

INTERNATIONAL TAX AND TRANSFER PRICING CONSIDERATIONS IN THE WAKE OF COVID 19 DEVELOPMENTS

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Presentation agenda



- ❑ Brief introduction to transfer pricing principles
- ❑ Transfer Pricing documentation Process
- ❑ Comparability analysis and challenges
- ❑ The Impact of Covid-19 on Transfer pricing and international taxation system

Introduction to TP



What is transfer pricing?

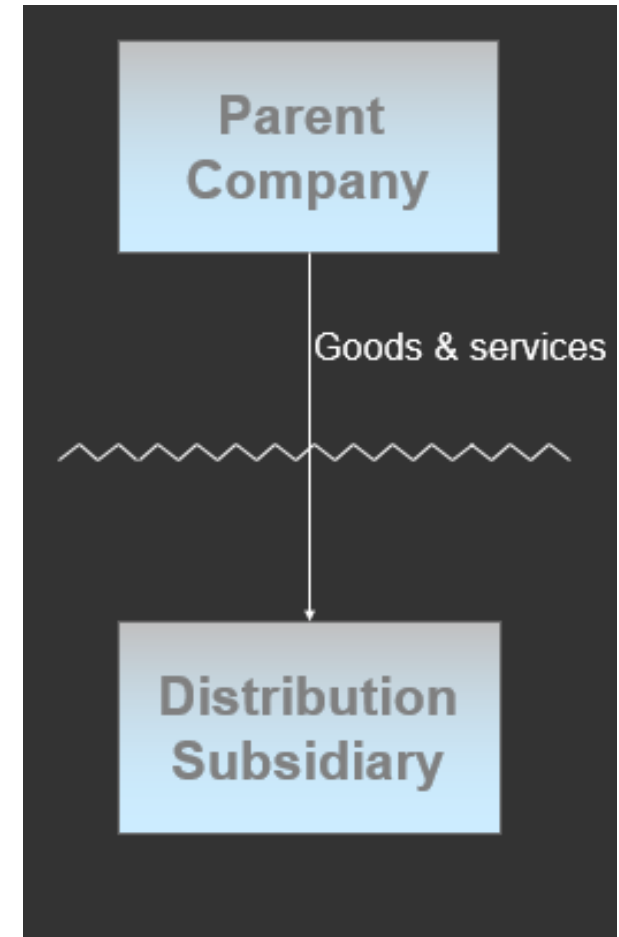


- ☐ Price charged for tangible/intangible goods or services or loans between related legal entities
 - ☐ Recurring basis
 - ☐ One-time basis
- ☐ Corporate structure is key
 - ☐ Legally distinct
 - ☐ Economically distinct
- ☐ Cross-border intercompany transactions
 - ☐ International boundaries
 - ☐ State or local boundaries

Example



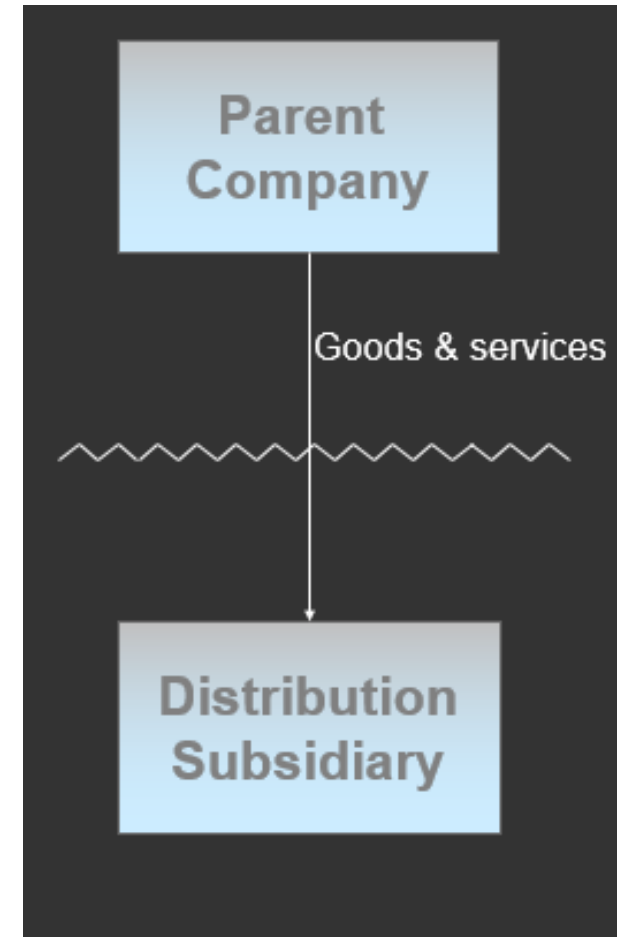
- ❑ French parent manufacturer with Irish distribution subsidiary (sub)
 - ❑ Parent company undercharges Irish sub for goods, services and loans
 - ❑ Creates lower taxable income in France and higher taxable income in Ireland
 - ❑ Tax rate of sub in Ireland is 12.5% as compared to 33.3% in France
 - ❑ Result is higher after-tax profits for combined organization, but less tax revenue for France



TP affects profit allocation and taxes



- ❑ As the transfer price for the goods charged to the Distribution Company increases, Distribution Company earns less profit and Manufacturing Company earns more profit.
- ❑ Therefore, the transfer price determines how profit is divided between both companies
- ❑ Due to different tax rates transfer prices influence the total tax burden of a group of companies



BUT.....It's not that easy



- ❑ The arm's length standard constrains opportunism
- ❑ Fiscal authorities want their “fair share” of the global profit pie
 - ❑ Tax rate arbitrage drives MNEs to/from different jurisdictions
 - ❑ At a minimum, protect the tax revenue base
 - ❑ At a maximum, grow the revenues collected
- ❑ In international trade, over 60% involves transactions between companies within Multinational Enterprises (MNEs)
- ❑ Getting it wrong can be expensive – double taxation

Key terms in transfer pricing



✓	Related parties	<ul style="list-style-type: none">– Common shareholding / control / capital– Common Directorship and management
✓	Control	Participate directly or indirectly in the management, control or capital of an enterprise.
✓	Transfer pricing	The pricing of goods, services, intangibles and financial arrangements between related parties located in the same or different tax jurisdictions.
✓	Transfer mispricing	The trade between related parties at prices designed to manipulate markets and to deceive tax authorities (shifting income from a high tax jurisdiction to a low tax jurisdiction)
✓	Controlled transaction	A transaction between related parties

Key terms in transfer pricing



Uncontrolled transaction

A transaction between unrelated / independent parties



Arm's Length price

Price which is generally charged in a transaction between independent parties

The price of a transaction in an open market



The arm's length principle

The amount charged by one related party to another for a given transaction must be the same as if the parties were not related (independent parties)

Reference is made to the profits that would have arisen if a similar transaction to the controlled transaction had been executed by or between independent enterprises

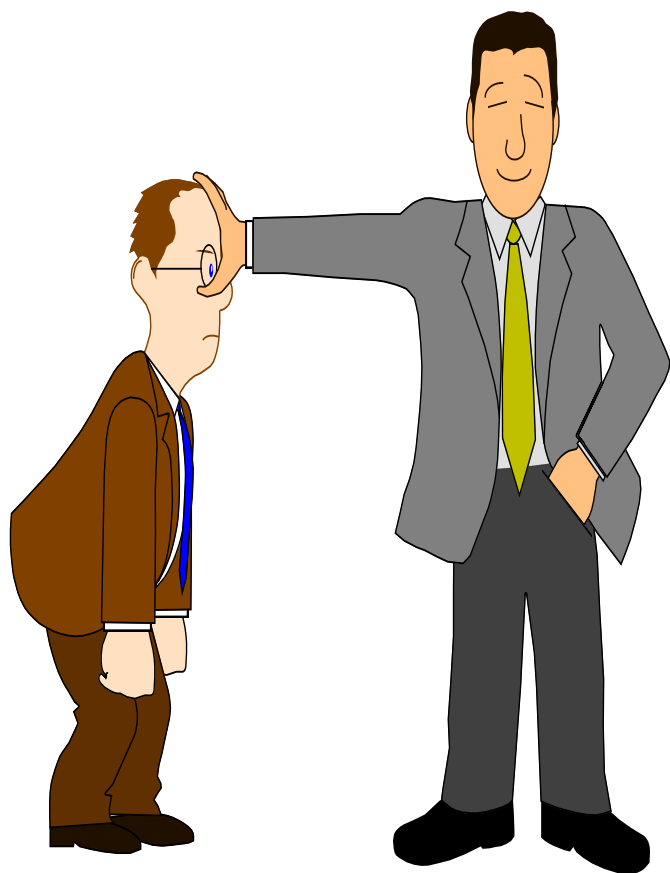


Basis of transfer pricing



- ❑ Arm's length price:
 - ❑ Price which is generally charged in a transaction between independent parties
 - ❑ The price of a transaction in an open market
- ❑ Arm's length principle (ALP)
 - ❑ The amount charged by one related party to another for a given transaction must be the same as if the parties were not related (independent parties)
 - ❑ Reference: profits that would have arisen if a similar transaction to the controlled transaction had been executed by or between independent enterprises

The arm's length standard



- ❑ “Establishing the conditions of the commercial and financial relations that one would expect to find between independent enterprises in similar transactions under similar circumstances.” - OECD TP Guidelines 1.3

Basis of transfer pricing: ALP



- ❑ Arm's length principle is based on comparing all the conditions of the inter-company versus third parties transactions
 - ❑ therefore, members of an MNE group are treated as separate entities
 - ❑ therefore, the economically relevant characteristics inherent to or associated with the transaction under consideration must be sufficiently comparable
 - ❑ accurate adjustments based on realistically available options may help to remove some differences

Transactions subject to Transfer pricing



- ☐ Purchase and sale of goods (including assets)
- ☐ Rendering or receiving services
- ☐ Agency arrangements, leasing arrangements, & license agreements
- ☐ Financial transactions including guarantees and collaterals
- ☐ Transfer of Intangible including R&D
- ☐ Management contracts; and
- ☐ Any other transactions which may affect the profit or loss of involved entity

Transfer pricing documentation process



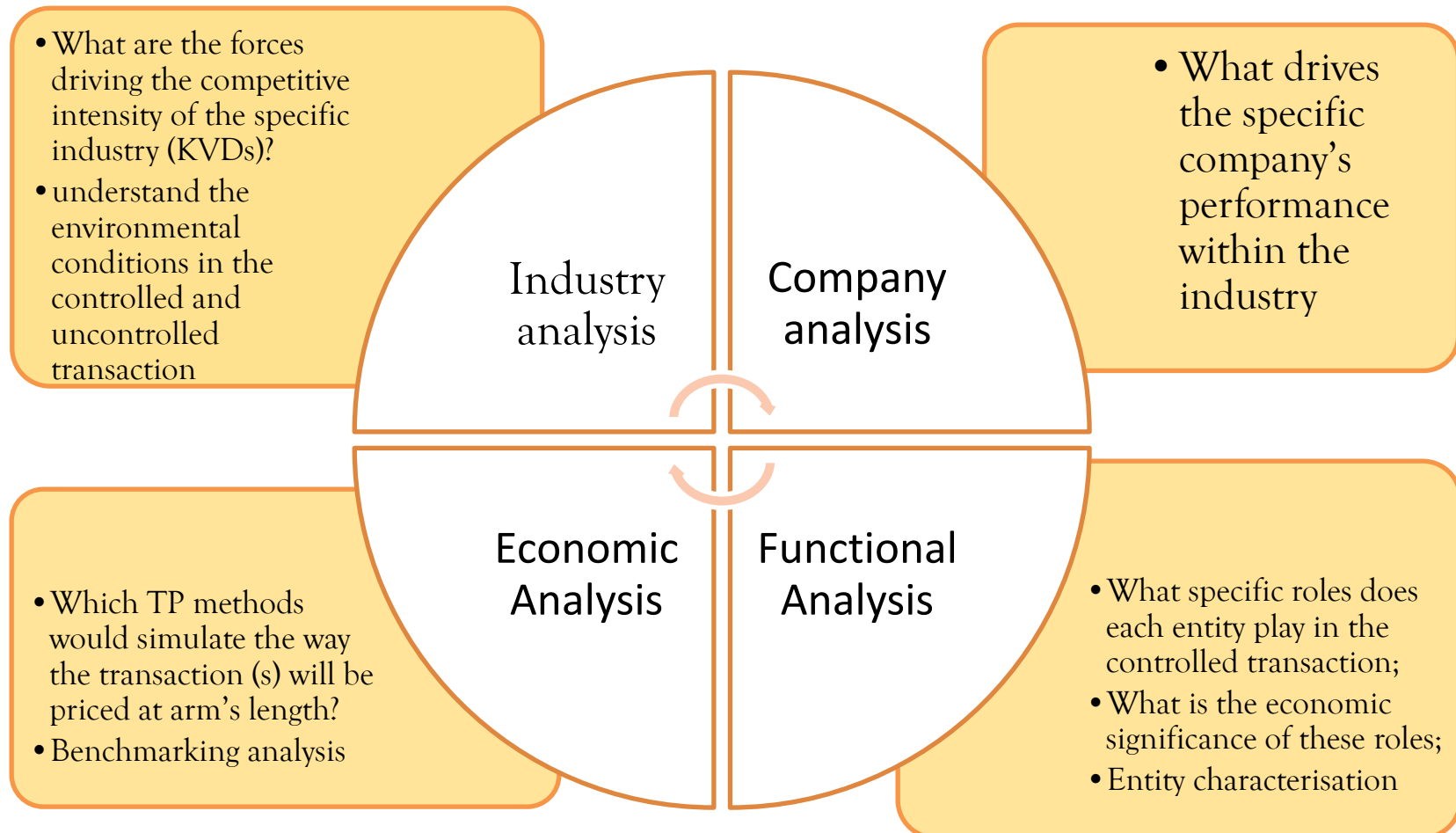
“Documentation” is the vital tool for
successful
communication of the TP system with the
stakeholders – external and internal

Types of TP projects

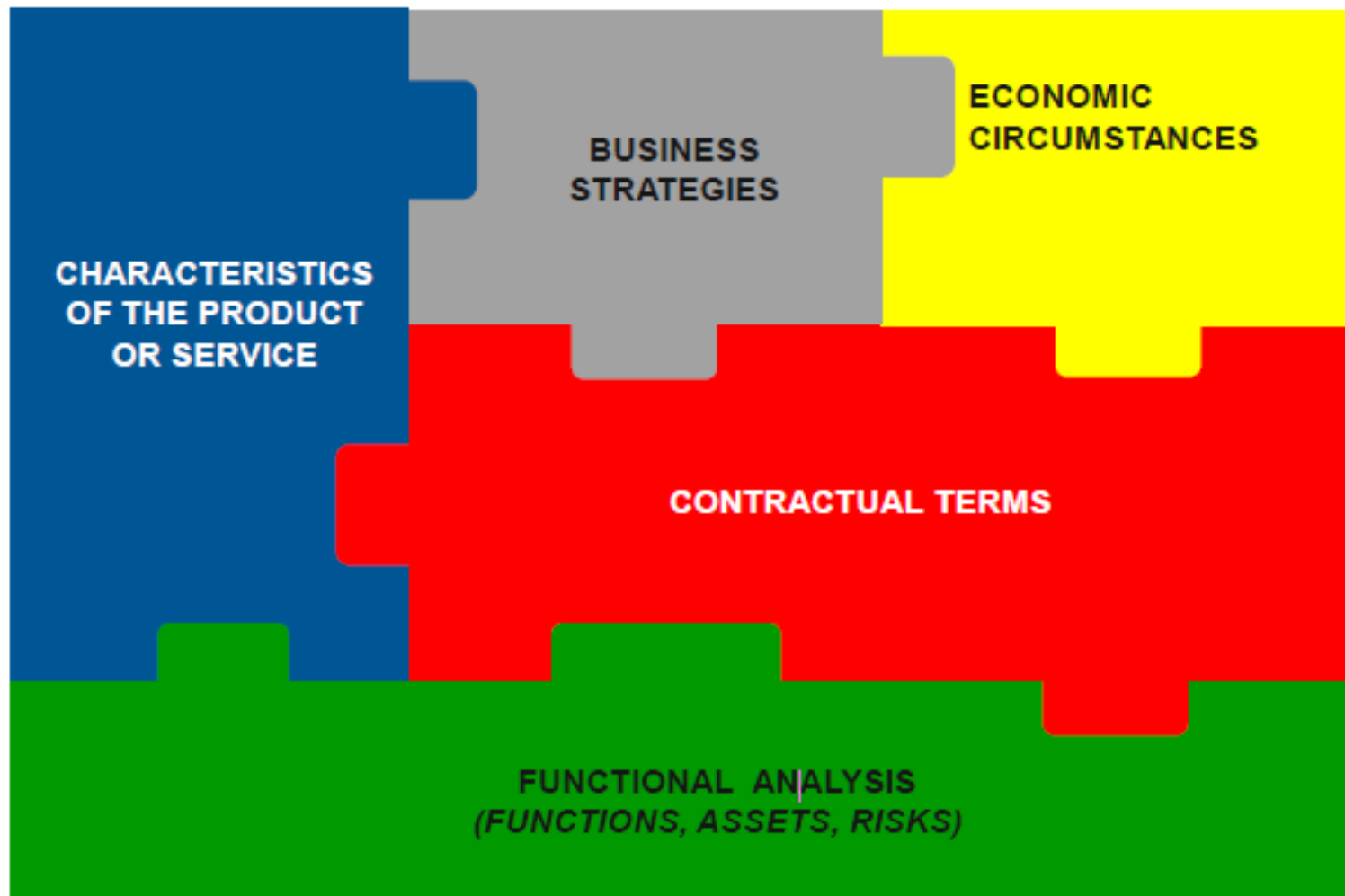


- ❑ A transfer pricing study typically aims at maximizing the potential for increased after-tax income and/or at minimizing the likelihood of adverse tax adjustments and penalties
- ❑ There are five broad categories of transfer pricing studies
 - ❑ Documentation project:
 - ❑ Design project
 - ❑ Audit defense project
 - ❑ Planning project
 - ❑ Advance pricing agreements / rulings

Structure of a transfer pricing document



Thorough identification of Relevant Characteristics of the Transaction



Comparability



Comparability analysis



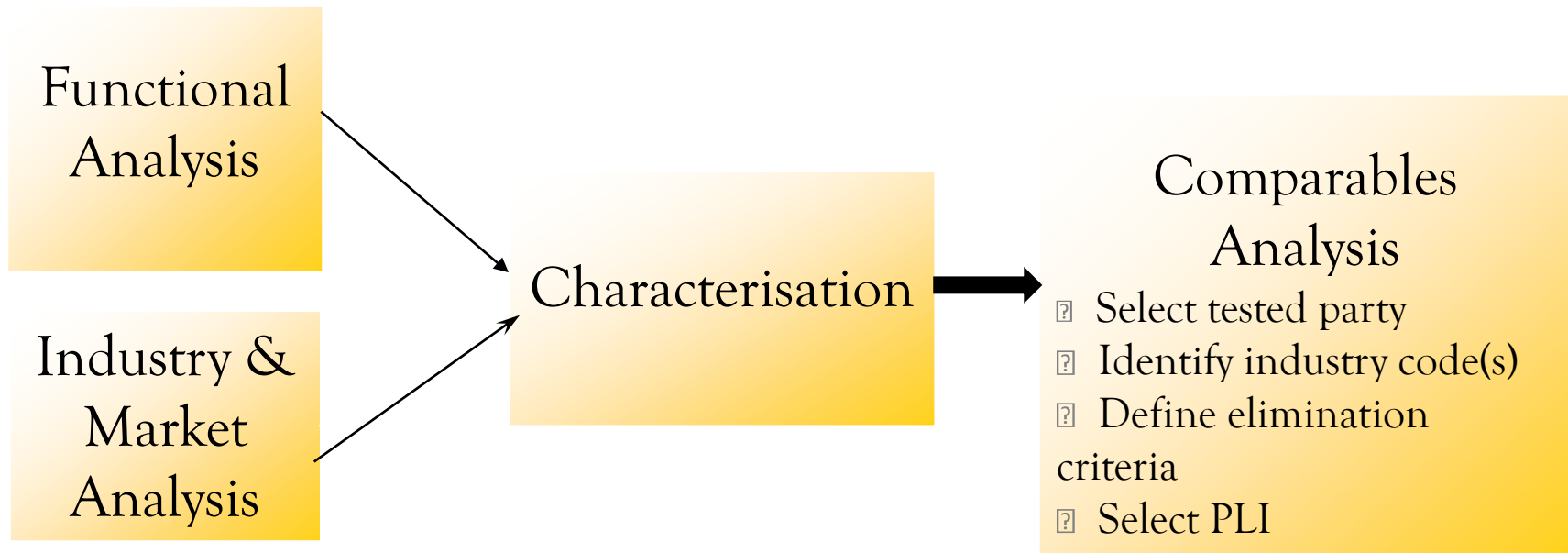
- ❑ **Arm's Length Principle** is based on comparison of conditions of the intercompany versus third party transactions
- ❑ The OECD transfer pricing guidelines indicate five factors determining comparability:
 - ❑ Characteristics of property or services
 - ❑ Functional analysis
 - ❑ Contractual terms
 - ❑ Economic circumstances
 - ❑ Business strategies?
- ❑ In the absence of an internal comparable transaction, we need to identify independent companies engaged in similar transactions to the ones we are testing in order to benchmark their profitability on those transactions

Comparability analysis



- ❑ If no adequate comparables can be found, consider identifying and quantifying the differences and adjusting for these.
- ❑ The reliability of results should increase through the performance of adjustments

What defines comparability criteria:

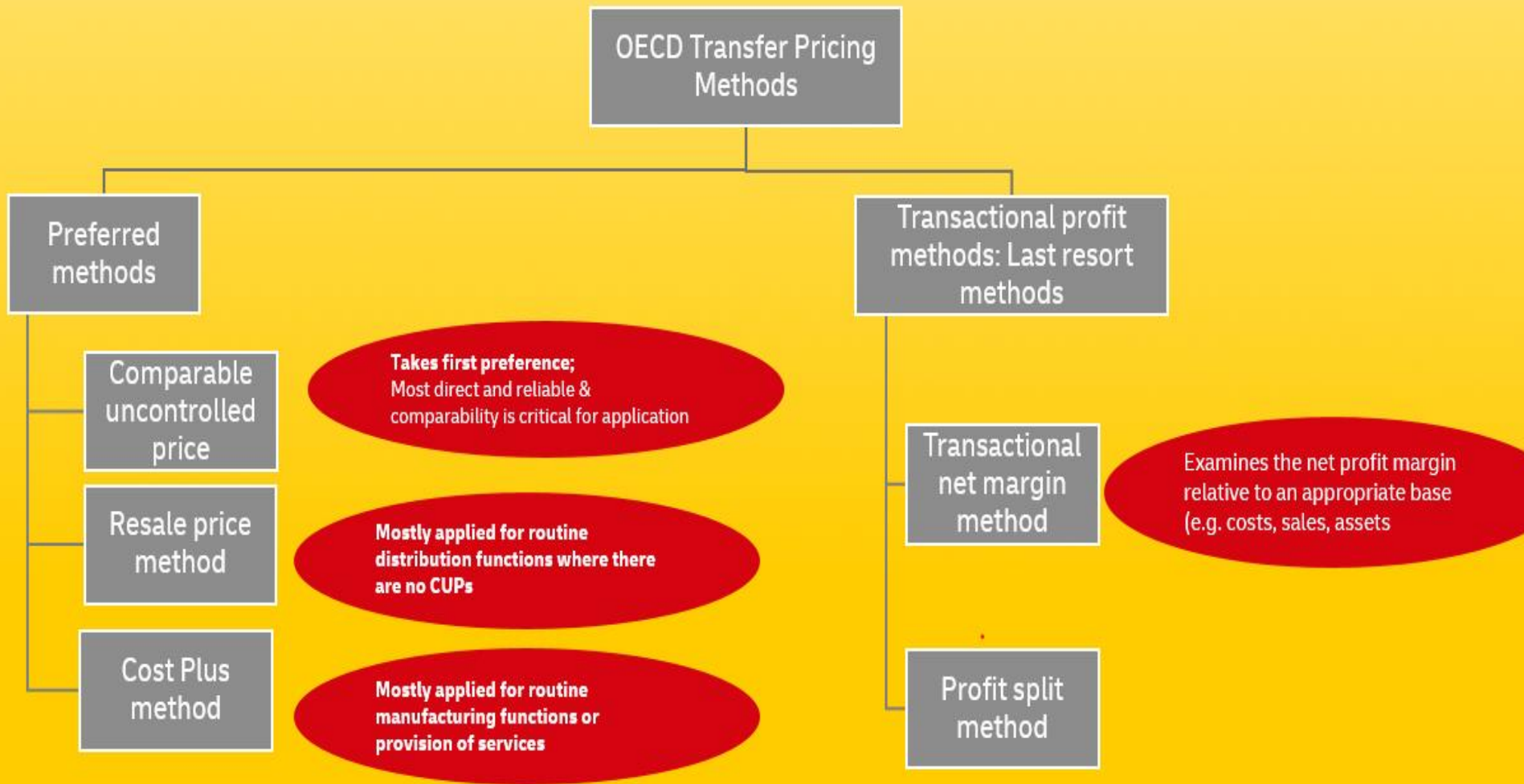


- ❑ NOTE: Even in applying a transactional based method, we are seeking to benchmark the return to a transaction, rather than the overall profitability of the taxpayer under review (i.e., tested party)

Transfer pricing methods



Transfer pricing Methods



TP methods descriptors



Based on the order of preference

CUP Method: the most direct and reliable

- Internal CUPs – between the related party and third party
- External CUP – between independent and unrelated parties
- Requires highest degree of comparability – the product/service, the characteristics, contractual terms and conditions, economic /operating environment

RPM: mostly applied for routine distribution functions

- Considers the price at which a product, that had been bought from a related party, is sold to a third party.
- The price is adjusted by an appropriate gross margin to cover reseller expenses and appropriate profit
- Other costs to adjust include import duties to determine the arm's length original price

Cost plus method: Routine manufacturing or provision of services

- Considers the costs incurred by the supplier to produce the good or services
- An appropriate mark-up is added to the costs to make an appropriate profit
- Considers the functions performed and the market conditions
- The resulting price may be regarded as an arm's length price for the controlled transaction
- However
 - Differential treatment of costs as direct, indirect or operating expenses (inconsistencies in accounting), may affect comparability of the cost base

TP methods descriptors



Based on the order of preference

Profit split method: Highly integrated and valuable contributions

- Contribution analysis – based on functions performed, assets used and risks assumed
- Residual analysis – profit allocated in two stages
 - Remuneration for non-unique contributions or routine activities (stage1)
 - Remuneration for unique contributions from the residual profit (stage 2)

TNMM: comparability analysis at the net profit level

- Net profit relative to an appropriate base (e.g. costs, sales, assets) used as the PLI
- Preferred because net profit indicators are less affected by transactional differences

Final transfer pricing documentation



- Increase transparency for tax authorities
- Form MNEs with Revenue >€750m

Masterfile

- High-level information on MNC available to all tax authorities on:
 - MNC's business, TP policies and agreements with tax authorities

Local file

- Detailed information about the local business
 - Including related party payments and receipts for products, services, royalties, interest etc

CbC Report

High-level information on:

- Allocation of profits
- Revenues
- Employees
- Assets
- Taxes paid

Transfer pricing documentation - Masterfile



Organizational Structure	Business description	Intangibles	Intercompany financial activities	Financial and tax positions
Structure chart: ► Legal ownership ► Geographic location	Important drivers of business profit	Overall strategy description	Financing arrangements for the group (related and unrelated lenders)	Annual consolidated financial statements
	Supply chain of: ► Five largest products/services by turnover ► Products/services generating more than 5% of turnover	List of important intangibles and legal owners	Identification of financing entities	List and description of existing unilateral advance pricing agreements (APAs) and other tax rulings
	Main geographic markets of above products	List of important intangible agreements	Details of financial TP policies	
	List and brief description of important service arrangements	R&D and intangible transfer pricing policies		
	Functional analysis of principal contributions to value creation by individual entities	Details of important transfers		
	Business restructuring/acquisitions/divestitures during fiscal year			

Transfer pricing documentation – Local file



Local entity	Controlled transactions	Financial information
<ul style="list-style-type: none"> ▶ Management structure ▶ Local organization chart ▶ Details on individuals to whom local management reports 	<ul style="list-style-type: none"> ▶ Description of material controlled transactions and context in which they take place. ▶ Identification of associated enterprises party to controlled transactions and relationship ▶ Functional analysis ▶ Transfer pricing methods used ▶ Comparables and details of methodology 	Local entity financial statements
Description of business and business strategy pursued	Amounts of intragroup payments and receipts for controlled transactions (products, services, royalties, interest etc.)	Reconciliation to show how financial data used in applying the transfer pricing method ties to the financial statements
Details of business restructurings and/or intangible transfers	Unilateral and bilateral/multilateral APAs and other tax rulings related to the controlled transactions	Summary of relevant financial data for comparables and sources from which data was obtained
Key competitors		R&D and intangible transfer pricing policies
		Details of important transfers

Transfer pricing in the wake of Covid-19



Background



- ❑ The world has gone through various shocks: the Great Depression, World War II, the Financial Crisis of 2008, and now Covid-19.
- ❑ Likely to see two phases to this crisis:
 - ❑ **Shock phase:**
 - ❑ Governments doing everything to save and protect the economy: giving incentives, subsidies to stimulate the economy and retain jobs
 - ❑ Businesses – immediate cost savings, protection of employees, cash protection
 - ❑ **After the shock phase:** governments need more money to:
 - ❑ (1) fund the spending (2) repay the debts they accumulated during the shock phase;

Background



- ❑ With Governments demand for more money, the pressure will be on the Revenue Authorities (RA) – aggression expected in collection:
 - ❑ More audits, and specifically transfer pricing related audits
 - ❑ New sources of revenue – Digital taxation.
- ❑ Transfer pricing is a significant driver for profit allocation. But we are now having to contend with losses following the shocks caused by Covid-19.
 - ❑ How do we allocate the losses?
 - ❑ What aspects do you need to be aware of?
- ❑ Likely to result in shift in international taxation regimes to accommodate the shifts in economic conditions.

Covid-19 ...more long term



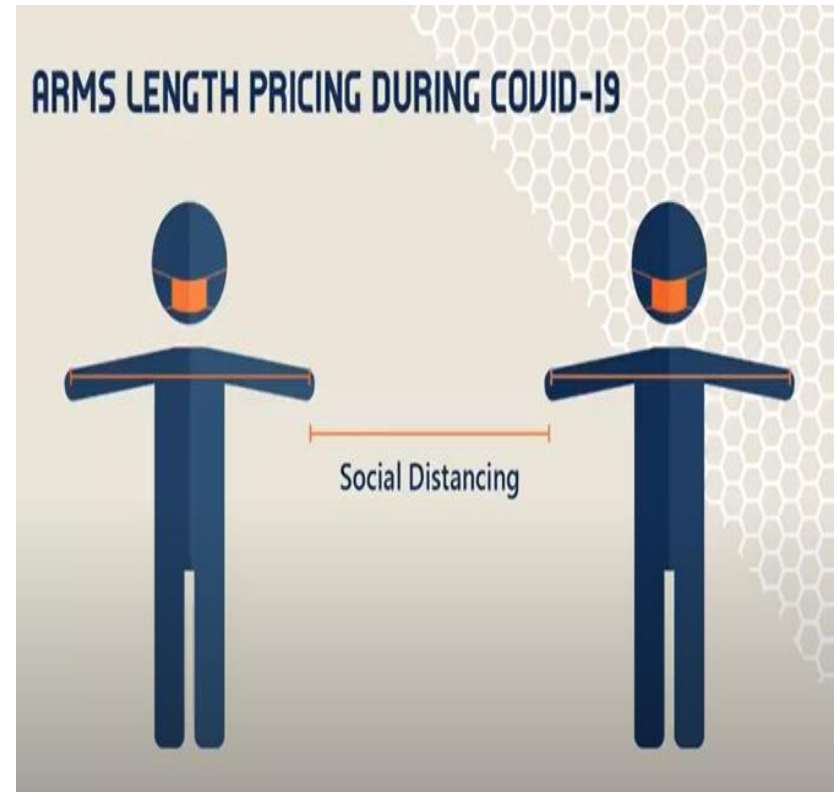
Main transfer pricing and international tax issues that MNEs have to tackle post Covid-19:

- ☐ Documentation:
- ☐ Benchmarking
- ☐ Allocation of losses
- ☐ PE determination
- ☐ Government stimulus measures impact
- ☐ Business restructuring

Transfer pricing consideration – Covid-19



❑ What is arm's length during Covid-19:



Documentation



- ☐ Companies, (both independent and MNEs) are acting in their best interest
- ☐ What decisions have been made for the survival of the business? Have you documented that, as and when they are made?
 - ☐ Document what business decisions are being made now and why, and
 - ☐ Maintain evidence of what other businesses are doing.
 - ☐ Any cost and losses incurred will need to be allocated for tax and transfer pricing purposes, and tax authorities will be very weary to accept those.
- ☐ Documentation is Key – not the length of the document but rather the timeliness of it – saying we are doing this at this particular time for this reason, as of this day

Financing



- ☐ How do companies keep their businesses afloat and protect their cash flow?
 - ☐ Debt vs. Equity Injection?
 - ☐ Debt injection:
 - ☐ Third-party loans: ease of accessing the loans? how much? Guarantee – arm's length fees?
 - ☐ Inter-company loans: ease of moving money? Is it wise? What terms do you grant the loan – interest bearing or interest-free? Determination of arm's length interest rates and loan valuation
- ☐ Thin capitalization considerations
- ☐ Restructure IC transactions:
 - ☐ IC Service repayments? Not charge or charge without requiring remittance; retain money locally, but does it attract a deemed interest?
 - ☐ Selling goods at discounted prices

Benchmarking Analysis



- ❑ Can the already benchmarked margins be adjusted, with the expectation that 2020 data (when eventually available) will show lower margins or losses?
 - ❑ Guidance – modest: as recognizing that within a range of arm's length comparables, a taxpayer can actually switch to the lower end of the range - as compared to the previously used median- ; or
 - ❑ make the case for a switch to using one-year data where previously three or four-year comparable data were used.
 - ❑ Bold: - as looking at the (average) observed drop in revenue that a sector experienced and applying that to your company's financials and benchmarked margins for 2020.
 - ❑ As adjusting for 2020 at this point in time is hardly realistic, can transfer pricing for 2020 and 2021 be looked at on a consolidated basis perhaps?
- ❑ Lack of guidance will lead to benchmarking being a major TP audit issue – as consistency is key to TP methodology

Benchmarking Analysis



- ❑ Consider adjusting the IC contracts (based on the “**Force Majeure**” clause – this would then facilitate the allocation of Covid-19 related costs and losses
 - ❑ Parties (independent) can re-negotiate the terms of a contract based on hardship – and so should associated enterprises
 - ❑ Difficulty to perform is not the same as impossibility to perform.
 - ❑ Foreseeability is another issue. Two years from now, witness previous experiences with SARS, Ebola and the Avian Flu, some may say the Covid-19 impact was (somewhat) foreseeable
- ❑ If and to the extent IC agreements can be adjusted - reference be made that both parties to the agreement will perform in good faith and will do everything they can to avoid frustration of performance.

Benchmarking Analysis



- ☐ Out-rightly acknowledge that
 - ☐ the global pandemic and
 - ☐ the future development of the pandemic and
 - ☐ future consequences of government-imposed Covid-19 restrictionsare not known and cannot be taken into account by the parties to the contract.
- ☐ As such these consequences cannot be reasonably foreseen or are not reasonably foreseeable.
- ☐ The parties agree up-front that the risk of future Covid-19 restrictions are not attributable to the parties and beyond their respective control and that they will inform each other on the Covid-19 developments and agree that Covid-19 consequences will be considered as hardship by both parties.

Benchmarking Analysis



- ☐ Unrelated parties are granting breaks and exceptions to contract partners during the current pandemic, such as:
 - ☐ Banks temporarily waiving interest rates,
 - ☐ companies extending payment terms from 30 to 120 days, or
 - ☐ companies granting deferrals for performance
 - ☐ Do these provide comparables for TP purposes?
 - ☐ Is there hard evidence on the changes /concessions?
 - ☐ Must the evidence be sector specific?
- ☐ Having an updated Force Majeure or specific Covid-19 clause could, –
 - ☐ without necessarily changing risk profiles in the TP structure materially-, it would carve out the consequences resulting directly from the Covid-19 pandemic and allow those to be applied after the -regular- comparables are consulted and support an adjustment to the comparable margins

Benchmarking Analysis



- ☐ Limited risk distributors / routine service providers
 - ☐ Can you adjust the routine margins?
 - ☐ What evidence do you use for that adjustment and what do you do in future years when pandemic-affected comparables are included in benchmark data
- ☐ **Risk:** ad hoc change triggers the perception that the limited risk entity was actually an entrepreneur all along and that tax authorities take the position that as a result, in pre-Covid-19 years there has been an underreporting of taxable income.

Permanent establishment (PE)



- ❑ Travel restrictions and lockdown have led to people working from home (WFH), with no access to their formal designated offices
- ❑ Article 5 of the OECD Model Convention defines a PE as a fixed place of business through which the business of an enterprise is wholly or partly carried on. It includes inter alia:
 - ❑ *A place of management and an office*
 - ❑ *Does WFH therefore mean that the premises are at the disposal of an enterprise – thus leading to creation of a PE*
 - ❑ Individuals being present in another State for a *period or periods exceeding in the aggregate 183 days (i.e. 6 months) in any twelve-month*
 - ❑ an employee WFH acting on behalf of its employer in another jurisdiction may be considered as rendering services from a PE
 - ❑ may be considered as rendering DEMPE functions where they are, and as such, their presence would attract significant transfer pricing challenges.

Permanent establishment (PE)



- ❑ Re-consider the 183 day test, and issue guidance
 - ❑ that activities should only be regarded as habitual where there is a degree of permanence (as regards the conclusion of contracts/doing business leading to a PE).

Business Restructuring



- ☐ Changes or moves from the East to West Production facilities.
 - ☐ Is the move permanent, or short-term?
 - ☐ If permanent, when did that happen, or was decision made?
- ☐ What buy out considerations do you make?

Transfer pricing key challenges



Management control

Strategic decisions

- 7. Company / Asset Valuation
- 8. Roles, Responsibilities and "control"
- 9. Business Restructuring

TRANSFER PRICING

Tax & Legal

TP Risk Management

- 1. Benchmarking Analysis
- 2. Reconsider TP Methods
- 3. The Real Change

Finance

Optimize Cash Management

- 4. Intercompany loan
- 5. Guarantee fees
- 6. Thin Capitalization

What is transfer pricing?



Is transfer pricing primarily a tax issue
with possible management impact?

OR

A management control issue with tax
consequences?

Recommendations



- ☐ Do what needs to be done from a business operational perspective
- ☐ Documentation contemporaneously the decisions of the management – as they are rational and reasonable, and this may not be the case in the next three years – not easy to document
 - ☐ Making decisions now, with the information readily available today and facing an uncertain future
- ☐ International tax system is still relying on the ALP – meaning decisions have to be rationalized, financial and economic analysis should be at the basis of any documentation for restructuring or any transfer pricing consideration
- ☐ RA to issue guidance on various tax issues

Summary



- ❑ Before Covid-19, uncertain and tense international tax context
- ❑ Crisis are great trend accelerators: So Covid-19 will likely be an accelerator the major international tax issues in both developed and emerging economies – taxation of the digital economy
- ❑ MNEs – perceived as wealth entities – will continue being targeted for revenue
- ❑ If guidance is communicated now during the crisis: increased levels of compliance and hopefully reduced controversy

Questions



THANK YOU

