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TRANSFER PRICING IN AN ECONOMIC DOWNTURN

KEY CONSIDERATIONS AND ACTION POINTS

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The current economic downturn presents many challenges to businesses. For medium-sized and large groups, transfer pricing may be one of the areas they need to review in light of changing market conditions, to help preserve cash and improve funding across the business. We look at some of the implications and possible action points.

BACKGROUND

Transfer pricing is based on the arm's length principle – the terms and pricing between independent parties. Given that terms and pricing between such parties may change in extraordinary times, such as now, established transfer pricing policies and pricing may no longer give rise to an arm's length result. It may therefore be appropriate to revise transfer pricing to remain compliant with tax law, and in doing so, cash flow and cash tax benefits may result.

The challenge is to understand the effects of a recession on transfer prices, and to adjust them to correct for distortions caused by the downturn. It may be advisable to adapt the pricing based on the economic conditions prevailing for example during the current recessionary phase, and then as the economy improves during the recovery. This approach should address short-term business needs and manage changes to business models or supply chains in the longer term. This challenge may mean that the organisation's current transfer pricing strategy is no longer fit for purpose, in which case a different approach for some may be both beneficial and necessary.

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CONSIDERATIONS AND POSSIBLE SOLUTIONS

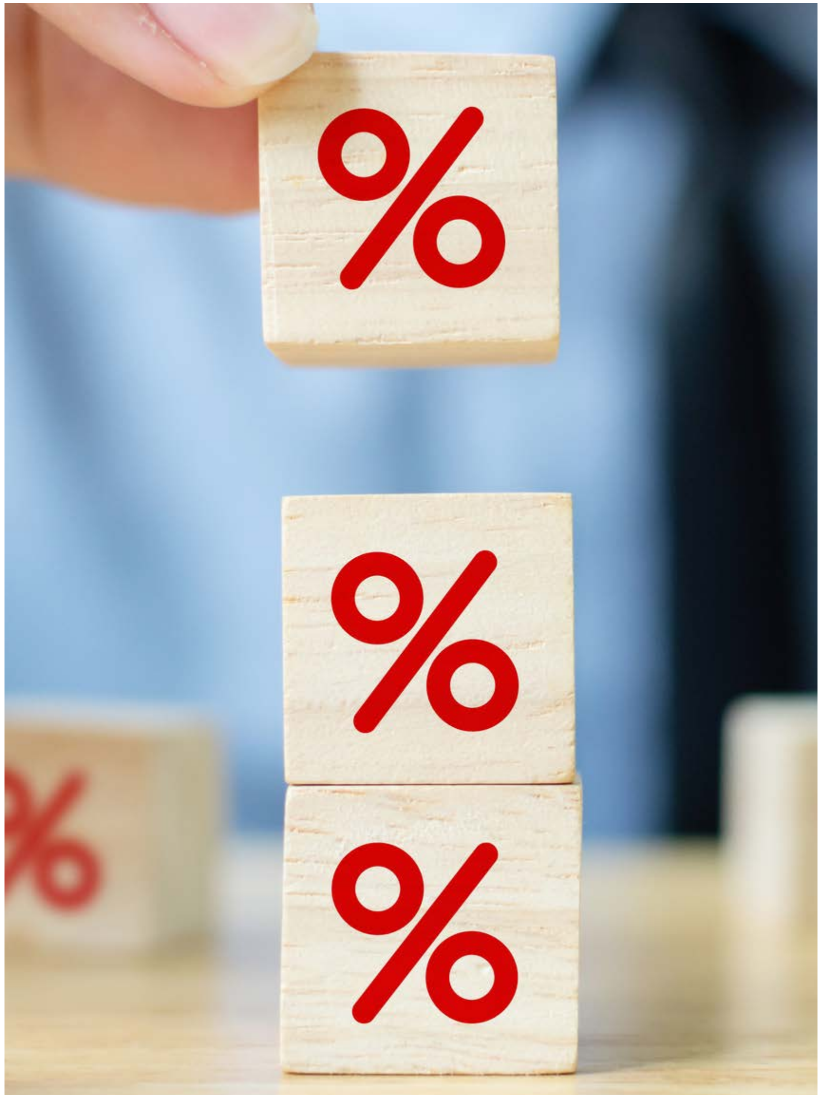
In a review of transfer pricing policies, the questions to ask will include:

- Are the comparables used to set transfer prices based on normal market conditions and pre-COVID-19 benchmarking data? Are these still applicable and appropriate in the changed circumstances? Is an alternative approach needed, for example including loss-making comparables?
- How are businesses renegotiating terms and pricing with third parties - for example, deferring payments, changing contract terms and negotiating new pricing structures? Should these be reflected for intragroup transactions?
- Is the business model or supply chain changing, and does this present transfer pricing opportunities and challenges?

SOME SPECIFIC AREAS FOR CONSIDERATION

The areas in which action should be considered include:

- **Reducing margins:** fixed or cost-plus basis margins may now result in cash tax issues for limited risk sales and distribution, manufacturing and other entities. Affected businesses should consider reducing or temporarily eliminating margins, where this can be justified
- **Reviewing funding arrangements:** there may be justification for changing interest rates, guarantee fees and cash pool terms, or agreeing interest deferrals, holidays or covenant relaxation
- **Payment deferrals:** there may be economic or market justification for delaying payments in relation to goods, services or finance
- **Royalty holidays:** a royalty holiday could be based on sales in a particular region or market recovering to an agreed level, or royalty rates could be linked to certain targets being met
- **Adjusting service fees:** consideration should be given to adjusting the cost base where employees are furloughed, to reflect the fact that some services are not being delivered.



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REVISITING ADVANCE PRICING AGREEMENTS (APAS) AND ADVANCE THIN CAPITALISATION AGREEMENTS (ATCAS)

APAs and ATCAs are intended to replicate events in the real world. HMRC will therefore almost certainly be open to conversations around matters such as relaxing or changing covenants in ATCAs, or potentially redrafting the entire agreement.

- Most ATCAs will include covenants which depend on EBITDA levels, and breaches of such covenants have potential consequences – typically, a restriction on the interest deductible for tax purposes.

  Properly drawn-up ATCAs will contain clauses which allow the agreement to be revisited in the event of unforeseen circumstances or exceptional events. The current economic environment certainly qualifies as exceptional, with banks and other lenders changing rules on interest, repayments and other matters, including granting repayment holidays.

APAS

- APAs should similarly be revisited, to ensure that the assumptions in place when the agreement was entered into can cope with the current economic circumstances.

IMPORTANT POINTS TO REMEMBER

Any changes should comply with the requirements of the authorities in all jurisdictions concerned, particularly as governments may regard multinational companies as suitable targets for raising much-needed additional revenue. There is an acceptance by tax authorities that pricing may need to change, given the abnormal conditions. This was generally the case during previous downturns.

It will be important to retain well-supported evidence and documentation in relation to changes, update legal agreements and correctly implement systems and processes. Tax authorities are likely to scrutinise any changes to transfer pricing policies in detail. The issue may be a high priority for them, as they will be likely to be looking to raise tax revenues and recoup the cost of stimulus measures. In addition, transfer pricing theory and practice have evolved considerably in recent years, as have the resources of tax authorities focusing on the subject.

Businesses also need to be mindful of potential reputational risk issues and the cost of defending poorly conceived or executed policy changes.

CONCLUSION

Updating transfer pricing policies can assist better cash flow management, but it is not simply a case of adjusting pricing - there may be other tax implications, and a review of the transfer pricing policy and model may be required, especially as existing policies are likely to be based on evidence from significantly different market conditions.

An organisation's existing policies and transfer pricing may no longer be appropriate. It may be possible to flex existing policies, but where this is not possible or appropriate, a new approach may be necessary.

Well-based economic analysis and documentation, monitoring and implementation is arguably even more important in an economic downturn.

ATCAs and APAs and should be reviewed - action sooner rather than later will help to avoid potential tax controversy and double taxation further down the line.

Looking to the future, businesses will need to consider more far-reaching changes to transfer pricing policies when the ramifications of the 'new normal' become clearer. This will include reviewing supply chains and business models, and considering the allocation of higher costs, changed IP models and the assessment and reward of higher-risk profiles. Transfer pricing will inevitably be just one part of a process that will incorporate a number of tax and other issues.

HOW WE CAN HELP YOU

For more information about how we can help you and your clients please contact:

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42005044

ISSN 2056-7332

www.bdo.co.uk