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INSIGHT: How Will Covid-19 Impact Your 2020 Transfer Pricing Process?

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The Organization for Economic Co-operation and Development (OECD) has warned that Covid-19 is the greatest danger to the world economy since the 2008 financial crisis. It is therefore to be expected that the Covid-19 epidemic will have a negative bearing on the operating income of multinational enterprises (MNEs), and impose a considerable burden on the cash flow of an MNE as well as its individual subsidiaries.

It is clear that such an economic downturn will impact a group's transfer prices, analysis and documentation. Similar economic turmoil was experienced by MNEs during the global financial crisis of 2008 and the SARS outbreak in 2003. However, the transfer pricing landscape during those periods was substantially different. Specifically, the BEPS Action Plans are now in force, and the level of transfer pricing scrutiny is high across all markets.

Against this backdrop, how should an MNE prepare for the impact of Covid-19 on its transfer pricing process?

Continuous Documentation of Specific Economic Factors

Most tax authorities seem to accept the view that associated enterprises, like independent enterprises, can sustain genuine losses due to unfavorable economic conditions and other legitimate business reasons.

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The financial impact experienced by businesses as a result of Covid-19 is a valid adverse economic condition. Independent enterprises are likely to make losses this year if the effects of Covid-19 last much further. Thus, it can be argued that associated enterprises should also be given an opportunity to record similar losses.

A range of questions arise in such a situation:

- Did the associated enterprise have an opportunity to record increased profits during the good years?
- Are such losses consistent with the function, asset and risk profile of the associated enterprise?
- Even if the associated enterprise is considered to be a limited risk, limited function entity, is there a justified reason, as detailed in the company records or agreements, that allow it to record a reduced level of profit?
- The Covid-19 epidemic is an unforeseen, unprecedented event. There are narratives of companies missing earnings forecasts. Should this also be applicable to associated enterprises?
- There have been cases where third parties have started canceling orders and reneging on their commitments. If third parties are allowed to do this, should associated enterprises also be permitted to renege on their commitments with little or no penalties?

While it is still hoped that the Covid-19 epidemic will end by the second quarter of this year, allowing for the possibility of a recovery, it is highly recommended that taxpayers prepare and maintain evidentiary support in relation to the weekly or monthly impact of Covid-19 on the overall operations.

Hard to Measure Impact It should be noted that the impact of Covid-19 may not all be quantitatively measurable. For example, there may be negative psychological impact on employees as a result of social distancing. This is not something that will be immediately obvious from the financial statement. However, the impact can still be felt on the company due to reduced productivity. Thus, continued ''practical'' documentation is necessary to accurately document the true impact of Covid-19.

An Example As an example, let's look at a company that functions as a regional headquarters and whose principal activity is to provide services to its overseas network of related companies. It recovers all its costs incurred in providing the services with an arm's-length mark-up. If one of its employees is down with Covid-19 and that also results in several other employees being quarantined, there will be a drop in the level of services that the company ordinarily provides to its related companies. This can be exacerbated by the fact that cross-border travel restrictions prevent the employees from undertaking services that were planned for under the inter-company service agreements.

While the company will still incur the same level of staff costs, the productivity of its employees would have been substantially impacted. Is it reasonable for the company to be charging the same level of fees to its related parties as in the past?

MNEs can, therefore, carry out ongoing internal communications and make a start on the preparation of corresponding documents to support the reasonableness of the profit/loss allocation to each related party during the epidemic. The documentation could cover, among other things, the following:

- supply-chain disruptions;
- changes in employees' cross-border movements and assignments;
- impact on branding and marketing intangibles;
- temporary relocation of business functions to reduce geographical risks;
- challenges due to staff absenteeism;
- impact on cashflows and liquidity.

Ex-Ante vs Ex-Post Analysis

The OECD Transfer Pricing Guidelines, 2017 note that taxpayers may establish their transfer pricing documentation to demonstrate that they have made reasonable efforts to comply with the arm's-length principle at the time their intra-group transactions were undertaken, i.e., on an ex-ante basis. This arm's-length price setting approach would be based on information that was reasonably available to them at that point (paragraph 3.69 of the OECD Transfer Pricing Guidelines).

In other instances, taxpayers might test the actual outcome of their controlled transactions to demonstrate that the conditions of these transactions were consistent with the arm's-length principle, i.e., on an ex-post basis. This arm's length outcome-testing approach (paragraph 3.70 of the OECD Transfer Pricing Guidelines), will typically take place as part of the process for establishing the tax return at year-end.

The Singapore Transfer Pricing Guidelines also note that contemporaneous documentation may refer to documentation and information that is relied upon by taxpayers to determine the transfer price at the time of the transaction. In addition, the Inland Revenue Authority of Singapore is prepared to accept transfer pricing documentation as contemporaneous if it is prepared before the statutory deadline for filing of the tax return (paragraph 6.8 and 6.9 of the Singapore Transfer Pricing Guidelines).

Most taxpayers have typically prepared their transfer pricing documentation on an ex-post/outcome testing basis, whereby they evaluate the results achieved based on the whole year's financial results against what comparable companies have earned. Such an approach may not work for FY 2020 for the following reasons:

- The financial data of the comparable companies for FY 2020 are not likely to be available by the time the tax return is due. Thus, by going on an ex-post approach, taxpayers would end up evaluating their related party transactions against FY 2019 financial results, which obviously have not been impacted by Covid-19.
- While this may be rectified by testing both the tested party and the comparable companies' results on a multiple year basis, such an approach may not be accepted by certain tax authorities (e.g., Singapore) as they prefer to test the taxpayer's results for a particular year against the multiple year data of the comparable companies.

Thus, by preparing documentation on an ex-ante basis, it would be possible for the taxpayer to demonstrate that the transfer prices that are established at the start of the year would have ensured that an arm's-length outcome would have been achieved. Thus, any deviation from arm's length would have been a result of Covid-19, either directly or indirectly.

This analysis, accompanied by the ''practical'' documentation that the taxpayer maintains, will help support the view that any non-arm's-length result may be caused by commercial/ business reasons rather than transfer pricing.

Financial Support Through Delayed Payment Terms and Financing

The pressure on cash flows may result in a range of financial support not just between related parties but also between third parties. Suppliers may allow customers to pay them on a slightly delayed basis to help them manage their cash flows. Such a practice may be adopted without a change in the price in order to preserve longstanding customer relationships.

Similarly, associated enterprises may also offer their related party customers a delay in paying, without an impact on the transfer price. As such, MNEs could forecast the potential cash flow issues in the future to determine alternative methods to support the cash flow of their subsidiaries in a timely and effective manner. In such cases, it is necessary for taxpayers to demonstrate that such practices are consistent with how they would transact with third parties.

MNEs may also increase intercompany lending in order to manage the working capital needs of their subsidiaries. Intercompany financing is a hot topic for taxpayers and with the recent guidance provided by the OECD on transfer pricing aspects of intercompany financing, it is likely that tax authorities will give close scrutiny to loans and other financial support extended within the group.

Planning Points

Companies with significant operations in affected countries could think about the broader implications of their business decisions and consider taking the following steps:

- Review 2020 tax planning based on the impact that such a magnitude of disruption could have on business operations.
- Determine whether there is an impact on tax accruals/estimates across the board, or if issues are isolated to specific locations.
- Evaluate transfer pricing activity related to moving cash into or out of affected countries to pay for epidemic-related expenses.
- Evaluate and document the impact on transfer prices due to adjustments made to supply chains or employee locations and movements during the crisis.

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