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Transfer Pricing Newsletter

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Editor’s welcome

Welcome to Kreston Transfer Pricing Newsletter, bringing together topical articles from Kreston member firms around the world.

Through these publications we hope to raise awareness of Transfer Pricing risks and opportunities to help you.

I hope you enjoy the latest updates!

If you would like to contribute to the next edition, please get in touch with Hana, hana@kreston.com.

USA

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Year-end transfer pricing considerations in light of COVID-19

COVID-19 has caused significant decreases in demand and increased costs for multinational companies, resulting in unexpected operating losses. Examples of US businesses affected by COVID-19 include those that depend on human mobility, service delivery, and discretionary spending. Multinational companies impacted by COVID-19 should be proactive in managing their transfer pricing (TP) policies; here, we highlight some year-end considerations.

Monitoring and adjusting transfer pricing policies

Companies should consider the need to demonstrate that low operating profits or operating losses attributed to COVID-19 were a result of market conditions. With this in mind, there will be several new challenges for benchmarking comparable companies. The set of comparable companies utilised by multinational companies for periods before COVID-19 may be unreliable and show significant variations from the tested party. Multinational companies will need to provide evidence of comparable companies that are similarly susceptible to COVID-19. When performing a benchmarking analysis, multinational companies may need to consider new operating metrics when searching for comparable companies, such as operating leverage. Multinational companies may also consider evaluating historical financial data of potentially comparable companies during similar economic downturns for their particular industry.

Similarly, if a multinational company's transfer prices are based on the individual product level, they may want to consider making changes to their transfer prices to reflect the impact of COVID-19. In this case, the multinational company may need to consider how they can demonstrate that companies in their industry made similar changes to product pricing.

Another consideration for multinational companies is changing multinational companies' multi-year averaging approach when performing a benchmarking analysis. Multinational companies typically rely on a multi-year approach when calculating the returns for comparable companies. Due to COVID-19's effect on the current economic environment, a single-year approach may be more appropriate for capturing the impact of COVID-19 when benchmarking operating results.

The timing of financial data for private and publicly listed companies is another consideration to keep in mind when performing benchmarking analyses for planning purposes. As live financial data is unavailable, multinational companies typically rely on historical financial data when utilising benchmarking studies to set current-year TP. Given the delayed timing of financial data for private and publicly listed companies, it might make sense to consider frequently updating TP analyses that are being used for planning purposes.

Intercompany strategic services payments

Multinational companies are spending significant time and resources on navigating the complex economic environment created by COVID-19. In some cases, they might need to evaluate the benefit of strategic

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Year-end transfer pricing considerations in light of COVID-19 continued

services received by their global affiliates and whether an intercompany support payment should be implemented for such services.

IRS FAQ on transfer pricing best practices

In May 2020, the US Internal Revenue Service released a 'frequently asked questions' report (FAQ) to help taxpayers use best practices when preparing TP documentation. While COVID-19 has not modified US TP principles, multinationals should self-review their current TP documentation to see if it can be improved. The FAQ addresses the following questions:

- What benefits, in addition to potential protection against penalties, might there be for taxpayers who invest in robust TP documentation?
- How can a "self-assessment" help to anticipate questions and prepare better documentation?
- What is the guiding principle for establishing that arm's-length prices were charged in intercompany transactions?
- What areas of TP documentation could typically benefit from improvement?
- What are some features of the most useful TP documentation reports?
- Can you provide an example of a presentation of a company's intercompany transactions that would be a helpful summary for examiners to use in risk assessment?

Within the FAQ, the IRS recommends performing a sensitivity analysis to assess how changes in the parameters used will affect the analysis results. For example, a taxpayer could try removing one of the comparable companies used in a set to see if the tested party results fall outside of the benchmarked range. Additionally, taxpayers can assess the tested party's results against various profit level indicators to see if the same conclusions are reached.

In the FAQ, the IRS also identifies several areas within TP documentation reports that could benefit from improvement. These may offer useful pointers for non-US multinationals too, since improving them may increase efficiency in the event of an audit:

- Industry and company analysis sections of the report should be clear and provide context for related-party transactions.
- Functional analysis narratives should be robust and link facts to analysis.
- Risk analysis should be consistent with intercompany agreements.
- Support for best method selection must be provided, as well as the reason for rejecting specified methods.
- Analysis should be provided to support the Profit Level Indicator conclusion.
- Complete comparability analysis should be provided.
- The impact of differences in risks or functions between the tested party and the comparable companies should be provided.
- Detailed well-reasoned support for proposed adjustments to the application of a specified method should be provided.

SINGAPORE

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Transfer pricing support measures by the Inland Revenue Authority of Singapore

Singapore businesses, which have been adversely impacted due to COVID-19, will welcome the much-awaited support measures and tax guidance recently released by the Inland Revenue Authority of Singapore. Key points are outlined below.

Transfer pricing documentation

Information to be included (to the extent applicable) in the TP documentation to substantiate the impact of COVID on profitability:

- **Industry analysis:** Effect on industry due to COVID, and as a consequence how it has impacted the group or Singapore entity.
- **Key decision makers:** Which entity in the group is responsible for taking key decisions and is therefore responsible for assuming the related risks.
- **Functional analysis:** Functional, asset and risk analysis of the Singapore entity and the related parties before and after COVID, to highlight any reallocation of functions/assets/risks.
- **Contractual arrangements:** Detail of inter-company agreements, specifically highlighting any changes to the terms and conditions resulting from COVID.
- **Budget versus actuals:** Comparison of budgeted versus actual profit and loss, and explanation for the variance.
- **Profitability:** Reasons and explanations for the negative impact on profitability.
- **Government assistance:** Details of any government assistance received and the impact on operations due to restrictions.

Term testing

Multiple-year analysis in case of tested party:

- Multiple-year data for the Singapore entity may be considered as a one-off approach for the year of assessment 2021 without consulting the IRAS.
- Data for financial years 2018, 2019 and 2020 (of the Singapore entity) can be considered to calculate the appropriate profit level indicator.

The rationale for this approach is to improve comparability. Based on multiple-year analysis, appropriate adjustment can be done in the account books for the financial year 2020 to reflect the arm's length outcome.

Advance pricing arrangement

- IRAS recommends discussion to assess whether a new or renewal APA application may be filed (in case business has not been significantly impacted by COVID), or defer filing until there is greater level of certainty with regard to the factors that influence inter-company pricing.
- For applications under review and negotiation, IRAS suggests that the taxpayers should assess whether there are any TP implications arising from COVID. If there are significant uncertainties, IRAS may put the case on hold or terminate the APA process.
- For an existing APA agreement, the business should assess whether there is any breach of conditions due to COVID. If so, IRAS will evaluate the best possible outcome.

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Transfer pricing support measures by the Inland Revenue Authority of Singapore continued

Conclusion

This much-needed guidance demonstrates IRAS's commitment to guiding and supporting business. IRAS understands the challenges they face, and offers taxpayers an opportunity to engage in early discussion to agree a future course of action.

GERMANY

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Impact of the coronavirus pandemic on transfer pricing in Germany

Despite the COVID-19 pandemic and the associated loss of sales and profit for many German companies, fiscal audits with a focus on transfer prices continue to be carried out in Germany with unchanged rigour. Companies are increasingly facing difficulties in bearing the resulting tax payments. Against this background, it is becoming crucial for our clients to adjust transfer prices to market changes resulting from the pandemic, without exposing themselves to further future audit risks. The following considerations play an important role.

Control of routine margins

If the transaction-related net margin method (TNMM) is used, target margins for low-risk contract manufacturing and sales companies should be quickly adjusted to the new market conditions. This can also be helpful to ensure liquidity.

The current margins and experience from the 2008/9 financial crisis could be used as a benchmark. Short-term indicators should also be considered. Regional as well as industry differences must be taken into account.

It should be noted that in the past, the margins of contract manufacturers were significantly more cyclical than the margins of routine sales companies.

According to the German tax administration, routine companies should generate low but steady profits in the usual course of business. Because of the coronavirus pandemic and the timing of the lockdown in almost all states, it is no longer possible to speak of a normal course of business. Routine companies should therefore be allowed to generate losses, at least for a limited period of time.

Regular annual reviews of margins are recommended, including reviews based on the latest economic data.

Securing liquidity (intra-group loans)

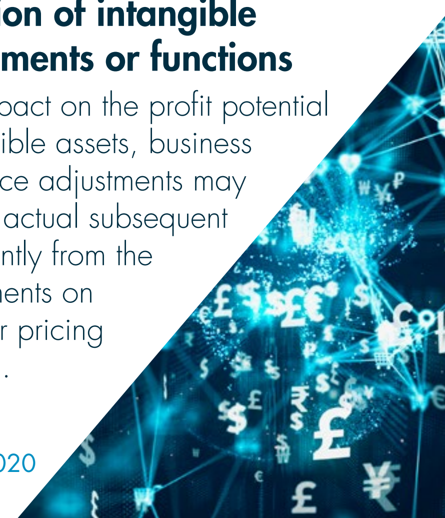
When lending within a group in the current situation, loan conditions such as collateral and special rights of termination must be considered. Along with the risk of default, these affect the transfer price (interest rate).

If intra-group loans are refinanced by third parties, any increase in refinancing costs must be considered when determining the arm’s length intra-group interest rate.

An alternative way of providing liquidity support could be to grant income subsidies. If the company involved is strategically important for the group (e.g. for serving international customers), then it is quite conceivable that a third party would grant an income subsidy, for example, to be able to service the orders (see also the European Court of Justice judgment of 31 May 2018 – C-382/16, Hornbach case).

Transfer and valuation of intangible assets, business segments or functions

The pandemic has an impact on the profit potential of past transfers of intangible assets, business segments or functions. Price adjustments may have to be made, as the actual subsequent profits can differ significantly from the expected profit developments on which the original transfer pricing determination was based.



Impact of the coronavirus pandemic on transfer pricing in Germany continued

Extraordinary expenses and service fees

As the crises can lead to extraordinary expenses, some of which can be connected to intra-group services, some companies are faced with the question of whether these extraordinary expenses can or should be charged to other group companies as part of a service fee. While a definitive position of the German tax administration is not yet known, intra-group service agreements should still be checked for any necessary adjustments.

MEXICO

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Tax perspectives for transnational companies in Mexico

The global COVID-19 pandemic has forced many countries to adjust their tax audits and economies; and Mexico is no exception. The current scenario is that we will be losing about 9% of GDP, representing the loss of some 5 million jobs according to various experts. This severely impacts the local economy, as well as the labour force for transnational transactions. The Mexican tax authority has taken a regulating approach towards foreign entities in Mexico, with greater emphasis on enforcing tax obligations.

Derived from Action 12 of the BEPS plan, congress has approved a new model for the tax authority that comes into effect this year. The 'Esquemas Reportables'[1] (Reportable Schemes) model now requires that certain transactions are reported not only by the company itself, but also by the tax consultant of the company – defined as 'any individual or company that in their activities is responsible, or is involved in the design, commercialization organization or administration of any reportable scheme'. Examples of relevant transactions include:

- Legal acts that allow transfer of losses
- Corporate restructurings
- Transactions affecting >20% of the total accounting
- Transactions between related parties that don't comply with the tax requirements, when the activity reports a tax benefit for the company.

Most of the points in this new model align with the BEPS plan. If a reportable scheme is not presented, the company will be fined, but there will be a much higher fine for the tax consultant. The new model thus aims to make the tax consultant responsible, and TP consultants must report clearly to the tax authority on these kinds of operation.

The reportable scheme model, and the increase in tax collection, indicates that the current government plans closer monitoring of any transaction that can erode the taxable base for Mexican entities

Despite the pandemic, tax collection increased by about 3% in the first two quarters of 2020, translating to 53,591 million pesos,[2] mainly from big companies with TP-related issues.

The reportable scheme model, and the increase in tax collection, indicates that the current government plans closer monitoring of any transaction that can erode the taxable base for Mexican entities. This will make TP specialists in Mexico more proactive in determining the current arm's length model: they must review each transaction in depth to ensure that it complies with the new regulations. We can expect increasing audits from the tax authority, especially given that this year, most comparable companies/transactions will have a decrease in their margins so it will be difficult to choose the comparability for any Mexican entity. Adjustments, revisions and selection of models will be more difficult than ever, since Mexico is one of the countries with the highest GDP loss; but perhaps this offers an opportunity to resolve current issues with the model of any transnational company.

1. http://www.prodecon.gob.mx/Documentos/bannerPrincipal/2020/esquemas_reportables.pdf

2. https://www.gob.mx/sat/prensa/incrementa-recaudacion-por-ingresos-tributarios-en-el-primer-trimestre-de-2020-10-2020

SPAIN

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Related parties in Spanish tax law versus Spanish commercial law

Given the broad range of business operations possible, a clear definition of 'related-party' operations is essential to ensure that legal requirements are met in both the tax and commercial spheres.

- **Tax:** The Spanish Corporation Tax Act (*Ley de Impuesto sobre Sociedades* – LIS) includes provisions regarding related parties that aim to counteract the high risk of tax fraud, making it an anti-avoidance provision (transfer price provisions).
- **Commerce:** In the Spanish General Accounting Plan (PGC) provisions on compiling annual accounts and the Spanish Code of Commerce (CC), the definition of related parties aims to comply with regulations on financial/accounting information and proper understanding of financial statements and transactions carried out by companies.

Since tax and commercial laws serve different purposes, they generate rather different meanings of what is considered 'related parties'. This can cause some confusion: since the commercial definition must be included in the report with the annual accounts, it is sometimes mistakenly also used for tax purposes.

Here, we examine situations that can arise where the related parties established in tax law (the LIS) differ from the related parties defined in commercial law (the PGC provisions on compiling annual accounts, and the CC). Some companies are considered related parties under commercial law that are not defined as such under tax law, or vice versa:

- **Case 1:** Both tax and commercial law coincide in defining the ties between two or more companies as related parties if they belong to a group, as per the definition of a group in article 42 of the CC. In this case, there is no discrepancy between the two laws in their classification of related parties.
- **Case 2:** For tax purposes, 'significant influence' is strict and cannot be refuted: 'related parties' is determined by the company, or partners, having a stake of 25% or more.

Commercial law, however, considers companies to be related parties if 'significant influence' is exerted on the management of the other company, defined as follows:

- The company, or one or several companies in the group, including the controlling organisations or individuals, holds a stake in the other company, *and*
- They have the power to intervene in decision-making regarding the financial policy and exploitation of the company in which a stake is held, without having control of it.

Likewise, significant influence can be proven in any of the following ways:

- Representation on the board of directors or equivalent governing body of the company in which a stake is held
- Participation in policy-making processes
- Significant transactions with the company in which a stake is held
- Interchange of managerial personnel
- Provision of essential technical information.

Significant influence is presumed, unless proof is provided to the contrary, when the company – or one or several companies in the group, including the controlling organisations or individuals – holds at least 20% of the voting rights in the other company.

Related parties in Spanish tax law versus Spanish commercial law continued

Some companies are considered related parties under commercial law (and their operations reflected as such in their annual accounts), but not under the Spanish Corporation Tax Act. This would apply, for example, to operations between one company and another the first holds a stake in, when the former holds between 20% and 24% of the latter.

- **Case 3**: Tax law establishes a relationship between a company resident in Spanish territory and its permanent establishments (PEs) abroad, while commercial law does not. This is logical because, in line with the provisions of tax law, income from the PE is exempt from taxation in Spain; so it is vital that operations between the company and its PEs abroad are carried out at market value. In commercial law, however, operations between a company and its PE are irrelevant because they are carried out by the same legal entity and are all included in the same annual accounts.

We advise companies to analyse their related-party operations by type, looking at the tax and commercial ramifications separately, to determine precisely which are related-party transactions and, above all, when they must be documented in a transfer pricing study, in addition to the annual accounts.

BRAZIL

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Resale price less profit method (PRL)

The Brazilian equivalent of the PM is defined as the weighted average price for the year of the resale of property, services or rights minus unconditional discounts, taxes and contributions on sales, commissions and a gross profit margin determined in the tax legislation. As of 1 January 2013, a 20% gross profit margin is required for industries/sectors that are not specified in the legislation, calculated based on the percentage of the value imported over the final resale price. For the following industries/ sectors. a different mark-up is required.

Sectors where a 40% profit margin is required:

- Pharma chemicals and pharmaceutical products
- Smoke products
- Optical, photographic and cinematographic equipment and instruments
- Machines, apparatus and equipment for dental, medical and hospital use
- Extraction of oil and natural gas, and oil derivative products.

Sectors where a 30% profit margin is required:

- Chemical products
- Glass and glass products
- Pulp, paper and paper products
- Metallurgy.

Transfer pricing methods – exports

The methods established by Brazilian legislation to calculate transfer prices on the export of goods, services or rights between related parties are:

- Export sales price method
- Wholesale price in country of destination less profit method
- Retail price in country of destination less profit method
- Acquisition or production cost plus taxes and profit method.

It is worth mentioning that companies falling within the safe harbour set forth in the applicable legislation are not required to prepare a study to demonstrate the legality of their transfer prices

The only recent change in respect to exports refers to the creation of a fifth method, which is destined to calculate transfer prices connected with the export of commodities ('commodity exchange export price').

It is worth mentioning that companies falling within the safe harbour set forth in the applicable legislation are not required to prepare a study to demonstrate the legality of their transfer prices. If a given company has registered more than 10% of the export revenue in the transactions with related parties as profit, it is entitled to demonstrate the correctness of its transfer pricing control based solely on the transaction's documentation (this percentage used to be 5%). However, please note that such safe harbour only applies if the net export revenue derived from transactions with related parties represents up to 20% of the total net export revenues.

INDIA

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Indian tax: Safe harbour rules

On 20 May 2020, the Indian tax department issued a notification specifying the safe harbour rates applicable for the 12-month financial year ending in March 2020 (FY 2019/20), for determining arm's length rates for certain international transactions affecting the transfer pricing regulations.

The notification states that the same rates as were applicable during the last three financial years (FY 2016/17 to 2018/19) would also apply for FY 2019/20. Unlike earlier (2013 and 2017) safe harbour notifications by the tax department, which gave safe harbour rates for 5 years and 3 years, respectively, the current notification provides safe harbour rates for only 1 year (2019/20).

Safe harbour rates provide the arm's length price issued by the tax department for specified international transactions. If a taxpayer undertakes certain specific international transactions at the specified safe harbour rates, it will be acceptable to the tax authorities and no further transfer pricing audit, or consequent adjustment, will be required. The table summarises the safe harbour rates notified for various transactions for FY 2019/20.

Taxpayers opting for the safe harbour rules for FY 2019/20 must file Form 3CEFA with the Assessing Officer on or before 30 November 2020.

There has also been a significant amendment in the Indian tax laws in 2020: the safe harbour provisions now also cover profit attribution for permanent establishments.

Sl no.	International transactions	Monetary threshold	Safe harbour rates
1	Software and information technology enabled services	Up to INR 1 billion	17%
		INR 1 to 2 billion	18%
2	KPO services	Up to INR 2 billion and employee cost to total cost ratio is:	
		Up to 40%	18%
		40–60%	21%
		>60%	24%
3	R&D services related to software development	Up to INR 2 billion	24%
4	R&D services in generic pharmaceutical sector	Up to INR 2 billion	24%
5	Intragroup loans in Indian currency	Depending on credit rating of AE from AAA to D	Lending rate of State Bank of India as on 1 Apr 2019 + 175–425 bps
6	Intragroup loans in foreign currency	Depending on credit rating of AE from AAA to D	6 months LIBOR as on 30 Sep 2019 + 155–400 bps
7	Corporate guarantee	No threshold	1%
8	Manufacture and export of core auto components	No threshold	Operating cost + 12%
9	Manufacture and export of non-core auto components	No threshold	Operating cost + 8.5%
10	Receipt of low value-added intragroup services	Value below INR 1 million	Margin not more than 5%

VIETNAM

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Transfer pricing in Vietnam: Potentially high cost of overlooking local norms

This article provides practical insights on transfer pricing (TP) audits in Vietnam. It explains why MNCs in Vietnam invest considerable resources in preparing their TP documentation, yet often still end up paying significant amounts of tax and penalties associated with their related party transactions.

As COVID-19 continues to affect people and businesses around the world, and governments are providing relief packages to address the economic impacts of the pandemic, plans may be underway to recoup government spending through taxation. In Vietnam, apart from hard-hit sectors such as airlines and tourism, most affected businesses are medium and small businesses, which have been granted a 5-month deferral of tax payment and 30% corporate tax reduction in 2020.

This leniency to affected businesses is likely to continue. To compensate for this, tax authorities in Vietnam will probably focus on large local and multinational companies (MNCs) – especially TP, which has been audited more closely since the major reform of Vietnam's TP regulatory framework in 2017.

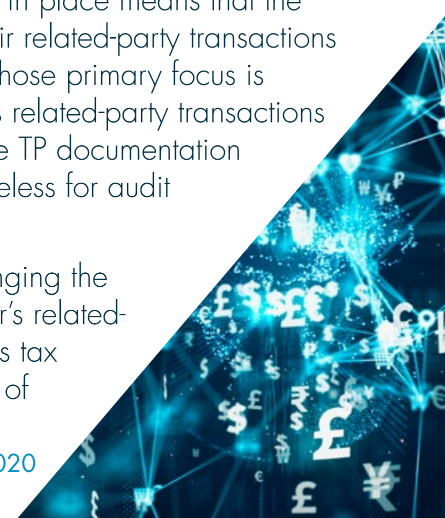
Transfer pricing – the pricing of intragroup transactions (mostly cross-border) within and between enterprises under common ownership or control ('related parties') – is not illegal. It is only unacceptable to tax authorities when a related-party transaction is not considered by tax auditors as a legitimate transaction, or is not conducted at arm's-length (i.e. at a fair market price).

Vietnam's first TP regulatory framework in 2017 was widely regarded by finance and tax specialists as a comprehensive set of rules that align well with international practices, closely following the OECD's TP guidelines. Many MNCs in Vietnam invest heavily in their preparation of TP documentation, to defend their TP practice if challenged by tax auditors. However, unless this adheres to local norms of transaction recording and documentation, MNCs can still face heavy penalties, including:

- A 20% tax penalty on the amount of corporate income tax adjustments resulting from the disallowed tax deductions of related-party charges;
- A 0.03% daily accruing interest penalty on the tax in arrears, in addition to the tax claw-back arising from TP adjustments;
- Foreign contractor withholding tax, which applies when a company in Vietnam makes a contract payment to a overseas related party (e.g. loan interest, service charges, cost reimbursements, royalty fees). This cost (which represents the foreign contractor's deemed corporate income tax) ranges from 1% to 10% of the gross amounts of the contract payments.

Companies would be wrong to assume that having proper TP documentation in place means that the arm's length nature of their related-party transactions will satisfy TP auditors, whose primary focus is legitimacy. If a taxpayer's related-party transactions fail the legitimacy test, the TP documentation dossier could become useless for audit purposes.

In practical terms, challenging the arm's-length of a taxpayer's related-party transactions requires tax auditors to research a lot of



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Transfer pricing in Vietnam: Potentially high cost of overlooking local norms continued

information (e.g. identifying or developing their own comparables). And it is not difficult for taxpayers to prove the legitimacy of related-party transactions with tangible exchanges of resources (e.g. loans, sale/purchase of goods, contract/toll-manufacturing). It is much easier for tax auditors to apply the legitimacy test to transactions involving less tangible exchanges of resources, such as shared services (e.g. tax, accounting, HR, legal, IT support), strategic management services, R&D services, intellectual property licensing, cost-sharing arrangements, secondment of personnel, and so on.

Taxpayers can be surprised by what tax auditors look for when applying a legitimacy test. They might look for little things, such as a missing document named 'invoice' (MNCs often use 'debit note' instead), a formal statement of work, a service level agreement (master services agreements alone are often insufficient), service charge allocation keys, evidence of specific service requests, proofs of services rendered, sample of service deliverables, service completion and handover reports, independent auditor's verification report of the service charges, and so on.

Many MNCs do not have all of these formal documents to support their related-party transactions because related parties are usually unlikely to have a legal dispute over an intragroup transaction, and because paperwork is streamlined for administrative efficiency. However, although email communications are now a prevalent mode of doing business, tax auditors rarely accept them as substitutes for formal paper documents. A taxpayer with a clear email trail proving the legitimacy of its related-party transactions could still end up being denied tax deductions of related-party expenses by tax auditors.

While Vietnam's tax system is moving fast to digital tax administration (e.g. online tax filings, e-invoices, etc), tax auditors have yet to move on from the traditional norms of working with paper-based transaction documents

Tax auditors also insist that almost everything concerning related-party charges must be substantiated by formal paperwork: only originals or certified photocopies are accepted as transaction evidence for tax deduction purposes. Furthermore, if the transaction evidence is in another language, a Vietnamese full or summary translation must be provided.

While Vietnam's tax system is moving fast to digital tax administration (e.g. online tax filings, e-invoices, etc), tax auditors have yet to move on from the traditional norms of working with paper-based transaction documents. Until this changes, taxpayers in Vietnam (especially MNCs) are advised to beware of these local norms: overlooking or ignoring them could have costly consequences.

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