



THOUGHT LEADERSHIP:
IMPACT OF THE COVID-19
PANDEMIC ON TRANSFER PRICING
– CHALLENGES IN UNCERTAIN
TIMES



THOUGHT LEADERSHIP: IMPACT OF THE COVID-19 PANDEMIC ON TRANSFER PRICING – CHALLENGES IN UNCERTAIN TIMES

INTRODUCTION

Unfortunately, COVID-19 is an unavoidable part of daily life today. The virus is causing restrictions in just about every area of life and many companies are facing massive challenges. This includes but is not limited to overcoming disruption of supply chains, curtailment of operations and corresponding reductions in output.

Many factories, mines, shops and restaurants across the globe have even been forced to close their business operations, at least temporarily. In some industries, the pandemic has caused a collapse in demand. In others, on the other hand, new opportunities have been opened up (e.g. the market for video conferences).¹

The crisis and its dimension were unpredictable and some companies need to adapt in order to prevent insolvency. Significant cash-flow constraints force enterprises to develop and implement strategies to conserve and generate cash.

As regards transfer pricing, issues of comparability analysis, loss absorption by routine companies in crisis, allocation of extraordinary costs, treatment of

pandemic-related government assistance in transfer-pricing models, and issues of the impact of the pandemic on completed and negotiated Advanced Pricing Agreements (APAs) all merit detailed attention and are therefore addressed in this article.

Against this background, the OECD has recently (18 December 2020) published in addition to its regular Transfer Pricing Guidelines (TPG) further guidance covering the transfer-pricing aspects, implications and consequences stemming from the COVID-19 crisis.² To enhance tax certainty, the Guidance attempts to clarify and illustrate the practical application of the arm's length principle in the face of current economic challenges. The report focuses on the following issues where it is recognised that the practical challenges posed by COVID-19 are most significant.

COMPARABILITY ANALYSIS

During the COVID-19 crisis, practical approaches by reference to the performance of comparability analysis are needed. It is important to emphasise, however, that these practical approaches should be consistent with the transfer-pricing policy of the taxpayer over time.³

As already mentioned above, the impact caused by the COVID-19 pandemic varies between the individual sector in which the enterprises operate. Therefore, it makes sense to document the actual effects in an industry-specific manner.

The following aspects can be an important source of information in this context:

- Development of sales figures
- Capacity utilisation
- Type and level of extraordinary costs
- Use of government aid and its impact on pricing
- Macroeconomic data
- Quarterly reports
- Plan/actual variance analyses and
- An estimate of notional profit in the absence of the pandemic⁴

USABLE METHODS AND PRACTICAL APPROACHES

According to the OECD, statistical methods can be used for the performance of deviation analyses. However, the use of historical data is not always appropriate. For example, the use of historical data from the financial crisis 2008/2009 is rather unsuitable for analysis purposes, as the COVID-19 crisis is not comparable with the financial crisis.⁵ Rather, the highly individual circumstances and challenges of the current situation must be taken into account.

For purposes of the adequacy analysis of crisis-related margins, the OECD suggests exceptionally admitting information that only becomes known after the fact (e.g. financial information from peer companies).

Moreover, the OECD recommends allowing *outcome testing*.⁶ This approach should not only apply to year-

end adjustments booked in 2020, but, if appropriate, also to adjustments in the following financial year, before the tax return for 2020 is submitted. In any case, if no unilateral agreement is possible, disputes should be resolved in a mutual-agreement procedure.

Implications using TNMM as the transfer-pricing method

The OECD recommends the use of internal comparison data, documenting the behaviour of third parties⁷ and the use of several transfer-pricing methods for testing purposes. This is due to the fact that information in databases is limited, which leads to difficulties in carrying out a TNMM (transactional net-margin method) analysis, especially because of the many unobservable influences in the comparator companies (e.g. the extent of the state aid used).

Nevertheless, even though the TNMM needs contemporaneous data in most cases, this method might be applicable in certain scenarios: for example, a long-term arrangement covering the financial years 2019 to 2022 may be in place, including an arm's length price based on comparables contemporaneous with the negotiation of the arrangement, insulating the tested party from risks that the tested party does not assume, such as those that play out during the pandemic.⁸

Problems occur due to the fact that state aids vary from country to country, are shown differently for accounting purposes, depending on the measure, and can therefore extremely distort the comparability of the margins. In order to avoid such distortions, which are based on differences between countries that are hardly observable in the data, the OECD recommends

1). Guidance on the transfer-pricing implications of the COVID-19 pandemic, Para. 2. Hereafter, 'Guidance'

2). https://read.oecd-ilibrary.org/view/?ref=1059_1059931-t94e20hrqo&title=Guidance-on-the-transfer-pricing-implications-of-the-COVID-19-pandemic,_last accessed 28.01.2021

3). Guidance, Para. 9.

4). A more detailed listing can be found in: Guidance, Para. 11, 12.

5). Ibid, Para. 25.

6). Ibid, Para. 23.

7). Ibid, Para. 15.

8). Ibid, Para. 17.

primarily using comparable companies in the same jurisdiction as the tested party.⁹

As regards the most reliable information, the OECD points to the conditions of comparable uncontrolled transactions that have been undertaken during the same period as the controlled transactions. This is due to the fact that this information gives an appropriate reflection on how independently the companies behave in the same or at least a similar economic environment to that of the controlled transaction.¹⁰ However, problems might occur when using the TNMM, as already described above.

In general, loss-making comparables can be used as there is no overriding rule on their inclusion or exclusion in the OECD TPG. Ergo, the Guidance notes that loss-making comparables that satisfy the comparability criteria in a specific case should not be rejected on the sole basis that they suffer losses in periods affected by the COVID-19 crisis.

LOSSES AND THE DISTRIBUTION OF EXCEPTIONAL COSTS

The allocation of losses is an important topic to consider given the probable increase in the frequency and magnitude of losses during the COVID-19 pandemic.

ALLOCATION OF LOSSES

Under the given circumstances, the question arises whether entities under limited-risk arrangements incur losses. The OECD TPG state: “*Simple or low-risk functions in particular are not expected to generate losses for a long period of time*”. From this, it can be concluded that simple or low-risk functions may incur losses at least in the short run.

A specific aspect is the allocation of risks between the parties. This allocation affects how profits or losses resulting from a transaction are allocated at arm’s length through the pricing of a transaction.

The unexampled economic conditions arising from

9). Ibid, Para. 84.

10). Ibid, Para. 14.

11). Ibid, Para. 47.

12). Ibid, Para. 40.

13). Ibid, Para. 40.

COVID-19 and unique government responses to it have resulted in challenges for the application of the arm’s length principle. Specific cases need a specific approach.

It is important to evaluate how exceptional, non-recurring operating costs arising because of COVID-19 should be allocated between related parties. For the allocation of these costs, an assessment of how independent companies operate under comparable circumstances should be made.

Furthermore, a distinction between operating and non-operating costs should be made in order to be able to improve the reliability of a comparability-analysis exercise. In determining how these costs should be allocated between related parties, it will also be important to consider how these costs would be allocated between independent parties operating in comparable circumstances¹¹

When allocating losses to associated companies, especially to ‘limited-risk’ distributors, the arm’s length principle should always be respected. For example, it will not be appropriate for a ‘limited-risk’ distributor that does not carry any marketplace risk to bear a portion of the loss associated with the playing-out of that risk.¹²

The extent of the loss that may be earned at arm’s length will be determined by the conditions and the economically relevant characteristics of the accurately delineated transaction compared to those of comparable uncontrolled transactions, including application of the most appropriate transfer-pricing method and following the guidance in Chapters II and III of the OECD TPG.¹³

FORCE MAJEURE

In some civil-law countries, *force majeure* clauses have either been agreed upon or explicitly codified in the law. In Germany, for example, art. 313 BGB (*Bürgerliches Gesetzbuch*; German Civil Code) gives the right to renegotiate certain aspects of the contract in the event of a change of circumstances which could not have been foreseen by the parties at the time of the conclusion of the contract. In cases where it is

unreasonable for one party to adhere to a contract, there is even the right to withdraw from it or, in the case of continuing obligations, to terminate it.

The OECD recommends the following procedure:

- Examine the relevant contract, if any, including the wording of the *force majeure* clause, if any, and the applicable legal framework.
- Examine the actual conduct of the parties and assess the materiality of the *force majeure*, and analyse the economic context.

In the absence of clear evidence that independent parties in comparable circumstances would have revised their existing agreements or commercial relationship, the modification of existing intercompany arrangements of associated parties is not consistent with the arm’s length principle. Overall, collection of well-supported evidence on how independent parties in comparable circumstances would have amended their commercial and financial relations plays an important role.

STATE-AID PROGRAMMES

During the COVID-19 pandemic, governments are trying to reduce its negative impacts by granting (wage) subsidies, tax benefits, investment aid, guarantees and direct financing commitments. Whether and to which extent government aids are seen as an economically relevant characteristic may vary.¹⁴

Concerning transfer-pricing analysis, the decisive factors are: which companies receive the abovementioned aids; whether the measures have an effect on pricing because benefits are passed on to customers or suppliers; and how long the measures last.¹⁵

In the light of these massive government actions, the OECD calls for the utmost care to be taken in the use of unilateral methods. Primarily, a thorough examination is required to determine whether the government measures reduce the cost base, increase revenue, or qualify as extraordinary income.¹⁶

If a thorough analysis concludes that the aid

received from the government is an economically relevant factor, the taxpayer is advised to include this information in its documentation.¹⁷ However, one must be careful not to jump to conclusions. It would be contrary to the arm’s length principle to assume that every aid received would affect the price of a controlled transaction. In addition, the fact that there might be different legal limitations or conditions for receiving aid should be taken into account when performing a comparability analysis.

IMPACTS ON APAS

Due to the unpredictability of the pandemic, contracting parties might consider revising already existing APAs. In some cases, the parties might even consider breaking away from the contract.

Here the OECD clarifies that, despite the unpredictability of the COVID-19 crisis, already completed APAs must be complied with, both by tax administrations and by taxpayers. Taxpayers who are prevented by the crisis from fulfilling the APA conditions or who have difficulties in complying with them are encouraged to contact the tax administration instead of independently seeking a solution or unilaterally breaking the APA.¹⁸

TIMING

Regarding the timing, it is advisable for the taxpayer to reach out to the tax administrations as soon as possible. This helps to give the affected parties more time to reach an agreement on revising the APA and therefore reducing the likelihood of cancellation.

Due to the fact that economic conditions will remain uncertain for a long time, tax administrations may want to wait for a reasonable period until data and information on the magnitude and time of the economic impact of COVID-19 are available before determining how to respond to a breach.¹⁹

14). Ibid, Para. 68.

15). Ibid, Para. 74.

16). Ibid, Para. 78.

17). Ibid, Para. 69.

18). Ibid, Para. 89.

19). Ibid, Para. 103.

IN CASE OF A BREACH

If there is a breach of the validity conditions (critical assumptions), national procedural consequences must be drawn. The failure to meet the validity conditions may lead to revision, early termination or revocation of the APA from the beginning.

For the taxpayer it is important to document in detail the reasons why the breach of the APA conditions occurred. In particular, the taxpayer is advised to explain the deviation of the actual data from the plan, possible contract changes, its industrial sector, the explanation of restructuring/risk allocation as well as the causality of the pandemic for these changes.

Furthermore, a detailed analysis of the impacts of the crisis regarding the income statement ('P&L') with a special focus on the accounting of government aid, and the observed behaviour of external third parties during the crisis should be provided.²⁰

The same procedure applies to APAs currently under negotiation. The OECD suggests that, if necessary, the APA period should be divided into the COVID period and the post-COVID period. The OECD also strongly encourages continuing ongoing APAs through virtual meetings.²¹

CONCLUSION

The new OECD guidance on how to handle the COVID-19 crisis has positive but potentially also negative consequences for taxpayers and tax administrations.

The OECD's clear acknowledgement that even routine companies can bear losses, at least for a short time, if the corresponding business risks were attributable to them, is especially a particularly appropriate and positive response in this current crisis. The OECD's suggestion not to analyse the results of individual years of the tested party, as is often done e.g. by German tax field auditors, but rather to use multi-year averages here as well, i.e. an average of years with and without a crisis, is valuable for subsequent tax audits.

20). Ibid, Para. 104.

21). Ibid, Para. 112.

The recommendation increasingly to allow outcome testing with possibly even more time-lagged compensation payments in view of the great uncertainty caused by the COVID-19 pandemic is also a positive development.

Nevertheless, there might also be negative aspects that should be mentioned. According to the new guidance, the taxpayer has to meet extensive documentation requirements as to how the crisis has affected its business operations. One might also be critical of the OECD's statement that in reference to comparability analysis the use of databases is acceptable to a limited extent only for the crisis year. Unsurprisingly, given the range of domestic circumstances, the Guidance provides general principles for the application of the arm's length principle without providing specific solutions.

The OECD's encouragement of pragmatism and flexibility offers a welcome practical approach in dealing with challenging transfer-pricing issues. It remains to be seen how the various tax authorities will implement the suggestions in their dealings with taxpayers.

All in all, the Guidance provides a certain amount of orientation and guidance to taxpayers and their advisers. However, the familiar uncertainties and the consequences of the rather vague definition of the arm's length principle remain and may not be overcome by the Guidance.

SVEN HELM

Global Chair, Transfer Pricing
Moore TK
Mannheim, Germany
+49 621 42508 25
sven.helm@moore-tk.de
www.moore-tk.de



MOORE GLOBAL NETWORK

We've spent more than 100 years serving clients through our professional services. For more information on how our global services could help your business thrive in a changing world, just get in touch.

CONTACT US

Find your nearest member firm at
www.moore-global.com

Or email:
marketing@moore-global.com



www.moore-global.com
