



Transfer Pricing Strategies in an Uncertain Economic Environment

Duff & Phelps Presenters

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Introductions



Simon Webber

- Over 25 years experience in transfer pricing
- Specialized focus in cost sharing, IP transfers, tax related IP, legal entity and business valuations.
- Advises some of the largest, most valuable companies in the world
- Thought leader on transfer pricing issues and developments

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Patrick McColgan

- Over 15 years experience in transfer pricing
- Specialized focus in developing defensible transfer pricing policies for both emerging and established companies
- Strong focus on operational transfer pricing and transfer pricing implementation support
- Provided expert witness support for several landmark transfer pricing cases

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Agenda

I. Transfer Pricing Issues and Considerations

Provide a framework for applying transfer pricing practical approaches in the short-term to meet business objectives

II. Evaluating and Supporting TP Policies during times of Uncertainty

Common challenges MNE's are facing in the current economic environment and key considerations when evaluating / supporting transfer pricing policies in the current economic environment.

III. IP Valuation Considerations in the Current Climate

Best practices, opportunities and challenges associated with recent and current/future IP valuations in uncertain times.

IV. Closing Remarks

Section I

COVID-19 Issues and Transfer Pricing Implications



COVID-19 and Transfer Pricing Implications and Opportunities

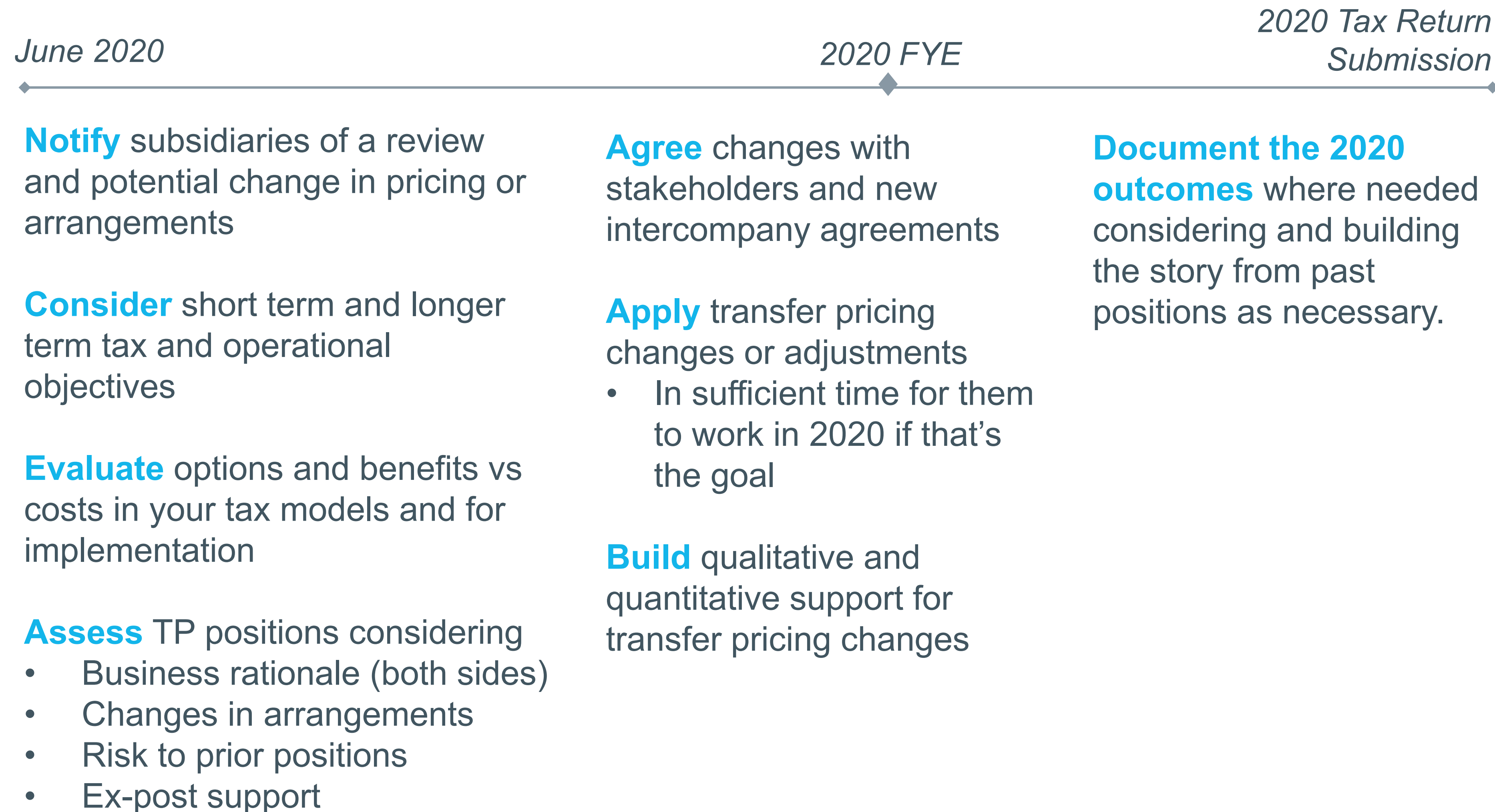
TACTICAL	Transfer Pricing Considerations
Governmental support	<ul style="list-style-type: none"> • Specific rules often absent • Practical rule is that governments expect to benefit the local economy and not be “exported” through transfer pricing
Subsidiaries may be running out of cash and need funding	<ul style="list-style-type: none"> • Existing transactional transfer pricing • New transactional transfer pricing • Lending vs Capital
Overall business may be experiencing losses but foreign entities may still be profitable because of TP <ul style="list-style-type: none"> • Cash drain from business from taxes • Lost foreign tax credits in US 	<ul style="list-style-type: none"> • Optimize outcomes from existing transfer pricing practices and agreements • Consider what additional changes you might want to make for short term <u>and</u> long term goals
US losses changes others aspects of US tax profile <ul style="list-style-type: none"> • BEAT may become an issue for the current year. 	<ul style="list-style-type: none"> • Some transfer pricing related exceptions (Cost based in SCM absent the business judgment rule)
<ul style="list-style-type: none"> • CARES Act, opportunity to carry back US losses into prior years (at higher tax rates) 	<ul style="list-style-type: none"> • Current year foreign cash taxes at local rates vs. • Refunds of prior year cash taxes at higher US rates (perhaps with a delay)
Tax Dept Budget Constraints	<ul style="list-style-type: none"> • Reassess compliance requirements to optimize limited resource use

COVID-19 and Transfer Pricing Implications and Opportunities

STRATEGIC- Opportunity for Change	Transfer Pricing Considerations
Clean up existing IP structure	<ul style="list-style-type: none"> • IP onshoring / repatriation • Integrate foreign acquisitions that you might have left out
Releasing Tax Attributes	Transactions that: <ul style="list-style-type: none"> • Generate losses to carry back • Generate gains to offset expiring losses • Release foreign tax credits
Optimizing US Tax Profiles:	
<ul style="list-style-type: none"> • BEAT 	<ul style="list-style-type: none"> • Transactional changes to bring charges into COGS • Agreement / arrangement structural changes to separate non-SCM and SCM eligible services
<ul style="list-style-type: none"> • Foreign R&D charges post 2021 	<ul style="list-style-type: none"> • Agreement changes to affiliate transfer pricing arrangements to optimize long term balance between: <ul style="list-style-type: none"> • s174 deductions deferral • Immediate s162 deductions
Realign TP with new value chains	<ul style="list-style-type: none"> • Reassess supply chains and value drivers to reflect requirements and opportunities from changes or new emerging businesses

Process

Approach to Meeting Business and Tax Objectives



Section II

Evaluating and Supporting Transfer Pricing Policies During Times of Uncertainty



CV19 Transfer Pricing Evaluation Framework

Assessing Current TP Model
and Legal Entity
Characterization

TP Tools to Respond to
Covid-19 Impact

FY2020 Benchmarking /
Adjustments

Audit Readiness

Think about:

1. Consistency with or the reason for the break with **the past.**
2. How do these actions and positions play out in an upturn and in **the future.**

CV19 Transfer Pricing Evaluation Framework

Assessing Current TP Model
and Legal Entity
Characterization

TP Tools to Respond to
Covid-19 Impact

FY2020 Benchmarking /
Adjustments

Audit Readiness

- Intercompany agreements
 - Starting point for analysis
 - Compensation and TP change clauses
- Common principal structures
 - Limited risk distributors
 - Contract manufacturers
 - Limited risk service providers
- Assessing risk
 - Actual practice versus agreement
 - Buy-sell special considerations
 - Risk of changes
 - Realistic alternatives of both parties
- Revenue authority considerations
 - Prior audit positions
 - Future changes
 - Local rules

CV19 Transfer Pricing Evaluation Framework

Assessing Current TP Model
and Legal Entity
Characterization

TP Tools to Respond to
Covid-19 Impact

FY2020 Benchmarking /
Adjustments

Audit Readiness

- Importance of internal facts
- Transactional pricing versus Targeted profit margins
- Transactional pricing (e.g. sale of products)
 - Variance analysis
 - Other adjustments may be needed (e.g. subsidies/market support payments)
- Targeted profit margin:
 - Extraordinary costs
 - Treatment of Government support
 - Test party cost segmentation
 - Determining an appropriate profit margin to apply for FY 2020

CV19 Transfer Pricing Evaluation Framework

Assessing Current TP Model
and Legal Entity
Characterization

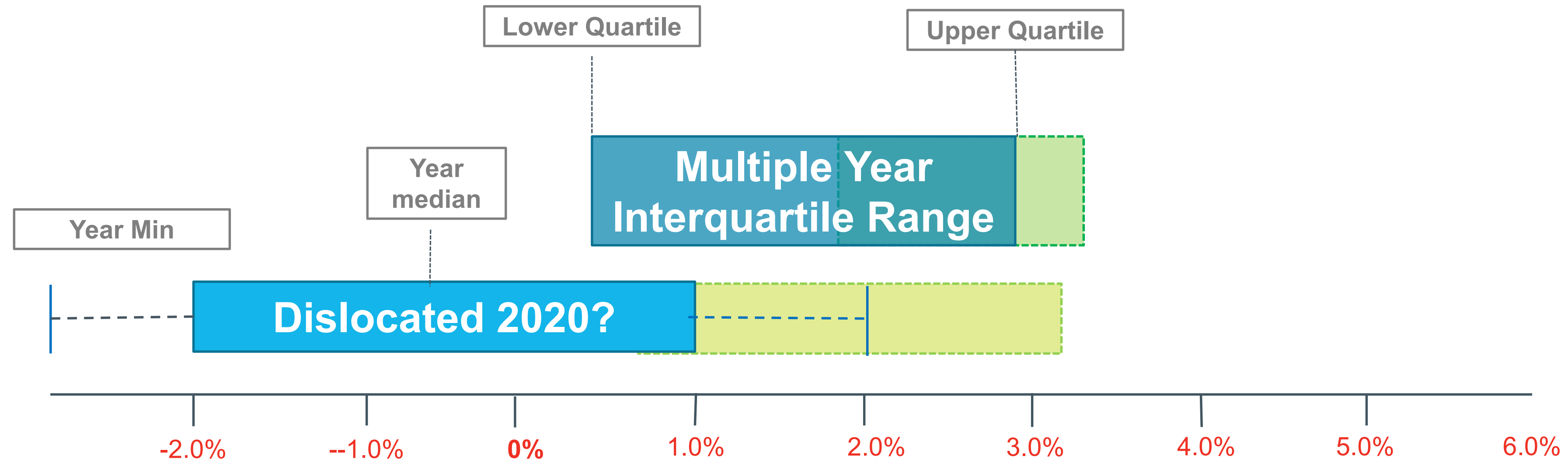
TP Tools to Respond to
Covid-19 Impact

FY2020 Benchmarking /
Adjustments

Audit Readiness

- Benchmarking limitations
- Revisit search criteria
 - Loss making comparables
 - Industry comparability
- Evaluate point within current range
 - Movement to lower quartile (and beyond)
 - Single-year vs. Multi-year analyses (e.g. 5-year or 7-year “business cycle” averages)
- Considerations for other intercompany transactions
 - License agreements
 - Intercompany loans

Example Reference Points From Results Ranges



- Annual Results vs **Business cycle (No risk vs limited risk)**
 - More years, less individual years matter, more static
 - But more difficult to get back in when you fall out.
- **US** (more mechanical)
 - Outside Multiple Year IQR then adjust to Median of current year
- **OECD** (more subjective)
 - Consideration of facts and circumstances
 - What the most appropriate result in the range
- **Local Country** rules

CV19 Transfer Pricing Evaluation Framework

Assessing Current TP Model
and Legal Entity
Characterization

TP Tools to Respond to
Covid-19 Impact / Issues

FY2020 Benchmarking /
Adjustments

Audit Readiness

- Expected tax authority response
- Contemporaneous COVID-19 adjustment Memorandum
 - Industry and company specific commercial rationale for changes
 - Articulate TP supply chain
 - Cost data and projections relied upon
 - Adjusted benchmark data
 - Adjustments to Intercompany Agreements
- FY 2020 transfer pricing documentation
 - Overlay tested party rationale with external benchmark data
- Consider need for strategic restructuring

Key Takeaways

- **Carefully consider the risk profile of limited or low risk entities in your supply chain**
 - Review the agreements and consider amending where appropriate.
 - Manage the risk of compensation being required
 - It may be appropriate for limited risk entities to bear extraordinary expenses that they incur as a result of COVID-19
 - Sharing of channel losses may be appropriate
- **For pricing of related party transactions in FY2020**
 - Adjust benchmarking from prior years to account for the impact of COVID-19
 - Amend pricing in light of current facts and circumstances and be able to demonstrate this as arm's length behavior
- **Prepare contemporaneous support for FY2020 price setting policies/adjustments**
 - The commercial reasons for decisions made and for losses incurred
 - The options that were realistically available at the time
- **Documentation as a valuable risk management tool**

Section III

IP Valuation Considerations in Periods of Uncertainty



IP Valuations

Historical and Recent Past IP Transactions

Transactions (Post
COVID-19 Onset)



COVID19 Impacts on Prior IP Transactions

- **Ex-post outcomes or events**

GAAP

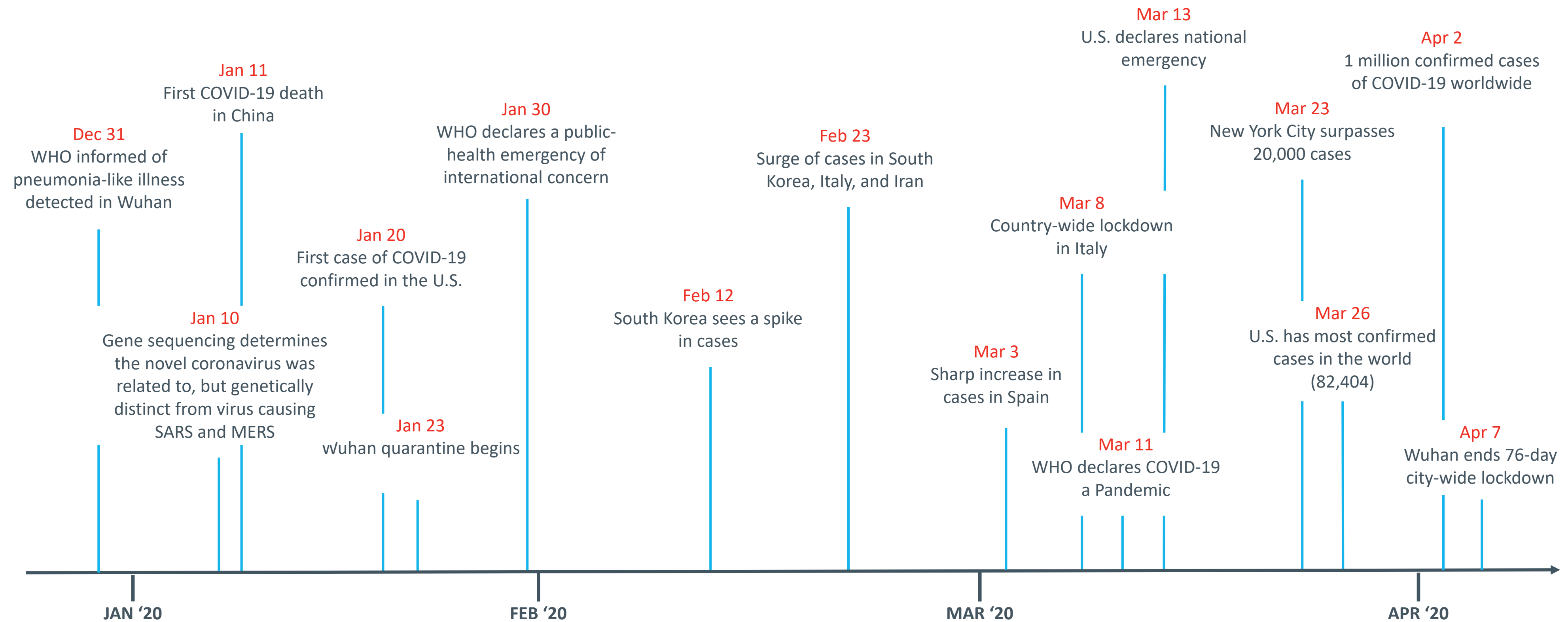
- Generally not considered under GAAP valuation principles for the initial valuation
 - » Ex-ante information “known or knowable” as of the valuation date.
- May trigger an impairment study
 - » Does not change the original transaction price
 - » Write-down of asset carrying values
 - » Special rules / steps (not necessarily a revaluation)

Tax/Transfer Pricing

- ***Ex-post outcomes may be considered by the tax authority and potentially taxpayers***
- What is arm’s length practice? (e.g., observable, rationale, realistic alternatives)
- Limitations on amended returns
- Tax return disclosures or reporting
 - » e.g., 6662 contemporaneous documentation – relevant significant post year end events

Supporting an Existing Valuation: What did we know and when did we know it?

COVID-19 Brief Timeline



Recent Intercompany IP Valuations

Additional Tax Considerations

- **Ex-Post Adjustments for Tax Purposes**

- **Taxpayer Initiated**

- What does your agreement say?
 - » Required (periodic reviews, periodic adjustment rules)
 - » Possible (adjustment clauses and related limitations)
 - » Payment structure (lump sums, royalties, installments, other contingent payments)
 - Tax characterization (sale, license, contribution)
 - When was the transaction?
 - » Interpretations of ex-ante vary depending on local rules and facts and circumstances
 - » E.g., US taxpayers may have some flexibility for transactions in the current year / on unfiled tax returns based on interpretation of case law and/or some IRS notices
 - Economic and business rationale for both parties
 - Other considerations:
 - » Potentially lowers the bar for tax authority adjustments for example if the value goes up
 - » Financial reporting considerations (possible indicator for a financial reporting impairment)

Recent Intercompany IP Valuations

Additional Tax Considerations

- **Ex-Post Adjustments for Tax Purposes**

- **Tax Authority Initiated**

- Initial audits vs subsequent audits
 - Tax authorities have given themselves additional powers to combat perceived asymmetry of information

- **U.S. Tax**

- IRC 482 commensurate with income standard for intangibles
 - » Arm's length standard applies "taking into consideration all the facts and circumstances"
 - » Regs provide IRS with broad powers of adjustment to open years
 - » Absence of adjustments in prior years does not preclude adjustments in later years
 - » Structure generally not at issue unless undermined by conduct or economic substance
 - » Includes specified exceptions and limitations
 - **Extraordinary or unforeseen or foreseeable events**
 - » Other exceptions vary depending on the form of the intercompany transaction,
 - » For example:
 - General transfer or license of intangibles - § 1.482-4(f)
 - Cost sharing transactions - § 1.482.7(i)(2)
 - Platform Contribution ("buy-in") transactions - § 1.482.7(i)(6) or § 1.482-4(f)
 - Contributions of intangibles - section 367(d) with its in built CWI
 - » ***Adjustments under 482 may replace forecasts with actuals + new forecasts***

Recent Intercompany IP Valuations

Additional Tax Considerations

- **Ex-Post Adjustments for Tax Purposes**

- Tax Authority Initiated**

- Foreign Tax**

- Local rules / OECD Hard to Value Intangibles (HTVI)
 - OECD HTVI Approach in Chapter VI
 - » Significant variation of ex-post actual experience vs ex-ante forecast is a rebuttable presumption that not arm's length and adjustment
 - » Approach similar to U.S rules
 - » More of an emphasis on support for transactions structure especially if high levels of uncertainty
 - » Exceptions to adjustments are also similar to U.S. rules
 - » However, adjustment mechanism is different:
 - » ***Potentially redetermine ALP based on appropriate structure and ex-ante assumptions***
 - Local Rules
 - » Often closer links between tax and GAAP values/charges and amortization and in some cases also impairments.

Recent Intercompany IP Valuations

Recommendations

- **If making changes:**
 - Consider all the facts and circumstances
 - Consider the implications
 - Build appropriate support and documentation for the legal and economic basis for the changes from both parties' perspectives
- **If sustaining historical transactions:**
 - Know or knowable – Extraordinary exemption
 - Review supporting analysis and documentation now
 - » Better not to wait for an inquiry from a tax authority
 - For recent transactions gather relevant information:
 - » Clear and accurate description of the state of the COVID-19 outbreak at the time of the transaction
 - » Sufficient and specific detail on how COVID-19 was or was not considered with respect to each key value driver

IP Transactions and Valuation

Historical and Recent
IP Transactions

Current / Future IP
Transactions (Post
COVID-19 Onset)



Current / Future Intercompany IP Transactions and Valuations

Companies with depressed IP values may want to consider changes where high IP values have historically been a constraint

- Outbound IP transfers
- U.S. IP Repatriations
- Foreign IP transfers at lower exit cost
- Realization of losses to offset current, prior or future income
- Correction of royalties going forward
- Impact on RAB shares based on short periods of data

Other taxable transactions with significant entry valuation components include:

- Legal entity reorganization
- Unchecking or recharacterizing entities
- Creating Subpart F income

Planning looking to maximize basis in a purchase of IP may be worth delaying

CAUTION: Cost sharing RAB shares are long term, not annual, even if you measure them that way for convenience

IP Valuation: Back to the Fundamentals

- **IP valuations best practices :**
 - Correctly identifying the intangibles (ownership rights, license rights)
 - Their **profit potential**
 - Transaction date and structure (characterization)
 - **Economic and business facts and circumstances**
 - The most **reliable** valuation method(s) considering their inputs and assumptions
 - **Perspective** for the valuation (arm's length, market participant, going concern, distress, etc.)
 - Intangibles are **long-term assets** which are dependent on current situation but also expectations about the future

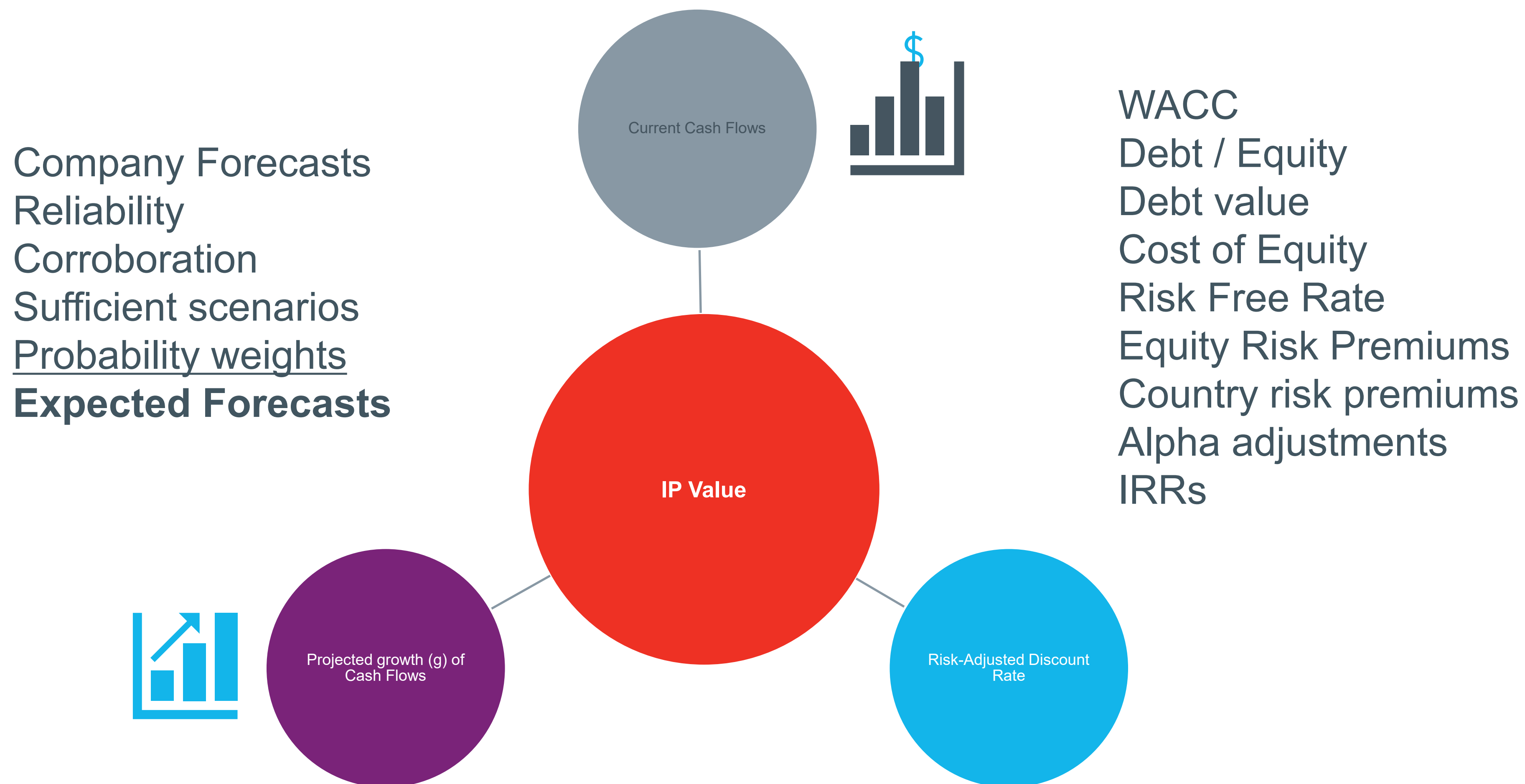
Current / Future Intercompany IP Transactions and Valuations Considerations

- **COVID-19 is not an unforeseeable event for post COVID-19 transactions**
 - » Valuation will need to take pandemic impacts into account
- **Valuation best practices very important**
- **Tax authority scrutiny very likely**
 - Initial audits
 - Subsequent audits
- **CWI and HTVI provisions put increased pressure on the structure of the transactions and the valuation**
 - Be careful about characterization
- **Coordinate with business and finance:**
 - There may be relevant financial reporting valuations and/or impairment analyses already in play, and relevant resources
 - Tax transactions for the same IP at lower values may be a financial reporting factor signaling a need for an impairment assessment

IP Valuation: Back to the Fundamentals

Income Approach

Care, Consideration, Support



Current / Future Intercompany IP Transactions and Valuations

Valuation Best Practices

- **Current facts and circumstances necessitate a more robust process**
 - Identify and characterize key uncertainties
 - Apply scenario-based approach to address valuation uncertainty around market disruption and availability of reliable market inputs
 - Be careful with historical data
 - Validate and test input data
 - Relevant independent support for inputs and assumptions
 - Use multiple methods / corroborate
 - Coordination and consistency with finance and business

Closing – Revisiting Adjustment Process

Approach to Meeting Business and Tax Objectives

