



Impact of COVID-19 on Transfer Pricing

Key Takeaway



- ❖ Affected transactions:
 - Cross border transactions
 - Management services
 - IP related transactions
 - Financial assistance
 - Limited risk transactions/ companies
- ❖ Solutions
 - Consider making changes to the functions or supply chain
 - Justify losses or low profits and quantify impact of COVID on business
 - Provide for TP adjustments
- ❖ Companies should start compiling the necessary documents for preparation of TP documentation

The COVID-19 has had devastating effects on not just people's health but the economy as a whole. Through-out this past few months, the financial system worldwide has been experiencing great pressure. Companies especially, are facing cash flow problems and difficulties sustaining the business.

Highlighted below are some of the issues faced, especially by Companies involved in related party transactions:

- **Companies involved in cross border transactions**
In situations where the supply chain and related party transactions spans across different countries, companies are obligated to segregate clearly the functions, assets and risks carried out by each entity to determine the value drivers. The pandemic may have affected the related companies' ability to perform their role in the supply chain resulting in temporary or permanent changes to the value chain.
- **Companies receiving or providing management services**
There might be situations in which local MNE companies are forced to continue paying for service fees or management fees despite the fact that there is reduced or no assistance being provided by the service provider during the lock-down period.

MNE Groups may have also provided additional services to assist subsidiaries during the pandemic. However, it's important to determine if the services pass the benefit test if charges are imposed.



- **Companies with intangible properties (“IP”)**

Companies charging royalties for IP or branding activities, especially those charging as a percentage of sales or revenue would face a severe impact on royalty income during the pandemic. This also gives rise to lower taxes paid resulting to potential queries by the tax authorities.

- **Companies involved in cross border financial assistance**

Companies who have provided any type of financial assistance with pre-determined payment terms and interest would not be able to collect the debt and would have to look into deferring all amount dues, similar to the approach adopted by banks with the moratorium. Alternatively, larger MNEs with centralized cash pooling arrangement or with extra cash may extend the cash availabilities to its subsidiaries during this time of need. Interest may or may not be charged in these circumstances resulting in a transaction that may not be considered to have been conducted at arm’s length.

- **Limited risk companies**

Companies with limited functional profile and involved in low or limited risk operations such as contract manufacturers or distribution arms on behalf of its related companies would also face a problem business losses if the other party is affected. These Companies are generally expected to earn a fixed margin, hence it would be a challenge to justify these drop in profits in the year of the pandemic.

Taking into consideration the struggles Companies could potentially face, listed below is some of the ways in which Companies can be more prepared with the impact on their transfer pricing arrangements. Companies can consider:

1. Making changes in the supply chain or functions carried out by the company to ascertain if it can help mitigate some of the risks borne by the company. Changes made must also be documented with the impact analysis.
2. Companies who experience losses or low operating profits would have to justify the losses in the TP documentation prepared for the year in which the pandemic hit. It would have to contain an explanation that the losses were not as a result of non-conformance to the arm’s length policies.

It would be worthwhile for companies to start compiling the necessary information and analysis to document the impact of COVID-19 on the operating profit.

3. Making transfer pricing adjustments or changes in the pricing policy. Although these adjustments are usually debatable and subject to scrutiny by the tax authorities, Companies may not have a choice but to document the calculation and quantify the impact of the adjustments.

Preparation of TP documentation for FY 2020 will definitely be a challenge not only for Companies but also for service providers. Due to the negative impact of the pandemic on operating profits, the likelihood of obtaining a positive benchmarking results are low. It would be worthwhile to consider a multiple year benchmarking analysis and an average profitability across 2 to 3 years as an alternative benchmarking approach.

There might also be a time-lag in the completion of the TP documentation due to insufficient financial information for benchmarking. Companies in Malaysia have been given an extension of time to submit their audited financial statements.

Given the above challenges, it is imperative for taxpayers to start documenting the impact of the pandemic on their business including the changes that were implemented, justification for the change, financial impact and any other relevant information.

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Kuala Lumpur 吉隆坡	+603 780 55022	Johor Bahru 柔佛	+607 595 2299	Penang 檳城	+604 371 3419 / +604 371 3318
Labuan 纳闽岛	+6087 599 328	Muar 麻坡	+606 952 0205	Sitiawan 实兆远	+605 688 5112
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