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Challenges for Transfer Pricing in an Economic Downturn

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Key Findings

- Transfer pricing rules will come under pressure during the economic downturn.
- Businesses will need to adjust their transfer pricing to reflect the changing economic circumstances with limited real-time data on comparable entities and transactions.
- Royalty arrangements with production facilities, distributor returns, and loss attributions all create decision points for companies to adjust their transfer pricing.
- Significant transfer pricing changes could lead to new disputes with governments unless there is flexibility.
- The OECD should provide guidance that allows for flexibility in adjusting transfer pricing and future corrective payments once comparable data is available.

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Introduction

In the first quarter of 2020, the Bureau of Economic Analysis estimated that U.S. corporate profits fell by 13.9 percent. Part of that decline is a 10.8 percent drop in corporate profits from international transactions.[1] The Congressional Budget Office has projected that the economic downturn will be worse in the second quarter of 2020 before a slow recovery begins.[2]

The economic crisis driven by the COVID-19 pandemic has created many challenges for players in the international tax system. One of these challenges is how current international tax rules apply to multinational corporations with operations and offices all over the globe.

The rules that these businesses follow to determine where and how much they owe in taxes are complex even in normal times. The crisis has revealed challenging questions, especially when it comes to the significant losses that many businesses are currently facing.

Companies with subsidiaries in other countries rely on the practice of transfer pricing and the use of the arm's length principle to attribute taxable profits to the various jurisdictions where they have operations.[3] Transfer pricing regulations require businesses to examine data pertaining to transactions between unrelated parties as supporting evidence that the taxable profits of their subsidiaries are comparable to the profits in unrelated entities.

Several key issues lead to challenges in transfer pricing calculations during an economic downturn. These include:

1. Changing royalty arrangements
2. Adjusting comparable data to reflect current economic conditions
3. Attributing losses to subsidiaries

The Organisation for Economic Co-operation and Development (OECD) is exploring the need for additional guidance on transfer pricing rules in the midst of the crisis.[4] Such guidance should clarify how companies should adjust for the limitations of transfer pricing rules in the face of significant losses and a rapidly changing economic environment.

The nature of the current economic situation means that some sectors and businesses will face greater challenges with their transfer pricing than others. Some companies will survive the crisis without adjusting transfer pricing because relationships with suppliers, distributors, and customers will be maintained. For those businesses that are seeing a severe collapse in demand for their products and services, however, standard transfer pricing approaches will need to be applied flexibly to reflect the challenging economic reality.

1 "Gross Domestic Product, 1st Quarter 2020 (Second Estimate); Corporate Profits, 1st Quarter 2020 (Preliminary Estimate)," U.S. Bureau of Economic Analysis (BEA), May 28, 2020, https://www.bea.gov/news/2020/gross-domestic-product-1st-quarter-2020-second-estimate-corporate-profits-1st-quarter. See tables 9 and 10 on corporate profits.

2 "Interim Economic Projections for 2020 and 2021," Congressional Budget Office, May 19, 2020, https://www.cbo.gov/publication/56351.

3 The arm's length principle is used to treat related business entities (e.g., a parent company and a subsidiary) as unrelated parties in a transaction to determine prices that should be charged on products or services transferred between the entities.

4 "OECD Tax Talks," OECD, May 4, 2020, http://www.oecd.org/tax/oecd-tax-talks-presentation-may-2020.pdf.

Prior recessions have revealed the need for adjusting transfer pricing analysis, but the current situation is likely to reveal that need to an even greater extent due to the size and scope of the downturn.[5]

For simplicity, this paper relies on an example of a U.S. manufacturing company with operations in the U.S. and abroad. It owns a production facility in France and a distributor in Denmark. It also has a contract with an unrelated distributor in Italy. In normal times, the manufacturer benchmarks the profitability of its foreign subsidiaries against data with comparable unrelated entities with which it has contracts and other data from similar market players.

Royalty Agreements

The U.S. company develops its products and patents at its headquarters in the United States and licenses rights in those patents to its subsidiary in France for production in the European market. The license agreements are based on a five-year product life cycle and the French producer pays royalties to the U.S. company for use of the license.

In 2019, the company arranged a licensing agreement for production that would begin in 2020. To determine the price the U.S. company should charge its French subsidiary under the license, the company forecasts revenues associated with the product using comparable data from similar licensing arrangements and the company's own historical experience with demand for its products in Europe.

The company forecasts revenues of $1 million in 2020 which grew at a 5 percent rate through 2024.

The U.S. company also surveyed the profit margins of production facilities and found that a 10 percent profit margin was common in similar arrangements.

Combining the estimated revenue and profit margin with the operating costs of the French subsidiary, the U.S. company settled on a royalty schedule that required a $400,000 payment (40 percent of revenue) from the French subsidiary to the U.S. company in 2020. Additionally, the company expected to pay French taxes on $100,000 of profits in 2020.

TABLE 1.

Royalty Arrangement Agreed to in 2019

Year	2020	2021	2022	2023	2024
Estimated Revenues from Production	$1,000,000	$1,050,000	$1,102,500	$1,157,625	$1,215,506
French Production Facility Operating Costs	$500,000	$525,000	$551,250	$578,813	$607,753
Royalty Payment Schedule	$400,000	$420,000	$441,000	$463,050	$486,203
Profits	$100,000	$105,000	$110,250	$115,763	$121,551
French Production Facility Profit Margin	10%	10%	10%	10%	10%

Source: Author's calculations

5 Nobuo Mori, Nihan Mert-Beydilli, and Graham Poole, "Transfer Pricing in Troubled Times," *Tax Management Transfer Pricing Report*, May 14, 2009, https://www.nera.com/content/dam/nera/publications/archive1/PUB_TP_Troubled_Times_5.2009.pdf.

However, with the onset of the crisis the company is adjusting the royalty payment schedule. Relevant data to benchmark the adjustments will likely not be available until 2021. The rapidly evolving economic situation means that real-time comparable data may be unreliable for planning, and the company determines a 20 percent adjustment would be reasonable based on the limited market information available in 2020.

Adjustments to the production level and cost cutting measures (partially limited by fixed costs) lead to a taxable profit in France of $64,000 and a royalty payment of $320,000 to the U.S. headquarters.

When more data becomes available, the U.S. company plans to adjust the royalty payment and taxable profit margin in France based on that data. Temporarily, however, it is making the adjustment to reflect the data it has on hand.

Distributor Margins

On the distribution side of its business, the U.S. company has a subsidiary in Denmark distributing its products in Northern Europe but relies on a company in Italy to do the same in Southern Europe under a contract. While the U.S. company owns the subsidiary in Denmark, it has no relationship with the distributor in Italy apart from the distribution contract. If the terms of the contract with the Italian distributor result in a profit margin of 2.5 percent for that distributor, then under the arm's length principle the Danish subsidiary should be attributed a taxable profit of 2.5 percent (all other things being equal).

The U.S. company also surveys market data of other distributors around the world to support its analysis in attributing profits to the subsidiary in Denmark. Specifically, the company uses three-year moving averages of the profitability of dozens of other similar distributors to determine a reasonable range of profitability. In 2019, the manufacturer found that the three-year moving average of distributor profit margins supported attributing a 2.5 percent profit margin to its subsidiary in Denmark.

However, economic downturns change things significantly and quickly, so that the data the U.S. manufacturer relies on for attributing profits to its Danish subsidiary in 2020 may not reflect economic reality.

The U.S. manufacturer may renegotiate its distribution contract with the Italian distributor (leading to a lower profit margin for the distributor) or sever the relationship because of collapsed demand for the manufacturer's products. In such a situation, the arm's length principle would suggest that the subsidiary in Denmark could have a lower, or zero, attributed profit margin in 2020.

The three-year moving average looks backward, and if the company relied on that analysis, a 2.5 percent profit margin could be taxed in Denmark in 2020 rather than a margin that is more reflective of current economic conditions.

When the Losses Pile Up

In addition to considering the questions that arise when adjusting transfer pricing for its production facility in France and its distributor in Denmark, the U.S. company may need to consider how to attribute losses among its various entities. If, on a consolidated basis, the company runs a $100 million loss in 2020, where do those losses belong?

Current transfer pricing rules can be insufficient when businesses generate significant losses during an economic downturn. One challenge for a business such as that in the example is determining where those net operating losses belong for tax purposes.

Transfer pricing rules generally require the entity that is taking the economic risk to be attributed losses when they occur. This means that the U.S. headquarters and the French production facility should be more likely to be attributed losses than, say, the Danish distributor.

OECD transfer pricing guidance says that "unfavorable economic conditions" can result in losses in subsidiaries, but the general guidance is to assume profitability, especially if the parent company is profitable.[6]

In the current economic situation, it is possible that some multinational groups will be in a loss position overall. Attributing losses to foreign subsidiaries can have significant tax consequences because countries have different corporate tax rates and different tax treatment for losses.

It would not make much economic sense for the corporate group to be in, for example, a $100,000 loss position on a consolidated basis but post a $170,000 net operating loss in the United States while reporting a $64,000 profit in France and a $6,000 profit in Denmark.

Losses can and should be attributed to those other entities. The question is to what extent.

In some cases, the losses will simply need to reflect the cash flow of the entities in the company. If the economic situation is such that the French production facility sustains losses even after the parent company revises the royalty agreement, those losses should be deductible against French taxes.

The distributor in Denmark, however, is usually attributed a positive taxable profit margin based on analysis of comparable entities as described previously. Even though the Danish distributor bears very little risk in the overall corporate structure, a crisis that puts the corporate group into a net loss position represents existential risk even to the distributor.

In normal times, transfer pricing rules for profit and loss allocation are driven where the entrepreneurial risk is. In other words, business units that are innovating and investing in new products are in a much more productive (and riskier) position than a business unit simply tasked with making sure those products get to customers.

6 "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017," OECD, https://doi.org/10.1787/tpg-2017-en.

This means that, under OECD rules, the Danish distribution unit will get a steady and small return because it is in a lower-risk portion of the U.S. manufacturer's value chain. However, if the current crisis causes the entire company to be in a net loss position, unrelated distributors like the one in Italy would likely be impacted through lower revenues and tighter margins. In turn, it would be a reasonable outcome for the Danish subsidiary to assume some share of the overall losses.

The parent company could also simply cover the costs of the distributor, leading to no taxable income or loss deductions in Denmark. The change of the profit or loss allocation could be based on real-time analysis of the market and comparisons with other distributors, including the Italian distributor.

The Role of Fixed Costs

The example used above will likely not reflect the experience of companies in all sectors. Digital platforms will fare better than the airline industry or hotel chains. Even among the industries that will be hit hard by the crisis, key differences between supply and distribution chains will lead to a variety of pressures on transfer pricing.[7]

One way to show how the underlying economics of different businesses might result in more (or less) pressure on transfer pricing is to look at the role of fixed costs in the context of lower revenues.

Fixed costs are those costs that a business has regardless of its volume of sales. In an economic downturn, a business's costs associated with sales volumes—so-called variable costs—will drop. A business with relatively high fixed costs will face a more severe contraction in profits than a business with similar sales revenue, but lower fixed costs.[8]

For example, two businesses that both earn $100 in sales revenue with a 10 percent profit margin in normal times would face different impacts based on differences in fixed costs. If one business has fixed costs that make up 10 percent of total costs and the other has fixed costs that make up 20 percent of total costs, a downturn that reduces revenues by 20 percent would lead to a 40 percent profit margin reduction in the business with lower fixed costs. The business with higher fixed costs would see a 60 percent reduction in its operating margin in that scenario. In normal times, however, the margins for both businesses are identical.

7 For analysis related to the 2001 recession, see Richard Sciacca, George H. Soba, and Stephen C. Wrappe, "Adjusting Transfer Pricing Analyses for Economic Downturns," *Tax Management Transfer Pricing Report*, Dec. 12, 2001, and Ayden Hayri and Richard A. Clark, "Firm Profitability in Recessions: Part II," *Tax Management Transfer Pricing Report*, May 1, 2002.

8 Nobuo Mori, Nihan Mert-Beydilli, and Graham Poole, "Transfer Pricing in Troubled Times."

TABLE 2.

Businesses with High Fixed Costs Are Hit Harder During Economic Downturns

		Fixed costs= 10% of total costs			Fixed costs = 20% of total costs		
		Normal Times	Economic Downturn	Change (%)	Normal Times	Economic Downturn	Change (%)
Revenue	Sales Revenue	$100	$80	-20%	$100	$80	-20%
Costs	Cost of Goods Sold (variable cost)	$60	$48	-20%	$60	$48	-20%
	Sales, general, and administrative expense (variable cost)	$20	$16	-20%	$10	$8	-20%
	Sales, general, and administrative expense (fixed cost)	$10	$10	0%	$20	$20	0%
	Total costs	$90	$74	-18%	$90	$76	-16%
Margins	Operating profit (sales revenue minus total costs)	$10	$6	-40%	$10	$4	-60%
	Return on sales (operating profit divided by sales revenue)	10%	7.5%	-25%	10%	5%	-50%

Source: Nobuo Mori, Nihan Mert-Beydilli, and Graham Poole, "Transfer Pricing in Troubled Times," *Tax Management Transfer Pricing Report* 18:1 (May 14, 2009).

This example simply shows that industries with higher fixed costs may feel more pressure to preserve cash throughout the company through cost savings (including tax costs) alongside changes to contracts with external vendors and distributors. Because tax cost savings could arise through transfer pricing adjustments, industries with higher fixed costs may be more likely to make those adjustments.

Creating an Environment for Tax Certainty

All the choices that the U.S. company in the example faces in adjusting its transfer pricing and profit attribution to subsidiaries will impact the taxes that it pays and where it pays them. However, the company will face uncertainty on whether the choices it makes will be challenged by the U.S., French, or Danish tax authorities.

If, for instance, the company chooses to attribute a zero profit margin to the Danish distributor in 2020, reflecting real-time analysis rather than standard three-year averages for similar distributors and a need to preserve cash, the company runs a risk that the Danish government will propose income adjustments, and possibly penalties.

The current environment will certainly impact overall tax revenues for countries, and audit offices will be working to ensure that tax payments are in line with rules.

In each of the areas mentioned above governments will need to provide guidance and flexibility to minimize the tax uncertainty that multinational businesses face in the current environment. Otherwise, disputes could proliferate.

The OECD should provide assistance by developing guidance that gives companies flexibility in adjusting their transfer pricing in 2020 while requiring true-up adjustments once comparable data and sufficient analysis can be performed.

Conclusion

Transfer pricing rules are under stress given the current economic crisis. Businesses and tax authorities should consider real-time market evidence, however limited, in assessing the adjustments to pricing arrangements that are being implemented in response to the crisis to ensure that tax payments or loss attributions reflect economic reality.

Challenges arise in analyzing comparable companies and transactions, adjusting royalty arrangements, and attributing losses.

Adjustments will inevitably impact where and how much taxes are paid and could lead to tax disputes with governments. To minimize tax disputes and uncertainty, the OECD should provide guidance on transfer pricing flexibility to allow companies an opportunity to adjust their pricing and profit attribution during the downturn.

The economic challenges of the pandemic are many, and government should seek to provide certainty whenever possible.