

Recent Issues and Practical Solutions for Estimating An Arm's-Length Range for North American Retailers

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In this article, the authors explain the challenges transfer pricing practitioners are currently facing with developing an arm's-length transfer pricing range for North American retail distribution companies and offer some practical solutions.

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This article addresses challenges transfer pricing practitioners are facing with developing an arm's-length transfer pricing range for North

American retail distribution companies. The authors hypothesize that the impact of COVID-19 and other recent economic industry factors created these complexities because some companies that historically had relatively lower overall profits no longer appear in practitioner databases — contributing to the increase in the range for broadly comparable companies. The article concludes with practical suggestions for 2022 transfer pricing documentation and onwards.

Background

The comparable profits method as set forth in Treas. reg. section 1.482-5 is based on objective measures of profitability obtained from uncontrolled taxpayers that engage in business activities similar to those of the controlled taxpayer (and under similar circumstances) to determine whether the amount charged in a controlled transaction is arm's length.¹ More specifically, the determination of an arm's-length result under the CPM is based on the amount of operating profit that the tested party would have earned on related-party transactions if its profit level indicator were equal to that of an uncontrolled comparable (that is, the "comparable operating profit").² Practically speaking, constructing a range of returns for those comparable uncontrolled entities requires *reliable* publicly available data. To identify comparable North American companies, data is generally limited to companies that file statements with the SEC.

¹ See reg. section 1.482-5(a).

² See reg. section 1.482-5(b).

**Table 1. 2016-2018 Summary of Operating Margins
For a Broad Set of North American Retailers**

Operating Margin	2016	2017	2018	Weighted Average
Count	153	154	152	154
Minimum	-68.8%	-27.9%	-16.8%	-28.7%
25th Percentile	2.5%	2.1%	1.8%	2%
50th Percentile	4.7%	4.6%	4.1%	4.5%
75th Percentile	8.6%	7.9%	6.9%	7.8%
Maximum	21.8%	23.1%	22.7%	22.6%

**Table 2. 2019-2021 Summary of Operating Margins
For a Broad Set of North American Retailers**

Operating Margin	2019	2020	2021	Weighted Average
Count	130	130	121	130
Minimum	-24.3%	-38.5%	-15.1%	-19.6%
25th Percentile	2.1%	1.1%	4.2%	3%
50th Percentile	4%	4.4%	7.1%	5.2%
75th Percentile	6.4%	7.9%	11.6%	8.2%
Maximum	22.7%	23%	25.9%	22.8%

The practical limitation of the use of SEC registrants may not immediately appear significant, considering that KPMG's licensed database source provides financial information for more than 50,000 public companies. However, when filtering and removing companies that (i) are not classified as retail distributors, (ii) are inactive, or (iii) do not have sufficient financial data (that is, do not have at least two years out of a three-year period analyzed), the real starting point for a comparable search for North American distributors is less than 300 companies. This is before applying quantitative screening or removing companies that are operating under bankruptcy or if the auditor has expressed a going concern matter in a recent annual report.³

³ Companies with going concern issues may be rejected because when the survival of the entity is on the line, management may not operate with the goal of profit maximization, which can distort the profitability ratios used in the benchmarking analysis. For example, a company may be in a liquidity crunch and be willing to sell inventory at a loss, to avoid insolvency.

Given the limited universe of companies and the impact of COVID-19 as an accelerator of the challenges affecting the retail industry, the preparation of transfer pricing documentation for fiscal year 2022 may be challenging. Companies reacted differently to the disruptors that affected the industry before, during, and after COVID-19. In addition, customers shifted their purchasing preferences significantly during this period. Examples of these factors include: (i) an increase in online sales, which was permanent for some companies and temporary for others; (ii) the shift in sales volume, which saw a significant drop during COVID-19, followed by a robust recovery afterward; and (iii) material changes to supply chains during and after COVID-19. Some companies were not able to adapt to the impact of these dynamic patterns, and in some instances, they became targets for acquisitions, reorganized, liquidated, or filed for bankruptcy.

Tables 1 and 2 compare the results of a broad search for companies in North America performing retail functions between the periods

2016-2018 (FY18) and 2019-2021 (FY21). For the FY18 search, KPMG used the August 14, 2019, version of its KPMG tpEngine™ database. KPMG identified 446 companies and eliminated 151 under the data sufficiency screen (companies that do not have available financial data for at least two years out of a three-year period analyzed), resulting in 295 companies for qualitative review. After qualitative screening, which are listed in the appendix, 154 retail distributors were identified.⁴

For the FY21 search, KPMG used the May 17, 2022, version of its KPMG tpEngine™ database. KPMG identified 500 potentially comparable companies and eliminated 216 under the data sufficiency screen resulting in 284 companies for qualitative review. After qualitative screening, which are listed in the appendix, 130 retail distributors were identified.

The increase in the 25th percentile and median between the two periods may appear small but could have a significant impact for many companies that use the CPM. If a company was targeting a 2.5 percent, 3 percent, or 4 percent operating margin (OM),⁵ which are generally quite representative of the targeted returns for routine retail operations, these levels of profitability were safely within the arm's-length range before COVID-19 (that is, 2.5 percent, 3 percent, and 4 percent are within the interquartile range shown in Table 1 for the three-year period, or 2.0 to 7.8 percent.)⁶ The interquartile range for the period 2019 to 2021 is between 3 percent and 8.2 percent, with a median of 5.2 percent. The 25th percentile increased by 50 percent, from 2 percent to 3 percent. With reference to the example above, a 2.5 percent OM policy is not supportable as arm's length for the period 2019 to 2021, and a 3 percent policy is just at the low end of the interquartile range. While the median and the upper quartile from the three-year average do not

experience a significant increase, when considering the last years of the three-year average periods, 2018 and 2021, we can see that the change in the OM is quite dramatic as shown in Table 3.

Table 3. Comparison of 2018 and 2021 Interquartile Range of Operating Margin For a Broad Set of North American Retailers

Operating Margin	2018	2021	% Change
Count	152	121	-20%
25th Percentile	1.8%	4.2%	133%
50th Percentile	4.1%	7.1%	73%
75th Percentile	6.9%	11.6%	68%

The differences from 2018 to 2021 are quite dramatic. First, one in five companies, or 20 percent of the set, is not present in the 2021 comparable set.⁷ If these were companies struggling in the period leading up to 2019, it is likely that a number of them exited the market, pushing the interquartile range higher. Specifically, 17 were acquired, five filed for bankruptcy, five became inactive in the database, eight had going concern issues, and five were rejected as part of the qualitative review.⁸ If we analyze the 40 companies accepted in the FY18 set but not appearing in the FY21 set, the results (as measured by the interquartile range) tend to be significantly lower than the larger set in Table 1. Is it possible that the tendency towards higher OM in the FY21 set is simply the result of survivor bias?

The question that a transfer pricing practitioner should ask is whether the increase in the 25th percentile and median signals a higher profitability for performing retail functions. Also, if the 2021 trend toward increasing OM continued for 2022, this would imply that companies targeting a retail distribution return lower than 3 to 4 percent may need to reconsider their transfer pricing analysis.

⁴ Companies were rejected if they had a different primary function (for example, non-retail activities represented a majority of revenues).

⁵ Operating margin is defined as operating profit (gross profit less selling, general, and administrative costs and less depreciation and amortization) over net sales. Alternatively, OM is also defined as earnings before interest and taxes (EBIT) over net sales.

⁶ It is important to note that every company has specific facts and circumstances related to its intercompany transactions. The statements above should not reduce the need to perform a full functional analysis and a tailored economic analysis before determining the arm's-length range for the tested party.

⁷ There are some new companies appearing in the FY21 set.

⁸ Four companies were rejected for operating outside North America, and one company had significant financing revenue.

Table 4. Interquartile Range for OM of a Normally Distributed Set of Comparables For the Period 2018-2022

Formulas ^a	Statistic	2018	2019	2020	2021	2022	Weighted Average
Sum(value1,..)/n	Average	4.5%	4%	3.2%	7.4%	5.3%	5.2%
Sample standard deviation of the observations	Standard Deviation	6.8%	6.2%	9.2%	6.7%	7.3%	6.1%
$zQ1 = -0.67449 * \text{Standard Deviation} + \text{Average}$	Lower Quartile	-0.16%	-0.2%	-3.01%	2.89%	0.38%	1.07%
$zQ3 = 0.67449 * \text{Standard Deviation} + \text{Average}$	Upper Quartile	9.06%	8.18%	9.39%	11.95%	10.19%	9.29%

^aThe first quartile of a standard normal distribution is obtained by subtracting 0.67449 times the normal distribution's standard deviation from its mean.

Preparing FY22 Documentation for Retail Affiliates Tested Using the OM

Are the results in tables 1 and 2 a signal that a U.S. routine retailer should receive a higher return for the same functions, assets, and risks performed in the U.S. market in 2022? The answer is, of course, dependent on facts and circumstances specific to each taxpayer. During FY21, some companies may have adapted their business to the challenges introduced since COVID-19, resulting in an increase in profitability. For example, companies may have reduced costs associated with maintaining storefront real estate with a more focused number of outlets, smaller in size but more connected with consumers through a proper omnichannel strategy. The stores may not carry every product, or every style or size of product, allowing the customer to enjoy the customer experience, as well as the opportunity to try the product in person. For those stores, it is less relevant that the exact color or specification of the product is immediately at hand because it can be shipped to the customer in a very short period of time, including same day delivery.

Companies prepare a transfer pricing study to document the arm's-length nature of their intercompany transactions for fiscal year 2022. If the transfer pricing documentation is prepared before the filing of the U.S. federal tax return, showing that the intercompany transactions took place at prices consistent with the arm's-length

principle, the company may be able to protect itself against the imposition of penalties in the case of a transfer pricing adjustment. The variability in the interquartile range of OM shown in Table 3 raises the question of whether a transfer pricing adjustment should be made or whether there are factors that may explain this variability. We include below some considerations for companies preparing their 2022 transfer pricing documentation.

Use a Longer Time Period

Companies should consider whether a five-year period weighted average may be a better representation of a "steady state" to benchmark the arm's-length retail distribution return, mitigating single-year periods of extreme variability. Depending on the business, the taxpayer should consider whether five years is an appropriate estimate for a business cycle or if the analysis should include more than five years.

Use a Different Statistical Method

Reg. section 1.482-1(e)(2)(iii)(B) notes that taxpayers may use the interquartile range of acceptable comparable companies to estimate the arm's-length range when it is not possible to adjust for all the differences in comparability between the tested party and the comparable companies, which is generally the case when applying a CPM. Importantly, reg. section 1.482

indicates that the application of a “valid statistical method” (different from the interquartile range) can be used if it provides a more reliable measure of the arm’s-length range. This decision depends on the facts and circumstances of the company involved in the intercompany transactions, and more work would be required to assess the appropriateness of applying a different statistical method. For example, if we were able to demonstrate that the profit margins of these companies are part of a population that is normally distributed, we could create the interquartile range by determining the central 50 percent range of values for the normal distribution. This article is not demonstrating that the group of companies sampled are extracted from a normal distribution, as compared with a different distribution. The purpose of this article is to find alternative approaches to the traditional interquartile range. If the set of comparable companies is normally distributed, we could compute the interquartile range using the mean and the standard error, as illustrated in Table 4.

These results illustrate that depending on the variability of the observations, the central 50 percent of the observations may need to be wider than one could expect.

Revisit Acceptance and Rejection Criteria

Given the current environment and the challenges faced by the retail industry, should we consider revising the rejection criteria that tends to eliminate companies sustaining “prolonged” losses? We believe there is a case to evaluate each situation on a case-by-case basis, because companies may need a longer period to react and restructure and to be able to serve their clients in the post-COVID-19 environment. The existence of survival bias reflects the fact that we may not have a sufficient representation of loss-making companies. To address this challenge, we could identify companies that are earning extraordinary returns because they have been able to capitalize on the industry developments. These companies may have developed new intangibles or may be performing different functions compared with the tested party around e-commerce, omnichannel, subscription, or experience-based retail activities. It should be considered whether these types of companies belong in the comparable company

set. In the alternative, we could review the loss-making companies and include their financial data up to the year in which a going concern issue is raised by the auditor. If we combine this approach with a slightly longer period of analysis (for example, five years instead of three years), we may be able to bring more balance in the set.

Traditional Interquartile Range Alternatives?

Are there alternatives to the traditional searches using a set of public companies with SEC filings to determine an arm’s-length return for retail activities? The 30 companies that are part of the Dow Jones Industrial Average (DJIA) represent a proxy for the return of the entire stock market. If 30 companies can be representative of more than 50,000 public companies, perhaps there is a case for developing a retail index which includes a fixed number of companies that are reviewed and potentially revised periodically like the DJIA. This index will then be used to provide a smoother indication of profitability. The range (or more appropriately, a confidence interval) can be created using the standard error of this index. The benefits of this approach would be to focus on companies that are representative of the retail industry and that tend to be more stable in terms of profitability. Newer companies, or companies struggling to remain in business, would not be in the index and therefore not introduce the level of volatility we are currently seeing in the interquartile range. This will facilitate comparison of the profitability over time, even if the composition of the index tends to change.

The challenges of this approach arise from the need to identify which companies are part of the set, potential questions surrounding comparability of the set with the tested party, and the mechanism to replace these companies over time. It is our opinion that if objective criteria are established and followed over time, it may be possible to obtain a small set of companies that are representative of the retail industry. For example, the companies in the set should include traditional retailers, as well as retailers that have successfully embraced e-commerce. We could establish a set of screens to avoid including companies that perform significant manufacturing activities by focusing on property, plant, and equipment as a percentage of assets.

We could establish a minimum number of years required for a company to be publicly traded before being included in the set. Once the index is obtained, the next challenge would be to compute the interquartile range to evaluate the arm's-length nature of a company's OM. This would require an approach similar to the one illustrated in Table 4, based on evidence supporting the type of random distribution for the company in the index.

Another alternative to the traditional interquartile range could be to modify the calculation of the three-year average by pooling the observations for the three years. The three-year interquartile range will not be computed using the three-year average for each company but rather by considering each year as a separate observation. This approach should reduce the impact of companies exiting the set on the interquartile range, because we have three times more observations than in the traditional approach. While section 482 arguably implies that averaging is the preferred approach, they are not prescriptive on this point,⁹ and approaches such as pooling have sometimes been used.

Unspecified Method for Contemporaneous Transfer Pricing Preparation

While the methods discussed above are all potentially valid approaches, there is the risk that the IRS may interpret these adjustments to be the application of an "unspecified method." This increases the burden of proof for the taxpayer to meet the 6662 requirements for penalty protection. Under the section 6662 regulations, the IRS may impose substantial penalties on taxpayers that (1) are subject to transfer pricing adjustments in excess of certain thresholds and (2) that fail to prepare contemporaneous documentation that demonstrates the taxpayer's reasonable effort to determine arm's-length prices

with respect to their controlled transactions.¹⁰ The section 6662 regulations provide that taxpayers may avoid transfer pricing penalties if they satisfy certain requirements;¹¹ the requirements for avoidance of penalties when using an unspecified method are higher than the requirements for a specified method because a taxpayer would need to reasonably conclude that (1) none of the specified methods was likely to provide a reliable measure of an arm's-length result and (2) that the method used was likely to result in a reliable measure of an arm's-length price.¹² While historically transfer pricing penalties were rarely assessed, the IRS has been making it clear both in directives¹³ as well as public statements, that taxpayers can expect more transfer pricing penalties.¹⁴

APA as Alternative to Transfer Pricing Documentation

An alternative to the application of an unspecified method or a heavily adjusted CPM (both would be subject to challenge) would be to obtain an advance pricing agreement. We expect, post-COVID-19, for tax authorities to continue to challenge transfer pricing — and we expect increased enforcement/audit activity in the United States. We have seen taxpayers obtain certainty using reasonable approaches, and many taxpayers prefer the APA process especially when faced with a potentially contentious audit. We do

⁹ See reg. section 1.482-1(f)(2)(iii)(D).

¹⁰ See reg. section 1.6662-6.

¹¹ See reg. section 1.6662-6.

¹² See reg. section 1.6662-6(d)(3)(ii)(B).

¹³ See IRS Large Business and International Division, "Instructions for Examiners on Transfer Pricing Issue Examination Scope — Appropriate Application of IRC Section 6662(e) Penalties," LB&I-04-0118-003 (Jan. 12, 2018).

¹⁴ Recently and repeatedly, IRS officials have stated that taxpayers should expect more transfer pricing penalties to be asserted in the hopes that this will lead the IRS to receive more robust documentation. See, e.g., Kiarra M. Strocko, "IRS May Assert More Penalties for Transfer Pricing Documentation," *Tax Notes Int'l*, Sept. 26, 2022, p. 1575.

note that there has been an increase in APA requests in the United States: 121 complete APA requests were filed in both 2019 and 2020, climbing to 145 in 2021 and 183 in 2022.¹⁵ While we can only hypothesize the reasons for this marked increase, it shows that many companies well understand the benefits surrounding certainty that an APA can bring. Coupled with increased staffing going forward at the U.S. APA office; it

¹⁵ See IRS, Announcement 2023-10, 2023-16 IRB 1.

seems that now would be a good time for many to consider this program.¹⁶

¹⁶ The foregoing information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG LLP.

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Appendices

Appendix 1.

FY18 Retail Distribution Search Criteria

#	Operator	Category	Condition	Criteria	Eliminated	Remaining
1		KPMG's licensed database			0	47,401
2	And	SIC Code	Includes Tree	Division – G. Retail Trades 52. Building Materials, Hardware, Garden Supply & Mobile Home Dealers 53. General Merchandise Stores 54. Food Stores 55. Automotive Dealers and Gasoline Service Stations 56. Apparel and Accessory Stores 57. Home Furniture, Furnishings, and Equipment Stores 58. Eating and Drinking Places 59. Miscellaneous Retail	45,362	2,039
3	And	Status Marker	Equals	Active	1,593	446

Qualitative Screening

Screen	Eliminated	Remaining
Different function	97	198
Subsidiary	16	182
Different risks	15	167
Insufficient information	7	160
Different service	5	155
Serves different markets	1	154

Appendix 2

FY21 Retail Distribution Search Criteria

#	Operator	Category	Condition	Criteria	Eliminated	Remaining
1		KPMG's licensed database			0	51,728
2	And	SIC Code	Includes Tree	Division — G. Retail Trades 52. Building Materials, Hardware, Garden Supply & Mobile Home Dealers 53. General Merchandise Stores 54. Food Stores 55. Automotive Dealers and Gasoline Service Stations 56. Apparel and Accessory Stores 57. Home Furniture, Furnishings, and Equipment Stores 58. Eating and Drinking Places 59. Miscellaneous Retail	49,586	2,142
3	And	Status Marker	Equals	Active	1,642	500

Qualitative Screening

Screen	Eliminated	Remaining
Different function	102	182
Subsidiary	14	168
Different Service	13	155
Operates in different market	12	143
Different risks	9	134
Insufficient information	2	132
Serves different markets	1	131
Different assets	1	130



