GERMANY

NERA Economic Consulting

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Assessing the transfer pricing treatment of COVID-19 restructuring

The global public health crisis that is COVID-19 has forced small and large multinational companies to respond to revenue and margin degradation with substantial two to three-year corporate restructuring plans. These reactive and proactive responses are efforts to stabilise and restore continuity, as well as ensure the eventual growth of business operations and financial results.

Many companies are incurring substantial restructuring expenses on activities that span organisational change, manufacturing, supply chain and vendor changes, product portfolio rationalisation and so on. At the same time, tax departments are updating their global transfer pricing (TP) policies and methods to reflect the realities of where decisions are made, where value is created for current and future years, and towards those who benefit from business recovery actions.

Companies have many different tax structures that reflect how business is conducted. Limited and full risk distribution and manufacturing entities work alongside intellectual property (IP), procurement and digital strategy principals and service companies. However, multinational groups that apply a target operating margin under a transactional net margin method (TNMM)/comparable profits method (CPM), must pay close attention to what is deemed a normal operating expense versus an extraordinary or non-recurring item.

Why? In many instances, legacy TP policies apply the target margin to all expenses classified as 'above the line' by the accounting standard in effect in the entity's jurisdiction. A deeper examination of these expenses, and an economically sound base, to rethink these classifications may present companies an alternative to automatically moving unjustifiable expenses to IP, procurement or strategic principal entities.

Deciphering a 'restructuring'

The term 'restructuring expense' necessitated by COVID-19, or any major business transformation, is naturally very broad. It encompasses organisational restructuring, supply chain changes, product and go-to-market rationalisation and much more.

- Organisational restructuring activity and associated expenses may include voluntary and involuntary severance and exit 'packages' and other downsizing expenses related to workforce reduction. It also includes costs of combining departments across business units (rebadging, training, changing workflows and processes to accommodate fewer people or people temporarily working from home).
- Supply chain restructuring activity includes changes in the inter-company flow of intermediary and finished goods through legal entities and third parties; renegotiation of external vendor pricing and other contractual terms; and the closure or scale-back of manufacturing capacity, etc.
- Product rationalisation and go-to-market changes (GTM) restructuring includes the discontinuation of certain product families or stock keeping units (SKUs) and services to the customer; the centralisation of key pricing decisions; discounting conventions and global demand planning functions; and the creation or new marketing channels such as the use of less expensive third party distributors, etc.

Which of these expenses should be classified as 'above the line' and 'below the line' for TP purposes? Arm's-length pricing economics state that the 'beneficiary' from restructuring initiatives should pay. Therefore, the answer in practice depends on the functional characterisation of the controlled entity incurring the cost; the competitive or oligopolistic nature of the market in which similar uncontrolled parties operate; *force majeure* and termination/renegotiation clauses in the inter-company contract in force before the onset of the pandemic; how the business-critical restructuring and capital allocation decisions have been taken and by which entities; and whether or not that represents the company's protocol on other large transformations, etc.

Implementing change

All these factors point to a careful parsing of the nature of each group of restructuring expense: who decided the course of action; who takes the risk of the failure of the action; who benefits in the short and long term; and the TP legislation or guidance under which each entity operates, leading to a principled conclusion on which controlled party must bear what portion of the total restructuring expense.

Companies must implement thoughtful changes to their tested party profit level indicator (PLI) construction for all years in which the COVID-19 restructuring activity will occur and nest the change within their legacy TP policy, in full compliance with applicable laws and regulations. It must work in tandem with the company's policies for profit/loss sharing, research and development (R&D) cost sharing arrangements, and definitions of stewardship and directly beneficial chargeable portion of normal headquarter expenses.

In effect, the treatment of restructuring expense as such is not a change in TP methods. When the exogenous shock subsides and companies return to normal and define new growth trajectories, many elements of the long-standing TP policies can be brought back.

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