How to apply the arm's length principle without comparables: a major challenge in emerging/developing economies

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JULY 2018

Background*

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- The arm’s length principle needs comparables in order to be applied
- Comparables are lacking in some regions of the World, for instance Africa

* Parts of this presentation were presented by TPED at IBFD African Tax Symposium in May 2018.

An Illustration of the Issue

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Cocoa processing in Ghana

[For illustration purpose – Does not constitute a compliant OECD/UN comparable search process]

- **20 companies are cited by Sutton in his study[1], among which two report financial data in a commercial database, but none of them is 'independent'.**
- **Extending the search to companies within the NACE Code: 1082* in Ghana , 1 comparable company has both financial data and is independent.**
- **Extending the search to <u>Africa</u> yields 170 companies with financial data out of which only 2 relate to cocoa manufacturing – 1 in Ghana (same as above), 1 outside of Ghana.**

[1] Sutton (2012) '*An Enterprise Map of Ghana'.* International Growth Centre

[2] NACE Code 1082: Manufacture of coca, chocolate and sugar confectionery

Objectives

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- This presentation aims at evaluating the various options available to tax authorities and tax payers to cope with the lack of comparables in Africa
  - The Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses, by the Platform of Cooperation on Tax (IMF, OECD, UN, WBG) is the most comprehensive document to date on the subject

- **We discuss two options to establish local arm's length ranges / safe harbors**:
  - Option #1 : Leverage from local domestic available financial information
  - Option #2 : Define economically-sound adjustments to non-local comparables

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Option #1: exploit local financial data

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- Tax authorities have access to locally filed financial information

- This information is often referred to as “secret comparables” – as tax payers do not have access to such information

- A comprehensive and economically sound review, treatment and analysis of local financial data available could allow tax authorities to:
  - Assess the quality of data available – whether it can be used for TP purposes or not
  - If yes, be in a position to publish regular economic aggregate analyses results based on this data (while ensuring confidentiality of individual company information)

Option #2: use foreign comparables

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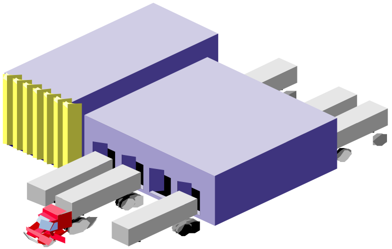
- Using foreign comparables is an option
  - What does foreign mean?
    - Neighboring countries
    - Africa as a whole
    - All emerging / developing countries
    - EU / USA

- Adjustments to foreign comparables are needed in certain circumstances

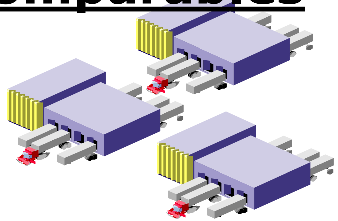
Case Study

The African tested party



A subsidiary of fruits/vegetables processing in Africa, that sells 100% of its production to the Group

Foreign Comparables



	Trade Description
Company 1	Processing fruit juices and concentrates.
Company 2	The company produces citrus juices, concentrates, oils, fruit cells and purées for the food & beverage industry.
Company 3	The company produces juices, juice concentrates, fruit pulps and aromas for the fruit juice, baby food and food industries.

Similarities Between the African Tested Party and the Foreign Comparables

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	African Tested Party	Foreign Comparables	Pass?
Industry	Manufacturing/Processing of fruits/vegetables	Manufacturing/Processing of fruit juices/concentrates	**Yes**
Role in the Value Chain	Upstream / sells its production to the Group	Contract manufacturers/serve the Food and Beverage Industry	**Yes**
Functions performed	Procurement, Production, Supply Chain (no ‘sales’)	Procurement, Production, Supply Chain (no complex ‘sales’)	**Yes**
Assets owned	Plant, Know-How	Plant, Know-How	**Yes**

Differences Between the African Tested Party and the Foreign Comparables

	African Tested Party	Comparables in • Neighbouring countries • Africa • Emerging/Developing Countries	Comparables in EU / USA
		Adjust?	**Adjust?**
Risks (including market, compliance, foreign exchange, etc.)	Greater risks?	**It depends.**	**Yes.** Specific situation of fixed margin guaranteed to the tested party.
Location Specific Advantages • Access to resources • Access to cheaper labour (but higher costs for other items – location specific disadvantages)	Local LSAs	**It depends.**	**Yes, an analysis is needed.**

Proposed Process For Using Foreign Comparables jn Africa

- Step 1: ensure similarities in terms of
  - Industry
  - Role in the Value Chain
  - Functions performed
  - Assets owned

- Step 2: assess differences in terms of risks and LSAs
  - Are there differences in risks?
    - If so: **Adjust**
      - Specific situation of fixed margin guaranteed to the tested party
  - Are there differences in location advantages
    - Access to Resources, lower labour costs: **Adjust (an analysis is needed)**

- If comparables in Africa or Emerging/Developing countries are selected, adjustments may not always be necessary

Case Study

- French Co has an operational subsidiary located in Angola involved in commercialisation within the local markets (i.e., Sub-Saharan Africa)

Difference in Economic Conditions Differences Can Influence the Margins That Companies Earn

- More competition & larger market
- Lower cost of capital
- Shorter term associated with payables and receivables
- Less political & country-specific risk factors

All above factors reduce the volatility of operating margins

- Smaller firms
- Higher cost of capital
- Longer term associated with payables and receivables
- More political and country-specific risk factors

All above factors increase the volatility of operating margins

Given such significant differences, how to adjust for economic circumstances?

Case Study
A 4-Step Process Has Been Followed

Step 1
Local Comparables Search

Step 2
Regional Comparables Search

Step 3
Pan EU Comparables Search

Step 4
Comparability Adjustments

- Perform a comparable search for similar functional comparable companies to the tested party operating in Angola
  - **No functional comparable companies with financial data could be identified**
- Expand our comparables search to Sub-Saharan Africa
  - **No functional comparable companies with financial data could be identified**
- Perform a Pan EU comparables search
  - **Identified functional comparable companies with financial data available**
- Perform comparability adjustments

Case Study
Key Differences In Economic Circumstances Can Be Observed Between Angola Co and EU Comparables

- Accounts receivable approximately 2x than of Europe
- Inventory days are 3x longer than in Europe
- Cost of capital higher than that of Europe
- Margins more volatile
- Commercialisation activity potentially more risky (credit scoring tools not available) with more uncertainty than in a more mature markets

To ensure that economic circumstances are adjusted in line with OECD comparability requirements, the above factors need to be adjusted for…

Adjustments Needed Will Vary From Case to Case and also Depend On the Capital Structure of the Tested Party

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Adjustment 1—
Working Capital Adjustment

- **Receivables and payables terms represent the extension of credit along with the transaction of the tangible (or intangible) property at issue**

- Receivables or payables terms that are higher or lower than "normal" may indicate the bundling of two transactions
  - The transfer of tangible (intangible) property at standard credit terms
  - A transfer of capital (i.e., intercompany loan)

- **Inventory has a financing cost associated with it. Differing levels of inventory will impact the profitability of comparables and tested party**

Addresses the impact that the working capital terms will have on profit margins and related credit risks

Adjustment 2—
Country Risk Adjustment

- The relationship between Risk & Return (Re) trade-off can be shown as:

Re = Rf + Risk Premium

Where:

Re = Return and **Rf** = Risk free rate

Risk Premium: Include risk factors such as, political risk and other business and market specific risks.

- **Step 1:** Estimate the representative cost of capital for the market in which AngolaCo operate in
- **Step 2**: Remove the impact of the EU cost of capital and incorporate the Sub-Saharan Africa cost of capital taking into account the country risk premium

Addresses the impact of wider country risks, such as market, political risks, etc.

Conclusion

- Lack of comparables in Emerging / Developing countries is a major issue in the context of the application of arm's length
- Regional (for instance African) or Emerging / Developing countries panels are preferred
- In case EU / USA comparables are used, adjustments are needed
  - Major items to be adjusted for : Higher market risks, Higher foreign exchange risks, Lower cost base and access to resources
- Local / domestic financial information available to local tax authorities (for instance in Africa) could be leveraged to assess whether it can be reliably used to determine arm's length ranges / safe harbors

Useful References

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