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# OECD Guidance on the Transfer Pricing Implications for COVID-19 Pandemic

CA Divakar Vijayasarathy

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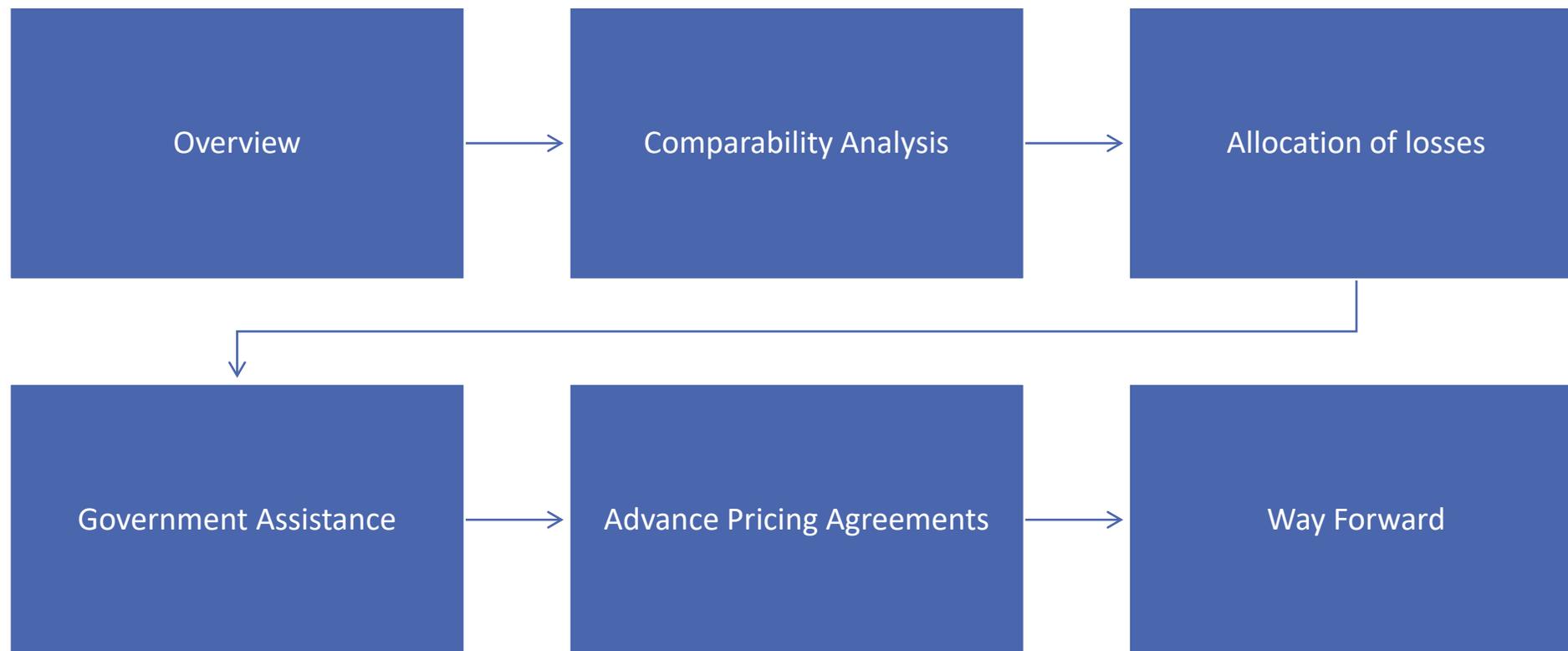
# Research Credits

Gracelin Lita  
CA Jugal Gala

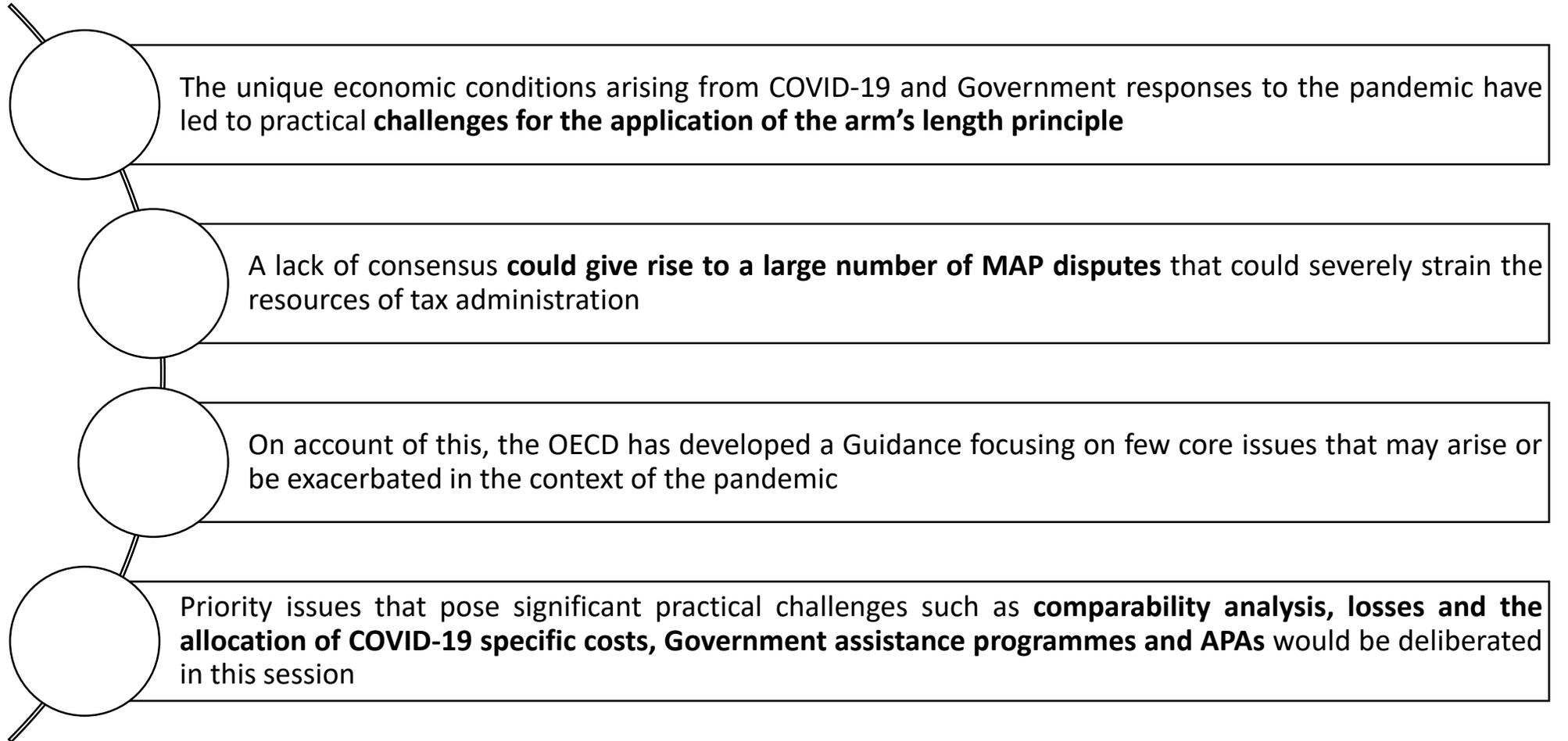
# Legends used

|      |   |
|------|---|
| AE   | Associated Enterprise                                 |
| ALP  | Arm's Length Principle                                |
| APA  | Advance Pricing Agreement                             |
| CPM  | Cost Plus Method                                      |
| MAP  | Mutual Agreement Procedure                            |
| OECD | Organisation for Economic Cooperation and Development |
| PPE  | Personal Protective Equipment                         |
| RPM  | Resale Price Method                                   |
| TNMM | Transactional Net Margin Method                       |
| TP   | Transfer Pricing                                      |

# Presentation Schema



# Overview



# Comparability Analysis

# The Issue

Significant impact on the **pricing of some transactions** between independent enterprises and may **reduce the reliance that can be placed on historical data** when performing comparability analyses

This may require taxpayers and tax administrations to consider practical approaches that can be adopted to address information deficiencies, such as comparability adjustments

It should be noted that such **challenges may vary depending on the impact of the pandemic on the economically relevant characteristics** of the accurately delineated transaction (such as a specific inter-company agreement)

# Sources to Support Comparability Analysis

Certain information (publicly available) that can be used to support comparability analysis by estimating the effect of the pandemic are as follows:

Analysis of changes in **sales volumes**

Change in **capacity utilisation**

Incremental or exceptional **costs borne by the parties involved**

Quantifying the effect of **Government assistance**

**Government interventions** that have affected the pricing

Interim Financial statements

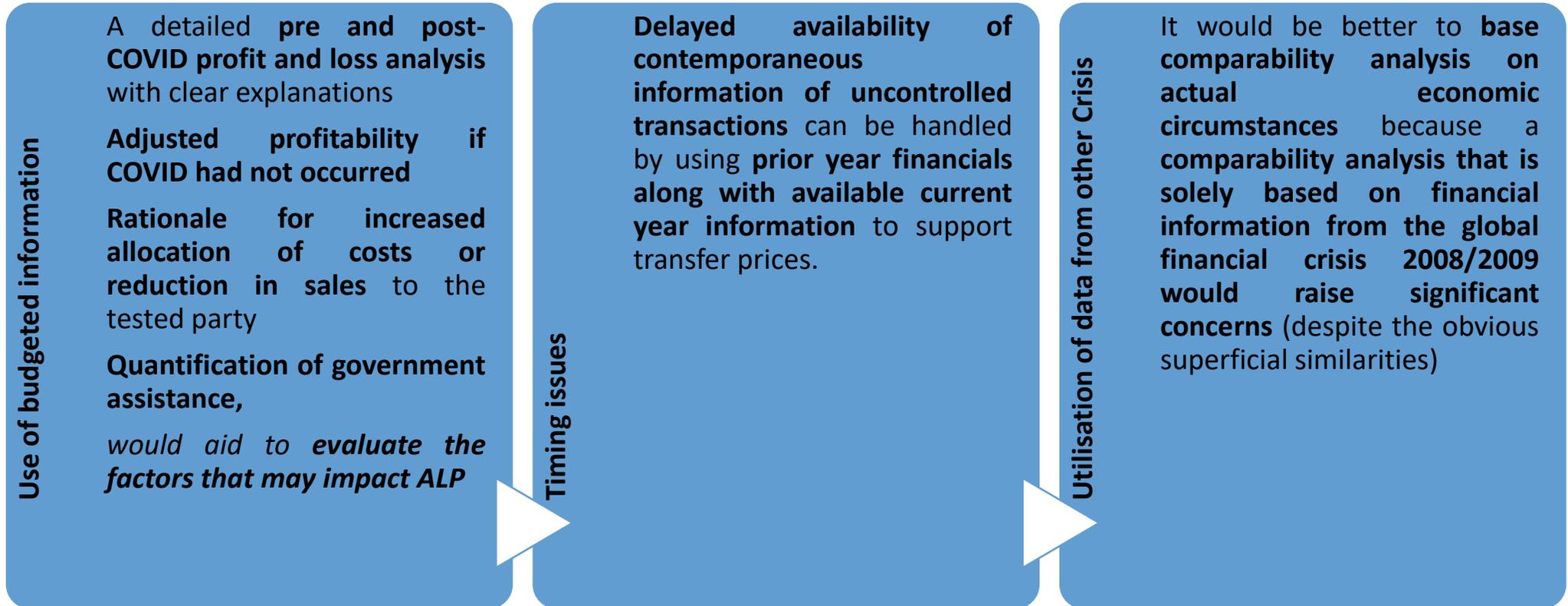
**Macroeconomic information**

**Statistical methods** such as regression analysis or variance analysis

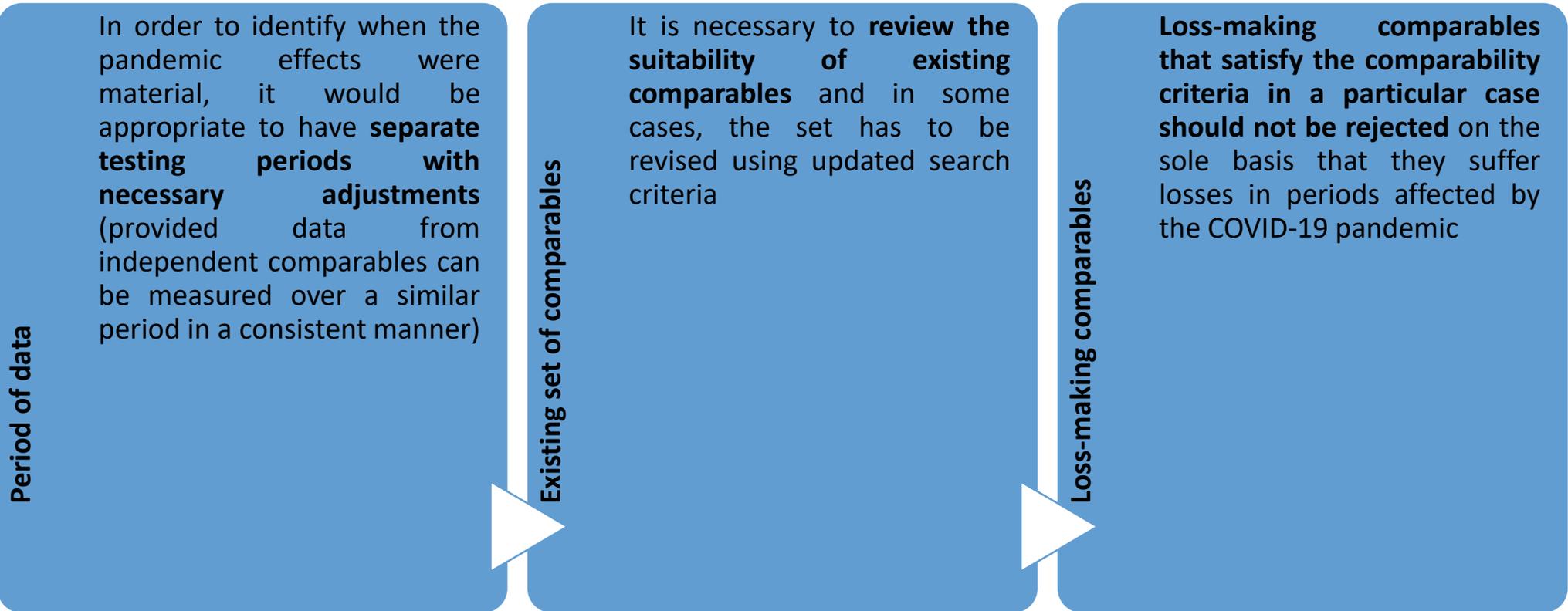
**Internal budgeted/forecasted data compared to actual results**

Analysis of **impact in previous recessionary periods.**

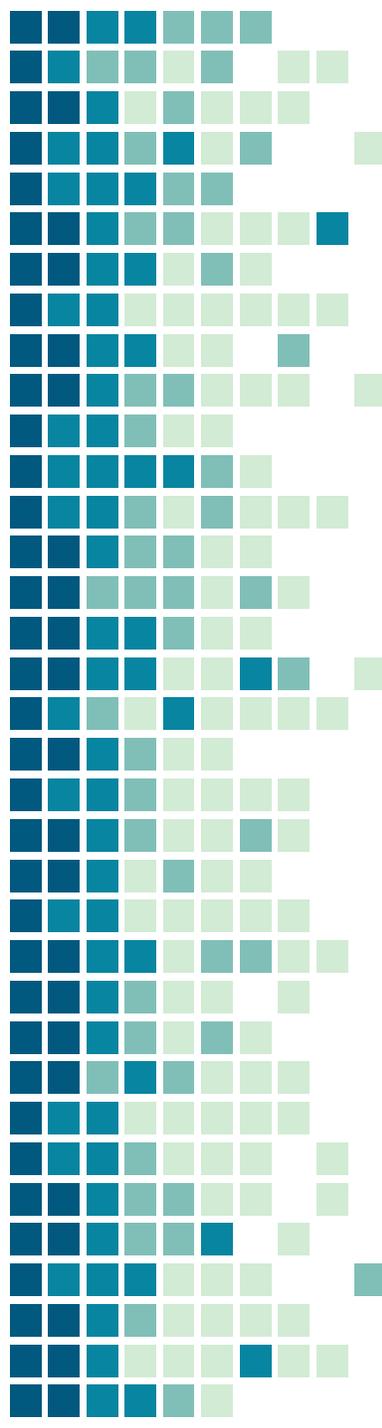
# Considerations in Setting Transfer Prices



# Contd...



# How to Handle Information Deficiencies?



• Tax authorities should **allow the use of reasonable commercial judgement supplemented by the documentation** provided by the taxpayer to set a reasonable estimate of arm's length price



• Tax administrations could provide **flexibility to allow amendments to FY 2020 tax returns** such that transfer prices are set on an arm's length basis and using available information.



• Jurisdictions can also allow for **price adjustment mechanism** along with proper description in TP documentation.



• The application of **more than one transfer pricing method** may be useful to corroborate the arm's length price provided the conclusion is satisfactory from a practical viewpoint

# Losses and Allocation of COVID-19 Specific Costs

# Allocation of Losses in the Context of the Pandemic

**Allocation of risks** between parties to an arrangement **affects how profits or losses** resulting from the transaction **are allocated at arm's length** through the pricing of the transaction.

It will be necessary to consider **how exceptional, non-recurring operating costs arising as a result of COVID-19 should be allocated** between associated parties

The pandemic has created conditions in which associated parties may consider whether they have the **option to apply force majeure clauses, revoke or otherwise revise their intercompany agreements**

# Issues and Plausible Solutions

## Allocation of losses to “limited risk” entity

- If **such an entity assumes a risk in the COVID scenario, then losses can be allocated.**
- Consideration should be given to the **commercial rationale for any purported change in the risks assumed** by a party before and after the outbreak of COVID-19 (and taking into consideration the accurate delineation of such purported change)

## Modification of inter-company agreements

- Determining whether a renegotiation represents the best interests of the parties to a transaction
- Careful **consideration of the options realistically available and the long-run effects on the profit potential of the parties**
- The **accurate delineation of the controlled transaction** (assessing how the actual behaviour of the parties to a transaction stacks up against what is provided in the written contract)
- Also, care should be taken to **assess whether the magnitude of the disruption** caused by COVID-19 in the specific related party situation **qualifies as a force majeure event**

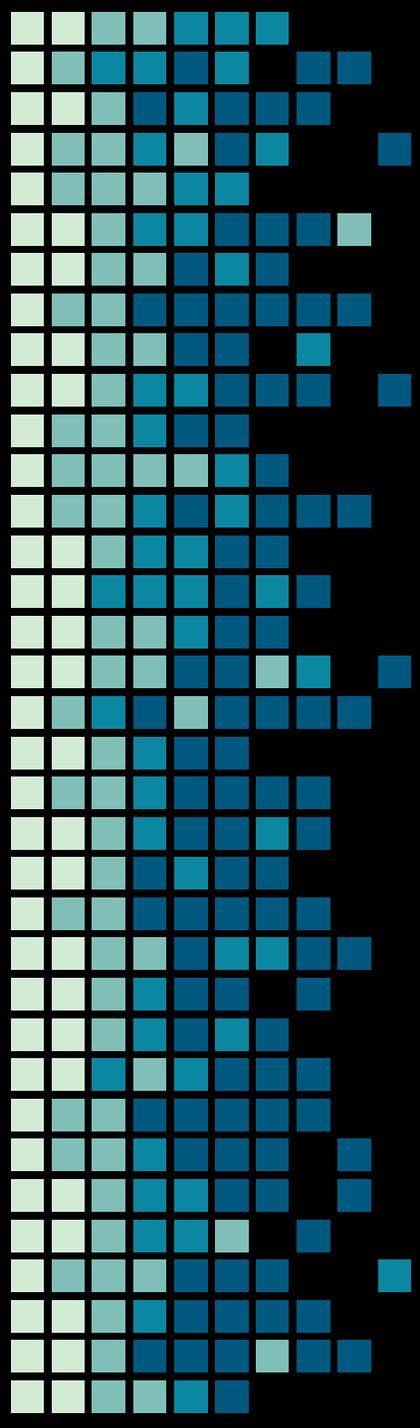
# Issues and Plausible Solutions

## Allocation of operational or exceptional costs such as expenditure on PPE, reconfiguration of workspaces, etc.

- Allocation of such losses would follow **risk assumption** and how third parties would treat such costs.
- In some cases, **the party initially incurring an exceptional cost may not be the party assuming risks** and consequently such costs may need to be passed on to parties that do assume such risks
- Where **certain operating costs may not be viewed as exceptional or nonrecurring** (i.e. where it relates to long-term or permanent in nature), it should be treated as such during delineation of transaction.

## Consideration of exceptional costs in comparability analysis

- Firstly, **exceptional costs should generally be excluded from the net profit indicator** except when those costs relate to the controlled transaction as accurately delineated.
- Second, **including exceptional costs in the cost basis would transfer these costs to the counterparty, whereas excluding them would have the effect of allocating them to the tested party** (decision should be taken based on which AE bears the additional costs)
- Third, **adjustments for accounting consistency** may be required to improve comparability.
- Example: The recognition of the purchase of PPE as an operating cost by the tested party and as a cost of goods sold by a comparable may have a significant impact when computing a profit level indicator based on gross profit and may require a comparability adjustment



# Government Assistance Programmes

# The Issue

Government assistance is a **monetary or non-monetary programme** wherein a direct or indirect economic benefit is provided to eligible taxpayers such as **grants, subsidies, forgivable loans, tax deductions, or investment allowances**

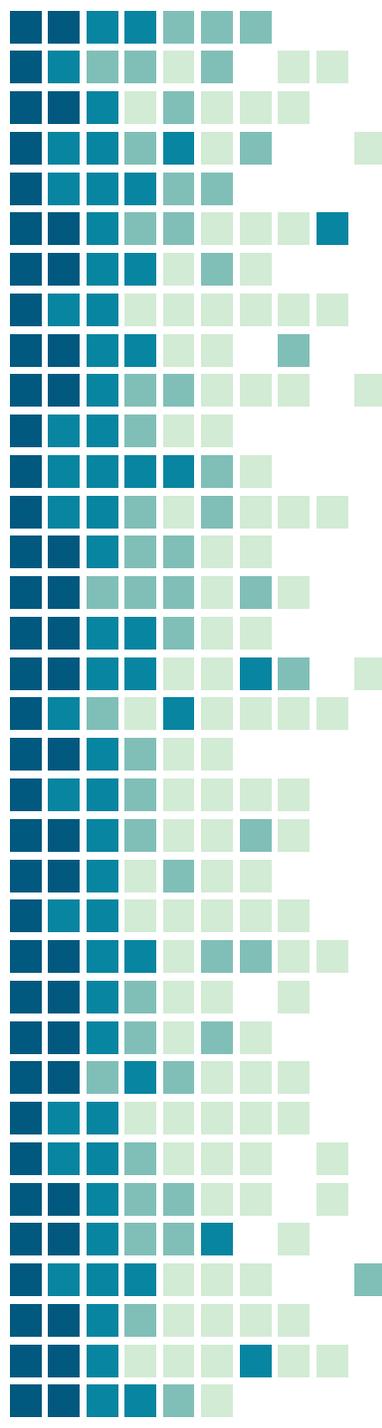


TP implications include whether the government assistance is provided to a member of an MNE group directly or made available to independent parties within the market where an MNE group operates, thus, **affecting the behaviour of enterprises engaged in potentially comparable transactions**



In addition, there may be challenges in **establishing the nature of government assistance received** by potential comparables.

# Ascertaining Nature of Assistance



- The extent to which the receipt of government assistance is an **economically relevant characteristic may vary** and if the same is affirmative, such information should be **included as a part of the documentation** to support the transfer pricing analysis.



- An example of where government assistance may be more economically relevant is the **provision of a wage subsidy, a government debt guarantee or short-term liquidity support.**

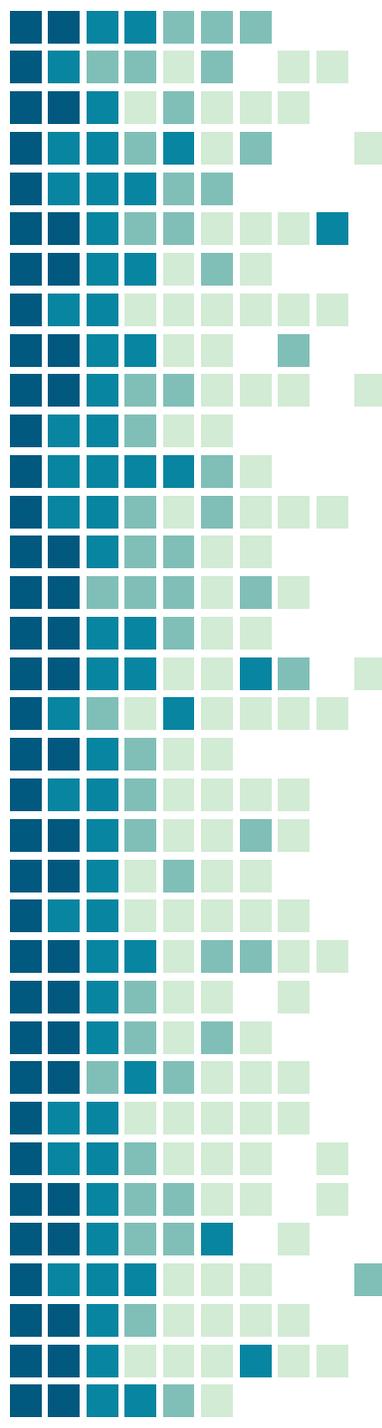


- The analysis of the receipt of government assistance as a **local market feature** may help to inform an analysis of **whether its receipt affects the price of a controlled transaction.**



- However, the particular nature of the government assistance should always be reviewed in the transfer pricing analysis, as under certain circumstances it may not be a general feature of the market, and/or it may not generate benefits for either party

# Effect on Controlled Transactions



• The **potential effect of the receipt of government assistance on the pricing of a controlled transaction** will depend on the **economically relevant characteristics of the transaction.**

• Broadly, analysing such an impact would involve **evaluation of how the MNE group responds to the receipt of government assistance**

• Such an analysis 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**

• Another aspect is that, the **provision of government assistance to an associated party will not change the allocation of risk** in a controlled transaction for TP purposes mostly.

# Impact on Comparability Analysis

Characteristics of the government assistance that might affect comparability, depending on the circumstances, could include the following:

- **Degree of economic relevance, duration of an assistance program and the relation between the assistance provided and the pandemic-related costs or the lost revenue**

The most reliable approach in identifying reliable comparables will be to refer to comparable uncontrolled transactions **in the same or comparable geographic market between independent enterprises** performing similar functions, assuming similar risks, and using similar assets.

Also, where **accounting treatments of the same type of assistance differ** between the tested party and the comparable, a **comparability adjustment** may be required

In addition, divergences in the accounting treatment of government assistance could point to a difference in the type of government support provided – e.g. the **accounting treatment of a conditional loan differs from that of an outright grant**

# Advance Pricing Agreements

# Core Issue

Incidence of **material changes in economic conditions** that were not **anticipated** when many APAs covering **FY2020** and potentially future financial years affected by COVID-19 were agreed

Application of existing APAs?

Taxpayer to adopt a **collaborative and transparent approach** by raising these issues with the relevant tax administrations in a timely manner

Breach of critical assumption?

YES

Generally, **COVID-19 would be breach of critical assumption** as it has dramatically affected economic conditions (which is considered in most APAs)

- **Revision of APA** can be made by approaching the tax administration
- Early notification is encouraged

NO

The **pandemic has not had the same impact on all enterprises.**

**Existing APA should be maintained and upheld**

# Response of Tax Administrations

- In some situations, the **APA agreement, 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 the absence of the same, a breach of critical assumption with the APA could have three potential outcomes as follows:

| Response            | Description   | Appropriateness   |
|---------------------|---|---|
| <b>Revision</b>     | Existing APA would apply except that different terms apply before and after the revision date (FY 2020) | <ul style="list-style-type: none"> <li>- There is a <b>material change</b> in conditions noted in a critical assumption in the APA</li> <li>- <b>Tax payer and tax administration agree on how to revise</b> the APA</li> <li>- Revisions could be specific or general</li> </ul>   |
| <b>Cancellation</b> | APA is effective upto the cancellation date and not for the whole of the proposed period                | <ul style="list-style-type: none"> <li>- There is a <b>material breach</b> in an APA's critical assumption OR</li> <li>- <b>Taxpayer failed to materially comply with any term or condition</b> of the APA</li> <li>- However, cancellation cannot be automatic.</li> </ul>   |
| <b>Revocation</b>   | Taxpayer is treated as if the APA had never been entered into   | <ul style="list-style-type: none"> <li>- There is a <b>misrepresentation, mistake or omission in an APA request or other relevant documentation</b></li> <li>- Taxpayer <b>failed to materially comply with a fundamental term or condition</b> of the APA</li> <li>- In the current scenario, revocations should be limited to situations where the above actions meet the standard for revocation regardless of whether such actions arose because of the pandemic</li> </ul> |

# Adequate Supporting Documentation to Approach for Revision of Existing APA



- A description of the narrowest relevant taxpayer **business segment** tracked by management that **encompasses the entities and covered transactions** involved in the APA.



- **Forecast and actual business segment profits** for the financial years ending with or within financial years **affected by COVID-19**



- Any proposed or implemented modifications to pre-existing agreements or of new intercompany contracts among the controlled parties affecting the covered transactions



- A **narrative explaining the anticipated effects of the current economic conditions** on an agreed transfer pricing methodology during the financial years affected by COVID-19 including **whether it caused any form of restructuring**



- A **detailed P&L** with a breakdown of COGS and selling, general and administrative expenses, exceptional operating costs, other non-interest expenses and income from government assistance programme.



- Information about third party behaviour.

# Solutions for APAs Under Negotiation

If APAs in the process of negotiation covering FY 2020

**Conclude a short period APA**



Covering the period affected by the COVID-19 pandemic and a separate APA covering the post-COVID period

**Extend the period of APA**



On a condition that retrospective amendments would be made if appropriate

**Conclude the APA for the whole period**



To mitigate the short term effect of the pandemic, depending on the magnitude and the length of such effect

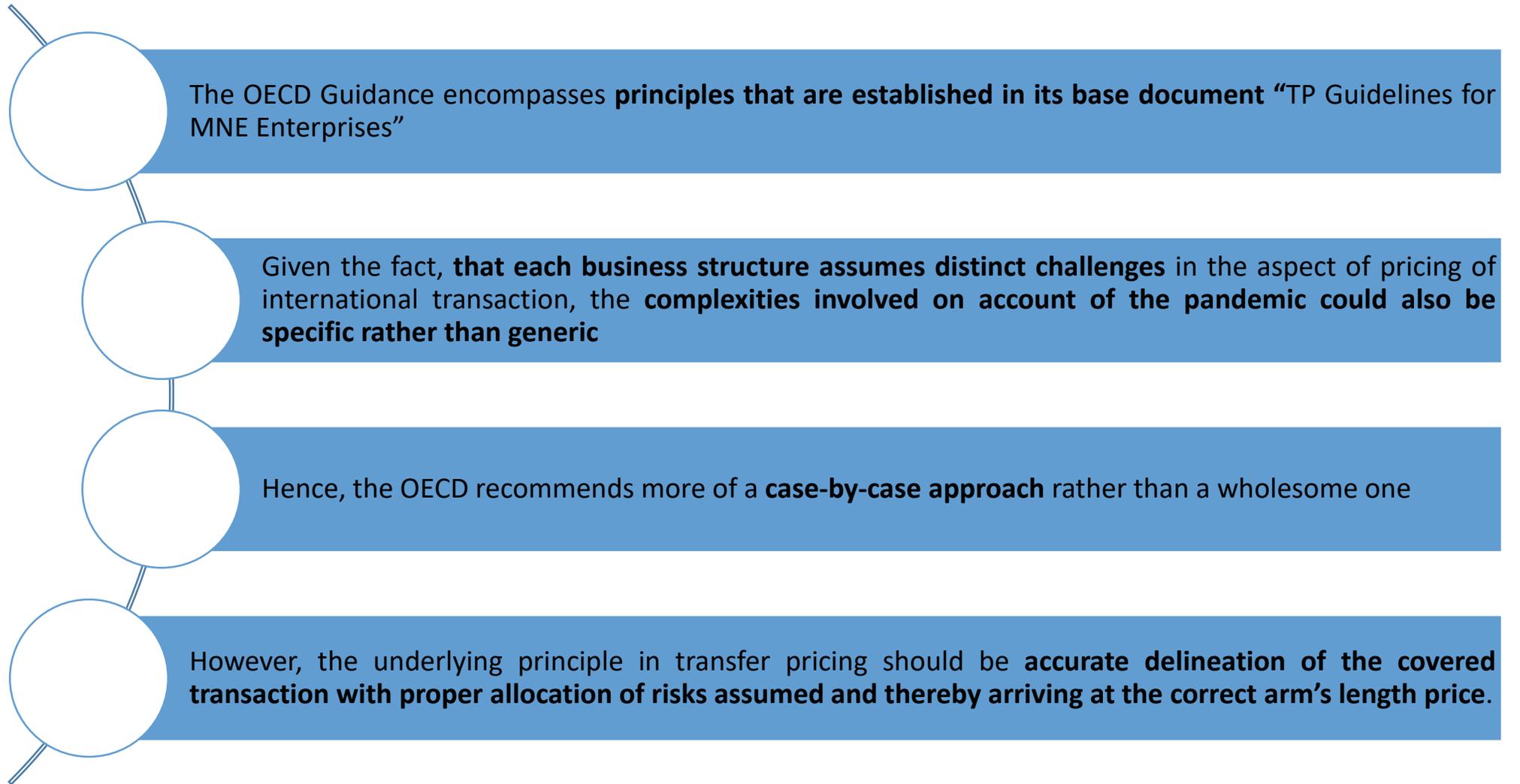
**Cumulative or term test throughout the APA period**

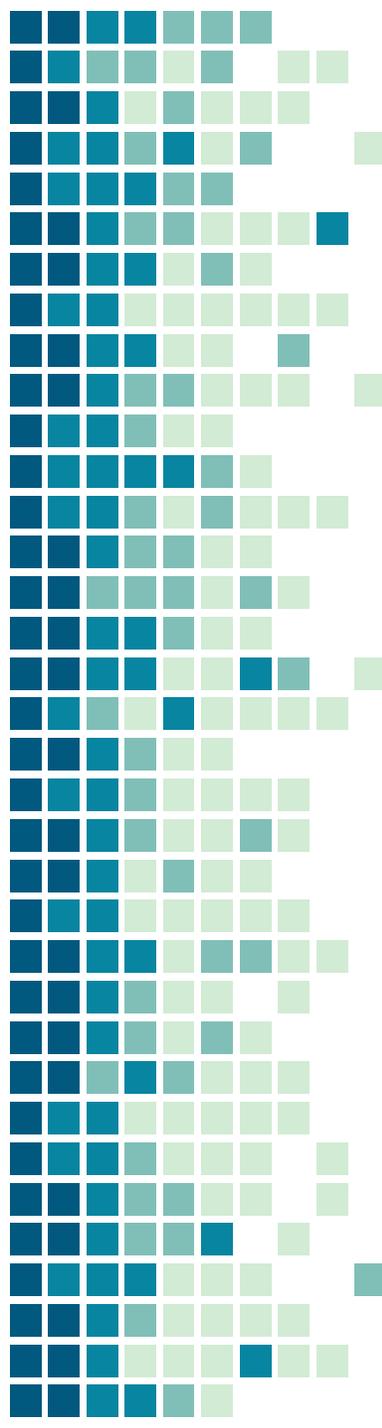


Evaluating the results of the transfer pricing methodology specified by the APA over the period of the APA, rather than on an annual basis

Other challenges arising due to restrictions on domestic and international travel, etc. can be mitigated by **technological solutions** that are available **to complement traditional methods of communication in the process of negotiating APAs.**

# Way Forward





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