**COVID-19: DOES YOUR TRANSFER PRICING REFLECT REALITY?**

COVID-19 has brought about many changes to our economic environment, causing consumers, businesses, and governments at every level to reassess prevalent economic truths. In times like this, it is imperative that companies perform an overall analysis of their structure and target opportunities to cut costs. In this context, one of the areas that should be analyzed is the company’s transfer pricing model.

In this article, we will walk you through how transfer pricing works and show you how to evaluate if it would be advantageous for your company to consider changing its current model.

SOME BACKGROUND

The rationale behind transfer pricing is to allocate revenue between related parties, based on the risks borne by each entity, using the “arm’s length” method. This method determines the margin that would be earned by an unrelated comparable party to perform the same function as the “tested” entity.

As such, it has become common practice for both tax practitioners and tax authorities to define certain entities performing limited and/or routine activities, and more importantly, bearing low levels of risk, as low-risk distributors (“LRD”) or low-risk service providers (“LRSP”). They contend that such entities can never lose money.  This contention may be too broad.

COVID-19 IMPACT

COVID-19 and the current economic downturn have brought this contention to the forefront. With many companies hard-hit economically, does it still make sense for a group member to be showing profit and paying tax, even as the effects of the pandemic financially cripple the rest of the group?

Many companies have requested to reevaluate their existing transfer pricing model, and assess what the “arm’s length” method would bring to comparable entities who have lost money during this period of economic distress.

In addition, if the comparable entities used in an existing transfer pricing study bear normative risks, and the study did not adjust for the market risk borne by the low risk “tested party”, this entity could potentially have earned returns in prior years above what it should have earned. This additional profit could, therefore, possibly validate a zero gain or loss during the current economic environment.

To support a change in the transfer pricing model, timely and robust documentation must be prepared, including external benchmarks pertaining to industry metrics or market information. For example, declines in industry metrics (revenues, sales, values, etc.) or in specific companies who are deemed competitors should be highlighted to provide validation of the change.

ITEMS TO CONSIDER

1. Determine which entity is requesting the transfer pricing change: parent company, subsidiary, or both;
2. Determine and measure quantitatively the factors which are causing the pricing change. Factors could be (a) a decline in sales or sales forecasts, (b) costs associated with releasing or firing workers, and/or (c) costs related to unused office space, etc. Note that the cost elements noted herein will not be part of the transfer pricing analysis when determining the appropriate arm’s length return. These costs will be classified as extemporaneous or one-time expenses and will be recorded after the transfer pricing benchmark is established;
3. Stock options included in the cost base of a “cost-plus” entity, should likely be repriced in the transfer pricing analysis, based on the present conditions in the appropriate stock market, or the economy at large. The difference between the previous price and the current price would be an expense that would not be incorporated into the cost base for the cost-plus markup;
4. Assess whether the intercompany contract allows for renegotiation of pricing terms. We note that some intercompany contracts expressly state a numeric return, which should be earned, while others state merely that the return should be arm’s length.  The latter is preferable;
5. If possible, redo the intercompany contract. In revising the legal contract, consider including a force majeure clause. Force majeure is a clause that includes unforeseen events like natural disasters such as earthquakes or man-made disasters such as a war or nuclear incident. This clause usually is used to invalidate a contract or, at a minimum, force a renegotiation.

In short, it is likely that by reassessing the existing transfer pricing and or/adapting the model to reflect the current reality, the company will be able to record a zero profit or loss for 2020. However, such a change MUST be backed up by adequate documentation and analysis to defend against aggressive tax examinations in the future.