Tax - Breaking News

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Consistent with our commitment to keep you updated on the most significant tax developments, we summarize below the "Guidance on the transfer pricing implications of the COVID-19 pandemic" (Covid Guidance"), released by the Organization for Economic Co-operation and Development ("OECD"), on 18th December 2020.

The report provides clarifying comments and support both to taxpayers and tax administrations on the application of the existing OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 ("OECD TPG") for the period impacted by COVID-19. The Covid Guidance represents a consensus view of the 137 members of the Inclusive Framework. The OECD reaffirms its view that the Covid Guidance should not be regarded as an expansion or revision of the OECD TPG.

Overview of the Covid Guidance

The Covid Guidance focuses on four priority areas where the challenges posed by COVID-19 are most significant:

1. Comparability Analysis
2. Losses and the allocation of COVID-19 specific costs
3. Government assistance programs
4. Advance Pricing Agreements (APAs)

We present below the main points of the Covid Guidance for each one of these areas.

Comparability analysis

The Covid Guidance recognizes that COVID-19 has created unique challenges for performing comparability analyses. Most notable complexities exist in the update of comparability analyses. In particular, when looking to account for current economic circumstances and any related changes in business strategies.

What are the available sources of contemporaneous information to support the performance of a FY2020 comparability analysis?

The report outlines the sources of information that may be relevant when updating a comparability analysis, to reflect the effect of the COVID-19 pandemic on a controlled transaction. It also highlights that not every application of the TNMM will require contemporaneous FY2020 information. In this respect, one needs to consider if the tested party is insulated from risks related to the pandemic, both (a) contractually and (b) as per the conduct of parties.

The available sources of information identified are:

— An analysis of how sales volumes have changed during COVID-19, including whether the change is due to the use of other sales channels.

— An analysis of the change in capacity utilization of the MNE group and the controlled transaction, and/or transactions with independent parties.

— Specific information about incremental or exceptional costs borne by parties to the controlled transaction or by the MNE group as a whole.

— Extent to which government assistance has been received, quantifying the effect, identifying the type of the assistance and its accounting treatment, and whether it has affected the pricing of controlled transactions.

— Information from interim financial statements.

— Macroeconomic information including country-specific Gross Domestic Product data or industry indicators from central banks to the extent useful in understanding the context of the controlled transaction.

— Statistical methods such as regression or variance analyses that are used to predict the extent to which a certain variable will vary with reference to other variables under certain specific conditions.

— Comparison of internal budgeted data on sales, costs and profitability, compared to actual results.

- An analysis of the effects on profitability or on third party behavior observed in previous recessionary periods or using any data available in the current year.

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

A comparison of budgeted or forecasted financial data to those actually achieved could be used to support the arm's length nature of existing transfer pricing policies.

Under this "But for" the impact of COVID-19 approach, taxpayers would provide an analysis of the financial outcomes that could have been achieved if the COVID-19 pandemic had not occurred.

Use of corroborative transfer pricing method

The report mentions the use of more than one transfer pricing method to corroborate the arm's length pricing of a controlled transaction.

Rolling forward existing sets of comparables

Taxpayers looking to roll forward their existing set of comparables may need to relax certain comparability criteria in order to obtain reliable data.

Can loss making comparables be used?

Loss-making comparables that satisfy the overall comparability criteria, should not be rejected on the sole basis that they suffer losses in periods affected by the COVID-19 pandemic.

Losses and allocation of COVID-19-specific costs

The Covid Guidance outlines three main issues, related to the allocation of losses between associated entities:

- The allocation of risks between the parties to a transaction affects how profits / losses resulting from the transaction are allocated at arm's length.
- The allocation of exceptional, non-recurring operating costs resulting from COVID-19 should be in line with third party conduct.
- Associated parties may consider the option to apply force majeure clauses, revoke or otherwise revise their intercompany agreements.

Can "limited-risk" entities incur losses?

Taxpayers need to consider the specific facts and circumstances to determine if "limited-risk" entities could incur losses at arm's length. The report leaves open the possibility for "limited-risk" entities to incur losses in the short run although it mentions that a long period of sustained losses would not be expected for this type of entities.

The Covid Guidance provides illustrative examples of two "limited-risk" distributors; one that assumes limited inventory risk and some market risk, and another that does not assume any inventory or market risk. In the first case, the distributor may incur losses, if sales volumes are not enough to cover fixed costs. This, however, should not be the case in the second case.

The Covid Guidance specifically addresses the situation whereby changes in the allocation of risks, and subsequently of any resulting losses, take place during the COVID-19 pandemic. Taxpayer should avoid taking inconsistent positions pre-and post-pandemic. The report also mentions that taxpayer may need to consider OECD TPG, Chapter IX on business restructurings in preparing a supporting analysis as well as the accompanying documentation.

Under what circumstances may arrangements be modified to address the consequences of COVID-19?

The Covid Guidance acknowledges that independent parties would try to renegotiate existing contracts if it is in the interest of both parties to do so, such as in cases where one party would seek to secure the financial survival of a good client that would be able to generate large amount of business in the future. In a similar way, associated parties could also consider renegotiating their intercompany agreements. Yet, they should be able to demonstrate that:

- their conduct is in line with independent parties' conduct;
- they have considered their options realistically available, the long-run effects on the profit potential of the parties, and whether any indemnification may be required as a result of the renegotiation.

Taxpayers should properly document any contemplated modification of their intercompany arrangement, to support the arm's length character of the contemplated modification.

COVID-19 related exceptional, non-recurring operating costs

The Covid Guidance identifies two important implications resulting from the existence of exceptional, non-recurring operating costs, such as the costs related to the reconfiguration of workspaces, and the implementation of telework, IT infrastructure expenses related to test, track and trace workflow.

1. The arm's length allocation of these costs, will need to consider:

   - The entity responsible for the activities related to these costs, and the one that assumes the risks related to these activities;
   - Whether to charge out part of these costs to parties that benefit from the underlying product or service to which the cost relates;
   - How third parties would treat these costs.

   Taxpayers should also assess if certain exceptional or non-recurring operating costs relate to long-term or permanent changes in the way businesses operate, in which case they may not be treated as exceptional nor non-recurring costs.

2. The update of a comparability analysis for FY2020, which will need to consider the following three principles:

   – Exceptional costs should, in general, be excluded from the net profit indicator, consistently at the level of the tested party and the comparables, unless they relate to the controlled transaction as accurately delineated.

   – Where the tested party is remunerated based on its costs, it is important to determine if exceptional costs should be part of the cost basis. If so, it is important to consider if these costs would be treated as pass though or not.

   – Differences in the classification of these costs i.e. OPEX, non OPEX, between the tested party and the set of comparables, and the need for comparability adjustments.

Force Majeure

The Covid Guidance finally discusses the use of force majeure clauses and recognizes that like third parties, related parties may also consider applying force majeure clauses.

However, simply relying on a force majeure clause that is included in an intercompany contract will not be enough if parties do not consider the conduct of the parties and how the force majeure clause interacts with other clauses of the contract. Similarly, it cannot be automatically assumed in the absence of such a clause in the intercompany contract that a renegotiation with a potentially similar outcome at arm's length would be inappropriate.

Government Assistance

As per the Covid Guidance, COVID-19 related government assistance programs, such as grants, subsidies, forgivable loans, tax deductions, or investment allowances, may constitute an "economically relevant characteristic", which may thus have an impact on controlled transactions. Government assistance programs may have an impact both on (a) the pricing of a controlled transaction and (b) on comparability, when government support is provided to entities that form part of a set of comparables.

Impact on the pricing of a controlled transaction

The potential impact on the pricing will depend on:

— the economically relevant characteristics of the transaction, such as the specific characteristics of the government assistance, the allocation of the economically significant risks and the level of competition and demand within the relevant markets;

— an accurate delineation of the controlled transaction;

— and the performance of a comparability analysis.

In the absence of reliable third-party information on the allocation of government assistance, taxpayers are required to carefully assess the arm's length character of a contemplated sharing of government assistance.

Impact on comparability

The differences in government assistance programs and the effect of the pandemic across different markets, may affect the results of comparables in different ways.

Furthermore, differences in the accounting treatment of the government assistance received by both the tested party and any comparable party may need to be considered when applying one-sided transfer pricing methodologies such as the TNMM.

Advance Pricing Agreements

The Covid Guidance addresses the impact of COVID-19 on both existing APAs and APAs under negotiation.

Impact of the COVID-19 on existing APAs

The Covid Guidance notes that existing APAs and their terms should be respected, maintained, and upheld, unless a condition leading to the cancellation or revision of the APA (e.g., breach of critical assumptions) has occurred. The Covid Guidance provides guidance on each of the three potential outcomes of a breach of critical assumptions, i.e. revision, cancellation and revocation.

Impact of the COVID-19 on APAs under negotiation

The Covid Guidance encourages taxpayers and tax administrations to adopt a flexible and collaborative approach to determine how to account for the current economic conditions. Possible approaches include concluding:

— a short-period APA for the period affected by the COVID-19 and a separate APA for the post-COVID-19 period;

— a single APA for the whole period with a condition for retrospective amendments to address the impact of COVID-19, an extended APA period to mitigate the impact of the pandemic or use a cumulative or term test option throughout the APA period.

The Covid Guidance notes that despite potential challenges, the value of achieving advanced certainty and effective dispute prevention through APAs remains compelling.

KPMG Comments

— The Covid Guidance recognizes that the specific facts and circumstances will ultimately determine the appropriate arm's length response to the effects of the COVID-19 pandemic on any controlled transaction.

— Considering the differences in the facts and circumstances encountered by various taxpayers and the need for consensus from 137 countries, the Covid Guidance provides general principles for evaluating the arm's length response but does not provide specific solutions.

— It remains to be seen how the Greek tax authorities will incorporate the proposed guidance in their dealings with taxpayers. In future audits and risk assessments tax administrations are encouraged to consider the complexities resulting from the impact of the COVID-19 pandemic on controlled transactions in order to minimize future disputes.

- At the same time, taxpayers should be able to demonstrate to tax authorities their reasonable efforts in complying with the arm's length principle. Taxpayers are expected to undertake the appropriate due diligence and evaluate the impact of the COVID-19 pandemic in their transfer pricing policies and any contemplated adjustments and changes should be well-supported and documented.

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