



Tax Management *Transfer Pricing* Report

Vol. 7, No. 17

A biweekly update on transfer pricing and related issues

December 23, 1998

HIGHLIGHTS

IRS Proposes Deleting Avoidance Finding From Rev. Proc. 65-17: The Internal Revenue Service proposes an updated version of Rev. Proc. 65-17 that would eliminate the need for the taxpayer to obtain a determination that the transaction was not for tax avoidance purposes. But taxpayers would have to show the §482 adjustment was not subject to a §6662 transfer pricing penalty. [p. 611]

IRS Working With Two Nations on Uniform Documentation Rules: The IRS is working with two treaty partners to develop uniform transfer pricing documentation requirements, Assistant Commissioner (International) John Lyons says. He declines to name the countries, but practitioners speculate that they are likely Canada and Mexico. [p. 612] . . . Lyons adds that the IRS opposes giving foreign tax authorities all of the terms and information included in a unilateral advance pricing agreement. [p. 613]

Inland Revenue Sets Forth Transfer Pricing Penalty Policies: The U.K. Inland Revenue will weigh such factors as the volume and value of related-party transactions, the size of the transfer pricing adjustment, and the profitability of the taxpayer's business when considering abatement of transfer pricing penalties, the Revenue says in a policy statement. [p. 619, Text p. 629] . . . The Revenue releases draft legislation outlining a formal APA program, but a top official warns that the agency will not consider an APA request unless there is "significant doubt" as to the tax treatment. [p. 620, Text p. 631] . . . The Revenue says it has completed 10 bilateral APAs with the United States and one with Japan and that it has 82 pending requests for competent authority relief. [p. 621]

Ford Executive Describes Work Behind German-U.S. Bilateral APAs: A Ford Motor Company executive details how and why Ford worked for two-and-a-half years with Germany and the United States to complete work on a bilateral APA. The Ford APA is one of the first two bilateral APAs that Germany has approved. [Feature, p. 626]

Economists Revisit Inflation Adjustment Issues for Profit Margins: Bryant L. Brooks and Brian C. Becker, Ph.D., of Economic Consulting Services Inc. in Washington, D.C., revisit issues that arise when taxpayers make inflation adjustments to margin-type profit level indicators across countries. [Analysis, p. 639]

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At the IRS [p. 611]

The IRS does not anticipate major changes in APA procedures after a reorganization takes place, an official says. [p. 611]

In the Courts [p. 614]

A California company says it paid its Taiwanese parent arm's-length prices for computer monitors in 1994-95, challenging \$7.9 million in §482 allocations. [p. 614]

EG&G Inc. challenges pricing adjustments of \$3.5 million for 1994, adding that amount to the \$24.2 million already at issue under §482 for prior years. [p. 615]

Pending Cases [p. 616]

Around the World [p. 619]

An Organisation for Economic Co-operation and Development committee completes draft APA guidelines. [p. 624]

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Notice

Tax Management Transfer Pricing Report will not publish on Jan. 6. The next issue will be dated Jan. 13, 1999.



The Cost of Carry: Inflation Adjustments To Assure Consistent Real Profit Margins

by Bryant L. Brooks and Brian C. Becker, Ph.D.
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Washington, D.C.

There appears to be some difference of opinion regarding the applicability of the inflation rate adjustment when comparing the profitability of firms across countries. The use of the inflation adjustment that the authors proposed in this publication may be warranted when the taxpayer/tested party is foreign and being compared to U.S. comparable firms when the firms:

- Operate within the same industry;
- Have their financial statements reported in nominal values;
- Conduct operations primarily in their local currency, and
- Have a positive time of carry.¹

In other cases, such as when the firm has little or no working capital or states its financial reports in inflation adjusted values, this inflation rate adjustment is either not necessary or results in an insignificant adjustment.

The analytics of and motivation for this adjustment procedure were presented in a previous article published in BNA Tax Management's *Transfer Pricing Report*.² However, a recent article in the same publication by J. Harold McClure and E. Miller Williams of Arthur Andersen LLP in Atlanta, Ga. takes issue with respect to the theoretical foundation and the applicability of our inflation adjustment.³

Bryant L. Brooks is an economist and Brian C. Becker, Ph.D., is a senior economist with Economic Consulting Services Inc. in Washington, D.C.

A rereading of our original article confirms that the Brooks-Becker adjustment is based upon sound economic principles. McClure and Williams criticize the adjustment because it would be unfavorable for U.S.-based multinational enterprises. Our adjustment is not intended to specifically help or hinder any taxpayer or governmental tax authority.⁴ Rather, our adjustment simply serves to "level the field" of comparison across countries in an economically appropriate manner.

This latest article seeks to clarify the economic issues raised by McClure and Williams in their article and restate the economics and methodology of the authors' suggested adjustment. The authors will also present some general guidelines for its reasonable use in comparing margin-type profit level indicators across countries.

Inflation's Effects on Real vs. Nominal Values

In economic equilibrium, it is usually assumed that real interest rates⁵ are equalized across countries so that differences in observable (*i.e.* nominal) interest rates are solely attributable to differences in the expected rates of inflation for the borrowing currencies. As pointed out by McClure-Williams, this is a restatement of the neutrality proposition.⁶ However, due in part to differences in inflation, nominal interest and profit rates can vary across countries. Because companies' financial statements are reported in nominal terms, one would expect different profit rates across countries.⁷ In fact, nominal interest rate differences are necessary for different inflation rates to leave real values unchanged, and equal, across countries. Thus, the Brooks-Becker adjustment formula actually depends upon the equality of real interest and real profit rates across countries with different inflation rates, since the adjustment presumes that differences in nominal interest rates are primarily attributable to inflation rate differences.

¹ As in our original article, positive time of carry (or carrying time) implies the amount of time from the incurring of costs to the receipt of revenue from sales.

² See Brooks, Bryant L., and Becker, Brian C., Ph.D., "The Effects of Inflation on Cross-Country Profit Comparisons" (7 *Transfer Pricing Report* 77, 6/3/98). This article will be referenced as Brooks-Becker.

³ See McClure, J. Harold, Ph.D., and Williams, E. Miller, "Differences in Inflation Rates Have No Effect on Arm's-Length Profitability" (6 *Transfer Pricing Report* 825, 3/11/98). This article will be referenced as McClure-Williams.

⁴ In our practice, we continue to work with both taxpayers and governmental tax authorities (including the Internal Revenue Service).

⁵ As real interest rate equalize, so do real profit rates.

⁶ The concept of neutrality as generally defined by economists refers to the effect of inflation on real variables. Expected inflation is neutral if it does not affect the equality of real interest rates across countries.

⁷ See our original essay for a more technical presentation of this point.

The next section presents a restatement of the authors' adjustment and present some transactional examples to show how the Brooks-Becker adjustment depends upon a positive time of carry, not the nonneutrality of inflation.

Review of the Brooks-Becker Inflation Adjustment

The inflation adjustment mentioned in the authors' our previous analysis was given in the context of a "pure" example, assuming the non-U.S. company operated in its local currency, had positive time of carry—which implies some positive amount of work-

ing capital—and had operations that were comparable in every relevant respect to the operations of the U.S. comparable third-party transaction. In this example, the suggested inflation adjustment for the cost plus markup is given as:

$$\text{Non-U.S. Cost Plus} = \text{U.S. Cost Plus} + (i_{NUS} - i_{US}) * (T/360)^s$$

Or, as we noted in Brooks-Becker, this adjustment may also be restated in cost plus return format (1 + cost plus) as

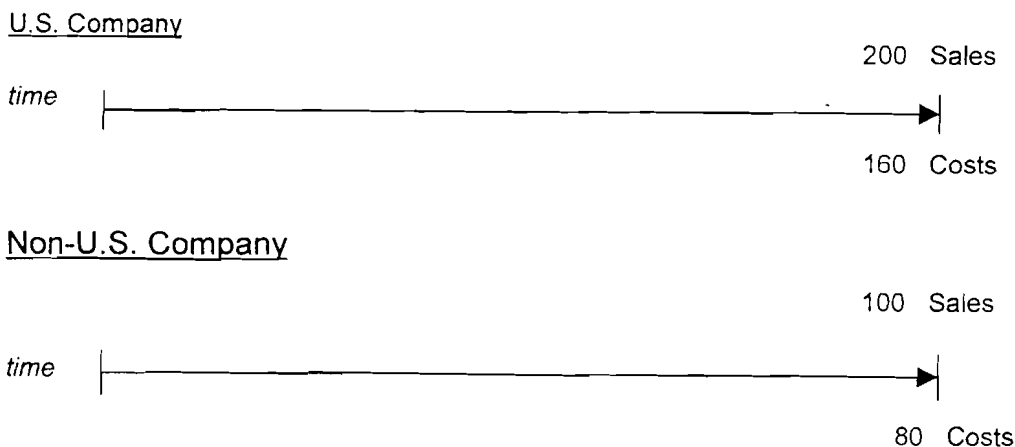
$$\text{Non - U.S. Cost Plus Return} = \text{U.S. Cost Plus Return} * \left(\frac{1 + \left(\frac{i_{NUS} * T}{360} \right)}{1 + \left(\frac{i_{US} * T}{360} \right)} \right)$$

Where T is the time of carry, and i_{NUS} and i_{US} are the annual inflation rates for the non-U.S. and U.S. countries. The fundamental difference between these two specifications is whether the inflation rate should also be applied to the cost plus markup instead of only the cost base. For the purposes of this analysis, we will only focus on the first form.

To see the logic behind this inflation adjustment, a simple transaction is selected to examine the adjustment's effect on a firm's (non-U.S. subsidiary of a U.S. multinational) income statement and one of its profit level indicators: the total cost plus markup.⁹ The comparison will involve two firms, for convenience they are labeled U.S. (comparable) and non-U.S. (taxpayer.) Both companies produce comparable goods, and, thus, the companies have comparable asset structures.

In Example 1, sales and costs for the U.S. and non-U.S. companies are incurred in the local currency of each company. The U.S. inflation rate is assumed to be zero, while the non-U.S. inflation rate is 30 percent per period. In Figure 1, the sales and costs of the firm are incurred at the end of the period, implying that the time of carry is zero. For the non-U.S. taxpayer, its sales are its transfer price.

Example 1.



⁸ This equation, taken from Brooks-Becker, differs from the equation attributed to our earlier paper by McClure and Williams.

⁹ Unless otherwise indicated, all income statement items are booked in nominal terms. That is, if a product is purchased (paid for) in

January and sold (payment received) in July, its January purchase price will be incorporated into its cost of goods sold and its July sale price will be incorporated into sales on its income statement. In this sense, the income statement does not account for inflation.

Example 1 Income Statements

Company	U.S. Company	Non-U.S. Company
Sales at 25% Cost Plus Markup	200	100
Costs	160	80
Inflation Adjusted Costs (end of period currency)	160	80
Profit on Income Statement	<u>40</u>	<u>20</u>
Real Profit (at end of period currency)	<u>40</u>	<u>20</u>
Arm's Length Sales Price	N/A	100
Implied Arm's Length Cost Plus	25.0%	25.0%
Inflation Rate	0.0%	30.0%

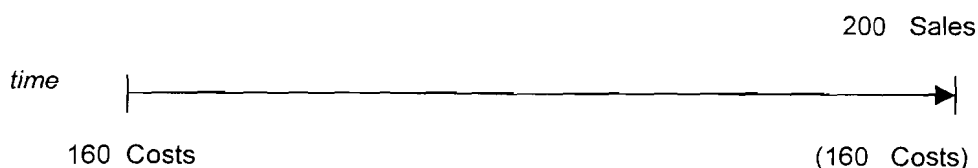
In this example, where inflation does not play a role because sales and costs occur at the same time, both companies earn a cost plus markup of 25%. This example is consistent with the cases considered by McClure and Williams in their analysis of the Brooks-Becker adjustment, since they assumed that the two firms had zero time of carry. However, their assertion that the Brooks-Becker adjustment is not valid in cases where there is no time of carry is not supported by the adjustment equation presented above. In actuality, the Brooks-Becker adjustment formulation implies that since time of carry is zero (Example 1), the adjustment is zero.¹⁰ Thus, the case of a contract

manufacturer or consignment manufacturer with no time of carry is also consistent with the Brooks-Becker adjustment mechanism.

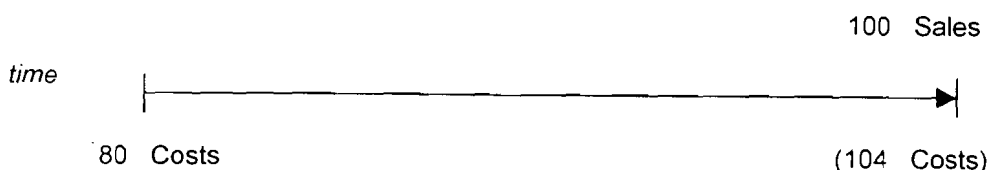
In Example 2, both firms incur costs at the beginning of the period instead of the end of the period. Both companies still receive sales, in nominal currency terms, at period's end. Costs and sales are assumed to be booked according to their nominal values at the time they are incurred. Thus, the U.S. and non-U.S. companies incur costs of 160 and 80 respectively in nominal values in their local currencies at the beginning of the period. Again the U.S. inflation rate is assumed to be zero, while the non-U.S. inflation rate is 30% per period.

Example 2.

U.S. Company



Non-U.S. Company



¹⁰ That is, Non-U.S. cost plus markup = 25% + (10%*0) = 25%.

Example 2 Income Statements

Company	U.S. Company	Non-U.S. Company
Sales at 25% Cost Plus Markup	200	100
Costs	160	80
Inflation Adjusted Costs (at end of period currency)	160	104 ¹¹
Profit on Income Statement	<u>40</u>	<u>20</u>
Real Profit (at end of period currency)	<u>40</u>	<u>-4</u>
Cost Plus Markup	25.0%	25.0%
Arm's Length Sales Price	N/A	124¹²
Implied Arm's Length Cost Plus	N/A	55.0%
Inflation Rate	0.0%	30.0%

To further emphasize the necessity of an inflation adjustment, one can consider Example 2 when the company borrows money for one period to pay its initial costs. Given the market interest rate (*i.e.*, inflation) of 30%, the company will essentially pay for the product at the end of the time period for 104 and earn revenues at the same time of 100. Thus, the failure to perform an inflation adjustment in this case would cause the taxpayer to incur real losses even though it should earn a real profit markup of 25%.

To appropriately account for the time period between incurring costs and receiving revenue, as well as earning an arm's length profit, the company's sale price must consider:

- (a) its costs (80);
- (b) the inflation seen since the costs were incurred (*i.e.*, 30% or 24); and
- (c) an arm's-length cost plus markup (*i.e.*, 25%, or 20).

Under this analysis, the appropriate transfer price is not 100, but 124. With an initial cost of 80, this implies a cost plus markup of 55%.¹³

¹¹ $80 \times (1 + 30\%) = 104$.

¹² $80 \times (1 + 25\% + 30\%) = 124$.

¹³ In fact, the adjustment to calculate the arm's length price could be performed in at least one additional way. This hinges on whether the 25% cost plus markup should be applied not only to cost of goods sold, but also to inflationary erosion costs. The Brooks-Becker methodology simplified the analysis by applying the 25% markup only to the cost of goods sold. To be complete (and to appropriately compare across countries), the 25% markup should also be applied to the costs of inflation. Under this fact pattern, the arm's-length price would be 130

Example 2 is somewhat similar to the McClure-Williams Table 3, except that their analysis does not perform an inflation adjustment. In the first year of their Table 3, (a) the nominal cost plus markups are 5%, (b) the carrying time being implied appears to be 1/2 year,¹⁴ and (c) the inflation rate is 10% per year. With these assumptions, McClure-Williams conclude that a company making a purchase for \$200 (its costs) and selling it 1/2 year later for \$210 (its sales) is earning an arm's-length profit of 5% of costs. Closer inspection reveals that this \$10 "profit" is only accounting for inflation, as \$210 in 6 months is equivalent to \$200 today. Therefore, the company earns no real profit. The same process is repeated in Years 2-5, with no real profit being earned.

These examples highlight the main issue addressed in our initial paper: an inflation adjustment for carrying time. Clearly, with nominal sales and costs occurring at different times in an inflationary economy (being compared to a non-inflationary economy), such an adjustment is appropriate.

Conclusion

The McClure-Williams analysis reinforces the common admonition that financial adjustments should be

($80 \times 1.25 \times 1.30$). With lower inflation rates and cost plus markups, the differences will be smaller.

¹⁴ The McClure-Williams paper does not mention carrying time in its critique of the Brooks-Becker paper. Nonetheless, with assets equal to half of costs, the best guess for their carrying time is 1/2 year.

applied cautiously and with some understanding of the underlying economic foundation. In this paper, the authors have demonstrated two relatively straightforward transactional examples that highlight the role of positive time of carry in adjusting for the effect of inflation on nominal financial variables. The cost plus adjustment that we presented is but one example of a margin-type profit level indicator that can incorporate the logic of

the adjustment. However, as we have indicated, the use of this adjustment is supported in situations where:

- There is positive time of carry;
- The firms operate within the same industry;
- Financial statements are reported in nominal values; and
- The companies conduct their business operations primarily in their local currency.



JOURNAL

CALENDAR

- Feb. 14:** Comments due on IRS announcement 98-99 on test of mediation procedure for appeals, specifically, procedures to deal with factual issues worth less than \$1 million may be sent to National Director of Appeals, 901 D St. S.W., P.O. Box 68, Washington, D.C. 20024, Attn: C:AP:ADR & CS, Room 236. Alternatively, taxpayers may submit comments electronically via the IRS Home Page, or by submitting comments directly to the IRS Internet site at www.irs.ustreas.gov/prod/tax_regs/comments.html.
 - Jan. 31:** Comments due on U.K. Inland Revenue draft legislation on advance pricing agreements and whether proposal meets the need of taxpayers. Comments should be sent to: Andrew Hickman, International Division, Inland Revenue, Room 409, Melbourne House, Aldwych, London, WC2B 4LL, Fax (44) (171) 421 8817, E-mail: ahickman-ir.mhl@gtnet.gov.uk.
 - March 31:** Comments due on scope and context of U.K. Inland Revenue draft statement of practice with respect to draft APA program. Comments should be sent to: Andrew Hickman, International Division, Inland Revenue, Room 409, Melbourne House, Aldwych, London, WC2B 4LL, Fax (44) (171) 421 8817, E-mail: ahickman-ir.mhl@gtnet.gov.uk.
- New York. Call (416) 777-2020 or toll free (888) 777-1707 or fax (416) 777-1292; or e-mail order@insightinfo.com; or visit website at www.insight.com.
- Jan. 27-29:** Alliance for Tax, Legal, & Accounting Seminars, *Intermediate U.S. International Tax Compliance & Planning*, Costa Mesa, Calif. Call (914) 328-5656 or fax (914) 328-5757.
 - Feb. 3-4:** American Conference Institute, *Transfer Pricing Audits*, New York. Call (888) ACI-2480 or fax (416) 927-1563; or visit website at www.mondaq.com.
 - Feb. 22-23:** Alliance for Tax, Legal, & Accounting Seminars, *Introduction to U.S. International Tax Compliance and Planning*, Costa Mesa, Calif. Call (914) 328-5656 or fax (914) 328-5757.
 - Feb. 24-26:** Alliance for Tax, Legal, & Accounting Seminars, *Intermediate U.S. International Tax Compliance & Planning*, Costa Mesa, Calif. Call (914) 328-5656 or fax (914) 328-5757.
 - Feb. 24-25:** Insight Information Co., *Canadian Forum on Advanced Transfer Pricing*, Toronto. Call (416) 777-2020 or fax (416) 777-1292; or e-mail order@insightinfo.com; or visit website at www.insightinfo.com.

MEETINGS

- Jan. 25-26:** Alliance for Tax, Legal, & Accounting Seminars, *Introduction to U.S. International Tax Compliance and Planning*, Costa Mesa, Calif. Call (914) 328-5656 or fax (914) 328-5757.
- Jan. 25-26:** Insight Information, *Transfer Pricing: Maximizing Profits While Minimizing Costs*,

Court decisions and other documents discussed in this issue are available for a fee from BNA PLUS, and can be delivered by facsimile transmission, overnight delivery, or regular mail. For information or orders, call BNA PLUS toll-free at (800) 452-7773 nationwide; (202) 452-4323 in Washington, D.C.; by fax at (202) 822-8092 or (202) 452-4644; or e-mail to bnaplus@bna.com.