TPGS

Transfer Pricing Global Solution Group

SUPSI

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Coronavirus: transfer pricing, double tax treaties e state aid rules

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The OECD TP Guidelines

OECD TP Guidelines deal about losses at paragraph 1.129, 1.130 (and 1.131)

1.129 When an associated enterprise consistently realizes losses while the MNE group as a whole is profitable, the facts could trigger some special scrutiny of transfer pricing issues. Of course, associated enterprises, like independent enterprises, can sustain genuine losses, whether due to heavy start-up costs, unfavourable economic conditions, inefficiencies, or other legitimate business reasons.

1.130 The fact that there is an enterprise making losses that is doing business with profitable members of its MNE group may suggest to the taxpayers or tax administrations that the transfer pricing should be examined. The loss enterprise may not be receiving adequate compensation from the MNE group of which it is a part in relation to the benefits derived from its activities.

We have not found any reference into the Guidelines about how to deal controlled transactions in such groups scoring consolidated losses. Refences to losses included into other paragraphs provide information about how to deal loss making associated companies of profitable groups, how to deal loss making entities in case of business restructuring. It seems that to score consolidated losses is not an option for OECD Guidelines.

TP Methods

	CUP	Cost Plus	Resale Minus	TNMM	Profit split
Focus	Transaction price	Costs to be remunerated	Distribution margin	Net margin vs costs/turnover	Profit vs allocation keys
Theoretical losses	Yes	Yes	Yes	No	?
Appetite of tax admins	Low	Low	Very low	High	Variable

Tax administrations worldwide and OECD as well, turned from the traditional transactional methods to profit based methods. There is a number of law cases where traditional methods like CUP or resale minus have been challenged for retail and distribution business or the cost plus method has been challenged for industrial operations. Since last decade the TNMM is the method preferred by tax administrations because it is the one maximizing the taxable income, avoiding - as a matter of fact - subsidiaries to score losses, disregarding – as a matter of fact – provisions of paragraph 1.129, 1.130 and 1.131. TNMM to date is probably the most frequent TP method applied worldwide to distribution and manufacturing activities, the ones much hit from Covid, BTW.

Theoretical alternatives

Strategy	To move to profit split method (1)	To not consider any flat remuneration for 2020 (2)	To segregate the Covid lock downs period (3)
How	MNE becomes the tested party, irrespectively from market results and comparables	CP and TNMM methods continue to be applied but on a zero MUP/margin basis	Traditional policies are applied as usual, but not for COVID lock down period whose losses remains to Subs.
Pros	PS is included into the Guidelines and its application does not require particular subjective assumptions.	Particularly feasible in case of sub-groups in loss of profitable MNEs. No TP method change. Recapture risk limited to the MUP if/any.	Particularly feasible for retail business.
Cons	Discontinuity with the past	Potential bilateral issues	No doctrinal background. Y/N agreement with tax admin with limited arguments to find middle settlements
Who best	Group scoring consolidated losses	Group scoring consolidated profit downsize	Integrated group operating from manufacturing to retail

Profit split vs. Loss split

OECD Guidelines, para 2.114 report: **«The transactional profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions. The transactional profit split method first identifies the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged (the "combined profits") References to "profits" should be taken as applying equally to losses».** Sentence above is not sufficient probably to built on it a TP structure for a MNE, but it is the only link we found into the OECD Guidelines to group losses.

All the above considered, we think that Profit Split method is probably the best solution to face the Covid crisis from the TP point of view. The MNE indeed become the tested party, without influences related to multi-year analysis, rejection of loss making comparables or other subjective criteria. Respect other envisaged policy it should minimize the risk of double taxations.

Cash traps, Local treasury and ratings: the chain reaction effect

It is a matter of fact that MNE will need treasury to re-load their activities. In the framework of BEPS Action 4 countries introduced limits to the deductions of interest almost related to the companies operating margin (EBIT, EBITDA, ROL, etc.). Also base eruption rules via interested have been not conceived to be sustainable in macro crisis periods. Covid 19 is going to hit MNE also below the EBIT line:

Enterprises scoring operating losses or small operating profits, can bear lower interest expenses. Such limitation is in contradiction with the companies need of additional liquidity to reload their operations.

Increasing debts and equities eroded by losses will affect the debt equity ratios generating additional not-deductible interest in those countries with D/E deduction rules.

Downsizing of turnover, margin and profits as well as an increase of D/E ratios could determine a worsening of credit rating, and an additional interest burden as well as the application of the default conditions in main financing agreements. Especially in RE industry, third party financing default clauses are related to LTV/ICR/D-E conditions. Some Local TP regulations (UK) are based on LTV/ICR/D-E ratios.

Cash traps?

Equity ? But what?

Additional tax burden.

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Practice Description

Cristiano Bortolotti has more than 20 years of experience in advising a wide range of clients active in luxury industry, shipping, trading of raw material, healthcare and financial services.

He has a particularly strong track record in rendering legal and international tax advice in relation to transfer pricing of multinational enterprises and investment funds.

Career

Prior to founding TPGS Group, he was equity partner at Dentons. He has also gained substantial experience working at tax and legal direction of prime conglomerates in the luxury and healthcare industries.

Academics

Cristiano Bortolotti is teacher at SUPSI - University of Italian Switzerland, since 2014, at Master of Advanced Studies in Tax Law.

He regularly speaks at seminars and contributes to the scientific publications of the University.