TRANSFER PRICING DURING AN ECONOMIC DOWNTURN

How will the current global economic downturn affect transfer pricing arrangements involving assured returns to the Indian subsidiaries?

- Vishnu Bagri

The transfer pricing arrangement is a reflection of allocation of functions, risks and assets amongst the associated enterprises participating in the supply chain. Several companies organize themselves in a way so as to achieve a desired apportionment of risk amongst the enterprises within the group, and perhaps at times choose structures involving a concentration of most business risks in a single enterprise. This is particularly visible in the context of multinationals in India, wherein the Indian subsidiaries have been established as contract manufacturers or captive contract service providers or limited risk distributors earning an assured margin.

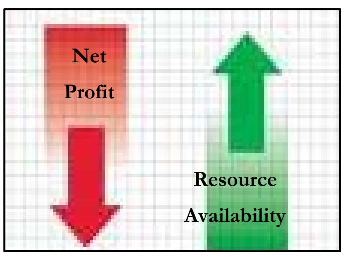
Profit = f (functions, assets, risks)

In times of a global economic downturn, the overall margins in a supply chain continuum are likely to be reduced. This article discusses the key implications of reduction in the supply chain margins and whether the same should be entirely absorbed by the principal risk taking enterprise or shared across the enterprises participating in the supply chain.

For example - an Indian company (IndCo) distributes goods manufactured by its parent company overseas (ForCo). The group has established a limited risk distributor arrangement i.e., the distributor enterprise is rewarded for its limited risk distribution activities by an entrepreneurial risk taking enterprise ("the principal") through a profits-based transfer price. The model provides that the limited risk distributor would recover all its costs together with an assured margin while the "residual profit of the supply chain" accrues to the principal. The transfer price for the import of goods by IndCo, lets assume is set based on an assured operating margin of 5% for IndCo. At the time of establishing the transfer price, the forecasted supply chain margins, say were expected to be 10% on an overall basis and the level of IndCo's assured return was determined as arm's length, based on the Transactional Net Margin Method (TNMM) with IndCo as the tested party. Today, when the business economics and the business models are largely impacted due to the economic downturn, the supply chain margins say become negative. Thus, if the same profits-based transfer price methodology is continued, the ForCo would incur a loss though IndCo continues to earn a profit. The following aspects emerge for consideration.

<u>Assured net margin based pricing models have an underlying focus to a single enterprise approach while determining the arm's length price</u>

A pricing model is chosen to reflect the allocation of functions, risks and assets between the enterprises. Perse a downturn economy itself does not make the pricing model inappropriate, since a change in the economic scenario does not essentially reflect a change in the functions, risks and assets performed by the enterprise. Thus the same transfer pricing model would continue to apply in a downturn economy resulting in a taxable profit for one enterprise, while the group could be incurring losses at a consolidated level.



In the above illustration, the single tested party approach for determining the assured net margin, results in an assured margin being earned by the tested party (IndCo) while the residual profits accrue to the other enterprise (ForCo). Transfer pricing policies based on the assured margin work conveniently, if not well, in an environment of steady economic performance, as one is rarely challenged to apportion the residual given a fair degree of profits being offered to tax in both jurisdictions. However, in times of downturn, this may no longer be true as margins are squeezed throughout the supply chain. To some extent, the fixed gross margins/mark-ups of the traditional transaction methods will allow a sharing of the supply chain margins between the entities since the operating margin would change in response to changes in sales volumes that allow the absorption of overheads. However, policies based on the net margin method do not do this, and force all adjustment into the residual party.

Can the assured return in downturn economy be lower – the arm's length principle?

Businesses are never entirely self-contained and related party transactions are part of a supply chain continuum that will involve third parties. In order to apply the arm's length principle, the behaviour of the third parties should be analysed. If in the industry supply chain the manufacturers are being squeezed while third party distributors are being supported, one might expect that captive contract manufacturers would be squeezed and captive wholesalers / distributors would be supported.

Further, the assured return for limited risk distributors or contract service providers or contract manufacturers could be understood to be economically equivalent to the risk free investment returns available in an economy. In a downturn economy, the risk free investment returns itself would be lower thereby providing a potential ground for contesting a reduction in the assured margins.

The reduction in margins would ideally also be reflected in the comparables. These comparables represent market outcomes, and, in principle will reflect many of the same forces and outcomes that should affect arm's length outcomes for controlled transactions. So, if there is a downturn, the comparable margins will also feel the impact. But even with the best of comparables there may be some differences in the timing of effects arising from the downturn or a recessionary trend. The timing differences are likely to affect more where profit-based, rather than transaction-based, methods are used. For this reason, taxpayers should look at averaging their results over time to better account for differences in the timing of business cycles. In practice though, taxpayers need to look backwards to move forward. Except in those circumstances in which taxpayers have real-time transactional comparables, they must evaluate their current transfer prices, either for planning or for documentation, based on the historical data of the comparables. In this context, three years or so of averaging may suffice to smooth out or normalize the volatility across a business cycle in a progressive or growing economy, but would not be able to normalize the impact of a company's performance that has fallen off a cliff with those still to announce the impact. To this, in the Indian context, when the financial data availability issues and regulatory framework of multiple-year data are added, the transfer pricing could look even more distorted. A careful consideration of the above aspects would be imperative in performing a comparability analysis to arrive at the arm's length price.

<u>Changing a transfer price – needs the extra diligence</u>

A transfer price may require a change to address the reduction in the supply chain margins. In the assured margin model, the tax authorities of the jurisdiction in which the risk mitigated enterprise operates, is likely to contest the change in price, on the grounds that in earlier period/s, the position presented by the tax payer was that it has minimal risks because it is assured of a certain level of margin over a period of time. Further, that a change in margin would mean a re-negotiation of the contract, thereby being subject to a higher level of risks. In these cases, in addition to the support from an economic analysis, a possible view would be that, as with uncontrolled arrangements, the parties did not, and could hardly be expected to, identify and evaluate risks beyond their forecasting exercise i.e. something which was unpredictable. Even the most diligent business process and functional analysis, is unlikely to enumerate purely hypothetical functions and risks not seen in the near past or forecasts. Given the parallels between controlled and uncontrolled parties, at the base of which lies the very human inability to predict the future accurately, it is essential that analysts turn to the uncontrolled comparable renegotiations for evidence and direction. Tax professionals need to be diligent in tracking down and maintaining evidence on third party renegotiations through discussions with the business managers and industry reports.

There are several other economic or business factors (which could also exist in uncontrolled transactions) which could affect or trigger a need for a change in the transfer price. Some of these include a change in the cost budgets or capacity assumptions or use of market penetration strategy. Companies could also adopt a marginal pricing strategy to reduce its losses or higher absorption of fixed costs. In the Indian context, it should be noted that the Delhi Tribunal did not accept the marginal costing strategy in the case of a MNC subsidiary company engaged in the assembly and distribution of electronic goods and opined that "*under-utilization of capacity, if any, are burden of overheads and motive to reduce them, cannot justify export at a price less than the price to any unrelated party. It was to be shown that the similar price was charged for similar item in similar circumstances.*" Thus, it is imperative that the factors considered for establishing or changing a transfer price are to be evidenced with parallels in uncontrolled transactions or conditions. While transaction level information could be difficult to find, an industry and functional analysis could be a useful substantiation.

A change in transfer price could also be effected through a business restructuring with a reallocation of the functions risks and assets. A downturn economy could in certain situations provide an opportunity for a tax efficient restructuring since the transfers of intangibles or considerations could be achieved at a lower valuation as compared to prospective times, thereby reducing transition tax costs.

In conclusion, there appear grounds to revisit the level of profit for the risk mitigated enterprise in a downturn economy. However, an implementation of any change would need to be evidenced with documentation to substantiate the arm's length standard. Multinational companies need to be even more vigilant with regard to possible increased scrutiny into their transfer pricing arrangements, given that treasuries around the globe would face budget shortfalls and would strive to gain additional tax revenues.

The author specializes in international tax and transfer pricing and the views expressed herein are necessarily of the author.
vishnu@accretiveglobal.com
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