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COVID-19

Impact on transfer pricing policies of multinational companies

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Introduction

Introduction

- Outbreak of COVID-19 (coronavirus) has become one of the largest threats to the global economy in history
- As a result, the change in economic circumstances will result in significant consequences for TP policies applied by multinational groups
- Multinationals, operating in different countries and markets, are currently forced to promptly adapt their business models in order to minimize the economic impact of the pandemic, as well as to ensure the normal operation of their business

Introduction

- The spread of the coronavirus is expected to lead to a detrimental effect on:
  - The value chain of multinational groups
  - The sales generated
  - The value of tangible and intangible assets
  - The EBIT of most multinationals
  - The cash flow of companies belonging to multinational groups

Introduction

- Reconsidering the existing TP system in order to adapt to the coronacrisis:
  - A crisis implies rapid changes with which current TP systems and methods have difficulties to cope with and therefore may lead to unacceptable results
  - Multinational groups should assess whether it is necessary to carry out a review of the pricing strategies, the location of subsidiaries, cost structures and intercompany contracts, as well as conducting a business restructuring to manage tax and TP policies
  - Groups should look whether reasonable arrangements to align TP policies between related parties in the context of a global pandemic are needed, as well as look to conduct targeted TP adjustments to align the functions of the group entities with the present economic environment
  - The development of the documentation needs to cope with potential controls set by tax authorities (i.e. the preparation of supporting documentation needed to justify the reasonable allocation of profits/losses to subsidiaries during the pandemic)
  - A review of the policies should be adopted with regard to intercompany financing (impact on credit rating, new financial flows (factoring, guarantees, waivers,…), revised payment conditions, etc.)

Key areas of the impact of the coronacrisis for multinationals

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- The coronacrisis has a significant impact on the following areas consecutively:
  - Liquidity
  - Operations
  - People
  - TP policy
  - Legal (contracts, documentation, APAs)

Key issues application TP policy

- Key questions with respect to transfer pricing:
  - Have the transfer pricing aspects of treasury matters been considered?
  - Could workers performing key-functions in new places affect the taxing rights allocated to group companies in the international supply chain?
  - Should closed down or temporarily paused operations be remunerated in the same way as when they were operational?
  - Should targeted methods of pricing (e.g. distributor models, C+ services) be reviewed in these extraordinary times ?
  - If functions, risks, assets are transferred overseas to consolidate business positions, has the transfer pricing impact been considered?

Disruption and the Arm's Length Principle

Arm‘s length principle

Benchmark:

Conditions agreed upon between

independent third parties

in the course of

comparable transactions

under

similar market conditions and situations

Comparability analysis

1. Identification of the economic and financial relationships among the dependent parties
2. Identification of the conditions and economically relevant environment
3. Comparison of the tested transaction with third party transactions

Comparability factors

- Contractual terms and conditions
- Functions, assets and risks
- Type of product or type of service
- Economic environment
- Business strategy

Disruption

Limits and Risks of the Classical Models and Methods During a crisis

Limits and Risks of the Classical Models during a crisis

- Given that the classical models are structured around:
  - Various local profit centers with routine activities and therefore with guaranteed low profits; and
  - One principal entity with non routine activities/IP ownership with potentially high profits;
  - The assumption of a "profit-generating" business and growing economy

➡ *The profit allocation within the group is not meant to be changed as it is difficult to defend a modification of the remuneration towards the local routine entities and its local tax authorities (i.e. little flexibility)*

Limits and Risks of the Classical Models during a crisis

- The application of those models during the recession may imply that:

  - The Principal entity is accumulating substantial losses
  - The local entities are taxed on their routine profits at high tax rates
  - Cash is generated at wrong locations

➡ *Sharp increase of the effective tax rate (unjustified tax burden), negative impact on financing structure*

➡ *Increased risk of transfer pricing audit as the methodology cannot be properly applied or the principal is incurring huge losses*

Limits and Risks of the Classical Models during a crisis

- The disequilibrium observed is due to a transition period during which companies are facing a sudden drop of the demand on the market

- The unforeseen significant development and the rapidly decreasing revenues are difficultly tackled by the routine entities with a higher proportion of fixed assets

- Contractual arrangements do not take into account the consequences of exceptional recession periods

Limits and Risks of the Classical Methods during a crisis

- Similarly, all the methods are based on the assumption that “profits” are made and assume reliable cost and sales forecasts
  - Cost Plus: sudden change in production capacity utilization will lead to unexpected losses to be allocated
  - Resale Price Margin: change in market volumes below plan will lead to insufficient gross margins to cover operating costs

➡ *In normal circumstances : this is often solved by means of year-end adjustments but might be difficult or impossible during recession*

Limits and Risks of the Classical Benchmarks during a crisis

- The benchmarks used for the determination of the level of remuneration are based on comparable data referring to prior years (i.e. today : 2016-2019, meaning positive economic conditions) and are not a real time comparison reflecting the current economic downturn
- Rewards of applied transfer pricing methods for low-risk routine activities are expected to decrease as the risk-free remuneration on financial markets declines in times of recession

➡ *The application of the current transfer pricing benchmark methods used have therefore a theoretical economical limit*

Envisaged Solutions and Opportunities

Envisaged Solutions and Opportunities
Solutions

- **Reflect the new economic environment in your transfer pricing documentation**
  - Background information (market, functional analysis)
    - Industry Analysis:
      - How does the industry react to the crisis (e.g. consolidation, non-going concern, focus on core business etc.)?
      - What are the new Key Success Factors of the Industry?
    - Company Analysis:
      - How is the group handling the crisis (e.g. selling non-strategic business divisions, reducing personnel, shutting down part of the business)?
      - What is the strategy of the group for the future?

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- **Economic Analysis: Modification of the use of the transfer pricing methods**
  - CUP Method:
    - Search for comparable agreements giving a particular attention to the renegotiation clauses in the comparability criteria
    - All market data used is generally up to date (e.g. interest rates, financial transactions data, trading activity data)

➡ *The CUP method may even more than else be the most defendable method to be used (if possible) as it reflects the actual exceptional market conditions more accurate*

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- **Economic Analysis: Modification of the use of the transfer pricing methods (cont.)**
  - Profit based methods (Resale Minus, Cost Plus and TNMM):
    - *Problem* : documentation is based on benchmarks still referring to years of economic growth (i.e. 2016-2019)
      - Include loss making companies in the set of comparable companies
      - Expand the period under consideration from 3 (or 5) years up to e.g. 10 years to include the full business cycle of the industry concerned
      - Make a corroborative benchmarking analysis using another recession period as a reference and compare the results (e.g. Include data of FY2008-2009 reflecting a period of economic downturn)

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- **Economic Analysis: Modification of the use of the transfer pricing methods (cont.)**
  - Profit based methods (cont.):
    - Adjust the results of the comparable companies based on a macroeconomic indicator (e.g. value added per person employed)
    - Chose another point in the interquartile range
    - Defend a “cost minus” approach to share the general decline of the activity with routine entities

➡ *The approach may only be accepted if the losses incurred through the cost minus are compensated by a future benefit (pay-off)*

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- **Economic Analysis: Modification of the use of the transfer pricing methods (cont.)**
  - <u>“Loss split” method: </u>foresee an appropriate split based on an analysis of the facts and risks generating those losses and the exposure of each entity to those risks (both economically and legally) taking into account the limits of the macro-economic theories
  - Implement variable remuneration schemes
  - Envisaging thresholds for renegotiation of the conditions

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- **Contractual arrangements:**
  - Draft new contracts versus appendix to existing agreements
  - Anticipate impact of future market conditions on rights and obligations of parties involved as would be agreed on between independent parties
  - Clearly document motivation/economic rationale for change of contractual arrangements

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- **Transfer pricing documentation/policy**

  - TP Policy for the future: first review budgets and financial plans for FY2020 and future years and then revise TP policy accordingly

  - As ex-post testing may not provide supportive results, companies should ex-ante prepare strong documentation to defend arm's length character of crisis adjustments made

Envisaged Solutions and Opportunities *Solutions*

- **Relation with tax authorities**

  – Increased risk for transfer pricing audits during recession:

    Tax authorities where routine entities are located may be reluctant to accept modifications of the transfer pricing methodology in place for the following reasons:

    - The model was negotiated in view of ensuring a limited taxable basis for the routine activities
    - The routine entity is only bearing limited risk and its profitability should therefore not vary significantly (and not be loss making!)

Envisaged Solutions and Opportunities
Solutions

- **Relation with tax authorities**

  – Proactively renegotiate the APA's with the tax authorities, when necessary, may be better perceived than awaiting a transfer pricing audit keeping in mind that:

    - The crisis is still a reality in all tax authorities' mind; and
    - You can temporary take advantage of the future favorable trends that will be observed in the comparable companies results (i.e. opposite situation than the one observed today)

Envisaged Solutions and Opportunities
Opportunities

- The crisis offers opportunities to set-up a Principal structure as
  - It will limit the discussions about exit issues in the local countries where functions and risks are stripped
  - Based on Chapter IX of the OECD Guidelines on Business restructurings, the possible alternatives available for local production or distribution entities in times of recession are much lower than in times of booming economy and therefore will limit indemnifications between unrelated parties

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