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INSIGHT

Practical Issues in Dealing with Year-end Transfer Pricing Adjustments

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As the year-end approaches for many companies, the necessity of making adjustments to compensate for discrepancies between financial results and transfer pricing policies occupies the minds of finance directors.

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Companies with December balance sheet dates are approaching their year-ends. In the world of transfer pricing this is traditionally the moment for a multinational enterprise (MNE) to reconcile the actual financial results of the various group companies with the group's applicable transfer pricing policies. If the actual figures deviate from the group's transfer pricing policy, year-end adjustments may be considered. We use this phrase to mean adjustments made to the accounts of the relevant group companies, either just before the year-end or just after the year-end, but before closing the accounts for the relevant period. However, some MNEs make adjustments more frequently, such as on a quarterly basis. Many of the comments in this article are equally relevant for "in year" adjustments to the extent that adjustments are being made to the amount originally invoiced at the time of the transaction.

Not adhering to the transfer pricing policies may result in serious challenges made by tax authorities, which could eventually result in transfer pricing adjustments (and double taxation), interest and penalties. For financial reporting reasons such a difference may also result in an uncertain tax position (e.g. based on ASC 740 for companies reporting under US GAAP). Thus, in general, MNEs are seeking to avoid or correct deviations and accordingly they process end of year adjustments.

A number of articles have been published on the regulatory environment in which year-end adjustments should be framed[1]. The main subjects discussed in those articles are, for example, whether

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specific domestic legislation exists for year-end adjustments, what formalities need to be fulfilled when making year-end adjustments, when a year-end adjustment would have to be made, whether both increases and decreases of the taxable amount would be accepted, et cetera. Some language on year-end adjustments can also be found in the OECD Transfer Pricing Guidelines,[2] albeit that this language contains no practical guidance whatsoever. The EU Joint Transfer Pricing Forum issued a publication containing the responses of tax administrations of 27 EU Member States to a questionnaire on year-end adjustments.[3] However, the vast majority of the questions related to the more formal and legalistic aspects of year-end adjustments.[4]

This article elaborates mainly on the practical aspects of year-end adjustments. The purpose is to provide guidance on how to actually calculate, analyze and process year-end adjustments. This article does not elaborate on any other tax implications than transfer pricing (e.g. customs and VAT implications).

I. What Causes Differences between TP Policy and Actual Financials?

An initial question that may arise is how actual financial results on transfer pricing transactions could actually deviate from the transfer pricing policy.

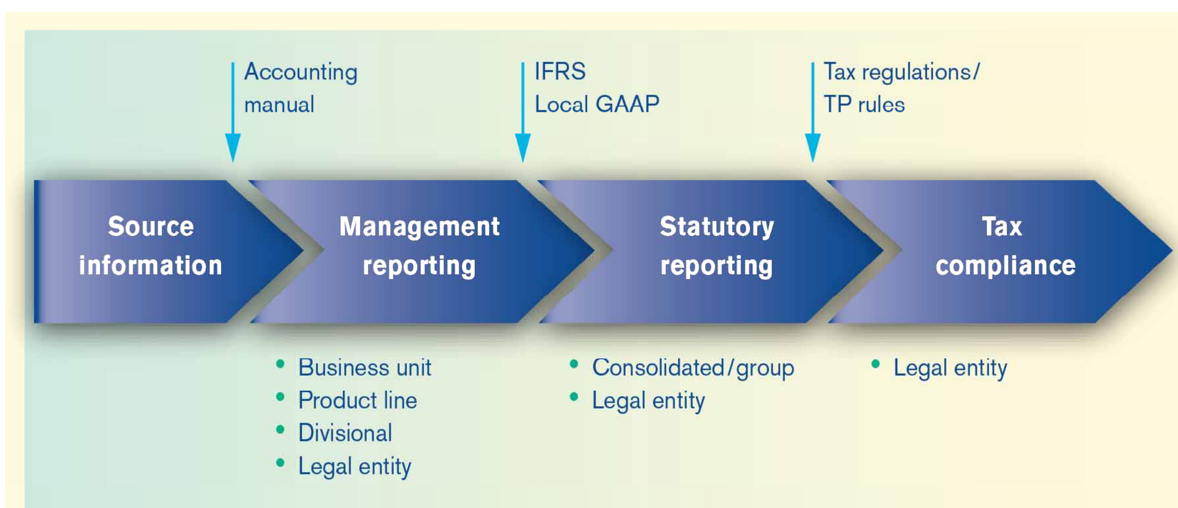
In some cases the transfer price that is used during the year may be set without regard to transfer pricing rules, with the intention that transfer pricing compliance will be brought about purely by way of a year-end adjustment. Most countries frame their transfer pricing rules as a test to be applied to the transfer pricing for tax purposes, rather than mandating how the price on the invoice is derived, so this approach is therefore usually legally acceptable. It is not, however, popular or generally to be recommended, because under this approach a year end adjustment is virtually inevitable.

Most companies prefer to set the transfer price with the aim that it will be as close as possible to a price that will meet the arm's length test. The factors that determine whether a year-end adjustment is necessary will depend, to an extent, on what transfer pricing method underlies the transfer pricing policy.

If the company considers that the best indication of the arm's length price is to use the comparable uncontrolled price method ("CUP"), then it would normally make sense to *set* the transfer price using this method, too, by direct comparison with the actual prices of comparable uncontrolled transactions (with adjustments where appropriate). In such cases, it is unlikely that the transfer price will then deviate from the policy unless an error is made in implementing the policy or the prices of the comparable transactions subsequently change and the transfer price is not changed to match.

Under the other four methods, there is much greater scope for deviation. The transfer price would normally be set indirectly, in order to target (depending on the method used) a gross margin or level of net profitability or profit split that is determined to be the arm's-length margin/profitability/split. If the transfer prices were appropriately implemented in the annual budget process, one might expect that the actual results would not be too far off. Unfortunately the day to day reality is different. There are multiple reasons why deviations appear during the financial year. These include:

- Budgeting/forecasting inaccuracies/changes in operational or economic circumstances: In most instances the actual financial results of a company will show deviations from the budgeted financial figures. There may be various reasons, amongst others, a higher than expected amount of operational costs due to inefficiencies or increased cost levels (particularly in industries with highly volatile raw materials prices), or lower sales prices or sales volumes due to a new competitor that entered the market or a decreasing demand for the product. Such variations are more likely if the budget was overly optimistic, for instance due to pressure from the management. If transfer prices are set at the beginning of the year based on the budget and not adjusted during the year according to budget deviations, there will evidently arise an actual result that is not aligned with the transfer pricing policy.
- Disconnection between tax/finance/business: It is in general the tax department that carries responsibility for the set up and documentation of a transfer pricing policy. However, the day-to day-calculation and processing of the transfer prices are often done by the finance department or business operations. If there is a disconnect between the tax and other departments, the transfer prices will typically be set without taking due consideration of transfer pricing compliance, with deviations as a consequence.
- Differences between management and local statutory reporting: The financial information that companies use to manage and control the company is typically derived from the management information system. In general the management information is organized along the lines of divisions, business units or product groups. For transfer pricing purposes, tax authorities assess the legal entities in their jurisdictions on the basis of the local statutory accounts. To arrive at the relevant statutory legal entity information, a company may need to undertake various steps, e.g. a translation of management information into consolidated group financials based on IFRS. From these IFRS accounts, an allocation of revenues and costs needs to be made to translate into relevant statutory legal entity information based on local GAAP. A process that requires so many steps, under various governing rules, could easily lead to deviations between the transfer pricing policy and the actual financial results. This may be illustrated by the picture on the next page.
- Inadequate IT systems to produce relevant financial data: Similar to the comments above on management and statutory reporting, most companies' IT systems are organized in alignment with the way the company is managed and controlled. IT systems are often built to facilitate the operations, management and decision-making for business units, divisions or product lines, and only in some instances for country organizations or legal entities. To derive relevant financial information for transfer pricing purposes, companies often need to manually download information from the ERP system into a spreadsheet. To add another level of complexity to this exercise, many companies often have more than one IT system (e.g. companies that use different software packages for business information, consolidation and local reporting purposes), requiring data extraction from more than one source. In



such an environment it often happens that relevant transfer pricing data cannot be produced, or contains errors.

II. Key Issues of Transfer Pricing Year-end Adjustments

In the situation where a company identifies that deviations exist between the actual financial result and the transfer pricing policy(ies) applied, it may consider making year-end adjustments. In the authors' view this would require that a number of consecutive steps are undertaken, allowing the company to actually calculate, analyze and process the adjustment. In the remainder of the article we will elaborate on the following steps:

- Testing of the results: what would be the relevant variables to be tested?
- Analysis and decision process: what analysis should one perform and what circumstances should be taken into account?
- Size of the adjustment: how would you calculate the exact amount of the year-end correction?
- Processing of the adjustment: how would you actually execute the year-end adjustment?

III. Testing of the Results: Quantitative

The question whether a year-end adjustment is necessary commences with a quantitative analysis: the actual financial results at year end are compared with the intercompany prices or profit margins as set out in the transfer pricing policy applied. Specifically, this should be taken from the statutory (rather than management) accounts of the tested party.[5] This is because the statutory accounts are the starting point for a tax inspector in the event of a review of the corporate income tax return. If the company keeps its accounting records based on accounting policies that are different from statutory GAAP, the relevant records should be adjusted to statutory GAAP. For the testing of the results it would even be necessary to undertake one additional step. In the statutory accounts, segmentation needs to be made to isolate the intercompany transactions from transactions with third parties. This would require a fair amount of work to allocate, in particular, costs to the various transactions. In addition, one would have to examine whether extraordinary or non-recurring items blurred the results.

The other element in the equation is the transfer price or profit margin for particular intercompany transactions as described in the transfer pricing policy. The transfer pricing policy describes the most appropriate transfer pricing method (based on a comparability analysis) for a specific transaction according to the OECD Transfer Guidelines.[6] It is generally accepted that the application of the most appropriate method or methods often produces a range of figures all of which are relatively equally reliable,[7] or in case of a lesser degree of comparability statistical tools (e.g. the interquartile range) may be used to enhance the reliability of the analysis.[8] In practice, such an interquartile range is, generally speaking,[9] determined on the basis of a benchmark study or comparables search.

The interquartile range for a particular intercompany transaction in practice serves as the reference point to be used to test the actual segregated financial results for the same transaction. Often the benchmark study provides an arm's length range at the EBIT[10] level. Accordingly the comparison of the actual statutory financial result relating to the relevant intercompany transaction is conducted at the same level.

Once the two components in the equation are known, the calculations can be made. In general, if the actual statutory EBIT number of a particular intercompany transaction is outside the interquartile range, companies consider a year-end adjustment. In terms of timing of these calculations there are a couple of comments to make:

- Statutory financials are often available only after a number of months following the closing of the books. In practice it is therefore often difficult to have a complete set of statutory financial information for a particular company at the stage the year-end adjustments are made. Year-end adjustments are commonly made before the close of the book year.
- It is preferable for any adjustments of transfer prices to be made during the year. If it is done at year-end, the calculations may result in a one-off year-end adjustment of a significant amount. Such a year-end adjustment is typically booked in what is known as period 13. From experience we know that tax authorities are regularly requesting period 13

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information. Large adjustments often give rise to questions from the tax authorities. A more regular review of the actual financials versus the transfer pricing policy would result in relatively smaller adjustments throughout the year. However, we also know from experience that the issues discussed above (mainly the fact that, for various reasons, companies do not produce financial information at a statutory legal entity level during the year) may not allow companies to conduct this exercise during the year.

IV. Analysis and Decisions: Qualitative

On the basis of the quantitative analysis, it may be that a number of intercompany transactions show results that are outside the interquartile range for that particular transaction. To make it a bit more 'tangible', suppose we focus on a very basic example: there is an intercompany supply of goods between a manufacturer and a (related) principal company. The manufacturer only supplies products to the principal company and is rewarded on the basis of fully loaded costs plus a profit mark-up of 7% (for *price setting* purposes). The profit mark-up was derived from a benchmark study that indicated that similar manufacturers would earn a profit ranging from 5%—11% (interquartile range, median at 8.5%). For various reasons, the actual profit for the contract manufacturer is 2.2% (EBIT level) at the end of the year.

The first observation to make is that the actual financial result of the manufacturer is outside the interquartile range.[11] An initial reaction may then be that an adjustment needs to be made. However, before doing so it would be worthwhile to consider a number of aspects. One of the main things to analyze is the reasons that caused the deviation between the manufacturer's actual financial result and the set transfer pricing policy. Such an analysis would reveal whether revenue or cost items resulted in an EBIT that was worse than expected, for reasons such as those discussed earlier.

Having identified the causes of the deviation from the arm's-length range, it is then necessary to determine whether an adjustment is appropriate. This will usually depend, at least in part, on whether there is an intercompany agreement and whether it addresses the question of adjustments. It should also be considered whether the treatment of adjustments under the intercompany agreement is consistent with the functional analysis. If there is no intercompany agreement or the agreement is silent on the question of adjustments, it may be necessary to hypothesize what would have been agreed in relation to adjustments if the parties had been independent from each other.

For instance, if the manufacturer is described in the functional analysis as having little or no risk, then it may be more appropriate for an adjustment to be made. Or, the analysis could conclude that the entire drop in profit is due to functions for which the manufacturer carries responsibility. In this particular situation, a year-end adjustment would be more difficult to defend. More generally, a sound analysis of the cause of the deviations, taking into consideration the functional and risk profiles of the relevant group companies based on the functional analysis, should be a major consideration when thinking about making year-end adjustments.

Another factor would be to look at the financial results of the manufacturer for more than one year, say for the past three years. This is not uncommon for tax authorities when they conduct a transfer pricing tax audit and assess a particular transaction.[12] Suppose the EBIT for the manufacturer in consecutive years was 8.5%, 9% and now 2.2%. This would lead to an average (unweighted) EBIT level of 6.6%. This is still within the interquartile range (which is also based on at least three years of financial information). This may provide an argument not to make any adjustments.

An interesting question relates to the previous year. What was the outcome of the quantitative test in the previous year for the same transaction, and did the company make any adjustments then? How did the adjustment look back then? In general, one of the key issues in transfer pricing is consistency. Tax authorities do not like the idea that taxpayers are using transfer pricing adjustments only to their benefit. In the example, it is not likely that an adjustment was made in the previous year since the margin was 9%, which was in the interquartile range. But suppose the manufacturer had realized 21% margin the previous year, due to increased volumes. Let us assume that, for whatever reason, the group decided not to make any year-end adjustment. This year the results decreased dramatically to an EBIT of 2.2%, mainly through a much lower than expected demand from the principal. The reason for the decline of results could probably be attributed to the principal, which would help support a year-end adjustment. However, the fact that a year-end adjustment was not made the year before may lead to questions from tax authorities in the country of the principal.

Finally, a number of practical issues may exist in relation to the year-end adjustments, some of which relate to formalities or local tax legislation. In some countries a downward adjustment of the taxable income through a year-end adjustment would not be allowed for corporate income tax reasons, though it is important to distinguish whether such a prohibition relates just to adjustments that are made in the tax return, after closing the accounts, or also to adjustments that are booked in the accounts. Even if there is such a prohibition, it may effectively be overridden by the relevant double tax agreement, subject to discussion under mutual agreement procedures. In other

> "Since the issue of year-end adjustments is a recurring event, it would be recommended to embed the various steps described above in a process."

countries some formal procedures need to be followed in cases where a year-end adjustment is executed. In Germany, for example, there is an expectation that one should have an agreement in place allowing for year-end adjustments. Some companies carry out performance measurement or assess bonus schemes at the EBIT level, and any year-end adjustments may not always be appreciated by all staff. These are only a number of examples that provide additional complexity to actually pushing through a year-end adjustment. Sometimes these are so difficult to overcome that companies eventually refrain from making the adjustment.

V. Size of the Adjustment

Once intercompany transactions have been identified that would be eligible for a year-end adjustment based on the quantitative and qualitative tests described above, the exact amount of the year-end adjustment should be determined. The first discussion one would probably have in practice is whether the adjustment should be made to the outer boundaries of the interquartile range[13] or to the median. A number of tax authorities[14] do indicate in their tax regulations that a corrective adjustment in case of a deficiency of income reported would be made to the median (again, it is important to be clear whether such regulations relate to adjustments in the tax return or also to adjustments that are booked for accounting purposes before the accounts are closed). In the authors' experience, most MNEs make adjustments to the outer boundary of the interquartile range.

A number of companies have software or a spreadsheet model that automatically calculates the deviations between legal entity information (in most situations based on management accounts) and the interquartile range for the relevant intercompany transaction. Adjustments would often be made to the outer boundary of the interquartile range (either the lower or the upper quartile). In our earlier example this would imply that the actual EBIT of 2.2% would be adjusted to 5%, thus leading to a year-end adjustment of 2.8% (assuming that the argument of a multi-year average would not be used).

The automatic adjustments—often based on practical reasons—do not take into consideration the functional and risk profile of the companies in the transactions and their respective roles and responsibilities in causing these deviations. This may give rise to discussions with tax authorities on the basis that under the arm's length principle a company would only bear additional costs if those costs were under its control. The other way around, a company would only forfeit profit if it were convinced that the profit was not generated as a result of its own efforts. The result of such discussions may be that only part of the year-end adjustment would be allowed for corporate income tax reasons, i.e. the part that could be attributed to the functional and risk profile of the company the income of which is adjusted.

However, it is not necessarily correct to determine the issue on the basis of whether or not an adjustment would have been acceptable to the company on an arm's-length basis. Arguably, the adjustment should not be assessed in isolation, rather, what should be assessed is whether the net result, after the adjustment, is consistent with the pricing/profitability that would have applied on an arm's-length basis. If arm's-length parties realize that they have undercharged or overcharged, they would generally agree an adjustment so that the price is correct. Why, then, should it be wrong for related parties to do the same thing?

It is also noted that adjustments calculated on the basis of management information do not always result in the desired interquartile range in the local *statutory* accounts of a particular legal entity. As addressed above, there may be significant differences between the management reporting and the statutory accounts. To avoid this, the authors would recommend gaining a good understanding of the bridging between the management reporting and statutory reporting. Although some differences between management and statutory reporting would be unknown/unexpected (e.g. a late entry made by the company's external auditor), the vast majority of differences would be recurring year after year and should therefore allow making the appropriate adjustments.

VI. Processing the Adjustment

A final step would be the actual processing of the year-end adjustment. This would imply that the adjustment is actually booked in the financial systems and an intercompany invoice is potentially sent out. In terms of timing, the year-end adjustments are—based on the authors' experience—most often made following the end of the financial year, but before the closing of the books. As indicated before, this often leads to a (significant) adjustment in the period 13 reporting. Some companies do have the possibility, in particular in terms of financial systems and resources, to calculate and process adjustments at a more regular basis, e.g. on a per quarter basis. These companies often include any required transfer pricing adjustment in the next period's invoices.

The moment a year-end adjustment is made, an invoice would normally have to be produced and sent out, although sometimes the adjustment is made by journal entry. An important question is what the invoice should be described as being for. In particular for VAT and customs purposes this will be relevant. In many circumstances the year-end adjustment to a particular transaction is considered to be a debit or credit note to the invoices relating to the same intercompany transaction sent previously during the year. Thus in the case of our example described above, the year-end adjustment equal to 2.8% should be considered to be a debit note from the manufacturer to the principal company. The argument would be that the manufacturer charged prices for its product supplies during the year that were too low. For transfer pricing purposes, such a year-end adjustment is often booked as a one-off amount.

For VAT and/or customs purposes, a number of tax authorities require that adjustments are made to all individual underlying invoices of the relevant transactions. In practice this implies that adjustments would have to be made to a large number of invoices. In general MNEs consider this to be too onerous. Therefore, companies may seek to characterize the year-end adjustment as a different transaction, allowing them to avoid the administrative burden of correcting all underlying invoices. For example, in the above situation the principal company may also support the manufacturer by providing it with a subsidy or marketing contribution which equals the 2.8%. In this situation the manufacturer would issue an invoice for particular services rendered. Obviously this may lead to challenges from the tax authorities in the country of the principal company. They would probably wish to understand what services have exactly been rendered

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and whether remuneration would be appropriate. Again, the wording of the intercompany agreement may be crucial in determining the proper characterization of payment.[15]

VIII. Concluding Remarks

In this article we addressed the issue of year-end adjustments, in particular the practical aspects of these adjustments. Year-end adjustments may be necessary when the actual financial results of an MNE deviate from its transfer pricing policy. There are quite a few reasons why MNEs have to accept that the actual financial results deviate from the set transfer prices. Examples would be budgeting inaccuracies, disconnects between the tax and finance departments and/or mismatches between management and statutory reporting.

If an MNE were to be faced with a deviation between the actual financial result and the transfer pricing policy(ies) applied, it may consider making year-end adjustments. However, applying year-end adjustments requires, in the authors' view, a number of subsequent steps. First, a quantitative analysis would be performed to establish whether the actual financial results deviate from the transfer pricing policy. In practice, the interquartile range for a particular intercompany transaction serves as a reference point to test the actual (segregated) financial results for the same transaction. If the first step results in one or more transactions that would require a year-end adjustment, a qualitative analysis would follow. This qualitative analysis would take into consideration issues like whether the functional and risk profile of the tested company would support an adjustment and whether year-end adjustments were made in the previous year.

If intercompany transactions are determined to be eligible for year-end adjustments following the quantitative and qualitative tests, the size of the adjustment has to be quantified. The main question relating to this issue is whether the adjustment should be made to the outer boundaries of the interquartile range or to the median. Based on the authors' experience, most MNEs make adjustments to the outer boundary of the interquartile range. Finally, the year-end adjustment needs to be processed. In practice this is often done either by way of an intercompany booking or through issuing an intercompany invoice. If an intercompany invoice is sent out, it would be important to carefully analyze the description of the intercompany transaction indicated on the invoice for VAT and/or customs purposes. A debit or credit note to the invoices previously sent would have different VAT/customs consequences than an invoice for a different transaction (e.g. for marketing support services).

Executing those steps would enhance the likelihood that the year-end adjustment would be accepted by the tax authorities at both sides of the transaction. Since the issue of year-end adjustments is a recurring event, it would be recommended to embed the various steps described above in a process. Such a process would enhance consistency in the choices made annually and improve efficiencies. Documenting the various steps in the process would also provide taxpayers with a line of defense in the event of queries from tax authorities. Finally, such a process would make the analysis and decision process less dependent on individuals.

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NOTES

[1] For example: 'Year-end adjustments – what tune is the EU singing?', Dirk van Stappen and Kathy Lim, Transfer Pricing International Journal, 02/12 and 'TP Doctor: End of year adjustments in China', Jeff Yuan and Ray Shu, TP Week, February 2, 2011

[2] Paragraphs 4.38 and 4.39 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 22 July 2010, OECD Paris.

[3] EU JOINT TRANSFER PRICING FORUM, Member States' responses to Questionnaire on compensating adjustments/year-end adjustments, Meeting of October 26, 2011,

[4] Only one question appears to refer to the question of how taxpayers would have to actually make the year-end adjustment in practice: "To what situations (e.g. deviation from the median range, falling outside the range) do compensating/year-end adjustments apply?". Most Member States indicated that ". . .a deviation from what is being considered as arm's length as being sufficient, while one MS explicitly applies the inter-quartile range and another MS only allows upward adjustments."

[5] Or a group of companies if they file a consolidated corporate income tax return under local corporate income tax legislation.

[6] Under the IRS regulations this would be based on the so-called 'best method rule'.

[7] Paragraph 3.55 of the OECD Guidelines.

[8] Paragraph 3.57 of the OECD Guidelines.

[9] In some instances so-called 'internal comparables' are available for the determination of the transfer price or profit margin, i.e. transactions with third parties that are more or less similar as the intercompany transaction under review.

[10] Earnings Before Interest and Tax.

[11] Assuming that all calculations have been made appropriately as described above, e.g. taking into consideration non-recurring items, or charges/payments that would not be visible in the management information but do show up in the statutory accounts.

[12] See for example Taxation Ruling TR 97/20 of the Australian Taxation Office, paragraphs 2.96 to 2.98 and Decree of November 14, 2013 issued by the Dutch Ministry of Finance, IFZ 2013/184M. It is noted that the Canada Revenue Agency (CRA) released Transfer Pricing Memorandum (TPM)-16 on February 13, 2015, which in fact states the opposite: TPM-16 states that while multiple year data may be useful when selecting or rejecting comparables, the CRA's policy is that transfer prices for a given tax year should be evaluated based on the results of a single year of data from the tested party and from each comparable.

[13] In some countries the entire range of results is considered to be arm's length. For instance, the UK tax authorities do not automatically accept the elimination of the top and bottom quartiles. See www.hmrc.gov.uk/manuals/intmanual/INTM485120.htm. For the purpose of this article we will focus on the interquartile range and median as relevant statistical measures only.

[14] For example in Germany legislation requires an income adjustment by the tax authorities to the median (as the arm's length value) if the price the taxpayer has agreed on is outside the range of arm's length prices (see section 1 subs. 3, sentence 4 of the Foreign Tax Act). The UK tax authority publishes its practice about how it would adjust the taxable profits if the statutory profits are outside the arm's length range. They adjust to the point in the range that they judge to be the best indication of the arm's length result, so it depends on the facts and circumstances. However, arguably this is not a rule about how to make *accounting* adjustments so that the accounting profits are within the arm's length range. www.hmrc.gov.uk/manuals/intmanual/INTM485120.htm

[15] This is not to say that the agreement is necessarily determinative if it is inconsistent with the conduct of the parties or with the functional analysis. This will become even more the case following the release of the recent Final Reports on Base Erosion and Profit Shifting by the OECD on October 5, 2015, under which there will clearly be greater scrutiny on the part of the tax authorities of the actual conduct of parties to a transfer pricing arrangement.