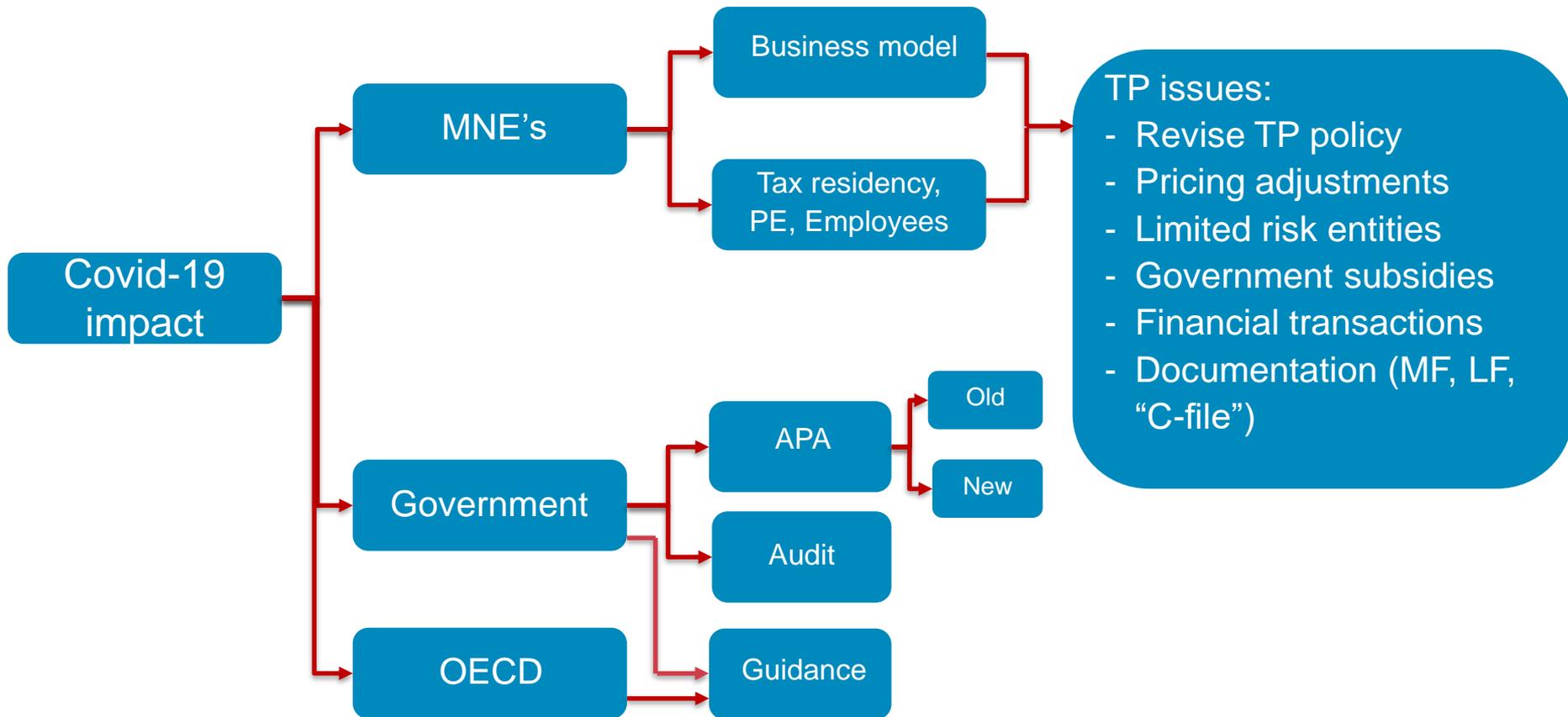


TP IMPACT OF COVID-19

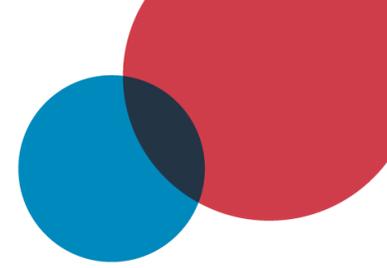
Jimmie van der Zwaan
Thomas Dijksman

October 1, 2020

Agenda

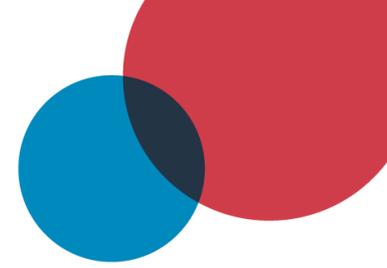


COVID-19 versus Transfer Pricing



- ❖ Due to the Outbreak, MNE's will review their business strategies and models, affecting their intra group transactions and thus transfer pricing agreements.
- ❖ Third parties will also reconsider their position in the market and if necessary, renegotiate with their suppliers and customers.

Relevant questions

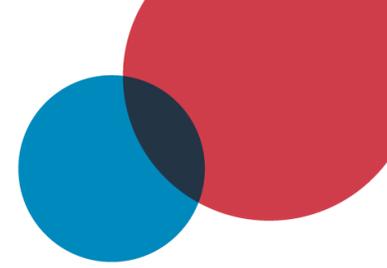


- ❖ What impact does the Outbreak have on an MNE's business, both on a global level and an entity level?
- ❖ Are the current transfer pricing policies still accurate or should they be revised?
- ❖ What are the strategies that could be undertaken by the MNEs to overcome such issues?
- ❖ What would third parties do to overcome the effects of the Outbreak?
- ❖ Should MNEs renegotiate their transfer pricing arrangements as third parties would?



**Business
models**

The impact on MNE's



Royal Dutch Shell PLC [+ Add to myFT](#)

Shell to cut up to 9,000 jobs in effort to shave \$2.5bn in costs

Pandemic adds to challenges facing industry grappling with shift to cleaner energy



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Online sales surge sends Nike shares to record high

Sportswear group finds ecommerce makes up for lower foot traffic at reopened stores



The company says some of its best-selling products included its Air Max 90 shoe, and a newly launched line of yoga apparel © Getty Images

Volkswagen AG [+ Add to myFT](#)

VW's MAN tears up deal with German unions as it pursues job cuts

Truck and bus manufacturer warns of 'perfect storm' as it cancels agree axe 9,500 roles



Property sector [+ Add to myFT](#)

Destruction of value in US real estate revealed

Commercial properties in difficulty are being valued at less than 75% previous level, appraisal data show



Commercial property [+ Add to myFT](#)

Debt collectors bulk up to deal with US property loan defaults

Rise in distressed commercial mortgages puts special servicers in demand



The onset of coronavirus and worldwide lockdowns have plunged a vast number of commercial properties into jeopardy © AFP via Getty Images

Opinion Lex [+ Add to myFT](#)

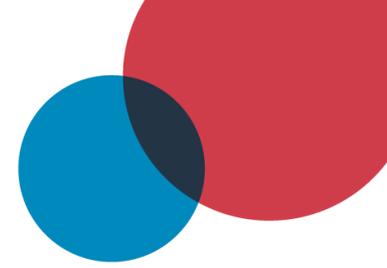
Travel sector: countdown to a fire sale

It will be wiser to accept the world has changed than hold out in hopes of a full recovery



New Covid-19 lockdowns could trigger a sale of travel industry assets: planes, ships and hotels © REUTERS

The impact on MNE's

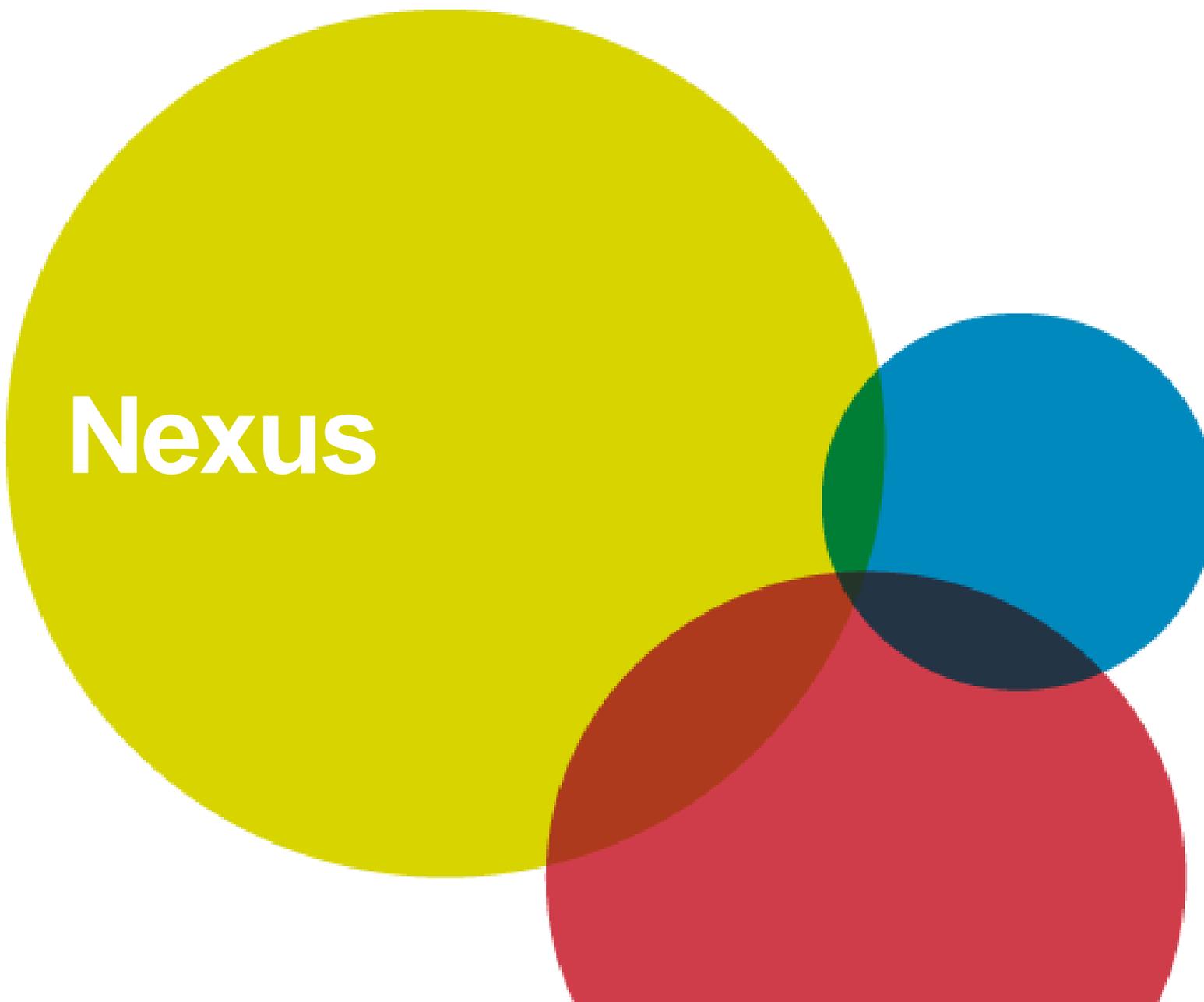


What follows the necessary government interventions:

- ❖ Disrupted supply chains.
- ❖ Reduced demand for products and services.
- ❖ Changing demand and customer behaviour.
- ❖ Lower consumer confidence.

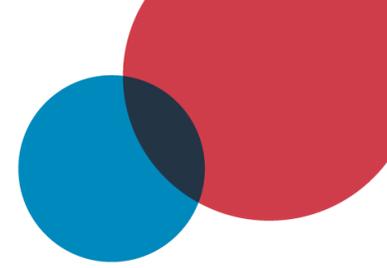
How companies respond:

- ❖ Staff reductions.
- ❖ Increased expenses in order to cope with the situation.
- ❖ More attention for cash management.
- ❖ A move towards decentralisation has been triggered (vendors, suppliers, procurement).
- ❖ New strategies are considered: digitalisation and moving from B2B to B2C.

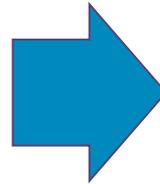


Nexus

Tax residency

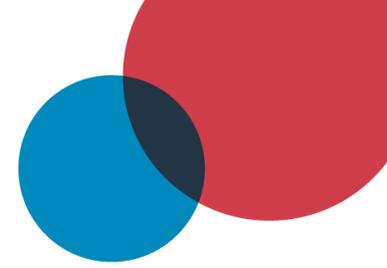


Travel bans and restrictions may cause that board members and other senior executives are unable to physically join the board meetings. Could this situation alter an entity's residence status?



The OECD Guidance states that such circumstance is unlikely to change an entity's residence status under a tax treaty since it is merely an **extraordinary and temporary** situation.

Permanent establishments



Could work from home trigger a PE?

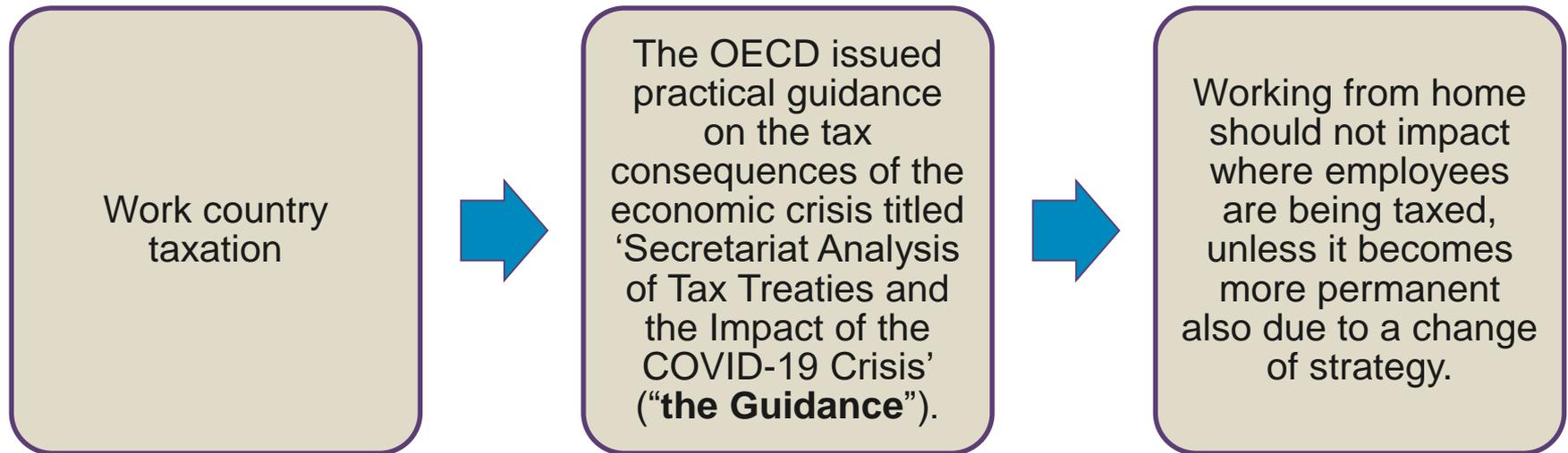
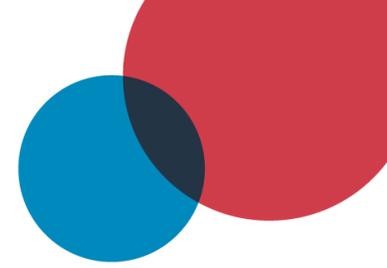


The OECD issued practical guidance on the tax consequences of the economic crisis titled 'Secretariat Analysis of Tax Treaties and the Impact of the COVID-19 Crisis' ("**the Guidance**").

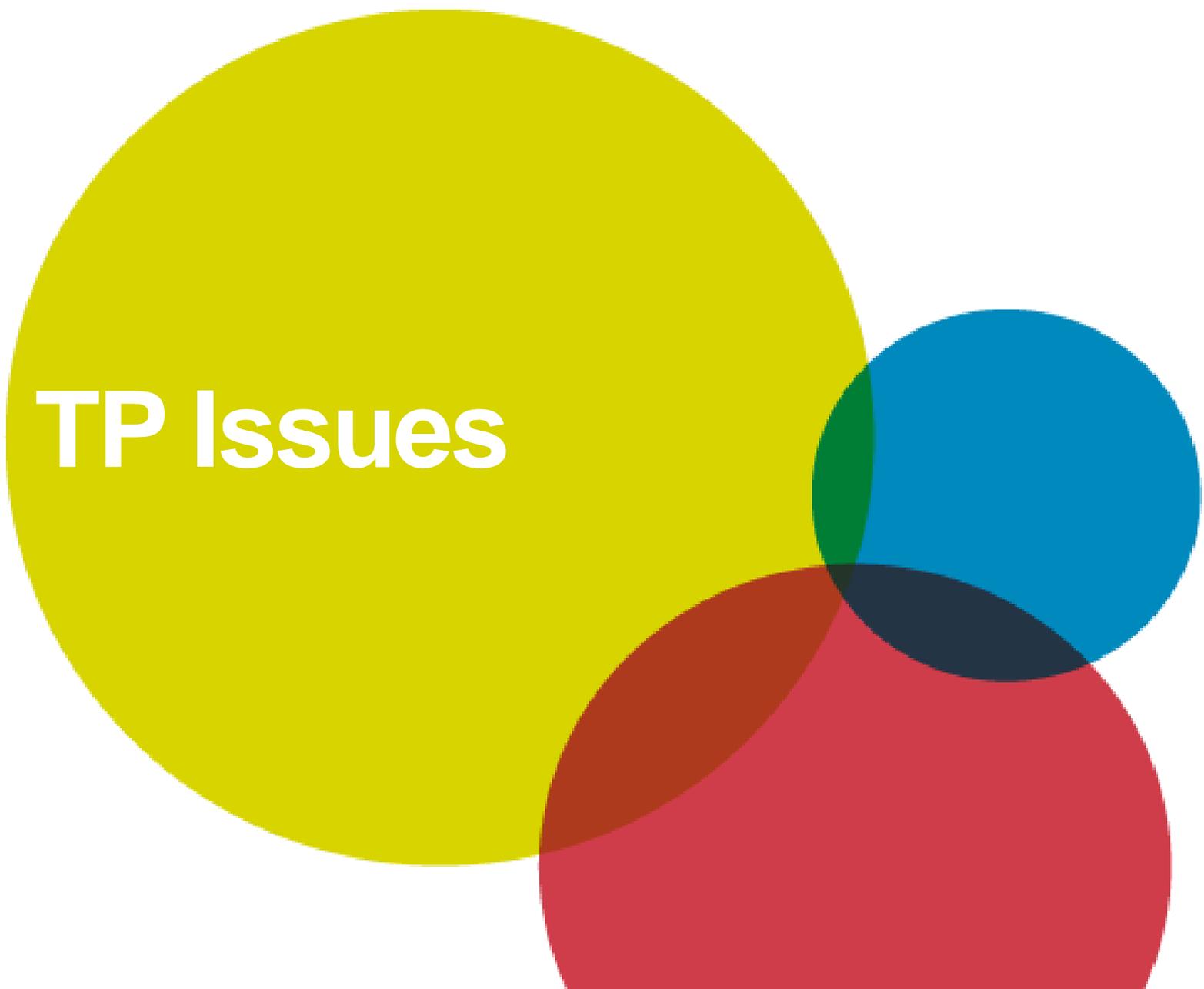


Working from home would not constitute a PE to the extent that it does not become the new norm over time. Further, such activity lacks a sufficient degree of permanency or the enterprise has no control over the home office.

Employee taxation



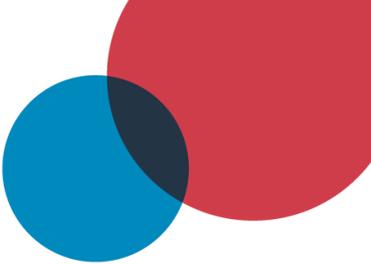
Duration crisis unknown when OECD published its guidance!



TP Issues

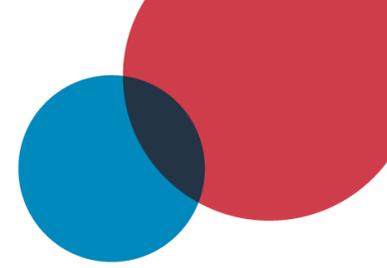
Revise TP policies

- ❖ First Aid and Crisis Management.
- ❖ Rationalization and business restructuring.
- ❖ Business restructurings should be reflected in the Master File.
- ❖ Are existing Transfer Pricing policy still valid?
- ❖ **Control over risk- test.**



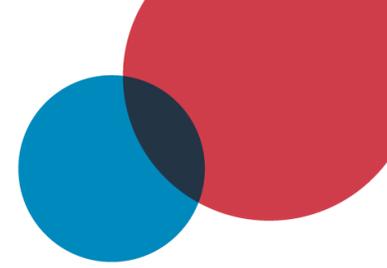
*TP Policies
should
follow the
business!*

Control over risk- test



- ❖ Arm's length pricing should always be based on a functional analysis (functions performed, risks assumed, assets used) of the parties involved
- ❖ Functions and assets are often less difficult to describe and allocate.
- ❖ Where control over risk is exercised is however more difficult to verify when risks do not materialize.
- ❖ However: the OECD Guidelines state that we should follow the actual conduct of the parties involved.
- ❖ Therefore it is important to test whether the current actual conduct is in line with what is included in TP documentation.

Control over risk-test

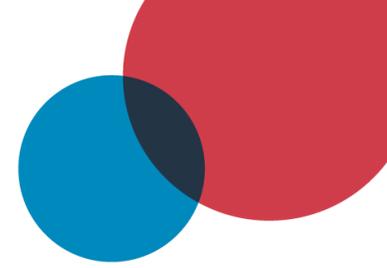


Par 1.56 OECD-TPG: Usually, in the open market, the assumption of increased risk would also be compensated by an increase in expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised.

Par 1.60 OECD-TPG: Six step analysis relating to risks: 1) determine significant risks, 2) how risks are allocated based on the contract, 3) functional analysis including who performs control functions and risk mitigation functions and has the financial capacity to assume the risks 4) check whether contractual situation is in line with actual conduct, 5 and 6) align pricing with outcome of risk analysis.

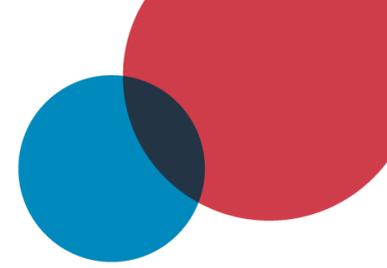
Par 1.72 OECD-TPG: List of sources of risk: 1) strategic or marketplace risks, 2) infrastructure or operational risk, 3) financial risk, 4) transactional risks 5) hazard risks.

Pricing adjustments

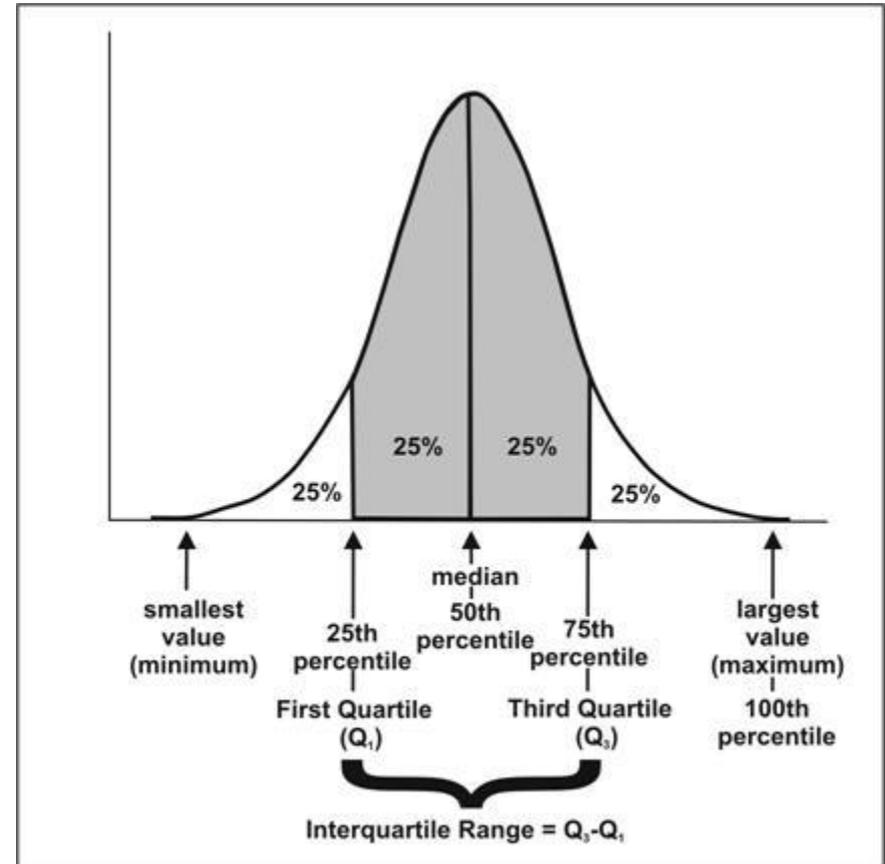


- ❖ Intercompany agreements are in principle leading.
- ❖ Are adjustment clauses included: Act of God, Force Majeure.
- ❖ Applicable law. Law of reasonableness and fairness.
- ❖ Would third parties share the loss?
- ❖ A two-sided approach is required considering the actual conduct of parties involved and the impacts on profitability.
- ❖ If required, conclude new agreements or make temporary adjustments.

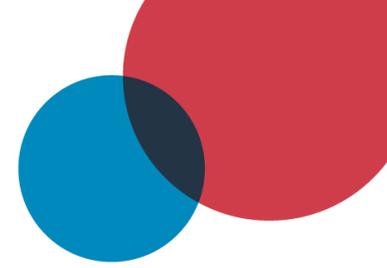
Pricing adjustments (2)



- ❖ Generally the median is applied
- ❖ Potentially the lower quartile in case of a crisis
- ❖ Or even a nil margin?
- ❖ Which benchmark to use?



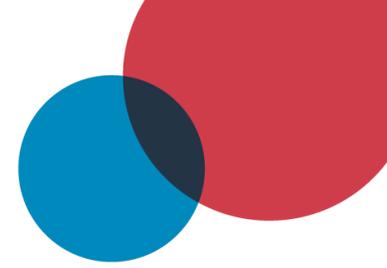
Limited risk entities (“LRE”)



Limited-risk pricing models are often considered generating a “guaranteed return” for taxpayers. However, what would a third parties do in comparable circumstances following the Outbreak? The questions that may arise are:

- ❖ Should LRE’s still report a low and stable margin?
- ❖ Or, should they bear some of the MNE group’s losses?
- ❖ What is consistent with both the functions, assets, and risks profile and the exceptional circumstances?
- ❖ Should the Entrepreneur / Full risk entity renegotiate with its affiliated LRE suppliers / customers?

Limited risk entities (2)

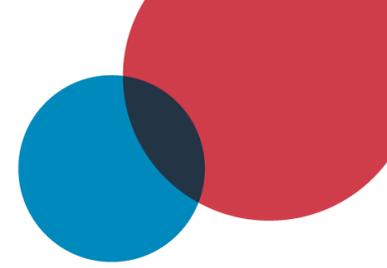


Par 1.110 OECD-TPG: Economic circumstances need to be taken into consideration as they may have a material effect on price.

Par 1.129 OECD-TPG: „...Of course, associated enterprises, like independent enterprises, can sustain genuine losses, whether due to heavy start-up costs, **unfavourable economic conditions**, inefficiencies, or other legitimate business reasons...“

Par 3.68 OECD-TPG: „...information relating to the conditions of comparable uncontrolled transactions undertaken or carried out **during the same period** of time as the controlled transaction (contemporaneous uncontrolled transactions) is expected to be the most reliable information to use in a comparability analysis...“

The impact of government subsidies



- ❖ How would third parties take government subsidies into account in setting their prices?
- ❖ In principle the subsidies are meant to retain jobs and to help companies through difficult times.
- ❖ Is it possible that a subsidy leads to lower intercompany charges?
- ❖ Otherwise it may result in a substantial part of the subsidy effectively being repaid through corporate income taxes.

The impact of government subsidies (2)

Par 1.132 OECD-TPG: 1.132 There are some circumstances in which a taxpayer will consider that an arm's length price must be adjusted to account for government interventions such as price controls (even price cuts), interest rate controls, controls over payments for services or management fees, controls over the payment of royalties, **subsidies** to particular sectors, exchange control, anti-dumping duties, or exchange rate policy. As a general rule, these government interventions **should be treated as conditions of the market in the particular country, and in the ordinary course they should be taken into account in evaluating the taxpayer's transfer price in that market.** The question then presented is whether in light of these conditions the transactions undertaken by the controlled parties are consistent with transactions between independent enterprises.

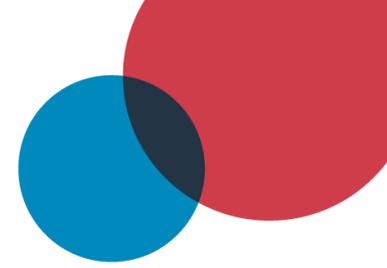
The impact of government subsidies (3)

- ❖ What is the impact on the cost base?
- ❖ Example
 - Cost base: 100
 - TNMM / Cost plus margin: 5%
 - Government wage cost subsidy: 50

Scenario's	Scenario 1	Scenario 2	Scenario 3
Intercompany transaction	105	52,5	55
Profit	55	2,5	5

- ❖ Both scenario 2 and 3 would be in line with the functions, risks and assets profile of the company, but some countries take the position that their subsidies are exported in this way and therefore argue that scenario 1 is correct.

Financial transactions

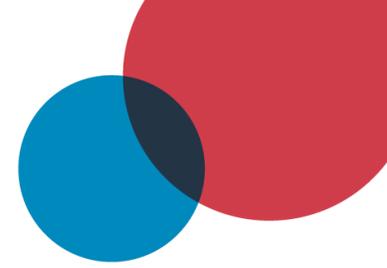


Due to the Outbreak, MNEs' cash flow and liquidity are substantially affected. This will have an impact on intercompany financial transactions:

- ❖ Re-examine the financing structure to ensure that the entities are properly capitalized.
- ❖ Consider conversion of debt into equity or re-financing.
- ❖ Amend the pricing policies of intra-group financing arrangements as the crisis may influence the credit rating of the group or the group members.
- ❖ The potential absence of covenants that are often in place with third party banks does not mean that related parties should not act if significant changes in ratio's (e.g. debt-to-equity and interest-coverage) occur.
- ❖ Benchmarking with third party loans that took place pre Covid-19 is a serious comparability defect and not accepted by tax authorities. Corporate bonds are a suitable alternative since their value changes on a day-to-day basis.

❖ **TAXAND**

Documentation (“C-File”)

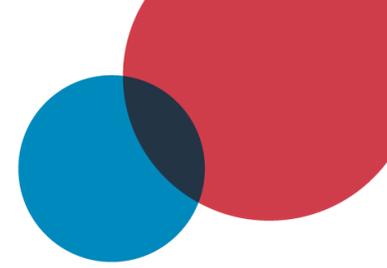


- ❖ General Transfer Pricing documentation such as Master File and Local File documentation covers a whole fiscal year
- ❖ However, to accurately document the Covid-19 impact on an MNE and on specific intercompany transactions, these documents might not fit for the purpose of substantiating pricing adjustments.
- ❖ A Covid-19 Times TP-file (“C-file”) should be prepared which includes MNE and company specific timelines and tracks relevant changes to the business of the MNE and who takes control over risk. The effect of these developments on pricing of intercompany transactions should also be included.



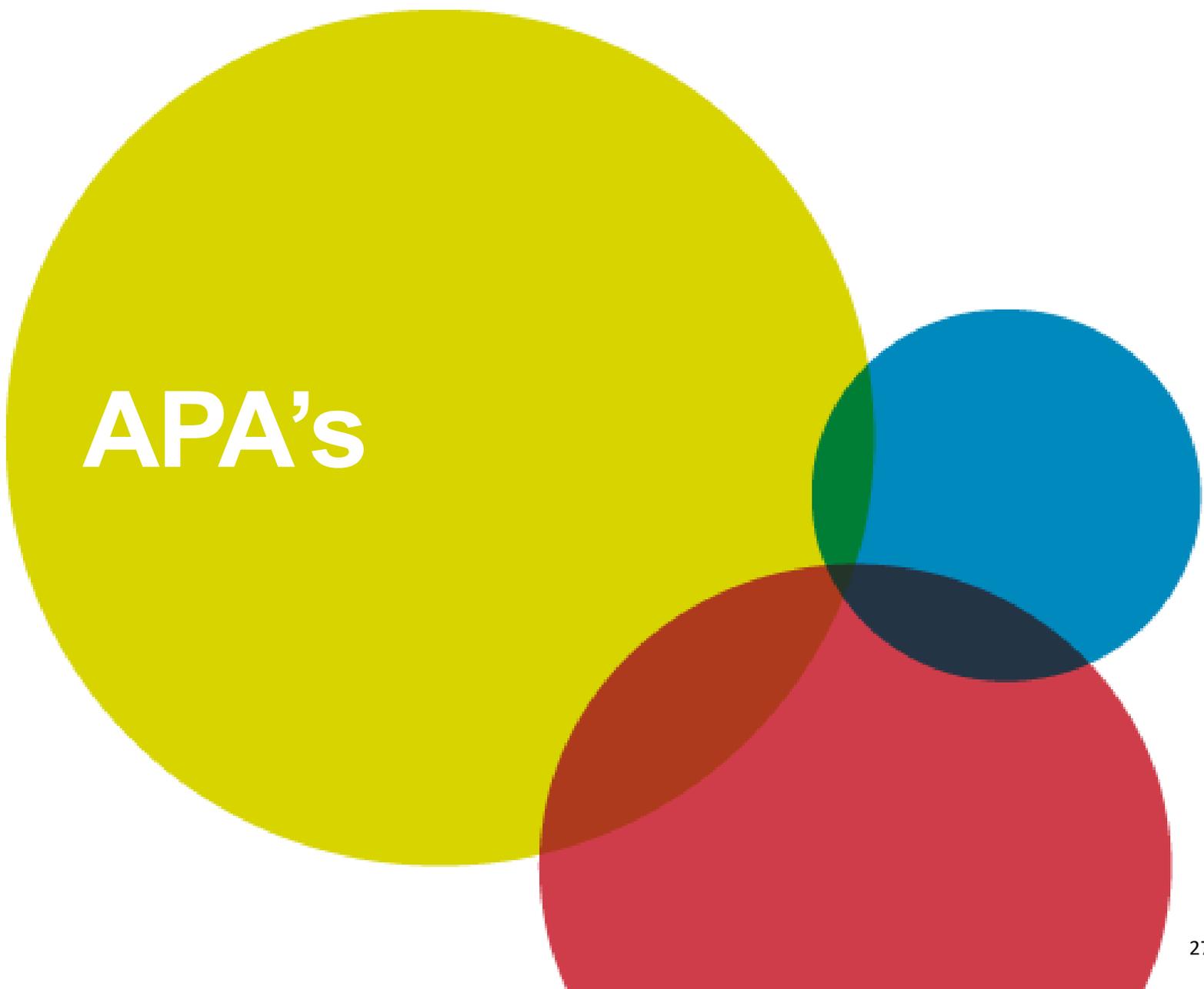
Tax audits

Tax audit anticipation



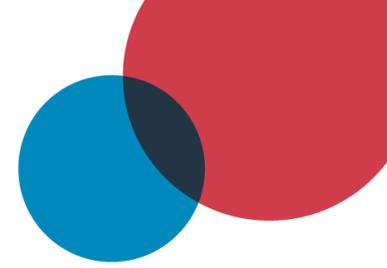
- Due to the Outbreak, the tax audit investigations will likely increase in the future due to the loss of revenue and the increased debt for the government.
- MNEs are advised to document thoroughly the extraordinary decisions since they can be used as a robust defense for any potential challenges in the future.
- MNEs are suggested to collect as much information as they can concerning the uncontrolled transactions behaviour in the same industry. Further, it may be considered to introduce force majeure clauses in intercompany agreements.

DOCUMENTATION
SUBSTANTIATION
DOCUMENTATION
SUBSTANTIATION



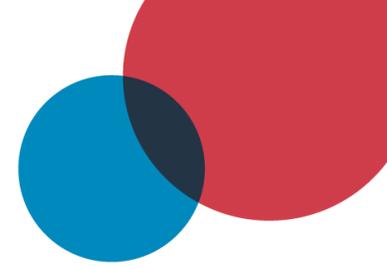
APA's

Existing APA's



- MNEs should analyze whether the critical assumptions in the agreed APA are still met. Critical assumptions usually comprise issues concerning substantial changes to economic conditions, fundamental changes in the market trend, etc.
- Should the critical assumptions be affected due to the Outbreak, taxpayers should discuss with the local tax authorities to determine if the impact of these extraordinary circumstances will lead to the agreement being invalidated or financials adjustments can be made in consultation with the tax authorities.
- It can be considered to request that the APA will not be applicable during Covid-years, assuming that this justifies changes to the pricing, from March 2020 onwards and potentially also in 2021. Or consider the APA temporarily not applicable, but with proper documentation.

New APA's

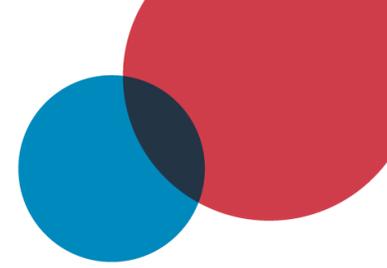


- ❖ APA's are often considered by MNEs to provide certainty with regards to the transfer pricing issues. In these uncertain times this can be extremely valuable.
- ❖ What would be the benefits of requesting a single year (or Covid-19) APA?
 - This allows you to understand the tax authorities' perspective on a specific transfer pricing issue
 - Exchange of information may give comfort in other countries
 - Pricing difficult to assess
 - Which benchmark to apply and discuss possibilities to apply the most appropriate point in the range.



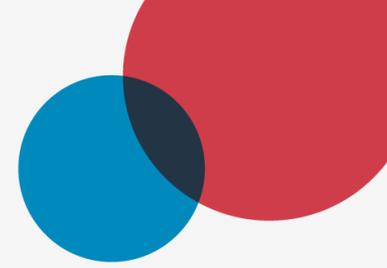
**OECD
Guidance**

OECD Guidance



- ❖ Previous Guidance March 2020
 - Duration Covid-19 Crisis unknown at that time!
- ❖ New OECD Guidance expected in Q4
- ❖ If no consensus: unilateral approaches

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