

Business disruption: Transfer pricing issues and effects for the banking and capital markets industry

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In brief

Intercompany pricing can have a magnified impact on a BCM business' financial and tax position during times of severe disruption. Transfer pricing therefore should be an important consideration for BCM businesses in these times.

A combination of reduced liquidity, negative impacts on taxable income (e.g., through loss of deposit base, drawdown of credit facilities, and increased risk of loan and credit defaults), constrained workforce mobility, and increased volatility results in greater complexity for the BCM sector's tax departments. The effects of the current economic climate on BCM business activity, and therefore a company's tax position, are difficult to assess and can change quickly. At the same time, it is critical to structure responses that are flexible and geared toward both managing the current environment as well as the weeks and months ahead. When developing strategies to address this difficult environment and maintain consistent tax positions, businesses should take into account the transfer pricing considerations outlined below.

In detail

Capital rebalancing

Multinational companies, especially those that operate diverse lines of business, may find that certain jurisdictions require immediate capital infusion or other forms of capital support. These may be provided through internal arrangements such as guarantees and debt.

Observation: Such arrangements must be transfer-priced and documented under appropriate standards, taking into account current conditions. In addition, such arrangements may have significant tax and non-tax implications that should be evaluated, especially when comparing alternative ways to shore up capital where needed.

Reduced profitability

Many BCM businesses currently are — or in the near future may be — experiencing extraordinary costs and expenses from disruption, work stoppage, and other business interruptions associated with the current downturn in the economy. These extraordinary expenses, in combination with a general softening

of the business outlook (e.g., margin erosion, reduced forecasts, depressed valuations, and lower investment income), could result in reduced US taxable income and potential negative tax consequences.

For example, BCM businesses that are experiencing reduced US taxable income because of a downturn in their business, but that still have base eroding deductions, may be more likely to have a BEAT liability. Furthermore, there is potential for increased scrutiny on banks' financial condition from regulators (e.g., Reg. W), which would need to be addressed.

To mitigate these impacts, an overall review of a company's operating model may be advisable, including potential changes to:

- Flows and terms of services (e.g., workforce mobility, staff shortages, and trade)
- Timing of income and expenses
- Operating infrastructure and IP (beneficial) ownership and exploitation (e.g., information technology and data, new technology, business outlook, and reduced forecasts)
- Routine returns for related-party service providers (e.g., sales agents and back-office support)
- Market comparables (e.g., lower margins) for benchmarking purposes.

Furthermore, the CARES Act may call for additional consideration for BCM businesses including provisions as to: (1) carryback of net operating losses (NOLs) from the 2018, 2019, and 2020 tax years to the previous five tax years (beginning with the earliest year first); and (2) suspension the 80% of taxable income NOL limitation through the 2020 tax year. BCM businesses should evaluate the potential tax implications and benefits of the CARES Act and make informed transfer pricing policy decisions by modeling various transfer pricing scenarios (e.g., NOL deductions that can be increased or carried back).

Observation: Transfer pricing may offer mechanisms and solutions (increase/reduce income) to adjust for these uncertain economic times in a manner consistent with the applicable standards, including identifying and addressing potential considerations with intercompany arrangements. BCM businesses also may want to consider the viability of obtaining an Advance Pricing Agreement (APA) in one or more significant regions. To the extent that transfer pricing methodologies are changed to address these issues, APAs can provide an opportunity to achieve certainty on the revised methodologies, on a current and prospective basis, and to avoid the enhanced risk of audit that could follow as tax authorities around the world address their countries' fiscal dilemmas.

Liquidity

As access to cash has become more challenging, BCM businesses will continue to look at drawing cash from existing facilities and resources, internal and external, and to expand capacity and deploy cash where lines are down. This brings up significant questions tied to financial valuation, including market and instrument value, interest rates, cash pools, revolvers, and guarantees, many of which need to be immediately addressed.

Benefits, including potentially updated interest rates, can be explored with new evidence from the markets. All movements of assets/or cash can carry potential transfer pricing consequences that should be evaluated and supported, or reconsidered given overall tax impact, including:

- New or revised intercompany arrangements to achieve cash redeployment objectives with consideration of loan modification rules for any revisions to terms; coordination with dividends
- Triggering of financial covenants and guarantees on both third-party and intercompany debt
- Loan guarantees to related-party borrowers to facilitate external borrowings at favorable interest rates
- Credit rating assessment on updated financial projections for any ongoing work
- Prepayments and acceleration/deferral of payments (of financial instruments or other operating arrangements, e.g., services)

- Addressing local thin capitalization requirements
- Distribution/allocation of foreign exchange gain/loss (e.g., strengthening of safe haven currencies).

Reduced workforce mobility

Various jurisdictions may be considering or have imposed travel restrictions, resulting in an increasingly immobile/virtual workforce. This particularly may be affecting the BCM industry, in light of reliance on traveling bankers and operating through a passporting regulatory structure. Furthermore, companies may have employees who cannot return to their home jurisdiction and are working abroad. BCM businesses should consider whether such reduced workforce mobility might inadvertently create substance and permanent establishment (PE) issues that may increase tax liability and exposure.

Observation: The OECD issued recommendations to its members on April 4 on this issue, suggesting that tax authorities should treat tax consequences that arise from any dislocated workforce in a reasonable manner and consider the underlying circumstances that give rise to the issue. At the same time, specific country guidance has been limited, and it remains uncertain how the international tax community will respond to these circumstances.

The Treasury Department and the IRS on April 21 issued guidance regarding COVID-19 related travel restrictions in the form of two revenue procedures and Frequently Asked Questions (FAQs). Specifically, Rev. Proc. 2020-20 provides that certain COVID-19 related travel disruptions for up to a 60-day period should not cause a nonresident individual to be treated as a US tax resident for federal income tax purposes or impact their tax treaty qualification with respect to income from dependent personal services. Rev. Proc. 2020-27 includes relief for US citizens living abroad and impacted by certain COVID-19 travel disruptions so that they still can qualify for an election to exclude their foreign earned income and housing cost amount from gross income under Section 911(d)(1). The FAQs clarify that certain activities and services that occur in the United States for a period of up to 60 days solely because of the COVID-19 pandemic should not impact certain US trade or business and PE determinations.

The takeaway

BCM businesses should review their transfer pricing policies and intercompany arrangements to navigate uncertainty in this unprecedented business and economic environment. BCM businesses that are experiencing capital, profitability, liquidity, and other pressures on existing transfer pricing policies may need to revisit and consider changes to existing transfer pricing methodologies to help alleviate or remediate these issues. In analyzing the potential implications noted above, comprehensive, real-time analysis and evaluation of the transfer pricing considerations in conjunction with overall forecasting, planning, and modeling are essential to inform tax, finance, and business decisions. Also, as noted above, BCM businesses may want to consider seeking APAs in order to avoid transfer pricing audits and to achieve certainty of their transfer pricing.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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