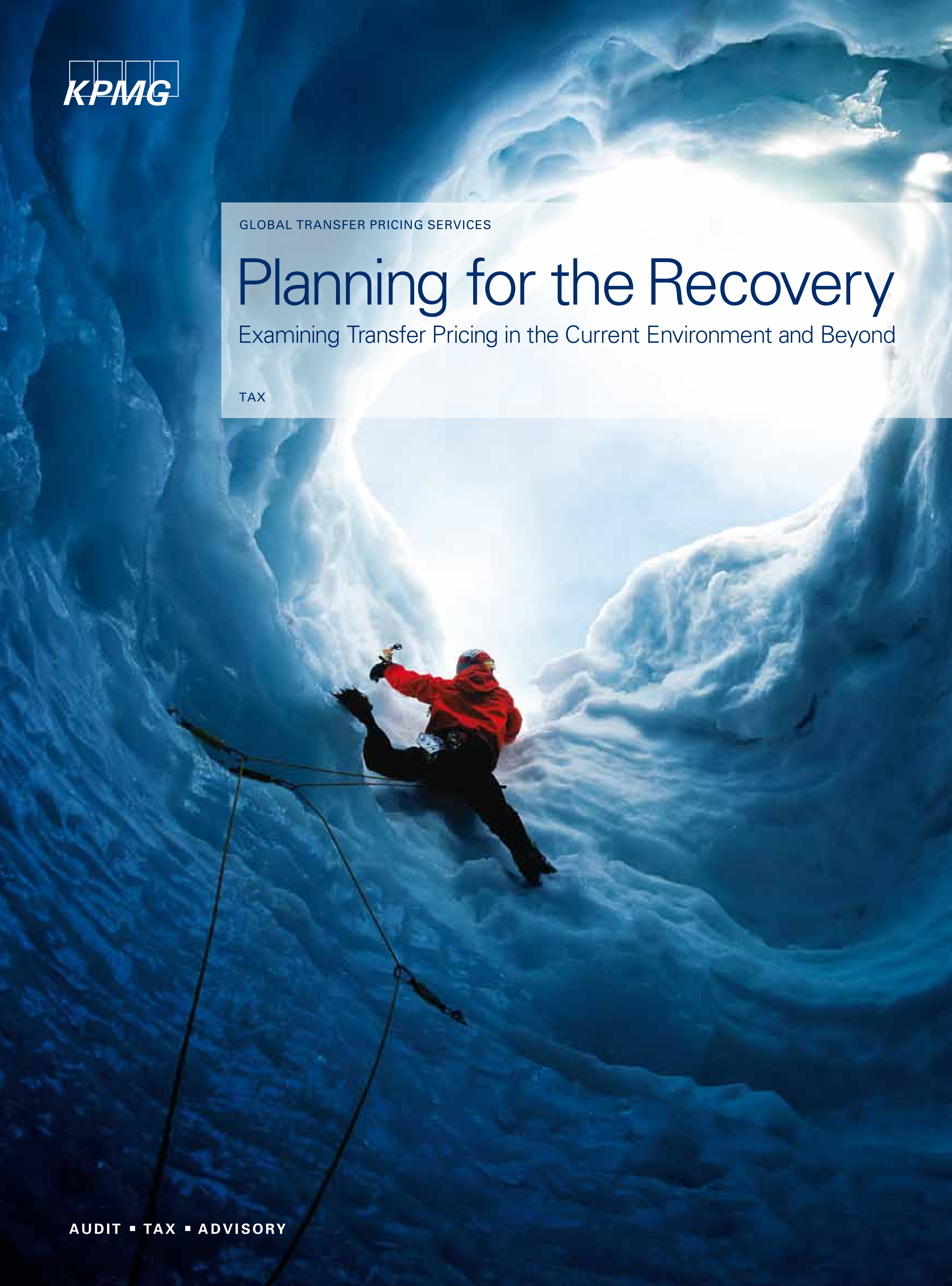
KPMG

GLOBAL TRANSFER PRICING SERVICES

Planning for the Recovery

Examining Transfer Pricing in the Current Environment and Beyond

TAX



AUDIT ▪ TAX ▪ ADVISORY

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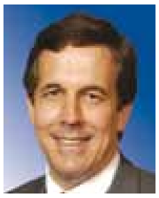
Introduction

The global economic downturn has confronted transfer pricing practitioners with a host of challenges. A recession that began in the United States at the end of 2007 morphed into a severe global contraction following the financial crisis of September 2008.[1] The International Monetary Fund (IMF) estimates that global GDP contracted at a 6 ¼ percent annual rate in the fourth quarter of 2008 and nearly as quickly in the first quarter of 2009.[2] While recent indications suggest that the pace of decline has slowed if not stopped, prospects for the end of 2009 and for 2010 remain very uncertain.



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Historically, recessions associated with financial crises have been deeper, longer lasting, and have been followed by slower recoveries than others.[3] As of this writing, the IMF predicts that global economic activity will contract by 1.4 percent in 2009 and grow by a modest 2.5 percent in 2010. The IMF projections are significantly weaker for the advanced economies (including the U.S., U.K., the Euro area, Canada and Japan): a 3.8 percent decline in 2009 and 0.6 percent growth in 2010. IMF projections for developing Asia are relatively better – 5.5 percent growth in 2009 and 7.0 percent growth in 2010 – yet these rates are sharply lower than those achieved in recent years. After growing at 7.2 percent in 2007 and 2.9 percent in 2008, world trade volume is expected to decline 12.2 percent in 2009 and to grow at only 1.0 percent in 2010.[4]

Documenting and sustaining transfer pricing in this economic environment can create many difficult issues for tax departments. While the problems may be particularly acute for a multinational enterprise (MNE) facing system losses that must be recognized somewhere, volatility and uncertainty of profits and prices can affect transfer pricing even at profitable companies. For example, the documentation required in one jurisdiction of a transaction affected by the global downturn may be very different from that needed to substantiate the transaction in another. Analyses prepared in these circumstances will require careful consideration of attribution of risk, adjustments to comparable results and consideration of "loss splits."

We begin with an article on the implications of the downturn and recovery for a common intercompany structure. Thomas Herr, Geoffrey Soh, Markus Wyss and Thomas Zollo focus on the issues arising in one common MNE structure in *Bringing Centralized Entrepreneur Structures Successfully Out of the Crisis*, noting that for some taxpayers the best approach may be to do nothing – or even use the downturn as an opportunity to enhance tax efficiency in a more profitable future.

Several of the articles in this publication address the defense of transfer pricing arrangements in the recession. Marcelo Castillo, Martin Graña and Antonio Macias remind us that one regime has already been "stress tested" in a major economic crisis. In their article, *Tango Lessons*, they explore the Argentine tax authority's transfer pricing approach and defenses by taxpayers during the 2001-2002 Argentinean crisis. Clark Chandler and Moiz Shirazi take a case study approach to consider the implications of risk allocation between a distributor and a manufacturer for CPM / TNMM analysis in *Transfer Pricing and the CPM/TNMM in a Downturn. Intercompany Services in Turbulent Times*, by Jacek Bajger, Stephen

Historically, recessions associated with financial crises have been deeper, longer lasting, and have been followed by slower recoveries than others.[3]

1. International Monetary Fund, "World Economic Outlook 2009 – Crisis and Recovery," April 2009, Chapter 1.
2. Ibid, page 4.
3. Ibid, page 98.
4. All projections cited are from International Monetary Fund, "World Economic Outlook Update," July 8, 2009, Table 1.

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Blough and Dirk Van Stappen, predicts that tax authorities will scrutinize, far more closely, the deductibility of head office services costs when local entities are incurring losses, and discusses the practical challenges faced by MNEs in defending such deductions. *Related-Party Loans*, by Lucia Fedina, Burcin Kasapoglu, Damian Preshaw and Jaap Reyneveld, examines the issues created for intercompany funding issues in the downturn, with a particular focus on the impact of volatile credit markets on interest rates and risk spreads.

As these authors remind us, even defensive documentation work should look forward to the implications for the future of the positions taken. Can the approach be sustained if losses continue? Is it consistent with the results anticipated when profits recover? Many MNEs are considering changes beyond simple documentation approaches – either by changing their transfer pricing methods to reflect more appropriately the actual risks faced by their various entities, or actual business restructuring often driven by broader operational considerations. MNEs are designing these new arrangements in order to facilitate effective operations while the downturn persists and flexibility towards achieving results during the subsequent recovery, however it develops. Such arrangements should be implemented only after careful consideration of potential results and tax authority responses in a variety of future economic scenarios.

In *Reacting to the Crisis – Can We Support Loss Splits?*, Cheng Chi, Gianni De Robertis, Atsuko Kamen and Hiroyuki Takahashi assess the pros and cons of changing from a CPM / TNMM to a profit/loss split methodology that provides more flexible division of risks. They examine the issues that may arise when growth resumes and offer advice on how to discuss the appropriateness of such a switch with tax authorities. *Recessionary Business Restructurings*, by Patricia Fouts, Tony Gorgas, John Neighbour and Stephanie Pantelidaki, explores how local tax authorities may question the commercial rationales of restructured operations and/or contractual allocations of risk in an economic downturn and, ultimately, how MNEs should take into account these potential reactions in the current economic environment, as well as in the future.

In an environment of greater transfer pricing risk, advance pricing agreements (APAs) have increased appeal. However, taxpayers with existing APAs may be finding that the terms were not well designed for the economic conditions that so few anticipated. In *Advance Pricing Agreements Under Pressure*, Sean Foley and François Vincent discuss the ability of taxpayers to mitigate issues with existing arrangements and achieve more flexible designs going forward.

Crises often pressure decision-makers towards short-term fixes to the most immediate problems. The articles in this volume remind us that a longer-term view with a global perspective is vital to achieving satisfactory results now and exploiting change for long-term benefit.

Kind regards,

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Acknowledgements

Twenty-six Global Transfer Pricing Services professionals, from 12 firms in the KPMG International network of firms from around the world, have contributed to the articles in this publication. The topics that they covered were chosen because they address some of the critical issues that companies are facing currently and will continue to face in the coming years.

Our thanks to co-editors Steve Blough and Clark Chandler, and to all of the authors for their contributions. We welcome feedback and other input on the topics and issues discussed here. Please convey your feedback to your KPMG adviser, or e-Mail us at transferpricing@kpmg.com.

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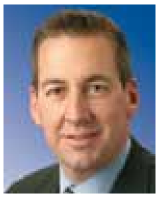

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Bringing Centralized Entrepreneur Structures Successfully Out of the Crisis

Many multinationals set up centralized structures to control their supply chains and drive cost and tax efficiencies. The tax advantage of such structures can come under considerable pressure in tough economic times as losses are shifted to the central entity. The authors, **Thomas Herr (KPMG in the U.S.)**, **Geoffrey Soh (KPMG in Singapore)**, **Markus Wyss (KPMG in Switzerland)**, and **Thomas Zollo (KPMG in the U.S.)**, discuss the impact of the current environment on centralized entrepreneurs and some of the opportunities that are emerging that may strengthen these structures.

Many multinational companies have implemented central entrepreneur structures in order to control their supply chain on a regional or global basis. Often, these central entrepreneurs are residents in relatively low tax countries, such as Switzerland[1] and Singapore[2], in the expectation that, under normal business conditions, their recognition of "residual" profits may lower the overall effective tax rate of the multinational group.

Under recessionary business conditions, however, the central entrepreneur may suffer losses while affiliates located in higher tax countries remain profitable, thereby increasing the group's effective tax rate. On the other hand, such business conditions may also provide the opportunity to enhance and expand such structures in a tax-efficient manner. This article discusses some of the alternatives available to multinational groups for mitigating some of the problems arising from the recessionary environment, as well as the opportunities to enhance a centralized entrepreneur structure under the current market conditions.

Overview of central entrepreneur structures

A typical central entrepreneur acts as the hub in a multinational's supply chain. Within the supply chain, the central entrepreneur determines the quantity and timing of output among its manufacturing affiliates (and perhaps some third party manufacturers). The central entrepreneur is often the owner or licensee of the intangible property used to make and market the products and is often responsible for determining the overall marketing strategy in its region. It usually sells in various countries through local affiliates, which may be either (i) related, limited risk buy-sell distributors, commissionaires, or commission agents or (ii) third party

Many multinational companies have implemented central entrepreneur structures in order to control their supply chain on a regional or global basis.

1. Switzerland offers attractive ordinary taxation of corporate income. For example, from January 1, 2010, onward the effective federal, cantonal, and communal corporate income tax rate of a company in the canton of Schwyz, community of Freienbach, will be as low as 11.75 percent. In addition, tax privileges available for mainly foreign market oriented activities lead to effective tax rates between 4.2 percent to 9 percent depending on the location and profile of the centralized entrepreneur.
2. In some instances, central entrepreneurs in Singapore may pay lower or even zero tax due to the various tax incentives provided in the Singapore Income Tax Act (ITA) and Economic Expansion Incentives Act (EEIA).

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Mr. Herr has published articles on transfer pricing issues in *International Tax Review*, *BNA Tax Management - Transfer Pricing Report*, and the *Journal of International Taxation*.

distributors. The central entrepreneur is also often responsible for selecting vendors, arranging logistics, and performing human resources, legal, accounting and tax services for the group.[3]

The specific relationships between central entrepreneurs and other group members vary significantly. For example, in some cases the central entrepreneur will have entered into long-term take-or-pay relationships with its related manufacturers. In other cases, it may simply purchase the output of its related manufacturers before turning to outside vendors. Similarly, the central entrepreneur may dictate the staffing and marketing efforts of its related distributors, and sell products (or pay commissions) to them at a level that assures them a stable operating margin. In other cases, the distributors may have more responsibility for developing their local markets and, therefore, may have a greater opportunity for profit and bear a greater risk of loss. As discussed in the next section, the actual legal and economic relationship between the central entrepreneur and its affiliates will help to determine the potential range of appropriate responses to an economic downturn.

The lure of the short-term fix

While a central entrepreneur structure can lead to significant income tax savings under normal business conditions if the entrepreneur is located in a low-tax jurisdiction, the structure can significantly increase the group's overall effective tax rate in a recession if the central entrepreneur is recognizing losses while other affiliates remain profitable. This occurs when the central entrepreneur has agreed to compensate captive affiliates with a return that always exceeds all operating costs, so that the affiliates earn (taxable) profits even when the group records an overall loss. In such a structure, the central entrepreneur bears the entire overall loss and additional losses equal to the profits earned by the affiliates, with limited prospects for future tax benefits from such losses if it is located in a low tax jurisdiction.

> A group seeking to respond to recessionary pressures first needs to review carefully how it has assigned risk within the intercompany group, either contractually or through group policies.

In such a situation, some companies may be tempted to "fix" the problem, by changing established transfer pricing policies or amending existing intercompany agreements to spread losses throughout the supply chain. But such hasty changes may create additional tax inefficiencies and lead to unnecessary tax disputes. In any event, disregarding contractual arrangements may undermine the historical and prospective viability of the central entrepreneur structure. More immediately, the tax authorities in the affiliates' countries may assert that the change from the historic relationship between group companies gives rise to immediately taxable transfers of contractual rights or other exit charges. Finally, any changes that result in retroactive downward adjustments of profits may simply be disallowed in certain jurisdictions, and could have negative indirect tax or customs consequences.[4]

3. In order to avoid generating foreign base company sales income under the US subpart F rules, the central entrepreneur will often perform functions that make a "substantial contribution" to manufacturing within the meaning of the new contract manufacturing regulations under section 954(d) of the Internal Revenue Code (the "Code"). See Treas. Reg. Section 1.954-3(a)(4)(iv) (effective for taxable years beginning after June 30, 2009, unless a taxpayer elects earlier application).
4. For example, Code Section 1059A generally prevents a taxpayer from including in its cost of goods sold for imported property any costs that it did not include in the declared customs value for the property. Thus, any retroactive upward adjustment on import prices to reduce profits in the United States is likely to also require an amendment to the customs value declaration.

The appropriate response to distribution arrangements in a downturn will also depend on the nature of the intercompany arrangements in place.

What can be done?

A group seeking to respond to recessionary pressures first needs to review carefully how it has assigned risk within the intercompany group, either contractually or through group policies. The analysis should include a detailed assessment of the actual transfer pricing practices pursued since the inception of the central entrepreneur structure. If the actual behavior of the parties has been inconsistent with the contractual or otherwise intended allocation of risk, the analysis of the range of supportable go-forward actions will be affected.

After the group has identified the intercompany allocation of risk, it should estimate how the economic downturn affects the returns that the various affiliates should receive. In some cases, the specific assignment of risk within the group may justify the specific allocation of losses. Finally, the group should determine how it might change its intercompany arrangements, if necessary, in a manner consistent with arm's-length dealings based on current market conditions. This requires that both parties receive appropriate inducements to enter into the new arrangement. A one-sided amendment to existing relationships could exacerbate the problem, by creating an unacceptable risk of exit taxes and may cause tax authorities to question the economic substance of the overall central entrepreneur structure.

Possible adjustments to manufacturing contracts

The possible adjustments to manufacturing contracts will depend upon the nature of the agreements between the central entrepreneur and its manufacturing affiliates. Assuming that the central entrepreneur has not given the manufacturers guarantees that it will purchase their output (or consignment manufacturing services) under take-or-pay contracts, the downturn in market conditions may provide comparable uncontrolled prices or other comparable information that justifies reducing prices to the related manufacturing group as a whole. Moreover, if the manufacturing plants have assumed responsibility for determining their capital investments and negotiating with local trade unions, the group may be able to demonstrate that the relative operational inefficiency of certain plants (e.g., due to higher labor costs or other cost disadvantages) justifies reducing their share of the overall output. Less efficient plants that cannot operate at full capacity under prevailing market conditions may be responsible for bearing the losses caused by their under-utilization costs.

If the central entrepreneur has guaranteed each manufacturer a certain return through a take-or-pay arrangement, the appropriate response may be more difficult to craft. One approach would be to amend the intercompany agreements to reduce the central entrepreneur's minimum purchase requirements (thereby reducing its current costs), while extending the term of the agreement or giving the manufacturer a greater return when market conditions improve (thereby giving the manufacturer an appropriate *quid pro quo* for its concession). Before altering an agreement in this way, however, a group should carefully consider the implications for the split of future group profits when market conditions improve.

Possible adjustments to distribution arrangements

The appropriate response to distribution arrangements in a downturn will also depend on the nature of the intercompany arrangements in place. If the distribution affiliates are commissionaires or commission agents whose compensation is based on a percentage of sales, the market downturn may actually push them into a more serious loss position than the central entrepreneur, because reduced sales will generate a lower commission base to cover their expenses. In these circumstances, the central entrepreneur may agree to a temporary increase in sales commissions, subject to a corresponding reduction in sales commissions when market conditions improve. Alternatively, if the distribution entities remain profitable despite the downturn, the central entrepreneur may be able to identify market comparables

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suggesting that commissions should be reduced.

In the case of buy-sell distributors, a distributor responsible for managing its sales force, including an after-market service department, should be responsible for bearing any costs associated with the inefficiency of that workforce during an economic downturn. If maintaining that workforce is pushing the distributor into an overall loss, but the central entrepreneur believes that the workforce is essential to its long-term profitability, it may increase the distributor's buy-sell spread in the short-term to induce the distributor not to cut its workforce too severely.

Possible adjustments to intangible property arrangements

As noted above, the central entrepreneur may either license the intangible property used in its supply chain or develop and own the intangible property, perhaps under a cost-sharing arrangement with other group entrepreneurs. The appropriate response to the downturn will depend on, among other factors, which intangible property paradigm the group has adopted.

If the central entrepreneur licenses intangible property from a related party, the central entrepreneur may consider renegotiating the license to provide a royalty holiday unless sales in its region exceed a specified level. To compensate the licensor for this concession, the new license may provide that the royalty will be higher than the existing royalty when market conditions improve. Alternatively, the central entrepreneur may agree to a new license based on a stepped-royalty structure that starts with a low royalty and increases the royalty rate several times as it achieves specified sales hurdles. The stepped royalty approach may be preferable to a royalty holiday if the group believes that the intangible property owner's home country would object to an arrangement with a royalty holiday. Any such changes should be documented to explain why an unrelated licensor would agree to any change in the arrangement given that even without such changes, royalty payments are reduced in proportion to sales.

If the central entrepreneur has entered into a cost sharing arrangement, it should assess both the "buy-in" payments it is required to make and its share of ongoing development costs. With respect to the former, the ability to reduce any commitment to make buy-in payments may depend on whether the cost sharing agreement contains an explicit adjustment clause authorizing the payments to be reduced if initial projections are not achieved.[5] However, even if the total buy-in is not reduced, the central entrepreneur may consider negotiating a deferral of any remaining buy-in payments to avoid increasing a current loss.[6] With respect to the latter, if the economic downturn materially affects one of the cost sharing participants more than the others, the downturn may justify (or require) adjusting the parties' cost shares. Note that this may increase or reduce a central entrepreneur's expenses.

5. The Internal Revenue Service takes the position that taxpayers cannot apply the commensurate with income rule to adjust buy-in payments if the effect of the adjustment is to reduce the income of a U.S. taxpayer unless the cost sharing agreement specifically provides for such an adjustment.
6. Whether such a deferral is advisable will depend upon the period over which the central entrepreneur recovers its buy-in payments via deduction or amortization, as well as the loss carry forward period in the central entrepreneur's home country.

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Possible adjustments to financing arrangements

The group may wish to consider whether its non-operating charges are appropriately structured for the current market conditions. For example, the group might re-examine its financing structure to determine whether various entities are appropriately capitalized given revised profit expectations. These conditions may, for example, suggest that some intercompany debt should be converted to equity, or that debt should be re-financed so that a different company group acts as the lender, to take advantage of operating losses.

Post-recession opportunities

The implications under improved economic conditions in the future of any modifications to the existing structure should be carefully considered. For example, can current losses be justified by increased opportunities for future profits? Such considerations may lead to a decision to leave the central entrepreneur structure unchanged: having the central entrepreneur realize losses[7] from its assumption of risks can both demonstrate the economic *bona fides* of the structure and position the group to recognize benefits when the economy recovers.

On the other hand, the recessionary environment may open up opportunities to enhance an ongoing centralized entrepreneur structure.

Increasing IP ownership

In many structures the functions of the central entrepreneur only cover the manufacturing and sales ends of the value chain process and exclude product development. That function and the associated assets and risks may be retained by another related entity. The recession, however, may enable a tax-efficient transfer of the IP, either because the buy-in value is significantly lower due to the lower overall profitability and higher perceived risk, or because the original IP owner and seller may be incurring losses that could off-set some or all of the gain resulting from the IP transfer. Although such an IP transfer would be likely to increase the costs shifted to the central entrepreneur in the short-term, it would create a platform for additional residual profits, and thus potentially a more favorable and more tax-efficient earnings mix in the central entrepreneur for the future.

Integrating additional countries

As discussed above, a central entrepreneur structure generally involves a number of distribution and manufacturing entities in other jurisdictions. Such structures are often gradually implemented, because the conversion of local distribution or manufacturing entities to limited-risk distributors or contract manufacturers may involve significant effort and costs. One key tax concern is that the conversion may trigger "exit-taxes" when the local tax authority argues that the change in the business models implies a transfer of goodwill or similar intangibles. The more significant the income change at the local entity, the more likely it is that such an argument will be made. If, however, the recession creates low profits or even losses in the local distribution or manufacturing entity, converting to an LRD or contract manufacturing model may not involve any substantial income shift in the short-term, and may even lead to additional profits. In such a case, the risk that the local tax jurisdiction will challenge the conversion may be substantially lower.

Obtaining certainty

Transactions involving a central entrepreneur in a lower tax jurisdiction have become a key target of tax authorities and may create significant transfer pricing risks for companies establishing such structures. One reason is that tax authorities are often skeptical of the purported risk-shift to the central entrepreneur which supports, in part, the profit shift to that entity.

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A recessionary environment may facilitate the conclusion of an advance pricing agreement (APA) on significant intercompany transactions involving the central entrepreneur, because the risk shift and realization are more easily documented in such conditions.

Conclusion

The economic downturn may require a reassessment of the arrangements between a central entrepreneur and the other participants in its supply chain, because they will have often been based on projections of future profitability, and may not have appropriately considered the consequences of the structure in an economic downturn. Devising an appropriate response to a downturn requires an understanding of the existing assignments of risk within the group, and how they can be renegotiated to reflect lower expectations on an arm's-length basis. Taxpayers should be careful not to alter existing arrangements in a one-sided way, which can create unintended tax consequences, such as exit charges, and potentially undermine the legitimacy of their intercompany arrangements. In anticipation of the recovery, they should devise a structure that also makes economic sense in normal times. They should also recognize that the economic downturn may strengthen the case for transforming a decentralized business model into a streamlined centralized model to achieve operational and management cost efficiencies, managed and administered by a central entrepreneur. In considering such reengineering, a company may benefit from lower exit charges due to decreased values of IP, goodwill and business transfer packages, as well as from less operational resistance due to reduced utilization of production capacities and distribution facilities.

7. Such losses can be carried forward in many countries. For example, in Switzerland the carry forward period is seven years. In Singapore, losses can be carried forward indefinitely, as long as there is no substantial change in ownership.

Tango Lessons

The current economic crisis may be the largest, deepest and most global since the introduction of modern transfer pricing documentation regimes, but it is not the first. **Marcelo Castillo (KPMG in Argentina), Martin Graña (KPMG in Argentina) and Antonio Macias (KPMG in the U.S.),** describe the results of the first transfer pricing stress test in Argentina.

The economic crisis may reduce the earnings of many multinational enterprises (MNEs) all over the world, and the reductions may affect the results of the methodologies taxpayers use to comply with local transfer pricing requirements. In some cases, the application of a particular methodology may require adjustments to reflect the economic conditions and taxpayers may want to know the likelihood that tax authorities will accept or challenge these adjustments.

One of the few countries to have endured a major economic downturn since introducing a transfer pricing documentation regime is Argentina, in 2002. Although a global mindset is needed now, much can be learned from Argentina's troubles about how the arm's-length standard operates in times of crisis including: (i) transfer pricing methods and adjustments; (ii) the reaction of tax authorities (in this case, the Argentinean Tax Authority [AFIP]) to such adjustments; and (iii) the resolution of any transfer pricing disputes arising from an economic crisis.

The background

Argentina introduced formal transfer pricing requirements in December 1998. The rules were based on the Organisation for Economic Co-operation and Development (OECD) standards and guidelines and included the arm's-length principle. Taxpayers were required to prepare, maintain, and file transfer pricing documentation. Many taxpayers in Argentina used transfer pricing methods similar to those used by taxpayers and tax authorities in Mexico and the U.S., with a strong emphasis on the transactional net margin method (TNMM).

Following extended periods of economic instability, including debt crises and hyper-inflation, the Argentinean government embarked on a major structural change program in 1991, including tax reform, privatization, trade liberalization, deregulation and the adoption of a currency board. The changes precipitated a decade of economic growth, until the Asian, Russian and Brazilian crises plunged the economy into a severe downturn at the end of 2001, which led to a major run on the banks, a devaluation of the peso and a huge trade deficit.

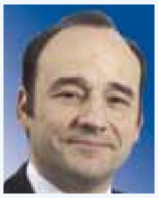
Transfer pricing issues faced by Argentinean taxpayers

Among the sectors affected by Argentina's crisis in 2002 were the automotive and pharmaceutical industries.

Automotive sector

The Argentinean automotive industry was already suffering from the fixed exchange rate before the 2002 economic crisis. Many multinational companies had decided to shift their manufacturing activities from Argentina to Brazil because exchange rates made the costs of importing finished vehicles from foreign related parties lower than the cost of production in Argentina. The government responded by reducing customs duties charged on imports of finished vehicles in line with the number of vehicles the importer built in Argentina.

This customs regime distorted the market in a way that produced high profit margins on imported vehicles, but operating losses on exported vehicles. Transfer pricing adjustments were required to correct the distortions and reveal the true economic returns of exports and imports.



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Taxpayers adopted different approaches. One common approach was to aggregate imports and exports and look at the Argentinean entity's overall profitability. Transactional methods require taxpayers to analyze each transaction separately, but in most cases the overall profitability of the Argentinean entity could be correlated to the trade balance between its import and export segments.

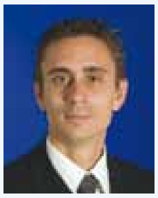
Another approach was to test the import and export transactions on separate bases. In most cases, the margins on distribution of imported finished products were above the interquartile range of comparable distribution entities, and the margins on manufacture of exported products were below the interquartile range. The excess profits in the distribution business were offset against the losses on manufactured exports; taxpayers argued that the company manufactured vehicles locally to obtain the benefit of the reduced customs duties on imported vehicles.

Many taxpayers in Argentina used transfer pricing methods similar to those used by taxpayers and tax authorities in Mexico and the U.S., with a strong emphasis on the transactional net margin method (TNMM).

In other cases, taxpayers estimated an idle capacity adjustment for the manufacturing export segment, based on the difference between the manufacturing facility's actual production and its theoretical capacity. This idle capacity adjustment was then applied to the fixed manufacturing costs in the segmented financial statements of the tested party.

In the absence of enough local comparables to calculate automotive industry ranges, comparable companies elsewhere, including Asian and Indian entities, were used to calculate the arm's-length range for the automotive industry.

It is important to note that when Argentinean automotive taxpayers were doing their analyses, they had no body of experience to draw on about how to deal with the kind of non-routine adjustments that would be required in an economic crisis. Until that time, many of their analyses had been heavily influenced by routine applications of the TNMM.



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In many cases, the AFIP rejected extraordinary adjustments…

Many Argentinean automotive taxpayers were subsequently audited by the AFIP, which began its examination by reviewing the transfer pricing documentation of all taxpayers in an industry and identifying inconsistencies and outlier results in each industry. This massive review of industry transfer pricing documentation gave the AFIP a deep knowledge of the challenges facing taxpayers in the industries concerned.

In many cases, the AFIP rejected extraordinary adjustments made to results on a transaction or aggregation basis, and compared the tested party's unadjusted results with the interquartile range of the comparables in the taxpayer's study. Idle capacity adjustments were routinely rejected on the grounds that the comparables chosen by the taxpayers also ran with unused capacity. The AFIP contacted the comparable companies to verify this.

Pharmaceutical sector

The 2002 Argentinean economic crisis led to an unexpected fall in pharmaceutical sales and prices. This reduced the profitability of some Argentinean pharmaceutical MNEs which distribute and sell products in the local market.

During 2002, many Argentinean pharmaceutical MNEs set prices using resale price formulae, based on gross margin targets for the local distribution affiliate. This approach placed most of the risk associated with sales volumes on the distribution affiliate.

The realization of these risks at Argentinean distributors posed a significant challenge to those charged with documenting imports of pharmaceuticals because falling volumes led to operating losses at the Argentinean distribution entities. The Argentinean distributors previously used either the TNMM or Resale Price Method (RPM) in their documentation studies, using external comparables.

One of the main challenges in benchmarking market returns for the pharmaceutical industry is the quality of available, uncontrolled comparables. In many cases, the distribution entities perform marketing and selling activities, but the available, uncontrolled industry comparables usually perform only distribution and logistic activities, and thus have a much lower gross margin as a result of lower ratios of operating expenses to sales than the tested party. This reduces the reliability of gross margin-based methods, such as the RPM.

Because of the significant differences in the operating expense to sales ratios of the comparable companies and the tested party, Argentinean pharmaceutical

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distributors found it hard to support analyses based on gross margin, and instead calculated adjustments based on the differences between the taxpayer's operating expenses to sales ratio and those of their Argentinean peers.

The AFIP calculated transfer pricing adjustments by applying the TNMM method and rejected many extraordinary adjustments proposed by the taxpayer. Many of those cases remain unresolved to this day, due to the lack of reliable comparable data. Nowadays, many controlled Argentinean pharmaceutical distributors use a resale minus approach to set prices, that targets a particular operating margin. By using this methodology for its transfer pricing policy, an Argentinean entity does not assume significant volume risk. It is important to be very clear about the allocation of the risks assumed by each entity in the intercompany agreement. The targeted operating margin approach often provides a better alignment between transfer pricing policy and a TNMM methodology applied in the documentation report.

Industry in general

Argentinean companies in many industries reported lower profits in the economic recession and thus their greatest transfer pricing challenge was to isolate the effect of the recession, so that they could assess the arm's-length nature of each intercompany transaction correctly.

Many Argentinean companies applied either the Cost Plus or RPM – both of which target gross margins – using external comparables during the recession. The reliability of both of these methods is highly dependent upon the quality and comparability of the comparable companies. Although taxpayers and the AFIP both had their reservations about the comparability of the comparables with the tested party at the gross margin level, neither could identify a more reliable method.

Argentinean taxpayers continued to use the TNMM with extraordinary adjustments, in many cases, to the tested entity or the comparable companies.

The AFIP initially rejected many extraordinary adjustments, but in many subsequent negotiations, it accepted adjustments if (i) strong economic arguments were adduced to support them; (ii) evidence was provided that the comparables had not recognized similar expenses; and (iii) agreement was reached with the tax authority on the size of the required adjustments.

Legal cases

Although several cases have come to court since the new regulatory regime came into effect, much of the case law relates to matters resolved before the Argentinean transfer pricing reforms of 1998.

As a general rule, Argentinean courts focus their attention on the quality of information introduced to support specific adjustments. Taxpayers would, therefore, be well-advised to carefully consider the issues outlined above when using extraordinary adjustments to support their transfer prices.

Transfer pricing issues in the current global economic crisis

When seeking lessons for the current economic crisis from the Argentinean experience, it is necessary first to identify the differences between the

There are some key differences between both the business downturns and the transfer pricing environments faced by Argentinean taxpayers in the 2002 crisis, and those faced by MNEs in the current global downturn.

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Argentinean crisis and today's global downturn. The main difference is that the Argentinean crisis was a local event, which only affected the earnings of the MNE entities in Argentina that were party to intercompany transactions. It had little impact on the global profitability of the MNEs. The current crisis is global and is affecting the overall profitability of many MNEs. Local tax authorities may resist accepting losses by the MNE subsidiaries operating in their countries, whether they are due to reduced global profitability or to local circumstances.

In addition to the sophistication of business models, the quality of transfer pricing policies and intercompany agreements have all increased since the Argentinean crisis in 2002, and the availability of financial information has improved. Nevertheless, taxpayers in the current environment may face many of the same issues Argentinean companies struggled with in 2002, particularly with respect to extraordinary adjustments and the selection of reliable economic comparables.

Extraordinary adjustments

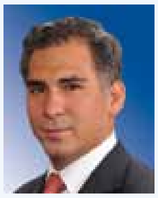
When applying an extraordinary adjustment, four main lessons can be learned from the Argentinean experience:

1. Apply extraordinary adjustments to comparable companies, not the tested party, to help reduce the differences in the economic circumstances of the tested party and each comparable.

2. Before applying an extraordinary adjustment, it is important to conduct in-depth research of the comparable company to determine that the comparable isn't facing the same economic challenge as the tested party. The importance of this point was clearly demonstrated by the AFIP's detailed research of comparable companies to establish whether or not they had idle capacity too. It should be noted here that some details cannot be obtained from the regulatory filings (Form 10-K) or annual reports of comparable companies. The taxpayer, therefore, may also find it helpful to dig deeper and search industry analyses and other sources of information to authenticate assumptions used when calculating the special adjustments.

3. One of the trickiest issues in applying special adjustments is quantifying these adjustments correctly. Document and keep information that supports the numbers used in the adjustments.

4. Explain the economic rationale for the adjustment in a simple way that anyone can understand.



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Mr. Macias graduated as an economist from the Autonomous Technological Institute of Mexico (ITAM) and obtained a post-graduate diploma in International Tax granted jointly by ITAM and the University of Harvard.

Comparable companies

During the Argentinean crisis, one of the main challenges faced by taxpayers was identifying comparable companies that were affected by the same economic conditions and operated in a similar industry as the tested party. Since Argentina has few companies about which reliable public information was available, many of the comparables chosen by taxpayers were non-Argentinean, and because of the local nature of the crisis, few of the non-Argentinean comparables were in the same economic circumstances as the tested party. Since the current economic crisis is global, taxpayers may not be facing the same problems, but it will still be important to obtain reliable current information on a timely basis.

Additional challenges are faced by taxpayers experiencing systemic reductions in global income. Competing tax authorities may expect the same profitability as in prior years and may propose transfer pricing adjustments if they see reduced profitability. The drafting of intercompany contracts that define in advance the risks assumed by each entity will help provide strong evidence to support losses caused by the risks assumed by a particular entity.

Conclusion

There are some key differences between both the business downturns and the transfer pricing environments faced by Argentinean taxpayers in the 2002 crisis, and those faced by MNEs in the current global downturn. Nevertheless, there are also some lessons taxpayers can learn from the Argentinean crisis about transfer pricing administration, particularly in relation to special adjustments and how they might be challenged by tax authorities. The study of history is always informative. In this case it can offer MNEs struggling with today's global downturn insights into some of the issues their Argentinean entities experienced during their own local crisis seven years ago.

The authors would like to thank German Crocenzi (KPMG in Argentina) for his contributions to the article.

Transfer Pricing and the CPM/TNMM in a Downturn

A sudden slump into losses can create problems for transfer pricing methodologies. **Clark Chandler (KPMG in the U.S.)** and **Moiz Shirazi (KPMG in the U.S.)** use a case study to explain how they can be addressed.

In a buoyant economy, transfer pricing policies often lead to operating profits at both parties that are consistent with profits at other firms, and thus acceptable to tax authorities. In an economic downturn, however, a multinational enterprise (MNE) may incur overall losses and the same transfer pricing policies may result in losses at one or both of the parties.

For example, a foreign affiliate targets product prices to its U.S. distributor that result in a return on sales for the distributor within the range achieved by a set of comparable distributors. The annual results vary, but over a three-year period, the return on sales is stable and consistent with those of comparables. Sales drop sharply in a downturn and large losses are incurred. Products purchased intercompany can't be sold in the anticipated volume, at the expected prices.

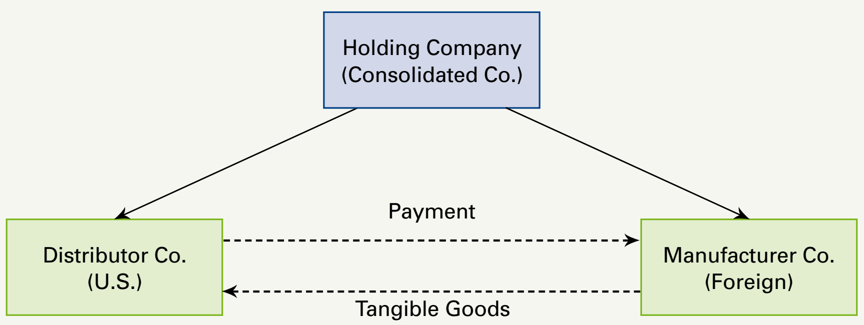
Taxpayers may be tempted to cut back on transfer pricing documentation in such a situation on the grounds that it is impossible to shift profits if there are no profits to shift. This would be unwise as losses often trigger very difficult transfer pricing audits almost regardless of their cause. In an economic downturn, it is more important than ever to develop strong transfer pricing documentation that demonstrates why the losses, although unexpected, reflect arm's-length transactions based on the functions, assets and risks assumed by each party to the intercompany agreement. Such documentation should be designed to show the tax authorities that (i) the adverse financial results are clearly due to non-transfer pricing factors and (ii) the results reported by each legal entity reflect the functional and risk attributes of the transaction.

This article uses a case study based on such a scenario to discuss the economic arguments needed to support the operating profitability of both sides of the intercompany transaction.

A case in point

In an MNE consisting of a manufacturer in one tax jurisdiction and a distributor in another, the manufacturer sells all its production to the related-party distributor.

Figure 1 Example MNE Structure



Source: For illustration purposes only, KPMG in the U.S.

Figure 2 **Results**

Consolidated Co.	**2004**	**2005**	**2006**	**2007**	**2008**	**2009 (Projected)**	**Wtd. Avg. 2006-2008**
Net Sales	10,000,000	10,500,000	10,920,000	11,247,600	7,085,988	6,023,090	9,751,196
Costs of Goods Sold	7,000,000	7,350,000	7,717,500	8,103,375	5,793,913	4,965,384	7,204,929
Gross Profit	3,000,000	3,150,000	3,202,500	3,144,225	1,292,075	1,057,706	2,546,267
Gross Margin	30.0%	30.0%	29.3%	28.0%	18.2%	17.6%	26.1%
Ordinary SG&A	2,100,000	2,194,500	2,271,308	2,384,873	2,166,260	1,804,554	2,274,147
AR Loss					354,299	150,577	118,100
Impairment					292,297		97,432
Operating Profit	900,000	955,500	931,193	759,352	(1,520,781)	(897,425)	56,588
Operating Margin	9.0%	9.1%	8.5%	6.8%	-21.5%	-14.9%	0.6%

Source: For illustration purposes only, KPMG in the U.S.

Previously, a comparable profit method (CPM)/transactional net margin method (TNMM) analysis of either the distributor or the manufacturer could be supported, but the economic downturn has produced results at both parties that are harder to support using this approach.

The results reported in Figure 2 reflect the consolidated results of the MNE. Strong results from 2004 through 2007 are followed by a sharp drop in profits in 2008 and the decline is expected to continue in 2009.

A review of the MNE's results show profitability was affected by a 37 percent drop in net sales in 2008, due to a 30 percent drop in volume and a ten percent drop in price.[1] As a consequence, the gross margin fell from 28 percent to 18.2 percent and ordinary selling, general and administrative (SG&A) expenses as a percentage of sales rose from 21 percent to 31 percent. There was also a US$292,000 write-down in fixed assets and a $354,000 bad debt write-off of accounts receivable from a major customer.

Note that these are the results of the MNE and the losses have to be borne by one or both of the two legal entities that comprise it. Moreover, a high level assessment of the reasons for the lower profitability can be made by performing a standard "variance analysis" comparing the 2008 and 2007 results.[2] Variance analysis, a tool of budgetary control used to evaluate performance by means of variances between budgeted amount, planned amount or standard amount, and the actual amount incurred/sold, can be carried out for costs and revenues. A variance analysis of the consolidated company suggests:

- The ten percent drop in prices reduces gross profits by about 10 percent or $1.1 million.
- The drop in sales volume reduces gross profit by about 30 percent of $3.1 ($0.9 million). Since SG&A has not fallen significantly, this produces a corresponding dollar reduction in operating profits.
- The bad debt write-off reduces pre-tax profits by $354,000.
- The asset impairment charge reduces pre-tax profits by $292,000.

Although this analysis shows why the MNE as a whole incurred losses and identifies the non-transfer pricing factors involved, it does not provide any insights into the appropriate assignment of the losses between the two legal entities. Further analysis is needed to demonstrate that the transfer pricing policies were consistently applied, and that the allocations of profits and losses reflected the contractual terms outlined in the intercompany agreements, and were consistent with those that would have occurred between unrelated parties in similar circumstances.

1. In this example case it is assumed the market price reductions could not be entirely passed along to suppliers through reductions in cost of goods sold.
2. Horngren et al.: Cost Accounting: A Managerial Emphasis, Pearson/Prentice Hall, 2009, pp. 96-115.

Figure 3 **Distributor's Results**

Distributor	2004	2005	2006	2007	2008	2009 (Projected)	Wtd. Avg. 2006-2008
Net Sales	10,000,000	10,500,000	10,920,000	11,247,600	7,085,988	6,023,090	9,751,196
Change in Sales		5.0%	4.0%	3.0%	-37.0%	-15.0%	
Costs of Goods Sold	8,250,000	8,662,500	9,009,000	9,279,270	5,845,940	4,969,049	8,044,737
Gross Profit	1,750,000	1,837,500	1,911,000	1,968,330	1,240,048	1,054,041	1,706,459
Gross Margin	17.5%	17.5%	17.5%	17.5%	17.5%	17.5%	17.5%
Ordinary SG&A	1,400,000	1,463,000	1,514,205	1,589,915	1,430,924	1,216,285	1,511,681
Change in Ordinary SG&A		4.5%	3.5%	5.0%	-10.0%	-15.0%	
Extraordinary AR Loss					354,299	150,577	118,100
Operating Profit	350,000	374,500	396,795	378,415	(545,175)	(312,822)	76,678
Operating Margin	3.5%	3.6%	3.6%	3.4%	-7.7%	-5.2%	0.8%

Source: For illustration purposes only, KPMG in the U.S.

Distributor analysis

Figure 3 shows the distributor's results.

From 2004 to 2007 the distributor recorded stable margins of about 3.5 percent and results could be supported by a CPM/TNMM analysis based on comparable distributors' results. The loss in 2008 pushed the 2006-2008 average down to 0.8 percent, which could be below a CPM/TNMM range, and similar losses are expected in 2009. On the face of it, this suggests that a transfer pricing adjustment is required and the distributor owes more tax. The distributor's tax authority may see the 2008 result as a result of transfer pricing, because they believe that distributors do not normally incur significant operating losses, unless there is a transfer pricing issue.

It has been suggested that one solution to this problem is to look at a longer business cycle to mitigate the effect of the economic downturn.[3] Instead of analyzing three years of data, a review of five years of data indicates that the distributor's 2004-2008 operating margin of 2.5 percent is consistent with comparables and indicates arm's-length transactions. There are several problems with this conclusion. Some tax authorities, Canada's for instance, will insist on looking at the 2008 results in isolation.

The conclusion also breaks down when more loss years are added resulting in the loss years becoming a continuing problem if a consistent approach to averaging is used. The approach ignores the reasonable expectation of tax authorities for discussions about which entity incurs the risks of the adverse economic conditions.

A longer averaging period helps to put the current year's results in context, but it is not a good starting point for transfer pricing documentation. The factors affecting the taxpayer's operating profit and how they affect transfer prices should be considered first. As noted above, the MNE's losses cannot be due to transfer pricing, but the distributor's losses are affected by a combination of transfer pricing and non-transfer pricing factors. The losses could result from a decrease in gross margin, a decrease in sales, or a relative increase in SG&A expenses. The recession can reduce sales volume and/or the prices the distributor can charge. A sharp fall in sales may reduce the distributor's operating profits and make it a loss maker in 2008 and 2009. The documentation needs to address this, and explain why the losses occurred and whether they are consistent with the functions, risks and MNE's transfer pricing policies.

A review of the distributor's financial results and transfer pricing policies in 2004-2008 suggested that its profitability in 2008 was affected by the following factors:

- Prices received from third parties fell by ten percent
- Unit sales fell by 30 percent
- The transfer price also fell ten percent
- Ordinary SG&A expenses dropped ten percent from 2007 to 2008, but increased six percentage points as a percent of sales
- Bad debt expenses were $354,000.

Since the transfer pricing analysis will be driven largely by the assignment of risk between distributor and manufacturer, the following questions have to be addressed:

- Is the distributor or manufacturer responsible for the price risks? In this case, the fact that transfer prices fell by ten percent suggests this risk was passed onto the manufacturer.

- Is the distributor or manufacturer responsible for the sales risk? The fact that the gross margin did not rise suggests the distributor bears the risks associated with its own fixed costs.

- Is the distributor or manufacturer responsible for bad debt expenses?

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In this case, the distributor incurred the bad debt expense, but this issue is complicated by the fact that some of this bad debt write-off may relate to sales in the prior year.

Gross profitability

The distributor's 2008 gross margin of 17.5 percent was consistent with prior years, but gross profits fell by $0.7 million. The transfer pricing agreement shows the manufacturer bears the risks associated with price fluctuations, but is not obliged to cover the distributor's fixed costs. The distributor's financial results indicate that the transfer pricing policy was consistently applied over the period. Therefore, an analysis based on gross margin suggests that the ratio between the transfer price and selling price is the same in 2008 as in earlier years. The 2008 transfer prices can be supported by a combination of the following:

- A CPM/TNMM analysis of the 2005-2007 period indicates that a 17.5 percent gross margin allows the distributor to earn the same level of profits as comparable firms, in normal economic times and the 17.5 percent gross margin was thus arm's length in 2005-2007.
- The intercompany agreement suggests the distributor should be earning the same gross margin in 2008 and 2007. Since it is, 17.5 percent is also arm's length in 2008, as is indicated by "comparable" resale price observations from prior years.[4]

The distributor's tax authority may object to the taxpayer arguing that a RPM is appropriate for 2008, but that a net margin analysis was appropriate in prior years. This brings us to an evaluation of the impact of the sales reduction on the dollar value of the gross margin and its interaction with fixed SG&A expenses.

SG&A

In an economic downturn companies often experience a rise in their SG&A/Sales ratios, because they can't reduce SG&A at the same rate as the drop in sales. This may be because they can't reduce fixed costs in the short term, there are diseconomies of reduced scale, or, although they could reduce costs, they have chosen not to for business reasons in order to keep options open.

The first two factors are beyond the control of a taxpayer and not related to transfer pricing, but the distributor's tax authority might challenge the third, because it is the parent's decision. It may, therefore, be useful to have the ability to demonstrate the business rationale for the decision from the distributor's perspective. For example, it could be argued that since it is hard to predict the length or depth of a downturn, a prudent company may postpone cost reductions until the prognosis is clearer. Instead of reducing SG&A in line with sales, it may decide to endure losses in the down years so that the company is well positioned for the rebound. Moreover, downsizing and then re-hiring and training is generally more expensive over the whole cycle.

The same argument applies at the business segment level. To remain in business, companies may need to maintain a presence in a market segment that's profitable in good times, but not in bad. In other words, there are pragmatic limits on the speed with which the SG&A can be reduced and it may be reasonable to run a higher SG&A/sales ratio in a recession. These decisions can lead to widely different profitabilities among companies in the same industry.

3. Philip Anderson and Melissa Heath: Transfer Pricing When Losses Arise. International Transfer Pricing Journal. Volume: 9, 2002, No. 5. William D. James: Transfer Pricing in a Poor Global Economic Climate. Transfer Pricing News – Special Alert. BKD, LLP. October 2008. Source: httransfer pricing://www.bkd.com/docs/service/TRANSFER PRICINGNewsAlert.pdf
4. An indirect analysis that is broadly consistent with this was used by Compaq to develop its CUPs, which were accepted by the Tax Court. Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001).

There is an inherent risk in any distribution business that customers will default on payments and this risk increases during an economic downturn.

There are a number of ways to demonstrate the impact of fixed SG&A expenses on operating profits. One can use an accounting "variance analysis" to compare 2007 to 2008, as in the approach discussed above to identifying the factors affecting the profitability of the MNE. The dollar value of the distributor's gross margin has fallen $0.7 million to $1.24 million in 2008. Ordinary SG&A has also fallen, but only by $0.2 million to $1.4 million, leading to a $0.5 million reduction in operating profit.

Another method is to assume sales were 30 percent higher than they actually were, to show what profits would have been at the old volume levels.[5] Both approaches do essentially the same thing, but one may be more likely to persuade the tax authority than the other.

Accounts receivable loss

There is an inherent risk in any distribution business that customers will default on payments and this risk increases during an economic downturn. When such customers represent a significant portion of sales or a company's balance of accounts receivable, the loss can lead to large income statement losses. Under U.S. GAAP, bad debts and accounts receivable losses are usually reported as part of income before tax, as a component of continuing operations.

It is difficult to capture the effect of a large bad debt write-off through a comparables analysis. Due to the one-time nature of such losses, there are likely to be significant differences between the distributor and the comparables both in the levels of the accounts receivable losses and their timing. The key question in our case is which of the two legal entities should incur the loss. Although this obviously depends upon intercompany contractual terms, the normal assumption is that an accounts receivable loss is properly assigned to the distributor.

A further question is whether, and if so how, a large bad debt loss fits into the transfer pricing analysis. At one level it may simply explain part of the difference between the 2007 and 2008 results; it is an expense incurred in 2008 not incurred in 2007. As noted above, part of the expense may relate to prior year sales. This could be particularly important in countries, such as Canada, where the tax authority insists on looking at transfer pricing issues on a year by year basis. Or the bad debt can be used to explain differences between the results of the tested party and of the comparables. This, of course, requires an examination of the comparables, to make sure that they do not have similar levels of bad debt. The bad debt analysis can be presented as either an explanation or an adjustment, i.e. excluded from the tested party's results. Whether or not to exclude them will depend on various factors, such as the scale of loss relative to those of comparable companies and to the tested party's historical bad debt experience.

Potential adjustments

Figure 4 shows two potential adjustments related to SG&A to mitigate the effects of the economic downturn on the distributor's operating profitability, and to help improve the level of comparability between the distributor and the comparable companies.

Prior to the downturn, the tested party had the same SG&A/Sales ratio as the comparables. The 2008 SG&A/Sales ratio of the comparable companies has not been affected by the downturn, but the tested party's ratio has increased six percentage points. The adjustment calculates an adjusted SG&A for the distributor, based on net sales and a "normal" SG&A/Sales ratio. A ratio of 14 percent can be construed as "normal" based on both the tested party's prior history and the ratios of the comparables. On that basis, the tested party's 2008 SG&A is reduced to that given by actual sales and the normal ratio. Based on this adjustment, the distributor's 2008 operating margin is adjusted from -7.7 percent to -1.5 percent. The distributor's

Figure 4

Distributor	2004	2005	2006	2007	2008
Gross Profit	1,750,000	1,837,500	1,911,000	1,968,330	1,240,048
SG&A	1,400,000	1,463,000	1,514,205	1,589,915	1,430,925
SG&A %	14%	14%	14%	14%	20%
Adj. SG&A %	14%	14%	14%	14%	14%
Adj. SG&A	1,400,000	1,463,000	1,514,205	1,589,915	990,985
AR					354,299
Operating Profit – SG&A adj.					(105,236)
Operating Margin – SG&A adj.					-1.5%
Operating Profit – SG&A + AR adj.					249,063
Operating Margin – SG&A + AR adj.					3.5%

Source: For illustration purposes only, KPMG in the U.S.

Although typically only one party is tested in a CPM/TNMM analysis tax authorities are ultimately concerned with the profitability on their side of the transaction.

adjusted, 2006-2008 three-year operating margin is 2.3 percent, and likely to be in line with those of the comparable companies. And, because the tested party's accounts receivable losses could be attributed to extraordinary circumstances, we can exclude them from the distributor's 2008 SG&A expense. This adjustment brings the distributor's adjusted 2006-2008 operating margin to 3.5 percent, consistent with prior years. Note that such adjustments are only appropriate if the comparables have not suffered as a result of the same risks.

Conclusion

This analysis suggests it is better to look at factors affecting the results of the tested party before selecting a method or reviewing comparable companies' results. In this case, the tested party's stable gross margins over the entire period show transfer pricing policies were applied consistently in the good and bad years. Operating profits fell significantly in 2008, due to the fall in unit sales and non-transfer pricing factors which prevented the distributor from reducing SG&A in line with falling sales. There are a number of ways to support the arm's-length nature of the distributor's prices, including an RPM analysis for 2008-09 based on the gross margin and a CPM/TNMM analysis with an SG&A adjustment, to bring the distributor's SG&A closer to the comparables'. Whatever approaches are chosen, the analysis has to tell a convincing economic story, to support the allocation of profits and losses to the distributor based on the transfer pricing policies and functions, assets and risks of each of the parties.

Manufacturer analysis

Although typically only one party is tested in a CPM/TNMM analysis tax authorities are ultimately concerned with the profitability on their side of the transaction. The selection of the tested party, and its economic rationale, are important when defending the MNE's transfer pricing. An in-depth transfer pricing study needs to be clear about which entity is the more appropriate tested party. Even when the distributor makes a loss, it is possible for the tax authority in the manufacturer's jurisdiction to test the manufacturer's financial results and propose an adjustment. This may become more common as tax authorities step up their enforcement efforts to increase tax revenues hit by the economic downturn.[6] An in-depth transfer pricing study must recognize this possibility and analyze results on both sides of the transaction.

5. Yet another approach would be to adjust the comparables companies in some way, either by estimating what would happen to their profits if sales fell by 30% or by adjusting their SG&A to sales ratios to approximate those of the tested party. The disadvantage of this approach is that generally less precise financial data of the comparables is available.
6. For example, the Internal Revenue Service recently released its Strategic Plan 2009-2013, detailing the roadmap to increased enforcement of international tax issues and key international tax areas, including transfer pricing. The Strategic Plan 2009-2013 was timely given President Obama's proposal to increase IRS resources with respect to international tax enforcement.

Figure 5 Manufacturer's Results

Manufacturer	2004	2005	2006	2007	2008	2009 (Projected)	Wtd. Avg. 2006-2008
Net Sales	8,250,000	8,662,500	9,009,000	9,279,270	5,845,940	4,969,049	8,044,737
Change in Sales		5.0%	4.0%	3.0%	-37.0%	-15.0%	
Costs of Goods Sold	7,000,000	7,350,000	7,717,500	8,103,375	5,793,913	4,965,384	7,204,929
Gross Profit	1,250,000	1,312,500	1,291,500	1,175,895	52,027	3,666	839,807
Gross Margin	15.2%	15.2%	14.3%	12.7%	0.9%	0.1%	10.4%
Ordinary SG&A	700,000	731,500	757,103	794,958	735,336	588,269	762,465
Change in Ordinary SG&A		4.5%	3.5%	5.0%	-7.5%	-20.0%	
Fixed Asset Impairment					292,297		97,432
Operating Profit	550,000	581,000	534,398	380,937	(975,606)	(584,603)	(20,090)
Operating Margin	6.7%	6.7%	5.9%	4.1%	-16.7%	-11.8%	-0.2%

Source: For illustration purposes only, KPMG in the U.S.

As the duration and depth of the economic downturn remain highly uncertain, it is advisable to maintain flexibility in APA negotiations.

Figure 5 shows the results of the manufacturer.

The manufacturer's profits decreased from $381,000 to -$976,000 in 2008. Variance analysis shows that its profitability was affected by the following factors:

- The price the manufacturer received from the distributor fell ten percent ($900,000), because of a ten percent fall in market prices. The transfer pricing issue here is whether the manufacturer agreed to bear this risk. The transfer pricing analysis must confirm that the transfer pricing was appropriate and the manufacturer was obliged to bear this risk.

- Unit sales fell 30 percent ($122,000), leading to an increase in per unit COGS. The transfer pricing issue is whether the distributor had agreed to pay a cost plus return to the manufacturer, or was party to a contract that shifted the risk to the distributor. The discussion of SG&A expenses for the distributor may also apply here, if the manufacturer was unable to reduce SG&A in line with sales and market prices. The ordinary SG&A/Sales ratio rose from 8.5 percent in 2007, to 12.1 percent in 2008. The value of gross profit fell $1.1 million, to $50,000. SG&A also fell, but only by $0.1 million.

- The fixed asset impairment charge of $292,000 would normally stay with the manufacturer, unless there is an agreement that the distributor will pick it up, or the distributor owns the manufacturing assets in question. (This is sometimes the case in contract manufacturing arrangements.)

As these items each have a bearing on the assignment of risk, they need to be addressed in transfer pricing documentation:

- Even if the distributor is the tested party under the CPM/TNMM, it is still important to explain the manufacturer's losses. This can be in the form of a written explanation, rather than part of the transfer pricing method.

- If an adjusted approach is applied to the distributor it will be important to document that the manufacturer also incurred a risk, as falling sales led to a sharp decline in profits.

- When testing the manufacturer, the analysis needs to reconcile results with last year's results, showing what led to the changes. This can either be done through a variance analysis, for example, or by explaining why the

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tested party's results differ from those of the comparables and showing that they would be consistent with those of the comparables if these factors were not present.

Restructuring costs and fixed asset impairments

The manufacturer incurred a $292,000 fixed asset impairment charge in 2008 to reflect a reduction in the utilization of manufacturing assets during the downturn. Assuming the company has followed its intercompany contracts and has properly assigned the restructuring charge to the entity responsible for bearing the risks associated with the restructuring, an important question is how to treat such expenses for CPM/TNMM purposes. The comparable companies may bear similar restructuring charges, but still be poor matches because of differences in the relative impact of such restructuring charges. The impact of restructuring charges on financial results obviously varies depending upon whether they are equal to 20 percent or two percent of total costs.[7] Such differences could undermine the reliability of the CPM/TNMM.[8]

One solution is to see such restructuring charges as non-operating expenses for CPM/TNMM purposes, to allow comparisons of financial results and operating profitability ratios. Excluding the fixed asset impairment charges for 2008, the 2006-2008 weighted average return on total costs for the manufacturing company is one percent. Given the expected decline in comparable company margins, this may be more supportable as part of a CPM/TNMM analysis.

Applicability to APAs

When negotiating advance pricing agreements (APAs) that involve profit-based methods, taxpayers should consider the issues outlined above and ask that certain items, such as accounts receivable losses and impairment charges, be excluded from operating expenses. This may be appropriate as APAs are normally negotiated on the basis of benchmarks constructed in buoyant economic times. Other options in an economic downturn include shortening the term of the APA and asking for critical assumptions about levels of sales reductions, impairment charges and accounts receivable losses. As the duration and depth of the economic downturn remain highly uncertain, it is advisable to maintain flexibility in APA negotiations.

Conclusion

The economic downturn has led to significantly reduced profits for many companies both on a consolidated basis and also on an entity level. Transfer pricing policies that produced consistent and predictable results in the past may produce completely unexpected results for 2008-2009. A CPM/TNMM analysis testing either the distributor or manufacturer that worked perfectly for prior years may now lead to situations where one or both are below the operating profit levels of comparable companies.

As governments seek to protect revenues by focusing more intently on transfer pricing and international tax issues, a more in-depth transfer pricing analysis is required to support the arm's-length nature of transfer prices. This analysis needs to consider the factors that led to reductions in operating profits, and whether they affected the comparables in the same way. If the transfer pricing policies were applied consistently and the losses were properly allocated to the entity contractually obliged to bear the risks, adjustments to the CPM/TNMM analysis to account for differences between the tested party and the comparables will help increase the reliability of the CPM/TNMM. Taxpayers should also be wary of the pitfalls of "knee jerk" reactions, such as lengthening the time period of the CPM/TNMM analysis. This could lead to negative consequences if the economic downturn continues longer than expected.

The authors would like to thank Tamas Kosztyu (KPMG in the U.S.) for his contributions to the article.

7. As an asset write-down also leads to a reduction in the book value of fixed assets, the profitability in future periods would be expected to increase due to a reduction in depreciation expense. However, this timing difference would continue to impact the operating profit comparisons between the tested party and the comparables.
8. An important factor to consider is how the comparable companies' financials as reflected in the databases treat fixed asset impairment charges. Although U.S. GAAP requires that impairment charges be reported on the income statement as a part of continuing operations (before tax), certain databases, including Compsutat, back out such charges for purposes of computing operating profit.

Intercompany Services in Turbulent Times

In today's volatile regulatory and economic environment, global companies may need to review how they provide and recharge the costs of headquarters and back-office support. **Jacek Bajger (KPMG in Poland), Stephen Blough (KPMG in the U.S.)** and **Dirk Van Stappen (KPMG in Belgium)** examine the tax issues that arise.

Multinational enterprises (MNEs) are under pressure, when it comes to headquarters and back-office services (HQBS)
On the one hand, the revised U.S. Regulations (Tr. Reg. §1.482-9T) have obliged MNEs to review the nature and value of the services rendered and, in some cases, to identify more services and related costs they should be recharging to their foreign entities. On the other hand, a turbulent global economic environment is encouraging other governments, and their tax authorities, to defend with more vigor their own tax bases and to scrutinize more closely the HQBS fees local subsidiaries are paying to confirm they pass the benefit test and don't include shareholder costs.

Less skepticism in Europe
In Europe, particularly Eastern Europe and the new European Union (EU) member states, some tax authorities were reluctant to accept certain inbound intercompany services fees as deductible business expenses. The local tax authorities of Eastern European countries, where many recipients of such services are located, often saw HQBS as a device for shifting local profit abroad, rather than a way to provide valuable support to local subsidiaries from headquarters. The situation has improved since the early 1990s, when HQBS, by definition were often treated as non-deductible for tax purposes. Eastern European tax authorities have a better understanding now of how MNEs operate and the role of HQBS in a global organization. Companies incurring and paying such fees can more readily defend their tax deductibility these days, but they have to be very well prepared, and a clear demonstration of benefit received is a pre-requisite of a successful defense of the tax deductibility of such expenses.

General crisis-related issues
The current economic climate raises specific issues for MNEs, such as what

How should chargeouts be determined, particularly if the new system is rolled out in different jurisdictions, at different times?

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to do with the costs of streamlining and reorganizing the departments delivering the HQBS. For example, an MNE might decide to restructure its internal finance and procurement organization to centralize many functions in a small number of regional service centers, and implement a single, worldwide information technology infrastructure behind these functions. While such a reorganization may be expected to save substantial costs in the longterm, there could be significant restructuring charges, IT capital investment and implementation expenses in the near term. Should these costs be treated as part of the cost base of the HQBS, and allocated and recharged to the various beneficiaries of the HQBS, or should they be borne by the entity providing the HQBS, or the entity that took the decision to streamline and reorganize the services entity? How should chargeouts be determined, particularly if the new system is rolled out in different jurisdictions, at different times?

These questions often arise in tax, or transfer pricing audits these days, and are not at all easy to answer. Doing so requires detailed analyses of the underlying facts and the business model, including the transfer pricing structure governing other intercompany relationships, which are beyond the scope of this article.

Compliance costs skyrocket

MNEs are faced with increased compliance costs when defending the deductibility of service charges and the appropriateness and arm's-length nature of plus-percentages used by the service provider.

All EU tax authorities adhere more or less to the Organisation for Economic Co-operation and Development (OECD) guidelines on transfer pricing issues relating to services in particular (as set out in Chapter VII of the OECD Guidelines), and thus should be willing to accept the tax deductibility of service(s) fees as long as the benefit test has been passed. This requires the taxpayer to prove that the services for which invoices have been issued have indeed been provided, and that the amounts charged comply with the arm's-length principle.

Problems passing the benefit test

The attention paid to HQBS in some EU countries, such as the Czech Republic, Germany, Hungary, Italy, Poland, Portugal and Spain, is such that passing the benefit test is sometimes a major hurdle. In Poland, for example, a regulation explicitly prevents the Polish tax authorities from accepting expenses as deductible costs when the value of rationally expected benefits of the transaction with a related party is clearly lower than the charge on the recipient. This approach has often been invoked by the Polish tax authorities – it is easier, after all, to disqualify the whole HQBS charge than embark on a difficult discussion about what is a legitimate charge under the arm's-length principle.

This can put a taxpayer in an uncomfortable position, because it is often hard to prove receipt of HQBS and even harder to demonstrate their true value. The problem is often made more challenging by the absence of any guidance from the local tax authorities about how to demonstrate receipt and what would constitute sufficient evidence of value. Local MNE subsidiaries must, therefore, spend a lot of time and effort on something they may perceive as an irksome bureaucratic burden associated with the daily support they receive from their headquarters.

More difficulties arise in the cases of subsidiaries that, because they are in a start-up phase or, more common recently, because of unfavorable market situation, are incurring losses. It may be very difficult, and in some cases even impossible, to convince the tax authorities that the HQBS were of benefit to the recipient. Some tax inspectors frequently treat the loss position of the taxpayer as evidence that the HQBS do not create any valuable benefits for the recipient.

Transfer pricing documentation may not be enough

Many countries have introduced regulations for documenting related party transactions for transfer pricing purposes. When preparing these documents taxpayers may overestimate their value. Some may find that, after spending a lot of time and money on preparing documents compliant with

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Mr. Van Stappen has also been appointed in 2002 (and reappointed in 2007) as one of the 10 (15 as from 2007) European business representatives of the EU Joint Transfer Pricing Forum of the European Commission.

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local and OECD rules, they still can't convince the local tax authorities of the benefits received from the HQBS fees. The issue of evidence is vital. Records maintained in the local entity that provide evidence of services received are often of more importance than a formal study in passing the benefit threshold.

Unfortunately, after the taxpayer has been able to prove a benefit has been received by the company paying the services fee, the tax authorities may turn their attention to the validity of the cost base (direct and indirect, and internal and external costs) and to the appropriateness of the allocation key(s) used.

Moreover, there is also likely to be some discussion and debate on what expenses should be construed as 'stewardship' or shareholder activity. The OECD Guidelines provide only limited guidance on how to define these categories of activity and cost. The U.S. Services Regulations specify a "sole effect" test, and include a relatively narrow definition of shareholder expenses, which may increase the chances of conflict with recipient authorities. The use and choice of allocation keys may also be disputed by local tax authorities.

In addition to providing support for recharging and allocating the basic costs, entities are also frequently required to justify the mark-ups (if any) applied when recharging the HQBS. In many cases they have to call on the services of outside transfer pricing practitioners for this support. This may entail significant compliance costs for the business, and produce benchmark mark-up outcomes ranging from three to ten percent for typical HQBS with relatively low perceived added value for the taxpayer's core business.

In the authors' experience, some countries will insist on lower mark-ups for inbound than for outbound charges and the current economic climate can only encourage such arbitrary behavior. The new U.S. Services Regulations specify a cost safe harbor (SCM) for routine back-office service charges out of U.S. head offices. Using the SCM has the merit of avoiding the costs and potential conflicts associated with choosing a mark-up.

Double taxation consequences

Following the increased focus of tax authorities on transfer pricing matters and the consequent explosion of transfer pricing adjustments, businesses now face an increased risk of double taxation when HQBS fees are partially or fully denied as deductible business expenses in the country of the paying group entity. Certain procedures, such as the EU's European Arbitration Convention and the Mutual Agreement Procedures set out in double tax treaties, may be used to help avoid or remedy this double taxation.

But the Mutual Agreement Procedures - at least in the form expected in most double tax treaties - are no guarantee that double taxation problems will be resolved. The European Arbitration Convention, in principle, does provide such a guarantee, but it appears that some

JTPF discussions on intra group services may produce recommendations that could ease the heavy compliance burden on taxpayers and liberate time and resources that could be used to help keep businesses afloat in these turbulent times.

member states, such as France and Spain, often levy a serious penalty after a transfer pricing adjustment. Such serious penalties would preclude the affected taxpayer's access to the European Arbitration Convention, resulting in substantially greater difficulties in resolving double tax issues.

A further difficulty arises when HQBS charges are incurred by and/or allocated among multiple jurisdictions within and outside the EU, as can occur in a cost contribution arrangement. In such cases the taxpayer is faced with a daunting task of achieving consistent resolution and full avoidance of double tax. The current debate in the EU Joint Transfer Pricing Forum (JTPF) on triangular cases may help to find a way to resolve this difficult problem.

Joint Transfer Pricing Forum debating services

The European Commission (EC) is aware of the intercompany services problems business is facing, and of the need to consider them. The JTPF is looking at the treatment of intercompany services, and the issue of shareholder services.

The main issue is how to cut compliance costs by, for example, the allocation of head office costs with a reasonable key, rather than incurring compliance costs resulting from an unnecessary analysis of the time spent by the head office. As already noted, at present, substantial compliance costs are incurred when demonstrating that the HQBS have been charged to group members in accordance with the arm's-length principle. In many cases, it is not possible to charge directly for central services and other methods, such as indirect allocation based on a reasonable allocation key, need to be found. More guidance is needed on the documentation requirements relating to the charging of intercompany services within a group. This will be beneficial to both MNEs and the tax authorities.

The JTPF has also discussed shareholder and stewardship costs. Its conclusions may result in guidance to taxpayers in addition to that included in the OECD Transfer Pricing Guidelines.

Business is also hoping the JTPF can agree on an indicative net cost plus range for deemed HQBS with relatively low added value that is acceptable to all tax authorities irrespective of whether they're at the receiving or paying end. Such a change has the potential to create significant saving of compliance costs, because taxpayers would no longer have to pay for benchmark studies to support their mark-ups. Even greater simplification would result from establishing circumstances where charges at cost (so without markup), as with the U.S. SCM, will be accepted.

The JTPF has also considered the issue of access to the European Arbitration Convention when serious penalties are being levied and recommended that access to the Convention should only be denied in exceptional cases, such as fraud.

The outcome of the discussions on HQBS within the JTPF will be set out in an activity report to the EC, which will then deal with it as it sees fit. At the time of writing, the report was expected to be made public late 2009.

In the meantime, MNEs should continue to pay close attention to the support of HQBS supplied and recharged within their organizations, because, in their increased quest for more revenues, tax authorities may continue to question and challenge their deductibility. JTPF discussions on intra group services may produce recommendations that could ease the heavy compliance burden on taxpayers and liberate time and resources that could be used to help keep businesses afloat in these turbulent times.

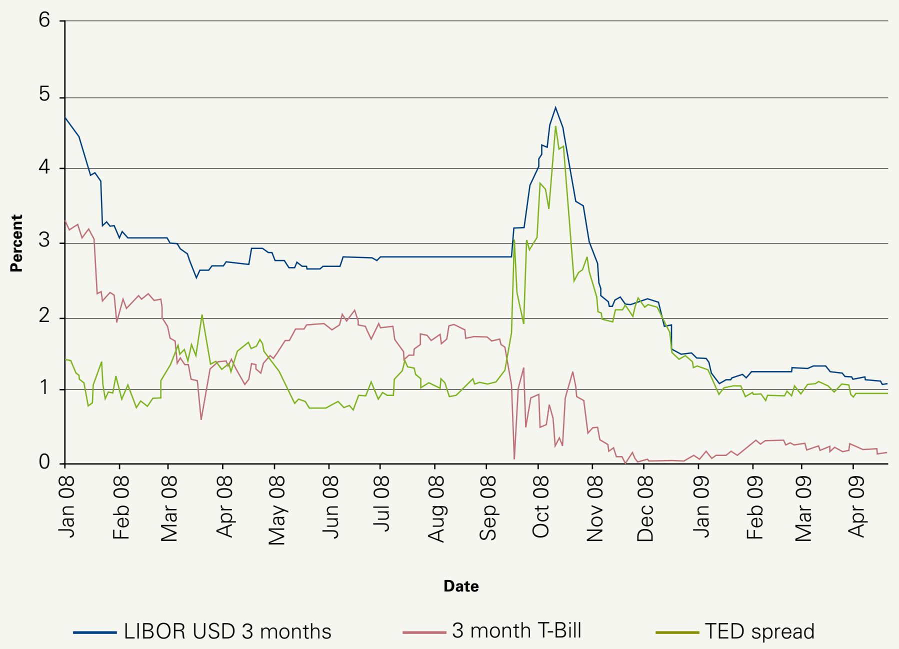
Related-Party Loans

Intragroup lending is an integral part of global financial management, but the transfer pricing policies associated with it are in uncharted territory. The authors, **Lucia Fedina (KPMG in the U.S.), Burcin Kasapoglu (KPMG in the U.S.), Damian Preshaw (KPMG in Australia)** and **Jaap Reyneveld (KPMG in the Netherlands)** discuss the problems caused by volatile rates and reduced liquidity.

Traditionally, interest rates for related-party loans have been evaluated by comparing them to market benchmarks. The global financial crisis and a consequent "flight to quality" have led to volatile credit spreads across all types of debt, changes in reference interest rates, and a sharp reduction in the number of debt transactions.

For multinational enterprises (MNEs), these developments raise many questions. Should interest rates on pre-existing inter-affiliate loans be reviewed? Can new loans be defended as debt when there is so little appetite for debt? How can you establish a related-party interest rate when benchmark transactions are few and rates vary? Should companies take the events of 2008 into account when setting the lending policies for 2009 onwards?

Figure 1 **TED Spread January 2008 – April 2009**



Source: http://chartmechanic.com/chart.jsp?c=dave/TED%20spread,%202008.chart

The global economic crisis

Interest rates as clearing prices for the demand and supply of money are sensitive to changes in the economic environment, such as the shock to the global economy that began to unfold in July 2007 when excessive earlier lending and declining loan standards began to produce borrower defaults, especially in the sub-prime home mortgage market. The supply of credit contracted, especially for riskier borrowers.

Declines in the value of securitized mortgages led to the failures of some large financial institutions and a dramatic rise in risk spreads in September 2008 and a further rise in November 2008. As shown in Figure 1, the TED spread,[1] an indicator of perceived credit risk in the banking sector, widened to 450 basis points (bps). Despite the injection of huge amounts of capital into the financial system by the Federal Reserve, the Bank of England and the European Central Bank, the crisis deepened, stock markets plunged and the global economy contracted.

Should companies take the events of 2008 into account when setting the lending policies for 2009 onwards?

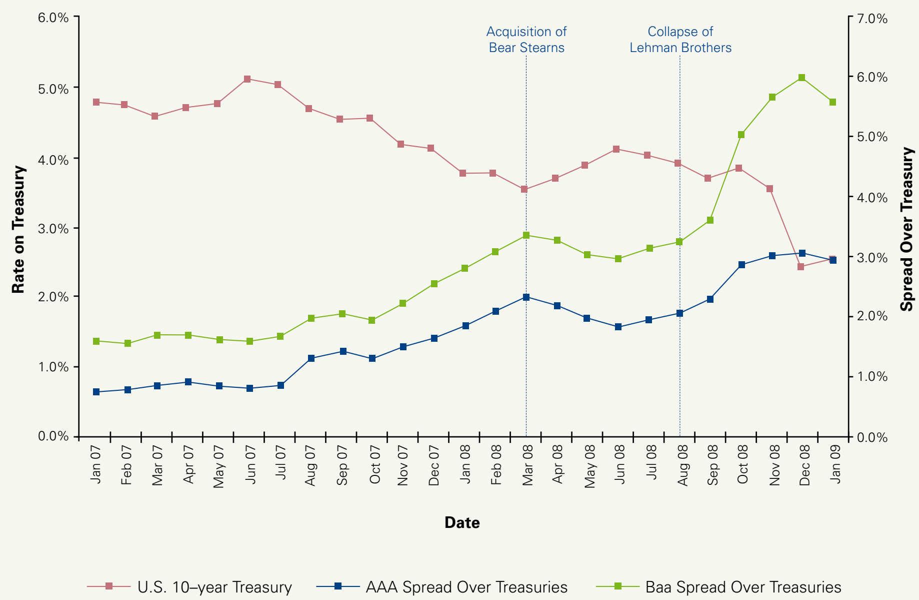
After peaking in October 2008, the TED spread narrowed and the LIBOR also fell significantly, indicating an increase in the willingness of banks to lend to each other. By March 2009, the TED spread at 0.98 percent was back within the long-term typical range of 50-100 bps.

Credit environment pre 2009

The deterioration in the equity positions of financial institutions and a tightening of lending standards reduced the supply of credit. As shown in Figure 2, credit spreads over interest base rates or benchmarks (such as 10 Year Treasuries) widened and steepened credit spread curves.

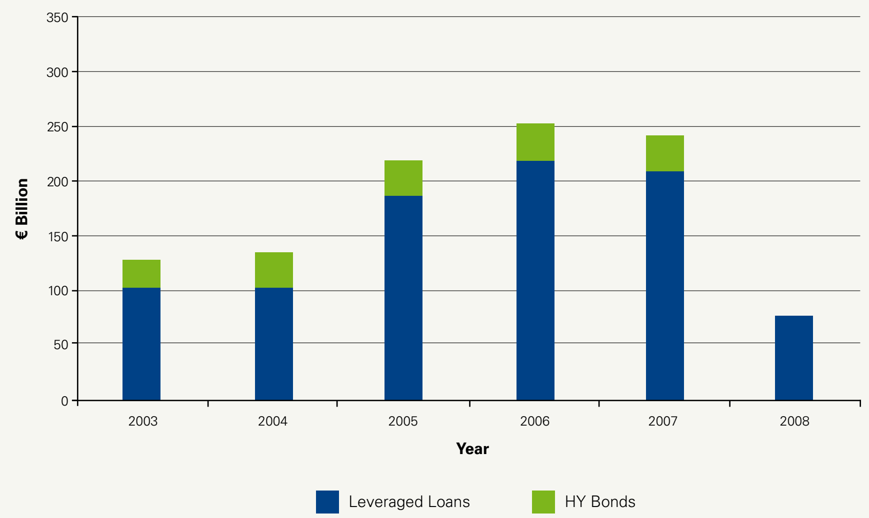
A striking loss of appetite for new debt issues is shown in Figure 3. The aggregate value of loans issued in Europe in 2008 dropped by about two-thirds from 2007 levels, and no high-yield corporate bonds were issued in Europe in 2008.

Figure 2 **AAA and Baa Spreads over 10 Year Treasury**



Source: http://www.federalreserve.gov/econresdata/releases/statisticsdata.htm

Figure 3 **European issuance of high-yield bonds and leveraged loans 2003–2008**



Source: European Quarterly High Yield and Leveraged Loan Report, Fourth Quarter, 2008

1. The TED spread is the difference between three-month LIBOR and the three-month T-bill interest rate.

U.S. companies also borrowed less and issued less public debt, as shown in Figure 4.

Recent trends

In late spring 2009, many investors were hoping the crisis was over. From early March 2009 to mid-May 2009, the S&P and German DAX rose by about a third, and the FTSE 100 was up by a fifth.[2] Many economic indicators were improving, consumer confidence was returning and, as prices fell in many countries while wages held steady, consumer spending power increased. But housing prices outside the U.S. were still falling as banks continued to re-build their capital.

Global credit markets were also recovering. Interbank spreads had come down and volatility and trading volumes were returning to pre-crisis levels. Risk premiums on corporate investment grade and high-yield debt fell by a quarter in April 2009 and between the end of 2008, and March 2009 average volumes in the interbank lending market jumped by a third to US$4.4 trillion. The value of outstanding commercial paper issued by U.S. banks for short-term funding has grown by a tenth so far in 2009, to $650 billion.[3]

Other signs of recovery included a 50 basis points fall credit in spreads on European investment-grade corporate bonds in April to 240 bps. Spreads on high-yield bonds globally fell by 246 bps to 1,517 bps in April, the sharpest monthly fall in high-yield spreads since the launch of Merrill Lynch's global high-yield bond index in 1997. The appetite for credit and for risk assets in general was returning. By the end of April, overnight LIBORs had touched new 2009 lows and the spreads had fallen to levels not seen since before the Lehman Brothers collapse.[4]

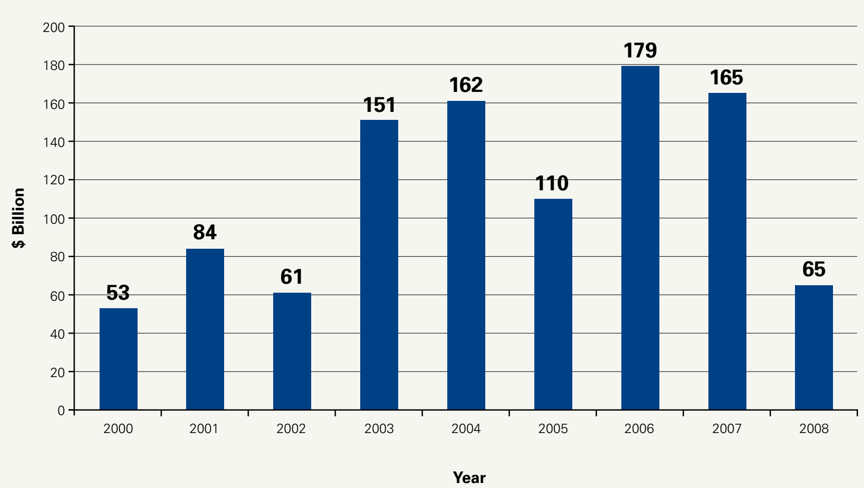
Implications for interest rate analysis

The original Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines, issued in 1979, included a chapter on loans, but this was not updated and incorporated into the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, issued in 1995. The lack of detailed up-to-date guidance at the international level exacerbates transfer pricing risks when markets are not functioning normally, and increases the potential for conflicts between tax administrations for the corporate tax dollar.

U.S. Treasury Regulations §1.482-2(a)(2) describe three ways to benchmark interest rates for related-party loans. The "arm's-length" method refers to comparable, third party transactions, and can be used to analyze any loan. The second method, applicable at the taxpayer's discretion to loans obtained by a lender on a borrower's behalf, refers to the rate paid by the lender and adds an amount that reflects the costs incurred by the lender in borrowing such amounts, and making such loans. The third, "safe haven" method, applicable at the taxpayer's discretion to U.S. dollar term and demand loans made by lenders not in the business lending loans, sets the safe haven rate at 100-130 percent of the relevant Applicable Federal Rate (AFR), where the AFR is based on U.S. Treasury rates. Short-, mid- or long-term AFRs may be applied, depending on the maturity of the loan.

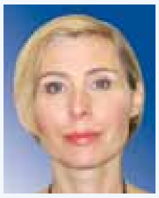
The regulations describe three methods and specify some basic factors for comparability, but leave many questions open (particularly those relating to comparable independent transactions), such as the benchmarking of illiquid related-party loans using liquid instruments, adjusting for the existence of embedded options, analyzing the arm's-length nature if the loan is a demand note, and the applicability of the safe haven rates when they are significantly different from market interest rates. The U.S. regulations are also unclear on whether or how floating loans should be treated under the safe haven approach.

Figure 4 **U.S. issuance of high-yield bonds and leveraged loans 2000-2008**



Source: Weekly Leveraged Finance Data Packet, Morgan Stanley, April 20, 2009

The value of outstanding commercial paper issued by U.S. banks for short-term funding has grown by a tenth so far in 2009, to $650 billion.



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Dr. Fedina's prior work experience includes two years as a chemical engineer (during which she obtained a patent for developing a new catalyst) and two years as a biotech researcher. Dr. Fedina has a PhD degree in economics from Ohio State University and a Masters Degree in physical chemistry from Kazakh State University.

Following the events of September 2008, U.S. Treasury rates were reduced close to zero to stimulate the economy. This led to very low AFRs and a narrow range of safe haven rates. In May 2009, the short term AFR was 0.76 percent,[5] producing a safe haven range of 0.76-0.99 percent, while the prime rate was 3.25 percent and short-term LIBOR was below 1.0 percent.[6] This meant that virtually any loan priced at a spread over LIBOR was above the safe haven range and, when extended to U.S. affiliates, could not be supported using the safe haven. Since other tax authorities do not accept the U.S. safe haven, rates within the U.S. safe haven on a loan made by a non-U.S. lender are unlikely to be acceptable to such lender's tax authority.

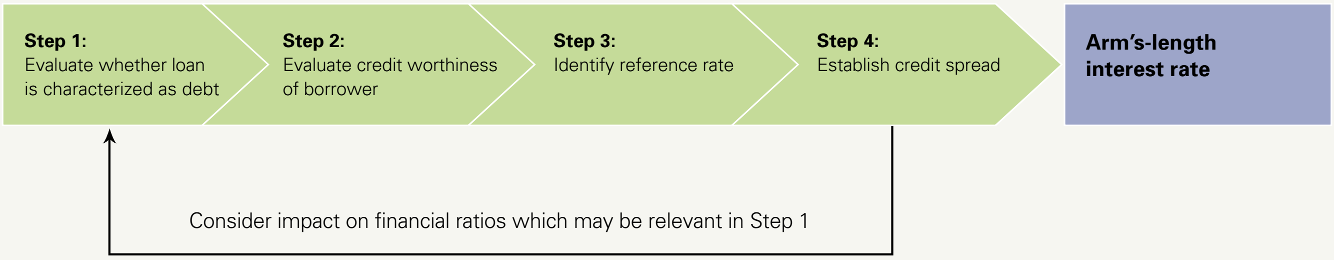
But, at the same time, these rate movements created opportunities. It may be advantageous, for example, to lend outside the U.S. at rates within the safe haven, because it seems unlikely that any foreign jurisdiction would object to a borrower in its jurisdiction paying low rates.

Benchmarking analysis

The benchmark analysis, outlined in Figure 5, typically proceeds in the following steps (combine steps 3 and 4 for fixed-rate loans):

2. "Turning the page on the crisis", The Daily Telegraph, 11 May 2009.
3. Ibid
4. The statistic in this paragraph came from "It is official: credit bounces back", Financial News, May 4, 2009.
5. The AFR is published by the IRS at http://www.irs.gov/app/picklist/list/federalRates.html
6. Short-term rates as of May 2009 were obtained from http://www.bloomberg.com/markets/rates/keyrates.html

Figure 5



Source: For illustration purposes only, KPMG in the U.S.

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The characterization of financial instruments as debt for tax purposes is evaluated under the domestic laws of each country.

The sections below discuss some of the abovementioned steps in further detail:

Debt versus equity

The characterization of financial instruments as debt for tax purposes is evaluated under the domestic laws of each country. In some countries, the economic substance and legal form determine the tax characterization of a transaction.[7] In others, only the legal form is relevant.

In a growing number of countries, such as Australia, the deductibility of interest associated with, or the characterization of cross-border related-party loans may be affected by thin capitalization[8] or transfer pricing rules.[9] Some use a safe harbor approach often based on a simple debt to equity ratio. Where there is no safe harbor, a facts and circumstances approach may be used to assess whether a related-party loan should be treated as debt or equity for tax purposes. For instance, an approach may be based on an assessment of whether the capital structure of the borrower is similar to that of the comparable companies or whether the borrower would have been able to borrow on its own from unrelated parties.

Because of the financial crisis, tax authorities may be in a position to argue that many related-party borrowers would have been unable to issue or borrow additional debt on their own. In these cases, the related party loans could be recharacterized as infusions of equity. It is, therefore, vital to prepare documentation that demonstrates that the affiliate could borrow from a third party under similar terms and conditions.

Creditworthiness of the borrower

If there are no third party loans that can be used as internal comparable transactions, the credit risk of the borrower can be used to assess which third party transactions are comparable. When the borrower is publicly rated, its rating can be used, but borrowers are more often subsidiaries with no public ratings and their credit worthiness must be established in another way.

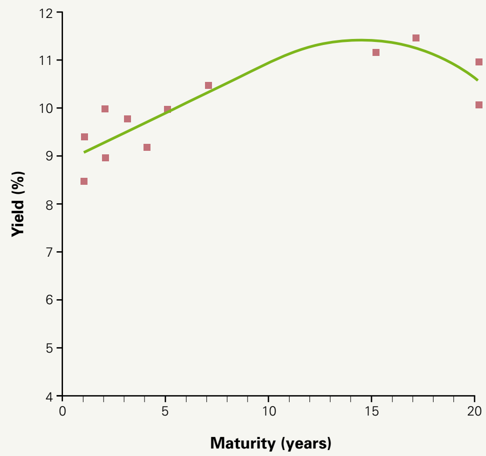
Moody's, Standard and Poor's, and Fitch use (and sometimes make available to others) proprietary tools that can generate credit ratings. Credit worthiness can also be evaluated by comparing the ratios of tested party borrowers with those of third parties that are publicly rated.

Figure 6 **A sample yield curve**

Indicative BB+rates

1.0	9.4
1.0	8.5
2.0	9.0
2.0	10.0
3.0	9.8
4.0	9.2
5.0	10.0
7.0	10.5
15.0	11.2
17.0	11.5
20.0	10.1
20.0	11.0

Interpolation of the yield curve



*The yield curve takes the form of a polynomial function (to the order of 3) and has been modeled based off notionally observed data points.

Source: KPMG in the U.S.

In the current environment it is vital to have proper legal documentation for related-party loans.

If intercompany policies rely on historical credit ratings, they may need to be reconsidered, because the global financial crisis affects existing ratings. A company rated A before the crisis may now be BBB. In addition, the credit rating agencies have been reviewing their rating standards and changing the financial ratios they use for each rating. It is advisable, therefore, to use recent tools, or recalibrate the outdated ones. This can be done by benchmarking a stand-alone affiliate against its consolidated entity. If the consolidated entity's estimated rating is AA, but its most recent public rating is AA-, the affiliate's estimated rating should come down by a notch, too.

Comparable interest rates

As already noted, the 1995 OECD Guidelines do not specifically address the interest rate benchmarking issue for intercompany financial transactions, although they seem to support the Comparable Uncontrolled Price (CUP) method where the data are available. The comparability factors of the CUP analysis include but are not confined to:[10]

- Date of the transaction
- Creditworthiness of the borrower
- Country of the borrower
- Currency of the loan under review
- The amount of the loan
- The term or maturity of the loan
- The coupon type, i.e. fixed or floating
- The seniority of the loan, i.e. senior or subordinated
- Security features, e.g. collateral; and
- Other loan features, such as prepayment penalty, demand clauses, loan covenants, etc.

The comparable transactions can be:

- internal (the taxpayer benchmarks the controlled transactions relying on its own third-party transactions) or
- external (the taxpayer benchmarks the controlled transactions relying on transactions between third parties that are unaffiliated with the taxpayer)

Where an analysis uses external financial transactions between third parties, data are usually obtained from publicly available databases, such as Bloomberg or DealScan. In the past, these databases provided a reliable number of comparable third-party loan/bond transactions, but the decline in market activity has made interest rate ranges more volatile, and more dependent on the peculiarities of particular deals. To address this problem it is advisable to perform an analysis of the yield curve, and benchmark the tested-party transactions on the results of both analyses (e.g. use the range if both analyses overlap).

Yield curves are based on market interest rate information on bonds for a large number of credit ratings and currencies.[11] The yield curves usually provide interest rate information on loans with maturities ranging from three months to 20 years. Yield curve information can be obtained from public databases such as Bloomberg. Using yield curve information avoids the need to search for individual transactions to substantiate the arm's-length nature of each intercompany loan, but it also means that the transactions constituting the yield curves are not known and the approach relies on the appropriateness of the way in which public databases calculate yield curves. Bloomberg's approach is just one of several ways to construct a yield curve. The yield curve shown in Figure 6, for instance, takes the form of a polynomial function.

7. Plantation Patterns, Inc. versus Commissioner of Internal Revenue 462 F.2d 712; Laidlaw Transportation, Inc v Commissioner of Internal Revenue T.C.M. 1998-232.; Estate of Travis Mixon v United States of America 464 F.2d 394.
8. "Financing: A Global Survey of Thin Capitalization and Transfer Pricing Rules in 35 Selected Countries", KPMG, International Transfer Pricing Journal, November/December 2008, pp283-352.
9. Intra-group finance guarantees and loans: Application of Australia's transfer pricing and thin capitalisation rules, Discussion paper issued by the Australian Taxation Office, June 2008.
10. Paragraph 199 of the 1979 OECD Guidelines provides some guidance in this area.
11. Bloomberg provides the following definition of a yield curve: "A chart consisting of the yields of bonds of the same quality but different maturities. This can be used as a gauge to evaluate the future of the interest rates. An upward trend with short-term rates lower than long-term rates is called a positive yield curve, while a down trend is a negative or inverted yield curve."

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Mr. Preshaw is a member of the OECD's Business Restructuring Advisory Group and the ATO's APA Co-design Committee.

Agreements and contracts

In the current environment it is vital to have proper legal documentation for related-party loans. Tax authorities expect related-party loans to be structured in much the same way as agreements between uncontrolled parties. If an agreement lacks a certain clause usual in similar agreements between third parties, a tax authority may impute the clause and either recalculate the pricing for the loan accordingly, or disallow the whole transaction. The same may happen if there is no agreement at all, thus leading to potential double-taxation, as when one tax authority considers the transaction as a debt, and the other, as an equity infusion. The following contractual issues relating to intercompany loans may be of interest in the current volatile economic environment.

Embedded options and early termination clauses

Most third-party agreements carefully define the term of the loan, and on what terms the loan agreement can be terminated. Some have clauses that stipulate penalties if one party chooses to end its participation before the end of the term. Others have "market-disruption clauses", which allow for re-negotiation under certain conditions.

Many loan contracts contain embedded options, such as the right to re-pay the loan, or to call the loan before its termination date. The value of these options depends on the market perception of how likely they are to end up "in the money." For example, in the case of a long-term fixed-rate loan established in 2006, a lender may have a right to terminate the loan with 60-days notice. If the lender doesn't exercise the option to terminate the loan and re-lend the money at a higher rate, a tax authority in the lender's jurisdiction may claim that the lender didn't behave in a manner consistent with the arm's-length standard.

Modification of agreements

Amending a related-party loan agreement may be deemed, for tax purposes, as creating a new loan. In such a case, the old loan terms, including the interest rate, will have to be re-visited. So, even if the loan agreement allows amendments, the taxpayer needs to assess whether the changes are so significant that the amended loan agreement may be considered a new loan.[12] Of greater concern is the possibility that a tax administration will claim that, in the circumstances prevailing at the time of the amendment, the related party would have been unable to borrow the funds on the same terms and conditions

In the current environment it is vital to have proper legal documentation for related-party loans.

Corporate treasurers need to co-ordinate with tax directors, to help evaluate whether related-party funding decisions trigger adverse tax consequences.

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from a third party, and the loan should, therefore, be treated as an equity infusion.

Hedges and hedging costs

A "trapped hedge" results when a hedge is booked in a different legal entity than the hedged transaction. For example, one affiliate "S" may have borrowed at a floating rate, while another "P" (e.g. the parent) has hedged part of this debt with a floating to fixed swap. If interest rates decline, S incurs lower interest expense while P must make payments equal to the difference between the fixed and floating rates, and additionally bears the cost of the hedge. The hedge is "trapped" if there is no agreement to pass the hedge costs and effects from P to S. If this amount becomes significant, P's tax authority may question whether P should be incurring these expenses while S enjoys the benefits of lower rates, while S's tax authority may not accept having the costs pushed to S in the absence of a proper agreement.

Conclusion

MNEs are facing significant challenges in aligning treasury policies with their business goals while complying with tax and transfer pricing requirements in the countries in which they operate. Corporate treasurers need to co-ordinate with tax directors, to help evaluate whether related-party funding decisions trigger adverse tax consequences. Documentation of related-party loans, which might have seemed unnecessary in the past, needs to be reconsidered. Many tax authorities are under tremendous fiscal pressure to raise revenues, and may seek opportunities to disallow interest expense deductions or adjust interest income because of inadequate documentation.

This is an area where tax law and regulations continue to evolve, so it is vital to monitor developments constantly.

The authors would like to thank John Bush, Bob Clair and Maggie Fritz (KPMG in the U.S.) for their reviews and contributions.

12. E.g., In the United States under Treas. Reg. 1.1001-3.

Reacting to the Crisis—Can We Support Loss Splits?

Under the current economic downturn, multinational enterprises suffer from losses which may not support an ordinary CPM/TNMM analysis. One of the options is to change the transfer pricing method to profit/loss split. **Cheng Chi (KPMG in China), Gianni De Robertis (KPMG in Italy), Atsuko Kamen (KPMG in the U.S.)** and **Hiroyuki Takahashi (KPMG in China)** explore various implications for making the switch.

In the current economic downturn many multinational enterprise (MNEs) are earning reduced system-wide profits or incurring system-wide losses. Transfer pricing systems developed during more stable economic times often used a comparable profits method (CPM)/ transactional net margin method (TNMM) approach to test results that generally left one entity with a routine level of profits. This approach was easy to apply and consistent with economic behavior in the absence of extraordinary events. Such an approach applied now often leaves the parent company absorbing the entire system-wide loss, as well as the losses due to the profits retained by the subsidiaries. This may not reflect the true underlying economics of the group and may ultimately be inconsistent with the arm's-length standard, given the current economic downturn. The approach also may lead to tax inefficiencies, because of positive tax liabilities of subsidiaries of a loss-making multinational group.

An MNE in this position may consider changing its transfer pricing method to a profit (or loss) split approach. This article considers the issues presented by such a change, considering issues both during and beyond the current recession. In transfer pricing, "profit split" often refers to an approach in which profits are split according to respective economic ownership of intangible assets. In this article, however, the term "profit/loss split" is defined as any transfer pricing method that assigns profits/losses according to the assumption and outcome of risk, rather than non-routine functions or intangible assets within related parties. As will be discussed, there are circumstances where such a profit split approach may be appropriate even if the parent company owns significant non-routine intangibles while its subsidiaries perform only routine functions. This article explores the advantages and disadvantages of the application of a profit/loss split during and beyond the current recessionary

The recession has affected MNEs in many industries, with the financial services and automotive industries being among the most severely affected.

environment, with particular reference to the U.S., Japan, China and Europe.

Key concerns in the economic downturn

The recession has affected MNEs in many industries, with the financial services and automotive industries being among the most severely affected. The recession is generally considered to be the worst since the Great Depression of the 1930s, and it has exposed companies to many risks that were considered merely theoretical in the past.

Taxpayers are facing difficulties in continuing their long established transfer pricing policies and documenting them using standard comparable analyses. Policies implemented during periods of economic growth are often based on the CPM, the TNMM or another traditional method, such as the comparable uncontrolled pricing method (CUP), the resale price method (RPM) or the cost plus method (CPLM), which may produce biased results in a global recession. A TNMM policy is commonly based on the distinction between an "entrepreneur," which performs non-routine functions and owns intangible assets, and a "routine-function" company with no intangible assets. Under this CPM framework, the routine company is typically considered to have limited risks and will be granted a stable profit margin. TNMM is popular, because it is straightforward and has worked well in negotiations with tax authorities. When the economy is strong, a profit for the routine party is reasonable. However when there are significant system-wide losses the method places them all on one party. This situation may be aggravated by each tax authority asserting that its local entity should be treated as the routine party. The assumption that at arm's length the parties would agree that only one should bear the risk associated with a major unanticipated economic event is strained.

Furthermore the TNMM relies heavily on comparable analysis, which requires the identification of comparable companies, followed by testing of transfer prices with reference to the profit margins of the comparables. Finding and analyzing reliable comparables data becomes much more complicated during a severe recession.

To start with, timing issues become more important. There is a lag of up to two years between the fiscal year end and the time at which data becomes publicly available, which may be as long as two years. In normal economic conditions, the use of "old" comparable data has a limited effect on the results of the transfer pricing analysis. In times of economic volatility and consequent dramatic changes in corporate profitability, pre-recession benchmarks may no longer be appropriate. Comparable sets should be reviewed to account for the effect of the recession on the comparables themselves,[1] but data limitations may limit the reliability of any such analysis and adjustment.

Search criteria may also be affected. Tax authorities often demand the exclusion of comparable companies incurring persistent losses on "going-concern" grounds. Even in the best of circumstances, this leads to a sample biased towards those with superior financial performance. In a recession, more companies may be eliminated on this basis, magnifying the bias. Moreover, this exclusion criterion may eliminate comparables facing the very same economic challenges as the taxpayer being evaluated.

1. There are several ways to adjust pre-recession benchmarks in order to improve their reliability in times of recession. For an overview, see "Recessionary Business Restructuring," on page 46 of this publication, by Patricia Fouts, Tony Gorgas, John Neighbour, Stephanie Pantelidaki.

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Taxpayers are facing difficulties in continuing their long established transfer pricing policies and documenting them using standard comparable analyses.

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Many authorities are uncomfortable with the application of profit split and other transfer pricing methods, and for their own convenience see the TNMM as a safe play.

Even in countries where financial data are readily available and the issue of "old" benchmarks does not arise, comparable sets may still underestimate the effect of the recession on companies' profitability. For a reliable test using after-the-fact results, comparables must not only bear the same ex ante expectation of risk; they must also have the same ex post realization of risk. However, the recession is likely to affect different companies to different extents: a few companies may actually benefit from economic downturns and improve their profitability; a larger number may experience reductions; some may be hit so hard they are forced out of business. Comparable analyses performed during economic downturns might, therefore, understate the effect of the recession on profitability, because they are unlikely to include, in the benchmark, the companies most affected.

The global nature of the current recession exacerbates these problems, because of the greater likelihood of system-wide losses, as parent companies and their subsidiaries suffer simultaneously. In such cases, supporting group-wide transfer pricing policies under the CPM/TNMM becomes difficult.

When taxpayers have difficulty defending their transfer pricing positions under historically applied methods, such as the CPM/TNMM, a profit/loss split approach may become the most reliable option, especially when related parties generate a system-wide loss. Note, however, that such a "loss split" will be driven by an examination of how the adverse effects of the recession should be shared, and will, therefore, depend on an examination of risk factors rather than of economic ownership of intangible assets. It is worth noting that while tax authorities often talk in terms of needing an "upside" if the "routine" entity incurs a loss, bargaining theory may suggest a different result. The party with valuable rights to intangible assets is most likely to have the stronger bargaining position in a negotiation. In an arm's-length situation, it may be able to force the routine distributors and manufacturers to share some of the losses.

Taxpayers, however, should be careful about switching to a loss split method in a recession, because it may raise a red flag. In our experience tax authorities tend to resist such innovations.

Tax authority responses

Severe declines in corporate profitability lead to corresponding declines in corporate tax revenues which, combined with increased public spending, have generated soaring budget deficits in many countries. For example, in the U.S., the 2009 budget deficit is expected to approach USD 2 trillion, approximately four times the 2008 budget deficit.

At the same time, tax audit examinations have become more frequent, as governments try to prevent leakage of tax revenues. President Obama's comments on his economic stimulus package in February 2009, and his proposal in May 2009 for restrictions on offshore tax havens, indicate a greater focus on international issues in tax auditing. Other countries are taking similar measures to prevent taxable profits leaving their jurisdictions, as evidenced by the proliferation of audit activities targeting transfer pricing and other cross-border issues, and the Organisation for Economic Co-operation and Development's (OECD) recent discussion draft on business restructuring.

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As part of her broad experience, she has participated in the negotiation of bilateral and unilateral advance pricing agreements (APAs) and provided support to companies under audit by U.S. and Japanese tax authorities with respect to transfer pricing. In addition, Dr. Kamen has performed analyses related to U.S.-Japan transfer pricing matters impacting tax provisions over a wide variety of industries and undertaken intangible property valuations. Dr. Kamen has a PhD and an MA in economics from Columbia University.

…in the U.S., the 2009 budget deficit is expected to approach USD 2 trillion, approximately four times the 2008 budget deficit.

Under these circumstances taxpayers should expect that any transfer pricing changes that result in reductions of taxable income in local jurisdictions will be vigorously challenged by local tax authorities. Many of the challenges we have seen revolve around the following two themes:

TNMM is a valid methodology regardless of the economic situation.

Many authorities are uncomfortable with the application of profit split and other transfer pricing methods, and for their own convenience see the TNMM as a safe play. They may argue that a TNMM, in theory, should capture changes in economic or market conditions, because the profits of taxpayers' comparable companies should be affected similarly to those of the taxpayer.

In many tax audits in the U.S., the IRS field agents prefer to analyze taxpayers' transfer pricing policies under the CPM/TNMM, because it is a fairly straightforward method with which field agents are very familiar. Moreover, under the tax audit currency initiative, which requires audit processes to be "current" and encourages IRS field agents to speed up processes, the TNMM is more attractive to field agents than methods that require a substantially more data and analysis.

China's tax authorities have gone even further, by releasing regulations with specific requirements for companies with limited risks and functions, or "single-function entities" in Chinese terminology. These regulations require that Chinese single-function entities "maintain a reasonable profit level" and submit contemporaneous documentation if they are in a loss position. This requirement implicitly refers to TNMM and has been widely applied by Chinese authorities in audits. Chinese authorities, and many of their counterparts in other jurisdictions, argue that a routine-function party does not have strategic decision-making capabilities and cannot, therefore, assume risks it does not control.

The tax authorities may thus merely emphasize the entrepreneur-limited risk relationship between two related entities, enforce the TNMM on the limited risk party, and disregard any risks it may very well have assumed.

Shifting to a loss split is simply cherry-picking

Tax authorities may also argue that taxpayers are shifting to a loss split as

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Mr. Takahashi participated in the LCG meeting (a conference for 10 Commissioners of the main Tax Administrations), the Asian Commissioners conference, and Japan-USA, Japan-Canada, Japan-UK, Japan-Germany, Japan-China, Japan-Korea and Japan-Australia Commissioners meetings representing the government of Japan.

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There is a growing mutual dependency between suppliers and their customers.

a cherry-picking strategy to justify the losses of a routine-function party which earned only modest profits during good times. This challenge is common, because most stakeholders, including many taxpayers themselves, acknowledge the merit of consistency in applying a transfer pricing strategy throughout the cycle. Switching from a TNMM, which yields profits, to a profit/loss split, which may lead to a loss, may be seen as little more than an attempt to avoid taxes.

Economic rationale for switching to a loss split

Given likely tax authority reactions, it is important to develop a strong and persuasive rationale for shifting from a typical TNMM analysis to a loss split. As noted above, the economic downturn is much deeper than previous cyclical declines. The unprecedented nature of the impact on group results needs to be considered in the arm's-length transfer pricing analysis.

The ability of the TNMM to capture the impact of this severe economic downturn may be limited by the difficulty of finding a set of comparable companies which closely mirrors the taxpayers' business results. The taxpayer may identify companies with similar business models, but finding comparable companies that underwent similar degrees of economic distress (e.g. just lost a major customer, discontinued major business segments, etc.) through publicly available information is difficult. This may result in a set of companies that are not comparable under this unprecedented downturn.

Splitting a system profit or loss is, in theory, a reasonable way to capture the impact of the current abnormal economic environment, if profits or losses are allocated correctly among related entities based on the respective functions undertaken and risks assumed. Even companies with seemingly routine functions and limited risks may share the losses as unanticipated outcomes of risks materialize. As a hypothetical example, consider Clean Fast, a fictional company operating in the cleaning services industry. In 2007, it secured a very large, long-term contract to provide cleaning services to Lehman Brothers, an A-rated financial institution, which would keep Clean Fast's personnel fully employed. At that time, everyone would have agreed to classify Clean Fast as a low risk service provider. However, this would not prevent Clean Fast from incurring large losses and potentially going bankrupt only a year later, as a consequence of the economic downturn and Lehman's default.

There is a growing mutual dependency between suppliers and their customers. For example, many automotive suppliers share the burden with OEMs in pricing when the market is down, and thus essentially share risks. In a downturn, it sometimes works out better for both supplier and customer to share the risks, than to force the other party to take on all the consequences which may eventually drive that party out of business. This is not in the best interests of either party and is not arm's length.

Our profit/loss split concept builds on the premise that companies share business risks, based on their respective roles in the related party transactions. In analyzing this, the initial focus should be on the impact of the recession on both parties' operations. This reduces the analysis to a discussion of how the recession affects the financial results of the group and how it would affect each legal entity were it an independent company. Economic downturns may affect independent companies and create losses in various ways, such as:

- reduction of market prices
- reduction of volumes
- increase in product returns
- increased discounts
- increased bad debts
- increased controversies regarding product quality, delivery times, etc.

In a classic manufacturer-distributor relationship, it may well be the case that the distributor bears the risks that prices fall, while the manufacturer bears the risks that volumes fall. It can also be the case that both bear the risk that volumes fall, but the manufacturer bears the risk of lower capacity utilization, while the distributor bears the risks associated with fixed SG&A costs. This kind of risk allocation should be based on the respective roles the two entities play in managing the relevant risks and/or in influencing the control of those risks. If the manufacturer builds the capacity to produce the products, and has a system for monitoring demand and managing capacity utilization, it should be the one ultimately responsible for the risks associated with the under-utilization of capacity. Likewise, a distributor responsible for sales and in a position to decide the level of discount it can offer to its customers should bear the consequences of any demands by its customers for deeper discounts. When the purpose is to maintain market share, a loss resulting from a bigger discount may very well be the responsibility of the distributor.

In a classic manufacturer-distributor relationship, it may well be the case that the distributor bears the risks that prices fall, while the manufacturer bears the risks that volumes fall.

When introducing a profit/loss split method, a taxpayer needs to be prepared to undertake analyses significantly more complex and time-consuming than the TNMM. For example, segmented financial information of all related entities, including a parent company, on related party transactions needs to be obtained and documented, to provide the tax authority with support for the analyses. In addition, the robustness of a profit/loss split analysis relies heavily on accuracy in identifying the share of the functions undertaken and risks assumed for each party among related parties. If analyses are built upon incorrect/inaccurate measurement of the share within the group, they could fall apart.

Ex ante versus ex post considerations

In general, a profit/loss split should reflect an ex ante sharing of risks – the two parties reach an up front agreement as to which risks will be borne by each party, and share in the impact of the recession on profits based upon this agreed upon allocation of risks. However, the severity of the recession has introduced additional complications into this risk sharing analysis for several reasons. First, the magnitude of the economic impact of the recession was not anticipated, and up front agreements may be silent on which

Under the economic downturn, the most severe in decades, established transfer pricing policies may no longer give arm's-length results.

of the parties bears a risk that was not anticipated or considered up front. Second, practical consideration may force one party to share in the risks that were initially assumed by the other – even if an agreement in theory provides that a contract manufacturer will be assured of earning a profit, it may be forced to share in a severe loss if the alternative is to drive its customer into bankruptcy. Finally, in the context of testing after the fact results, changes in data availability may dictate a shift to a different transfer pricing method, in that there may be comparables that had the same outcome of risk in 2007 but a very different outcome of risk in 2008 and 2009. As comparables have to have the same outcome of risk in order to be comparable, under such circumstances, the data needed to apply a CPM/TNMM analysis existed in 2007, but not in 2008 – 2009.

The reason given for shifting from a CPM/TNMM to a profit split analysis may have important implications both in terms of the type of arguments used to support the shift and for the transfer pricing method used in the future. A shift that reflects the existing contractual allocation of risk is likely to be much easier to support than one that is due to extraordinary circumstances that were not anticipated or to the argument that past comparables are no longer comparable. It is likely to be especially difficult to persuade tax authorities that an allocation of risk that was agreed upon up front should be set aside due to extraordinary circumstances, which is likely to be possible only if there is clear evidence that unrelated third parties have behaved in the same way.

Procedural considerations

A well-conducted economic analysis that outlines the impact of the recession on the taxpayer should provide the technical basis for responding to any challenges by the tax authorities, and refuting their two concerns:

- *TNMM is a valid methodology, regardless of economic conditions.* Not so. It is much harder to find appropriate comparables during a recession, because the recession is likely to have different impacts on different firms. A loss split that explicitly examines which entities would have borne the various impacts of the recession at arm's length is likely to be a more targeted and reliable analysis.

- *Shifting to a loss split is cherry-picking.* Not so. Shifting to a loss split simply reflects economic reality. The recession has led to bankruptcies and widespread financial distress, and routine demands by companies for suppliers to cut costs.

In addition to challenging the appropriateness of a TNMM in the current economic environment, a persuasive analysis of how risks arise and how the various parties involved manage them should provide the basis for splitting the losses or lower profits between them. In some sectors, such as the automotive industry, there may be clear evidence of independent companies sharing the risk and the burden of the downturn by splitting losses. In other sectors such evidence might be hard to find, but even anecdotal evidence may be helpful.

Regardless of the merits of the technical arguments, however, taxpayers need to consider which forum will be most effective within each relevant tax authority. This is likely to vary by country. For example, in the U.S., even if the taxpayer's analysis is rejected at the tax examination level, there is a relatively effective appeals process with a number of different procedural options. Getting an adjustment proposed at examination either reversed or reduced through the appeals process is a real possibility in the U.S. The same, however, is not true in other countries. In China, for example, the negotiations at the examination level are more important.

A competent authority (CA) proceeding is another option, and has the merit of requiring the two governments to negotiate directly. If one tax authority manages to sustain an adjustment, the other has to accept larger losses.

When approaching the issues raised by this recession, it is important to look beyond it.

There are limits to the efficiency and effectiveness of the CA, but it is nevertheless something the taxpayer can bring to the negotiation table. Even here, however, tax authority biases may affect the outcome. Japan's tax authorities used to favor profit split over TNMM, but they began to accept TNMM especially in an APA context. Now, however, they are suffering from the TNMM structures devised by Japanese multinationals for their overseas subsidiaries in the current economic environment. A similar line of argument can be presented that Japanese subsidiaries of overseas companies should switch from TNMM to a profit split.

Within Europe, the arbitration convention may increase the attractiveness of the CA option, because it stipulates that if the two CAs cannot agree, the case goes to an arbitration process that will give double tax relief. Because of this, there is increased pressure on tax authorities to reach a settlement while they still have some control over the outcome.

When the size of the adjustment is significant, initiating an advance pricing agreement (APA) may be better than waiting for an audit. An APA also provides an opportunity for both the taxpayer and the tax authority to develop a clearer view of how the present will affect the future. Accepting a loss is hard for a tax authority, but if the future seems rosy, it may accept the loss more readily.

Conclusion

Under the economic downturn, the most severe in decades, established transfer pricing policies may no longer give arm's-length results. Under these circumstances, a profit/loss split method, focusing on sharing profit or loss among group entities according to risks, is an option to consider.

When approaching the issues raised by this recession, it is important to look beyond it. Should this recession be considered part of a normal business cycle in which the splitting of losses will be subsequently offset by a splitting of profits? Or is the recession an unusual, one-off event, in which case the losses may be permanent, but the company can revert to the TNMM when normal business conditions return. A view of the future is important for the tax authorities, so such a view needs to be developed before matters are brought to their attention.

Tax authorities naturally resist attempts to reduce taxable profits in their jurisdictions, particularly now, when they are under pressure to reduce revenue shortfalls. In introducing a new method that may reduce some jurisdictions' taxable profits, the local nature of the regulatory environment makes it even more difficult for taxpayers to comply with the policies of each tax jurisdiction. A profit/loss split method may be best applied in an APA context, in which taxpayers have an opportunity to discuss downturn economics with tax authorities, as well as the post-recession arrangements.

Whether the scale of the downturn is seen as anomalous or as a regular cyclical hiccup could affect the longer-term applicability of a profit split method. If it is a normal cyclical economic downturn a consistent application of a profit/loss split for future years is essential, to prove that a loss-making taxpayer did not "cherry pick" a method.

Recessionary Business Restructurings

Restructuring businesses during a recession often raises difficult transfer pricing issues. **Patricia Fouts (KPMG in the U.S.), Tony Gorgas (KPMG in Australia), John Neighbour (KPMG in the U.K.)** and **Stephanie Pantelidaki (KPMG in the U.K.)** describe the challenges and suggest possible approaches.

Business restructuring can raise challenging issues and is often the subject of significant scrutiny on the part of tax authorities globally. The transfer pricing issues raised by business restructuring have been the topic of examination by Working Party 6, with the preliminary views of the Organisation for Economic Co-operation and Development (OECD) set forth in the OECD Business Restructuring Draft.[1] One of the core values of the OECD Draft is that the basic OECD principles apply in the same way to restructuring and to restructured entities as they apply in other contexts.

But the current recession may place special stress on the application of the arm's-length standard as set forth in the OECD Guidelines.[2] A recession tends to bring greater pressure for increased rationalization, consolidation, and efficiency, and therefore often forces businesses to review the existing transfer pricing policies/results and, in many cases, modify or restructure the operations and contractual allocation of risk in the supply chain. As will be discussed, a multinational enterprise's (MNEs) response to the economic downturn can vary from a minor tweaking of the company's transfer pricing models to a redesign of the supply chain. However, tax authorities may resist both changes in pricing policies and business restructurings that lower local profits. They may therefore attempt to impose significant tax "exit charges" on the restructuring steps or re-characterize intercompany transactions to give a better result.

The purpose of this article is to delineate some guiding principles and approaches that may be used in a depressed/recessionary economy whilst respecting the arm's-length principle (ALP) underpinning the OECD Guidelines and OECD Draft.

Impact of recession on intercompany transactions and business restructuring

At a macro level, what a recession introduces in a growing or steady state economy is a change in the business environment and external conditions,

Business restructuring can raise challenging issues and is often the subject of significant scrutiny on the part of tax authorities globally.

1. Organisation For Economic Co-Operation And Development (2008), "Transfer pricing aspects of business restructurings", September 19, 2008.
2. Organisation For Economic Co-Operation And Development (1995), "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", July 13 1995.
3. Issue Note 1 of the OECD Draft highlights the fact that the entities bearing restructured risk would need to have the requisite functions and people to bear such risks.

accompanied by a potential change in the business model of the enterprises. At the micro level, recession may translate into materialization of market risk (e.g., lower prices of goods, sales volumes, and values), as well as other types of risks (e.g. credit, forex, inventory, and restructuring risks).

An economic downturn may also give rise to circumstances that may lead an MNE to reconsider its historical business model. Examples of such circumstances may include:

- losses in a historically profitable jurisdiction or product line
- excess or obsolete inventories resulting from lower sales volumes or slower turns
- cash flow constraints resulting from slower-paying customers and/or higher bad debts
- lack of available credit
- business disruptions or supplier shutdowns, which may lead to increased operating expenses as an MNE seeks alternate suppliers, and
- industry consolidation or supplier consolidation, which may impact an MNE's customer base, operations and pricing.

As a general matter, MNEs facing lower sales and profits have three possible options:

- Retain the same transfer pricing policies and contractual relationships. Even in this case, however, the profit margins realized under these policies may most likely change as a result of the impact of the recession on the profitability of the comparables.

- Modify the contractual allocation of risk in response to the unusual demands brought on by the current recession or the current materialization of risk, which will inevitably trigger a review of the functions required to be undertaken by the relevant entities in light of the new risk profile.[3]

- Proactively move functions/operations from one legal entity to another in order to respond to competitive challenges, with associated changes in the contractual allocation of responsibilities and risks.

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The latter two of these options are treated as restructurings under the OECD Draft, and a cautionary note is in order before continuing the discussion of such options. It would be prudent for an MNE considering undertaking either of the latter two options to evaluate the potential impact of such changes on its operations when the economy recovers, to ensure that the changes do not introduce unanticipated, problematic issues post-recession.

The basic economic analysis may be similar in each case. The restructured entities are subject to the same arm's-length terms and "recessionary forces" as any other entities. What becomes imperative in a business restructuring context is that all restructured operations, transfer pricing policies, and contracts are "refreshed" so as to account for any changes brought in by the recession.

The following two guiding principles can be used in implementing changes required by the economic effects of a recession:

Guiding Principle 1

The transfer pricing policy (methods and benchmarks) and intercompany contracts applied during a recessionary climate will most likely be different from the pre-recession ones.

In a recessionary climate, because of the scarcity of comparable data, an MNE may be forced to abandon what had previously been an appropriate method and replace it with one for which data are available. For example, a Comparable Uncontrolled Price (CUP) method that was used pre-recession may not be applicable anymore in the recessionary climate if, for example, third-party agreements are being renegotiated or terminated in light of current lower prices. This would lead the MNE to consider alternative transfer pricing methods to the CUP.

More evidently, comparable profit level indicator benchmarks updated to account for the impact of the recession on the financials of comparables reflect a downward trend and deterioration in profitability. In the example below, recent financial data for 2008 indicates lower profits compared with the prior year (i.e. 2007) and with the bullish period from 2004 to 2007, which will produce different interquartile ranges.

Distribution (Australia)

Figure 1 outlines the operating margin results for an Australian distribution comparable set for 2008 compared with 2007.

Figure 2 shows the operating margin results for an Australian distribution comparable set for 2008 compared with the weighted average results for the years 2004-2007.

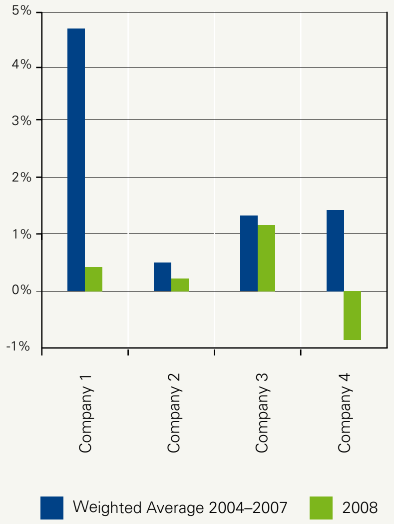
Figure 1 **Distribution (Australia)**

Company	2007	2008
1	4.5%	0.4%
2	1.0%	0.2%
3	1.3%	1.2%
4	-0.1%	-0.9%

Source: For illustration purposes only, KPMG in Australia

The data demonstrates deterioration in Australian distributors' profits during 2008 compared with 2007 and the bullish period from 2004 to 2007.

Figure 2
Distribution (Operating Margins)



Source: For illustration purposes only, KPMG in Australia

Manufacturing (Australia)

Figure 3 outlines the operating margin results for an Australian manufacturing comparable set for 2008 compared with 2007.

Figure 4 shows the operating margin results for an Australian manufacturing comparable set for 2008 compared with the weighted average results for the years 2004-2007.

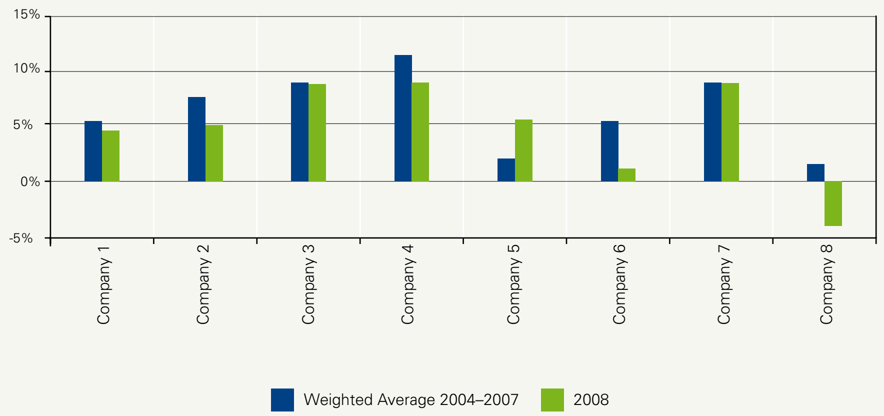
Figure 3 **Manufacturing (Australia)**

Company	2007	2008
1	4.69%	4.60%
2	8.61%	5.04%
3	9.17%	8.73%
4	2.76%	8.89%
5	6.80%	5.49%
6	3.29%	1.07%
7	9.17%	8.73%
8	0.91%	-4.08%

Source: For illustration purposes only, KPMG in Australia

The data demonstrates deterioration in Australian manufacturers profits during 2008 compared with 2007 and the bullish period from 2004 to 2007.

Figure 4 **Manufacturing (Operating Margin Results)**



Source: For illustration purposes only, KPMG in Australia

Figure 5 **Services (Australia and North American)**

Company	2007	2008
1	2.49%	2.32%
2	0.27%	-2.96%
3	4.96%	3.64%
4	0.74%	-2.04%
5	7.12%	5.87%
6	6.68%	6.11%
7	8.82%	4.64%
8	2.05%	1.35%
9	7.97%	6.59%
10	36.62%	38.37%
11	8.09%	12.14%
12	4.20%	3.90%
13	8.60%	4.20%
14	61.21%	40.13%
15	52.60%	27.76%
16	10.43%	6.78%
17	8.65%	10.02%
18	0.52%	-3.12%
19	7.26%	8.19%
20	68.57%	40.24%
21	14.63%	13.22%
22	53.51%	58.00%
23	4.20%	3.90%
24	8.60%	4.20%

Source: For illustration purposes only, KPMG in Australia

Services (Australia and North American)

Figure 5 outlines the net cost plus margin results for an Australian and North American service comparable set for 2008 compared with 2007.

Figure 6 shows the net cost plus margin results for an Australian and North American service comparable set for 2008 compared with the weighted average results for the years 2004-2007. Again, the results for 2008 show a downshift in profitability amongst Australian and North American service comparables compared with recent years.

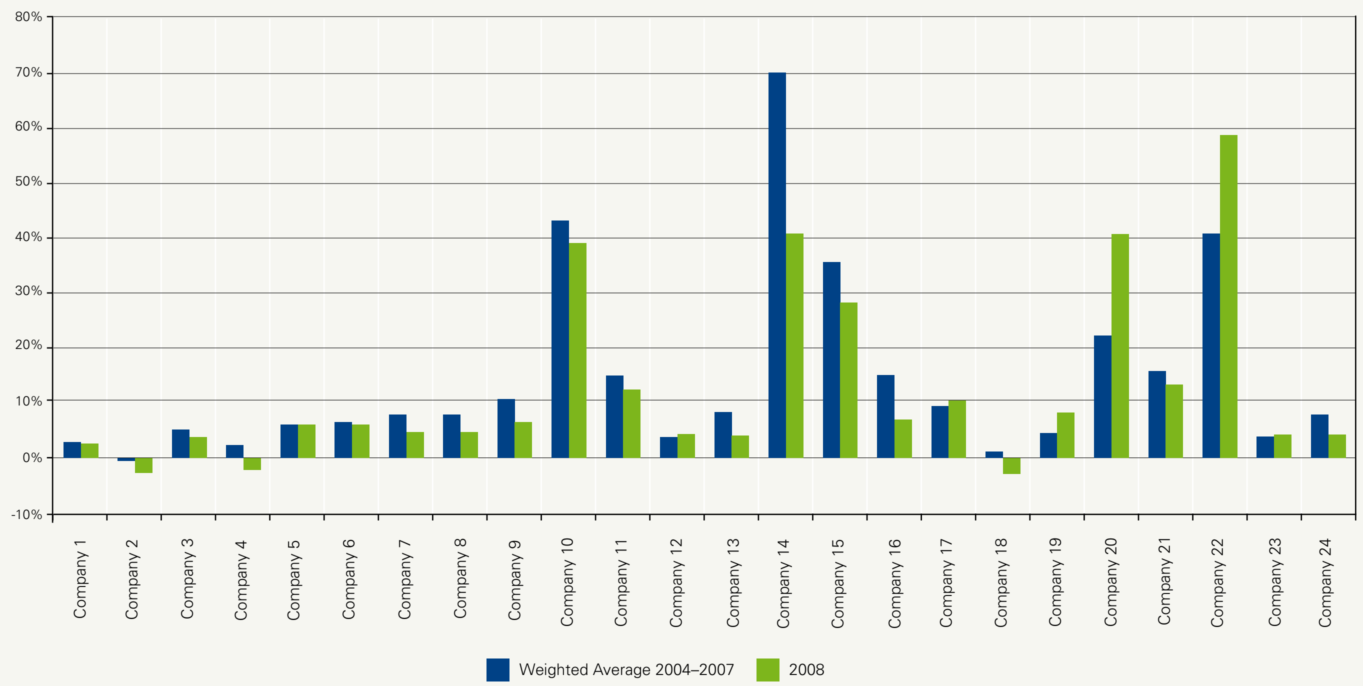
While care is always needed in developing a transfer pricing policy, more attention to detail may be needed when determining and implementing a transfer pricing policy and contractual agreements in a recessionary time because of the unusual nature and volatility of current economic conditions.

Guiding Principle 2

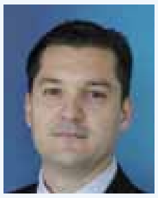
During recessionary times bargaining theory is a more prevalent expression of the ALP

The ALP is not different in a recessionary economy than in a growing economy. However, in a recession, external constraints on the behaviors of economic agents are more prevalent, and the impact of such constraints on arm's-length behavior and pricing can often be evaluated effectively using bargaining/game theoretical approaches. More specifically, game/bargaining theory can be used to identify the way two unrelated parties negotiate so as to achieve an equitable outcome based on their respective market/bargaining power in the context of a changing operating environment and conflicting interests. It is particularly suitable for allocating the benefits and costs of business restructuring between the transferor and transferee in a way that other transfer pricing methods cannot. An important consideration in this context is that entities' bargaining positions may change dramatically in recessionary periods as a result

Figure 6 **Services (Australia and North America)**



Source: For illustration purposes only, KPMG in Australia



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of changes in spending patterns, industry performance, supplier performance, the relative availability of other alternatives, and other relevant factors.

The implication of the above is that more complex economic models may need to be used in the recessionary climate when considering both the amount of any exit charge due at the time of the restructuring and the transfer pricing structure post restructuring to:

a) reflect the changing behavior of economic agents, and
b) justify the profitability results of the tested party.

Approaches for business restructuring in a recession (within the OECD Draft framework)

In this section, we outline approaches for addressing the main issues raised when undertaking business restructuring in a recessionary climate.

Dealing with loss making positions

During recessions, MNEs often report losses across the whole supply chain, whether restructured or not. These losses are real, and have to be borne by some participant in the supply chain. In general, tax authorities tend to take a highly skeptical view towards losses in subsidiaries of groups. Especially for routine (limited risk) operators, often the expectation of the tax authorities is that third parties would not be able/willing to sustain losses for an extended period of time and that in an MNE context routine operators should be profitable even when the overall supply chain is loss making. For this reason, many tax authorities would not consider including loss making companies in the final set of comparables. Although such a position is debatable, the decision to include loss makers can become economically appropriate in a recessionary climate on the basis that these comparables reflect the current recessionary market conditions, as well as the fact that some independent suppliers (such as those in the automotive industry) face the choice between accepting buyer-imposed price concessions that generate short-term losses (with no guarantee of future profits) or immediate shutdown.

The ability to treat a routine (limited risk) operator as a loss maker during a recession is often complicated by the pre-recessionary transfer pricing policy. In many cases, such a policy was designed to attribute guaranteed returns to the limited risk operator on the premise that the operator was practically immune from market risks (risks not materializing in a growing economy). Furthermore, the policy was based on pre-recession benchmarks measured in profitable years. In the current market, however, limited risk operators are absorbing risks, for example, market risk, which were neither reflected in the comparables nor explicitly anticipated in the intercompany agreements. It may therefore be appropriate in such cases for the policy and its results to be revised by assessing:

1) the impact of the realization of the risks on the profitability of the routine (limited risk) operators
2) the ability of the routine operators to bear and monitor risk,[4] and
3) the likely way third party routine operators would have negotiated such arrangements, considering each party's relative negotiating power under current economic conditions.

Different scenarios can be envisaged for structuring the contractual risk and corresponding rewards for the limited risk operators and the rest of the supply chain. The scenarios below are illustrated for a limited risk distributor (LRD), but the principle applies to any routine operator.

Scenario 1: Reduced profitability

Given the recent observed reduction in sales volumes, values and increases in costs (materialization of market risk), an up-to-date comparables search for LRDs should establish a new arm's-length range, expected to be lower than the pre-recessionary benchmarks. The results of the transfer pricing policy would need to reflect the revised arm's-length range, but no revision of the intercompany contract is necessary at this stage.

Scenario 2: Breakeven or loss making position

Even a breakeven position (operating margin in the region of zero percent) can be supported for the LRD if the transfer policy reflects the commercial reality of third party transactions similar to the intragroup one. That is, it would need to be demonstrated that environmental factors were such that the business is truly impaired and that an independent party acting in its own economic interest

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The ability to treat a routine (limited risk) operator as a loss maker during a recession is often complicated by the pre-recessionary transfer pricing policy.

would have accepted the need to bear losses and is actually being saved from going out of business.

A variation of the above scenario can be to allow the LRD under the revised transfer pricing policy to be a loss maker for the duration of the downturn, but reward the entity with a higher than normal return in the upturn. The objective in this case would be to achieve an average arm's-length return over the duration of the business cycle (or a fixed period of time). It should be noted, however, that the relative negotiating position and alternatives available to each party to the transaction must be considered in developing support for taking such a position.

In both of the above cases, revisions are likely to be required for the transfer pricing policy and the intercompany agreements.

Scenario 3: Distributor as "entrepreneur"

A new transfer policy can be put in place (assuming it is supported by the facts, underlying functions and risks) that underpins a set-up where the Distributor is now an "entrepreneur." For example, driven by business restructuring and/or recession the entity now assumes more risk and undertakes the development of local marketing intangibles. In that case, a loss position for such a Distributor is commercial and aligned with the ALP.

New transfer pricing policy and contractual arrangements would be required in this case. However, contracts are not the sole basis for this analysis of the new functions and risks undertaken by the entrepreneur. It is necessary to determine what is actually happening "on the ground" and assess the contractual allocation of a risk with economic substance and change in the associated functions performed by the entrepreneur.[5]

An important issue to consider when restructuring is the compensation payable upon a conversion associated with a disposal of a business asset or transfer of something of value to another party (e.g. potential profit). Independent parties dealing at arm's length and prepared to enter a restructuring arrangement would be expected to agree to an appropriate compensation for anything of value transferred or supplied between them as a result of a business restructuring.

Finally, the splitting of losses in an integrated restructured supply chain is of current interest in a recessionary climate. Apart from the fact that the "routine" restructured entities (including service providers) may legitimately absorb some of the losses in the supply chain, as illustrated in the above scenarios[6], the residual supply chain loss may be appropriately split on the basis of:

1. key decision making functions
2. ownership of assets, including physical location
3. ownership of intangibles, and
4. significant supply chain risks and control (with explicit considerations for non-diversifiable risk, i.e., market risk).

Such a split would be in accordance with the ALP and OECD Draft.[7] Clauses of contractual agreements accounting explicitly for loss, as well as profit, splits are expected to become more standard after the current recession.

The above facts and analysis should be taken into account when considering the impact of a restructuring on the transfer pricing policy of the restructured group.

4. As per Issue Note 1 of the OECD Draft.
5. Business Restructuring, 'Discussion Paper on application of Article 9 OECD Model Tax Convention, Australian Taxation Office, May 2007
6. The authors explore this topic in greater detail in an article entitled, 'Restructuring operations and contractual arrangements under OECD business restructuring,' which appears as a chapter in the special report entitled Transfer Pricing in a Recession, BNA International, April 2009.
7. With respect to the loss split, the allocation key used for splitting profits would need to be validated in the case of losses. There may be cases where an adjusted or different key is more appropriate for splitting losses.

Documentation and benchmarking restructured entities in a recession

Due to the increased complexity caused by the recession, arguably a different level of transfer pricing documentation is required to support the transactions occurring both during restructuring and post restructuring. Specifically, as the availability of comparable data becomes more limited (distressed companies going out of business and little information regarding the sale of assets in a distressed climate) and reduced profitability or losses are reported/expected for both the comparables and the MNE, greater emphasis is put on supporting and documenting the transfer pricing of the MNE through different approaches.

Due to the increased complexity caused by the recession, arguably a different level of transfer pricing documentation is required to support the transactions occurring both during restructuring and post restructuring.

This will inevitably mean greater reliance on geographic market analysis, industry analysis, and competitor analysis, as well as use of alternative pricing methods to prove and cross-validate the arm's-length nature of the transfer prices. Within this framework, a "before and after" (i.e., recession and restructuring) comparability analysis of the functions and risks of the multinational group and what really has changed would be documentation that most tax authorities would expect.

Perhaps the most challenging aspect when designing or supporting a transfer pricing policy during a recession is in identifying a robust set of comparable transactions or comparable companies. Many of the previous (pre-recession) comparables may simply no longer exist. A further complexity is the fact that there is usually a two-year lag between the time the company statutory accounts are filed and the time the company financial data appear in the databases. Consequently, calculating a robust recessionary arm-length's range is not an easy task.

Various quantitative approaches can be used to determine the arm-length's range in a recession, reflecting differences in the way that comparability and select comparables are viewed. Some key options include:

- Analysis of business cycles from previous recessions: Use insights gained from previous recessions for the specific business/industry cycle and extrapolate them to the current recessionary years. More specifically, the objective is to identify the reduction in profitability "from peak to trough" in the previous recessions and apply it to the comparables in the current recessionary climate. This can be corroborated with an analysis of macroeconomic indices of economic activity – e.g. GDP, GVA (gross value added), or indices that underpin the specific industry/sector.

- A reconsideration of past comparables: Companies that used to be appropriate comparables may no longer be comparable. This is because recessions tend to have uneven effects across the same industry/sector (e.g., discount distributors do better in recession than upscale ones). In short, enhanced screening may be needed in relation to the effects of the recession to the tested party and its peers or in relation to the tested party's susceptibility to the effects of the recession.

- Inclusion of loss makers/companies in financial distress. These companies may reflect the impact of the same economic factors that are pushing down the financial results of the taxpayer.

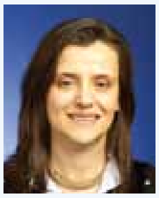
- Reconsideration of multi-year averaging may also be appropriate. While the use of longer historical averaging periods for the interquartile statistics may mask a loss that is occurring in the current year, its impact on the reliability for benchmarking the arm's-length range in recessionary years has to be evaluated carefully. While the inclusion of additional years of data provides effectively a long-term average industry rate of return, doing so would not necessarily address the problem at hand as the arm's-length range in any particular year does not necessarily correspond with multiyear average performance.[8]

- Consideration of recent data in the interquartile range analysis. While a conclusion as to what constitutes an arm's-length outcome usually requires examination of several years of data in an equal manner, it might be appropriate to provide recent recessionary data with more weight (compared with previous years) in calculating the weighted average interquartile range to reflect the current economic environment.

Considering post-downturn transfer pricing policies

For reasons analogous to those presented in the section above, it is also important for an MNE to identify circumstances that signal potential recovery, that may reduce the appropriateness of applying the recessionary transfer pricing method. This will assist in determining the nature and timing for implementation of post-downturn policies and updated benchmarks. Each MNE's fact pattern, including its allocation of functions and risks along the supply chain, as well as the performance of its industry and general economic conditions, may influence its development and implementation of post-downturn transfer pricing policies. Some approaches to consider include the following:

- Reviewing transfer pricing policies and the division of enterprise profits annually to assess whether policies



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implemented during the downturn still generate reasonable results in light of prevailing economic conditions and other relevant factors at the time of the assessment.

- Monitoring the results of third-party negotiations each year to assess whether changes in the outcome of negotiations may signal a potential post-downturn environment and merit reconsideration of the transfer pricing policy.

- Considering the implementation of quantitative or enterprise specific conditions in transfer pricing policies to aid in identifying potential recovery conditions that may merit reconsidering policies.

Conclusion

Undertaking business restructuring within the framework of the OECD Draft in a recessionary climate poses additional challenges related to a large extent to the unavailability of recessionary arm's-length prices and contracts. Uneven distribution of losses in the supply chain due to the materialization of risks not previously factored into existing transfer pricing policies further accentuates the effects of the recession on the supply chain.

Irrespective of the degree and nature of their restructuring, MNEs should be prepared to provide enhanced documentation for justifying the arm's-length prices of the transactions in a restructuring context. This will most likely include a review of the transfer pricing methods and profitability indicators, with the possibility of using benchmarks adjusted downwards to account for the impact of the recession. It is also expected that the current materialization of risks through the recession will lead to a review of the contractual allocation of risk incorporated in the intercompany agreement clauses. Finally, it is also important for an MNE to consider the impacts of recessionary-induced policies in a post-recession economic climate, to ensure that such policies do not introduce unanticipated, problematic issues post-recession.

8. Paragraph 1.16 of the OECD Guidelines states that "… in no event can unadjusted industry average returns themselves establish arm's length conditions".

Advance Pricing Agreements Under Pressure

Advance Pricing Agreements are a boon for multinationals seeking tax certainty, but they can be overtaken by events. **Sean Foley (KPMG in the U.S.)** and **François Vincent (KPMG in Canada)** explore the scope for amending them.

The Organisation for Economic Co-operation and Development's (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, define an 'advance pricing arrangement' (agreement) (APA) as:

"an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time." (paragraph 4-124.)

An APA is essentially a long-term contract between the tax authority and taxpayers. It can provide certainty, which is of benefit to taxpayers trying to manage or reduce transfer pricing risk on their intercompany transactions, but long-term, fixed agreements can have pitfalls. As long as a taxpayer complies with the terms and conditions of the APA, the tax authorities will not contest applications of the agreed transfer pricing methodology for transactions covered by the APA.

But taxpayers need to be aware that some tax authorities, including the U.S. Internal Revenue Service (IRS) and the Canada Revenue Agency (CRA), see APAs as binding contractual agreements, the terms of which, once agreed upon, are fixed during the period of the agreement.

This view of APAs as inflexible contracts can create difficulties for taxpayers, because, unless otherwise stipulated in the agreement, a change in macroeconomic conditions is not a reason to amend an APA.

Taxpayers seldom "break" APAs. When they do, published guidance in the U.S. and Canada is that the tax authority may either enforce, or cancel the APA and subject the years no longer covered by the APA to an audit. Taxpayers should, therefore, expect an aggressive approach to their transfer pricing if they do not comply with an executed APA. This being so, understanding the relevant tax authority's views on APAs is important for companies in or expecting to enter an APA in the current environment.

The tax authority's approach

To understand why tax authorities are so reluctant to reopen APAs when business conditions change, it may be useful to consider an example of a long term contract.

A fictitious airline company enters a five-year, fixed supply agreement for jet fuel in mid 2005. The contract effectively guarantees delivery of jet fuel, pegged to a $65 a barrel oil price. When the contract is signed, oil trades between $50 and $60 per barrel. The airline is incurring a cost today - the difference between the fixed price of $65, and the spot price – to gain certainty in the future. If the spot price of oil climbs sharply, as it did from mid 2005 to the summer of 2008, the airline is in the money. The contract may have seemed less favorable, however, when the economic slowdown precipitated a sharp fall in the oil price, to a low of $35 a barrel by late 2008. The company faces increased costs on two fronts: it is locked into its agreement at $65 a barrel (nearly double the late 2008 price), at a time when reduced consumer and business spending is causing a decline

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in passenger volume. The mere fact that oil did not follow the price path the airline expected, did not allow it to break the contract. Tax authorities can be expected to take the same view on APAs.

From the point of view of the tax authority with jurisdiction over the tested party, it is agreeing to an assured outcome (the tested party will achieve results within an agreed range) and a certain level of tax. The tax authority agrees not to seek higher levels of income in good times, but it also expects to receive the agreed return in bad times.

In discussions with the authors, IRS and CRA officials said they do not expect taxpayers with APAs to ask that their APAs be amended when business results are more favorable than anticipated and that there should be symmetry in any process resulting in an amendment, i.e., if taxpayers are to be allowed to amend their APAs in a downturn, the tax officials should be able to revisit the APA in a boom period.

Critical assumptions and special adjustments

There are two mechanisms for reconciling changes to the taxpayer's business with the fixed contractual nature of an APA; the critical assumption and the 'special adjustment' agreed during the original negotiation of the APA.

There are two mechanisms for reconciling changes to the taxpayer's business with the fixed contractual nature of an APA; the critical assumption and the 'special adjustment'…

A critical assumption is a fact assumed in the APA contract, which if it ceases to be so, automatically reopens negotiations. The IRS APA template contains the following standard critical assumption:

> "*The business activities, function performed, risks assumed, assets employed, and financial and tax accounting methods and classifications of Taxpayer in relation to the Covered Transactions will remain materially the same as described or used in Taxpayer's APA Request.* **A mere change in business results will not be a material change.**"

Note that this IRS standard critical assumption expressly does not allow a renegotiation of the APA merely because of bad (or good) business results. The CRA's standard critical assumption does not contain a reference to business results, but experience shows that the CRA considers this stipulation to be implicit.

Taxpayers and the tax authorities can add critical assumptions, to take into account various economic contingencies, but as a general rule, a critical assumption should not be based on the accounting concept of an extraordinary event, because it is relatively narrow. For instance, the terrorist attack on the twin towers on September 11, 2001, which

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dramatically affected a number of APAs, was not an extraordinary event for accounting purposes. Few, if any, taxpayer signatories to these APAs could point to financial statement items that could be categorized as 'extraordinary', and thus outside the scope of their APA's basic assumptions.

Critical assumptions should generally be unambiguous statements of conditions or events that the taxpayer and the tax authority agree would create a need to renegotiate an APA. Examples might be capacity utilization, sales volume, oil or other input prices, labor unrest, or currency fluctuations. One would have thought that taxpayers, in particular, would want such critical assumptions in their APAs, but the data published by the IRS indicates that APAs with anything other than the standard critical assumption are relatively rare.

The principal difference between special adjustments, and critical assumptions is that the former include agreed ways to address an issue if it arises. A typical special adjustment would state that, if a pre-defined event occurs, such as a strike or the bankruptcy of a major customer, certain specified steps will be taken, which will normally involve adjusting the profit level indicator used to determine whether the taxpayer is in compliance with the APA. For example, in the event of a strike sales may be expected to fall while fixed costs remain relatively constant, leading to a reduced operating profit. A special adjustment might provide that, for the purposes of the APA, profit lost because of the strike can be added back and compliance with the APA will be tested under the adjusted financials. Similarly, a bankruptcy special adjustment might add back any account receivables rendered uncollectable by a bankruptcy.

Generally, special adjustments are best used when a contingency is well defined and has a significant probability of occurring. Importantly, special adjustments are found in arm's-length contracts to protect the parties against certain contingencies. For example, it is common for suppliers of manufactured products to include price adjustment clauses, often tied to a published index, to account for price changes of an important input.

The principal difference between special adjustments, and critical assumptions is that the former include agreed ways to address an issue if it arises.

A special adjustment has the important advantage over a critical assumption in that the method of addressing the external event is settled and known. Its disadvantage is that the future is always surprising. A special adjustment is typically designed to address one particular event. If it doesn't occur and another important event affects the business, the special adjustment mechanism will not help. Another consideration is that it might be difficult to negotiate a special adjustment mechanism with the tax authority, which may prolong the APA negotiation or require the taxpayer to make some concession to obtain the special adjustment. Moreover, a special adjustment won after lengthy negotiations may become less valuable as the chances of the specified event occurring fall during the APA period.

The case for critical assumptions

Many APAs use a transactional net margin method/comparable profits method with fixed ranges derived from sets of comparable companies from the period immediately preceding the APA term. In other words the tested party is benchmarked throughout the APA term against a set of comparable companies that prospered (or failed to prosper) during a particular economic period. As time and the APA term move forward, this benchmark period may or may not be consistent with the business conditions faced by the tested party. In particular, business results can be heavily affected by non-transfer pricing factors such as a downturn in the economy that materially reduces sales, exchange rate fluctuations, strikes and other unexpected disruptions, input cost increases, and the bankruptcy of key customers.

One example of a non-transfer pricing event that can greatly affect results is a drop in stock market value. The effect occurs due to pension accounting. The costs of pensions (whether defined benefit or defined contribution) are typically captured as compensation expense in the income statement and flow into the operating income line item. Depending on pension type, they tend, in normal economic times, to be consistent from year to year. But certain accounting attributes of defined benefit plans result in pension expense rising sharply when stock markets fall sharply. In a defined benefit pension plan, the company holds the investment risk of plan assets (in a defined contribution plan – e.g. a 401(k) - the employee holds the investment risk) and when assets perform poorly, as many did in 2008, the pension expense in the income statement rises. A number of large public companies in the U.S. and elsewhere, have disclosed large increases in pension expenses attributable to the decline in the company's plan assets, which will directly affect the company's operating profit. For a taxpayer with an APA, the reduced operating profit is likely to be independent of APA covered transactions, but the reduced operating profit could make it difficult, if not impossible, to meet the APA benchmarks.

Many APAs use a transactional net margin method/comparable profits method with fixed ranges derived from sets of comparable companies from the period immediately preceding the APA term.

One option for this pension problem would be a special adjustment mechanism that excludes an "extraordinary" change in pension asset value from the calculation of the taxpayer's operating profit when testing compliance with the APA.

One option for this pension problem would be a special adjustment mechanism that excludes an "extraordinary" change in pension asset value from the calculation of the taxpayer's operating profit when testing compliance with the APA. As noted above, a special adjustment has the important advantage that when the contingency happens, the impact on the APA is known. This adjustment approach is taken in some APAs. In the authors' experience, however, there are important limitations on the special adjustment approach. First, a tax authority seeking symmetry may insist on increasing the operating profit when asset values rise by an "extraordinary" amount. Second, it can be very hard to agree on a definition of "extraordinary." Third, special adjustments only work for narrowly defined events, and the economic issues that crop up during an APA are often unanticipated or their impact on financial accounting is hard to predict.

As discussed earlier, the alternative to a special adjustment is a critical assumption. This might stipulate, for example, that if sales fall below a specified level, for whatever reason, the APA will be renegotiated. An even broader critical assumption would be system profit; the profits of the tested party and other related parties involved in the transaction. A critical assumption focused on system profit would, when triggered, allow the taxpayer to ask the tax authority to address the problem. A sudden reduction in system profits might occur because of the pension issue discussed above, or any number of reasons, including currency fluctuations, input price increases and sales declines. But taxpayers also need to take into account the loss in certainty created by a particular critical assumption. The broader the critical assumption, the more likely it is to be triggered and thus the APA to be renegotiated.

In the authors' experience, tax authorities may expect some *quid pro quo* when they agree to a critical assumption. Taxpayers should be prepared to accept some symmetry in the assumptions, that the assumption is triggered by relatively high, as well as relatively low system profits, or some other compensation, such as a higher range for the tested party. Of course, in a bilateral APA, it is often the case that the interests of one of the two tax authorities align more closely to the taxpayer. As part of the negotiation over any critical assumption, the taxpayer will generally work closely with its "champion" to secure its position.

Triggering a critical assumption

What happens when a critical assumption is violated? In Canada and the U.S., the

Taxpayers need to approach the negotiation of an APA as they would any long-term commercial contract, and think about the types of events that should trigger a re-negotiation, or termination of the contract.

first step is to re-open negotiations with the tax authorities. In our experience, renegotiation is often relatively straightforward. The sometimes lengthy initial APA negotiation has often laid the foundation for a relatively rapid agreement on an amendment. If the taxpayer and the tax authority can't agree on an amendment, the APA is canceled; deemed void for the year in which the critical assumption is violated and for the remainder of the APA term. It remains in force for earlier years. Failure to reach an agreement on an amendment is relatively rare. In 2008 the IRS concluded 68 APAs, amended 12 and canceled one. Many cancelations follow a change in the taxpayers business so fundamental that the APA no longer makes sense, e.g., closing, or disposing of the line of business covered by the APA.

Conclusion

APAs have been an important part of the transfer pricing landscape since the mid 1990s and, until 2008, have operated in a relatively stable world economy. During this time taxpayers have found APAs with five year terms and fixed benchmarks are practical solutions to difficult transfer pricing issues.

The economic events of 2008 and 2009 are testing the APA process.

IRS published statistics on APAs reveal that taxpayers and the IRS have generally not included any critical assumptions, other than the standard critical assumption. As a result, taxpayers that have negotiated APAs in the expectation of normal economic conditions may find themselves caught in what may be disadvantageous deals as a result of the current economic crisis.

Taxpayers need to approach the negotiation of an APA as they would any long-term commercial contract, and think about the types of events that should trigger a re-negotiation, or termination of the contract. Examples of issues that could be covered in the critical assumptions and/or an adjustment mechanism are the loss of a major customer, changes in sales volume or capacity utilization, changes in certain costs not related to transfer pricing, particularly large changes in the prices paid for raw materials, exchange rate changes and large changes in the prices received from third parties.

Tax authorities, including the IRS and CRA, have taken a hard line on amending APAs without specific critical assumptions, to take into account the economic downturn. Properly structured critical assumptions can add important flexibility to an APA. Taxpayers should be aware that tax authorities may demand something in return for accepting a critical assumption the taxpayer requests. Critical assumptions can increase the risk that an APA will need to be re-negotiated, but in the experience of the authors, negotiations to amend an APA after a critical assumption has been violated, are relatively stream-lined and usually successful.

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