K C Mehta & Co.

Chartered Accountants

kcmSpark

Transfer Pricing

Covid-19

Will your intra-group transactions stay immune?

June 6, 2020

Snapshot

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Background and Coverage

In 2019, the business world was already grappling with consequences of rising trade barriers and geopolitics impacting its businesses, when unbeknownst to all, a new crisis was preparing for its arrival. The Covid-19 pandemic has already resulted in staggering levels of travel restrictions and nationwide lockdowns. The businesses have been severely impacted, and the IMF has revisited its projections and estimates the global economy to contract sharply by 3% instead of growing by 3% in 2020.

Covid-19 has effectively disrupted the businesses and their supply chains globally. Functional and risk profiles of various entities have undergone changes due to external forces (halt in production due to lockdown, travel and transport restrictions, etc.) or on account of internal supply chain reorganization / restructuring (which is not from investment holding perspective) due to changed priorities in terms of products, geographies, etc. keeping in mind the domino effects of Covid-19.

Any change in functional profile would invariably require MNEs to consider impact of such changes in their transfer pricing policies. Further, this black swan event bringing uncertainty and substantial changes in business & economic circumstances would also have its impact.

In this publication, we would be discussing various facets of transfer pricing arrangements.

What are the supply chain restructuring possibilities?

The unpredictable and uncertain business scenario compels the groups to evaluate each entity / section of its existing supply chain and identify areas where rationalisation / restructuring will add more value. e.g. manufacturing entities located in geographies with lower impact can strive to work at a higher capacity utilisation to off-set the decrease in manufacture in a more impacted geography.

Similarly, where the group has entities which are providing services within the group and have been impacted by the pandemic, the groups can evaluate the possibility to avail such services from a third party service provider in their respective geographies to reduce the delivery time of service as well as for ease of operations.

The groups may also evaluate whether the entities hitherto characterised as 'low risk' or 'limited risk' can take up a profile with higher risks and add value along the group supply chain more effectively. This will be more relevant where the risk-bearing entities are located in more impacted geographies hampering their ability to effectively take up a higher-risk position. e.g. where a limited risk distributor has already piled up stock due to decrease in demand, is already facing a market risk because of the pandemic affecting market demand and hence, is undertaking market risk and inventory risk. Further, with the manufacturing entities looking at a higher loss, it may be worth evaluating whether customer credit risk or price risk may be undertaken by distribution entities and hence, making the business model more sustainable in difficult times.

Restructuring may warrant compensation

Supply chain restructuring would also amount to 'international transaction' and may warrant a compensation to be passed on between Associated Enterprises depending upon the nature of such restructuring and also whether it was carried out based on mutual understanding or was forced by market forces. Undoubtedly, such a restructuring has to be effected not only for the period of pandemic but also when the businesses start recovering and moving on from the crisis. Any restructuring which is effected only with the objective of allocating loss in a crisis period and then reverting when the groups move to a profit position will be viewed as an opportunistic move by tax offices in such geographies.

Can you revisit the contractual arrangements?

Arm's Length approach requires revisiting intra-group arrangements

A question often arises as to whether a revision in intra-group agreements be permissible where the original contract has a life to serve.

Adopting arm's length approach, where companies are also re-evaluating their contracts with independent entities, it makes a case for re-evaluating and updating the intra-group contracts as well. e.g. independent parties are now re-evaluating the need to include *force majeure* clauses in their contracts, negotiating the product pricing, delivery terms as well as other conditions to make the contracts sustainable in a difficult business scenario.

Taking a cue from the same, intra-group contracts could also be re-negotiated and updated to match the current business scenario.

Businesses can even take independent re-negotiated contracts as a benchmark to revise their intra-group contracts. e.g. where a manufacturing entity has revised its independent contract for reduction in pricing based on a certain volume of sales, a proportionate adjustment in intra-group agreements will be a strong case to argue the reduction in pricing since it is backed by an independent contract revision.

A contract is only as good as its conduct

It is important to note here that in a post-BEPS Transfer Pricing analysis, a contract is only as good as its conduct. Hence, if in the above example, a limited risk distributor entity is termed as one just for namesake while undertaking risks on account of higher inventory or product liability, etc., the OECD Transfer Pricing Guidelines supports one to look beyond the contract and evaluate the actual conduct for computing the arm's length price of the transactions.

'Control over risk' would be vital in Covid-19 scenario

Covid-19 scenario would actually aid in evaluation of control over risk. Since uncertain times calls for quick decision-making, this scenario would, in effect, reflect where the decisions are *really* taken and hence, the focus will shift from a contractual risk-bearing entity to *actual* risk-bearing entity.

A thorough risk analysis, including not just contractual allocation of risk but actual control over those risks might pose a different result from overall group perspective, considering that lockdowns, severity of the pandemic and restrictions may impact the risk-taking ability of few entities within the group. An entity which was hitherto characterised as a principal risk bearing entity may be severely impacted by the pandemic and hence, unable to perform the functions or undertake risks it used to in the pre-crisis period.

From the perspective of intangibles and research entities, it becomes all the more imperative to evaluate allocation of DEMPE (development, enhancement, maintenance, protection and exploitation) not just from a contractual standpoint, which would usually be pre-crisis, but also from conduct standpoint, which may pose different results due to the above factors. e.g. a contract research entity employing research scientists which complete a particular research without inputs from the principal entity impacted by the pandemic, will now be allocated larger share of the DEMPE functions, if not the complete share. Another example could be research scientists of a group who moved back to their home country and carried out their research activities with help of another group research entity in their home country. In this case also, a portion of the DEMPE functions will now be allocated to the research entity located in home country of the research scientists.

Consequently, where the change in business dynamics result in change in functional profiles of group entities, it would be prudent to realign the contract to match the conduct of entities in intra-group transactions along with realignment of transfer pricing policies.

Should cost-plus margins for limited risk / risk-free entities be updated?

A whole new set of risks have come into existence since this pandemic has put to question the concept of 'risk free' entities and transfer pricing policies adopted to remunerate such contractual / captive risk-free entities within the group.

Originally when multinationals started setting up entities which performed minimum value additions or minimum functions and operated as a captive entity, it was argued that since their risks are lower, their returns should also be commensurate with the same. Overtime, the concept morphed into current one where the belief among taxpayers and tax administration is that such entities can *never* incur losses and hence, the term 'risk-free entity' came into existence where 'limited risk entity' was earlier used.

It has to be noted that even where the term 'limited risk' is used, it does not denote 'limited' in terms of quantum of risk, but 'limited' in terms of items of risk that it undertakes. Hence, in a situation where the entire business world is looking at contracting growth and losses, it would be imprudent to claim that these 'limited risk entities' are precluded from incurring losses. In an ideal scenario, the limited-risk entities shall incur losses in proportion to their limited risk bearing. e.g. in case of a limited risk undertaking entity engaged in providing software development services to its group parent, if the group parent is facing losses due to reduced contracts and increased costs, the proportion of loss that the parent bears shall be higher because of its 'principal' nature and the captive service provider shall bear a loss, albeit lower than its principal.

Again, even in this case, any opportunistic loss allocation which is dis-proportionate to the entity's position in group value chain shall be viewed negatively by the tax offices. Any allocation of losses to a contractual / captive entity should be strongly backed by documentary support evaluating the losses incurred by the group and how these losses were allocated in proportion to their functions.

Does it make sense to continue arrangements at Safe Harbour margins?

Looking purely from economic perspective, in a shrinking economy with reduced demand, value or reward for functions is set to go downward but the quantum could be anyone's guess.

Hence, even where groups are not facing a loss-scenario, a review of the arm's length margin over costs is a judicious option. e.g. in case of back-office support entities, an arm's length analysis could give an appropriate margin within the range of 10-15% whereas the safe-harbour rate was 18%.

Carrying out an evaluation on the basis of cost of certainty vs. cost of litigation, the negotiated contracts usually adopted the safe harbour margin towards certainty in a steadily growing market. However, in today's scenario and future economic downturn, the corporations may be more willing to bear the costs of future litigation rather than going on safe harbour with higher tax outgo currently. To put it simply, Covid-19 changes the equilibrium between 'cost of certainty' and 'cost of litigation'.

The Government extended the Safe Harbour rules with the same margins for FY 2019-20 and have refrained from notifying safe harbour margins for FY 2020-21 onwards. Tweaking of safe harbour margins reflecting post Covid economic circumstances could be the only possible explanation for that and if that be the case, it also justifies reduction in mark-up in cost-plus arrangements.

Groups facing a severe cash crunch at the group level could also re-negotiate the intra-group arrangements for a reduced / no mark-up for a temporary time-frame, with the assurance of compensating for it at the end of such time-frame.

In these cases, the captive entities of the groups which are not remunerated on cost-plus basis can be given an assurance of absorption of costs, albeit without any mark-up, for such temporary time-frame, depending on the overall group scenario and future business expectations.

What should be the treatment of costs incurred during lock-down in cost-plus arrangements?

The remuneration in cost plus arrangements is computed on the basis of *operating expenses* incurred by the limited risk service provider i.e. those expenses are taken into consideration which pertain to fulfilment of contractual obligations. The idea is that since a captive entity is incurring expenses solely for the purpose of fulfilling its contractual obligations to the principal, it should be remunerated on the basis of those expenses. Hence, an arm's length mark-up is added to such expenses at the time of invoicing.

Where, in pandemic situation, a company has incurred fixed expenditure e.g. employee cost to retain the employees during mandatory lockdown period, or fixed overheads, which remained unutilised i.e. were not incurred for fulfilment of contractual obligations, the question arises as to whether since these expenses were not incurred for fulfilment of contractual obligations, should they be considered as 'non-operating' in nature?

Going by the logic behind cost-plus arrangements, it would be an extreme view to not recharge such unutilised expenses at all. However, based on the exceptional situation currently, it might be possible to take a position that such expenses, being not utilized to render services, should only be recharged at cost without a mark-up. The service provider is entitled to mark-up for the services / activities that it performs for the other entity. However, in this case, the services were not performed and hence it could be good case to argue to recharge such costs without mark-up.

Going by the trend where Indian tax authorities have even sought to apply mark-up on recovery of pure expenses (unrelated to services), it could surely invite potential litigation and again the choice would be between cost of litigation v. cost of certainty.

Whether comparability analysis would require micro-level evaluation?

The OECD Transfer Pricing Guidelines as well as Transfer Pricing Regulations contained in the Income-tax Act, 1961 always considered the industry in which a company operates as well as market conditions an important factor for carrying out comparability analysis. However, since the business world has not witnessed a crisis where industries are impacted in a staggered manner (even the 2008 financial crisis did not impact industries differently), this principle has largely remained a theoretical concept until now.

Until now, while carrying out comparability analysis, functions performed and the product were considered important parameters for determining comparability. However, now, where different geographies and different industries are impacted differently by the crisis, the comparability analysis should also factor this aspect.

For example, where a database management company catering to both pharma sector as well as tourism sector would be considered comparable in pre-crisis period owing to their functional similarities, in the post-crisis period with pharma and tourism sector differently impacted, they cannot be held comparable owing to significant differences in the business and economic circumstances.

Another example could be of an electronics segment where a company engaged in assembly of mobile phones from components sourced from different countries is impacted because one of its assembly component was sourced from China until now. With Chinese manufacturers severely impacted by the pandemic, the supply has slowed down. In comparison, one of its comparable companies sourced all its components from a geography which is not as severely impacted and hence, is able to smoothly function post the mandatory lockdown. The comparability of these companies is also under question because of differences in their business circumstances.

How to tackle limited data availability for evaluation of comparables?

Clear preference for internal comparables

What emerges from this discussion is that in a post-crisis comparability analysis, whether internal or external, (i) entity characterisation (ii) economic circumstances (iii) sectors / customers served (iv) geographies are all important factors which need to be considered before concluding on the companies selected as comparable.

In effect, any external comparability analysis carried out in this scenario requires significant information for the probable comparable companies to meet the comparability test. In absence of complete information to evaluate these aspects, the comparability and hence, the arm's length analysis could give incorrect or misleading results.

Hence, any external comparable should ideally be used very judiciously and only as a last resort. Where internal comparables, whether transactional or functional, are available, they should be given a preference over external comparables, especially in this scenario.

Whether multi-year data provide realistic arm's length range?

The Indian Transfer Pricing Regulations require that margin earned by a company in one year has to be compared with margins earned by comparable companies for a three-year period (including 2 immediately preceding years).

Multi-year data has been generally considered more reliable on the ground that it generally covers a business cycle and iron out any extra-ordinary temporary differences. However, in this case, the tested party itself would be subject to extra-ordinary circumstances and hence it is possible to argue that because of the pandemic, prior period data is not comparable. Accordingly, the current year data of a company should only be compared to current year data of comparable companies.

However, this argument also comes with a stumbling block of availability of data of comparable companies for the current year, both from the perspective of availability of financials itself, or sufficient data for carrying out comparability analysis based on above factors.

Where data pertaining to current year is available, the companies may have provided certain disclosures in their financial statements pertaining to impact on their business due to the pandemic, which may be useful for carrying out the comparability as well as economic analysis. Especially for listed companies, this disclosure has been mandated by the SEBI and hence, any comparable listed company shall provide more insight into impact on its business and hence, lead to better comparability.

What adjustments can be made to eliminate differences if current year data is not available?

Where such data pertaining to current year is not available, certain adjustments can be made to the margin earned by a company in current year to arrive at a normalised margin, which can then be compared with margins earned by comparable companies in previous periods. These could include elimination of capacity utilisation differences on account of under-utilised fixed expenditure (e.g. employee cost and fixed overheads incurred during lockdown period which was unutilised), identifiable losses on account of business considerations, extra-ordinary expenses incurred for the purpose of coping with pandemic (e.g. expense incurred for sanitisation of premises, distribution of protective gear to employees, etc.).

Tax authorities have taken a position in past that adjustment or normalisation cannot be done in case of tested party, however, in absence of availability of proper and reliable data of current year of comparables, this could be one of the best ways to establish arm's length nature.

Alternatively, where adjustment needs to be made to margins earned by comparable companies in previous years, industry specific reports (or in absence of the same, GDP reports) giving information on COVID impact on industry could be taken as a statistical base for adjusting comparable margins. However, we may point out that this could be very crude and unreliable unless the base data has been properly collected and analysed.

Where segmental financial information is available, the companies can also apply the percentages of reduction in revenue and costs in case of sales to independent parties to the data of comparable companies in previous periods to arrive at a margin which shall be compared to margin earned by the company in case of sales to related parties.

In both the above cases, it is important to note that any computation based on statistics should be strongly backed by reasoning as to why the same can be applied to the company data, in absence of which, the adjustment could be rendered ineffective at the time of audit / assessment. Two factors shall be most important in determining the reliability of an adjustment (i) Simplicity (ii) Basis. If an adjustment is simple to be applied and understood and is based on strong documentary evidence, the same is more likely to be accepted by tax administration than a one based on complex statistics or assumptions which are not evidenced.

What impact will the current business scenario have on management fees, royalty, etc.?

As in a normal business scenario, any intra-group service shall have to fulfil the basic tenets of arm's length i.e. service rendition test, benefit test and the arm's length test. However, the foremost question that multinational groups will have to address is the 'need test' i.e. would a group company in these turbulent business circumstances avail the kind of services which are part of its management service portfolio if such an agreement was entered into with an independent enterprise.

If the need test is indeed satisfied, the other tenets would need to be substantiated very critically. Even in normal business circumstances, a stringent documentation for these services is a must. However, in these circumstances, these transactions could be in greater focus of the tax offices, who will undoubtedly look for *wolf in a sheep's clothing!*

Additionally, where such intra-group services / management fees are evaluated from the perspective of service recipient and aggregated with other transactions, until now an overall profit scenario may not have brought these transactions into questioning. However, with change in business circumstances and possibility of entities recording a loss in their books, the groups shall have to look at an alternative benchmarking methodology i.e. from the perspective of service provider. This shall be in addition to the stringent documentation required to substantiate the tenets discussed hereinabove.

Having regard to transactions of royalty, the same principle applies. As far as possible, an evaluation with other royalty / intangible property transactions may be a more appropriate method of benchmarking such transactions, especially when it is not possible to segregate the loss into (i) loss on account of business circumstances and (ii) loss on account of intra-group transactions.

One may look at suspending royalty charge for a temporary period, however, this would also need to be considered from the perspective of provider of the technology and the tax administration of that country may insist on continuing the royalty charge because the reduction in business was not on account of technology but on account of external factors.

Would my APA continue to apply in the same way or is there possibility of re-negotiation?

APAs are intended to provide tax certainty for transfer pricing issues. However, with the business circumstances changing so suddenly, the existing APAs will render the multinationals susceptible to tax adjustments for not meeting the agreed margins and conditions.

In respect of existing APAs however, there are a few items that need to be given consideration. One is that the agreement is based on FAR analysis as submitted during the discussions. However, in view of the current business situations and the altered risk profile (even functional profile in some cases), the functions actually performed, assets actually employed and risks actually undertaken by the group entities may be quite different from those envisaged and documented while entering into the APA. Secondly, APAs are based on critical assumptions which are documented therein, most likely containing a clause debarring transactions where the FAR profile is *materially* different. Taxpayers may evaluate these two factors and approach their transfer pricing compliance and assessments accordingly.

In respect of APAs being negotiated or proposed, the taxpayers have the option to either evaluate the material impact of Covid-19 once substantial and reliable data for comparable companies or industry in which the taxpayer operates is available, or withdraw from the application and defer the said plan until such time as the business circumstances have stabilised.

An additional issue for consideration is in respect of roll-back provisions. While APA regimes in most countries allow for roll-back provisions i.e. APA to be applicable to a certain number of earlier years as well, what is important for roll-back to apply is consistency in the business & economic scenarios as well as the functional analysis being evaluated.

In light of Covid-19, the business & economic circumstances for the roll-back period may be completely irreconcilable with the circumstances for current and future years and hence, such an agreement may not be plausible in this case.

Concluding Remarks

In any transfer pricing analysis, the documents and evidence in support of the evaluation are very important. Any analysis which is not backed by or evidenced by documentation is not aptly supported and hence, liable to questions. Especially in scenarios like these where the economic circumstances surrounding the transactions have an impact on re-characterisation of entities or change in the remuneration model or change in manner of computing the arm's length price, a record of the reports / statistics relied upon, assumptions made, decisions taken, etc. need to be documented meticulously.

Additionally, what is also important is documenting the analysis not from a single perspective but from the perspective of both entities to a transaction / arrangement. e.g. where a contract is re-negotiated, the circumstances of both the parties to the arrangement shall be required to be documented. A simple parallel comparison with industry from one entity's perspective might not suffice.

Based on the entire discussion, the businesses shall be required to look at transfer pricing, not only from a compliance viewpoint, but also to understand the appropriate margins for companies in its supply chain and rationalise the distribution of profits across group entities.

It should also be noted that orthodox benchmarking methodologies including review of a company's financials may not provide the required insight into economic and business circumstances of the company, and hence, an evaluation from industry standpoint, finance media, etc. may provide additional insight.

Further, while the general business circumstances will favour a loss-making entity and hence, a certain leeway because of uncertainties and data unavailability may be expected, any opportunistic adjustment or transaction may be taken very negatively by the tax offices.

Should you need more information, kindly reach out to

Stuti Trivedi

Senior Manager

stuti.trivedi@kcmehta.com

+91 79 4910 2231 (Direct)

+91 99982 40000 (Handheld)

Locations

Ahmedabad

Arpit Jain

Level 11, Tower B,
Ratnaakar Nine Square,
Vastrapur,
Ahmedabad - 380 015

+ 91 79 4910 2200
arpit.jain@kcmehta.com

Bengaluru

Payal Shah

19/4, Between 7th & 8th Cross,
Malleswaram,
Bengaluru - 560 003

+91 80 2356 1880
payal.shah@kcmehta.com

Mumbai

Vishal Doshi

508, The Summit Business Bay,
Nr. WEH Metro Station,
Gundavali, Andheri East,
Mumbai – 400 069

+91 22 2612 5834
vishal.doshi@kcmehta.com

Vadodara

Milin Mehta

Meghdhanush,
Race Course,
Vadodara - 390 007

+91 265 2440400
milin.mehta@kcmehta.com

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