

Detailed overview and considerations of the OECD’s “Guidance on the transfer pricing implications of the COVID-19 pandemic”

3. Long-read: Detailed analysis per chapter

This section includes a more detailed overview of what we believe are the most important items described in each Paper chapter.

CHAPTER I. TRANSFER PRICING GUIDANCE ON COMPARABILITY ANALYSIS

According to the Paper, it is important to consider any changes in the economically relevant characteristics, including the terms and conditions of the agreement, and whether at arm’s length, unrelated parties would have tried to renegotiate those terms and conditions. The COVID-19 pandemic has created unique challenges for performing comparability analyses.

- Where the arm’s length principle for controlled transactions is tested on an annual basis, it will be necessary to perform a comparability analysis for FY2020.
 - The Paper sets out what sources can be used to support the performance of a comparability analysis for FY2020 and states **that any form of (relevant) publicly-available information** may be used. Furthermore, it includes some examples of information that may support the comparability analysis, such as **impact on sales, impact on capacity utilization, incremental/exceptional costs, government assistance, government interventions, macroeconomic information, regression analysis, budget vs. actual data and effects on profitability or on third party behaviour observed in previous recessionary periods or using any data available in the current year, even if partial** (it is stated that information based on the financial crisis in 2008/2009 could be used – but never as a sole approach/without a further comparability analysis considering there is only a superficial similarity).
 - Hence, although in these cases transfer prices are tested each year, and as such the determination of the FY2020 transfer prices would be determined and documented in line with previous years, additional information based on the above should be included in the documentation package as it will provide more support when under scrutiny.
- Regarding **timing issues for the data available at the moment that taxpayers have to perform the comparability analysis**, the Paper acknowledges that applying the Transactional Net Margin Method (“TNMM”) may be challenging as this method typically relies on historical data included in databases. The Paper has recognised that the relevant information will typically not be available when assessing FY2020.
 - The Paper puts forward **pragmatic approaches** (see the examples above) that address the issue and states that tax administrations could consider these in an attempt to minimise disputes where taxpayers are **making good faith efforts to determine arm’s length prices in the context of the information deficiencies associated with the COVID-19 pandemic**.
 - Determining a reliable arm’s length outcome **requires flexibility and the exercise of good judgment**. The Paper includes a concern that difficult transfer pricing issues resulting from the COVID-19 pandemic may increase controversy, such as increasing the number of MAPs. Therefore, the OECD encourages tax administrations to keep these complexities in mind when performing risk assessments, or evaluating transfer pricing positions on audits and considering the support and documentation taxpayers provide that might demonstrate reasonable efforts and care when trying to comply with the arm’s length principle.

- Taxpayers should undertake reasonable and appropriate due diligence in evaluating the likely effects of the COVID-19 pandemic and in implementing appropriate changes in their transfer prices. MNE groups **should document the best available market evidence currently available**, which may be in the form of internal comparables, external comparables, or other relevant evidence of the COVID-19 pandemic's economic impact.
 - Where taxpayers make thorough impact/variance assessments of the COVID-19 pandemic following the arm's length principle that is based on information available at that moment, we strongly believe that tax administrations should be flexible and exercise good judgment and not attempt to use hindsight. The burden of proof, if the tax administration would not agree with the taxpayer's assessment, should therefore lie with the tax administration.
 - Moreover, although the Paper emphasizes that appropriate adjustments should be made on the comparable companies in a (TNMM) benchmark study, tax administrations need to accept that for most adjustments stated in the Paper probably no relevant information will be available to perform such adjustments. Additionally, in line with paragraph 5.28 of the OECD TPG, where a taxpayer reasonably demonstrates, having regard to the principles of the OECD TPG, that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue, the taxpayer should not be required to incur costs in searching for such data.
- Furthermore, the Paper states that an **“outcome testing” approach**, in which information that becomes available after the close of the taxable year, may be incorporated to determine arm's length conditions and report results on the tax return. The Paper states that, where possible and where legally permissible, tax authorities could allow taxpayers to take into account information that becomes available after the close of the taxable year in the tax returns.
 - As this **may lead to double taxation**, the Paper further states that tax administrations may provide for flexibility in allowing **“compensating adjustments”** to be made before the tax return is filed, where it is legally permissible and to **ensure access to MAP** (or alternative applicable procedures).
 - We welcome the idea but fear that in practice the tax administration may **attempt to use information that is only available in hindsight during audits**, which may result in double taxation.
 - **Price adjustment mechanisms** are also discussed, which would allow the intercompany pricing for FY2020 to be adjusted in a later period (e.g. likely to be 2021), when permitted by domestic law. Where price adjustment mechanisms could be observable between unrelated parties in practice, it is very important to consider all comparability criteria when using third party references in this respect, as such mechanisms are often very case specific. We repeat the note above that caution should be exercised when making adjustments in hindsight, in view of the arm's length principle, but also on the annuity principle applying in many jurisdictions. Third parties, when applying price adjustments mechanisms, generally tend to renegotiate the existing agreement.
- **Multiple year data and averages** are often used for comparability analysis. The Paper states that caution should be exercised when using the data of periods prior to, during and after the pandemic. Financial data for years affected by the pandemic should not unduly distort results from pre- or post-pandemic periods and it should be considered that government intervention in a market may materially affect the performance of activities.

- This may lead to (timing) issues when dealing with the practical implementation. The Paper proposes the idea of having separate testing periods for the pandemic’s duration or for the period when certain material effects of the pandemic were most evident. The Paper states that this is to be considered on a case-by-case basis.
- Furthermore, the Paper notes that existing benchmarks may need to be updated, or the suitability of existing comparables (e.g. geographic criterion) or search criteria may need to be reassessed.
 - We understand the comment, but believe that this should not be the standard as case-by-case evaluations should be made. In other words, we believe that existing benchmarks should not *de facto* be rejected if no adjustments are made for the COVID-19 pandemic.
- Furthermore, regarding loss-making comparables, the Paper states that the OECD TPG do not include an overriding rule on the inclusion or exclusion of loss-making comparables. Furthermore, the Paper includes that, when performing a comparability analysis for FY2020, it may be appropriate to include loss-making comparables when the accurate delineation of the transaction indicates that those comparables are reliable.
 - Again, a case-by-case evaluation should be made to be able to determine whether loss-making comparables should be included or not in line with the specific risks borne by the tested party.

CHAPTER II. TRANSFER PRICING GUIDANCE ON LOSSES AND ALLOCATION OF COVID-19 SPECIFIC COSTS

As many groups have incurred losses due to a decrease in demand, inability to obtain or supply products or services, or as a result of exceptional, non-recurring operating costs, the question arises how the losses and COVID-19 specific costs should be allocated amongst group entities.

- The Paper states that – when applying the OECD TPG - it is important to emphasize that the allocation of risks between the parties to an arrangement affects how profits or losses resulting from the transaction are allocated at arm’s length through the pricing of the transaction. Hence, the **existing guidance on the analysis of risks in commercial or financial relations will be particularly relevant for determining how losses are allocated** between associated parties.
- The **allocation of costs** arising as a result of the COVID-19 pandemic should be made in accordance with how independent parties would operate under comparable circumstances. Costs are to be accurately delineated and should not be treated only by their label (e.g. exceptional costs, as in the TNMM’s application, the operating result is often the focus of many practitioners).
- Furthermore, the Paper refers to companies being able to apply *force majeure* clauses, revoke or revise intercompany agreements, which may affect the allocation of losses and specific COVID-19 pandemic-related costs. We think this is a very broad statement that requires some further explanation, but agree that all comparability factors should be considered in the assessment.

Moreover, the Paper includes a reply to the questions about whether so-called “**limited risk**” entities should or should not be able to incur losses given COVID-19.

- The Paper states that it is **not possible to establish a general rule** in this respect.

- An important note in view of this topic is that neither the mere labelling of activities as “limited-risk” nor the fact that an entity receives a fixed remuneration means by itself that an entity operates on a limited risk basis in a controlled transaction.
 - Moreover, whether or not an entity operates on a limited risk basis, limited risk is not equal to no risk, which is accordingly acknowledged in the next paragraph
- Furthermore, the reference is made to the OECD TPG, which states that “*simple or low risk functions in particular are not expected to generate losses for a long period of time*”, and therefore this results in the **possibility that simple or low risk functions may incur losses in the short-run.**
- However, when determining whether or not a “limited-risk” entity may incur losses, **the risks assumed by an entity will be particularly important**, as this reflects the fact that at arm’s length, the allocation of risks between the parties to an arrangement affects how profits or losses resulting from the transaction are allocated.
- The Paper includes an **example in which a limited risk distributor (limited given limited inventory risk) assumes a certain market risk** and may incur a loss if a market risk materialized (in this context, in view of the COVID-19 pandemic).
- An important note is that the Paper states that caution should be exercised when there is a change in risks assumed by an entity before and after the COVID-19 pandemic outbreak and it stipulates that Chapter IX may become relevant in such cases. We agree this may become relevant, but this requires a more detailed assessment and it should be confirmed whether such changes are of a temporary/exceptional nature or indeed remain in place.

The Paper further discusses the renegotiation of (intercompany) agreements:

- The accurate delineation of the controlled transaction will determine whether the revision of intercompany agreements is consistent with the behaviour of unrelated parties operating under comparable circumstances.
- The Paper notes that in the current economic environment, **it is possible that independent parties: may not strictly hold another party to their contractual obligations**, particularly if it is **in the interest of both parties to renegotiate the contract or to amend certain aspects of their behaviour**; and that unrelated enterprises **may opt to renegotiate a contract to support the financial survival of any of the transactional counterparties** given the potential costs or business disruption of enforcing the contractual obligations, or given anticipated increased future business with the counterparty.
 - In fact, the information above confirms that the options realistically available to the parties involved in a certain transaction are of the utmost importance, whether or not changes are of a temporary or exceptional nature or would be denoted as a business restructuring in line with Chapter IX of the OECD TPG.
- It is stated that a renegotiation of a commercial arrangement requires careful consideration of the **options realistically available to the parties and the long-run effects on the profit potential of the parties and also that** consideration should be given to whether the economic impact resulting from the renegotiation **may require indemnification of the harmed party.**
- Furthermore, the Paper includes an example on a deferral of payment terms that can be granted in certain circumstances.
 - This demonstrates that it is important that taxpayers attempt to follow as much as possible, in good faith, third party behaviour in comparable circumstances. We believe that in practice it may prove difficult for taxpayers to demonstrate third party behaviour as the relevant business information may not be publicly available.

Lastly, the Paper considers **force majeure clauses** that may be invoked to suspend, defer, or release an enterprise from its contractual duties without liability in certain situations:

- The Paper states that in cases where one party seeks to invoke *force majeure*, the starting point for the transfer pricing analysis, is the agreement and underlying legal framework.
- It should not be automatically assumed that where a relevant intercompany contract contains a *force majeure* clause, that the COVID-19 pandemic is sufficient for a party to that contract to invoke the clause, nor can it be automatically assumed in the absence of such a clause in the intercompany contract that a renegotiation with a potentially similar outcome at arm's length would be inappropriate.
- The accurate delineation of the controlled transaction will determine whether invoking *force majeure* is permissible, including by reference to the parties' conduct and not just with reference to the legal agreement.
- Considering the long-term nature of the relationship and the short-term nature of the disruption, it could be that neither company would invoke the clause.
- In our view, invoking *force majeure* clauses in a group context is often not advisable and a (temporary) renegotiation of the arrangements would be preferred.

CHAPTER III. TRANSFER PRICING GUIDANCE ON GOVERNMENT ASSISTANCE PROGRAMMES

Given the COVID-19 pandemic, many governments and other public authorities have introduced (monetary or non-monetary) assistance programmes. Some examples include job retention programmes to preserve jobs in enterprises experiencing a temporary reduction in business activity or types of broader financial and liquidity support to ensure enterprises can continue to operate through the period of reduction in business activity. The availability, substance, duration and take-up of these programmes may have transfer pricing implications.

The Paper states that the terms and conditions of government assistance programmes related to the COVID-19 pandemic should be considered when determining the potential impact of these programmes on controlled transactions and when comparing their effects with those of other pre-existing assistance programmes. In addition, it is stated that there may be challenges in establishing the nature of government assistance received by potential comparables, given the various different types of COVID-19 government assistance programmes, the practical difficulties in obtaining detailed and reliable information on them, and the delay in data availability. An example is given in which 2 entities providing comparable manufacturing services in different jurisdictions where different forms of government assistance apply and have different effects. It is stated that there may be a material difference that could result in non-comparability as a result of government intervention.

The Paper includes any analysis undertaken should consider the economic impact of the assistance programmes on the accurately delineated transaction. Furthermore, the Paper states that an exhaustive analysis of the specific characteristics of government assistance would not be required in circumstances where the receipt of government assistance is unlikely to have a material impact on the accurately delineated controlled transaction. In other words, the receipt of government assistance will be relevant in the transfer pricing assessment to the extent to which the receipt of government assistance is an economically relevant characteristic for the controlled transaction. It is also noted that the receipt of government assistance may reduce the quantitative negative impact of a risk in certain cases.

Furthermore, it is stated that it would be contrary to the arm's length principle to assume that the mere receipt of government assistance would affect the price of the accurately delineated controlled transaction, without performing a careful comparability analysis. Aspects to consider in analysing the impact of government assistance on the price of a controlled transaction, if any, include the **availability, purpose, duration and other conditions imposed by the government in granting the assistance; the allocation of the economically significant risks; and the level of competition and demand within the relevant markets.**

When establishing arm's length prices using one-sided methods (such as the TNMM), particular care must be taken to: avoid adopting, without further analysis, a particular mechanical approach (such as offsetting cost savings achieved through government assistance against the relevant cost base for the transaction; recognizing government assistance as revenue; or recognizing government assistance as extraordinary income) since this could lead to non-arm's length prices in transactions among associated parties.

- Again, a case-by-case evaluation should be made to assess the impact of government assistance on the relevant transactions.
- Moreover, although the Paper stresses that appropriate adjustments should be made on the comparable companies in a (TNMM) benchmark study, tax administrations would need to accept that for most adjustments stated in the Paper probably no relevant information will be available to perform such adjustments. Additionally, in line with paragraph 5.28 of the OECD TPG, where a taxpayer reasonably demonstrates, having regard to the principles of the OECD TPG, that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue, the taxpayer should not be required to incur costs in search of such data.

Some examples are provided where government assistance may be more economically relevant, i.e. the provision of a wage subsidy, a government debt guarantee or short-term liquidity support. Also, an example is included where the receipt of government assistance may be less economically relevant, i.e. the provision of local infrastructure by a government. It is also recognized that there may be other situations in which the parties to a controlled transaction do not receive government assistance, but another party does, and this may influence the economically relevant characteristics of the transaction. In our view, as case-by-case analysis will be important in different situations, these examples only provide indicative guidance. In practice, it may be very difficult to assess the impact on controlled transactions.

An important note that is included in the Paper is that government interventions should be treated as market conditions in the particular country. Therefore, the receipt of government assistance may be part of the economic circumstances of the parties and a feature of the market in which the parties operate.

In line with the OECD TPG, according to the Paper, the analysis of the implications of the receipt of government assistance should consider the **following factors** to identify reliable market comparables when they exist, but also in cases where such comparables cannot be identified:

- Whether the receipt of government assistance **provides a market advantage** to the recipient.
- The amount of any **increase in revenues, decrease in costs, vis-à-vis those of reliable comparables**, that are attributable to the government assistance received, and the **duration** of the assistance.
- The **degree to which benefits** of government assistance, at arm's length, **are passed on to independent customers or suppliers**.
- Where benefits attributable to government assistance exist and are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate such benefits between them.

The Paper includes an example on market risk for a distributor. The distributor assumes the market risk for the sale of goods in its local market. If the distributor would receive a cash grant to help the entity support its costs during the period in which it is affected by the COVID-19 pandemic, then the receipt of government assistance does not alter the distributor's contractual arrangements and does not alter the capability and actual performance of decision-making functions relating to the

marketplace risk. Therefore, the government intervention does not modify the allocation of the market risk to the distributor as such.

CHAPTER IV. ADVANCE PRICING ARRANGEMENTS

Material changes resulting in economic conditions that were not anticipated when APAs were concluded in the past for FY2020 and potentially future financial years, raise questions about how the economic conditions arising from the COVID-19 pandemic should be treated in existing unilateral, bilateral and multilateral APAs and APAs under negotiation.

The Paper encourages taxpayers to adopt a **collaborative and transparent approach by raising these issues with the relevant tax administrations in a timely manner** and stipulates that taxpayers should not seek to resolve them unilaterally without consulting with the relevant tax administrations. Where it is stated that early notification of a potential breach to the tax administration, it is also stated that tax administration may consider waiting until more data and information on the impact are available prior to responding.

The Paper firmly states that existing APAs still apply and that terms and conditions should be respected, maintained and upheld unless a condition leading to the cancellation or revision of the APA (e.g. breach of critical assumptions) has occurred. In our view, this should always be verified based on local law, regulations and procedural provisions in this respect.

Most APAs include critical assumptions about the operational and economic conditions that will affect the transactions covered by the APA and it is the OECD's view that a mere change in business results during the period affected by the COVID-19 pandemic would not result in a breach of a critical assumption (unless the particular APA had a critical assumption regarding changes in business results). Whether critical assumptions have been breached should always be assessed on a case-by case basis and should take into account the individual circumstances of the taxpayer and commercial environment.

In line with other chapters in the Paper, it is recommended that taxpayers collect and provide tax administrations with relevant support documentation on relevant facts and circumstances. The Paper includes some specific items that could be provided, which are very much in line with what has been stipulated in the Paper and as detailed in this article.

The Paper has put forward **three potential outcomes** in the event of a breach of critical assumptions with the APA (based on the OECD TPG):

- **Revision:** which means that the taxpayer and tax administrations still have the benefit of the APA for the whole of the proposed period, albeit that different terms apply before and after the revision date. This would be the outcome when there has been a material change in conditions noted in the critical assumptions in the APA and the taxpayer and tax administration agree on how to revise the APA in this respect.
- **Cancellation:** which means the APA is treated as being effective and in force but only up to the cancellation date and not for the whole of the proposed period. This would be the outcome when in FY2020 (i) there is a material breach in an APA's critical assumption as a result of a change in economic circumstances or (ii) the taxpayer failed to materially comply with any term or condition of the APA.

- **Revocation:** which has the effect that the taxpayer is treated as if the APA had never been entered into. For COVID-19, it is noted that the pandemic has not altered the standard for revocation.

Concerning APAs under negotiation, the Paper stresses the importance of APA for providing tax certainty and preventing tax disputes, even (and, according to us, often and especially) in uncertain times. In line with the other chapters, it is indicated that all parties are encouraged to adopt a flexible and collaborative approach to determine how to take the current economic conditions into account.

Furthermore, the Paper puts forward some considerations that in our view should be assessed on a case-by-case basis and how APAs could (practically) be negotiated during the COVID-19 pandemic.

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