taxnotes®
international
Volume 98, Number 4 ■ April 27, 2020

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Reprinted from *Tax Notes International*, April 27, 2020, p. 439

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The author thanks Anna Soubbotina and David Kemp of Charles River Associates for comments on an earlier draft.

In this article, the author discusses how to reevaluate transfer prices based on market conditions caused by COVID-19 and mitigate complexities associated with year-end processes. He also examines how (re)structuring intercompany transactions with high upfront payments can be effective in deploying cash within a multinational group.

As supply chains stall and consumer confidence falls as a result of the COVID-19 pandemic, multinational enterprises are evaluating the economic impact on their effective tax rates and cash management, which puts a focus on transfer pricing considerations. One way to counter economic disruption on transfer pricing outcomes is to trigger *force majeure* or price-adjustment clauses in intercompany contracts. While that is certainly a prudent first step, it raises a more complex question: How should the transfer prices be adjusted to allocate the impact?

Recall that transfer pricing requires entities in a controlled group to transact in a manner that mimics transactions between independent profit-maximizing companies. If unrelated parties are renegotiating contracts or pricing based on current market conditions, then transfer prices can similarly be recalibrated. Doing so may substantially alleviate complexities that arise from forecasting the effective tax rate and the interconnectivity of VAT, customs, and transfer pricing, particularly when transfer pricing considerations require large year-end adjustments.

The July 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations provide that transfer prices based on economic conditions known either before or after the transactions were entered into can be compliant with the arm's-length principle.[1]

The Arm's-Length Price-Setting Approach

Following the arm's-length price-setting approach allows taxpayers to factor in current market information while maintaining adherence to the arm's-length principle. It would generally apply in the context of traditional transaction methods, such as the comparable uncontrolled price, resale price, or cost-plus method.

Consider an example. A controlled foreign corporation purchases consumer electronics from a related party, as well as uncontrolled third parties, for resale into traditional retail and e-commerce channels in its territory. It has adopted the resale price method as its transfer pricing method using the range of gross margins of the products procured from the uncontrolled vendors. In light of the decrease in volume sold

[1] See paras. 3.69 (the arm's-length price-setting approach) and 3.70 (the arm's-length outcome-testing approach), respectively.

via the traditional retail channel and flash sale discounts offered via the e-commerce channel, the CFC and its unrelated-party vendors have negotiated price adjustments that result in the CFC earning lower expected gross margins. Correspondingly, the transfer price should be revised such that the expected gross margin earned on related-party purchases targets the lower expected gross margins earned from third-party purchases.

Once the transfer price has been recalibrated using updated internal or external benchmarks that reflect current economic conditions, the intercompany invoices for the rest of the pandemic period (or tax year, as appropriate) should adopt the revised transfer price. The resulting share of profits or losses among the supply-side, demand-side, and principal entities will be based on each entity's exposure to the economic forces presented by the pandemic in accordance with the accurate delineation of the transaction.[2] Depending on the actual outcomes, that approach may support losses throughout the supply chain for manufacturing entities in locked-down locations or distributors in affected markets, as well as super-profits for markets that saw a spike in demand, such as medical supplies.

The Arm's-Length Outcome-Testing Approach

Transactional profit methods such as the transactional net margin method (TNMM) and the profit-split method are typically applied using the arm's-length outcome-testing approach of computing year-end adjustments and testing the results against updated comparable company benchmark sets. Preemptive modifications to the transfer price can alleviate some of the pressure associated with large year-end adjustments and can potentially help with the deployment of cash within the group. Applying this approach requires modeling the potential economic impact on the profitability of comparable companies in the benchmark sets and then recalibrating the transfer price based on revised forecasts for each affected entity in the group.

Assume a CFC is a limited-risk distributor of car tires, which it purchases from a related party. It has adopted the TNMM as its transfer pricing method, and the estimated transfer price is adjusted at year-end such that it earns a target operating margin that falls in the benchmarked range of wholesale distributors of car parts. Because of shelter-in-place restrictions, there has been a precipitous drop in vehicle miles traveled, so the demand for tires has decreased. Faced with similar demand-side factors, the comparable wholesale distributors revise their full-year guidance to reflect lower revenue and profit expectations during their quarterly earnings releases. The CFC performs an analysis to forecast the expected arm's-length range of operating margins based on the comparables' full-year guidance and resets the transfer price to target the revised range.

In a recessionary economic environment triggered by the unique nature of a pandemic, there could be several complexities in the arm's-length outcome-testing approach at year-end and in preparation of contemporaneous documentation:

- By the time that year-end adjustments are required, the impact of the pandemic on the comparable companies' financial results will still be publicly unavailable.
- Some entities will likely require downward transfer pricing adjustments that are disallowed in some jurisdictions or require the taxpayer to pursue the matter through the lengthy and complex competent authority process.
- Once the comparable company results are publicly available (after the deadline to prepare contemporaneous documentation in some jurisdictions), it is highly likely that the pandemic's effects will be asymmetric and might not match the economic conditions of the tested party — for example, comparable companies operating in markets or industries that exhibited similar economic conditions before the pandemic may have been affected to different degrees.
- Survival bias will likely result in benchmark results that are skewed higher in the post-pandemic economy because some comparable companies may file for

[2] Chapter I, D.1.2.1, of the OECD guidelines provides that for transfer pricing purposes, the evaluation of risk requires the identification of economically significant risks, an analysis of any contractual terms, and the consideration of whether the party assuming a risk exercises control over that risk and has the financial capacity to assume it.

bankruptcy protection or may be acquired by competitors or private equity. If that occurs, the comparable sets will not reflect the pandemic's full downward economic impact.

That is not to say that those concerns cannot be rationally adjusted for, but it is reasonable to expect that controversies with tax authorities will be more complex if the taxpayer's exposure to the pandemic differs from those of comparable companies.

Transactional Approach to Cash Management

Transfer pricing can also be used as a strategic tool to deploy cash resources from entities where it is not needed to those that need to finance raw materials, inventory, payroll, rent, or interest payments.[3] Transactions can be (re)structured with a high upfront payment to transfer cash to entities in financial distress. The payment terms of existing transactions could be restructured for a temporary period by way of extending receivables,[4] prepaying royalties, or paying an upfront fee for services. A market support payment or a loan can provide bridge financing to entities in financial distress. One-time transactions can be entered into that may permanently change the functional or risk profiles of the parties, including sale and leaseback transactions, the factoring of receivables, or the licensing of intangibles.

Those one-time transactions may be effective in justifying large transfers of cash within the group, but consideration must be given to the long-term tax strategy, as well as to analytical and administrative requirements regarding business restructuring and hard-to-value intangibles,[5] as well as mandatory EU disclosures.[6]

Conclusion

The recalibration of transfer prices to take into account the pandemic's economic impact or the (re)structuring of transactions should be deliberate and rigorous in its design and administration. Many tax authorities require contemporaneously executed contracts or policies to support losses or one-time costs borne in their jurisdictions or the transfer of risks or hard-to-value intangibles from their jurisdictions. ■

[3] Robin Hart and Marcela Lopez, "Cash Emergency: The Transfer Pricing Toolkit," 17 *Transfer Pricing Rep.* 541 (Nov. 6, 2008).

[4] Transfer pricing rules provide for a mechanism to adjust for the implicit financing of working capital balances.

[5] OECD guidelines, chapters IX and VI, respectively.

[6] EU Council Directive 2018/822 (DAC6).