

Changed rules of cooperation between related parties as a result of a pandemic – permanent or temporary restructuring of operations? TRANSFER PRICING prospects

Changes in the economic market caused by the COVID-19 pandemic will probably affect many taxpayers. Entities that are part of larger groups of companies – more specifically those that are involved in settlements with related parties – will have to analyse the impact of the modified market conditions on the settlements and cooperation rules applicable so far and, if they decide to introduce amendments in this respect, to ensure that the new schemes are in line with the arm's length principle. When introducing changes, one of their important aspects will be the time horizon – will they be temporary solutions for the time of crisis or will they be permanent in the long run? At the same time, it will be important to verify whether the changes introduced do not look like restructuring in the light of the applicable transfer pricing regulations.

It is important to remember that the changes in settlements in intra-group transactions will be reflected both in the transfer pricing documentation prepared for the current and subsequent years (Local File and Master File) and in the submitted transfer pricing declaration (TPR form). One also needs to bear in mind that the analysis of transfer pricing information (TPR) for several-year periods will provide the tax authorities with information on permanent restructurings carried out as well as temporary changes in settlements introduced only during the crisis. This means that such information may be of interest to the tax authorities and may trigger an audit.

Below we will look into important aspects of potential changes in cooperation and settlements between related parties, resulting from the pandemic:

Change of remuneration rules for entities with a limited functional profile

In the context of the COVID-19 pandemic, many international groups of companies will certainly be carefully analyzing their financial situation. One aspect to be considered is the change of the existing related party settlement model. Changes in the rules of related party settlements are likely to attract increased interest from tax authorities. The authorities will probably want to verify whether the changes are justified and whether the new settlement schemes are consistent with the arm's length principle.

In case of a change in the transfer pricing policy, the greater risk of audit is to be expected by entities operating in the group as entities with a limited functional profile (contract manufacturers or distributors with limited risk). Such entities generally have a guaranteed profit level indicator. However, in a situation of reduced performance at the level of the group as a whole, and especially when losses are incurred across the entire value chain, decisions may be taken to reduce the profit indicator of entities with a limited functional profile or to allocate part of the losses to them.

Before such decisions are made, it is essential to perform relevant analyses, including the impact of the new economic situation on the manner in which the transactions are carried out, the involvement of the parties, the distribution of the actual risks and the justification for planned changes. The pandemic itself and its financial impact (without changes to the current functional profile of the entities involved in the transaction) may not be sufficient to justify changes in the remuneration of entities with a limited functional profile. Short-term changes in the remuneration policy of such entities introduced only during the crisis and dictated only by the changed market situation as a result of the pandemic are at risk of being challenged by the tax authorities.

Restructuring

It is also important to consider any changes in settlements in the context of being considered as restructuring. According to the MF Regulation on transfer pricing in the area of corporate income tax, restructuring is understood as reorganisation:

- involving a substantial change in commercial or financial relations, including termination of existing agreements or modification of their essential terms, and
- involving a transfer between related parties of functions, assets or risk categories if, as a result of such a transfer, the taxpayer's projected average annual profit before interest and taxes (EBIT) for the three-year period after that transfer would change by at least 20% of the projected average annual EBIT for the same period if no transfer took place.

If the changes are recognized as restructuring, the tax authorities will investigate, among others:

- trade or financial relations between entities before and after restructuring, in particular by determining the actual functions, risks and assets of related entities before and after restructuring, including the ability of entities to perform the functions, risks and assets assigned to them as a result of restructuring
- an analysis of the economic grounds for the restructuring carried out as well as the benefits expected from the restructuring, in particular synergy effects.

A failure to provide economic justification, the expected benefits, as well as actual changes in the functional profile on a lasting basis may lead the tax authorities to determine that the restructuring has not been carried out in accordance with the arm's length principle.

Disclosure of changes in transfer pricing policy in the documentation and TPR form

Restructuring, as well as any change in the manner of settlements between entities in a group of companies, should be described in local and group transfer pricing documentation, the elements of which are specified in detail in Polish regulations. Moreover, these changes will be reflected in the transfer pricing information (TPR form) that taxpayers are required to submit as of January 1, 2019 – the form contains detailed information on the transactions made, together with a presentation of the benchmarking results. It is important to remember that this tool is intended to be used by the tax authorities to analyse the risk of underestimating transfer pricing tax revenue. The changes introduced in the transfer pricing policy will therefore be easily identifiable for the tax authorities on the basis of the analysis of the TPR forms and may easily trigger an audit. Therefore, when making changes to the transfer pricing policy, one should be well prepared for this kind of control.

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