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Transfer Pricing

INSIGHT: Transfer Pricing & Supply Chains—Global Developments Due to Covid-19

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The Covid-19 pandemic is putting pressure on global supply chains across all industry sectors. Baker McKenzie practitioners look at the disruptions and possible responses in Part 2 of a seven part series.

Global supply chains across all industry sectors are facing an unprecedented challenge due to the Covid-19 pandemic. Increased pressure on supply chain linkages is nothing new to multinational enterprises (MNEs), due to national tax and trade protectionism measures, evolving international tax policies, and technological disruption, but the current global pandemic is materially different. Covid-19 is unlike typical supply chain disruptions in that it has rapidly moved across the globe and forced companies to respond almost immediately to address the near-term sustainability of their existing supply chains. This development is putting a massive strain on MNEs' operations and creates a profound level of future risk and exposure from a business, tax, and legal perspective.

STATE OF PLAY

Before Covid-19

Before the onset of Covid-19, MNEs were already facing increased attention on supply chain management due to factors such as technological disruption, national protectionist measures, climate change policies, and global tax changes. Many companies had been considering the diversification and/or relocation of manufacturing activities to mitigate the effects of rising costs in major manufacturing jurisdictions like China, (Countries like China have tried to use policy to stimulate investment. The Belt and Road Initiative also increased investment by Chinese private and state companies in manufacturing and transportation in Southeast Asia and beyond.) even before the uncertainties from the recent wave of trade disputes between the United States and its trading partners. In addition to considering new locations, companies have been expanding their strategic suppliers and increasingly interested in having redundancy in their supply chain to minimize risk. Another trend “near-sourcing,” or shifting sourcing and manufacturing closer to major operations or end customers, has resulted from the 2016 Paris Climate Agreement and companies’ attempting to reduce their carbon footprint in supply chains. On the tax side, supply chains have also been under scrutiny from a tax and transfer pricing perspective as audit activity has been accelerating globally – driven by the focus of the Organisation of Co-operation and Economic Development’s (OECD) Base Erosion and Profit Shifting (“BEPS”) project. The BEPS roadmap has handed tax authorities the appropriate transfer pricing toolboxes to point at all major companies. As a result, tax and transfer pricing challenges have been particularly prevalent in Europe, and companies have already been strengthening their tax positions in response.

Covid-19 Supply Chain Impacts

On top of these pressures, Covid-19 has created a sudden, unexpected supply chain disruption. The virus nearly shut down manufacturing in the heart of China and other North Asian countries and is rapidly moving to impact manufacturing all over the world. Business closures across the globe have already impacted suppliers and customers, depending on the industry, and are likely to impact more in the near term as global consumers are required to stay home and unemployment is on the rise.

These disruptions raise many questions both in reacting to the near term and planning for the future. In the immediate term, companies are reviewing force majeure clauses in supply contracts and evaluating alternative means of performing contract obligations. Companies are looking to temporary supply options, including assessing whether to support their suppliers with advance payments or even acquisitions in order to keep them afloat. Current travel restrictions are forcing many business activities to be put on hold or performed virtually.

In jurisdictions that are beginning to recover, demand has widely shifted, and the health of customers’ finances are in question. Inventory levels for both raw materials and finished goods are being reassessed and may require additional investment, or cuts, to prepare for future shifts in demand.

In the longer term, companies are beginning to focus on responding to all of their specific issues and recalibrating their supply chains now that Covid-19 is priority number one. Companies are considering supplier diversification to prepare for the future. The potential for annual travel restrictions if Covid-19 becomes a recurring event puts an additional burden on companies to have local teams in jurisdictions where they have significant supplier or customer relationships. Short-term and long-term changes to the location of decision-making personnel can have significant adverse impacts on legal, tax, and transfer pricing positions.

RESPONDING TO THE COVID-19 PANDEMIC

Manage the Rapidly Changing Supply Chain

During a period in which companies are managing supply crises, commercial arrangements are constantly being re-assessed. New third-party supply and distribution arrangements are being evaluated, which could have a material impact on existing structures. Companies will need to be mindful of the impact this period may have on establishing transfer prices for new intercompany arrangements. For example, where a company may not previously have had a comparable uncontrolled price, it may have one as a result of this period, which at a minimum, the company will need to consider if it is ultimately rejected in benchmarking the new arrangement.

Potentially Modifying Transfer Pricing in Existing Supply Chains

As commercial supply chains are under strain due to Covid-19, companies should consider whether transfer pricing changes are appropriate. It may be both necessary and beneficial to re-evaluate functional profiles and levels of profit for all parts of the supply chain and analyze which party is ultimately bearing the risk associated with decisions currently being made. Changes may be needed to reduce levels of guaranteed profit in entities that are limited-risk distributors, contract manufacturers, sales agents, and the like, as an example. Management may be changing or moving from one place to another to address the crisis, and employees may be terminated or furloughed as a result of governmental requirements or adverse financial results.

Once decisions have been made about how transfer pricing should be handled during the Covid-19 crisis, companies should make sure intercompany agreements support such decisions. These agreements should appropriately reflect the new financial and commercial conditions and current best practices.

Agreements that are put in place in connection with setting up new procurement, manufacturing, and distribution arrangements should strike a balance between preserving flexibility for future termination or reduction of activity and appropriately reflecting the risks and benefits of the arrangement. In particular, special consideration should be given to drafting provisions related to term and termination, including the notice period and the rights and obligations upon termination. For example, a very short agreement term or termination notice period may provide the greatest flexibility in the future, but may also impact the level of investment considered appropriate for a company to bear in the absence of expectations for a continued arrangement. MNEs should also consider what rights are needed under the agreement, such as whether a license of intangible property is needed, and if so, how broad such a license should be (e.g., exclusive/non-exclusive, royalty-bearing/royalty-free, etc.).

Analyzing and Managing Temporary Changes to the Supply Chain

Supply issues may result in temporary shifts to the ordinary supply chain flows in any given structure. These changes could have unanticipated results that need to be analyzed closely. For U.S.-parented companies, there could be adverse Subpart F impacts and VAT and customs implications for all companies. “Substantial contribution” may be more difficult to achieve and disregarded flows may become regarded flows. It may be necessary to evaluate beneficial ownership transfers in the short term, in light of the difficulty of legal transfers in some jurisdictions that require extensive formalities.

A variety of additional issues are likely to arise, especially as extraordinary expenses such as potential layoffs, termination payments, lease breakage fees, and asset impairments occur. Consideration will have to be given as to who should bear these costs based on the functional and risk profiles of the various pieces of the supply chain as they exist during the crisis. Now more than ever before many companies will be experiencing losses potentially in many different countries, and analysis should be done immediately to determine which legal entities and countries should bear those losses.

Maintain Supply Chains

Respect the Linkages

As commercial forces are driving rapid adjustments to supply chains, tax departments are required to stay abreast of these changes to ensure compliance and mitigate risk. To taxing authorities, Covid-19 may have created a challenging circumstance to test the validity and sustainability of a particular structure. Changes may be required and documenting them contemporaneously will be extremely important in the future.

Document Changes

When analyzing the supply chain, careful attention should be paid to the transfer pricing guidance in each applicable jurisdiction and its interaction with functions and risks (e.g., under the 2017 OECD Transfer Pricing Guidelines (“OECD TPG”)), especially with regard to the control over risk. Companies should examine and document the impact the virus is having on their supply chain to be able to effectively defend challenges. Supporting the defense and formulating the related arguments can be akin to invoking a force majeure clause in a legal agreement, as companies often have little to no choice in formulating their response and may be forced to take action that would not materialize under normal trading conditions.

Companies will also be limited in where directors, officers, and other key personnel can travel. While the hope is tax authorities will be flexible for companies that otherwise have good track records both before and after the global crisis, care must be taken to avoid tax nexus (e.g., tax residency by management and control or permanent establishments). Practically speaking, ideal substance and other best practices may not be possible under the current conditions. Companies should create contemporaneous documentation about the circumstances when local activities or activities in particular places are not possible by documenting the global situation, travel bans, attempts made for meetings (e.g., if travel had already been booked), etc.

Replace Intercompany Links

If an existing supply location is no longer viable, a company should consider the impact of any exit. Similar considerations as discussed above would apply, including evaluating the local law's requirements for termination compensation and what the intercompany agreement provides for upon termination (e.g., what is the effect of a waiver of termination compensation). Whether a local company has developed or acquired a compensable intangible through the course of the intercompany arrangement is often of greatest interest to tax authorities. Companies should be prepared to document the terms of the termination of the arrangement and the agreement between the relevant parties on the transfer of rights and obligations. A transfer pricing analysis will be key to supporting any amount paid in connection with the exit or defending why there is no compensable value being transferred, which may well be the case post Covid-19.

BEYOND COVID-19

Covid-19 has magnified the spotlight on the perils of relying on inflexible supply chains. When the immediate crisis is over, many companies will be even more incentivized to diversify their supply chain. Solutions will vary for companies, but many will seek strategic investment in production redundancy, move more production near market, and accelerate adoption of next generation manufacturing technology.

- 1. Production Redundancy.** Trade protection and conflict had already recently reminded companies of the importance of strategically building in redundancy throughout their supply chains. However, companies' responses to those challenges were primarily limited to the movement of final operations that determined the origin of a good. Faced with the current crisis, companies are now re-learning what happens when you cannot get the raw materials, components, and subassemblies necessary to make the product at all. To counter this risk, it is likely that more companies will building redundancy at all phases of the supply chain, e.g., through region-specific chains.
- 2. Production Near Shoring.** The trend of near shoring is also likely to accelerate when possible. While near shoring may counter the risk of trade protectionism and tariffs, it does not itself address supply chain disruption caused by viruses, climate change, natural disasters, or political unrest, as no location is immune from such contingencies. Nevertheless, as companies pursue strategic production redundancy, we expect much of this to happen close to home, as it will drive other business benefits, such as shortened lead times, reduced logistics costs, investment in local communities, and increased substance.
- 3. Next Generation Manufacturing.** Production redundancy, along with near shoring, means that production processes will be duplicated and disperse, sometimes reducing cost-cutting benefits of economies of scale. Companies are already using logistical, overhead and efficiency costs through digitalization and next generation production technologies, which have their own tax and transfer pricing challenges.

CONCLUSION

MNEs will have to work more effectively than ever to manage their supply chains in the rapidly changing environment due to Covid-19. In most instances, this will require monitoring and documenting the temporary changes due to the crisis. However, for many, it may involve rethinking the supply chain to ensure future sustainability. Given the novel challenge at hand, this uncharted territory for many companies will create a natural imperative for legal, tax, trade-compliance, and operational professionals to team together, draw from collective experience, and collect and assess relevant information on past trends to forge a sustainable path into the future.

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