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

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AGENDA

- Introduction
- Comparability Adjustments
  - Accounting and Financial Risk Adjustments
    - Accounting (in-)consistency
    - Working Capital Adjustments
    - Capital Adjustments
    - Additional (FX-Risk; economic life-cycle; different asset utilziation, etc)
  - Strategic / Market Adjustments
    - Country Risk Adjustments
    - Other risk-based adjustments
    - Economic Circumstances Adjustments
- Conclusion and Future Research

Introduction

- Why Comparablity?
  - Basic rationale/aim of tax regulations on Transfer Pricing => Arm‘s Length Principle
  - Tested (controlled) transaction needs to yield the same result as a comparable uncontrolled transaction

- Why Comparablity Adjustments?
  - Usually it is not possible to detect a comparable uncontrolled transaction or to gather the necessary data/information
  - Often comparablity not at the level of individual transactions but on the level of the sum of multiple transactions => comparability of profit margins (with various specifications – e.g. EBIT-margin, operating margin, ROA, ROI, etc) => TNMM-Method
  - Comparison of affiliated (controlled) company with a stand-alone company

Introduction

- Comparability Characteristics
  - Industry, Size, Location
    - Country, economic area (EU/EEA, North America, OECD, etc)
    - proximity (neighbouring countries, etc)
  - Business Model
    - Manufacturer
    - Distributer
    - Agent, Sales Rep, etc
  - „Economic configuration“
    - Balance sheet structure
    - Cash Flow
    - Risk
  - Contractual Terms
  - Product / Service characteristics
  - etc…

Introduction

- 1. Step
  - Identify (bundle of) controlled transaction(s) and ist specifics
- 2. Step
  - Identify a suitable comparable transaction between stand-alone companies
    - Usually very difficult on an individual basis => comparison of Profit measure
- 3. Step
  - Identify necessary adjustments for uncontrolled transaction to be more suitable
  - Perform necessary adjustments to profit measure of uncontrolled (stand-alone) company
  - Aim: „turn an imperfectly comparable transaction into a benchmark transaction"
  - *Remaining differences do not materially affect the outcome of the comparability analysis*
- 4. Step
  - Compare adjustemd profit measure of stand-alone company with profit measure of affiliated company

Comparability Adjustments

- Main Issue:
  - very little (to almost no) practical guidance by scientific research, practitioners' literature or standard setters (OECD, EU, lawmakers, tax administrations, etc)

- OECD:
  - Some guidance in TP Guidelines (Section A.6)
  - Some guidance in publication *Comparability Adjustments* (2010)
- EU Joint Transfer Pricing Forum:
  - *REPORT ON THE USE OF COMPARABLES IN THE EU* (Draft 2016)
- IMF / OECD / UN / World Bank
  - *A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses* (Discussion Draft 2017)

Comparability Adjustments

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- Accounting (in-)consistency
  - Tax Return Data usually not publicly available => Book Income
  - Problem of identifying the accounting standard of the comparable
  - Often local GAAP
  - Sometimes IFRS, yet IFRS with local peculiarities ("local IFRS")
  - Differences because of acceptable differing accounting choices within the same set of GAAPs
    - Measurement and presentation / disclosure
    - Depreciation choices
    - Inventory write-offs / inventory valuation methods
    - Goodwill amortization and impairment
- Issue mentioned but not addressed (nor solved) by OECD
- Literature points at harmonization through IFRS and downplays the issue to some extend however also acknowledges that it might be impossible to comprehensively adjust for accounting (in-)consistency

Comparability Adjustments

- Working Capital Adjustments
  - Adjusting for differences in the relation between current assets and current liabilities
  - Adjusting the employed profit measure
- Usually no consideration of implicit interest payments / rates ->
  - could have material effects especially when comparing companies from different geographical regions

- OECD TP Guidelines contain a detailed example (6 pages)
- Majority of literature focuses on working capital adjustments
  - “the most important adjustment”
  - Ignoring other also important forms of adjustment

Comparability Adjustments

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- Other Capital Adjustments
  - Adjusting for differences in the Balance Sheet structure
  - Focus on cost of capital -> not exclusively working capital
    - Access to credit markets
    - (Longterm) Interest Rates
    - Tax Rates,
    - etc
  - Adjusting the employed profit measure

- OECD TP Guidelines do not mention these adjustments
- Majority of literature focuses on working capital adjustments
  - "the most important adjustment"
  - Widely ignoring other forms of adjustments of the balance sheet

Comparability Adjustments

- Additional Accounting/Financial Adjustments – Risk Adjustments
  - Adjusting for differences in accumulation or apportionment of Risk in the company
  - MNEs usually allocate risk to one (or a small number of) company and thus the risk allocation affects the transfer price structure differently than the price setting between stand-alone companies
  - Aim: eradicating the effects of differing risk allocations

- OECD TP Guidelines ignore these adjustments
- Literature criticises OECD and domestic lawmakers for focusing only on the relatively simple and straightforward working capital adjustment and for ignoring risk adjustments

Comparability Adjustments

- Country Risk Adjustments
  - Necessary when comparing companies from different regions
  - Especially: developed countries vs developing or emerging countries
  - Usually: Differences in Country Ratings (S&P, Fitch, etc) – might ignore the general attitude of the business towards risk
  - Alternative: "*sovereign yield spread approach*" -> regressing the spread between local bonds and US bonds on specific country risk factors (GDP, economic stability, public debt, etc) and using the residual to calculate the non-systemic country risk.

- OECD TP Guidelines mentions this issue but does not provide any specific guidance
- Literature started to focus on it just recently

Comparability Adjustments

- Economic Circumstances
  - Market conditions, geographic situation, governmental regulations
  - Product life cycle (stars vs poor dogs)
  - Business life cycle (start-up vs established)
  - Contractual relationships!!!
  - Capacity utilization
  - Economic crises adjustments

- OECD TP Guidelines ignores these types of adjustments
- Literature started to focus on them just recently. Mainly papers that draw attention to it but very little practical (usable) guidance available

Conclusion

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- Search for Comparables becomes more and more important; esp because of the increasing scrutiny TP documentations face by domestic tax administrations.
- Globalisation often demands comparing companies within the same industry but from different regions (and vice versa).
- Availability of tax data is very scarce -> public CbCR as a data source (?).
- Various aspects that need to be accounted for and that can be adjusted for.
- A lot guidance focus on one specific type of adjustment (Working Capital) which leaves the wrong impression that there are no other aspects that need to be taken into account and need to be addressed.
- Very little to almost no guidance by standard setters with respect to other types of adjustments.
- Literature is very slow to pick up on alternative adjustment procedures.
- A lot of practical knowledge might be out there but very few gets published.

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