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Transfer Pricing in uncertain times – considerations for year-end book closure

Private and confidential
April 2021

Is your business affected by the pandemic - impact compared to your peers in industry?

(Select one of the options flashing on the right panel to respond)

Impact of COVID-19 on Transfer Pricing Policies – considerations for book closure

Do Transfer Pricing Policies require a RESET due to supply chain disruptions?

In Medium to Long term: Intercompany pricing policies would need a reset:

- to capture change in supply chain due to COVID-19
- to capture the growing role of digital economy in global value chains
- to plan for a global tax reset - OECD's pillar one and pillar two proposals

In Short Run: the situation will be more challenging:

- as companies need to contemporaneously evaluate how, and to what extent, they have been impacted by the pandemic
- information to be collated on fixed costs, sales volumes, incremental or exceptional costs, trends, budget Vs. actual data, change in contractual arrangements, if any, relocation of control functions viz people movement, etc.

Can limited risk arrangements incur losses?

How can I align my risks?

Can I reallocate my pandemic related exceptional costs?

Summary of OECD Guidance

In general, OECD in its COVID-19 guidelines has Four areas of focus:

- Comparability analysis
- Losses and the allocation of COVID-19 specific costs
- Government assistance programs
- APAs

Traditionally, historical data of comparable companies is used to benchmark company’s remuneration earned from related party(s);
The unprecedented change in the economic environment restricts the use of historical data to benchmark the current economic activity

How should companies navigate this?

Have you changed your intercompany pricing policies due to impact of the pandemic?

(Select one of the options flashing on the right panel to respond)

Ex-ante COVID-19 Impact analysis

Indian economy and its relation to transfer pricing

As the Indian economy suffers the first ever growth decline, different businesses are likely to be impacted differently in the short-term and long-term

The impact will also depend on the extent of integration with the global demand and supply factors

What you can do

Apply a multi-dimensional analysis to determine, ex ante, the arm's length range under TNMM using:

Regression analysis to estimate profitability of the comparable companies in line with macroeconomic outcomes which drive the market.

Quarterly performance of listed companies in similar sector/industry.

Specific adjustments to revenue/costs of tested party- but for Covid-19 analysis

Why ex-ante analysis is required?

Financial results of comparable companies with a time-lag cannot be compared with the tested party's present financials due to significant deviations

Given the scale of the pandemic, ex-post results cannot be reasonably ascertained by continuing with the traditional approach of multiple year average

Where can it be applied?

For general TP setting in the light of COVID-19 and to defend tested party results during compliance and controversy

For supporting expected year-end results for statutory auditors and tax authorities

During Advance Pricing Agreement negotiations to build in appropriate future benchmark results

Predictive analysis

Deloitte has undertaken a study which examines:

- Impact of macroeconomic indicators on Profit Level Indicators of previously accepted comparable datasets
- If an econometric relationship is established, it would indicate how PLIs are expected to be affected in the future on account of economic growth cycles

- GDP growth was considered as it provides an overall snapshot of the state of the economy
- Scope of study entailed a period ranging from 2007 through 2019
- Objective is to help understand how the PLI of comparable companies reacted to the GDP growth fluctuations

Relationship between PLI and GDP growth rate

Predictive analysis

How will it help

The arm's length results will vary as the forecasts for Indian GDP growth rate vary

Insights from the analysis

- Arm's length profitability based on TNMM benchmarks derived from independent comparable company sets
- Existing transfer pricing theory allow for amendments to transfer pricing policies in response to economic circumstances

Arm's length range

Revised range of comparable companies would be computed based on the predicted movement of the PLI for each of the finally accepted comparable company

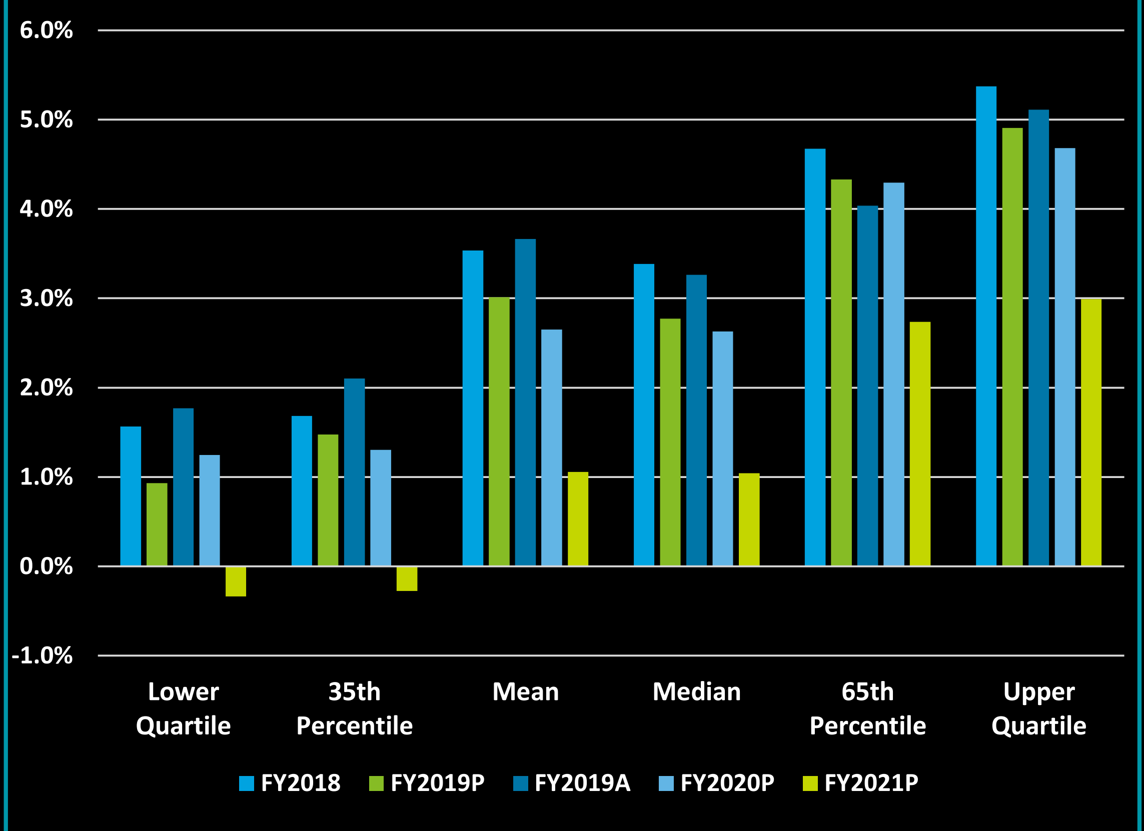
How will the analysis be useful

- Comparability needs to factor in economic conditions that result in lower levels of profitability for its entities
- As the financial results of comparable companies for 2020 may not be available until later in 2021, this analysis supports realised profitability based on ex ante approach
- Can be included as an ex-ante analysis in the TP documentation for 2020-21, further supported, if available by actual results of the comparable companies ex-post
- Helps to substantiate lower profits/ losses, if any, with financial auditors and tax authorities
- May be used for controversy management including both litigation and APAs

Predictive analysis

Showing predictive results (OM) on an Indian Manufacturing comparable set # #

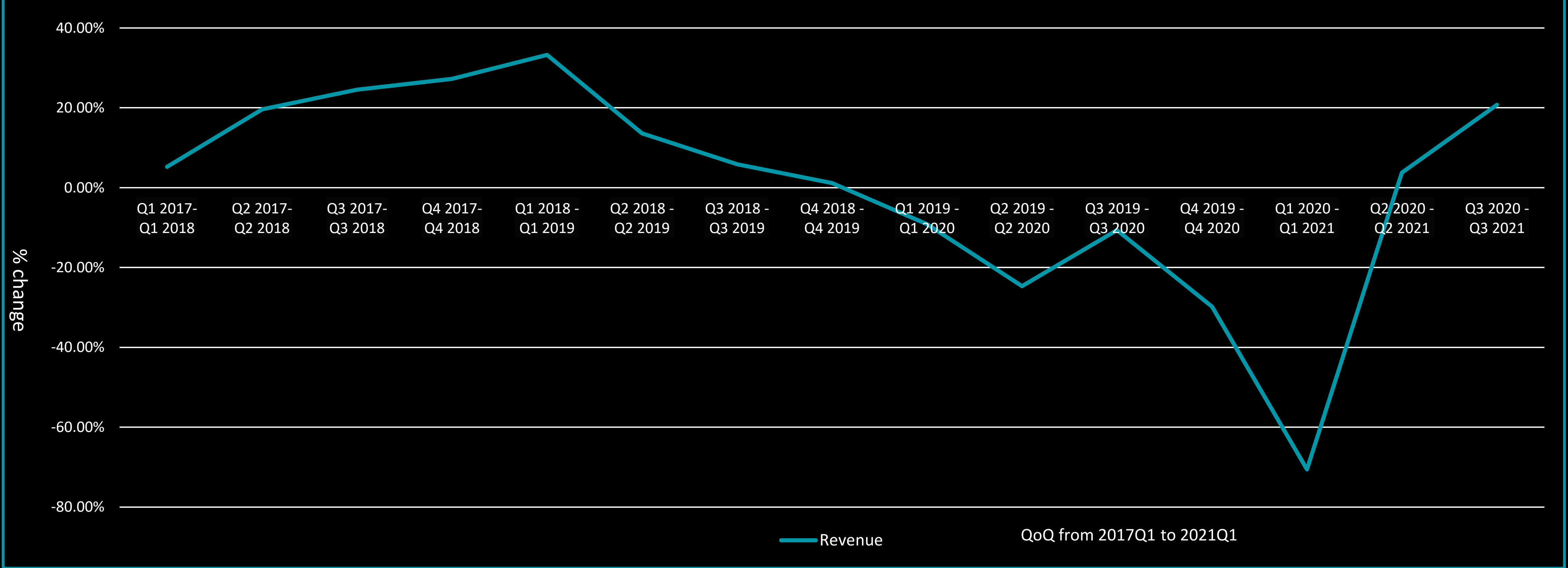
Showing predictive results (OM) on an Indian Trading comparable set#



Analysis based on quarterly trends

This analysis enables comparison across a variety of financial parameters for listed companies- Comparing pre-Covid-19 trajectory with Covid-19 impacted path

QoQ trends in aggregate revenue and OP for consumer automotive companies (listed)



But for Covid analysis

Covid-19 impact analysis based on tested party data:

- Identifying Covid-19-specific costs - extraordinary costs
- Adjustments on the basis of variance in costs/revenues , Covid-19 and pre-Covid-19, for the tested party
- Whether to include persistent loss making companies to approximate the pandemic scenario
- Whether to consider using multiple year data for the tested party

Comparability adjustment

Degree of operating leverage (DOL):

- Income-tax Act, 1961 allows taxpayers to carry out reasonable adjustments to comparables to arrive at the appropriate arm's length range
- Operating leverage is an indicator of risk that a company bears on account of its fixed costs
- The volatility in business due to the pandemic has increased the importance of looking at operating leverage as a relevant comparability adjustment factor

Particulars	Company A	Company B
Revenue (R)	1,000	1,000
Variable Costs (VC)	300	500
Fixed Costs (FC)	500	300
Contribution margin	700	500
Operating Profit	200	200
Operating Leverage	3.5	2.5

DOL* = <u>% change in profitability</u>
% change in revenue

*In absence of breakup between fixed cost and variable cost, DOL can also be empirically determined through tracking change in profitability against change in revenue

Comparability adjustments (illustration)

Step 1	**Computation of tested party margin and degree of operating leverage**						
	Tested Party Margin (impacted year)		1.5%	Tested Party DOL		3	
Step 2	**Comparable range analysis**						
	Comparable 1	**Comparable 2**	**Comparable 3**	**Comparable 4**	**Lower Quartile**	**Median**	**Upper Quartile**
Operating Margin	7.86%	5.22%	2.88%	2.40%	2.76%	5.22%	6.54%
DOL	1.66	1.74	2	2.68			
Step 3	**Revised range - Adjusting Comparable profitability with Tested Party's DOL**						
	Comparable 1	**Comparable 2**	**Comparable 3**	**Comparable 4**	**Lower Quartile**	**Median**	**Upper Quartile**
Revised operating margin	4.29%	3.68%	-0.57%	1.27%	0.81%	3.68%	3.98%

* The above table is only for illustration purposes (Range used per the OECD guidelines). Results will vary based on data of tested party and of comparable(s)

What will be your tax team's priority in short term – in the current economic environment?

(Select one of the options flashing on the right panel to respond)

Future Dispute Trend – Reduced Margins / Change in cost base

Scenario 1: Captive units agrees to receive a reduced markup on the entire cost base

Scenario 2: Captive units agrees to remove Idle cost form the cost base

Revenue Service

In pre-COVID-19 times, when the group was earning good profits, the Indian entity was getting a fixed mark-up. Hence in the current situation (Covid-19), Indian entity should continue to get the same agreed markup.

Reduced mark-up/ margin would mean pushing the risk to the Indian entity, thereby changing the characterization

This will be termed as business re-structuring and the AE should compensate for the change in risk profile.

Previous years should be re-opened due to change in characterization imposing substance rule rather than the form

Taxpayer

- **Extraordinary/abnormal cost** for the period of disruption should be treated as non operating.
- The **change in characterization if at all will be temporary** and that cannot be termed as business re-structuring requiring a compensation.
- On reopening of **past years - the characterization remains intact,** and the change is only in pricing policy due to unforeseen circumstances.
- **Reduced markup based on margins earned by comparable companies** in similar circumstances – carryout economic adjustment

Judicial Precedence

Benefit/Advantage accruing to AE is irrelevant

- **Watson Pharma Ltd. v. DCIT [2015] 54 taxmann.com 88 (Mumbai - Trib.)**

Abnormal/Extraordinary cost should be treated as non-operating

- **Honda Motorcycle & Scooters India (P.) Ltd. v. ACIT [2017] 77 taxmann.com 119 (Punjab & Haryana)**

Idle capacity adjustment must be granted

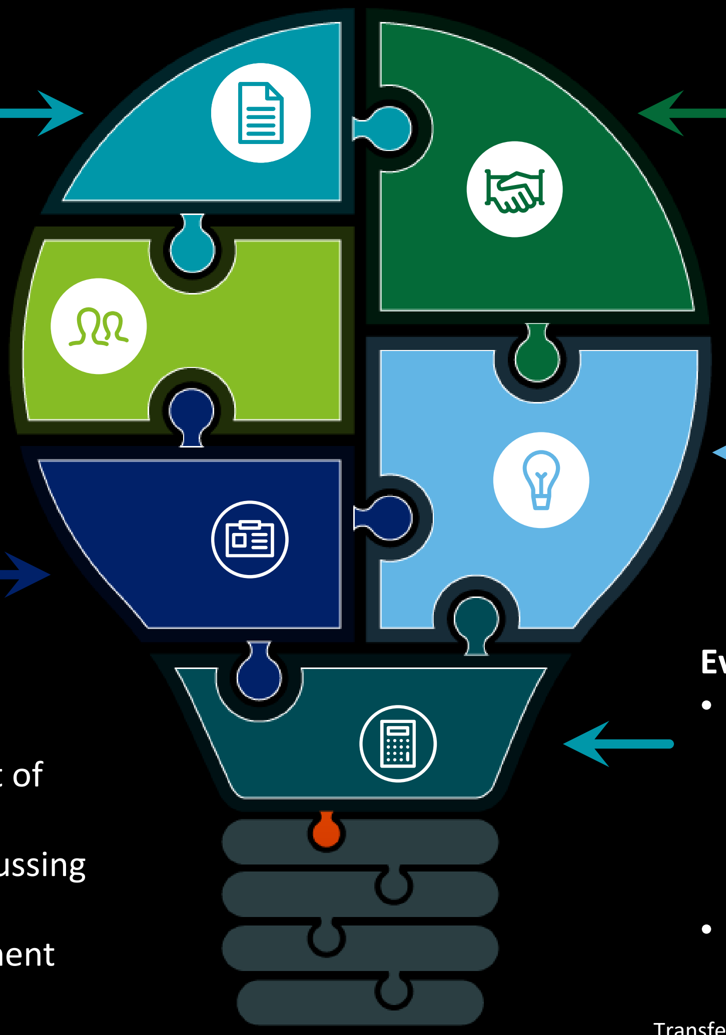
- **CIT v. Petro Araldite Pvt. Ltd. [2018] 93 taxmann.com 438 (Bombay)**

Future Dispute Trend – Reduced Margins / Change in cost base

Documentation
- Change in FAR, its intensity and even performance
- Impact of business disruption on the Industry
- Identification of extraordinary/Abnormal Cost
- Economic Adjustments

Behaviour evaluation
- Third party behaviour – eg. reduction in rent
- Company behaviour - eg. salary reduction
- Customer behaviour – eg. customers asking for a discount

Evidence gathering
- Contemporaneous / real time data
- Discussion in board meetings
- Disclosure in financial statement in relation to impact of Covid-19
- Email correspondence with vendors / customers discussing impact of Covid -19
- Relief measures / policies announced by the government



Evaluate/Renegotiate agreements
- Definition of cost
- Mark up to be worded as being commensurate to ALP, rather then a fixed margin
- Invoicing / Credit period
- Force Majeure clause

Mitigation of Business restructuring
- Compensation for business restructuring

Evaluate APA Agreements
- Companies may want to revisit the critical assumptions under the APA since they may not be in a position to meet the same; shelter of provision under Rule 10M(4) and 10M(5) to revise the APA conditions.
- Intimation to PCCIT (Intl tax) within 60 days of change in facts

In your experience, do customs authority respect the transfer pricing analysis carried out by the assessee?

(Select one of the options flashing on the right panel to respond)

Indirect tax implications – Illustrative scenarios*

Function – International transaction	COVID -19 impact	Year-end transfer pricing scenario because of COVID-19 impact	Indirect tax implication
Manufacturer/ Distributor (i) Purchase of goods from AE (ii) Payment of royalty/ license fees to AE	**Manufacturer:** Reduction in operating margin due to COVID-19 related disruption **Distributor:** Reduction in operating margin due to COVID-19 related disruption	Scenario 1: Reduction of import price paid/ payable to AE Scenario 2: Reduction of payment of royalty/ license fees Scenario 3: Receipt of aid from AE Scenario 4: Undertaking book tax adjustment during return filing	**Scenario 1 and 2:** (i) Unlikely to result in retroactive re-opening of assessed B/E (ii) No customs duty refund on assessed B/E consequent to reduced import price/ royalties (iii) Going forward, customs is likely to question the reduction in import price/royalties **Scenario 3 & 4:** (i) IDT position remains unchanged (ii) Inflows from AE disregarded from IDT perspective (iii) Characterisation of inflow is key- towards service /goods or is simply financial support
Captive service provider - Provision of services	Provision of services by Indian entity to AE at cost plus markup Because of COVID-19 related disruption Group is unable to compensate at agreed cost plus markup and seeks reduced markup	Scenario 1: Renegotiation of pricing arrangement to predicted arm's length percentage Scenario 2: Undertaking book tax adjustment during return filing	**Scenario 1:** Any inflows from AE on account of renegotiation may not be considered towards exported services and consequently unlikely to count towards any export related benefit/incentive **Scenario 2:** IDT position remains unchanged

*There can be other scenarios which would need to be discussed on a case to case basis

Key takeaways

- Identify the impact on company's business, sector, industry and global operations
- Compare with trends from quarterly analysis for the relevant industry segment
- Analyse variance in costs and revenues- Undertake "But for Covid Analysis"
- Apply predictive modelling to determine year-end defensible TNMM range
- Gather evidence of third party and business aspects on real time basis to mitigate TP audit risks
- Quarterly and predictive analysis to be updated in 2021 Q4; document findings in a memo, consider Indirect tax implications

Determining arm's length margins for the Covid-19 period using multi-dimensional ex-ante analysis and predicting audit risks

Thoughtware

Covid-19 Impact: Benchmarking in uncertain times

This paper attempts to provide a detailed step by step approach for predicting arm's length margins to factor in the Covid-19 impact.

Click here to read

Thank you!

Kindly spare a minute to help us with your valuable feedback for today’s session…

For any queries, please feel free to write to us at intax@deloitte.com