

TRANSFER PRICING IN THE AGE OF COVID-19

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A textured horizontal line is positioned below the name.
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Agenda

- Related Party Contracts in the Era of COVID-19
- Overview of Transfer Pricing Concepts, Substantiation, Reporting
- International Dispute Resolution: Treaty vs. Non-Treaty Situations
- International Impact of BEPS, C-by-C Reporting, etc.
- Updating Studies to Reflect COVID, Market Changes
- Summary and Key “Takeaways”

Agenda

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Learning Objectives

- After viewing this webinar, attendees will be able to address the challenges posed by transfer pricing and related tax audits. Specifically, attendees will be able to:
 - Manage international business transactions with related parties amid the COVID-19 pandemic
 - Determine when to review and revise transfer pricing agreements
 - Recognize inconsistent audits or changes by different tax authorities
 - Evaluate if the cost of changing transfer pricing methods or comparables is worth the effort in the time of a down market
 - Identify what changes you need to pay close attention to

Related Party Contracts in the Era of COVID-19

Intercompany Agreements

- Business Considerations:
 - How will the business evolve over the coming 5 to 10 years?
 - What are the company's current and future intangible assets?
 - Is the business becoming more global?
 - Which markets (product and geographic) will the business enter?
 - Is the business centralizing or decentralizing activities?
 - Regionally
 - Globally

Intercompany Agreements (cont.)

- Not required, but IRS has the right to impute them if they don't exist
- Lay out arm's length terms, including a markup for transfer pricing purposes
- Critical in evaluating the facts and circumstances underlying a taxpayer's intercompany transactions
 - Outline the functional, legal, and economic analyses that support a taxpayer's transfer pricing positions
- Deficient agreements:
 - Failing to cover key items
 - Excessively vague
 - Poorly thought-out

Intercompany Agreements (cont.)

- Deficient agreements (cont.):
 - Not taking into account local law, or violating local law
 - Granting authority that potentially creates a permanent establishment (PE) (e.g., giving the entity or individuals authority to bind an affiliate), exposing the parent/affiliate to taxation in that entity's jurisdiction
 - Insufficiently identifying the intangible property
 - Failing to adhere to the terms of intercompany agreements
 - Entering into an intercompany agreement then failing to terminate it properly:
 - E.G., an intercompany agreement requiring a royalty payment that ceases after a number of years when the technology is obsolete, such as the subsidiary stops paying a royalty to the parent, but the agreement is not terminated.

Intercompany Agreements (cont.)

- Contract situations aggravated by COVID-19:
 - Reneging on deals
 - Force Majeure
 - Termination for insolvency
 - Failure to meet obligations
 - Renegotiating deals
 - Price
 - Warranties and warranty periods
 - Remedies for breach
 - Recourse to dispute resolution

Intercompany Agreements (cont.)

- Governmental situations aggravated by COVID-19:
 - Delay or stoppage of movement of goods (customs, export controls, export licenses)
 - Delay or stoppage of movement of individuals (immigration)
 - Delay or stoppage of movement of employees (labor approvals, visas, etc.)
 - Shutdown or slowdown of government ministries (technology registrations, transfers, incorporations, construction permits, etc.)
 - Economic threats of COVID that result in liberalization of antitrust, financing rules enabling market access by competitors not previously present

Overview of Transfer Pricing Concepts, Substantiation, Reporting

Overview of Transfer Pricing (cont.)

- Theory: related party transactions should produce results consistent with unrelated party transactions
 - Intercompany pricing (sales, services, licenses) should reflect arms-length relationships
 - Standard: what would an unrelated party pay for the same product, service or license, neither party being under a compulsion, under the same or substantially similar circumstances?
 - Substantiation for pricing must be documented (in writing) and updated periodically

Overview of Transfer Pricing (cont.)

- Tax authorities closely audit intercompany contracts to ensure profits not being artificially diverted from a high- to lower-tax jurisdiction
 - Various technical approaches are used for audits to challenge substantiation, comparables
 - Independent pricing studies done in advance and independently help determine, support pricing policy; provide evidence of management's justification for intercompany approach
 - Experts needed to defend studies/reports in case of contest
 - “Hot tubbing” anyone? (If you don't know, ask about Judge Laro's approach in the U.S. Tax Court regarding transfer pricing cases...)

Overview of Transfer Pricing (cont.)

- Heavy audit attention by tax authorities around the world
 - If “comparables” exist for unrelated/uncontrolled transactions, or if in the future they will exist, prepare to be challenged on different pricing among related parties
 - Some tax *audit triggers* include:
 - transactions with or through tax havens/low tax jurisdictions
 - cost sharing or other intangibles transfers/licenses
 - general/unsubstantiated corporate allocations
 - absence of documentation
 - failure to adhere to pricing ranges in such documentation, etc.
 - Adjustments can go back many years; PRC has 10 year exposure

Overview of Transfer Pricing (cont.)

- Many countries (including USA) require “contemporaneous documentation” at time tax return filed for transactions between “related” parties
 - Countries vary in requirements and approach; also, may require formal disclosures on filed returns, local (foreign) language for pricing study (e.g., PRC), frequency of study updates, etc.
 - *Failures of “compliance”* include absence of:
 - transfer pricing documentation in proper form and content
 - required information filings
 - written/signed intercompany agreements
 - actual intercompany invoices and payments, etc.

Overview of Transfer Pricing (cont.)

- Beware of related party pricing that varies from pricing of comparable products/services to unrelated parties
- Some countries require local language for the transfer pricing report/substantiation documentation (e.g., PRC, Mexico)
- Some countries look to less than 50% as “common ownership or control” threshold for purposes of determining “related” parties:
 - PRC deems “control” at 25%
 - “Control Group” / concert parties
 - Common management/operational/economic control

Overview of Transfer Pricing (cont.)

- Generally:
 - Update transfer pricing analysis on a regular cadence
 - Annually, as data shifts significantly, etc.
 - Update transfer pricing documentation on a regular cadence
 - Annually, every three years, with pertinent business (functions, risks, and assets) change, etc.
 - Update transfer pricing approach and methods used on occasion
 - With business changes, when new methods are applicable/appealing, etc.

International Disputes: Treaty vs. Non-Treaty Situations

International Dispute Resolution: Tax Treaties

- “Permanent Establishments” – the tax treaty concept resulting in local nexus, tax reporting, “attribution” of income/expense, etc.
 - A PE is treated as a separate taxpayer locally; once asserted by foreign tax authorities, may expose many past years of noncompliance
- Related party transactions involving treaty partners enables taxpayer to seek “competent authority” relief from inconsistent treatment of same item/transaction or treaty interpretation
 - See Rev. Proc. 2015-40, etc.
 - Applies to PE/Parent, Parent/Sub, or Affiliate/Affiliate
 - US Income Tax (and Estate/Gift Tax) treaties include relief provision
 - Some US treaties now include arbitration provision (to speed decisions...)

Int'l Dispute Resolution: Tax Treaties (cont.)

- Permanent Establishment Nuances:
 - U.S. “check the box” election (or DRE status) has no effect on local (foreign) tax reporting obligations or transfer pricing requirements
 - “Permanent establishment” (PE) or branch situs in a foreign treaty partner is treated as a *separate taxpayer* for local (foreign) tax purposes
 - PEs must abide by the same pricing rules, documentation, invoice submissions/payments, etc., as actual entities...
 - Subjects PE/branch to full local tax filing and payment obligations itself
 - Risk of adjustments for inter-company charges (between branch and “parent”) not properly documented or paid
 - Source-based withholding due to local (foreign) country

Int'l Dispute Resolution: Tax Treaties (cont.)

- Some uncertain situations/fact patterns for PEs:
 - “Rep offices” through which inappropriate “business” may be conducted
 - Employees (or in some cases “independent contractors”) having and habitually exercising contracting authority -- or effective authority to resolve terms, leaving only ministerial execution of contract in home office
 - Company-owned server installed in the foreign country, or “connectivity” supplied to local hardware (e.g., *Galileo*)
 - Using an *affiliate company’s* offices (e.g., India’s *Rolls Royce* case) or a *customer’s offices* to conduct business (Cf. Canada’s *Dudney* case)
 - Under certain treaties (e.g., US/China, US/Canada), *performance of certain services* for > 183 cumulative days may be PE
 - New “remote” employment internationally (“office in the home” issues)

International Dispute Resolution: No Tax Treaty

- If *no tax treaty* is applicable, what are the options?
 - Administrative appeal/resolution with local tax authority?
 - Local mediation/arbitration? Litigation in local courts?
 - **Ultimate risk:** inconsistent treatment of same transaction by differing tax authorities with no available inter-country dispute resolution method
 - Do not assume the U.S. foreign tax credit rules will bail you out...
 - Is the tax paid abroad a “compulsory” or “voluntary” payment?
 - U.S. will **not** allow FTCs for local taxes imposed when administrative remedies are not first exhausted (i.e., if tax paid is not “compulsory”); See Rev. Rul. 92-75, Treas. Reg. § 1.901-2(e)(5) (requirement to exhaust “all effective and practical remedies” in order to claim that “tax” paid locally is a compulsory payment)

International Impact of BEPS, C-by-C Reporting, etc.

Int'l Impact of BEPS, C-by-C Reporting, etc.

- Perception of tax abuse leads G20 to commission Organization for Economic Cooperation and Development (OECD)
 - OECD creates Base Erosion and Profit Shifting (BEPS initiative)
 - Three specific transfer pricing documentation requirements:
 1. Country by Country Reporting (C-by-C)
 - T/P provides information (employees, revenue, profit) to all tax authorities with filing of return
 2. Master File
 - T/P provides transfer pricing approach, method regarding its functions, risks, and assets in all jurisdictions to tax authorities upon request
 3. Local File
 - T/P provides transfer pricing method and analysis for specific jurisdictions to tax authority upon request

Int'l Impact of BEPS, C-by-C, etc. (cont.)

- Other initiatives
 - UN Transfer Pricing Guidelines
 - Digital tax initiatives
 - US Tax Reform (BEAT, FDII, GILTI, revisions to Internal Revenue Code on IP reference in Section 482)
 - State transfer pricing initiatives
- Generally, heightened interest in transfer pricing
- Heightened scrutiny of transfer pricing
- Heightened guidelines and regulations

Updating Transfer Pricing Studies to Reflect COVID, Market Changes

Updating Studies for COVID, Market Changes, etc.

- Standard: what would an unrelated party pay for the same product, service or license, neither party being under a compulsion, under the same or substantially similar circumstances?
- Same COVID impact on the Taxpayer as on a third party
 - Renege/Renegotiate deal or dispute resolution
 - Delay or stoppage / shutdown
 - Same economic and privacy issues

Updating Studies for COVID, Market Changes, etc.

- Generally:
 - Update transfer pricing analysis on a regular cadence
 - Annually, as data shifts significantly, etc.
 - Update transfer pricing documentation on a regular cadence
 - Annually/every 3 years, with pertinent business (functions/risks/assets) change, etc.
 - Update transfer pricing approach and methods used on occasion
 - With business changes, when new methods are applicable/appealing, etc.
- How to update intercompany pricing to comparable, third party results?
 - Generally, transfer pricing uses lagged information
 - How to use real-time information?

Updating Studies for COVID, Market Changes, etc.

- Real time Macroeconomic data

Country/Region	2009	2020 (projected)	Delta
GDP Growth Rates³			
Global	-0.1%	-4.9%	-4.8%
US	-2.5%	-8.0%	-5.5%
Europe	-4.5%	-10.2%	-5.7%
China	9.5%	1.0%	-8.5%
JP Morgan Global Manufacturing PMI⁴			
Global (Index, late 2015 = 50)	-20.0	-3.0 – 3.5 ⁵	TBD
Global Merchandise Trade Volume⁶			
Global (Index, 2015 = 100)	-10.0	-13.0 – 32.0	-3.0 - 22.0

¹ <https://www.washingtonpost.com/business/2020/07/02/june-2020-jobs-report/?arc404=true>.

² All data as of July 21, 2020

³ <https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020>

⁴ <https://www.markiteconomics.com/Public/Home/PressRelease/005fca529aa5415bbd9f09af66764844>

⁵ Publicly available 2020 projections were unavailable. Drop is indicative of only March output results.

⁶ https://www.wto.org/english/news_e/pres20_e/pr855_e.htm

Updating Studies for COVID, Market Changes, etc.

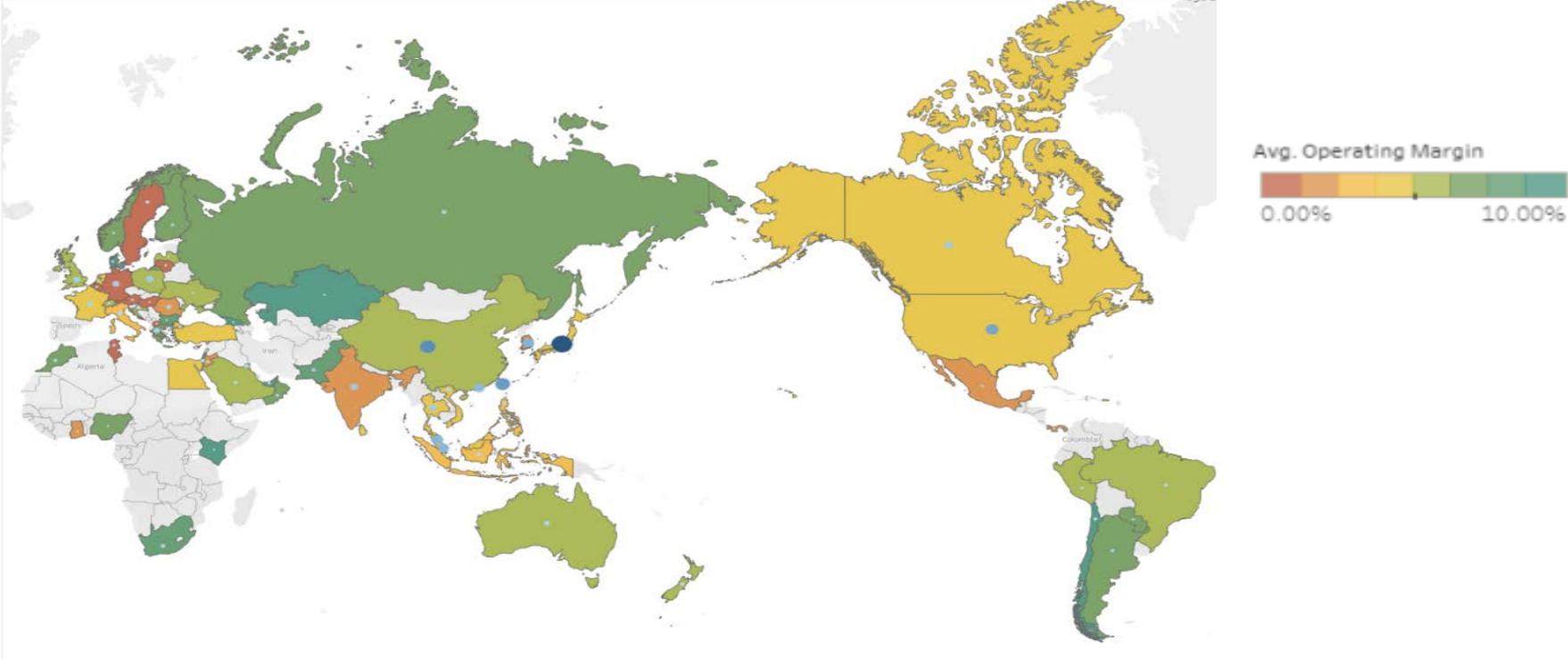
- Current economic shocks vs. previous recession

Manufacturing	Delta from steady state
APAC	-1.8%
EMEA	-2.7%
NA	-3.5%

Distribution	Delta from steady state
APAC	-0.8%
EMEA	-1.8%
NA	-0.6%

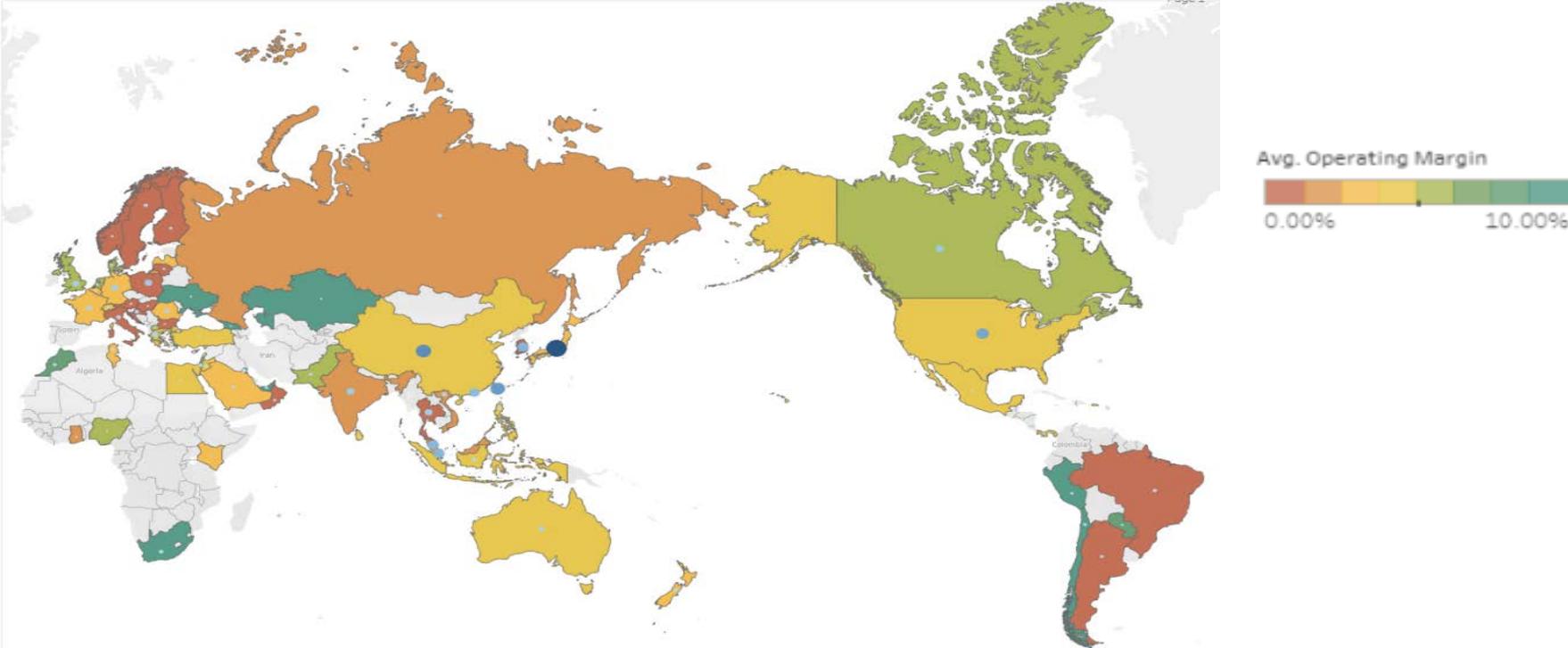
Updating Studies for COVID, Market Changes, etc.

Average Operating Margin - Steady State (2005-2007)



Updating Studies for COVID, Market Changes, etc.

Average Operating Margin - Recession (2008-2009)



Summary and Key “Takeaways”

- The COVID environment has not changed tax authorities’ preoccupation with transfer pricing and substantiation of returns/reporting
- Increased international reporting requirements, electronic and technology exchanges of information, and revenue maximization focus makes this area a *key* audit exposure
- QUERY: Has COVID impacted your/clients’ business such that transfer pricing policy, approach, methods, or comparables can be changed advantageously?
 - Do NOT wait to change and document accordingly

Summary and Key “Takeaways” (cont.)

- Be prepared with transfer pricing support when the tax authorities walk in – Many countries actually require “contemporaneous” documentation when tax returns filed...
- Companies should have:
 - Intercompany agreements
 - Transfer pricing documentation: It is less costly to develop and maintain transfer pricing documentation properly updated rather than having to react to transfer pricing adjustments (or suffer double taxation and non-deductible penalties and interest)
 - Transfer pricing audits are time consuming and expensive – and can be a slippery slope when dealing with the IRS and tax authorities of other jurisdictions

Summary and Key “Takeaways” (cont.)

- The IRS and tax authorities of other countries are going after ill-prepared small and mid-sized companies
- Just because a Company has been audited in the past does not mean the taxing authorities have signed off on its transfer pricing policies and results
- Audits and resulting adjustments to taxable income typically involve multiple years – that often quickly add up
- Transfer pricing has (at least) two sides and it is advisable to incorporate input from local transfer pricing specialists

Thanks!