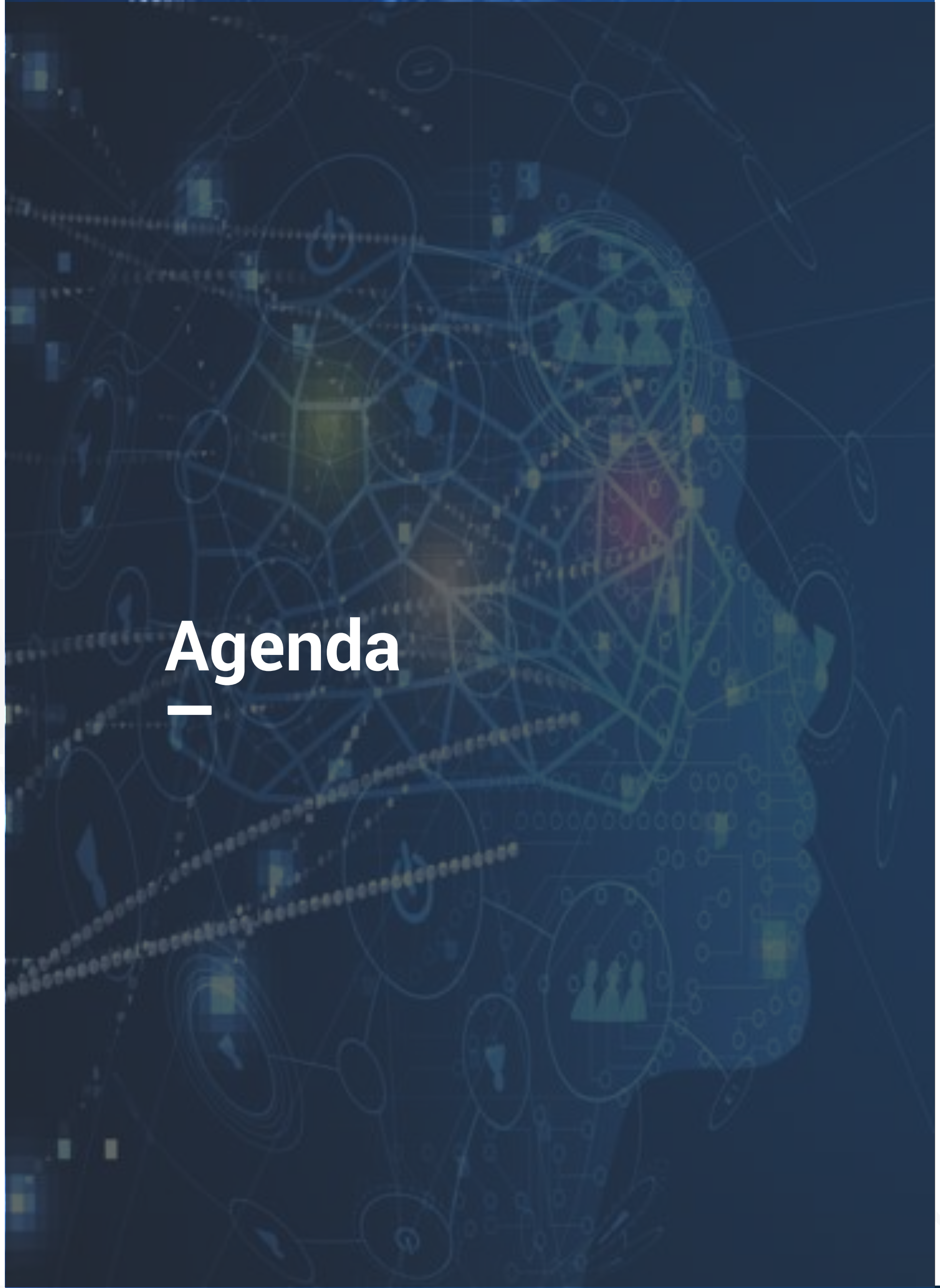
FY 2020 Transfer Pricing Documentation- how to deal with the Covid-19 impact?

Piergiorgio Valente; Federico Vincenti, Valente Associati GEB Partners-TPA Global Member
Yariv Ben Dov, TPA Global Member
Steef Huibregtse, TPA Global
Maria Grigoryeva, TPA Global

November 4, 2020



- OECD and Country References
- What would third parties do?
- Measuring covid-19 impacts-sensitivity analysis
- Change of business model
- Change of transfer pricing system
- Change of benchmarking used

OECD Transfer Pricing Guidelines

- Par. 1,3 For tax purposes the profits of associated enterprises may be adjusted…… an appropriate adjustment is achieved by establishing the conditions of the commercial and financial relations that they would expect to find between independent enterprises in comparable transactions under comparable circumstances.
- Par. 1,5 Enterprises respond to economic situations arising from market conditions, in their relations with both third parties and associated enterprises.
- Par. 1,36 Economically relevant characteristics or comparability factors: (i) the contractual terms of the transaction; (ii)The functions performed by each of the parties to the transaction; (iii)the characteristics of property transferred or services provided; (iv)the economic circumstances of the parties and of the market; (v)the business strategies pursued by the parties
- Par. 1,43 the analysis of economically relevant characteristics in all five categories provides evidence of the actual conduct of the associated enterprises.
- Par. 1,45 If the characteristics of the transaction that are economically relevant are inconsistent with the written contract between the associated enterprises, the actual transaction should generally be delineated for purposes of the transfer pricing analysis in accordance with the characteristics of the transaction reflected in the conduct of the parties.
- Par. 1,49 Where no written terms exist, the actual transaction would need to be deduced from the evidence of actual conduct provided by identifying the economically relevant characteristics of the transaction.

Local Guidance-Australia (ATO)

- Analysis of fact and circumstances
- FAR analysis before and after COVID-19
- The actual economic impacts of COVID-19 should be outlined and evidenced
- The contractual arrangements
- Evidence of the financial impact (if any) of COVID-19 on the specific product and service offerings
- Evidence of changes in business strategies as a result of COVID-19.

- How to support the arm's length nature of your transfer pricing outcomes
- A detailed P&L analysis showing changes in revenue and expenses
- Where your outcome would have been if COVID-19 had not occurred
- The rationale and evidence for events
- Any government assistance.

Local Guidance-Singapore IRAS

- Information to be provided in the TP Documentation
- How your industry has been affected by COVID-19
- Which entity made decisions
- The functional analysis before and after COVID-19
- The contractual arrangements
- Compare the budgeted (pre-COVID 19) and actual results
- Reasons and supporting evidence how your company's profitability has been impacted
- COVID-19 specific government assistance.

- How to test the intercompany transactions
- Perform a three-year analysis
- Multi-year testing is only allowed under exceptional circumstances and after consultation with IRAS.

- APA
- Review of the critical assumptions for existing/under review APAs
- File a new APA application or request for renewal of an existing APA

What would third parties do?

- The OECD has given priority to the conduct of parties.
- The OECD has used the booklet by Peter Bogetoft *Design of Production Contracts* as inspiration for how third parties negotiate terms and conditions.
- The book has three interesting angles of contracts vs third parties:

1. Contract theory ≠ contract practice
“Papers in contract theory as well as papers analysing specific contracts tend to fucus on a single or a few problems within a contracting context. ... It is not a fruitful approach to practical contract design.”
2. Definition of contract
“We emphasize the systems view of contracts. We view contract design as a multi-criteria decision-making problem and seek compromises that fulfill a number of possibly conflicting goals”
3. The goal hierarchy in the analysis of specific contracts

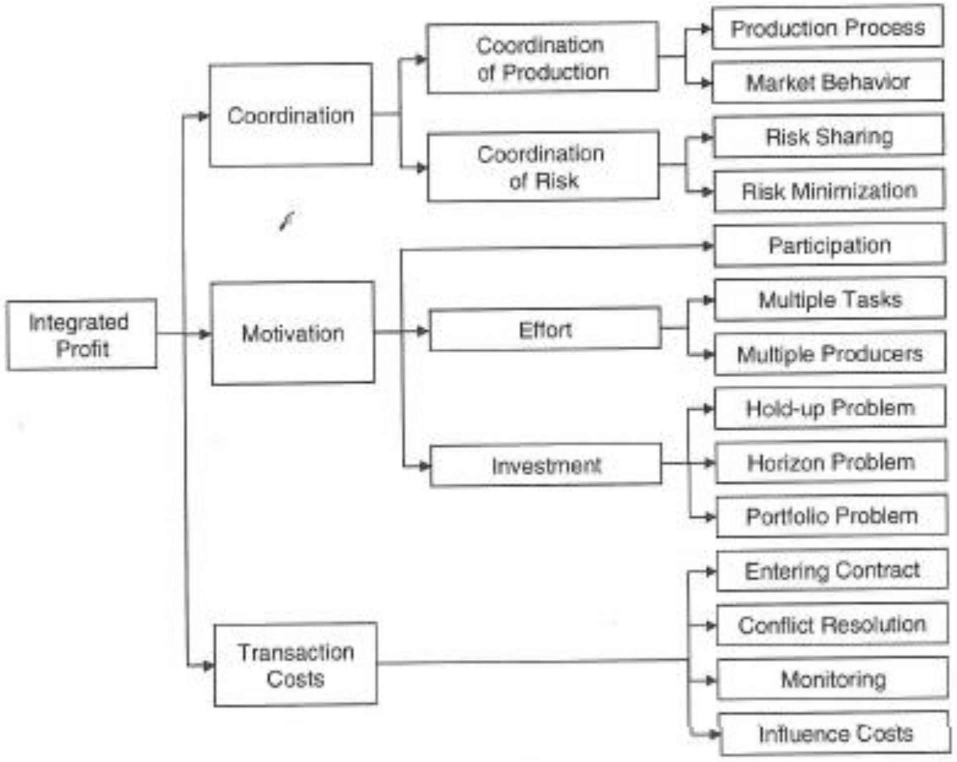


Figure 3:1 Hierarchy of goals for contract design

Measuring covid-19 impacts-sensitivity analysis

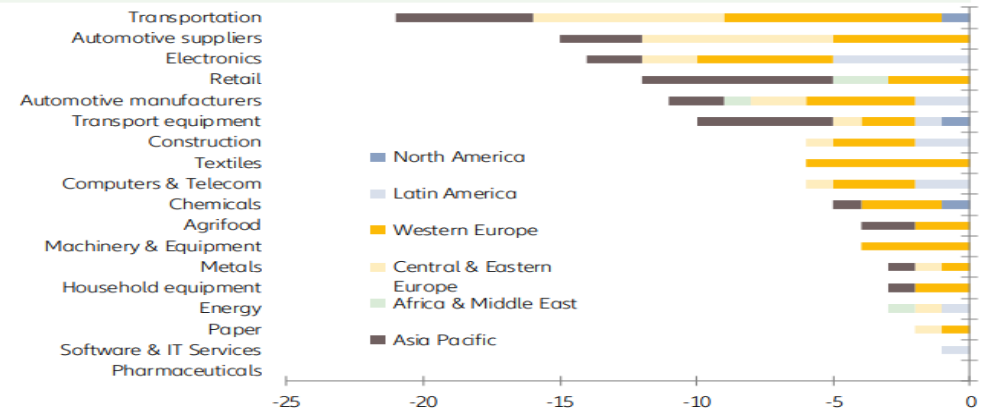
TP Guidelines Para. 1,34 …economically relevant circumstances attaching to those relations requires a broad-based understanding of the industry sector in which the MNE group operates and of the factors affecting the performance of any business operating in that sector.

Which global sectors are most at risk? Transportation (-40%), automotive (-20%), electronics and retail.

- The lockdown of one third of world population is impacting **transportation**, especially the air transport segment.
- In **automotive**, the strong dependency on the top three markets is aggravating ongoing structural challenges.
- The impact in the **electronics** sector is most felt in APAC, with low value-added players at risk across all regions.
- Lockdowns will hit sales badly in non-food **retail** and squeeze margins of already vulnerable companies.

Sources: Euler Hermes, Allianz Research

Figure 1: Changes in sector risk ratings by sector and region (Q4 2019 vs Q3 2019)



RadarView™: Coronavirus Impact Index by Industry

Categories affected by COVID-19	Banking, Financial Services & Insurance	Energy & Resources	Healthcare & Life Sciences	High Tech & Tele-communications	Media & Entertainment	Public Sector	Retail	Manufacturing	Universities & Colleges	Non-profits	Travel & Transportation
Personnel	Significant	Major	Moderate	Significant	Significant	Major	Severe	Severe	Severe	Severe	Severe
Operations	Significant	Major	Severe	Major	Severe	Moderate	Major	Severe	Moderate	Major	Severe
Supply Chain	Minor Impact	Severe	Major	Severe	Moderate	Minor Impact	Severe	Severe	Minor Impact	Minor Impact	Severe
Revenue	Severe	Major	Major	Severe	Significant	Significant	Major	Severe	Severe	Severe	Severe
Overall Avasant Assessment	Significant	Major	Major	Major	Major	Significant	Severe	Severe	Major	Major	Severe

Minor Impact · Moderate · Significant · Major · Severe

Source: Avasant, LLC, 2020

Figure 1

Change of business model

- Change of strategy

COVID 19 will have lasting impact on the consumer preference. As a result, businesses will have to reshape strategy for business continuity (e.g. digital transformation; long-term consideration around shifts in core market or business models), and renew business continuity plans accordingly.

- Business restructuring

Companies are facing a myriad of issues related to business disruption, salvaging relationships and restructuring liabilities and business structures to facilitate ongoing trading.

- Change of supply chain

Covid-19 impacts the supply chain of any firm by hurting the sourcing, production, and distribution capabilities of its suppliers. Many companies are developing a diversified portfolio of suppliers by reevaluating sourcing strategies in real-time, integrating advanced technologies such as AI and deep learning-based tools, developing scenario-based supply chain models and optimization routines

- Change of financing structure

The economic downturn may require MNEs to reassess their existing intercompany financing arrangements and come up with appropriate liquidity management structures. A stronger need for intragroup funding and parent or cross guarantees on third party lending can be expected for group entities operating in the affected regions. Cash pooling structures can also be set up to manage liquidity within the corporate group and support group entities in the affected regions.

Minimum Audit Trail:

- **Industry and Sensitivity analysis;**
- **Impact on Business Model Footprint;**
- **Changes in FTEs functionally & Geographical footprint;**
- **Loan and Investor Documents, etc.**

Change of transfer pricing system

- Routine functions-Is it a cost center or a expense center?
- Should the limited-risk entities ("LREs") continue to receive a stable profit for their routine functions during the current crisis?
- No risk = taxable profit?
- Taxpayers might consider to invoke the Force Majeure' clauses in order to not comply some of the contractual obligations.
- Advance Pricing Agreements ("APAs") –Critical conditions?
- It is vital for MNEs to reconsider whether or not the critical assumptions in the existing APA are still accommodated (e.g. changes in economic circumstances; changes of business model; changes of profit level).
- Existing APA may be terminated or adjusted if such assumptions are no longer met.
- Government subsidy
- Government subsidy is usually catered to the MNEs in the case of exceptional or extraordinary circumstances, which can reduce their cost basis, used to determine the remuneration of entity.
- Documentation on extraordinary events or decisions
- It is suggested that any extraordinary events or decisions should be thoroughly documented by MNEs.

Extraordinary Decisions Examples:
- Closure of plants;
- Modifying channel of sales;
- Impost cost savings also for routine activities;
- From sales stores to experience centers;
- Modifying or terminating intercompany contracts
- Shift of production locations;
- Acceleration of digital transition

Extraordinary Events Examples:
- Significant reduction of sales;
- Restrictions on supply chain logistics;
- Double office cost.

Case study/Quantitative example-distribution company

Company X (in USD)		FY 2020 (Covid 19 times)
NET SALES		150.000.000
COGS		85.000.000
GROSS MARGIN		65.000.000
%	43,33%	
SG&A		58.000.000
%	38,67%	
OPERATING PROFIT		7.000.000
%	4,67%	
% Target (TP Range 2.3% to 4.18% with Median 3.26%)	3,26%	
in USD		4.890.000
Adjustment		2.110.000
% Target (TP Range 2.3% to 4.18% with Median 3.26%) - Covid-19 time	2,3%	
in USD		3.450.000
Adjustment in USD due to COVID		3.550.000

Question: Which part of the P&L to adjust?

Change of transfer pricing system

- Transfer of IP (Valuation of Intangible assets)-Timing?

- Retrospective methods (restated assets method, capitalised earnings method, capitalised dividends method, etc.)
- Financial data does not reflect the current situation.
- Revising most recent financial year as the most representative one, instead favour another past year(s) which would best represent the business performance to be expected in the near future.

- Prospective methods ('Discounted Cash Flow' method)
- Industry sensitivity analysis and adjustments
- Company sensitivity analysis and adjustments
- Is the crisis challenging the very survival of the company?
- Integrate the consequences of the crisis on the future profits of the company

➢ **See example**

Case study/Quantitative example-Transfer of IP/valuation

	FY 20	FY 21	FY 22	FY 23	FY 24
Turnover (Pre-COVID)	1.000.000	1.500.000	2.000.000	2.500.000	3.000.000
Royalty on IP (5%)	50.000	75.000	100.000	125.000	150.000
DEMPE cost (50%)	25.000	37.500	50.000	62.500	75.000
EBIT on IP	25.000	37.500	50.000	62.500	75.000
DCF (discount factor 10%)	180.542				

	FY 20	FY 21	FY 22	FY 23	FY 24
Turnover (COVID-19 impact)	800.000	1.000.000	1.200.000	1.200.000	1.200.000
Royalty on IP (4%)	32.000	40.000	48.000	48.000	48.000
DEMPE cost (60%)	19.200	24.000	28.800	28.800	28.800
EBIT on IP	12.800	16.000	19.200	19.200	19.200
DCF (discount factor 15%)	56.377				

Question: Should I consider transferring the IP this year or wait for more reliable financials?

Change of transfer pricing system

- Financial transactions
- Intercompany financing arrangements will be affected by the current climate.
- Possible changes of credit ratings of both borrower and lender need to be taken into account.
- Borrowing entities may not be able to settle their intercompany payables.
- Financing companies within the group may be unable to provide capital injections into other group to sustain their own operations.
- Timing to revisit financing arrangements

Examples:
- loss-financing;
- supplier credit;
- customer credit;
- shortage of working capitals;
- refinancing through own treasury or through external banks, etc.

Minimum Audit Trail:
- Industry sensitivity analysis;
- Applying a holistic approach to group’s value chain;
- Modified footprint on Treasury activities;
- Explaining why transfer pricing system requires modification while business model does not change.

Case study/Quantitative example-Financial transactions

Facts:

- Company A1 gets in 2020 a third party loan by syndicate of banks.
- Company A1 provided a loan to Company A2 in 2018, which needs to be refinanced.
- The intercompany compensation to Company A1 consist of a “margin spread” as well as a “Return on Equity at risk”.

The CAPM to calculate the “Return on Equity” is expressed in the following formula:

$$E(Ri) = (R_f + \beta_i \times (Rm - Rf)) * (equity / total\ assets)$$

β_i and Rm could be affected by the COVID-19. Taking the Hotel industry as an example, Rm should be higher in Covid-19 times than pre-covid time due to the increase of market risk. β_i reflects the sensitivity for the risks of the tested party. The beta for a company is usually publicly available but not yet public for today’s COVID-19 impact.

Assume that Beta and Rm both increase 10%, the Expected return on Equity would increase with more than 20%

Pre-COVID: Rf(0,5%)+ß(0,9)*[Rm(5%)-Rf(0,5)]=4,55
COVID impact: Rf(0,5%)+ß(1,0)*[Rm(5,5%)-Rf(0,5)]=5,5

Change of benchmark used

What are the transaction that can be reassessed?

- Head Quarter services;
- Licensing;
- Sales agent services;
- Contract R&D services;
- Global Sourcing services.

How to find the comparables to reflect your business under COVID impacts?

- Using recent period - Quarterly financial data supplemented with historical data from the last downturn;
- Limiting to prior downturn years only. (e.g. 2008-2009, considering industry and market sensitive, such as airlines);
- Adjusting comparables profitability range (e.g. From 25th to 75th percentile to 25th to 50th percentile; or even full profitability range);
- Considering loss making companies in the comparables set;
- Applying lower remuneration to the limited risk entities (cost-plus zero has been used in 2008/2009 crisis)
- Modifying your working capital adjustment (higher or lower)

Change of benchmark used

Adjustments to the tested party financials

How to deal with abnormal levels of extraordinary costs? If comparable company results are based on recent historical financial data, it may be reasonable to adjust the tested party financial data to **eliminate the extraordinary costs** due to the outbreak since those are not reflected in the comparable company data. Some of extraordinary or excessive costs that MNEs affected financially by COVID-19 are as following:

- Receivables write-offs;
- Inventory Write-downs;
- Asset impairments;
- Underutilized production capacity;
- Idle sales force.

Possible solutions in practice:

- Cost-plus zero/Cost-plus minus
- Including loss-making comparables;
- Adjustments on ROA based on sales reduction;
- Working capital adjustments

Minimum Audit Trail:

- Financial analysis before and after COVID;
- Business sensitivity analysis, including change in governance structure,
- Volume impact and differences in cost structure,
- Assessment of quality of comparable data set.
- Cost of capital to capture the impact of increased risks.

Time of the adjustments- why now?

- Level of audit trail left in G/L versus in audit trail & documents created after the financial years   November and December 2020 are crucial to get adjustments implemented.
- Change in strategy – might not require lots of “audit trails” and FY 2020 press releases.
- Change in the business model – mostly internal “blue prints”.
- Change in the TP model (without change in the business model) – heavily relies on your before/after analysis.
- Change in benchmarks – lots of financial/accounting/data analysis required.

Main takeaways

1. Perform a Sensitivity analysis on business before/after COVID
2. For external factors, find enough evidence in public domain.
3. Create a minimum Audit Trail for change of busines models:
   - Industry and Sensitivity analysis;
   - Impact on Business Model Footprint;
   - Changes in FTEs functionally & Geographical footprint;
   - Loan and Investor Documents, etc.
4. Create a minimum Audit Trail for change of TP system:
   - Industry sensitivity analysis;
   - Applying a holistic approach to group's value chain;
   - Modified footprint on Treasury activities.
5. Create a minimum Audit Trail for change of benchmark used:
   - Financial analysis before and after COVID;
   - Business sensitivity analysis, including change in governance structure,
   - Volume impact and differences in cost structure,
   - Cost of capital to capture the impact of increased risks.

6 Optimize your tax impact of your TP system:
   - Risk (cost) allocation to limited risk entities;
   - Reconsideration on current APAs;
   - Revision on financial arrangements,
   - Transfer of IP

7. Perform benchmark studies that reflect the Covid-19 impact, by possibly
   - accepting loss-making comparable;
   - applying cost plus zero on limited risk entities; and
   - using comparable data properly.

8. At all times, keep your economic reality (conduct of parties) synchronized with the functional & contractual realities.

Health warning:

The timing is critical-if and insofar adjustments on your transfer pricing system and benchmark used need to be made in the FY 2020

–Implementation of adjustments are required in November/ December 2020

Get In Touch

Transforming the World of Tax

info@tpa-global.com

+31 20 462 3530

www.tpa-global.com

Headquarters:
H.J.E. Wenckebachweg 210
1096AS Amsterdam
The Netherlands.

Find Us

Thank You

Our global network covers over 5,000 professionals who enable us to deliver scalable solutions in the area of tax & legal, digital transformation, running a compliance factory and effectively dealing with dispute resolution.
To ensure the highest quality and seamless service provision, thereby meeting international standards and regulations, a global team of dedicated professionals and specialists is a key and determining factor.
Through linking three ecosystems: Tax, Transfer Pricing and Valuation, Tax + Technology and Tax Litigation and Mediation – we deliver a world of tax in control.

H.J.E. Wenckebachweg 210 . 1096 AS Amsterdam . The Netherlands . +31 (0)20 462 3530 . tpa-global.com

The views expressed and the information provided in this material are of general nature and is not intended to address the circumstances of any particular individual or entity. The above content should neither be regarded as comprehensive nor sufficient for making decisions. No one should act on the information or views provided in this publication without appropriate professional advise. It should be noted that no assurance is given for any loss arising from any actions taken or to be taken or not taken by anyone based on this publication.