



# What's News in Tax

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## COVID-19 and Transfer Pricing Policy: A Lookback Analysis Of Routine Returns

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International tax directors face the unenviable challenge of determining whether they should modify transfer pricing policies in the face of the economic downturn caused by COVID-19. The business impacts vary greatly by industry sector and geography. Moreover, while these directors need to make these decisions in real time, the profit margin data often used for setting or testing transfer prices is generally only available with a lag of five to six months for North American databases and up to 18 months for some foreign databases.

This article focuses on a few of the various factors and approaches tax directors might consider when determining if their current target profit margins are appropriate during the COVID-19 disruption and, if not, how they might adjust those target margins consistent with the arm's-length standard.

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International tax directors face the unenviable challenge of addressing the following questions: “Should I modify my transfer pricing policy in the face of an economic downturn? And, if so by how much?” COVID-19 has caused an almost immediate economic downturn. Forecasting the economic future is perilous. The length of the COVID-19 economic downturn, the speed of the recovery, and which specific sectors will suffer the most are unknown. Streaming entertainment services are up and the travel sector is down. Tax directors and transfer pricing directors, however, need to set intercompany pricing in real time. Compounding the problem is the lag in data reporting—profit margin data often used for setting or testing transfer prices is generally only available with a lag of five to six months for North American databases and up to 18 months for some foreign databases.

In many cases transfer pricing analysts document compliance with the arm’s-length standard for intercompany transactions by comparing the profitability of the “tested party” in the intercompany transaction with the profitability of comparable uncontrolled firms. In normal economic times, comparability of these uncontrolled firms focuses on the functions performed, assets used, and risks taken. In addition, the tests commonly use previous year data and multiyear averaging to smooth swings in the business cycle.

One principle in transfer pricing is “Determine the economic factors (e.g., functions, assets, risks, market conditions) driving your tested party, and select comparables driven by the same economic factors.” Thus, when your tested party profitability goes down so will the comparables and the profitability of the tested party will stay in the interquartile range.

Determining the market conditions is part of a good industry analysis (an often-overlooked part of transfer pricing documentation). A good industry analysis is never more important than at the cusp of an economic downturn. An economic downturn introduces a volatility to corporate profitability that challenges the execution of common transfer pricing methods; in such circumstances, relying on the previous year’s data and on three-year averages may be unreliable as it may not reflect current market conditions and arm’s-length results.

While we do not know the future, we can look at the past for guidance. The last economic downturn of 2008-2009 also represented a major shock to the economy that was uneven across sectors. We cannot know if the economic downturn resulting from COVID-19 will be more or less severe than the 2008-09 economic downturn. Nonetheless, it is unlikely to have the same pattern of contraction by industry. The economic downturn of 2008-09 was primarily driven by a financial crisis and the bursting of a bubble in the housing finance industry; accordingly, the downturn in these sectors was much more dramatic. The economic downturn beginning 2020 is the result of a global public health emergency, which is affecting different industries differently.

That said, examining the impact on different industries during the last economic downturn can give some insight as to how to adjust intercompany prices during the current economic downturn.

In this exercise, we have taken several commonly used sets of North American comparables and a sample of European comparable sets prepared in the last two years and analyzed their historical data from the 2006-2013 period.<sup>1</sup> This provides data from the last years of the expansion, the economic downturn years and the first years of the recovery.<sup>2</sup> Our review includes an analysis of:

- Six North American comparable sets: administrative services providers; wholesale distributors in each of the electrical parts and equipment, construction supplies, and industrial supplies and equipment industries; and manufacturers in each of the motor vehicle parts and accessories, and industrial supplies and equipment industries.<sup>3</sup>
- Six European comparable sets: administrative services providers; wholesale distributors in each of the clothing and accessories, machinery and equipment, and electrical equipment industries; and manufacturers in each of the motor vehicle parts and accessories, and bakery industries.<sup>4</sup>

The sets we have analyzed represent operations that do not involve significant intellectual property. As this analysis examines downturn-era data of companies from recently prepared comparable sets, we recognize that this creates an inherent “survival” bias towards companies that remained in business throughout the economic downturn.

## Observations on North American Comparable Set Data through the Economic Downturn

### *Administrative Services Sets*

Administrative services providers' median net cost plus (“NCP”) declined significantly in 2009 and 2010—see table 1—and the interquartile ranges realized were considerably narrower than the years preceding and following the economic downturn period. Overall, the margins included in the interquartile range were cut by more than half from 2008 to 2009 with the first quartile in 2009 being nearly zero, indicating that some administrative services providers essentially broke even.

[see Table 1 on next page]

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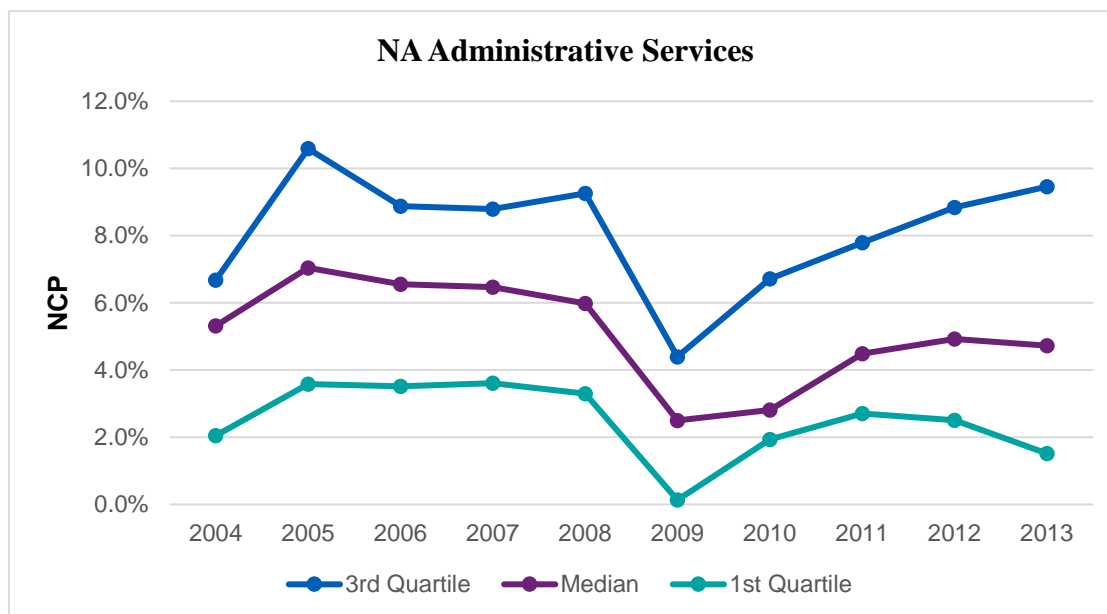
<sup>1</sup> This analysis is based on a limited sample of comparables sets for illustrative purposes only. Actual results are specific to a taxpayer's facts and circumstances. Therefore, the results of this analysis should not be relied upon for making adjustments.

<sup>2</sup> As defined by the National Bureau of Economic Research, at <https://www.nber.org/cycles/>.

<sup>3</sup> KPMG performed the detailed comparables analysis, calculation of PLIs, and analysis of the arm's-length ranges based upon underlying financial statement data and analytics provided by S&P Global Markets Intelligence.

<sup>4</sup> The data analysed in this work was sourced from Bureau van Dijk, a Moody Analytics company.

**Table 1: North American Administration Services Providers**



*Wholesale Distribution Sets*

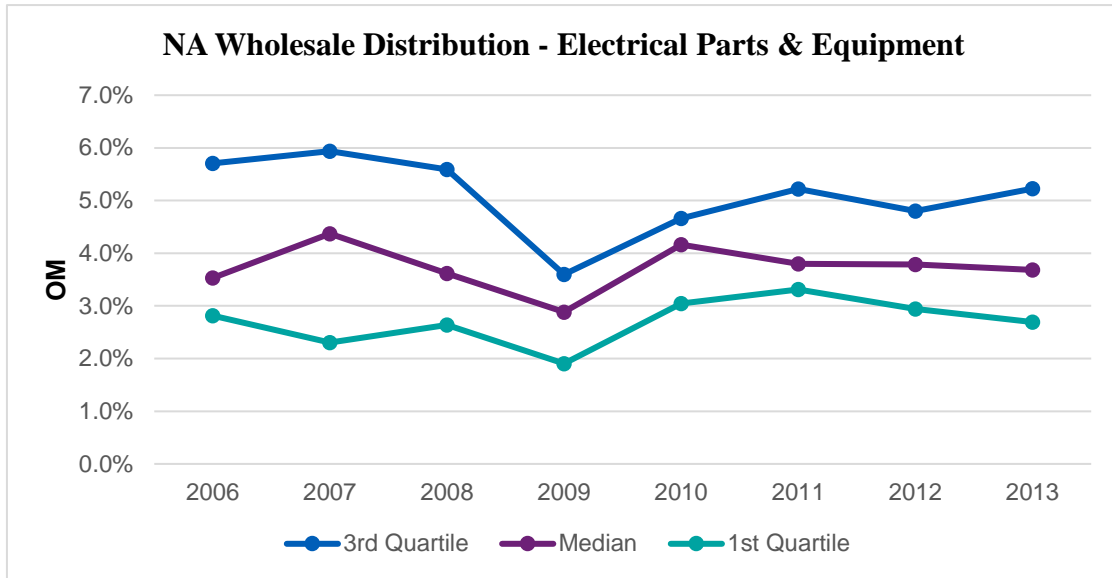
Wholesale distributors experienced a downturn in profitability in 2009 and 2010 that varies by product type/industry—see tables 2 through 4 below. The median and third quartile declined by approximately 25 percent for wholesalers of electrical products in 2009, but the first quartile shows little change and does not show loss at an overall level. Nevertheless, it should be noted that the entire range of margins compressed quite substantially and has remained so during the entire post-recessionary period.

Wholesalers of industrial products showed similar results, although the first quartile shows more impact compared to electrical products. Specifically, the median and lower quartile declined by about 25-30 percent from 2008 to 2009, with this decline seeming to continue a significant downward movement in margins that appears to have begun several years previous to 2008 and have accelerated in 2006 or 2007.

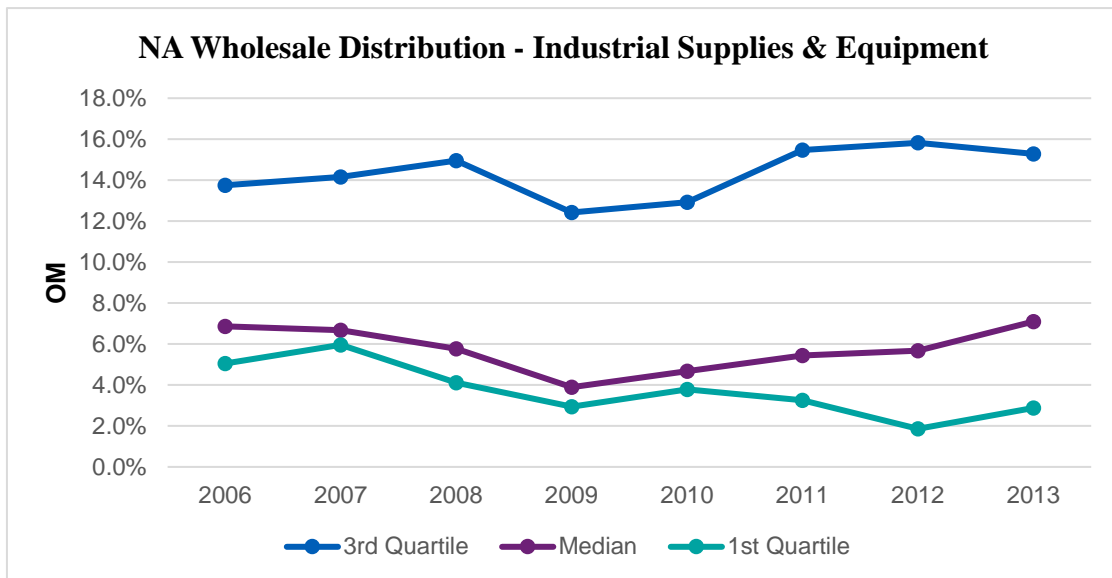
Contrast this with the impact on wholesalers of construction materials—the entire range decreases and the first quartile is negative, thus showing a loss. In fact, the median of the interquartile range in 2008 is below the first quartile result from just two years earlier. It isn't until about 2013 that wholesalers of construction materials return to profit margins similar to the pre-economic downturn years. This significant and sustained negative impact on margins should not be surprising in many respects given the causes of the recession—financial overhang related to real estate, particularly residential.

While the overall, significant, downward trend of distribution margins is evident across all three sectors, differences exist across the individual sectors. These differences illustrate the absolute necessity of conducting a careful industry analysis in selecting comparable firms.

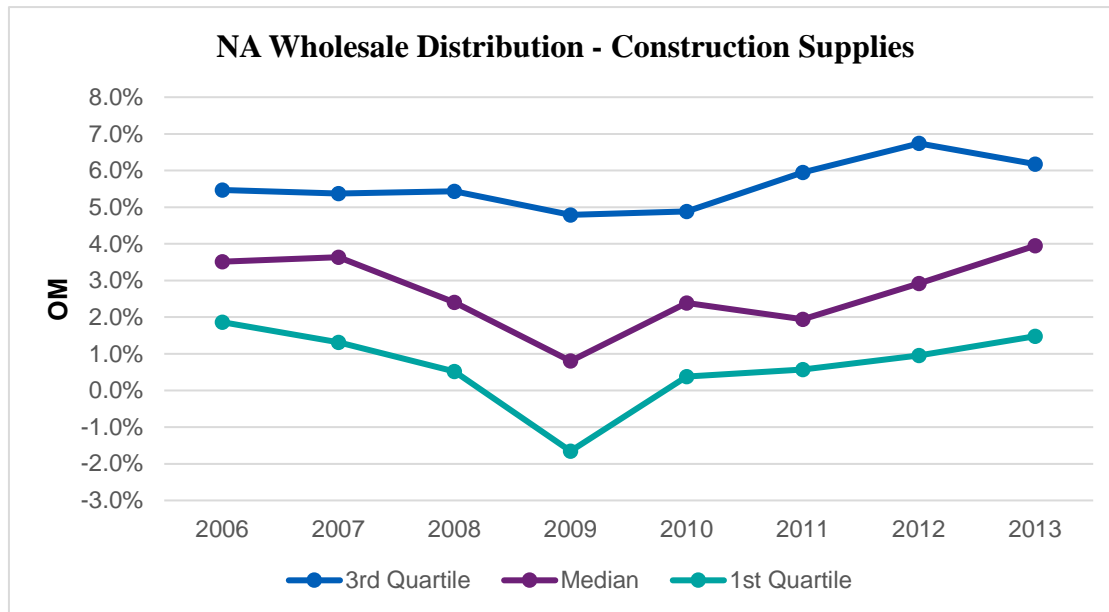
**Table 2: North American Wholesalers – Electrical Parts & Equipment**



**Table 3: North American Wholesalers – Industrial Supplies & Equipment**



**Table 4: North American Wholesalers – Construction Supplies**



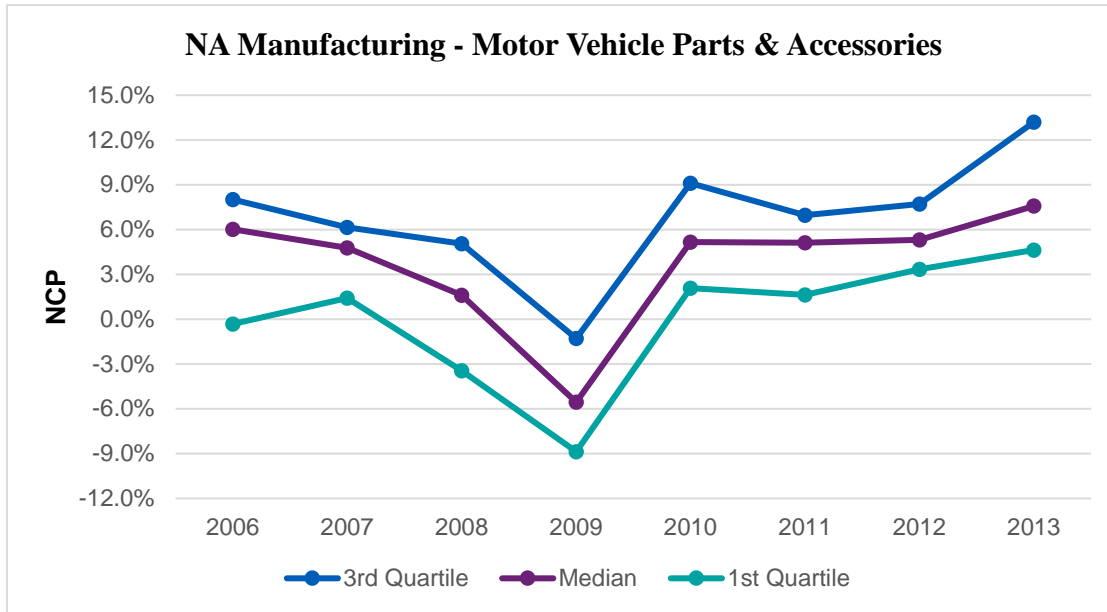
*Manufacturing Sets*

The decline resulting from the 2008-2009 economic downturn is more dramatic for North American manufacturers—see tables 5 and 6. The profit margins of manufacturers of motor vehicle products fell dramatically, resulting in an interquartile range that is negative throughout. Moreover, the range of manufacturing margins for these producers seems to recover quite quickly, returning to near pre-recessionary levels during the next year.

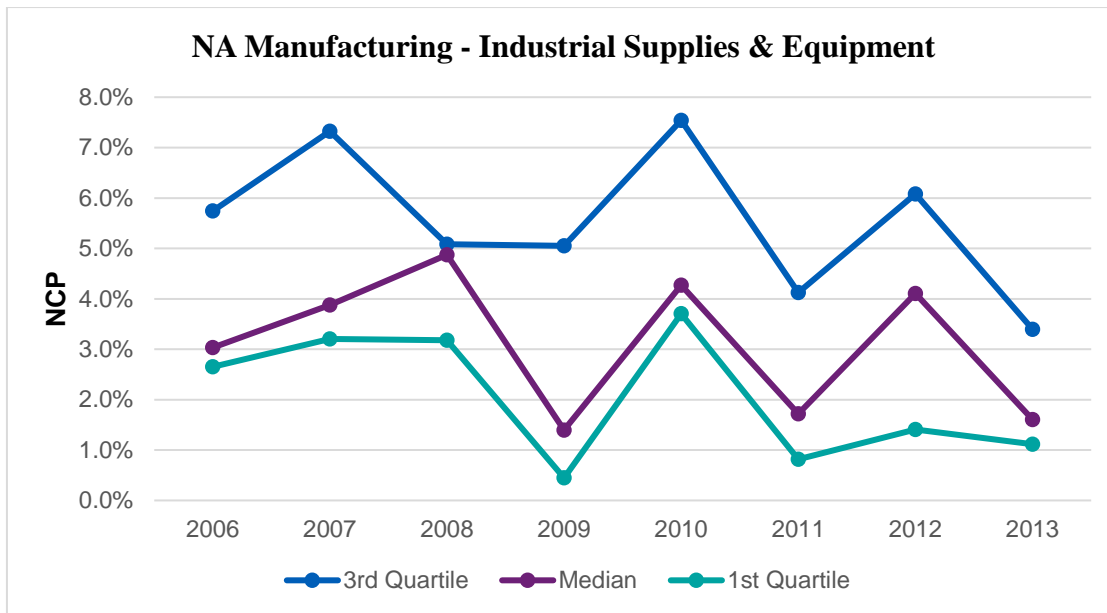
Manufacturers of industrial products also showed a dramatic decline of over 50 percent at the median and first quartile. While the interquartile range did not dip into losses, it is important to note that the full range reported large losses, which again were reversed rather quickly. A tax director with a tested party that is a related party manufacturer might need to consider whether a transfer pricing policy with a target for operating profitability might need to be changed. Depending on the industry and how it is expected to be affected by COVID-19, the target could be lowered, perhaps to zero or even to share in a system loss.

[see Table 5 on next page]

**Table 5: North American Manufacturers – Motor Vehicle Parts & Accessories**



**Table 6: North American Manufacturers – Industrial Supplies & Equipment**

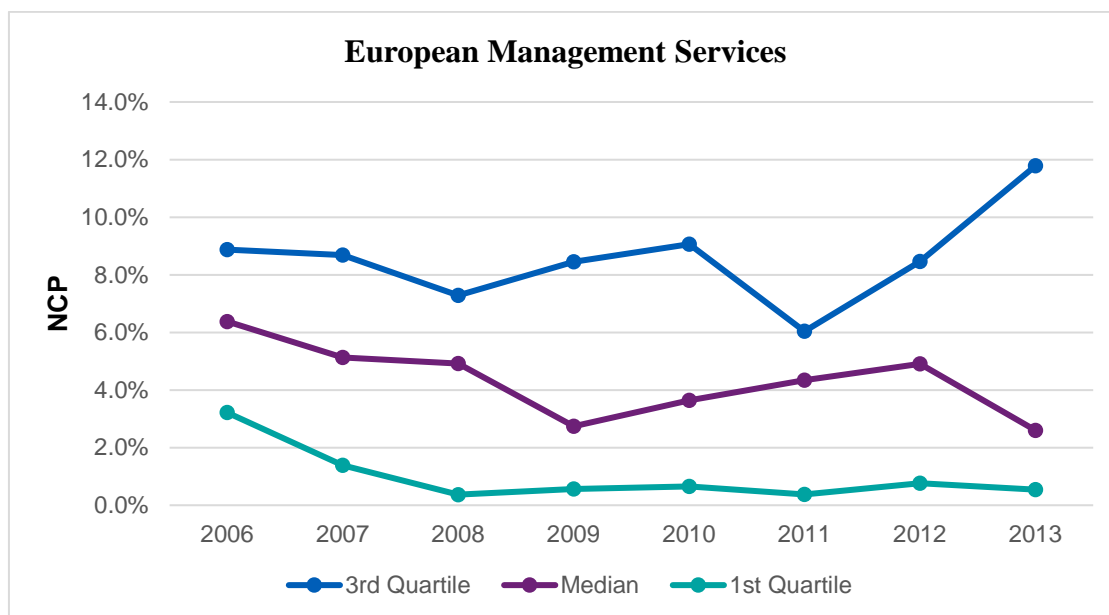


## Observations on European Comparable Set Data through the Economic Downturn <sup>5</sup>

### Administrative Services Set

Management service providers’ median and lower quartile NCP declined significantly in 2008 and 2009, with the lower quartile approaching nearly zero—see table 7. The interquartile ranges widened in the years of the economic downturn. Overall, the median was cut almost by half at the bottom of the curve, while the reduction of the lower quartile was more than 80 percent from 2006 to 2009 and remained low thereafter.

**Table 7: European Service Providers – Management Services**



### Wholesale Distribution Sets

Wholesale distributors experienced a downturn in profitability in 2009 and 2010 that varies by product type/industry—see tables 8 through 10 below.

For the set of distributors of clothing and apparel the median and lower quartile decrease by approximately 40 percent from the 2007 peak. From the value of 2006 however, the reduction was significantly smaller (approximately 9 percent and 30 percent respectively). In addition the interquartile range was wider during the period of economic downturn. It should be noted that the lower margins remained in the entire post-economic downturn period.

<sup>5</sup> European sets were selected across various industries and countries. Some of the sets were composed of companies from EU 15 countries, other from EU 28 countries and other also included non-EU countries in Europe.

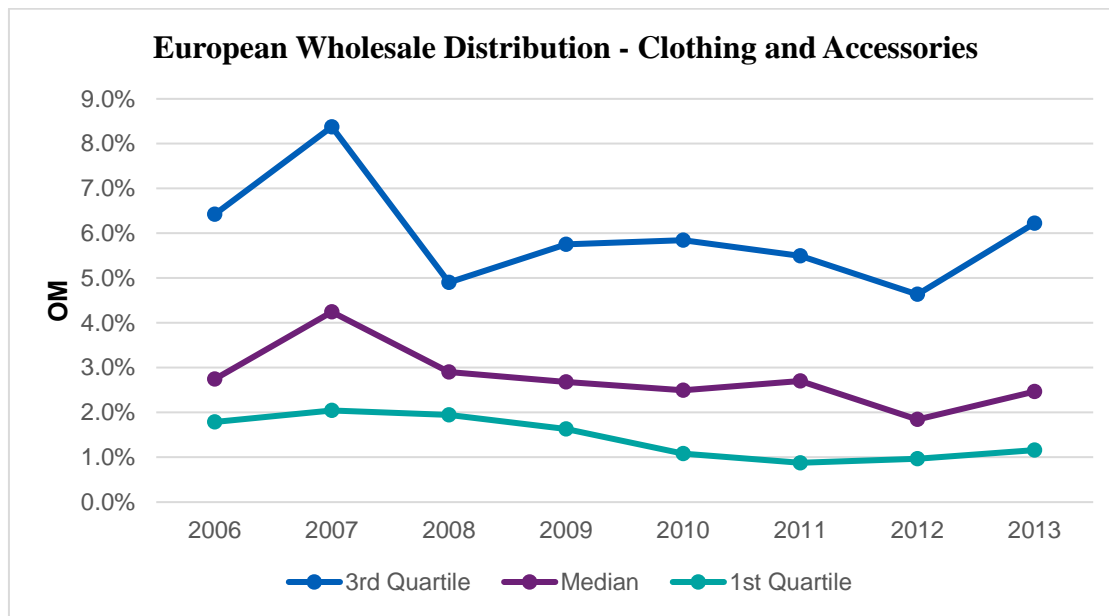


In the machinery and equipment set, the entire range shifted downwards in 2008 and 2009 with the lower quartile becoming negative. From peak to bottom the median decreased by 50 percent. The downward trend reversed in 2010 and returned to pre-economic downturn levels between 2011 and 2013.

In the electrical products distribution set the interquartile range started decreasing in 2008 and followed a downward movement for the period under analysis. Between 2007 and 2009 the median decreased by more than 40 percent and the lower quartile by almost 60 percent.

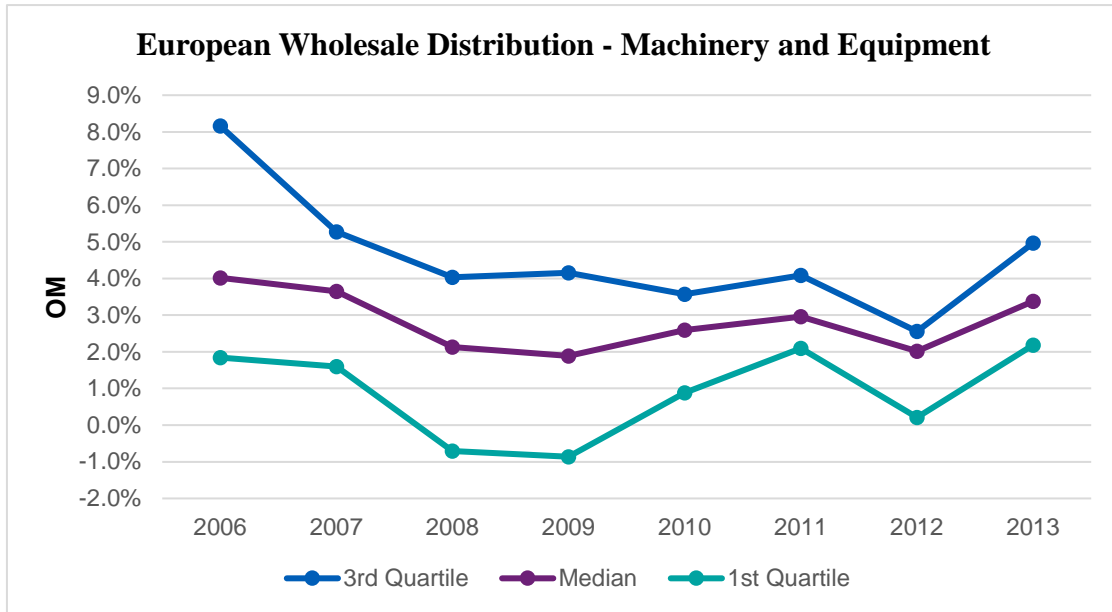
While the overall, significant, downward trend of distribution margins is evident across all three sectors, differences exist across the individual sectors. These differences illustrate the absolute necessity of conducting a careful industry analysis in selecting comparable firms.

**Table 8: European Distributors – Clothing and Accessories**

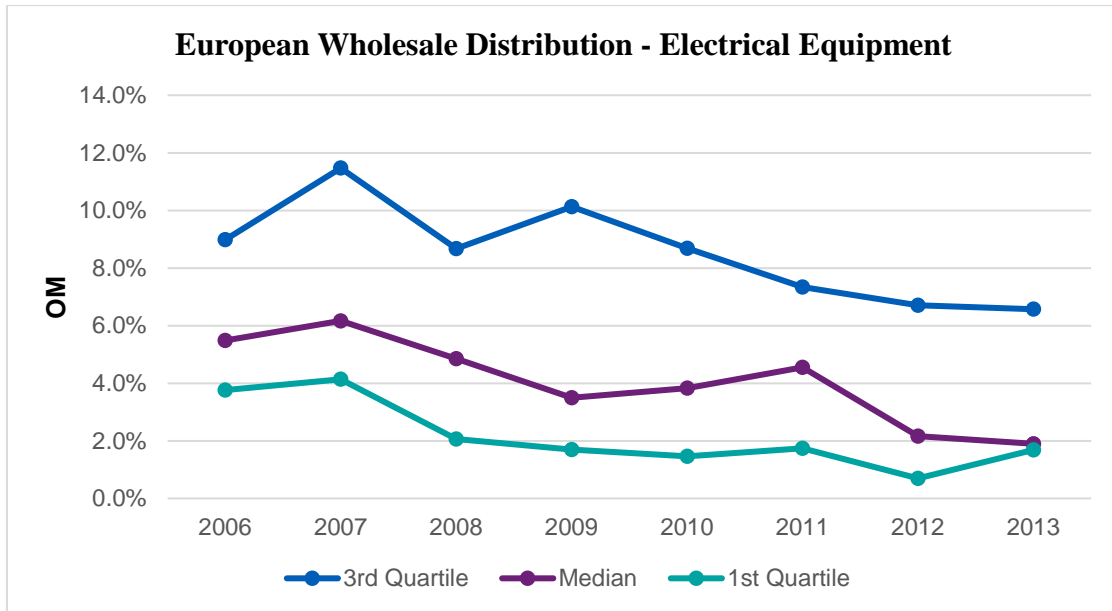


[see Table 9 on next page]

**Table 9: European Distributors – Machinery and Equipment**



**Table 10: European Distributors – Electrical Equipment**



### Manufacturing Sets

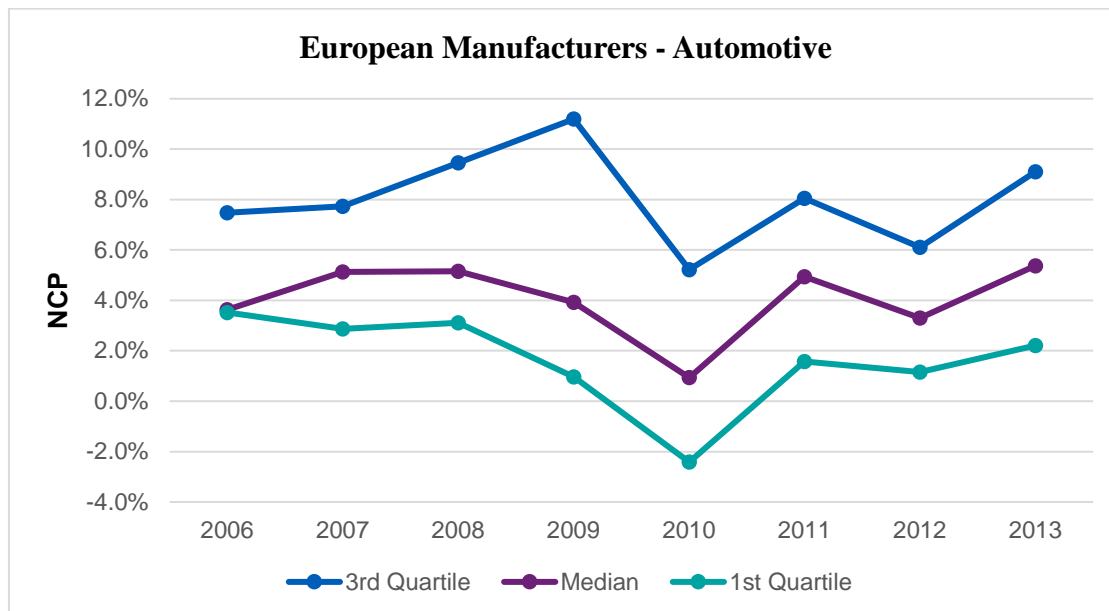
The importance of the industry analysis is evidenced by the results of the manufacturing sets, which show very different performances in the period between 2007 and 2010—see tables 11 and 12.

In the European set of manufacturers of motor vehicle products, similar to the North American one, the profit margins fell significantly in 2009 and 2010, resulting in a negative lower quartile and a median that fell below one percent. The range of manufacturing margins for these producers, however, seems to recover quite quickly returning to near pre-economic downturn levels already in 2011.

Manufacturers of bakery products showed a strong counter-cyclical performance that reflects the characteristics of the food sector and unusual volatility in wheat prices throughout the economic downturn. The profit margin range increased substantially from 2007 to 2009 and returned to pre-economic downturn levels after 2010.

Similar to the distribution sets, the manufacturing sets show significant differences across industry sectors. Based on additional analysis we have performed, differences exist also within the same industry, depending on the search strategy adopted (which derives from the functional profile of the tested party). Therefore, it would be necessary not only to perform a careful industry analysis but also a detailed functional analysis to guide the selection of comparable firms.

**Table 11: European Manufacturers – Automotive**



**Table 12: European Manufacturers – Bakery**



**Going Beyond the Averages—Analysis of Individual Comparables**

As the data show, administrative service providers, wholesale distributors, and manufacturers on average experienced often significant declines in profitability, particularly at the median and lower quartile levels, during the economic downturn years. Most importantly, the degree of the decline varied by industry. For example, manufacturers of motor vehicle products experienced a more dramatic decline that included some losses during 2009 and rebounded more quickly than the wholesale distributors and administrative services providers. North American wholesale distributors of electrical products and industrial products, on the other hand, maintained relatively consistent profitability levels during economic downturn years, with the median operating margin declining minimally in 2009 and 2010.

Analysts typically look to the interquartile range as confirmation of whether transfer prices are reasonable and satisfy the arm’s-length standard. The average results—interquartile ranges—presented above are helpful to understand the average trends one observes for a particular functional profile or industry. Nevertheless, they can mask the experience of individual comparables across the period. The volatility in individual firm results is quite simply masked by the average or observed variability in the industry results. Recognizing the distinction between the average industry and individual firm experience has important implications for assessing how a company should monitor and, potentially, adjust its transfer pricing during economic downturns.

When we look through industry averages to the individual firm levels, we see much more interesting detail and variation as evident in the 2006-2011 returns earned by the individual firms included in the North American administrative services providers set. In a somewhat cursory assessment, it would appear that five of the 22 firms were relatively unaffected by the economic downturn—some even saw an increase in margins. Most of the firms (16 of the 22 firms) show a negative impact that lasted anywhere from one to three years. One firm showed a pattern in profitability that is likely driven by

factors other than the economic downturn. This suggests that it is necessary not only to perform a careful industry analysis but also a detailed functional analysis to guide the selection of comparable firms and any adjustments to transfer pricing policies.

**Table 13: Individual Company Results for North American Administrative Services Providers<sup>6</sup>**

Net Cost Plus						
Comparable Companies	2006	2007	2008	2009	2010	2011
<b><u>Little or No Impact</u></b>						
COMPANY A	18.50%	18.21%	19.52%	19.41%	18.95%	15.21%
COMPANY B	7.55%	8.86%	10.91%	8.58%	8.66%	8.57%
COMPANY C	3.50%	5.95%	13.06%	13.54%	13.99%	15.05%
COMPANY D	6.44%	8.14%	8.77%	9.31%	7.39%	7.61%
COMPANY E	6.60%	9.27%	10.38%	10.43%	8.91%	9.03%
<b><u>One Year of Negative Impact</u></b>						
COMPANY F	3.58%	5.27%	7.57%	3.94%	4.59%	7.85%
COMPANY G	11.17%	14.72%	9.42%	-0.11%	4.69%	6.09%
COMPANY H	4.64%	4.21%	3.92%	1.66%	2.51%	4.13%
COMPANY I	1.43%	1.59%	0.62%	-1.32%	0.96%	1.10%
COMPANY J	6.51%	7.40%	4.66%	2.70%	3.62%	4.19%
COMPANY K	14.36%	12.35%	7.24%	3.09%	12.11%	10.95%
COMPANY L	8.22%	4.78%	5.58%	4.40%	1.99%	5.81%
<b><u>Two Years of Negative Impact</u></b>						
COMPANY M	6.76%	6.71%	6.43%	4.38%	2.64%	4.79%
COMPANY N	9.57%	8.57%	4.24%	-3.87%	2.98%	4.11%
COMPANY O	1.05%	2.33%	0.50%	-4.12%	-0.49%	1.98%
COMPANY P	3.25%	3.41%	3.10%	0.86%	1.91%	2.55%
COMPANY Q	12.61%	11.45%	9.89%	2.20%	3.74%	7.07%
<b><u>Three Years of Negative Impact</u></b>						
COMPANY R	8.38%	7.25%	5.04%	1.18%	2.52%	3.77%
COMPANY S	2.57%	2.96%	0.30%	-0.74%	0.13%	3.18%
COMPANY T	5.62%	6.22%	6.38%	3.54%	2.44%	2.24%
COMPANY U	9.05%	2.09%	-5.65%	-22.18%	-2.13%	1.21%
<b><u>Hard to Discern Business Cycle Impact</u></b>						
COMPANY V	2.56%	0.09%	-2.30%	2.30%	-5.54%	-7.16%

<sup>6</sup> The data in this table reflect actual company results, only company names have been redacted.

## Practical Considerations for Tax Directors

Tax directors will need to consider actions that are reasonable to take now. Historical data from the 2016-2018 period may not be a good predictor for results in 2020. Accordingly, tax directors need to consider if their current target margin is appropriate and may consider adjusting the target margins in line with the expected decline.

If the transfer pricing policy is based on targeting a profit margin there are a number of considerations:

- It is reasonable to consider reducing the target margin now with potential true ups at the end of the year. The size of the reduction may vary depending on the industry or within an industry, depending on the functional profile. From a transfer pricing perspective, these tables show the importance of matching up industry characteristics of the taxpayer with the comparable firms to ensure that they are affected by the same economic factors.
- Given the lag in the availability of 2020 data, it is reasonable to consider making adjustments to either the tested party data or to the comparables data. These adjustments would be designed to capture the impact of an economic downturn. Using information from the 2008-2009 economic downturn may provide a basis for such adjustments.
- In the examples we analyzed, in only a limited number of cases does the interquartile range become negative (i.e., indicating losses for the comparable companies). Comparable data from the year of economic downturn may not fully reflect the impact of the downturn on independent companies due to a survival bias that is intrinsic to comparable analyses: During an economic downturn some of the companies most affected will go out of business and disappear from the final sets. This potential bias would need to be analyzed and may require adjustments.
- If the contractual arrangement between the related parties sets a specific margin (such as the provider will be paid cost plus a markup), consider revising the contractual arrangement. Even if it is a long-term, multi-year contract, unrelated parties renegotiate contracts when faced with severe economic shocks.

How companies adjust their transfer pricing policies and for how long is dependent on specific facts and circumstances for individual taxpayers. The justification for the change in policy should be documented in the transfer pricing report as part of the industry analysis and/or discussion of adjustments. If the transfer pricing documentation must be prepared using pre-downturn data for the comparables and a downturn year for the tested party, a downward adjustment for the comparables may be appropriate. This fact pattern is common with comparable sets using European comparables when the lag to data reporting and release are much longer than North American data.

Tax directors need to attempt to predict the future in order to set transfer prices that meet the arm's-length standard—not an easy job!

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