Acclimatizing Transfer Pricing of MNEs to COVID-19 Environment!

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Everyone is praying to God to reload 2020 as the current version has virus in it! The onset of new decade received a deadly blow with COVID-19 pandemic which has disrupted the entire socio-economic landscape world-over in no time. The geographical travel of the lethal Coronavirus at an exploding pace has not only impacted different age group and strata of the society across the globe in an unimaginable proportion, but the domino effect of the lockdowns and crisis management measures by all countries have put all economies and financial markets in a black hole situation.

With the increase in globalization, integration of world trade, dilution of geographical boundaries, work on the go and emergence of new business models, the Multinational Enterprises ("MNE's") have restructured and modified their operating structures in a way to ensure decentralization and distribution of functions across geographies. Functions like product design/ Intellectual Property ("IP") management, procurement functions are typically housed in a centralized entity while other members of the MNE group may perform contract manufacturing, contract R&D services and routine sales and distribution activities in different geographies. In this integrated and inter-dependent world, cross border Transfer Pricing ("TP") transactions among group entities have a far-reaching impact on the global economy, MNE operations, financial flows as well as each country's tax ecosystems.

The measures taken by various governments to control this pandemic (including nationwide lockdowns) has created significant business disruptions impacting liquidity, organizations supply chain operations, cross border and in-border restrictions on movement of people creating demand and supplies imbalances, and deep dent in output and consumption. From TP perspective, this has an immediate impact as organizations would now need to quickly and closely look into some of the critical elements from short, medium and long-term strategy perspective. While liquidity, operationalization of supply chain especially the manufacturing units and sustainability remain the immediate focus, Groups will also have to re-look at the existing modus operandi and acclimatize its TP policy and design to the post COVID-19 environment. Outlined below are some of the key TP related aspects which MNE group and its members will have to evaluate for its business operations in light of the current business environment:

1. Existing supply chain re-design

The first thing on the mind of management would be how and when to operationalize its plants and begin manufacturing. The existing supply chain is severely disrupted due to various factors like lockdown, sealing of international borders, raw material and labor shortages, limited supplies, demand forecasting challenges, inventory write off, etc. Further, on the market side, changing consumer buying options, demand slowdown, market downturn, cash crunch, etc. would be some of the major factors which may trigger MNEs to either shift its operations, scale down or even shut down in some particular jurisdictions. This is likely to result in re-allocation of functions performed by one group entity to another. In such crisis, the key aspect would be to evaluate the risk control and Development, Enhancement, Maintenance, Protection and Exploitation ("DEMPE") functions. Such reallocation of functions and risks including shifting of jurisdictions would require a TP evaluation and revising the existing Global TP policies along with characterization and arm's length remuneration for each group entity. Tax aspects of business restructuring will need to be evaluated while effecting such re-designing. MNEs would be required to prepare exhaustive documentation in the current backdrop including analysis of "Option Realistically Available" in such a scenario to justify the business reasons for structural changes. This also means corresponding changes in the Master File ("MF") and Country-by-Country Report ("CbCR") filings.

2. Impact assessment for intra-group financial transactions

The immediate challenge for all MNEs would be cash flow and managing the requirements of group entities worldwide. When the recession will start, what would be the impact and when would it end, would be a question in every board room depending upon each industry. Thus, cash flow issues and maintaining a positive flow would a become critical. Given the current lockdown condition, companies need to manage their short-term working capital requirement and also need to assess the long-term effect of the pandemic on the continuity of the business operations. With the business operations getting impacted, the credit profile of the businesses would also get affected in similar proportion. Thus, the global treasury functions (such as cash pooling arrangements) and intra-group financing as well as intra-group guarantees would gain more relevance.

Clearly, there is the need to review the borrowing intra-group company's credit rating and adjust for the reduced fiscal interest rates in the market. Impact of Section 94B (i.e. interest limitation clause) of the Income Tax Act, 1961 ("the Act") on inter-company loans/ loans under corporate guarantee also needs to be evaluated since the company margins would decrease and the increase in intra-group funding requirement could bring Section 94B of the Act, into forefront. Further, like the RBI has deferred the interest payments on loans for 3 months, similarly the payment terms can be devised in intra-group financial transactions along with additional interest component built-in case of all inter-company transactions in case of delayed payments. Another possibility could be buy-back of inventories by the Parent Companies to ease the cash flow obligation/ infuse liquidity, this again could impose its own TP challenges.

All such intra-group transactions need to be documented well along with the business/ commercial rationale, changes in contractual terms and the arm's length basis of such transactions since the said transactions have always been prone to stringent audit by the Tax Authorities. A possible impact could be TP analysis would have pre-COVID-19 interest rates which would not match the expectation and realities of post-COVID-19 economic environment.

3. Global TP policy redesign

Revisions in Global TP policy should be based on careful evaluation of the characterization of the group entities which will be dependent on actual functions performed and risk controlled in COVID-19 impacted economic environment and way forward functional and risk profiling. Deeper evaluation will be required for re-adjusting of price/ margins in comparison with industry/ third party trend and data. Adequate business rationale should be established to justify change in remuneration within the MNE group.

For benchmarking the margins, attention should be given regarding availability of third party data in databases (which may not include COVID-19 impacted financial data of comparable companies) and hence, there may be a need to undertake economic adjustments to determine the price/ margins on ex-ante basis.

MNE may be required to design its Global TP policy from a short to medium term perspective (to consider immediate and foreseeable future impact considering system profits/ losses of MNE group) and may have to revisit the TP policy in due course from a long term sustainable perspective. Hence, the Global TP policy will have to be dynamic to incorporate the changes of the environment and not be a static one. Which means, how these have been defined and evaluated in the already filed MF and CbCR, would have to be re-aligned and re-calibrated to address the current economic realities.

4. Revision/ termination of inter-company agreements

Revision/ termination of existing inter-company agreements will be a key action items for MNE groups which can result due to – (i) Price/margin change; (ii) Production and Delivery schedule changes; (iii) Credit terms and payment resetting; (iv) Impact of exchange rates among others. However, the critical aspect of either revision or termination would be invocation of the "force majeure" clause. A careful analysis and documentation would be required for such invocation. Due considerations will also have to be given for changes in the functional and risk profiling of entities in revising the inter-company agreements to sync with the actual conduct of the parties. Another point of consideration here would be substance over form, change in future revenue earning capabilities, forgoing of a right, relinquishing of any right, etc. which itself would lead to more TP sensitivities.

5. Re-evaluation of Advance Pricing Agreements ("APAs") option

Considering the uncertain market situation and unanticipated actions of the Tax Authorities, it becomes pertinent for the MNEs to gain certainty through APAs, both new and renewals, in order to reduce significant cash tax outflows in future years. Additionally, there is a requirement for the MNEs to re-look at the terms of the agreed APAs since they may not reflect the current economic situation in post COVID-19 period. Section 92CC(6) of the Act read with Rule 10Q of the Income Tax Rules, 1962 ("Rules") provides for revision of the APA either suo-moto by the Central Board of Direct Tax ("CBDT") or at the request of the Taxpayer or by Competent Authority. Considering the years pending to be complied under APA, Taxpayer could technically explore the possibility of revision of the APA. However, detailed economic and business rationale would need to be documented to discuss the revision at the negotiation table. It is advisable that Taxpayers assess the situation quickly and take necessary steps, failing which to comply with agreement terms may render the APA to be non-binding. Similarly, for new APAs under negotiation and APAs under renewal, the post-COVID-19 economic environment would have a significant role to play.

6. Analysis of Permanent Establishment ("PE") Risk arising from virtual working and E-decisions made by key personnel from remote locations

It is pertinent for businesses to review the new location of the significant people functions to understand whether "E-decisions" are made by them from remote locations or any changes in the DEMPE functions/ responsibilities of the IPs that requires revisiting the TP policy. Virtual working on account of the restricted people movement due to shut down of country borders requires analysis of PE Risk and the profit attribution basis the arm's length remuneration thereon. In case of Tax Authorities picking these cases and/ or proposing adjustment, the Groups may opt for Mutual Agreement Procedure (MAP), to avoid economic double taxation and to better represent their cases during the hour of crisis.

7. Impact on TP documentation and re-looking entity level profitability

With business downturn, lockdowns, idle capacity/ bench, financing crunches, declining sales, less cross border trade, etc., all MNEs will have to closely re-look on the approach toward the TP documentation which will need careful crafting. Some of the key areas which demands attention will be as follows:

• ***In-depth industry assessment* -** The immediate requirement for MNEs is to undertake in-depth industry impact assessment of the crisis i.e. the effect of lockdown, reduced demand, reduced supply, stockpiles, unavailability of manpower, reduced margins, etc. It will be important to clearly articulate the impact of COVID-19 on the key business drivers, situation of the market players, measures taken by industry to fight the situation and competitive landscape and advantage/disadvantages which has been created.

• ***Revamping Function, Asset and Risk ("FAR") analysis* –** Irrespective of the supply chain re-design, companies will have to closely look into the FAR analysis for the current year as many of the functions performed could have been re-allocated, significant decision making may have to be transitioned and risk control functions (i.e. market volatility, forex exposure, manpower risks, etc.) could be undergoing significant changes. This will require an all-round refresh of the existing FAR and appropriate documentation will have to be undertaken to reflect the changes, which will also drive the benchmarking approach. Companies should invest time and effort in undertaking such exercise.

• ***"Extra-ordinary" expenditure and its financial impact* –** The impact on the top and bottom line of the business would necessitate to prepare a robust audit defense package addressing "extra-ordinary" expenses incurred amidst the crisis undertaking relevant economic adjustment model (such as effect of lockdown on capacity utilization, market volatility exposures, manpower productivity, etc.) to arrive at arm's length price/ transfer price. It would be pertinent to analyze and document the arm's length nature of the intra-group transactions like royalties and management services wherein a waiver/ moratorium would be provided to AEs in specific situations where such payments exacerbate losses. Alternatively, there could also be a spike in royalties and management services cross charges as the Head Offices would be facing the similar cash flow crunch.

• ***Arm's length profitability indicators & Economic adjustments* –** In light of business and economic downturn, arm's length margins for routine entities (contract manufacturers/ tollers, limited risk distributors, contract service providers etc.) will have to be determined in an pragmatic manner to consider the impact of the COVID-19 related disruptions. This could be done more effectively with the availability of the internal comparable or other market data such as revision of prices/ contractual terms with third parties. However, undertaking external benchmarking, given that the financial data of the comparable as well as the financial projections of the Taxpayer would not be available at the TP planning stage, one would need to be careful and pragmatic while determining the margins. From a compliance perspective, given that benchmarking data for the relevant year showing the economic downturn would not be available at the time of preparing the contemporaneous TP documentation, companies would need to evaluate different economic adjustments (e.g. capacity, foreign exchange volatility, utilization adjustment, working capital adjustment etc.). From a Taxpayer standpoint, this means that a deep drill down and dissection of financial items (and other data) would need to be undertaken.

Lastly, MNE groups need to ensure that the local TP documentation should be synchronized with the Global TP policy documents, i.e. MF and CbCR. As discussed above, all the inter-company documents would require re-alignment and re-calibration in this dynamic environment.

Way forward in turbulent times

Impact of COVID-19 will be long lasting one and staying within the realms of home, with only guess work being available, it’s hard to assess the overall impact and as to when things start getting back to normal. Thus, channelizing the internal funds would be in focus and with it, the TP implications. As we are doing during this period of lockdown i.e. going back to the basics, it may also be time for MNE to go back to the drawing board and closely assess their organizational and operational structure, and reset many of the conventional arrangements with revised/ new arrangements in these turbulent times. The period under perspective could be short to medium for some industries and medium to long term for other industries. The key aspect of all TP analysis will be to prepare robust documentation having regards to commercial/ business rationale for business re-alignment and making changes to the TP policies on real time basis which will allow MNEs to defend the revised pricing of their intercompany transactions more effectively. A rigid or less flexible TP policy may not be ideal and in today’s world lessons learnt from such pandemic would require flexible and adaptable business models. As the world weathers through the COVID-19 storm, MNEs should proactively and at an early stage undertake detailed analysis, create business conversion documentation package and positions in a holistic manner and implement the same on a timely basis in its compliance requirements globally. All businesses would need to bite the bullet and brace themselves for the times ahead. But before that, let us all be good global citizens and fight the pandemic collectively.