ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

COMPARABILITY ADJUSTMENTS

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CENTRE FOR TAX POLICY AND ADMINISTRATION

COMPARABILITY ADJUSTMENTS

Introduction

1. Chapters I and III of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter the "TPG") contain extensive guidance on comparability analyses for transfer pricing purposes. Guidance on comparability adjustments is found in paragraphs 3.47-3.54 and in the Annex to Chapter III of the TPG. A revised version of this guidance was approved by the Council of the OECD on 22 July 2010 and can be downloaded from the Internet (see www.oecd.org/ctp/tp/cpm). All the references in this paper are references to the 2010 edition of the TPG.

A. What is a comparability adjustment?

2. When applying the arm's length principle, the conditions of a controlled transaction (*i.e.* a transaction between a taxpayer and an associated enterprise) are generally compared to the conditions of comparable uncontrolled transactions. In this context, to be comparable means that:

- None of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (*e.g.* price or margin), or

- Reasonably accurate adjustments can be made to eliminate the effect of any such differences. These are called "**comparability adjustments**".

3. Thus, a comparability adjustment is an adjustment made to the conditions of uncontrolled transactions in order to eliminate the effects of material differences which exist between them and the controlled transaction being examined.

4. For instance, assume that a taxpayer sells the same products to an associated enterprise and to an independent enterprise. Assume that the two sales transactions are comparable, except that, in the controlled transaction (sale by the taxpayer to its associated enterprise), the currency risk is borne by the taxpayer while in the uncontrolled transaction (sale by the taxpayer to an independent enterprise), the currency risk is borne by the customer. Assume that the different allocations of this risk in the controlled and uncontrolled transactions materially affect the comparison, because the currency risk is significant. In such a case, it may nevertheless be possible to use the uncontrolled transaction as a comparable to the controlled transaction, subject to an adjustment being made to eliminate the effects on the comparison of the different allocations of currency risk.

5. Examples of comparability adjustments include adjustments for accounting consistency designed to eliminate differences that may arise from differing accounting practices between the

controlled and uncontrolled transactions; segmentation of financial data to eliminate significant non-comparable transactions; adjustments for differences in capital, functions, assets, risks.

6. An example of a working capital adjustment designed to reflect differing levels of accounts receivable, accounts payable and inventory is provided in Section C hereafter. The fact that such adjustments are found in practice does not mean that they should be performed on a routine or mandatory basis. Rather, the improvement to comparability should be shown when proposing these types of adjustments (as for any type of adjustment). Further, a significantly different level of relative working capital between the controlled and uncontrolled parties may result in further investigation of the comparability characteristics of the potential comparable.

B. When to do a comparability adjustment

7. Comparability adjustments should be considered if (and only if) they are expected to increase the reliability of the results. Relevant considerations in this regard include the materiality of the difference for which an adjustment is being considered, the quality of the data subject to adjustment, the purpose of the adjustment and the reliability of the approach used to make the adjustment.

8. It bears emphasis that comparability adjustments are only appropriate for differences that will have a material effect on the comparison. Some differences will invariably exist between the taxpayer's controlled transactions and the third party comparables. A comparison may be appropriate despite an unadjusted difference, provided that the difference does not have a material effect on the reliability of the comparison. On the other hand, the need to perform numerous or substantial adjustments to key comparability factors may indicate that the third party transactions are in fact not sufficiently comparable.

9. It is not always the case that adjustments are warranted. For instance, an adjustment for differences in accounts receivable may not be particularly useful if major differences in accounting standards were also present that could not be resolved. Likewise, sophisticated adjustments are sometimes applied to create the false impression that the outcome of the comparables search is "scientific", reliable and accurate.

10. It is not appropriate to view some comparability adjustments, such as for differences in levels of working capital, as "routine" and uncontroversial, and to view certain other adjustments, such as for country risk, as more subjective and therefore subject to additional requirements of proof and reliability. The only adjustments that should be made are those that are expected to improve comparability.

11. Ensuring the needed level of transparency of comparability adjustments may depend upon the availability of an explanation of any adjustments performed, the reasons for the adjustments being considered appropriate, how they were calculated, how they changed the results for each comparable and how the adjustment improves comparability.

Country experience

Indian courts have released several decisions relevant to comparability adjustments and in particular to the extent to which comparability adjustments performed are sufficiently reliable.

The need to perform in certain cases comparability adjustments to eliminate differences in working capital, risk, growth and R&D expenses was laid down in Mentor Graphics [Mentor Graphics (Noida) (P.) Ltd. v. DCIT, Circle 6(1), New Delhi [2007] 109 ITD 101 (DELHI) / 112 TTJ 408] and confirmed in several decisions since. In Philips Software Centre [Philips Software Centre (P.) Ltd. v. ACIT, Circle 12(2) [2008] 26 SOT 226 (BANG.)] ITAT approved comparability adjustments being made to eliminate differences on account of different functions, assets and risks, and specifically for differences in risk profile, working capital and accounting policies. On the other hand, if the differences between the companies or transactions are so material that it is not possible to perform a reasonably accurate adjustment, then the "comparables" should be rejected [Mentor Graphics (*ibid*) and Egain Communication (P.) Ltd. v. Income-tax Officer, Ward 1(4), Pune [2008] 23 SOT 385 (PUNE)]. Furthermore, a working capital adjustment should not be performed in a particular case if its effect would be very marginal [Sony India (P.) Ltd. v. Deputy Commissioner of Income-tax, Circle 9(1) [2008] 114 ITD 448 (DELHI)].

A remaining difficulty is the subjective question of determining what a "reasonably accurate comparability adjustment" is. In Sony India (*ibid)*, ITAT upheld an overall flat adjustment of 20 per cent proposed by the Transfer Pricing Officer for differences in intangible ownership and risks assumed in the controlled transaction and "comparables" as being "fair and reasonable". By contrast, in CIT v. Philips Software Centre [CIT v. Philips Software Centre Pvt. Ltd. (2009) TIOL-123-HC-KAR-IT], the High Court of India examined whether the Tribunal was correct in allowing a flat comparability adjustment of 11.72% (6.46% working capital adjustment +5.25% risk adjustment) "ignoring all important issues like the quality of adjustment data, purpose and reliability of the adjustment performed to be considered before making adjustment on account of capital and risk", and found this contrary to Rule 10B(3)(ii) which provides for only reasonably accurate adjustment, and accordingly stayed the operation of judgement of ITAT.

Other questions addressed in Indian decisions with respect to comparability include the use of data from other years than the year of the controlled transaction [Mentor Graphics (*ibid*)]; acceptability as comparables of companies in start-up years and of loss-making companies [Mentor Graphics (*ibid*) and Skoda Auto India Pvt. Ltd. v. ACIT (2009-TIOL-214-ITAT-PUNE)]; acceptability as comparables of companies with low employee costs [Mentor Graphics (*ibid*)]; exclusion from the set of comparables of companies with significant "other income" such as interest, dividends, licenses [Egain Communication (*ibid)*]; treatment of "pass-through costs" [Sony India (P.) Ltd. (*ibid)*]; under-utilisation of capacity [Sony India (P.) Ltd. *(ibid)* and Skoda Auto India *(ibid)*]; acceptability of a comparability adjustment for a very material difference [Essar Shipping Limited v. Deputy Commissioner of Income Tax (2008-TIOL-652-ITAT-MUM)]; selection of the point of adjustment within the arm's length range [Mentor Graphics (*ibid*) and Sony India (P.) Ltd. (*ibid)*]; use of multi-year data in case of different product cycles [Skoda Auto India *(ibid)*]; etc.

C. Example of a working capital adjustment

The assumptions about arm's length arrangements in the following examples are intended for illustrative purposes only and should not be taken as prescribing adjustments or arm's length arrangements in actual cases of particular industries. While they seek to demonstrate the principles of the TPG, those principles must be applied in each case according to the specific facts and circumstances of that case.

This example is provided for illustration purposes as it represents one way, but not necessarily the only way, in which such an adjustment can be calculated.

Furthermore, the comments below relate to the application of a transactional net margin method in the situations where, given the facts and circumstances of the case and in particular the comparability (including functional) analysis of the transaction and the review of the information available on uncontrolled comparables, such a method is found to be the most appropriate method to use.

12. This simple example shows how to make an adjustment in recognition of differences in levels of working capital between a tested party (TestCo) and a comparable (CompCo). Working capital adjustments may be warranted when applying the transactional net margin method. In practice they are usually found when applying a transactional net margin method, although they might also be applicable in cost plus or resale price methods. Working capital adjustments should only be considered when the reliability of the comparables will be improved and reasonably accurate adjustments can be made. They should not be automatically made and would not be automatically accepted by tax administrations.

Why make a working capital adjustment?

13. In a competitive environment, money has a time value. If a company provided, say, 60 days trade terms for payment of accounts, the price of the goods should equate to the price for immediate payment plus 60 days of interest on the immediate payment price. By carrying high accounts receivable a company is allowing its customers a relatively long period to pay their accounts. It would need to borrow money to fund the credit terms and/or suffer a reduction in the amount of cash surplus which it would otherwise have available to invest. In a competitive environment, the price should therefore include an element to reflect these payment terms and compensate for the timing effect.

14. The opposite applies to higher levels of accounts payable. By carrying high accounts payable, a company is benefitting from a relatively long period to pay its suppliers. It would need to borrow less money to fund its purchases and/or benefit from an increase in the amount of cash surplus available to invest. In a competitive environment, the cost of goods sold should include an element to reflect these payment terms and compensate for the timing effect.

15. A company with high levels of inventory would similarly need to either borrow to fund the purchase, or reduce the amount of cash surplus which it is able to invest. Note that the interest rate

might be affected by the funding structure (*e.g.* where the purchase of inventory is partly funded by equity) or by the risk associated with holding specific types of inventory)

16. Making a working capital adjustment is an attempt to adjust for the differences in time value of money between the tested party and potential comparables, with an assumption that the difference should be reflected in profits. The underlying reasoning is that:

- A company will need funding to cover the time gap between the time it invests money (*i.e.* pays money to supplier) and the time it collects the investment (*i.e.* collects money from customers)
- This time gap is calculated as: the period needed to sell inventories to customers + (plus) the period needed to collect money from customers – (less) the period granted to pay debts to suppliers.

The process of calculating working capital adjustments:

- Identify differences in the levels of working capital. Generally trade receivables, inventory and trade payables are the three accounts considered. The transactional net margin method is applied relative to an appropriate base, for example, costs, sales or assets. So, if the appropriate base is sales, then any differences in working capital levels should be measured relative to sales.

- Calculate a value for differences in levels of working capital between the tested party and the comparable relative to the appropriate base and reflecting the time value of money by use of an appropriate interest rate.

- Adjust the result to reflect differences in levels of working capital. The following example adjusts the comparable's result to reflect the tested party's levels of working capital. Alternative calculations are to adjust the tested party's results to reflect the comparables levels of working capital or to adjust both the tested party and the comparable's results to reflect "zero" working capital.

A practical example of calculating working capital adjustments

17. The following calculation is hypothetical. It is only to demonstrate how a working capital adjustment can be calculated.

TESTCO	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Sales	$179.5m	$182.5m	$187m	$195m	$198m
Earnings Before Interest & Tax (EBIT)	$1.5m	$1.83m	$2.43m	$2.54m	$1.78m
EBIT/Sales (%)	0.8%	1%	1.3%	1.3%	0.9%

TestCo	Year 1	Year 2	Year 3	Year 4	Year 5
Working Capital (at end of year)					
Trade Receivables (R)	$30m	$32m	$33m	$35m	$37m
Inventories (I)	$36m	$36m	$38m	$40m	$45m
Trade Payables (P)	$20m	$21m	$26m	$23m	$24m
Receivables (R) + Inventory (I) – Payables (P)	$46m	$47m	$45m	$52m	$58m
(R + I – P) / Sales	25.6%	25.8%	24.1%	26.7%	29.3%

CompCo	Year 1	Year 2	Year 3	Year 4	Year 5
Sales	$120.4m	$121.2m	$121.8m	$126.3m	$130.2m
Earnings Before Interest & Tax (EBIT)	$1.59m	$3.59m	$3.15m	$4.18m	$6.44m
EBIT/Sales (%)	1.32%	2.96%	2.59%	3.31%	4.95%
Working Capital (at end of year)					
Trade Receivables (R)	$17m	$18m	$20m	$22m	$23m
Inventory (I)	$18m	$20m	$26m	$24m	$25m
Trade Payables (P)	$11m	$13m	$11m	$15m	$16m
Receivables (R) + Inventory (I) – Payables (P)	$24m	$25m	$35m	$31m	$32m
(R + I – P) / Sales	19.9%	20.6%	28.7%	24.5%	24.6%

Working Capital Adjustment	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
TestCo's (R + I – P) / Sales	25.6%	25.8%	24.1%	26.7%	29.3%
CompCo's (R + I – P) / Sales	19.9%	20.6%	28.7%	24.5%	24.6%
Difference (D)	5.7%	5.1%	-4.7%	2.1%	4.7%
Interest Rate (i)	4.8%	5.4%	5.0%	5.5%	4.5%
Adjustment (D*i)	**0.27%**	**0.28%**	**-0.23%**	**0.12%**	**0.21%**
CompCo's EBIT/Sales (%)	1.32%	2.96%	2.59%	3.31%	4.95%
Working Capital Adjusted EBIT / Sales for CompCo	**1.59%**	**3.24%**	**2.35%**	**3.43%**	**5.16%**

Some observations

- An issue in making working capital adjustments is to determine the point in time at which the Receivables, Inventory and Payables should be compared between the tested party and the comparables. The above example compares their levels on the last day of the financial year. This may not, however, be appropriate if this timing does not give a representative level of working capital over the year. In such cases, averages might be used if they better reflect the level of working capital over the year.

- A major issue in making working capital adjustments involves the selection of the appropriate interest rate (or rates) to use. The rate (or rates) should generally be determined by reference to the rate(s) of interest applicable to a commercial enterprise operating in the same market as the tested party. In most cases a commercial loan rate will be appropriate. In cases where the tested party's working capital balance is negative (that is Payables > Receivables + Inventory), a different rate may be appropriate.

  In the case where *"payables < receivables + inventories"*, a borrowing rate is generally used because the company has to invest in the receivables (extent credit) and inventories (finance the inventory). In other words, the sums invested in receivables and inventory are greater than the "return" on the payment deferral the company received (the company has to "borrow" money for financing its investment in receivables and inventory). In the case where *"payables > receivables + inventories"*, a lending rate is generally used because in a way the company receives an additional advantage through the payment deferral.

  The rate used in the above example reflects the rate at which TestCo is able to borrow funds in its local market. This example also assumes that the same interest rate is appropriate for payables, receivables and inventory, but that may or may not be the case in practice. Where different rates of interest are found to be appropriately applicable to individual classes of assets or liabilities, the calculation may be considerably more complex than shown above.

- The purpose of working capital adjustments is to improve the reliability of the comparables. There is a question whether working capital adjustments should be made when the results of some comparables can be reliably adjusted while the results of some others cannot.