23 December 2020

Global Tax Alert

OECD releases guidance on transfer pricing implications of COVID-19 pandemic

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Executive summary

On 18 December 2020, the Organisation for Economic Co-operation and Development (OECD) released a report containing guidance on the transfer pricing implications of the COVID-19 pandemic (the Report). The Report notes that the unique economic conditions arising from COVID-19 and government responses to the pandemic have led to practical challenges for the application of the arm's-length principle. According to the Report, the arm's-length principle and the OECD Transfer Pricing Guidelines for Multinational Enterprises (MNEs) and Tax Administrations 2017 (OECD TP Guidelines) should continue to be relied upon by tax administrations and MNEs when performing a transfer pricing analysis, including under the possibly unique circumstances introduced by the pandemic. The Report focuses on how the arm's-length principle and the OECD TP Guidelines apply to issues that may arise or be exacerbated in the context of the COVID-19 pandemic, rather than on developing specialized guidance beyond what is currently addressed in the OECD TP Guidelines. The Report focuses on four priority issues where it is recognized that the additional practical challenges posed by COVID-19 are most significant:

(i) Comparability analysis

(ii) Losses and the allocation of COVID-19 specific costs

(iii) Government assistance programs

(iv) Advance pricing agreements (APAs)

Building a better working world

These issues have been presented as discrete topics in the Report, but it is emphasized that in performing a transfer pricing analysis, these topics may be interrelated and therefore should be considered together and within the analytical framework of the OECD TP Guidelines. The Report has been developed and approved by the Inclusive Framework on Base Erosion and Profit Shifting (Inclusive Framework) and represents a consensus based document. While it is recognized that some developing country Inclusive Framework members may also follow the United Nations (UN) Practical Manual on Transfer Pricing for Developing Countries (2017), the press release states that the guidance should be helpful in circumstances where the UN Manual follows a similar analytical framework and allows for similar conclusions as the OECD TP Guidelines.

Detailed discussion

Background

The impact of the COVID-19 pandemic has been profound. Many enterprises have faced or continue to face significant cash flow constraints, swings in profitability, restrictions affecting their business, and disruptions to their supply chains. In the presence of significant financial hardship, some enterprises have reviewed their contractual arrangements with third parties to ascertain whether they remain bound by them or have attempted to renegotiate key terms.

According to the Report, the arm's-length principle has been found to work effectively in the vast majority of cases. The OECD TP Guidelines are intended to help tax administrations and MNEs find mutually satisfactory solutions to transfer pricing cases and should be relied upon when performing a transfer pricing analysis under the possibly unique circumstances introduced by the pandemic. However, the unique and almost unprecedented economic conditions arising from and government responses to COVID-19 have led to practical challenges for the application of the arm's-length principle.

The Report addresses four priority issues which are further described in separate chapters in the Report:

(i) Comparability analysis

(ii) Losses and the allocation of COVID-19 specific costs

(iii) Government assistance programs[1]

(iv) APAs

Comparability analysis

The unprecedented change in the economic environment following the outbreak of COVID-19 has created unique challenges for performing a comparability analysis. The Report considers that the pandemic may impact pricing between independent enterprises and reduces the reliance that can be placed on historical data when performing comparability analyses. The challenges associated with performing a comparability analysis may vary depending on the impact of the COVID-19 pandemic on the economically relevant characteristics of the accurately delineated transaction. In reaching a conclusion on whether the facts and circumstances of an accurately delineated controlled transaction have (not) changed, it is important to consider any changes in the economically relevant characteristics, including the terms and conditions of the applicable intercompany agreement, and whether at arm's length, unrelated parties would have tried to renegotiate those terms and conditions.

The Report states that, in principle, any form of publicly available information regarding the effects of COVID-19 on the business, industry and controlled transaction may be relevant in analyzing transfer pricing policies. This can include for example information on sales volumes, macroeconomic trends, incremental or exceptional costs, budget versus actual data, and third party behavior observed in previous recessionary periods or data available in the current year. When comparing budget to actual data as a means to support intercompany price setting, all relevant economic factors that affected the financial results should be considered to determine the (isolated) impact of the pandemic. The rationale and evidence for any increased allocation of costs or any reduction of sales should be part of the comparability analysis.

With respect to timing, it is recognized that while contemporaneous information may be available for financial transactions for example, the application of the transactional net margin method (TNMM) often relies on information from commercial databases that will only be available at a later time. In these circumstances, taxpayers will need to base their analysis on prior year data, utilizing current year data to the extent available. However, using data from preceding years without considering the specific impact of the pandemic may not lead to a sufficiently reliable benchmark or outcome.

It is recognized that the difficulty posed by the delayed availability of contemporaneous data on comparable companies or transactions may have been exacerbated by the COVID-19 pandemic. Tax administrations are encouraged to keep these complexities in mind when performing their assessments.

The OECD TP Guidelines describe two approaches for identifying and collecting data required for the transfer pricing analysis: an ex-ante approach (price setting) and an ex-post approach (outcome testing). The Report considers that tax administrations that otherwise would use the price-setting approach can allow for an outcome-testing approach, to take into account information that becomes available after the close of the taxable year. They could provide flexibility to allow amendments to the tax returns once information becomes available. Taxpayers should undertake reasonable and appropriate due diligence in evaluating the effects of the pandemic, documenting the best available market evidence currently available, which may be in the form of internal comparables, external comparables, or other relevant evidence of the economic impact. The use of more than one transfer pricing method, although not required under the OECD TP Guidelines, may be useful to corroborate the arm's-length nature of the intercompany pricing.

According to the Report, the (sole) use of data from other crises is viewed as giving rise to significant concerns in comparability, due to the unique and unprecedented nature of the COVID-19 pandemic. Furthermore, in selecting the appropriate period for the comparability analysis, care should be taken to ensure the financial data of years affected by the pandemic do not unduly distort results from pre- or post-pandemic periods. This includes considerations relating to the effect of government interventions on business operations and imposed restrictions or conditions. If such interventions are identified, it may be necessary to adjust the period over which the comparison is performed. Depending on the fact pattern, the guidance states that reliability may be improved through either the application of separate testing periods or the use of combined periods for testing.

Three other distinct topics relating to the comparability analysis that are covered in the Report include:

- **Price adjustment mechanisms**: Another potential solution for the current uncertainty caused by the pandemic and the related lack of reliable contemporaneous information is the inclusion of price adjustment mechanisms. Through such a mechanism, prices for the current year would be adjusted in a later period when more accurate information to establish the arm's-length transfer price becomes available. If it is considered consistent with the arm's-length principle to apply such a mechanism, the related adjustment should be appropriately characterized, any effects that the payment may have on the comparability analysis for FY2021 should be considered, and their potential resulting Value Added Tax/Goods and Services Tax and customs duty implications should be analyzed.
- **Evaluation of comparables set**: Where taxpayers roll forward their existing set of comparables, a review may be necessary to validate their continued comparability, and revisions made to the comparables set if required.
- **Loss-making comparables**: Loss-making comparables that satisfy the comparability criteria in a particular case should not be rejected on the sole basis that they suffer losses in periods affected by the COVID-19 pandemic. It may be appropriate to include loss-making comparables when the accurate delineation of the transaction indicates that those comparables are reliable (e.g., the comparables involve assumption of similar levels of risk and have been similarly impacted by the crisis).

Losses and allocation of COVID-19 specific costs

During the COVID-19 pandemic, many MNE groups have incurred losses due to a decrease in demand or an inability to obtain or supply products or services or as a result of exceptional, non-recurring operating costs. The Report acknowledges that the allocation of losses between associated entities can give rise to disputes and thus requires consideration, given the probable increase in the frequency and magnitude of losses in the current economic environment. The Report notes three issues that warrant specific discussion.

First, with respect to the allocation of risks, the guidance indicates that risks affect how profits or losses resulting from a transaction are allocated at arm's length through the pricing of the transaction. Hence, the existing guidance in the OECD TP Guidelines on the analysis of risks in commercial or financial relations will be particularly relevant for determining how losses are allocated between associated parties.

The Report notes that, when considering the risks assumed by a party to a controlled transaction, the commercial rationale for any purported change in the risks assumed by a party before and after the outbreak of COVID-19 should be carefully considered. In this respect, the guidance in

Chapter IX of the OECD TP Guidelines may be relevant. In general, consideration should be given to whether a taxpayer is taking inconsistent positions pre- and post-pandemic and, if so, whether either position is consistent with the accurate delineation of the transaction.

With respect to so-called "limited-risk" entities, the functions performed, assets used and risks assumed vary. Therefore, it is not possible to establish a general rule that entities so-described should or should not incur losses. It will be necessary to consider the specific facts and circumstances when determining whether it is at arm's length that a "limited-risk" entity could incur losses. This is reflected in paragraph 3.64 of Chapter III of the OECD TP Guidelines which states that "simple or low risk functions in particular are not expected to generate losses for a long period of time," and therefore holds open the possibility that simple or low risk functions may incur losses in the short-run.

The second issue described in this chapter relates to the application of force majeure clauses and the option to revoke or otherwise revise intercompany agreements. In response to the COVID-19 pandemic, independent parties could seek to renegotiate certain terms in their existing agreements. It cannot be automatically assumed 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 force majeure, 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 the revision of intercompany agreements is consistent with the behavior of unrelated parties operating under comparable circumstances. Determining whether a renegotiation of a commercial arrangement represents the best interests of the parties to a transaction requires careful consideration of their options that are realistically available and the long-run effects on the profit potential of the parties. The guidance stipulates that 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 and/or the commercial relationships of associated parties is not consistent with the arm's-length principle. Accordingly, such modifications should be well-supported by documentation outlining how the modification is in line with the arm's-length principle.

Third, this chapter of the Report covers the allocation of "exceptional," "non-recurring" or "extraordinary" costs. These costs should be allocated based on an assessment of how independent enterprises under comparable circumstances operate, based on: (i) an accurate delineation of the transaction; (ii) an analysis of the risks assumed by the parties; (iii) an understanding of how independent enterprises may reflect such costs in arm's-length prices; and (iv) how such costs may impact prices charged in transactions between the associated enterprises (see OECD TP Guidelines paragraph 2.86, for example).

Government assistance programs

Government assistance is a monetary or non-monetary program where a government or other public authority provides a direct or indirect economic benefit to eligible taxpayers such as grants, subsidies, forgivable loans, tax deductions, or investment allowances. The availability, substance, duration and take-up of these programs potentially have transfer pricing implications, regardless of whether the government assistance is provided to a member of an MNE group directly or made available to independent parties within the market where an MNE group operates. The terms and conditions of government assistance programs related to COVID-19 need to be considered when determining the potential impact on controlled transactions and when comparing their effects with those of other pre-existing assistance programs.

Section D.4 of Chapter I of the OECD TP Guidelines elaborates on the effect of government policies noting that, as a general rule, government interventions should be treated as conditions of the market in the particular country. Therefore, the particular nature of the government assistance should always be reviewed in the transfer pricing analysis, as under certain circumstances it may not be a general feature of the market, and/or it may not generate benefits for either party. If the government assistance is an economically relevant characteristic, this information should be included as a part of the documentation to support the transfer pricing analysis.

Furthermore, the comparability of open market transactions or enterprises may be influenced by the receipt of government assistance, both affecting how the parties establish their commercial or financial relations and how they price their transactions. Therefore, when performing a comparability analysis, it may be necessary to take into account the receipt of government assistance when reviewing potential comparables.

The potential effect of the receipt of government assistance on the pricing of a controlled transaction will depend on the economically relevant characteristics of the transaction, following an accurate delineation of the controlled transaction and the performance of a comparability analysis. Therefore, 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. The Report identifies certain aspects to consider in the analysis of the impact of government assistance on the pricing of a controlled transaction, such as 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.

The receipt of government assistance may reduce the quantitative negative impact of a risk. For instance, a party assuming credit risk could expect to incur losses from a transaction due to financial difficulties of its counterparty. However, the counterparty may in fact be able to meet its obligations by benefitting from government assistance. This aspect must be distinguished from the allocation of risk under the guidance in Chapter I of the OECD TP Guidelines. Under that guidance, the provision of government assistance to an associated party will not change the allocation of risk in a controlled transaction for transfer pricing purposes.

Advance pricing arrangements

COVID-19 has led to material changes in economic conditions that were not anticipated when many APAs covering the current year and potentially future financial years that may be affected by COVID-19 were agreed. Therefore, it is important to determine to what extent, if any, the change in economic conditions affects the application of existing APAs. The Report encourages taxpayers and tax authorities to take constructive and collaborative approaches in the APA process.

With regard to existing APAs, the Report confirms that these APAs and their terms 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. Typically, the mere change in business results during the pandemic would not result in a breach of the critical assumptions, unless specific assumptions regarding business results were included. If a taxpayer believes that the terms of the APA are no longer appropriate, the Report stipulates that the taxpayer should not seek unilaterally to breach critical assumptions deliberately or fail to comply with the terms or conditions of the APA, but rather should approach the tax administration in a transparent way to discuss its concerns.

The response of the tax administration to a failure to meet the critical assumptions will depend on the extent of the divergence between the conditions agreed upon for the APA and current conditions, the type of APA, the terms of the APA itself, applicable local procedures and available discretion, and other domestic law. In the absence of other rules and procedures prescribed by domestic law, there would be three potential outcomes based on chapter V of the OECD TP Guidelines. First, the APA may be subject to revision, whereby the APA remains applicable for the proposed period, albeit that different terms apply before and after the revision date. The second option is cancellation, in which case 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. If the APA is revoked, the taxpayer is treated as if the APA had never been entered into. Which option is most appropriate will depend on the underlying facts of the case, whereby revocation should generally only occur where there is a misrepresentation, mistake or omission that was attributable to the neglect, carelessness, or willful default of a taxpayer.

The Report continues by stating that the timing for addressing the terms of existing APAs impacted by COVID-19 is important. Where material changes in economic conditions lead to the breach of one or more of the critical assumptions, taxpayers should notify the relevant tax administrations as soon as practicable after the change occurs or the taxpayer becomes aware of the change. The guidance considers that tax administrations may want to consider waiting for a reasonable period until data and information on the magnitude and longevity of the economic impact of COVID-19 are available before determining how to respond to a breach. Where the critical assumptions of an APA are breached, it is important that taxpayers collect and provide tax administrations with relevant supporting documentation to help the latter understand the underlying facts and circumstances. The Report notes that in so doing, they will help to maintain the non-adversarial spirit and environment that is vital to the success of APA negotiations.

For APAs under negotiation, the Report describes various options for taking into account the current economic conditions. These may include for example agreeing on a short APA covering the period of the pandemic and concluding a separate APA covering the post-COVID period, allowing for retrospective amendments when appropriate, or extending the period of the APA to mitigate the short-term effects of the pandemic. The guidance acknowledges that the pandemic may also result in practical difficulties for taxpayers and tax administrations in concluding APAs. However, it encourages innovative and flexible approaches in order to minimize delays in concluding APAs.

Implications

The COVID-19 pandemic and related government responses have resulted in unique economic conditions and thereby have led to practical challenges in the application of the arm's-length principle. MNEs should review the impact of the pandemic on their transfer pricing policies and APAs, and contemporaneously document how and to what extent they have been impacted. Collection of clear evidence on how independent parties in comparable circumstances would have amended their commercial and financial relations plays an important role. The guidance contained in this Report provides a framework for analyzing some of the key transfer pricing implications related to the pandemic.

Endnote

1. EY's Covid-19 tracker provides an overview of the various government assistance programs available to businesses. https://www.ey.com/en_gl/tax/how-covid-19-is-causing-governments-to-adopt-economic-stimulus--.

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EYG no. 008945-20Gbl

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