ACCOUNTING CHANGES AND TRANSFER PRICE TAX COMPLIANCE: A RISKIER ENVIRONMENT IN PORTUGAL?

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Abstract. *In 2010 Portugal adopted an IAS-based system of financial accounting. Detailed rules on transfer pricing do exist in Portugal since 2001. In transfer pricing methods, especially when based on margins, accounting indicators are of paramount relevance to assessing the profitability of firms, and to compare such indicators to samples of similar companies. The purpose of this paper, drawing on the legal research method, is to discuss the following question: when using the transactional net margin, quite common in transfer pricing tax reporting, does the new Portuguese financial accounting system produce profit level indicators that are closer to the underlying reality that transfer pricing aims to capture, or are these profit level indicators of a lower quality than before? Our main conclusion is that the new accounting regime has a significant potential for increasing uncertainty and compliance costs in the area of transfer pricing, given the nature of operating income adopted in the new IAS based system.*

Keywords*: tax environment; tax compliance risks; financial accounting; transfer pricing; Portugal.*

Introduction

In 2010, Portugal adopted an International Accounting Standards (IAS) based system of financial accounting. Issues like fair value, impairment charges, provisions or financial instruments´ valuation deeply affected the nature and values of recorded assets, liabilities, revenues, and costs. The discussion if management decision making is now anchored in better accounting data is a highly charged one, given recent developments in the wake of the financial crisis (Autrey, 2012; Martins, 2012).

Detailed rules on transfer pricing do exist in Portugal since 2001. Curtailing the possibility of using intragroup transactions to manipulate the tax base was a major policy goal, and the tax law followed international best practices in laying out specific transfer price rules. OECD´s Guidelines were the building block of transfer price laws and regulations (OECD, 2010; Pereira, 2014). Dealing with transfer pricing has a significant degree of subjectivism, centered on the concept of comparability of transactions. As such, it is prone to risks in tax compliance and is a potential source of litigation (Autrey, 2012). In transfer pricing methods, particularly the ones based on margins, accounting indicators are of paramount relevance to assessing the profitability of firms and refer such indicators to samples of comparable companies (Hyde & Choe, 2005; Miller & Lynne, 2014).

Variables like return on assets, return on sales, gross margins and operating income, constitute relevant accounting indicators that are essential to evaluate if transactions between related parties are conducted by respecting arm´s length conditions (Cools, Emmanuel & Jorissen, 2008).

The purpose of this paper, drawing on the legal research method, is to discuss the following questions: when using the transactional net margin, quite common in transfer pricing tax reporting, does the new Portuguese financial accounting system produce profit level indicators that are closer to the underlying reality that transfer pricing aims to capture, or are these profit level indicators of a lower quality than before? Risks in tax compliance, in the area of transfer pricing, were reduced or increased by the new accounting paradigm?

Our analysis is centered on the discussion of the accounting recognition of revenues and expenses, and how operating income is computed in the new system. In our perspective, the necessary adjustments to arrive at consistent profit level indicators increased, given the underlying options of the new accounting system. In particular, the concept of operating income is affected by the adoption of a much-extended definition of operational revenues and costs, masking, in our view, the nature of what should be presented as the regular, or recurrent, performance of firms.

The paper will, firstly, present a brief review of the relevant international literature on financial accounting developments and the transfer pricing core issues, with particular emphasis on OECD Guidelines; then will present the Portuguese tax and accounting scene; and finally, focus on the analysis and discussion of the aforementioned research question. We believe it is a relevant contribution to tax policymakers, accounting standards setters and tax authorities, given the practical complexity of transfer pricing and its links to accounting information.

Analysis

The methodology used in the paper draws on legal research. Here, the so-called evaluative approach is the chosen perspective. As van Hoecke (2011) states, the legal research method is often criticized by not making the empirical sciences´ type of generalizations. There are no general valid principles derived from legal research, since many problems are, by nature, related to national legal systems and, therefore, proposed solutions are not valid outside a specific territory. However, we believe that the nature of the accounting and tax issues identified and discussed in the paper is relevant outside Portugal, given the widespread adoption of IAS based accounting systems and the multinational impact of transfer pricing principles´ and legislation.

Our purpose is to discuss the research question identified at the beginning the paper. Thus, the interpretation of legal texts (accounting standards and transfer pricing legislation) and the *ratio legal* discussion, the evaluation of advantages and disadvantages of the new version of operating income and the use of hypothetical situations where the quality of information impacts transfer pricing tax compliance be used to analyze the topic.

Taking into account the aim of this study, the discussion of a Portuguese particular feature of corporate financial information and tax system can highlight useful policy points to a broader audience (Hutchinson & Nigel, 2012). Many OECD countries face a dire situation in budgetary terms. Therefore, given the pressure to increase tax receipts, transfer pricing issues can shed some light on solutions being applied in other countries, and enhance awareness of corporate tax policy points.

Transfer pricing (TP) deals with prices used between associated firms for the transfer of goods, services and intangibles. As these prices can be used for the manipulation of taxable income, the arm´s length principle is the basis of TP control by tax authorities (OECD, 2010; Smith, 2002). The arm's length principle demands the use of transactions of independent companies as a benchmark to determine how profits should be allocated in the context of transactions between related parties. It compares the prices a company has contracted with its associated enterprises with what a truly independent enterprise would have done in similar circumstances.

Moreover, countries have a right to protect their fiscal base form tax avoidance strategies, based on transfer pricing, used by corporations. The location of profits in low-tax jurisdictions is a well-known tax-minimizing strategy. It is not surprising that, in recent decades, an increasing number of legislative tools have been adopted to counter such practices. Additionally, transfer pricing legislation demands that companies report increasing data (e.g., sales, assets, profits, employees, royalties, financial transfers) that are related to different jurisdictions. Also, the level of cooperation between tax authorities of different countries can act as a counterbalance to the manipulation of the tax base. By cross-checking international transactions, countries are able to capture and fight some of the most common strategies to locate profits in favorable tax jurisdictions.

In political terms, this reaction of policy makers and tax authorities increase fairness, by trying to tax mobile income flows. Even if partially successful, it is a positive factor in the public perception of fighting evasion and may increase revenues in times of stringent budgetary policies. The OECD (2013) Base Erosion and Profit Shifting project and the measures put forward to tackle tax avoidance by multinationals, is a sign of increasing awareness of policymakers. In this Action Plan, transfer pricing issues are at the center of actions 8, 9, 10 and 13. These actions relate to a better alignment between prices and intangibles´ location, functions, and risks of each party contributing to an economic transaction. Also, there is a call for an increase in information disclosure for big international groups. If this ambitious plan becomes effective, additional steps will be implemented to strengthen the right of sovereign states to fight tax avoidance in a more coordinated way.

As said, the arm´s length prince is the cornerstone of fighting transfer pricing potential evasive practices. The principle requires related enterprises to charge the same price, in the context of a controlled transaction that would be charged by independent firms, in an uncontrolled transaction in comparable circumstances. It represents the closest approximation to an open market scenario and would produce a reasonable allocation of income within a multinational group (Cools et al., 2008; OECD, 2010; Pereira, 2014).

The arm's length principle can be implemented by the following steps:
- characterize transactions between associated enterprises and document them;

- select the most appropriate transfer pricing methodology and document the choice;
- apply the most appropriate transfer pricing methodology, determine the arm's length outcome and document the process;
- implement support processes, including review steps, to ensure adjustment for material changes.

If a transaction's price, charged between non-related parties is, in all material respects, comparable to the transfer price between related enterprises, it becomes a comparable uncontrolled price. While all comparability factors should be considered, the most important ones are the similarity of products, contract terms, and economic/ market conditions. However, in many real-life situations, the uncontrolled market price is not observable. Consequently, the comparison is not based on these prices, but by using margins, taken from samples of comparable firms, and then pairing median or quartile values with margins computed for the tested party. Thus, as margins are derived from accounting numbers, with a special emphasis in operating expenses and revenues, accounting data are crucial in many TP cases. A digression on this issue is clearly important.

Before 2010 Portugal had a financial accounting system based on the "Plano Oficial de Contabilidade" (POC). Although it incorporated many developments observed in EU after POC´s setting up, in 1977, it was not an IAS-based system. In particular, the computation of firms´ net income was divided, purposively, into operating, financial and extraordinary items, which helped users of financial information to have a detailed grasp on how income was originated. Table 1 shows, for a hypothetical entity, the income statement that, in the context of POC, it would exhibit.

Table 1. Income statement (POC) - in euro

Type	Indicators	Value
Costs	Cost of merchandises	148.698,30
	Cost of raw materials	7.995.624,28
	Services from third parties	4.916.072,52
	Salaries and wages	1.355.835,92
	Social security contributions	537,52
	Other salary related charges	430.819,86
	Depreciation	392.247,16
	Adjustments on asset values, other than depreciation	280.204,71
	Taxes	59.684,99
	Other operating costs	7.500,00
	Interest paid	601.757,19
	Extraordinary losses	63.172,00
	Income tax	0,00
	Net income	160.765,32
	Total	16.412.919,77
Revenues	Sales of merchandise	969.200,98
	Sales of products	12.956.759,99
	Services rendered	1.355.819,51
	Works for the entity	36.058,90
	Supplementary revenues	84.212,28

	Other operating revenues	93.857,14
	Financial income from equity holdings	121.825,51
	Interest received	33.157,83
	Extraordinary gains	762.027,63
	Total	16.412.919,77
Income	Operating income	-91.316,46
	Financial income	-446.773,85
	Extraordinary income	698.855,63
	Income before tax	160.765,32
	Net income	160.765,32

As Table 1 shows, the operating income is negative (€ -91,316,46), as well as the financial income (€ -446.773,85). Net income (€+160.765,32) is thus obtained by an important (positive) contribution of extraordinary or non-recurrent items (+698.855,63) that compensates for the negative operating and financial income. From this simple example, two conclusions can be drawn.

The first one, on the company's operating performance, which reported a loss. This is not, in general, a positive feature and usually requires better management of operating revenues and costs. Second, the composition and breakdown of accounts "Extraordinary losses" and "Extraordinary gains" is necessary to enable users of financial statements forming a detailed view of what is included in extraordinary income. In this particular case, extraordinary items are very relevant (even decisive) to a positive net income. Thus, a critical analysis of extraordinary gains and losses is a crucial step for a financial analyst. Breaking down, for example, the economic facts recorded in Account 69 - "Extraordinary costs and losses" of POC is a helpful exercise. It included the following subaccounts:
69- Extraordinary costs and losses
691 Donations
692 Uncollectible debts
693 Loss on inventory (theft, mishandling)
694 Capital losses on fixed assets
695 Fines and penalties
696 Extraordinary amortizations of assets
697 Losses from previous years
698 Other extraordinary losses

As shown in POC´s account 69, it includes the registration of facts concerning events typically unusual or non-recurring in the regular economic life of companies. In fact, phenomena such as uncollectible debts, inventory theft, losses on investments (financial, tangible and intangible), fines, and other of similar nature do not affect the operating income. If extraordinary income is seen as derived from operations outside the ordinary or regular course of business activity, then this option inserted in POC was, in our view, perfectly adequate. Why did the new regime (Sistema de Normalização Contabilística - SNC) change it?

For a first glimpse of the issue, let us see Table 2, which presents the income statement prepared by an entity subjected to this new regime (SNC).

Table 2. Income statement by nature (SNC) - in euro

Indicators	Value
Sales and services rendered	13.960.172,10
Subsidies	0,00
Gains/losses on financial investments	-1.290.386,11
Works for the entity	2.512,95
Cost of raw materials	7.549.973,63
Services provided by third parties	4.733.702,19
Personal costs	1.947.779,24
Impairment losses on trade debts	1.822.413,80
Provisions	644.470,71
Fair value adjustments	0,00
Other revenues and gains	3.814.443,12
Other expense and losses	1.436.666,81
EBITDA	-1.648.264,32
Depreciation	428.148,05
EBIT (Operating profit)	-2.076.412,37
Interest received	0,00
Interest paid	401.979,14
EBT	-2.478.391,51
Corporate income tax	16.665,04
Net profit	-2.495.056,55

Quite important differences emerge from Table 2 between this new type of income statement and the one adopted by POC. One of the most critical is how net income is originated. Indeed, EBITDA (Earnings before depreciation, taxes and financing costs) is the first of several types of profits to emerge (-1,648,264.32). Then, depreciation, amortization, and some impairment are subtracted to determine EBIT or operating income (-2,076,412.37). Thus, from the outset, if we look into accounts "Other revenues and gains" (3,814,443.12) and "Other expenses and losses" (1,436,666.81) it easily follows they significantly impact EBIT. That is, residual items of revenue and costs have a highly material impact on operating income. However, given their designation, it is worthwhile to dissect the true nature of these, supposedly, *residual* revenues and expenses.

Taking a closer look into account 68- "Other expenses and losses", shown in the SNC plan of accounts, the following subaccounts are found:

68 - Other expenses and losses
681 Taxes
682 Financial discounts
683 Uncollectible debts
684 Loss on inventory (theft, mishandling)
685 Expenses and losses on subsidiaries (e.g.; capital losses)
686 Expenses and losses in other financial investments (e.g.; capital losses)
687 Expenses and losses in fixed assets (e.g.; capital losses)
688 Other
6881 Losses from previous years
6882 Donations

It is, in our view, quite reasonable to argue that items such as capital losses, uncollectible debts or inventory theft will be events of a usually nonrecurring nature, or outside the core activities of a company (Martins, 2012; Mulford & Comiskey, 2002). The scope of accounts 68 (and 78, which is the reverse, for the revenue side) of the SNC came, in our view, to include phenomena that, given the informational needs of users, would be better disclosed separately and not amalgamated on EBIT. The nature of operating incomes is now more uncertain, fuzzy and exhibits a lower quality than the notion adopted by POC. How did the new Portuguese accounting system opted for a concept of operating income that includes items that are clearly extraordinary, or non-recurrent, in nature?

The reason most commonly given for the new concept of operating income in the SNC is that international accounting standards do not include an explicit definition of operating income (IAASA, 2013). In addition, it is ventured that events such as sales of assets, uncollectible debts, donations, impairments, to mention just a few, are also part of the economic life of the organizations, and thus not extraordinary or accidental. Some of them (e.g. divestitures) stem from the very will of managers and, therefore, have no extraordinary nature, in the sense, they happen outside the regular flow of a company´s controlled events. Following this perspective, the concept of operating income should not leave out events that, albeit not recurring or regular, fall within the scope of management decision making.

We are faced with two perspectives: one (POC) which placed great emphasis on the separation between operational, financial and extraordinary phenomena. Other (SNC) that abandoned the concept of extraordinary results, and seems to adopt the view that business entities will have no such thing as "extraordinary" items. That means all phenomena or facts that deserve accounting recognition would follow from the deliberate purpose of management, or to imponderables that a company is normally subjected, for simply developing its activity in the continuous flow of economic environment.

For example a cost related to a bad trade debt would not be extraordinary because exposure to clients who do not meet their debts is a situation, perhaps occasional but potentially inevitable, that affects a large majority of companies selling goods or services. An impairment loss in a tangible asset is non-recurring in nature but comes from economic phenomena to which a company is exposed, like sudden technological changes, which are not totally strange or absolutely separate from the normal operations. Given these conflicting views about the nature of operating income, let us now digress on the literature related to this topic.

Discussion and implications

The accounting and corporate finance literature has dealt thoroughly the issue of quality and relevance of financial information disclosed by companies and how the accounting standards to influence (Libby, Libby & Short, 2009; Ross, Westerfield, Jaffe & Jordan, 2010). The analysis and the centrality of "operating income" have been suggested by several authors (Libby et al., 2009; Mulford & Comiskey, 2002; Neves, 2012). In this context, Baker, Lembke and King (1993) argue that operating revenues and expenses arise from on-going major central operations. Gains and losses that are "peripheral" or "incidental" should be classified as non-operating. In the context of a company providing health services, Baker et al. stress that the non-operating gains result from sources other than the provision of services to patients and related activities. Non-operating gains should include, among others, investment income, and gains in real estate transactions. The authors argue that because operating income does not include the effects of remote or peripheral operations of companies then if they occur, their effects should be disclosed in non-operating items.

Libby et al. (2009) sustain that "operating activities are the central focus of the business". Again, operating activities are defined as the normal, regular or primary focus of a company. The impact of other activities or transactions should not integrate the operating income. In a financial analysis perspective, Neves (2012) and Ross et al. (2010) argue that, in the income statement, operating elements should relate to normal or recurrent operations. On the other hand, according to Neves, the definition of extraordinary elements would include non-standard transactions or facts, outside the ordinary scope of the business. The same author underlines that the income statement should be developed in order to determine the operating income, isolating the accidental and unusual components of profits. Thus, special or unusual items, discontinued operations, and extraordinary items should be separately identified and left out of operating income.

For a financial analyst, it is important to grasp operating income and items that are recurrent in nature. Thus, any event having a nonrecurring nature should be reclassified in extraordinary income. The detailed identification of these situations - whether impairment charges, extraordinary provisions, gains and losses resulting from non-recurring transactions, including the purchase and sale of fixed assets, discontinuity of business segments, forgiveness of debts - should be disclosed as not affecting in operating income.

The author notes that in the Portuguese SNC, the account “68 Other expenses and losses” includes, as a miscellaneous set:
- Sub-accounts related to operating activities (e.g., taxes, inventory gifts to clients)
- Sub-accounts related extraordinary or non-recurrent items (e.g., capital losses, write-offs)
- Sub-accounts related to financial events (e.g., financial discounts)

A financial analyst should develop a previous reclassification and segregation of these components, before assessing the true or effective operational performance of an entity. If, in the finance literature, a strong line argues for segregating several components that converge in the net income, why did the SNC pursued a path that departed from this analytical trend? In other words, why amalgamating in operating income a wide range of phenomena while introducing an IAS-based accounting system, in Portugal? A first reason stems from the fact that international accounting standards do not expressly provide a clear dividing line between operating and extraordinary items. That is, professionals who prepare financial statements have some leeway with regard to value judgments on how to break down revenues and expenses. Nonetheless, in our view, this is not a definitive argument. For example, In Ireland, IAASA (2013, p.7) mentions that International Accounting Standard (IAS) 7 - "Statement of cash flows" establishes that "operating activities are the main revenue-producing activities of the entity and other activities which are not investing or financing activities" . The statement of cash flows is quite clear in separating between operational activities and non-operating events. IAASA (2013, p.10) also states that when financial statements issuers present items outside of the area of operating activities, the expectation is that they will provide detailed explanations.

Their analysis of what constitutes 'operating activity' and the basis upon which amounts affected operating income is highly relevant. Given the importance placed on "operating profit" in financial reports, and the degree of judgment required in the classification of items, issuers should consider whether it is necessary to include a disclosure explaining value judgments. International standards and accounting literature are open to a non-rigid approach, allowing for the separation of non-recurring or unusual items. The Portuguese option cannot be seen as flowing from a mandatory IAS line of amalgamating ordinary and extraordinary items in the EBIT computation.

Some entities, in search of a certain uniformity of criteria, sought to define rules for the selection and presentation of designated "exceptional items". The following excerpts (IAASA, 2013, p.8) are also illustrative examples:
"In presenting the Income Statement, entities:
-are not prevented from including "exceptional" items in the Income Statement
-should select a form of presentation for "exceptional items" (e.g. disclosure in the accompanying explanatory notes, disclosure as a separate line item on the face of the Income Statement or presentation as a separate column on the face of the Income Statement)".

The SNC could have adopted a more nuanced view, instead of eliminating extraordinary or non-recurrent items and include them in operating profit. Personally, we are not convinced of the advantage of this new option, in comparison with what was established in POC. And, to discuss the potential negative consequences of what we see as lower quality of financial information, let us turn to the next topic, where some important issues are analyzed.

Article 63 of the Corporate Income Tax (CIT), on transfer pricing, establishes that:
"1 - In commercial operations, including transactions of goods or services, as well as financial transactions carried out by a firm and any other entity, which is in a situation of a special relationship with the former, terms and conditions substantially identical to those contracted between independent entities, in similar transactions, should be practiced.
2 - The taxpayer must adopt, for the determination of terms and conditions that would normally be agreed between independent entities, the method ensuring the highest degree of comparability between performed operations and substantially identical transactions under normal market conditions."

Additionally, Regulation C-1446/2001, closely following OECD Guidelines, details methods that must be used in TP. Its article 10 reads as follows:
"The Net margin method
1 - The net margin method is based on the calculation of the net margin obtained by a taxpayer in related party transactions, with reference to the net margin obtained in similar independent operations performed by independent entities.

2 - The net margin is computed by reference to an appropriate indicator in accordance with the circumstances, characteristics and the nature of the activity, which may be represented by sales, costs, assets, or another relevant variable."

The OECD Guidelines (OECD, 2010, p.83), when discussing the transactional net margin method, underline that, as a matter of principle, "only those items that (a) directly or indirectly report to the controlled transaction under analysis and (b) are of an operating nature, should be taken into account in the determination of the net profit indicator for the application of the transactional net margin method". This brief legal overview regarding TP in Portugal is enough to highlight the importance of an adequate and economically sustained notion of operating income. When margin methods are used this is a crucial issue for firms and tax authorities.

Tax auditing is often preceded by an in-house analysis, performed by the tax authorities (TA) services, using companies´ tax returns. When dealing with TP issues, and the net margin method is adopted by companies to prove they are respecting the arm's length principle, certain indicators such as: operating income /assets, operating income /sales, operating income / expenses are used as financial ratios considered being proxies to effective margins generated by the core business activity. At a conceptual level, two companies can have different operating performances and, nonetheless, their reported operating income being similar if computed on the basis of SNC rules.

Company A, for example, the independent party, shows an EBIT of 10 million and a net margin of 10%. Company B, the tested party for TP purposes, has a recurrent EBIT of 3 million, and its net margin could be significantly below the interquartile range used in TP tax analysis. Then, if company B amalgamates in account 78- "Other operating revenues" the impact of financial discounts, capital gains, etc., accounting EBIT can reach 10 million and be inside the acceptable margin range. A superficial comparison of accounting numbers is, in our view, misleading, because operating margins are not comparable without adjustments.

On a more concrete and usual situation, suppose a firm ALFA has a related party (BETA) that is a contract manufacturer. BETA has submitted, in year t, to the Portuguese tax authorities a TP file, where the net margin method is adopted. The profit level indicator is net cost plus margin (NCPM) = operating income / expenses

Taking into account that: (i) functional analysis of BETA has shown that the company is characterized by being a contract manufacturer, whose purpose lies mainly in efficiently fulfilling production schedules placed by ALFA (the parent); and (ii) BETA does not perform functions closely related to the marketing and distribution of manufactured products, it was understood that the use of NCPM is appropriate to the case. Considering that, taken from a sample of comparable companies, NCPM presents the following values, for year t:

Table 3. Interquartile range in TP sample

Minimum	1st quartile	median	3rd quartile	maximum
-1%	2,2%	4%	5,5%	9%

NCPM for BETA, in year t, is 2,5%. However, suppose that in the same year, BETA booked a reversion for a previously recorded provision. Without that specific reversion (revenue) NCPM would be -3%. If BETA considered, as it formally could within SNC´s rules, that the reversion is included in operating income, and the tax auditor makes an adjustment, arguing that a reversion of a provision is not recurrent or normal in the ordinary course of business, then only tax courts can decide on the right course of action.

Recalling what we mentioned in section 4 of this paper about the change of paradigm between POC and SNC, about the elimination (by SNC) of extraordinary items, and the content of accounts 68 and 78 of SNC, it is easily anticipated that a detailed tax audit could challenge the "true" amount of EBIT, given the emphasis on operating items made by OECD´s Guidelines.

If one looks into issues like capital gains/losses, financial discounts, inventory theft, fixed assets impairment charges, that in SNC´s accounting system impact operating revenue, and thus TP operating margin level indicators, it is easy to see that between managers, auditors and tax authorities, a significant amount of tension can develop in figuring out what adjustments should be made to reveal the appropriate level of operating margins.

For tax managers, tax consultants and tax auditors, the new accounting environment (SNC) is thus more uncertain, in the sense that TP compliance can be riskier. If one adds that tax courts are, in many cases, not very prone to enter the intricacies of accounting definitions, a riskier environment can be probably detected in Portugal. These risks can be mitigated by an enlightened intervention of internal and external auditors, alerting management to sensible accounting choices and disclosures, mainly by adopting a proper definition of operating items for TP purposes. In this sense, the POC based accounting system, by separating extraordinary items, produced an accounting approximation more attuned to TP needs and presented companies with lower compliance risks than the one incorporated in SNC.

A legal question also arises, adding to risky sources of litigation. Neither the Portuguese CIT Code nor TP regulations define the precise algebraic formula to compute margin methods. The OECD Guidelines on TP, a primary doctrinaire source, describe several profit level indicators, in the context of margin methods. The Guidelines underline the operating nature of variables that should be included in these indicators. Thus, the question emerges: is the EBIT computed by SNC rules an unchallengeable operating variable to be accepted by tax courts in TP litigation? In our view, that is not a closed case. If the tax law does not provide a definition of operating income, and given trends observed in accounting and financial literature, and also in OECD´s Guidelines, the question leaves room for interpretation. A gray area of potential divergent views between firms and tax auditors can increase compliance costs of taxation for Portuguese firms using TP.

Conclusion

The comparable uncontrolled price is a cornerstone in transfer pricing analysis for tax purposes. While all comparability factors should be considered, the most important are the similarity of products, contract terms, and economic/ market conditions. However, in many real-life situations, the uncontrolled market prices are not observable.

Consequently, using margins, taken from samples of comparable firms, is a regular phenomenon in TP compliance by firms.

Margins are derived from accounting numbers, with a special emphasis in operating expenses and revenues. In Portugal, in recent times, we are faced with two perspectives: one (POC) which placed great emphasis on the separation between operational, financial and extraordinary phenomena. The other (SNC) that abandoned the concept of extraordinary results, and seems to adopt the view that business entities will have no such thing as "extraordinary" items. That means all phenomena or facts that deserve accounting records would be due to the deliberate purpose of managers, or to imponderables that a company is normally subjected, for simply developing its activity in the continuous flow of economic environment. If, in the literature, a marked line arguing for segregating several components that converge in the net income, why did the SNC, which is in line with international accounting standards, pursued a path that departed from this analytical trend? The SNC could have adopted a more nuanced view instead of eliminating extraordinary or non-recurrent items and include them in operating profit. Personally, we are not convinced of the superiority of this new option, in comparison with what was established in POC. For tax managers, tax consultants and tax auditors, the new accounting environment is more uncertain, in the sense that TP compliance can be riskier. If one adds to this picture the fact that courts are in many cases, not very prone to enter the intricacies of accounting definitions, a riskier environment can be detected in Portugal.

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