Bolster the resilience of your transfer pricing model

How to help your group adapt to recent changes and new challenges

Bolster the resilience of your transfer pricing model

This article offers guidance for multinational groups to help your thinking process as you navigate necessary changes for your transfer pricing model in the wake of the coronavirus. We suggest key areas to focus on and describe a number of tools multinational groups may find helpful while reviewing your transfer pricing policies to ensure they are appropriate and effective.

Identify how you are impacted

The majority of multinationals' transfer pricing policies have been impacted by measures taken to protect people during the pandemic.

Key points of impact may include:

- The group has a Principal – Limited Risk Model, and severe losses have been / will be incurred.
- Part of the production units have been closed down during the lockdown period, or production units had to be kept operational just to avoid huge relaunch costs in case they would have been temporarily discontinued (e.g. steel, cement, glass, paper industries).
- External warehousing capacity had to be rented to store unsold production.
- Sales force was unable to reach out to clients and prospects.
- Planned services could not be rendered as premises of the clients were closed.
- Intercompany agreements in place do not include renegotiation, Force Majeure, or early termination clauses.
- Key responsible persons managing the current turmoil and mitigating the related risks are not the same as before the crisis.
- An important number of licensing / franchise fee flows are in place for the use on trade and technology intangibles.
- This crisis made visible that the group needs to reconsider its former value chain.
- The creditworthiness of the group and the underlying group entities has been impacted, resulting in a change in cost of debt.
- External banks are requesting formal guarantees.
- Extra inventory, due to a drop in sales, inflates the need for working capital.
- Cash flows problems arise, and the level of capitalization of the individual group companies is thin.
- Waiver of intercompany debt is being considered.
- Terms and conditions with joint venture partners are being modified, but not the intercompany transactions yet.

Consider profit split models

Decentralized operational and transfer pricing models will be able to better spread the impact of the exceptional cost incurred. Residual profit split or full profit split models should enable the proper repartition of losses over the supply chain.

It can be questioned whether, in the application of the residual profit split method, the level of initial routine remuneration to be allocated should not be revised downwards, as will be further discussed below. This is particularly the case if the same level of residual profit would be earned by the different parties involved, and adjustment would only have a minimal or no impact.

The methodology applied to split the profits between the related parties might also have to be reviewed taking into account possible changes in functionality / contribution. Strong operational arguments should be in place before modifying the profit allocation key used historically.

Groups applying the internal Comparable Uncontrolled Pricing ("CUP") method on certain types of transactions, will most likely also have a robust model in place for such transactions[1]. Indeed, the impact of the Covid-19 crisis is supposed to be fairly rapidly reflected in the pricing towards third parties. It's important to make sure that the crisis did not impact the functional profile of the related parties, and analyze whether the CUP can still be applied as is, or whether additional comparability adjustments should be performed.

The robustness of methodologies based on external CUPs can be more questionable. External comparables, which can for instance be identified in licensing agreement databases, are often not very recent, and are slow to take into account the impact of the crisis. It should be noted that in a number of such third party licensing agreements, parties did already implement a royalty payment methodology where the royalty fee varies according to the EBIT level of the licensee. Depending on the type of technology or trade name a multinational group is licensing to its related parties, the renegotiation of the intercompany agreements and the introduction of an equivalent pricing clause might be opportune. Although the licensor may earn zero, or reduced, royalty income over one or two years, the licensor will be able to give oxygen to the licensee to survive, thereby ensuring its future revenue / royalty streams.

In the context of intercompany financing, we observe that the external CUP method is often being used, with reference to *Bloomberg* or *Thomson Reuters* data. Although such data is being updated on a constant basis and should therefore accurately reflect market evolutions, care should be given to correct allocation of the credit rating to the borrowing entity. The crisis might have an impact on the credit rating of the group and the credit rating allocated to individual group companies. The implied credit rating of the borrowing entity is one of the key factors in determining an arm's length interest rate. The available options at the level of the borrower and the lender might also have changed, and will have to be reviewed. The importance of the latter element has been stressed in the OECD report dated February 11, 2020 "*Transfer Pricing Guidance on Financial Transactions*", and will certainly be applied by tax administrations.

Transfer pricing implementation models which have historically always applied accurate budgeted costs, without having applied year-end adjustments based on actuals, might be better equipped to argue that excess costs will have to be kept locally. However, in practice we see that having a budgeted cost based pricing model which would be as accurate as the one observed between third parties is difficult / rarely observed, and that most multinational groups have historically applied targeted return based on actual costs.

1 Complete transfer pricing policies which are based on the external CUP method are however rarely observed.

Investigate available remedies

A number of remedies are available to help multinational groups recover, adapt, and move forward, including:

— **Renegotiation of contractual terms**

The basis of the arm's length principle looks at what would typically be agreed upon in a contract between third parties. Newspapers are reporting numerous example of ongoing negotiations between third parties, whereby initial contractual agreements are being renegotiated.

Even if intercompany agreements are not foreseeing explicit renegotiation clauses, one should consider what would have been agreed upon between third parties, and therefore envisage revising the terms and conditions thereof.

The OECD Transfer Pricing Guidelines are also confirming this position under Chapter III, Comparability Analysis and more precisely section B3 "Valuation highly uncertain at the outset and unpredictable events". Although this section is mainly referring to valuations, it can be said to be also applicable for other intercompany transactions.

Section 3.72: "The question arises whether, and if so how, to take account in the transfer pricing analysis of future events that were unpredictable at the time of the testing of a controlled transaction, in particular where valuation at that time was highly uncertain. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction."

Section 3.73 "[…] The main question is to determine whether the valuation was sufficiently uncertain at the outset that the parties at arm's length would have required a price adjustment mechanism, or whether the change in value was so fundamental a development that it would have led to a renegotiation of the transaction. Where this is the case, the tax administration would be justified in determining the arm's length price for the transaction on the basis of the adjustment clause or renegotiation that would be provided at arm's length in a comparable uncontrolled transaction."

— **Lock-down related costs**

As opposed to the financial crisis of 2008, the Covid-19 crisis impacted all group entities unexpectedly. Production sites had to be temporary closed, not because of a reduced number of orders which would be the result of a decision taken by the Principal, but merely because of measures imposed in the country of production, or the countries which are supplying raw materials or semi-finished goods.

Covid-19 is not something which impacts only the Principal; it impacts any third party or related party contact manufacturer as well. A third party contract manufacturer would most likely not be able to simply push through exceptional inactivity costs incurred to its Principal.

Agreements sometimes already include Force Majeure clauses, outlining the conduct between parties in such exceptional cases. Whether or not such a clause is present in intercompany agreements, it should be possible to apply the same principle.

However, there might be an interdependency between parties, depending on the reasonably available options to both parties. A contract manufacturer might be willing to lower its margin or to bear losses in order to make sure that its Principal does not enter into bankruptcy. Similarly, the Principal might be inclined to support a contract manufacturer if the number of manufacturing alternatives are scarce.

Depending on the facts and circumstances, it is not unreasonable to assume that a part or all of such inactivity costs should be retained by the tested party in an intercompany context as well.

Although the Belgian transfer pricing Circular of February 25, 2020[2] does touch upon the notion of cost linked to inefficiencies and exception costs, we feel that the exceptional costs incurred in the context of Covid-19 should be treated differently.

More specifically, the Circular notes:

— Section 48:[3] *"It is generally accepted that costs which are higher as a result of a lack of effectiveness should be borne by the company who renders the products or services, as it is that enterprise which is able to influence the magnitude of such costs. Under such circumstances, an independent buyer would not agree to adjust the price."*
— Section 181:[4] *"The tax administration estimates that in case of the application of the cost plus method or the transactional net margin method based on costs, one should take into account the following elements: (i) […]; (ii) the profitability of a service rendering company which is assuming limited risks, should in principle be guaranteed and should as a result not be impacted negatively by financial or non-recurring charges which would not correspond to the functional profile of the services provider."*
— However, the same reasoning applied to the inefficiency costs can also be applied to Covid-19 related inactivity costs, i.e. *"as it is that enterprise which is able to influence the magnitude of such costs".* Since the Principal is not able to manage these costs, it is most likely that such costs should not totally be recharged to the latter. 'Limited risk' does not mean 'no risk'.

2 2020/C/35.
3 Ibid.
4 2020/C/35

— **Anticipated economic downturn**

The aftermath of the Covid crisis is expected to be long and will impact business severely. Profitability available within the total supply chain will no longer be that of past years.

Transfer pricing benchmarking studies based on the transactional net margin method typically refer to the performance of comparable independent companies over the past three to five years. In this respect, there is always a delay of one year, before the financials of the independent comparable are publically available. In documenting the transfer prices to be applied for the financial year 2020, it is common to refer to comparable financial information from the period of 2017 to 2019. Taking into account the severe financial downturn expected, the past performance of the independent comparables selected is no longer accurate as a benchmark.

Instead, it's important to analyze whether reasonably accurate adjustments could be performed to the initial benchmarking results obtained covering the period 2017 to 2019.

Possible approaches could include:

— A positioning on the lower end of the arm's length range, i.e. closer to the 25th percentile instead of targeting the median. In this respect, the Belgian transfer pricing Circular[5] refers to the fact that a position within the interquartile range should be acceptable. This statement assumes that the final set of comparables obtained through the benchmarking study is indeed comparable. As we all know, the performance of benchmarking studies is not an exact science, and due to the fact that only independent companies are to be included, perfect comparables can rarely be identified. However, throughout the year, practitioners and tax authorities have a relatively precise view on the type of interquartile range to be expected in the respective industries.
— For certain multinational groups and industries, a positioning on the 25th percentile will not be sufficient. Alternative methods will therefore have to be defined based on quantifiable data available on the market. Such market information could include the drop of GDP of the country, sector specific information, or quarterly results published by quoted companies. As will be discussed further down in this article, such approaches might be most at risk in the context of a transfer pricing audit. Hopefully, at the time a transfer pricing audit is being initiated, the financial year 2020 information of the independent comparables selected is available, to help make the total story coherent. Falling back on margins earned during the previous financial crisis, i.e. 2008 – 2009 could also be envisaged as a way to guide the magnitude of the adjustment to be carried through.

— **Royalty free period**

As referred to above, royalty free periods can be observed in agreements between third parties in case of losses or underperformance. This enables the licensee to recover from an economic downturn or a new entrant putting pressure on margins, and to be stronger to grow once the economy picks-up again. Depending on the facts and circumstances, such approaches could be envisaged in an intercompany context as well.

— **Take the opportunity to rethink your model**

For groups which have long been envisaging an update of their transfer pricing model, the current situation could provide the right opportunity and momentum to take action.

Whereas during times of economic growth, a change in transfer pricing policy could have resulted in significant exit tax risks or costs, the current circumstances might change these outcomes. Considering the uncertain period to come, a third party might be willing to be converted into a limited risk entity in order to ensure more stable profitability. Meanwhile, a Principal might also be willing to decentralize certain functions again in order to avoid having to bear the total risk in relation to a potentially lengthy and uncertain profitability period. Local entities might therefore be willing to absorb a part of the current losses if medium-term profit potential is expected.

The transfer pricing model should of course follow the operational reality. The above centralization or decentralization should therefore be driven by the business. However, it might be that the management of the Covid-19 crisis has shown that the decision making process and that persons in charge of mitigating the related risks did change, and that an equivalent change in the transfer pricing model should be envisaged.

Needless to say, all decisions in relation to a change in transfer pricing method should take into account a medium or long term view. Changing the transfer pricing policy again when the economic downturn is over will certainly frustrate a tax inspector in his review of the acceptability of the model. Moreover, opportunistic changes in models could also lead to scrutiny by certain NGOs and result in reputational damage.

5 i.e. the on performing the so-called "DEMPE"-functions (Development; Enhancement; Maintenance; Protection and Exploitation).

Consider the ramifications

In assessing which modified model to implement or temporary measures to take, there are also potentially undesirable outcomes to take into account, including:

The Principal is often not only performing the 'significant people functions', but is also the economic[6] and legal owner of the Intangible Property ("IP"). In practice, we see that such Principals, or the group companies owning the IP, are applying tax friendly[7] IP-Box regimes. In Belgium, there is the attractive IP-Box regime called "Innovation Income Deduction", which is exempting 85% of the net income related to patents or copyrighted software. Many other European countries have similar regimes. The IP used by groups is considered to generate non-routine profits and transfer pricing methodologies are therefore often allocating part of the residual profit to the IP. In envisioning the conversion of a Principal model to a profit split model, it's important to be aware of the fact that in the future, once the economy picks up again, less income might be allocated to the IP-Box. However, transfer pricing methods allocating a fixed royalty rate based on an external or internal CUP analysis might be less vulnerable to such side effects.

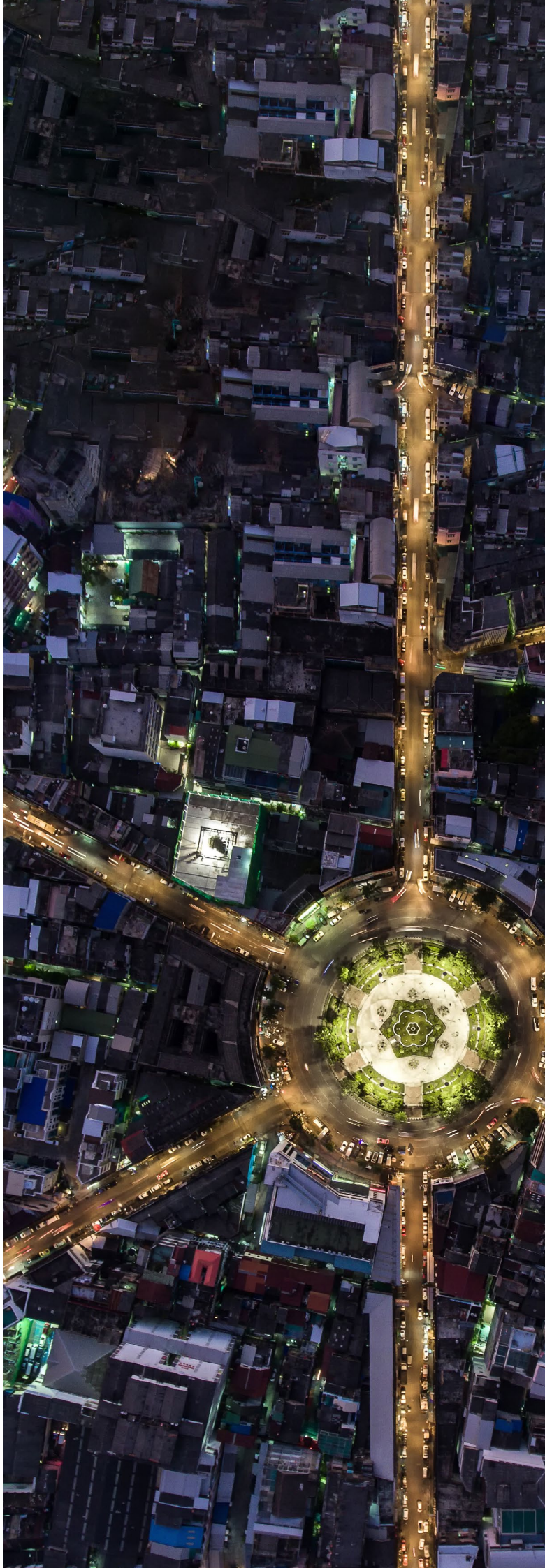
As has always been the case, the customs impact of transfer pricing policies to be implemented should not be overseen. Adjustments to the transfer pricing methods will result in changes in the future product pricing and the application of potential year-end adjustments. This will trigger the attention of the customs authorities, and might therefore result in a customs audit. The customs impacts of the changed pricing model in the short and long term should therefore be carefully considered.

Another side effect, although manageable, is the potential impact of a revised transfer pricing model on the remuneration of individuals. Past experience has shown that this is often a very sensitive point for organizations. KPIs might therefore have to be revisited / adjusted to avoid adverse effects.

Multinationals might also have a number of Advanced Pricing Agreements ("APAs") or unilateral rulings in place which are covering the targeted returns of a number of tested parties. When deciding on a lower positioning within the range for transactions not covered by an APA / ruling, the question can be raised as to whether APAs / rulings need to be reopened, considering the changed economic environment.

Loans concluded prior to June 17, 2016 are not to be included into the 30% fiscal EBITDA thin cap rule (based on the EU Anti-Tax Avoidance Directive ("ATAD"), as implemented in Belgian Law), unless significant changes are subsequently made to the terms & conditions of these loans.

Where group entities are renegotiating certain terms and conditions of such older loans in the context of the Covid-19 crisis, start by estimating the potential impact thereof in terms of interest deductibility.



6 Tax friendly, but also in compliance with the requirements listed in Action point 5 of the OECD BEPS Reports.
7 Belgian transfer pricing Circular dated February 25, 2020.

Anticipate an audit

Of course it is not only the multinational groups that are brainstorming and simulating the impact of the Covid-19 crisis on the taxable basis and the transfer pricing policies. Tax authorities are also creating workgroups to align viewpoints as to what will be acceptable or not. The Belgian tax authorities involved in transfer pricing matters have also created a Covid-19 workgroup, composed of the same parties which have been working together on the recently published Belgian transfer pricing Circular[8].

In this respect, we already know some of the viewpoints taken by tax authorities in the context of the 2008 economic downturn. For instance, we recall Mr. P. Chiau, formerly active within the Belgian transfer pricing audit department and now active within the Belgian special investigation squad, saying: *"In times of economic growth, I never observe any Belgian routine entity earning a margin above the median of the arm's length range. However, in times of economic downturn, everybody is arguing that a positioning below the interquartile or full range should be acceptable for the tested party."*

The Force Majeure element which is the basis of the current crisis might however be an important differentiator compared to the 2008 crisis. Although it might be a differentiator for the lock-down period, this type of discussion will be inevitable in relation to the period after the lock-down, which will most likely take at least one year.

We understand in this respect that the OECD is also working on further guidance in this respect, to be issued before year-end.

Today, we see that Belgian transfer pricing audits are initiated, based on information included in the Local File Forms which are submitted together with the corporate income / branch tax returns. In such forms, one also has to indicate whether a 'Business Restructuring' took place, as described under Chapter IX of the OECD Transfer Pricing Guidelines. A clear correlation could be observed this year between the selected companies and the ones who ticked the restructuring box. Covid-19 impacts will certainly lead to business restructurings and such boxes will also have to be ticked in this context. We can therefore assume that any substantial change to the methodology will be audited in the near future. This trend is probably not different in other countries around the world.

Review payment structures

Cash is king. Many groups are struggling to overcome liquidity problems. Between third parties, delays of payment are being applied, be it for account payables, rental, or interest payments. There is no reason that such payment delays could not be introduced in an intercompany context.

However, it's important to be able to demonstrate the real need for such payment delays for the entities concerned and define precisely the modalities around it, as would occur between third parties. A detailed and quantifiable repayment schedule would be expected, which takes into account the facts and circumstances surrounding the transactions and related entities.

Waiver of debt, potentially subject to revival, could also be observed between third parties. Such types of waivers were already observed in the context of the 2008 crisis. Consistency between the intercompany financing policy implemented and the credit rating model applied therein will be crucial.

It will also be necessary to review the terms and conditions of the intercompany loans. Are the borrowing companies still able to service the loans? Should interest be capitalized? Banks might also require additional guarantees in order to keep on providing liquidity to a local operating group entity. It will have to be reviewed, based on the guidance provided in the latest OECD paper on intercompany financing, whether or not such formal guarantees will require the payment of guarantee fees. Tax authorities could try to proportionally refuse the deductibility of intercompany interest charges, insofar as the borrowing entity would only have been able to borrow a lower amount in the event that no formal group guarantee is provided.

8 OECD Secretariat Proposal for a "Unified Approach" under Pillar One: *"51. The first type of profit, Amount A, would reallocation of a portion of the deemed residual profit of a multinational business (on a group or business line basis) to market jurisdictions irrespective of the location and/or residence of that business, consistent with the creation of a new nexus unconstrained by physical presence requirements. The deemed residual profit would represent the profit that remains after designating a deemed routine profit on the activities of the group or business line."*

Expect tracking of impacted groups

Not only will groups have to handle the impact of the crisis on their transfer pricing model, they might also be tracked following the implementation of restructuring related to Covid-19.

Under the Mandatory Disclose Requirement introduced under DAC 6, multinational groups will have to report, amongst others, any transfers of hard to value intangibles or transfer of functions, risks or assets where a reduction of more than 50 percent of the EBIT is expected in the coming 3 years.

Depending on the changed transfer pricing model to be introduced, one could rapidly be confronted with this "E3" transfer pricing hallmark, as from the moment that some functions, risks assets are moved. This makes it even more difficult to estimate the budgeted impact of the transfer on the EBIT result for the coming three years. The decision as to whether to report such a transfer or not will therefore not be an evident one.

Although the regulations and reporting requirements will remain in place in most of the European countries, the reporting deadlines may yet be postponed at country and EU level.

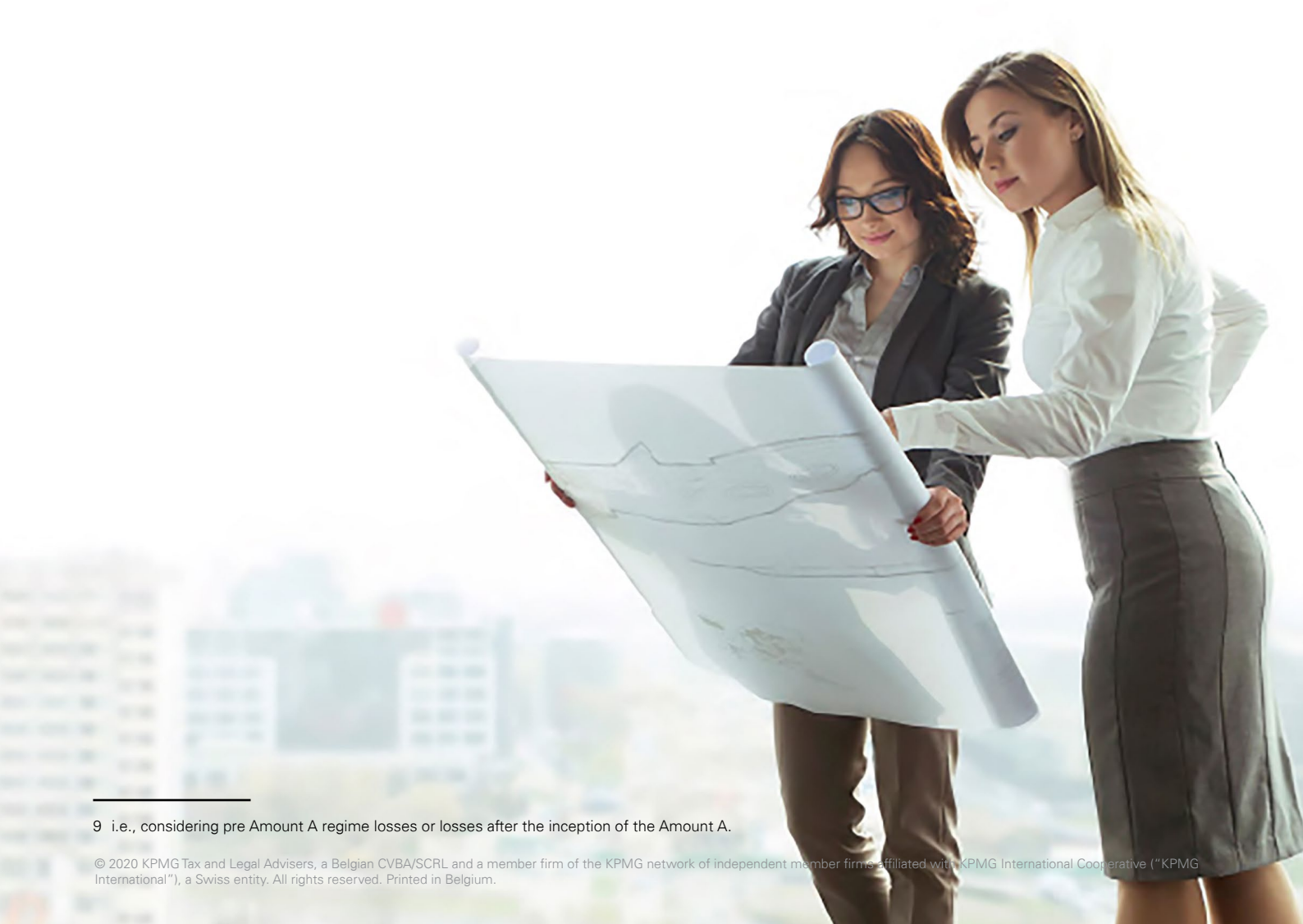
Don't forget to stress-test

In adjusting the current transfer pricing policy based on the above recommendations, it is important not to forget to stress-test the desired model for future expected 'best case' and 'worst case' scenarios.

Although operational and economic evolutions might be difficult to predict, some trends in relation to future regulatory restrictions have already been disclosed by authorities. One of those elements is the impact of the work being performed by the OECD around BEPS 2.0.

The OECD itself will however have to reflect as well on the impact of the current crisis on the robustness of the 'Unified Approach' model proposed under Pillar One.

Without wanting to address the impact in the present article, the question remains as to how willing countries would be to absorb residual losses which would be available at the level of the so-called 'Amount A'[9]. However, the current version of the OECD papers mention that the new allocation rules would also apply to losses. *The design of the loss rules is still pending.*



9 i.e., considering pre Amount A regime losses or losses after the inception of the Amount A.

Put things into perspective

While BEPS 2.0 might have felt like a storm, we did not see the Covid-19 tornado coming. This pandemic is yet another reminder of the unpredictability of the international business environment. We have known a long period of delocalization of production to Asian countries and tried to mitigate exit tax issues related to such transfers. It appears now that some of those transfers might have to be reversed, as we face the limits of globalization.

The world is constantly changing and it becomes more and more difficult to implement a transfer pricing model which is immune to all new challenges. Adapting policies to operational needs, economic circumstances, regulatory environment and the latest tax / compliance requirements will be an ongoing task on our 'to-do' lists in the years to come.

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