
Transfer pricing

Recommendations
in relation to the COVID-19
crisis

If the group goes into losses on a consolidated basis, does it have to continue guaranteeing a profit to limited risk distributors or intra-group service providers?

Many groups operate with models that treat subsidiaries as limited risk entities, generally contract manufacturers or limited risk distributors and service providers.

Their functions are remunerated with a reduced (though assured) margin on their costs or sales, whereas the residual profit or loss is attributed to the counterparty, which is treated as owner of the transaction.

The slowdown in economic activity and increase in overheads and extraordinary costs that multinational groups have had to face could give reason to question the suitability of these remuneration arrangements.

To address this, it may be necessary to include “exceptions” in the set transfer pricing policies, or temporary adjustments allowing the circumstances we are experiencing to be taken into account.

These exceptions or adjustments always have to be based on functional and industry analyses, involving particular attention to the contractual clauses.

What needs to be considered if the group has to make changes in its value or supply chain, or in the way it carries out its business operations among its member entities?

The value chain and habitual transactions of businesses may be impacted in multiple ways, because almost none of them were designed to absorb the effects of the type of shock we are experiencing.

Events like the centralization / decentralization, relocation or digitalization of activities will have a decisive effect on the contribution that the various entities in a multinational group make to the generation of value by the business (and on risk control).

For that reason, an alignment of transfer pricing policies will be needed because they will have to be adapted to every entity's new functional and risk profile.

Situations may also arise requiring a decision as to whether a profit split method may be used, with or without any additional adjustments, for the allocation of losses accumulated globally among the various entities in a group.

All these elements need to be examined in detail, and companies will have to explain and document exhaustively the business and economic arguments that justify and will be able to support in the future the reasonableness of the added adjustments.

What factors need to be considered in group decision-making?

The COVID-19 crisis is going to cause liquidity problems at many groups due to a reduction or deferral in the generation of revenues.

Multinational groups have various options for mitigating these difficulties: renegotiating financing agreements, temporarily postponing interest payments, converting short-term into long-term loans or using cash pooling to centralize cash flows, among others.

These changes in financing structures, added to the economic aid that some governments will provide to their countries' businesses, will make it necessary to reassess the new solvency of borrowers, their future repayment ability and the various available alternatives.

A new market return will also need to be determined, for which attention is needed to the new guidance released by the OECD on financial transactions.

Can charges for management fees or for the use of intangibles be adjusted if they are causing or aggravating recipients' losses?

Another mechanism for softening the pandemic's impact on companies' cash flows could be to relax the terms and conditions of certain payments for services or royalties.

Within groups, consideration could be given to reducing or even suspending these charges, if this is consistent with the behavior of independent third parties.

It should also be studied whether in the current situation the received services or licensed intangibles are bringing actual benefits (greater sales, more efficiency, etc.) for their recipient.

To do this it is crucial to examine thoroughly the factual and transfer pricing circumstances existing in each case, along with studying the options realistically available to parties for adopting a solution.

What needs to be done if the effects of the crisis cause a breach of the terms of an APA currently in force?

Many companies may be experiencing difficulties to meet some of the critical assumptions determined by the tax authorities in advance pricing agreements (APA), including the (quantitative or qualitative) assumptions considered for concluding them before the COVID-19 outbreak.

In these cases, the terms of the agreements need to be studied to determine whether they allow any type of adjustment on the occurrence of unforeseen events.

Companies should not lose sight either of the option of approaching the tax authorities to inform them and assess together the need to add changes in the APAs, or even consider canceling them.

From all angles, the level of uncertainty that is going to remain with us for a long time makes it more recommendable to seek arrangements for transactions which, due to their size in quantitative terms or their technical complexity, are difficult to value from a transfer pricing standpoint.

Do intra-group contracts contain a clause allowing exceptions or changes to be added to the transfer pricing policy as a result of the crisis? What options are there if they do not?

Contracts between independent parties usually contain a force majeure clause, providing solutions for the occurrence of extraordinary events.

Inter-company agreements, however, may not contain this type of clause, or if they do they may not be drafted in sufficient detail or suitably adapted to the facts.

In those cases it is legitimate for parties to renegotiate the contractual terms to restore balance in the relationship, preserve profitability as far as possible, or prevent or mitigate losses, which is acknowledged in the Transfer Pricing Guidelines of the OECD and is what independent parties would do in practice.

To achieve this, it is particularly important to analyze accessible contracts between independent parties, and document and adequately support the variables considered to reconcile the contract with the new economic circumstances.

Can benchmarks prepared in earlier years be used for the documentation of controlled transactions in 2020?

One of the biggest problems that companies may face when preparing the documentation of controlled transactions in 2020 is the more than likely mismatch between the benchmarks prepared at an earlier date and the circumstances in the current situation.

This is because, with a few exceptions, there will be significant differences between this fiscal year and past years, at the entity under analysis and at the comparables.

Solving this might require comparability adjustments to provide an adequate reflection of the current economic and business conditions.

Although every case is different and will need a detailed analysis, adjustments might have to be considered to reflect: 1) idle capacity; 2) extraordinary expenses (advertising expenses, inventory cancellations, cost restructuring); 3) fluctuations in exchange rates; 4) changes in the solvency of entities, etc.

The transfer pricing documentation (masterfile and localfiles) will be in a similar situation: the contents of those documents will need to be examined thoroughly to adapt them to any extraordinary circumstances (both operational and economic) occurring at each group as a result of the crisis.

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