



International Tax ADVISORY ■

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Risky Business – Allocating Losses When Your Supply Chain Is Disrupted

In a turn of events that hardly anyone could have predicted when 2020 began, COVID-19 has crippled economies throughout the world. One byproduct of this pandemic has been widespread supply chain disruptions across all industries. These disruptions have impacted various points along supply chains: manufacturing has ground to a halt in certain regions and brick-and-mortar retail sales have plummeted, while categories of e-commerce transactions have increased significantly.

For the additional costs and losses caused by these disruptions, multinational enterprises (MNEs) need to determine which entities in the supply chain should incur such costs and bear losses, in whole or in part. Transfer pricing principles, including Section 482 of the Code and the 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TPG), generally look to the arm's-length standard and which parties bear and control risks to allocate losses between related parties. MNEs also need to evaluate Section 162 and extensive case law relating to, for example, the ability of a parent company to deduct losses or expenses incurred by its subsidiary, as well as other potential implications and planning opportunities (e.g., BEAT, FDII, GILTI, Subpart F, NOLs, Section 163(j)). In addition, nontax considerations should be evaluated (e.g., customs, VAT).

Who Bears and Controls the Risk

When a U.S. taxpayer is determining how to allocate such costs and losses among related parties, Section 482 of the Code and related Treasury Regulations are a good place to start. In addition to applying the foundational principle of the arm's-length standard and evaluating how unrelated parties would allocate such items, Treasury Regulations Section 1.482-1(d)(3)(iii)(B) provides guidance for identifying which party bears risk associated with the costs or losses. Generally, under the regulations, parties can look to the relevant contract terms to ascertain which party bears a particular risk. Contractually allocated risk is respected only if it follows economic substance. Whether the allocated risk follows economic substance depends on (1) whether the party's behavior is consistent with the allocation of risk; (2) whether the party can fund the losses it may incur based on the risk allocation, or whether, at arm's length, another party would suffer the consequences of such losses; and (3) the extent to which the party has managerial or operational control over the activities that generate income or loss.

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The Treasury Regulations contain multiple examples illustrating how to determine which party bears a particular risk. One example involves a U.S. manufacturer (USM) and its wholly-owned foreign distributor (FD). Pursuant to a written contract, FD buys a set number of widgets at a set price from USM each year, the widgets are sold under FD's label, FD finances all marketing strategies in the foreign market, and there are no rebate or buyback provisions. The example notes that FD has adequate financial capacity to fund its obligations under "any circumstances that could reasonably be expected to arise." The example concludes that FD will be deemed to bear the risk of loss in years when it could not sell all the widgets that it purchased from USM. This conclusion was reached because the contractual terms allocating market risk were agreed to before the outcome of such risk was known or reasonably knowable, FD had the financial capacity to bear the market risk that it would be unable to sell all the widgets it purchased currently, and FD's conduct was consistent over time. In our COVID-19 environment, a closer analysis of the facts would be necessary to determine, for example, if COVID-19 falls within "any circumstances that could reasonably be expected to arise," the existence of a force majeure clause, etc.

Extensive U.S. case law shows that a parent company can deduct as ordinary losses or business expenses payments made for the benefit of its subsidiary if the parent company can show that the payment was actually made for its own business benefit. For example, courts have ruled that a parent company could deduct as ordinary losses or business expenses payments made in the following scenarios: to cover operating losses of a subsidiary that performed essential services for the parent; to keep a subsidiary out of bankruptcy when the parent needed to sell its merchandise in the foreign market supplied by the subsidiary; to reimburse the operating losses of a subsidiary that was the parent's only source of the supply of an important item; and to reimburse a subsidiary's warranty expenses when the warranty services performed by the subsidiary improved the parent's sales.

Although U.S. taxpayers are bound by the Code, Treasury Regulations, and case law, the OECD TPG are also informative and provide guidance on how other tax authorities may approach the issue. The OECD TPG define risk as the "effect of uncertainty on the objectives of the business." Like the Treasury Regulations, the OECD TPG first look to the relevant contract terms related to each economically significant risk when determining which party has assumed a particular risk. The contract terms will be respected if: (1) the parties follow the contract terms; (2) the party assuming the risk exercises control over the risk; and (3) the party assuming the risk has the financial capacity to assume the risk.

The OECD TPG provide that a party exercises control over a risk if the party has the capability to make decisions (1) to take on, lay off, or decline a risk-bearing opportunity; and (2) on whether and how to respond to the risks associated with the opportunity, and if it actually performs these decision-making functions. A party can be found to exercise control over a risk even if it outsources the performance of day-to-day mitigation. Additionally, the OECD TPG provide that a party has the financial capacity to assume a risk if it has access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions, and to bear the consequence of the risk if it materializes.

If the party that has contractually assumed a risk does not actually exercise control over the risk or does not have the financial capacity to assume the risk, the OECD TPG provide that the risk should be allocated to the party that exercises control over the risk and has the financial capacity to assume the risk. If multiple parties are found to exercise control over the risk and have the financial capacity to assume the risk, the risk should be allocated to the party exercising the most control, and the other parties performing control activities should be appropriately remunerated.

Actions to Take Now and in the Future

The impact of COVID-19 on businesses and tax issues is without precedent, so it is not possible to summarize all actions for MNEs to take now and in the future. However, here are a few starters.

As an initial step, MNEs should:

- Identify extraordinary costs, losses, impairments, credit impacts, etc., within its supply chain.
- Review intercompany agreements and local law concerning such costs, losses, etc., arising from COVID-19.

- Evaluate governmental agreements (e.g., advance pricing agreements (APAs), rulings) for potential issues arising from COVID-19.
- Document information relating to COVID-19 that may be relevant to address future tax issues, including reasons for losses and permanent establishment issues from personnel dislocations.

Going forward, MNEs should consider effective strategies for addressing the impact of COVID-19 on their supply chains, including:

- Optimize supply chain extraordinary costs, losses, etc., arising from COVID-19, as well as applicable intercompany charges for services to respond to COVID-19.
- Ensure deductibility of losses or expenses within the supply chain.
- Address potential collateral tax issues and planning opportunities for such losses or expenses, such as IP migration, BEAT, FDII, GILTI, Subpart F, NOLs, and interest expense limitations, and nontax considerations (e.g., customs, VAT).
- Test transfer pricing benchmarking and evaluate modifications to reflect the current economic environment, changes in supply chain functions and risks, etc.
- Update intercompany agreements to reflect appropriate modifications (e.g., changes in functions, risks, assets, force majeure).
- Evaluate the impact of credit ratings and other economic developments on intercompany borrowing, guarantees, keepwell agreements, and other financing.
- Determine whether revisions may be appropriate or necessary for existing APAs (e.g., due to critical assumptions), governmental rulings, etc.

Stay tuned, stay safe, and stay healthy.

For more information, please contact [Richard Slowinski](#) at 202.239.3231 or [Stefanie Kavanagh](#) at 202.239.3914.

Alston & Bird has formed a multidisciplinary [task force](#) to advise clients on the business and legal implications of the coronavirus (COVID-19). You can [view all our work](#) on the coronavirus across industries and [subscribe](#) to our future webinars and advisories.

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