CORONAVIRUS
OVERCOMING THE DIFFICULTIES

IMPACT OF COVID-19 EMERGENCY ON TRANSFER PRICING POLICIES

DE BERTI JACCHIA FRANCHINI FORLANI
STUDIO LEGALE

1. Foreword

COVID-19 emergency has caused global adverse economic conditions detrimental to trades and business. Multinational Enterprises Group (MNEs) are called to substantially review their business model and current transfer pricing policies to counteract negative impacts.

Starting point is that the transfer pricing policies of MNEs should be developed and implemented taking into account economic environment and strategic and practical solutions coping with unexpected changes in the relevant market consistently with OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD TP Guidelines").

Under these unexpected circumstances therefore it is crucial to recognize and deal with economic and tax perverse effects, in the short and long run, because MNEs group relies on transfer pricing policy designed behind and in view of normal economic conditions.

This global transformation warmly suggests MNEs to promptly take care of key transfer pricing policy factors we summarized below.

2. To be addressed in the short run

2.1 Allocation of risks among Group's companies

Current adverse economic background is basically caused by twofold circumstances: (i) sales and profitability decreases, due to lockdowns, with subsequent crisis of consumptions; and (ii) extraordinary expenses either on workers' safety (e.g. sanitation costs, security system), or on early termination of contracts (e.g. sanctions).

For transfer pricing policy purposes, the identification of the MNEs group entities bearing negative impacts (e.g., economic risk, market risk) is pivotal.

In such perspective, the transfer pricing policies based on Transactional Net Margin Method ("TNMM") involving transfer pricing adjustment ("TPA") mechanisms, seems to be mostly affected raising questions as to "if" and "how" risks should be allocated between Principal and limited risk entities (distributors, manufactures, service suppliers).

The key point here is to ascertain how associated entities having less complex functional profile, bearing limited risk and remunerated on target margin basis, are impacted by the crisis. In other words, it should be evaluated how and if, due to limited functions performed and limited risk run, the negative effect of crisis at stake could be allocated to those entities.

According to OECD TP Guidelines, any evaluation should take into account a risk analysis process and, above all, a comparability analysis.

In principle, it cannot be carved out that the Principal - who deem pandemic risk, albeit extraordinary, among those to be run - could fully bear the COVID-19 negative effects, triggering accounts, incomes and financials consequences increased by timing (i.e., portion of FY 2020 impacted by pandemic) and by geographical factors (i.e., importance of "infected" market where MNEs group operates). In such perspective, the Principal might hold harmless from pandemic effects the limited risk associated entities by remunerating their functions with an "ordinary" TNMM.

From a different perspective, seemingly the most appropriate to the case, the associated entities are not protected from risks (although in accordance with their limited risk profile) so that they should proportionally bear negative effects of an external economic crisis. This is even more true if, in compliance with any transfer pricing analysis, one compares economic effects of pandemic suffered by independent entities in comparable transactions/circumstances.

Transfer pricing policies construed in view of these circumstances, whereby part of the crisis risk is attributed to limited risk entities (i.e. without recognizing them, all or part, of their remuneration), should be reliably documented, for countries with a MNEs group presence, by virtue of benchmarking analysis showing behaviors undertaken by comparable independent entities including the effects of force majeure clause on outstanding contractual obligations.

2.2 Impact on supply chain and routine activity

Warehousing difficulties on global scale related to slow down and stop of supply chain (e.g., due to lock down of warehouses) have negative impact on goods and services offered, production capability and international delivering.

Within a MNEs group, this might lead to negative consequences. On the one hand, the need to suffer extraordinary expenses to secure ordinary operations and, on the other, the need to establish new intra-group transactions to temporarily reallocate functions within the group – especially those groups having centralized production or warehouse activities – to reduce adverse warehouse conditions. This would also suggest to reshape the functional profiles of the entities involved.

2.3 Impact of cash-flows crisis on intercompany financial transactions

For many companies the cash-flows crisis could imply to review external and internal financing sources. Particularly, the latter may require to restructure cash-pooling system, as well as terms and conditions of inter-company financing and warranties.

The above should be substantiated also in light of the new chapter on financial transactions of the OECD Guidelines.

2.4 Reliability of benchmark analysis and changes on Advanced Price Agreement (cd. APA)

As an economic downturn is expected, the benchmark analysis for current fiscal year could factorize the serious challenges of COVID-19 crisis, thus multiple-years approach (e.g., three years average) should be reviewed and normalized since the financial data available on public database suffer of a delay which does not allow to properly catch current fiscal year crisis effects.

Additionally, where settled bilateral and/or multilateral APA could be amended due to changed economic circumstances is a matter to be evaluated on a case by case basis.

2.5 Consistency of intercompany set of documentations: agreements and transfer pricing

Another point to keep in mind regards the consistency between agreements, sharing and proving rights and obligations among companies involved, and the actual behaviors of the parties, especially for MNEs operating in jurisdictions imposing the so-called contemporaneous documentation.

In particular, MNEs should take account of : (i) renegotiation of outstanding intercompany agreements, collating empirical evidence that it is normal business practice, or at least not unusual, in similar circumstances for third-party agreements; (ii) updating transfer pricing documentations, in order to outline how and to which extent the changed economic conditions impact TP Policy and related choices of MNE group.

Agreements and TP documentations (as well as any other supporting documents and analysis) play a strategic role when tax audit is faced in countries where MNEs operate.

3. To be addressed in the medium-long run: impact on Business Restructuring

Besides, COVID-19 could impact long-term strategies of MNEs in preserving profitability or reducing losses via structured actions aimed at streamlining overhead costs, centralizing activities, exploiting economies of scale, achieving flexibility in their supply chains, focusing resources on the most profitable markets, automating e processes and focusing on integrated distributing channels (i.e., e-commerce).

These medium-long term solutions require careful analysis of the tax implications for all stakeholders involved in the reorganization process consistently with OECD TP Guidelines (see chapter IX). This mainly because these solutions may involve, business models reorganization of MNEs' global value chain with relocation of the value matrix of risks, functions and assets.

4. Final remarks

The above are just some of the general issues that MNEs group will have to face in order to manage the effects of the Covid-19 pandemic. Specific structures of each Group should carefully be scrutinized on a case-by-case basis to correctly evaluate the effects brought by the crisis and these must be assessed not only for current fiscal year but, in some cases, also for the year just ended (e.g., Groups with entities in Asian markets that suffered the economic crisis already at the end of 2019) and in other cases also for the future fiscal years.

It is worth noting that on April 4th 2020 the OECD released a preliminary analysis on the impact of Covid-19 on double tax treaty providing information on certain cross-border aspects: (i) permanent establishment (particularly on home-work issue), (ii) residence (companies and individuals) and (iii) cross border workers. It is expected that OECD will also publish clarifications on transfer pricing issues aimed at minimizing the inevitable conflicts of interest of countries which will arise from by Budget new financial requirements.

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I nostri contributi di informazione e aggiornamento sulla crisi del Covid-19 e sulle sue implicazioni sono uno sforzo collettivo dello Studio ed una iniziativa di servizio. Per sottolinearlo, gli autori hanno rinunciato ad indicare il proprio nome in calce ai singoli lavori. Il presente articolo ha esclusivamente finalità informative e non costituisce parere legale.

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MILANO
Via San Paolo, 7 · 20121 Milano, Italia
T. +39 02 72554.1 · F. +39 02 72554.400
milan@dejalex.com

ROMA
Via Vincenzo Bellini, 24 · 00198 Roma, Italia
T. +39 06 809154.1 · F. +39 06 809154.44
rome@dejalex.com

BRUXELLES
Chaussée de La Hulpe 187 · 1170 Bruxelles, Belgique
T. +32 (0)26455670 · F. +32 (0)27420138
brussels@dejalex.com

MOSCOW
Ulitsa Bolshaya Ordynka 37/4 · 119017, Moscow, Russia
T. +7 495 792 54 92 · F. +7 495 792 54 93
moscow@dejalex.com

debertijacchia