CRISIS TRANSFER PRICING

By Kathrine A. Kimball

As our hearts are immersed in the global crisis of COVID-19, and our hands are busy creating a safe place for our families, we recognize that our clients are also carrying on with their transfer pricing responsibilities. In the spirit of a pragmatic, intellectual distraction for you, we share our insights below and are available to join you on a call or Zoom video to brainstorm your transfer pricing implications, or simply to connect and "change the channel" for a moment. No formalities required, dogs and cats are welcome, children are encouraged; it is our gift to you.

The best-laid plans could not have anticipated the intensity of the economic impact from COVID-19, nor can anyone reliably predict the length of this crisis cycle as the world is literally changing daily. While the operative word in supply chain strategy for the past decade has been resilience, responding to economic challenges by creating a Plan B throughout the supply chain, the companies that will prevail in the coming months will be those that have created optionality, or multiple sources from every step along the path from raw materials to finished goods; transformed their business model to capture new opportunities or swiftly abandon those that are unprofitable; and, perhaps most importantly, prioritized the availability of tax-efficient cash in the right places at the right time.

Consumer behavior has gone beyond preparedness to irrational buying patterns with stockpiling, even hoarding. While this unpredictable pattern may briefly spike sales for major retailers who have the infrastructure to manage the variability, smaller suppliers do not have the scale and flexibility afforded by centralized procurement nor the capital foundation to keep pace. There has never been a more critical time for the supply chain and tax decisions to be in sync.

Given the velocity of the unfolding economic impact, earnings pressures at the close of Q1 for calendar companies could be an impending disaster should companies stay the course of their pre-pandemic transfer pricing assumptions. Losses for many are inevitable yet thoughtful characterization of the business flows driving the value chain could change the benefit of those losses now and could also contribute to preserving the traditional transfer pricing framework once the world, and profitability, return to what is likely to be the new normal.

With first quarter close looming next week for many multinationals, it is timely to share some practical insights as to how the pandemic may impact transfer pricing – whether it is the optionality of an upside opportunity or the mitigation of a downside risk. On the upside for the medical device and healthcare supplies industry, the velocity of the supply chain cannot be moving fast enough for certain goods, it is critical to capture the essence of a newly-formed business model or product offering within the transfer pricing framework to ensure that the profit or loss, and any associated intangible property is attributed to its rightful party within the value chain as well as the inherent risks. For those industries that may be negatively impacted by quarantine measures, such as restaurants and entertainment venues of all kinds, it is also an opportunity to revisit the transfer pricing adjustment policy – quickly. To that end, both the availability and the use of government aid packages will be an extraordinary consideration for crisis transfer pricing, assessing the alignment with arm's length behavior in sustaining affiliates as independent businesses in a crisis. There is no specific guidance in the treatment of such government aid in transfer pricing but it is an area to explore as to how the opportunity cost of foregoing such aid, as much as the benefit of using it, should be treated across a transfer pricing system.

The first pragmatic step for either scenario involves a review of the material aberrations in the quarterly estimated tax calculations: including assessing the nature of new costs being incurred to sustain the business or form a new venture; understanding what fixed costs are not being covered by an affiliate suffering from a compromised production scenario; and defining any business opportunities that may be missed because of shortages as well as any closure costs associated with shutdowns or layoffs. In addressing these kinds of changes, it is important to ask who should bear the risk of such costs and missed growth and how to allocate the financial consequences accordingly. It may be appropriate to make immediate transfer pricing adjustments to align the cash with the part of the organization bearing the most risk or has the greatest opportunity, rather than deferring to routine Treasury mechanisms to fund abnormal cash requirements through intercompany debt. The same questions would apply to the estimated VAT payments where the inputs have suddenly disconnected from the outputs. In any case, challenge the status quo as part of crisis transfer pricing best practices.

Once the mechanics of the Q1 close are under control, the global transfer pricing policy and supporting agreements should be reviewed and modified to capture any extraordinary measures or adjustments that will be made during this cycle of crisis. At arm's length, we are observing many drastic modifications to business strategies with companies transforming manufacturing capabilities to capture opportunity for greater demand elsewhere. At the same time, we have witnessed the voluntary and involuntary closures of businesses who have attempted to retain staff by forming alternate, temporary business models, all of which would bear a reevaluation of transfer pricing.

When the crisis is behind us, the global transfer pricing strategy should be aligned with the new normal. The most important step in refining a transfer pricing strategy, arguably with the greatest long-term impact, will be to gather the new facts as they evolve. Each scenario of your organization modifying a business model, or even a competitor shifting a pricing strategy, to adapt in this dynamic environment is going to be a critical fact to preserve for telling the story of 2020. A well-written value chain story is the foundation of a defendable tax strategy, particularly one that bears inherent uncertainty and potentially limited connection to the fundamentals of the past.

Be well.
Kathrine

Please reach out for a call regarding your transfer pricing implications or even to share a moment of encouragement; no need is too small, no question irrelevant; we are all in this together.

NORTH AMERICA
Kathrine A. Kimball | Principal and Founder
o. +1 858 433 2701 | kkimball@aptisglobal.com

EUROPE
Sofie Stas | Principal and Founding Member
o. +32 2 791 75 45 | sstas@aptisglobal.com