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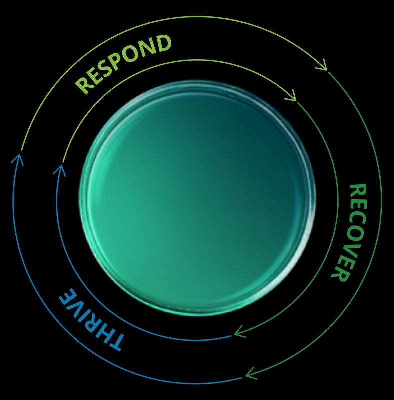


Combating COVID-19 with resilience

Newsletter Transfer Pricing #3

May 2020

Time for a remuneration holiday?

As the world faces unprecedented challenges due to the outbreak of the novel Coronavirus (COVID-19), introducing a temporary waiver or postponement of certain intragroup payments through the introduction of a 'remuneration holiday' may be a way to ease some of the financial burdens being faced by companies experiencing cash flow shortages.

Effective transfer pricing policy seeks to ensure that transactions between related parties reflect the conditions of similar activities taking place in the open market, in accordance with the arm's length principle.

But what happens when the market is witnessing temporary government-imposed commercial closures and emergency measures and where independent companies are renegotiating agreements and delaying payment obligations?

In this context, it is important that companies engaged in intragroup transactions are able to make similar adjustments to their intragroup arrangements in order to be able to remain in-business, retain their workforce and be prepared for the gradual lifting of the restrictions imposed.

Impact of COVID-19 on transfer prices
- Cash flow shortages;
- Operational changes;
- Unreliable market information.

Evaluate the impact in terms of transfer pricing

One of the most perceptible effects of the COVID-19 restrictions is their impact on cash flow. A remuneration holiday could substantially ease the pressure on group companies and provide affiliates with a lifeline at a time when their ability to generate revenues is severely limited and operating costs are mounting.

Checklist

1. Consider the intragroup commercial terms in legal agreements
2. Identify market behavior for intragroup commercial terms
3. Negotiate a remuneration holiday with related party(ies)
4. Justify and document changes on transfer pricing policies

The crucial point to bear in mind is that, while introducing a remuneration holiday may be vital to enable group entities to remain operational, it must be justifiable before the tax authorities. Past experience has shown that when tax revenues are lower, the tax authorities often look at changes in profitability more closely. A strong defence and appropriate documentation are therefore crucial.

On this basis, it is relevant to consider the following points when analysing the arm's length nature of the remuneration holiday.

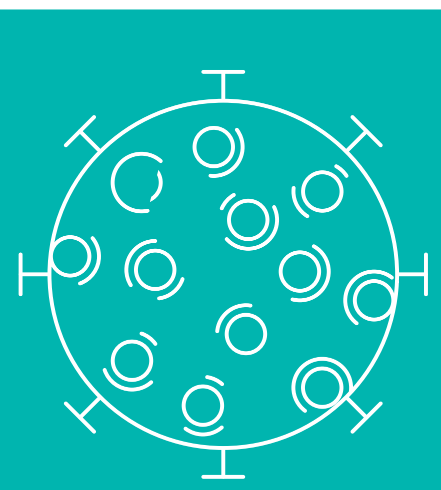
Is a remuneration holiday justifiable in a third party context?

Independent companies, when re-evaluating the commercial terms of an existing transaction (pricing and / or payment terms), will compare the option to other options realistically available to them and will only accept new terms if they see no alternative that offers a clearly more attractive opportunity to meet their objectives.

As the hardships felt as a result of the COVID-19 measures are widespread, independent companies may be willing to consider delays or waivers in payments, where the alternative would be having many of its clients going out of business.

Under normal circumstances, an independent company would not give up its right to be paid for the goods/services/rights/funds being provided/granted, where it is not compelled to do so, without a corresponding upside. On the other hand, an independent payee facing a weakened liquidity position and the uncertainty to the return to normal business, may be willing to postpone or waive payments for a determinate period in return for a higher remuneration at a later date. Also, a stepped-remuneration structure may be envisaged by the parties, starting at a low level of remuneration and foreseeing levels of high remuneration, being dependant on a specified indicator (vg. sales volume in case of royalty-type of transaction).

Where a remuneration holiday is introduced in an intragroup context it is important to identify corresponding behaviour in the open market and to retain documentation to demonstrate the rationale for the decisions taken.



Considering changes to transfer pricing policy

To avoid entering in losses at a time when the company/group is generating lower revenues, it may be relevant to consider changes to pricing policy that provide group entities with temporary relief from payment or reduced remuneration.

The ability to adjust the level of remuneration and/or payments terms may depend on whether the agreement contains an explicit adjustment clause authorizing the review of such terms if agreed by the parties.

While this may be an appropriate alternative to assume the middle of the crisis (as this would be expected in independent context), it is important to bear in mind that any changes to transfer pricing policy should continue to make economic sense in the post-COVID period as otherwise the legitimacy of policy changes may questioned by the tax authorities.

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