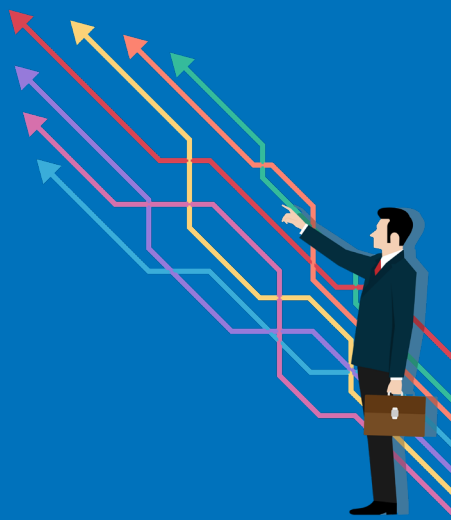
May 2020

Tax Talks

COVID-19 and transfer pricing – how to approach 2020 transfer pricing analysis?



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Beyond the shadow of a doubt, COVID-19 pandemic has impacted many aspects of our lives. While assessing the impact of the pandemic on the business operations and managing the challenges it caused, we must not forget to deal with our tax and transfer pricing ("TP") obligations.

Namely, the impact of COVID-19 raises several practical and tactical TP issues which are worth of the detailed consideration. While no official guidance has yet been released by the Serbian Ministry of Finance or OECD or regulatory body of developed countries (such as HMRC[1] or ATO[2]), we present below our initial thoughts on the potential issues which companies in Serbia, both members of Multinational enterprises ("MNE") and local, may face in the COVID-19 landscape.

Firstly, although the COVID-19 crisis has endangered day-to-day operations and business of most of the companies (some bringing to complete halt, like passenger air traffic and tourism industry), it must be noted that some other companies were prospering or pursuing new opportunities resulting in unexpected profits due to the new circumstances (for instance retail supermarket chains, pharmaceutical and IT industry). Nevertheless, regardless of the level of impact on a particular industry, each future TP analysis should take into account the factual circumstances of the particular case. This analysis refers to the tax periods that cover pandemic, which in Serbia is definitely calendar year 2020 and the tax periods that include the period from March 2020 onwards. In addition, it may refer even to the tax periods after 2020 depending on the speed of recovery of the national and global economy.

The hot topic in a TP world today is: **What will happen with the Principal structures?** Namely, would largely present TP model within MNEs, the Entrepreneur/ Principal model, survive the second test in last 20 years?

In short, the Principal model refers to a business model where there is a central Entrepreneur/the Principal company that usually bears economic risks, in most cases owns valuable IP and which is in return rewarded with the entitlement to keep the residual profit realized by the whole MNE.

On the other hand, there are numerous related companies which bear limited risks ("LR"), such as contract / toll manufacturers, LR distributors, etc. In TP theory LR also entails the mechanism that provides for the Principal to assume economic risks if those materialize, or at least this is what most Principals strongly defend in the period of economic growth. This factual pattern according to OECD TP Guidelines, leads to a conclusion that these entities should earn a modest stable return notwithstanding the MNE Group consolidated result. During the COVID-19 crisis, certain MNEs may record operating losses on a consolidated level. The main question which arises in this respect is: Would the Tax authorities ("TA") of the jurisdictions where LR entities are based, still expect LR entities to record the routine profit?

Based on the experience of regional and other countries (Czech Republic, Romania and China) from 2008 crisis, the practice of TA of countries where LR entities are based, was generally to require LR entities to report profitability corresponding to their limited risks. However, a unified conclusion and the advice cannot be made, as in fact, many of the tax disputes in relation to these matters are still pending.

Reactions in the worldwide TP profession so far are somewhat anecdotal, as it is noticeable that risks are more emphasized by the TP profession based in countries where LR entities are based. In Serbia, where more stringent TP practice is established, the risks should not be ignored. The thorough analysis will be needed to determine the facts and circumstances of each LR entity case, before any sustainable and justifiable conclusion is made. In the following text we note some issues that should be carefully considered.

[1] Her Majesty's Revenue and Customs (UK)
[2] Australian Taxation Office (Australija)

Elements of the contractual arrangement should be considered. Namely, whether the related party contract contains a force majeure clause, limiting the parties' obligations in situations beyond their prediction or control. The main question here to be answered, is the following: Should COVID -19 be considered as a force majeure event? This is a difficult question, and, in all circumstances, it should be assessed solely on a case by case basis with the assistance of legal experts. In this respect, measuring properly the COVID-19 loss is also an issue.

What would third party do in a comparable situation? – As contracts between independent contract manufacturers / distributers and independent Principals are in most circumstances confidential information, MNEs that engage in LR arrangements both with independent parties and related parties will be in a better position to assess the reality and **provide evidence** how third parties considered COVID-19 crisis.

Special care should be devoted to already filed TP documentation and statements presented therein, before any conclusion is made, and especially the conclusion that once LR entity should share the loss occurred due to COVID-19 now. However, if MNE insists on changing the TP policy due to the crisis, it should be considered if the new model is going to bring enough post-crisis profits to the company.

Moreover, there is a more general issue, applicable both to LR entities and the ones not qualified as LR: **How to conduct a realistic benchmarking analysis for 2020 financial year results and what is the right timing to do so?** This question is particularly relevant for Serbian groups, which were, even in previous periods, more exposed to whims of capitalistic economy. The fact that TP adjustments are regularly seen in tax returns in Serbia, is particularly driven by these circumstances. Namely, the need for a swift response to the opportunity on the market, often resulted in commercial decisions being brought without thorough elaboration of TP aspects and resulting in TP adjustment at the end of the year.

Having said that, we may conclude that 2020 margins (maybe even 2021) will be affected by COVID-19 pandemic. Every benchmarking analysis should consider the specifics of the macroeconomy for the year for which results are assessed. So far, relevant samples were based on the data from previous years. But, what to do now? Is it fair to base the arm's length margins solely on the past data, not taking into account figures realized by independent entities during COVID-19 crises? The arm's length range based on previous years' financial data would not reflect the current COVID 19 economic conditions, and consequently the analysis would not be reliable.

One possible solution is postponing the deadline for TP Documentation for 2020 until the financial data for 2020 is available. Another solution might be changing the requirement to calculate TP adjustment on an annual basis. These are the questions we believe should be addressed to the Serbian Ministry of Finance.

Finally, it is to be hoped that TA will take an open and flexible approach to addressing COVID-19's impact on TP.

If you would like to discuss your TP position for 2020 and start planning the approach on above issues, we would be pleased to organize a direct or video meeting.

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