

Informative Note

Comparability adjustments in the post-COVID-19 setting

2nd July 2020

Related-party transactions should be valued in accordance with the arm's length principle (on the same terms that would have been negotiated between independent entities). In this respect, comparability analysis is a key tool for its application.

The comparability analysis is established in Article 17 of Royal Decree 634/2015 of 10th July, approving the Corporate Income Tax Regulations (hereinafter RIS), and in Chapter III of the OECD Transfer Pricing Guidelines, is the analytical process through which the conditions of potentially comparable transactions with the related-party transactions under analysis are identified and contrasted (through the previous study of the related-party transactions carried out by the taxpayer, the relevant characteristics of the transactions -comparability factors-, the selection of the most appropriate methodology for the determination of transfer prices, the selection of potential comparables, etc.).

Within the "standard" process proposed by the OECD guidelines in chapter III, comparability adjustments are included, that is, those adjustments necessary to homogenize the conditions of linked transactions with those of unlinked transactions and to eliminate the effect of differences that might arise (in accordance with paragraph 3.47 of the OECD guidelines).

Comparability adjustments will be made if they result in an improvement in results, with differences between the taxpayer's related party transactions and those of independent third parties being inevitable. In turn, it should be taken into account that an excess of adjustments may lead to an indication that the comparable transactions selected are not sufficiently comparable, and therefore justification will always be required (evidence, reasons for the adjustment, calculation procedure, etc.)

Although there is no closed list of possible adjustments - and of methodologies for their application - Chapter III of the OECD Guidelines includes a list of those that can be used to eliminate/remove differences in comparability, among which are the following:

- **Adjustments for differences in accounting criteria/segmentation financial data:** it is necessary to homogenize the different accounting rules and approaches used - depreciation and amortization methods, recognition of revenues and expenses, etc. The diversity of accounting criteria may appear when we select foreign comparables (section 3.35 of the OECD Guidelines), and we must unify them to proceed to a comparison from the same perspective.
- **Adjustments for capacity use:** in exceptional situations, entities are not able to take full advantage of their production capacity – start-up phases, times of crisis, etc. - resulting in (i)



lower absorption of fixed costs and (ii) a decrease in net profitability. In a scenario of under-capacity production, and with the aim of obtaining a sufficiently reliable sample of comparables, we should be able to determine (i) the percentage of capacity utilization of the test party and comparables, (ii) the fixed cost base -and where appropriate the fixed part of the semi-variables-. These fixed costs will be increased or decreased according to the percentage of capacity utilization obtained. Generally, this type of adjustment is made when the method selected is the net margin of the whole operation.

- **Adjustments to working capital:** differences in the structure of working capital (financing of customer/supplier accounts, inventories) may impact on the operating profit of entities. This type of adjustment seeks to homogenize the receivables/payables between the tested party and the comparables. Taking into account that in a competitive environment money has a temporary value, if a company sets a delay in the collection of its accounts of 60 days, the price of the goods must be equal to the price in case of immediate payment plus 60 days of interest on that price, thus including an element that reflects the payment conditions -an appropriate interest rate in each case-. This type of adjustment allows the results of the test party to be adapted to reflect the working capital levels of the comparables -or to adjust the results to reflect "o" working capital. However, when practicing this type of adjustment, we should take a number of considerations into account, the applicable interest rate and the time at which the adjustment is to be made, among others. Working capital adjustments are the most frequent in practice, usually applied when the net margin method is used for all transactions.
- **Adjustments for functional differences:** differences in functions, assets and risks have a direct effect on the returns obtained - to a greater extent when applying methods using gross margins, which are more sensitive to these differences. In some cases, we may be able to use working capital adjustments to address these differences. However, careful consideration needs to be given to each individual case.

In practice, in addition to those listed above, there are other comparability adjustments that may be applicable: adjustments for country risk, for differences in geographical markets, regression analysis, etc., which may be used to correct possible financial/economic differences.

In the circumstances we are dealing with, the effects of the COVID-19 have been clearly reflected in the income statements of the taxpayers corresponding to the year 2020. Given that in the case of using external comparables, the only financial data that will be available to the taxpayer will be those corresponding to fiscal years 2019 and earlier, it will be of vital importance to adjust them. Although the type of adjustment and the methodology to be applied to adjust the results of these "comparable" companies remain to be confirmed, different alternatives are being considered: adjustments for exchange rates in the FOREX market (currency market), economic adjustments due to instability in the markets, changes in demand, and extraordinary expenses incurred in the crisis, among others.

We hope the information is useful and of your interest. At Andersen Tax & Legal we have created a multidisciplinary team to attend to all the questions that may arise on this aspect or in relation to the COVID-19.

For more information please contact:

[Rafael Leal](#) | Director in the Tax department
rafael.leal@AndersenTaxLegal.es

[Andrea Pérez](#) | Consultant in the Tax department
andrea.perez@andersentaxlegal.es

The above comments are for information purposes only and do not constitute professional opinions or legal advice, nor do they necessarily include the opinions of the authors. If you are interested in obtaining additional information or clarification of the content, please contact us by telephone on + 34 963 527 546/34 917 813 300 or by e-mail at communications@andersentaxlegal.es.