A Proactive Transfer Pricing Approach to the COVID-19 Crisis

All of us are by now aware of the significant impacts that the COVID19 crisis is having on the world around us. The pandemic will have considerable consequences for multinational groups' transfer prices and compliance. **Now is the time to take action and start planning or restructuring your transfer prices accordingly**.

But what actions can taxpayers take at this time? BaseFirma is sharing some key recommendations on how to better approach this economic downturn.

The Importance of a Proactive Response

It is important to highlight that multinational groups should take a proactive approach instead of waiting until year-end to make any necessary adjustments. Waiting for next year when compliance documentation is due and worrying at that time what the documentation strategy should be for your group is a bad choice.

The first thing you need to determine is whether your industry is affected, and if so, how negatively it is impacted. A good industry analysis may be key to better explain the financial results of the group companies. You can certainly leave this work to your tax preparer; however, who knows your industry better than you? Your input in this matter is strongly recommended.

Second, we recommend regularly quantifying whenever possible the impact of the COVID19 crisis on the company's business. For this, it is important to keep constant logs of small impacts.

Just stating that your business was heavily affected will not be sufficient. Tax authorities will request proof of such an impact. Keep in mind that the transfer pricing documentation will be of vital importance and an appropriate description of the impact will be necessary. Now, what type of information should you be quantifying exactly? It depends on the specific situation, but you could start by:

- counting how many employees were sick during the period;
- quantifying how many employees were laid off, if any, and its resultant cost (severance);
- accounting for any extraordinary expenses;
- quantifying the impact of exchange rate volatility;
- accounting for sales reductions or increases in costs (i.e. inventory holding costs, rent of unused spaces, etc);
- quantifying for how long the crisis affected your business;
- quantifying idle capacity;
- documenting the implicit or hard to value impact of COVID19 (i.e. employee morale, productivity);

- quantifying the effects of the renegotiation of contracts or the negotiation of terms and conditions different from the usual ones (requested by suppliers and customers);
- documenting how the supply chain was affected; and / or
- quantifying demand decreases both direct and downstream (i.e. how the crisis affected your own customers).

The above-mentioned elements are some examples of relevant information that may be used to support the facts stated in the transfer pricing documentation, certain extraordinary adjustments to financial results, or comparable companies, among others.

Transfer Pricing Planning or Restructuring

In terms of transfer pricing planning, there are many recommended actions that multinational groups can take during these difficult times.

For instance, review your transfer pricing policies and allocations along the value chain. Does the impact of the COVID19 crisis mirror the risk profile of each link of your value chain? It may be time to review your distributors' margins, and /or evaluate whether to reduce the mark-up on your services, among other things. For such changes, evaluate renegotiating your intercompany agreements. Moreover, operating costs warranting a mark-up should be revised this year. Typically, captive service providers are remunerated on a fully loaded cost plus mark-up basis. However, at this time, the definition of operating costs is distorted. The recharge of fixed costs may be questioned by tax authorities.

A supply chain restructuring may be also salient to avoid unnecessary or duplicative intercompany charges. Remember, these are extraordinary times and require extraordinary measures. At this stage, it is important to demonstrate to tax authorities that your group has made reasonable efforts to comply with the arm's length principle. As such, we recommend including a summary of key measures taken in your transfer pricing documentation.

Groups must also review the terms of existing intercompany financial arrangements. Given the liquidity crunch, current terms should be analyzed to see whether they still apply, or whether your loans need to be refinanced. On the other hand, intercompany financing may be a good alternative, if not already in place, to provide some extra cash flow to group companies if needed. Just remember to structure your loans following the arm's length principle, current market conditions and debt capacity of the borrower, among others.

Tax Preparers' Strategies

Across the globe, tax consultants are providing their opinions and some alternative approaches they are considering for tackling the 2020 documentation strategy for their clients. Notice the documentation strategy will have to be customized as per each client's needs, risk exposure, and other characteristics of the business and industry they operate in. Also, some approaches may not be accepted by certain tax authorities if not properly supported in the report.

Some alternatives are discussed below:

- using a business cycle of three years for the tested party;
- refine comparable' search strategy to avoid industries that experienced a different impact;
- not rejecting companies due to losses, as many of your previous comparables will be at loss;
- applying extraordinary adjustments to comparable companies and/or tested party;
- evaluating an ex-ante analysis to demonstrate that the transfer prices established at the start of the year would have ensured an arm's-length result, indicating any deviation from arm's length is the result of the COVID19 crisis;
- evaluating the option of implementing a profit/loss split for certain businesses, or replacing the pricing methodology in place with a more appropriate one (however, if this approach is selected then implications for previous and future fiscal years need to be considered).

It is important to mention that taxpayers need to carefully evaluate the potential benefits of modifying transfer pricing policies against possible future impacts.

Conclusions

After the crisis, cash strapped tax authorities are likely to increase scrutiny and initiate examination processes. Taxpayers should follow the arm's length standard, ensure compliance with their local regulations, and prepare for controversy.

Evaluate the best alternative for your business in order to ensure compliance with the arm's length principle. Your analyses, accompanied by practical transfer pricing documentation, will help support the view that any non-arm's length result may be caused by commercial/business reasons rather than transfer pricing.

BaseFirma can help you tackle all necessary steps to ensure a smooth transition during this planning phase. Please reach out to us if you have any questions.

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