup> is likely to involve a much greater level of expense and require a much greater level of experience than currently exists.

The Paper, in fact, recognizes the potential significance of using “out-of-country”/regional comparables, as well as the need to explore the issue of country adjustments. KPMG believes that the OECD can not only play a valuable role in encouraging tax authorities to be more open to “out-of-country” comparables, but also that this approach would be more fruitful than analytic approaches such as value chain analysis, or even APAs or MAPs, which for all the value they provide, are not feasible on the scale needed.

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<sup>2</sup> It is worth pointing out that the European Union Joint Transfer Pricing Forum has tried to encourage the use of regional comparable sets, and that, even for developed countries, it is sometimes difficult to get a set of only “in-country” comparables.

<sup>3</sup> While North American comparable companies have good qualitative information and reliable financial data – given required regulatory financial reporting – they tend to have, many would argue, too broad a range of functionality, to be considered very good TNMM comparables. European and Asian databases, on the other hand, present challenges with respect to independence issues, a paucity of qualitative information and potential comparables sometimes being quite small. Nonetheless, European, U.S. and Asian developed country practitioners find workable solutions, in part by acknowledging the imprecision. In short, searching for comparables calls for setting reasonable expectations.

<sup>4</sup> Value chain analyses, profit splits, APAs.

## **Expanding access to data sources for comparables**

KPMG is supportive of OECD efforts to work with various data vendors to improve access to the data collected by such vendors.<sup>5</sup> In addressing cost issues, KPMG would encourage the OECD to consider not only costs to tax authorities, but also costs to taxpayers, which can be substantial, particularly when coupled with requirements to use data for a specific country, or from a specific vendor.<sup>6</sup> KPMG would note that the OECD should incorporate improving access to other types of comparables data (e.g., data on licensing, data on financial transactions and rates) as part of its comparables initiative.

KPMG would encourage the OECD to be realistic about the availability of data, however, and to avoid actions that would lead to increased compliance costs, possibly coupled with a reduction in reliability. KPMG believes that the use of regional comparables should be presented as a reasonable response to the paucity and other deficiencies in local data, and notes that such data may be more comparable to that of the local affiliates of MNEs, in terms of access to capital, technology, and even markets, than data from a limited number of local comparables.

KPMG is concerned that the OECD's suggestions that countries be encouraged to adopt statutory reporting is not appropriate in a document dealing with transfer pricing compliance, as (1) the issue of whether or not to have local statutory reporting should be based upon issues (e.g., the need for appropriate financial disclosures to investors as compared to costs and privacy concerns) that have little or nothing to do with transfer pricing and (2) even if increased statutory reporting requirements are mandated they may do very little as a practical matter to alleviate the effective "availability and quality of information" on comparable companies. The OECD itself acknowledges that the number of independent companies of sufficient size to be uncovered in any effort to broaden the available comparable company data is not likely to be very large in many developing countries. KPMG, however, approves of, and encourages, efforts to motivate database suppliers to improve coverage in their databases, as outlined in paragraph 13.

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<sup>5</sup> In this regard, the major suppliers of the databases could be engaged to ensure that the reasons for the limited coverage of developing countries have been accurately identified and explore the steps that could be taken to improve developing country coverage and access. This engagement may also provide an opportunity to explore the improvement of the quality and suitability of data provided for transfer pricing purposes. Costs remain a concern for developing countries and support could be provided by donors to fund access to such databases

<sup>6</sup> For example, while databases exist in India, the heavy costs involved in subscribing to these databases means that all taxpayers are not able to subscribe to these databases. Even after subscribing to these databases, taxpayers are not equipped to utilize the database appropriately and are unable to get all the relevant data especially on Small and Medium Enterprises, closely held private companies or captive companies ('small and private companies').

Finally, secret comparables should not be used to support transfer pricing adjustments. The Paper does draw a distinction between “use for risk evaluation purposes (i.e. identifying a taxpayer for possible audit) and for making a transfer pricing adjustment,”<sup>7</sup> and points out that “Both the Guidelines and the Practical Manual note that it would be inequitable to make use of secret comparables to make an adjustment unless the data can be disclosed to the affected taxpayers...”<sup>8</sup> KPMG’s experience is that in practice, however, it is very difficult to tax authorities to draw a bright line in this regard, and that the use of secret comparables as a risk assessment tool often evolves into their use in supporting specific adjustments. KPMG believes that the secret comparable issue is so important that this Paper should have made clear that the principle expressed in the Guidelines and the Practical Manual applies even in the context of the comparable data issue.

#### **More effective use of data sources for comparables**

KPMG believes that guidance on the more effective use of comparables is the most important contribution that the OECD can make in this area. In this regard, the OECD’s guidance should focus on the more effective use of existing sources of comparable data. There are cases, for example, where even though commercial databases are available and taxpayers are competent in their use, rules or procedures adopted by tax authorities inhibit such use. In one instance KPMG is aware of, for example, a tax authority insists on financial statement data to validate the database data, an expensive exercise for a taxpayer to undertake, even if possible.

More generally, guidance could be provided by the OECD in certain areas that may reduce conflicts between taxpayers and tax authorities. When taxpayers conduct searches they use a large array of filters/search criteria. In TP audits the tax authorities tend to disagree with the filters used by the taxpayers. For example, in India, taxpayers often use a turnover filter in their search process which is very often challenged and eventually rejected by the tax authorities. In this regard, it would be beneficial to taxpayers if some standard guidance was provided with regard to search filters.

KPMG supports the increased use of regional comparable sets as a practical way of addressing comparability issues. Experience has shown that, in many instances- particularly for standard functions such as distribution – comparable company ranges do not vary that much by country.<sup>9</sup> Second, even where they do, it is often because, requiring local comparables means that one will have small, unstable sets which, while they may be local, do not match up to the tested party in

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<sup>7</sup> Paragraph 17.

<sup>8</sup> Ibid.

<sup>9</sup> Research on this would be welcome.

other comparability dimensions. Thus, using comparables from other countries might mean lowering comparability in the geographic dimension, while increasing it in other dimensions because of the greater diversity or richness of alternative databases.

Given the above, KPMG believes that regional comparables can often be used without the need for country specific adjustments, and has some concern that country-specific adjustments may be applied in a way that leads to biased outcomes. While such adjustments may be needed in some cases, more research is needed on balanced analytic approaches to the issue, and to the issue of use of regional comparables, in general.

Too often, the country-specific adjustments take the “out of country” comparable returns and automatically increase them to reflect the country-specific risk for developing countries, thus ignoring the fact that greater risk implies not only higher expected profit, but also larger and more frequent losses. Moreover, many of the factors that give rise to the higher risk referred to earlier don’t apply in the context of a global supply chain, where, for example, there are adequate capital resources and where the enterprise often effectively guarantees to buy all of the local company’s output.

The provision of appropriate training to local tax authorities and encouraging local tax authorities to share experiences in dealing with the resolution of transfer pricing issues in developing countries would be helpful. Such training should emphasize the need for adherence to the arm’s length standard, and the preference for pragmatic, uncomplicated approaches when faced with a lack of local comparables.

Having mentioned where OECD guidance could make a difference, it is worth noting the influence that the OECD’s proposals have, making it important that they carry the weight of supportive evidence. If the OECD suggests that “Methods that may be applied to improve the robustness....such as the use of sector averages and consolidated global returns,” one hopes that the OECD does not underestimate the degree to which its words will be taken at face value. KPMG recommends making clear that speculative adjustments such as these may, or may not, improve robustness. One does not want to create a false sense of robustness by the use of these adjustments.

## **Approaches to identifying arm's length prices without reliance on direct comparables**

While KPMG welcomes the simplification suggestions in the OECD paper, and in particular the suggestion for safe harbors, KPMG also believes that the OECD should stress that any approaches that are used that place less reliance on comparables should adhere to arm's length principles, and should in general require that the "most appropriate method" be used.

Use of safe harbors would be a positive step, particularly with respect to routine functions and services, but only if they are elective.<sup>10</sup> The key advantages of such safe harbors are that they are relatively easy and inexpensive to administer, they provide an effective way of dealing with low risk transactions, and allow tax authorities and taxpayers to focus their efforts on significant transactions rather than low risk transactions. However, in setting safe harbors there does need to be some minimum level of transparency around the empirical data upon which these are based. It does become more difficult to use safe harbors as the business operations become more complex, but a tiered safe harbor approach (using sector/regional averages) may be appropriate for a developing economy to ensure a certain level of revenue for its tax base, and to prevent early stage base erosion. More detailed comments can be found in KPMG's earlier comments on safe harbors.

On the other hand, KPMG is troubled by various suggestions that seem to encourage the rather arbitrary departure from normal approaches to the selection and application of the most appropriate transfer pricing method solely because of lack of data on local comparables. Three areas of particular concern are:

- 1) That certain approaches be arbitrarily applied, apparently in preference to relying upon the most appropriate method. For example, while "the use of publicly quoted commodity prices for certain transactions involving commodity products"<sup>11</sup> *may* be the most appropriate method in some cases, that should be determined on a facts and circumstances basis, and there is no basis for mandating their use.<sup>12</sup>

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<sup>10</sup> Transparency around the empirical data upon which safe harbors are based, would perhaps enhance their use.

<sup>11</sup> Paragraph 27

<sup>12</sup> It is worth noting that use of CUP data often requires a relatively high level of experience on the part of local tax authorities, in part because of the need to adjust for differences between the tested transaction and the CUP transaction. KPMG, thus, appreciates the Paper's acknowledgement of a "primary concern relat(ing) to the divergence between the conditions under which the publicly quoted prices are quoted and the conditions of the actual transactions that may mean the publicly quoted price may not be the arm's length price." It is, thus, important to consider a broad array of

- 2) The use of overly complex pricing methods – for example, profit split methods and value chain analysis – solely because they might not require local comparable data, is subject to a high risk of misuse. Some might, for example, use them as the entrée to formulary apportionment. KPMG, thus, urges the OECD to make clear that any use of such methods is to be consistent with the arm’s length standard. This issue aside, KPMG notes that the use of these methods requires a high level of skill and experience. Constraints within the tax authorities make the use – certainly wide use – of such approaches difficult to envision. Finally, reference in paragraph 25 to “Consideration of similar transactions that might provide reasonable alternatives for accomplishing business objectives” leaves one concerned that this could become a rationalization for recharacterization, undermining the parameters of paragraphs 1.64 to 1.69.
- 3) Testing the foreign counterparty when comparable data is not available for the local (developing country) related party. KPMG believes again that it is important here not to make the issue of lack of local comparable data the overriding, or even central, issue determining the effective choice of a tested party, or, more broadly even, preferred analytic method. The lack of local data for the typically obvious choice as tested party should not be the sole, or determining factor, in tested party selection, but rather one among many factors – including the potential availability of “out of country” or regional, comparable data for the local tested party- in determining the overall most preferred analytic approach.

An overarching KPMG concern is that any move away from the arm’s length standard – whether towards secret comparables, or use of foreign counterparties that would not typically be selected as tested parties, or use of rules of thumb – raises the risk of double taxation in a context that would make resolution difficult.

### **APAs and MAPs**

APAs and MAPs can play an important role in addressing transfer pricing issues in an effective way. Therefore, KPMG supports OECD efforts to encourage countries to make these options available to taxpayers with international transactions. At the same time, it is important to recognize that APAs often involve relatively complex negotiations, and require a high level of skill and

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comparability factors such as date, seasonality, stage, term of contract, volume, and even the location of the commodity (e.g. inland v. FOB ship; travel time on ship; west v. east of Panama Canal).

experience to be most effective.<sup>13</sup> Since most developing country tax authorities are still building capacity in their transfer pricing expertise, one would be hard-pressed to argue that an effective use of these resources would be to deploy them primarily to negotiate APAs and MAPs. Moreover, the negotiation of an APA often involves significant costs on the part of both taxpayers and tax authorities. Therefore, while APAs should certainly be an available option, they are unlikely to be used on a scale that would have a significant impact upon the problem the Paper is trying to solve.

Access to MAPs is critical to resolving the substantial double tax issues that result from transfer pricing adjustments, and are also a key way of bringing the interests of both tax authorities to bear on the resolution of a transfer pricing dispute. All tax authorities should be strongly encourage to provide taxpayers with ready access to MAP in cases where tax treaties exist, and to make the relief of double taxation a primary objective of the MAP process.

KPMG, thus, recommends that:

- The OECD should offer training and other support to developing countries that implement APA and MAP programs;

The APA programs should be structured such that they can include roll-back years so that a large period of time can be covered.

### ***Concluding Remarks***

KPMG welcomes the OECD's response to the G8 request on Comparability Data and Developing Countries, and is supportive of a number of the approaches suggested. In particular, KPMG appreciates:

- The focus on training; and
- The pragmatism shown in the openness to safe harbors, and the use of either regional comparables or comparables from other countries. The Paper itself, in paragraph 19, points to the importance of a pragmatic approach, when it says, "Paragraph 3.38 of the Guidelines notes that 'independent transactions may be scarce in certain markets and industries. A pragmatic solution may need to be found, on a case-by-case basis.'"

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<sup>13</sup> APAs and MAPs invariably also require comparable data results, although these processes have more flexibility than field tax audit teams.

At the same time, KPMG believes that the Paper would have been even more effective if it had adopted a more holistic approach. Specifically, KPMG would have welcomed a clearer embedding of the comparability data issue in the broader issue of transfer pricing analytics in the developing country context. In places, the Paper seemed too focused on creating more developing country data for its own sake, to the exclusion of thinking about comparability issues other than mere geography. In other places, it seemed so focused on creating workarounds – value chain analysis, and APAs, for example - to the data issue that it did not consider broader issues such as skill and experience constraints.

Notwithstanding KPMG's reservations, it is important to reiterate here KPMG's recognition of the comparability issue, and the need to address it, in a context that continues to recognize important principles such as the arm's length standard, the right of taxpayers to see the evidence against them, and the voluntary use of safe harbors.

## **About KPMG**

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 155 countries and have more than 155,000 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.