OECD Guidance on Transfer Pricing Implications of COVID-19 & Key 2020 Amendments to Korean Transfer Pricing Regulations

Summary

The Organisation for Economic Co-operation and Development (OECD) released its “Guidance on the transfer pricing implications of the COVID-19 pandemic” on December 18, 2020. The guidance is intended to provide assistance to both taxpayers and tax administrations in addressing and evaluating the financial periods affected by COVID-19, together with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 (OECD Guidelines). The recent guidance provides comments on the practical application of the arm’s length principle, specifically with respect to (i) comparability analysis, (ii) losses and allocation of COVID-19 specific costs; (iii) government assistance programs; and (iv) advance pricing agreements (APAs).

This news flash aims to summarize key takeaways from the OECD guidance and provide examples of how certain tax jurisdictions have started applying such guidance. In addition, this news flash summarizes the latest amendments to Korea’s Law for the Coordination of International Tax Affairs (LCITA) announced on December 22, 2020. The amendments are intended to prevent tax evasion while providing a tax regime that is more taxpayer friendly. Key amendments include expanded scope of an overseas related party, extension of APA roll-back years, and exemption of compliance filing and extension of compliance deadlines.

OECD Guidance on Transfer Pricing under COVID-19

The OECD guidance comments on the following four areas: (i) comparability analysis, (ii) losses and allocation of COVID-19 specific costs, (iii) government assistance programs, and (iv) APAs.

Comparability Analysis

The guidance recognizes the challenges of performing a comparability analysis as a result of COVID-19. This is due to COVID-19 affecting the pricing of controlled and uncontrolled transactions, and the fact that comparability analysis is typically performed based on historical data. The guidance provides practical recommendations to mitigate such challenges - the following are a few examples.
1) What sources of contemporaneous information may be used to support the performance of a comparability analysis applicable for FY2020?

- The following information may support the effects of COVID-19 on the controlled transaction: changes in sales volumes, capacity utilization, and exceptional costs borne; extent of government assistance and government interventions; information from interim financial statements; macroeconomic information such as GDP or industry indicators; statistical methods such as regression analysis or variance analysis; comparison of internal budgeted/forecast data relating to sales, costs, and profitability with actual results; and an analysis of the effects on profitability observed in previous recessionary periods, etc.

2) Can budgeted financial information be used to support the setting of arm’s length prices?

- Comparing budgeted/forecast financial results established prior to COVID-19 with actual results achieved may approximate the effects of COVID-19 in terms of sales, costs, and margins.

3) Can data from other crises be used to support price setting?

- A comparability analysis should be performed based on the actual economic circumstances of the controlled transaction. Performing a comparability analysis based on financial information from the 2008/2009 global financial crisis would not be reliable given the unique nature of COVID-19 and differences in the impact by business sector between the two crises.

4) How might the period of data used to evaluate arm’s length pricing be established to support a comparability analysis?

- A term test, which includes both the years that are impacted by COVID-19 and those that are not, may prove more reliable for purposes of a comparability analysis as there is a lag in comparable data in general.

5) What actions may be taken to evaluate the set of comparable companies or transactions used?

- Under COVID-19, a roll forward of an existing comparable set may not be appropriate given the unique economic circumstances. Similarly, geographic comparability may need to be prioritized over other comparability criteria.

6) Can loss making comparables be used?

- The OECD Guidelines does not specifically rule out loss making companies as comparables. In this regard, loss making comparables should not be automatically disregarded because they incur losses in the periods affected by COVID-19. In fact, loss making companies may be appropriate comparables provided that the comparables assume similar level of risks and have been similarly impacted by COVID-19 as the taxpayer.

The guidance further notes the challenges of using contemporaneous uncontrolled transactions as part of a comparability analysis, notably in the application of the transactional net margin method (TNMM). The application of the TNMM typically relies on historical information from commercial databases in order to set and test prices. FY2020 information will typically not be available until mid FY2021 since commercial databases are updated with publicly available information several months after the period to which they relate.

Data from independent comparable transactions or companies from other time periods, such as average returns in preceding years, may not provide a sufficiently reliable benchmark for the current period without considering the specific impact of the pandemic on the controlled transactions under review.

Taxpayers and tax administrations should be mindful that determining a reliable arm’s length outcome requires flexibility and the exercise of good judgment.

**Losses and Allocation of COVID-19 Specific Costs**

In examining how to allocate losses and COVID-19 specific costs amongst affiliates, the guidance considers the allocation of risks, allocation of exceptional, non-recurring operating costs, and force majeure clauses in intercompany agreements. The OECD recommends considering how independent parties may treat these issues.

1) Can entities operating under limited risk arrangements incur losses?

- The OECD Guidelines only states that simple or low risk functions are not expected to generate losses for a long period of time. In this regard, the guidance suggests that limited risk entities can incur losses in the short run. For instance, a limited risk distributor which assumes some market risk may incur losses...
due to a decline in demand from COVID-19, and its comparable distributors may also exhibit losses because the decline in sales is not sufficient to cover their fixed costs. However, the taxpayer’s risk profile pre vs. post COVID-19 should remain unchanged.

2) How should operational or exceptional costs arising from COVID-19 be allocated between related parties?

- It will be necessary to identify who is responsible to perform activities related to those costs and who assumes the risks. Also, it will be necessary to determine whether such exceptional costs will become ordinary operating costs in the long run. For example, remote working may become the new norm in the future, and then teleworking costs will no longer be deemed exceptional costs arising from COVID-19. In which case, the guidance recommends allocating such costs amongst all beneficiaries.

3) How should exceptional costs arising from COVID-19 be taken into account in a comparability analysis?

- In general, exceptional costs should be excluded in the calculation of the net profit indicator unless such costs relate to the controlled transaction. The exclusion should be performed consistently to both the tested party and comparable data.

- In determining whether exceptional costs should be included in the cost base to be charged to a related party, it will be important to consider which party would have borne such costs in an uncontrolled transaction.

4) How may force majeure affect the allocation of losses derived from COVID-19?

- A simple existence of a force majeure clause in an intercompany agreement should not allow a party to waive its obligations. The controlled transaction as well as the conduct of the parties will need to be closely examined in comparison to the expected behavior of independent parties.

**Government Assistance Programs**

The guidance lists a wage subsidy, government debt guarantee, and short-term liquidity support as examples of government assistance provided during COVID-19 which may be economically relevant, and notes that such assistance needs to be analyzed for both the tested party and comparables from a transfer pricing perspective.

Generally, the receipt of government assistance is not likely to alter the original risk profile of a taxpayer, and such assistance may need to be reflected in the selection of comparable companies from the same or comparable geographic markets as the form of government assistance may vary between jurisdictions and therefore affect the comparables’ financial results differently.

**APAs**

The guidance discusses COVID-19’s impact on existing APAs as well as APAs that are undergoing negotiation. It is noted that existing APAs should be respected unless a breach of critical assumptions has occurred, and if COVID-19 has impacted economic conditions, taxpayers should discuss with tax administrations as soon as possible upon learning of the change in their circumstances if they believe there has been a breach of a critical assumption.

The guidance also acknowledges the benefits of APAs and encourages taxpayers and tax administrations to adopt a flexible and collaborative approach with respect to APAs that cover COVID-19 impacted years, rather than halting an ongoing negotiation process. Some examples of a flexible and collaborative approach are: separate the APA covered period into COVID-19 and post-COVID period, extend the APA period to mitigate the short term effect of COVID-19, use a term test throughout the APA period instead of an annual test, etc.

**Guidance on COVID-19 in Different Jurisdictions**

Certain tax jurisdictions in the Asia Pacific region have already announced their specific guidance in regard to transfer pricing under COVID-19.

The Australian Taxation Office (ATO) stated that it will assess the economic impacts of COVID-19 on transfer pricing by reviewing the function, asset, and risk profile of the Australian entity pre and post COVID-19, economic circumstances including the relevant industry, intercompany contractual arrangements, evidence of impact on product/service offerings and how it has affected the taxpayer’s financial results, and evidence of changes in business strategies post COVID-19.

The ATO also mentioned that it will seek to understand the financial outcomes the taxpayer would have achieved in the absence of COVID-19 by looking at the profit and loss analysis of
budgeted (pre COVID-19) vs. actual results, rationale and evidence for any increased costs or reduced sales for the Australian entity, evidence of any government assistance affecting the Australian operations, etc. In addition, the ATO encourages taxpayers to approach them in regard to breaching an APA or placing an ongoing process on hold.

The Inland Revenue Authority of Singapore (IRAS) provides similar guidance as the ATO with regard to preparing transfer pricing documentation to support the arm’s length nature of the taxpayer’s transfer pricing outcome under COVID-19. In addition, the IRAS offers term testing (generally over three years) for FY2021 (i.e. testing of 2018 through 2020) to taxpayers to spread out the impact of COVID-19. The term testing for FY2021 can be applied without prior consulting with the IRAS. Regarding APAs, the IRAS shares the view that taxpayers wait until their operations are normalized to apply for new APAs or continue APA negotiations. The IRAS also encourages taxpayers to approach them if they believe a critical assumption has been breached.

The U.S. Internal Revenue Service (IRS) released transfer pricing documentation FAQ and best practices in April 2020 to improve the quality of transfer pricing documentation. While the FAQ does not make specific reference to COVID-19, it provides an example where a U.S. entity purchasing goods from its foreign parent earned significant losses during the year it was audited. Such losses may be seen as an initial indicator that transfer pricing is not at arm’s length, and it will be necessary to prepare transfer pricing documentation thoroughly explaining the taxpayer’s business circumstances and impact on the U.S. taxpayer’s financial results and how it is not a result of transfer pricing. This example may be relevant for the COVID-19 environment where taxpayers may face extraordinary results due to the pandemic.

The IRS believes that taxpayers can anticipate and proactively address concerns by performing basic sensitivity analyses. Examples provided by the IRS include:

- Evaluating the strength of comparable companies used in benchmarking;
- Comparing tested party results to multiple profit level indicators and being ready to address potential inconsistencies;
- Evaluating the reasonableness of how system profits are shared between related parties based on their relative contributions.

Our Recommendations

The OECD guidance provides examples of approaches which can be applied by taxpayers to reflect the extraordinary economic impact of COVID-19 on their businesses and determine the arm’s length nature of transfer prices.

Accordingly, at the time of closing FY2020 (or beyond) for financial and tax purposes, taxpayers should perform the following review in assessing the need for potential transfer pricing adjustments and preparation of appropriate documentation:

- Consistency between actual functions and risks for 2020 and those indicated under transfer pricing policy;
- Determination of the appropriate entity to which COVID-19 related losses or costs should be attributed;
- Transfer pricing adjustments to achieve arm’s length profitability (upward versus downward adjustment);
- Determination of a comparable arm’s length range which reflects the economic environment;
- Analysis of specific impacts from COVID-19 on transfer prices, and documentation and collection of relevant evidentiary materials;
- Potential customs implications from transfer pricing adjustments (e.g. need for amended customs value declaration);
- Pursue an APA in situations where preparing suitable documentation is difficult or long-term transfer pricing risk is expected.

The OECD guidance essentially lays out the importance for taxpayers to demonstrate and document the impact of COVID-19 on their transfer prices. Accordingly, it will be critical for taxpayers to prepare transfer pricing documentation for 2020 which is based on reasonable and contemporaneous data and which clearly demonstrates the efforts taken manage arm’s length transfer prices.

Recent Amendments to Korean Transfer Pricing Regulations

Expanded Scope of Overseas Related Party

Based on the LCITA, in determining whether a foreign transaction party is a related party of a Korean entity for tax purposes, one of the prescribed criteria includes the relationship between both parties to a transaction where a third party directly or indirectly owns at least 50% of voting shares of both parties. In an attempt to prevent tax evasion, this provision was tightened to include the shares owned directly or indirectly
by the relatives of the third party. Here, a relative refers to any relative by blood or by marriage as defined under Article 2, Item 20(a) of the Basic National Tax Law. This amendment will apply to the fiscal years beginning on or after January 1, 2021.

Extension of APA Roll-back Years

Currently, the Korean APA program allows rollbacks (i.e. retroactive coverage of APA) of up to 3 years for a unilateral APA and 5 years for a bilateral APA. Under the amended regulations, taxpayers will be able to request up to 5 roll-back years for a unilateral APA and 7 years for a bilateral APA. This will be effective for applications submitted on or after January 1, 2021.

Exemption of Compliance Filing and Extension of Compliance Deadlines

Taxpayers submitting the Master file and Local file may be exempt from the submission of transfer pricing disclosure forms which were submitted as part of the annual corporate income tax return if they provide an advance notice in the corporate income tax return. This is effective for the filings submitted on or after January 1, 2020.

Furthermore, for taxpayers that are not subject to the Master file and Local file submission, the deadline for the submission of transfer pricing disclosure forms has been extended from the corporate tax return filing date (i.e. 3 months from the fiscal year end) to 6 months from the fiscal year end. The deadline for APA annual report has also been extended from 6 months from the corporate tax return filing date (i.e. 9 months from the fiscal year end) to 12 months from the fiscal year end. These will be effective for filings/reports submitted on or after January 1, 2021.

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