



PRC & INTERNATIONAL

Will Multinational Companies Be Able to Guarantee a Profit to their Limited Risk Subsidiaries in 2020?

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Introduction

Many multinational enterprises (“MNEs”) are structured with an entrepreneur and one or a few limited risk affiliates. The latter may be manufacturers, distributors, or service providers. These MNEs generally use the transactional net margin method (“TNMM”) in transfer pricing to set the remuneration of their affiliates. In transfer pricing, the TNMM 1) compares the net profit margin of a taxpayer arising from a non-arm’s length transaction with the net profit margins realised by arm’s length parties from similar transactions and 2) examines the net profit margin relative to an appropriate base, such as costs, sales, or assets.

In many developing countries in Asia, entities will only carry out single simple functions. For example, many manufacturers in China and Vietnam are either toll manufacturers or contract manufacturers. These

manufacturers will only carry out the manufacturing functions under contracts for the principal, generally the entrepreneur in the supply chain. Other single function entities include pure distribution entities and entities which provide contract R&D services.

It is the view of the tax authorities in these developing countries that the single simple functions are limited risk functions and may not be compensated with a high profit margin. By the same token, these functions should not bear any losses. For example, in China, pursuant to Article 28 of *Public Notice Number 6 (2017)* issued by the State Taxation Administration, enterprises in China which are carrying out a single contract manufacturing function, single distributing function, or single contract R&D function for an overseas related party should maintain a reasonable profitability level. In the event these enterprises incur losses, even if they have not met the required threshold for preparation of a Local File

in accordance with *Public Notice Number 42 (2016)*, they would be required to prepare and submit a Local File to the tax authority. In general, explanations of the losses incurred by these enterprises, such as a wrong strategic decision of the overseas principal leading to the insufficient utilisation of production capacity, the slow movement of inventory, or the failure of R&D efforts, would not be accepted by the tax authority. Transfer pricing adjustments could be imposed.

Impact of the COVID-19 Crisis

COVID-19 has significantly impacted MNE groups. The sales of many MNE groups have decreased significantly. Many MNE groups anticipate significant losses for 2020 and a few years thereafter. From the transfer pricing perspective, the above views of the tax authorities in developing countries may need to be reconsidered. This article discusses whether MNEs need to review and modify their transfer pricing policies in the context of the COVID-19 crisis.

Possible Positions of Tax Authorities

1. Special Factors

It should be noted that the views of tax authorities on losses incurred by limited risk single-function entities would not generally be accepted by them, especially if the limited risk single-function entities would not be participating in making strategic decisions. This view is reasonable in that under normal conditions, it is the entrepreneur of the MNE group who defines the strategy of the group, which is then executed by the limited risk entity of the group under the control and monitoring of the entrepreneur. If the strategy of the entrepreneur generates profits, the entrepreneur gets the residual profit after the limited risk entity gets its routine compensation. Conversely, if the strategy generates losses, the limited risk entity should continue to get its compensation, and the entrepreneur gets a bigger residual loss.

Despite the above view taken by tax authorities, a limited risk single-function entity may still be able to justify some losses incurred by, or the reduction of profits of, the entity as long as it is because of uncontrollable external factors. For example, a factory could be shut down because of a flood. The losses triggered during the shutdown months could be offset from the profit which would normally be realised.

These uncontrollable external factors are the so-called “special factors”. In order to be able to deduct losses incurred because of these special factors, the special factors would need to be clearly explained with supporting documents and the quantum of the losses be justified.

In the current COVID-19 context, it is not the strategy of the entrepreneur which will generate the overall loss of the MNEs in 2020. It is the shutdown of certain sectors of the economy, managed by states around the globe, which will be the origin of the 2020 losses of MNEs in the shutdown sectors. Some of the losses could be justified as special factors: for example, plants may be closed down because of the COVID-19 crisis. The limited risk single-function entities of an MNE group should assess their circumstances to see if there are possible special factors to justify any losses incurred during the crisis.

With respect to past experience, during the financial crisis in 2008, the tax authorities were not that stringent in insisting on imposing transfer pricing adjustments to limited risk single-function entities suffering from setbacks due to the financial crisis, as long as explanations on special factors were provided. It is expected that the tax authorities will follow this practice during the COVID-19 crisis.

However, the tax authorities (e.g. the Chinese tax authority) did not agree to an allocation of MNEs’ losses to Chinese limited risk affiliates during the 2008 financial crisis, and it is expected that they will not accept a general allocation of MNEs’ losses during the COVID-19 crisis.

2. Sharing of MNEs' Losses

The above is the view of the tax authority of the jurisdiction in which the limited risk single-function entity is located.

Having said that, the tax authority of the jurisdiction in which the entrepreneur is located may take a different view and may not accept the result that the entrepreneur takes the residual loss of an MNE group after the limited risk single-function entity has been compensated.

The tax authority may contend the following:

- (i) The 2020 losses originated from the shutdown of the economy managed by all states around the globe. Entrepreneurs should therefore not be held liable for the losses generated by the COVID-19 crisis.
- (ii) No independent company would accept incurring all the residual losses of an MNE group if it is dealing with an arm's length party.
- (iii) Utilisation of previous years' financial information of comparable companies to set the 2020 remuneration of the limited risk affiliated entity may not be appropriate. Such financial information has not taken the COVID-19 crisis into consideration.
- (iv) For enterprises which use safe harbour rules to set the remuneration of limited risk affiliates, the said safe harbour remuneration has not taken the COVID-19 into account.
- (v) Finally, it may be contended that limited risk entities are not completely risk free, such that losses of the MNE group should be allocated to the limited risk affiliates in certain cases. The COVID-19 crisis is one of these cases.

Even if the tax authority of the jurisdiction where the limited risk entity is located accepts a "special factor" adjustment, there would be the potential issue of double taxation in that there could be a profit being allocated

to the limited risk entity but a portion of the MNE's loss being disallowed by the tax authority of the other jurisdiction. Unless the two competent authorities can arrive at a settlement, there would be potential double taxation.

Unfortunately, the OECD has currently yet to give its position to clarify the situation.

Will MNEs Need to Review and Modify their Transfer Pricing Policies in the Context of the COVID-19 Crisis?

MNEs will have to ask themselves the following questions in 2020:

1. How Should Manufacturers, Distributors, and Service Providers with Low Risk be Remunerated in 2020?

MNEs will likely have to review and modify their transfer pricing policies because of the economic crisis caused by COVID-19. Thus, many of them have structured their transfer pricing policies around an entrepreneur and limited risk entities. The latter have a "guaranteed" profit, while the entrepreneur gets the residual profit or loss. In this context:

- Manufacturers with limited risk which have been remunerated up to now on a cost-plus basis will have to put in place effective measures to monitor production costs and potentially assume losses if the MNE to which they belong is in an overall loss situation.
- The level of remuneration of distributors with limited risks which until now have been remunerated through a "guaranteed" operating margin could also be revised downwards depending on the 2020 result of the MNE group.

- Head offices or corporate shared service centres that bear personnel or other costs may not be able to provide the usual services due to travel restrictions or containment measures. In addition, it will be difficult for companies which ordinarily receive these services to demonstrate to tax authorities the economic value of the services in question and their market price. Alternative approaches may have to be considered.
- MNEs may also have set up central procurement companies. As they are generally remunerated on the basis of commission on purchases made, their profit should be mechanically reduced in the event of a decline in MNEs' turnover.

The remuneration to be granted to manufacturers, distributors, and service providers with low risk will have to be re-evaluated in 2020 on a case-by-case basis and properly documented in order to pass future transfer pricing audits.

2. How Should the Costs of Restructuring Resulting from the COVID-19 Crisis be Allocated?

MNEs whose 2020 financial aggregates will be strongly affected by the COVID-19 crisis, both in terms of turnover and results, could be required to restructure their supply chain and relocate some activities, resulting in a reduction of activity or even the closure of manufacturing sites abroad: for example, contract R&D service providers within an MNE group may have to be consolidated in order to save costs in the near future.

These restructurings will affect the transfer pricing policies of MNEs. As a result, MNEs will have to not only review the remuneration of the single-function limited risk entities within their group but also organise the allocation of restructuring costs between their subsidiaries. In this context, it will be important to attribute restructuring and closure costs in accordance with the arm's length principle. Compensation, in

particular that related to the rupture or renegotiation of intra-group contracts, will have to be carefully examined, taking into account the existence of possible compensation clauses in existing contracts. This allocation of restructuring costs will have to be duly documented in order to be prepared for future transfer pricing audits.

3. How Should Intra-group Financing be Set in 2020?

As a result of the economic crisis, MNEs will most certainly have to adapt their intra-group financing facilities: for example, certain parent companies may have to provide emergency financing to their subsidiaries and/or provide explicit guarantees on the bank loans of their subsidiaries. To finance supply chain restructuring and relocations, MNEs will also likely have to borrow.

Moreover, to reflect the current financial situation, MNEs may also be required to adjust the interest rates on their existing intra-group loans.

In addition, the crisis is likely to have an impact on the credit ratings of MNEs and/or their subsidiaries.

In this respect, if intra-group financing policies are established on the basis of historical credit ratings, the relevance of such a practice will have to be reconsidered. In any case, the methods used to determine credit ratings when setting interest rates for loans and other intra-group financial transactions will have to be duly documented.

In this changing environment, MNEs will likely be required to change the level of interest charged on existing or new intra-group financing and may have to provide explicit parent company guarantees and/or cross-guarantees in order to reduce the future cost of financing their subsidiaries or the MNE as a whole.

In February 2020, the OECD released the final "*Transfer Pricing Guidance on Financial Transactions*", providing an insight into the arm's length treatment of

various financial transactions among related parties, including intra-group loans. MNEs should adapt to the guidance in conjunction with the necessity to review their intra-group financing because of the COVID-19 crisis.

The financing options taken will also have to be well documented to pass upcoming transfer pricing audits. Thus, intra-group financing is nowadays generally included in the scope of tax audits.

4. Will Royalties for Brand Licensing and Other Intellectual and Technical Property have to be Reduced in 2020?

As many MNEs are likely to experience a reduction in turnover in 2020, it is highly probable that the level of their royalties will be reduced automatically since the basis for calculating royalties is generally based on turnover. In addition, MNEs may consider reducing their royalty rate(s) in 2020 and thereafter. Finally, due to the crisis, the licensees of intra-group licences of the right to use trademarks or more generally intangible assets may make a request to their licensor for a temporary suspension of the royalty payments. Such a suspension could be granted by the licensor on the condition that it can demonstrate that such measures exist between independent companies and that they constitute a normal act of management.

5. Is it Appropriate to Opt for a Profit and Loss Sharing Method in 2020?

For those MNEs whose transfer pricing policy is usually based on the use of the TNMM, it may be appropriate to change the transfer pricing methods in 2020. Thus, some of them could decide to suspend the application of the TNMM under conditions to be defined by the subsidiaries in order to allocate the MNE's overall losses appropriately. MNEs are again advised to document properly any changes in transfer pricing policies in order to pass future transfer pricing audits.

What Will Be the Impact of the COVID-19 Crisis on the Benchmarking Studies and Safe Harbours Used by MNEs?

1. What will be the Impact on Benchmarking Studies?

Regardless of the method used to determine an arm's length price, its confirmation requires a comparison with a transaction or result realised by an independent comparable. This confirmation of transfer prices by reference to independent comparables will have to consider the effects of the COVID-19 crisis.

In order to validate that a current or a future transfer price is set in accordance with the arm's length principle, a search and selection of comparable companies whose financial data are most often available on databases with a time lag of one year is generally carried out. Therefore, in an economic crisis context, companies are facing the difficulty of having to validate the level of their transfer prices by reference to comparable data that do not consider the impact of the crisis. As a result, comparability studies carried out in 2020 may not reflect current economic conditions and thus they prevent the setting of an arm's length price for future transactions. The fact that tested parties and comparable companies can react differently during the COVID-19 crisis, particularly in terms of demand and sales, could also compromise the reliability of transfer pricing methods.

As a consequence, benchmarking strategies may need to be revised by targeting subsets of comparables that are closer to the tested party (both in terms of sensitivity to an economic downturn, as well as general characteristics and timing). These subsets can be arrived at by refining existing sets of comparable companies and by eliminating companies that did not face similar adverse economic conditions or that do not have sufficient financial data. MNEs should also consider broadening search criteria

to include companies with similar sales declines by removing certain screening criteria that would allow for the identification of comparables experiencing financial distress (i.e. bankruptcy or operating losses).

Moreover, MNEs should apply certain screening to ensure that highly profitable comparables that are not impacted by the economic crisis are not included in the sets of comparables. In addition, the use of a multiple-year approach may no longer be suitable for generating reliable comparables in all cases.

MNEs and tax authorities could evaluate whether the use of a year-by-year approach could better capture the effect of events causing dramatic changes in the market in a given year. There are instances, however, in which the use of multiple-year averages or pooled financial results for years in which comparables suffered from similar economic conditions (whether or not sequential/concurrent) could help to develop a more reliable range.

Again, MNEs will have to adjust their benchmarking approaches in 2020 and be able to justify these changes when they are subject to a tax audit of the year 2020. That is why before taking actions, MNEs should consider performing financial simulations using their best forecasts of 2020 in order to figure out the required adjustments.

In addition, MNEs will need to analyse the gap between their fixed costs and the turnover decline during the crisis in order to determine any adjustments that need to be made.

Finally, MNEs may consider making adjustments in 2021 on the basis of comparable studies covering the financial year 2020. Considering the complexity of taking into account the impact of the economic crisis when conducting comparable searches, we recommend that MNEs contact transfer pricing experts.

2. What will be the Impact on Safe Harbours Used by MNEs?

Some countries have adopted safe harbour rules. These rules generally allow smaller companies or less complex transactions to follow simpler rules for setting their transfer prices (i.e. the safe harbour rules).

The advantages and limitations of these safe harbours will have to be analysed in the context of the COVID-19 crisis. MNEs will have to determine whether or not it remains advantageous for them to continue to use the safe harbour rules.

Finally, as safe harbour rules vary from country to country, MNEs will need to keep abreast of legislative and regulatory developments relating to safe harbours in the states where they operate.

What Should Be the Approach of MNEs for Advance Pricing Arrangements (“APAs”) and the Relationship with Tax Authorities?

1. Should MNEs Proactively Contact the Competent Authorities for APAs?

Because of the economic impact of the crisis on the financial results of taxpayers, the said impact on APAs already in force, new APAs, or APAs under negotiation will have to be carefully examined by the MNEs concerned.

Taxpayers may have concluded APAs covering more than one fiscal year, allowing them to have the legal certainty of avoiding any questioning of the transfer pricing methodology if the terms of the agreement are respected.

However, the transfer pricing method covered by the agreement may need to be adjusted or modified in the event of the occurrence of circumstances that alter the terms of the agreement, such as the existence of an economic recession (e.g. COVID-19). In the case of French APAs, the French tax authority's doctrine provides that the agreement could be amended by mutual agreement between the parties or suspended from the date of occurrence of the event. Similarly, on the basis of observations during the financial crisis in 2008, the Chinese tax authority agreed to skip one year which was covered under the relevant APA.

According to the French doctrine, companies and competent authorities will be able to renegotiate their prior agreements in order to consider the impact of the economic crisis related to COVID-19 and to provide legal certainty on a potential new transfer pricing method.

While the Chinese tax authority could agree to skip the year 2020 in the APA, it remains to be seen whether the Chinese tax authority would agree to renegotiate prior agreements entered into before 2020 in order to consider the future impact of COVID-19.

Under these circumstances, it is recommended that companies contact the competent authorities to discuss with them how the impact of the economic crisis could be considered in their APAs.

Conclusion

In the view of the writers of this article, the OECD will need to come up with guidance on the impact on COVID-19 on transfer pricing, in particular with regard to the remuneration to be received by single-function limited risk entities in an MNE group. In addition, the COVID-19 crisis will require MNEs to adapt their transfer pricing policies on a case-by-case basis. MNEs will also need to adapt their approaches to benchmarking studies and reassess the benefits of the safe harbour rules

that they apply. Finally, they will have to determine whether they need to contact the competent authorities regarding their APAs.

In this evolving context, it is important for MNEs to document (e.g. through e-mail correspondence, minutes/presentations of the board of directors and notes/reports) in real time the changes introduced in 2020. **T**