

Bird & Bird & Tax Alert

Transfer Pricing and COVID-19: the OECD guidance



OECD guidance on COVID-19 and transfer pricing

The COVID-19 pandemic is causing disruptive effects on the entire global economic and financial system, with evident impacts on business activities. Among these, companies belonging to multinational groups may find themselves forced to review their business models and related transfer pricing policies, in order to face the recessive effects caused by COVID-19.

In fact, the definition and verification of transfer prices must take into account the reference economic scenario. Therefore, in the current context, it is essential for companies to understand what actions to take to manage the impact of the pandemic, which has significantly changed ordinary activities, with direct effects on transfer pricing policies.

The OECD, as expected, intervened on the issue by publishing the “Guidance on transfer pricing implications of the COVID-19 pandemic” report on 18 December 2020, which provides practical information on how to manage the impact of the pandemic in order to correctly apply the arm's length principle in intra-group transactions.

The report addresses four priority issues:

- 1 comparability analysis;
- 2 losses and allocation of COVID-19 specific costs;
- 3 government assistance programs;
- 4 advance pricing agreements (APAs).

1. Comparability analysis

The recessive effects caused by the COVID-19 pandemic have completely changed the economic assumptions underlying the definition of transfer prices, requiring a review of intra-group transactions and of the analyses performed to verify arm's length conditions.

To this end, the comparability analysis assumes further relevance, since it must clearly represent the implications of the pandemic on the economic environment.

The comparability analysis must be based on information that is as current as possible in relation to the business carried out by the company, the reference sector and intra-group transactions, in order to clearly highlight the effects of COVID-19 on business results.

To support this analysis, given the non-immediate availability of official data on transactions concluded between independent parties, the OECD suggests using any available information that may be useful for assessing arm's length conditions, in light of the impacts of COVID-19.

Among these, the main sources of information that, according to the OECD, may support such determination through the comparability analysis are:

- an analysis of the trend in sales volumes and a comparison with those generated in pre-COVID years;
- an analysis of costs to highlight the incurrence of incremental or exceptional costs;
- macroeconomic information like country specific GDP data or industry indicators from central banks, government agencies, industry or trade associations to the extent useful in understanding the context of the controlled transaction;
- an analysis of the effects on profitability observed in previous recessionary periods or using any available data relating to the current pandemic, even if partial.

In addition, the OECD suggests analysing the differences between budgeted/forecasted and actual

data in order to approximate the effects of the pandemic on the company's profitability.

Still about comparability analysis, the OECD focuses on the problem arising from the possible unavailability of current and updated information on comparables, which could jeopardise the correct application of certain transfer pricing methods.

The use of outdated income data, which does not reflect the effects of the pandemic on the profitability of comparable companies, could in fact distort the results of the benchmark analysis.

In order to address this issue, the OECD suggests some practical approaches which, in our opinion, could be difficult to apply in Italy, also in the light of the novelties regarding transfer pricing documentation introduced by the recent Provision of the Revenue Agency of 23 November 2020.

Specifically, the OECD suggests to:

- wait for the publication of the official 2020 data to carry out the transfer pricing analysis;
- use a specific reference period for the comparability analysis in order to distinguish diverging economic conditions in the pre- and post-COVID-19 contexts;
- provide for retroactive transfer pricing adjustments in order to incorporate more accurate and current information into the transfer pricing policy;
- also include comparable loss-making entities, if they meet the comparability criteria;
- use several methods to assess compliance with the arm's length principle of the controlled transaction.

In addition, the OECD highlights that tax administrations should guarantee the taxpayer greater flexibility, allowing them to proceed with specific adjustments with the use of updated information, later available.

It is also specified that, contrary to what some authors have suggested, the OECD rejects the possibility of using data from the 2008/2009 global financial crisis to approximate the effects of the pandemic, given the differences between the two crises in terms of nature and effect on economic conditions, as well as the variability of the impact by business sector of the 2008/2009 crisis.

2. Losses and COVID-19 specific costs

The COVID-19 pandemic is causing negative effects on the profitability of companies and multinational groups, which are recording losses caused both by a reduction in profits and by incurring extraordinary operating costs.

It is therefore of the utmost importance for businesses to understand how to properly allocate losses and costs between related companies.

With specific reference to losses, the OECD clarifies that they should be allocated in consideration of the risks incurred by each entity involved in the transaction.

On this point, in particular, the OECD provides the example of a "limited-risk distributor", highlighting that, following a significant drop in demand as a result of COVID-19, the distributor may incur losses only if it bears certain risks, such as market and credit risks.

According to the interpretation provided by the OECD, therefore, for the purpose of allocating losses it will be necessary to evaluate the functions performed and the risks assumed by the entity in the pre- and post-COVID-19 period. Essentially, an entity that before the pandemic did not assume any risk will not be able to bear any portion of the related losses, unless evidence is provided of a corporate restructuring that has led to the modification of the functional and risk structure of the same entity.

The OECD also expresses its opinion on the possibility of modifying existing intercompany agreements, as well as the conduct of the parties in their commercial relationships. On this point, in particular, the report highlights the need to assess what independent parties would have done under comparable circumstances. If it is not possible to demonstrate that independent companies, in comparable circumstances, would have considered it convenient to modify the agreements and/or commercial relationships, a change between related parties would not be consistent with the arm's length principle.

Finally, the OECD provides useful information to correctly allocate exceptional, non-recurring operating costs, related to COVID-19, among related parties. Also in this case, for a correct allocation, it is important to consider the behavior of independent parties in comparable circumstances.

Therefore, it will have to be considered that:

- allocation of exceptional costs would follow risk assumption and how third parties would treat such costs;
- exceptional costs that replace normal operations should be treated as operating costs;
- in some cases, exceptional costs may be passed on (wholly or partially) to customers or suppliers.

In general, these costs should be excluded from the calculation of the net profit indicator. The exclusion, however, must be done consistently at the level of the tested party and the selected comparables.

The OECD then highlights that the “extraordinary” situation caused by the pandemic could lead some companies to invoke the force majeure clauses in order to revoke or review the intercompany agreements that affect the allocation of losses and COVID-19 specific costs between related parties. On this point, the OECD stresses the need to analyse the agreement and the underlying economic circumstances to assess whether an independent party, in comparable circumstances, would have invoked a force majeure clause.

3. Government assistance programs

To address the negative economic effects deriving from the COVID-19 pandemic, governments have introduced several extraordinary measures aimed at supporting entrepreneurial activities such as loan guarantees, loan deferrals, specific grants and tax reliefs.

The OECD highlights that the terms and conditions of such government assistance programs will need to be considered in order to analyse their potential impact on intra-group and comparable transactions.

In order to properly assess the implications associated with the use of these programs, a number of factors will have to be considered such as: the availability, substance, duration and other conditions imposed by the government in the provision of assistance; the potential benefits in terms of increased revenues and decreased costs; and the degree to which benefits are passed on to customers or suppliers.

It is also of fundamental importance to understand how the multinational group has responded to the possibility of taking advantage of government

assistance programs. To this end, a specific case by case analysis will be required to understand the potential effect of these programs on transfer pricing policies.

The OECD, while clarifying that the use of government assistance programs does not change the allocation of risk in an intra-group transaction, also highlights that such programs could affect the comparability analysis and the choice of comparables. This, in consideration of the fact that government assistance programs are different among jurisdictions and, also for this reason, the related economic effect could be recognised in the accounts in a different way, with potential effects on the profitability of the tested party and of the comparables taken into account in the analysis.

To overcome these difficulties, the OECD suggests to:

- perform comparability adjustments;
- identify comparables belonging to the same geographic market;
- apply more than one method in the analysis for corroborative purposes.

4. Advance Pricing Agreements

Lastly, the OECD focuses on the impact that changes in economic conditions resulting from COVID-19 could have on existing Advance Pricing Agreements (“APAs”) or APAs under negotiation.

As a general premise, the OECD points out that taxpayers should adopt a transparent and collaborative approach by promptly informing the relevant tax administration of the impact of the current economic conditions on the agreement, also producing supporting documentation highlighting these effects.

With specific reference to existing APAs covering FY2020, the OECD highlights that, if changes in economic conditions have not led to any modification of the terms of the agreement, the latter should be still considered valid. Otherwise, it will be necessary to proceed with an analysis of the specific case to evaluate the possible revision, cancellation or revocation of the agreement itself. To this end, the competent tax administrations will have to assess: (i) the actual divergence between the agreed parameters in the APA and the current ones, which reflect the impact of the COVID-19 economic scenario, and (ii) whether the agreed parameters and methodology are already, in themselves, capable of

reflecting arm's length pricing of a controlled transaction under the new economic circumstances.

Regarding the agreements under negotiation, the OECD suggests adopting a flexible and collaborative approach that allows tax authorities and taxpayers to assess together the effects of the changed economic conditions.

In this regard, the OECD also indicates the possibility of agreeing: (i) two separate APAs, a "short" one covering only the financial years affected by the COVID-19 pandemic, and a separate one for subsequent years; (ii) an agreement for the whole ordinary period provided with an ex-post assessment of the COVID-19 impact for each covered year, with the possibility of making retrospective amendments.

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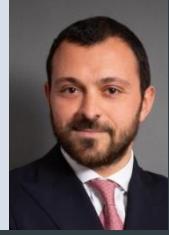


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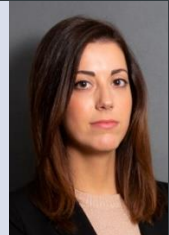


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