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Transfer Pricing – Navigating volatility

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MAKING AN IMPACT THAT MATTERS since 1845

Today’s Speakers & Facilitators

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Supply Chain and Transfer Pricing Policy

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Supply Chain

Tax teams should understand business decisions being taken in order to identify potential risks and opportunities that may arise.

Change in supply chain

Change in supply chain may be accompanied by changes in existing functional and risk profiles of various group entities that would warrant a realignment of the value chain and therefore affecting costs and margins on transfer pricing.

Business restructuring

Economic slowdowns may lead to business restructurings. Proper treatment and allocation of costs of ceasing operations as well as potential exit tax issues should be considered.

IP migration

Valuations done in the context of a business restructuring will be affected by market uncertainty. This might cause challenges in valuations especially in certain industries where COVID-19 might have a longer effect. Could give rise to hard to value intangibles.

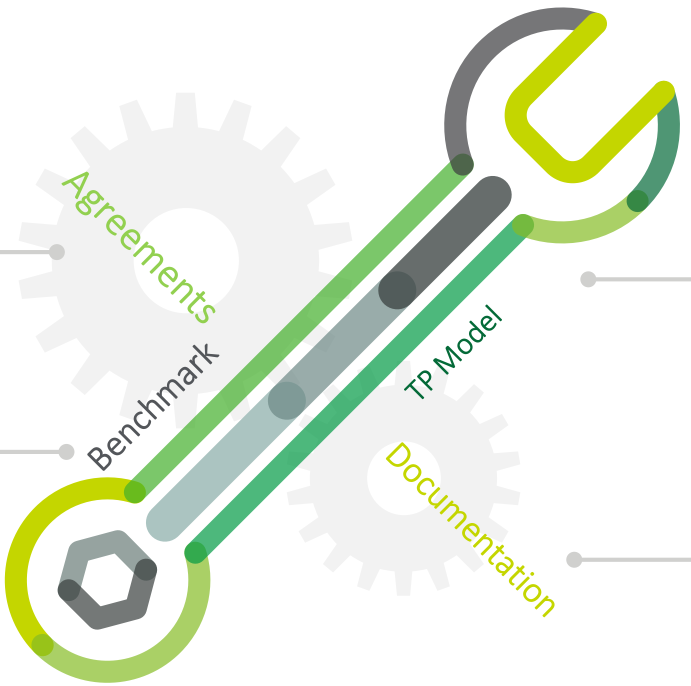
The operational changes need to be appropriately documented and placed into agreements.

Transfer Pricing Policy

Review and amend intercompany agreements

Review intercompany agreements and analyse if changes in transfer pricing need to be reflected in formal documents, e.g.

- Termination clauses
- Notice periods
- Penalties
- Force majeure



Value chain profitability analysis

Profit-split plausibility check

- Review expected profit and loss profiles across jurisdictions.

Benchmark analysis

Re-evaluate benchmark analyses to reflect current economic circumstances and time lag of data. This may call for a number of alterations and adjustments:

- Re-evaluate existing internal comparables
- Evaluate internal information with suppliers/customers
- Evaluate adjusting external comparable data.

Documentation

Important for taxpayers to support their transfer pricing positions for future tax audits. This becomes even more important where companies are expected to make losses. Document approach taken including:

- Options realistically available
- internal and external evidence
- Actual economic analysis performed to substantiate losses or decline in profit

Operational TP and Incentives

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Measures taken by companies to manage cash tax

Examples of measures some companies have taken to (temporarily) preserve cash (avoid cash tax payment):

- Temporary stop / Postponement of royalty payments (withholding tax saving)
- Temporary stop/Postponement of intercompany service charges (withholding tax saving)
- Reduction of routine remuneration of "routine entities" in the group. Reduction can be to "zero" or lower quartile of a benchmark range (corporate tax prepayments saving)

NB: important to document the economic rationale (other than cash tax saving) and put agreements in place

These business reasons can include:

- Losses or decreased profits for routine functions due to suspended operations
- Benefit test for management service during pandemic may not be accepted

How to take (employee related) subsidies / governmental measures into account when calculating transfer prices?

Incentives by governments might be available to businesses as a result of the crisis which may reduce or eliminate losses in some countries.

If a company is successful in filing for incentives/benefits, the Transfer Pricing questions are:

- Which entity in a multinational group is entitled to these benefits
- On which line in the P&L should these incentives / benefits be booked

The interaction with the transfer pricing model and arm's length outcomes will need to be evaluated.

Force majeure clauses and their impact on transfer prices

Basic principles of Force Majeure:

- **Impossibility** to fulfil contractual obligation
- Event is **not attributable** to defaulting party

Review the intercompany agreement for:

a. Force majeure clause

- Definition or list of force majeure events (pandemic, epidemic, difficulties with supply, etc.)
- Is there a contractual procedure to be complied with to invoke force majeure
- Consequences of force majeure

- Notify the other party as soon as possible of the force majeure event
- It is expected of parties to take all actions to limit / mitigate the consequences of force majeure
- Document all communications and measures taken to limit the consequences

b. Hardship clause

- Not every situation caused by COVID-19 / government measures will constitute a force majeure event
- A hardship clause (in general) obliges parties to renegotiate the terms of the agreement if an unforeseeable event disrupts the economic balance of the agreement (even if the event does not constitute a force majeure event)

IMPORTANT: a causal link between the non-performed obligation and the force majeure event

Our recommendation:

- Review contracts for force majeure clause and/or hardship clause
- Even if contract does not foresee in such clauses, conclude a "letter of intent" between the parties referring to the exceptional economic circumstances and allowing the parties to renegotiate existing arrangements in the near future / when impact of the current crisis has become clear

Intercompany Financing and Liquidity

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Intercompany financing and liquidity

Introduction

Businesses are developing a treasury plan for cash management as part of their overall business risk and continuity programs. In addition, the current environment may also lead to changes in their underlying financial results and impact their financial metrics.

Tax (including transfer pricing) can have a significant impact on, or can change, the outcome of actions that treasury teams take.

Actions taken by businesses

1. Repatriation (e.g. distribution of profits, new lending, cash pooling, revised intercompany arrangements)
2. Managing liquidity and capital
3. Controlling revenue and costs
4. Examining loan portfolios and terms
5. Review trading and hedging strategies

Impact on financial transactions

The current environment may require (or present opportunities for) businesses to **restructure financing transactions and other treasury operations**; for example in response to changes in credit profile, lower market interest rates, banking and regulatory demands, as well as COVID-19 relief legislation.

It is essential to consider the potential tax and accounting implications arising from these actions including their impact on **transfer pricing**.

Global tax teams need to work closely with Treasury/Finance real-time to take **decisive** and **coordinated actions**.

Intercompany financing and liquidity

Potential key transfer pricing areas of focus related to finance and treasury during the crisis

Transfer pricing of financial transactions needs to reflect arm's length conditions. What is arm's length in the financial markets **in the current climate** will likely be very different from prevailing conditions in a normal business environment.

Governments are responding in unprecedented ways to support their economies, and so it is difficult to say how things may develop in specific areas of tax. However, the following general transfer pricing aspects of intercompany financing may need to be considered:

Credit rating deterioration (reduced performance)

- Quantum of borrowings
- Level of equity that the lender may need to hold to sustain enhanced risk
- Pricing of borrowing

Short term liquidity

- Cash pool overdraft needed for longer as cash cycles become longer
- Characterization of such balances as longer term instruments in substance

Existing loan agreements

- Term and conditions inherent within the financial instruments need to be considered. Specific consideration needs to be given to call and put options inherent in the agreements

Cash pools

- Depositors may be exposed to greater financial risks if they are exposed to the creditworthiness of the borrowing entity or if parental guarantee is less valuable

Widening of spreads

- Leading to increase in interest rates for certain instruments
- Recent benchmarking studies need to be revisited as they are not reflective of the latest market fundamentals

Financial guarantees

- Requirement for guarantees to enable group entities to secure borrowing
- Guarantees may be in respect of the borrowings or performance of the entity
- Guarantees will require pricing and paying for

New loans

- Analysis to be carried out to determine of whether the borrower could in fact sustain borrowing in the current climate.

Documentation

- Documentation of instruments and decisions (at real time) will be important
- OECD Guidance is clear that any transfer pricing analysis or examination begins by examining the contractual terms between the parties and the borrower and lenders perspective

People

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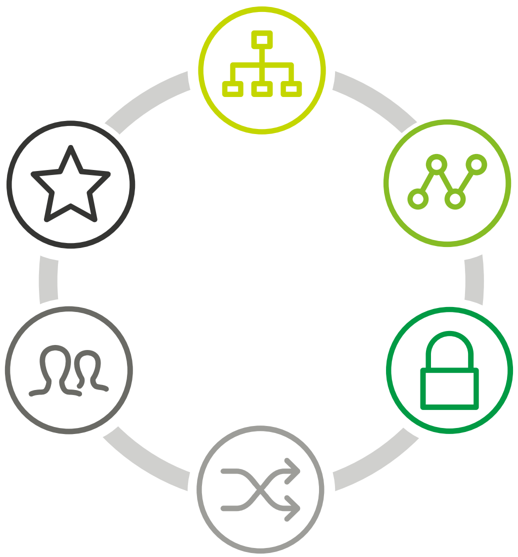
People

Management fees

There may be additional or less intra-group services rendered by HQ in relation to the crisis.

Decision making

Who makes important decisions in relation to the COVID-19 induced issues and changes?



Resizing of business

Headcount adjustments, plant closures may lead to questions as to whether the transfer pricing model needs to be amended or redesigned.

DEMPE impact

Are there any changes to DEMPE?

Relocation of people

May potentially give rise to permanent establishment issues.

Redundancies

Sharp decrease in market demand / (temporary) shut-downs may make headcount partially redundant: what is the impact on the cost base of "idle people" and how to account for state indemnities / social contributions waivers?

Transfer pricing in a downturn - An ATAF perspective

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Transfer pricing in an economic downturn

Comparability

- How will we address benchmarking issues which are a fundamental part of determining a transfer price. This involves looking at the profitability of third parties engaged in comparable transactions.
- This may become extremely difficult to do due to the economic circumstances created by the pandemic.

Limited risk distributors

- There may also be difficult transfer pricing questions that arise on how the economic downturn would impact on entities in an MNE group which were limited risk entities such as limited risk distributors.

Complexity of pricing

- There will no doubt be numerous other difficult and complex pricing questions that arise from the downturn, and this raises the possibility for a greater role for more proactive engagement between taxpayers and tax administrations to take early action to prevent pricing disputes such as through APAs

Tax policy and administration

- There will also be challenges in some cases where company's financial position may have deteriorated to the point where they are unable to pay the additional tax due on a transfer pricing adjustment, and tax administrations will need to consider how they address such difficulties where there may be no liquidity to pay additional tax

Taxing the digitalised economy: An important step for Africa

Scale without Mass

Capacity of digitalised businesses to reach wider markets with no or very limited physical taxable presence (no infrastructure, no employees) distorting allocation of taxing rights.

Reliance on Intangible Assets

Capacity to develop intangible assets such as technology IP, Trademarks, brands and to exploit them worldwide. This strains allocation of income from these assets across jurisdictions and creates BEPS opportunities.

Big Data & User Participation

Highly digitalised business exploit data and user-generated content to make significant profits through targeted adverts and digital networks; but have little or no taxable presence in the jurisdiction where the users are located.

Fluidity & Mobility

Digitalisation has enhanced mobility of intangible assets, users or customers and business functions.

What benefits are there for Africa?

AMOUNT A

Will allocate a portion of the residual profit of large MNEs to a market jurisdiction for:

- providing services referred to as Automated Digital Services (ADS); or
- undertaking Consumer Facing Businesses (CFB).

AMOUNT B

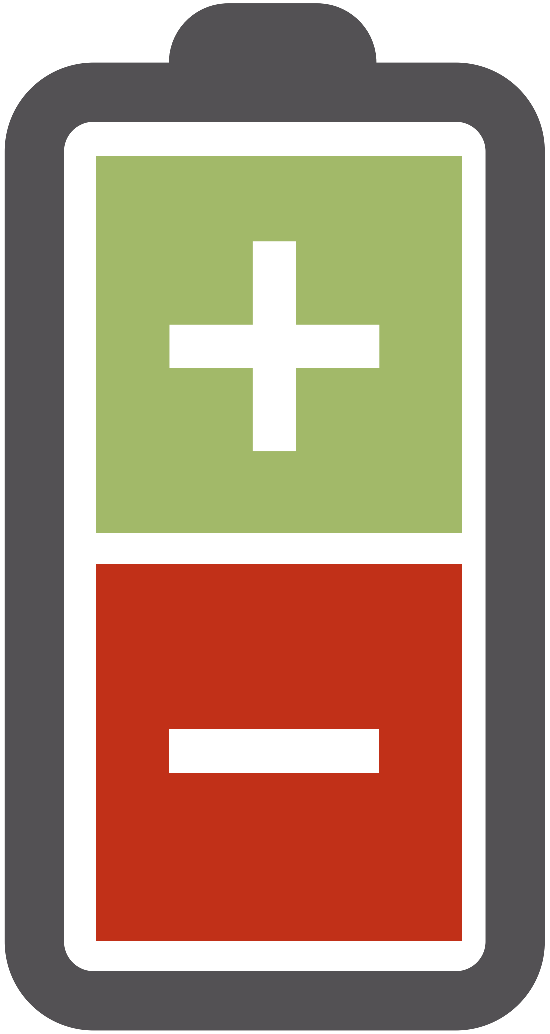
Fixed return for baseline routine distribution activities

AMOUNT C

Tax certainty for Amount A, B and other dispute (Amount C)

Arguments for the support of Amount B

- It may **provide simplification** to determination of taxable profits for companies engaged in the routine distribution and marketing activities [FIXED RETURN].
- It may **help in addressing many tax disputes** involving transfer pricing issues of MNEs engaged in these activities.
- It will **enhance tax certainty and reduce tax compliance costs** (taxpayers) and administration cost by tax Administrations.



- The definition must be clear to avoid further cases of tax disputes
- It must be broad to cover majority of distribution activities for it to be beneficial to African countries.
- The quantum of the fixed return
  - Should fairly approximate (proxy) the arm's length return for similar activities [functional profile].

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