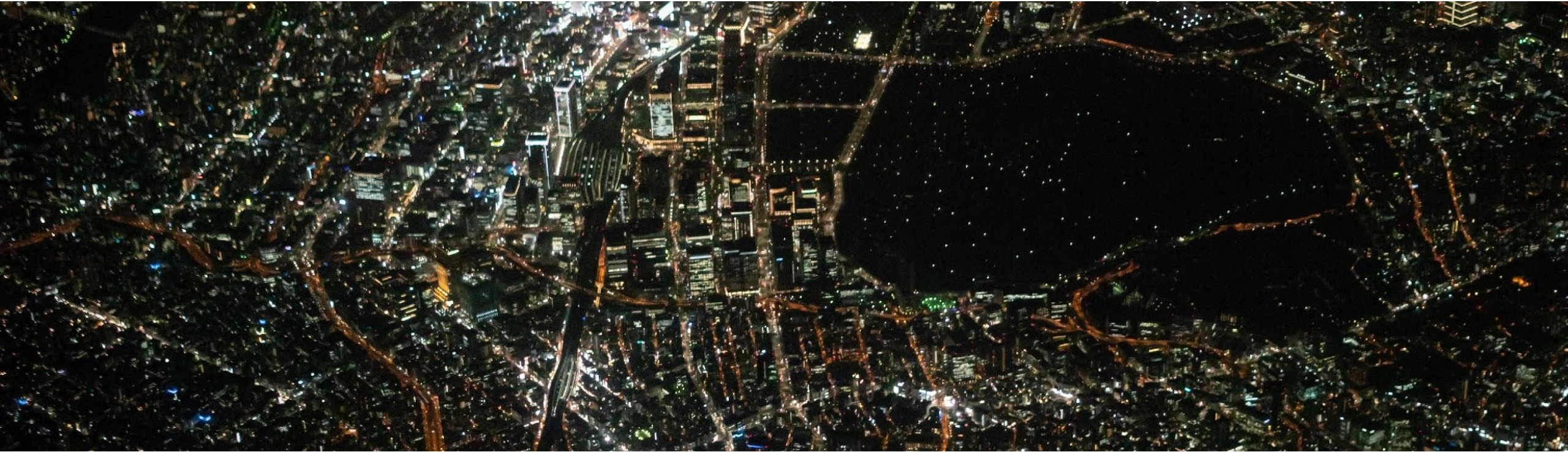
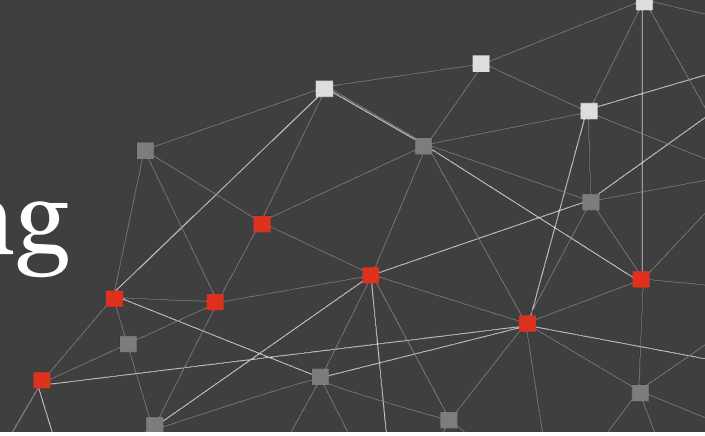


Impact of Covid-19 on Transfer Pricing

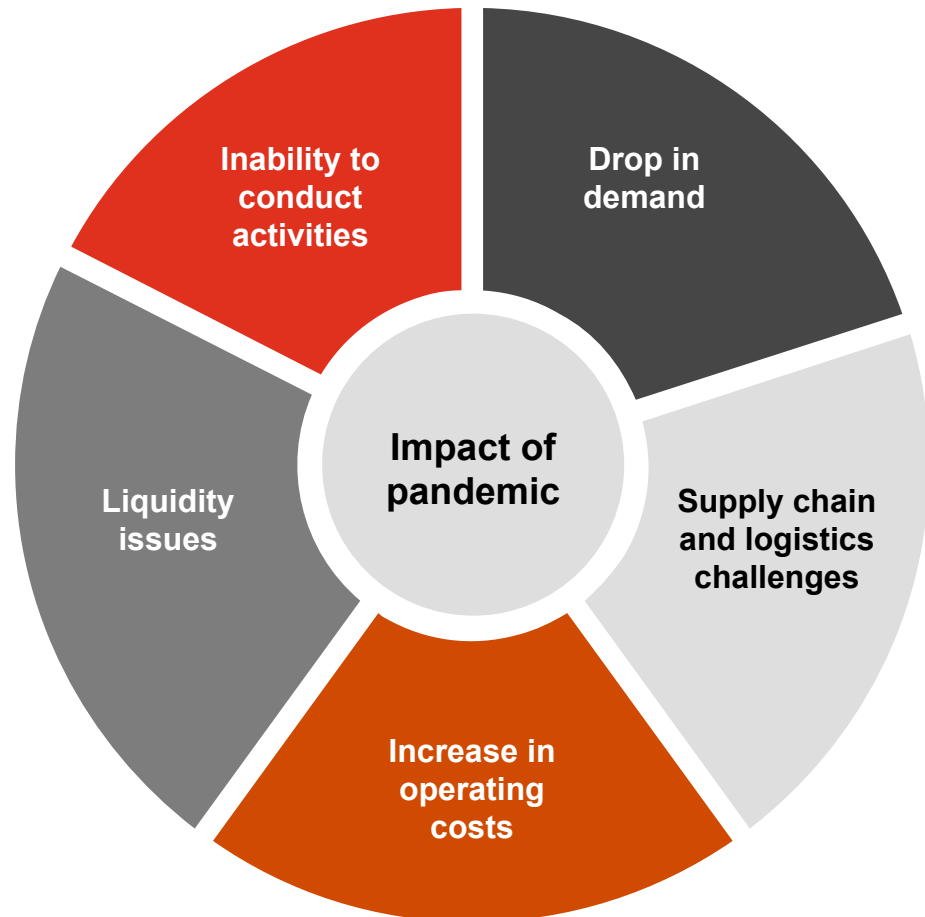


Topics

1. Introduction
2. Impact of Covid-19 on tested party, comparables and contracts
3. Impact on financial transactions
4. Business model changes during the pandemic
5. What's next and key takeaways
6. Q&A



How can Covid-19 impact your transfer pricing position?



Impact on transfer pricing policy or APA



Derogation from contractual terms



Allocation of losses and impact on tested party's result



Changes in business models, supply chain and financing arrangements

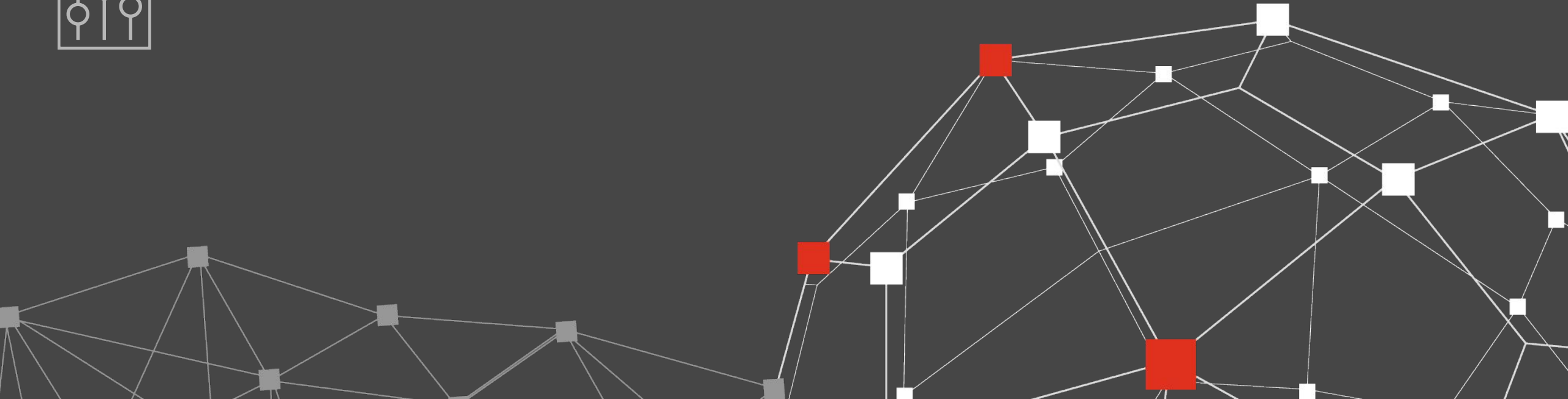
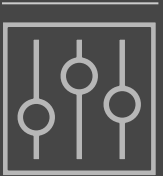


Increased audit scrutiny and pressure

Position of Tax Authorities in the SEE region

Countries	Croatia	Slovenia	Bulgaria	Macedonia	Albania	Serbia	Bosnia and Herzegovina	Kosovo	Montenegro
Is there any published guidance or views from the authorities?	No published guidance	No published guidance	No published guidance	No published guidance	No published guidance	No published guidance	No published guidance	No published guidance	No published guidance
APA impact	APA available, but limited number of existing cases	APA available, but limited number of existing cases	No APA	No APA	APA available, but limited number of existing cases	No APA	No APA	APA available, but limited number of existing cases	No APA
Reconsideration of business operating models during or following the pandemic	As most of the local subsidiaries of MNEs operate as limited risk / managed margin entities, any reconsideration of business models envisaged in light of group overall losses impacting the local entity need to be carefully considered from a local perspective in order to ensure sustainability.								

TP considerations of changes in operations



Changes in the operation and supply chain



Supply chains, factory shutdowns, staff shortages, customers and trade issues



Significant impact on existing I/C transactions

- Transactions involving the flow of goods, services and financing in particular, may be disrupted or economically altered.



MNEs may enter into one-off new I/C transactions to meet short term needs



Subsidiary A, country A and subsidiary B, country B – the same raw material component – a third party vendor (China)

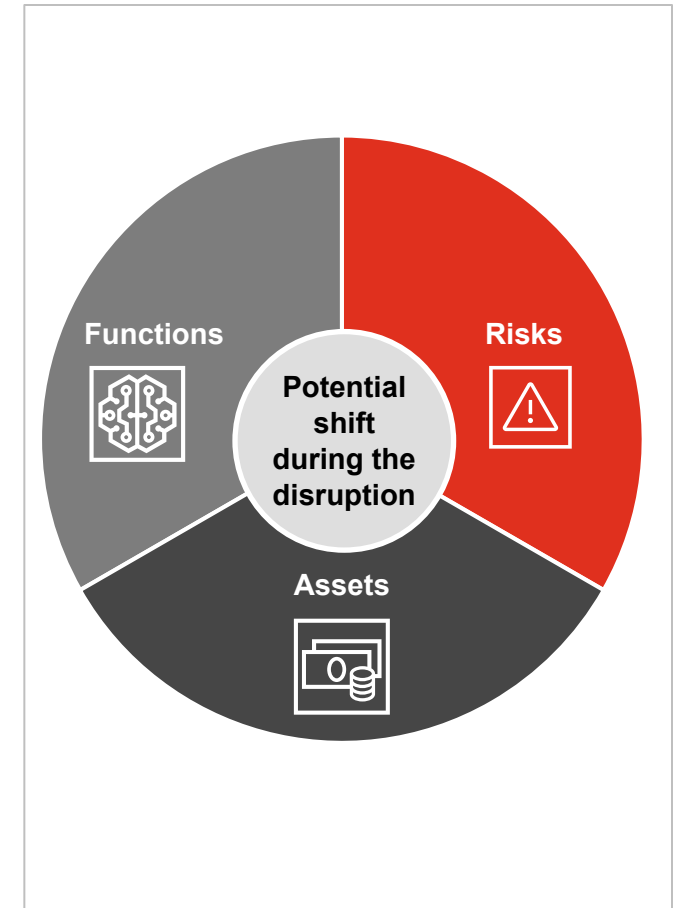


Result of a supply chain disruption – the Chinese vendor temporarily suspend supplies. The in-house procurement department (at HQ) – identifying a surplus of raw materials in Subsidiary B – I/C transfer to subsidiary A.

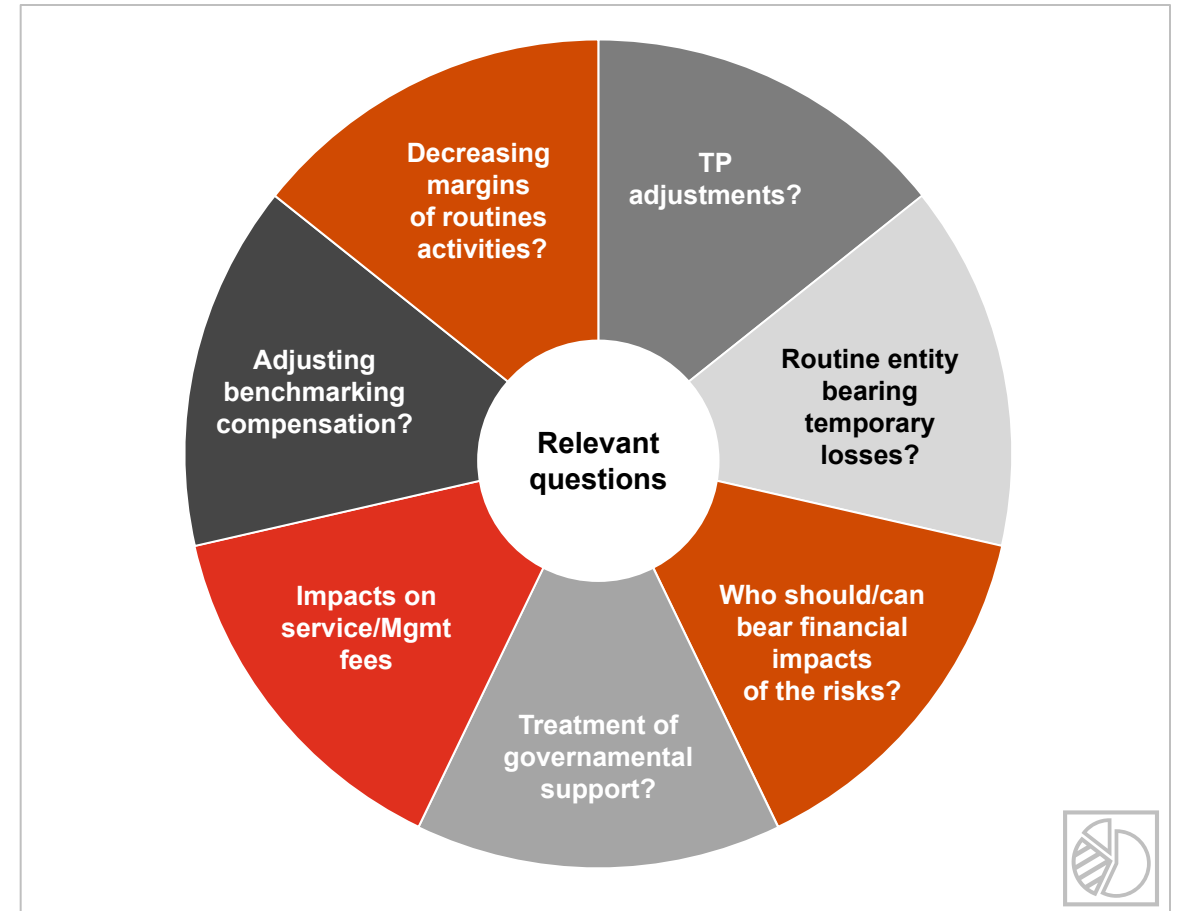
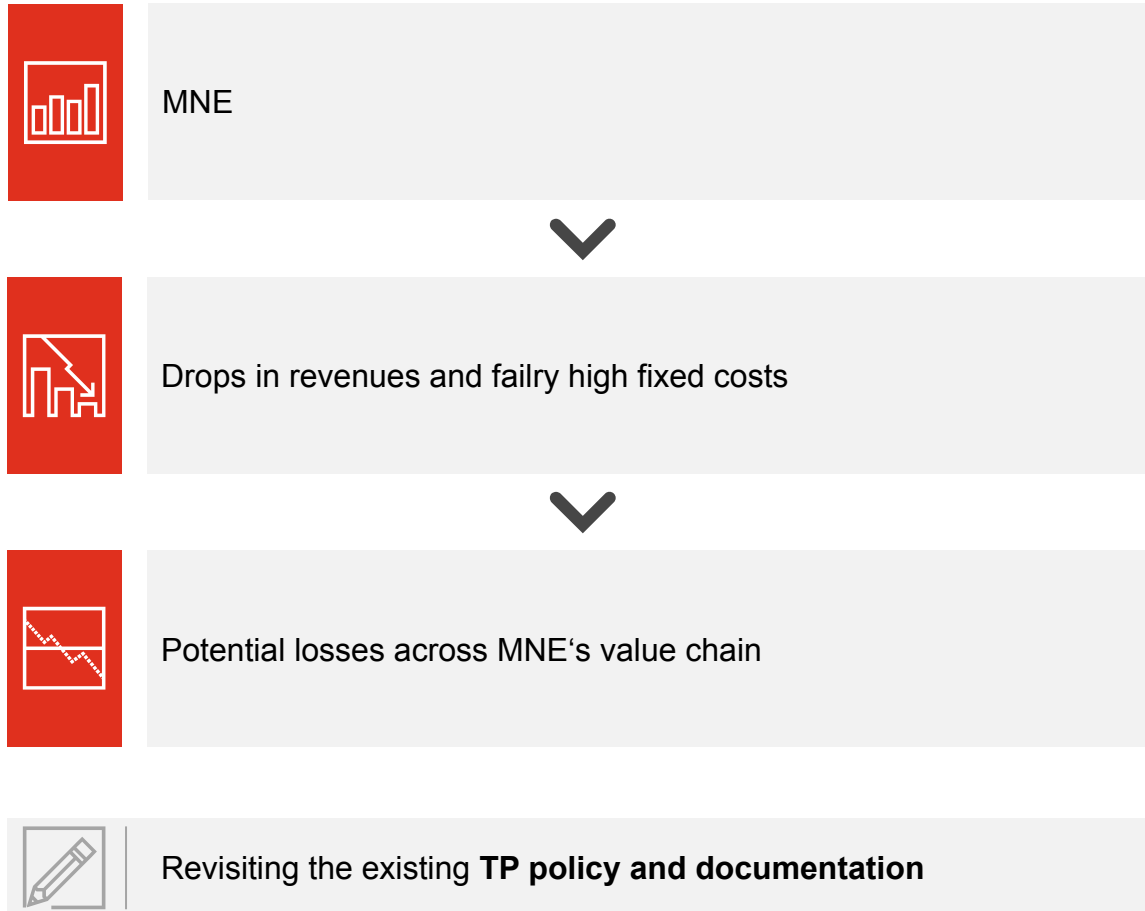
- Similarly, **groups may change the level of functions performed by certain entities (i.e. scaling down or up production capacity).**

- Groups are also making **changes in headcount** in certain legal entities due to changes in demand.

- **Technology** may play a bigger role in the value chain and may be considered as a replacement of specific headcount and/or wider functions



The impact of Covid-19 on routine profits

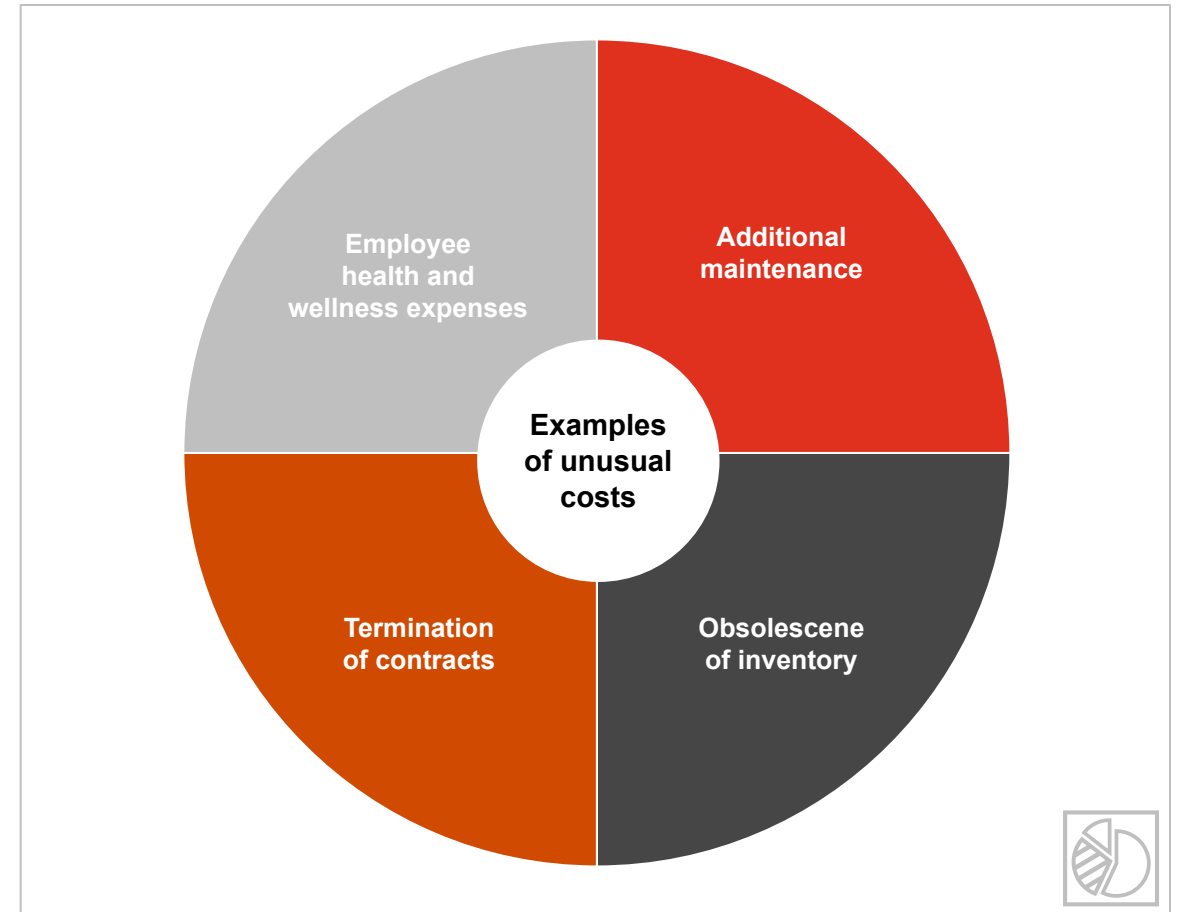


Unusual one-time charges



Allocation of unusual cost

It is recommended to distinguish the unusual costs caused at different stages (e.g. during the epidemic period and during the recovery period after the epidemic) and **to prepare corresponding documentation to explain which party in a group should bear the costs or quantify the extraordinary losses caused by the epidemic** – justification of unusual costs.



Changes in contractual terms



Challenging questions

- Are current IC agreements tailored to cope with the current situation and do they have unforeseen consequences to the non-anticipation of the current events?
- Can IC agreements be amended to provide for different pricing terms?
- How to justify the amendments / changes of IC agreements?

Tax

As to what are the TP consequences of failing to follow the contractual pricing terms (or of amending the contractual pricing terms)

Legal

As to whether the existing pricing terms are contractually binding on the parties as a matter of contract law



Two base issues regarding changes in contractual terms

Tax

Legal



FORCE MAJEURE

The pandemic triggers application of the contractual FORCE MAJEURE clause / provisions which are usually buried deep within IC agreements or within the “Miscellaneous”. These provisions have been looked to as a potential means to effectuate a change in pricing.

Due to unforeseen events outside the control of the parties that delay performance or otherwise prevent performance entirely

Changes in contractual terms



OECD

OECD is currently reviewing the TP rules in light of the economic consequences resulting from Covid-19 pandemic and shall be issuing additional guidance.

Among the topics being considered include:

- The renegotiation of contractual terms within the parameters of the arm's length principle, as well the relevance of
- Market observations in connection with contractual modifications.

Potential considerations and arguments from the Tax Authorities

Tax authorities might consider changing of related party arrangements as trying to make tax advantages (triggering tax deductions, avoiding ongoing withholding obligations, reducing assessable income from right or property, Increasing contractually assumed risks and allocation of losses etc.)

Would independent enterprise cut the prices because of the loss as a consequence of Covid-19?



Are independent enterprises affected by the same challenges (genuine losses, heavy start-up costs, inefficiencies, etc.)?



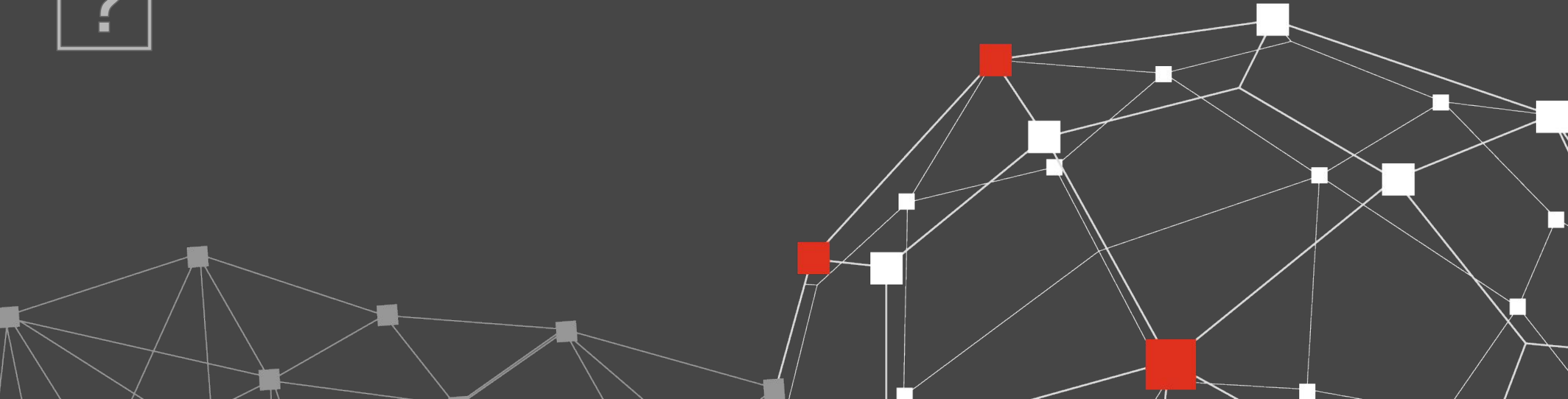
Profit sharing in the previous years -> Loss sharing in the time of Covid-19 (TP method)



Would independent enterprises seek to hold each other to the terms of the contract?



Potential adjustments to the benchmark studies



Challenges

Comparability is more difficult to establish



A need for adjustments not normally performed in ordinary years

Showing that a controlled entity earns profits within the range derived from comparable companies is often simple

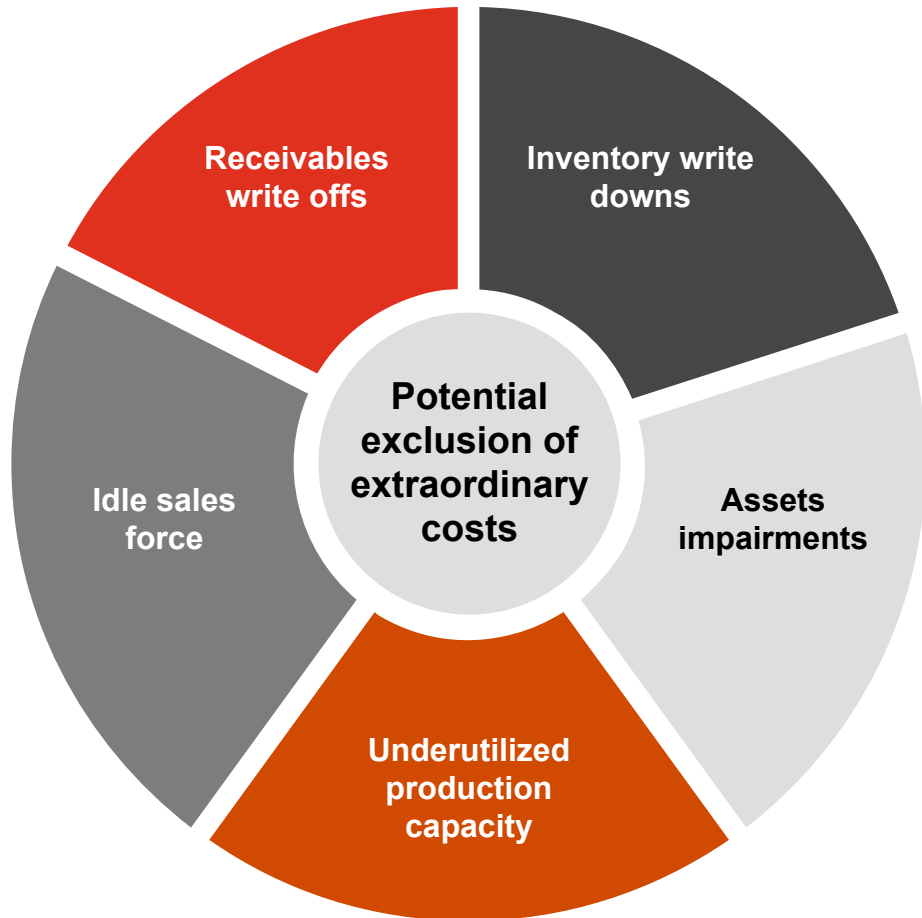


Comparability differences may become more prominent and make it harder to establish reliable benchmarks

Any potential adjustments made have to be properly justified and reflect Covid-19 impact!



Adjustments to the tested party financials



In the context of determining the net profit indicator in the application of the TNMM, OECD Guidelines state:

“Exceptional and extraordinary items of a non-recurring nature should generally also be excluded.”

(Chapter II, para. 2.86.)

Adjustments to the benchmarking period

The most recently available data for analyzing 2020 tested party results would normally be a range of years from 2017-2019



Practical challenges with regard to comparability, as the economic conditions in 2020 are very different from those of the immediately preceding years

**Limit Benchmarking
Data to Current
Downturn**

**Extension of the
Benchmarking
Period to Include
Prior Downturn**

**Limit Benchmarking
Period to Prior
Downturn Years**



Adjustments to the comparable companies profitability measures

Adjustments to the range used for benchmarking

- 10 to 60 percentile levels rather than the customary interquartile range (the 25 to 75 percentile levels)
- Perhaps even full range

Adjustments to comparable company results based on company metrics

- Review of companies' fixed and variable cost
- Changing profit level indicator
- Qualitative approaches

Adjustments to comparable company results based on macroeconomic indicators

- Taking into account data on GDP

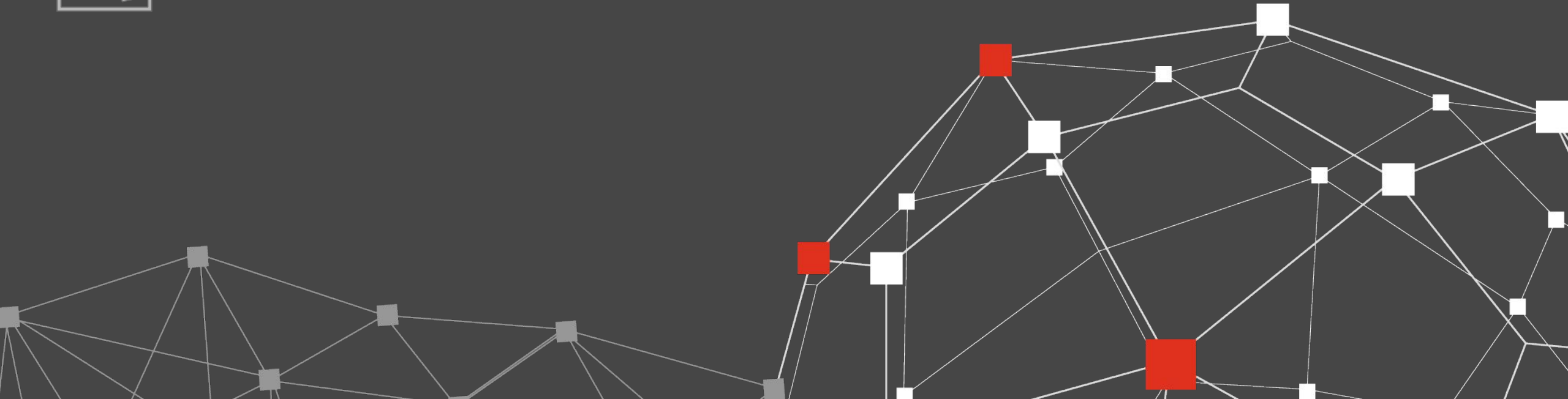
Key takeaways



- Adjustments and analysis should be based on an understanding of the specific factual circumstances and contractual terms surrounding the controlled transactions
- It is expected that tax authorities will increase the number of their reviews
- What will be the favourable approach by the tax authorities is still uncertain



Impact on financial transactions



Challenges to inter-company financial transactions



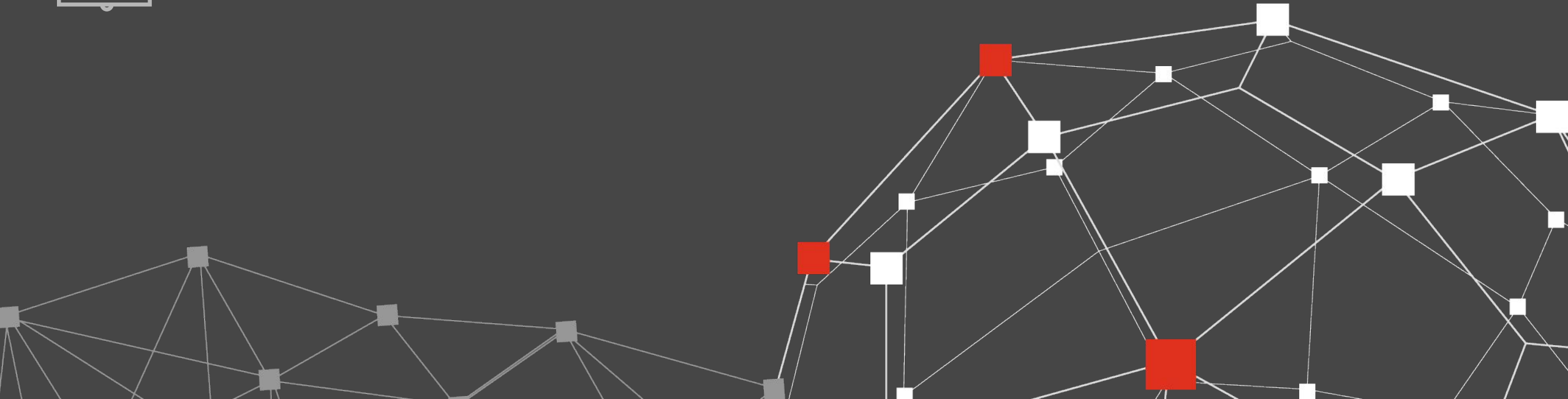
Area	Key challenges
Changes in MNE's external funding arrangements	<ul style="list-style-type: none">• Lenders may require revised terms and conditions, including pledging collateral or guarantees from affiliate companies• Parties might agree to restructure the debt with fewer, less restrictive covenants albeit at a higher interest rate• In extreme cases, lenders might attempt to enforce breaches of contract prior to actual default in order to recover
New - or changes in existing – intra-group financial transaction	<ul style="list-style-type: none">• Any financing decision should consider the current economic conditions and resulting impact on key terms.• Important to consider how creditworthiness may impact the pricing of intercompany financing transactions.• Changes in credit capacity and possible challenges to bona fide debt? (Loss making companies)
Challenges to comparability studies	<ul style="list-style-type: none">• Market rates of interest are subject to extreme volatility in today's environment, which makes the documentation and timing of the arm's length interest rate benchmarking of critical importance.• Interest rate benchmarking should be representative of the market as of the execution date. If transactions are delayed, benchmarks may have to be refreshed.
Changing TP guidelines and practices	<ul style="list-style-type: none">• New OECD Guidance and country-by-country specifics

New OECD Guidance on Financial Transactions



Area	Key tenets
Accurate delineation and opportunities realistically available	<ul style="list-style-type: none">• Loan terms must be demonstrably arm's length (duration, currency, security etc.)• The transactions must be reasonable from the perspective of the borrower• The transaction must be reasonable from the perspective of the lender• The amount borrowed must be an arm's length amount.
Cash pools	<ul style="list-style-type: none">• There must be a functional analysis• Cash pool leaders will have limited risk/function and should therefore receive limited return• Substance is key – for example the duration of deposits must be considered.
Guarantees	<ul style="list-style-type: none">• There should only be a guarantee fee if the guarantee is explicit and provides a qualifying benefit• Where guarantees result in increased borrowing capacity, calculating guarantee fees is complicated.• There are 4 alternatives methods for calculating fees.
Credit ratings	<ul style="list-style-type: none">• Credit rating estimates are important part of pricing loans (and guarantees under some methods);• Black box models should not be used• Neither the “member of the group” or “stand alone” approach is always correct. The analysis and model adopted must depend on the groups facts and circumstances.

Business model changes during the pandemic



Changes in business model during pandemic



Business restructuring

Change in:

- Operations,
- Business model or
- Other operating procedures.

Restructuring process can among other involve:

- Transfer of something of value
- Transfer of risk or function
- Termination or substantial change of contractual terms



It is necessary to examine whether in the restructuring process a transfer was made which would require compensation if it occurred under similar conditions and circumstances between third parties;

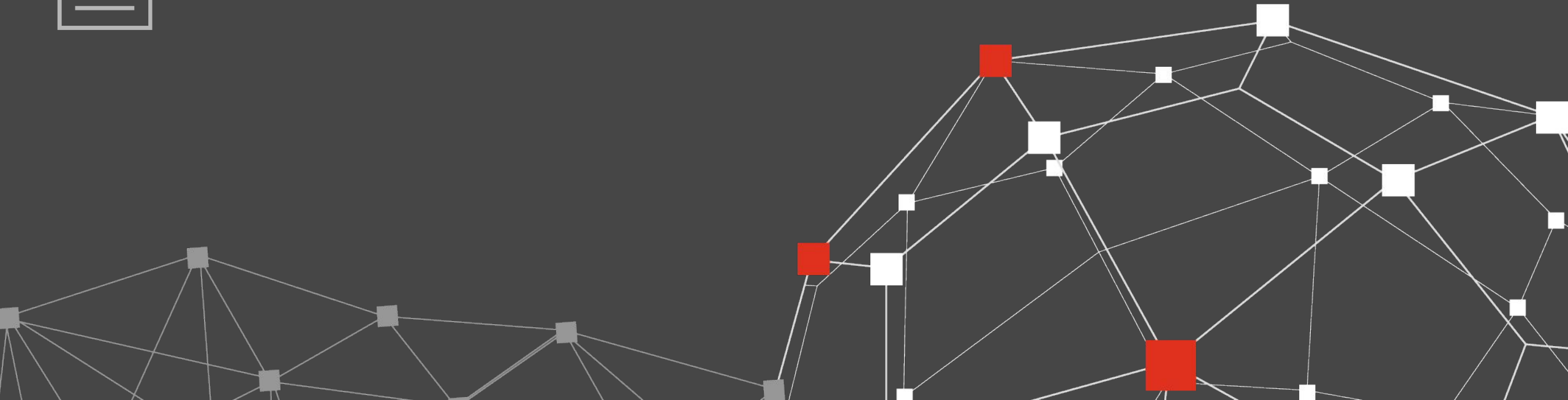


Challenges due to circumstances caused by Covid-19 pandemic :

- What are reasonable projections?
- Which data to use for the valuation?
- Should Covid-19 impact be accounted for?
- What was the driver behind the decision?
- What are realistic alternatives?



What's next?



Key takeaways

01

Additional considerations and analysis might be required from TP stand point



02

Transfer pricing impact and consideration will be highly dependent on specific circumstances of the company



03

Be mindful of local implications of Group level decisions regarding changes in TP policy

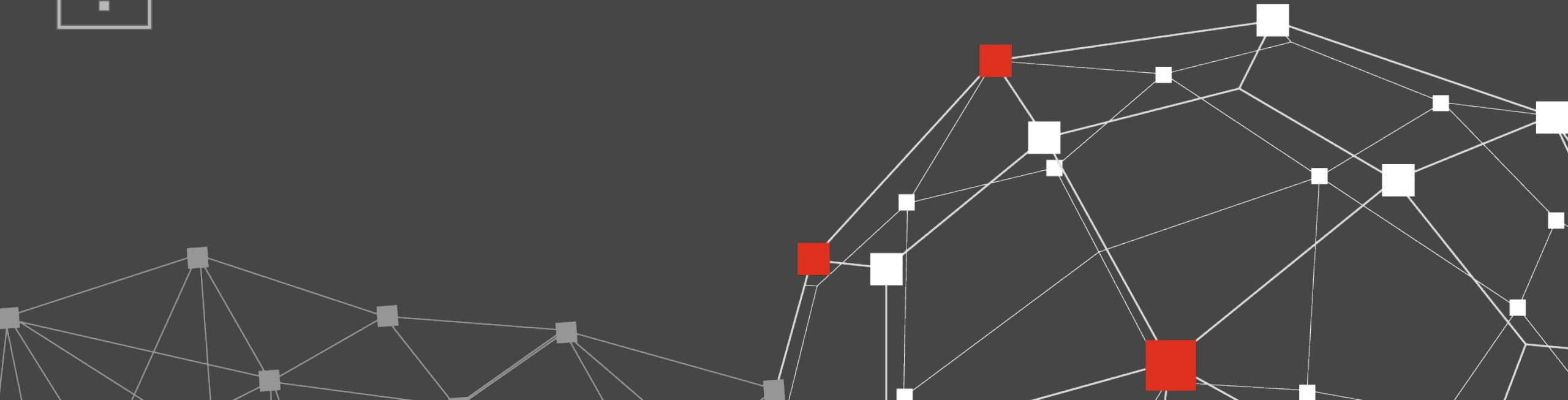


04

Ensure proper documentary and transfer pricing support for any derogations from the standard approach



Questions?



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Thank you!

