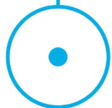
Optimizing Losses from a Transfer Pricing Perspective in the Wake of a Pandemic



Bloomberg Tax & Accounting

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I. INTRODUCTION

Governments and central banks around the world are struggling to address the Covid-19 pandemic and its impact on the economy. While certain governments may mitigate the crisis by doing whatever it takes, businesses are still required to operate and transact with their international affiliates at arm's length as prescribed by their local transfer pricing rules.

For many companies, the Covid-19 pandemic is causing important supply chain and operational disruptions, and is reducing system-wide profits. Despite governmental measures and stimulus, the financial impact may be even greater for parent companies of local subsidiaries operating as limited-risk distributors or service providers and earning a guaranteed return. Under the current circumstances, it may be appropriate to share losses among different members of a global group depending on functional profiles and where the economic risk is ultimately borne.

This article provides companies with practical tips and identifies issues that may need to be addressed given the uncertainty caused by the Covid-19 pandemic. Companies face a number of technical challenges related to the tax treatment of losses, and should address such challenges proactively by reaching out to their tax advisor for industry-specific and specific tax and transfer pricing advice.

II. LOSSES PLANNING CONSIDERATIONS FOR U.S. CORPORATIONS

On March 27, 2020, the U.S. government adopted the Coronavirus Aid, Relief and Economic Security ("CARES") Act. The CARES Act provides some measures to mitigate the financial impact of Covid-19 at the U.S.-parent level. For example, the CARES Act repeals the 80% income limitation for net operating losses ("NOLs") carryovers arising in taxable years beginning before January 1, 2021, and allows carrybacks of NOLs arising in taxable years beginning after December 31, 2017, and before January 1, 2021. The 80% limitation on taxable income remains for taxable years beginning after December 2020. However, through the CARES Act, Congress clarified that for purposes of the 80% limitation, taxable income does not account for deductions under §172,[1] deductions for qualified business income under §199A, and deductions for foreign-derived intangible income ("FDII") and global intangible low-taxed income ("GILTI") under 250. Notwithstanding certain interactions with FDII and GILTI deductions, NOL carrybacks may be a potential source of liquidity for corporations suffering losses, and an interesting option given the higher maximum corporate tax rate of 35% in prior years (vs. 21% now).

III. EVALUATING LOSSES FOR TRANSFER PRICING PURPOSES

Outside the United States, transfer pricing audit activity in recent years has increasingly driven some multinational enterprises ("MNEs") to adopt return on sales transfer pricing models for their local subsidiaries, rather than cost-plus models. While local tax authorities undoubtedly like the potential financial upside that such models provide, they are less enthusiastic about the downside financial risk that materializes when local sales decline. In general, whether it is appropriate for losses to be shared among the MNE group depends on the nature of the losses, the

[1] All section references herein are to the Internal Revenue Code (the Code), as amended, and to the regulations promulgated unless otherwise indicated.

contractual arrangements in place within the group,[2] and the functions performed, assets owned, and risks managed by each member of the group.[3]

Losses can arise for a variety of reasons. Establishing that the losses relate to the extraordinary circumstances of the Covid-19 outbreak rather than intercompany pricing is key in supporting and defending transfer pricing positions. Companies should analyze the commercial and financial cause of the loss and distinguish between the pandemic period and recovery period. In other words, companies should demonstrate how Covid-19 is changing the commercial circumstances of the business in reducing customer demand or disrupting supply chains. The nature of this analysis will vary by industry and company, but it will often take the form of a detailed industry analysis, providing concrete examples of the many challenges the industry and company are facing due to Covid-19. It may also prove relevant to review and compare the economic impact across markets. For a number of industries, large regional markets encompassing more than one country may remain reasonably homogeneous, while for others, differences among domestic markets (or even within domestic markets) may be significant.[4] This information may be incorporated in the annual transfer pricing documentation to support current year results.

IV. ISOLATING THE FINANCIAL IMPACT OF COVID-19

After explaining the relation between operating and financial losses and the extraordinary circumstances of the Covid-19 outbreak, the next step is to determine what proportion of the losses a limited-risk entity should bear, and how to support the entity's financial results. Some considerations for making this determination may include evaluating the behavior of unrelated parties in comparable uncontrolled transactions and the financial results of comparable companies during the same period (in the context of the comparable profit method/transactional net margin method).

Aside from the typical comparability adjustments to the financials of comparable companies' results, MNEs may isolate the impact of the Covid-19 crisis (and hence, isolate the loss) by adjusting the tested party and comparable companies' results based on the SG&A-to-sales ratio experienced during unaffected years. During an economic downturn, companies typically experience an increase in SG&A as a percentage of sales given that they cannot rapidly adjust their fixed costs to offset lower sales. Although they may no longer require the same amount of assets to operate their businesses, contractual arrangements like leases do not allow for short-term changes without significant penalties. In business economics, companies have an economic incentive to continue operations despite losses, as long as revenues offset variable costs.

Adjusting the tested party results may also be necessary to account for government subsidies or available tax credits. Governments across the globe are releasing stimulus plans to counteract the financial crisis. Italy, for example, committed to grant certain tax credits on sanitation expenses.[5] Moreover, in certain cases, companies have business interruption insurance against revenue lost and operating margins reductions. Allocating insurance proceeds among related parties may be relevant for transfer pricing purposes. This is due to the fact that this type of insurance policies is not entered at the level of each subsidiary but at the parent or the principal company level.

V. ADJUSTMENTS TO CONTRACTUAL TERMS: LOOK OUT FOR COMPARABLE UNCONTROLLED TRANSACTIONS

To avoid deductibility issues, support actions (or the absence of support actions) within MNEs (e.g., adapting payment terms, granting funding, etc.),

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[2] 2017 *Organization for Economic Co-Operation and Development* (*OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the "TPG"), ¶ 1.42.

[3] TPG ¶ 1.43.

[4] TPG ¶1.112.

[5] *See* Covid-19 Government Intervention Schemes in Europe (providing additional information on government intervention).

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should follow the same principles that unrelated parties would consider before deciding whether to provide such support. Due to the Covid-19 outbreak, certain companies may seek to invoke *force majeure*, or renegotiate existing contractual terms with their suppliers, business partners, or customers. Such market transactions can serve as indicators of arm's-length behavior and provide the necessary evidence to justify a temporary change to the terms of intercompany arrangements or transfer prices. In addition, the comparable uncontrolled price ("CUP") method is typically the preferred transfer pricing method of all tax jurisdictions. Relying on the CUP method thus provides a great opportunity for implementing a coordinated and consistent global defense strategy across jurisdictions.

VI. FINANCIAL IMPLICATION OF LOSSES

As a result of the Covid-19 pandemic, many companies will rely on government loans, loan guarantees, and grants, as part of the multi-trillion dollar financial stimulus plans that governments are implementing. In the United States, the CARES Act specifically grants the Treasury authority to provide up to $500 billion in loans, loan guarantees, some of which will benefit qualifying businesses.

For MNEs, there may be significant transfer pricing implications related to the distribution of funds within the group to individual subsidiaries experiencing financial stress, whether the source of funding is external or not. While MNEs are under pressure to act quickly, it remains essential to consider the characterization and implication of intercompany financial transactions used to distribute the funds. Failure to take such steps may have significant tax consequences. This is also particularly important in an environment where some companies in a group are tax-paying while others are shielded by losses.

MNEs can provide funds to a subsidiary through various financial transactions such as an injection of equity capital, an intercompany loan, or a settlement of guarantees. While the injection of equity capital would not lead to any direct tax consequences, an intercompany loan may constitute a better arrangement in cases where the subsidiary has unused tax capacity and the parent is shielded by losses. In the alternative, if the parent has tax capacity, a transaction that gives the parent a deduction (e.g., a settlement under a guarantee) might be an interesting option, especially if there is a formal guarantee in place. In the case of a U.S. parent with tax capacity, companies should also consider the revised §163(j) limitation on interest expenses under the CARES Act. As another measure to alleviate the financial impact of Covid-19, the U.S. government increased the deduction for business interest expense to 50% of adjusted taxable income ("ATI") for tax years beginning in 2019 and 2020. Certain companies may further increase their interest deduction by substituting their 2019 ATI for their 2020 ATI.

A. Loans

While it may seem straightforward to issue an intercompany loan, the current economic environment causes some challenges. For example, would a lender be willing to make such a loan without the support, either explicit or implicit, of the group? In fact, would a lender even be willing to lend at all to the group as a whole? What interest rates are appropriate? While base rates are very low, the credit spreads will be much higher and should be considered as part of the analysis. Furthermore, the debt capacity of subsidiaries may be impacted by the application of interest limitation rules to reduced earnings. It may not be possible to make loans if the borrower has no debt capacity either now or in the immediate future. In such cases, less credit-sensitive structures such as cash pool arrangements might be useful as an alternative.

B. Guarantees

Another alternative is to characterize the provisions of funds as the settlement of guarantees. For explicit guarantees, the transaction can be seen as a settlement of the guarantee to the extent there was debt in place, either internal or external. With respect to implicit guarantees, companies should carefully consider and document the process. In

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the case of intercompany loans, for example, documentation will indicate whether the funds are replaced as a settlement of the implicit guarantee, or written down or written off completely. If the parent is not the same as the lender, then it should settle the loan with the lender directly and document that it is doing so under the implicit guarantee. Otherwise, it will in effect write off the loan, document the reasons, and claim a loss just as a bank would under a bad debt scenario.

VII. OTHER CONSIDERATIONS

Before adjusting their transfer pricing model in response to losses associated with the Covid-19 pandemic, companies should be wary of potential customs duty or indirect tax consequences of certain types of transfer pricing adjustments. In many jurisdictions, tensions exist between transfer pricing and customs values. For example, a downward adjustment to cost of goods sold may later trigger inquiry by local customs authorities. Retrospective transfer pricing adjustments (where permitted) may lead to an adjustment to dutiable imported goods, which in turn may necessitate a voluntary disclosure to customs authorities.

VIII. CONCLUSION

In summary, the Covid-19 crisis creates important challenges for companies and the urgency to react quickly. However, as governments respond to the crisis with stimulus plans and fiscal reliefs, tax and transfer pricing become important levers to manage losses and sources of liquidity within the group.

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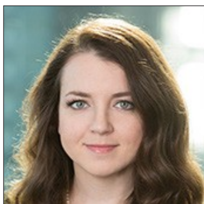

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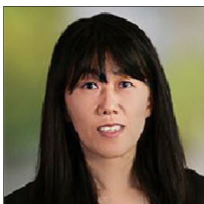

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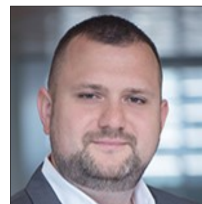

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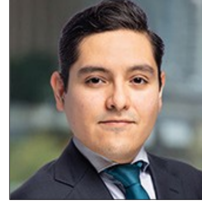

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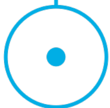

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