GERMANY

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How to share manufacturing network losses in the face of COVID-19

Yves Hervé and Philip de Homont of NERA Economic Consulting explain how multinationals can plan to mitigate losses faced in their manufacturing transfer pricing model.

Many large industrial groups have a global manufacturing footprint that is driven by business requirements. The functional profile of the manufacturing entities is different in each case and can range from contract manufacturers to fully fledged intellectual property owning entrepreneurs.

However, one thing that multinationals have in common is that the footprint, the product programme, and the contribution to the group value chain is always the outcome of the multinational's business strategy. Production plants will usually produce only a segment of the global product portfolio and sell their output globally or regionally via related companies. The underlying decisions, in this regard, will usually be centrally governed, just as major investment and restructuring decisions.

The COVID-19 crisis has hit multinationals on a global scale, while the local impact depends on the severity of the crisis in the respective countries, local policy countermeasures, the legacy footprint, supply chain setups, and investments made by the group. Overall, most manufacturing sites will be negatively affected from a supply and global demand perspective due to the integration of global value chains.

The resulting decline of capacity utilisation of plants will make a severe dent in their profitability and, in many cases, trigger losses. Whether and how to react to this utilisation problem is a complex challenge that requires a global master plan that cannot be left to the discretion of local entities, as local decisions could trigger negative externalities for the rest of the group.

A negative externality would arise, for example, if an entrepreneurial site closes down operations or capacities because serving customers locally is no longer profitable. This would negatively affect the entire group if such key customers are global key accounts. If the group is overall exposed to existential financial risk, this would put the survival of any operating company at risk.

Thus, COVID-19 presents extraordinary challenges that require extraordinary business adjustments. In such a situation, all group manufacturers have a joint predominant interest, namely to align to optimise the group's overall liquidity situation.

This optimisation implies, among other things, reducing group income tax payments that would arise from profitable subsidiaries in an overall heavily loss-making group. This could imply sharing the burden of cut-throat price competition in times of crisis and of underutilised group-wide manufacturing capacities, if such under-utilisation is temporary and closing down operations is not in the long-term interest of the manufacturing network. If, on the other hand, adjusting group manufacturing is deemed necessary for the survival of the overall network, there is a business case for sharing the restructuring costs between the surviving manufacturing units.

If the entrepreneurial profiles of the group manufacturers are different, such loss-splitting or restructuring cost allocation cannot be proportionate across the network. Manufacturers that are considered more routine in normal times, should have the upside to earn some compensatory excess profit in future recovery years if taking temporary losses now.

Sharing group residual profits and losses from capacity under-utilisation across a manufacturing network is not an unheard-of transfer pricing practice even in normal times. Some well-known global industrial market leaders have run such models across key territories and tax authorities have agreed to the arm's-length nature of such arrangements in advanced pricing agreements.

In times of crisis like the present period, the case for such arrangements is even more compelling. However, the transition into such a model must be diligently designed and justified through sound inter-temporal economic analysis to prevent major negative surprises in future tax audits. The arm's-length considerations at the time of the crisis, with an elaborate analysis of the risks of sticking to legacy transfer pricing systems, must be proactively documented. The post-BEPS international tax regulatory environment, which is generally supportive of more flexible transfer pricing arrangements, is a facilitator rather than a stumbling block for moving into such new innovative arrangements that reflect the unique business circumstances in which multinationals are currently operating.

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