



Transfer Pricing Sharing Series

Episode 02: Reconsiderations for intra-group arrangements

19 June 2020

Our sharing series will cover the following key areas (and beyond):

1. Supply chain disruption due to Covid-19 – How the existing group supply chain model may be changed forever and what potential subordinate risks may be involved. Refer the [link](#) for details.
2. Pre-Covid-19 intra-group pricing arrangements may potentially become irrelevant and the need to revisit them
3. Planning ahead for loss-making or fluctuating profitability in periods impacted by Covid-19
4. Business re-structuring from the perspective of transfer pricing specialists
5. More tolerance for low-risk entities due to Covid-19 – is it true?
6. Covid-19's impact on APA negotiation and/or implementation process
7. Transfer pricing audit trends: relaxation in approach for taxpayers or aggressive plan for State budget?

Introduction

As you may have already be aware, the local transfer pricing (“TP”) regulations indicated documentation that could be requested to prove the occurrence of the transfers of goods and services between related parties of multinational enterprise (“MNE”) groups and the arm’s length nature of such transactions. These have led to increases in challenges on substance versus form, differences between ex-ante and ex-post results leading to TP adjustments, and adequately sufficient supporting documents, etc. from the local Tax authorities in a case of tax or TP audit in the pre-Covid-19 time.

Now because the pandemic has caused disruptions to the traditional supply chains of MNEs as we discussed in Episode 1, the need to establish new transaction flows leading to foundations of new intra-group arrangements has become urgent and essential. Accordingly, Deloitte would like to provide our views based on our experiences and observations on the development of TP practices in Vietnam. We hope this would add value to local Chief Executive Officers (“CEOs”)/Chief Finance Officers (“CFOs”) in discussion with regional and/or global headquarters.

Our observations and suggestions

Maintain supporting documents

In a normal context, local taxpayers are advised, at least, to maintain the following supporting documents to prove:

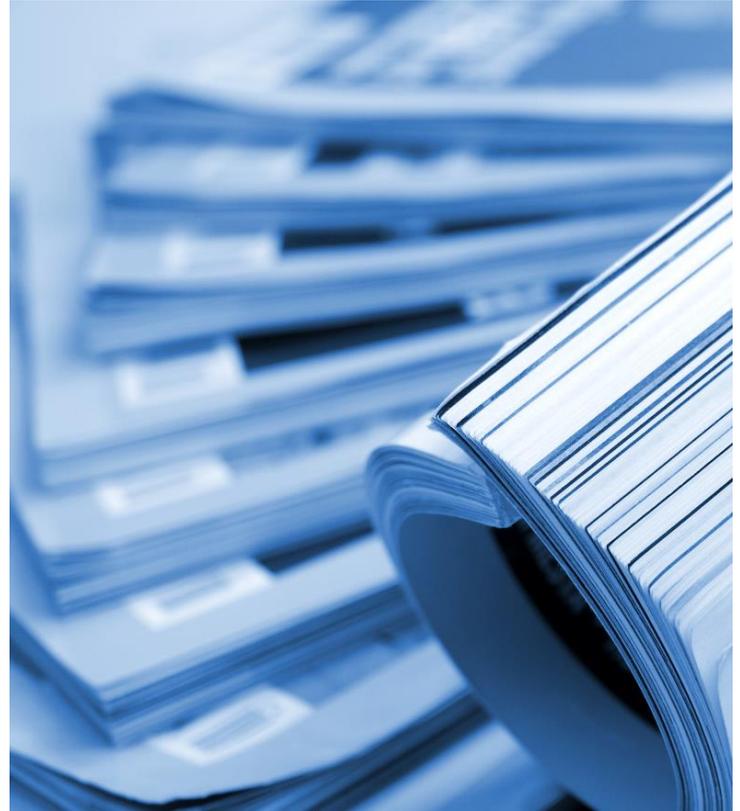
- The goods transferred serve the needs of the local buyer;
- The necessity and economic benefit of the services rendered by related parties;
- Fees charged at arm's length and applied consistently within the MNE group.

In a comprehensive tax audit, taxpayers may also be asked to prove the substance, such as capabilities (in terms of business functions, size, assets, etc.) of the service providers in providing such services.

On top of these, what else should CEOs and CFOs consider from a TP perspective in the post pandemic environment?

Reconsideration for intra-group arrangement

Most local foreign direct investment taxpayers are subsidiaries of a foreign MNE group and characterized as limited risk entities. Nevertheless, such local companies should always bear in mind that limited risk is not equal to risk-free, which means that their business results could be affected by unpredicted factors on a global scale like Covid-19. In other words, how much a limited risk entity and the group entity, who bears the entrepreneur risks, share and absorb the local and regional impacts from Covid-19 damage will become a critical question. Most likely, all members of such MNE groups may have to share certain level of the damage. In such cases, an effective ex-ante approach with early changes in intra-group arrangements would be carefully reviewed and determined at the group level. For local Vietnamese limited risk entities, a margin below the median or even lower than inter-quartile range of the prior year could be anticipated.



Inbound service charges, such as a royalty for use of brands charged to local limited risk entities under intra-group arrangements, may be reduced due to less effectiveness compared to prior years. In a research on consumer behavior of McKinsey in 2009 when the global economy started recovering from the 2007-2008 financial crisis, a large portion of consumers switched to purchase lower brands although they still preferred premium brands¹. The point here is that although the value of the brand could still be there, in an economic crisis, the brand itself may not help bring as much revenue to the sellers/distributors as it could otherwise have done. Therefore, the percentage on sales for royalty charged by the brand owners could be considered reduced, at least for a short-term.

In any case, it is always recommended that local CEOs and CFOs proactively participate in the group's information exchange process and learn the impact to their businesses from the group's viewpoints.

Note:

¹ Betsy Bohlen, Steve Carlotti, and Liz Mihos, McKinsey & Company, "How the recession has changed US customer behavior", 01 December 2009, retrieved from <https://www.mckinsey.com/industries/consumer-packaged-goods/our-insights/how-the-recession-has-changed-us-consumer-behavior>



Lessons from the past

Most taxpayers will report their 2020 result with the impact of the epidemic in 2021. Accordingly, taxpayers still have time to discuss with their headquarters to revise intra-group agreements. One of the factors that could be considered is to evaluate lessons from the past crises. Since 1997, the global economy has experienced major recessions every decade. Although the impacts varied across sectors, we would say analyzing what went wrong and what went well in how the groups responded then thrived in the past events could be one of the concrete bases to set new arrangements in this pandemic environment.

Force Majeure terms

A commercial contract between independent parties always has force majeure terms. All taxpayers are recommended to revisit, together with their legal counsel, such terms in the agreement with the related party providers. The local entities may consider triggering compensation terms due to the Covid-19's impacts, for example postpone delivery of materials for production, from foreign related suppliers. Further, legally and technically, penalties for late payment may also need to be taken into account. We would suggest all these be quantified and documented clearly with concrete evidence in the local entity's TP report.

Manage the uncertainties by advance agreements

Given the unforeseen events and business circumstances post Covid-19, taxpayers may consider applying for an Advance Pricing Agreement ("APA") for certain types of related party transactions or for the business operation's financial result. Technically, from The Organization for Economic Co-operation and Development viewpoint and international practice, the purpose of APA application is to make the inter-group pricing policy more transparent to the competent authorities and to both the taxpayer and the tax authorities to have more tax certainty.

Since the introduction of Circular No. 201/2013/TT-BTC providing guidance on the application of APAs in 2013, many enterprises have been applying for APAs with the Vietnamese Government. In the very near future, when new guidance is released, we expect breakthroughs in the application of the APA mechanism of the Vietnamese Government to ensure a more stable tax position for businesses. As such, local CEOs and CFOs are also suggested to bring this to their headquarters' attention as one of the method to manage the uncertainties for the local operations.

In summary, the above are our observations and recommendations for some common types of arrangements. Depending on the nature of the industry, the impacts on the local business leading to changes in the existing transactions arrangements could vary. Please feel free to contact us for further discussion on your concern. We look forward to collaborating with you during the difficult time to prosperous developments.



How we can help

- In-depth transfer pricing analysis from a local perspective
- BEPS-contracts/Intra-group agreements review
- Transfer pricing documentation review
- Transfer pricing health-check
- APA strategic planning, dossier preparation and process assistance

WHAT'S NEXT?

Our next episode will discuss on Planning ahead for loss-making or fluctuating profitability in periods impacted by Covid-19.



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