Ian: Kristine, welcome to the podcast. So great to have you on to talk about transfer pricing, especially in the current environment.

Kristine: Thank you, Ian. Really appreciate the opportunity to speak with you today.

Ian: So, given the current economy, my first question is, will transfer pricing specialists be able to document those intercompany transactions according to the policies that were set pre-COVID? Not all of them are going to be able to meet those in FY20. So how do you suggest that companies approach the documentation of profit margin adjustments for functions that might be below that set transfer pricing policy in the COVID year?

Kristine: Yeah, as we all know, the coronavirus outbreak has brought considerable human suffering and major economic disruption. More than 175 countries and territories have been directly impacted by COVID-19 infection. And the worldwide virus outbreak is currently causing substantial shifts in financial markets and the macroeconomy with, of course, direct implications for global supply chains and the profitability of companies.

So, for many companies, the COVID-19 virus has created unprecedented and unforeseen financial stress and uncertainty. Some companies may see a sharp drop in sales or revenue. They might incur costs associated with mandated closures and find that they are unable to right-size operating costs in the short-term. They may incur costs associated with furloughs or layoffs or incur other expenses or items that impact profitability locally or globally.

So, the OECD, which is the Organization for Economic Cooperation and Development, has warned that COVID-19 is the greatest danger to the world economy since the 2008 financial crisis. And therefore, it’s expected that the COVID-19 pandemic will have a negative bearing on the operating income of multinational enterprises and therefore impose a considerable burden on the cashflow of the multinational, as well as its individual subsidiaries.

It’s likely that a resultant downturn will, in effect, decrease real output of these conglomerates, leading to decreased profitability and earnings for many operations. Such impact is likely to be felt not only on principal companies, but also on distributors and manufacturers, irrespective of their transfer pricing characterizations. During an economic downturn, the margins earned by such independent entities may be reduced, as exceptional economic circumstances start affecting all of the supply chain profitability.

So, it’s important to reassess the potential long-term impact of the COVID-19 outbreak on businesses, particularly on—and now we get to the transfer pricing impact—when we talk about related party transactions and value chain profitability. Due to the lack of a similar observable event in the past, reliable data just may not be available, and a COVID-19-specific analysis will not be feasible.

So, we have done a couple of things at our firm where we have an overall quantitative impact that may still be assessed, taking into account historical data of macroeconomic variables and comparability data over a reasonable period of time.
Jay: When it comes to transfer pricing considerations, what are some of the immediate concerns that companies are focused on when it comes to the impact of COVID and obviously the impact that the pandemic is having on the economy and to the business?

Kristine: So, among many other concerns, an immediate question is whether the limited risk entity should bear some of the burden imposed by COVID-19. If the parent company or the principal of a group is taking an enormous hit due to COVID-19, it could be that that uncertainty and liquidity of the current situation would need to be pushed down to some of the limited risk entities. And the multinational may not have an immediate or definitive answer to this because many companies have perhaps already experienced reductions in sales or production irrespective of the duration of the current situation.

It is reasonable to conclude that by year end, many multinationals will be reporting substantially lower in overall profitability across supply chains and potentially limiting transfer pricing policies.

So, there are common themes, both when we are considering changing the current transfer pricing policy due to COVID and the impact on the business, and when we are asked to document the past fiscal year’s transfer pricing policy that remained unchanged post-COVID.

Jay: Companies obviously don’t have comparables when it comes to doing business during a global pandemic. So, from a transfer pricing perspective, what are the criteria that can be used?

Kristine: From a transfer pricing point of view, it may be reasonable for a company to consider adopting a different transfer pricing policy than what is contained in their current agreements, or if a company doesn’t have an agreement, in its current course of conduct. In the unusual situation that’s caused by this pandemic and the resulting impact on the economy, unrelated parties may take actions that are different from those required by their current contract or their historic course of dealings. And this is consistent with the arm’s-length standard as contained both in the US regulation and in the OECD guidelines.

We are currently working with the following propositions of changes to adjust routine company profit margins. We can base the selection of tested party comparable companies on the criteria that has caused the financial stress. This may simply require relying on a new set of comparable companies than have historically been used.

For example, if a related distributor experienced a 30% decline in sales, search for comparable companies that experienced a similar decline in sales. Another example could be if a related contract manufacturer experienced a significant reduction in orders, then search for comparable companies that experienced a similar decline in orders.

It could be that a client may reduce its R&D budget, which will cause less work for contract R&D service providers. In such a case, the company may want to search for comparable companies that experienced a similar decline in revenue. If a company’s salaries, or occupancy cost, depreciation, or other costs in relation to revenue increase substantially, a company may want to consider those ratios in selecting the comparable companies.

So, these were just a few examples of what happens and what could be done when we are looking at comparable companies and documenting this year.

Jay: Let’s talk a little bit about calendar year-end companies. What are some of the considerations and challenges there?

Kristine: The situation is that we’re in the middle of it, and certainly for calendar year-end companies, we are still in the midst of figuring out what are we going to do? Should we change our transfer pricing policy now or how does it look?

It simply may be that comparable companies full-year results obviously may not be available when a company is thinking about making the transfer pricing decisions for the period that’s impacted by COVID. So, companies may want to look at Form 10Qs quarterly or other interim statements in determining its transfer pricing policy for the current year.

Historically, comparable companies that had a history of losses or growing concern issues may be rejected in the final selection of comparable companies, but in situations impacted by COVID, it may be appropriate to continue to include those companies as comparable.

Historically, also, companies may have used three years of data to determine the range of transfer pricing results. It may now be appropriate to use only one year of data in situations impacted by COVID because of the financial stress that’s caused in this current year.

So, when we are advising clients on whether to adjust the tested party financial results for transfer pricing testing purposes, we just addressed above what happens if we want to make any changes to the agreement and the current policy. If we are at the end of the year and the year has gone and we are seeing now post-year close the financial results and we are asked to document and test these transfer pricing results that are impacted by COVID-19 matters, there are a couple of other measures that could be taken.

If a contract manufacturer was forced to shut down for a month because of a shelter-in-place order, it may be possible to isolate those costs and treat them as extraordinary expenses for transfer pricing purposes to be borne by the contract manufacturer and not the principal. If a distributor had to furlough staff or incurred severance costs, it may be possible to isolate those costs and treat them separately in determining the required operating margin.

If a company experienced a significant revenue reduction related to prior years, for example, through a loss of a customer or a contract or inability to conduct operations, then we could consider normalizing the revenue to prior years to demonstrate lower profits are due to COVID impacts and not incorrect transfer pricing.

So, there’s a wealth of obvious examples. We have many of them that we have thought through and any of us obviously would be happy to comment on them and go into detail with how this could be addressed.

Jay: In addition to tested party and comparable companies as an approach to this environment, what about a regression analysis? Is that something companies should be considering?
Kristine: Yes, we can also adjust using a regression analysis either with the data from an existing set of comparables or with a broader set of uncontrolled companies where we attempt to determine what impact a downturn has on comparable companies’ profitability levels.

Obviously, from a US perspective, the idea of lowering margins in this year because of COVID may also be particularly interesting for BEAT planning, especially for services markups in scenarios where service doesn’t qualify for the SCM in a normal economy. With a downward adjustment, we could get a median below seven and qualify for as a low margin covered service.

This provides the means to adjust comparable financial data to correct for these COVID distortions. Deloitte has undertaken a study which examines profit-level indicators, impact of macroeconomic indicators on previously accepted comparable data sets, which we use in transfer pricing. And if a casualty is established, it would indicate how profit-level indicators are expected to be affected in the future, given a previously observed downturn or global financial crisis and through natural economic growth cycles.

Such a combined circle is represented by a period that we selected, 2007 through 2019. And based on this premise, we have developed six predictive models using macroeconomic indicators for manufacturing in APAC, Americas, and Europe regions and distribution in the APAC, Americas, and Europe regions.

So, the predictive models based on the econometric studies determine how the profit-level indicators, meaning the operating margin and the net cost plus results of independent distributors, manufacturers, respectively, are likely impacted by changes predicted in key macroeconomic indicators.

So currently we have no knowledge about how benchmark sets will look in 2020 as a result of COVID. And with our analysis, which is based on GDP and other publicly available information, it’s possible to predict the impact which could be helpful in APA negotiations, when you’re considering making changes to the transfer pricing policy, and potentially for considering FIN 48 and year-end adjustments.

Ian: And let’s talk about at the country level, are there any particular countries that you’ve noticed that either are more likely to accept or not accept adjustments to the operating margin?

Kristine: Yeah, it’s interesting. What we have observed is that this is very fact specific. I mean, most taxing authorities will be open to hear taxpayers’ argument on COVID impact and why adjustments are reasonable. And certain jurisdictions have allowed for potentially adjustments down to zero during these unprecedented times.

One interesting example that I do want to point out here, and maybe other countries will follow, is not sure. But the Dutch minister of Social Affairs and Employment, they have actually published some official guidance on COVID-19 measures. And it really came out of the minister of Social Affairs and Employment meant to assist and support Dutch resident entity to survive the COVID-19 crisis and, more specifically, to preserve employment.

And they basically came out and said that if you had a decrease in turnover of 20% or more and even in certain situations, if you didn’t meet this 20% threshold in terms of turnover decrease, you would not be able to make changes to your transfer pricing for this particular year.

So, you would basically carry forward FY19 annual accounts or the latest available, they would be applied for the measured period of FY20. So, it really goes from countries being open to and hearing the arguments for adjustments and then other countries being very set on no adjustments allowed. We want to see how this year goes and then take it on a case-by-case basis.

Ian: And then when it comes to the transfer pricing economic analyses, what adjustments do you suggest that the people consider during this, quote, COVID year?

Kristine: Yeah, so any other adjustments to transfer pricing economic analysis that I would consider, I would say intercompany transactions that I certainly would encourage companies having a look at is to revisit their interest on loans and guarantee fees and cash-pooling arrangements in the light of the crisis. Many of the multinationals are expected to face continued liquidity pressure, and an updated transfer pricing policy that takes COVID-19 into account can keep cash centralized for easier access and use for operations.

But nevertheless, some of these policy changes, coupled with other economic events, may necessitate financial rebalancing as earnings and values may be impacted along with market liquidity and then with cascading effects on capital structure. So, for example, existing debt financing, both third party and inter-company, may be bound by incidence on maintenance covenants. For example, debt to EBITD, which may now be at risk of breach. Waivers to covenants or amendments to existing loans may be required to avoid default.

So that is certainly a group that I would encourage all companies to look into and revisit as an outcome of this crisis.

Ian: And what about the IRS’s perspective on COVID impacts in advance pricing agreements?

Kristine: Yeah, so the APMA program is actively discussing various substantive and procedural issues with treaty partners, including technical issues such as the application of transfer pricing methods and period of economic distress and the impacts of current economic conditions on specific industries, types of taxpayers, regions, especially for executed APAs where 2020 is a covered year.

One of the APA requirements state that the business activities, functions performed, risk assumed as it’s employed in the financial and tax accounting methods, and classifications of taxpayer in relation to the covered transaction will remain materially the same as described or used in the taxpayer’s APA request. And they’re saying that a major change in business results will not be a material change. So, some clients business activities have ceased or partially ceased for a period of time while others may be taking on different functions. For example, the manufacture of ventilators instead of automobiles.

So, either could be a basis for failure to meet the standard critical assumptions and an opportunity to revise the APA to reflect new economic conditions. An APA revision may reflect new comparability adjustments,
shorter or longer term of the APA, at different arm’s-length range of results, or additional critical assumptions.

Ian: We’ve got time for one last question. Given all the changes that are going on and the unforeseen future, but what are the one or two things that transfer pricing specialists should either be doing now or watching for in the immediate future?

Kristine: I think key critical right now for transfer pricing is certainly make sure that you can get good data. It is typically a pain point. I see this crisis becoming even more of a pressure point for companies. If you can’t prove that a downturn really is due to COVID, but your business perhaps was already going down, you have to be able to dissect and prove that, “Nope, it wasn’t my business going down, it wasn’t wrong transfer pricing. It was really COVID that was a reason for how my results look for this year.” So, having good data, key critical.

Number two, document your positions in a lot of detail. Otherwise, I would expect there to be significant controversy down the pipe. So I would say document and have robust files and arguments and detailed economic analysis showing how you are defending, how you’re documenting, how you are testing, and is it a non-econometrics or an econometric approach you have taken in terms of testing or changing or documenting your policy that needs to be put in the file and preserved.

Ian: Kristine, thank you so much for coming on the podcast today. Wonderful information. Really appreciate you being here.

Kristine: Thank you so much for having me.