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Q&A: Impact of Covid-19 on Transfer Pricing

Legal flash

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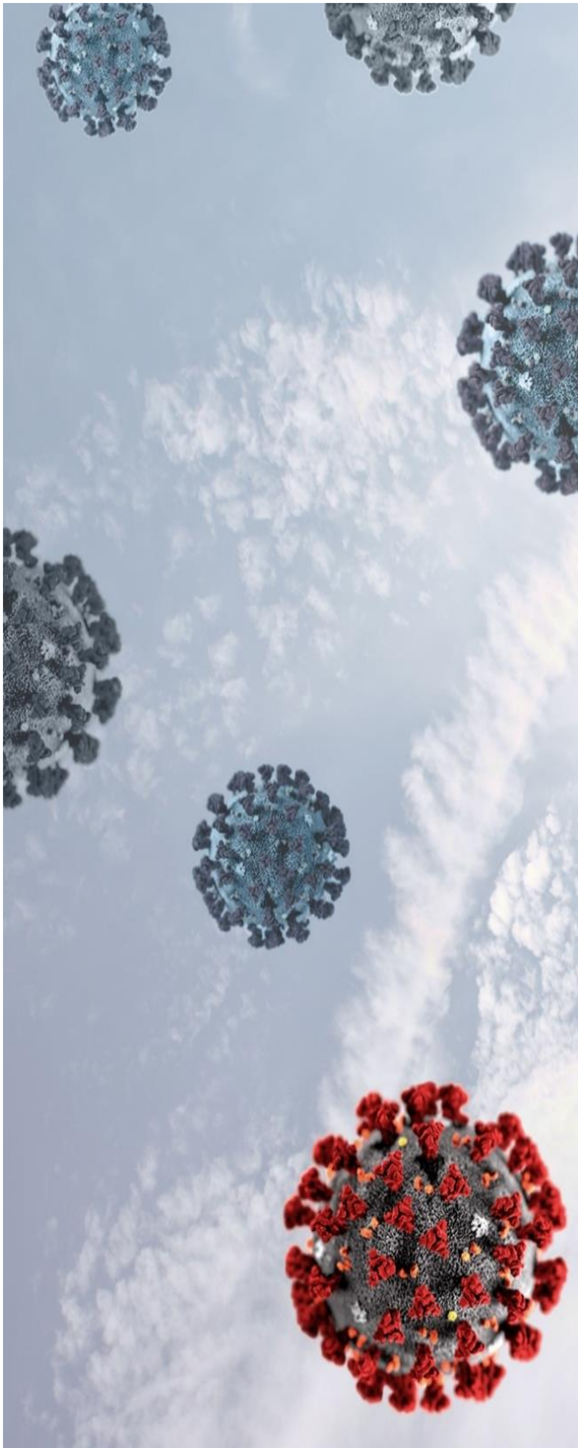

The public health emergency brought on by COVID-19 and especially its worldwide economic impact have greatly affected the activity of most multinational groups and the transfer pricing policies they apply to related-party transactions.

The purpose of this document is to organize some basic criteria on how to deal with the impacts most commonly observed in practice.

- An approach to dealing with thepotential impact of covid-19
- Financing
- Intangible assets
- Services
- Leases
- Limited-risk entities
- Advanced pricing agreements
- Changes occurring in business models
- Documentation and selection of comparable data

This document is a general assessment and should not be considered a detailed, case-by-case analysis of recommended actions in response to the specific impact of COVID-19 on multinational groups or business sectors.

An approach to dealing with covid-19 potential impact

What issues must be considered when assessing the impact of COVID-19 on transfer pricing policies?

The impact of COVID-19 varies among multinational groups and even among companies of a single group. In this context, assessment of any measures to be taken must begin with reviewing the actual impact on every company and analyzing each individual case, region and industry.

Despite the abnormal nature of the current situation and the clear difficulty in obtaining comparable data, the arm's-length principle remains the norm.

In these circumstances, we suggest keeping a record of all decisions regarding transfer pricing, including contracts and transfer pricing documentation, to reflect the circumstances and interests of all parties involved. This makes it possible to subsequently justify the reasons for maintaining or modifying the transfer pricing policies applied up to that point and defend such decisions in the future if challenged.

Are there any guidelines on this?

The OECD's transfer pricing Guidelines are a key reference for the correct application of the arm's-length principle in normal situations and in special circumstances such as the COVID-19 crisis. These Guidelines are supplemented by specific recommended guidance such as that released in February on financial transactions, which deals with some of the issues discussed below.

OECD guidance on how to deal with the issues caused by COVID-19 will be released later this year.

Similarly, the tax authorities in some jurisdictions have released preliminary guidelines on the impact of COVID-19 on transfer pricing (e.g., Australia, the UK and the US), and others have passed specific legislation in response to the most recent financial crisis (e.g., the People's Republic of China).

FINANCING

Can the terms of existing debt be renegotiated when it is no longer possible to deal with it?

At this time, many companies are refinancing or modifying the terms of their bank loans due to temporary cash shortfall or abrupt decline of revenue caused by restrictions on their activities.

These extraordinary measures may also be extended to intragroup financing.

Third-party transactions that provide comparable internal data (i.e., internal CUP) may be used as a reference for adjustment of related-party transactions.

If the multinational group does not resort to external financing and relies solely on internal resources (e.g., cash-pooling arrangements or revolving-fund policies), delaying the repayment of principal may result in part of the debt being recharacterized as equity by the tax authorities. To deal with this issue, these arrangements may be replaced with ordinary long-term loans (in which, similar to state-backed financing, repayment schedules with grace periods may be established), with special attention on the accounting effects of the change in terms.

How should the valuation of new intragroup financing be approached?

Once again, actions being taken in relation to third parties may be used as reference in relation to the cost of financing (e.g., interest rates, fees, terms of payment) in cases of subsidiaries receiving financing and in case of centralized group financing.

Without these internal references, or when the references do not resemble the terms of financing, 2019 market data remains a valid reference, as the interest rate curve has remained stable. However, depending on the circumstances of each group, the market data may be adjusted to more closely match current conditions based on objective parameters (e.g., performance of creditworthiness, country risk performance or impact of the crisis on business plans).

Should additional collateral be remunerated?

The remuneration of collateral is a typical point of contention when dealing with the tax authorities. In keeping with the OECD guidance on financial transactions, remuneration of collateral may vary depending on the type of collateral and how the borrower is affected.

As a rule, when posted collateral results in a lower interest rate being applied to the company seeking the new financing, it should be remunerated, provided that there is an objective basis for the calculation of such remuneration.

In any event, it is reasonable to assume that expenses arising from posting, managing and maintaining collateral will be billed.

What else should be considered?

In circumstances such as the present, the balance between debt and capital may be upset, which in turn may result in some of the debt being reclassified as capital. Debt-to-capital ratios must be compared to those of the same sector, and any deviation must be justified. Capital contributions may be also considered as an alternative course of action.

Similarly, for new financing and extension of existing financing, repayment capacity must be evaluated on the basis of the foreseeable business plan, as well as the possibility of establishing covenants when the borrower has minority shareholders (as a third party would require, provided that the credit rating is static and may not accurately reflect the situation).

INTANGIBLE ASSETS

Is it valid to negotiate a downward revision of the transfer price of an intangible asset?

As a rule, the price agreed when a transaction is closed is final, unless the agreement establishes contingent prices based on reaching certain milestones or price-revision mechanisms.

The OECD Guidelines do not allow *ex-post* adjustment by the tax authorities on hard-to-value intangible assets, provided that it is proven that the assumptions used to set the price of the asset were reasonable at the time of the transaction and that associated risks and their implications were taken into account.

Just as in transactions among independent parties, an unforeseeable event such as a pandemic is not a legitimate reason to change completed transactions.

Is it necessary to suspend an agreement when remuneration for using an intangible asset is linked to a percentage of sales, and the sales register a downturn?

As a rule, this is not necessary, provided the remuneration is self-regulated by the downturn in sales.

However, distortion may arise when minimal payments have been established for the use of an intangible asset. In these cases, the best course of action may be to isolate and exclude from the calculation any periods affected by COVID-19 for the purpose of rebalancing the mutual obligations established in the agreement and to prevent the obligation from becoming too onerous for the party that has posted the intangible asset.

It is also recommendable to review the situation at tax-year-end when the remuneration has no minimal limit, taking into account any group actions in relation to licenses granted to third parties and the costs of maintenance, protection and development of the intangible asset.

SERVICES

Is it possible not to remunerate intragroup services provided?

When an intragroup service has been provided and has been useful for the receiving party, it would be unreasonable to suggest that it not be remunerated, and the same applies vice-versa.

When a service provider's activity shrinks, is there some way to recover the cost of the downturn?

The answer depends on the type of service and on the type of service agreement.

If the services are provided on demand, there is no valid reason for the provider to pass on its loss to its customers. Independent third parties would not accept such a measure, although it would depend on the specific terms of the agreements between the parties.

However, if the contract includes a provision on the remuneration of service availability, or in situations in which services are provided in the context of a cost sharing agreement (i.e., with the risk shared evenly among all participants), there would be a valid reason to pass on the costs of the reduced activity to those receiving the services, provided that they assume the risk associated with the reduced demand for the services.

In addition, it is important to evaluate the position of the tax authorities in the jurisdictions involved in relation to limited risk entities and losses.

If the activity of the party receiving the service has shrunk, is it possible to reach an agreement to reduce the remuneration?

As long as the service is provided and remains useful, there is no reason to modify remuneration.

However, it would be a different issue if a reduction in the level of service were agreed in response to the current situation, and remuneration were also reduced as a result of diminished effective dedication.

LEASES

Is it possible to negotiate grace periods, allowances or rent reductions in intragroup leases, as seen elsewhere in the market?

The state of emergency and the restrictive measures taken to prevent the spread of COVID-19 have forced many businesses to close their doors temporarily. In the case of business conducted in leased property, many lessors and lessees have agreed on ways to mitigate the adverse impact.

Likewise, related parties may also take extraordinary measures in their transactions through the application of *rebus sic stantibus* clause.

LIMITED-RISK ENTITIES

Can part of the group's incurred loss be attributed to limited-risk entities, even if the transfer pricing policy guarantees a minimum margin for these entities?

Entities that operate entirely under contract (e.g., contract manufacturers and limited-risk distributors) and that assume moderate levels of risk can expect to obtain a return that is similarly moderate and relatively stable over time. As a rule, there is no reason for these entities to incur in losses, although deterioration of economic conditions may narrow their margins.

In these cases, to distribute losses caused by COVID-19, it is necessary to identify the risks that have had the greatest bearing on the loss (e.g., market risk, financial risk or inventory

risk) and to determine who has effective control of them, starting with existing contractual arrangements. This way, losses may be attributed only to the companies that manage the elements that have caused the loss.

Depending on the circumstances, we may consider the possibility of isolating and excluding from calculation any periods affected by COVID-19 (e.g., shutdowns ordered by authorities rather than by the group itself) and applying a specific methodology in these periods.

ADVANCED PRICING AGREEMENTS

Is it possible to modify the terms of an APA in force?

APAs rely on the economic and technological circumstances existing at the time of their authorization. Typically, APAs include critical assumptions that condition their applicability.

When there is a clear breach of the terms or the critical assumptions of the APA, the group may choose not to apply it. This would require full documentation of the economic circumstances that bring about the failure to comply with the assumptions, and the application of the APA in subsequent years would remain unaffected within its term.

Nonetheless, the assumptions are sometimes too generic or may not have been significantly affected. In such cases, it is advisable that an agreement is reached with the tax authorities regarding the best way to apply the APA under the current circumstances, to achieve greater security to deal with future issues (e.g., when the tax authorities of a third state disagree with that the assumed criteria is reasonable).

Are tax authorities responding to requests involving APAs?

During the state of emergency, cases filed have met with the response of the tax authorities, which have been receptive toward these matters and have shown a preference for issues involving APAs that are in force.

CHANGES OCCURRING IN BUSINESS MODELS

Can compensation be sought for changes to a business model to offset the impact of the crisis?

As a result of the current situation and due to the lack of uniformity in content and in the timeliness of the measures taken by governments, multinational groups have seen their chains of value disrupted and have had to reassign duties among their companies, which has

brought about change to their business models. In some cases, it is expected that the change will remain in place in the foreseeable future.

This requires reviewing the functional characterization of the companies in the group, taking into account the impact of the changes on the global business model (i.e., entities that benefit from the change and others that are adversely affected) to project potential cash flows and risk.

In addition, the OECD Guidelines establish that these circumstances may warrant compensation in cases in which assets are transferred and in others in which the contractual renegotiation that takes place would be compensated among independent parties.

DOCUMENTATION AND SELECTION OF COMPARABLE DATA

Has there been a change in the period for preparation of documentation?

For the time being, it seems unlikely that there will be an extension of the period to prepare transfer pricing documentation and make it available to the tax authorities or of the deadline to submit the statement of related-party transactions or of the country-by-country report.

What data should be considered comparable to document tax year 2020?

Under regular criteria, we must start with data available for the three preceding years and use them as a basis for any necessary adjustment.

At this point, it seems reasonable to include entities that are incurring losses in the sample, and when the sector has been affected by COVID-19, to adjust the range of the sample based on information in reports released to the general public on the specific impact on the sector.

As an alternative, the adjustment may be based on the taxpayer information (e.g., comparison of the decline in sales in 2020 vs. the average of the three preceding years). However, given that that data are generated within the company, this should be considered a last resort.

There may also be internal comparable data for transactions that, until now, were only carried out with associated companies (e.g., if the multinational group had to resort to a third-party supplier due to the shutdown of the activity of an associated supplier).

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