

COVID-19 Pandemic: What do MNEs need to know about Managing Transfer Pricing Risks?

By Transfer Pricing Team

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Amidst the COVID-19 pandemic globally, countries are imposing lockdown measures to contain the rapid spread of the virus. Economy is virtually at a standstill as consumption plummeted, compounded by large scale closure of manufacturing and trade activities. This sudden jerk of global supply chain landscape coupled with an array of dysfunctional events are putting tremendous pressure on multinational enterprises (“MNEs”).



As a CEO or CFO of the Malaysian subsidiary of MNEs, you are faced with the immediate concerns on keeping up the robustness of the company’s transfer pricing process.

We will examine the transfer pricing issues, establish analytical frameworks and suggest for action plans by addressing on the following 4 areas of contention:



- Limited risk operations

- Special factor analysis



- Transfer pricing adjustment

- Selection of third party comparable companies





Limited risk operations

Manufacturing, distribution and service operators structured using a limited risk model are common in businesses. In particular, subsidiaries of MNEs operating globally are organized with limited functional profile and conferred with limited decision-making power. Under a limited risk model, as the market risk and/or operational risk are not assumed by the limited risk entities, the general expectation is that limited risk entities should earn a routine profit in line with their peers in the industry based on the returns derived from the periodic updates of their benchmarking studies.

With the COVID-19 pandemic, even in the best case scenario, most Malaysian companies will likely lose one full month of sales. While companies are putting hope of catching-up with the lost sales in the remaining part of the year, global demand may be suppressed putting the hope at great risk. Unfortunately, the overhead costs are not reducing at a speed in tandem with the drop in business revenue. These combined factors could very well erode the entire profits of the Malaysian company for 2020 resulting in losses, or a non-tax paying position.

Fast forward to post COVID-19 era, it will not be surprising to see the Inland Revenue Board (“IRB”) taking the conventional approach to dispute the loss making positions for these limited risk operators. In the eyes of the IRB, limited risk operators should earn routine profits, notwithstanding the ups and downs of the economy. With this hindsight in mind, limited risk companies need to better manage their transfer pricing affairs now rather than later.

Conclusion

The transfer pricing risks in Malaysia may be mitigated through the following measures:

- Companies may choose to continue with the current transfer pricing policy set under the limited risk structure, i.e. earning a targeted routine return. To meet this objective, loss making companies will need to resort to making year end transfer pricing adjustments (upwards) on their operating margins.
- Alternatively, companies may wish to review the current transfer pricing policies by seeking for a reduced target margin for the remaining part of the year. To this end, additional steps are required to provide a robust defense against any accusation of inappropriate transfer pricing practices. This involves comprehensive documentation of the financial impacts of COVID-19 on the final operating results.



Special factor analysis

The transfer pricing documentation for 2020 is to be contemporaneous to address the different business landscape in light of the COVID-19 pandemic. Every affected business should carry out a special factor analysis where all legal, commercial rationales and justifications are in place to establish a defensible position. Amongst others, a detailed discussion relating to the options considered by the business in confronting the issues threatening its survival during the COVID-19 hardship. Bearing in mind the IRB is less likely in accepting cosmetic explanations that coronaviruses are to be blamed for the business losses or reduced profits.

The special factor analysis of each factor, may include but not be limited to the following:

- **Contractual analysis:** The starting point of an analysis is to conduct a thorough review of the contracts governing the intercompany transactions - the terms, rights, and obligations. Many contracts contain force majeure clauses. The pertinent question is whether the related parties will be able to rely on the clause to relieve related parties from compensating the Malaysian entities' reduced profitability under the existing transfer pricing framework. The actions warranted to be taken would depend upon the contractual terms.
- **Loss factor analysis:** The detailed analysis relating to the commercial rationales contributing to the loss making position seek to help identifying the direct impacts attributed to the virus outbreak, away from those impacts of the transfer pricing systems itself.
- **Specific period analysis:** A final piece of a convincing analysis should include the segregation of the results in different stages of the business: (i) fully-virus-impacted, (ii) transition, and (ii) resumption. Such analysis shows the details of the costs incurred and revenue generated during the respective periods, thus justifying the decisions made by taking different measures to counteract the impacts at different levels. Arguably, much of the analysis should focus on the fully-virus impacted period, and to a lesser extent, the transition period. Whereas during resumption periods, existing transfer pricing policies should be observed without the need of adjustments.

Conclusion

A sound transfer pricing position is to be supported by a set of contemporaneous transfer pricing documentation setting out the specific business factors, contractual and financial analysis as evidences of the loss making position.



Transfer pricing adjustment

An examination into the latest third party comparable companies and the broader business practices would shed lights on the approach for MNEs to adopt when faced with the issue of whether and how to compensate the Malaysian entity.

The financial results of comparable companies provide an indicator on the level of profit that should be earned by the Malaysian entity (i.e. tested party) through a benchmarking analysis. It is anticipated that third party companies in similar businesses may tend to suffer losses given the overall unfavorable economic conditions. Even with third party results that may likely to align with the tested party's results, the final hurdle is the IRB, who may decide to reject loss-making comparable companies on grounds of non-comparability. It is therefore imperative for taxpayers to document down the functional analysis and the process involved in selecting third party companies. The functional analysis helps to support comparability of third party companies in terms of functions, risks and assets. The selection of third party companies should strictly adhere to the comparability requirements and meet with independence criterion.

The reality in a benchmarking analysis is that information on financial results of third party companies earned during the span of the coronavirus in 2020 will not be publicly available until sometime in 2021, making it impossible for any real time analysis. The lack of real-time data is an hindrance to the required comparable analysis, and without such analysis, sound comparability adjustments could not be made.

Conclusion

During a period of crisis, MNEs are faced with numerous challenges affecting their transfer pricing systems, including selection of comparable companies. It is an added burden to the MNEs to be able to carefully assess the comparability of the third party companies for inclusion in their benchmarking analysis. The benefits of which could be garnered when its transfer pricing position in Malaysia is being challenged by the IRB post COVID-19 period.



Selection of third party comparable companies

Traditionally, to achieve a targeted profit level for the Malaysian subsidiary, MNEs resorted to making an accounting adjustment to make up the difference between the actual profit of the Malaysian subsidiary, and the targeted profit level, with the objective of meeting the targeted profit level that is defensible in a transfer pricing audit. This adjustment is known as a transfer pricing adjustment. A transfer pricing adjustment is often made at the year end, and can be either an upward or downward adjustment depending on the actual profit vis-à-vis targeted profit.

In the Malaysia context, a transfer pricing adjustment can be a highly disputable area due to lack of clarity. In the absence of guidance from the IRB, MNEs have to exercise extra caution with regards to making transfer pricing adjustments. When performing an analysis on the quantum of the transfer pricing adjustment, it is important for MNEs to evaluate all aspects of their transfer pricing policy. Some areas are highlighted below:

- Ascertain the impact on the industry as a whole, which sets the foundation for any profitability analysis for the group companies involved in intercompany transactions.
- Evaluate the impact of the low participation of the consumers in the market and its correlation with the MNE's inventory obsolescence.
- Identify significant issues on the supply chain management in light of the border closure policies adopted by affected tax jurisdictions.
- Assess the type of risks for the members in the group involved in the intercompany transactions and identify the parties bearing the risks.
- Internalize any revised transfer pricing policy devised for the entire MNEs that is aimed to ensure the sustainability of the MNEs.

Conclusion

In making a transfer pricing adjustment, various commercial considerations have to be taken into account such as those highlighted above, to ensure that the transfer pricing adjustments will not end up futile but could withstand any challenges posted by the IRB.



What's next?

While your company navigates itself through this economic turbulence, managing tax and transfer pricing risks is an item of your long to-do list. There are many areas that can possibly give rise to tax and transfer pricing risks for MNEs operating in multiple tax jurisdictions, including Malaysia. The 4 areas of contention for transfer pricing disputes could well be a tip of the iceberg.

The outcome of the COVID-19 is that MNEs are constrained by limited resources to address all business needs. As a result, the non-essential aspect of the business may need to give ways to other areas of top most priorities. Given this, will MNEs seek to maintain the financial budgets for transfer pricing compliance? The answer is quite negative at this moment. Nevertheless, to strike a balance between meeting compliance requirements and maximizing its resources, MNEs may consider a more streamlined, cost-effective solutions to manage their transfer pricing risks and compliance across all the tax jurisdictions they are operating in.



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