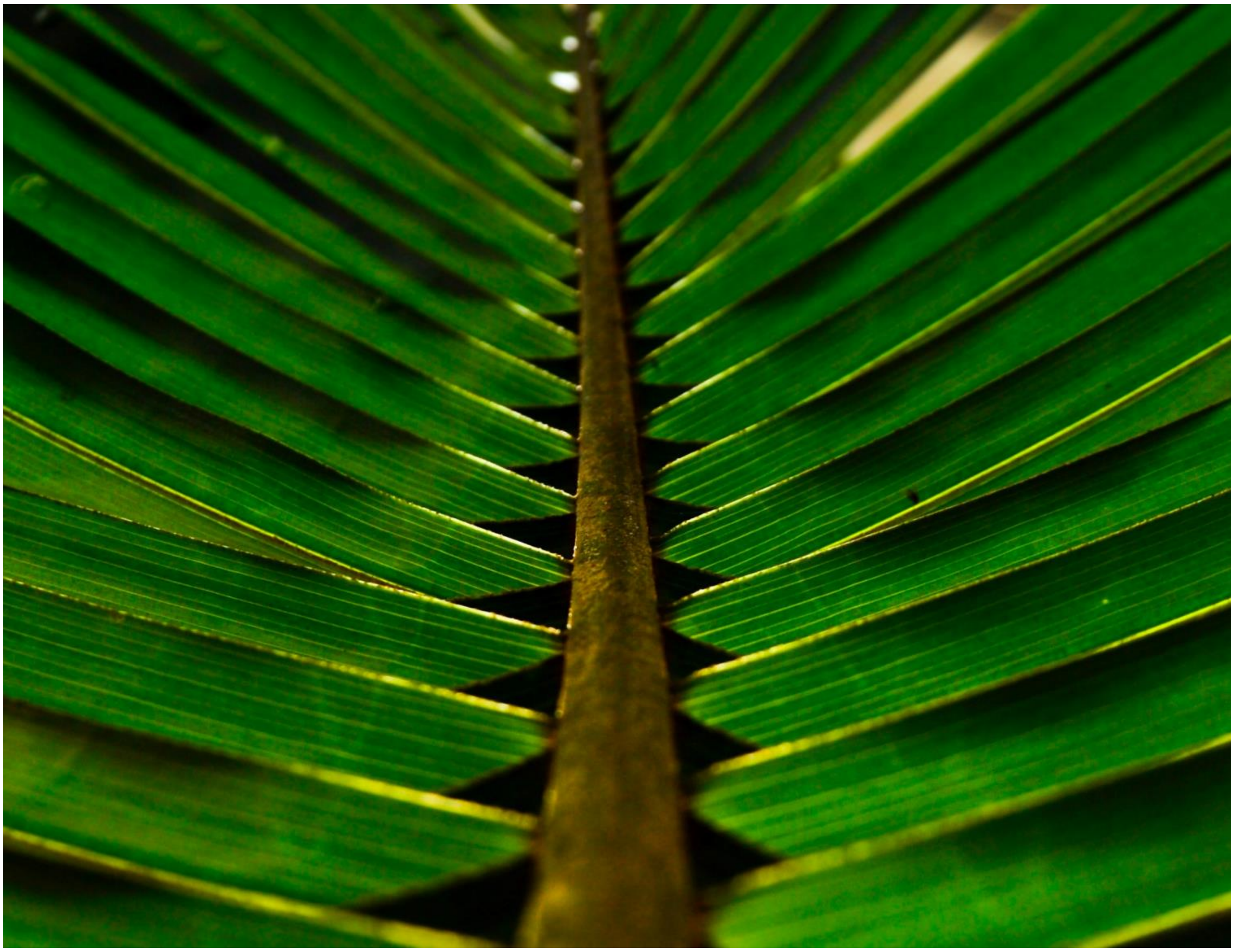
COVID-19 & Transfer Pricing

Impact and opportunities



Although MNEs are currently facing challenges that are likely more pressing than taxation/transfer pricing, the current crisis may also provide opportunities in this field. MNEs are advised to investigate these transfer pricing opportunities and act urgently to (i) reduce the current tax expense by amending intercompany prices and (ii) timely substantiate these changes in their transfer documentation. In this post we further explore these opportunities from a Dutch transfer pricing perspective. If you wish to discuss the below in more detail, please indicate this to your Atlas contact or our transfer pricing specialists so that we can contact you for an online meeting.

Impact on businesses

Despite the uncertainty surrounding the COVID-19 outbreak (the "Outbreak"), we can see that it forms a clear and present danger for the global economy. The Outbreak has already led to an abrupt reduction and termination of business activities on a global scale. Supply chains of many businesses are disrupted. For many businesses this leads to a reduced demand of products and services, staff reductions and lower consumer confidence. Businesses are mobilizing all their forces and energies to manage cashflow needs and at the same time trying to keep their business afloat. Due to significantly reduced revenues and at the same time increased expenses, many MNEs will either face (consolidated) losses, or experience significantly impacted operating results in 2020 - and perhaps further on.

Impact on transfer pricing / tax positions

The economic impact of the Outbreak will have obvious tax and transfer pricing consequences for MNEs, in particular those with centralized business models. Due to the set-up of such models, limited risk entities ("LREs") will often report steady positive taxable income whilst they may, on a consolidated basis, report losses in 2020. We currently see the following impact of the Outbreak from a transfer pricing point of view:

- 2020 tax cash out for LREs reporting steady positive income while the business is faced with cash flow needs.
- Local and/or entrepreneur's tax authorities challenging the deduction of extraordinary expenses or losses.
- Increased intercompany financing needs due to a local lack of liquidity.

Due to the ongoing developments in the transfer pricing landscape following BEPS, MNEs should not only focus on substantiating amended pricing, but also the commercial rationale for changing the intercompany transactions itself.

We currently see that MNEs are reviewing the impact of the Outbreak on their current transfer pricing models. We expect that in the next days and weeks many MNES will decide to take any of the following actions:

- Amend intercompany agreements for existing transactions.
- Conclude agreements for new intercompany transactions (e.g. crisis management services)
- Request reduced preliminary 2020 CIT assessments.
- Substantiate amended and new intercompany agreements and transfer pricing positions in the 2020 CIT return and in BEPS compliant transfer pricing documentation.

Opportunities

What to do now ('price setting')?

MNEs with centralized business models may decide to reduce 2020 tax cash out for LREs by reducing intercompany pricing, or to report losses for such subsidiaries. This requires a review of intercompany agreements from a (i) legal and/or (ii) economic perspective.

i. From a legal perspective, amending pricing in intercompany agreements may be possible based on the existence in these agreements of e.g. price adjustment, force majeure or termination clauses. In the absence of such clauses, reference can be made to behavior of third parties under commercial law; and

ii. From an economic perspective, in addition to the legal review or in the absence of intercompany agreements, MNEs will need to analyze the possibility to amend current intercompany transactions in line with actual conduct of the parties involved. This analysis will need to focus on (a) which party to the transaction performs which functions, and manages and incurs which risks, (b) the behavior we currently see between third parties and (c) whether the price adjustment can be considered commercially rational for both parties involved (taking into account "options realistically available", or ORAs)

Based on the outcome of this analysis, the pricing of intercompany transactions may be reduced as follows (with increasing controversy risk for each subsequent option):

- Lower quartile (or the minimum) of the full range;
- Cost-plus 0% (i.e. recharging costs without mark-up);
- Cover variable expenses; or
- 'Excess' or full loss absorption.

Such amendment should be governed by revised or amendments to existing intercompany agreements.

What to do later ('price testing')?

The amendment of the transfer prices should be documented in the local transfer pricing files drawn up for FY2020 (and potentially later years), containing benchmarking analysis used to test the revised intercompany prices.

Specifically for Dutch LREs, it should be noted that on the basis of the Dutch Transfer Pricing Decree, they are allowed to apply pricing in line with the lower quartile of the range. Even a price below the range, which may result in a loss for the year under review, may be accepted provided that, on the basis of a multi-year moving average, the price falls within the range. The Dutch Transfer Pricing Decree further allows taxpayers the possibility to apply a 0% mark-up on cost for activities that qualify as "low-value intragroup services". If these pricing options are applied, taxpayers will need to properly substantiate the applicability of these options in their transfer pricing documentation and (internal) notes to the (2020) tax return.

Editorial Team

Frank Schwarte
fs@atlas.tax
T +31 205 354 550
Atlas Tax Lawyers

Taco Wiertsema
tw@atlas.tax
T +31 202 376 233
Atlas Tax Lawyers

Joris Steunenberg
js@atlas.tax
T +31 202 376 247
Atlas Tax Lawyers

Mick Willemsen
mw@atlas.tax
T +31 202 376 248
Atlas Tax Lawyers

Eli van Exel
eve@atlas.tax
T +31 202 376 284
Atlas Tax Lawyers

Andy Neuteleers
andy@TAeconomics.com
T +32 471 892 316
T/A economics

Ben Plessers
ben@TAeconomics.com
T +32 494 397 002
T/A economics

Heleen van Baelen
heleen@TAeconomics.com
T +32 477 560 206
T/A economics

Kenny van Tulder
kenny@TAeconomics.com
T +32 498 74 62 29
T/A economics

Bert Naegels
bert@TAeconomics.com
T +32 498 74 62 01
T/A economics

Eduard van Nevel
eduard@TAeconomics.com
T/A economics

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