Multinationals Should Review Their Transfer Pricing Methods

By **Fabian Alfonso, Matt Billings and Justin Radziewicz** (June 4, 2020, 5:44 PM EDT)

The COVID-19 crisis is significantly disrupting multinational corporations and will lead to unexpected — and for most, unfavorable — group profit outcomes in 2020. From a tax perspective, this disruption may be magnified by traditional transfer pricing models and the relatively simple ways they allocate group risk and profit between jurisdictions.

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Tax directors are already faced with difficult questions as to whether their existing transfer pricing models remain appropriate in times of such extreme crisis and how to benchmark arm's-length outcomes in such an environment.

In times of crisis, cash preservation often becomes a higher priority for multinationals, and taxes represent a significant type of cash outlay that could be strongly affected by transfer pricing.

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Many groups have relied on one-sided transfer pricing methodologies, such as the transactional net margin method, or TNMM, or comparable profits method, or CPM, that provide a target level of profit to limited risk group members in certain jurisdictions. By construction, such a one-sided model leaves any residual profit or loss to be reported by related entities in other jurisdictions.

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The practical limitations of these one-sided transfer pricing models become more evident in times of crisis, raising questions about its appropriateness. Notably, its allocation of positive profits to specific jurisdictions if the shock is expected to create substantial operating losses for the overall group.

The impact of the COVID-19 crisis on financial accounting returns for samples of comparables and for taxpayers are hard to predict. This makes efforts to comply with the arm's-length standard under CPM/TNMM and residual profit split approaches particularly challenging for 2020.[1]

Tax directors relying on these pricing methods, therefore, face challenges in predicting what the arm's-length benchmarks and associated profit ranges for 2020 will be, and how to implement internal pricing policies intended to hit such profit targets. Questions facing tax departments operating under these methods include:

- Should profit targets be revised midyear, in anticipation of benchmarks shifting for 2020?
- How should differences in forecasted versus actual revenue levels, idle production assets, inventory obsolescence, intragroup services that are temporarily not provided, etc., be addressed?
- Can loss-making companies be reliable comparables, even for limited risk taxpayers?

- Are geographic, industry and product comparability factors worth reconsidering and reevaluating now?

This article will focus mainly on the TNMM/CPM, considering how commonly they are used and how sensitive they can be to economic shocks that affect operating profit levels.

Applying the Transactional Net Margin Method or Comparable Profits Method During the COVID-19 Crisis

The TNMM/CPM appears to be the most commonly applied transfer pricing method by a wide margin, by both taxpayers and tax authorities. The TNMM/CPM tests the profit level for one of the participants to the transaction. The tested party is typically the one that is considered the least complex, not contributing to the development of valuable or unique intangible assets; the other related-party participant to the transaction, whose profitability is not tested, is the claimant on any remaining, or residual, profits.[2]

The impact of economic shocks may fall to either, or both, of the parties in intercompany transactions under TNMM approaches, though in our experience, return streams for more routine tested parties tend to fluctuate less than those for their transaction partners in times of economic distress.

Taxpayers may wish that this weren't the case and might prefer to have the impacts of the current crisis spread more evenly between intercompany transaction partners. However, taxpayers should be careful about taking steps that would either directly or indirectly change risk allocations for 2020.

Taxpayers need, in particular, to consider the importance of intragroup risk-allocation decisions made in the past, such as to what extent the respective parties have been able to participate in financial upside during relatively high-profit years for the group, and to consider the longer term impact that changing risk allocations may have.

Maintaining consistent transfer pricing policies through an event as disruptive as COVID-19 may become a helpful fact to defend against tax authority concerns about limited profit levels earned by local tested parties in other tax years, past or future.

Alternatively, examination of these fact patterns may reveal hard truths about reliance upon one-sided methods in establishing a group's transfer pricing leading to untenable results. Assessing a change in approach may be necessary in some instances.

For example, from a theoretical perspective, a profit split method may yield a more robust view of pricing and profit outcomes throughout a multinational group where the allocation of risks and functions is not quite as cut and dry as a one-sided method may indicate. Contemplating a revised transfer pricing policy is a significant undertaking with varied implications on both future and past tax years and is not the focus of this discussion, but one worth highlighting.

Instead of changing transfer pricing methods to achieve more desirable profit allocations in the near term, taxpayers may instead want to invest resources understanding and analyzing how profit targets should change under the TNMM/CPM. Specifically, taxpayers should focus on the development of arm's-length benchmarks for operating profits attributable to the relatively routine functions, taking into consideration expected or actual impacts from the crisis.

With or without changes to benchmark profit rates, many companies will likely need to reconsider their transfer prices to meet targeted profits. Accurately forecasting prices that will allow business to meet a particular target margin in these highly uncertain times will prove challenging.

Furthermore, for many businesses, modifications to transfer prices can have cost implications beyond income taxes: Withholding taxes, customs duties and indirect taxes may be affected by the transfer prices set for tangible goods and services. As such, it is necessary to coordinate across multiple groups to ensure optimal outcomes when developing profit benchmarks for fiscal year 2020.

Challenges in Developing Profit Benchmarks

When benchmarking arm's-length operating profit levels for use in the TNMM/CPM, it is rare to find available data from arm's-length companies that are perfectly comparable. From a practical perspective, it is not uncommon for taxpayers to be forced to rely on arm's-length data that may not be entirely comparable in terms of:

- Time period, such as using data from 2019 to establish transfer pricing policies for use in 2020, given the lag in financial data being reported by databases;
- Market or jurisdiction, such as relying on regional or continental comparables when an insufficient number of local country comparables are available; or
- Product or industry, where functional comparability is considered sufficient.

Under normal circumstances, the impact of the above comparability differences might be negligible after the implementation of statistical measures (e.g., such as an interquartile range) and the consideration of capital adjustments to enhance reliability.

However, more scrutiny on these differences may be warranted for 2020, given that the COVID-19 crisis is likely to drive substantial profitability differences from many companies in 2020 as compared to 2019, affect some countries more than others,[3] and affect some industries very differently than others. Multiyear analysis, often undertaken to capture entire business cycles, likely will not fully address the challenges associated with the COVID-19 economic downturn.

As a usual practice, many taxpayers would wait until comparable data becomes available and make a lump sum adjustment at year-end. This approach provides certainty in terms of economic results but, under the current circumstances, the adjustment may be so abrupt it may create many different hurdles like an increase in compliance burden, significant audit exposure and customs issues — when dealing with tangible goods.

Below, we will discuss different approaches that instead may help forecasting changes during the year and mitigate or eliminate the need for post-year-end adjustments.

In some jurisdictions, quarterly reporting of financial data may allow for informed views on updated benchmarking results before the end of 2020. Where the local transfer regimes allow, taxpayers might consider relying more heavily on current-year results for 2020 instead of multiple-year averages.

When current-year 2020 data from comparable companies is not yet available, taxpayers might consider adjusting prior year data from the comparables based on the economic impact examined in the aftermath of prior economic crises, as a proxy for what is expected to be observed from the comparables once 2020 data is available. One example is to identify relationships between certain financial ratios and profitability for common comparable sets (e.g., wholesale distributors and service providers) during the 2008 financial crisis.

There may be a potential to more accurately predict the outcomes of comparables using these types of approaches, which may provide a strong analysis for supporting changes to profit targets before actual outcomes are known. At the very least, affected taxpayers might consider appropriate placement for their profit targets within a previously established arm's-length range. (e.g., targeting the minimum or the first quartile from the most recently available comparable company data, rather than a measure of central tendency).

Perhaps, in some circumstances, cost recovery might be considered sufficient instead of also expecting transfer prices to provide a profit element (e.g., periods of inactivity due to forced governmental shutdowns).

When 2020 financial data becomes available for comparable arm's-length companies, careful consideration of comparables will be required. The question of whether any company is truly limited risk through an economic crisis the magnitude of COVID-19 will need to be analyzed.

The common practice of rejecting potential comparables based on operating losses will need careful consideration. It will be necessary to revisit existing comparables with a renewed focus on both industry and geographical similarity due to the divergent impact COVID-19 has had on specific regions and industries which may have been sufficiently comparable previously.

Whatever profitability results are observed from comparable companies, taxpayers should exercise caution in applying those benchmarks to their own operations in 2020 without further consideration of the comparability of business conditions.

Considerations could include comparability in the level of excess capacity/idle production assets — especially for manufacturers — or comparability in periods of dormancy in economic activity more broadly, and comparability in the impact of deterioration in expected realization of accounts receivable balances.

From a financial reporting perspective, it remains to be seen to what extent companies will segregate COVID-19 related costs as unusual or non-recurring (e.g., severance costs). This may provide some perspective for considering to what extent a tested party's costs should be included within its calculations of operating profitability for application of the TNMM/CPM.

Ultimately, the presented results of the comparables should align closely with the outcomes of the taxpayer. Aligning the fact patterns of the comparables to the taxpayer's business will be more important than it has in recent time periods as a result of the economic shocks of COVID-19.

Conclusion

Transfer pricing decisions made today are typically going to be reviewed and audited by tax authorities years later, when government attitudes are likely to be less taxpayer-friendly

than they have been in the early stages of the COVID-19 crisis.

Similarly to the aftermath of the 2007-2008 global financial crisis, in the wake of COVID-19, we expect tax authorities to become even more aggressive in seeking to raise local tax revenues to counter the effects of a shrunken tax base and fund additional government spending. This may be especially true in jurisdictions where multinationals have restructured operations or exited the market.

Companies should understand and weigh accurately the implications of transfer pricing decisions that will be taken during the COVID-19 crisis and be prepared in 2020 for how they will explain and defend their decisions upon future tax audits. We expect many taxpayers relying on the TNMM/CPM will choose to revise their profitability targets before the year-end.

Multinational groups expecting overall operating losses in 2020 may be primarily concerned whether it is appropriate for their transfer pricing policies to provide positive operating profits in certain jurisdictions and undertake approaches to realize outcomes that are more consistent with arm's length profit allocations in these types of circumstances.

Transfer pricing policy decisions for 2020 should consider the multinational group's fact pattern, business and tax objectives, and the actions taken by arm's-length parties — including suppliers and customers. Tax directors should consider the impact of their decisions regarding transfer pricing and risk-sharing within the multinational group in 2020, on other tax years. Because of the COVID-19 crisis, 2020 may be such an unusual year that it requires unique outcomes from a pricing and profit perspective.

Alternatively, maintaining the status quo on transfer pricing outcomes through 2020 may add credibility to arguments that certain tested parties are truly insulated from risk — and not entitled to share in profit upside — over the long run, including prior and future tax years. Taxpayers should be examining their current policies today in order to best make the best decisions possible for their business in the future.

Correction: A previous version of this article incorrectly captioned Radziewicz's photo. The error has been corrected.

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[1] By contrast, the comparable uncontrolled price method, resale price method, cost plus method and other forms of transactional profit split methods do not directly consider the operating profitability of comparable companies, nor the operating costs of the taxpayer, and so are relatively less sensitive to changes in operating costs or sales volumes.

[2] The tested party may actually engage in multiple types of intragroup transactions, with

multiple related counterparties, but for simplicity, we describe a single transaction type with a single related counterparty.

[3] Infection rates, economic impact and government action have all appeared variable by country.