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Transfer Pricing Sharing Series

Episode No. 05 & 06: Covid-19's impact on business restructuring and low risk businesses

30 September 2020

Our sharing series will cover the following key areas (and beyond):

1. Supply chain disruption due to Covid-19 – How existing group supply chain model may require long-term changes and what potential risks may be involved. Please refer the link for details.
2. Pre-Covid-19 intra-group pricing arrangements may potentially become irrelevant and the need to revaluate them. Please refer the link for details.
3. Amending regulations on interest deductibility cap: What enterprises should consider and proposed action. Please refer the link for details.
4. Planning ahead for loss-making or fluctuating profitability in periods impacted by Covid-19. Please refer the link for details.
5. Business re-structuring from the perspective of specialists.
6. Are low-risk classified entities actually less impacted by Covid-19?
7. Covid-19's impact on APA negotiation and/or implementation process.
8. Transfer pricing audit trends: relaxation in approach for taxpayers or aggressive plan for State budget?

Introduction

We are witnessing serious disruptions to the global economy caused by the Covid-19 pandemic. It has negatively impacted demand and has caused disruption to the supply chain. Consequently, a large number of businesses may have been forced to either close down or suspend their operation temporarily. Even after resuming their operation, many enterprises may be currently operating at a significantly lower capacity as compared to their installed capacity as the demand has not been fully restored and the supply chain is gradually coming back to normal. This is relevant for companies in Vietnam which are constituent entities of a multinational enterprise ("MNE") group and act as limited/low risk entities. These entities operate as contract manufacturers or contract service providers or limited-risk distributors. These entities normally operate in an insulated environment as they are remunerated on the basis of a cost plus mark-up or they distribute products on the basis of back to back orders. However as we are witnessing serious disruptions to the global economy caused by the Covid-19 pandemic, there are questions being asked as to whether such limited risk entities should continue to operate at the pre-Covid-19 levels of profitability or should there be a downward adjustment made to their profitability so that they can pick-up a share in the losses being incurred by the parent company.

It is also worth noting that as MNEs start to shut down their facilities in certain jurisdictions or switch to others, a revaluation of the group's structure and related party arrangements should also be considered. For example, the group may consider to restructure its supply chain to manage supply chain disruptions or to shut down certain production facilities to limit losses. Whether such decision is temporary or permanent, there will either be new related party transactions arising or termination/ modification of certain related party transactions. Accordingly, in the process of considering such restructuring activities, detailed analyses of each entity's functional profiles and circumstances should be performed.

Our Suggestions

Detailed transfer pricing analysis

Losses are largely associated with the capacity to control the risk of operations. If an entity has been set up as a low-risk entity and is entitled to a cost-plus mark-up, it is difficult to justify a loss. However, we could evaluate whether such entities can operate at reduced levels of guaranteed profits or even at a loss by looking at whether similar companies have borne the relevant costs and have therefore incurred losses during the period in which business has been disrupted by the Covid-19 pandemic. This would require detailed analysis and should be supported by a benchmarking analysis. Some pointers towards performing such transfer pricing analysis and benchmarking are as below:

- By using only the current year data or even quarterly data of comparable, if available to reflect the impact of the pandemic
- By making appropriate Special Factor Analysis adjustment to profitability of the tested party
- By analyzing the profitability of the company in multiple time-periods as follows:
  - i. Before the impact of the pandemic, i.e. under the normal business circumstances;
  - ii. During the pandemic period; and
  - iii. During the recovery period.

This will clearly demonstrate the impact of the pandemic. A detailed industry analysis will also be useful in this exercise to explain how the pandemic has impacted the industry in which it operates.

Modification of transfer pricing in existing supply chains

As commercial supply chains are under stress due to the Covid-19 pandemic, it may be necessary and beneficial to re-evaluate functional profiles of group companies and level of profitability for all constituent entities in the supply chain. This exercise has to be done keeping in mind which party is ultimately bearing the risk associated with the operations and business decisions.

Revision/modification in group's structures

As MNEs decide to restructure their business models to lessen the impacts of the Covid-19 pandemic, transfer pricing models may need to be adjusted to give effect to the re-allocation of functions, assets and risks across the group. Companies will have to review whether the new models and respective inter-company agreements have reflected the actual allocation of functions, assets and risks.

Our Suggestions (cont.)

Revision/modification in inter-company agreements

An in-depth assessment of the existing inter-company arrangements (whether or not formalized by way of a formal agreement) is required to determine if such an arrangement needs to be revised/modified, given this ongoing crisis. This revision in the arrangement/agreement should reflect the results of the analysis performed towards modification of transfer pricing in existing supply chains (as detailed in the preceding paragraph).

In addition, regarding the financial arrangement, should pricing policies be reconsidered in an environment that are extremely volatile and unpredictable? For instances, a higher quantum of debt and/or higher interest rate may seem at arm's length but will also put borrowers under even higher financial strain and at a risk of thin capitalization. Similarly, future pricing policies should also take into consideration the market expectation after Covid-19.

Invoking the force majeure clause in inter-company agreements

A force majeure clause of an inter-company agreement defines circumstances beyond the parties' control that can render contractual performance too difficult or even impossible. If such clause is triggered, the party invoking the clause may suspend, defer or be released from its duties without any penal consequences. Some relevant aspects have been summarized below:

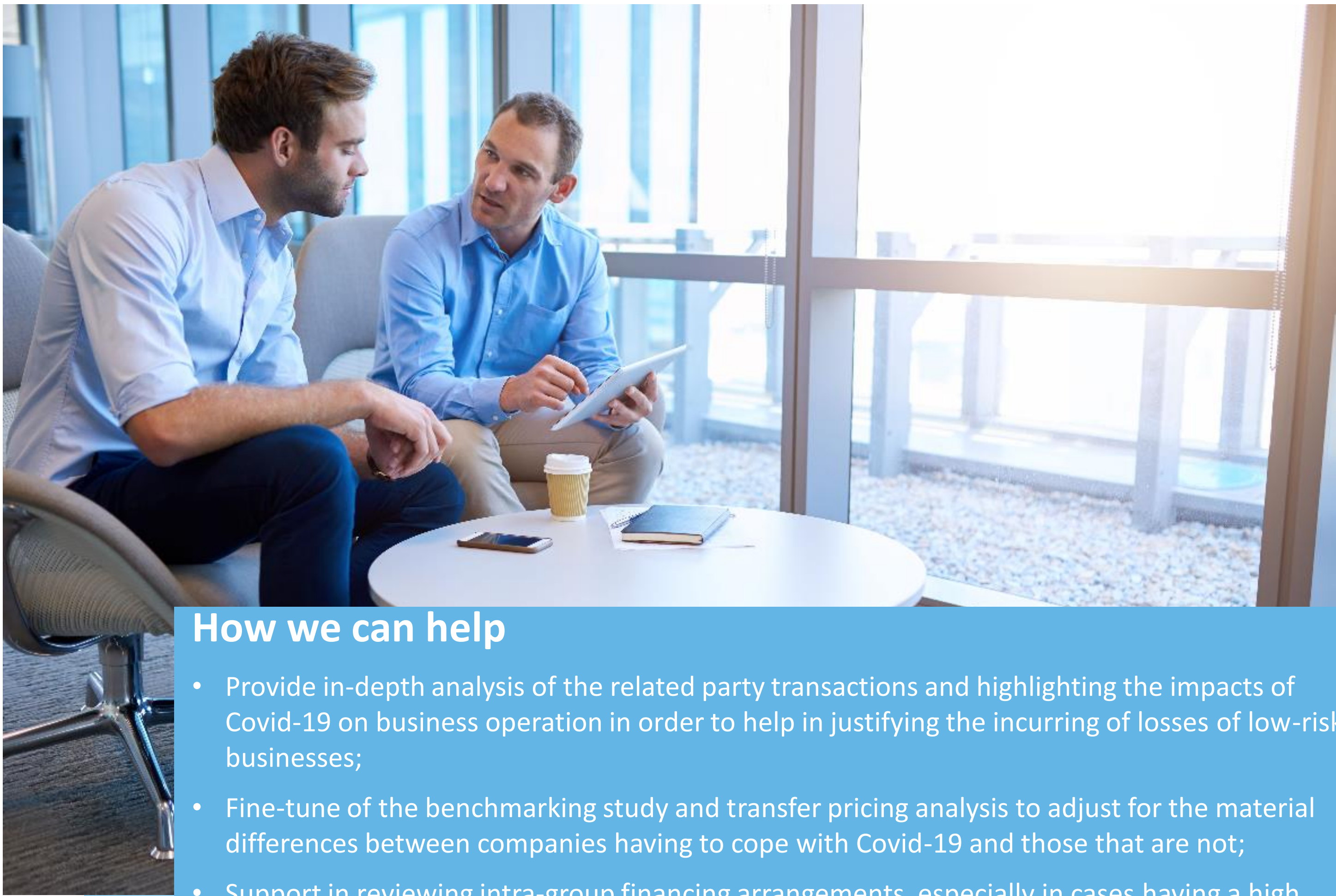
- Whether the impact of Covid-19 has been severe enough for a company to invoke the force majeure clause of its inter-company agreement will require a fact-specific analysis of the company's business, such an analysis also needs to be documented properly and sufficiently.
- Also, it has to be seen how long a company is not able to perform its duties under the inter-company agreement. For example, if the effect of the pandemic prevents a party from performing its duties for only a short period in comparison to the whole contractual term, will that be enough to invoke the force majeure clause?

- Covid-19 has caused a supply chain disruption, worker displacement, business interruption and depressed profit or losses. Depending upon the severity of impact caused by supply chain disruption and business interruption, there could arise instances of non-performance and consequently the invoking of the force majeure clause. However each case is required to be evaluated carefully to ascertain whether such supply chain disruption or business interruption caused by the Covid-19 pandemic was significant enough to invoke the force majeure clause. Also depressed profit or losses cannot be used as a cause to invoke the force majeure clause. This is because a contractual obligation to perform an activity is not a guarantee of profits.
- The age-old question will be whether the renegotiated terms agreed between the related parties (by invoking the force majeure clause) are at arm's length? To answer this question, we will have to analyze what would have been the response of unrelated parties if faced with similar circumstances? Will they have also renegotiated the agreement in a similar manner?
- Sometimes it may be better to continue with the current agreement with a revised approach (i.e. a revised agreement that reflects the commercial pressures caused by the Covid-19 pandemic) rather that terminating/renegotiating the agreement.

Our Suggestions (cont.)

Evidence gathering

If the impact of Covid-19 necessitates changes to the transfer pricing policies, intra-group supply chains, valuation approaches, etc., it is a good practice to prepare an audit file now. It will be very helpful to the company if it can document the commercial pressures presented by the Covid-19 pandemic (and the related tax/transfer pricing analysis) (for examples: decrease in sales orders, disruption in revenue stream, disruption in traditional supply chains, expenses incurred due to idle capacity, etc.) on a real-time basis in the form of emails, board minutes and memos/reports. Doing this exercise proactively now will save time and effort for the company in the event of any future tax audit.



How we can help

- Provide in-depth analysis of the related party transactions and highlighting the impacts of Covid-19 on business operation in order to help in justifying the incurring of losses of low-risk businesses;
- Fine-tune of the benchmarking study and transfer pricing analysis to adjust for the material differences between companies having to cope with Covid-19 and those that are not;
- Support in reviewing intra-group financing arrangements, especially in cases having a high debt-equity ratio;
- Support in reviewing the restructured business models from a Vietnamese transfer pricing perspective;
- Support in formulating and managing of new related party transactions arising out of business restructuring;
- Support in preparation of supporting document to demonstrate the actual impact of Covid-19 on the Company's business.

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