Podcast transcript

Navigating through challenging times – A Transfer Pricing Perspective

Podcast with Brian Cody, Principal, Washington National Tax, KPMG in the US and Gianni De Robertis, Chief Economist and Head of Transfer Pricing and the GTPS Leader for the KPMG EMA Region, KPMG in Italy*.

Musical intro

Announcer:

Hello and welcome to another episode of the KPMG podcast series for tax leaders. For today's episode, I spoke to Brian Cody, Principal, Washington National Tax, KPMG in the US and Gianni De Robertis, Chief Economist and Head of Transfer Pricing and the GTPS Leader for the KPMG EMA Region, KPMG in Italy.

Brian and Gianni, thanks for taking the time to join me on the phone today. As you both know, this podcast series has been developed as part of the KPMG Future of Tax program where we are exploring the themes of geopolitics and international developments, digitalization and changing business models.

Today I want to talk about COVID-19 and Transfer Pricing Policy and the challenges leaders' have faced and the practical solutions businesses are using to manage through and beyond COVID-19. So to start the conversation, can you both describe the challenges your TP clients have faced during COVID-19? And was the impact the same for all sectors and geographies? Brian, perhaps we can start with you?

Brian:

Well I'd have to say that a lockdown is really a very unusual event and most sectors of the economy have suffered to some extent. For example, if you look at the fashion and luxury industry – we've seen a big drop in turnover due to store closures while industrial sectors have experienced problems with their upstream supply chain.

I think some sectors have actually observed a countercyclical trend, meaning that they've done better, particularly if we look at, the revenues of food and digital industries and even some parts of the life science and pharmaceutical sectors – they've actually risen. But even those industries have had to adjust parts of their supply chain to really cope with the disruptions to supplies of materials and travel restrictions and the lockdown.

And getting to the transfer pricing initiative, I think recognizing these disruptions our clients are faced with challenges across their portfolio of intercompany transactions and I think really one of the foremost is product pricing.

The concerns regarding product pricing have risen in many if not most cases, since many intercompany transactions structures are built on the common concept of certain entities being characterized as what we'd call routine or low risk entities. Such characterization is commonly expressed as the notion that the entities will consistently earn profits within an often pretty narrow range of results.

These can be sales and distribution companies, manufacturing companies, service companies, kind of the full gamut, right. And I think the margin pressures that COVID-driven disruptions have put on companies – their supply chains, access to customers and so forth – are challenging the notion of what it means to be low risk.

We're really raising the question as to whether these entities can actually earn losses either in the immediate case or over a longer term. And really, I think these pressures are raising serious questions about potentially modifications to transfer pricing policies.

Announcer:

Gianni, how's it been for your clients?

Gianni:

I would add to that the impact of COVID has been different also across geographies with Italy, for example, being one of the most affected countries. I was speaking with a multinational company, which I've been assisting for a few years on transfer pricing matters and they were telling me that in the – in the first quarter they lost about 70 percent of turnover within Italy. So obviously that – that is a really big impact.

In terms of transfer pricing challenges, in addition to challenges in managing product prices, I think two other areas have been quite difficult to manage – one being financial transactions. As companies have focused on ensuring liquidity to their subsidiaries in the first phase of the crisis, and the further they put in place a number of new intercompany financial transactions. And the other area is the area of services – intragroup services, as crisis management costs are being ramping up over time, over the past few weeks.

Announcer:

It sounds like Transfer Pricing business leaders have had to deal with a lot of change. So, Gianni, during this time did you see your clients modify [their] transfer pricing policy in the face of an economic downturn? And if so, by how much?

Gianni:

I think companies reacted in different ways based on their functional profile and also on how badly they were affected by the crisis. Very centralized companies reacted differently than companies where decisions are made more on a local basis. I can say some multinational level switched to a survival mode, so they have changed their standard transfer pricing policies almost immediately.

However, I think this is an exception. Most companies have been considering changes or adjustment to their existing transfer pricing policies, but they've been waiting to see the evolution of the crisis. In general, transfer pricing is assessed on a financial year basis. So instead of making quick decisions, most companies have been monitoring the situation and considering the options, waiting to get a better picturing of how the year will end up.

For example, one group in the fashion sector, which was impacted very early by COVID because they had a big exposure in China, decided to completely switch from one transfer pricing policy to another because they wanted to ensure that losses would not all be borne by the central entity.

However, I think again this is an extreme case – it's an exception. Most of the other companies I am seeing are basically considering how to adjust their existing transfer pricing policy to reflect the current market conditions.

Announcer:

And Brian, would you add anything to Gianni's comments?

Brian:

Yes, I'd say at the moment we're learning about the impacts of COVID. I think really that first phase was the initial impact when many companies simply kept their policies in place, no change. This is when shutdowns were first put in place and there was just so much uncertainty.

I think as we started to open up a bit, businesses are starting to – really start to see their businesses open a bit. Companies are more directly trying to address whether their transfer pricing adjustments are really necessary. Yet, I think all this still comes at a time when there's – a great deal of uncertainty still exists for companies.

It's really so difficult even now to forecast what the rest of the years will look like – that the clients we are talking to in the US here, most of those are still saying "look, we've got several scenarios that we're running for the rest of the year, there's still a great deal of uncertainty and we might wait a little bit more before we actually change prices, even though we're very actively looking at how those changes might be implemented".

Announcer:

Gianni, what approaches did you see tax directors consider when determining if their comparables are appropriate during the COVID-19 disruption?

Gianni:

Obviously many companies set their intragroup prices by looking at comparable companies in their markets. The data for comparable companies, however, are not available in real time so in general companies would use a prior year data for the comparables.

So, to give an example, transfer pricings for 2019 would be set by looking at comparable data for the proceeding three years, 2016 to 2018. No while this is fine under normal economic circumstances, in an economic crisis this becomes a problem because the previous years will not reflect the current market conditions.

So I think the single biggest transfer pricing challenge for most companies has been what data from comparables to use in their analogies. Often the challenge boils down to exactly that point so, should we change the comparables or should we change the data that we use.

I think at the end of the day most companies will confirm their current transfer pricing policy, they will likely confirm more so their current comparables but they will have to make adjustments to the data and the margins of those comparables to ensure that they reflect the conditions – the economic conditions of 2020.

Announcer:

Brian?

Brian:

Yes, I'd agree. And I think a further point to make here is that I would say compared to previous analyses where maybe we would look at a multiyear period like the two or three year period, I think we're also likely to see companies more often now – especially for 2020 or particularly for 2020 – using a 1 year analysis as opposed to a longer range in order to test the reasonableness of the pricing this year. I think it follows from the uniqueness of 2020, how quickly COVID disruptions came on and it's really not spread across, like I say a typical multiyear downturn or business cycle.

Announcer:

And Brian, what can companies do if they conclude and/or realize that their comparables are not appropriate?

Brian:

Yes, here and I think building on the – on the other questions, I think the universal thing about appropriate being, is that previous range that we had, is that appropriate for 2020? And I think this is where the research becomes so important, right. I think we see a number of transfer pricing professionals focus on the arm's length range for say, 2017 through 2018 or '19 and asking whether they can defend targeting in 2020 for example, the low end of that range.

Well I think what we need to do is we need to shift our view of what the actual ranges will be for 2020 and simply not just use previous ranges and say we're going to move to the bottom of that and moving that unadjusted target for 2020. But rather use research to say OK, what impact is the current disruption likely to have on those margins, how likely are they to drop and by how much and use projections rather than looking back and evaluate the appropriateness of comparables in that way.

Gianni:

On this point for example, we have been assisting a number of companies in trying to estimate how the historic data of comparables many need to be adjusted to really reflect current market conditions. For example, we've been looking at how comparables performed during the previous crisis, so during the financial crisis of 2007, 2009 with the objective of using this information to adjust comparables for 2020.

That is an approach. Another approach which we have been following is to perform some regression analysis on a longer time frame and try to find some correlation between comparables' margins and other economic variables for which we already have data available for 2020. So for example, GDP or inflation or unemployment. So, if we find a link between this macroeconomic data which are available and the comparables' margins, then we can use this data to make adjustments for 2020.

Announcer:

COVID-19 has obviously presented many challenges to tax and legal functions but as we move forward from resilience into the recovery phase, what are the immediate challenges which lie ahead for transfer pricing business leaders? And what learnings can they take from this situation to build into their business continuity plans and processes going forward?

Brian:

I think there are just so many opportunities, you know, how long do we have to talk about these? But seriously, just to focus on one point that I think has been really somewhat overlooked in the past and that is creating real issues and difficult points to work through for companies. And I would say that's really around their intercompany agreements and making sure that those agreements really fully reflect arm's length terms, adjustment provisions, termination clauses, et cetera. And not really just the pricing itself, not just the arm's length range in there itself.

Third parties renegotiate their terms regularly and the ability of related parties to renegotiate their arrangements has been really an important consideration in all the discussions that we're having with companies about their transfer pricing response to COVID disruptions. So I would say a focus on those is really important.

Gianni:

If I may add a couple of other points, I think one area where companies will need to make a decision pretty quickly is what to do with transfer pricing adjustments. Because prices for 2020 were set before the COVID time, right, so they necessarily do not reflect the current conditions of the market.

So companies will have to decide whether to make adjustment to those prices or make year-end adjustments to profit margins of their subsidiaries. So that is one area. The other area I think which would require some decisions from companies is, as I mentioned before, financial transactions.

And this is for two reasons, not only because with COVID there were several new transactions implemented in the financial area within multinational groups, but also because the OECD published guidance in January on financial transactions. So companies need to make sure that not only new transactions are compliant but also, existing transactions are compliant with the new OECD guidance.

Announcer:

To conclude the podcast today, if I could ask you both – what's the one piece of advice you would like to leave our listeners with? Brian, maybe we can start with you and then move to Gianni?

Brian:

Yes, I guess I would just reiterate the point on the intercompany agreements and making sure that as companies are looking at their transfer pricing, that we don't just focus upon the range or the actual pricing itself but really the full scope of the arrangement – allocation of risk, how that's documented in the agreement and make sure that we've got the full arm's length treatment in that agreement and not just the ranges.

Gianni:

And my advice would be to consider the long-term consequences of current decisions and not to rush into some short-term fixes, which would then be detrimental for the future of the company. So for example, if a company reacts to COVID-19 by changing its transfer pricing policy, then the company may be in a different position to change it back when things go back to normal.

Announcer:

Brian and Gianni, once again thanks for taking the time to join us today.

Brian:

Thanks very much, it's been a real pleasure.

Gianni:

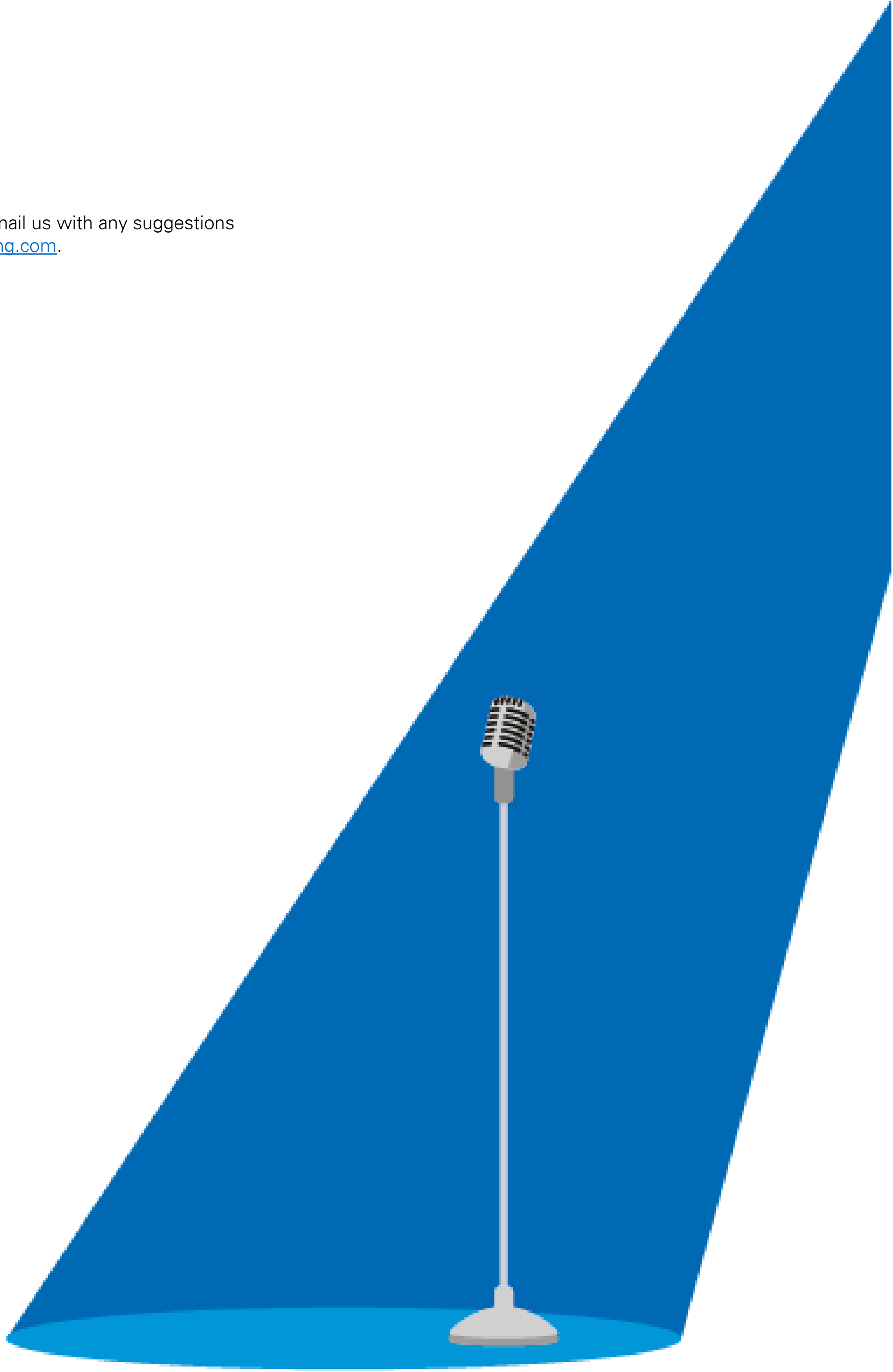
Oh yes, thank you for your time.

Announcer:

Join us again next time and please email us with any suggestions you have for future topics at tax@kpmg.com.

Thanks for listening.

Musical exit



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