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COVID-19: Implications on Transfer Pricing

1. Introduction

The outbreak of novel coronavirus disease 2019 ("COVID-19") raises a number of substantial transfer pricing issues, on the background of which Multinational Enterprises (MNEs) may consider reviewing their business model and current transfer pricing policies to avoid potential future disputes with tax authorities.

2. Multiple-Year Analysis

Under normal conditions, multiple year data generally provides a more reliable approximation of arm's length prices than single year data. However, in the first year of an economic downturn, tax consultants need to carefully consider the impact of multiple year data usage on the accuracy of the results. By calculating the average of comparables' indicators over multiple years (usually, three years), the economic shock of the current year's financial crisis wouldn't be appropriately mirrored in the results. In fact, while in 2020 and in the subsequent years the profitability of companies will be negatively impacted by COVID-19, such pandemic had no impact at all on the economic results of 2017, 2018 and 2019. Thus, the most reliable approach would be to calculate the arm's length range by looking only at 2020 results, provided that financial data on public databases will be actually available when performing the analysis.

3. Function, Risk and Asset Analysis

MNEs with a global presence will feel the effects of the COVID-19 pandemic in every jurisdiction in which they operate. Supply chains have been disrupted and some functions have been temporarily reallocated among the companies in the group. This will require tax consultants to properly (re)consider the functions, assets, and risks profile of the 'tested party' when conducting the comparability analysis. MNEs should evaluate whether such changes are temporary or they have a more permanent status, which may require changes to the transfer pricing policies.

4. Legitimate Losses

Particular consideration must be paid to the comparable companies selected for comparability analyses. Normally, companies with consecutive years of operating losses are rejected for benchmarking purposes. However, in a period of severe economic instability, such a rejection may no longer be appropriate as the tested party may have faced similar circumstances. In the post-COVID-19 world, even the most routine comparability analyses must be heavily scrutinized, in order to make sure that the companies selected to benchmark a taxpayer's profitability are truly comparable.

On the other hand, when operating losses are incurred by the 'tested party', MNEs need to verify whether those losses are actually legitimate. OECD Transfer Pricing Guidelines provide that "*associated enterprises, like independent enterprises, can sustain genuine losses*" due to "*unfavorable economic conditions, inefficiencies, or other legitimate business reasons*". While COVID-19 can be certainly considered an unfavorable economic condition, that alone does not necessarily legitimate operating losses in a company. In fact, when a company has been set-up as a low-risk entity (e.g., a low-risk distributor) and is compensated using a cost-plus method, it might be complicated to justify to tax authorities the operating losses. In such a case, it would be appropriate: *(i)* to check that the intercompany transactions are well documented through accurate and appropriate agreements; and *(ii)* to conduct a comparability analysis to prove that also unrelated parties in the same or similar circumstances have incurred losses because of the pandemic.

5. Intercompany Agreements

MNEs should review existing intercompany agreements to check whether these agreements contain a force majeure clause. In the event they contain a force majeure clause, companies should evaluate whether - under similar circumstances - an unrelated party would have made use of it. On the other hand, in the event the intercompany agreement does not contain a force majeure provision, companies might still evaluate whether they have the option to renegotiate the terms of such agreement under the assumption that unrelated parties would have sought to do the same.

6. Cash Flows on Intercompany Financial Transactions

The COVID-19 pandemic is expected to have a huge impact also on the cash flow of many MNEs. As businesses face a prolonged decline in their sales and delayed payments of their receivables, many enterprises will find themselves constrained due to inadequate cash flow. Parent companies within the group may be unable to infuse additional capital into their subsidiaries, while the latter may be unable to repay their debts and interests to the lender entities of the group. This will require MNEs to restructure the intercompany financial agreements, as well as to re-think the structure of their eventual cash-pooling systems. Finally, a close attention should be paid to cash management across the group, in order to put in place tax efficient cash repatriation strategies.

7. Advance Pricing Arrangements (APAs) and Rulings

Companies which have APAs and/or rulings should review the terms of these agreements to evaluate whether the critical assumptions defined in the APAs/rulings may no longer hold true with a significant change in the underlying economic conditions.

8. Conclusions

The challenging times associated with the COVID-19 pandemic are expected to continue, and at this stage it is difficult to entirely predict the extensiveness of the impact it will have. From a transfer pricing perspective, we will keep monitoring the implications of this pandemic, while also awaiting for further guidance that OECD is expected to provide in the months to come.

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