

ATO releases guidance on the impact of COVID-19 on transfer pricing and related-party agreements

July 20, 2020

In brief

The Australian Taxation Office (ATO) has released [guidance](#) on the impact of COVID-19 on transfer pricing arrangements as well as a [separate notice](#) highlighting the intention to review changes to related-party arrangements in light of the current environment that may be deemed to result in certain Australian tax advantages. Both publications were released via the ATO website on June 19, 2020.

The first publication, entitled *COVID-19 economic impacts on transfer pricing arrangements* (the ATO guidance); aims to assist taxpayers economically affected by COVID-19 when preparing documentation to support the arm's-length nature of their transfer pricing arrangements. The guidance does not address the arm's-length nature of any terminations, amendments, or replacements of related-party arrangements in light of the pandemic.

The second publication, entitled *Changing related party agreements* (the ATO notice), states that the ATO is aware of certain communications suggesting tax advantages by changing related-party arrangements in the COVID-19 environment. The ATO said it is committed to reviewing changes of the kinds described in the notice by examining documentation to assess compliance with Australian transfer pricing and other anti-avoidance rules.

In detail

There has been limited guidance from tax authorities to assist taxpayers in navigating the uncertainties surrounding the impact of COVID-19 on their transfer pricing outcomes. With its new publication, the ATO becomes one of the first tax authorities based in an OECD member country to release specific guidance on this topic.

The ATO guidance aims to assist taxpayers economically affected by COVID-19 when preparing documentation to support the arm's-length nature of their transfer pricing arrangements. It sets out the ATO's expectations around the analysis that will be required to support any pandemic-impacted transfer pricing positions. However, the guidance does not address the arm's-length nature of any terminations, amendments, or replacements of related-party arrangements in light of COVID-19.

Observation: This latter topic will be of interest to many taxpayers that have encountered unprecedented disruption and change in light of the current environment, so future guidance on the topic from the ATO would be welcomed.

In addition to the ATO guidance, the ATO notice highlights key areas relating to changes in related-party agreements that the ATO plans to review more closely.

How will the ATO assess the economic impact on transfer pricing arrangements?

The ATO notes that the effects of the pandemic on the Australian economy are not yet known or quantifiable and that the impacts on specific taxpayers will vary, with some businesses negatively affected through reduced revenues, increased costs, and overall changes in profit outcomes.

Negative impacts on Australian profit outcomes can be expected to lead to transfer pricing-related inquiry from the ATO. In that respect, the ATO has highlighted that in undertaking such analysis, it will consider and assess the following:

- the function, asset, and risk profile of the Australian entity before and after COVID-19;
- economic circumstances, where the actual economic impacts of the pandemic on the Australian operations should be outlined and evidenced — this may include a broader analysis of how the relevant industry has been affected;
- the contractual arrangements between the Australian entity and its related parties, and if any obligations or material terms and conditions have been varied, amended, or terminated;
- evidence of any impact of COVID-19 on the specific product and service offerings of the Australian entity and how this has affected the financial results; and
- evidence of resulting changes in business strategies, including decisions made, outcomes sort, and actions taken to give effect to those strategies.

The ATO says it will emphasize the collection of evidence to support any changes or impacts on the business and recommends that taxpayers document such changes contemporaneously.

Guidance on how to support the arm's-length nature of the company's transfer pricing outcomes

There has been a great deal of uncertainty around how taxpayers are expected to approach the evaluation of their transfer pricing outcomes in light of COVID-19, particularly in the absence of reliable benchmarking studies, given the lag in the disclosure and publication of comparables' data. The ATO guidance recognizes the limitations in obtaining reliable benchmarking by stating that taxpayers may adopt a 'but for' test in supporting their transfer pricing outcomes in the current environment.

Specifically, the ATO notes that in reviewing taxpayers' transfer pricing positions, it will seek to understand the financial outcomes taxpayers would have achieved 'but for' the impact of COVID-19. This analysis may include:

- a detailed profit and loss analysis showing changes in revenue and expenses, with an explanation for variances attributable to the pandemic from COVID-19 — this may include a variance analysis of budgeted (pre-COVID) versus actual results;
- details of profitability adjusted to where the company's outcome would have been if COVID-19 had not occurred — this should consider all factors that have a positive or negative impact on profits and should be supported by evidence;
- the rationale and evidence for any increased allocation of costs or a reduction of sales (and subsequent changes in operating margins) to the Australian entity, taking into consideration its function, asset, and risk profile; and
- evidence of any government assistance provided or affecting the Australian operations.

Impact on PCG 2019/1

The ATO has confirmed that it will not currently be reviewing [PCG 2019/1](#) due to the effect of COVID-19. This appears to be driven by an absence of analysis or benchmarking, indicating that changes may be required in the inbound distribution risk assessment framework at this stage.

COVID-19 and the impact on APAs

The ATO has provided guidance on the potential impact of COVID-19 on existing APAs as well as on taxpayers currently in the APA process without an agreed APA.

In relation to existing APAs, the ATO notes that the impact on the business could result in a breach of critical assumptions agreed to in the APA. In that case, the ATO encourages prompt and proactive engagement as soon as the taxpayer becomes aware that a potential breach of the APA terms has occurred or is likely to occur. Following ATO consideration of the impact and potential breach, the potential outcomes could include the APA:

- continuing to operate as usual;
- being renegotiated over the time period of the demonstrable impact; and
- being suspended or modified for a set period.

In relation to taxpayers that currently are in the APA process but have not yet agreed to an APA, the ATO notes that it will continue to work on the application. However, the ATO has outlined that standard APA processes apply where the taxpayer's economic performance is not significantly impacted by COVID-19.

If economic performance is significantly affected, the ATO notes that it may be difficult to progress the APA application without objective evidence of the impact or more certainty around potential outcomes. In such cases, the ATO will consider placing cases on hold or potentially ending the APA process by mutual consent. Bilateral APA applications will need to be considered in consultation with the corresponding tax authority/jurisdiction.

ATO notice on specific areas of inquiry

The ATO notice states that the ATO is aware of communications suggesting tax advantages by changing related-party arrangements in the COVID-19 environment. Specifically, the ATO has noted such circumstances include:

- triggering tax deductions for foreign exchange losses by early termination or repayment of liabilities under related-party financing agreements;
- avoiding ongoing withholding obligations on amounts payable to overseas parties by changing related-party agreements;
- reducing assessable income from rights or property provided to overseas related parties by changing related-party agreements; and
- increasing contractually assumed risks and allocation of global economic losses for limited-risk entities by changing related-party agreements.

The ATO will review such changes by examining documentation to assess whether the changes adhere to Australia's transfer pricing and other anti-avoidance rules, including considering whether:

- independent parties dealing wholly independently in comparable circumstances would have mutually agreed to change the existing related-party agreements or arrangements;
- independent parties dealing wholly independently in comparable circumstances would have entered into the terms or conditions of the new related-party agreements or arrangements (for example, if the new contracts or arrangements produced detriments or limited benefits for the taxpayer);
- there is a mismatch between the substance of the actual dealings or relations, and changes made to related-party agreements or arrangements;
- a purpose of the changes to the agreements or arrangements was to obtain an Australian tax benefit or a diverted profits tax benefit relevant to considering application of Part IVA of the Income Tax Assessment Act 1936 or other anti-avoidance rules; and

- the changes to the related-party agreements or arrangements and the commercial justification, developed in anticipation of a potential review by the ATO, originated with a tax adviser.

The takeaway

The ATO is one of the first tax authorities to publish guidance on the impact of COVID-19 on transfer pricing arrangements. The guidance provides taxpayers with some direction and understanding of the ATO's expectations in a period of uncertainty and disruption. More guidance in the future also would be welcomed.

Key takeaways from the ATO guidance include the following:

- **Areas of focus and the 'but for' test:** The ATO's areas of focus align with the five comparability factors typically covered in Australian transfer pricing documentation, as required by Subdivision 284-E of the Tax Administration Act 1953. This means that taxpayers should revisit their transfer pricing documentation to determine if it appropriately takes into account the areas highlighted by the ATO in supporting their transfer pricing position. The emphasis on direct evidence to support the taxpayer's position also means that companies should gather direct business evidence on a live basis to support key assertions on which the transfer pricing position is likely to turn.

The 'but for' test outlines the ATO's expectations around the analysis required to support pandemic-impacted transfer pricing positions. Pursuant to the guidance, affected taxpayers are expected to undertake important analysis, diving deeper into the economic impacts on their business. Taxpayers should collect evidence throughout the impacted financial period. This may include reviewing business plans and budgets prepared ahead of the financial year impacted by COVID-19 and analyzing how these changed throughout the year, compiling direct evidence regarding the reasons for change. **Observation:** This can help to better understand and isolate the impact of COVID-19 and lend further support to what financial outcomes the business would have achieved 'but for' the pandemic and the resultant implications on its transfer pricing position.

- **PCG 2019/1:** The Australian market includes a significant number of inbound distributors within the scope of PCG 2019/1 whose business has been negatively impacted by COVID-19. Reduced profit outcomes for these distributors indicates that they are more likely to land in higher-risk zones in PCG 2019/1. For those requiring completion of the Reportable Tax Position schedule, this will mean higher-risk disclosures.

By its very nature, a higher-risk PCG 2019/1 outcome can mean a greater likelihood of ATO inquiry. Therefore, inbound distributors that have been negatively impacted by COVID-19 should consider their position in light of PCG 2019/1 and confirm whether they have prepared contemporaneous documentation and compiled evidence supporting their transfer pricing position. **Observation:** This is particularly important as we anticipate there will be greater ATO scrutiny of COVID-19 affected periods, from an Australian transfer pricing perspective.

- **APAs:** Taxpayers either with concluded APAs or currently in APA process but without an agreed APA should consider any potential impact of COVID-19 on their circumstances and discuss any potential pandemic impact on the business with the ATO promptly and proactively to make sure that there are no surprises and that any potential implications can be appropriately addressed.

The ATO notice, on the other hand, is focused on potential tax advantages obtained as a result of changes to related-party agreements in light of COVID-19. As the economic impact of the pandemic is likely to lead to business changes, whether temporary or permanent, including changes to related-party arrangements, taxpayers should analyze the impact of any such changes from an Australian tax perspective. This includes preparing contemporaneous transfer pricing documentation to assist in supporting the positions taken. If changes lead to any of the tax impacts highlighted by the ATO, evidence should be compiled to demonstrate the commercial rationale underpinning the changes, along with additional analysis considering the potential application of Part IVA of the Income Tax Assessment Act 1936, where appropriate.

Expectations of increased ATO scrutiny in relation to transfer pricing positions taken during the pandemic-affected period have been signaled through the ATO notice and therefore increase the importance of collating evidence on a real-time basis and preparing contemporaneous transfer pricing documentation to support the positions taken and to assist in penalty protection in the event of a transfer pricing dispute.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Transfer Pricing

Lyndon James, *Sydney*
+61 2 8266 3278
lyndon.james@pwc.com

Edwin Baghdasarayan, *Sydney*
+61 2 8266 3974
edwin.baghdasarayan@pwc.com

Nick Houseman, *Sydney*
+61 2 8266 4647
nick.p.houseman@pwc.com

Transfer Pricing Global, Americas, and US Leaders

Isabel Verlinden, *Brussels*
Global Transfer Pricing Leader
+32 2 710 44 22
isabel.verlinden@be.pwc.com

Horacio Peña, *New York*
Americas Transfer Pricing Leader
+1 917 478 5817
horacio.pena@pwc.com

Paige Hill, *New York*
US Transfer Pricing Leader
+1 917 478 5817
paige.hill@pwc.com

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