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Transfer Pricing in Troubled Times

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A topic that has attracted considerable attention in recent months has been how transfer pricing practitioners should address the serious challenges thrown up by the current economic crisis. Although this is not the first recession many practitioners will have experienced professionally, it is the most severe and far-reaching. The challenges certainly will exceed the limits of what can be managed within the transfer pricing systems currently applied by many multinational enterprises, and may well require a changed approach to transfer pricing for some of them. In that respect, two questions in particular need to be addressed.

The first is how to ensure that comparable data used for setting or testing transfer prices are appropriate in terms of both comparability and adequately reflecting economic reality for the controlled party. The second is what action, if any, is required if the controlled party's results fall below an existing arm's-length range in forecast or actual terms, or if comparables data suggests that part or all of the arm's-length range is negative.

This article aims at providing a framework for answering these questions. In doing so, it examines various ways of fine-tuning and adjusting comparable data, including the use of regression analysis. It also considers the relevance of the underlying commercial and financial relationships between related parties, whether so-called routine companies should always receive a guaranteed minimum return, and what call there is for related parties to renegotiate transfer prices. The analy-

sis highlights the importance of admitting flexibility into the design of transfer pricing systems to allow them to better cope with extreme economic conditions.

Background

The literature on the challenges and effects of recession on transfer pricing dates back to 2001 when the United States, Japan, and many European countries went through a phase of economic slowdown. However, transfer pricing practitioners and tax authorities have yet to develop a well-defined solution to cope with the challenges of an economic downturn. While many articles written on this subject attempt to explore the effects of recession on transfer prices and highlight the need to adjust transfer pricing analyses to correct for distortions caused by such downturns, only a few have evaluated specific refinements or adjustments. The most commonly discussed approaches include refining existing comparables sets, using alternative range computations, and expanding or reducing the period of analysis.¹ These measures aim to sustain the degree of comparability between a taxpayer and an existing set of comparable companies, given that a downturn may diminish comparability between a taxpayer and initially selected uncontrolled comparable companies. Another approach that has been discussed relies on regression analysis as a potential solution. Conducting a regression analysis either with the data from an existing set of comparables, or with a broader set of uncontrolled companies, attempts to determine what impact a downturn has on comparable companies' profitability levels.² This provides the means to adjust comparables' financial data to correct for distortions.³

Tax authorities also have acknowledged the need to address the impact of the recent economic downturn on taxpayers' ability to manage transfer pricing and com-

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¹ Sciacca, Richard; Soba, George; and Wrappe, Steven, "Adjusting Transfer Pricing Analyses for Economic Downturn," 10 *Transfer Pricing Report* 685, 12/12/01.

² Hayri, Aydin; Clark, Richard, "Firm Profitability in Recessions: Part II," 11 *Transfer Pricing Report* 29, 5/1/02.

³ *Ibid.*

Illustrative volume effects on distributor margins

	Fixed costs = 10% of total costs			Fixed costs = 20% of total costs		
	Normal business operations	Economic downturn	Change (%)	Normal business operations	Economic downturn	Change (%)
Sales revenue	100	80	-20	100	80	-20
CoGS (variable cost)	60	48	-20	60	48	-20
SG&A (variable cost)	20	16	-20	10	8	-20
SG&A (fixed cost)	10	10	0	20	20	0
Operating profit	10	6	-40	10	4	-60
Return on sales	10%	7.5%	-25	10%	5%	-50
Operating profit/SG&A	33%	23%	-30	33%	14%	-58

ply with relevant regulations.⁴ However, they themselves do not yet have clear guidelines and likely will develop their own thinking and methods as they work on individual cases. The Internal Revenue Service, if not other tax authorities, has stated publicly that it is considering some measures and will be providing feedback to taxpayers as to the appropriateness of possible adjustments.⁵

Much of the discussion to date focuses on solutions for making adjustments to account for or eliminate the effect of an economic downturn within the framework of the comparable profits method (CPM) or the transactional net margin method (TNMM). There has been limited discussion of the issue from a wider perspective that considers the nature of the underlying commercial and contractual relationships that exist between related parties. This article attempts to address that topic, in addition to providing an overall analytical framework.

Firm Profitability in a Recession

During a recession, many companies experience significant declines in sales volumes and capacity utilization as a result of downward demand shocks. Such declines lead to significant erosion in profitability and the response of affected companies typically is to make operational adjustments to align their cost bases with lower demand for their products and services. This takes time, however, and will affect even so-called routine companies—limited-risk distributors, contract manufacturers, back-office service providers, and so on.

An important determinant of the extent to which companies (for instance, a limited-risk distributor) will experience profit declines is the magnitude of fixed costs (that is, costs wholly unrelated to sales revenue) relative to the total cost base. In the first example presented below, the majority of a hypothetical company's costs are variable costs, and fixed costs represent only 10 percent of sales. If sales revenue decreases by 20

percent from the current level of 100 to 80, operating profit will decrease by 40 percent in absolute terms, return on sales by 25 percent, and the ratio of selling, general, and administrative expenses (that is essentially the Berry ratio) by 30 percent. As also shown by the table, however, the impact on profitability of sales declines becomes more significant with higher fixed costs in proportion to total costs.

In addition to changes in demand, the current recession has been accompanied by significant foreign exchange fluctuations. This volatility is another important factor affecting profitability. For example, the Japanese yen appreciated by approximately 20 percent against the U.S. dollar between September 2008 and February 2009, with a significant impact on profitability of Japanese parent companies and their U.S. subsidiaries as well as the U.S. parent companies and their Japanese subsidiaries. Conversely, the pound sterling lost approximately 20 percent of its value against the euro and 30 percent against the U.S. dollar since the first half of 2008.

In the sort of circumstances described above, transfer pricing practitioners are confronted by two key questions:

- how to ensure that comparables data used for setting or testing transfer prices are the “right” data, in terms both of comparability and of adequately reflecting economic reality for the controlled party; and
- what action is required if the controlled party's results fall below what is taken to be the arm's-length range in actual or forecast terms, or if comparable data suggest that part or all of the arm's-length range is negative.

Ensuring Comparability, Reflecting Economic Conditions

While taxpayer's financial results and forecasts will of course reflect current economic conditions, the same is not necessarily true for the available comparable data. This may be because some potential comparables are not affected in the same way as the taxpayer (for example, suppliers to fast food chains currently are likely to be faring better than suppliers to more upscale restaurants), or because up-to-date results for comparables are not yet available. Continued use of compa-

⁴ “Musher Acknowledges Mismatch Between Comparables, Current Economic Conditions,” 17 *Transfer Pricing Report* 625, 12/18/08.

⁵ “Panelists Address Transfer Pricing Issues Arising in Economic Downturn, Role of APAs,” 17 *Transfer Pricing Report* 675, 1/22/09.

rable data that are one or two years old presents serious challenges to taxpayers in terms of setting prices for the current year, budgeting for coming years, and complying with applicable transfer pricing regulations.

To ensure that potential comparable data are indeed comparable and do reflect economic reality for controlled parties, a four-step process can be envisaged.

Step 1: Rescreen comparable data sets

The existing comparables sets can be rescreened to eliminate companies that have not been affected by the economic downturn in the same way, or to the same degree, as the taxpayer. Additional screening criteria might be the percentage of sales decline in the taxpayer's business plus or minus an appropriate variance, the level of excess capacity the taxpayer is operating with to the extent such data can be quantified or estimated for potential comparables, or the amount of fixed costs relative to total costs. This exercise may result in too few comparables, in which case it may be appropriate to relax other screening criteria, including the number of consecutive years for which data are drawn as well as geographic and product screens.

Step 2: Update comparable data

As transfer pricing practitioners are well aware, the availability of data for potential comparables inevitably lags behind that of controlled or tested parties. This does not necessarily create a problem during times of relative economic stability, but clearly it is a significant issue at present. Comparable data that are one or two years old in many cases simply will predate the start of the economic downturn. This creates obvious difficulties for taxpayers trying to set or test their transfer prices, or perhaps determine the magnitude of provisions or year-end adjustments.

In such circumstances, updating comparable data using interim or forecast data may be a realistic option. Many listed companies, for example, publish interim figures on a quarterly basis that could be used to establish interim ranges for transfer pricing purposes. Interim financial reports are somewhat limited, however, and do not cover an entire year. Other limitations include lack of information or detailed data that are used to screen the comparables and to make adjustments for differences between the taxpayers and the comparables, and the preliminary nature of such data before audit and year-end adjustments. Alternatively, forecast data for the full year can be obtained from investment research companies, such as I/B/E/S (Institutional Brokers' Estimate System) or Value Line, which publishes Value Line Investment Survey. The latter provides projections of sales, operating profit, net profit, depreciation expense, working capital, and other balance sheet items for approximately 1,700 publicly traded companies in the United States every 13 weeks.

The reliability of forecast data can, of course, be a concern. Nevertheless, the approach still may prove useful in some cases. It should be noted, however, that it may not offer a solution for comparable data required for particular jurisdictions or geographical areas. In the United Kingdom and Europe, for example, financial data are publicly available for many privately owned companies. Although often smaller than listed companies, such private companies typically are less diverse in their business activities. As a result, best practice is

to apply stricter comparability criteria than is sometimes possible elsewhere, and comparable data sets typically comprise more privately owned companies than listed ones. Unfortunately, the former do not publish interim results or forecasts, and accounts typically do not have to be filed immediately after the end of the financial year. In the United Kingdom, for example, accounts do not need to be filed until nine months after the end of the relevant financial year (six months for public companies). Consequently, by the time companies' results are available in published databases, they are between 12 and 18 months out of date. In such cases, other approaches are likely to be necessary. In Japan, while most major companies provide financial forecasts for the coming 12 months, smaller companies, which tend to be "routine" functional enterprises and thus are more likely to be selected as comparables, do not generally provide such forecasts. Similarly, forecasts by securities analysts are typically limited for smaller companies.

Step 3: Choose an appropriate time frame for comparables

The generally accepted rationale for using multiple-year data is to smooth out "the effect of business cycles in the controlled taxpayer's industry, or the effects of life cycles of the product or intangibles being examined."⁶ If a taxpayer has been particularly affected by the economic downturn, however, relying on a three-year average including data from the two preceding years may not be appropriate. In this case, one might opt to use only the results from the latest year. Although it sounds fairly easy to implement, this option requires careful application so as not to reduce sample size and unduly lessen the robustness of results from a statistical point of view. Due to an increased number of companies exiting the market or filing for bankruptcy during an economic recession, for instance, the sample size of comparable data sets may be reduced. The fact that surviving companies fare better also may lend an upwards bias to results. Counter-intuitively, this may result in a higher range than appropriate. Relying on single-year data for the comparables, one may risk inducing unexpected instability for future years and the question always will remain about when to revert back to multiple-year data. This consideration also applies to the idea of using future multiple-year (for example, three-year) data on a rolling average basis.

Using multiple-year data including the years from the last recession may not necessarily reflect the current economic conditions since the current recession is proving to be much more significant than the last one. Moreover, this approach does not take into account the impact on comparables' returns of changes in technology, products, and markets since then.

Step 4: Adjust comparables' financial data

If steps 1 through 3 do not provide an adequate solution, a fourth step may be considered. This is to adjust comparables' financial data to calibrate the results to the current economic conditions. This step may be necessary anyway since U.S. transfer pricing regulations, for example, require using multiple-year data in apply-

⁶ Regs. § 1.482-1(f)(2)(iii).

ing the comparable profits method. The adjustments may be done in several ways—for example, by adjusting for median differentials, making adjustments using regression analysis, and adjusting for volume effects, differences in cost structure, inventory, and foreign exchange effects.

An adjustment based on median profit-level indicator (PLI) differentials can be applied by deducting the difference between the median PLI in the current fiscal

year and in the year the adjustment is being made from the PLI return for each comparable. For example, as shown in the illustration below, comparable A's return on assets (ROA) for 2006 was reduced by six percentage points—from 15 percent to 9 percent—where six percentage points is the difference between the median ROA for 2006 (12 percent) and the median ROA for 2008 (6 percent).

Illustration of adjusting comparables' data based on median PLI differentials

Comparable	Actual Return on Assets (%)				Adjusted Return on Assets (%)			
	2006	2007	2008	Average	2006	2007	2008	Average
A	15	13	6	11.3	9	9	6	8.0
B	18	14	9	13.7	12	10	9	10.3
C	10	10	7	9.0	4	6	7	5.7
D	4	6	5	5.0	-2	2	5	1.7
E	12	9	3	8.0	6	5	3	4.7
Q1	10	9	5	8.0	4	5	5	4.7
Median	12	10	6	9.0	6	6	6	5.7
Q3	15	13	7	11.3	9	9	7	8.0

Alternatively, adjustments can be made using a regression analysis to determine the systematic differences between observation years in the selected PLI in each year t , with the adjustment applied to historic financial results for the comparables to include this systematic component:

$$OP_{ct}^{adj} = OP_{ct} + (\hat{PLI}_T - \hat{PLI}_t) PLI \text{ Base}_{ct}$$

where T designates the current year to which the comparables' data are applied, OP_{ct} is the operating profit of comparable c in year t , $PLI \text{ Base}_{ct}$ is the denominator of the PLI return of comparable c in year t , and OP_{ct}^{adj} designates the adjusted operating profit data for each comparable c and observation year t . The annual PLI estimates \hat{PLI}_t are derived from a regression of the form:

$$OP_{ct} = PLI_{05} \delta_{05} PLI \text{ Base}_{ct} + PLI_{06} \delta_{06} PLI \text{ Base}_{ct} + \dots + PLI_T \delta_T PLI \text{ Base}_{ct} + u_{ct}$$

where the dummy variables δ_t are 1 in year t and zero otherwise, and u_{ct} is the regression residual (error) term.

Other regression-based analyses can be performed to establish the systematic relationship between changes in sales and profitability. This can be done using existing comparable sets, depending on sample size and reliability of the resulting coefficients, or expanded sets.⁷ The resulting regression coefficients provide an estimate of the decrease in profitability (as a percent of sales, assets, etc.) for each percentage of decrease in sales and can be used to adjust each comparable's profitability based on the percentage decline in the taxpayer's sales.

A third possibility is to make adjustments to account for such factors as differences in the ratio of fixed costs to total costs (or assets or capital employed) between the taxpayer and the comparables. Companies with higher levels of fixed costs typically experience larger

swings in their profitability when sales level changes. While classification of fixed versus variable costs can be made more reliably for the taxpayer, it may be challenging to do so for the comparables based on publicly available data. The economics of the industry in which the taxpayers and their respective comparables operate as well as relevant industry statistics could be a guideline in quantifying the relative magnitude of fixed costs. Other similar adjustments might focus on inventory costs, foreign exchange effects of the recession, and so on.

Such adjustments are consistent with the U.S. transfer pricing regulations, since they address requirements not only to consider the effect on comparability of the business cycle and market conditions, but also the need to use multiple-year data where necessary.⁸ Similarly, the adjustments are consistent with principles outlined in the Organization for Economic Cooperation and Development's transfer pricing guidelines concerning comparability, using multiple-year data, and making appropriate adjustments to establish arm's-length conditions.⁹ Thus, from a U.S. and general transfer pricing perspective, the proposed adjustments seem appropriate, provided they are sufficiently robust to ensure reliability.

Underlying Commercial, Financial Relationships

Having refined and adjusted comparable data, the next key question for practitioners to answer in the current environment is what action is required if the controlled party's results in actual or forecast terms fall be-

⁸ Regs. § 1.482-5 and § 1.482-1.

⁹ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Chapter I, paragraphs 1.17 and 1.50, and Chapter III, paragraph 3.44.

⁷ 11 *Transfer Pricing Report* 29, 5/1/02.

low an arm's-length range, or if comparable data suggest that part or all of the arm's-length range data is negative. So far, the focus of this article has been on testing the results of the taxpayer by using comparable data. This presupposes that, in the commercial and financial relationship of the taxpayer with a related party or parties, the taxpayer is solely responsible for decisions made, for example, in regard to investing in fixed assets, and thus for the corresponding fixed costs. In reality, in long-term cooperative relationships between independent parties, some form of co-responsibility for investment usually exists. To understand the relevance and impact of this requires the analysis to be broadened to include consideration of the relational context in which the taxpayer operates, and the introduction of elements that can no longer be characterized as relating to the application of one-sided methods. If a controlled party's actual results fall below an arm's-length range, then a transfer pricing practitioner might find him- or herself in the position of seeking to justify year-end adjustments to business management, auditors, or the relevant tax authorities. This is done even though retrospective adjustments are not standard in third-party situations, and many tax authorities accept such adjustments only begrudgingly if at all, with some exceptions in the context, and therefore, renegotiation of advance pricing agreements.

Although it is not a complete solution, arguably a more realistic alternative from a third-party perspective might be for related parties to consider *renegotiating future transfer prices* and perhaps even terms and conditions more generally. Indeed, if this can be done on a real-time basis, rather than only during the annual budget cycle, then difficult transfer pricing issues might be reduced considerably. Either way, taxpayers need to go through a number of steps before renegotiating their transfer pricing.

First, of course, taxpayers must establish whether renegotiation is feasible given relevant contract law. This will depend on the facts of the case and jurisdictions involved.

Second, the taxpayer should, if possible, collate empirical evidence that it is normal business practice, or at least not unusual, for third-party agreements in its industry or own business to be renegotiated when circumstances require it. Clearly, the closer the circumstances surrounding the third-party reference point to the ones faced by the taxpayer in the current environment, the better. Either way, examples of contracts being renegotiated or varied between third parties are commonplace. As an example, Gartner reported from a survey carried out in 2005 that four out of five outsourcing deals will be renegotiated during the lifetime of the contract.¹⁰ Contract resets also are commonplace in such sectors as information technology. From an empirical viewpoint, therefore, there may be little argument that contracts cannot reasonably be varied when circumstances demand.

Third, the taxpayer should document the economic rationale for the parties involved to renegotiate contracts. For example, the anticipated costs to a party of not renegotiating may well exceed the short-run concessions made to a partner to save it from going out of business. It is especially relevant here that third parties involved in long-term partnerships where both invest

substantially in capacity and their commercial relationship are likely to agree prices in a transparent, open-book process in which the parties arrive at shared conclusions on terms and conditions.¹¹ This more or less describes the situation encountered in a related-party context. In a related-party context, therefore, renegotiation may be wholly reasonable from an economic perspective.

Assuming the taxpayer progresses through the above steps, then renegotiating transfer prices may indeed be a realistic and sensible option. Caution does need to be exercised, however, since it may be seen as setting a precedent. Moreover, there might be a need to establish reverse "negotiation" when times improve.

The Case for Sharing Losses

When comparable data indicate that all or part of the arm's-length range is negative, then the transfer pricing practitioner may need to assess whether a controlled party could reasonably be expected to make a loss. This question may even apply to so-called routine companies—limited-risk distributors, contract manufacturers, back-office service providers, and so on.

In the current economic conditions, it is not hard to find examples of toll manufacturers, contract manufacturers, and simple distribution companies that are suffering financially, or even going bankrupt. Indeed, in certain sectors of the economy—engineering and automotive being good examples—industry experts describe the entire supply chain from original equipment manufacturers to primary contractors and then on to first-, second-, and third-tier manufacturers as being "locked." The idea that "routine" companies in this context should necessarily earn basic but guaranteed returns therefore may be misguided and does not consider adequately the different types of risk. It is not sensible to assume that volume guarantees will be sustained for a considerably long time even when the final market substantially deteriorates. Thus, third-party enterprises in a value chain experiencing similar economic deterioration of the market are subject to substantial risk of not being able to recover their fixed costs.

In many other cases, however, the above is not true and companies enter into commercial arrangements with third parties that insulate them from risk, or at least market and inventory risk. Such arrangements take a variety of forms, including take-or-pay contracts that often are seen in utilities and resource-based industries. Other examples are found in the fast-moving consumer goods sector. The next portion of the article focuses primarily on these sort of arrangements, but similar considerations may apply in the case of simple distributors.

Although the contractual terms associated with take-or-pay contracts can be quite complex, the principle involved is quite simple. Specifically, purchasers either buy minimum volumes at pre-agreed prices or make up any shortfall in overhead contributions according to a predetermined formula. Variations range from simple arrangements (for example, minimum volumes guaranteed), to more complex ones (processing charges are

¹⁰ Source: www.management.silicom.com, 4/27/05.

¹¹ Fris, P. and Gonnet, S., "How Analysis Can Define the Nature, Use and Pricing of Intangibles," *International Tax Review*, Intellectual Property (4th edition), 2005.

based on a pro rata share of total costs plus markup, where shares are determined in proportion to capacity used plus that held on “standby”). Another way of framing the question is to consider how costs should be defined in determining cost plus recharges—total costs for an entire plant, or perhaps average total costs assuming full utilization multiplied by actual capacity use. The use of a two-step approach here would not be unusual—for example, charging fixed costs in advance or in accordance with an agreed schedule and then variable costs according to volumes ordered. Applying standard or benchmark costs of production is another possibility.

In seeking to understand whether a related-party toll or contract manufacturer (or equivalent) should be sheltered from the worst effects of a recession and assigned a guaranteed basic return, three factors should be taken into account:

- whether such arrangements are in evidence in the industry or sector being considered;
- the underlying economic justification for such an arrangement; and
- whether the resulting allocation of risks between the related parties is justified.

If take-or-pay arrangements are seen in the industry or sector under consideration, then it becomes easier to justify the equivalent in a related-party context. If, however, the answer to the first question is “no”, then the second and third questions become more important. Either way, this first question highlights the importance of conducting a detailed industry or market analysis and forming a basic understanding of how the supply chain is organized in comparable third-party situations.

In regard to the second question, the answer(s) will vary from a case-to-case basis and it is necessary to conduct a detailed examination of the facts. Factors that provide an economic justification could include one or more of the following:

- The specific transaction between the related parties forms part of a more extensive commercial relationship, perhaps agreed as part of a wider deal, and the provision of a guaranteed return is a *quid pro quo* for other elements of the commercial relationship.
- The manufacturer needed at some point to make substantial investments in capacity or new plants to

meet the requirements of its affiliate(s) and this did not make sense without a degree of certainty about utilization or ability to cover the costs of such investment.

- In practical terms (for example, design or technological specificity), the manufacturer has limited or no ability to seek alternative uses for unused capacity.

- The manufacturer’s affiliate(s) seeks exclusivity from the manufacturer.

The third question—whether the resulting allocation of risks between the related parties is justified—is partly addressed in paragraph 1.27 of the OECD’s transfer pricing guidelines, where it is noted that in arm’s-length transactions, it generally makes sense for parties to be allocated a greater share of risks over which they have greater control. It was taken up again in the OECD’s September 2008 discussion draft on transfer pricing aspects of business restructurings. The draft comprises four issues notes, the first of which states:

[W]here no comparables exist to support a contractual allocation of risk between related parties, it becomes necessary to determine whether that allocation of risk is one that might be expected to have been agreed between independent parties in similar circumstances. One factor that can assist in this determination is the examination of which party(ies) has (have) control over the risk. . . . [T]he OECD is of the view that in arm’s length dealings, another factor that may influence an independent party’s willingness to take on a risk is its anticipated financial capacity to bear that risk.¹²

The note continues, adding:

[T]he OECD is of the view that in the context of paragraph 1.27 of the TP Guidelines, ‘control’ should be understood as the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider. This would require the company to have people – employees or

¹² OECD. 2008. Transfer pricing aspects of business restructurings: discussion draft for public comment. Issues Note 1, para. 28.

Simulated distributor returns under different risk sharing scenarios

Changes in sales volume (%)	Allocation of risk to manufacturer (%)				
	0%	25%	50%	75%	100%
-5%	4.21	4.42	4.62	4.81	5.00
-10%	3.33	3.78	4.21	4.62	5.00
-15%	2.35	3.10	3.78	4.42	5.00
-20%	1.25	2.35	3.33	4.21	5.00
-25%	0.00	1.54	2.86	4.00	5.00
-30%	-1.43	0.65	2.35	3.78	5.00
-40%	-5.00	-1.43	1.25	3.33	5.00
+5%	5.71	5.54	5.37	5.19	5.00
+10%	6.36	6.05	5.71	5.37	5.00
+15%	6.96	6.52	6.05	5.54	5.00
+20%	7.50	6.96	6.36	5.71	5.00
+25%	8.00	7.37	6.67	5.88	5.00
+30%	8.46	7.76	6.96	6.05	5.00
+40%	9.29	8.46	7.50	6.36	5.00

directors – who have the authority to, and effectively do, perform these control functions.¹³

Of course, few if any entities will be able to control or manage all the risks associated with an economic downturn, especially one as severe as the current one. A functional analysis that focuses sufficient attention on the employees and directors of the related parties involved will shed light on whether a toll or contract manufacturer, for example, could reasonably have been expected in a third-party situation to have taken on substantial risks given the potential financial consequences of doing so. For instance, it might be entirely reasonable to argue that a contract manufacturing operation that has neither the people nor the authority to make strategic or tactical decisions about how to cope with the effects of a severe recession should be insulated from at least part of the risk, especially if it did not remotely have the financial resources to weather the storm.

If the conclusion arrived at is that a controlled party should indeed receive a guaranteed basic return, then presumably this would indicate some sort of problem with the original comparable data that suggested the arm's-length result was negative. The practitioner might need to revisit the data and ensure that the right multiple-year data is used. Otherwise, the practitioner would need to interpret the comparable data in a similar fashion to how comparable data might be handled outside a recession. This might be relatively straightforward (for example, target the median), or involve con-

sidering how losses are shared by two related parties (for example, a manufacturer and a distribution company).

If the conclusion arrived at is that the risk of loss should be shared among controlled parties, the following example illustrates that given the level of volume declines observed in many industries, it can be reasonably anticipated that some routine players, such as distributors, will need to absorb a portion of the loss. The table below presents simulated target operating margins for a distributor procuring solely from a related manufacturer under various alternatives for sharing volume risks, by way of allocation to the manufacturer, corresponding to varying levels of changes in sales volume compared with a base operating margin of 5 percent. Fixed costs are assumed to be 15 percent of sales. As indicated, between a 30 percent and a 40 percent reduction in sales volume currently observed in many industries implies negative operating margins depending on the combination of parameters.

Conclusion

Practitioners facing challenges brought by the current economic downturn should carefully scrutinize comparable data, examine underlying commercial and financial relationships between related parties, and consider what room there is for related parties to renegotiate transfer prices. A major question is whether so-called routine companies always should receive a guaranteed minimum return. Recent economic conditions highlight the importance of building flexibility into transfer pricing systems.

¹³ *Ibid.*, para. 30.