# TAX FLASH NEWS

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## OECD releases guidance on TP implications of COVID-19, represents consensus view of members to Inclusive Framework

The Organisation for Economic Co-operation and Development (OECD) on 18 December 2020 released "*Guidance on the transfer pricing implications of the COVID-19 pandemic*" (the guidelines)[1] that intends to help both taxpayers (in reporting the financial periods affected by the pandemic) and tax administrations (in evaluating the implementation of taxpayers' TP policies). It has been clarified that these guidelines do not intend to expand or revise the existing OECD TPG[2]. It rather focuses on how arm's length principle and the OECD TPG is to be applied to the challenges that arise in context of COVID-19.

The guidelines address four priority issues namely; (i) comparability analysis; (ii) allocation of losses and COVID-19 specific costs; (iii) government assistance programmes; and (iv) advance pricing agreements (APAs).

### Guidance on Comparability analysis

**a) Source of contemporaneous information to support comparability analysis**

The materiality of the change in economically relevant characteristics created by the impact of COVID-19 is a key determinant in comparability analysis. Any form of publicly available information regarding effect of COVID-19 on business, industry and controlled transaction may be relevant for ascertaining the arm's length nature. Following may supplement comparability analysis:

- Analysis of how sales volumes changed during COVID-19;
- Analysis of change in capacity utilization relevant for MNE group and the controlled transaction;
- Information relating to incremental or exceptional cost;
- Extent to which government assistance has been received;
- Details of government interventions that have affected pricing;
- Information from interim financial statements such as quarterly filings;
- Macroeconomic information like country specific GDP data or industry indicators from central banks, government agencies, industry or trade associations;
- Statistical methods like regression analysis or variance analysis used to predict the extent to which certain variable will vary with reference to other variables under certain specific conditions;
- Comparison of internal budgeted/ forecasted data relating to sales, costs and profitability, compared to actual results; and
- Analysis of the effects on profitability or on third party behavior observed in previous recessionary periods.

**b) Use of budgeted financial information to support the setting up of arm's length price**

In setting up transfer prices, budgeted or forecast financial results can be compared to those achieved, to bring forward specific impact of COVID-19 on revenues, costs and margins. The analysis may include:

- Preparation of a profit and loss analysis showing changes in revenue and expenses, with an explanation for variances resulting from COVID-19;
- Details of profitability, adjusted to where the outcome would have been if COVID-19 had not occurred, considering all factors with positive or negative impact, supported by evidence;

[1] Represent the consensus view of 137 member countries of the Inclusive Framework on BEPS

[2] OECD Transfer Pricing Guidelines for Multinational Enterprise and Tax Administrations

- Rationale and evidence for any increased allocation of costs or a reduction of sales, taking into consideration its function, asset and risk profile; and
- Evidence of any government assistance provided or affecting transaction, its effect and its accounting treatment.

**c) Circumstances under which timing issues are most pronounced**

Information relating to contemporaneous uncontrolled transactions is the most reliable information to be used in a comparability analysis. When applying the TNMM, taxpayers and tax administrations typically rely on historical information from databases in order to set and test prices. FY 2020 information will typically not be available until mid FY 2021 at the earliest. Thus, taxpayers will need to perform a comparability analysis based on available prior year financial information and, depending on the facts and circumstances of the case, utilizing whatever current year information is available to support their transfer prices.

**d) Practical approaches to address information deficiencies**

Economic circumstances caused by the pandemic are continuing and evolving over time, taxpayers may encounter difficulties in determining arm's length conditions due to the lag in time between the occurrence of controlled transactions and availability of information regarding contemporaneous uncontrolled transactions. 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.

The guidance provides certain pragmatic approaches:

i. *Use of reasonable commercial judgment supplemented by contemporaneous information:* Both taxpayers and tax administrations need to appreciate that transfer pricing is not an exact science. More often than not, it requires exercise of judgement. Taxpayers undertaking comparability analysis need to undertake reasonable due diligence in evaluating the impact of COVID-19 on specific facts.

ii. *Use of arm's length outcome testing approach:* Considering the difficulty that may arise in obtaining comparable information, tax administrations could consider allowing use of information that becomes available after close of tax year or allow flexibility to make amendments in tax returns enabling taxpayers to set transfer prices on arm's length basis.

iii. Use of more than one transfer pricing method: Arm's length principle in general does not require application of more than one method. However, under specific circumstances like COVID-19, use of more than one transfer pricing method may be useful to corroborate the arm's length price of a controlled transaction.

**e) Use of data from global financial crisis**

Given the unique and unprecedented nature of the pandemic, comparability analysis based on financial information/ performance from the global financial crises would raise significant concerns.

**f) Period of data to be used to evaluate arm's length price**

Use of multiple year data or multiple year averages is advocated in OECD TPG. However, considering the current challenges of different economic conditions, it may be apt to have separate testing of the pre- and post COVID-19 periods, as long as information on uncontrolled comparables can be sourced over a similar period, in a consistent manner. 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 period. Further, while undertaking a benchmark analysis, care should be taken in verifying that comparable enterprises have faced similar restrictions or conditions. Otherwise, it might be necessary to adjust the period over which the comparison is performed (e.g. excluding the economic data corresponding to the months where the taxpayer was unable to operate).

**g) Appropriateness of price adjustment mechanisms**

Depending upon domestic law provisions, use of price adjustments in subsequent periods can be allowed by tax administrations. However, potential VAT/GST/ Customs duty implications may need evaluation.

**h) Actions to evaluate the set of comparables used**

Where taxpayers roll forward an existing set of comparables, it may be necessary to review the suitability of these existing comparables and potentially in some cases, it may be useful to revise the set, based on updated search criteria.

**i) Use of loss-making comparable companies**

Companies that satisfy the comparability criteria need not be rejected solely because they suffer losses in periods affected by COVID-19[3].

[3] Also refer para 3.64 and 3.65 of OECD TPG

## Losses and allocation of COVID-19 specific costs

### a) Can entities operating under limited risk arrangements incur losses

Functions performed, assets utilized and risk assumed by limited risk entities differ on case-to-case basis and thus having a general rule in relation to profit or loss situation of such entities is difficult. OECD TPG however maintains that simple or low risk functions can incur losses[4] At arm's length, allocation of risk between the parties to an arrangement affect how profits or losses are allocated. Thus, in determining whether a limited risk entity incurs losses, analysis of risk assumed becomes of paramount importance. When considering risk assumed by a party to controlled transaction, the tax administrations should carefully consider the commercial rational for purported change in the risk profile pre and post COVID-19. 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 inconsistent with the accurate delineation of the transaction.

### b) Circumstances under which, inter-company arrangements may be modified

MNEs may consider revising terms of their inter-company agreement in response to COVID-19 pandemic. This, however, should be consistent with the behavior of the independent third parties operating in similar economic environment. Determining whether a renegotiation of a commercial arrangement represents the best interests of the parties to a transaction requires careful consideration of their options realistically available and long run effects on profit potential.

In absence of evidence that independent parties in comparable circumstances would have revised their agreements, modification of existing intercompany arrangements is not considered as consistent with the arm's length principle.

### c) Allocation of operational and exceptional costs

To determine which of the group entity should bear exceptional costs, it is first necessary to accurately delineate the inter-company transaction. This would indicate who has the responsibility for performing activities related to the relevant costs and who assumes risks related to these activities. Exceptional cost may be passed on to the entities that assume the risk.

[4] OECD TPG in para 3.64 states that "Simple or low risk functions in particular are not expected to generate losses for long period of time"

Costs related to long-term or permanent changes in the business (such as teleworking arrangements, which may become the new normal going forward) or that relate to substitutes to the means of conducting business would likely be treated as operating costs.

### d) How to account for exceptional cost in a comparability analysis

In general, exceptional costs should be excluded from net profit indicator except when those costs relate to controlled transaction as accurately delineated. The exclusion of exceptional costs must be done consistently at the level of tested party and the comparables.

While determining cost basis, it is important to consider whether the basis should include or exclude exceptional costs that relate to controlled transactions. If included in the cost basis, whether such cost should or should not be treated as pass-through cost on which no profit element should be attributed.

If exceptional costs are accounted for as either operating or non-operating items by different taxpayers in different transactions, then comparability adjustments may be necessary. There can also be differences in in whether the COVID-19 related costs are taken into account above or below the gross profit line. Thus, adjustments for accounting consistency may be required to improve comparability.

### e) Exercise of Force Majeure

Whether COVID-19 related disruption qualifies as a force majeure event in a particular case will depend on the plain language of the force majeure provision. It is relevant to analyze the conduct of the parties in reviewing an existing force majeure provision. Accurate delineation of the controlled transaction and an analysis of the economic circumstance of the commercial arrangement will determine whether, at arm's length, force majeure clause can be invoked.

Tax administrations should carefully review the assertions made by taxpayers in seeking force majeure, in light of the accurately delineated transaction and the economically relevant circumstances of the transaction.

## Government Assistance Programmes

### a) Government assistance - whether an economically relevant characteristic

The effect of government assistance to taxpayers needs to be evaluated (a) when accurately delineating the controlled transaction and (b) performing comparability analysis. Based on facts, receipt of government assistance may or may not be an economically relevant characteristic. For instance, receipt of wage subsidy, a government debt-guarantee or short-term liquidity support may be economically relevant when evaluating controlled transaction. In such circumstances, the receipt of government assistance may have a direct impact on the controlled transactions and comparable transactions between independent parties and their prices. In other situations, the receipt of government assistance may be less economically relevant.

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.

**b) Guidance on local market features relevant when analyzing transfer pricing implication of government assistance**

Analysis of the receipt of government assistance as a local market feature may help to inform whether the receipt affects the price of a controlled transaction. The analysis of the implications of the receipt of government assistance would need to consider the following factors:

- 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; and,
- 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.

**c) Government assistance – does it affect the price of controlled transaction**

The economically relevant characteristics of the accurately delineated controlled transaction will help in determining the potential effect of the receipt of government assistance on the pricing of the controlled transaction, if any.

Analysis of the effect of government assistance on the price of a controlled transaction will take into account the allocation of the economically significant risks under the accurate delineation of the controlled transaction, the impact of the pandemic on the outcome of the economically significant risks, and the linkage between the type of government assistance and those risks.

**d) Effect of government assistance on allocation of risk**

Although the receipt of government assistance may reduce the quantitative negative impact of a risk, it does not change the allocation of risk in a controlled transaction for transfer pricing purposes.

**e) Effect of government assistance on comparability analysis**

Comparability of open market transactions or enterprises may be influenced by the receipt of government assistance, affecting both 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 most reliable approach in identifying reliable comparables will be to refer, where possible, to data regarding comparable uncontrolled transactions in the same or comparable geographic market between independent enterprises performing similar functions, assuming similar risks, and using similar assets.

When applying one-sided method such as RPM or the CPLM, or the TNMM, the accounting treatment of the government assistance in both the tested party and any comparable may need to be specifically identified, especially when the tested party and the comparables apply different accounting standards. A comparability adjustment may be required, where accounting treatments of the same type of assistance differ between the tested party and the comparable.

## Advance Pricing Agreements

**a) Impact of COVID-19 on existing APAs**

i) *Are existing APAs binding in light of changes in economic conditions* - Taxpayers and tax administrations cannot automatically disregard or alter the terms of existing APAs due to the change in economic circumstances. APAs and their terms are expected to be respected, maintained and upheld, unless condition leading to cancelation or revision of APA has occurred.

ii) *Does change in economic conditions constitute a breach of a critical assumption* - Mere change in business results owing to COVID-19 in general would not result in breach of a critical assumption. In case a breach has occurred, the tax administrations should evaluate the extent of deviation in the agreed parameters and the new circumstances that transpired owing to COVID-19. Where the tax administration establish that the critical assumptions have not been breached, the existing APA must continue to be respected. Where taxpayers have concerns, they should approach the relevant tax administration in a transparent way to discuss their concerns.

iii) *How should tax administrations respond to failure to meet critical assumptions* - Domestic law or procedural provisions may prescribe procedures to follow, or describe the consequences that will arise, in situations where there is a failure to fulfil critical assumptions. In case taxpayers face challenges adhering to the terms of existing APAs under the economic circumstances resulting from COVID-19, they should adopt a collaborative and transparent approach by engaging in discussion with tax administrations.

- *Revision* of APA would be the appropriate response where there has been a material change in conditions noted in a critical assumption and both, tax administration and taxpayer, agree on how to revise the APA.

- *Cancelation* of APA may occur where (i) there is a material breach of critical assumption as a result of change in economic circumstances, or (ii) the taxpayer fails to materially comply with any term of the APA. Cancellation would not be automatic and the tax administration may waive cancellation under certain circumstances. Cancellation would have the effect from an agreed date.

- *Revocation* of APA occurs (i) where there is misrepresentation, mistake or omission, or (ii) the taxpayer fails to materially comply with a fundamental term of APA. Circumstances caused due to COVID-19 should not be a cause for revocation.

iv) *When should taxpayers notify tax administrations of failure to meet critical assumptions* - Where a material change has occurred, taxpayers should notify the tax administration as soon as practicable after the change occurs. Early notification is encouraged.

v) *How should taxpayers document failure to meet critical assumptions* – It is important that taxpayers collect and provide tax administrations with relevant supporting documentation. These could include, for example – forecast and actual business segment profits for the impacted period; modified or new inter-company agreements; narrative explaining anticipated effects of the current economic conditions and mitigation steps; detailed P&L analysis with reasons; information about third party behavior; etc.

vi) *How should tax administrations respond to non-compliance* - When considering the consequences of non-compliance with terms and conditions of an existing APA, tax administrations should adopt a similar approach to situations where there is a failure to meet critical assumptions. However, tax administrations are likely to respond differently to the failure to comply with the terms and conditions of an existing APA, than to the failure to meet critical assumptions.

**b) Impact of COVID-19 on APAs under negotiation**

Taxpayers and tax administrations are encouraged to be flexible and adopt a collaborative approach while negotiating APAs that intend to cover the impacted period. Options that taxpayers and tax administrations can consider while negotiating APAs - agree for different APA terms for COVID-19 period and post COVID-19 period; APA for whole period with allowance for retrospective amendments for COVID-19 impacts; extended APA period to mitigate short term impact of COVID-19; and use of term test throughout the APA period.

## Our comments

While MNEs with varied commercial arrangements between related parties are still grappling with ascertaining the impact of COVID-19 on business for the past 9 months, with Q4 of India fiscal year 2020-21 on the anvil, this guidance from OECD is directional and timely. The guidance, taking cues from the OECD TPG, provides a broad-based view on various practical issues that MNEs are dealing with and need answers to.

In recent years, tax administration in India has made efforts to align India regulations with global standards. India being a member to the inclusive framework on BEPS, acceptance to the suggestions in the guidance during transfer pricing audit proceedings would help serve equitable interests of all stakeholders.

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