PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers Tax Services (Pty) Ltd
Reg. no. 1983/008289/07
2 Eglin Road
Sunninghill 2157
Private Bag X36
Sunninghill 2157
Telephone +27 (11) 797 4000
Facsimile +27 (11) 797 5800
www.pwc.com/za

Jeffery Owens
Director
OECD Centre for Tax Policy and Administration
2, rue Andre-Pascal 75775 Paris Cedex 16
France

Our ref: JvR/584307

15 December 2006

Dear Mr Owens

Comparability: Public invitation to comment on a series of draft issues notes

We refer to your invitation to comment on the various issues raised in respect of comparability, as published on the OECD website, and thank you for the opportunity to provide our input and comments.

Although South Africa is not a member of the OECD, South African Practice Note: No 7 dated 6 August 1999 regarding Transfer Pricing is based on, *inter alia*, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("the OECD Guidelines") because of their international importance. As a result, we consider it is appropriate for PricewaterhouseCoopers Tax Services (Pty) Ltd ("PwC SA") to provide representations on the issues of comparability, as published by the Working Party No. 6.

We have provided our specific comments on each of the topics provided with reference to the existing order contained within the invitation.

1. Timing Issues in Comparability

B - Timing of collection of information by the taxpayer

Locally, partly due to the fact that the South African Revenue Services ("SARS") is not in favour of adopting Advance Pricing Agreements ("APAs"), we find that many local clients conduct comparability studies, both pre and post the relevant tax year. In both instances,

South African taxpayers will test the actual outcome of the controlled transactions and when results do not fall within the arm's length range, they will:

(a) Perform a year-end adjustment (usually in cases where the risk of penalty exceeds the adjusted amount) if the annual financial statements have not been signed off; or

(b) Make an adjustment in their tax returns; or

(c) Provide SARS with detailed information as to reasons why their transactions do not fall within the arm's length range. Where operational or economic factors exist that negatively impacted the taxpayer's return, adjustments are made to the financial analysis performed to provide SARS with a secondary calculation that demonstrates the position which the taxpayer would have been in had their results not been impacted by the operational and economic factors.

SARS, however, does not look favourably upon year end adjustments, as SARS often views such adjustments as a profit stripping mechanism and as such, any TP adjustments by offshore holding companies are deemed to raise a "red flag" for SARS to raise queries or perform an audit. SARS also states that the taxpayer cannot use hindsight and year-end adjustments are based on hindsight.

As such, documentation has become an extremely important component of any client's transfer pricing policy. In terms of local documentation, we generally apply a combination of the approaches documented in the invitation. By way of example, we would document the process that led to the establishment of the TP Policy (i.e. prior to the transactions taking place) and then, in addition, the outcome of the transaction may be tested.

In terms of double taxation, we often do find such situations, especially in our dealing with African countries where there are no Double Taxation Agreements ("DTA's") between the cross-border country and South Africa. In addition, many of the treaties which do exist are old and/or based on the UN model as opposed to the OCED model. Further, the authorities of these countries are inefficient and do not necessarily recognise or apply the transfer pricing principles contained in the OECD Guidelines.

C - Ex post facto review of transfer prices

In practice, the overriding principle pertaining to documentation and information gathering in most client cases is that the greater the risk of a client being audited by SARS, the greater the amount of documentation that is prepared.

In the case that a South Africa company's results do not fall within the arm's length range or lie below or close to the lower quartile of the range, documentation is usually prepared which may include a variety of information pertaining to the client's industry conditions, competitor studies, working capital adjustments and more detailed financial analysis.

In cases where the South African company's returns are more "favourable" in comparison to the arm's length range, the client will rarely select to gather an exhaustive amount of post facto information as they consider themselves to be "safely" dealing at arm's length and the risk from a South African perspective is minimal. Although, this may represent a risk from the perspective of the cross border country which is often not fully appreciated.

D - Time of origin of comparable uncontrolled transactions

Due to the delayed statutory filing requirements within most countries, "live-time" data is not available on benchmarking databases. Hence, taxpayers are unable to obtain up to date information to benchmark their current transfer prices against, and therefore must rely on the latest published information which is often only available up to two financial years following the end of the accounting period to which it relates.

The question arising is whether material discrepancies may arise in benchmarking results from one year to the next and therefore whether relying on historic data to benchmark current results may result in incorrect transfer pricing applications by taxpayers. Furthermore, how should taxpayers resolve this potential issue and what adjustments should or can be made to correct this potential discrepancy?

First of all, the potential for material discrepancies in benchmarking results from one year to the next should be investigated. This however will largely depend on the industry being reviewed. The OECD suggests that a three year average should be used when performing benchmarking studies. However, in order to capture business cycles sufficiently, we would suggest that a minimum five year weighted average seems to be more appropriate. By applying a five year weighted average, the majority of fluctuations in business cycles should hopefully be evened out and taken into consideration through the use of multiple year data and the calculation of a range of results. We therefore consider that the use of historic data should not generally result in material discrepancies between the uncontrolled returns currently being generated and the historic range determined by using a 5 year average, where the tested party operates within a fairly stable industry. However, there will always be situations where some discrepancies may arise e.g. where there has been a significant downturn within the specific industry being considered or where the industry is very volatile, such as the semi-conductors industry. The length of period should ideally however reflect the typical business cycle for the industry in which the company under review operates.

In situations where material discrepancies may arise between historic data and present data, we would advocate that the use of historic data for the purposes of setting transfer prices can only practically act as a guide and there is likely to be a significant amount of additional qualitative information that should be taken into consideration when assessing the arm's length nature of the pricing. It is likely to be impractical to review the present returns achieved against the returns earned by independent companies for the same

period. The taxpayer company may decide to review its pricing on a quarterly basis, but (as previously indicated) the results achieved by the independent companies are unlikely to be available for another two years, resulting in a significant time lag. This would mean that the required information would not be available in time for the taxpayer to complete and submit its tax return. On this basis, the use of year-end adjustments to account for these differences would appear to be impractical.

.

Although many tax administrations argue that year-end adjustments are a non-arm's length practice, there may be instances where they are appropriate. The reality is that a group situation will never be able to copycat a complete stand alone operation in every sense. Although group companies can try and ensure that their pricing reflects that of stand alone operations as much as possible, discrepancies may arise due to circumstances outside of the control of the taxpayer. As a result, year end adjustments may be relevant in certain circumstances (e.g. where taxpayer operates on limited risk basis), however this would need to be reviewed on a case by case basis.

2. Internal Comparables

A - Definition – Existing guidance

The OECD supplies guidance on the use of internal comparables. Practically they are inherently of more value when considering the use of the traditional transactional methods, where the degree of comparability and financial detail is greater and hence more readily available.

In addition, in practice internal comparables, if found, are particularly useful in determining the arm's length remuneration for transactions involving intangibles. In the area of intangibles, it is more difficult to find reliable external comparables.

B – Practical experience

In practice, we find that applying any of the traditional transaction methods is in many cases dependent on the availability of internal comparables. Where reliable internal comparables cannot be found, we are generally limited to the use of external databases with limited financial information available which invariably results in adopting the transactional profit methods (with reservation), and generally prevents a reliable use of the traditional transaction methods.

C – General preference for internal comparables over external comparables: rationale and limits

In our view, greater emphasis on the use of internal comparables is beneficial as they generally provide a more reliable comparable, better data integrity and closer market

comparability. The issue however is, how reliable are internal comparables? For example, purchases from a group company which are on-sold to a third party may be under very different terms to similar goods purchased from third parties. Volumes are likely to be different and of course payments terms will differ, also the third party customer and group company customer could be at different market levels. This could make the operating cash cycle associated with group purchases almost subsidise third party purchases.

For companies selling to connected parties versus third parties, the sales price which ultimately affects the profit margin achieved is also likely to be customer and product specific.

Another issue to consider is that internal agreements with both connected and third parties could have reciprocal arrangements that are not initially obvious. For instance, selling products to an independent party at a lower price to compensate for access to raw material suppliers, selling products at lower prices to third parties to cover excess capacity at factories, providing after sales support not provided to group companies. All these detract from the true comparability and would need to be identified and adjusted for.

In our view, an internal comparable from another group company remains more preferable to an external comparable. It is more closely aligned with the product and the business. Where reliable adjustments can be made, internal comparables should be the first point of the analysis.

D – Possible developments

When discussing the use of internal comparables versus external comparables in relation to various methods the following comments have been made.

In relation to the CUP method, no preference is stated. Practically however it is very difficult to apply the CUP without internal comparables by virtue of the comparability requirements associated with this method, as with the other traditional transactional methods.

A classic case in point is analysing intellectual property ("IP") and services of a tested party. As IP is, in most cases unique, an internal comparable which looks at the same IP would be more reliable as opposed to generic IP obtained from external databases that form part of an external comparable search. In fact, one could almost question whether an external comparable can even be used.

Likewise with services, comparing a back office support service supplied from a parent company to its subsidiary with a third party service provider, where the service is a core activity is problematic and can suggest an unrealistic price should be charged for an otherwise simple administrative support activity.

As mentioned above, internal comparables do make the application of the traditional transactional methods more reliable and the fall back position of relying on external comparables tends to result in reliance on the transactional profit methods, notably the Transactional Net Margin Method (TNMM).

E – Preliminary conclusion

The OECD proposes making explicit a preference for internal comparables over external comparables. As practically this process is followed in any event as internal comparables generally provide a more reliable measure, it is our view that there is no need to make this and explicit requirement.

Further, to make an explicit requirement in the revised guidelines could lead to problems in that when preparing support for an entity in the group that is perhaps a subsidiary, having to first rely on internal comparables may require having to obtain sensitive information from the parent company in another jurisdiction. This not only has practical problems but can also lead to business insensitivities and friction where asked for. These practical issues must be borne in mind before including such requirements in the revised guidelines.

3. Determination of Available Sources of Information and their Reliability

Introduction

We agree with your comments that a significant amount of internal information is required in order to perform a reasonable comparability analysis. This reiterates our view that a detailed analysis of the taxpayer's business should be undertaken prior to the search for any internal or external comparables.

A.2 – Use of information and confidential information by a tax administration

The discussion note explains that tax administrations lack the detailed information that taxpayers have access to, which affects the ability of tax administrations from effectively applying the comparability criteria to the available external data, and therefore suggests that the use of "secret comparables" may be acceptable given this information asymmetry and the lack of public information in certain countries. We consider that one of the reasons for providing tax administrations with detailed written transfer pricing documentation is to deal with this so called "information asymmetry" and that the use of secret comparables cannot be justified on this basis. Advocating the use of secret comparables when there is arguably no better source of information could be subjective. We strongly concur with the requests by the business community for the OECD to

specifically reject the use of "secret comparables". We have included some of our further reasoning below.

The use of secret comparables does not actually resolve any of the issues encountered by tax administrations as a result of this information asymmetry. Where they seek to use secret comparables for the purposes of assessing the arm's length nature of the taxpayer's transfer pricing, tax administrations will still have difficulties in applying the comparability criteria to these secret comparables. The only resolution to this information asymmetry in our view is for tax administrations to request a detailed functional analysis from the taxpayer.

As stated under section A.1 of this topic regarding the use of informal or confidential information by a taxpayer, it is not considered appropriate for taxpayers to use information or confidential information to support their transfer prices. As a result, if taxpayers are not permitted to use such information, then it would seem unfair and unjust to permit such information to be used by tax administrations. Taxpayers would not have access to such information when setting related party prices or prices with third parties and therefore it would be inappropriate to use such information for the purposes of a transfer pricing audit. Where tax administrations utilise secret comparables, the taxpayer cannot rebut the arguments put forward as they are not privy to the underlying information on which the tax administration has reached its conclusions. The use of secret comparables for the purposes of a transfer pricing audit often involves the use of hindsight which is inconsistent with the way that independent enterprises operate. As previously noted, SARS states taxpayers should not use hindsight in order to justify year end adjustments. The use of hindsight by SARS in considering secret comparables would therefore appear to be inconsistent with SARS' view on year-end adjustments.

Furthermore, tax administrations often utilise data regarding the taxpayer's competitors, which is not necessarily appropriate as these competitors may not be considered to be independent enterprises for the purposes of the transfer pricing analysis and their results may be distorted as a result of entering into non-arm's length transactions. Where external comparable searches are undertaken using publicly available commercial databases, it is common practice to exclude non-independent companies, with the specific rejection criteria ultimately depending on the definition of connected persons in the relevant country being considered. Therefore, it would be illogical to apply one set of criteria to searches for external comparables using such commercial databases and a different set of criteria when determining whether the results of the taxpayer's competitors can be relied upon.

When using secret comparables or the results of competitors in general, tax administrations also often use the consolidated results of the "potentially" comparable company. In such cases, there is no analysis of the activities of the company's subsidiaries and whether they could also be considered to be comparable to those of the taxpayer. Where the consolidated group undertakes material non-comparable activities, it

would be inappropriate to utilise the consolidated results of such companies. In line with our comments above, the use of unconsolidated data may raise issues regarding the arm's length nature of the results where the company is not independent (i.e. has connected parties).

We recognise that the use of secret comparables by tax administrations may be justified in a risk assessment as a guideline only in assessing whether it may be appropriate to select a company for further review; however we feel strongly that they should not be used by tax administrations as a foundation for proposing a transfer pricing adjustment.

Although the OECD has stated that proper safeguards should be in place to ensure reasonableness, fairness and reliability for taxpayers where secret comparables are used, no indication is provided of what type of safeguards would be envisaged. We consider that the issue of confidentiality would continue to exist regardless of the safeguards put in place and therefore consider that the use of secret comparables should be categorically rejected.

Point 20 of this section of the discussion paper suggests that it may be appropriate for competent authorities to retain the ability to use secret comparables in Mutual Agreement Procedure (MAP) cases. We agree that this may be appropriate where the competent authorities are unable to reach a mutual agreement without the use of such comparables; however stress that this should be viewed in light of our comments above that such secret comparables should not be initially relied upon by the tax administration to legitimise the original transfer pricing adjustment imposed on the taxpayer. Further, the issues outlined above regarding potential reliability and true comparability issues with the use of secret comparables would continue to be relevant where such secret comparables are used by competent authorities for the purpose of resolving MAP cases.

B.1 – Commercial databases

In line with our comments at Section 2 of this letter, we agree with the comments contained within the discussion paper that potential internal comparables should be fully explored and reviewed prior to undertaking any search using commercial databases as such internal comparables will generally provide the company with more reliable, more detailed and better quality data than would be available from commercial databases.

We appreciate that the base information from which commercial databases are derived is not prepared specifically for transfer pricing purposes, however we would note that one of the key information providers within the European region, Bureau van Dijk ("BvD"), is seeking to improve and develop the databases that it offers bearing in mind the requirements of its "transfer pricing" clients. The OECD would like to consider whether the commercial databases could be improved to include more transactional information where this is not required by the domestic legislation. We understand that the provision of segmented data is an area that BvD is currently investigating, however as the data

contained within databases is generally based on information filed for statutory purposes, this level of analysis has only been possible for listed companies, which would invariably fail the required level of comparability under the arm's length standard.

We would also note that generally there is very limited reliable comparable evidence available that is prepared for transfer pricing purposes and therefore this source of information should not be disregarded on this basis.

We disagree with the concern expressed by many countries that the use of commercial databases has the tendency to encourage quantity over quality. Our experience of the searches undertaken by PricewaterhouseCoopers in South Africa, the UK and Australia is that detailed search criteria are selected based on the functional profile of the tested party, with a view to ensuring that the five comparability factors are applied as far as possible based on the information available. Thereafter, a detailed review of the information available on the internet is undertaken to ensure that the potentially comparable companies identified from such commercial databases are comparable (as far as possible) and any companies considered to be non-comparable are rejected. This approach however does have some drawbacks as the information available on the internet in respect of companies based in certain European countries is often only included in the local language, often no English alternative is provided and the on-line translation tools are limited. In such cases, and where it is not possible to reach a conclusion on the comparability of a company based on the trade description information obtained from the database alone, our approach would be to reject such a company.

C – Public information

Given our comments above, we agree with the proposal that information extracted from commercial databases must be used in conjunction with other sources of information, such as statutory accounts (where available), websites and trade journals. However, there are likely to be issues with the use of some of this data, depending on the specific facts and also issues with accessing the information for certain countries.

As previously mentioned, there may be independence and comparability issues when considering listed companies. The listed companies may have connected parties, which may not therefore provide results of an arm's length transaction. Further, the information contained in the annual report may be on a consolidated basis, and the subsidiaries may not perform the same or similar functions.

We disagree with your comments regarding the ability to conduct an exhaustive search using public information, without using a commercial database. An exhaustive search will only be possible where every possible source of information is used. This is highly impractical and most probably impossible and therefore we consider that the use of these commercial databases provides a useful starting point. It may obviously be appropriate to

supplement the results of this database search with information obtained from other sources, however in such cases we would query why the additional information had not been picked up by the original database search and whether the search strategy should be reassessed.

D – Foreign source or non-domestic comparables

The use of foreign source comparables is particularly relevant in the context of South Africa. As there are no locally available sources of reliable information with which to conduct a comparability study in South Africa, both the taxpayer and the South African Revenue Services rely on foreign sources of information. Although, we hope that this will become less of a problem going forward with the introduction of statutory filing requirements in South Africa. We agree that such searches should be capable of being reviewed by tax administrations, but generally this is not an issue in South Africa as SARS utilise the same commercial databases as ourselves and the other main professional advisors in the South African market.

We note that no detailed discussion is included within the discussion paper in connection with the use of non-domestic data and the need to make reliable adjustments in respect of market differences. We would welcome further discussion and guidance regarding such adjustments. We have included further comments in connection with this matter under Topic 7 – Determination of and making comparability adjustments.

In conclusion, the OECD must take cognisance of the fact that the sources of reliable information available to both the taxpayer and the tax authorities are very limited. Both taxpayers and taxing authorities have to rely on publicly available information when considering potential external comparables and both parties should be bound to only utilise the information which is available within the public domain and not rely upon secret comparables.

4. Uncontrolled Transactions

A – Description of the Issue and existing guidance

With increased globalisation, many industries are becoming integrated, making comparability studies very difficult because many Multinational Enterprises (MNE's) are not transacting on an independent basis. In practice the identification of an independent third party comparable is not easy and the list of potential comparables is often limited.

Practical Experience

South Africa has very strict independence criteria, with the current Income Tax Act defining a "connected person" as any other company where that company holds more than 20 percent of the equity share capital of another company. This strict independent

screen restricts the number of comparable companies that we can identify. Should the independence criteria be relaxed to 50 per cent, we would be able to obtain a larger (and potentially more reliable) set of comparable companies as it is difficult to reach a conclusion where the set of companies identified is very small (e.g. lower than 3-4).

We have in the past tested whether the pricing policy of the tested party is at arm's length using two different approaches / sets of companies, i.e. one set of companies that are independent (apply the 20% shareholding threshold) but operate in a broadly comparable industry (e.g. manufacturers of all vehicles, bodies, trailers and vehicle components) and one set of companies that operate in the same industry and deal in the same products (e.g. restricting search to manufacturers of cars only) but where the independence screen has been relaxed. If both sets of data have convergent outcomes, they provided us with sufficient comfort that the shortcomings of each of the sets, taken separately, are reasonably overcome.

B – Extent to which controlled transactions can be used in a transfer pricing analysis

We agree that controlled transactions should not be used as a basis for a transfer pricing adjustment. However, in our experience a controlled transaction may be a useful pointer and 'sanity check' on whether a particular affected transaction should be analysed in detail.

In addition, we agree that the mere fact that a taxpayer's profits are within the norms of its competitors does not mean that they are transacting at arm's length. This view has been endorsed by SARS in Practice Note 7.

C – Alternative Options

C.1 - Broadening the search

As indicated above, the use of foreign source comparables is particularly relevant in the context of South Africa. As there are no local available sources of reliable information with which to conduct a comparability study in South Africa, both the taxpayer and SARS rely on foreign sources of information (i.e. external comparable databases). SARS has occasionally been of the view that a country risk adjustment is necessary. However, this view is not consistently applied to all clients. There is much debate on what the appropriate model would be to make such an adjustment and whether such an adjustment will have a significant impact on the arm's length range. Also, it is debatable whether a country risk adjustment is always necessary based on the fact that in the South African market, certain industries are well developed (e.g. mining) or are not necessarily impacted by a difference in the geographic market.

The external databases utilised do not provide any information on the business strategies or business models which the potentially comparable companies apply. We therefore do not consider that the OECD's suggestion that business strategies, product lifecycles, return of investment etc. should be taken into account when performing the comparable analysis using an external database. Although limited information in his regard is sometimes included within the company's website (depending on the size of the company), this information is invariably difficult, if not impossible, to obtain for independent companies.

C.2 - Uncontrolled transactions carried out by MNE

The discussion paper comments that subsidiaries belonging to an MNE group may carry out uncontrolled transactions that can potentially be used in a comparability analysis. In practice however, it is very difficult or even impossible to obtain documentary evidence of these transactions for the following reasons:

- When considering internal comparables, fellow subsidiaries are often not willing to share this information for commercial reasons and due to internal politics and obtaining such information from a fellow group company is also problematic where the fellow group company is in direct competition with the tested party; and

- For external comparables, the external databases used do not provide such detailed information on a transaction by transaction basis.

The fact that fellow subsidiaries are unwilling to share such information should go some way towards showing the arm's length nature of the internal relationships within the MNE group.

C.3 - Possible use of consolidated data

Where we use the external database to identify comparable data, we in certain cases select companies that have consolidated data, where the following criteria are met:

- The company into which the results have been consolidated does not have more than 5 subsidiaries, as we take the view that where the company has more than 5 subsidiaries, it is unlikely that all subsidiaries will be undertaking activities which are comparable to the tested party;

- The subsidiaries are based in the same country as the company with the consolidated accounts; and

- The company with the consolidated accounts and all of its material subsidiaries perform activities comparable to the tested party.

C.4 - Influence of minority shareholders

We agree with the statement that the presence of minority shareholders influence a transaction, however this would have to be proved by the taxpayer, by showing, *inter alia* that the minority shareholder was involved and had significant influence in the negotiation of the transactions and the terms on which the transaction were entered into.

SARS has stated that the presence of minority shareholding does not necessarily mean that the parties are dealing at an arm's length. Further proof would have to be provided to demonstrate the influence that the minority shareholder has.

5. Examining the Five Comparability Factors

A - General comments on the five comparability factors

We are in agreement with the comments of the business commentators supporting the use of the five comparability factors, however we also agree with their comments regarding the difficulty in applying these standards in practice where publicly available information is limited.

In South Africa especially, we are very much reliant on the use of databases of European companies, which generally contain very limited quantitative or qualitative information. In contrast, we find that SARS has access to resources (and budgets) which our clients cannot reasonably be expected to match. In practice, the level of detail and information needed on each of the five comparability factors is assessed on a case by case basis i.e. we determine the extent to which the missing information is likely to affect the reliability of the comparable transaction or company.

B – Discussion on specific issues in relation to each of the five comparability factors

B.1 - Characteristics of property or services

The comparability of characteristics of property / services is the first criteria set for determining comparability, as per the comments of the working party. Although these factors are generally most relevant when using certain methods, such as the CUP method, or the other traditional transaction methods.

In practice, comparability in functions is generally regarded to be more important when using the transactional profit methods. However, the Working Party is of the opinion that functionality should only be used as a preference when:

- no accurate data is available; and

- product differences do not materially affect the reliability of the comparisons.

However, in practice, we have found that due to the limited amount of comparable data available, it is rarely possible to find a set of comparable transactions or companies involving goods or services with exactly the same characteristics as the goods or services being analysed. When using the TNMM method, we are of the opinion that selecting transactions or companies with goods or services with different characteristics, but with similar functionality to the taxpayer, often produces very similar results to what could have been expected if comparables with the exact same product or service characteristics had been utilised. This is particularly true with regard to distribution activities. We have evidenced this through research undertaken regarding the returns earned by distributors of durable and non-durable goods. As outlined in our submission to the Working Party on the transaction profit methods (see letter dated 29 August 2006), we have concluded that the returns earned by distributors does not differ significantly even where there are fundamental differences in the products being distributed.

B.2 - Functional analysis

We agree with the comments made by the Working Party in this respect. In particular, although it is often possible to obtain a significant level of detailed information regarding the functions, risks and assets of the tested party, it is generally impossible to obtain the same level of information regarding external comparable transactions and/or companies. The functional analysis of the comparable companies often involves a subjective analysis of the limited information available. We agree that deciding on whether the outcome of such an analysis is sufficient should be considered on a case by case basis and will likely depend on the extent to which other comparable evidence is available and can be relied upon.

B.3 - Contractual terms

Comparability of contractual terms is essential as this provides valuable information on how the affected companies allocate the various functions and risks between themselves. However, as highlighted by the Working Party obtaining the same level of detail in connection with independent transactions and/or companies is problematic due to confidentiality. Consideration of the contract terms is particularly relevant where a comparability analysis is undertaken on a transactional basis and the sources of evidence identified are third party agreements. In addition, as explained further below, where information regarding the contractual terms is available, it is extremely difficult to ascertain the extent to which, if any, the differences in the contractual terms impact the pricing.

B.4 - Economic circumstances

In reference to the use of quantitative data identified to assist in determining the comparability of the potentially comparable transactions or companies to the tested party or transaction, we generally make use of all of the examples documented, to a greater or lesser extent depending on the specific circumstances. However, we find it extremely difficult and costly to obtain the relevant economic data which may be used in the comparable analysis, in particular relevant information regarding the business or product cycles. Our clients may be able to give us detailed information on economic factors which they have identified as having a significant influence on their industry, but we cannot sufficiently evaluate the significance of these economic factors on the companies within the comparable company set and determine whether an "adjustment" is required to take into consideration the impact of these economic factors. In the case of business cycles especially, it is common knowledge that there is generally a lag effect in business cycles of different countries e.g. European business cycle vs. South African business cycles for vehicle manufacturers. It is the existence of these business cycles in different markets which does in fact serve to justify the use of multiple year data vs. single year data.

We are in agreement with the statement that the use of non-domestic comparability analysis results in issues pertaining to (a) whether the markets are actually comparable and (b) differences in accounting standards. Point (b) is of particular relevance in that we often find very limited financial information on comparable companies from particular countries within the external databases available. As much as we would like to make use of adjustments to account for differences in market specifics (e.g. interest rates, price of land, labour costs etc.), there is no clear guidance as to the best model with which to make these adjustments and therefore any such adjustments will continue to be subjective and potentially unreliable until guidance on when adjustments should be made and how the adjustment should be affected is made available.

B.5 - Business strategies

We are in agreement that business strategies may impact on the selected transfer pricing methods and thus the reliability of the potential comparable transaction. However, as correctly pointed out, we are unable to obtain this type of information on third parties and as such; we are unable to perform any adjustments to take into account these potential unknown differences.

6. Selecting or Rejecting Third Parties or Third Party Transactions

A – Typical process for identifying comparable transactions

In connection with your illustrative order of the steps to be followed in searching for comparable transaction, we agree that it is important to consider potential internal comparables prior to considering available sources of external information (e.g. external databases). A review of potential internal comparables should be a key part of the fact

finding process and where possible should consider internal comparables within the taxpayer's worldwide group rather than limiting the analysis to only those transactions which the taxpayer itself is party to. We do however recognise that there can be difficulties in obtaining such information from other parts of the taxpayer's worldwide group. In addition, we agree that it may be necessary to review the other sources of information several times before concluding on which source of information provides the most reliable results.

B – Degree of objectivity of the list of comparables: the "additive" and "deductive" approaches

We have concerns regarding the use of the "additive" approach in connection with certain transfer pricing methods, such as the TNMM. The list of third parties drawn up by the taxpayer is likely to include competitors and these third parties may not meet the required standards of independence in the taxpayer's country of residence. The information collated by the taxpayer in connection with these taxpayers and their comparable transactions is likely to be on a whole of entity basis rather than transactional data and therefore the results may include related party transactions which may not have been undertaken at arm's length, hence potentially distorting the results achieved. This approach may however be useful when specifically searching for transactional data using the CUP method e.g. royalty and commission rates included within publicly available inter-company agreements filed with the Securities and Exchange Commission (SEC).

Combining the "additive" and "deductive" approaches may also be viewed as selective or cherry picking and therefore we would advise caution when adopting this approach. If companies are identified from the additive approach which have not been picked up as a result of the deductive approach, this may suggest that the search strategy applied under the deductive approach is not sufficiently robust and should be reassessed. If the correct search strategy was used, these additional companies should have already been picked up. As a result, we consider that the additive approach could be useful for assessing whether the deductive search strategy is reliable, comprehensive and appropriate given the economic characteristics being considered.

We agree with your reluctance to advocate the process of adding known-competitors to the set of comparable companies. Our experience shows that it is common for known-competitors to be classified under different industry codes and for this reason, our standard approach is always to use relevant key words in addition to industry codes within our search strategies. This approach aims to identify those companies that may have similar trade descriptions to the taxpayer but are incorrectly classified under a different industry code. We would determine the key words to be used based on the functional analysis of the taxpayer. In line with our comments above regarding combining the additive and deductive approaches, we agree with your concerns that simply adding such known-competitors to the set of comparable companies would be subjective and this should only be used as a tool for reassessing the completeness and reliability of the

search steps and criteria adopted. There may be valid reasons why such known-competitors are not included within the final set of comparable companies (e.g. independence, insufficient data) and it is therefore important to review the search to ascertain if these companies have been rejected at a previous stage and if so, the rejection reason. If these companies have not been previously identified through the search and they are considered to be comparable, this provides an indication that the search strategy should be reviewed. If the company is then identified as a result of amending the search criteria and meets all of the remaining search criteria, it would be appropriate to retain the company. This may also result in further additional companies being identified. We consider that under no circumstances should such known-competitors simply be added to the set of comparable companies, without reassessing the search strategy and applying all of the comparability criteria to the additional companies identified.

7. Determination of and Making Comparability Adjustments where Appropriate

A – Existing guidance

As stated under point 5 of this topic, the discussion regarding comparability adjustments concentrates on adjustments in the context of a cost plus, resale price or transactional net margin method. We are therefore perplexed as to why the CUP method was not included in the discussion whilst reference to applying comparability adjustments under the CUP method is made in paragraphs 2.7 to 2.9, paragraph 2.16 and paragraph 2.34 of the OECD Guidelines. We consider that the discussion regarding comparability adjustments is equally relevant in the context of a comparability analysis using the CUP method.

B.1 - Accounting adjustments

We accept and agree in principle with the comparability adjustments stated in section B-1 of the discussion in connection with accounting adjustments. However, although the adjustments are based on sound theoretical principles, we feel that such adjustments are often impractical to implement due to the lack of availability of reliable comparable data within the public domain. In other words, regarding the accounting adjustments required, it is near impossible to access the required level of information with which to apply adjustments. Companies are generally reluctant to publish commercially sensitive information. Furthermore, the level of detail and quality of accounting data throughout Europe varies considerably. Paragraph 14 states that it is almost impossible to identify "all differences". Given the problems accessing detailed information across Europe, we consider that it is almost impossible to identify "most" of the differences and not just "all" differences. We acknowledge that for potentially comparable companies within the UK, full statutory accounting data are filed with Companies House and this original data can be accessed by the public for a fee; however in general it is not possible to access such detailed original information for other European countries. In particular, the level of

original information available in respect of companies in Germany and Eastern Europe is extremely limited.

Many of the issues regarding the identification of differences in accounting standards may be resolved with the introduction of International Financial Reporting Standards ("IFRS"), however companies will likely still have the ability to select various reporting options within these accounting standards and therefore it is likely that applying accounting adjustments will continue to pose difficulties until the quality of data reported is standardised and detailed financial information becomes readily available to the public. We would welcome further comments from the OECD on applying appropriate adjustments where there are difficulties in accessing original accounting data.

Given the difficulties in accessing the required information, it may be necessary to consider alternative approaches to applying certain accounting adjustments. For example, differences in the age of operating assets and the use of conservative economic useful lives for accounting purposes can potentially distort the results (e.g. return on operating assets) of manufacturing companies in capital intensive industries. We understand that it is common practice within the corporate finance industry to adjust the net book value of assets to reflect a re-valued net book value, taking into consideration the full economic lives of assets and the effects of high inflationary environment on the economic value of the assets. Our view is that it may be appropriate to consider such alterative approaches for the purposes of undertaking transfer pricing analyses.

B.2 - Balance sheet of asset intensity adjustments

We agree that adjustments (balance sheet, asset intensity or other) should only be performed where they improve the level of comparability between the controlled and uncontrolled taxpayers. We would firstly seek to eliminate companies that were not considered to be comparable due to material differences in functions, assets or risks. Further details regarding this aspect of the discussion note are included below under section B-3 – Other adjustments.

B.3 - Other adjustments

With regard to section B-3 "Other adjustments", we have included some comments below in connection with the various examples provided.

We reiterate your point regarding how reliably adjustments for equipment failure, inefficiency or investment in new plant and equipment can be made. Firstly, it is difficult to access such information regarding third parties and secondly, the effect of such factors on a company's profitability would be extremely difficult to measure. The effects of such factors may be reported by companies as exceptional or extraordinary items, however for

the reasons stated above; it is very difficult to access this level of data for the potentially comparable companies being considered.

Adjustments to account for differences in contractual terms are also extremely difficult and are potentially unreliable. For example, how would an adjustment be made for the fact that a taxpayer company has exclusive distribution rights under a related party contract and a comparable company has non-exclusive distribution rights covering the same territory, or the taxpayer company has a 5 year distribution contract whereas the comparable company has a 10 year contract?

There is currently much debate globally and within South Africa regarding adjustments for geographical/market differences, in which circumstances they should be applied and the methodology for calculating the adjustments. This is particularly relevant in the context of South Africa as the generally accepted approach is to utilise European third party evidence given the lack of South African financial data available. We understand that SARS are of the view that country risk adjustments should be made where European comparable companies are being used to test the results of a South African tested company, arguing that South Africa is a riskier environment to operate in compared to Europe and thus the potential for increased profits exists. In determining a suitable measure for a country risk adjustment, SARS is using the differential in government bond yields in Europe compared to South Africa as indicative of the additional risk borne by companies operating in South Africa. In our view, the use of generic government bonds does not take into consideration variances in risk across industry groups, thus any risk adjustment should also include an industry variant to make it relevant for the purposes of any transfer pricing analyses. Secondly, there is no evidence that companies in South Africa do in fact bear higher risks and earn higher returns than comparable companies in certain European countries. This is particularly true in relation to the former Eastern Block countries such as Poland and Hungary. A further concern which we have is that SARS is of the view that the differential in government bonds rates should be used to increase the upper end of the range of returns earned by the comparable companies identified from Europe only. This suggest that higher risk only results in increased profit potential, whereas in reality it would result in a greater variant in both profit and loss potential and hence the lower end of the range of returns should also be adjusted downwards by an equivalent amount.

We agree with your comments that it is preferable not to make adjustments to third party transactions for material differences in functions, risks or assets. We would firstly seek to eliminate companies that were not functionally comparable based on the information available. In your example of a search for contract manufacturers, it should be recognised that identifying whether a third party company acts as a contract manufacturer is very difficult. We would not simply seek to apply an inventory adjustment to improve the set. We would seek to analyse the economic circumstances of the taxpayer company and ensure that the comparable companies were subject to similar economic circumstances through the use of various financial screens. This may involve rejecting companies with

inventory levels, working capital levels or asset intensity levels which were not comparable to the tested party, rather than simply adjusting the results of the set to take account of such differences. The remaining companies within the set, after applying the various financial screens, should therefore have characteristics which are closely comparable to the tested party.

C.1 - Quality of the data being used

We are in agreement with section C-1 point 26 that applying sophisticated and complex adjustments in respect of broad comparables is less than desirable. However, in certain instances, we are only able to obtain such broad comparables, with no better or more reliable sources of information being readily available.

C.2 - Purpose of the adjustment performed

We agree that differences which do not materially affect the comparability should not be adjusted, however often it is difficult to determine whether a difference is likely to materially affect price. Please see above regarding our comments in connection with differences in contractual terms e.g. term of agreement, exclusivity.

C.4 - Reliability of the adjustment performed

It is often difficult to find objective and verifiable economic data on which to base comparability adjustments, in particular for differences in the level of risk borne. For example, how is an adjustment to be made for the fact that one company bears inventory and credit risk whilst another company does not? Traditional working capital type adjustments are generally intended to adjustment for the cost of financing working capital, rather than the risks associated with investing in such items.

We welcome and agree with your comments that whichever party proposed the adjustment should be in a position to defend its use. This will be particularly relevant where tax administrations have used data from secret comparables in order to arrive at the proposed adjustment.

We note that the discussion indicates that different approaches may be adopted by different countries in performing comparability adjustments and that for some countries, unadjusted data should generally be given preference. However, we are of the view that if the proposed adjustment improves the comparability analysis and the effect on the price is material, the adjustment should be made regardless of the country involved.

Finally, we consider that one needs to ensure that the same standard of reliability is applied in respect of adjustments to both internal comparables and external comparables.

C.5 - Consequence of having performed a well focused and reliable enough adjustment

We also welcome your comments regarding accepting quality and reliable adjustments in good faith where they meet certain requirements, however we feel that tax administrations are likely to be unwilling to follow this approach where the adjustment results in a reduction in the potential range of returns, therefore potentially decreasing their ability to make a transfer pricing adjustment. As a result, we believe that this recommendation should be specifically incorporated into the OECD Guidelines.

Annex: Example of a Working Capital Adjustment

As it is not possible to know the levels of receivables, inventory and payables for the comparables over the period under review, we would recommend that the average of the opening and closing balances are used for the purposes of any working capital adjustments.

With regard to the interest rate to be used, we consider that it should be the rate at which the comparable company can borrow in its jurisdiction, rather than the rate at which the tested party can borrow in its jurisdiction, which may represent very different rates. As such information will generally not be available for each comparable company, we consider that the local short term borrowing rate of interest in the territory of the comparable companies should be used as a starting point (e.g. relevant inter-bank lending rate). It may also be appropriate to increase this rate by a margin to take account of the commercial risks associated with lending money to businesses rather than banks; however the appropriateness or reliability of any such adjustments to the interest rate would depend on the level of information available with which to make such an adjustment.

8. Multiple Year Data

A - Existing guidance

Our experience shows that multiple year analyses prove useful when trying to understand the facts and circumstances surrounding a controlled transaction and is also useful in providing information about relevant business and product life cycles of comparable data.

B – Comments received from the business community

We agree with the comments raised by the business community that multiple year data is a useful tool to smooth out fluctuations caused by business and/or economic life-cycles. In general, we would also agreed that the use of multiple year data will generally be useful, although this will ultimately depend on the particular facts and circumstances being used, and in particular cases, it may be considered more appropriate to use single year data.

C – A few considerations related to the use of multiple year data

We are of the view that in the context of transfer pricing the use of multiple year data is defendable based on the following:

- Multiple year data takes into account the effect on the tested party's profit of product life cycles and short term economic conditions; and

- A taxpayer's pricing policy could be based on its business strategy which is focused on a 3 to 5 year business plan.

Also, if multiple year data is used for the comparable data, it should also be used for the tested party to ensure consistency in the analysis. In practice, for the reasons stated above, we always apply multiple year data for both identifying the arm's length range and for testing whether the transfer pricing policies applied by the tested party is at arm's length.

Furthermore, multiple year data is particularly useful where the sale of commodity products is involved.

When comparing multiple year data (over the selected period or on an average basis) of independent comparable companies to the taxpayer's financial information for the underlying years, we clearly document the reasons why the taxpayer's results for a particular year fell above or below the arm's length range identified for the independent comparable companies.

C.1 – Multiple year data and cycles

We appreciate that it would not be appropriate to be prescriptive in setting guidance on the numbers of years of data to be used, as factors such as industry, functions, assets and risks need to be considered. For example, a fully fledged manufacturing entity that possesses intellectual property, huge asset investment and marketing intangibles will generally have a longer economic life cycle than a limited risk distributor. Therefore the manufacturing entity and comparable independent companies will tend to be evaluated over a greater period than limited risk distributors.

However, we do think that it would be useful for the OECD to provide some additional high level guidance on the number of years to be considered (in the absence of specific industry factors which may affect the selection) for statistical purposes and the ways in which data should be combined or averaged, given the varying views taken on this by the various OECD Member States. For example, certain countries use 3 year average as standard, where other countries use 5 years. Certain countries calculate a weighted average, whereas others calculate a simple average. This potentially causes problems for multi-nationals where they want to use one pan-regional study for the purposes of supporting their pricing in various territories. As a result, the current difference in approaches places an additional administrative burden upon taxpayers in complying with the various different tax authorities approaches.

C.2 – Multiple year data in loss-making situations

We agree with your comments that multiple year data can provide a useful tool to support the consistent loss making position of the taxpayer, where the data obtained on third parties also shows consistent losses. We have found that this has been of particular relevance in the car industry where many manufacturers are making heavy losses.

C.3 – Use of multiple year data to examine volatility or to detect anomalies in third party data

Please see our comments under Section 10A in connection with this topic and the use of standard deviations.

D.1 – Adjustment of a taxpayer's profits over a multiple year period of time

SARS has indicated that they will analyse a tested party's results on a year by year basis to determine whether the transfer pricing policy applied during that particular year was at arm's length. In particular, where a taxpayer earns a return in one year that is less than the median or the lower quartile result achieved by the independent comparable companies, but the taxpayer has achieved an acceptable return taken on an average basis over a number of years, SARS will not accept the low return made in the year under examination. SARS bases their view on the fact that tax is an annual event. The effect of this is that SARS is willing to tax the high profits achieved in certain years, but is unwilling to allow the low profits in other years, which results in an un-equitable position for the taxpayer and puts South African taxpayers in an extremely difficult position.

As indicated, most OECD countries also have the rule that each fiscal year must be examined separately. As a result of this potential inequity, taxpayer must be afforded the opportunity to re-open assessments and apply for reduced assessments if the transfer prices were above the arm's length range, and not only be assessed upwards if transfer prices were below the arm's length range. However, this brings with it an additional administrative burden, and therefore flexibility on the part of the tax authorities is encouraged.

E – Preliminary conclusion

We recognise your comments that the usefulness of multiple year data is not intended to contradict the yearly examination procedures adopted by domestic tax administration, however we would ask that the OECD clearly recommends in the revised guidelines that tax administrations should approach this assessment with flexibility and reasonableness, given the particular facts of each case, rather than trying to apply a strict rule to all taxpayers.

We also recognise the need to distinguish between considering multiple years of data to support the arm's length nature of the taxpayer's pricing and the statistical approach of calculating an average of the results over a specified number of years to arrive at one overall range for the purposes of comparison to the taxpayer's results. This would appear to be a key misunderstanding amongst the business community.

9. Aggregation of Transactions

As previously indicated, in South Africa, we mainly use comparables sourced from publicly available databases using predominantly European companies ("external databases") to undertake our external benchmarking exercises. As the financial information provided in these external databases is limited, it is impossible to segregate third party data using the information contained within the databases and furthermore, it is not possible to access the statutory filed accounts of the companies. As a result, we are generally compelled to use the company wide data as provided in the external database. However, as part of our search process, we will look at the trade description of the companies, obtain information from the companies' websites and/or the internet and critically examine the financial data provided in the external database to determine, as far as possible, whether the independent companies are functionally comparable to our tested party (e.g. performing a sales agent function or purely a distribution function etc.). If through our stringent criteria, we identify that the company is performing a further function (i.e. manufacturing) the company will be rejected as it is impossible to obtain segregated financial data using the external database. In particular, where the external database indicates that the company's secondary industry code is not comparable with the activities undertaken by the tested party, the company would be rejected as the secondary code generally represent at least 10% of a company's income source. Although, some subjectivity may be involved at the website review stage in retaining companies with immaterial non-comparable or additional functions, where we experience difficulties in finding companies solely involved in the requisite functions.

Also, it is rarely possible to identify companies in the external database that, for instance, distribute highly comparable products to those distributed by our tested party. We are in most instances compelled to focus on a wider category of products (for instance electronic products) as opposed to a specific product (i.e. toaster) when identifying independent comparable companies.

Where the tested party is involved in a number of different affected transactions (i.e. manufacturing activities and distribution activities), we will as a general rule seek to segregate the tested party's financial data per category of affected transaction. A difficulty that we have experienced in obtaining segregated data for the tested party is the fact that most companies have detailed segregated information to the gross profit level, but are not able to supply the same level of segregation to the operating profit level. This poses a problem since in most cases, due to the external database not having sufficient gross profit data, the TNMM method tends to be used. To apply the TNMM method, financial data up to the operating profit (before interest and tax) is required. To overcome this

problem a reasonable allocation key is selected to allocate operating expenses to the specific transactions. This allocation can be subjective, open to potential manipulation and can significantly influence the results obtained.

One particular issue arises with the aggregation of transactions in the South African motor industry. There is an argument that due to the application of the Motor Industry Development Programme ("MIDP"), which includes an import-export complementation scheme, that it is defendable or appropriate to examine the tested party's results on an aggregated basis. MIDP rebates are earned by a company from exporting the products which it manufactures. However, these MIDP rebates are generally used to reduce the tariffs on "Completely Built Up" vehicles imported from other territories and subsequently distributed within South Africa. The treatment of MIDP rebates can therefore cause potential problems for the purposes of undertaking a financial analysis on the segmented results for each activity due to this element of cross subsidisation.

10. Definition of Arm's Length Range, Extreme Results, Methods to Enhance Reliability, Loss Making Companies

A – Definition of the arm's length range

The OECD discusses what should constitute a range, what level of statistical analysis should be done when analysing the range to be adopted, and the application of statistical analysis tools to limit or widen the range, but also emphasises that statistical tools should not be a substitute for poor comparability. What the paper does identify and which is supported by South Africa is that statistical tools are very useful to help identify comparability problems and hence comparables which may need further scrutiny where large generic databases are used, which only provide limited information.

Statistical tools also play an important role in analysing a range or a variety of ranges which may be obtained through the use of varying methods. Even under one method, with differing profit level indicators used, the ranges can vary so much that some form of statistical analysis is required to help understand the variances.

The increasing integration of economic theory and statistics into transfer pricing is also becoming more relevant. Use of standard deviations as an indication of the over-all risk profile of a company's operations and hence as a means of determining deviations from comparability within a set is not used as often as it perhaps should be, as it plays a useful part in analysing results. Furthermore, analysing the range of results achieved by the total set of comparable companies identified in terms of various variables, such as turnover level, asset intensity and operating expenses to sales ratios can also provide useful information to assist in determining whether these factors affect the returns earned by the comparable companies (i.e. any positive correlation) and hence whether this additional

analyses can assist in determining where within the total range of results the tested party should be ideally be positioned.

Finally, although the use of the inter-quartile range or the median return is not specifically encouraged by the OECD Guidelines, there is a tendency for tax administrations, practitioners and taxpayer to place significant reliance on the inter-quartile range as a pseudo safe harbour approach. Our view is that too much focus is currently placed on the use of this range. What we believe is of greater importance is an analysis as to where and why a tested party's results falls within the total range identified.

B – Extreme results: comparability considerations

The OECD recognises that there is a temptation to remove statistical outliers from comparable sets. We do not agree with adopting this approach at face value for the following reasons.

What needs to be understood is the reason for the results and whether this detracts from the comparability. Based on these analyses and further investigations, a decision should then be taken as to whether these outlying companies should be included or not. Thus, statistical analysis could be used as a useful tool to identify comparables which require greater scrutiny, but should not necessarily be used as exclusion criteria.

The second issue is more one of practicalities. In South Africa, we are faced with limited information on comparables sourced from publicly available databases and hence predominantly use European companies. As such, some inherent subjectivity is required to analyse these. Limiting the set using a statistical analysis like the inter-quartile range may help to identify companies with abnormal results which, if further scrutinised, could be non-comparable and should therefore be removed. Likewise, as indicated above, a review of the standard deviation of the final comparable set will provide some comfort or otherwise of the consistency of the set obtained.

C – Approaches to enhance reliability

The use of statistical analysis to enhance reliability is accepted. Most revenue authorities, South Africa included, accept that an arm's length range falls within an inter-quartile range of comparable companies identified (assuming all relevant comparability factors have been checked). Thus, as already mentioned, provided appropriate search criteria have been adopted to ensure comparability as far as possible and any outliers have been thoroughly investigated, a result within the inter-quartile range does provide a pseudo safe harbour for the tested party without too much need for further analysis.

Our main concern as already alluded to is to qualify where and why the tested party falls within that range and how that is justified.

Ranges which adopt multiple year data can also be misleading and distorted by erroneous data included. A statistical analysis could help alleviate and identify this thus smoothing the results into a more consistent range.

One example of how statistical analysis can be used to enhance the reliability of comparability is in determining the appetite for risk of the comparable. Using statistical analysis to counter this can increase the likelihood of comparability. For instance, a low risk entity would expect to earn consistent results and may only suffer losses in the initial years. Higher or fluctuating profits and big losses tend to suggest the comparable is a higher risk taking enterprise and reduces potential comparability.

A statistical analysis to eliminate variances could potentially have the effect of removing companies with a varying risk profile to the tested party and leave more comparable companies in the set. However, such an approach should be taken with extreme care.

We would then concur that in very limited cases, it is possible to exclude high profits and losses when benchmarking limited risk entities but that this approach should be taken with extreme care to ensure we are not replacing a comparable review with a statistical test.

C - Ranking the points in the range

This is an area in South Africa that we are starting to focus on more. In our view, it is quite acceptable to have “A” and “B” sets where the comparability criterion is problematic. For instance, a classic case is where we can only find perhaps two truly comparable companies but to try and obtain a larger set will then widen the search by relaxing some of the comparability criteria.

In practice, we believe a better solution should be to split the analysis using the initial two comparables identified as an “A” set and include the wider results as a “B” set. It demonstrates less subjectivity and provides a two tier approach to testing the reasonableness of the outcome.

D - Loss making comparables

In general, a company should not, in our view, be disregarded solely because of its results. Again the most important aspect is what is giving rise to those results and is this detracting from comparability?

Having said this, companies with consistent losses are likely to be either in liquidation or bankruptcy or at best not operating under normal trading circumstances on the basis independent companies do not make consistent losses. The existence of continued losses is also often an indication that the company is not independent and highlights that further investigation may be required. When such results are encountered, a further check of the company should be undertaken to try and identify the reason for the results and whether this in fact does detract from the comparability.

11. Documenting a Search for Comparables

As outlined in the discussion paper, the OECD Guidelines do not provide much guidance on the documentation of comparables. Locally, due to the fact that the external comparable analysis often serves as the basis for establishing the arm's length range, much effort is directed at documenting the steps and processes followed in order to derive the comparable set of companies. Due to the fact that there is no transfer pricing legislation or court cases which depict what these comparable search steps should entail, we take the approach of fully documenting in detail the various steps taken in arriving at the set of comparable companies. This allows SARS to test the work undertaken and also provides an audit trail from a defence perspective, should the comparables be contested in a court of law. This audit trail shows that we have reasonably applied our minds in deriving the comparable set.

Our approach to documenting the comparables search process has developed over many years and is something that is continually evolving and improving. As a result, we recognise that it would be difficult for the OECD to provide a defined list of what information should be included within any such documentation. However, it would be useful if some general guidance was provided within the OECD Guidelines e.g. whether a rejection matrix and details of the calculation of working capital adjustments should be included. This would hopefully assist in making the documentation approaches adopted globally across various different territories and by various practitioners consistent. On this basis, we agree with the suggestions made regarding extending the existing guidance within Chapter V to include a discussion of the documentation of comparables searches.

Finally, we provide our authorisation for our comments to be published on the OECD's internet site. Should any adjustment be made to the content of this memo, we request a review of the final proof prior to publication.

Should you have any queries regarding the above comments, please feel free to contact either Karen Miller on +27 21 529 2143 or Jacques van Rhyn on +27 (0)11 797 5340.

Yours faithfully

PRICEWATERHOUSECOOPERS

David Lermer

PricewaterhouseCoopers Tax Services (Pty) Ltd