EY Asia-Pacific Tax

How COVID-19 is impacting transfer pricing models

Luis Coronado and Stephen Lam, of Ernst & Young Solutions LLP, focus on what companies need to consider in terms of modifications to their group transfer pricing (TP) model to manage the impact of COVID-19 and improve their overall cash and operational positions.

Global TP models have not been designed with pandemics in mind. As such, the operational shifts resulting from the pandemic have put pressure on these existing TP models, particularly where routine activities such as limited risk distribution, manufacturing and services are often designed with guaranteed profits.

Finance and tax professionals should perform a detailed review of the business operations to mitigate TP risks and identify ways to help management deal with their cash and operational concerns.

Transfer Pricing risks

Unexpected costs can occur across a group's supply chain as a result of COVID-19 disruptions:

- **Funding** becomes a preeminent concern to maintain operations afloat and the initial assessment is within the organization's own surpluses and shortages that could be managed via cash pooling mechanisms prior to accessing external loans or capital
- **Procurement** cost increases due to supplier disruption or purchasing at higher spot prices
- **Manufacturing** cost increases due to supplier disruption, labor shortages or operation lockdowns
- **Distribution** challenges due to changes in demand, transportation or distribution channels (e.g., mall closures, quarantine and travel restrictions)
- **Services** are disrupted as installation and training of customers is made impossible due to travel restrictions or lockdowns
- **Intellectual property value** deteriorates due to decline in demand

Which entity within the group should be bearing these additional costs and would the tax authorities challenge it from a TP perspective? Where these risks are ultimately borne within a group is typically aligned to their business model: either centralized or decentralized. Simply put, whilst the costs arising from the pandemic may initially occur at the point where the business activity is conducted, the headquarters should ultimately bear these risks in a centralized business model. A decentralized business should ultimately bear costs by function, entity or business segment and with no support from the headquarters

For example, in a centralized business model, the principal would undertake the residual risk for which they earn the residual profits and losses of the group. During the COVID-19 pandemic, losses incurred by a local, limited risk distributor due to loss of sales (as an example) are often guaranteed an operating margin return. The margin would typically be guaranteed by either adjusting intercompany sale of goods to the distributor or via a support payment to the distributor from the principal

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Change in location of management decisions:

A centralized group may have a central committee to analyse and develop the strategic response for the pandemic.

Decentralized groups may have key functions (procurement, manufacturing, etc.) or business units to manage the issues arising from the pandemic. However, this may not always be the case given the uniqueness of the situation. The C-suite may take a more active role, which may complicate the issue of tracing responsibilities for decisions around COVID-19. This can be aggravated if company officials are locked down in a remote location due to travel restrictions.

An analysis of the business can provide insights about:

- The entities within the group bearing COVID-19 costs and if the current TP policies are aligned
- Areas of risks and costs not yet considered by existing TP policies, and whether current TP policies can still accommodate COVID-19 or new policies will be needed

In addition, an analysis of revised COVID-19 financial projections would highlight where expected losses (and cash flow or funding issues) from COVID-19 may arise, and the entities that these are connected to.

Some companies may record higher than expected profits from the COVID-19 situation (i.e., certain companies within the new digital economy offerings or businesses selling consumer staples and health-related equipment and products). A review of their financial performance should also be considered to ensure profits are reported correctly within the group in line with the overall TP model.

The financial review would help:

- Allow for scenario planning using existing TP policies to determine where potential requirements for cash are, and where potential excesses exist, if any
- Identify considerations on how to support potential losses within the group (loans, advances, subsidy or top-up payments)

Documentation and agreements may need to be reconsidered:

Typically, TP documentation considers risks for the group under normal business conditions. Risks associated with the pandemic are likely not included within such documentation, as well as considerations on how to manage them.

In addition to TP documentation, intercompany agreements should also be reviewed to consider if risks such as COVID-19 have been covered and how they should be allocated between participants. The review needs to consider if each party is able to fulfil their responsibilities under COVID-19 or whether force majeure would be invoked to alleviate either party's obligations during the pandemic. A practical starting point is to factor in the outcome of dealings with third-party customers and the alternative terms that have been agreed.

The documentary review should conclude:

- The impacts that COVID-19 pandemic may have on the existing TP model and what the group can proactively do within the existing benchmarking and policies to manage these impacts
- The gaps where additional TP policies may be required to manage the pandemic results

Transfer Pricing opportunities

The COVID-19 pandemic has forced companies to focus on the mantra–"cash is king". TP objectives should be largely geared to facilitate and support this objective. The steps undertaken from the detailed review should allow the group to make an informed view of how prepared they are to manage their TP during the COVID-19 period and what policy adjustments need to be made.

Ultimately, the companies' overall management during the COVID-19 pandemic will be based on their perspective of the impact that the pandemic will have on the business and their outlook on their liquidity. TP policies should seek to complement and support the view of management in this regard.

Short-term outlook

Taking a short-term perspective (6 –12 months), the group may not consider changes to their TP policies, particularly if the management believes that their overall requirement for additional liquidity is limited. For loss-making group entities,

additional documentary support to their TP compliance documentation may be required to substantiate these losses due to COVID-19 and to support TP policies taken.

In addition, the group may update their comparable analyses (where available) to support lower margins or loss-making entities.

Medium- to long-term outlook

If the group has a medium- to long-term (one to two years plus) view of managing the impact of the COVID-19 pandemic, additional cash flow needs for the group will take priority. TP can support these funding requirements via various options. Here are a few examples:

1. **Invoke forgiveness or force majeure clauses**

   The COVID-19 (Temporary Measures) Act in Singapore is an example of where certain jurisdictions have introduced certain measures to alleviate or release parties temporarily from their obligations. This may correlate with intercompany agreements (i.e., management fee, distribution or manufacturing) that may contain force majeure clauses that can be evoked during the pandemic period. Whilst only a temporary measure, once each party's rights are established for the contractual arrangement, the related parties may be able to seek relief from payment of such things as management fees or royalties (as examples) under the force majeure clause of the contract

2. **Use of benchmarking data**

   Whilst updated comparables may not be available yet during the current period, alternatives could be considered such as quarterly announcements from listed companies, historical results from prior financial crisis, industry comparables, or use of time series or regression analyses. The updated comparables may support lowering operating margins for routine entities such as distribution which, under normal business conditions, are remunerated with a higher operating margin. This in turn, reduces the level of corporate tax cost for that period. These comparables may also support loss-making entities depending on the comparables chosen

3. **Adjusting existing policies or creating additional policies specifically to apply during COVID-19**

   This can take various forms and is highly dependent on the operational nature of the business. For example, a centralized procurement function under normal market conditions secures supply and manages the purchasing costs for the group. During the COVID-19 pandemic, purchasing goods in the spot market can attract higher costs. Whilst under normal circumstances the purchasing entity would absorb such cost overruns, during COVID-19, these substantially higher costs may have to be passed on to other entities within the group via intercompany transactions.

   If the outlook for managing the impact of COVID-19 for the group is even longer than two years, the group may further consider an overall supply chain restructure. This may particularly be the case if the group's profit outlook continues to be depressed for some time.

Final thoughts

Regardless of the group's outlook for COVID-19, they will require evidential documentation on the positions taken. Tax scrutiny and audits will typically occur following the pandemic, hence documentation should be in place to recount the TP actions taken during the pandemic period. Documentation may include several parts:

- TP documentation: TP compliance documentation spanning the COVID-19 period, including rationale for losses, inclusion of additional documentation of risks and the TP policies prevailing at that time. Benchmarks should be updated to the extent possible
- Updated intercompany contracts: These should align with the updated TP documentation and incorporate changes to existing TP policies or inclusion of new considerations covering the COVID-19 impact
- TP defense memo: Supplementary document to the TP documentation that may include further details of the market conditions, operational issues impacting the group, further reasons for the losses of the group, and financial analysis

- Information repository: Other relevant information such as meeting minutes, budgets, internal correspondence, treatment of extraordinary expenses, additional comparables (industry and loss companies) and working capital adjustments are a few of the items that could be covered. This information may be provided to a tax authority during the audit

Consideration should also be given to pre-existing tax incentives, tax rulings, advanced pricing arrangements and mutual agreement procedures. Given that upfront arrangements have been made with these authorities, any consideration of adjustments to areas, such as existing margins, will need to be considered as potential renegotiation of these arrangements may be required.

As the COVID-19 situation is evolving daily, it is important to monitor the situation closely to understand the impact on the business and the TP model. An assessment of the group as outlined above should be made to consider these developments and determine if further modifications to the group TP model may be needed to assist the company in mitigating the impact of the COVID-19 pandemic and managing its cash flow.

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EYG no. 004383-20Gbl

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