Checkpoint Contents
International Tax Library
WG&L Journals
Journal of International Taxation (WG&L)
Journal of International Taxation
2020
Volume 31, Number 08, August 2020
Articles
Shock to the System: Key International Tax Issues Associated with Supply Chain Disruption, Journal of International Taxation, Aug 2020

Supply Chains

Shock to the System: Key International Tax Issues Associated with Supply Chain Disruption

COVID-19 has placed unforeseen stress on distribution structures and corresponding transfer pricing analyses due to catastrophic losses and costs from supply chain interruptions and plummeting demand.

Author: Michael Lebovitz, Matthew Mortimer, Jason Osborn, Astrid Pieron, Kitty Swanson, Juan Lopez Valek and Xiao Xiao

Michael Lebovitz, Matthew Mortimer, Jason Osborn, Astrid Pieron, Kitty Swanson, Juan Lopez Valek and Xiao Xiao are all members of the global tax practice of Mayer Brown.

The COVID-19 crisis has highlighted the challenges a multinational enterprise ("MNE") faces when global supply chains are disrupted. Decisions must be made quickly when a distribution center is temporarily shut down, when employees in key supply chain roles cannot perform their functions in their expected locations and when the source of raw materials or components changes from one country to another.

Tax is an important component to an efficient global supply chain. Sound international tax planning consistent with global standards ensures that the proper amount of income is allocated to the functions, risks and assets employed by the supply chain and also ensures that no income tax arises where functions performed in a location do not rise to the level of taxable nexus. Moreover, indirect taxes (e.g., VAT) depend directly on how goods and services flow between countries.

The COVID-19 crisis has created a shock to the global supply chain system. This article discusses some of the key international tax challenges associated with this disruption.

I. Transfer Pricing Challenges

COVID-19 has placed unforeseen stress on distribution structures and corresponding transfer pricing analyses due to catastrophic losses and costs from supply chain interruptions and plummeting demand. In these challenging times, MNEs should consider embarking on a proactive review of these structures to determine whether they continue to make sense from both a practical, operational and compliance standpoint.

Intercompany Agreements

The starting point for any such review of an MNE's structure and transfer pricing policies should be the existing intercompany agreements. In many cases, MNEs will find that their existing agreements do not directly address how short-term losses of an unanticipated catastrophic nature should be taken into account. For example, a typical limited risk distributor (“LRD”) agreement will usually provide for the LRD to earn a predictable, fixed margin with the residual profit or loss inuring to the principal. While such LRD agreements may provide for most operating costs incurred in the ordinary course of business to effectively be borne by the principal, such agreements are typically drafted with “normal” operating conditions in mind and may not directly address how unanticipated costs of a catastrophic nature should be allocated between the parties. MNEs may therefore have flexibility to support and document a position for allocating such unanticipated costs among group members in a manner consistent with arm's length behavior.

MNEs may also consider modifying, terminating or entering into new intercompany agreements in order to realign supply chains or provide additional financing to its members. Rescinding a transaction might be the easiest way for an MNE to cancel the effects of a catastrophic change in circumstances; however, MNEs should note that tax authorities have generally only respected rescission of related party transactions in part or in whole in very limited circumstances. On the other hand, if an MNE decides to terminate an existing agreement, such as a distribution and supply agreement, careful attention must be given to what damages a supplier or distributor may be entitled to receive as a result of the termination; as it would be the case between independent parties. “Liquidated damages” provisions or penalty clauses can be helpful in limiting the amount of damages for which a related distributor or supplier may be entitled, to the extent such clauses are accepted in the jurisdiction of concern. Conversely, “hardship”, “force majeure” and other provisions may allow for one-time reallocations of profit or loss.

MNEs may also need to modify intercompany financing arrangements, for example, if external borrowings are in default or thin cap thresholds breached. There may also be valid business reasons to depart from original agreements if it improves the potential profitability of both parties. Modifications could include extension of maturities, grace periods, adjustments to interest rates, alteration of covenants, etc. Consideration should be given to the transfer pricing implications of modifying the terms of intercompany financing and any adjustments should be adequately documented and reflect the actual conduct of the parties. In addition, MNEs should consider whether a modification could trigger cancellation of indebtedness income for the issuer[1] and a taxable exchange for the holder.[2] It is also important to consider whether new or modified financings would still be respected as debt for income tax purposes or whether the modifications undermine the original treatment of the transaction as debt.[3] Moreover, modifications that cause an instrument to be treated as new debt may cause the debt to lose grandfather status with respect to newly enacted interest deductibility limitations.[4]

As discussed above, administering intercompany agreements designed for “normal” operating conditions during the COVID-19 crisis will require considerable judgment and may give rise to numerous interpretational issues. MNEs should address these interpretational issues now and document their rationale for interpreting any relevant provisions. Further, while new intercompany agreements and clarifying amendments enacted to address COVID-19 may have less persuasive weight with tax authorities than preexisting arrangements, such agreements could nevertheless be considered as part of a proactive strategy to document uncertain transfer pricing positions.

Transfer Pricing Documentation

The impact of COVID-19 on an MNE's comparability analyses and transfer pricing documentation should be considered based on the particular circumstances of each company. In many cases, a fresh look may be required and an MNE may find that it will need to make exceptions to longstanding transfer pricing and benchmarking practices designed for “normal” operating conditions.

For most MNEs, identifying comparables for 2020 transfer pricing analyses will be particularly difficult since the economic conditions during 2020 are unlike those during any other year. Moreover, MNEs that experience near total shutdown as a result of a major supply chain interruption may find that there are simply no good comparables for 2020. Some MNEs with a calendar fiscal year might be able to take a “wait and see” approach and make appropriate retroactive adjustments for transfer pricing purposes once full-year 2020 financial data for comparable companies similarly adversely affected by the COVID-19 crisis becomes publicly available. However, MNEs with earlier fiscal year ends or with entities in jurisdictions that do not allow retroactive adjustments, may not have the option to “wait and see” and may need to take more urgent action to adjust margins for the current conditions without the direct benefit of complete comparables-based data.

MNEs navigating the current environment may also consider some of the approaches for comparability analyses and transfer pricing documentation that were developed during the last financial crisis of 2008-2009. These approaches included, among others, using the financial data from the last recession (2001-02) and longer time horizons (up to 10 years) in transfer pricing analyses in order to take into account complete business cycles.

MNEs should also consider the impact of COVID-19 on multi-year analyses that include data from 2020 or that incorporate industries and jurisdictions that may have been disproportionally affected by this crisis. MNEs that recognize upfront the limitations of such multi-year or cross-sector approaches may be better prepared to face these issues in the future.

Incidentally, it is important to note that the IRS recently issued guidance in the form of FAQs addressing recurring issues and best practices with respect to transfer pricing documentation.[5] In response to one particularly timely FAQ involving a distributor in a loss position, the IRS suggested that it would be beneficial in an audit if this MNE prepared transfer pricing documentation that thoroughly explained how unforeseen business circumstances caused unexpected financial results and why such losses were not caused by intercompany prices.[6] The FAQ further explains that it would be counterproductive if, rather than addressing the business circumstances that caused the loss, the taxpayer instead manipulated its set of comparable companies. As suggested by this FAQ, an MNE trying to support allocation of COVID-19 losses to distributors may be better served by including in its 2020 transfer pricing documentation a robust discussion of the facts and circumstances and qualitative arguments supporting its position rather than using a less-robust economic analysis to demonstrate that the distributor's atypical 2020 results fall within an arm's length range.

Transfers of Value

Conversely, as a result of the disruption, MNE's may provide financial, technical or other support to a group member in order to ensure that member's profitability and viability as a going concern. This support may be considered a cross-border transfer of value requiring compensation from a transfer pricing standpoint and may also give rise to tax consequences associated with an outbound transfer of IP or “business restructuring” in the context of Chapter IX of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2017) (the “OECD Guidelines”).

Support and other payments can give rise to broader tax concerns beyond transfer pricing. Support payments may not be deductible by the paying party or may give rise to withholding taxes. Moreover, a payment by a U.S. member of an MNE group to a related party may be considered a base erosion payment under the U.S. base erosion and anti-abuse tax (“BEAT”) rules.[7]

II. Functional Dislocation

Travel restrictions and disruptions caused by COVID-19 have significant consequences on the operations of multinational companies. Personnel may be dislocated in different countries and temporary projects may be prolonged. The challenges caused by the pandemic may raise unexpected tax issues.

Permanent Establishment and Residency Issues

Employees may be stranded in another country as a result of travel restrictions or other limitations. The presence of such displaced employees may cause the employer to have a permanent establishment in that country. In addition, many countries use a central management and control test to determine whether a company is a tax resident. An employee's activity may create risk that the company is viewed as having its central management and control in that country, or cause the company to lose a desired tax residency in a country.

The Treasury Department and the IRS have issued guidance providing relief to those affected by the disruptions caused by COVID-19. Under Rev. Proc. 2020-20, up to 60 consecutive calendar days of U.S. presence arising from travel disruptions will not be counted in determining U.S. tax residency. The IRS also clarified in a new FAQ[8] that certain activities conducted by a nonresident alien or foreign corporation in the U.S. due to travel disruptions 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.

Internationally, the OECD suggested that because activities conducted at employees' home offices are temporary and impacted by force majeure or government directives, the pandemic alone is unlikely to cause a company to have a permanent establishment or change in tax residency.[9] Many countries, such as the United Kingdom, Australia, Ireland, Luxembourg, France, India and Belgium have also issued guidance to alleviate tax implications caused by the pandemic.[10]

CFC Considerations

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. In the United Kingdom, for example, 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.[11] These and other CFC related requirements are generally tested on an annual basis. As a result, when because of external events such as COVID-19, 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.

DEMPE Dislocation

Many countries have implemented the recommendations of BEPS Action 8, now incorporated in the OECD Guidelines, that evaluates whether an entity maintains a sufficient level of substance in determining the appropriate level of return that the entity should earn from the exploitation of 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 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.

III. Indirect Taxes and Customs Duties

The application of indirect taxes such as value added tax ("VAT") or goods and services tax to supplies of goods and services generally depends upon where the supplies are treated as taking place. In consequence, an alteration in the provenance or destination of supplies in response to the COVID-19 crisis may have indirect tax consequences. Similarly, there may also be customs duties consequences.

The precise indirect tax and customs duties consequences of a supply depend on various factors, including the location of the parties and the nature of the goods or services. Suppliers and customers facing supply chain disruption should consider these consequences for each step of their supply chain, including: where indirect taxes and customs duties apply and at what rates; which party must charge, collect and/or account for those taxes and duties; the filing, registration or reporting obligations; whether relief is available for indirect taxes incurred; and the impact on the cost-effectiveness of the relevant step in the supply chain and on the pricing of subsequent steps.

Supply-Side Issues

Exhibit 1 below illustrates some supply-side implications of supply chain modifications. Here, the usual distribution methods of a hypothetical EU-based distributor of medical products (to business customers) are affected by the COVID-19 crisis. For example, it may be unable to supply customers in certain jurisdictions due to export restrictions and may simultaneously face increased domestic demand for its products. In these circumstances, the EU-based distributor may switch from non-EU customers (to whom it would not generally be required to charge VAT) to domestic customers or customers elsewhere in the EU, which will change the place of supply for VAT purposes.

For new domestic customers, the distributor will charge VAT at the appropriate rate on its invoices, collect that VAT from its customers, and then account for that VAT to the relevant tax authority. For customers in other EU jurisdictions, it is unlikely to need to charge and collect VAT, but must ensure that its invoices satisfy the requirements for intra-EU zero-rated supplies. If the distributor sells goods stored in another EU jurisdiction, then, for indirect tax purposes, it will usually need to determine customer location from that jurisdiction's perspective.

Where supplies create VAT obligations in new jurisdictions, the distributor must determine how its products are classified there to identify the applicable VAT rate and any available exemptions. Although VAT is generally harmonized across the EU, headline rates (and the availability of exemptions or reliefs) vary between jurisdictions.

The distributor should consider whether the supply chain modification creates different tax registration, reporting and other compliance obligations, whether changes to the indirect tax treatment of a supply (including the ability to recover related input VAT) will increase its costs and whether it can pass any increased costs to customers.

If the distributor has had to cancel orders for which it had been paid and has already accounted to the relevant tax authority for any VAT collected, it should investigate whether it can reclaim that VAT to refund the customer – otherwise, it risks being out of pocket.

Customer-Side Issues

Exhibit 2 below illustrates some customer-side implications of supply chain modifications. Here, the usual supply network of a hypothetical UK-based supermarket chain is affected by the COVID-19 crisis. For example, it may be unable to source products from the usual jurisdictions due to transport restrictions, or may need additional suppliers due to increased demand for certain products.

The change from a domestic supplier to an overseas supplier (or vice versa) would not normally alter the applicable VAT regime or rate of VAT, as in both cases the regime of the supermarket chain's jurisdiction would usually apply. However, for domestic purchases the supermarket chain will pay VAT to the supplier (which will account for that VAT to the tax authorities), while for cross-border purchases it will generally account for import VAT or acquisition VAT (depending on whether the supply comes from outside or inside the EU).

However, if the supermarket chain takes possession of overseas goods and arranges its own transport to the UK, the place of supply is typically the location of the goods when it takes possession. This could expose it to overseas indirect taxes, which may apply at higher rates (with potential cash flow implications).

In some cases, the supermarket chain may not be entitled to credit or relief for foreign indirect taxes incurred – this would increase the cost of the supply unless a corresponding discount can be negotiated with the supplier. If credit or relief is available, it will still need to finance the tax charge upfront.

Where goods are sourced from new overseas jurisdictions, customs duties may be relevant. Changing suppliers can significantly increase customs duties – although they generally apply on a product-specific basis, there can be significant differences by source country due to duty elimination programs like free trade agreements or punitive measures such as those in place in the U.S. against Chinese imports. This could increase the cost of the supply and impose potentially onerous compliance obligations.

Conclusion

Every efficient supply chain is built in part on sound international tax planning. The COVID-19 crisis requires MNEs to reassess their planning to take into consideration the pressures and challenges described above. MNEs should also consider whether the COVID-19 crisis creates opportunities to improve the structure in light of reduced margins and pressures on valuations.

Exhibit 1. Supply-Side Implications of Supply Chain Modifications

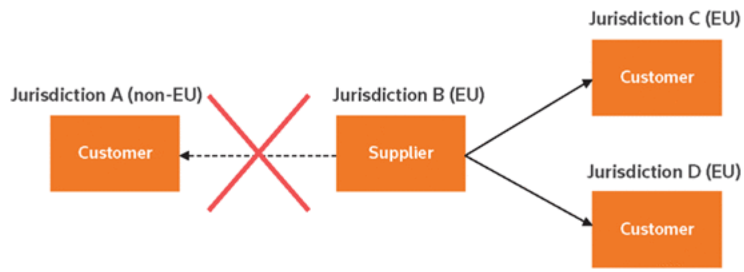
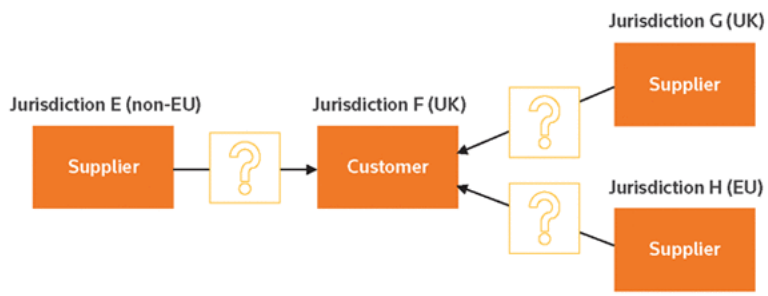


Exhibit 2. Customer-Side Implications of Supply Chain Modifications



---

[1] *See* generally Section 61(a)(11) and Section 108. All Section references are to the Internal Revenue Code of 1986 (as amended) (the "Code") and Treasury Regulations promulgated with respect thereto.

[2] *See* Treas. Reg. Sec. 1.1001-3(b), which provides that if a debt instrument is "modified" in such a way that it is considered to have undergone a "significant modification,“ then such modification will be treated as an exchange of the debt instrument for a new debt instrument.

[3] Section 385 and Treas. Reg. Sec. 1.385-3. See also new OECD Transfer Pricing Guidance on Financial Transactions, February 2020, Section B - Accurate Delineation of Financial Transactions

[4] When implementing the interest limitation rule enacted by the EU directive ATAD I, EU member states were allowed to opt for the grandfathering of loans concluded before June 17, 2016. When applicable, the grandfathering clause provides that a loan concluded before the effective date is excluded from the scope of "excess borrowing costs," unless there was a fundamental change to the terms and conditions of the loan after June 17, 2016. Belgium opted to include such a clause. In the context of COVID-19, the Belgian tax administration published Circular 2020/C/62, which clarifies that the granting of specific payment modalities, related to bank or intercompany loans, should not constitute a fundamental change in relation to the interest limitation rule if the changes are designed to support borrowers with payment issues resulting from the COVID-19 outbreak.

[5] Transfer Pricing Documentation Frequently Asked Questions ("FAQs") published by the Internal Revenue Service ("IRS") on April 14, 2020. The FAQs do not specifically address COVID-19 and were likely finalized before the onset of the crisis.

[6] FAQs 1 addresses a situation where a distributor incurred a loss in 2017, which was determined to be attributable to an unexpected decrease in demand for the distributors product rather than improper transfer pricing. The IRS explains that it would be beneficial in an audit if the company prepared documentation that thoroughly explains how the unforeseen

business circumstances experienced by the company caused the observed financial results and how the losses were not caused by intercompany prices. 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 counterproductive if, rather than addressing the business circumstances that caused the loss, the taxpayer instead manipulated its set of comparable companies. 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.

[7] Section 59A.

[8] IRS, Information for Nonresident Aliens and Foreign Businesses Impacted by COVID-19 Travel Disruptions (Apr. 21, 2020), available at https://www.irs.gov/newsroom/information-for-nonresident-aliens-and-foreign-businesses-impacted-by-covid-19-travel-disruptions.

[9] OECD, Tackling Coronavirus (COVID-19) Contributing to a Global Effort: OECD Secretariat Analysis of Tax Treaties and the Impact of the COVD-19 Crisis (Apr. 3, 2020), available at https://read.oecd-ilibrary.org/view/?ref=127_127237-vsdagpp2t3&title=OECD-Secretariat-analysis-of-tax-treaties-and-the-impact-of-the-COVID-19-Crisis.

[10] See, e.g., Gov. UK, HMRC Approach to UK Permanent Establishments in Response to COVID-19 Pandemic (last viewed May 31, 2020), available at https://www.gov.uk/hmrc-internal-manuals/international-manual/intm261010; Australian Government, Australian Taxation Office, COVID-19: We're Here to Help (last viewed My 31, 2020), available at https://www.ato.gov.au/General/COVID-19/?=redirected_URL; Revenue, COVID-19 Information and Advice for Taxpayers and Agents (last viewed May 31, 2020), available at https://www.revenue.ie/en/corporate/communications/covid19/temporary-covid-19-wage-subsidy-scheme.aspx.

[11] Treas. Reg. Sec. 1.954-3(a)(4)(iv).

END OF DOCUMENT -