

Disruption of Supply Chain

(A transfer pricing perspective)

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Disruption in existing supply chain

Covid-19 impact

- ✓ Businesses are experiencing economic challenges as a result of the Covid-19 crisis and have to temporarily suspend or substantially reduce their activities and the working hours of their staff
- ✓ Sales plunged, shortage of raw material, unavailability of labours, unutilized capacity, liquidity crunch has resulted in **significant supply chain disruption**.
- ✓ Diversify supply chain

US China tariff war

- ✓ US created ripples in the global trade by levying steep tariffs on trade valuing billions of dollars from various countries including China.
- ✓ Increased tariffs might lead to **relocation of global supply chain** to escape from the tariffs on originating goods from such countries.

European Union Vietnam Free Trade Agreement (EVFTA)

- ✓ Vietnam ratified free trade agreement with the European Union on Monday that will remove **99% of tariffs on goods traded**
- ✓ The trade deal will give a much-needed boost to Vietnam's economy as it looks to recover from the COVID-19 pandemic.
- ✓ EVFTA is expected to boost trade and investment in Vietnam significantly

- All three events will disrupt the current supply chain of MNEs which has transfer pricing implication
- Vietnam is the key beneficiary of such investment

Key Transfer Pricing issues

Transfer pricing impact

✓ Business Restructuring

- The supply chain of MNE groups may be disrupted.
- Review the potential impact of terminating or renegotiating inter-company contracts. Will tax authority levy exit charge?
- Transfer pricing policies may have to be redesigned to reflect the changes in the value chain
- To review if the current pricing model adopted by a MNE is consistent with the underlying functional, asset and risk profile of the group entities to avoid any subsequent challenges by the tax authorities
- Lockdown impact strategies for temporary or permanent on group's operation

✓ Loss or reduced profitability strategy for MNE

- **Arm's length principle is mostly based on comparability (of profitability or pricing). i.e. MNE's profit is compared to publicly available profit margin of comparable companies.**
- **Lockdown led to reduced profitability or loss may result in non-arm's length** situation. To establish that the reduced profitability or loss is not because of transfer pricing issues but extraordinary situations
- Is the reduced profitability losses consistent with the function, asset and risk profile of the associated entity?
- Publicly available financials is of last year and it cannot be used to test the profit margin of tested party

Transfer pricing impact

✓ **Loss or reduced profitability strategy for MNE**

- **Long term strategy:** The documentation could cover, among other things, **supply-chain disruptions, cross-border movements of employees** and assignments, **temporary relocation of business functions** to reduce geographical risks, impact on cash flows and liquidity.
- **Short term strategy:** The need for making comparability adjustment would have to be evaluated on a case to case basis and adjustments on account of **underutilization of capacity, contractual defaults/penalties, foreign exchange movement** and other extra ordinary expenses would have to be made to normalize the profits effected due to COVID-19.
- Documentation- cover the entire story of impact

✓ **Comparability**

- While comparing the profit margin to determine arm's length it should be considered that same industry or geography can have different impact. COVID – 19 may have negative impact on FMCG manufacturing say facial cream but positive impact on say sanitizer, soap, masks, PPE, etc
- Geographic market of the product being sold would have different impact while determining arm's length. In Asian countries, the way Korea was impacted is not same as Taiwan.

Important TP issues for clients

The most important transfer pricing issue that is bothering the clients are:

- What should be the transfer pricing strategy for loss or reduced profitability scenarios as a result of lockdown/ economic disruption
- Is management fee or royalty (that is basically considered as cash repatriation tool by tax authorities) is justified under loss scenario. These transaction requires cost benefit analysis and evidence. Under lockdown scenario when people are working from home or stuck at different geography, how to justify the management fee payment or royalty payment to headquarter. How to prove services where actually catered and benefitted for which payment is made

Transfer pricing Impact

✓ Operating models

- To speak on what happens in limited risk entity which generally operates under ring-fenced environment and gets guaranteed return. If the operation is closed due to Covid19 will they still get guaranteed return?

✓ TP Audit

- TP Audit is expected to be stringent
- Challenges in justifying intra group transactions of management charges and royalty which is based on cost benefit analysis and evidence test. Such tests difficult in lockdown situations.

✓ Cash flow pressures

- Limit to what a subsidiary in Vietnam can take loan. Loan interest exceeding 30% of EBIDTA will be disallowed
- Huge receivables, the authority may try to re-characterize as loan and impute interest

Small and Medium sized Enterprises ("SME")

SME

- ✓ Brief Vietnam's economic journey and emergence of SME
- ✓ Next few years crucial and Vietnam is expecting lots of investment
- ✓ Key constraint that SME is facing in Vietnam like traditionally State owned enterprises were encouraged, challenges in access to finance, etc
- ✓ Europe Vietnam Free Trade Agreement ("EVFTA") and US Tariff war impact on SME and opens huge opportunities for SME
- ✓ Emergence of SME multinationals and transfer pricing challenges when they go outbound to other countries or when they partners with MNEs coming to Vietnam
 - Documentation requirement
 - Is the structure tax efficient
 - Inter-company agreement aligned to commercial substance
 - Strategies for key transactions that may be challenged like royalty and management