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MEMORANDUM FOR APA PROGRAM PROFESSIONAL STAFF
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FROM: Robert Weissler, APA Team Leader
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SUBJECT: CPM Comparables' Abnormal Profit Levels: Minutes of Meeting of
September 21, 2000

This memorandum memorializes the discussion of CPM comparables' abnormal profit levels at our September 21, 2000, meeting. We covered three subjects: losses, bankruptcy and going concern issues, and profit level spikes (up or down).

Losses

There was consensus that operating losses alone should not disqualify a potential comparable. However, there were several reasons why comparables with operating losses might be eliminated:

- A review of the 10K or other material might show that the loss resulted from an unusual circumstance that makes the potential comparable inappropriate. (However, one can often find some qualitative reason to eliminate a company, and it is to some extent a policy call how hard to push to eliminate companies with losses.)
- In a bilateral case, we might face a country that routinely eliminates loss comparables in CPM analyses of its taxpayers.
- Some expressed the view that a potential comparable's losses for one or perhaps two years are acceptable, but losses for three or more years typically are not. However, persistent losses might result from certain economic conditions facing the comparable's industry.
- Many would look to the effect on the range. If, for example, there are two comparables out of twenty with negative operating margins over the test

period, the comparables bring down the interquartile range but do not take it below zero. One can think of the two comparables' negative results as balanced by very high results of some other companies. The comparables set is large, and comparables with negative operating margins are just part of the mix.

However, if the comparables with losses actually yielded an interquartile range that went below a zero operating margin, that would raise serious concerns. Some believe that, under the CPM, protecting the tested party from losses is a quid pro quo for limiting the tested party's upside potential. However, for some industries in some years (e.g., semiconductor manufacturing or distribution during a downturn), a negative operating margin might reflect an arm's length result. One might also consider the likelihood that the particular taxpayer will aim to achieve results at the bottom of the range.

After the meeting, Russell Kwiat expressed the opinion that a negative operating profit has no special economic meaning, either for individual comparables or the range. The reason for focusing on negative operating profits is the feeling that in the long term a company cannot survive with losses. While profitability can fluctuate in the short term, when short-term losses are incurred one naturally asks if some special factors are at work. However, as a theoretical matter, to be viable in the long term, a business must achieve not merely a nonnegative return, but a positive return on assets that is enough above a risk-free rate of return (such as the return on U.S. Treasury instruments) to attract and maintain investment. Thus, positive returns below this risk-free rate, like negative returns, invite an inquiry into whether special factors are at work.

Bankruptcy and Going Concern Issues

There was consensus that normally a potential comparable should not be used for a year in which the company is in bankruptcy (whether chapter 11 (reorganization) or chapter 7 (liquidation)), or in which auditors have raised going concern issues. While these companies encompass a spectrum, the whole spectrum seemed beyond the pale because business would not be conducted normally. For example, it would be harder to get bank loans, and credibility with customers and suppliers would be impaired. Companies in reorganization bankruptcy would be run for the benefit of creditors rather than stockholders. Companies in liquidation bankruptcy would be liquidating rather than doing normal business.

Excluding these companies is consistent with a critical assumption regarding bankruptcy and going concern issues: the restriction on the comparables matches the restriction on the tested party.

One might make an occasional exception. For example, if one were short on comparables, one might include a comparable for a year in which a bankruptcy or going concern issue arose late in the year. One might use partial year results, eliminating the period with the problem; or one might use full year results, on the theory that the small part of the year with the problem will not unduly distort the results.

Profit Spikes

Kris raised the issues of upward or downward profit spikes. These might result from unusual circumstances that make the potential comparable inappropriate for the spike year. One could review the 10K or other material to search for an explanation. If a downward spike is caused by a meteor hitting the tested party's factory, one would exclude the potential comparable for that year. If a downward spike is caused by a company losing a major customer, one might exclude the comparable for that year and also have a critical assumption about losing major customers. Alternatively, one might include the comparable and have no such critical assumption.

But what if one can find no particular reason for the spike? (For foreign comparables, we often have very limited descriptive information.) Kris would exclude a comparable using statistical techniques if its profit volatility during the test period is much greater than its historical profit volatility. He would use a statistical confidence interval, excluding a comparable if its volatility during the test period would arise at most x percent of the time given its historical volatility. The way the math works, comparables with short available histories would tend to be eliminated less.

Sean invited Kris to propose such an approach in an actual case.