

TAX ALERT FOR

OECD's Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic

The Organisation for Economic Co-operation and Development ("OECD") has released a much-awaited guidance report on the transfer pricing implications of COVID-19 ("Report").

The OECD report aims to address the practical challenges for the application of the arm's length principles. However, instead of developing a new or specialised guidance, it continues to recommend the reliance of tax administrators and multinational enterprises on the use of existing arm's length principles and the OECD's Transfer Pricing Guidelines which was issued in 2017 ("OECD Guidelines").

The Report focuses on four priority issues, these being:

- 1** Comparability analysis
- 2** Losses and allocation of COVID-19 specific costs
- 3** Government assistance programs
- 4** Advance pricing agreements

The OECD believes that most of the challenges that businesses are likely to encounter from COVID-19 disruptions would be by way of:

- the need for maintaining steady cash-flow positions;
- unpredictable swings in the ability to maintain or report profitability across group entities;
- severe disruptions to the supply chain including curtailment of operations in many instances; and,
- new measures that businesses have had to put in place for business continuity (like working from home, where this is a feasible option).

It is worth noting that while the OECD has addressed the COVID-19 issues under discrete topic headings, nevertheless it recommends that these could be interrelated and should be considered together within the framework of the OECD Guidelines where a transfer pricing analysis is being performed.



The link to the Guidance can be found [here](#).

A more detailed look at the OECD's suggestions under the priority issues are set out below:

1 Comparability analysis

The Report recognises that the unprecedented changes in the economic environment has created unique challenges for performing comparability analysis; with significant changes to the nature and pricing of transactions as a direct result of the pandemic. This reduces the reliance that can be placed on historical data for benchmarking purposes. The OECD encourages taxpayers and tax administrations to consider practical approaches that can be adopted to address information deficiencies.

The Report states that in undertaking a comparability analysis it is necessary to consider the economically relevant characteristics of the intra-group transactions as well as the terms and conditions of the intercompany agreements – as before. In the pandemic settings, using and relying on examples found in unrelated party settings for reviewing internal policies, is likely to have greater acceptability as it would be reflective of market practice.

Significant emphasis is placed on using publicly available information, in any form, regarding the effects of COVID-19 on businesses, industry and intra-group transactions.

Examples of such information could be:

- third-party behaviour as available in the current year or previous recessionary period
- quantification of government assistance and interventions,
- economic trends – both macro and micro – like country specific GDP data or industry indicators,
- reliable interim financial information based on filing positions where this is statutorily mandated (such as SEC filings or earnings releases),
- use of specialised statistical tools such as regression analysis or variance analysis,
- data on sales volumes, and exceptional, non-recurring costs
- analysis with respect to changes in capacity utilisation relevant for the Multinational Enterprise ("MNE"), and
- budgeted versus actual or forecasted data.

One of the most contentious issues relates to the timely availability of contemporaneous data to the taxpayers. Businesses rely on data to support their claims of economic justifications and this would be greatly hampered with the time-lags that are frequently experienced.

The OECD has urged tax administrators to be mindful of complexities that taxpayers could bear as relying on data from previous years without considering the specific impact of the pandemic is unlikely to provide practical or reasonable benchmarks, nor provide reliable outcomes, particularly where the transactional net margin method is applied. To ameliorate such positions, the OECD draws reference to the approaches for identifying and collecting data required for transfer pricing analysis as set out in the OECD Guidelines.

These approaches are:

1. **the ex-ante approach (price setting)** which uses historical data updated to reflect changes in economic conditions through the date of contract; and,
2. **the ex-post approach (outcome testing)** which may make use of information that becomes available after the close of the taxable year to determine arm's length conditions and report results on the tax return.

The COVID-19 guidance suggests that even if it is used as a temporary measure, the outcome-testing approach may be considerably more reasonable as it allows the use of more accurate information which becomes available after the close of the taxable year. Further steps on the part of the tax administrators to support businesses could include allowing taxpayers the flexibility to allow amendments to their tax returns as and when material information becomes available.

On the part of the taxpayers the OECD's expectation is that Groups would undertake reasonable and appropriate due diligence in evaluating the effects of the pandemic, documenting the best available market evidence (this could be internal comparables, external comparables or any other relevant economic evidence), and judicious use of applying appropriate transfer pricing methodologies.

Contrary to expectation, the OECD believes that using data from other crises is likely to give rise to significant concerns in comparability owing to the incomparable and unprecedented nature of the COVID-19 impact. Selection of the appropriate period for the financial data would also be unclear given the changes that the global economy has been through since the last crisis of a comparable nature.

On comparability analysis, the Report also addresses the following issues:

- **Period of data being used:** The Report maintains that the use of multiple year data and weighted averages should continue as before. In practical terms, such an approach could mean separating and testing the taxpayers economic conditions in distinct pre- and post-pandemic periods. However, for this approach to provide meaningful outcomes, data from independent comparables should also be available and measured over a similar period and in a consistent manner.
- **Price adjustment mechanisms:** Under this, the expectation is that prices for the COVID-19 year would be adjusted in a later year when more accurate information to establish the arm's length standard becomes available. The OECD recognises this approach is limited to the extent it is permitted under the domestic laws in allowing adjustments by way of additional invoices or intercompany payments in later periods.

- Evaluation of comparables set: A review to validate the continued usage of the same comparables should be the pre-requisite for using a roll-forward approach for confirming the arms-length behaviour. This should also be supplemented with revisions / updates to the financial data of the comparables set.
- Loss making comparables: In a significant departure from standard practice, a suggestion has been put forth to make use of loss making comparables if they satisfy the comparability criteria particularly if the losses are for periods affected by COVID-19.

2 Losses and allocation of COVID-19 costs

Considering that businesses have borne higher than 'normal' (exceptional, non-recurring operating) costs with reduced off-take of sales and services, the Report acknowledges that allocation of losses within the Group entities is an area which is likely to raise disputes. Going forward, there is a greater possibility to find such occurrences between the tax payer and the tax administration based on positions adopted by each.

To deal with this issue, the Report outlines the following points:

- Risk assessment of entities: The Report has drawn reference to the need for analysing risks as set out in the documentation and intercompany agreements of the MNE. This is an important requirement particularly if taxpayers are found to be taking inconsistent positions in pre- and post- COVID-19 settings.

In respect of group entities which have been characterised as limited risk entities, the Report maintains that a detailed analysis of the functions, assets and risks needs to be the starting point, recognising that setting a general rule would be difficult as the functions for such entities could vary within the Group.

However, the OECD does recognise that limited risk entities can incur losses in the short term. To support this assertion, the OECD draws reference to the OECD Guidelines which states that "low risk functions in particular are not expected to generate losses for a long period of time". As a word of caution, before all group entities look to allocating losses to limited risk entities, the domestic tax laws and attitude of tax authorities also needs to be considered to ensure that the MNE Group is not caught on the wrong foot
- Treatment of "exceptional", "non-recurring" or "extraordinary" costs: In dealing with such costs, the Report emphasises the need to analyse the nature of these costs in greater detail, including looking at other factors such as how independent enterprises treat and label them, the risks assumed by the parties, and the impact of such costs on the intercompany pricing.
- Reliance on Force Majeure clauses: The OECD recognises that independent third parties could look at re-negotiating, or at times revoking, the terms in existing agreements. However, the ability to make changes would again be very fact specific and based on the terms of each intercompany agreement. Accordingly, modifications which rely on the application of the Force Majeure clauses would need to be documented and it would need to be demonstrated (through third-party evidence, or similar internal situations in the past) how this is in line with the arm's length principles.

3 Government assistance programs

The Report suggests that terms and conditions of government assistance programs for COVID-19 should be factored into the impact on controlled transactions. Government assistance could take the form of monetary or non-monetary assistance, such as grants, subsidies, soft loans, tax deductions, etc., which provide taxpayers with both direct and indirect economic benefits.

As a general rule, the OECD guidelines recommend that government assistance should be considered as a factor for transfer pricing outcomes in a particular jurisdiction. Where a business has received any assistance, this fact should be disclosed as relevant information in the

documentation when performing the transfer pricing analysis irrespective of whether the government assistance has resulted in any economic benefit for the local entity. This disclosure would also be relevant when performing the comparability analysis and in the selection of potential comparables.

The Report mentions certain factors that should be considered in the analysis of the government assistance and these could be regarding the availability, purpose, duration, risks allocation, level of competition within the market and any other factors that the government outlines as conditions precedent for availing the assistance.

4 Advance pricing arrangements (“APAs”)

Though APAs are very attractive for businesses and authorities as it provides certainty, there is hesitation on both sides on what terms would be reasonable to agree to during these uncertain periods arising from the pandemic. For APAs that have been agreed upon between taxpayers and tax authorities, the Report encourages following a collaborative approach throughout the process.

A more detailed approach on the collaborative approach suggests the following:

- For existing APAs, the Report maintains that the terms should continue to be respected, maintained and upheld unless conditions which contribute to breach of critical assumptions occur requiring a cancellation or revision of the APA. Mere changes to business results are not factors which can be held to be a breach of the critical assumptions unless this was specifically included as such.
- Reactions of the tax administrations would depend on factors such as the jurisdiction and domestic law, the extent of divergence from the agreed upon terms and conditions surrounding the APA, the terms of the APA, and the type of APA.

The Report states that, broadly, there are three results possible under the APA process during the COVID-19 period:

- The taxpayer and tax administrators may agree to a revision to the APA wherein the terms would be modified, potentially with a revised analysis of the conditions that the business is experiencing and the forecast expectations of the domestic administration;
- Both parties to the APA may agree to a cancellation of the APA in which case it would be treated as effective for the period up to the cancellation;
- A revocation of the APA in which case it would be treated as not having been entered into.

The Report further states that while there is a possibility of APAs being put up to tax administrators for reconsideration in the coming periods, it may be useful for them to consider waiting until data and information on the magnitude and longevity of the impact of COVID-19 becomes available. On the other hand, practically this would result in taxpayers witnessing a longer time for administrators to resume entering APAs, or the entire APA process itself becoming very time consuming.

The Report however does state that to reach a consensus, the taxpayer will need to collect and provide relevant information and supporting documentation for tax administrators to understand facts and circumstances for the business and industry. This, in the view of the OECD, will help maintain a non-adversarial environment and promote the success for APA negotiations.

For APA's which are / were being negotiated, some practical alternatives put forward in the Report include (i) agreeing for short term APAs specifically for the period of the pandemic and another for the post-COVID period; (ii) allowing retrospective amendments; (iii) modifying the period of the APA. While these are welcome suggestions, yet the greatest bottleneck in the APA process is likely to be the receptivity of the tax administrators in setting up innovative and flexible approaches.

Conclusion

In addition to unique economic conditions, the COVID-19 period has also presented practical challenges in the application of the arm's length principle. The most reasonable suggestion for taxpayers in these times is that they ought to remain steadfast with the traditional approach i.e. documenting how and to what extent they have been impacted. Empirical evidence of independent parties and review of their own transfer pricing policies will remain key to be able to come out unscathed of the COVID-19 situation.

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