Post-pandemic Transfer Pricing Issues

How to manage and mitigate the risk

About the Speakers

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Contents

Transfer pricing conceptual framework and analysis of economic models

Transfer Pricing Conceptual Framework

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Regulatory Environment

Keeping track of evolving transfer pricing regulatory framework. Regulatory framework include OECD TP guidelines/ UN TP guidelines, Country specific Acts, regulations & guidelines, International treaties & commentary, Global Accounting standards etc..

Economic theories

Amalgamation of economic theories and models based on financial projections, mathematical derivations and statistical models.

Practical Aspects

Understanding the practical aspects like ground level procedures, understanding the concept of burden of proof and identifying inconsistencies and provide practical solutions

Economic Model 1- Expense Intensity Adjustment

$$PurchasingPrice = ResalePrice*(1-gm)$$

$$\sum_{i=1}^{n} RP = NetSales$$

$$\sum_{i=1}^{n} PP = COGS$$

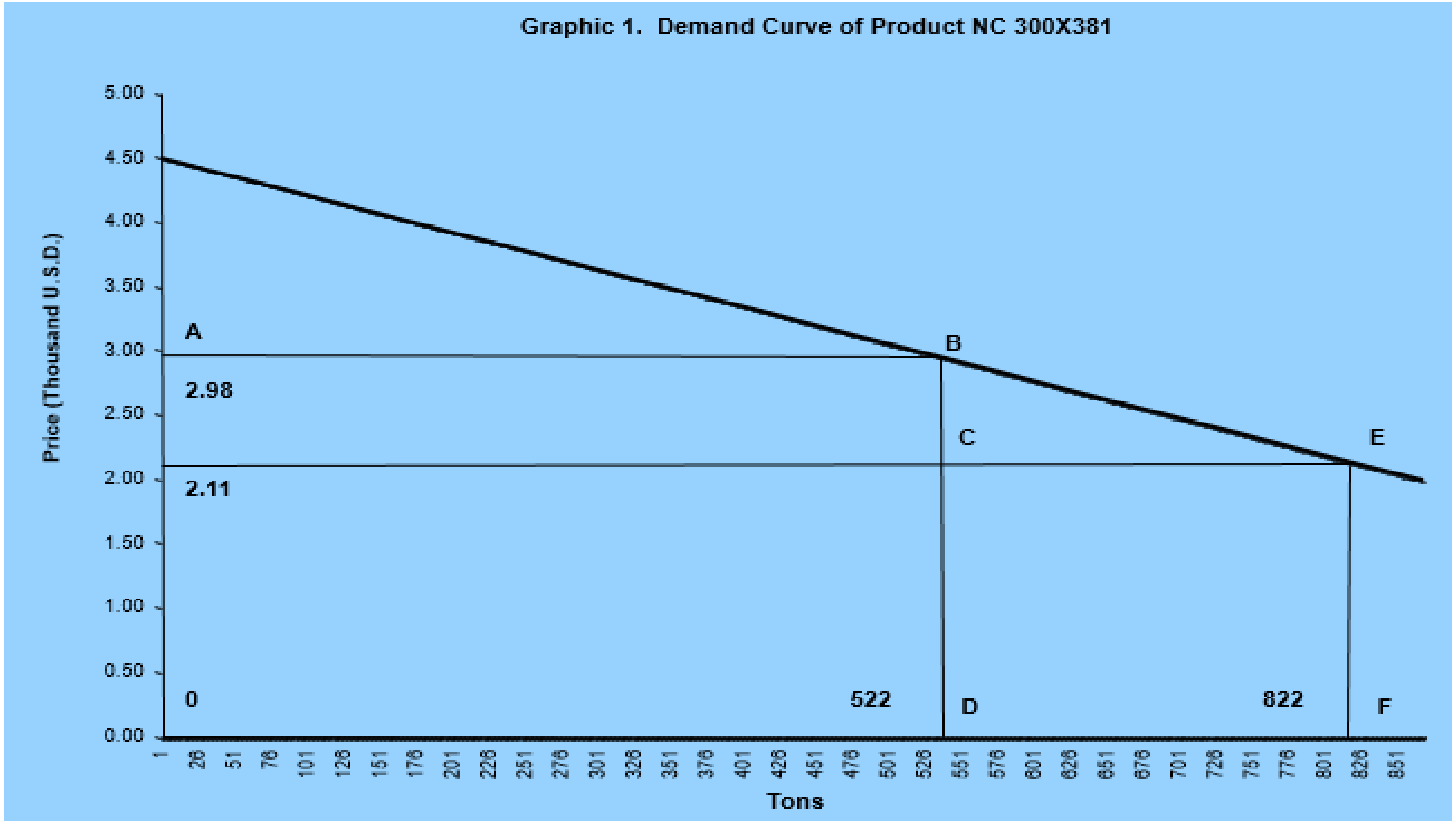
$$COGS = NetSales*(1-gm)$$

$$\frac{OperatingExpenes}{NetSales} = ExpenseIntensity$$

$$\frac{NetSales - COGS}{NetSales} = ExpenseIntensity + OperatingMargin$$

$$GrossMargin = ExpenseIntensity + OperatingMargin$$

Economic Model II - CUP Method
Price Discrimination

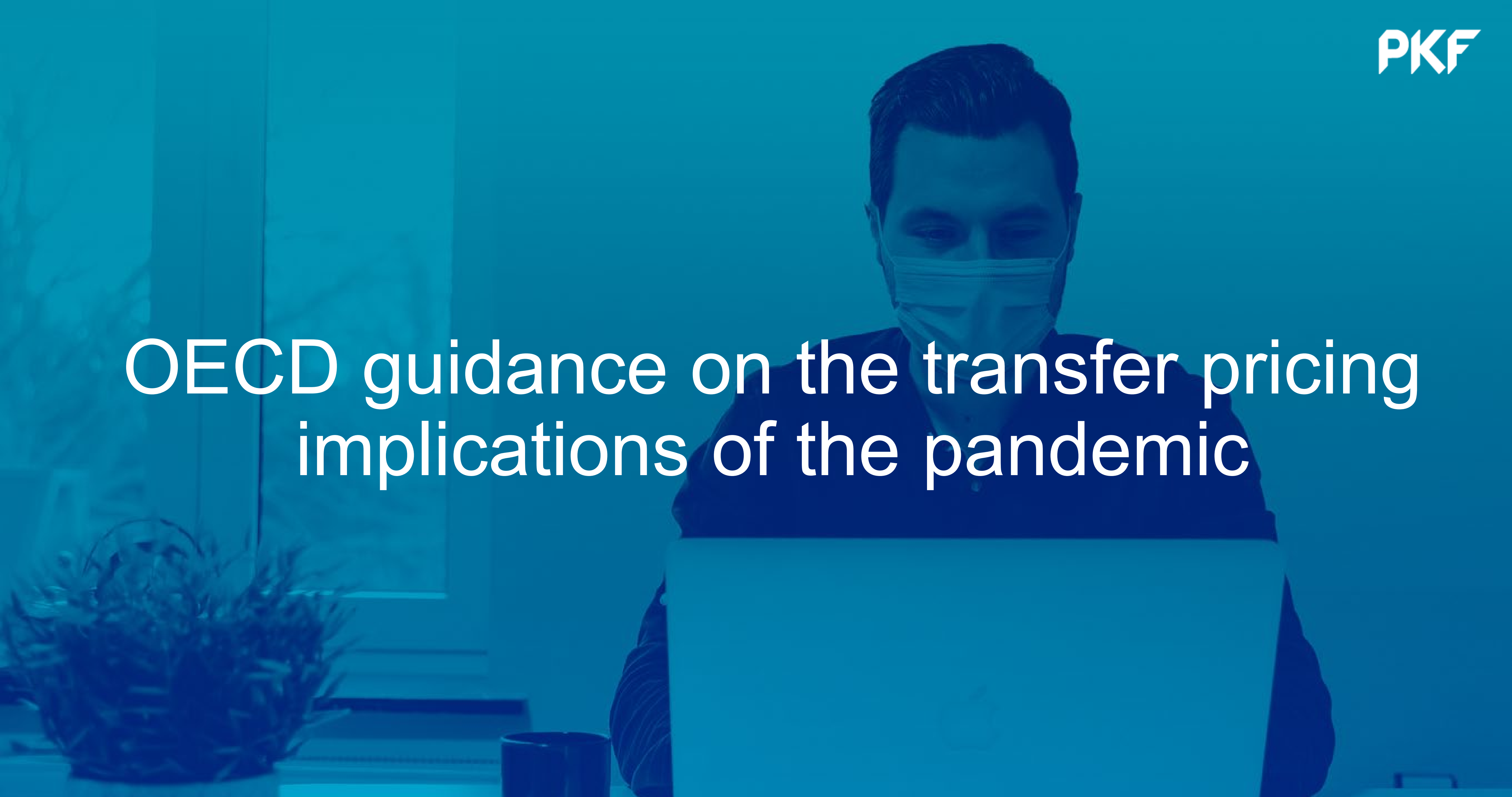


Economic model III - Forward Contract Economic Model

- ADM Mexico agreed to purchase USD from ADM Latin with the delivery of the currency in future determined dates.
- The exchange rate is determined in public markets. The mathematical formula used to calculate the theoretical rate is described as:

$$ForwardE.R. = spot\ e.r.*\left[\frac{(1+ip*n/360)}{(1+iusd*n/360)}\right]$$

- A search for the spot exchange rates was carried out for every date that ADM Mexico and ADM Latin agreed on doing forward transactions. The variables of interest are the following: spot exchange rate, interest rate in pesos and the interest rate in USD.
- After the calculation of the theoretical exchange rate, a +/-2.5% range oscillating around the forward rate was implemented.

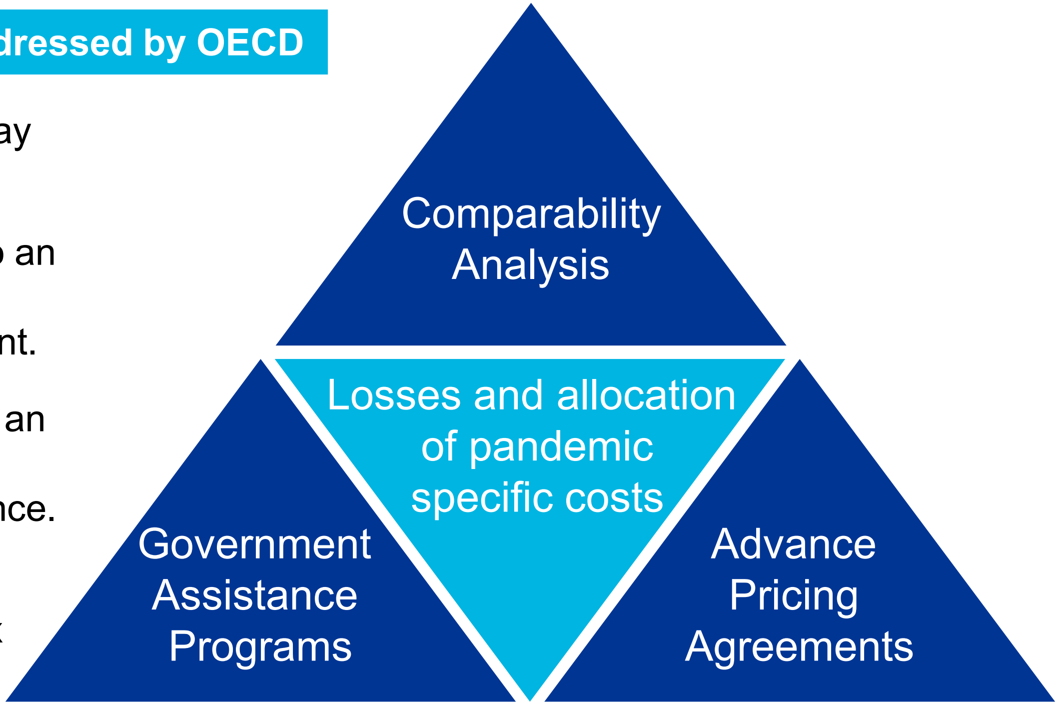


OECD guidance on the transfer pricing implications of the pandemic

OECD Guidance on TP Implications of Pandemic

Four Priority Issues addressed by OECD

- The Guidance lists several types of information and approaches that may be relevant to address the comparability challenges.
- The Guidance emphasizes the allocation of risks between the parties to an intercompany arrangement and how the profits or losses would be allocated between independent parties under a comparable arrangement.
- The Guidance states that the extent to which government assistance is an “economically relevant characteristic” that needs to be factored into the pricing of a controlled transaction depends on the nature of the assistance.
- The Guidance encourages taxpayers to adopt a collaborative and transparent approach by raising and discussing relevant issues with tax administrations.



Key Issues to Consider

- **Allocation of losses across group entities.** Are Low risk entities (LREs) and Contract manufacturers immune from losses?
- **Comparability of data.** It might not be appropriate to use data of previous years as the situation then might be comparable with current situation
- **Change in business model.** Rapid increased in digitalization brought by pandemic and the creation of new IP. Change in significant people functions, assets utilized and risk shifted across group entities. Remuneration model to be reviewed.
- **Impact on group financing.** Borrowing and lending capacity might be impacted negatively. Characterisation of transaction can be questioned.
- **Documentation considerations.** Contemporaneous evidence, enhanced documentation in the form of a defense
- **Timing of adjustment- A**udit trail in General Ledger vs Audit trail created after the year end

Comparability challenges with practical examples

Comparability Challenges – Approach to Adjustments

Some possible approaches to adjusting TNMM analyses in accordance with the arm's-length standard to account for comparability challenges arising during the economic downturn. It is not meant to provide an exhaustive listing or discussion of possible adjustments. Further, there may be various approaches besides adjusting profitability benchmarks that involve different transfer pricing methods altogether, such as profit split methods.

Adjustments to the tested party financials

- **Receivables write offs**: Economic disruptions on supply chain may result in liquidity issues.
- **Inventory write downs**: Mandated/govt shutdowns may translate into inventory buildups.
- **Asset impairments**: Permanent adjustment subject to impairment for accounting purposes.
- **Underutilized production capacity**: Abnormally low manufacturing capacity utilization.
- **Idle sales force**: Pandemic disruptions may result in unusual revenue losses.

Adjustments to comparable periods

- Constraining comparable data to current downturn period.
- If possible, extension of comparable period (years) to prior downslide period.
- Limiting comparable period (years) to prior downslide years.

Adjustments to the comparable companies' profitability measures

- Adjustments to the range used for benchmarking.
- Adjustments to comparable company results based on company metrics/measure.
- Adjustments to comparable company results based on macroeconomic indicators.

Identifying Evidence - Supporting Negative Impact on Profitability

Reasons and supporting evidence to justify how the company's profitability has been negatively impacted by pandemic. Please find impact on Profit and loss account below of a sample distributor.

	2019	2020	2021
Sales/Revenue (Net)	**140,000**	**100,000**	**120,000**
Cost of Goods Sold (COGS)	115,000	82,000	98,000
Gross Profit (GP)	**25,000**	**18,000**	**22,000**
Selling & General expenses (SG & A)	15,000	10,000	14,000
Receivable Write-off	-	6,600	
Capacity loss	-	3,200	
Impairment loss	-	5,400	
Total Operating expenses (OE)	15,000	25,200	14,000
Operating Profit (OP)	**10,000**	**(7,200)**	**8,000**
Operating Margin (OM)	**7%**	**-7%**	**6.67%**
Pandemic Adjusted Operating Profit		15,200	
Pandemic Adjusted Operating Margin		**8%**	

Impact on Profitability – Pre and Post Pandemic Analysis

A comparison of the budgeted (pre-pandemic) and actual results of the profit and loss analysis of the distributor, providing explanation and evidence to support the variance. Please find the P&L impact below

	Second Quarter					Third Quarter				
FYE 2020	Budgeted P&L (Pre-Covid)	Actual results (Post-Covid)	Pandemic Loss (+)	Govt assistance** (-)	Pandemic expenses (-)	Budgeted P&L (Pre-Covid)	Actual results (Post-Covid)	Covid Loss (+)	Govt assistance** (-)	Pandemic expenses (-)
Turnover/sales	**100**	**70***	35	**5****		**100**	**90***	10	**0****	
Cost of Goods	75	50	25			75	70	5		
Gross Profit	**25**	**20**				**25**	**20**			
Selling expenses	20	25			**5***	20	16			**4***
Operating Profit	**5**	**-5**				**5**	**4**			
Operating Margin	**5%**	**-7%**				**5%**	**4%**			

*Considering sales losses, government subsidies, and additional pandemic expenses leads to clear variance on the operating margin from budgeted margins.
**considering pandemic specific government assistance that the company has received which has an impact on its operations.

Comparable Company Adjustments Based on Company Metrics

A company's profit margins depend on its performance on various operational (and consequently, financial) metrics, e.g., its ability to trim down its sales force or its ability to utilize existing production capacity during the economic downturn. If the comparable companies are different from the tested party in terms of their performance on key metrics that are significantly impacted by the downturn, an adjustment to comparable company results based on such metrics may be reasonable.

	Company A	Company B
Revenue (R)	67	67
Variable Costs (VC)	42	50
Fixed Costs (FC)	10	4
R – VC	25	17
(R – VC) – FC	15	13
Degree of Operating Leverage (DOL)	1.66x	1.30x

$$DOL = \frac{R - VC}{R - VC - FC}$$

- When volumes decrease, fixed costs do not decrease at the same rate, which results in a disproportionate reduction in operating profit.
- If we denote revenue by "R", variable costs by "VC", fixed costs by "FC" and the degree of operating leverage as "DOL"
- For Company A in the Table, the DOL is 1.66x while for Company B, which has lower fixed costs, the DOL is 1.3x.
- Based on the revenue levels shown in the table, both companies earn the same profit amount (i.e., R – VC – FC).

Case Study: Adjustments Based on Company Metrics

Company	OI 2019	OI 2020	OI 2021	R 2019	R 2020	R 2021	OM 2021
Company A	614	270	-181	7050	6024	2880	-6.30%
Company B	78	108	38	498	513	406	9.40%
Company C	5701	3844	5530	48513	42146	41389	13.40%
Company D	68	40	31	1057	959	698	4.40%
Company E	5467	3849	2596	49133	42798	32712	7.90%
Company F	16	14	13	177	171	140	9.60%
Company G	978	1053	53	4243	4588	2901	1.80%
Company H	71	55	56	343	316	468	11.90%
Company I	2528	3359	1376	15052	28881	16949	8.10%
LQ							4.40%
Median							8.10%
UQ							9.60%
Tested Party	1251	1069	-626	14370	14124	11271	-5.60%

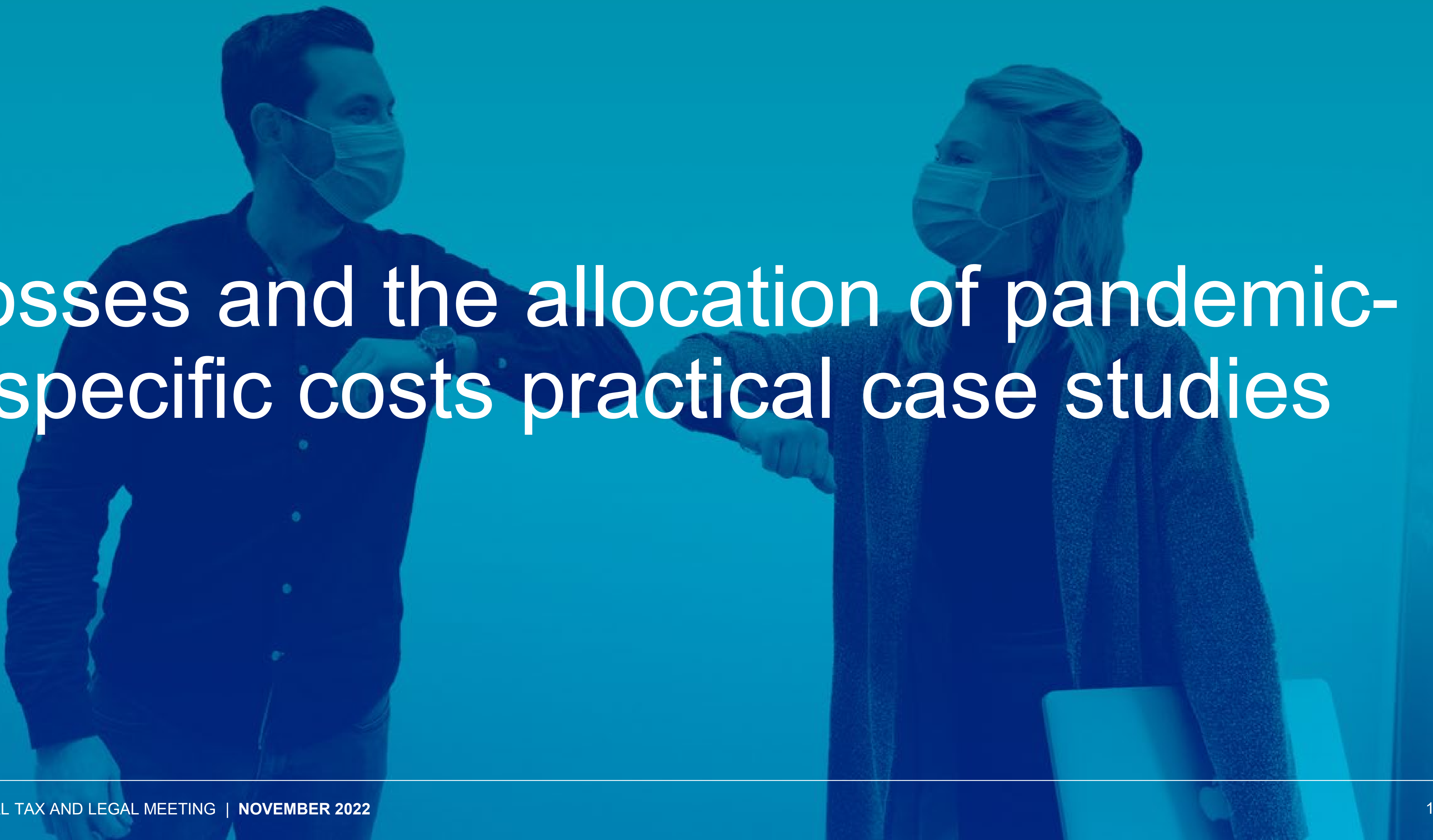
$$\mathbf{DOL} = \frac{\%\ \textbf{change in operating profit}}{\%\ \textbf{change in revenue}}$$

$$\mathbf{DOL^{A\_2020}} = \frac{(\frac{270}{614} - 1)}{(\frac{6024}{7050} - 1)} = (-\ 56\%)/\ (-15\%) = 3.85$$

Company	DOL	OM
Company A	3.86	-10.50%
Company B	2.53	4.00%
Company C	3.31	8.60%
Company D	3.17	0.60%
Company E	2.03	0.50%
Company F	2.65	2.80%
Company G	0.62	-18.0%
Company H	2.08	34.7%
Company I	0.46	-13.50%
LQ		-10.50%
Median		0.50%
UQ		4.00%
Tested Party	4.06	-5.60%

It is clear from the table that the tested party has higher DOL than the benchmarking group. One way to calculate an adjustment for the differences in cost structures of the benchmark companies and the tested party is to estimate how the benchmark companies' operating profit might have changed from 2020 to 2021 if they also had DOL of 4.06.

Losses and the allocation of pandemic-specific costs practical case studies



Case A: Pandemic Shuts Down Manufacturing Activity

What challenges do we foresee in determining the arm's length price of goods procured by the Singapore principal from the European parent entity?

Economic owner of Group European Region

Group Headquartered Europe

Procures goods from EU parent

Economic owner of Group APAC Region

Regional Headquarters APAC

Contract Manufacturer China

Closed for 6 months due to pandemic

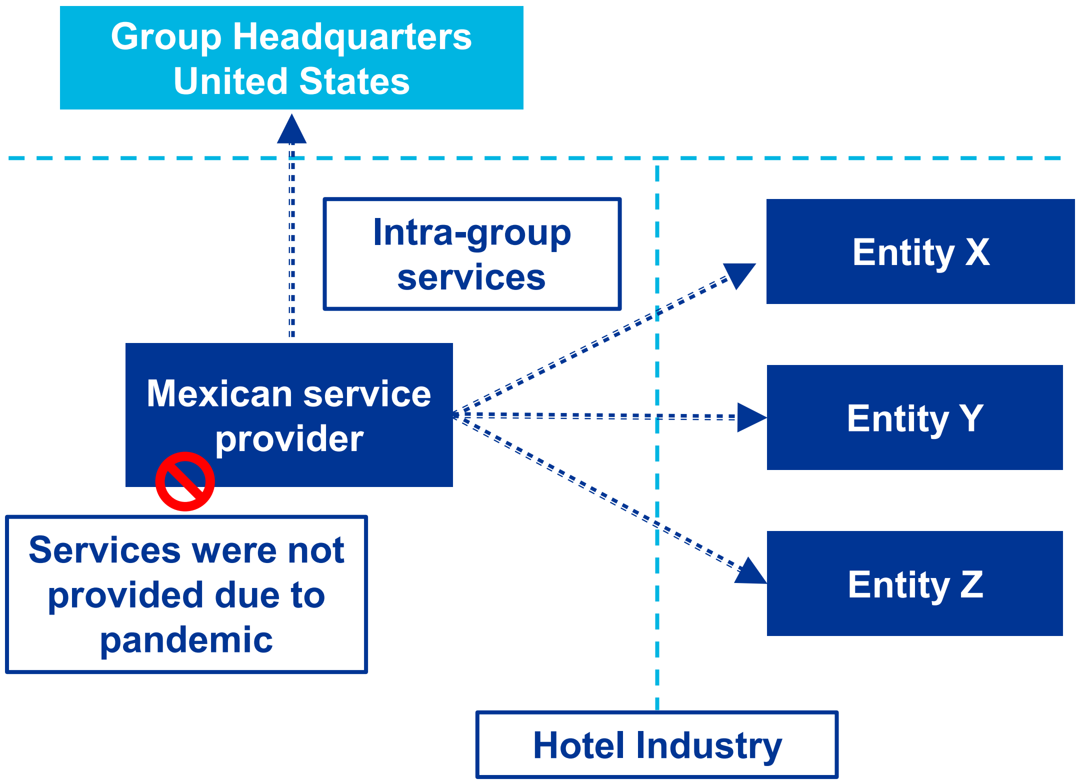
? Do the regional HQ be re-characterised as a distributor for the APAC region in relation to the supplies sought during the six months months?

? Do we just consider the regional HQ as the entrepreneur whilst re-characterising the European parent entity as a contract-manufacturer (or supplier to OEM) for goods supplied to regional HQ during the six months?

? Should the two principals continue to be characterised as entrepreneurs and the transactions be treated as dealings between two principals? Will this necessitate a profit split? How should the profits be split?

Case B: Pandemic Impact on Centralised Support Services

The Mexican service provider has always been characterised as a low risk entity involved in dealings within the group and has been remunerated with a cost plus arm's length mark up.



?

The 'benefit test' analysis leads to a conclusion that services fees should not be charged to group entities. Does this mean that risk allocation between parties need to be updated and the characterisation of the service provider altered?

?

Should the US HQ bear the costs being incurred by the service provider? If so, is there a basis for assuming these costs?

?

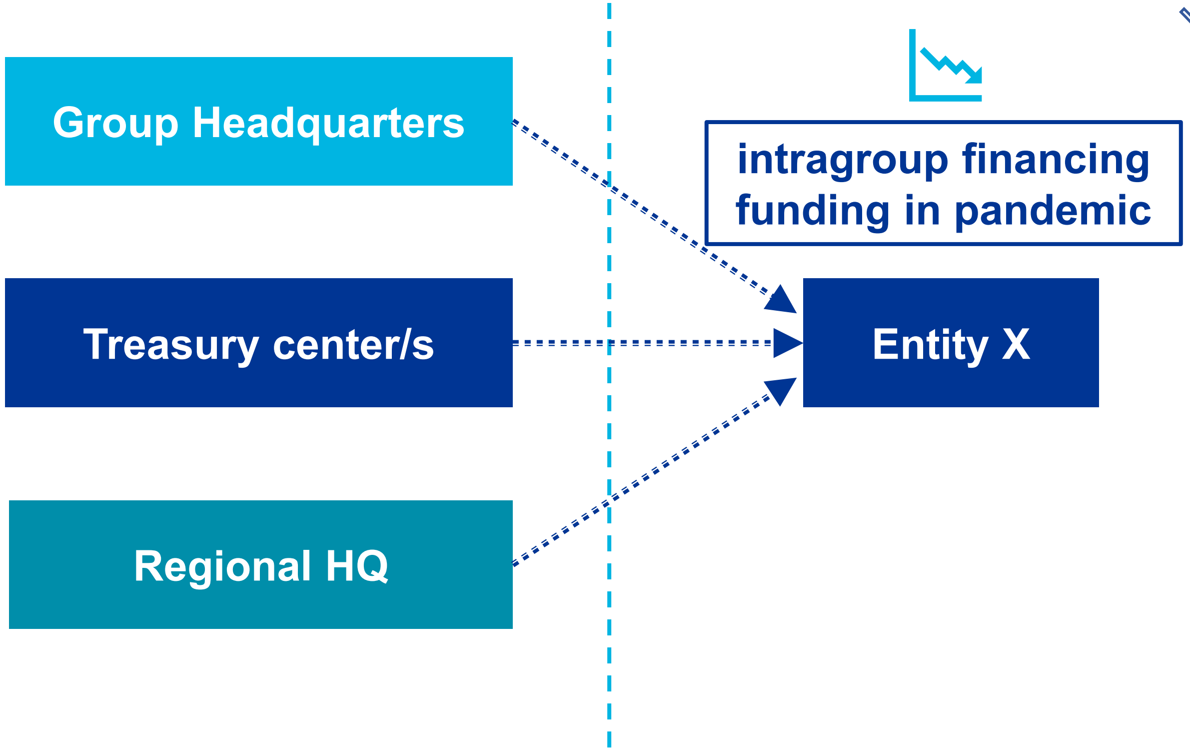
What are the options realistically available to the Mexican service provider?

?

What transfer pricing documentation should the service provider have in place to support its losses?

Case C: Pandemic Results in Cash Flow Issues for Business

Creditworthiness of companies have been adversely impacted and considerably weakened due to lack of cash flows resulting from the economic downturn. Given the weaken credit quality, it is now relatively expensive to get funding from third party financial institutions due to varying interest rates on impending global inflation. On this account, group treasury centres along with regional and global HQs are providing new intragroup financing at a considerably reduced rate (mostly lower than market rate).



? How do we assess the arm's length remuneration of the above arrangements whilst third party arrangements would result in comparatively higher borrowing costs due to a weaker credit rating of borrower (even after factoring in implicit support from the group)?

? Will this lending arrangement can be acceptable with the revenue authorities in the lender country of operations

? What documentation do we need to support the interest rate charged?

Advance Pricing Agreements (APA)

Pandemic Impact on Advance Pricing Agreement

Incidence of material changes in economic conditions that were not anticipated when many APAs covering FY2020 and potentially future financial years affected by COVID-19 were agreed

Application of existing APAs?

Taxpayer to have a transparent approach to disclose the current issues with respective tax authorities

Breach of Critical Assumption?

Yes

Pandemic impact resulted in breach impacted in most APAs

Revision of APA can be made by approaching the tax administration – following the local procedures

No

No pandemic impact

Existing APA should be maintained

Global Response of Tax Authorities in APAs

- In some instances, the APA, domestic law or procedural provisions may of respective jurisdictions prescribe procedures to follow, or describe the consequences that will arise, in situations where there is a failure to fulfil critical assumptions.

- In the absence of the same, a breach of critical assumptions with the APA could have three potential outcomes as follows:

Response	Description	Appropriateness
Revision	Existing APA would apply except that different terms apply before and after the revision date (FY 2020)	• There is a **material change** in conditions noted in a critical assumption in the APA • **Tax payer and tax administration agree on how to revise** the APA Revisions could be specific or general
Cancellation	APA is effective up until the cancellation date and not for the whole of the proposed period	• There is a **material breach** in an APA's critical assumption OR • **Taxpayer failed to materially comply with any term or condition of the APA** • However, cancellation cannot be automatic.
Revocation	Taxpayer is treated as if the APA had never been engaged	• There is a **misrepresentation, mistake or omission in an APA request or other relevant documentation** • Taxpayer **failed to materially comply with a fundamental terms** or conditions of the APA • In the current scenario, revocations should be limited to situations where the above actions meet the standard for revocation regardless of whether such actions arose because of the pandemic

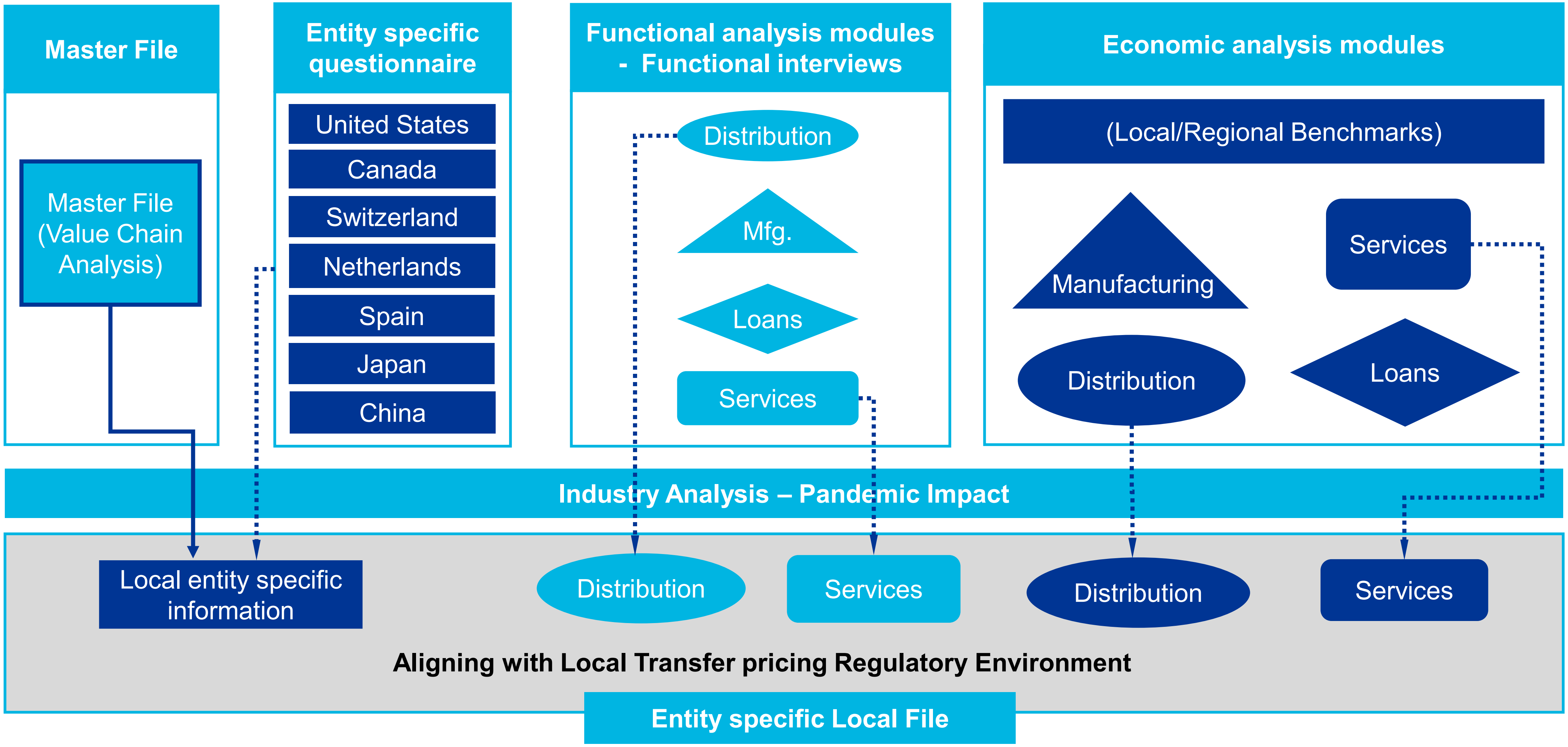
Clarifications for APAs Under Negotiation

If APAs in the process of negotiation covering FY 2020

Conclude a short period APA	Covering the period affected by pandemic and a separate APA.
Extend the period of APA	On a condition that retrospective amendments would be made if appropriate.
Conclude the APA for the whole period	To mitigate the short term affect of pandemic, depending on the magnitude and the length of such affect.
Cumulative or term test throughout the APA period	Evaluating the results of the transfer pricing methodology specified by the APA over the period of the APA, rather than on an annual basis.

Central of Excellence - Approach to transfer pricing documentation

Modular Approach to TP Documentation



Key Takeaways

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1. Develop solid audit trail for all

Business model
- Industry and sensitive analysis
- Changes in footprint
- Changes in people functions

TP model
- Review of Functions, Assets and Risks
- Holistic approach to group value chain

TP adjustment
- Reflect before the year end rather than after the year end.

Change in benchmark
- Extensive data/ financial and accounting analysis and preparing and selecting relevant arm's length point for implementation

Consistency
- Consistency is required to be maintained from financial statements, TP forms, TP disclosures, local file(s) and Master file.

2. Documentation to support arm's length pricing (benchmarking)

Identifying the flow of transactions

Contemporaneous preparation/update of comparable analysis

Testing the comparable analysis against the financials of tested parties

Implementation of comparable analysis via True ups and True downs

OPTIMIZED TAX IMPACT OF TP POLICY

Questions