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Adjusting group transfer pricing in the COVID-19 economic crisis

Yves Hervé and Philip de Homont of NERA Economic Consulting analyse how the economic decline caused by the coronavirus outbreak may prompt multinationals to alter their transfer pricing models.

As the pandemic ensues, the COVID-19 outbreak has the potential to trigger a global economic crisis to a level unprecedented since the 1930s.

Government-imposed shutdowns of the economy to contain the spread of the virus have led to a large-scale breakdown of supply chains in many industrial and service sectors. Most multinationals have shelved their investment plans. Underemployment and unemployment levels have increased massively, which could lead to deterioration of consumer confidence and demand in the short and medium term. Governments have provided guarantees to the private sector and the banking system to mitigate the storm, but this may increase public debt to unsustainable levels.

The result could be a steep economic decline followed by a quick rebound, but the economic development might also be gloomier if long-term economic depression is combined with an increase in risk-premia, upward tax pressure, protectionism, and political disruptions. Either way, multinationals – which have established their global footprint in a pre-crisis era of globalisation and liberalisation – will have to rethink liquidity-preserving measures to survive the crisis. One vehicle will be for multinationals to reconsider their existing transfer pricing arrangements to allocate group profits or, more relevant in the present economic context, losses.

Most groups have established transfer pricing systems that ensure stable, benchmarked profit margins for a large majority of group functions and legal entities. The result is that most of the remaining group profit – or losses – is concentrated in a few central entrepreneurial entities. In the case of a major downturn, such systems mean the group would still make substantial cash tax payments, exacerbating the cash-flow pressure.

In the crisis, third-party behaviour can indicate possible solutions for multinationals. Established contractual relations are terminated or renegotiated on short notice by invoking hardship or *force majeure* situations in order to prevent bankruptcies. Multinationals that can evidence similar existential crisis situations should not hesitate to consider making their established transfer pricing models more flexible in order to share the burden of losses more broadly within the group. In an existential situation where a group bankruptcy is looming, any group entity has the entrepreneurial incentive to share the burden of the crisis in proportion to the relative future upside it will reap once the crisis abates and the group has survived the liquidity crunch.

While this aspect of transfer pricing crisis management will be a solution for many multinationals, it must still be applied with extreme diligence, both in terms of transfer pricing documentation and underlying analytics, as well as in providing a framework for intertemporal evolutions of the transfer pricing model. Multinationals must expect that fiscal generosity by governments through *ad hoc* guarantees, non-taxation, and subsidies in 2020 will, in the subsequent years, turn to more aggressive tax environments as governments themselves must act to get their fiscal position in order to preserve the confidence of their creditors.

In post-crisis tax audits, multinationals that have survived the crisis must hence expect they will experience severe transfer pricing challenges where national governments will exercise beggar-thy-neighbour policies, arguing that COVID-19-induced group losses should have arisen elsewhere. The stressed financial position of governments by that time will also likely not facilitate traditional dispute resolutions through mutual agreement procedures.

In expectation of such future situations, it is wise for multinationals to embed their transfer pricing adjustments in a greater intellectual framework that is consistent with the evolution of the tax regulatory landscape in the pre-COVID years. The changes brought by the BEPS initiative provide excellent opportunities in this regard. In particular, the OECD has introduced the development, enhancement, maintenance, protection and exploitation (DEMPE) concept for intangibles and risk. This approach casts a somewhat critical view on traditional benchmarks of transfer pricing solutions and is a regulatory initiative that may be of particular help in the crisis at hand.

Public authorities wanted transfer pricing systems to evolve into more co-entrepreneurial types of profit- and loss-sharing. Adapting this regulatory drive in the COVID-19 crisis can thus be considered not only an *ad-hoc* financial reaction by taxpayers, but also a tax-compliant alignment towards a changed regulatory landscape.

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