

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

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In brief

The Organisation for Economic Co-operation and Development (OECD) on December 18 issued Guidance on transfer pricing implications of the COVID-19 pandemic (the Guidance) as part of its efforts to provide policy recommendations to respond to the COVID-19 pandemic. The 31-page document, which represents the consensus view of the 137 members of the Inclusive Framework on BEPS, is intended to provide guidance to help address challenges in applying transfer pricing rules in years impacted by the pandemic. The Guidance maintains that the arm's-length principle (ALP) remains the applicable standard for purposes of evaluating controlled transactions in the economic environment shaped by the COVID-19 crisis.

The Guidance focuses on four areas:

- comparability analysis;
- losses and the allocation of COVID-19 specific costs;
- government assistance programs; and
- advance pricing agreements (APAs).

The Guidance has been anticipated by taxpayers and tax authorities given the unique challenges created by the COVID-19 crisis. While taxpayers likely would have preferred more illustrative examples, the Guidance does discuss several practical approaches to addressing transfer pricing issues created or exacerbated by the pandemic.

Observation: The approaches described in the Guidance are all grounded in the ALP. The Guidance avoids standardized and prescriptive approaches and reinforces the need for transfer pricing outcomes to reflect the specific facts of the controlled transaction and the underlying economic circumstances. The conduct of the parties constitutes an important part of the relevant facts and circumstances under the Guidance and is relevant to the correct "delineation of the transaction." Taxpayers will need to prepare robust documentation detailing the specific impact of the COVID-19 pandemic to support their transfer pricing outcomes under the ALP.

In detail

Background

The Guidance acknowledges that the disparate economic impact of the COVID-19 pandemic across economies, industries, and businesses has created, or exacerbated, certain practical challenges in applying the ALP. Accordingly, the Guidance focuses on four priority issues (identified in consultation with Business at the OECD) that make application of the ALP more challenging under current economic circumstances. The four areas are: (1) comparability analysis; (2) losses and the allocation of COVID-19 specific costs; (3) government assistance programs; and (4) APAs. Each issue is covered in a separate chapter. At the same time, the document notes that a number of these issues are interrelated and, depending on the facts and circumstances, may need to be considered together.

The Guidance underscores that the objective of any transfer pricing analyses is to “find a reasonable estimate of an arm’s length outcome” and stresses that taxpayers and tax administrations should exercise judgment to achieve that objective in the face of the challenges created by the COVID-19 crisis. An overarching theme throughout the document is the importance given to the ‘accurate delineation’ of the relevant controlled transaction and the consideration of specific facts and circumstances, as contrasted with a reliance on prescriptive assumptions and outcomes.

The role of risk and its contractual allocation between associated enterprises is given particular importance in the discussion of the four priority issues. In this context, the COVID-19 pandemic is framed as a ‘hazard risk’ that impacts other types of risks relevant to transfer pricing outcomes — e.g., ‘marketplace risk’ related to demand, ‘operational risk’ related to supply chains, and ‘financial risk’ related to the cost of capital. Per the COVID-19 TP Guidance, which member(s) of the MNE group control and bear a particular risk and how such risk is impacted by the COVID-19 pandemic needs to be identified based on a factual analysis. Such identification then should guide the analysis to determine which member(s) of the MNE group should bear the consequences of the COVID-19 pandemic.

Observation: The framing of the COVID-19 pandemic as a hazard risk relates to the OECD Transfer Pricing Guidelines

(OECD TPG) definition of hazard risks as risks that “are likely to include adverse external events that may cause damages or losses, including accidents and natural disasters. Such risks can often be mitigated through insurance, but

insurance may not cover all the potential loss, particularly where there are significant impacts on operations or reputation.”

A practical challenge that taxpayers will need to address is that intercompany contracts (and even third-party contracts) may be silent about the allocation of such ‘systemic risks’ as represented by the COVID-19 pandemic.

Comparability analysis

A comparability analysis — between the controlled transaction and potentially uncontrolled comparables — is fundamental to transfer pricing analyses under the ALP. In the chapter on comparability analysis, the Guidance notes how such analyses may be much more challenging in the COVID-19 environment. This is on account of the impact of the pandemic on transactions between unrelated parties as well as the fact that transfer pricing analyses typically rely on historical data. While such a reliance may not present a challenge or concern in normal economic conditions, it can when the relevant economic conditions underlying a controlled transaction are significantly altered by the pandemic. In response, the Guidance discusses approaches such as comparability adjustments.

The Guidance lists several types of information and approaches that may be relevant to address the comparability challenges. These include different types of contemporaneous information pertaining to the parties to the controlled transaction that can help quantify the impact of the crisis (e.g., change in sales volumes, capacity utilization, and incremental or exceptional costs) as well as wider macroeconomic data (e.g., GDP data, industry indicators, etc.). Statistical methods such as regression analysis specifically are listed among the approaches that can be useful in a comparability analysis. On the potential uses of budgeted financial information (which reflect financial performance expectations preceding the crisis), the Guidance discusses how such information can be useful in conducting a ‘but-for’ analysis to isolate the financial impact of the pandemic.

Other approaches that are discussed include the analysis of effects on profitability observed in prior recessionary periods as well as for partial periods (where available) during the current crisis. Regarding the relevance of prior economic crises, the Guidance cautions against a simplistic comparability analysis that relies solely on data from the 2008/2009 financial crisis (because of the unique and unprecedented nature of the pandemic).

Several other practical issues are covered in the chapter. Contemporaneous data on ‘internal comparables’ — transactions involving (one of the) taxpayers and unrelated parties — are discussed as a potential reference for use in pricing related-party transactions. In general, MNEs are encouraged to use contemporaneous market evidence and its documentation to inform transfer pricing outcomes. Per the guidance, a practical approach (under “some fact patterns”) to test transfer pricing outcomes in a year affected by atypical economic conditions may be to aggregate the results of the ‘exceptional’ year(s) with the more ‘normal’ results of prior years.

Lastly, the chapter opines on the appropriateness of using loss-making companies as comparables under particular facts and circumstances. In keeping with the overall theme — with an emphasis on an accurate delineation of the transaction and the underlying facts and circumstances — the chapter concludes that loss-making independent companies may be valid benchmarks as long as the relevant comparability criteria are met.

Observation: Given the magnitude of the COVID-19 crisis, there are many taxpayers whose businesses have been impacted at a fundamental level. Those taxpayers have been grappling with the challenges (e.g., unreliability of unadjusted historical data) that constrain contemporaneous comparability analysis, as discussed in this chapter. The chapter offers helpful and practical guidance to address these challenges in a way that is grounded in an overarching principle — i.e., that of finding a reasonable estimate of an arm’s-length outcome. Taxpayers will need to be thoughtful in selecting and implementing the approach — or in many cases, a combination of approaches — that is best suited to them given their unique facts and circumstances and the type of data/information available to them. Facts and circumstances will vary, and the correct approach will be bespoke and ‘not one-size fits all.’ Contemporaneous documentation of the impact of the pandemic on their business will be critical in supporting the reliability of taxpayers’ comparability analysis. As additional information will become available, taxpayers should consider updating their supporting analysis.

Losses and allocation of COVID-19 specific costs

The chapter on pandemic-related losses deals with transfer pricing issues related to exceptional circumstances facing businesses due to such factors as decreased demand, supply chain disruptions (e.g., reduced access to inputs or ability to supply output), and other exceptional and non-recurring operating costs. A key transfer pricing question that arises in the context of such situations is which MNE group member(s) should bear such costs.

In addressing this question, the Guidance emphasizes the allocation of risks between the parties to an intercompany arrangement and how the profits or losses would be allocated between independent parties under a comparable arrangement.

Five specific issues related to this question are covered in the chapter:

- whether so-called ‘limited-risk’ entities can incur losses under the ALP;
- how and when contracts may be modified because of an event like COVID-19;
- how exceptional costs related to COVID-19 should be allocated between related parties;
- how such costs need to be factored into a comparability analysis; and
- the applicability of force majeure clauses in intercompany contracts.

The Guidance points out that the term “limited-risk” is universally and uniformly defined; therefore, there can be no single rule regarding whether such entities can bear losses under the ALP. Instead, the Guidance stresses the need to accurately delineate the relevant transaction and the underlying allocation of risks between the relevant parties. This, the Guidance states, leaves “open the possibility that simple or low risk functions may incur losses in the short run.” As an example, the Guidance discusses how a ‘limited-risk’ distributor that assumes some marketplace risk “may at arm’s length earn a loss.” In analyzing the arm’s-length nature of such an outcome under the transactional net margin method (TNMM), the Guidance stresses the importance of selecting suitable comparables that reflect an accurate delineation of the controlled transaction, particularly in reference to the allocation of risks between the relevant parties. On the issue of renegotiation and modification of intercompany contracts in light of the unique economic conditions, the Guidance states that this may be consistent with arm’s-length behavior. However, whether such renegotiation should be respected is (again) dependent on the accurate delineation of the transaction. The Guidance cites the importance of third-

party evidence — e.g., of contractual terms not being enforced or amended in light of special circumstances — as being particularly relevant in supporting analogous revisions in related-party dealings. The Guidance cautions that in the absence of such clear evidence, the modification of existing intercompany arrangements is unlikely to be consistent with the ALP.

On the issue of operating or exceptional costs related to COVID-19, the Guidance states that the allocation of such costs between related parties needs to reflect the true allocation of risks between the relevant parties. The Guidance elaborates that certain costs may not be truly exceptional or non-recurring because they may reflect permanent changes to how the business operates. Where costs truly belong in the 'exceptional' or 'non-recurring' category, the Guidance states that such costs generally should be excluded from the net profit indicator of the tested party and uncontrolled comparables (e.g., under the TNMM). The exception to this is when such costs specifically relate to the controlled transaction.

Finally, the Guidance discusses the issue of force majeure clauses in intercompany contracts and cautions against assuming that the mere existence of such a clause in an agreement is sufficient grounds for it to be invoked because of the pandemic. Once again, the Guidance refers to the accurate delineation of the transaction and the conduct of the parties together with relevant third-party evidence as factors that will determine whether the invoking of a force majeure clause in an intercompany agreement (by one of the parties to the agreement) is in fact consistent with the ALP.

Observation: The unique and severe economic circumstances presented by the COVID-19 pandemic may present grounds for taxpayers to modify existing intercompany agreements or consider whether a force majeure clause should be invoked by one of the parties to such an agreement. Taxpayers will need to be able to show that any amendment to a contract or invoking of a force majeure clause is in fact consistent with the ALP. For that, identifying and documenting credible third-party evidence of similar behavior in relation to arrangements that are comparable to the related-party arrangements will be critical.

Government assistance programs

The chapter on government assistance identifies several types of such assistance that may be relevant to a transfer pricing analysis covering a year affected by COVID-19. Relevant government assistance is described as providing a "direct or indirect economic benefit to eligible taxpayers" (e.g., wage subsidies, financing, or loan guarantees). The Guidance differentiates pandemic-related government assistance from other pre-existing programs, stating that the former is more temporary in nature and provided to temporarily help preserve a business as a going concern over the duration of the crisis. Consequently, the impact of such assistance on controlled transactions may be different from longer-term ongoing government support.

The Guidance states that the extent to which government assistance is an "economically relevant characteristic" that needs to be factored into the pricing of a controlled transaction depends on the nature of the assistance. The Guidance identifies wage subsidies, debt guarantees, and short-term liquidity support as examples that are more likely to fall into this category. The Guidance refers to the OECD TPG (Chapter I, Section D.4) for guidance on analyzing government interventions as a market characteristic of the relevant country as a way of incorporating government assistance programs in a transfer pricing analysis of a given controlled transaction. For instance, this may be a relevant comparability criterion when identifying comparable uncontrolled transactions or companies. Note: The guidance does not provide a prescriptive view on whether the economic benefit of government assistance (e.g., a wage subsidy) should be retained by the controlled taxpayer that directly receives it, or whether such a benefit should be passed on to its (affiliated) counterparty (via the pricing of the controlled transaction). Instead, the Guidance refers to the aspects discussed in Chapter I of the OECD TPG (i.e., market conditions and circumstances relevant to a comparability analysis) that need to be taken into consideration together with the particular feature of the specific government assistance to determine an outcome consistent with the ALP. Among the factors that should be considered when assessing the impact of a specific government assistance on the price of a controlled transaction are the nature of the assistance (i.e., availability, purpose, and duration), the allocation of risks between the parties to the controlled transaction, and the level of competition and demand within the relevant markets.

The Guidance cautions against adopting a "mechanical approach" without careful analysis when using one-sided methods (e.g., the TNMM) — e.g., offsetting a party's cost base by the amount of the government assistance, treating the government assistance as extraordinary income, etc. Instead, the Guidance again points to the need for reliable

comparables and other robust analysis (e.g., of the economically relevant characteristics) to determine the appropriate arm's-length outcome.

Finally, the Guidance discusses how the specific characteristics of government assistance offered in different countries may differ given the disparate impact of the pandemic. This may affect the (potential) uncontrolled comparables in different ways. As such, this may require additional comparability criteria to be applied when identifying comparable transactions or companies than what a taxpayer would have considered in previous years.

Observation: Taxpayers will need to consider the impact of government assistance programs in their analysis and documentation during years impacted by COVID-19. This may be because one or more controlled taxpayers are recipients of government assistance in a given jurisdiction. Or, more generally, this may be because government assistance programs may constitute a significant aspect impacting (potential) uncontrolled comparables used in the taxpayer's transfer pricing analysis. For an analysis to be considered robust, it should carefully reflect the relevant facts and circumstances: the correct characterization of the transaction and risk allocation between the parties, the specific characteristics of the government assistance, and evidence of arm's-length behavior that supports the taxpayer's transfer pricing outcome (e.g., how the economic benefit of the government assistance is shared between the parties).

Advance pricing agreements

The chapter on APAs discusses how the COVID-19 pandemic can impact existing APAs and those currently being negotiated by taxpayers and tax administrations. Overall, the Guidance encourages taxpayers to adopt a collaborative and transparent approach by raising and discussing relevant issues with tax administrations.

With respect to existing APAs covering years affected by the pandemic, the Guidance is clear in its view that the terms of these APAs should be respected and maintained unless there is reason for the APA to be cancelled or revised. The Guidance cites a breach of "critical assumptions" as one such important reason. The Guidance notes that the pandemic has led to material changes in economic conditions that were not anticipated when many APAs covering the COVID-19 impacted year(s) were agreed upon and executed.

In light of this, it is necessary to assess to what extent, if any, the change in economic conditions affects the application of existing APAs. However, the Guidance also points out that the pandemic has not had the same impact on all MNEs; therefore, the revised economic conditions may not amount to a breach of critical assumptions for all taxpayers. In the event a breach has occurred, it is of critical importance to assess the difference in the parameters under the COVID-19 economic circumstances and those agreed to under the APA, as well as whether the agreed transfer pricing method has the ability to continue to reliably reflect arm's-length pricing under the COVID-19 economic circumstances.

The Guidance recommends that taxpayers provide early notification to the tax authorities in the event of a breach of critical assumptions to allow more time to discuss and reach agreement on revising the APA. In connection with notifying the tax authorities, taxpayers are encouraged to maintain relevant supporting documentation (examples are provided in the Guidance but are not limited to those discussed) to provide to the tax authorities. While non-compliance with an existing APA may have different consequences under the prescribed procedures, domestic law, or procedural provisions, the guidance encourages tax administrations to adopt a similar approach as they would in circumstances where there is a failure to meet critical assumptions.

With respect to APAs that currently are under negotiation, the Guidance acknowledges that taxpayers may be reluctant to pursue an APA given the underlying uncertainty around economic conditions and business activity. However, the Guidance reiterates the important role of APAs in achieving tax certainty and preventing future tax disputes. As such, the Guidance encourages taxpayers and tax administrations to adopt a "flexible and collaborative approach." The Guidance provides some examples to address the economic uncertainty due to the COVID-19 pandemic in the context of APAs.

Observation: The benefits of tax certainty may outweigh the burdens of addressing the economic uncertainty brought about by the COVID-19 pandemic in relation to existing APAs as well those that taxpayers may be negotiating or contemplating. APAs can remain a viable means of achieving tax certainty and reducing the potential for tax disputes despite the COVID-19 uncertainty. However, this will require tax administrations and taxpayers to adopt a flexible, transparent, and collaborative approach.

The takeaway

The COVID-19 pandemic has caused significant economic disruptions to many businesses in a way that can require taxpayers to account for these disruptions in their transfer pricing analysis and documentation. This likely will create significant challenges for many taxpayers and exacerbate other issues that more commonly are encountered in transfer pricing (e.g., data limitations and lack of good comparables).

The Guidance has been much-awaited and discusses several practical approaches that can be used by taxpayers and tax administrations to address immediate short-term challenges as well as more long-term industry systems challenges. These approaches are all tied to the overarching standard of the ALP. Indeed, the Guidance avoids prescriptive approaches to addressing these challenges and instead encourages analyses that are based on the specific facts and circumstances, the correct characterization of the relevant transaction, and, where available, evidence of observed arm's-length behavior.

Let's talk

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

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