COVID-19

COVID-19 and its impact on Transfer Pricing

Webcast on key action areas and practical considerations
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Your PwC team presenting today

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1 Introduction

Challenges

Intercompany Financing Transactions

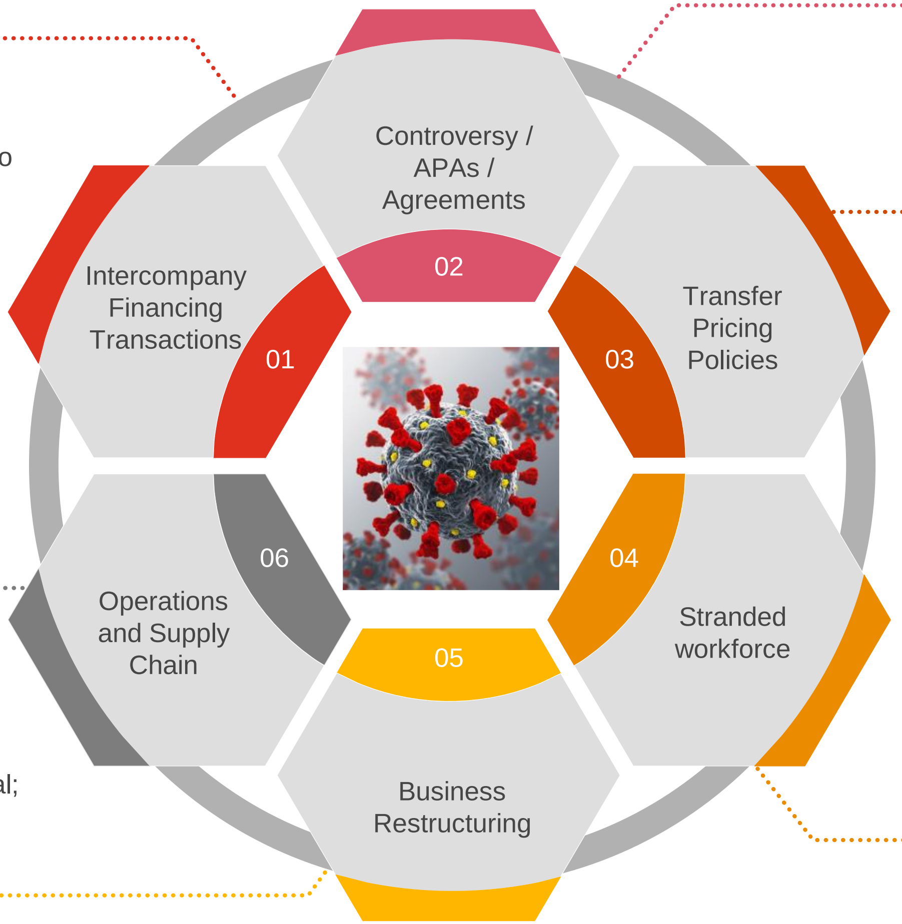
- Changes in group's external funding arrangements
- New/different/larger intra-group financial transactions to get cash and get it where it is needed
- An increased recognition of risk
- Volatile market pricing
- New OECD Guidance

Operations and Supply Chain

- Shift in functions, risks and assets;
- Changes in TP outcomes;
- Changes in intercompany agreements; and
- Potential impact on royalties and valuations.

Business Restructuring

- Business disruption;
- Movement of functions, assets, risks and profit potential;
- Certain functions to be replaced by technology; and
- What will the new normal look like?



Controversy / APAs / Agreements

- Postponed litigation and future effect on tax controversy;
- Considerations on APAs; and
- Short-term changes to intercompany agreements.

Transfer Pricing Policies

- Potential losses;
- Strain in "limited risk" models;
- Tax authority challenges if losses are borne by routine entities;
- Impacts on comparability;
- Comparability adjustments;
- Allocation of extraordinary expenses;
- TP provisions; and
- Extraordinary expense justification.

Stranded workforce

- Stranded employees;
- Value chain analysis alteration;
- PE and personal income tax exposures;
- PE profit attribution analysis; and
- OECD paper.

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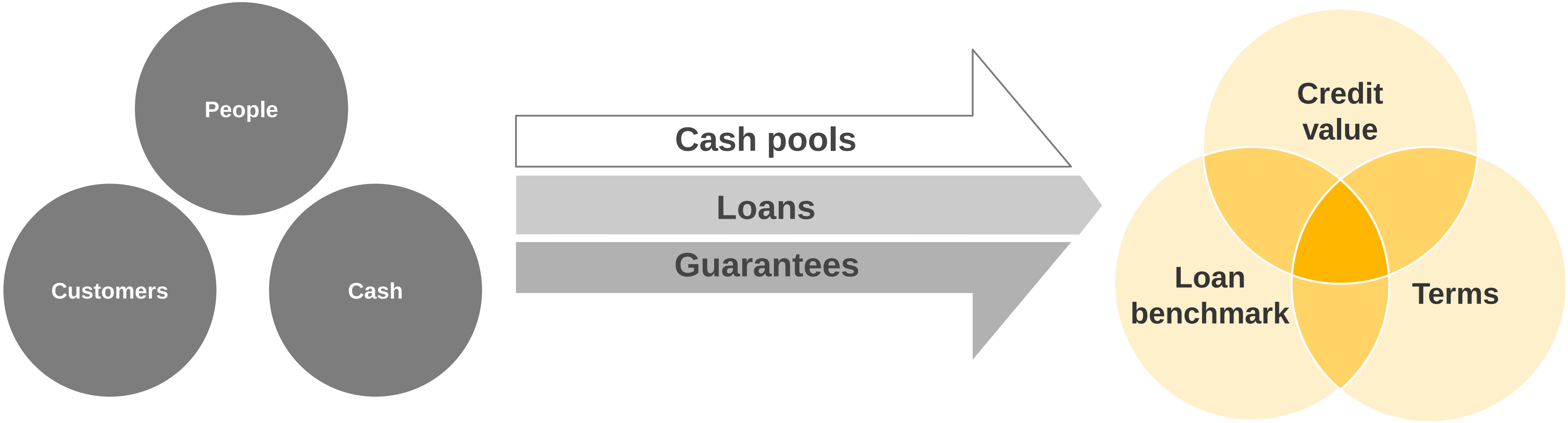
Intercompany Financing Transactions

Intercompany Financing Transactions



New OECD guidance on Financial Transactions

OECD area	Key tenets
Accurate delineation and opportunities realistically available	• Loan terms must be demonstrably arm's length (duration, currency, security etc…) • The transaction must be reasonable from the perspective of the borrower • The transaction must be reasonable from the perspective of the lender • The amount borrowed must be an arm's length amount
Cash pools	• There must be a functional analysis • Cash pool leaders will typically have limited risk/function and should therefore receive a limited return • Substance is key – for example the duration of deposits must be considered
Guarantees	• There should only be a guarantee fee if the guarantee is explicit and if it provides a qualifying benefit • Where guarantees result in increased borrowing capacity, calculating guarantee fees is complicated • There are 4 alternative methods for calculating guarantee fees
Credit ratings	• Credit rating estimates are important part of pricing loans (and guarantees under some methods) • Black box models should not be used • Neither the 'member of a group' or 'stand-alone' approaches is always correct. The analysis and model adopted must depend on the group facts and circumstances

External financing

Trends that impact intercompany financing transactions

The current market developments that many groups are facing impact their intra-group financing arrangements. For example:

Access to funding and impact on funding cost

- Monitoring of limits on existing credit lines, potential need to increase existing credit lines, draw new credit lines
- Access to funding may only be accessed at a premium or less favourable terms than before
- Conversely, well-positioned borrowers with may have opportunities to seek additional funding more cheaply

Changes in terms and conditions

- Lenders may require revised terms and conditions, including pledging collateral or guarantees from affiliate companies
- Parties might agree to restructure the debt with fewer, less restrictive covenants albeit at a higher interest rate
- In extreme cases, lenders might attempt to enforce breaches of contract prior to actual default in order to recover expected losses in advance

Government intervention

- Borrowers may benefit from government intervention or relief programs with more favourable terms and conditions compared to financing obtained under commercial circumstances
- Level of intervention and terms will vary across countries

What if it is a mix of changes?

Takeaway:
Impact will vary on a case by case basis. Assess which of these aspects are relevant for your group and consider these when structuring new intercompany financing transactions or refinancing existing transactions

Intercompany financing

Critical issues and considerations

Intercompany financing policies with respect to financial transactions should be examined in seeking to avail of cash tax and/or effective tax rate opportunities or to mitigate the downside tax and operational costs of maintaining the status quo. The starting point should be large new transactions.

Below are critical issues and considerations in light of financing policies in the current economic environment:

Accurate delineation	• Any financing decision should consider the current economic conditions and resulting impact on key terms. • Important to consider how creditworthiness may impact the pricing of intercompany financing transactions.
Options realistically available	• Should existing loan agreements be modified and would this have happened at arm's length? • Does the borrower have the right and would it beneficial to them to prepay early? • What about the lender. Could it demand early repayment and refinancing at a higher rate? • Could the borrower really access borrowing in the current market environment?

Intercompany financing

Critical issues and considerations (cont.)

Cost of borrowing	• Market rates of interest are subject to extreme volatility in today's environment, which makes the documentation and timing of the arm's length interest rate benchmarking of critical importance. • Interest rate benchmarking should be representative of the market as of the execution date. If transactions are delayed, benchmarks may have to be refreshed.
Government stimulus	• Affiliate companies may obtain financing on terms more favorable than otherwise available in the market through government incentives. An evaluation would be required to determine if such terms can be mirrored in intercompany financing arrangements (or adapted as necessary). • For example, the arm's length question could be: As a standalone subsidiary with a strong credit rating, could it have been eligible for the government-supported programs?
Guarantees	• External lending institutions may require additional financial and/or performance guarantees from parent or affiliate companies. • Pricing of the guarantee must be considered based on the benefit received, which can include additional risk being borne by the guarantor, a potential rate benefit, or it may be more of an administrative purpose (e.g., more direct access to assets during bankruptcy). There are varying pricing approaches that can apply, as highlighted in the OECD FT Paper.

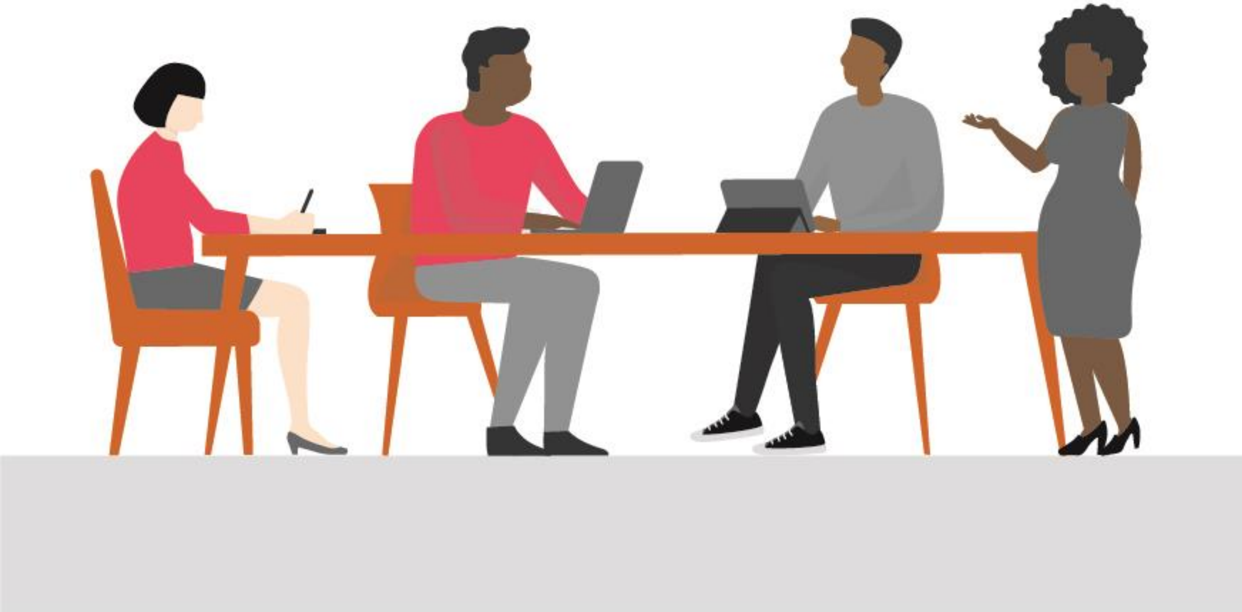
Intercompany financing

Cash pooling and Treasury Centres

- Cash pooling policies should be evaluated to take into account current market changes and the new OECD guidance.
- A higher utilization of cash pools is expected as the mobility of short-term cash becomes critical to fund working capital and other needs.
- Whilst CHF and EUR base rates have been low for some time, the steep reduction in the base rates of other currencies can impact the overall economics of the pool and significantly reduce the return that could be earned by the treasury center on deposits.
- In cases the cash pool leader requires external funding to finance the cash pool, the increase of external funding costs to the treasury center could lead to structural losses at the treasury center (if deposit and draw down rates are not adjusted).
- There are further questions with how cash pool synergies should be adjusted in line with the new OECD guidance and whether support payments should be made from pool participants if the pool is in a loss position.

Recommended actions

- Ensure that you are aware of any significant new related party financial transactions – and evaluate pricing carefully
- Review existing large transactions to see if they are impacted in the ways outlined in these slides
- Review your current approach on pricing of intercompany financial transactions and perform a gap analysis to assess effort to comply with the new OECD guidance
- Based on the results of the gap analysis, update financial transactions transfer pricing policies within 2020



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Transfer Pricing Policies

Transfer Pricing Policies

TP Models

Key Issues

- Loss-making businesses are realizing that their TP models designed for times of economic prosperity are not adapted to current crisis
- Can limited risk models continue to earn the same target profit margins?
- Losses at the level of central entrepreneur and profits at the level of limited risk entities create liquidity issues and impact the group ETR

Key Questions

- Have you revisited the group's TP policy to potentially share risks / losses?
- Should the Principal bear all losses given it earns the residual profits in good times?
- Can the target profit margins of limited risk structures be lowered? Does limited risk means risk-free?
- Have you considered the implications that changes in year-end TP adjustments may have on customs, VAT and withholding taxes?

Key Action Points

1. Analysis of your intercompany agreements

- 3rd parties are renegotiating their contractual arrangements (pricing, production volumes, payment terms, etc.)
- Grounds for contractual renegotiations – built-in clauses on term renegotiations, clauses of force majeure/unforeseen circumstances

2. Functional analysis

- Focus on conduct of the parties - control of economically significant risks
- Refer to 6-step risk analysis framework (para 1.60 of OECD TP Guidelines)
- Verify risk analysis description in existing TP documentation (Master File/Local Files)

3. Change in TP policy

- Revisit group TP model based on analysis in steps 1 and 2 and remember to document!
- Change intercompany agreement or suspend its application (e.g. MoU between the parties that different terms apply during COVID crisis)
- Take into account TP adjustments when implementing revised TP policy

Transfer Pricing Policies

Comparability Analysis

Key Issues

- Existing benchmarks do not reflect the current operational reality in a COVID environment
- Current benchmarks reflect target profit margins to be achieved during times of economic prosperity
- Benchmarks in place are one-sided analyses of limited risk models that ignore overall group profitability
- Companies may have a different functional profile in COVID times (changes in working capital, different activities because of stranded workforce, increased market risk and credit risk)

Key Questions

- Are your current benchmarking analyses aligned to a COVID environment?
- What TP solutions can you use to adjust benchmarks to change target profit margins of limited risk models to improve group liquidity and ETR?
- Should you run these comparability adjustments now or should you wait? What about the timing of documenting such adjustments?

Key Action Points

1. Comparability adjustments

- ➢ Identify real-life 3rd party examples (e.g. decrease in sales commission paid to 3rd party agents)
- ➢ Adjust benchmarks to quantify profitability decrease in crisis times (e.g. through statistical regression analyses)
- ➢ Adapt search strategy to capture crisis-impacted comparables, test returns over different economic cycles
- ➢ Consider value chain analyses (profit split vs. TNMM)

2. Robust documentation

- ➢ Do not wait as time lag implies that 2020 benchmarking data reflecting COVID will only be available in late 2021/early 2022! No guarantee that such benchmarks fully reflect crisis!
- ➢ Document comparability adjustments supporting change in TP policy – an ex-ante analysis to revise arm’s length pricing mirrors 3rd party behavior and is more robust than an ex-post justification of deviations from established pre-crisis TP policies

Transfer Pricing Policies

Extraordinary Expenses

Key Issues

- Businesses incur extraordinary expenses, e.g. workforce redundancy costs, plant shutdown costs, supply chain disruption costs, inventory obsolescence, contractual termination costs
- Extraordinary expenses are unforeseen and generally have not been provisioned
- Most companies do not have a clear pre-defined policy on which group entities should bear these extraordinary expenses

Key Questions

- Are these extraordinary expenses covered by your existing contractual framework or TP documentation?
- Should you recharge all extraordinary expenses to your Principal/HQ?
- Is there a case to make a limited risk entity bear part of the extraordinary expenses? What if these expenses arise from local decisions?
- Have you considered booking TP provisions?

Key Action Points

1. Analysis of existing documentation

- Are intercompany agreements explicit about extraordinary expenses
- Does the functional analysis in the Master File & Local Files provide clues as to which party should bear the extraordinary expenses

2. In-depth analysis

- Nature of extraordinary expenses and factors leading to these being incurred
- Parties responsible/in control of extraordinary expenses being incurred
- Determine reasonable/defensible allocation of extraordinary expenses between relevant group entities

3. Robust documentation

- Document in detail analysis performed, rationale for allocation methodology chosen
- Contemporaneous defense file of extraordinary expense allocation will come in handy when dealing with statutory auditors and in future tax audits

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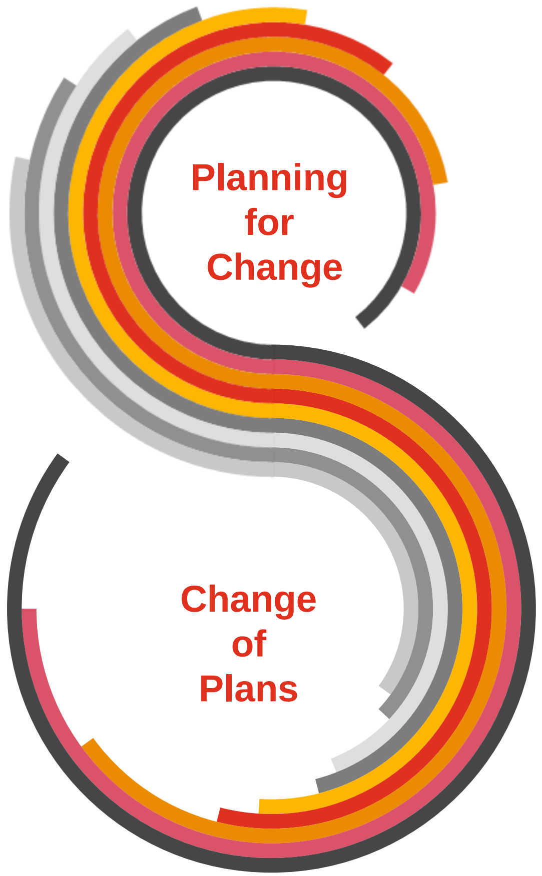
Controversy / APAs / Agreements

Controversy / APAs / Agreements

Handling Critical Assumptions during Critical Times

Predicting the unpredictable

- Overall dynamic market and regulatory environment – even without COVID-19 impact
- Transfer pricing models are dependent on a number of critical assumptions
- Taxpayers rely on critical assumptions when entering Advance Pricing Agreements (APAs) and ordinary agreements (legal contracts) with related/unrelated parties
- Unpredictable and volatile “black swan” events affect both tax payers and tax authorities
- Most affected industries and businesses forced to quickly adjust transfer pricing models
- Current tax and transfer pricing litigation and rulings likely to be delayed / postponed
- After an initial adjustment period tax authorities usually increase tax collection efforts
- Combined together: material impact on transfer pricing models and tax controversy



Controversy / APAs / Agreements

Handling Critical Assumptions during Critical Times

Impact on APAs - Challenges

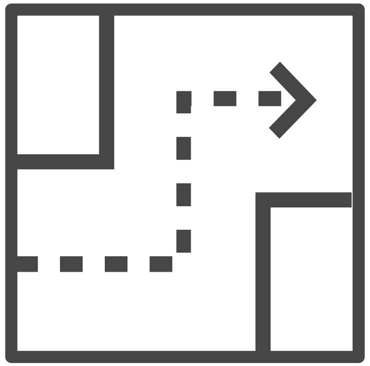
- APAs by nature involve a longer time-horizon based on critical assumptions
- Significant and unpredictable changes may result in material impact on the financial result of the business model subject to an APA
- Sudden and unpredictable change (e.g. COVID-19) often requires that business reacts fast
- Deviation from the APA parameters or critical assumptions may invalidate it
- Changes to APA parameters and critical assumptions require time
- Pro-active approach towards Competent Authorities is highly recommended
- Global Financial Crisis (2007/08) experiences show there is room to act / discuss

Controversy / APAs / Agreements

Handling Critical Assumptions during Critical Times

Impact on APAs – Options to manage exposure

- Force majeure clauses may be invoked – high burden of proof and very fact specific
- Re-negotiation of certain APA parameters linked to underlying market data may be possible
- Timing of impact – adjust now (necessity) or wait for “full picture” (new data)
- Effects of disruption to business vs. government stimulus programmes slowly crystallising
- Potential for negotiation of adjustment to past (closed) financial years under APA
- Competent Authorities currently view the situation as “developing”
- Urgent need for change vs. “wait-and-see” approach to discussions with Competent Authorities



Controversy / APAs / Agreements

Handling Critical Assumptions during Critical Times

Impact on Intercompany Agreements

- Unpredictable events (e.g. COVID-19) result in material disruption to various business models
- This may invalidate certain core financial and operating assumptions of transfer pricing models
- Unforeseen margin volatility, inability to perform functions or carry risks, and other examples
- Ordinary termination clauses will often not allow for sufficiently quick reaction time
- Urgent changes to the underlying legal framework using the hardship or force majeure clauses
- Experience shows that a comprehensive and targeted approach allows for a fast reaction - helping to contain or manage financial impact of the external shock

5 Wrap-up and outlook

Wrap-up and outlook

Financial Transactions
- New / different / larger related party financial transactions
- Benchmarks are moving. Terms / quantum have to be considered. New technical requirements
- Triage and focus on biggest transactions first

Controversy / APAs / Agreements
- Litigation – status quo?
- APA critical assumptions and parameters affected
- Contractual obligations potentially under strain

Business Restructuring

TP policies
- Dealing with losses
- Adjustment of BMs?
- Extraordinary expenses

Operations & Supply Chain

Stranded Workforce

Webcast April 17

Webcast May 8

Q&A

Thank you

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