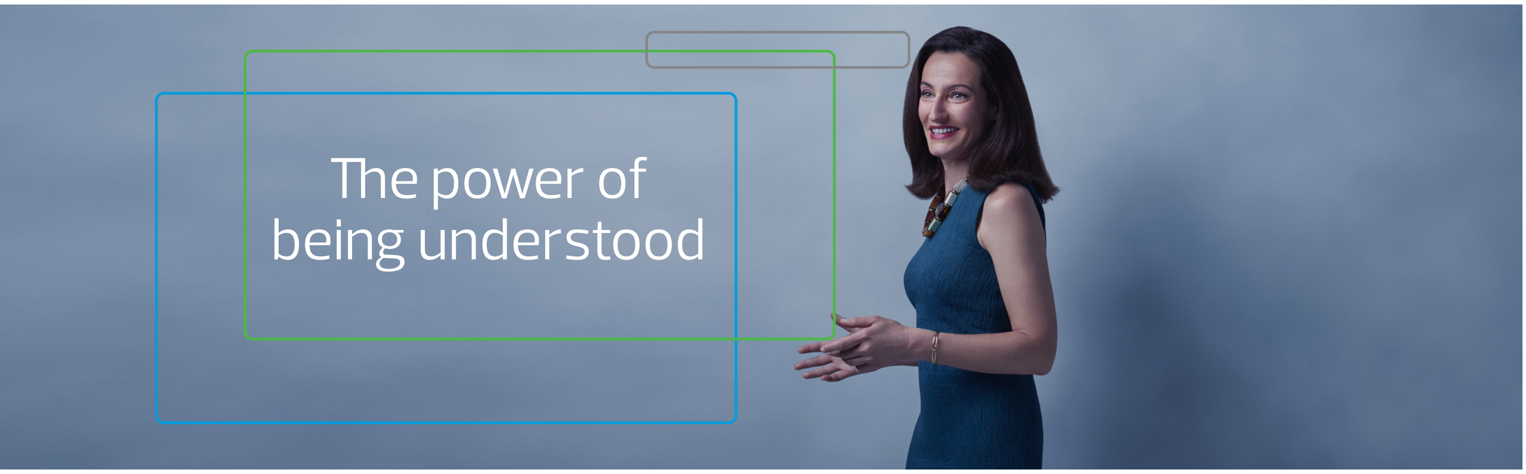

COVID-19 AND TRANSFER PRICING: YEAR-END ADJUSTMENTS

The Covid-19 pandemic, unprecedented economic downturn and widespread uncertainty are a few of the global themes that have characterized 2020. We hope that this article can serve as a point of departure to help companies address the uncertainty in their businesses which has been caused by the pandemic and economic downturn.

The Covid-19 pandemic and resultant economic downturn have not only taken a toll on business and consumers, but has also hit revenue authorities where it hurts most; their pockets. Tax revenue collection shortfalls coupled with the implementation of emergency Corona support measures have put severe strain on government budgets . To alleviate some of the pressure, we expect to see an uptick in transfer pricing audit activity as revenue authorities seek to curb revenue collection shortfalls by imposing lucrative transfer pricing adjustments. With financial year end for many companies rapidly approaching, now is the time for businesses to review their current transfer pricing policy against the backdrop of actions they have taken over the course of 2020 to address the Covid-19 imposed stress on their business. Failure to do so could result in costly transfer pricing adjustments.

Every business is impacted by and responds differently to external stress. Unfortunately, it is not possible to address all of these issues in one article. Accordingly, the following represents only a sample of some of the issues experienced and actions which businesses may have already taken, or should consider taking, in order to alleviate stress caused by the pandemic and avoid costly transfer pricing adjustments:

1. Changes in profitability and the resultant impact on current transfer pricing policy.
2. Impact of the Covid-19 pandemic on advance pricing agreements (APAs).
3. Transfer pricing treatment of government subsidies.
4. Business restructurings.
5. Intragroup loans.

Changes in profitability and the resultant impact on current transfer pricing policy

Many businesses may have experienced a substantial reduction in profitability as a result of the Covid-19 pandemic. This reduction in profitability was particularly pronounced as companies experienced both supply and demand pressures as a result of the containment measures.

Changes in profitability are particularly relevant for multinational enterprises (MNEs) which utilize structures that contain limited risk distributors (LRDs), contract manufacturers (CMs) or routine service providers. This is because they may be forced to maintain significant cost overheads whilst dealing with unutilized production capacity (in the case of contract manufacturers) and declining sales volume (in the case of limited risk distributors). Moreover, routine service providers, LRDs and CMs are entitled to a routine remuneration, even in circumstances where they are currently loss-making due to Covid-19. In such a scenario, MNEs need to consider how such losses should be allocated between group entities.

In this respect, MNEs should consider whether it is more appropriate to remunerate group entities based either on a highly reduced margin, at cost or alternatively to re-allocate losses resulting from the decreased profitability amongst other group entities. In order to avoid a costly transfer pricing adjustment, businesses should conduct a comprehensive value chain analysis in order to obtain a clear overview of:

- Where strategic decisions are taken within the group;
- Where non-strategic activities (i.e. "routine", "implementation", "execution" functions) are performed;
- How losses should be allocated within the group value chain.

Depending on the facts and circumstances, it may also be necessary to perform new benchmarking studies in order to substantiate the reduced profitability margin.

Impact of the Covid-19 pandemic on APAs

APAs provide companies with advance certainty that their method for determining the arm's length price of cross-border transactions between associated enterprises will be accepted by the relevant revenue authority. However, revenue authorities are only bound by the terms of the APA to the extent that the taxpayer complies with or fulfils certain terms and conditions (called critical assumptions).

MNEs need to consider the impact of Covid-19 on APAs from at least three perspectives:

1. They should consider if any of the steps taken to mitigate losses impacts the critical assumptions in their current APAs. If any of the critical assumptions no longer hold true, companies should be proactive and approach the relevant competent authority and propose a renegotiation of the critical assumptions and comparables. Additionally, companies should review the terms of their APAs to check whether they are permitted to make certain financial adjustments due to unforeseen events.
2. Companies which have started the APA application process should consider whether it is still in their best interest to continue with the application in its current form. The short and medium-term economic outlook is still extremely uncertain and there is significant risk that the critical assumptions agreed upon today, may not hold true for the duration of the APAs effective life.
3. Companies with APAs should consider whether it is in their best interests to continue to remain bound by the agreement. Changes in economic circumstances and the critical assumptions may be so immense that it is preferable to withdraw from the APA. Rules surrounding withdrawal from an APA differs between jurisdictions.

Whilst specifics may differ from country-to-country, countries which follow the guidance on APAs as set out by the Organization for Economic Co-operation and Development (OECD) in the Transfer Pricing Guidelines generally have the opinion that extraordinary scenarios (such as the Covid-19 pandemic) materially impact the critical assumptions, thereby necessitating a re-negotiation of the terms of the APA.Generally, countries which do not follow this specific guidance on APAs, do not hold the same opinion meaning that the critical assumptions are not necessarily impacted. Companies need to be proactive and seek clarity from the competent authorities with which they have APAs, in order to get ahead of any transfer pricing adjustments stemming from non-adherence with the critical assumptions.

Transfer pricing treatment of government subsidies

Governments around the world have rolled out a suite of relief and subsidy programs designed to help businesses stay afloat during these challenging times. Whilst these subsidies may have come as welcome relief for many businesses, it is imperative that companies adopt the correct tax treatment of these receipts in order to ensure that their current transfer pricing policy continues to deliver arm's length prices. In this respect, the core question which businesses need to consider is whether a third party would factor in the receipt of government subsidies when setting their prices.

The correct treatment of government subsidies depends on the nature of the subsidy and the rules of the country in question. The issue is particularly relevant for entities which are remunerated on the basis of costs incurred plus an arm's length mark-up. The core issue to consider is whether such an entity should allocate the subsidy against its cost base, thereby reducing the cost base on which the arm's length mark-up is applied, or, whether the subsidy should not be netted against the cost base and instead be regarded as income in the hands of the receiving entity.

For example, in the Netherlands it is assumed that subsidies are deductible from the cost base if there is a direct connection between the subsidy and the provision of the product or service, and compensation is granted in the form of a discount on or a contribution to the costs. On the other hand, subsidies which are awarded to the entity as such and have no causal connection with the activity to which a cost-related remuneration is attributed are not deductible from the cost base.

Companies need to consider the nature of the subsidy as well as the applicable rules to determine its correct treatment. Failure to do so could result in a costly transfer pricing adjustment as well as an embarrassing public scandal if the company is seen to be misusing or abusing Covid-19 relief funds.

Business restructurings

In response to the sudden upheaval of their global business operations, many MNEs have already undertaken business restructuring projects and many more will do so in the coming months. Global supply chains have been reorganized and functions, assets and risks have been re-allocated to account for the new business realities of a post-Covid world.

The potential impact of business restructurings varies widely based on the particular facts and circumstances at hand and range from potential exit charges to the recharacterization of entities thereby necessitating an updated transfer pricing policy.

MNEs should undertake a comprehensive value chain analysis (see above) to identify and manage their transfer pricing risks which may have arisen as a result of business restructuring projects. Failure to do so could result in an expensive transfer pricing adjustment. Performing a value chain analysis provides the added benefit of identifying opportunities to manage the groups effective tax rate and improve the group's competitive advantage in the marketplace.

Intragroup loans

Since the start of the pandemic, MNEs have found themselves in the midst of a liquidity crisis with group subsidiaries calling for financial assistance in the form of intra-group loans where sources of external finance have dried up.

Shortly before the scale of the Covid-19 pandemic became apparent, the OECD finalized Chapter X of the OECD Transfer Pricing Guidelines. Chapter X marks the first time dedicated guidance on the transfer pricing of financial transactions has been given by the OECD.

For example, one of the focus areas of the new Chapter X relates to lenders lacking the necessary people functions to manage and control financial risks. MNEs must take note that intragroup lenders may be entitled to no more than a risk-free rate of return in respect of a loan granted to a group entity, where the lending entity does not possess the people functions necessary to manage and control the financial risks associated with the loan in question.

The result is that any remaining interest income (after allocation of the risk-free rate of return to the lender) is allocable to the group entity which exercises the necessary control functions over the loan.

In order to prevent a transfer pricing adjustment due to a failure to align their financing activities with the new guidance in Chapter X of the OECD Transfer Pricing Guidelines, MNEs must scrutinize all intercompany financing transactions they have undertaken during 2020 to ensure complete alignment with the newly updated guidance.

Conclusion

The Covid-19 pandemic and resultant economic downturn has upended the global business environment and necessitated a shake-up in the way that MNE tax directors approach their transfer pricing policies and strategies. As financial year-end approaches and businesses begin preparation of their financial accounts, there is no better time to consider the transfer pricing implication of actions taken in an effort to combat shortfalls in profitability, liquidity issues and disruptions to global supply chains. If you have any questions related to the issues raised in this article, please contact Juan Dosal at JDosal@rsmnl.nl.

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