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COVID-19 Transfer Pricing Strategies for Private Equity Portfolio Companies

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Disruptions to supply and distribution chains arising from COVID-19 have created pressure on corporate profitability and cash flows. These pressures can be magnified for private equity portfolio companies that are typically highly leveraged. For multinational portfolio companies, proactive steps to revisit transfer pricing policies may provide opportunities to reduce tax liabilities and preserve cash flows.

Transfer pricing policies govern how corporate revenues, costs, and profits are allocated across a multinational portfolio company's entities. In recent years a growing number of private equity firms have added transfer pricing to their toolkit for driving cash flow optimization, tax efficiency, and investment returns at portfolio companies, particularly in light of high valuation multiples being paid for acquisitions.[1]

However, transfer pricing policies that may achieve desired goals in normal or prosperous times can become stressed in recessionary environments, particularly downturns such as that arising from COVID-19. Group entities with guaranteed margins may distort effective tax rates at a time when the

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[1] In recent years, until the COVID-19 crisis, valuations have soared with average portfolio company purchase multiples exceeding 10x EBITDA. Pitchbook 2018 Private Equity Outlook, https://files.pitchbook.com/website/files/pdf/PitchBook_2018_PE_Outlook.pdf.

group as a whole is losing money. The allocation of global liquidity might also become distorted, complicating for instance the group's ability to service external debt.

Adjustments to existing transfer pricing policies during economic downturns can improve tax efficiency while moving cash to where it's needed. Cash flow and tax benefits in turn improve investment returns from portfolio holdings.

Rethinking Transfer Pricing in Light of COVID-19

COVID-19 has led to a collapse in customer demand for many businesses, and disruption of their supply chains for both inputs and output products/services. Meanwhile, they continue to bear carrying costs of labor and facilities that are at least partially fixed, and may even have extraordinary costs arising from the crisis (e.g., input shortages, labor redundancies).

While all of a portfolio company's entities will be affected by the economic slowdown, some may fare better than others. For example, the bulk of COVID-19 crisis management costs may be borne by the parent company, while reduced demand and loss of key customers may disproportionately affect certain group operating entities. Manufacturing entities will largely bear the burden of fixed facility costs.

When unrelated parties face such challenges, they often seek to renegotiate customer contracts or pricing, re-assess supply chains, or undertake other steps to protect revenues and profits. It should not be any different for related parties.

The questions that arise are: What steps should portfolio companies with international operations take to re-assess how revenues and profits are allocated under such severe conditions? Do those steps comport with the transfer pricing rules in each country? Making a decision will require evaluating the current economic conditions and imperative for change against longer term considerations, which might include the tax risk of making a change now and reverting to status quo when the crisis is past.

The opportunities to reassess transfer pricing policies depend on how a company is organized and its specific facts and circumstances. Below we highlight a few potential opportunities stemming from the economic downturn.

Reducing Targeted Profit Margins of Limited Risk Entities

Many U.S.-headquartered portfolio companies are organized with a U.S. company that is the group entrepreneur and that owns the group's key intangible property, with the overseas entities being limited-risk distributors, manufacturers or service providers. In normal times, the limited-risk affiliates earn their targeted profit margins, with the residual group profit accruing to the U.S. entrepreneur.

This kind of structure can have negative tax consequences in economic downturns. For example, while the group as a whole may have losses, it will have profits in the jurisdictions of the limited risk affiliates on which it will have to pay taxes. Even if the group as a whole remains profitable, albeit at a reduced level, the group's effective global tax rate will likely increase to the extent the limited risk affiliates are in high-tax jurisdictions.

Reducing the targeted profitability of the limited risk entities during the period of the economic downturn can help reduce this tax leakage. It would also leave more of the group's profits with the U.S. entrepreneur to cover external debt and other costs. The targeted margins of the affiliates might be reduced to the lower part of a previously established arm's length range, or even below it if special economic circumstances can be cited. Alternatively, the cost base on which the profit margins are calculated can be narrowed if there is an argument that the affiliates have the responsibility to manage at least some of their own costs in downturns.

Any such adjustments must be carefully supported, taking into account current intercompany contracts as well as existing transfer pricing studies with analyses that support the targeted margin earned by the limited risk entities. Changes to policies should not contradict the function and risk profiles of the relevant entities already documented.

Consideration should also be given to any risks raised in the country where the limited risk entity is resident. Foreign tax authorities could object to reductions in taxable income of entities that would not be expected to benefit in years of high group profits. (China is one jurisdiction where it can be challenging to adjust transfer prices in such cases.[2]) An economic argument that both parties are better off from the revised transfer pricing policy could be helpful.

Increasing Royalty Rates

A U.S.-based portfolio company may be licensing technology and trademark intangibles to related parties overseas in return for a royalty. Transfer pricing rules require that the royalty rate is commensurate with the profit potential of the subject intangible assets.

An opening assumption might be that royalty rates should stay the same if not be reduced in an economic downturn. However, if the royalty rate was set conservatively, there may be an opportunity to increase it, resulting in increased cash flow to the U.S. parent. Doing so may also have an added tax benefit in that the royalty paid to the U.S. could be eligible to be taxed at a lower effective rate of between 13.125 percent and 16.406 percent to the extent the royalty is foreign-derived intangible income (FDII),[3] which is significantly lower than the headline U.S. corporate tax rate of 21 percent and also lower than corporate tax rates of many other major countries.

One would still need to ensure that any increased royalty rate is supportable when compared to comparable agreements between unrelated parties. And there needs to be a rationale and convincing

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[2] Cheng Chi, Choon Beng Teoh, Tanya Tang, and Brian Cody, *INSIGHT: Covid-19 Puts Limited Risk Structure at Risk—Analysis from the Chinese Angle*, Daily Tax Report (Mar. 26, 2020).

[3] Under FDII, certain income from the sale of property and services to non-U.S. entities/persons qualifies for a deduction that lowers the effective U.S. tax rate on that income to 13.125 percent through 2025, and to 16.406 percent thereafter. The lower tax rate on FDII eligible income, with some exceptions, is also available to the export of property and services by U.S. multinationals (or U.S. subsidiaries of foreign multinationals) to overseas affiliates.

argument as to why the licensee would agree to a higher royalty rate—such as ensuring the economic survival of the licensor so that the licensee continues to have future access to the licensed intangibles.[4]

Charging Affiliates for COVID-19 Extraordinary Costs

Many U.S. multinationals have set up crisis management teams at their U.S. headquarters to respond to COVID-19 issues worldwide. Some are incurring significant costs as they revisit supply chains, look for new suppliers of raw materials, renegotiate contractual arrangements with customers and labor, or devise strategies to respond to declining demand.

Under transfer pricing rules, activities that provide direct economic benefit to affiliates by helping them protect revenues and minimize costs should be charged to the affiliates. This charge could take the form of cost plus a profit markup, a value added service fee, or in some cases a contingent fee.[5]

Apart from providing the U.S. parent with additional cash flow, the service charge could be eligible to be taxed at the lower FDII rate, subject to careful analysis of the beneficiaries of such costs and whether they should be classified as stewardship.

Treasury and Cash Management

While there may be adequate profitability and cash flow on a consolidated basis to service external debt, the available cash may not be in the right entity. If the U.S. parent of a portfolio company issued the debt but the needed cash is sitting in overseas affiliates, getting that cash up to the United States through dividends can take time and may also be tax inefficient if it attracts withholding tax.

One alternative would be for the foreign affiliate(s) to make a short-term intercompany loan to the U.S. parent. The loan should be at prevailing market rates and be appropriately documented.

In addition, there may be an opportunity for Treasury to pool excess group cash to make it available on a short term basis to affiliates with funding needs. The lenders should of course be compensated with an arm's length interest rate.

Conclusion

COVID-19 has dampened business activity worldwide, with pervasive consequential effects on tax and liquidity positions. As a result, revisiting existing transfer pricing policies in light of current conditions could reveal that arm's length terms have changed, and adjusting to the new realities can potentially reduce tax inefficiencies. Private equity sponsors are well-advised to proactively scrutinize transfer

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[4] In some cases a royalty holiday or lower royalty in the short-term may be appropriate. Doing so may also provide a tax benefit to the extent that it leaves the U.S. licensor with a loss that it is able to carry back to prior years under the recently passed CARES Act in the United States. Unless this carry back provides a cash refund, however, doing so may not help with cash needs in the United States to service external debt.

[5] A contingent fee is permissible under U.S. and OECD transfer pricing rules provided the arrangement is put in place before the materialization of risk outcomes and appropriately documented.

pricing policies and results at their portfolio companies and confirm that they are not distorting financial and tax results, as well as evaluate opportunities in which intercompany flows can be adjusted to move cash to where it is needed.

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