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Supply Chain Disruption: Key International Tax Issues

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Agenda

- Introductions
- General observations
- Transfer pricing challenges
- Tax issues associated with functional dislocation
- Indirect tax issues
- Concluding remarks
- Upcoming webinars and other resources

General Observations

- Supply chains are being disrupted as a result of the COVID-19 crisis
- Distribution channels
- Contract manufacturing arrangements impacted
- Margins under pressure
- Employees working remotely and/or having different responsibilities
- Tax is a key component in every supply chain structure
- When that structure is disrupted, important tax considerations arise

Transfer Pricing Challenges in Connection with COVID-19

Impact on Distribution Structures

- **Intercompany agreements and distribution structures**
  - Intercompany Agreements should adequately reflect the functions, risks and assets used by members of a MNE in their distribution structures.
    - Basis for identification of the commercial or financial relations with verification of economic reality of contractually assumed risks.
    - First line of defense against tax audits.
  - Drafted under assumption of "normal" operating conditions.
  - Generally, do not address the consequences of unanticipated catastrophic events.
  - Force majeure or other similar provisions could impact the interpretation or legal effect of the agreement.

Impact on Distribution Structures

- **Challenges arising in respect of distribution structures under COVID-19**
  - How should intercompany distribution agreements apply where an MNE suffers catastrophic losses as a result of COVID-19?
    - **Ex 1.** A MNE has a typical limited risk distributor ("LRD") agreement that provides for the LRD to earn a predictable, fixed margin and for all residual profit or loss to inure to the principal and for the principal to bear most of the LRD's ordinary business costs and risks.
    - **Ex. 2**. A MNE has a "routine" or "full-fledged" distribution agreement in which the distributor has no contractual guarantee of profitability but is nevertheless intended to bear only the routine risks of distributing products.

Impact on Distribution Structures

- **Potential approach to impact of COVID-19 on distribution structures**
  - Maintaining pre-existing Intercompany Agreements.
    - Potential for uncertainty administering agreements designed for "normal" operating conditions.
    - Interpretation issues.
    - Judgement calls.
  - Establishing new Intercompany Agreements or amending existing agreements
    - Proactive strategy to adequately document allocation COVID-19-related costs and losses.
    - May have less persuasive weight with tax authorities in case of audit.

Impact on Transfer Pricing Documentation

- **Challenges to Transfer Pricing planning and documentation process under COVID-19**
  - Transfer pricing documentation for 2020 will be challenging
    - 2020 financial data for comparable companies similarly adversely affected by COVID-19 generally will not be available until 2021
    - "Wait and see" approach may be possible for MNEs with calendar year fiscal years, but not for those with earlier fiscal year ends (e.g., March 31 or June 30)
    - "Wait and see" may also not be possible for entities in jurisdictions that do not permit retroactive adjustments
  - Well-accepted benchmarking practices may be drawn into question
    - Impact on multiple year analyses.
    - Questions relating to use of large comparable sets of functionally similar companies that may be disparately affected by the COVID-19 crisis.

Impact on Transfer Pricing Documentation

- **Potential approach to Transfer Pricing planning and documentation Process**
  - "Fresh-look" at longstanding MNE transfer pricing policies.
  - Consider comparability analyses and transfer pricing documentation approaches developed during 2008-09 financial crisis
    - However, COVID-19 may be significantly different than the financial crisis in key ways.
  - Novel approaches to loss allocation should be considered.
    - What are local entities doing to stem losses in their jurisdiction?
    - How can this be measured against the severity of the local downturn?

Impact on Transfer Pricing Documentation

- **IRS Transfer Pricing Documentation FAQs released April 14, 2020 provide timely guidance**
- FAQs do not address COVID-19 specifically (and were likely finalized before the onset of the crisis) but nevertheless address issues more relevant now than ever
- FAQ 1, analyzes the transfer pricing documentation approach of a U.S. distributor that incurs losses in 2017 because of an unexpected decrease in demand.
  - *In the example provided, the IRS explains that it would be <u>beneficial in an audit</u> if the company prepared documentation that <u>thoroughly explains how the unforeseen business circumstances experienced by the company caused the observed financial</u> results and <u>how the losses were not caused by intercompany prices</u>. This approach would address a core issue in the transfer pricing analysis and facilitate an efficient examination.*
  - *The IRS further explains that "it would be <u>counterproductive if, rather than addressing the business circumstances that caused the loss, the taxpayer instead manipulated its set of comparable companies</u>. For example, the taxpayer might adopt an analysis in its documentation that includes companies not truly comparable to the distributor but cause the results of the distributor to fall within the interquartile range of comparable company profitability. This approach would result in additional rounds of Information Document Requests (IDRs) and a lengthy analysis of the reliability of the comparable companies selected by the taxpayer, which could lengthen the audit period considerably."*

Allocation of Catastrophic Costs

- **Allocation of COVID-19-related costs**
  - Catastrophic costs are of unprecedented scale for MNE’s.
  - Allocation of costs among members of a MNE should be reviewed and monitored from a tax and transfer pricing standpoint.
    - Should costs be shared among an MNE group? If so, how?
    - Review of rights and assets, of the risks assumed, of the economic rationale and the options realistically available to the parties.
    - Review of contractual terms in intercompany agreements.

Transfers of Value

- **Documenting COVID-19 related support between members of a MNE**
  - Transfer Pricing Considerations:
    - Financial, technical and other support may be treated as a going concern.
    - Potential for cross-border transfer of value requiring compensation and adequate documentation.
  - Tax Considerations:
    - OECD Transfer Pricing Guidelines for MNEs
      - Potential for "outbound transfer of IP" or "business restructuring"
    - Support and other payments may result in potential withholding taxes.
    - Potential issues with deductibility of payments.
    - U.S. BEAT considerations.

Distributor/Supplier Terminations

- **Termination of distribution agreements in connection with COVID-19**
  - MNEs may consider rescinding or terminating related-party transactions to realign supply chain.
    - **Rescission**: Allows a company to unwind a transaction restoring the parties original status.
      - The IRS has allowed rescinding a transaction in part or in whole in very limited circumstances.
    - **Termination:** Terminates legal relationship between parties, may result in contractual damages from termination.
      - Liquidated damages provisions can be helpful in mitigating damages.
      - Limited third-party comparable data.

Financing Arrangements

- **COVID-19 challenges to intra-group financing arrangements.**
  - Stress on financial system may impact MNE financing arrangements and how they are reported for transfer pricing purposes.
    - Distressed entities may require financial support leading to potential "debt vs. equity" considerations if new funds are advanced by a related party.
      - *Would an unrelated third party lend under the current business circumstances?*
    - Third-party lenders may reassess financing arrangements based on the creditworthiness of the borrower.
      - *Diminished credit ratings may impact the determination of interest rates.*
    - Cash-flow pressures may lead to alteration of terms of payment on a loan.
      - *Potential need for guarantees from parent companies to support local entities.*

Financing Arrangements

- **Potential approach to COVID-19 challenges to intra-group financing arrangements.**
  - MNEs should prepare documentation supporting financing decisions taken in respect of COVID-19.
    - Document intra-group financing arrangements via a transfer pricing study before the funds are advanced.
    - Consider how to document unexpected costs from renegotiating financing arrangements with third parties.
    - Corresponding adjustments to calculated credit ratings may be required.

Consistency with Customs Valuations

- **COVID-19 impact on import operations**
  - Change in transfer pricing policy should also consider customs regulations.
  - Potential issues:
    - Customs authorities approach to transfer pricing on a transaction-by-transaction basis.
    - Different rules than those applied by the tax authorities in comparing to market prices.

Recommended Actions

- Review intercompany agreements to analyze how COVID-19 should be addressed for transfer pricing purposes.
- Consider “hardship”, “force majeure” and other provisions that may allow for one time reallocations of profit or loss.
- Document variances from transfer pricing policies that may be appropriate for 2020.
- Review impact of changes in transfer pricing methods to customs valuations in each jurisdiction.

Tax Challenges Arising from Functional Dislocation

Permanent Establishment and Residency Issues

- **Permanent Establishment – General Rules**
  - The presence of employees working in a country may cause the employer to have a permanent establishment in that country under an applicable income tax treaty, e.g.,
    - The employee works in that country through a fixed place of business of his or her employer.
    - The employee has and habitually exercises the authority to conclude contracts in the name of the employer in that country.

Permanent Establishment and Residency Issues

- **Permanent Establishment – COVID-19 Related Challenges**
  - Due to COVID-19, an employee may be stranded in another country as a result of travel restrictions or other limitations and potentially cause the employer to have a permanent establishment in that country.
    - The employee may be required to work in a location that is treated as a fixed place of business of the employer.
    - Business exigencies may require the employee to exercise contractual authority.
  - Stranded employees themselves may become subject to tax where their stay exceeds the number of days allowed under relevant local law or income tax treaty.

Permanent Establishment and Residency Issues

- **Tax Residency – General Rules and Challenges**
  - Many countries use a central management and control test to determine whether a company is resident in that country for tax purposes.
  - Certain activity may create a risk that the company could be viewed as having its central management and control in that country.
    - E.g., an employee working remotely and acting in a management capacity or exercising authority as a member of the board of directors of a company
  - Other circumstances may cause the company to cease to be resident in a country when such residency is desired (e.g., avoid exit charges).
    - Directors cease to exercise central management and control over their company in a particular country when they are unable to travel to that country.

Permanent Establishment and Residency Issues

- **U.S. Guidance**
  - On April 21, the Treasury Department and the IRS issued guidance that provides relief to individuals and businesses affected by travel disruptions arising from the COVID-19 emergency.
    - A new FAQ ("Information for nonresident aliens and foreign businesses impacted by COVID-19 travel disruptions") provides that certain U.S. business activities conducted by a nonresident alien or foreign corporation will not be counted for up to 60 consecutive calendar days in determining whether the individual or entity is engaged in a U.S. trade or business or has a U.S. permanent establishment, but only if those activities would not have been conducted in the U.S. but for travel disruptions arising from the COVID-19 emergency.
    - Rev. Proc. 2020-20 provides that under certain circumstances, up to 60 consecutive calendar days of U.S. presence that are presumed to arise from travel disruptions caused by COVID-19 will not be counted in determining U.S. tax residency or whether an individual qualifies for tax treaty benefits for income from personal services performed in the U.S.

Permanent Establishment and Residency Issues

- **OECD Recommendations**
  - On April 3, the OECD published guidance analyzing implications of international tax treaty rules with respect to extraordinary measures that governments have taken in response to COVID-19.
  - The OECD advised that the pandemic may have temporarily changed the way cross-border employees work, but it is unlikely to lead to permanent establishment and tax residency changes under existing tax treaties.
  - The OECD encourages countries to work together to alleviate the unplanned tax implications and potential new burdens arising due to effects of the COVID-19 crisis.

Permanent Establishment and Residency Issues

- **OECD Recommendations (cont.)**
  - The OECD guidance suggested that –
    - Because home offices in such circumstances lack permanency and aren't necessarily at the disposal of an enterprise, they would not be considered a fixed place of business according to tax treaty rules.
    - If contracts are concluded temporarily at employees' or agents' homes because of force majeure or government directives as a result of the crisis, there is no PE created for the businesses involved.
    - The pandemic is unlikely to change the residency status of a company under a tax treaty due to the displacement of senior executives.
    - If a government helps a company retain employees during the crisis and those employees receive government-subsidized salaries as a result, that income should be attributed for tax purposes to the place where employment was exercised before the crisis.

Permanent Establishment and Residency Issues

- **International Guidance**
  - Luxembourg and France declares COVID-19 a case of force majeure and announces that cross-border workers may telework work from their home country without being considered resident there for tax purposes.
  - Belgium acknowledges that COVID-19 is a force majeure situation and states that Belgian and French authorities will not take into account the presence of French cross-border workers at their residences in France when calculating residency for tax purposes.
  - Luxembourg also clarifies that the rule allowing taxpayers to work up to 24 days per calendar year outside Luxembourg without being subject to taxation in Belgium will not be enforced until further notice.

Permanent Establishment and Residency Issues

- **International Guidance (cont.)**
  - U.K. disregards certain days spent in the country because of COVID-19 related self-isolation or travel restrictions for purposes of the tax residence test.
  - Australia clarifies that COVID-19 will not in itself result in a company having a permanent establishment or central management and control in Australia.
  - Ireland calls the COVID-19 pandemic a case of force majeure, saying that a taxpayer will not suffer negative tax repercussions for being present in Ireland because of travel restrictions.

Permanent Establishment and Residency Issues

- **Installation, Construction or Building Projects – General Rules**
  - Under most income tax treaties, an installation, construction or building project is not considered a permanent establishment provided the project is temporary.
  - Both the US and OECD Model Income Tax Treaties provide a twelve month period after which the project will become a permanent establishment.
  - The Commentary to the OECD Model Treaty indicates that temporary interruptions in a project for seasonal weather delays or similar events do not extend the relevant time period.

Permanent Establishment and Residency Issues

- **Installation, Construction or Building Project – COVID-19 Related Challenges**
  - Permanent establishment risk arises when a project is delayed by events such as COVID-19.
  - Given the unprecedented and catastrophic nature of COVID-19, a case can be made that the crisis is different from more predictable weather and other events.

CFC Considerations

- **General Rules**
  - The controlled foreign corporation ("CFC") laws of many countries require a level of substance in a CFC in order to prevent an income inclusion to the shareholder of the CFC. They may also provide for safe harbors from that inclusion, which a supply chain might previously have relied upon.
  - For example,
    - In the U.K., a CFC inclusion may not be required in certain circumstances if the CFC has no or limited "UK-managed" risks and assets or has sufficiently low profits.
    - In the U.S., the subpart F substantial contribution test requires the CFC to be actively engaged in a number of functions supporting manufacturing.
  - These and other CFC related requirements are generally tested on an annual basis.

CFC Considerations

- **COVID-19 Related Challenges**
  - Under the current circumstances, if employees of a CFC are not able to perform particular functions, or that CFC is required to perform different functions, there is a risk that an income inclusion will be required at the shareholder level.
  - MNE’s may need to shift production from a CFC to another CFC or back to the MNE’s home country.
  - Broad tax considerations arise here including relative tax rates between the jurisdictions and taxation of royalty and other payments arising from the shift.

DEMPE Dislocation

- **General Rules**
  - Many countries have implemented the recommendations of BEPS Action 8 requiring that an entity maintain a sufficient level of substance in order to earn a risk adjusted return on intangible property ("IP").
  - For this purpose, the sufficiency of an entity's substance is determined primarily by reference to the development, enhancement, maintenance, protection and exploitation ("DEMPE") functions that it performs or controls.
  - Under this standard, in order to earn premium returns associated with IP, an entity needs to be able to perform or control the DEMPE functions with respect to such IP.

DEMPE Dislocation

- **COVID-19 Related Challenges**
  - DEMPE functions are also important in years of minimal profitability and losses, when there are no premium returns from IP to allocate.
  - When employees of a company cannot perform the necessary DEMPE functions, there is a risk that a licensee of IP will lose deductions for royalties paid to the licensor or that the licensee will be required to withhold taxes on a royalty payment.

Recommended Actions

- MNE's should be reviewing their delegations of authority for key personnel working from remote locations in order to assess risk with respect to the above issues.
- Although the consequences may vary on a country by country basis, where remote board meetings need to take place during the crisis, documentation should be maintained as to the location of the meeting and why the meeting could not take place in the relevant country.

Indirect Tax Issues

Indirect Tax Issues - Introduction

- The application of indirect taxes such as VAT or GST to supplies of goods and services under a supply chain will generally depend upon where the supplies take place for the purposes of these taxes

- As a result, an alteration in the provenance or destination of those supplies in response to the Covid-19 crisis may have indirect tax consequences

- We will discuss:
  - Typical indirect tax treatment of cross-border and domestic business to business supplies
  - Indirect tax implications of supply chain modifications for a supplier
  - Indirect tax implications of supply chain modifications for customer
  - Customs duties
  - Key indirect tax issues for those facing supply chain disruption to consider

Cross-Border Supplies

Cross-border supply of goods – EU to non-EU

Treats supply as exempt with credit if customer is a relevant business person

Supplier

Jurisdiction A (EU)

Place of supply typically in customer jurisdiction

May need to account for indirect tax in jurisdiction of establishment; may be entitled to credit

Customer

Jurisdiction B (non-EU)

Cross-border supply of goods – non-EU to EU

Jurisdiction C (non-EU)

Supplier

Typically would not be required to charge and collect local indirect taxes

Place of supply typically in customer jurisdiction

Jurisdiction D (EU)

Customer

Will need to account for import VAT in jurisdiction of establishment unless supply is exempt; may be entitled to credit

Intra-EU Supplies

Standard cross-border supply of goods – EU to EU

Treats supply as exempt with credit if customer is a relevant business person

Supplier

Jurisdiction E (EU)

Goods move from jurisdiction E to jurisdiction F when supplied

Place of supply typically in jurisdiction F

Customer

Jurisdiction F (EU)

Will need to account for acquisition VAT in jurisdiction of establishment unless supply is exempt; may be entitled to credit

Cross-border supply of goods – EU to EU – goods located in customer jurisdiction at time of supply

Jurisdiction G (EU)

Supplier

Required to charge, collect and account for VAT in jurisdiction H unless supply is exempt; requires jurisdiction H VAT registration

Goods already located in jurisdiction H when supplied

Place of supply in jurisdiction H

Jurisdiction H (EU)

Customer

Will need to pay VAT at jurisdiction H rate to supplier unless supply is exempt; may be entitled to credit

Domestic Supplies

Domestic supply of goods

Required to charge, collect and account for VAT in jurisdiction I unless supply is exempt; requires jurisdiction I VAT registration

Supplier

↓

Customer

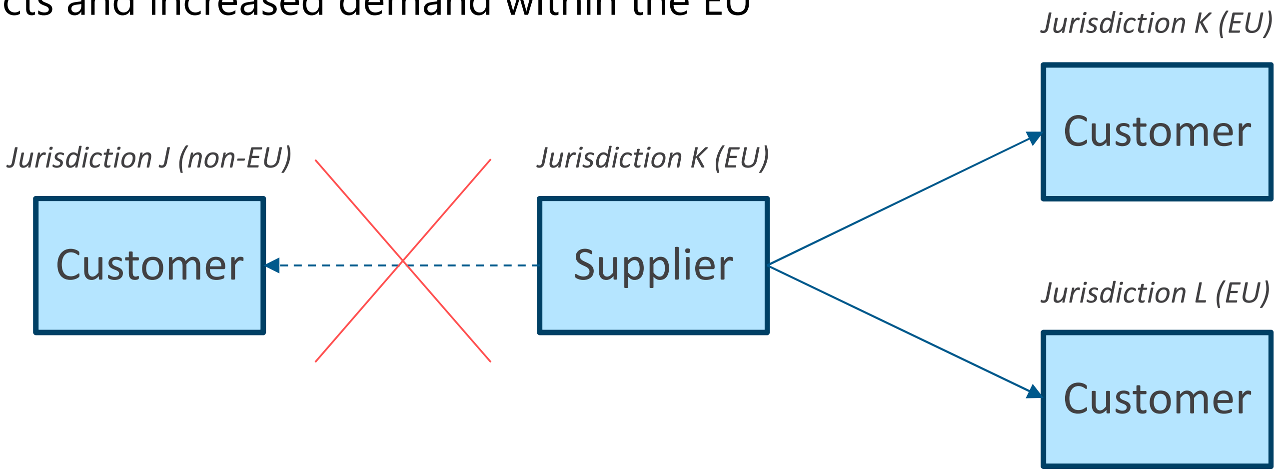
Will need to pay VAT at jurisdiction I rate to supplier unless supply is exempt; may be entitled to credit

Jurisdiction I

Place of supply typically in jurisdiction I

Supplier Implications

Case study: distributor of pharmaceutical and medical products established in the EU, making supplies to business customers only – Covid-19 crisis results in a change from customers established outside the EU to customers established in the EU (including home jurisdiction) due to EU restrictions on export of certain products and increased demand within the EU



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Supplier Implications

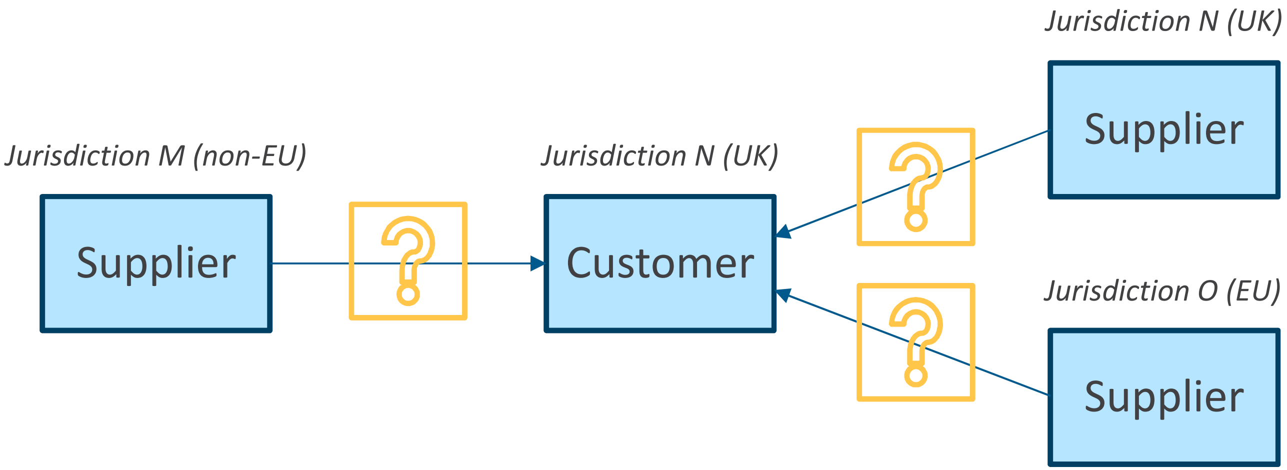
- Change of customer jurisdiction can lead to change in place of supply for indirect tax purposes (which is typically in the customer's jurisdiction)
- Distributor previously made exports that would have been treated as exempt with credit (i.e. no obligation to charge or collect VAT)
- For new customers in other EU jurisdictions, distributor will need to ensure its invoices satisfy the requirements for intra-EU zero rated supplies
- For new domestic customers, distributor will need to charge VAT at the appropriate rate on its invoices, collect that VAT from customers and account for that VAT to the relevant tax authority
- Similar issues apply where goods stored in another EU country (i.e. not where distributor is established) are supplied to domestic or EU customers rather than exported

Supplier Implications

- Where distributor has VAT obligations in different jurisdictions, it needs to consider:
  - Whether it is required to register for VAT in new jurisdictions
  - How its products are classified for VAT purposes in the relevant jurisdiction (including the appropriate rate of VAT and whether any exemption or relief applies)
  - The invoicing and reporting requirements that apply
  - Whether the supply chain modification increases its costs of making the supply (e.g. if a supply that was previously exempt with credit when made to overseas customers becomes simply exempt when made to domestic customers, affecting entitlement to input VAT recovery
  - If it has already accounted to a tax authority for VAT in respect of orders that it has been obliged to cancel, whether and how this can be reclaimed from the relevant tax authority

Customer Implications

Case study: supermarket chain established in the UK, receiving business to business supplies – Covid-19 crisis results in a change from overseas to local suppliers due to shipping challenges or lack of overseas supply, or in a change from local to overseas suppliers due to increased demand for particular products



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Customer Implications

- The place of supply for indirect tax purposes is typically in the customer's jurisdiction, so the place of supply for supplies of goods to the supermarket chain would generally be in the UK regardless of the location of the supplier
- It is therefore likely that UK VAT would apply (except where the relevant supply is exempt or zero rated) and the rate of VAT would be the same regardless of the location of the supplier
- For domestic supplies, the supermarket chain would generally be required to pay VAT to its supplier (which would be responsible for accounting for that VAT to the UK tax authorities)
- For cross-border supplies, the supermarket chain would generally be required to account for import VAT (for non-EU sourced supplies) or acquisition VAT (for EU-sourced supplies)

Customer Implications

- If the supermarket chain takes possession of overseas goods where they are located and subsequently arranges its own transport to the UK, the place of supply would typically be the location of the goods at the time the supermarket chain takes possession
- This could expose the supermarket chain to overseas indirect taxes, which may apply at higher rates than domestic VAT (with potential cash flow implications for the supermarket chain)
- Depending on the applicable regime (and whether it is inside or outside the EU), the supermarket chain may or may not be entitled to credit or relief for foreign indirect taxes – if relief is not available, this would increase the cost of the supply for the supermarket chain
- The supermarket chain may have new customs duties obligations in respect of supplies from outside the EU (see next slide)

Customs Duties

- Supply chain modifications can trigger new customs duties obligations if goods are sourced from overseas instead of locally
- Supply chain modifications can alter existing customs duties obligations if goods are sourced from a new foreign supplier in a different jurisdiction
- Changing overseas suppliers can increase the customs duties payable
- Although customs duties are generally applied on a product-specific basis, there can be significant differences in tariff depending on the source country (e.g. due to duty elimination programs like free trade agreements or punitive measures such as those the US is currently imposing on Chinese imports)
- Associated compliance obligations can be onerous

Summary of Key Indirect Tax Issues to Consider

- What indirect taxes/customs duties apply? (in which jurisdictions and at which rates?)
- Which party is responsible for charging, collecting and/or accounting for the indirect taxes that are due?
- Are any additional registrations required?
- What filing and reporting obligations apply?
- Is relief or credit available for indirect taxes paid?
- Is any particular documentation required to support the indirect tax or customs duties treatment of a supply or to support a right to relief or credit for indirect tax incurred?

Concluding Remarks

- Efficient supply chains are built in part on sound international tax planning
- The COVID-19 crisis requires MNE's to reassess their tax planning
- Is transfer pricing consistent with evolving functionality?
- Does the international structure still work in light of employee dislocation?
- Is our VAT system still in compliance?
- Are there other opportunities to improve the structure in light of depressed values and margins?
- The Tax Departments should be an integral part of every MNE's crisis management planning

Recent and Upcoming Webinars

- April 28, 2020 - REVERSEinquiries Workshop: US Taxation of Structured Notes
  Thomas A. Humphreys, Remmelt Reigersman
  View Webinar: https://www.mayerbrown.com/en/perspectives-events/events/2020/04/reverseinquiries-workshop-us-taxation-of-structured-notes

- May 2020 - Intra-Group Financing Post BEPS and TCJA Webinar, Including Covid-19 Considerations
  Scott Stewart, Astrid Pieron, Elena Khripounova, Maria Critelli

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Optimize Tax Efficiency	Protect Intellectual Property Rights	Comply with Antitrust & Competition Laws
	Leverage AI, Platforms and Other Technology to Innovate and Adapt	

Mayer Brown's COVID-19 Portal

- https://covid19.mayerbrown.com/

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