



[Covid-19 & Transfer pricing]

Insights into the adjustments of the comparable studies

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The recent publication of the Organisation for Economic Co-operation and Development (OECD) provides us with generic guidance on how to handle comparability analysis during the pandemic period. However, the lack of practical guidelines from the OECD forces us to ask ourselves what approach should be taken.

Our first observation is that the OECD guidance will lead to an increase of the documentation requirements. This is not a surprise as, in ordinary circumstances, changes in the business and market environment must be detailed in the transfer pricing documentation. However, the OECD provides us with a list of information which can be studied to support the impact the Covid-19 pandemic on the controlled transactions.

These insights and the OECD guidance will be applicable in, at least, the two years following the Covid-19 pandemic.

According to the OECD guidance, the first step would consist in estimating the effect of the pandemic on the controlled transactions by analyzing several sources of information. Thus, companies are recommended to further analyze and document their economic situation before performing any comparability analysis and we recommend performing an update of the functional analysis.

Indeed, the pandemic has affected multinational enterprises (MNEs) that have been forced to rethink and optimize their value chain. Consequently, it is necessary to carry out a new functional analysis that will take into account the operational reality of each group entity during this exceptional period. This step is crucial as it allows to set an adequate arm's length remuneration in the light of the actual functional profile of the entities. Accordingly, either a new transfer pricing method or only adjustments to the comparability studies can be considered.

This article provides insights about the adjustments to the comparable studies dealt with by the Mazars worldwide Transfer Pricing (TP) teams in 2020 in order to reflect the impact of the Covid-19 pandemic.



Comparability adjustments performed by the TP teams of Mazars in 2020

The Mazars TP teams performed two categories of comparability adjustments to reflect the new economic reality:

- Micro-economic adjustments; and
- Macro-economic adjustments.

We would suggest using these adjustments simultaneously with macro-economic adjustments being used as a corroborative approach. This will depend, among other things, on the characteristics of the transaction being analyzed and the availability of data.

Our experiences presented here below are based on a case by case analysis and might not be applicable for all groups involved in the studied markets.

Micro-economic adjustments

These micro-economic adjustments have been performed for clients which were using the Transactional Net Margin Method (TNMM) or the Cost Plus Method (CPM). They have been based upon the analysis of the revenue and the costs fluctuations of these clients in 2020 versus 2019.

These adjustments consisted in revising the financials of the comparable companies based upon the actual revenue and costs fluctuations of the tested party.

Experience of the French TP team

In France, the Mazars TP team has assisted automotive and aircraft suppliers as well as car ferries' companies. The impact of the crisis has been very different in these three sectors.

The automotive suppliers have all faced a decline of their revenue, which has been different from one country/subsidiary to another; also depending on the pieces manufactured and the OEMs delivered. Overall, these companies have made less revenue in 2020 than in 2019. Moreover, they have applied for partial

employment schemes in France and abroad. We have consequently adjusted the financials of their comparable companies to reflect the reduction of their revenue as well as their costs.

With regards to the aircraft suppliers, they generally have long term agreements which have not been renegotiated to date by the aircraft manufacturers. For these companies, the impact of the Covid-19 pandemic has been a postponement of their revenue but no loss of revenue to date. Since our clients did not face revenue decline and did not apply for partial employment schemes, we have not adjusted their comparable studies.

With regards to the car ferries companies, they have faced significant decrease of their revenue as a result of the lockdowns and quarantines imposed by local governments. For these companies, we also adjusted the revenue and costs of comparable companies when the tested entity benefited for partial employment schemes.

Experience of the Hungarian TP team

The Mazars Hungary TP team assisted a Group in the construction sector specifically regarding intragroup transportation service. The issue dealt by the Hungarian TP team was whether a roll-forward of the financial data of comparable companies was sufficient, or whether a new benchmark was necessary and what adjustments should be performed.

During the benchmarking analysis, the Hungarian TP team followed the OECD guidance. First, based on the functional analysis, it was identified that the transportation company was not acting as a limited risk entity anymore.

Thus, the Hungarian TP team considered:

- the possibility to perform a new benchmark focusing on Hungary;
- the macro economic data available on the Central Statistical Office regarding the output changes in volume of the construction industry between 2019 and 2020. The construction industry was considered as the

relevant industry instead of transportation industry in general because the tested company only serves this sector. Indeed, changes in the activity of the construction industry have huge impact on the number of orders of the tested company; and

- the significant decrease in fuel prices in 2020 compared to 2019. Such statistics were available on the Hungarian Tax Authority's website. This decrease had immediate impact on the variable costs of the transportation companies and a delayed impact on their revenues due to fuel price indexes generally applied by parties of the industry.

Finally, adjustments were performed on the data of the comparable companies as their latest publicly available data were from 2019.

Experience of the Singaporean TP team

The Mazars Singapore TP team has witnessed a general decline in the revenues and margins of clients (varying across different industries) who were operating at a fixed or pre-agreed remuneration-based model i.e., entities operating at the lower end of the MNE Group value chain. As the current pandemic majorly impacted the working capital cycles and the risk profile of such entities, the Singapore TP team performed detailed comparability adjustments towards varying levels of receivables, payables and inventory along with risk adjustments.

Experience of the US TP team

The Mazars US TP team has assisted clients who have experienced unusual losses as well as clients who have earned higher than normal profits during the pandemic. The approaches used to analyze each of these clients' results has been quite different.

The US TP team has typically tried to adjust the tested party's data to account for pandemic related costs and/or reduced sales caused by supply chain issues or reduced demand. However, the necessary data for this approach is not always available. So, in some cases, the US TP team has chosen to forgo adjustments and search for an altogether new comparable company set. This approach has allowed to account for comparability differences that were not material during normal years. When determining comparability, the US TP team has added relative sales decline and the ratio of variable to fixed costs to current set of comparability criteria.

Additionally, the US TP team has considered adjusting comparable company data based on the tested party's fixed cost to sales ratio. In several cases, we have adjusted the time period and frequency of the data used instead of adjusting the actual data itself. In one analysis, we chose to use quarterly data and tested the pandemic period alone.

Regardless of the adjustment or approach taken, the US TP team believes that having appropriate TP documentation is critical. Moreover, changes in the TP methodology used, analysis steps taken, and adjustments made should be thoroughly explained, and sufficient information should be provided to adequately support the rationale for any TP positions taken.



Macro-economic adjustments

In certain case, there is correlation between macroeconomic factors and companies' performance. An adjustment based on these data should be performed, however many tax authorities will be more inclined to accept this method as corroborative approach.

These adjustments involve revising the financials of the comparable companies and/or the tested party based upon the average revenue and costs fluctuations of their market (industry or geography). A more targeted approach may also base the adjustment on the specific underlying factors that caused the revenue and cost fluctuations, such as timing differences or government programs.

Experience of the China/Hong-Kong TP team

The Mazars China and Hong Kong TP teams differentiated the industries which were significantly impacted by the Covid-19 from the other ones. For the industries which were severely impacted, macro-economic adjustments were performed.

Experience of the French TP team

The Mazars France TP team has used this method as a corroborative approach. Indeed, statistical methods are not necessarily accepted by the French tax authorities such as, for example, for the calculation of provisions (e.g. for bad debts).

In this context, the French TP team analyzed whether the impact of the pandemic on each group entities was similar to the average impact on entities operating in this market.

And, in the event of a significant difference, it was necessary to identify and document the exogenous and/or endogenous factors causing this difference.



Experience of the Italian TP team

Among the different approaches that may be adopted to evaluate the effect of the economic downturn on the business profitability, support the performance of a comparability analysis, and ascertain the arm's length nature of the transfer pricing policy implemented for FY 2020, the Mazars Italy TP team has mainly focused on the use of macroeconomic indicators and a statistical method like the regression analysis.

The Italian TP team has estimated the impact of the economic downturn on different industries like, for example:

- Automotive,
- Textiles, and
- Construction.

The Italian TP team has first identified a broad sample of independent routine entities operating in those industries and analyzed the profitability of the entities across a relevant time period and examined its variation.

Then the Team has used the statistical method of the linear regression analysis to estimate the statistical significance and quantitative importance of the relationship (correlation) between the change in the entities' profitability and the change in the GDP.

Given the statistically significant and quantitatively significant relationship (correlation) observed in the analysis, the Team has used the regression coefficient, which provides an estimation of the change in the routine entities' profitability compared to change in the level of the GDP, to make comparability adjustments to the data of the comparable companies to determine the arm's length range to be considered for 2020.

Other considerations related to comparability adjustment

The OECD Guidance raises other issues under the principle of comparability. Indeed, taking into account the impact of the crisis in order to produce analyses that are consistent with the actual condition of the market can raise concerns about the availability of data and the geographical areas to be used for such analyses.

2021 TP adjustments relating to FY2020

The OECD appreciates that taxpayers may encounter difficulties in determining arm's length conditions as a result of the lag in time between the occurrence of controlled transactions and the availability of information regarding contemporaneous uncontrolled transactions.

The timing issue results in the fact that comparable companies' 2017-2019 financial data do not reflect the financial consequences of the Covid-19 crisis in the case of the application of the TNMM.

Since the FY2020 financials of the comparable companies will not be available until Q3 or Q4 2021, the Mazars TP teams are planning to look at these financial data in 2021 and will assess the need for a further adjustment in 2021, relating to the FY2020.

Related to these information deficiencies, the OECD asks Tax Authorities to adopt a flexible approach in the tax audits related to the impacted years. It begs the question as to "how the said Tax Authorities will react?"

Relevance of using separate testing period

The OECD explains that the use of multiple-year data and multiple-year averages for comparability analyses may have certain advantages in ordinary circumstances. It recognises that this would not be the case in this pandemic situation.

Thus, if divergent economic conditions during and post-pandemic period are evidenced, it may

be appropriate to have separate testing periods for the duration of the pandemic and for the immediately following years, when certain material effects of the pandemic were most evident. However, the OECD publication does not provide clues on how find and use data.

The exceptional situation which occurred in 2020 allows us to suggest MNEs to apply an annual data approach for FY2020 economic analysis.

In the same way, a 2-years approach might be considered for FY2021 economic analysis if the pandemic has a similar impact on 2020 and 2021.

Finally, it is to be noted that when the situation will go back to "normal", it will not be possible either to apply a multiple-year approach since data from the years impacted by the Covid-19 crisis should be excluded from the comparable studies, since they won't reflect normal economic situation.

Relevance of using country data instead of Regional data

The COVID-19 has impacted differently each region, and within a region such as the EEU, the impact of COVID-19 has been different by country. Thus, each country in the EEU had different strategies concerning lockdowns and quarantines.

However, one need to bear in mind that a country approach vs. regional approach for comparable studies increases the risk of a lack of comparable companies on the market and increases the need for a more flexible approach on the comparability of products/services.

To conclude, the Covid-19 pandemic will increase the burden of the proof of the MNEs, their risk of double taxation, their work to prepare their TP documentation as well as the cost of the said documentation.

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