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Transfer Pricing Guidance for MNEs in the Wake of COVID-19

Presenters

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Agenda and Presenters

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1. Introduction
2. Impact of the COVID-19 Crisis
3. Distribution Entities and COVID-19
4. Charges for Head Office Services and Intangibles
5. Financial Transactions
6. Transfer Pricing Implications of COVID-19 Government Support Payments

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Impact of the COVID-19 Crisis



Impact of the COVID-19 Crisis

- The effect of the current pandemic on MNEs varies greatly, according to industry and adaptation to the changed circumstances introduced globally to counter COVID-19.
 - Certain online sellers are reporting record profits.
 - Sectors reliant on the free movement of people, such as the travel industry, are in crisis.
- Demand and supply side have both been hit, with consumer demand down and production and supply chain disruption.
- Governments have intervened on a massive level with assistance programmes.
- These combine to create a number of transfer pricing issues, ranging from how to establish relevant comparability analyses, the consequences of shifting manufacturing capability, what to do when the presumptions underpinning APAs have been upset and how to treat government stimulus.

Guidance for Transfer Pricing Arrangements Affected by COVID-19

- Limited guidance has so far been released that addresses the transfer pricing issues created by the unusual circumstances of the pandemic.
- The ATO has produced information on documentation for MNEs economically affected by COVID-19.
 - This places emphasis on gathering evidence to support changes to the business as a result of COVID-19.
 - Without short-term comparable data for benchmarking, the ATO will seek to establish arm's length pricing by viewing actual results in the context of the results that might have been achieved in the absence of COVID-19.
 - The analysis will be expected to include changes in revenue and expenses and COVID-related factors affecting these, with supporting evidence and rationale for amended allocation of costs and sales.
- The OECD is hoping to release additional transfer pricing guidance by the end of 2020 addressing specific characteristics of the COVID-19 crisis.

Benchmarking an Exceptional Year

- We can hope that the coordinated nature of the OECD's prospective guidance will serve to avoid future disputes with tax administrations.
- Questions of how to establish relevant comparable data for the results of 2020 or how to adjust benchmarked margins in anticipation of 2020 outcomes remain key.
- It would be helpful to have commentary on, inter alia:
 - Use of the lower end of an established range.
 - Moving away from reliance on multiple-year comparable data.
 - Application of adjustments, in the absence of comparable current data, based on industry average impacts.
 - Invocation of force majeure in intra-group contracts to support an adjustment to margins through reallocation of COVID-19 related costs.

Does existing benchmarking remain valid and, if not, how does one establish pricing?

- No single answer can apply across all industries and territories.
- In the short term, many MNEs are experiencing strongly reduced profitability, creating the transfer pricing issue of how to reflect this across the group.
- Comparable data for recent years is not helpful in an extraordinary year.
- How can one adjust benchmarked margins to reflect the still unquantified outcomes of 2020?
- Attempting adjustment based on parallels from the financial crisis may not prove valid. Then the banking industry was hard hit, but supply chains were not disrupted.
- Where change is dictated, what evidence will be needed to support changes to transfer pricing policy?

Distribution Entities and COVID-19



Routine Distribution Entities and FY 2020 Losses

COVID-19 impact on FY 2020 results:

- Different across industries and even sub-sectors (think for example of medical devices vs. food & beverages vs. fashion & apparel)
- Different for Wholesale Distribution vs. Retail Distribution (the latter, more directly impacted by lock-down measures imposed by governments world-wide during first semester)
- Focus of our discussion:
 - Retail distribution in an industry significantly impacted by COVID-19 (e.g. apparel, consumer products, etc.) world-wide
 - Impact of COVID-19 on the transfer pricing policies of a multinational group operating under a Principal model with local subsidiaries in the various countries charge of directly managing own stores having a routine responsibility profile / LRD profile

Routine Distribution Entities and FY 2020 Losses

1) Is COVID-19 a reason to change the transfer pricing method adopted for previous years?

- Maybe not, if the facts / business model of the Group and the functional, risks and assets' profile of the related entities involved have not changed
- Consistency mostly important to prevent “quick wins” from foreign tax authorities for future years

2) How to adjust for COVID-19 impact (and related losses on distributors)?

- Change in the “search strategy” of usual benchmark analysis (e.g. assess acceptability of loss making comparables);
- Use of multi-year financial data of comparables with adjustments (e.g. econometric analysis to evaluate COVID-19 impact on profitability of distribution entities based on previous economic crisis or shocks) vs. single-year contemporaneous data (e.g. assessing COVID-19 impact based on listed companies' financials);
- Segregate COVID-19 specific costs

Routine Distribution Entities and FY 2020 Losses

P&L RETAILER	2020 Budget	
Turnover		1200
Cost of Goods sold	50%	600
Gross Margin	50%	600
<i>Selling & Labour costs</i>	28%	336
<i>Rents</i>	11%	132
<i>Advertising</i>	2%	24
<i>G&A</i>	5%	60
Operating Expenditures	46%	552
Operating Margin	4%	48
Operating Margin %		

Profit = 48
Profit = 4%

Pre COVID-19		
Jan	Feb	
100,0	100,0	
50,0	50,0	
50,0	50,0	
28,0	28,0	
11,0	11,0	
2,0	2,0	
5,0	5,0	
46,0	46,0	
4,0	4,0	
4%	4%	

Profit = 8
Profit = 4%

LOCK DOWN PERIOD		
Mar	Apr	May
0	0	0
0	0	0
0	0	0
8,4	8,4	8,4
11,0	11,0	11,0
1,0	1,0	1,0
4,8	4,8	4,8
25,2	25,2	25,2
-25,2	-25,2	-25,2

Loss = (75)

POST LOCK DOWN PERIOD						
Jun	Jul	Aug	Sep	Oct	Nov	Dec
50	60	70	70	70	80	80
25	30	35	35	35	40	40
25	30	35	35	35	40	40
25,2	25,2	25,2	25,2	25,2	25,2	25,2
11,0	11,0	11,0	11,0	11,0	11,0	11,0
2,0	2,0	2,0	2,0	2,0	2,0	2,0
5,0	5,0	5,0	5,0	5,0	5,0	5,0
43,2	43,2	43,2	43,2	43,2	43,2	43,2
-18,2	-13,2	-8,2	-8,2	-8,2	-3,2	-3,2
-36%	-22%	-12%	-12%	-12%	-4%	-4%

Loss = (62)
Loss = (13%)

2020 REFORECASTS	
100%	680
50%	340
50%	340
38%	258
19%	132
3%	21
9%	59
69%	470
-19%	-130

Loss = (130)
Loss = (19%)

Arm's length Range OM : 2% / 6%
Median: 4%

Example from the article by Soldani, G. and Tempestini, A., "Transfer pricing and Covid-19: Loss Allocation for Retailers", in Tax Notes International, June 2020

Routine Distribution Entities and FY 2020 Losses Conclusions

- COVID-19 outbreak is not in itself a reason to change TP policies
- To allocate losses to a routine distributor is not in itself forbidden
- Consistency and reasonableness of the outcome (grounded on analytical exercises as far as possible; sanity checks desirable)

Charges for Head Office Services and Intangibles



Head Office Services and Intangibles

- **COVID-19 business issues:**
 - Fall in subsidiaries' revenue, EBIT
 - Increase in head office services (IT, Supply Chain, Treasury, etc.)
 - Restricted travel by head office teams
 - Charges defensible in prior years might look excessive
- **Transfer pricing issues:**
 - How to demonstrate benefit of service, IP in light financial results?
 - » Are extra costs incurred at HO shareholder expenses?
 - » Deductibility?
 - Do I/C service/license agreements allow flexibility?
 - Have subsidiaries been effected differentially?
 - Are allocation keys still valid? Need adjustment?

Foreign Sales and Distribution Subsidiary: 2020 vs 2019

Effect of a 20% reduction in revenue

(million euros)	2020			2019	
Revenue	800			1000	
<u>COS (related party)</u>	<u>640</u>			<u>800</u>	
Gross Profit	160	20%		200	20%
<u>SG&A</u>	<u>150</u>			<u>150</u>	
EBIT	10	1%		50	5%
<u>Mgmt fee</u>	<u>20</u>			<u>20</u>	
EBIT*	-10	-1%		30	3%

“Management fee drives subsidiary into a loss position”

Likely Tax Authority Reactions

- **Foreign tax authority**

- Disallow deduction
- No evidence of benefit from head office services/IP – disallowed
- Head office services = shareholder expenses – disallowed
- Head office charges are excessive – disallowed
- Only allow deduction for head office services if TP reduced

- **Head Office tax authority**

- Must charge true service costs
- Same beneficial services/IP as in prior years
- Not shareholder expenses in prior years
- Additional services provided during crisis – additional benefit
- Same TP policy as in prior years
Problem is sales volume, not TP

What Head Offices Need to do Now

- Review changes in head office activities during 2020
- Distinguish shareholder expenses from services
- Review allocation keys and adjust if necessary
- Review (and amend if necessary) I/C service/license agreements
- Document decision and rationale
 - Master file
 - Local files
- Special attention to the benefits of head office services/IP
 - Demonstrate alternatives realistically available would increase costs

Financial Transactions

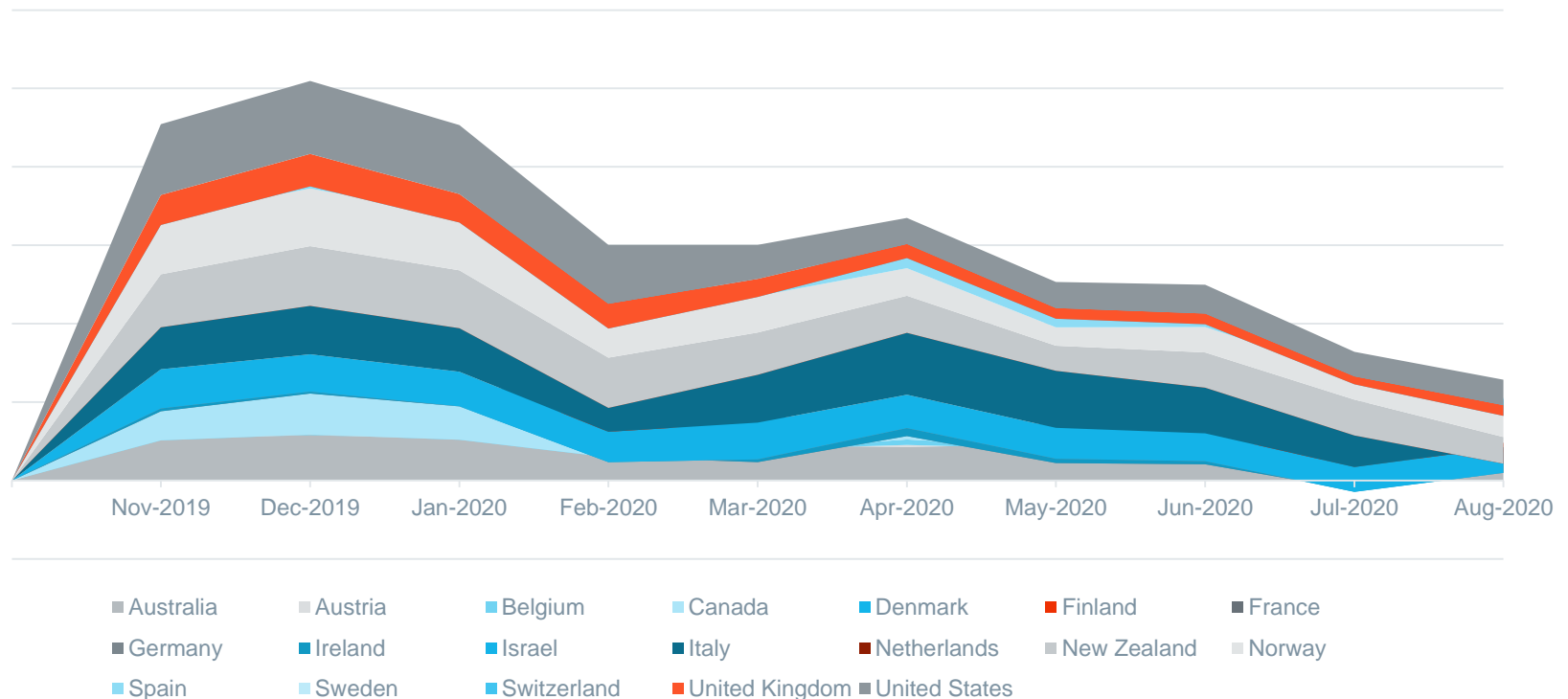


Financial Transactions

What is the impact of COVID-19 on financial markets?

- ✓ Increased interest rate volatility
- ✓ Increased risk of liquidity
- Increased country risk
- Increased credit risk

Long term interest rates (€)



Data extracted on 07 Oct 2020 16:19 UTC (GMT) from OECD.Stat

Financial Transactions

What is the impact of COVID-19 on financial transactions?

Existing Loans

- Review terms & conditions of the agreements;
- Restructure existing funding arrangements;
- Re-Price interest rates in line with third party interest rates;
- Interest payment moratorium clauses;
- Collateral package;
- Review guarantee agreements.

New Loans

- Commercial rational (both parties);
- Debt capacity analysis;
- Borrowers financial capacity to repay the loan;
- What about lenders? Are they in a position to lend money?;
- Obligation to pay interest;
- Source of interest repayment;
- Monitoring of the loan.

Financial Transactions

What is the impact of COVID-19 on financial transactions?

Credit rating impact

- ✓ Increased payment defaults
- ✓ Debt capacity analysis
 - ❑ Perform debt capacity analysis considering COVID-19 impact.
 - ❑ Are the borrowers able to service debt?
- ✓ Consider decreased credit rating
- ✓ Guarantees

Economically relevant characteristics of the transaction

Accurate delineation of the transaction

Lenders and borrowers perspective

Financial Transactions

What is the impact of COVID-19 on financial transactions?

Cash Pooling

- ❑ Deposit and credit rates should reflect market conditions
- ❑ Are depositors exposed to the credit rating of the group?
- ❑ What if parental guarantee is less valuable?
- ❑ What if....Cash pool characterization is used as a long term instrument.

Financial Guarantees

- ✓ Aligned with the performance of the entity
- ✓ Financial guarantees have to be priced and payed for.

Financial Transactions

What is the impact of COVID-19 on pricing financial transactions?

Benchmarking

- ✓ Benchmarking analysis that doesn't reflect the market conditions should be revisited.
- ✓ Reduced bond issuances observed after March 2020.
- ✓ Increased interest rates for certain financial instruments.
- ✓ Central banks policies having impact on external funding and impacting on intragroup interest margins
- ✓ Is historical data the right source to perform benchmarks?



Financial markets trends are highly correlated with the virus spread, make sure transfer pricing policies for financial transactions are aligned with the financial markets evolution.

Financial Transactions

How to be prepared for Tax Audits?

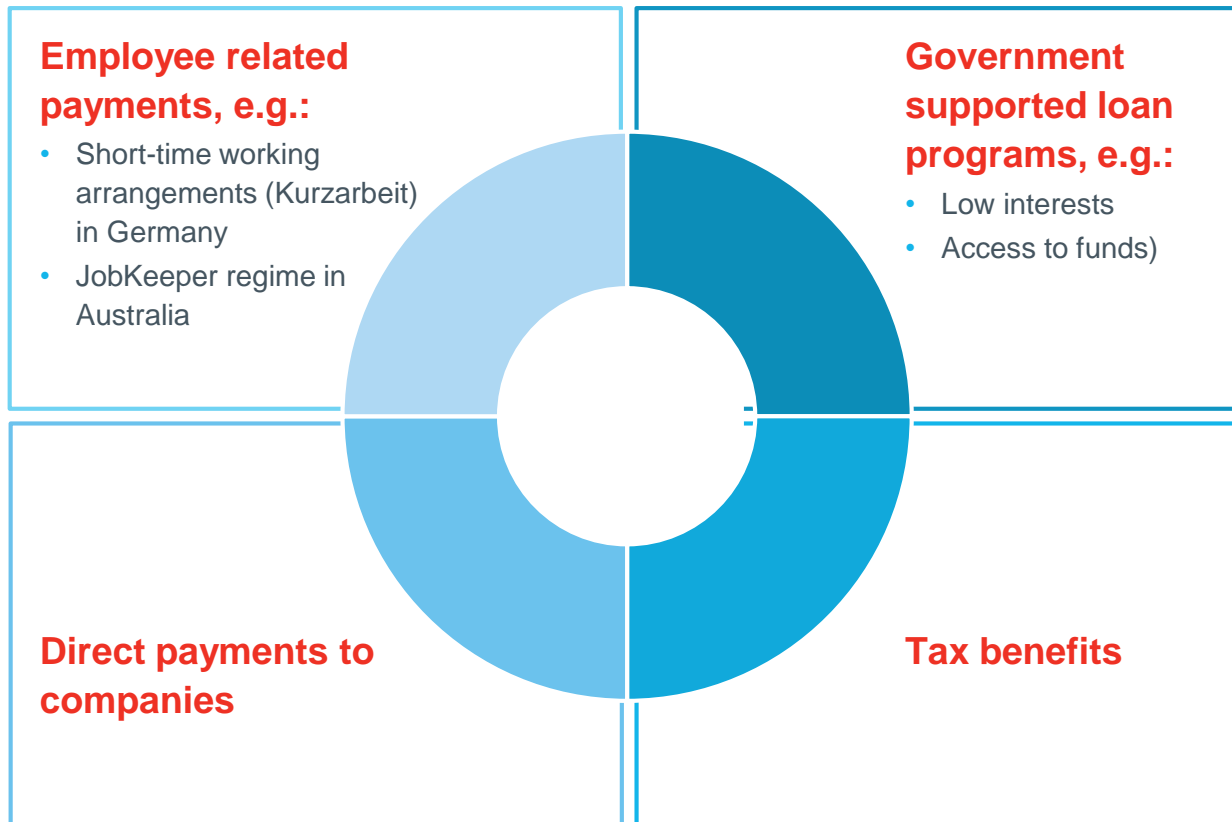
Transfer Pricing Documentation

- Prepare transfer pricing documentation, aligned to OECD guidance, that helps to sustain the TP policies applied for intra-group loans in COVID-19;
- Document amended loan agreements;
- Save any internal documents that justify the changes made to the TP policies;
- Document market evidence of modification of agreements; and
- Save any changes made in third party agreements (force majeure clause).

Transfer Pricing Implications of COVID-19 Government Support Payments



How to Treat COVID-19 Government Support Payments



- Little guidance available
- ATO published a guidance regarding employee related support payments
- No reason to divert from the arm's length principle
- Can impact different P&L positions

Different types of support mechanisms

Employee Related or Direct Support Payments

Service Provider Example

(million euros)	2019	2020	Support	2020 (ATO guidance)
Revenue (related party)	110	?		110
Other Costs	40	40		40
Salaries Costs	60		60	
EBIT	10	?		70
C+	10%			

- What should be the service revenue?
- ATO argues: “Independent parties ... would not be expected to share the benefit of the government assistance.”
 - ➔ Is this arm’s length?

Employee Related or Direct Support Payments

LRD Example

(million euros)	2019	2020	Support	2020
Revenue	1.000	300		300
COGS (related party)	500	?		?
Gross Profit	500	?		?
Other	200	200		200
Salaries	200	50	150	200
EBIT	100	?		?
GM	50%			
EBIT / Revenue	10%			

- What margin does the LRD need to achieve in an AL scenario
- Does the salary support payment need to be considered in the P&L

Employee Related or Direct Support Payments

Contract Manufacture Example

(million euros)	2019	2020	Support	2020
Revenue (related party)	1.100	?		?
COGS	600	300		300
Gross Profit	500	?		?
Other	200	200		200
Salaries	200	50	150	200
EBIT	100	?		?
GM	45%			
C+	10%			

- Output has been reduced by 50%
- What margin does the CM need to earn?
- What should be the revenue?

Employee Related or Direct Support Payments

Issues to Address

- What is the arm's length result?
- What would have happened without the government support?
- What input was utilized / what output has been generated?

Conclusion and Outlook



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Ted Keen is a managing director in the London Office and European Leader of Duff & Phelps' Transfer Pricing practice, bringing to the firm 24 years of transfer pricing consulting experience gained at Big Four accounting and economic consulting firms.

Ted is recognized as one of the world's leading transfer pricing experts and has presented on the application of the OECD Guidelines on Transfer Pricing in the UK, the U.S., Mexico, Japan, Russia, India, Germany, Sweden, Finland, Poland, Belgium, Portugal, South Africa and Malawi. Additionally, he was a featured speaker at an OECD-sponsored conference for European tax authorities in Budapest, and frequently speaks at numerous conferences on Transfer Pricing and to hundreds of multinational taxpayers worldwide.

Prior to joining Duff & Phelps, Ted established his own consulting practice where he worked closely with corporate clients and law firms on technical transfer pricing matters. He has advised clients on numerous global planning and documentation projects, applying economic analysis to complex transfer pricing valuation across a wide range of industries, including life sciences, high-tech, consumer and industrial products, natural resources and business services.

Ted holds a Ph.D. in Economics from Claremont Graduate University, and a B.S.Ch.E. from Case Western Reserve University. While completing his graduate studies, he held positions as a Lecturer in Economics at Pomona, Claremont McKenna, Pitzer and Scripps Colleges, as well as conducted courses at the California Youth Authority through LaVerne University.

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Andrew Cousins is a director in the London office and part of the Transfer Pricing practice, an international tax practitioner with more than 20 years of cross-border experience gained in private practice, industry and government. He brings a comprehensive regulatory, commercial and advisory perspective to the fields of transfer pricing and business restructuring.

Andrew spent 8 years in industry as a global head of transfer pricing, leading the transfer pricing function in two FTSE 100 multinationals, first Gallaher plc, then Cadbury plc, where he built the in-house transfer pricing team, handling development of transfer pricing policy, business restructuring, negotiation of APAs and ATCA, transfer pricing documentation, management of audits and controversy, focusing on the implementation of practical solutions aligned with the business.

Immediately prior to joining Duff & Phelps, Andrew served as Deputy Comptroller of Taxes in the Jersey tax administration, competent authority for all of Jersey's international tax agreements, handling MAP and exchange of information (automatic and by request) with other tax authorities. He was heavily involved in the nascent field of litigation associated with information exchange and represented Jersey at various governmental and OECD fora.

Andrew is author of numerous books and articles on transfer pricing and tax transparency and serves on the Editorial Board of quarterly journal Transfer Pricing Forum. For more than a decade he has contributed commentary to the OECD in its ongoing work developing tax and transfer pricing guidance.

Andrew trained as a chartered accountant in the M&A tax department at Deloitte in London before focusing on transfer pricing at Ernst & Young, where he was a member of the Tax Effective Supply Chain Management (TESCM) team. He is a graduate of Oxford University and a Fellow of the Institute of Chartered Accountants in England and Wales.

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Enrico De Angelis is a managing director in the Milan Office and leads Duff & Phelps' Transfer Pricing practice in Italy. Enrico has more than 18 years of specialized advisory experience in assisting multinationals of all sizes with their transfer pricing and custom valuation policies.

Prior to joining Duff & Phelps, Enrico served as a managing director for Quanteria Global with responsibility for the Italian market. Before that, he was a partner at a boutique transfer pricing firm in Zurich and Milan. Enrico started his career with McKinsey & Company, followed by serving as a senior associate at a Big 4 accounting firm.

Enrico is a frequent speaker at national and international transfer pricing conferences and seminars and has authored a number of articles in specialized magazines and book chapters dealing with transfer pricing and customs valuation.

Areas of Expertise:

- Transfer pricing and customs valuation
- Acquisition integration transactions
- Luxury goods, apparel & clothing, FMCG, food & beverages, software

Certifications / Affiliations:

- Member of the Institute of Chartered Accountants in Italy

Education:

- B.A. in economics, LUISS University
- M.A. in international economics, The World Trade Institute
- Ph.D. in economics, IMT School of Advanced Studies

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Pilar Barriguete has been practicing transfer pricing for over fourteen years, having significant experience advising clients on transfer pricing and valuation matters.

Pilar has broad experience in transfer pricing and has served clients of different industries and jurisdictions. She has managed various scale documentation projects, planning engagements, restructuring and tax audit defence for clients headquartered in UK, Spain and other countries in the EMEIA region.

Focusing on treasury TP in the recent years Pilar has gained extensive experience in pricing of intercompany loans, cash pooling, guarantees and other financial transactions. Pilar is a member of Duff & Phelps' financial services transfer pricing group and has significant experience assisting companies with pricing matters involving asset management, insurance, banking, global dealing and financial transactions.

In a previous role she was leading the EMEIA FS Transfer Pricing Center of Excellence at EY having spent time in the company's London and Madrid offices.

Prior to joining EY, she started her TP career at Deloitte in 2006. Before that she worked as an auditor at Deloitte as well.

She has participated as co-authorship in transfer pricing publications and as panelist in seminars and client events.

Pilar obtained her Masters degree in Financial Markets and Alternative Investments issued by Bolsasy Mercados Españoles (BME), where she obtained the official license to trade derivatives in the Spanish market (MEFF), and additionally an Advanced Corporate Finance postgraduate course from the London School of Economics.

Pilar holds a dual degree in Law and Business Administration from Universidad Autónoma de Madrid, being member of the Spanish Bar Association since 2006.

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Kerim Keser is a managing director in the Munich Office and leads Duff & Phelps' German, Swiss and Austrian Transfer Pricing activities, leveraging over 15 years of transfer pricing experience in consulting firms and at the Australian Taxation Office (ATO).

Kerim has extensive experience advising or auditing companies of all industries, including automotive, consumer products, pharmaceuticals, technology and financial services. Kerim has a results-driven approach, developing transfer pricing solutions for companies considering their size, complexity and industry's best practices. He is always aiming at practical solutions that are easy to implement.

Before joining Duff & Phelps, Kerim worked as an executive director for a Big4 firm in Munich, where he advised companies on transfer pricing issues associated with setting up new business units, decentralizing key functions, entering new markets and post-merger integration. He has successfully supported multinationals during difficult audits and competent authority procedures, delivered global documentation projects and served as an expert witness for an intellectual property dispute. His clients ranged from startups to large DAX companies. In addition, he has considerable experience developing and leading country-by-country reporting initiatives in Germany and is a key source for consultation on BEPS related topics.

During his time at the ATO, Kerim was a lead economist in Australia's most important transfer pricing cases, a member of the ATO's National Transfer Pricing Review Panel and a member of the National Tax Liaison Sub-group for Transfer Pricing. He also built a team specializing in financial transactions and the financial services industry.

Kerim holds a PhD and MA in Economics (Dipl. Volkswirt) from the University of Potsdam, and an MA in Economics from the University of Wisconsin-Milwaukee.