COVID-19 & Transfer Pricing – Re-assess, Re-think, Re-position

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This is part of 'Supporting You Through Covid-19 Series'.

The rapid outbreak of COVID-19 has greatly affected the world – disrupting lives, overwhelming healthcare systems, devastating world economies. Many industries are shut down; the free-flow movement of goods, services, and people are severely restricted.

Unlike typical supply chain disruption which generally are more isolated/localised, COVID-19 has caused disruption on a global basis. It has compelled companies to respond immediately to address the near- term sustainability of their existing businesses. There is a massive strain on multinational enterprises' (MNEs) current operations as well as significant future risks and exposure from business, tax, and legal perspectives.

Most businesses are likely to be impacted in the following ways:

- Prolonged shut down of commercial operations;
- Drastic change in customer priorities and a resulting lack of demand;
- Disruption in traditional distribution channels;
- Inventory obsolescence;
- Drop in human productivity and
- Tightened cashflow & liquidity and stretched working capital.

Charting the way forward

Given the challenges laid out above, MNEs should consider re-looking at the functional profiles of each entity in the group, and possibly reallocating significant functions, risks and assets to lesser-affected jurisdictions and conduct business restructuring to mitigate the overall loss.

While low-risk entities such as captive service providers within the group may still operate under the financial umbrella of the parent, the support/margins provided to them previously may not be available in the current situation, due to the group struggling with limited means to keep the business running. Hence, it is important to evaluate whether a temporary reduction in margins for such low-risk entities can be justified.

Similarly, in cases where losses are made by affected subsidiaries with routine functions (e.g. contract manufacturers, limited-risk distributors) which are due to lowered productivity and/or reduced market demand for their products, it needs to be evaluated if such losses should be borne by the principal and whether such a position is reasonable and defensible.

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A further possibility is that group losses may be allocated among the entities in the group, even the low-risk entities mentioned above.

Apart from the above, inter-company transactions where the quantum of payments is fixed such as management fees and royalty fees may need to be renegotiated due to the fact that the basis (e.g. projections) on which the fees were arrived at previously may not be realistic/achievable in the current economic scenario.

While planning for/carrying out the adjustments mentioned above, MNEs should keep the following items in mind:

Factors to consider re-adjustments
While applying the methods for determining arm's length price, adequate economic adjustments would be needed to address capacity disruption, working capital positions, exchange fluctuations, extra-ordinary expenses (higher input costs, severance payments, interest payments on defaults, penalties etc.), differences in inventory valuations, depreciation and various market related issues in order to arrive at proper comparability.

Availability of comparable data
Where possible, internal comparability could be a better yardstick compared to external comparability since the variable factors affecting a particular entity while dealing with related as well as unrelated transactions would remain relatively similar. There is also the added benefit of the data being immediately available compared to a general time lag in relation to information uploaded into a transfer pricing database

Advanced Pricing Agreements (APAs)
For companies who have existing APAs, you may want initiate dialogues with the relevant tax authorities on to reassess how COVID-19 has affected assumptions that were relied upon to arrive at the pricing which was agreed upon previously.

Way forward

Challenging situations like these have brought in an array of uncertainties which could pave the way for innovative solutions from MNEs and business consultants to address the critical situation at hand. We need to work together to chart out a path for aligning transfer pricing considerations arising from this unprecedented situation. An integrated approach covering group level as well as country specific work will enable companies to come up with defendable and realistic pricing and policies.

While you may be focused on making timely business decisions to ensure business continuity, the need for proactively acting on transfer pricing considerations must not be downplayed. Reach out to us to see how we can best help you through this situation.

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