MOORE

TRANSFER PRICING BRIEF

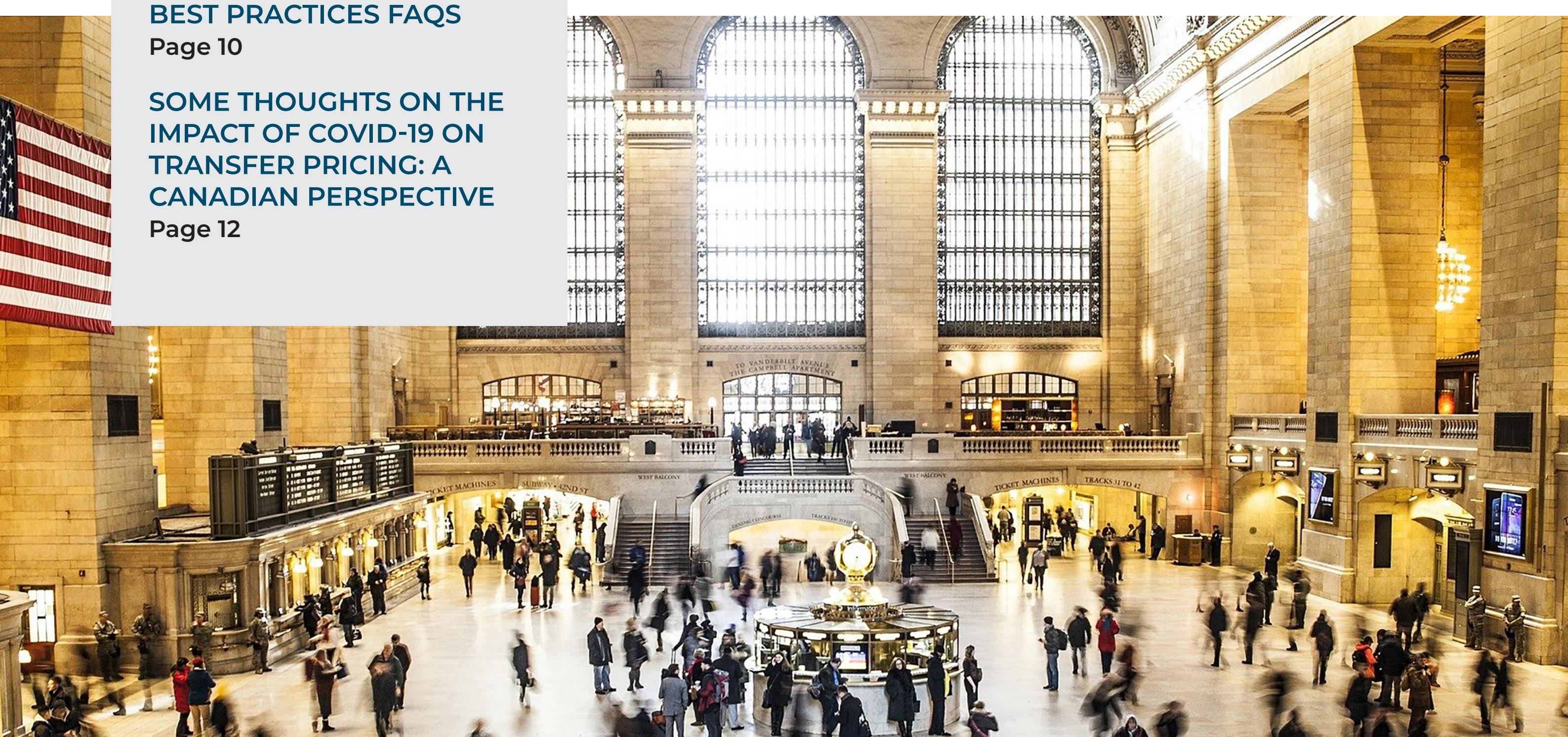
October 2020

CONTENTS

INTRODUCTION

Welcome to this, Issue No 3 of 2020 of Moore's Transfer Pricing Brief. This issue has a wholly North American flavour.

Jackie Honeycutt and **Paul Currie**, from Elliott Davis, set the scene in their broad introduction to transfer-pricing law and practice in the United States, while **Nghi Huynh** and **Jon Davies** of Armanino discuss the latest repercussions from the Altera case as it winds its way through the US courts and Nghi comments on the TP Documentation Best Practice FAQs recently published by the IRS. As the COVID-19 pandemic continues to dominate both the political and public-health agenda, **Rita Chung** from Citrin Cooperman and **Christina Leonard** from law firm Sandler, Travis & Rosenberg suggest how MNEs with one or more routine entities abroad performing limited-risk functions should revisit their existing transfer-pricing policy and identify opportunities to improve their cash position, while **Avinash Tukrel** from Canadian firm Segal surveys the impact of COVID-19 on the TP environment in Canada.



INTRODUCTION TO US TRANSFER PRICING

Section 482 of the Internal Revenue Code ('IRC') and the regulations thereunder provide that transfer prices within a controlled group must be consistent with an arm's length standard. The arm's length standard is considered to be met if results of a controlled transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.

Regulations issued under section 6662 IRC further provide that substantial or gross valuation-misstatement penalties can be imposed for failure to comply with transfer-pricing rules and regulations. In order to avoid the imposition of these penalties, a taxpayer must apply a method of evaluating its transfer prices that provides the most reliable measure of arm's length transfer pricing and the taxpayer must comply with strict contemporaneous documentation requirements.

TRANSFER PRICING – GENERAL CONCEPTS

Section 482 of the Internal Revenue Code allows the Secretary of the Treasury (through the Internal Revenue Service ('IRS') to make adjustments to 'clearly' reflect the income of any two or more entities, trades or businesses transacting with each other.

Clear reflection of income is based on the arm's length principle. Under the arm's length principle, related taxpayers must set transfer prices for any intercompany transaction as if they were unrelated entities transacting under the same circumstances.

Transactions determined by the IRS not to be at arm's length may be adjusted. Any adjustments resulting in tax may also carry a 20% or 40% penalty. The transfer-pricing penalties may potentially be avoided only if a taxpayer can demonstrate that it had a reasonable basis for believing that its transfer pricing would produce arm's length results, and appropriate documentation of the analysis upon which that belief was based existed at the time the tax return was filed.

BEST-METHOD RULE (TREASURY REGULATION §1.482-1(C))

A taxpayer must select one of the pricing methods specified in the section 482 regulations to test the arm's length character of its transfer pricing. Under the Best-Method Rule, the pricing method selected, under the facts and circumstances of the transactions under review, should provide the most reliable measure of an arm's length result, relative to the reliability of the other potentially applicable methods. The relative reliability of the various transaction-based pricing methods depends primarily upon:

- the use of comparable uncontrolled transactions and the degree of comparability between those transactions and the taxpayer's transactions under review; and
- the completeness and accuracy of the underlying data and the reliability of the assumptions made and the adjustments required to improve comparability.

Adjustments must be made to the uncontrolled comparables if such adjustments will improve the reliability of the results obtained under the selected pricing method. Determination of the degree of comparability is based on an analysis made to identify the economically significant functions performed, assets used and risks assumed by the controlled and uncontrolled parties involved in the transactions under review.

METHODS LISTED IN THE SECTION 482 REGULATIONS

The arm's length amount charged in a controlled transfer of tangible property must be determined under one of the six methods listed in Treasury Regulation §1.482-3(a):

- Comparable Uncontrolled-Price Method
- Resale-Price Method
- Cost-Plus Method
- Comparable-Profits Method (see also Treasury Regulation §1.482-5)
- Profit-Split Method (see also Treasury Regulation §1.482-6) and
- Unspecified Methods: Methods not specified above may be used to evaluate whether the amount charged in a controlled transaction is arm's length. Any unspecified method must be applied in accordance with the provisions of Treasury Regulation §1.482-1.

In addition, the section 482 regulations provide guidance as follows:

§1.482-2: Loans or Advances

§1.482-4: Intangible Property

§1.482-7: Cost-Sharing Arrangements

§1.482-9: Services

COMPARABLE-PROFITS METHOD V. TRANSACTIONAL NET-MARGIN METHOD

The Comparable-Profits Method ('CPM'), similarly to the Transactional Net-Margin Method ('TNMM'), is the most commonly used transfer-pricing method. The question of whether the TNMM can be used for US transfer-pricing documentation frequently arises for US subsidiaries of parent companies located in countries whose transfer-pricing documentation requirements are aligned with the OECD transfer-pricing guidelines. Practically speaking, the TNMM is analogous to the CPM and if applied appropriately, would likely result in similar conclusions. However, in preparing transfer-pricing documentation that is intended to justify a company's US transfer-pricing position, care should be taken to assess whether the TNMM documentation satisfies the US transfer-pricing and contemporaneous-document regulations, and in particular, whether the requirements under Treasury Regulation §§1.482-5 and 1.6662-6(d) have been met. Furthermore, using TNMM as the transfer-pricing method may suggest to a reader that the documentation was not prepared pursuant to US transfer-pricing regulations. Thus, while a TNMM analysis could be leveraged for a CPM analysis, it would perhaps be more prudent to perform a transfer-pricing study based on US rules and regulations.

ACCEPTABLE PROFIT-LEVEL INDICATORS UNDER THE CPM

Proving an arm's length result in controlled transactions under the CPM necessitates the selection of an appropriate profit-level indicator ('PLI'). PLIs are ratios that measure relationships between profits and costs incurred or resources employed. Per Treasury Regulation §1.482-5(b)(4), factors that determine an appropriate PLI selection include the nature of the activities of the tested party, the reliability of the available data with respect to uncontrolled comparables, and the extent to which the PLI is likely to produce a reliable measure of the income that the tested party would have earned had it dealt with controlled taxpayers at arm's length. As discussed in the next section, PLIs should be derived from a sufficient number of years of data to reasonably measure returns that accrue to uncontrolled comparables, generally encompassing the taxable year under review and the preceding two taxable years. PLIs that may provide a reliable basis for comparing operating profits of the tested party and uncontrolled comparables include the following:

- **Rate of Return on Capital Employed** – the rate of return on capital employed is the ratio of operating profit to operating assets. Reliability of this PLI increases as operating assets play a greater role in generating operating profits for both the tested party and the uncontrolled

comparables. Additionally, composition of the tested party's assets must be similar to uncontrolled comparables for this PLI to provide reliable results.

- **Financial Ratios** – financial ratios measure relationships between profit and costs or sales revenue. Functional differences must be evaluated before selecting financial ratio PLIs, as functionality has a greater effect on the relationship between profit and costs or revenue than the relationship between profit and operating assets. As such, closer scrutiny of functional comparability to uncontrolled comparables is needed to ensure a reliable arm's length result. Common financial ratios that may be appropriate include the following:
  - Ratio of operating profit to sales and
  - Ratio of gross profit to operating expenses, also known as the Berry Ratio. The Berry Ratio is typically applied when the tested party operates as a distributor, as the composition of the tested party's operating expenses must be similar to that of uncontrolled comparables.
- **Other Profit-Level Indicators** – other PLIs not described under Treasury Regulation §1.482-5(b)(4) may be used if they provide reliable measures of the income that the tested party would have earned had it dealt with controlled taxpayers at arm's length.

RELIANCE ON MULTIPLE-YEAR DATA

As discussed under Treasury Regulation §1.482-1(f)(2)(iii), results of a controlled transaction will ordinarily be compared with the results of uncontrolled comparables occurring in the taxable year under review. It may be acceptable, and appropriate, to consider data relating to the uncontrolled comparables or the controlled taxpayer for one or more years before or after the year under review. The extent to which it is appropriate to consider multiple-year data depends on the method being applied and the issue being addressed. Factors that may warrant the use of multiple-year data include the extent to which complete and accurate data are available for the taxable year under review, the effect of business cycles in the controlled taxpayer's industry, or the effects of life cycles of the product or intangible property being examined. While use of multiple years of data is often appropriate under the CPM method, it is ordinarily not considered for purposes of applying the comparable uncontrolled-price method, except to the extent that risk or market-share strategy issues are present. Finally, if use of multiple-year data reduces the effect of short-term variations that may be unrelated to transfer pricing, it may be appropriate to conduct an analysis using average results over a multiple-year period

.

CONTEMPORANEOUS DOCUMENTATION (TREASURY REGULATION § 1.6662-6(D))

An amount is excluded from the net increase to taxable income from transfer-pricing adjustments and thus not subject to penalties if:

(a) a taxpayer selects and applies, in a reasonable manner, a specified method that provides the most reliable measure of an arm's length result given the nature of available data and

(b) meets the documentation requirement. The documentation requirement is met if the taxpayer maintains sufficient documentation to establish that the taxpayer reasonably concluded that, given the available data and the applicable pricing methods, the method selected (and its application of that method) provided the most reliable measure of an arm's length result under the principles of the best-method rule and the taxpayer provides that documentation to the IRS within 30 days of a request for it in connection with an examination of the taxable year to which the documentation relates. That documentation must be in existence when the return is filed but is not provided to the IRS until requested.

The following principal documents, listed in detail at Treasury Regulation § 1.6662-6(d)(2)(iii)(B), are commonly referred to as contemporaneous documentation:

- Overview of business;
- Organisational structure;
- Documentation specifically required by IRC 482 and the regulations thereunder;
- Description of method chosen;
- Explanation of methods not chosen;
- Description of controlled transactions;
- Description of the comparables;
- Explanation of economic analysis;
- Relevant year-end data, and
- Index

The IRS may also request background documents and data that support the principal documentation provided.

AFFIRMATIVE USE OF SECTION 482 (TREASURY REGULATION §1.482-1(A)(3))

Generally, section 482 may only be used by the IRS. However, taxpayers are allowed to invoke section 482 under certain situations:

- On a timely filed US income tax return, the taxpayer is reporting the results of a transaction which differ from the actual prices charged but is doing so to clearly reflect an arm's length result.
- In appropriate circumstances, the IRS may permit amended returns that increase taxable income if the results are otherwise at arm's length.
- A taxpayer may request a set-off when the IRS proposes a section 482 allocation. The set-off transactions must be between the taxpayer and the same controlled party involved in the proposed section 482 adjustment, be in the same tax year and follow certain procedural requirements.

For any transfer-pricing adjustments made, customs ramifications and any necessary correlative adjustments would need to be considered.

Taxpayers are not allowed to file an untimely or amended return that decreases US taxable income based on allocations with respect to controlled transactions. Thus, if taxable income is increased due to a transfer-pricing audit of a related party in another jurisdiction, and a US entity is party to that transaction, the US entity would not be allowed to reduce its US taxable income to correspond to the increase in the taxable income of its related party. However, the US taxpayer may have access to double tax relief and the Mutual Agreement Process ('MAP') under a relevant income tax treaty, if applicable.

TAX-PROVISION CONSIDERATIONS (ASC 740)

ASC 740 requires a jurisdiction-by-jurisdiction analysis. As discussed above, adjustments in one jurisdiction may not be offset in the other jurisdiction. In that event, a permanent increase of the effective tax rate may result, or an uncertain tax position should be booked if circumstances warrant a reserve instead (e.g. if seeking relief under the MAP). On an ongoing basis, not only should the existence of adequate contemporaneous documentation be evaluated, but also the impact of a US taxpayer's transfer-pricing position on its US tax liability for purposes of the tax provision.

CONCLUSION

Transfer-pricing continues to be high on the list of priorities for the IRS, which recently posted 'Transfer Pricing Documentation Frequently Asked Questions' on its website irs.gov. Arguably, however, documentation of transfer pricing should be the last step of a critical process for related entities transacting with each other across multiple jurisdictions. Proactively determining the group's transfer-pricing policies and refreshing those policies on a regular basis and in light of global economic shifts, such as those caused by the COVID-19 pandemic, is a best practice that would not only help to avoid inadvertent tax 'foot faults' but also allow the multinational enterprise effectively to manage the global tax impact of its value chain.

JACKIE HONEYCUTT

Elliott Davis LLC
+1 864 370 5694
jackie.honeycutt@elliottdavis.com

PAUL CURREY

Elliott Davis LLC
+1 864 250 3930
paul.currey@elliottdavis.com

STOCK-BASED COMPENSATION SHOULD BE INCLUDED IN COST-SHARING ARRANGEMENTS, COURT AFFIRMS

By deciding not to review the lower court's judgment in the *Altera* case, the US Supreme Court has effectively confirmed that stock-based compensation (SBC) should be included in valuing cost-sharing arrangements for US tax transfer-pricing purposes when intangible assets are moved abroad.

In *Altera Corp & Subsidiaries v Commissioner* (9th Cir. July 24, 2018), the US Court of Appeals for the Ninth Circuit upheld the validity of Internal Revenue Service (IRS) Regulations that force companies to include stock-option compensation in cost-sharing arrangements when valuing transfer prices on an export of intangible assets. In its decision, the Court of Appeals overturned a lower Tax Court decision that invalidated the Regulations. Altera, which is owned by Intel, appealed to the Supreme Court for a review.

Since the Supreme Court decided to not review the Altera case, the Ninth Circuit's decision will be the final word on the SBC issue. The Ninth Circuit's decision will be precedent for taxpayers resident in the Ninth Circuit (i.e. California, Washington, Oregon, and several other Western states).

However, taxpayers outside the Ninth Circuit can continue to rely on the Tax Court opinion that invalidated the regulations requiring related parties to share the costs of SBC in cost-sharing arrangements (CSAs) on the grounds that they violate the Administrative Procedure Act. Therefore, a taxpayer's location is a key factor in considering the implications of the *Altera* issue.

WHOM DOES THIS AFFECT?

- It applies to all entities with cost-sharing arrangements that have excluded Stock Based Compensation from cost-sharing reimbursements based on the prior Tax Court ruling.
- It also has implications in situations where stock-based compensation is not included in cost pools for service transactions.

REVERSE CLAW-BACKS

Taxpayers should review their CSA agreements for the taxpayer's reverse claw-back provisions to determine the adjustments that need to be made to share SBC costs retroactively.

- Generally, adjustments to cost-sharing transactions should be allocated to the tax years in which the intangible development costs were incurred, meaning amending tax returns for open years. Taxpayers can consider filing an amended return sharing SBC before it is under examination by the authorities. A taxpayer may not file a Qualified Amended Return ('QAR') for a year under examination. However, without more IRS guidance, it is uncertain whether taxpayers are better off reporting the adjustment in the current year or not in light of COVID-19 and the NOL (net operating loss) carry-back provisions.

- Including SBC adjustments in the current year will likely lead to increased taxable income, but it may be a better answer since the corporate tax rate is 21% rather than the pre-2018 tax rate of 35%.
- Any Section 482 (transfer pricing) adjustments to share SBC could reduce E&P (earnings and profits) in the foreign participant – leading to adjustments in section 965 calculations or reduce tested income in section 951A calculations. The Tax Cuts and Jobs Act 2017 ('TCJA') added section 965 to the US Tax Code. Broadly, this section requires US shareholders to pay a transition tax on untaxed foreign earnings of certain specified foreign corporations, as if those earnings had been repatriated to the US. Section 951A pertains to the new federal tax on global intangible low-taxed income ('GILTI') that is also part of the TCJA and is intended to tax a US shareholder's share of its controlled foreign corporation's GILTI, using a lower-than-ordinary effective rate of 10.5%.
- Taxpayers may face double taxation if the SBC expenses cannot be deducted in the current year or prior years in the foreign jurisdictions.

ASC-740

Generally, most taxpayers should have accrued a tax provision for the additional income and interest in the US if SBC had been included in the cost-sharing arrangements over the summer of 2019 when the Ninth Circuit released its decision.

PENALTIES

Taxpayers that have not been sharing the costs of stock-based compensation may be exposed to penalties. Penalties that could apply include the penalty for negligence or disregard of the Regulations (20%) and the transfer-pricing net-adjustment penalty (20% or 40%). If taxpayers have not been including SBC expenses in their CSAs, existing transfer-pricing documentation does not preclude the IRS from asserting penalties since the taxpayer did not follow the relevant requirements set forth in regulations under section 482.

DO NOTHING

Alternatively, taxpayers may want to wait until any future IRS audits before making any changes.

FINANCIAL IMPACT AND TIMING

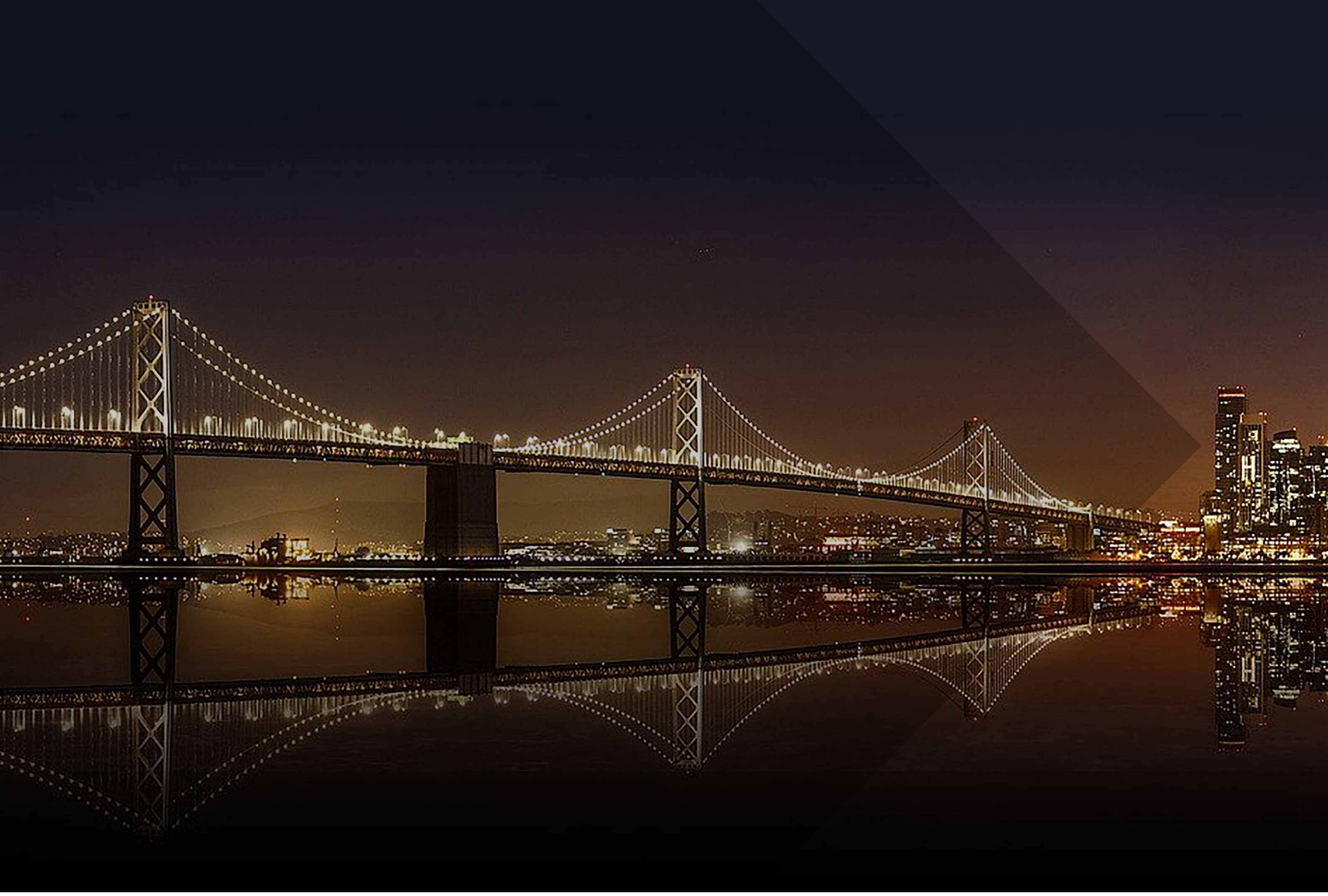
The impact of including SBC in the QCSA should be reviewed for the quarterly provisions, year-end, estimated tax payment and other reporting requirements.

NGHI HUYNH CPA

Armanino LLP, San Jose
+1 408 200 6429
nghi.huynh@armaninollp.com

JON DAVIES CPA

Armanino LLP, San Jose
+1 408 200 6411
jon.davies@armaninollp.com



TRANSFER PRICING, IMPORT SAVINGS, AND COVID-19

Many businesses around the globe are facing significant financial challenges due to COVID-19. Disruption in the global supply chain, mandatory quarantine/lockdowns, and significant increases in unemployment rates are contributing to changes in consumption patterns, thereby causing cash-flow issues for many businesses.

Multinational enterprises (MNEs) are facing a growing list of issues and challenges during the crisis and transfer pricing is on that list. For MNEs with structures comprised of a principal and one or more routine entities, performing limited-risk functions whereby the routine entity is compensated at a certain guaranteed profit level, this may be a good time to revisit the existing transfer-pricing policy and identify opportunities to improve its cash position.

The MNE may be able to decrease the tax liability in those taxing jurisdictions where the routine entity operates by analysing and re-evaluating the arm's length range of profit level that the routine entity should earn, given the economic environment. There may be certain adjustments that may be performed to support the lower arm's length range (potentially break-even, or even losses) of profits that the routine entity should earn. This will be especially beneficial if the credit for tax payments made in a foreign jurisdiction cannot be utilised in the principal's taxing jurisdiction due to various limitations. A word of caution when performing such modifications: supporting analysis and documentation are absolute necessities.

Another opportunity for cash-flow improvement is customs duty refunds. If the projected sales for the foreseeable future have decreased significantly, but there is no correlative decrease in operating costs, e.g. fixed costs, the routine entity could face significant losses, which is most likely not acceptable from a transfer-pricing perspective. To avoid such a predicament, the principal may need to modify the future price of goods sold to the routine entity or perform an adjustment on the price of goods already

sold to the routine entity. In order to claim a customs duty refund for the reduction in the transfer price of goods, there are certain procedures that must be followed.

The most commonly used procedure an importer (routine entity) can utilise is US Customs and Border Protection's (CBP) reconciliation program. Reconciliation allows the importer to flag entries at the time of importation, declare the transfer price at the time of entry, and complete, or reconcile, the transfer price (upwards or downwards) no later than 21 months after importation. Note that the importer (routine entity) must also have a pre-existing transfer-price policy that it adheres to for determining the value of any transfer-price adjustments and satisfy the arm's length pricing requirements set forth in the Customs Regulations (19 CFR Part 152) prior to import.

Participating in the CBP's reconciliation program provides the importer (routine entity) with a mechanism for reporting transfer-price adjustments to CBP that impact the customs value of imported goods. Failure to report increases to the customs value could expose the importer to customs penalties under 19 USC Section 1592. However, in situations where the transfer-price adjustments decrease the customs value of imported goods, and thus the customs duties owed, reconciliation can be used as a mechanism for seeking customs duty refunds.

RITA CHUNG

Citrin Cooperman & Company, LLP
+ 1 646 979 3953
rchung@citrincooperman.com

CHRISTINA LEONARD

Sandler, Travis & Rosenberg, P.A.
+1 212 549 0143
cleonard@srtrtrade.com

IRS PUBLISHES TRANSFER-PRICING DOCUMENTATION BEST PRACTICES FAQS

EMPHASISES NEED FOR BETTER DOCUMENTATION

In general, a taxpayer may avoid penalties described in Internal Revenue Code (IRC) § 6662(e) by maintaining contemporaneous transfer-pricing documentation meeting the requirements of section 482 regulations. In January 2018, the IRS Large Business & International Division (LB&I) issued a directive to agents not to waive the penalties for mere existence of transfer-pricing documentation but to examine the adequacy and reasonableness of the documentation. To promote higher-quality transfer-pricing documentation, the IRS (Internal Revenue Service) recently published a list of frequently asked questions (FAQs) on Transfer Pricing Documentation Best Practices. Below are some notable points:

- **FAQ 1** explains the benefits to taxpayers who invest in robust transfer-pricing documentation, notably that a limited-risk distributor may incur losses due to unusual business circumstances such as reduction in sales and not due to incorrect intercompany pricing. Having inadequate information reduces the reliability of the transfer-pricing documentation and increases the time and length of the audit involving multiple rounds of Information Document Requests (IDRs).
- **FAQ 2** recommends that taxpayers consider conducting a self-assessment of the potential indicators of transfer-pricing non-compliance such as sensitivity analysis of search parameters used, strength of the benchmarking set, comparing tested-party results with a variety of profit-level indicators, and evaluating how system profits are shared between related parties.
- **FAQ 3** explains the IRS's guiding principle in establishing arm's length price by emphasising compliance with the section 482 regulations. Additionally, IRS stresses the importance of providing complete information on the economic analysis and need and application of comparability adjustments to take into account the current business environment.
- **FAQ 4** identifies the areas in transfer-pricing documentation that could benefit from improvement:
  - Industry and Company Analysis sections are a place for a taxpayer to 'tell its story' and provide context for related-party transactions.
  - Functional Analysis should be well-supported factually, linking the business's operational structure to the subject transactions and intercompany pricing, and explain how and where the value is created that supports the allocation of profits among the parties.
  - Risk Analysis should be consistent with intercompany agreements since they generally establish how risks are allocated.
- **FAQ 5** illustrates the features of most useful transfer-pricing documentation which touches upon similar areas as those of **FAQ 4**.
- **FAQ 6** provides an example presentation of a company's intercompany transactions that would be helpful summary for examiners to use in risk assessment. Providing a summary of the intercompany transactions at the beginning of the documentation helps the IRS deselect certain transactions from the scope of audit, saving time. (See example grid to the right).

NGHI HUYNH

Armanino LLP, San Jose
+1 408 200 6429
nghi.huynh@armaninollp.com

<table>
<tr><th colspan="12">Sample Intercompany Transaction Summary</th></tr>
<tr><th colspan="12">Thousands USD</th></tr>
<tr><th>Country</th><th>Transaction</th><th>TP Doc Location</th><th>APA</th><th>Amt Reported Local Tax</th><th>Transfer Pricing Policy</th><th>Transfer Pricing Method</th><th>Tested Party</th><th colspan="3">Benchmark Range</th><th>Actual Results</th></tr>
<tr><td rowspan="3">CA</td><td rowspan="3">XYZ America License of Trademarks, know how</td><td rowspan="3">A1</td><td rowspan="3">Y</td><td rowspan="3">$12,345</td><td rowspan="3">Royalty Rate-2% of Net Sales</td><td rowspan="3">CUT</td><td rowspan="3">N/A</td><td rowspan="3">Royalty Rate</td><td>LQ</td><td>2%</td><td rowspan="3">2.10%</td></tr>
<tr><td>M</td><td>3.4%</td></tr>
<tr><td>UQ</td><td>4.3%</td></tr>
<tr><td>IT</td><td>XYZ America purchase of product form from F Sub for distribution to US Market</td><td>B2</td><td>N</td><td>$23,456</td><td>Cost Plus 10% Markup</td><td>CPM(3yr)</td><td>XYZ</td><td>OM</td><td>LQ</td><td>1.6%</td><td>OM=2.9%</td></tr>
</table>

SOME THOUGHTS ON THE IMPACT OF COVID-19 ON TRANSFER PRICING: A CANADIAN PERSPECTIVE

The world as we know it has changed and continues to rapidly change because of COVID-19 and ongoing political developments, such as the upcoming elections in the United States, the United Kingdom's impending effective exit from the European Union ('Brexit' – although the UK formally left the EU on 31 January 2020, during the transitional period which ends on 31 December 2020, there has been no effective change in trade terms), trade wars between economic superpowers, and climate change, among other global emergencies.

COVID-19 was categorised as a pandemic by the World Health Organization (WHO). This pandemic has not just impacted individual health and stretched healthcare systems worldwide, it has substantially impacted the world's financial markets and economies, affecting global supply chains and profitability for years to come.

China had to initiate factory lockdowns early on, which impacted global production output and caused delays in distribution to end-markets. Factory closures in China and lockdowns in key economic centres worldwide, had a domino effect on other industries such as oil and gas, airlines and hospitality and retail, among others. Governments worldwide have announced emergency fiscal measures including the slashing of interest rates by central banks on borrowings to insulate their economies from the effects of recession.

While the macro-economic impact of the COVID-19 crisis continues to be evaluated, it is critical that multinational corporations that are operating cross-border and entering into inter-company transactions, manage their response to this development. This would include assessing the impact the crisis has had on their profitability as well as a potential overhaul of their global supply chains. Some considerations to note from a transfer-pricing perspective are:

REVISIT TRANSFER PRICING MODELS AND POLICIES

In instances where a multinational group has had a significant impact on its performance and chooses to restructure its operations by reallocating functions, assets and risks ('FAR') better to manage its supply chain it will be important that the transfer-pricing model / policy be revisited and updated accordingly. Where this results in a change to the transaction profile as well as the terms and conditions that govern inter-company contracts (examples include, an increase in inter-company financing and related guarantees, increase/decrease in sale/purchase prices, interactions due to inter-company services, negotiation of customer contracts, change to credit terms, impact on inventory flows due to supply disruptions, among others), it could result in changes to inter-company pricing bases and the arm's length returns attributable to each entity involved. It should not be assumed in the current environment, where the parent entity that traditionally performed key functions, owned high-value assets (including intellectual property) and assumed significant risks, would be the only entity to centralise group-wide losses while the other entities remain profitable.

PERFORM FUNCTION, ASSET AND RISK AND VALUE-CHAIN ANALYSIS

While updating transfer-pricing policies and inter-company pricing models, it is critical that the multinational group perform a thorough value-chain analysis to reflect changes that may have occurred in each of the entity's key functions, asset ownership and assumption of risks.

ECONOMIC ANALYSIS

One of the key principles when performing an economic analysis to determine the arm's length range of returns to substantiate a taxpayer's position is that significant events be factored in and such analysis be revisited. The traditional practice of updating or a roll-forward of comparable company benchmarks / prices using the comparable uncontrolled-price (CUP) method, are unlikely to reflect the most up-to-date economic realities faced by the multinational group. That being so, taxpayers may have to consider the following options:

- Reallocation of the FAR and use of the Profit-Split Method (PSM) – taxpayers may potentially consider adoption of the profit-split approach and allocate profits/losses, if suitable. However, when adopting the PSM, it is crucial that several (stringent) conditions are met and there is a clear identification of value generated by each entity involved, resulting in the allocation of profits/ losses. Not only will a simplistic approach to adopting the PSM be likely to attract scrutiny, it will also be challenging to document the rationale and support the arm's length nature of such an allocation.
- Consistent loss-making comparable benchmarks – when performing a benchmarking study to identify a comparable set, the approach of rejecting consistent loss-making companies outright may have to be revisited.
- Use of the CUP and price comparisons – where a taxpayer relies on price benchmarks using the CUP method, it will be important that the five

factors of comparability be evaluated in the context of any changes and determine if the price comparison continues to remain appropriate.

EMPLOYEES AND SECONDMENT ARRANGEMENTS

Cross-border arrangements include key personnel (employees) and it is therefore critical that multinational groups assess the impact of ongoing changes to immigration law considering a crisis like COVID-19. These changes will have a direct impact on employees on secondments to other countries as well as the inter-company arrangement(s) in question. Additionally, if employees who travel for business to other locations and are unable to return to their home country due to travel restrictions and advisories, thereby warranting remote-working arrangements, such arrangements could create permanent-establishment (PE) implications for the multinational group. While the Canada Revenue Agency (CRA) has issued pronouncements that there will not be a PE if the employees are in Canada because of travel restrictions, this position might differ country to country.

GOVERNANCE AND IMPLEMENTATION OF CHANGES

Where multinational groups make changes to their transfer-pricing model/policy, these changes should be immediately reflected in the inter-company agreements, inter-company accounting systems and invoices They should also ensure that any year-end adjustments required are put through prior to the close of the financial year or filing the annual tax return, to reflect the up-to-date facts and circumstances.

DOCUMENT IMPACT ON BUSINESS

Where multinational groups have made changes to their transfer-pricing model/policy or are adversely impacted by the COVID-19 crisis, it will be imperative that taxpayers be able to articulate such changes and/or the reasons for changes to the profitability, in their annual transfer-pricing documentation. While this could vary depending on the industry, it will be crucial to document any variances to performance as a first instance to defending the taxpayer's transfer-pricing position to tax authorities, going forward. Alternatively, if a taxpayer is pursuing an Advance Pricing Arrangement (APA), the taxpayer should model and document the impact on the business as this will qualify as a change to the crucial, underlying assumptions on which the APA is/will be based.

MANAGE TRANSFER-PRICING OBLIGATIONS

Where a multinational group is required to prepare and file a Country-by-Country (CbC) Report and/or CbC notifications, local transfer-pricing disclosures as well as to prepare or file a Group Master File, multinational groups should monitor any changes to filing deadlines (where these might be extended in the short term). Such filings should incorporate both quantitative (information on accounting adjustments, write-offs, disposal of assets etc.) and qualitative information on the impact on the multinational group's business. If one or more entities is faced with a local transfer-pricing audit, it is important that deadlines be managed with the tax authority accordingly and any delays to submission of information requested are agreed upon.

OTHER TAXES

If a multinational group restructures its operations due to the impact of COVID-19 and the inter-company transactions are subject to withholding taxes, customs duties, goods and services tax (GST) / harmonised sales tax (HST) / value added tax (VAT) etc., it will be critical that the effect of these taxes be assessed when making changes. Alternatively, if a multinational group exits a certain market, it might need to meet exit tax and compliance obligations, prior to such closure or disposal.

CONCLUSION

Managing transfer-pricing risks is going to be critical as businesses and governments navigate uncertain times. Multinational groups have until most recently been witness to the placing of a renewed focus on transfer pricing and tax transparency by the Organisation for Economic Cooperation and Development (OECD) by way of the BEPS 2.0 project. With this continuing to be a key focus for the OECD and tax authorities worldwide, along with a global crisis such as COVID-19, transfer-pricing arrangements are likely to see increased scrutiny by tax authorities and viewed as a key driver for tax revenue to balance fiscal deficits and manage tax-collection targets.

AVINASH S TUKREL

Segal LLP, Toronto
+1 416 774 2446
atukrel@segalllp.com

ABOUT MOORE GLOBAL

At Moore, our purpose is to help people thrive – our clients, our people and the communities they live and work in. We're a global accounting and advisory family of over 30,000 people across more than 260 independent firms and 110 countries, connecting and collaborating to take care of your needs – local, national and international.

When you work with Moore firms, you'll work with people who care deeply about your success and who have the drive and dedication to deliver results for you and your business. You'll have greater access to senior expertise than with many firms. We'll be here for you whenever you need us – to help you see through the maze of information, to guide you in your decisions and to make sure you take advantage of every opportunity.

To help you thrive in a changing world.

marketing@moore-global.com

For more information please go to:
www.moore-global.com

MOORE

www.moore-global.com