Supply Chain Disruption – Tax Implications

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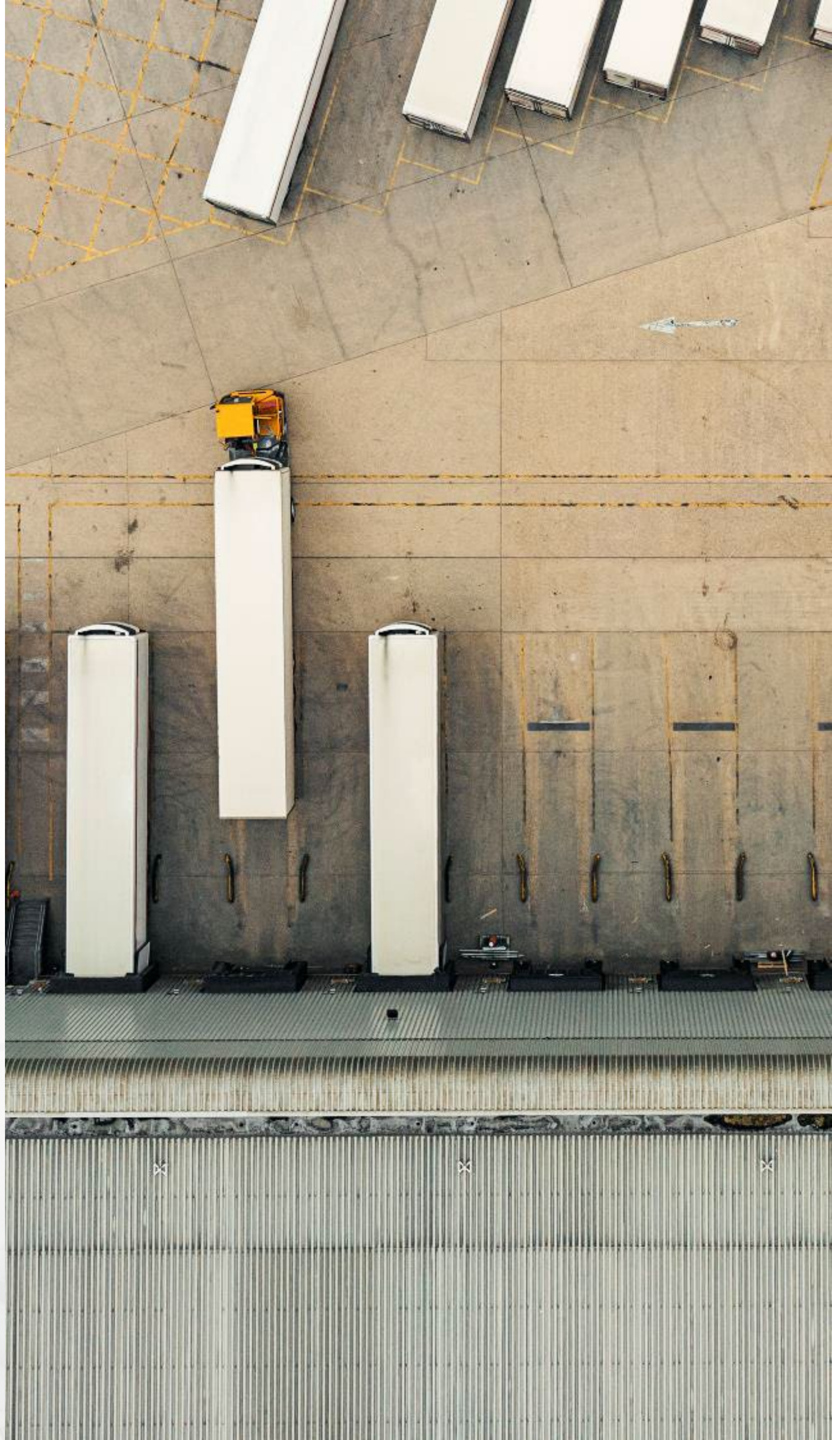
Geopolitics and the pandemic have highlighted the challenges a multinational enterprise ("MNE") faces when global supply chains are disrupted, leaving decision makers scrambling to ensure a continued flow of goods. Decisions must be made quickly when a site is temporarily shut down due to a chip shortage, or when the source of raw materials and 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. Moreover, indirect taxes (e.g., VAT, Customs) depend directly on how goods and services flow between countries.

Disruption caused a shock to the global supply chain system. We discuss some of the tax challenges associated with this disruption.



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Transfer Pricing Challenges

Disruption to the supply chain has had a sudden adverse impact on economic conditions and the profitability of many MNE's which in turn raises immediate challenges for transfer pricing planning and compliance. While an MNE's existing intercompany agreements should provide the starting point for analyzing the transfer pricing impact, which may not specifically address how short-term losses of an unanticipated catastrophic nature should be considered.

For example, a typical limited risk distributor ("LRD") agreement may provide for the LRD to earn a predictable, fixed margin and for all residual profit or loss to inure to the principal. While the LRD agreement may provide for the principal to bear most of the LRD's costs and risks in the ordinary course of business, tax authorities might challenge whether the agreement should be respected in a situation like the pandemic crisis where MNE's may face sudden, catastrophic losses from both supply chain interruptions and plummeting demand. Additional questions may be raised by the presence or absence of force majeure, hardship or other similar provisions that could impact the interpretation or legal effect of the agreement.

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In any event, administering intercompany agreements designed for "normal" operating conditions during the pandemic required considerable judgment and give rise to interpretational issues. MNE's have begun to address these interpretational issues now and consider documenting their rationale for interpretation of relevant provisions. While new intercompany agreements and clarifying amendments entered to specifically address supply chain disruption related matters may have weight with the tax authorities than preexisting agreements, they could nevertheless be considered in appropriate circumstances as part of a proactive strategy.

Disruption caused has also complicated the comparability analyses for both transfer pricing planning and documentation purposes.

While the pandemic impact on MNE's comparability analyses and transfer pricing documentation will likely vary from sector- to-sector and even from company-to-company, for certain MNEs, novel approaches to loss allocation could be considered that would consider the steps taken by local entities to stem the losses measured against the severity of local downturn.

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Pandemic related costs are of unprecedented scale for MNE's and the allocation of those costs among the members of the group should be reviewed and monitored from a tax and transfer pricing standpoint. Consideration will need to be given as to how such costs should be shared among the MNE group and whether it is appropriate for a group member that is only entitled to a limited or risk-free return to be allocated a share of such costs. An analysis of this issue should include the review of the rights and other assets of the parties, the risks assumed, the economic rationale and the options realistically available to the parties. Contractual terms in intercompany agreements will be especially important in this regard.

Conversely, because 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 supply chain restructuring in the context of the OECD Transfer Pricing Guidelines for Multinational Enterprises and

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MNE's may consider terminating distribution agreements as part of a plan to realign a supply chain in response to the crisis. Careful attention must be given to what damages a supplier or distributor may be entitled to because of the termination. Third party comparable data may not be available or may not be relevant in the case of limited risk distributors. Distribution and supply agreements often have liquidated damages provisions which can be helpful in limiting the amount of damages for which a related distributor or supplier may be entitled.

Finally, for those MNE's that have significant import operations, any change in transfer pricing methodology needs to be considered through the lens of customs regulations as well. Customs authorities consider transfer prices on a transaction-specific basis and typically apply different rules than tax authorities in assessing whether a transfer price reported on an import transaction is reasonable for customs valuation purposes.

MNE's should be reviewing their intercompany agreements to analyze how disruption should be addressed for transfer pricing purposes. A particular focus should be given to hardship, force majeure and other provisions that may allow for one-time reallocations of profit or loss to spread the cost of the crisis more fairly to the MNE group

MNE's shall also begin to consider and document now what variances from their transfer pricing policies may be appropriate for 2022, and for MNE's with a fiscal year ending in the next several months, the need is particularly urgent.

MNE's that have significant import operations should consider whether changes in transfer pricing methods also align with customs valuation regulations in China and other parts of APAC where they have operations.

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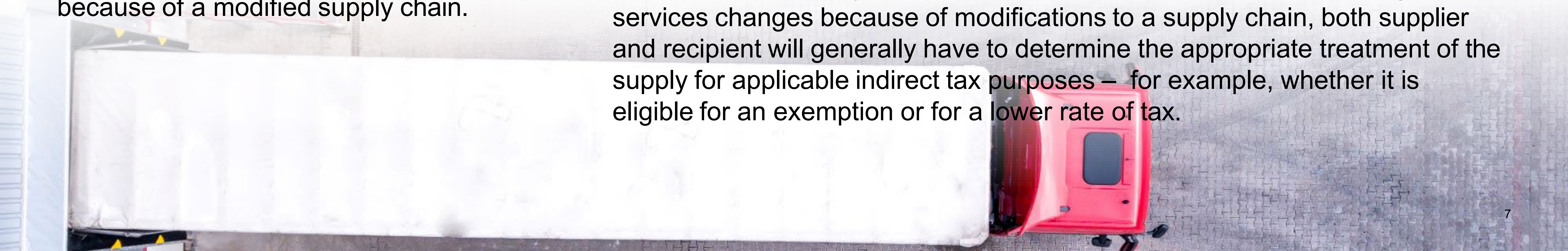
Indirect Taxes and Customs Duties

There are several ways in which changes because of supply chain disruption could result in changes to the indirect taxes (such as VAT or GST) that are payable by the various parties to that supply chain. Many of these changes will be driven by changes to the "place of supply" which is generally the basis on which jurisdictional taxing rights are asserted in respect of indirect taxes. The place of supply may alter from the perspective of the supplier or recipient because of a modified supply chain.

If a new supplier supplies goods or services to an overseas recipient because of a change to a supply chain, then, as regards certain types of supply, it may still be the supplier that is responsible for accounting for indirect tax on that supply, in which case the supplier may charge the indirect tax to the recipient by way of an increase in the contractual price for the supply. In turn, the recipient may not be able to recover the cost of that indirect tax by way of credit or repayment from relevant tax authorities, which might not have been the case as regards supplies it received from its previous, possibly local, supplier (the new overseas indirect tax might also be imposed at a higher rate). Tax reporting, registration and other compliance obligations may also arise in these and related circumstances for either the recipient or supplier that did not previously exist. In addition, if the nature of the supplied goods or services changes because of modifications to a supply chain, both supplier and recipient will generally have to determine the appropriate treatment of the supply for applicable indirect tax purposes – for example, whether it is eligible for an exemption or for a lower rate of tax.



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Similar considerations will also apply to customs duties. In particular, because of the supply chain transformation, a party to a supply chain may have to source goods from overseas that it has previously acquired from a local supplier or may have to change foreign suppliers due to localized outbreaks. Changing suppliers can result in a significant increase in customs duties. Customs duties are generally applied on a product-specific basis but there can be significant differences by source country due to both duty savings programs like free trade agreements or punitive measures such as those in place today in the United States against Chinese imports (i.e., Section 301 duties). Moreover, in addition to potential changes in the cost of supply, importers also take on compliance burdens to ensure that their import operation comply with local customs laws.

Overall, if a supply chain is proposed to be modified because of disruptions, affected suppliers and recipients should consider the following with respect to indirect taxes and customs duties:

- The ability of the relevant party to recover the cost of applicable indirect taxes by way of relief or credit.
- The impact of any new indirect taxes or customs duties on the cost effectiveness and pricing of the modified supply-chain.
- The country in which any new indirect taxes or customs duties need to be accounted for and which of the supplier or recipient is responsible for accounting for them; and
- The extent to which the new taxes and duties result in additional tax reporting, registration, and other compliance obligations for the responsible party.

> A well-functioning supply chain is crucial for business success, but its also important to be aware of the tax implications of any disruptions. By staying informed and seeking expert advice, you can minimize the impact of supply chain disruption on your taxes.

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PwC has a dedicated integrated supply chain team focused on the key legal and tax issues associated with supply chain disruptions.

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Thank you

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