The impact of Covid-19 on transfer pricing

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Introduction

The Covid-19 pandemic has far-reaching consequences, and will have serious implications on transfer pricing for many multinational enterprises (“MNEs”). This is particularly challenging for businesses to manage due to the current lack of guidance from the OECD.

With this guide, we review the impact of Covid-19 on:

- Transfer pricing treatment of government aid;
- Comparable searches;
- Low-risks entities (“LREs”);
- Advance pricing agreements (“APAs”).

This will be updated as new OECD guidance is published.

If you have any questions, please don’t hesitate to get in touch with any member of Mazars’ transfer pricing team.

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“Determining the impact of the Covid-19 risk on MNEs and our reputation is crucial to providing the best advice.”

Transfer pricing treatment of government aid

Impact of Covid-19 government aid on transfer prices

Government aid is typically provided to MNEs under exceptional or extraordinary circumstances, with the primary objective of either supplementing, augmenting or stabilising trading receipts and/or defraying operating expenses. This aid mainly took the form of:

- Employment protection aid (e.g. partial unemployment);
- Financial support (e.g. low interest, state guarantee programme for banking loans).

OECD's position

Paragraph 1.132 of the 2017 OECD Guidelines:

"There are some circumstances in which a taxpayer will consider that an arm's length price must be adjusted to account for government interventions such as price controls (even price cuts), interest rate controls, controls over payments for services or management fees, controls over the payment of royalties, subsidies to particular sectors, exchange control, anti-dumping duties, or exchange rate policy. As a general rule, these government interventions should be treated as conditions of the market in the particular country, and in the ordinary course they should be taken into account in evaluating the taxpayer's transfer price in that market."

A clear OECD position regarding government aid should be issued by the end of 2020.

Mazars' view

Generally, government aid may be treated as a market or economic condition and therefore reduce MNEs' cost basis when determining transfer prices. Even though this position is considered relevant for some jurisdictions(1) the local rules/practices may vary from country to country. Certain local tax authorities may not allow an entity's costs to be reduced by the government aid amount when determining its related-party remuneration(2). Therefore, consideration of the specific rules of a particular country and the specific functional/ economic analysis is important.

"In most countries, government aid paid to MNEs can reduce their cost basis, used todetermine the remuneration of an entity."

(1) For example: in France, employment protection aid granted to MNEs reduces the cost basis used to determine the remuneration of the local entities; and in the UK, aid was specifically designed to cover the cost of furloughed staff (i.e. staff withdrawn from contributing to economic activity).
(2) For example: the tax authorities in India, Canada and Senegal have clearly indicated that any subsidies granted to a local entity must not result in a reduction of the remuneration of said entity.

Impact of Covid-19 on comparable search

Impact of Covid-19 on comparable studies

It may not be possible to determine the arm's length nature of a controlled transaction occurring in 2020 based on comparable companies' 2017-2019 financial data, as this data will not reflect the financial consequences of the Covid-19 crisis.

OECD's position

Paragraph 3.68 of the 2017 OECD Guidelines:

"In principle [...] conditions of comparable controlled transactions undertaken or carried out in the same period of time as the controlled transaction [...] is expected to be the most reliable [...]

Paragraph 3.74 of the 2017 OECD Guidelines:

"multiple year data should be used where they add value to the transfer pricing analysis [...]"

Paragraph 3.77 of the 2017 OECD Guidelines:

"Multiple year data will also be useful in providing information about the relevant business and product life cycles of the comparables. [...] The data from earlier years may show whether the independent enterprise engaged in a comparable transaction was affected by comparable economic conditions in a comparable manner, or whether different conditions in an earlier year materially affected its price or profit so that it should not be used as a comparable."

Mazars' view

For those companies heavily impacted by the Covid-19 crisis, comparable company searches performed in 2019 or before should be reviewed for continued comparability. Because 2020 financial data will generally only be available in commercial databases by the middle or end of 2021, this gap period poses a potential issue for transfer pricing analyses. To address this situation, it may be appropriate to take one or more of the following approaches: (3)

- If the impact of the Covid-19 crisis on the tested party's results can be determined, adjust the comparable companies' prior-year financial data based on this impact. Segmenting data within a financial period may be helpful (e.g. pre- and post-Covid-19 affected periods within an accounting period).
- Make adjustments to comparable company financial data based on the effects sustained during prior crises (e.g. the financial crisis of 2008 and the Asian crisis of 1997).
- Performing an analysis that covers more than the typical three years may be a practical rather than a wholly technical solution depending on the facts and how significantly the tested party and wider group were affected.
- In all cases, consider a new search for comparable companies as the companies in a prior year set may no longer be comparable. New search criteria would select only those companies facing similar macro-economic conditions as the tested party. Certain other criteria typically used in a search (e.g. rejection of loss-making companies) may need to be relaxed and the transfer pricing method reviewed (e.g. traditional vs. transactional).
- Undertake a final further review once comparable data becomes available and consider "best estimate" disclosures when filing tax returns based on the potential solutions mentioned above. Refiling of tax returns should perhaps only be considered if the "best estimate" approach varies significantly as compared to the final 2020 comparables.

(3) Please note that these adjustments may lead to an arm's length loss.

Key points:

– Adjust the financials of the comparables;

– Perform a second TP adjustment in 2021;

– Use 2020 financial data of the comparable companies to test FY2020 financials.

Impact of Covid-19 on low-risks entities ("LREs")

Impact of Covid-19 on the profitability of LREs

Due to the adverse economic conditions, low-risk distributors, manufacturers and service providers may suffer from losses, especially if they operate in an industry heavily impacted by the Covid-19 crisis.(4)

OECD's position

Paragraph 1.60 of the 2017 OECD Guidelines:

"Analyse [...] whether the party assuming a risk [contractually] exercises control over the risk and has the financial capacity to assume the risk. Where the party assuming the risk [contractually] does not control the risk or does not have the financial capital to assume the risk, apply the guidance on allocating the risk.

Paragraph 3.65 of the 2017 OECD Guidelines:

"Generally speaking, a loss-making uncontrolled transaction should trigger further investigation in order to establish whether or not it can be a comparable. Circumstances in which loss-making transactions/enterprises should be excluded from the list of comparables include cases where losses do not reflect normal business conditions, and where the losses incurred by third parties reflect a level of risks that is not comparable to the one assumed by the taxpayer in its controlled transactions. Loss-making comparables that satisfy the comparability analysis should not however be rejected on the sole basis that they suffer losses."

(4) For example, the automotive, transportation, hospitality and banking industries.
(5) For example, in Senegal a loss-making LRE is not accepted.

Mazars' view

LREs operating in an industry negatively impacted by the Covid-19 crisis may be in a loss-position in 2020. Nevertheless:

- LREs could be treated as risk bearing entities, particularly if they are distributors (typically exercising some control over local market risk) during the current crisis, especially in cases where it can be shown that the results of their related-party transactions did not cause their losses.
- Each industry, market, and company may be affected differently by a crisis, and as such, a thorough review of the MNE's specific facts and circumstances is required before the characterisation of an entity or transfer pricing analysis is revised.
- If any revisions are made to an analysis or any atypical position taken (e.g. a loss-split), the impact of the Covid-19 crisis and all facts necessary for justification should be well documented.

It is advisable to properly review functional contributions to market risk control in particular and the regulations and tax authority guidance in each relevant country, as the transfer pricing treatment of LREs and acceptability of losses varies.(5)

"Low risk entities are not risk free. In FY2020, low risk entities could be permitted to realise operating losses based on the particular facts."

Impact of Covid-19 on advance pricing agreements

Impact of Covid-19 on APAs

MNEs may need to consider revising the terms of, or cancelling, any advance pricing agreements ("APAs") that were entered into before 2020.

OECD's position

Paragraphs 4.134 and 4.146 of the 2017 OECD Guidelines:

"An advance pricing arrangement (APA) is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria [...] for the determination of the transfer pricing for those transactions over a fixed period of time Ongoing APAs procedures."

Revision or cancellation should be granted to taxpayers "when business operations change significantly, or when uncontrolled economic circumstances [...] critically affect the reliability of the methodology in a manner that independent enterprises would consider significant."

Mazars' view

New and ongoing APAs procedures

If the Covid-19 crisis leads to a situation where the proposed transfer pricing methodology appears to be irrelevant for 2020 and potentially onwards, we advise MNEs to contact the competent authorities.

Concluded APAs

Companies should determine whether to maintain, revise, or cancel existing APAs.

If necessary, companies should communicate with the competent authorities and determine whether they can renegotiate the critical assumptions agreed upon in their existing APAs.

Current negotiations for new APAs may need to be suspended or potentially revised to account for the effects of the current crisis.

"MNEs should consider revising ongoing APAs or revoking existing APAs."

Key takeaways

Issue	Mazars' view
Industry analysis	MNEs should document the impact of the Covid-19 crisis on their industry and market.
Documentation of the impact(s)	MNEs should compare the budgeted financial results to the actual results for each legal entity in the group. The impacts of Covid-19 and any other differences should be thoroughly documented.
Documentation of government aid	MNEs should document any government aid received and determine its treatment for transfer pricing purposes.
Functional analysis	MNEs should review the functional analysis section in their transfer pricing documentation and update it to address the effects of Covid-19, including which affiliate made decisions concerning Covid-19 risk management.
Contractual arrangements	MNEs should review and modify their intercompany agreements, if necessary, to address any changes to the facts and circumstances due to the Covid-19 crisis.
Transfer pricing adjustments	MNEs should assess the need for transfer pricing adjustments to their financial statements due to the Covid-19 crisis. If needed, these adjustments should be performed before 31/12/2020. Potential further adjustments may be considered in 2021, if necessary once reliable comparable data become available.
Treatment of LREs	Limited risk entities in a stable market environment may not be regarded as LREs in a Covid-19 environment. Losses could conceptually arise therefore in these entities during Covid-19.

"The Covid-19 crisis has an impact on transfer pricing documentation that requires a case-by-case analysis."

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This document aims to analyse the impact of Covid-19 on transfer pricing issues and has been prepared for general information purposes. This document should be perceived as a contribution to the ongoing discussion, and should not be used by any company without a in-depth analysis of its transfer pricing policy and circumstances. It is not intended to be relied upon as tax or other professional advice.

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