



**Covid-19: Impact  
on (the Other) TP**



**Bloomberg  
Tax & Accounting**

**Baker  
McKenzie.**



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## Foreword

Dear Readers,

We hope you and your families are safe and healthy during this very difficult time.

The impact of Covid-19 has been profound. The spread of the virus has strained local medical infrastructures, introduced travel restrictions, limited social contacts, and created unprecedented disruptions to the global economy. A wide variety of industries are seeing disrupted supply chains, reduced customer demand, curtailed operations and output, decreased liquidity, and significant changes to how business is conducted (e.g., working from home and “virtual meetings”).

Governments across the world are struggling to release legislation and guidance addressing the most critical needs of their citizens and ensure the resilience of businesses large and small. They have turned to tax provisions in many cases to dampen economic hardships and free much needed cash resources. Global tax practices, like ours, are working hard to analyze and share new information and prior experience relevant to companies across a variety of industries. In this environment, however, it is important to share that information as widely as possible. This series of articles is an effort on our part to do exactly that.

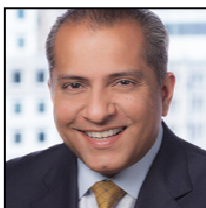
Our global transfer pricing team, comprised of lawyers and economists, has prepared this Special Report in partnership with Bloomberg Tax & Accounting to identify the most critical transfer pricing issues businesses should be analyzing now. Please feel free to reach out to the authors with any questions.

You can find further Baker McKenzie analysis and information at our [Coronavirus Resource Center](#), including our April webinar series, *The Importance of Tax in the Response to Covid-19*.

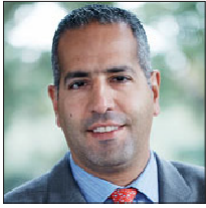
Finally, a big thank you to all the Baker McKenzie attorneys and economists from around the world who authored these articles, and those who offered their advice and insight, including: Rafic Barrage, George Clarke, Richard Fletcher, Brendan Kelly, Carlos Linares-Garcia, Melinda Phelan, and Caroline Silberztein. I would also like to acknowledge our professional staff who assisted with this effort: Michael Bennett, Elizabeth Boone, Gareth Kelly, Lena Pappas, and Martin Schuebel.

Salim Rahim,  
Salim.Rahim@bakermckenzie.com

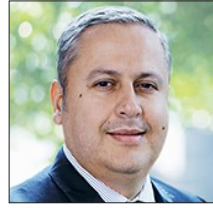
On behalf of *Baker McKenzie's Global Transfer Pricing Practice*



## Editorial Board



**Rafic Barrage**  
Partner  
Washington, DC  
Rafic.Barrage@bakermckenzie.com



**Carlos Linares-Garcia**  
Principal Economist  
Monterrey  
Carlos.Linares-Garcia@bakermckenzie.com



**George Clarke**  
Partner  
Washington, DC  
George.Clarke@bakermckenzie.com



**Melinda Phelan**  
Partner  
Dallas  
Melinda.Phelan@bakermckenzie.com



**Richard Fletcher**  
Principal Tax Advisor  
London  
Richard.Fletcher@bakermckenzie.com



**Caroline Silberstein**  
Partner  
Paris  
Caroline.Silberstein@bakermckenzie.com



**Brendan Kelly**  
Partner  
Shanghai  
Brendan.Kelly@bakermckenzie.com

# The OECD Transfer Pricing Guidelines: A Practical Guide for Applying the Arm's-Length Principle During an Economic Crisis

## I. INTRODUCTION

Economies and markets have been hit by the Covid-19 outbreak, and businesses are contingency planning to ensure their operations continue.

The adverse consequences of the virus could be broad, including reduction of consumer demand, supply chain disruption, and an increase in risk aversion in financial markets (driven by an overall downturn in business and consumer confidence). Local subsidiaries of multinational enterprises ("MNEs") in affected regions, even those that are operating "business as usual," may be making a loss or experiencing a substantial reduction in profitability due to this unforeseeable event. Some may find that their operations need to be reorganized, reduced, or relocated. A greater need for intragroup financing and cross guarantees is also possible.

The *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*<sup>1</sup> (the "TPG") has always served as a key reference point in the application of the arm's-length principle; the conditions of an unexpected, global economic crisis do not change this.

Indeed, the TPG and most recent guidance issued by the OECD, such as the new *Transfer*

*Pricing Guidance on Financial Transactions* (the "GFT"),<sup>2</sup> recognize that an economic crisis can have a wide-ranging impact on transfer pricing ("TP") and will pose many challenges and questions for tax practitioners. The GFT therefore provides a series of considerations, practical approaches, and useful tools for dealing with such circumstances.

## II. PRACTICAL APPROACHES AND USEFUL TOOLS

Documenting and maintaining TP policies in adverse economic environments can create a number of difficulties, depending on the particular market or transaction concerned. The TPG provides helpful guidance and practical approaches for tackling these issues.

### A. Benchmarking and TP Analysis

The more diverse the effects of an economic crisis between companies, industries, or markets, the lower the chances of finding appropriate comparable transactions and conducting a reliable TP pricing analysis.

Differences that materially affect the comparison will need to be adjusted to the extent that these adjustments are reasonable,

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<sup>1</sup> Issued in July 2017.

<sup>2</sup> Issued in February 2020.

reliable, and improve comparability.

<sup>3</sup> Therefore, in the current circumstances, adjustments to account for differences in idle capacity or extraordinary expenses (e.g., increased advertising expenses, inventory write-offs, or restructuring expenses) that may not be reflected in the financials of the comparables, could be worth considering. Similarly, to account for unprecedented fluctuations in exchange rates or the potential lack of foreign exchange risk demonstrated by comparables,<sup>4</sup> adjusting for foreign exchange could also warrant consideration.

The fact that tested parties and comparable companies can react differently, particularly in terms of demand and sales, could also compromise the reliability of particular TP methods. Benchmarking strategies may need to be revised by targeting subsets of comparables that are closer to the tested party (both in terms of sensitivity to an economic downturn, as well as general characteristics and timing). These subsets can be arrived at by:

- refining existing comparables sets by eliminating companies that did not face similar adverse economic conditions or that only have data for periods outside those conditions;
- broadening search criteria to include companies with similar sales declines by removing certain screening criteria that would allow for the identification of comparables experiencing financial distress (i.e., bankruptcy or operating losses);
- applying certain screens to ensure that highly profitable comparables

that are not impacted by the economic crisis are not included in the comparables sets; and

- screening for relative sales growth as well as absolute sales growth.

In addition, the use of a multiple-year approach might not be suitable for generating reliable comparables in all cases. MNEs and tax administrations may evaluate whether the use of a year-by-year approach could better capture the effect of events causing dramatic changes in the market. There are instances, however, in which the use of multiple-year averages or pooled financial results for years in which comparables suffered from similar economic conditions (whether or not sequential/concurrent) could help to develop a more reliable range.

Finally, expanding the acceptable range of results beyond the interquartile range<sup>5</sup> could be another useful technique in countries where such an approach is permitted.<sup>6</sup>

There are several potential approaches for enhancing comparability and the reliability of the analysis. These should be assessed on a case-by-case basis. Ultimately, though, the arm's-length principle comes down to the concept that independent enterprises should consider the options realistically available to them.<sup>7</sup>

## **B. Pricing Financial Transactions**

The economic downturn may lead MNEs to reassess their existing intercompany financing arrangements and to devise appropriate structures for cash and liquidity management. A heightened need for intragroup funding and parent or cross guarantees on third-party lending can be expected for group entities operating in affected regions or, where activities have been shifted away from such

<sup>3</sup> TPG ¶¶ 11.40, 139, 1.144-1.147, 2.80, 2.84, 3.47-3.54.

<sup>4</sup> This could also be useful to account for potential lack of or minimal FX risk borne by comparables and unique facts and circumstances related to the particular industry.

<sup>5</sup> TPG ¶¶ 3.75-3.79; GFT ¶ 10.32.

<sup>6</sup> It might be the case that comparables that are outliers of the range could have suffered from similar consequences to the tested party.

<sup>7</sup> TPG ¶ 1.40.

regions, to fund additional capabilities elsewhere.

**Related Party Loans.** The crisis and the consequent increase in risk aversion in financial markets has led to volatile credit spreads, changes in reference interest rates, and is likely to result in fewer debt transactions. For MNEs, these developments may raise many significant challenges and questions. For example, how can related party interest rates on loans be established in such an unstable environment, with few potential comparable transactions? Should interest rates on existing inter-affiliate loans be reviewed and changed to reflect the current (hopefully temporary) financial situation? Should the current circumstances be taken into account when determining future lending policies within the group even where expectations are that the crisis may be abated?

Macroeconomic factors may trigger changes in the financing costs in the market (e.g., higher interest rates and the general tightening of the credit markets), which could make intercompany interest rates unaffordable for some related borrowers with or without an explicit parent-company guarantee. To deal with these increased costs when securing new loans or renegotiating existing loans, MNEs may avail themselves of the "implicit support" of the group to meet their financial obligations. In the context of intragroup loans, this implicit support may take the

form of an improved credit rating, more closely aligned to that of the MNE group. The relative status of an entity within the group may help determine what impact that potential group support has on the credit rating of the borrower or debt issuer.<sup>8</sup>

When dealing with external funding, the implicit support from the group could also be enhanced by explicit intragroup guarantees.

The Covid-19 outbreak may put subsidiaries needing to pay salaries and other expenses under financial strain. Some may struggle to meet their payment obligations on intercompany loans. If this is the case, under the new GFT,<sup>9</sup> it may be reasonable to renegotiate more favourable terms than would usually be available, delay interest payments on a temporary basis, or re-characterize short-term loans as long-term loans. These measures would need to be well documented<sup>10</sup> though, demonstrating close consideration of the options realistically available to both the borrower and the lender.

**Credit Rating.** If existing intercompany policies rely on historical credit ratings,<sup>11</sup> these may need to be reconsidered in light of the current crisis. It is important that the MNE group appropriately documents the reasons behind the chosen credit rating when pricing intragroup loans and other controlled financial transactions.<sup>12</sup>

**Guarantees.** Explicit intragroup guarantees could be a useful tool for allowing MNEs facing decreased creditworthiness or liquidity restrictions to obtain larger loans or more favorable loan terms. Companies should refer to the new GFT when pricing guarantees as it sets out situations in which the price of a formal guarantee may be zero (e.g., when a parent company's loan covenants require it to support all its subsidiaries in the event of a potential default).<sup>13</sup>

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<sup>8</sup> GFT ¶ 10.77 ("An MNE group member with stronger links, that is integral to the group's identity or important to its future strategy, typically operating in the group's core business, would ordinarily be more likely to be supported by other MNE group members and consequently have a credit rating more closely linked to that of the MNE group.")

<sup>9</sup> GFT ¶¶ 10.59 - 10.61.

<sup>10</sup> GFT ¶ 10.60 provides that "... a transfer pricing analysis with regard to the possibilities of the borrower or the lender to renegotiate the terms of the loan to benefit from better conditions will be informed by the options realistically available to both the borrower and the lender."

<sup>11</sup> In general, the creditworthiness of the borrower is one of the main factors that independent investors take into account in determining an interest rate to charge.

<sup>12</sup> GFT ¶¶ 10.67-10.68.

<sup>13</sup> GFT ¶ 10.87.

**Cash Pooling.** Cash pooling is another efficient way of managing cash. For a cash pool to be implemented and priced, the cash pool transactions and the functions of the cash pool leader need to be defined accurately. The arm's-length remuneration of a cash pool leader should be decided on a case-by-case basis.

Cash pool financing policies should allow for long-term monitoring of cash pool transactions and, if necessary, their recharacterization. Consideration should also be given to whether to use notional cash pooling or physical cash pooling, as well as the 2017 U.S. tax reform, which in certain cases may allow for U.S. participants in the cash pool.<sup>14</sup>

### C. Allocation of Legitimate Losses

While some industries will be hit by the Covid-19 outbreak (some harder than others), other industries will benefit. Inevitably, companies in industries negatively affected by the Covid-19 could incur losses.

The TPG clearly provides that "*associated enterprises, like independent enterprises, can sustain genuine losses*" due to unfavorable economic conditions, inefficiencies, or other legitimate business reasons.<sup>15</sup>

The Covid-19 outbreak would certainly constitute an unfavorable economic condition. However, that alone does not justify the legitimacy of losses. How third parties deal with the same or similar conditions will be key here.

Losses, in the TPG, are largely associated with risk and the control of such risk. If a local entity has been set up as a low-risk

entity and has been compensated using corresponding TP methods (like cost plus), it might be difficult to justify losses in that local entity. That said, if companies can prove that unrelated parties in the same or similar situations have borne the relevant cost/expenses and incurred losses, then it may be possible to book losses in such "low-risk" entities. This, of course, would require detailed analysis of the facts and circumstances and benchmarking support. A similar issue occurs where the high-risk functions are allocated. In most normal circumstances, that jurisdiction would be expected to bear the gains and losses associated with an economic crisis. However, where an unforeseeable event such as Covid-19 causes those gains and losses, a re-evaluation may be in order based on where key management functions are actually performed and what changes are required to a company's overall operating structure.

It is worth noting that countries' views diverge in this respect. For example, the Chinese tax authorities specifically issued guidance after the 2008 financial crisis that single-function low-risk entities would not bear the risks related to the financial crisis and were not allowed to make losses. Therefore, it is advisable to survey the positions of local jurisdictions before reporting losses (or gains) locally.

### D. Business Restructuring/Reorganization

Some companies are shutting down or scaling back their operations in various jurisdictions, both voluntarily and involuntarily. Government lockdowns and unprecedented economic pressures have forced and will force companies to rethink and potentially restructure their intercompany arrangements. Chapter 9 of the TPG provides some helpful guidance on the "*termination or substantial renegotiation*" of intercompany arrangements in the context of business restructurings. These restructurings could involve temporary shutdowns of operations, measures to stem

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<sup>14</sup> GFT Section C.2.

<sup>15</sup> TPG ¶ 1.129.



losses in situations of over-capacity or economic downturn, and realignment of supply chains to introduce multiple sources.

In the case of a temporary shutdown of operations, production capacity may need to be relocated. Pricing, supply quantity, or service-level terms of the intercompany arrangement may also need to be reset.

Some companies could seek to restructure their supply chains to prevent single sourcing and ensure business continuity in case of disruptions. These business restructurings may therefore be necessary to improve supply chains, "*preserve profitability, or limit losses.*" The question is: which entity or entities within the MNE group should bear the costs of the restructuring and how the intercompany pricing should be reset?

If a loss-making entity is shut down, the restructured entity "*is actually being saved from the likelihood of a 'loss-making opportunity.'*" For example, it may make sense for manufacturing capacity to move from one entity to another because the first entity may no longer be able to operate through no fault of its own. No compensation likely would be due to the first entity, since it is not being relieved of a profit-making opportunity but rather of an expectation of significant losses. Similarly, if the tested party to a Transactional Net Margin Method transaction has shut down, it may make sense for that tested party to not receive a routine return for the duration of the shut-down period and only receive the cost of reimbursement. The cost base on which this reimbursement is calculated may also need to be carefully considered if many of the one-time expenses benefit future periods (such as preparing equipment to be restarted).

Further, there may be situations where a company needs to set up new or additional activities in a jurisdiction to make up for the lack of production elsewhere in its supply chain. This business decision may be temporary or may result in a long-term change to the supply chain to diversify and limit single-sourcing risk. In such situations, the loss-making or shut-down entity can be maintained, but the entities within the MNE group benefiting from its continued existence (and anticipated restart) would need to bear the costs of maintaining it.

## **E. Valuation of Highly Uncertain and Unpredictable Events**

Where a valuation is highly uncertain and the analysis of future events is unpredictable, both companies and tax administrations should always consider what independent enterprises would have done in comparable circumstances to take into account the uncertainty in the pricing of a transaction.<sup>16</sup>

In this regard, the TPG highlights how *ex-ante* pricing could be a reasonable and useful approach for companies and tax administrations to take, to the extent the companies can satisfactorily demonstrate what was foreseeable at the time of the transaction and reflect this in its pricing assumptions.<sup>17</sup> As such, companies should adequately document their analysis, providing sufficient information on the assumptions made and demonstrating that the divergence between projections and outcomes arose from unforeseeable events.

## **F. Safe Harbors**

As noted by the TPG,<sup>18</sup> a number of jurisdictions have adopted safe harbor rules in relation to TP. These rules typically enable smaller entities and/or less complex transactions to follow a simpler set of TP rules

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<sup>16</sup> TPG ¶ 3.72.

<sup>17</sup> TPG ¶ 6.194.

<sup>18</sup> TPG Section E.4 and Annex I to Chapter IV.

(or, possibly, be exempt from TP rules altogether). A number of the benefits and challenges of such regimes are brought into focus in light of the current Covid-19 outbreak. As such, groups should consider whether their historical approach to safe harbour rules now requires rethinking.

In terms of benefits for companies, the two main advantages of such regimes are simplified tax compliance obligations and future certainty.<sup>19</sup> The attractiveness of these benefits may be heightened for groups looking to redeploy internal resources and make cost savings as a matter of urgency in response to the Covid-19 outbreak. In particular, where TP documentation requires input (e.g., interviews) with other parts of the business to understand how the various roles and functions fit together, then this may not be feasible as the business reacts to the ongoing turmoil. Likewise, the current climate may frustrate TP policies that rely on data collection methods that are no longer reliable.

The above should be balanced against the risks of inflexibility and double taxation for companies when using safe harbour regimes.

**Inflexibility.** The details of safe harbour rules vary from jurisdiction to jurisdiction. Certain regimes limit a company's ability to opt into/out of the regime by requiring the company to notify the tax authority in advance (before entering into the regime) and/or to commit to staying within the regime for a prescribed period of time. Such restrictions can present obvious challenges in the current environment as: (i) the tax authority may simply not have the bandwidth to engage, where entry into the safe harbor regime requires express acceptance from the tax authority (this issue is even greater where the rules operate on a bilateral or multilateral basis, meaning that coordination from more than one tax authority is needed); and (ii) a commitment to stay within the safe harbour regime for a prescribed period may not be acceptable, given the uncertainty

generated by the current environment (this issue may be particularly prevalent where the group intends to undertake only short-term changes, or the longer term picture is not predictable).

**Double Taxation.** There is a risk that double taxation can arise where the transfer price is challenged and subsequently adjusted in the other relevant jurisdiction (i.e., the jurisdiction that is not operating a safe harbor regime). Whether such a double taxation risk arises may not become clear for many years, depending on the audit/assessment rules in that jurisdiction. In such circumstances, it may be possible to obtain relief from double taxation under mutual agreement procedures. This double taxation risk, therefore, should be weighed against the simplified compliance and certainty benefits noted above.

Drawing the above together, in terms of practical next steps:

- **All groups should monitor changes to the safe harbor rules in the jurisdictions in which they operate.** While it remains too early to say, it is possible that jurisdictions will review and amend their safe harbor rules in response to the impact of Covid-19 on the broader economy. Specifically, given the benefits that tax authorities can derive from simplified administrative compliance, it may be that we see measures intended to broaden the scope of, and encourage the use of, safe harbour rules (especially as many tax authorities face internal resource constraints/redeployment).
- **Groups that have not utilized safe harbor rules should consider whether now is the time to do so.** In particular, where the current environment prompts business restructurings, it may be that certain TP aspects of such restructurings could be covered by safe harbor rules. Before deciding to utilize such regimes, however, the benefits and risks noted above should be weighed carefully.
- **Groups that have availed themselves of safe harbor rules should consider whether it remains beneficial to do so.** In particular, it may be that the transfer price under the safe

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<sup>19</sup> Essentially, low/no risk of audit, the significance of this being amplified where the jurisdiction would otherwise levy material interest and penalties for tax understatements and/or documentation failure.

harbor rules is materially different from what could be supported under a "proper" arm's-length analysis. Where this is the case, the other practical considerations (in particular, the ability to elect out of the regime) noted above should be evaluated, to determine the most beneficial path forward.

### III. PRACTICAL ACTIONS FOR COMPANIES

**In-depth TP Analysis.** As governments increase their focus on TP and international tax matters, more in-depth TP analyses are required to support the arm's-length nature of transfer prices. MNEs should analyze the impact of Covid-19 on their businesses, assessing not only their own operations, but also whether the crisis affected any comparables upon which they rely. Furthermore, an in-depth assessment of existing intercompany arrangements may need to be conducted in order to determine if, given the ongoing crisis, they should be cancelled or modified. Under normal circumstances, tax authorities generally expect companies to keep their TP analysis up to date, refreshing them as required in response to material factual and wider economic circumstances. While tax authorities typically make this assertion when arguing that old TP policies have become outdated and under reward local functions, such that upward TP adjustments are required, the principle cuts both ways. As such, once the full impact of Covid-19 on a business and the wider economic circumstances have become clearer, it may present a natural opportunity to revisit and change its TP

arrangements. Particular areas requiring diligence include: (i) the factual basis on which the existing TP arrangements were prepared; (ii) the suitability of any comparable companies identified in the existing TP documentation; and (iii) the ability to reliably collect data that can be used to apply the TP policies. In this regard, it will be important to remain on top of the local compliance requirements (particularly in terms of any TP documentation requirement and deadlines for filing and amending tax returns).

**Impact on Live TP Disputes.** Although these are, strictly, only in relation to past periods (such that future periods are not within scope and should not have a bearing on the outcome), as a strategic and practical matter, there may be some benefit to explaining to the tax authority any future changes that are being driven by the Covid-19 outbreak. This will, of course, depend on the specific facts and circumstances of any given TP dispute. To take a very simple fact pattern, if a tax authority is placing considerable focus and getting bogged down on an issue that a business intends to change going forward as a result of Covid-19 (e.g., a business line that is predicted to soon become loss making or an element of the supply chain that is to be revised), then proactively explaining this may motivate the tax authority to deploy their resources elsewhere and break the deadlock. It is also possible that tax authorities may agree to pause any live TP disputes, as many tax authorities are being required to urgently redeploy their personnel and resources to departments that are responsible for Covid-19 relief measures. Finally, to the extent the current crisis demonstrates how risky a given entity or function actually is, the impact of the crisis on a company's actual business operations should be used as a real-life example of such riskiness.

**Impact on Roll Forward of Recent TP Disputes.** It is common in many disputes (particularly in the context of local sales and marketing and regional/global management functions) for the tax authority to require a

value chain and profit split analysis to be undertaken (either as the primary or a corroborative TP methodology). Again, although disputes are generally "backwards looking" (i.e., they do not bind a company and the tax authority in relation to future periods, as an advance pricing agreement may do), there is often a tacit understanding between the parties that, absent any material factual or economic changes, the settlement TP methodology will continue to be applied in future periods. The impact of the Covid-19 outbreak may warrant changes to this tacit assumption (particularly where any profit split analysis becomes a global residual loss allocation exercise).

**Engagement with Tax Authorities.** The level of engagement that companies have with tax authorities varies across jurisdictions. In the UK, for example, companies categorised as *Large Business* are assigned a *Customer Compliance Manager*, whose role is to act as a regular point of contact for that company and to build a detailed and up-to-date knowledge of the company's business and tax affairs. Where such a relationship exists, then proactively engaging with the tax authority to keep them updated would likely be a sensible course of action (as it will enable real-time information sharing with the tax authority, to support the "audit file" point noted below). This comes with the caveat that, where possible, it is advisable to wait and see how this situation develops and establish a more developed understanding of how the crisis has impacted/is impacting the business both locally and globally (as "knee jerk" reactions risk presenting an inconsistent narrative to tax authorities). Clearly, how effective this will be depends on the relevant tax authority's bandwidth to engage in return. As a practical matter, many tax authorities are still coming to terms with the new information technology, data sharing, and home working arrangements. In addition, tax authorities may undertake broader resource redeployment to focus on key Covid-19 measures, so it is possible that attempts to engage may fall on deaf ears in the short/medium term. That said,

taxpayers that are currently under audit should also be sure to engage with their case team to understand what the crisis means in terms of process and any statutory deadlines.

**Look Out for Guidance.** Many tax authorities have sought to present a "business as usual" outlook as the scale and duration of the Covid-19 outbreak develops, and it may be that tax authorities begin to issue specific guidance or dispensations to taxpayers. As any such guidance emerges, businesses should consider it in the context of their tax arrangements. Even if not specific to TP, there may be a read across interrelated tax issues (e.g., any guidance in relation to permanent establishment issues caused by remote workers may have an impact on the need to undertake permanent establishment profit attribution exercises). Future releases at both the OECD and domestic levels should be monitored closely. In particular, attention should be paid to any jurisdictions that deviate from the OECD approach.

**Contemporaneous Evidence Gathering.** To the extent that the Covid-19 outbreak necessitates changes to TP policies, intragroup supply chains, valuation approaches, or other TP matters, it is good practice to prepare an "audit file" now. Although it is impossible to predict exactly what the audit landscape will be when current periods are potentially open to tax authority review, based on current experiences, it would be very helpful if the commercial pressures presented by Covid-19 (and the related tax/TP analysis) are documented in contemporaneous documentation (e.g., email correspondence, board minutes/presentations and memos/reports). Proactively undertaking such evidence gathering now should save time and effort in the event of any future tax authority audits into the changes made.

**Global Consistency.** If businesses determine that they need to move resources, they should take consistent actions globally (rather than focusing on individual jurisdictions, where possible). This is a global crisis and, although the scale of the impact on the economy is not clear yet, it is likely that the global economy will be hit hard. For example, if royalties are increased to meet the cash needs in the group's home jurisdiction, the company should consider raising such royalties globally while, of course, complying with the arm's-length principle.

## Authors



**Mario D'Avossa**

Partner  
Milan  
Mario.D.Avossa@bakermckenzie.com



**Philip Thomas**

Associate  
Washington, DC  
Philip.Thomas@bakermckenzie.com



**Claudine Fox**

Senior Tax Advisor  
Washington, DC  
Claudine.Fox@bakermckenzie.com



**Fernanda Trujillo-Garcia**

Associate  
Milan  
Fernanda.Trujillo-Garcia@bakermckenzie.com



**Moisés Curiel-Garcia**

Partner  
Mexico City  
Moises.Curiel@bakermckenzie.com



**James Wilson**

Partner  
London/Washington, DC  
James.Wilson@bakermckenzie.com



**Andrew O'Brien-Penney**

Director of Economics  
Chicago  
Andrew.Obrien-Penney@bakermckenzie.com



**Shanwu Yuan**

International Tax Director  
New York  
Shanwu.Yuan@bakermckenzie.com



**Gustavo Sanchez-Gonzalez**

Senior Economist  
Bogota  
Gustavo.Sanchez-Gonzalez@bakermckenzie.com

# Transfer Pricing & Supply Chains: Global Developments Due to Covid-19

## I. THE CRISIS AT HAND

Global supply chains across all industry sectors are facing an unprecedented challenge due to the Covid-19 pandemic. Increased pressure on supply chain linkages is nothing new to multinational enterprises ("MNEs"), due to national tax and trade protectionism measures, evolving international tax policies, and technological disruption, but the current global pandemic is materially different. Covid-19 is unlike typical supply chain disruptions in that it has rapidly moved across the globe and forced companies to respond almost immediately to address the near-term sustainability of their existing supply chains. This development is putting a massive strain on MNEs' operations and creates a profound level of future risk and exposure from a business, tax, and legal perspective.

## II. STATE OF PLAY

### A. Before Covid-19

Before the onset of Covid-19, MNEs were already facing increased attention on supply chain management due to factors such as technological disruption, national protectionist measures, climate change policies, and global tax changes. Many companies had been considering the diversification and/or relocation of manufacturing activities to mitigate the effects of rising costs in major manufacturing jurisdictions like China,<sup>1</sup> even

before the uncertainties from the recent wave of trade disputes between the United States and its trading partners. In addition to considering new locations, companies have been expanding their strategic suppliers and increasingly interested in having redundancy in their supply chain to minimize risk. Another trend "near-sourcing," or shifting sourcing and manufacturing closer to major operations or end customers, has resulted from the 2016 Paris Climate Agreement and companies' attempting to reduce their carbon footprint in supply chains. On the tax side, supply chains have also been under scrutiny from a tax and transfer pricing perspective as audit activity has been accelerating globally - driven by the focus of the Organization of Co-operation and Economic Development's (OECD) Base Erosion and Profit Shifting ("BEPS") project. The BEPS roadmap has handed tax authorities the appropriate transfer pricing toolboxes to point at all major companies. As a result, tax and transfer pricing challenges have been particularly prevalent in Europe, and companies have already been strengthening their tax positions in response.

### B. Covid-19 Supply Chain Impacts

On top of these pressures, Covid-19 has created a sudden, unexpected supply chain disruption. The virus nearly shut down manufacturing in the heart of China and other North Asian countries and is rapidly moving to impact manufacturing all over the world. Business closures across the globe have already impacted suppliers and customers, depending on the industry, and are likely to impact more in the near term as global

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<sup>1</sup> Countries like China have tried to use policy to stimulate investment. The Belt and Road Initiative also increased investment by Chinese private and state companies in manufacturing and transportation in Southeast Asia and beyond.

consumers are required to stay home and unemployment is on the rise.

These disruptions raise many questions both in reacting to the near term and planning for the future. In the immediate term, companies are reviewing force majeure clauses in supply contracts and evaluating alternative means of performing contract obligations. Companies are looking to temporary supply options, including assessing whether to support their suppliers with advance payments or even acquisitions in order to keep them afloat. Current travel restrictions are forcing many business activities to be put on hold or performed virtually.

In jurisdictions that are beginning to recover, demand has widely shifted, and the health of customers' finances are in question. Inventory levels for both raw materials and finished goods are being reassessed and may require additional investment, or cuts, to prepare for future shifts in demand.

In the longer term, companies are beginning to focus on responding to all of their specific issues and recalibrating their supply chains now that Covid-19 is priority number one. Companies are considering supplier diversification to prepare for the future. The potential for annual travel restrictions if Covid-19 becomes a recurring event puts an additional burden on companies to have local teams in jurisdictions where they have significant supplier or customer relationships. Short-term and long-term changes to the location of decision-making personnel can have significant adverse impacts on legal, tax, and transfer pricing positions.

### **III. RESPONDING TO THE COVID-19 PANDEMIC**

#### **A. Manage the Rapidly Changing Supply Chain**

During a period in which companies are managing supply crises, commercial arrangements are constantly being re-assessed.

New third-party supply and distribution arrangements are being evaluated, which could have a material impact on existing structures. Companies will need to be mindful of the impact this period may have on establishing transfer prices for new intercompany arrangements. For example, where a company may not previously have had a comparable uncontrolled price, it may have one as a result of this period, which at a minimum, the company will need to consider if it is ultimately rejected in benchmarking the new arrangement.

#### **B. Potentially Modifying Transfer Pricing in Existing Supply Chains**

As commercial supply chains are under strain due to Covid-19, companies should consider whether transfer pricing changes are appropriate. It may be both necessary and beneficial to re-evaluate functional profiles and levels of profit for all parts of the supply chain and analyze which party is ultimately bearing the risk associated with decisions currently being made. Changes may be needed to reduce levels of guaranteed profit in entities that are limited-risk distributors, contract manufacturers, sales agents, and the like, as an example. Management may be changing or moving from one place to another to address the crisis, and employees may be terminated or furloughed as a result of governmental requirements or adverse financial results.

Once decisions have been made about how transfer pricing should be handled during the Covid-19 crisis, companies should make sure intercompany agreements support such decisions. These agreements should appropriately reflect the new financial and commercial conditions and current best practices.

Agreements that are put in place in connection with setting up new procurement, manufacturing, and distribution arrangements should strike a balance between preserving flexibility for future termination or reduction of activity and appropriately reflecting the risks

and benefits of the arrangement. In particular, special consideration should be given to drafting provisions related to term and termination, including the notice period and the rights and obligations upon termination. For example, a very short agreement term or termination notice period may provide the greatest flexibility in the future, but may also impact the level of investment considered appropriate for a company to bear in the absence of expectations for a continued arrangement. MNEs should also consider what rights are needed under the agreement, such as whether a license of intangible property is needed, and if so, how broad such a license should be (e.g., exclusive/non-exclusive, royalty-bearing/royalty-free, etc.).

### **C. Analyzing and Managing Temporary Changes to the Supply Chain**

Supply issues may result in temporary shifts to the ordinary supply chain flows in any given structure. These changes could have unanticipated results that need to be analyzed closely. For U.S.-parented companies, there could be adverse Subpart F impacts and VAT and customs implications for all companies. "Substantial contribution" may be more difficult to achieve and disregarded flows may become regarded flows. It may be necessary to evaluate beneficial ownership transfers in the short term, in light of the difficulty of legal transfers in some jurisdictions that require extensive formalities.

A variety of additional issues are likely to arise, especially as extraordinary expenses such as potential layoffs, termination payments, lease breakage fees, and asset impairments occur. Consideration will have to be given as to who should bear these costs based on the functional and risk profiles of the various pieces of the supply chain as they exist during the crisis. Now more than ever before many companies will be experiencing losses potentially in many different countries, and analysis should be done immediately to determine which legal entities and countries should bear those losses.

## **D. Maintain Supply Chains**

### **1. Respect the Linkages**

As commercial forces are driving rapid adjustments to supply chains, tax departments are required to stay abreast of these changes to ensure compliance and mitigate risk. To taxing authorities, Covid-19 may have created a challenging circumstance to test the validity and sustainability of a particular structure. Changes may be required and documenting them contemporaneously will be extremely important in the future.

### **2. Document Changes**

When analyzing the supply chain, careful attention should be paid to the transfer pricing guidance in each applicable jurisdiction and its interaction with functions and risks (e.g., under the 2017 OECD Transfer Pricing Guidelines ("OECD TPG")), especially with regard to the control over risk. Companies should examine and document the impact the virus is having on their supply chain to be able to effectively defend challenges. Supporting the defense and formulating the related arguments can be akin to invoking a force majeure clause in a legal agreement, as companies often have little to no choice in formulating their response and may be forced to take action that would not materialize under normal trading conditions.

Companies will also be limited in where directors, officers, and other key personnel can travel. While the hope is tax authorities will be flexible for companies that otherwise have good track records both before and after the global crisis, care must be taken to avoid tax nexus (e.g., tax residency by management and control or permanent establishments). Practically speaking, ideal substance and other best practices may not be possible under the current conditions. Companies should create contemporaneous documentation about the circumstances when local activities or activities in particular places are not possible by documenting the global situation, travel bans,



attempts made for meetings (e.g., if travel had already been booked), etc.

## E. Replace Intercompany Links

If an existing supply location is no longer viable, a company should consider the impact of any exit. Similar considerations as discussed above would apply, including evaluating the local law's requirements for termination compensation and what the intercompany agreement provides for upon termination (e.g., what is the effect of a waiver of termination compensation). Whether a local company has developed or acquired a compensable intangible through the course of the intercompany arrangement is often of greatest interest to tax authorities. Companies should be prepared to document the terms of the termination of the arrangement and the agreement between the relevant parties on the transfer of rights and obligations. A transfer pricing analysis will be key to supporting any amount paid in connection with the exit or defending why there is no compensable value being transferred, which may well be the case post Covid-19.

## IV. BEYOND COVID-19

Covid-19 has magnified the spotlight on the perils of relying on inflexible supply chains. When the immediate crisis is over, many companies will be even more incentivized to diversify their supply chain. Solutions will vary for companies, but many will seek strategic investment in production redundancy, move more production near market, and accelerate adoption of next generation manufacturing technology.

**Production Redundancy.** Trade protection and conflict had already recently reminded companies of the importance of strategically building in redundancy throughout their supply chains. However, companies' responses to those challenges were primarily limited to the movement of final operations that determined the origin of a good. Faced with the current crisis, companies are now re-learning what happens when you cannot get the raw

materials, components, and subassemblies necessary to make the product at all. To counter this risk, it is likely that more companies will building redundancy at all phases of the supply chain, e.g., through region-specific chains.

**Production Near Shoring.** The trend of near shoring is also likely to accelerate when possible. While near shoring may counter the risk of trade protectionism and tariffs, it does not itself address supply chain disruption caused by viruses, climate change, natural disasters, or political unrest, as no location is immune from such contingencies. Nevertheless, as companies pursue strategic production redundancy, we expect much of this to happen close to home, as it will drive other business benefits, such as shortened lead times, reduced logistics costs, investment in local communities, and increased substance.

**Next Generation Manufacturing.** Production redundancy, along with near shoring, means that production processes will be duplicated and disperse, sometimes reducing cost-cutting benefits of economies of scale. Companies are already using logistical, overhead and efficiency costs through digitalization and next generation production technologies, which have their own tax and transfer pricing challenges.

## V. CONCLUSION

MNEs will have to work more effectively than ever to manage their supply chains in the rapidly changing environment due to Covid-19. In most instances, this will require monitoring and documenting the temporary changes due to the crisis. However, for many, it may involve rethinking the supply chain to ensure future sustainability. Given the novel challenge at hand, this uncharted territory for many companies will create a natural imperative for legal, tax, trade-compliance, and operational professionals to team together, draw from collective experience, and collect and assess relevant information on past trends to forge a sustainable path into the future.

## Authors



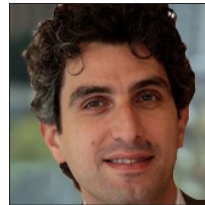
**Armando Cabrera-Nolasco**  
Partner  
Guadalajara  
Armando.Cabrera-Nolasco  
@bakermckenzie.com



**Tamara Levin**  
Partner  
San Francisco  
Tamara.Levin@bakermckenzie.com



**Jon Cowley**  
Partner  
Hong Kong  
Jon.Cowley@bakermckenzie.com



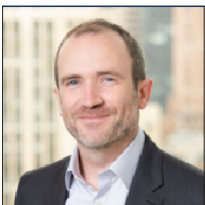
**Antonio Russo**  
Partner  
Amsterdam  
Antonio.Russo@bakermckenzie.com



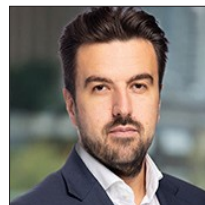
**Jukka Karjalainen**  
Partner  
London  
Jukka.Karjalainen@bakermckenzie.com



**Gene Tien**  
Director of Economics  
Palo Alto  
Gene.Tien@bakermckenzie.com



**Shane Koball**  
Director of Economics  
New York  
Shane.Koball@bakermckenzie.com



**Vladimir Zivkovic**  
Tax Director  
Amsterdam  
Vladimir.Zivkovic  
@bakermckenzie.com

# Transfer Pricing Considerations for Remote Workforces

## I. INTRODUCTION

The Covid-19 outbreak has led many countries to implement border controls as a temporary measure to curb infections, and many employers find their employees working from home or in locations outside the jurisdictions where employers typically operate or are located. International travel restrictions affect Boards of Directors and employees of multinational enterprises, alike, who find themselves marooned in various different locations around the world. Those unexpected remote employment and business activities may trigger a local tax presence for which the employer has not planned. This will in turn give rise to international tax complications, including increased permanent establishment (“PE”) risks and in some circumstances, a change in corporate tax residency.

Below, we discuss the issues arising from these remote business and employment activities as well as the risks that such remote activities could cause if they continue after the Covid-19 crisis is resolved (where personnel continue to desire or demand to work remotely). There are individual tax implications for employees working remotely abroad that are not discussed in this article but are worth considering together with the tax implications for corporations.

## II. PE ISSUES CAUSED BY EMPLOYEES WORKING OUTSIDE OF THEIR HOME OF JURISDICTION

### A. Risks of Creating a Fixed Place of Business (Voluntary vs. Involuntary) in the Jurisdiction of the Remote Workplace

If the remote working location of the employee is in the same jurisdiction as his/her employer, such arrangement should not trigger any international tax implications.<sup>1</sup> However, where the employee’s home base or location of temporary presence or quarantine is in a different country, the employee’s business activities might trigger PE assertions and potential corporate income taxation in the other country of the profit attributable to such PE. PE issues may also arise within certain countries (e.g., Canada’s provinces/territories generally impose income tax on corporations with a PE in the province/territory).

According to the Organization for Economic Co-operation and Development (OECD) Art. 5 (1) of the Model Tax Convention on Income and on Capital 2010 (“MTC 2010”) as well as OECD Art. 5 (1) of the Model Tax Convention on Income and on Capital 2017 (“MTC 2017”), a PE is any fixed place of business through which the business of an enterprise is wholly or partly carried on. To be characterized as a PE, the place of business needs a certain degree of permanency, i.e., it is not of a purely temporary nature.<sup>2</sup> A home office of an employee may qualify as a PE in some jurisdictions, if the use thereof is not intermittent or incidental and provided the foreign enterprise requests the employee to use the home office.<sup>3</sup> In other jurisdictions (such as Canada), an employee’s

<sup>1</sup> Employment related tax issues and (in the United States) state and local tax issues can still be a problem under such circumstances but are not addressed in this article.

<sup>2</sup> Model Tax Convention on Income and on Capital: Condensed Version 2010 (“OECD Commentary 2010”), Art. 5 mn. 6, Model Tax Convention on Income and on Capital: Condensed Version 2017 (“OECD Commentary 2017”), Art. 5

<sup>3</sup> OECD Commentary 2017, Art. 5 mn. 18.

home office generally will not constitute a PE.<sup>4</sup> However, in all cases the presence has to be continuous and thus, of a certain permanency. Generally, the OECD considers six months to be a requisite time period, unless the nature of the business requires less time. Countries, however, have varied interpretations on what is an appropriate time.<sup>5</sup> It is generally irrelevant whether the fixed place of business was put in place intentionally or whether circumstances led to such location becoming a fixed place of business.

As of now, expectations are that the Covid-19 crisis will be resolved in less than six months. Therefore, personnel should be able to return to their usual operations prior to the lapse of this period.

Companies may want to consider adopting guidelines for employees working remotely to minimize PE risk in the future in preparation for a second outbreak or another crisis that creates similar safety conditions.

In addition, many countries are considering legislative measures to clarify that the forced home office of an employee does not create a PE. For example, the Australian Taxation Office (ATO) has set up a Covid-19 frequently asked questions webpage, which addresses, amongst others, the issue of whether the presence of employees in Australia may create a PE in Australia.<sup>6</sup> The initial OECD guidance on tax measures that countries should consider taking in response to Covid-19 did not include PE mitigation, however.

According to the ATO, it will not use compliance resources to determine if a foreign company has a PE in Australia if such foreign company did not have a PE in Australia before being impacted by Covid-19, and the presence of employees in

Australia is the short-term result of them being temporarily relocated or restricted in their travel. France<sup>7</sup> and Luxembourg<sup>8</sup> have made similar announcements applicable to situations where employees usually travel cross border to their work from neighboring countries. Although helpful, these legislative developments should be closely monitored. In any event, businesses should revert to their normal business operations as soon as reasonably possible to ensure that temporary work from home arrangements do not become permanent. In particular, businesses should evaluate the extent that they are already running into issues with employees having worked in remote jurisdictions, or the potential desire of employees to continue to work in remote locations after the crisis has passed in order to not slip into unwanted PEs.

Certain treaties contain other PE deeming rules that could be triggered by a remote workforce. For example, the Canada-U.S. tax treaty may deem an enterprise of one state to have a PE in the other state if the enterprise performs services (for example, through employees) in the other state for an aggregate of 183 days or more in any 12-month period with respect to the same or connected projects for customers who are residents of or have a PE in the other state. This deeming rule does not require the services to be performed from a place that has any degree of permanency, or even from the same place. Further, these services have to be performed “for customers,” such that activities performed for the company itself (e.g., stewardship activities) generally should not count for this purpose.

For jurisdictions without comprehensive double-taxation agreements or situations where no

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<sup>4</sup> In Canada, an employee’s home office should generally not constitute a PE of the employer provided that the employer does not bear the cost of or exercise control over or have access to the employee’s home office, and that the employee’s home office is not identified with the employer (e.g., on the employer’s website).

<sup>5</sup> OECD Commentary 2017, Art. 5 mn. 28, OECD Commentary 2010, Art. 5 mn. 6.

<sup>6</sup> See <https://www.ato.gov.au/Individuals/Dealing-with-disasters/In-detail/Specific-disasters/Covid-19/?anchor=Internationalbusiness#Internationalbusiness>.

<sup>7</sup> [France MOF Explains Work From Home Condition for Cross-Border Workers During Coronavirus Pandemic](#), Transfer Pricing Rep. (Mar. 24, 2020).

<sup>8</sup> [Luxembourg MOF Explains Force Majeure Condition for French Cross-Border Workers During Coronavirus Pandemic](#), Transfer Pricing Rep. (Mar. 24, 2020).

double-taxation agreement applies and domestic law controls, the above-mentioned concepts do not govern. Thus, it will be crucial to review the remote workforce arrangements to identify the tax risks associated with domestic laws on PE and to consider the necessary mitigating steps.

For instance, whether remote business activity in the United States will trigger a U.S. taxable presence under domestic law depends on factors that can differ from the typical treaty analysis. A foreign corporation is subject to tax under U.S. domestic law only if it is considered to have sufficient nexus (i.e., a "U.S. trade or business") and derives income effectively connected with such U.S. trade or business (i.e., "ECI").<sup>9</sup> Whether a foreign corporation has a U.S. trade or business is generally a low threshold (i.e., it does not necessarily require a fixed place of business); however, this does not automatically subject a foreign corporation to U.S. tax -- it must still earn ECI.

Whether income is ECI depends on how the income is sourced under U.S. domestic law, so sourcing rules under U.S. domestic law become important. There are different rules for income derived from the performance of services, the sale of goods, or from passive investments, which impact the ECI determination.

In general, U.S.-source active business income associated with a U.S. trade or business is considered ECI.<sup>10</sup> In contrast, foreign-source active

business income is generally not ECI unless such income is attributable to a U.S. "office or other fixed place of business" (and if the company cannot further avail itself of further defenses in case of the sale of inventory).<sup>11</sup> Whether there is a fixed place of business depends on the facts and circumstances –including the use of fixed facilities through which a foreign corporation engages in the trade or business, while not having a fixed a place of business where the foreign corporation uses someone else's office on a relative sporadic or infrequent basis.<sup>12</sup>

### **B. Dependent Agent PE (Occasional vs. Routinely Entering into Contracts via Remote Workforce)**

In addition to a remote home office constituting a fixed place of business, employees contracting outside of the home jurisdiction may also constitute a dependent agent PE. According to Art. 5 (5) MTC 2010, a person is a dependent agent if that person acts on behalf of the foreign business and has, and habitually exercises, in a different country an authority to conclude contracts in the name of the foreign business.<sup>13</sup> The MTC 2017 update broadened this definition to include commissionaires and other individuals, who habitually play the principal role leading to the conclusion of contracts in the name of the foreign company that are routinely concluded without material modification. Whether the new definition applies depends on the applicable treaty and the position the respective country took in the Multilateral Instrument<sup>14</sup> with respect to the

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<sup>9</sup> §882(a)(1). All Section references herein are to the Internal Revenue Code (the Code), as amended, and to the regulations promulgated thereunder, unless otherwise stated.

<sup>10</sup> §864(c)(3). "Fixed or periodical" income (such as dividends, interest and royalties) requires an analysis as to whether such income was generated from the U.S. trade or business. §864(c)(2).

<sup>11</sup> §864(c)(4). See also §865(e)(2), which can resource income from the sale of property as U.S., thereby making it U.S. source ECI under the residual force of attraction rule in §864(c)(3). In particular, there are some technical rules that resource foreign source inventory sales income as U.S. source (and thus subject to taxation in the United States), where the income is attributable to a U.S. office and there is no "foreign material participation" by an office outside the United States. § 865(e)(2), § 864(c)(3).

<sup>12</sup> Reg. §1.864-7(b)(1), §1.864-7(b)(2).

<sup>13</sup> In the context of U.S. domestic principles, with respect to the sale of goods, ECI can be found where there is a U.S. office or fixed place of business of another that actively participates in the United States in soliciting the order, negotiating the contract, or performing other significant services necessary to the consummation of the sale. Reg. § 1.864-6(b)(2)(iii).

<sup>14</sup> *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, available at <https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf> (visited March 25, 2020).

application of the update. Note that the United States has not signed the MLI and existing double tax treaties are therefore not impacted.

Under both definitions, the individual has to exercise the authority repeatedly to create a permanent establishment. Occasional and one-off actions should not rise to the level of creating a remote contracting agent. While neither the OECD Commentary 2010 nor the OECD Commentary 2017 mention a specific period of time to create such a PE, the commentaries make reference to the general guidance issued for fixed places of businesses.<sup>15</sup> Therefore, the above-mentioned six-month period, as well as relevant guidance, should be considered.

If the restrictions caused by Covid-19 are lifted prior to the lapse of the six-month period, the risk of a dependent agent PE might be limited. However, businesses are well advised to consider how to move back to their regular business operations as soon as possible as to document the extraordinary nature of the current situation to clearly express that none of these remote measures were expected to occur or expected to be a permanent manner of operation. Although the intent of a company generally does not have a bearing on the PE analysis, such contemporaneous assertions may be helpful in case a tax administration tries to assert that the business operations were not solely caused by the Covid-19 circumstances but had already been contemplated by the foreign enterprise.

### **C. Profit Allocation in the Event a PE Found**

If a PE was in fact constituted from remote work arrangements, the profits attributable to this PE generally would be taxable in the remote jurisdiction. Typically, where there is a comprehensive double-taxation agreement in place, the profits of the foreign enterprise will be subject to tax where the PE is situated. This inevitably poses a challenge because it requires a

company to undertake an exercise to determine profits for a deemed arrangement where the PE is treated as a separate and independent enterprise and is entitled to an arm's length return.

Guidance on the Authorized OECD Approach ("AOA")<sup>16</sup> recommends that the profits to be determined are the profits which the PE is expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed through the PE and through other parts of the enterprise. Under the AOA, this would be equivalent to the profit any independent stand-alone business would have generated had it operated in such jurisdiction. If the activity is a sales activity, presumably the profit would be that profit generated through the sales concluded by the PE. In other situations, the taxable profit might be calculated on the basis of a cost-plus service remuneration. Which method applies depends on the underlying facts and is based on ordinary PE profit allocation determinations.

The domestic laws in some countries, like Canada, prohibit recognition of the types of notional transactions that would be necessary to fully apply the AOA, and it cannot be applied absent a specific agreement between the competent authorities of the respective treaty partners. Such an agreement exists between the competent authorities of Canada and the United States so the full AOA applies as between Canada and the United States. However, it does not yet apply vis-à-vis any other treaty partners.

In countries that have not adopted the AOA approach (e.g., Malaysia), the PE rules in their respective treaties, which are generally aligned to

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<sup>15</sup> OECD Commentary 2017, Art. 5 mn. 98, OECD Commentary 2010, Art. 5 mn. 6.3.

<sup>16</sup> *OECD 2010 Report on the Attribution of Profits to Permanent Establishments*, available at <https://www.oecd.org/ctp/transfer-pricing/45689524.pdf>

domestic law, will govern the treatment of the profits arising from the PE.<sup>17</sup>

#### **D. Even if the Temporary Activities Do Not Appear to Rise to the Level of a PE, Are there Concerns if Employees Continue to Work or Undertake Business Activity in Such Remote Jurisdictions?**

As mentioned above, businesses are well advised to monitor their remote operations closely and to return to their historical operations as soon as circumstances reasonably allow. Keeping the current temporary arrangements in place for a period longer than absolutely necessary might give tax authorities the argument to claim that the measures were never meant to be temporary or that a permanent presence has indeed been created. The PE will not start to exist from the time the measures could have been reversed, but from the time the measures were first implemented.<sup>18</sup>

### **III. PLACE OF EFFECTIVE MANAGEMENT/DUAL RESIDENCY CHANGES CREATED VIA THE TEMPORARY DISLOCATION OF THE PLACE OF OFFICERS/MANAGEMENT**

The Covid-19 outbreak may also result in MNEs having to change the location of their board meetings given substantial travel restrictions.

A company's board of directors may be composed of individuals resident for tax purposes in various countries. In particular, as a result of acquisitions, an integrated business may have geographically dispersed board members. These board members may regularly meet in one location to conduct their board meetings, usually at the place of incorporation of the company. In a situation like

the current Covid-19 crisis, where traveling is restricted but business has to continue, the board of directors is forced to find different ways of meeting and making decisions ideally without impacting the tax residence of the company in question. This might result in decision-making processes taking place in locations other than the place of incorporation, which in turn, might result in unwanted tax consequences.

Many civil law jurisdictions tie the residence taxation to the place of incorporation or the place of effective management. Meeting either criteria usually suffices to trigger residence and therefore, in some cases, worldwide taxation. Common law jurisdictions, such as the United Kingdom, Canada and Australia, tie taxation to the place of incorporation and/or the central management and control of a company, which refers to the highest level of management authority in a business and which is where strategic decisions are taken or supervisory functions are performed.<sup>19</sup> Most double tax treaties provide for a tie-breaker clause in their Art. 4 (3),<sup>20</sup> which provides that a company being a resident of both contracting states (under domestic law) is deemed to be a resident only of the state in which its place of effective management is situated. It is therefore paramount to keep the place of effective management where the company is resident for tax purposes to avoid the company becoming a tax resident of a different country, thereby potentially triggering exit tax in the country it used to be tax resident and/or limiting access to benefits under the intended treaty.

The term "place of effective management" refers to the top-level management, which is where executives and senior staff make the day-to-day management decisions.<sup>21</sup> Most double tax treaties

<sup>17</sup> But note that under U.S. domestic law, ECI treatment is an all or nothing venture – if ECI is found, all the income of the foreign corporation that is considered ECI is subject to U.S. taxation (i.e., there is no profit attribution).

<sup>18</sup> OECD Commentary 2017, Art. 5 mn. 34, OECD Commentary 2010, Art. 5 mn. 6.

<sup>19</sup> As developed in *De Beers Consolidated Mines, limited* (1906) AC 455, 5 TC 198, HL.

<sup>20</sup> Derived from the OECD Model Tax Convention prior to 2017; the 2017 version replaced the tie-breaker rule with the requirement for the competent authorities to agree on the tax residency of a tax payer. The Canada-U.S. tax treaty has a place of incorporation tie-breaker clause, but few other of Canada's treaties contain such a clause, typically relying on competent authority to decide.

<sup>21</sup> *Vogel*, Double Tax Conventions (1997) Art. 4 mn. 115.

(including those entered into by common law jurisdictions) follow the historical OECD Model Tax Convention, which means that the concept of central management and control only becomes relevant where there is no treaty in place. The OECD Commentary<sup>22</sup> defines the place of effective management as “the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made.” An entity may have more than one place of management, but it can have only one place of effective management at any one time.

As mentioned above, in ordinary times companies would make sure that the board of directors making critical management decisions would meet in one place. However, what can be done if people are not allowed to travel anymore? What if board members are located in countries that are not the country of incorporation?

Though not addressed by the OECD, countries commonly agree that where board meetings are conducted over telephone in a conference call or through video conferences with people being physically present in different countries, there is not one single place of effective management until a certain number of people in one location has the ultimately decisive vote. Where the voting rights are allocated such that two directors have the decisive vote, and both directors are resident in the same country, which is not the country of incorporation, tax authorities of such country may assert that the place of effective management is effectively located there. In this case, companies might want to temporarily change the voting rights providing for directors resident in the country of incorporation being part of the decisive vote. This should be feasible in countries that require at least one resident director under their local law or vote by proxy. Where the company does not have a director resident in the country of incorporation, care must be taken that the decisive votes are not concentrated in any one country. Where the bylaws provide for such allocation of the voting rights, a

temporary alteration should be implemented, thereby ensuring that directors who are all resident in different countries take the decisive vote. This might not be possible in all countries. For example, in Malaysia, a company will satisfy the tax residency test only if the management and control of a company’s business or affairs is exercised in Malaysia at any time during the year. The Malaysian tax authority will not issue a certificate of residency if board meetings are held virtually instead of physically in Malaysia.

Countries are also addressing this issue on a unilateral basis. The ATO has indicated that it will not apply compliance resources to determine if a company’s central management and control is in Australia, if the only reason for the change to the location of board meetings or where directors attend them from is due to impacts of Covid-19 and there are no other changes to the circumstances of the company. Similar guidance from other countries should be closely monitored.

If all of the above is not possible and the company cannot avoid having the effective place of management in a different country for the duration of the crisis, the company is well advised to keep the decision-making process to a minimum (if and where possible) and return to the previous process as soon as possible. Companies should also put in place documentary evidence showing that the “new” decision-making process is only allowed and in place for the duration of the crisis as an extraordinary measure and only because of existing travel limitations and safety concerns. Such documentation should clearly state that the process will be reversed as soon as restrictions are lifted. Contemporaneous board meeting minutes would serve as useful documentation to explain why such actions were taken.

Keeping critical decisions to a minimum might also support the position at a later point in time that compared to the situation prior to and after the crisis, the scope of day-to-day decisions during the crisis was fairly limited. Therefore, viewed over the

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<sup>22</sup> OECD Commentary 2010 Art. 4, mn. 24.



span of the entire year, the effective place of management was still in the country of incorporation. Obviously, this might be difficult as the crisis may require an unusual amount of day-to-day management decisions. Also, the effective place of management is generally not tied to a certain duration but can change multiple times throughout a year. It also does not require an intentional decision of the company to shift the management to a different country, but such changes are factually dependent. However, given that this is an unusual situation placing unusual restrictions on companies and individuals, tax authorities might be willing to be more lenient if such arrangements can be supported by written evidence that the shift only took place because of the crisis and was reverted immediately after the crisis ended.

#### **IV. FUNCTIONAL PROFILES FOR TRANSFER PRICING PURPOSES (DEMPE, SUBSTANCE, ETC.)**

Under OECD guidance, the functional analysis of an MNE and its different affiliates is key for a proper transfer pricing model within the group, as this requires identification of entrepreneurial group companies versus group companies with a more routine function, such as (limited risk) distributors, agents, toll/contract manufacturers, services providers, etc. With respect to intangible property ("IP") and the critical drivers for an appropriate allocation of the group's IP profit, the functions regarding development, enhancement, maintenance, protection and exploitation of IP (the so-called "DEMPE" functions) are important.

Within multinationals and integrated businesses, employees moving up the career ladder and taking on more important group functions are often required to relocate to the countries where the entrepreneurial group companies or companies with the most important functions (such as the DEMPE functions with respect to IP) are located. The most senior international workforce is typically also hired in these locations.

In the weeks and days before the outbreak of Covid-19 and lock-down measures being implemented, certain of these employees and their families may have returned to their home countries from which they continue to work. Given that, under the Covid-19 restrictions, it is unlikely that the relevant employees will integrate into the group companies in their home countries, but rather continue to work as an integrated member of the foreign affiliate, this should in principle not change the functional profile of the group companies. Consequently, in most cases, there should not be a fundamental impact on the group's transfer pricing model. As a result, in this context, most pressure from a tax perspective can also be expected to be on possible PE recognition and company residence as dealt with above and not with respect to transfer pricing.

For U.S. based MNEs, prolonged, although temporary, remote work of the employees of the U.S. MNE's subsidiaries in other jurisdictions instead of the employee's typical place of business can also affect a U.S. company's ability to comply with its intended positions with regards to subpart F income. For example, under the foreign base company services income rules, a controlled foreign corporation ("CFC") that performs services for or on behalf of a related person is only considered to derive foreign base company services income if the CFC performs services outside its country of organization.<sup>23</sup> Although an employee may typically provide those services in the country of organization, current circumstances may force an employee to provide those services remotely from another jurisdiction. This could cause the CFC to recognize foreign base company services income.

Remote work arrangements can also affect a company's subpart F position if the foreign employee cannot fully perform the intended activities remotely. This is especially important where the subpart F rules analyze the activities and functions of a CFC. Under the foreign base company sales income ("FBCSI") rules, income derived by a CFC "in connection with the sale of

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<sup>23</sup> §954(e)(1).

personal property manufactured, produced, or constructed by such corporation”<sup>24</sup> is not FBCSI. A CFC is considered to have manufactured property if it makes “a substantial contribution” to the manufacture of the property through the activities of its own employees (the “Substantial Contribution Test”).<sup>25</sup> The regulations provide a non-exhaustive list of activities which may constitute “substantial contribution” under this test, including:

- Oversight and direction of the manufacturing process;
- Performance of physical activities that do not rise to the level of direct and/or physical manufacturing;
- Material selection, vendor selection, or control of raw materials, work-in-process or finished goods;
- Management of manufacturing costs or capacities;
- Control of manufacturing related logistics;
- Quality control; and
- Development or direction of development of intellectual property for the purpose of manufacturing.<sup>26</sup>

Employees of the affiliate who are temporarily located in another jurisdiction due to travel restrictions will likely continue to work as integrated members of such foreign affiliate and should be counted toward the activities of the affiliate that demonstrate a substantial contribution to the manufacturing process. However, if such activities are taken over by employees of other foreign affiliates as the crisis continues, and such arrangements remain, the substantial contribution support may be weakened over time, causing the CFC's sales income to be potentially attacked as FBCSI.

## V. CONCLUSION

In conclusion, businesses should monitor the issuance of local country guidance on PE, domestic presence, and residence issues, and keep an eye on the six-month period. Any operational change implemented due to Covid-19 should be clearly and contemporaneously documented. It should also be made clear (ideally by circulating internal communications and guidelines which are retained as documentation) that cross-jurisdictional work from home arrangements and other structural changes are only temporary, and that all operations will revert back to the pre-Covid-19 structure as soon as it is safe to do so.

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<sup>24</sup> Reg. §1.954-3(a)(4)(i).

<sup>25</sup> Reg. §1.954-3(a)(4)(iv)(a).

<sup>26</sup> Reg. §1.954-3(a)(4)(iv)(b).

## Authors



**Géry Bombeke**  
Partner  
Brussels  
Gery.Bombeke@bakermckenzie.com



**Ivan Morales**  
Partner  
Palo Alto  
Ivan.Morales@bakermckenzie.com



**Stephanie Dewey**  
Partner  
Toronto  
Stephanie.Dewey@bakermckenzie.com



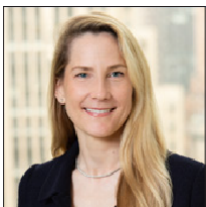
**Andrew Morreale**  
Associate  
Toronto  
Andrew.Morreale@bakermckenzie.com



**Bruno Dominguez**  
Partner  
Barcelona  
Bruno.Dominguez@bakermckenzie.com



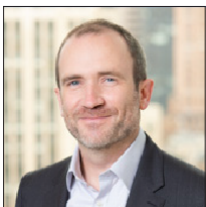
**Krystal Ng**  
Partner  
Kuala Lumpur  
Krystal.Ng@wongpartners.com



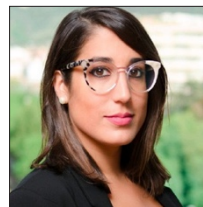
**Imke Gerdes**  
Partner  
New York  
Imke.Gerdes@bakermckenzie.com



**Chris Raybould**  
Director of Economics  
Toronto  
Christopher.Raybould@bakermckenzie.com



**Shane Koball**  
Director of Economics  
New York  
Shane.Koball@bakermckenzie.com



**Davinia Rogel**  
Associate  
Barcelona  
Davinia.Rogel@bakermckenzie.com



# The Impact of Covid-19 on Valuations and Debt

## I. INTRODUCTION

Covid-19, in a matter of a few weeks, has turned everything we viewed as normal on its head. The valuations area is no different. Companies and assets that were reaching all-time highs have seen precipitous declines and record volatility. This, of course, is not due to any underlying economic issue, but rather a health crisis that everyone knows (or at least dearly hopes) is temporary. In this environment, the complexity of valuations for transfer pricing and general tax purposes has increased tremendously. In addition, the recent declines in financial performance highlight various debt capacity and debt restructuring factors that may have previously been less critical. Valuation has always been viewed as more of an art than science, but in times like this, where so much is unknown and even less is known and knowable, there are a few steps multinational enterprises (“MNEs”) can take to adequately and reasonably navigate the challenging terrain. The following sections will provide a brief discussion of the major areas of consideration.

## II. VALUATIONS OF LEGAL ENTITIES, BUSINESSES, AND INTANGIBLE PROPERTY

Many intercompany transactions that require legal entity and business valuations have not halted despite the business challenges posed by Covid-19. For example, after an acquisition,

companies typically engage in post-acquisition integration to combine operations to achieve synergies and reduce the cost of duplicative legal entities. Such exercises often require valuations of legal entities being eliminated or consolidated. Other companies may be planning restructuring transactions to comply with law changes in various countries. These projects often include movements of intangible property to better align the economic ownership with development, enhancement, maintenance, protection, and exploitation (“DEMPE”) substance and where arriving at a proper value of the transferred intangible property is particularly important.

Traditional business valuation techniques rely on the income, market, and asset approaches – each having relative merits depending on particular business and market circumstances.<sup>1</sup> In the current environment, the market approach can be distorted by panic selling, bargain hunting, and/or low transactions volume. Also, market multiples derived under these volatile market conditions may not be indicative of long-term expectations. With large fluctuations in stock prices from day to day (and hour to hour), market capitalization alone is unlikely to be a reliable indicator of value. The asset approach typically is not a favored method for business valuations because, even during stable market conditions, it does not take into account self-developed intangibles and the goodwill of a company.<sup>2</sup> Therefore, the income approach may often be the most suited to address valuations in the context of Covid-19. The two main aspects of

<sup>1</sup> The market approach determines value by reference to guideline companies or transactions, the asset approach considers the net book value at a given point in time, and the income approach determines value by calculating the net present value of future cash flows.

<sup>2</sup> The asset approach may be an appropriate business valuation method in certain situations where the value of self-developed intangible assets and/or goodwill may be insignificant, such as in a very early stage company, a company in bankruptcy, where a company may have limited ability to continue as a going concern.

the income approach are forecasted cash flows and the required rate of return. The degree to which both of these aspects are influenced by the pandemic are discussed below.

### **A. Forecasted Cash Flows**

The fair market value and fair value standards of valuation only consider what is "known or knowable" as of the valuation date. Therefore, for valuation dates prior to the Covid-19 pandemic, forecasts would not include cash flow projections reflecting the economic and business disruptions of the virus. Conversely, those valuation dates falling after the Covid-19 pandemic must include cash flow projections that properly account for the current and future impact of the virus. Although there is still uncertainty about when life will return to normal, it would be inappropriate for most businesses to use cash flow projections that ignore a recovery in the long-term. Accordingly, one should consider a long-term growth rate based on the long-term performance of the economy in which the company or legal entity operates. Due diligence is critical to ensure that cash flow projections not only reflect current realities but also include reasonable expectations for the long-term. Tax authorities and statutory auditors alike will most certainly view cash flow projections with a critical eye. Based on our experience, tax authorities are prone to use hindsight and ex-post outcomes as presumptive evidence about the reasonableness of the cash flows. Therefore, it is important for MNEs to maintain proper documentation and work papers to support the reasonableness of the cash flow projections supporting their valuations. Moreover, given the elevated level of uncertainty, scenario analysis, probability weighted forecasts, and sensitivity analysis are prudent and frequent updates may be needed as forecasts are reevaluated until such time as the transaction is implemented. For example, the probability-weighted expected return method ("PWERM") can be used to determine the value of assets and businesses under different scenarios and assign different

probabilities to the outcome of each scenario. Under the PWERM, the concluded value is determined after weighing the values determined under each scenario against the probability of their outcome.

### **B. Required Rate of Return**

The required rate of return (i.e., discount rate) applicable to most business valuations is the weighted average cost of capital ("WACC"). The WACC represents the weighted after-tax costs (or required rates of returns) for debt and equity. Typically, the WACC is calculated using the capital asset pricing model, which relies on a number of market inputs including the risk-free rate, the equity risk premium, guideline company betas, and the cost of debt. Under stable market conditions, inputs that are contemporaneous to the valuation date typically serve as reasonable indicators for a longer-term view. However, given the current market turmoil, market inputs can yield materially different values over time. For example, the risk-free rate and the pre-tax cost of debt have deviated significantly from longer-term levels due to the emergency monetary easing initiated by the Federal Reserve and other central banks – essentially driving certain benchmark rates to near-zero. Fiscal stimulus by governments also has an impact, given the need in many cases to issue sovereign debt. If valuations rely solely on current market inputs, the impact will be an abnormally low discount rate and a potentially inflated valuation. The same holds true in instances where the underlying parameters of the discount rate are abnormally high, leading to a potentially underpriced asset. To avoid this disconnect between market values and values derived under the income approach, it is reasonable to consider the following adjustments to support a discount rate that leads to a more reasonable value conclusion:

- To capture the volatility in debt rates, consider using a longer time horizon for the risk-free rate or pre-tax cost of debt (e.g., 90-day average), for valuations that are being performed as of a current date

or within the next few months. For valuations with valuation dates that are further away, average yields over a less turbulent time period might be considered.

- To reduce the impact of short-term equity volatility, consider use of long-term betas adjusted to account for movement toward the market average (i.e., Blume Method, Bloomberg Method, and Vasicek Method).
- To achieve a balanced measure of country risk, consider both historical and current data/information (e.g., government relief efforts, changes to sovereign debt ratings, changes to the rates of credit default swaps, etc.). For example, the 2008-2010 financial crisis reduced the reliability of credit default swap curves, and data points that were previously considered as appropriate parameters for risk measurement were abandoned temporarily or completely.
- To account for exposure to certain supply chain risks that might not be applicable to the guideline public companies, consider use of company-specific risk premiums. For example, the perceived risk associated with non-diversified supply chains, particularly those that rely on most products coming from one or two specific markets, is clearly much higher today based on what we have seen with Covid-19.

### **C. Documentation of Intercompany Transactions Involving Transfers of Legal Entities, Businesses, and Intangible Property**

While care should be exercised when preparing the documents involving transfers of legal entities, businesses, and intangible property, it is especially important in the

current environment. For example, where a company's business forecasts used in a valuation have not yet been updated to reflect the impact of Covid-19, the parties may need to include a true-up/price adjustment clause in the document so long as the applicable law allows for one. If so, the documents should memorialize the intent of the parties at the time of the transaction with regard to any uncertainty around the value and the desire for a change if needed when updated forecasts are available and establish a clear date by which any adjustment needs to be made, ideally within the same taxable year as the transaction. Additionally, once finalized, the support for the valuation should be very clear as to what the assumptions are at the time the valuation was done and why different inputs were selected.

MNEs may also consider reviewing documents associated with recent transactions to determine if it is necessary to revisit the related intercompany payments in light of the Covid-19 pandemic. This may not be possible for "closed" transactions in which there were transfers of legal or economic ownership involving lump-sum payments, but other transactions, such as those structured as licenses, may have specific provisions that invite adjustment of royalty rates upon specified conditions. For example, depending on the terms of the agreement and the structure of the transaction, it may be possible to make an adjustment to the current consideration paid for intangible assets under the commensurate with income standard contained in the §482<sup>3</sup> regulations (and consistent with the guidance on hard-to-value intangibles from the Organization of Economic Co-operation and Development ("OECD")).

### **III. IMPAIRMENT CONCERNS**

As part of an annual process, MNEs perform impairment testing to ensure that the current book value of certain assets like goodwill,

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<sup>3</sup> All Section references herein are to the U.S. Internal Revenue Code (the Code), as amended, and the regulations promulgated thereunder, unless otherwise stated. §165(g).

intangible assets, and fixed assets is no greater than the amount that can be realized from their use or sale (see IAS 36). However, interim impairment testing is required if there is a change in circumstances and/or a triggering event. Examples of a triggering event might include supply chain disruptions, volatility in commodity prices, workforce limitations, curtailed operations, and a significant drop in stock price. Covid-19 has produced a number of potential triggering events and many companies may be subject to an unscheduled impairment test. Under such circumstances, the threshold analysis is to determine whether a company's market capitalization is lower than the book value of its net assets, as of a measurement date. In such a circumstance, management could consider determining the average market capitalization over a longer time period and adjusting the implied control premium to display the reasonableness of the valuations of the individual reporting units. In addition, a case could be made that a valuation performed using an income approach may serve as evidence that the subject assets are worth more than their carrying values regardless of the market capitalization because the market has not baked in the timing and extent of the recovery. In any case, companies should still expect to prepare a reconciliation to market capitalization and provide detailed support for the relevant inputs and assumptions to make sure that they are reasonable and well-supported. In other words, a company will need to substantiate why market capitalization is not the most reasonable indication of value and why differing assumptions under an asset-specific approach are warranted.

#### **IV. REVIEW OF DEFERRED TAX ASSETS AND VALUATION ALLOWANCES**

Many companies have deferred tax assets ("DTAs") such as net operating loss carryforwards ("NOLs") that can be used to reduce future taxable income (and cash taxes). The value of DTAs is an important aspect of legal entity valuations as it directly impacts the value conclusion. Under U.S. Generally Accepted Accounting Principles ("U.S. GAAP"), where there is more than a 50% chance (more likely than not) that some portion of the DTA will not be utilized, a valuation allowance must be created.<sup>4</sup> A valuation allowance is applicable if there is a high likelihood that a portion of the NOLs will expire due to a prolonged period of expected operating losses (e.g., the prospect of future taxable income against which the losses may be used is not good or can no longer be used because of multiple years of losses). Given the current Covid-19 environment, companies may need to establish valuation allowances and/or reassess current valuation allowances to account for any expected long-term business disruption. Conversely, companies should also consider whether government intervention may extend the life of DTAs and/or allow for their use in carryback periods. Companies previously on the cusp of triggering a valuation allowance may see themselves recording an allowance even for short-term disruptions if losses continue to mount. To avoid increased valuation allowances, companies should consider whether supportable changes to transfer pricing policies can be made or other actions taken such as deferring tax reliefs to increase the taxable income of the relevant entities. Proper analysis and modeling is needed to show that the forecasted profit is sufficient to utilize any loss carryforwards prior to expiration.

#### **V. WORTHLESS STOCK DEDUCTIONS**

Multiple companies across multiple industries, including oil and gas, travel, aviation, and

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<sup>4</sup> Under U.S. GAAP, the full DTA is recorded and then offset with an applicable valuation allowance. Under the International Financial Reporting Standards ("IFRS"), a DTA is recorded if it is probable (i.e., greater than a 50% likelihood) that it will be realized in the future (see IAS 12). The net DTA amount is consistent between both accounting frameworks but the presentation differs. Therefore, the issues raised in this section may also apply to companies that prepare financial statements under IFRS, as the DTA may need to be adjusted if its full realization is no longer probable.

hospitality have seen the value of their publicly traded stock decline as a result of Covid-19. Similarly, privately held companies and subsidiaries also are experiencing difficulties where their long-term solvency is called into question. Companies should consider their ability to take worthless stock deductions<sup>5</sup> and, where applicable, prepare valuations to demonstrate insolvency in order to take advantage of this tax benefit. Specifically, certain worthless stock deductions realized in 2020 may be treated as ordinary losses. Given the ability to carryback losses under the Coronavirus Aid, Relief, and Economic Security Act, these ordinary losses may possibly be used to offset income in pre-tax reform years when the corporate tax rate was 35%.

## VI. DEBT CONSIDERATIONS

Central banks have responded to Covid-19 by cutting benchmark interest rates in an attempt to promote liquidity. In the United States, the lower limit of the federal funds rate has been reduced to near zero. On one hand, companies are considering refinancing existing debt to take advantage of potential lower rates, but on the other, they are dealing with difficulty servicing existing debt. In the case of intercompany debt arrangements, the following provides a brief overview of the main debt related points of attention.

**Accurate Delineation and the Behavior of Parties.** As a result of the §385 regulations, many companies revamped their intercompany loan agreements to be more consistent with certain terms contained in third-party loan agreements. These revised agreements more clearly laid out the rights of the lender and the obligations of the borrower with respect to penalties for missed payments and stated a variety of covenants. As stated in some agreements, breaching the covenants may result in the loan requiring immediate repayment. Companies that are experiencing financial difficulties due to Covid-19 may breach one or more of covenants, depending

on what such agreements state; for example, financial covenants that specify that the borrower's financial ratios need to be within a certain band might be breached. Here, the parties need to consider the behavior of unrelated parties, while ensuring that the funding needs of the related borrower are met. Proactive steps can and should be taken to amend terms or refinance the intercompany debt in certain circumstances and where allowed by law.

**Realistic Alternatives.** Many intercompany loans have fixed interest rates that were established when the loan was originated. In a stable interest rate environment, the cost and administrative burden of refinancing debt may offset the benefits that can be realized. This may be especially true if the loan agreement includes a prepayment penalty clause. However, under the current rate environment, there is a possibility that certain borrowers may be able to take advantage of significantly lower rates. In the context of intercompany loans, companies should consider the implications of considering realistic alternatives as tax authorities may assert that the debt should have been refinanced.

**AFR/Safe Harbor Rates Versus Market Rates.** Historically, the U.S. applicable federal rate ("AFR") and other safe harbor interest rates have been lower than market rates. The situation may arise, however, where the safe harbor rates converge with the market rates or the market rates may be lower than AFR rates for certain credit ratings. Therefore, instead of selecting the AFR as the default for intercompany loans, companies should consider using market rates. In certain cases, the companies' intercompany loan agreement templates explicitly specify AFR as the applicable interest rate. Companies should consider amending this language to give them greater flexibility to choose between using a safe harbor rate and a market rate.



**Availability of Market Benchmarks.** Similar to conditions during the subprime mortgage crisis, there is an anticipation that Covid-19 will produce further restrictions on liquidity and a lack of interest rate benchmarks at certain credit ratings. Paradoxically, more debt facilities may be granted to below investment grade companies, creating an “abnormal” market for corporate lending. Companies should evaluate their internal processes and build in the flexibility to use different data sources and approaches to establishing arm's-length interest rates. Careful consideration of all current market information will be required for transfer pricing purposes.

**Debt Capacity Analysis.** As part of a debt capacity analysis, various financial ratios are computed for the subject entity and comparable companies. To increase the reliability of the analysis and insulate against any distortions in the data that may be caused by Covid-19, it is advisable to consider a longer horizon for the look-back period (e.g., weighted average five years).

**Parent Guarantees.** It is likely that the prevalence of parent guarantees may become more common when subsidiaries borrow directly from third-party financial institutions. As a result, it is important that this guarantee be evaluated to determine whether an incremental benefit beyond implicit support is provided and if so, that a proper intercompany charge is established. Moreover, consistent with guidance from the OECD, it is important to distinguish between guarantees that allow for more favorable terms and those that allow for the ability to borrow larger sums. In the latter case, the portion of the loan that would not have been made without the guarantee may need to be re-characterized as a loan to the guarantor, which would be contributed as equity to the borrower. MNEs can proactively address such risks by potentially restructuring existing arrangements.

## VII. CONCLUSION

Although Covid-19 is having a profound impact on the economy, many transactions requiring valuations and financing persist. The discussion above highlights some of the major areas companies should keep in mind when it comes to the selection/application of valuation methods; documenting transfers of legal entities, businesses, and intangible property; and analyzing intercompany debt arrangements in the current Covid-19 environment. Moreover, intangible asset impairment, valuation allowances, and worthless stock deduction issues should be considered in the context of their potential impact on financial statements and tax positions.

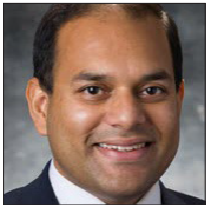
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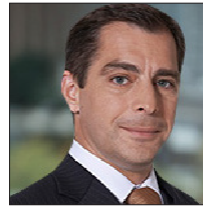
**Phil Carmichael**  
Principal Economist  
New York  
Philip.Carmichael@bakermckenzie.com



**Michael Nixon**  
Associate Principal, Economist  
Singapore  
Michael.Nixon@bakermckenzie.com



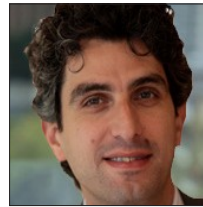
**Aditya Darbari**  
Director of Economics  
Washington, DC  
Aditya.Darbari@bakermckenzie.com



**Jens Rubart**  
Counsel  
Dusseldorf  
Jens.Rubart@bakermckenzie.com



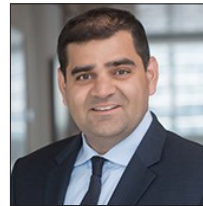
**Nigel Dolman**  
Partner  
London  
Nigel.Dolman@bakermckenzie.com



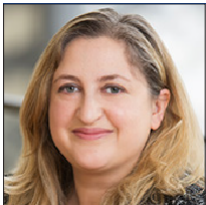
**Antonio Russo**  
Partner  
Amsterdam  
Antonio.Russo@bakermckenzie.com



**Mattia Falcone**  
Director of Economics  
Amsterdam  
Mattia.Falcone@bakermckenzie.com



**Moiz Shirazi**  
Principal Economist  
Chicago  
Moiz.Shirazi@bakermckenzie.com



**Tamara Levin**  
Partner  
San Francisco  
Tamara.Levin@bakermckenzie.com



**Perla Torres Guerrero**  
Tax Specialist  
Buenos Aires  
Perla.TorresGuerrero@bakermckenzie.com



**Folkert Mulder**  
Senior Economist  
Chicago  
Folkert.Mulder@bakermckenzie.com



**Ivan Tsios**  
Director of Economics  
Chicago  
Ivan.Tsios@bakermckenzie.com



# APAs: The Quest for Certainty in Times of Uncertainty

## I. INTRODUCTION

We are in the midst of a crisis, the breadth and depth of which changes daily and the full impact of which will not be known for some time. Understandably, companies want and need to take action to deal with the uncertainty caused by Covid-19, or to take measures to enable their operations to weather possible outbreaks or similar events in the future. Those actions have transfer pricing implications, and if companies have an Advance Pricing Arrangement (“APA”), or are pursuing an APA, the uncertainty created by Covid-19 heightens the need for careful scrutiny of a company’s transfer pricing policy.

## II. CONSIDERATIONS

During this period of economic crisis and uncertainty created by Covid-19, companies that utilize an APA to obtain transfer pricing certainty should give due consideration to how changes in the markets and economic conditions impact their transfer pricing policy that is either already the subject of an existing APA or is under review in an ongoing APA process. In particular, companies may want to evaluate (i) how changes in transfer pricing or the incurrence of non-recurring, one-time extraordinary expenses to address Covid-19 may impact or be incorporated into the APA; (ii) whether any of the economic support funds or measures being rolled out around the globe need to be factored into the company’s transfer pricing models and APAs and, if so, how; (iii) whether it is feasible or advisable to continue with an APA already in force considering the impact of Covid-19; (iv) the desirability of continuing with an APA application given the uncertainty around what the future economic conditions might be

during the APA term; and (v) how Covid-19 changes the outlook and timeline for the APA process.

### A. Does Covid-19 Impact My Company’s APA or APA Request?

The current economic environment that many companies are facing is likely quite different than the economic environment the companies faced at the time of filing the APA request and that environment is changing rapidly. Some companies are experiencing negative impacts and others positive impacts as the impact of this pandemic varies widely depending on the industry and the geography of the taxpayer. Many companies are evaluating their business and transfer pricing models and how they might need to adapt under varying possible circumstances (e.g., more versus less severe downturns, shorter versus longer periods of downturn, quick rebound versus long-term change, etc.). This is a difficult issue that companies are grappling with.

In addition, companies hit hard by the Covid-19 outbreak may need additional financial resources and may be contemplating reducing profit margins in local jurisdictions. It is important to first distinguish cash needs from profits as some short-term cash needs can be addressed without affecting profits, for example, through modifying payment terms on intercompany payables/receivables or short-term loans. However, if companies want to revise their transfer pricing, undertake new transactions or terminate certain transactions, it is important to understand the impacts of those decisions on an APA and what and when such changes should be disclosed to the treaty partners.

From a U.S. perspective, companies must timely notify the Advance Pricing and Mutual Agreement Program (“APMA”) of all material changes and updates to information previously submitted in connection with the APA request, which would include material changes to the transfer pricing of the proposed covered transactions. Failure to update APMA of a material change in fact could jeopardize negotiations. A fact is considered to be material if, for example, knowledge of the facts could have reasonably resulted in an APA with significantly different terms and conditions. Thus, to the extent the operations or transfer pricing of the company has materially changed as a result of Covid-19, these changes should be disclosed to the treaty partners. A further discussion of the types of changes to the APA proposal that could be considered from a U.S. perspective are included in Section III, below.

Under U.S. procedures, companies are able to request an amendment to an APA request at any time before the APA is consummated and APMA will give such a request due consideration. Once an APA is reached, however, it may be revised only by mutual agreement of the parties to the APA. For a bilateral APA, this will include seeking consent of the applicable treaty partner if APMA is willing to agree to the revision proposed by the company. If the treaty partners are unable to reach an agreement to amend an APA, then the APA remains in force without revision. In some cases, however, APMA and the taxpayer may agree unilaterally to (i) revise the APA with respect to one or more APA years; or (ii) to cancel the APA as of a specific date. It is unclear, however, how broad the scope of such revisions could be absent agreement with the bilateral treaty partner.

**China.** China utilizes an interquartile range and typically asks taxpayers in an APA to aim for the median of the range. The Chinese transfer pricing regulations also require a term test and if, upon the expiration of the APA, the weighted average margin over the entirety of the APA term is below the median, and the

taxpayer does not make an upward self-adjustment to the median, the Chinese tax authorities will not accept an APA renewal application. It is therefore acceptable for the margin to drop below the median in individual years, and as long as it is still above the lower quartile, the Chinese tax authorities will not make an adjustment. However, if the taxpayer wants to renew the APA, it will need to make a term adjustment to bring the overall margin to the median before the APA expires. That said, if there is specific language in the APA about how it must be implemented, then the company will need to adhere to that specific APA language. If a company is already operating at the lower quartile and wants to reduce it below that point, then it may want to revise the terms of the APA without annulling it.

**Canada.** It is more difficult to generalize about the pricing terms in a Canadian APA. Each taxpayer’s APA will specify the agreed transfer pricing terms. In the case of a routine service provider this may be a specific point rather than a range or there could be a very narrow range specified to allow some administrative simplicity if the result is off by a few tenths of a percent. While an arm’s-length range could be specified and is in some cases, whether it is or not depends on the agreement reached with the treaty partner. That being said, each APA will also include one or more critical assumptions and provisions that will allow the Canada Revenue Agency (“CRA”) to revise, cancel, or revoke the APA. Canadian APA’s typically include a standard term that allows taxpayers to advise the Director of circumstances that might require a revision of the APA but such revisions are granted at the discretion of the Director (in consultation with the treaty partner). Additionally, taxpayers are required to notify the director of material changes to the taxpayer’s business within 30 days.

**Latin America.** In most Latin American jurisdictions, as long as the company’s APA request has not been ruled on by the tax

authority, it is still possible to update the economic circumstances and/or the facts surrounding the transaction being analyzed. For these purposes, it is important to make a complementary filing, describing in detail the new facts that could modify the price or consideration in the transaction covered by the APA, in addition to including the proposed modification to the transfer pricing methodology reflecting the circumstances of the case (such as new comparability adjustments, modifications to the set of comparable companies or transactions as appropriate to the new facts, and differentiated profit margins for each period covered by the APA, among others).

If an APA has been reached and it covers the 2020 fiscal year, companies should conduct a detailed review of the critical assumptions in order to analyze the viability of renegotiating the terms originally reached with the tax authority. If the critical assumptions permit and a change is needed, the process would be to file a statement with the tax authority on the economic impacts and/or functional changes endured by reason of Covid-19, with the purpose of (i) revising the APA with respect to one or more APA years, or (ii) canceling the APA. If the critical assumptions do not allow for the renegotiation of the terms of an APA, such as in the case of Mexico, in practice this may be done by describing in the annual compliance report those extraordinary events/facts/expenses (due to Covid-19) that affected the transfer price in the transaction(s) covered by the APA.

**Europe.** European jurisdictions are quite unique in their APA processes with each being heavily dependent on the tax authorities involved. But, in many instances, APAs do not cover extraordinary scenarios such as pandemics, which could have a significant impact on the transfer pricing model. Potential impacts on the transfer pricing model could be (i) market conditions; (ii) other external Covid-19 related factors; (iii) business restructurings; (iv) changes in the taxpayer's functional and

risk profile; and /or (v) the taxpayer's value chain organization. Therefore, taxpayers that have entered APAs should review the terms and conditions of the APA to identify options for adjustments due to the economic downturn related to Covid-19.

Some tax authorities may want to break up the APA term into two separate terms, i.e., a "downturn" period and "normal" period. However, not all jurisdictions are likely to follow this approach. In general, proactively contacting the competent authorities in your jurisdiction and proposing changes to the APA conditions (i.e., critical assumptions and comparables) that arise due to the Covid-19 crisis is recommended. For example, one could assert that the target profit under the APA should be reduced in line with decreasing margins that can be expected to be achieved by comparable companies because of Covid-19. This is a constructive way of addressing potential difficulties with the competent authorities. It is, however, not entirely clear as to what extent the competent authorities would be willing to enter into such conversations with the taxpayer.

In some jurisdictions, APAs are agreements between countries only, but not between the country's tax administration and the taxpayer. The taxpayer is then not necessarily legally bound to adhere to the terms and conditions of the APA. When economic conditions gravely differ from what they had been understood to be when requesting the APA, an option to be considered is to break free from the terms of the APA, especially if the APA indeed has no clause on crisis situations.

It is expected that a change in critical assumptions as well as a potential lack of comparables will be taken into account by most tax authorities. If tax authorities are not willing to discuss a change in critical assumptions, the economic impact of Covid-19 may cause critical assumptions not to be met. Failing to meet critical assumptions could

potentially impact the validity of the APA, as discussed further below in Section IV.

## B. Does a Company Need to Factor Any Government Support into Its Transfer Pricing Under an APA and If so, How?

Governments around the world are announcing extreme measures, the likes of which have never been seen before. These are varied and wide ranging from income replacement and salary subsidies, interest-free or low-interest loans, guarantees, or grants, to name just a few examples. A critical question for taxpayers that have APAs is how these amounts should be treated for transfer pricing purposes. For example, if an entity receives compensation from a related party on a cost-plus basis, should any government grants or

amounts and how the terms of their APAs should be interpreted in this regard, which may be challenging since this type of scenario would not likely have been anticipated.

**Canada.** As an example, the CRA has published administrative guidance suggesting that the amounts should be excluded from transfer pricing computations and the full benefit should remain in Canada unless the taxpayer can prove that arm’s-length parties would treat such government support differently.

## C. What Can a Company Do If It Has an APA but Wants to Terminate It Because of the Impact of Covid-19?

Companies that are experiencing significant changes and impacts from Covid-19 may wish to completely withdraw from an APA. Under U.S. APA procedures, if a company wishes to terminate an APA, it should analyze whether the economic and business impacts from Covid-19 have triggered a failure in a critical assumption included in the APA. (Further discussion of Covid-19 and critical assumptions is included in Section IV, below.) Typically, it will be difficult to cancel an APA with APMA once it is entered into and the parties will instead often try to revisit and reopen the APA. Nevertheless, Covid-19 presents unique circumstances and APMA may be willing to entertain a cancellation if the parties are unable or unwilling to revise the APA. Such cancellation will be effective as of the beginning of the taxable year in which the critical assumption failed. For periods following the effective date of the cancellation, the APA has no further force and effect for the Internal Revenue Service or the company.

**China.** Although the Chinese APA template does not list the critical assumptions, in practice, both force majeure (including natural disasters) and economic downturns are commonly contained in the critical assumptions of the APA. After Covid-19 broke out in China, many companies have already

	Costs	Costs	
Revenue	99	110	[a]=[f]+[h]
R&D Costs	60	60	[b]
Government Assistance	(10)	(10)	[c]
Other Costs	40	40	[d]
Operating Profit	9	20	[e]=[a]-[b]-[c]-[d]
Costs Subject to Mark-up	90	100	[f]=[b]+[c]+[d] or =[b]+[d]
Mark-up (%)	10%	10%	[g]
Mark-up (\$)	9	10	[h]=[f]*[g]

wage subsidies be netted against costs for computing the cost base that is subject to mark-up or should it be kept out of the computation and become additional income for the entity that received it? Consider the following numerical example:

As illustrated above, this decision can have a material impact on intercompany charges and the resulting profits realized by the subsidiary. Given the magnitude of the supports being rolled out to mitigate the economic impact of Covid-19, taxpayers should be sure to identify and track any such supports and give due consideration to local transfer pricing rules/laws as they might apply to these types of

cited force majeure in their commercial dealings, and therefore it may be possible to terminate an APA in China on this basis. In addition, the economic downturn that follows may also be used as a reason to terminate an APA with the Chinese tax authorities if the facts and circumstances are not sufficient to justify force majeure. If a taxpayer wants to cite a critical assumption to revise or terminate the APA, the Chinese tax authorities would require the taxpayer to report the material changes which affects the APA within 30 days, and describe the impact on the APA. The Chinese tax authorities would analyze the impact, and decide to revise or terminate the APA based on the materiality of the impact.

**Canada.** Once an APA is signed in Canada, it is difficult for a taxpayer to cancel it. The standard terms allow the Director to cancel if there is a breach of a critical assumption and a revision cannot be agreed, if there was a material misrepresentation or omission on the part of the taxpayer, or if there is a failure to comply with the terms of the APA on the part of the taxpayer (and that failure would have to be such that simply making an audit adjustment to bring the taxpayer into compliance with the terms of the APA would be an insufficient remedy). Cancellation is at the discretion of the Director, and the Director could elect to continue to apply the existing APA.

The Director also has the right to revoke the APA, *ab initio*, under certain circumstances, including for non-compliance with a material term of the APA.

**Latin America.** In the case of Latin America, it is highly advisable to analyze the critical assumptions of each APA, to assess (i) whether the economic impacts sustained could put the APA's validity at risk (especially if there are changes in the functions, assets and risks assumed); and (ii) whether or not it would be possible to renegotiate the terms originally agreed upon with the tax authority. If it is decided that the APA will be canceled for any

reason after analyzing the specific case, this may be done by filing a notice with the tax authority, describing the material facts and/or circumstances giving rise to the request to cancel the APA.

**Europe.** How the taxpayer can get out of an APA depends on the rules on APAs in the countries involved, but is potentially simple for the taxpayer, assuming that bi- or multilateral APAs have been concluded.

In order to provide necessary information to the tax authorities, in most EMEA countries the taxpayer is obligated to provide the tax authorities with an annual APA report. Herein, the taxpayer must provide information on the implementation of an APA and whether the taxpayer satisfied the critical assumptions. For example, in Spain, a brief report should be filed annually jointly with the Corporate Income Tax Return. In this report, the taxpayer must expressly draw attention to every single deviation and state whether it has made any adjustments, and, if so, which. If the taxpayer breaches this obligation, consequences may follow, the harshest being the tax authorities withdrawing from an APA. If, according to the report, critical assumptions have not been satisfied, tax authorities will usually request the taxpayer to submit proposals for making relevant adjustments to the mutual agreement before withdrawing from an APA.

The taxpayer, however, can use this procedure to its advantage if it wants to get out of an APA. If the taxpayer no longer adheres to the critical assumptions under the APA, the tax authorities must no longer apply the APA. The taxpayer may simply inform the tax authorities by truthfully stipulating in their annual APA report that it no longer adhered to the critical assumptions under an APA. Consequently, the tax authorities will withdraw from the APA or will request the taxpayer to submit proposals for adjusting the APA.

## **D. If a Company Has Submitted an APA Request but No Longer Wants One Because of Uncertainty Created by Covid-19, How Does the Company Withdraw and What Are the Consequences?**

The substantial impact of Covid-19 may motivate companies in the process of negotiating an APA to reconsider their APA proposal and to consider full withdrawal from the program. Depending on the facts, a company should first consider whether an adjustment or amendment to the APA proposal is feasible under the procedures described above. If not, under U.S. APA procedures, taxpayers may unilaterally withdraw an APA request at any time before an APA is executed by filing a request with APMA. While the consequences of a withdrawal may be relatively minor, APMA generally will not refund user fees once it has begun its due diligence. Further, companies should carefully consider how information shared during the course of the APA process might be used during a field audit or subsequent proceedings.

**China.** Both the tax authorities and the taxpayers can terminate the APA negotiations at any time before the APA is executed, without having to cite Covid-19. Companies would have to file a report and explain the reasons they want to withdraw. In addition, according to the Chinese transfer pricing regulations, if a taxpayer withdraws the APA application, all the information shared and obtained during the discussion will be kept confidential by both taxpayers and tax authorities. Tax authorities cannot use the non-factual information obtained during this process, including proposals, reasoning, positions and judgment, against taxpayers in an audit of the same transactions.

**Canada.** As in the United States, a taxpayer is free to withdraw its request for an APA at any time up to the time it is signed. Canada does not impose a user fee for obtaining an APA but does require payment of a cost recovery amount, intended to cover the CRA's out of pocket costs (for things such as site visits) and any unused funds are refunded to the taxpayer. This decision should not be taken lightly and due consideration to suggesting a different approach to dealing with the consequences of Covid-19 should be given. Taxpayers should also recognize that any information provided to the CRA in connection with a request for an APA is considered to have been obtained for the purposes of administering the *Income Tax Act* (Canada) and as such can be shared with and used by the audit function. Since APAs are typically more collaborative undertakings than audits, taxpayers are expected to, and generally do, provide more information to tax authorities through this process than through audits and the implications of this disclosure should also be weighed in the decision making process.

**Latin America.** In the Latin American region, taxpayers generally may elect to cancel the APA request at any time, before formalizing the agreement; for these purposes, they will need to file a notice of withdrawal with the tax authority. While there are generally no repercussions from the tax authority due to the APA withdrawal, we advise evaluating, before filing the notice, whether the information and documentation supplied during the process is sensitive information that the tax authority might use in an eventual audit for future tax years.

**Europe.** If the taxpayer wants to withdraw its APA application, for example because the profit forecasts outlined in an APA application are no longer valid due to Covid-19, the taxpayer can withdraw an APA application or amend an APA application.



The withdrawal of an APA application means that there is no longer any basis for conducting the APA procedure, i.e., the procedure is terminated. From a procedural point of view, an APA application can be withdrawn at any time. Until an APA has been concluded with legal effect, the applicant may alter its APA application at any time. In many EMEA countries, e.g., in Germany, a substantial alteration to an APA application is regarded as a new application. The consequences of withdrawing or amending an APA application certainly depend on the status of an APA application and the amount of work performed by the competent authorities so far. In particular, if tax authorities have already started working on an APA application, the consequences of withdrawing and amending an APA application most likely will affect the relationship with the tax authorities, so relationship management is an important goal to keep in mind.

For example, under German law, fees for an APA procedure will be assessed as soon as the APA application is filed. The standard fee for an APA is 20,000 euro. If there is already an APA in place that the taxpayer wants to extend, fees will be reduced to 15,000 euro.<sup>1</sup> As the fees are assessed and due upon filing an APA application, the fees will not be refunded if the taxpayer withdraws its APA application. Amendments to prior APA filings are charged at a reduced rate of 10,000 euro. However, in other countries, such as Spain, the taxpayer is not obliged to pay any fees in order to request an APA. Hence, the withdrawal of the proposal would not result in any economic loss for the taxpayer.

## **E. If a Company Decides to Continue with the APA Process, How Does Covid-19 Impact the Outlook and Timeline for the APA Process?**

Covid-19 is likely to extend the timeline for most companies' APA applications globally. Many countries are under lockdown right now and international travel has been severely restricted. As a result, competent authorities have to reschedule their meetings or use alternatives such as video/audio conferencing. In addition, the tax authorities of many countries are not fully functioning and are facing systems limitations, as their employees have to work from home and take care of their children at the same time. While APMA and many other tax authorities continue to work on and review APA applications and are trying to minimize delays as much as possible, companies should anticipate that systems limitations, travel restrictions, and work-from-home challenges will inevitably lead to a delay in the APA process.

**China.** The Covid-19 outbreak has also given rise to some geopolitical tension between some countries, which may trickle down to their competent authorities. This could also hamper negotiations and further delay the process.

**Canada.** The members of the Competent Authority Services Division of the CRA, which handles MAP and APA requests, is deemed non-essential so they are working from home at the moment. They also face significant restrictions on their ability to access CRA resources (including email, IT networks, and files) so processes are expected to move more slowly. Priority will be given to files that are approaching key domestic or treaty based deadlines.

**Europe.** We expect that Covid-19 will result in longer processing times for APAs as the tax authorities are also facing challenges and restrictions in their everyday work, i.e., by working remotely. Therefore, it is more difficult for the tax authorities to coordinate internally as well as with the competent authority(ies) of

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<sup>1</sup> For taxpayers qualifying as small to medium companies in the meaning of the legislative regulations on transfer pricing documentation, the fees are limited to 10,000 euro, 7,500 euro and 5,000 euro, respectively.

other countries in the case of bilateral and multilateral APAs. Some EMEA countries, besides adopting other measures related to the deferral of taxes, also have put all tax-related administrative procedures on hold. In this regard, such countries have enacted measures on the suspension of tax audit procedures due to the current situation. This includes not only putting a freeze on previous procedures, but also avoiding starting new procedures, including the negotiation of new APAs.

### III. PERTINENT APA EXPERIENCE FROM SIMILAR ECONOMIC EVENTS IN THE PAST

Guidance during this Covid-19 environment can be gleaned from experience with APAs during prior recessions and economic shocks. For instance, as a result of the recession of 2008, APMA agreed to or considered certain adjustments to the APA proposals to address the unique impacts of downturn on an industry or individual company, particularly as compared to the uncontrolled companies used in the APA transfer pricing analysis. In light of this, companies should consider how prior APA experience may guide their analyses with respect to Covid-19 and should consider whether adjustments should be proposed for their APAs.

Based on relevant experience, such adjustments could include, for example:

- Separating the APA term into separate testing periods - i.e., a "normal" period and a "downturn" period, during which certain downward adjustments to the ranges or screening mechanisms for the comparables would be allowed;
- Applying a term test so that the impact of certain non-recurring, extraordinary expenses can be spread out over a longer period of years, rather than resulting in an adjustment to the single

year's results during which the non-recurring expense was incurred;

- Permitting certain extraordinary expenses incurred to respond to the economic environment or system losses to either be borne entirely by the parent company or shared among the relevant entities if appropriate;
- Making adjustments to the comparable sets to account for the economic impacts of the downturn, particularly where the tested party and comparables experience dissimilar impacts and levels of economic demand, thereby compromising the reliability of a particular method. This could include, for instance, (a) using comparables' data from different years, (b) using a regression or other statistical method to make an adjustment based on the economic impact of swings in revenue, (c) modifying the screening criteria either to eliminate companies that did not experience similar economic and financial distress, or, in the alternative, to include companies that would otherwise be removed in the course of a typical analysis due to financial distress, (d) applying a longer testing period to smooth out the non-transfer pricing related results, or (e) expanding the acceptable range of results beyond the interquartile range.

In the United States, the APA statutory reports from 2010 and 2011 are instructive for companies considering the impact of Covid-19 on their APAs. In particular, during 2010 and 2011, the APMA received numerous inquiries about the potential effect on existing and pending APAs of the economic downturn and the major earthquake and tsunami that struck Japan in 2011. The APA Report for 2010, for instance, notes the following:

Whether or not a special "down-economy adjustment" might be appropriate

depends on a variety of factors, including whether or not the tested party and the comparables have been similarly affected by the downturn, the tested party's historic risk profile and performance, and a taxpayer's willingness to accept a symmetrical adjustment (e.g., in a renewal APA) when the economy improves. Approaches to the down economy that have been considered include changing the APA term, waiting for more current financial data, using a different set of comparables, and/or applying a longer testing period.

APMA agreed that certain adjustments may potentially be appropriate to address the impact of the down economy on companies. Given this history, companies should carefully evaluate whether these types of adjustments would be useful in helping the company reach a successful resolution of their APA-related concerns given the impacts of Covid-19 and could be proposed to the treaty partners.

During the fallout of the 2008 recession and subsequent economic shocks, the APMA adopted a general policy not to reopen closed, agreed-to cases in the absence of a critical assumption on point. The U.S. APA statutory report for 2012 disclosed that there were no more than three APAs where a critical assumption was triggered and, in those cases, it related to "catastrophic events." Thus, few APAs were reopened or canceled as a result of a critical assumption being triggered in relation to the economic downturn. This experience, however, may not dictate APMA's current consideration of Covid-19 with respect to closed cases because, as discussed further below, there has been a change in the language in the U.S. APA template which may suggest increased flexibility to reopen cases as a result of material changes in economic conditions.

#### IV. CRITICAL ASSUMPTIONS

Depending on the actual impact of Covid-19 on the industry or individual company, it may provide a company with a basis to assert that a critical assumption in the APA has been triggered. APAs will define in advance the critical assumptions upon which the agreement is based and can include any fact about the company, industry, or general economic conditions. Under the old APA template in place prior to the release of a new model template on May 11, 2018, APMA included the following critical assumption language:

The business activities, functions performed, risks assumed, assets employed, and financial and tax accounting methods and classifications [and methods of estimation] of Taxpayer in relation to the Covered Transactions will remain materially the same as described or used in Taxpayer's APA Request. A mere change in business results will not be a material change.

APMA changed the critical assumption language in the U.S. APA template released on May 11, 2018. In particular, in its May 2018 model template draft, APMA revised the critical assumption language as follows:

The Covered Entities' business activities, functions performed, risks assumed, assets employed, contractual terms, **markets, and economic conditions** **faced** in relation to the Covered Issue(s) will remain materially the same as described in the APA Request. For this purpose, a mere change in business results will not be a material change.

APMA reverted to the earlier version of the critical assumption language in its most recent draft of the APA template, released in

December 2019, which left out the reference to markets and economic conditions.

Nevertheless, the May 2018 APA template language suggests that, at least at one point, APMA agreed that material changes in the market and economic conditions will trigger the critical assumption. This approach is also consistent with the *Organization for Economic Co-Operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the “TPG”), which recommends that APAs should include flexibility to account for significant and uncontrolled changes in economic circumstances. In particular, paragraph 4.146 of the 2017 TPG states the following:

At the conclusion of an APA process, the tax administrations should provide confirmation to the associated enterprises in their jurisdiction that no transfer pricing adjustment will be made as long as the taxpayer follows the terms of the arrangements. There should also be a provision in an APA (perhaps by reference to a range) that provides for possible revision or cancellation of the arrangement for future years **when business operations change significantly, or when uncontrolled economic circumstances** (e.g. significant changes in currency exchange rates) critically affect the reliability of the methodology in a manner that independent enterprises would consider significant for purposes of their transfer pricing.

**Europe.** In many EMEA countries, the critical assumptions underlying an APA must be clearly specified.

Critical assumptions could be (i) consistent shareholding ratios; (ii) consistent market conditions, market shares, business volumes, sales prices (e.g., no drastic changes due to

new technology); (iii) consistent conditions, e.g., relating to supervisory rights, customs duties, import and export restrictions, international payment transactions; and (iv) consistent exchange rates and interest rates.

All of the above are potentially impacted by Covid-19. Therefore, taxpayers must keep the following in mind: If any one of these conditions is defined as a critical assumption under an APA, a violation or disappearance of this condition could result in the tax authorities having a reason and cause to withdraw from or terminate the APA. Depending on the wording of the APA, the consequence might also be the “automatic” termination of the APA without any tax authority declaration.

However, with regard to bilateral and multilateral APAs, tax authorities may be willing to take up negotiations with the other countries involved in the APA in order to adjust the APA to the altered circumstances. In order to adjust the APA, the taxpayer may be required to enclose necessary documents. Additionally, depending on the jurisdiction, this procedure may only be available to the taxpayer upon request. If the taxpayer does not file such a request or if an adjustment by mutual agreement with the other country is not possible, depending on the wording of the APA, the APA may lose effect as from the date when the critical assumptions are no longer satisfied.

## V. PROCEDURAL UPDATES FROM TAX AUTHORITIES

As a result of changes to APMA’s operations amidst the turmoil created by Covid-19, APMA has issued modified procedures to assist taxpayers filing APA and MAP submissions, including APA requests, APA annual report filings, and extensions. In particular, APMA will accept filings through a one-way, secure portal through which representatives, including Baker McKenzie, can send APA, MAP, and annual

report submissions.<sup>2</sup> Nevertheless, as soon as feasible, APMA still requests that companies send the required number of hard copies, with original signatures (which may be modified), and other required materials set forth in Rev. Proc. 2015-40 (MAPs) and Rev. Proc. 2015-41 (APAs) and will not start reviewing the case before they receive these hard copies. APMA still has procedures in place to receive and process submissions.

Extensions continue to be granted only by the APMA Director and can be requested by an email to Heather Snodgrass (for MAP or APA requests) or Tony Duca (for APA annual reports), copying the team leader, manager, and assistant director (if known). The email should explain the circumstances behind the request and state the length of extension requested.

Importantly, APMA cannot waive treaty notification deadlines. Thus, companies should still provide the U.S. competent authority all information it would need for a request to provide timely notification under a given treaty and for the U.S. competent authority to notify its treaty partner.

**Canada.** The Competent Authority Services Division (“CASD”) is working to identify the best way for it to continue to advance cases, accept new cases, and communicate with taxpayers. While some issues can be handled by phone, providing taxpayers with conditional letters, query sheets, and other formal communications is more challenging since the CRA is not permitted to transfer taxpayer information by email. Voicemail messages

may also be left for the Director or the managers. Taxpayers are advised not to file paper copies at the moment since the mail room is closed and they will not be picked up or reviewed for the time being. It is recommended that taxpayers communicate with the department (at [MAP-APA/PAA-APP.CPB/DGPO@cra-arc.gc.ca](mailto:MAP-APA/PAA-APP.CPB/DGPO@cra-arc.gc.ca)) prior to submitting filings to agree to appropriate protocols (such as using a secure file transfer system to electronically file materials) with the appropriate individuals at CASD.

## VI. CONCLUSION

Covid-19 has led to many extreme situations and the actions being taken around the globe to contain and slow the spread of the virus is unprecedented. The impacts are widespread and reach every country, industry, and person around the globe to one degree or another. For some, the impacts are dire, for others it could be the opposite. Ultimately, few companies will be unaffected. The actions of governments around the globe are similarly unprecedented as they work desperately to mitigate the negative impacts on the global economy and this will certainly be telescoped to, and be understood by, tax authorities. While this does not guarantee any particular outcome, it does suggest that keeping the lines of communication with the relevant tax authorities open and thinking creatively about potential solutions to the challenges presented, is highly advisable.

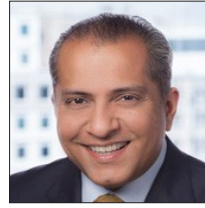
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<sup>2</sup> APMA will also accept submissions by email. For APA and MAP materials submitted by email, APMA requests that such emails be sent directly to Heather Snodgrass at [Heather.L.Snodgrass@irs.gov](mailto:Heather.L.Snodgrass@irs.gov). In addition, rather than sending all the files normally required in the MAP or APA submission, APMA requests that only the following documents be attached as .pdf to the email: (1) the APA request or MAP request letter (with the content required by the applicable revenue procedure); (2) the signed/scanned Form 2848 or other authorization form; (3) the signed/scanned consent to disclosure; and (4) the signed/scanned penalties of perjury statement. While APMA will acknowledge receipt in a separate email and will use the date of the email as the application date, it will not start processing the case until it receives the formal, complete request (within a reasonable amount of time after the email). If filed by email, APMA requests that APA annual report filings be sent to Tony Duca at [Anthony.W.Duca@irs.gov](mailto:Anthony.W.Duca@irs.gov). APMA will likewise acknowledge receipt, but requests that companies submit the full, complete APA annual report (with the number of required copies) as expeditiously as possible.

## Authors



**Montse Campmajó**  
Associate  
Barcelona  
Montse.Campmajo@bakermckenzie.com



**Salim Rahim**  
Partner  
Washington, DC  
Salim.Rahim@bakermckenzie.com



**Bruno Dominguez**  
Partner  
Barcelona  
Bruno.Dominguez@bakermckenzie.com



**Chris Raybould**  
Director of Economics  
Toronto  
Christopher.Raybould@bakermckenzie.com



**Rodolfo García-Aguirre**  
Tax Specialist  
Mexico City  
Rodolfo.Garcia-Aguirre@bakermckenzie.com



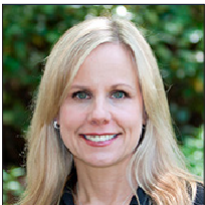
**Stephan Schnorberger**  
Partner  
Dusseldorf  
Stephan.Schnorberger@bakermckenzie.com



**Rabea Katharina Lingier**  
Associate  
Dusseldorf  
Rabea.Lingier@bakermckenzie.com



**Amanda Worcester-Martin**  
Partner  
Washington, DC  
Amanda.Worcester-Martin@bakermckenzie.com



**Donna McComber**  
Director of Economics  
Washington, DC  
Donna.Mccomber@bakermckenzie.com



**Shanwu Yuan**  
International Tax Director  
New York  
Shanwu.Yuan@bakermckenzie.com

# Contemplating Force Majeure and Other Contractual Considerations in Intercompany Agreements

## I. INTRODUCTION

Because of the unprecedented business and economic disruption caused by the Covid-19 pandemic, companies are considering defenses that might excuse non-performance of a contract, such as invoking force majeure clauses, or potentially less drastic options such as renegotiating contractual terms. In some cases, companies have already begun to file suit to invoke force majeure clauses.<sup>1</sup> Below we discuss the transfer pricing implications of companies seeking (or not seeking) to effectively invoke force majeure clauses in intercompany agreements, as well as similar contractual considerations in the absence of a force majeure clause.

## II. WHAT IS A FORCE MAJEURE CLAUSE?

The concept of force majeure is widely recognized in both civil law and common law jurisdictions. Force majeure clauses define circumstances beyond the parties' control that can render contractual performance too difficult or even impossible. Where an event, or series of events, triggers a force majeure clause, the party invoking the clause may suspend, defer, or be released from its duties to perform without liability. Force majeure clauses in commercial agreements typically provide a list of specific events outside of the contracting parties' control that, upon occurrence, would excuse or delay the invoking party's performance, or permit the cancellation of the contract (e.g., war, terrorist attacks, famine, earthquakes, floods, strikes, fire, epidemics, acts of God, and government action).

Certain European civil law countries such as Luxembourg, the Netherlands, and Spain, at least implicitly recognize the force majeure principle in their civil codes. Under Dutch and Spanish law, for instance, a force majeure clause does not need to be included in a contract because the statutory force majeure provisions apply automatically to all contracts. This, however, does not preclude parties from incorporating their own specific force majeure clause to deviate from the rules provided by law.

In common law jurisdictions, the application of force majeure is an issue of contract interpretation, the result of which may vary depending on the law of the jurisdiction that governs the agreement. A proper assessment of the impact of the Covid-19 pandemic requires a fact-specific analysis of a company's business and contractual relationships.<sup>2</sup>

## III. HOW DO UNRELATED PARTIES APPROACH FORCE MAJEURE (OR UNANTICIPATED) EVENTS?

As in any transfer pricing analysis, the actions of unrelated parties in the face of the pandemic, of course, are central to analyzing arm's-length behavior for related party transactions. In the context of written contractual arrangements, the starting point is analyzing the written terms of the agreement, which will generally be respected for transfer pricing purposes provided they do not lack economic substance.

Assuming a force majeure clause exists and the circumstances are right, a party in an unrelated party context may seek to invoke the clause to avoid the negative implications (or sometimes

<sup>1</sup> See e.g., *Third Wave Farms LLC v. Pure Valley Solutions LLC*, No. 6:20-cv-00069 (E.D. Ky. Mar. 20, 2020) (Kentucky hemp farming company filed federal suit asking judge to void its contract with an Oregon hemp processor asserting that the spread of the coronavirus and the state of emergency declared in Kentucky and Oregon triggered the contract's force majeure clause).

<sup>2</sup> See Jennifer Ancona Semko, Mark Goodman, et al., [US: When Is Force Majeure Really Force Majeure?](#), Baker McKenzie Insight (Mar.5,2020).

impossibility) of performing its obligations under an agreement, while avoiding the counterparty's ability to obtain specific performance or damages for the party's non-performance. Some common force majeure events in the context of Covid-19 could be natural disasters or governmental prohibition of activities.<sup>3</sup> It is unclear whether a resulting economic crisis may be such an event.<sup>4</sup>

However, given the current uncertainty of the scale of the impact of the pandemic, what magnitude of disruption would qualify as a force majeure event? As in most transfer pricing analyses, the answer depends on the facts and circumstances of the given transaction and business operations at issue. For example, some governmental actions may clearly and legally prohibit certain transactions from occurring in some industries and may be more ambiguous in others. Even if a certain governmental action is clearly within the context of the type of force majeure event contemplated, it may be unclear for companies right now how long they may not be able to perform duties under an agreement.

Further, companies should view the pandemic holistically within the context of the agreement. For example, if an agreement has a 10-year term and the effect of the pandemic prevents a party from performing for only a few months, is that enough to excuse performance? Would the result be different for an agreement with a two-year term? While a subsidiary and parent company would rarely consider the same litigation scenarios between each other as between unrelated parties, such considerations are relevant when considering the uncertainty of a given situation. The practical answer is that unrelated parties will be in court one to two years from now with the benefit of hindsight, but today no one has these answers.

#### IV. ABSENCE OR INAPPLICABILITY OF FORCE MAJEURE CLAUSES

What if an agreement does not contain a force majeure clause? In the United States, other common law and contractual principles may be available for a company to be excused from contractual obligations due to certain events that may typically be described in force majeure clauses. These include principles such as impossibility, impracticability, frustration of purpose, or the United Nations Convention on Contracts for the International Sale of Goods or Article 2 of the Uniform Commercial Code.<sup>5</sup>

For example, it is against public policy for a company to be compelled to perform a contractual obligation if doing so is against the law. Even if it is legally possible for a company to perform an obligation such as paying rent, perhaps the purpose for which the parties entered into the contract has been frustrated if the party obligated to pay rent cannot legally operate the business for which the parties entered into the contract. Again, the potential applicability of these principles will depend on the facts and circumstances of the given situation. Some of these considerations may be the same or similar as those described above, including duration of excused performance.

Regardless of the presence of a force majeure clause or the applicability of alternative legal remedies mentioned above between related parties, companies may want to consider whether they have the option to revise their intercompany agreements under the assumption that unrelated parties would seek to renegotiate the agreement if unforeseen or unduly burdensome circumstances arise. Under general contractual principles, renegotiating contracts could be viewed as problematic because one party may have a pre-existing duty to perform under the prior contract

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<sup>3</sup> For example, French courts have denied the spread of other illnesses as qualifying force majeure events because they were not considered as unforeseeable or unavoidable. See, e.g., CA Besançon 8-01-2014 no 12/0229 (H1N1); CA Paris 25-9-1998 no 1996/08159 (plague bacille); CA, Paris, 29-06-2006 no 04/09052 (SARS); CA Nancy 22-11-2010 no 09/00003 (dengue fever); CA Basse-Terre 17-12-2018 no 17/00739 (chikungunya virus).

<sup>4</sup> See, e.g., Luxembourg Court of Appeal on May 8, 2013 (n° 29096) (holding that the economic crisis could not be considered as a force majeure event and could not exempt the debtor of the obligation from reimbursing its loan).

<sup>5</sup> See Jennifer Ancona Semko, Mark Goodman, et al., [No Force Majeure Clause? Other Potential Options to Excuse Contractual Performance Under US Law in the Face of Covid-19](#), Baker McKenzie Insight (Mar. 6, 2020).



unless consideration is given for terminating the prior contract. However, in actual third-party transactions, parties often do not strictly hold another party to contractual obligations. For example, during Covid-19, there have been several instances of hotels refunding money to businesses for event cancellations and returning deposits in contravention of deposit forfeiture provisions.

When one party is struggling because of unforeseen or extraordinary circumstances, the counterparty may accept alternative performance, e.g., providing a more limited number of components in the short term and then providing an increased supply thereafter until it has fulfilled the backlogged demand. A party may even accept less favorable contractual terms despite a clear contractual right to sue for non-performance. These actions may be undertaken for reasons other than creation or furtherance of goodwill. It may be because it would be more disruptive to find a viable alternative business relationship, or anticipated future business with the counterparty may be more important despite an interruption in the short term. This concept has been accepted by the Tax Court, where renegotiating contracts in the intercompany context was accepted as consistent with the arm's length principle.<sup>6</sup>

It also is possible that having a force majeure clause can be more limiting to related parties than having no such clause. For example, a force majeure clause may not specifically list the event (e.g., an epidemic, pandemic, act of God, or government action), which may leave the non-performing party out of luck or in a court battle over the contract interpretation. The assumption may arise that if only certain events were identified to excuse performance, an event that was not identified was not contemplated to excuse performance.

Accordingly, many intercompany agreements today may not contain a force majeure clause. Regardless, whether or not an intercompany agreement has a force majeure clause, related parties should be free to renegotiate the terms of

the agreement depending on the facts and circumstances. The age-old question then arises, are the (re)negotiated terms arm's length?

## V. OTHER CONSIDERATIONS BEFORE INVOKING FORCE MAJEURE CLAUSES

Before rushing to seek to terminate and/or renegotiate intercompany agreements for relief of non-performance, it is necessary to consider the economic motivations and business reasons for seeking such relief. For multinational enterprises ("MNEs"), the ripple effect of the business and economic disruption that began in Wuhan, China in December, 2019, and has quickly spread to the rest of the world, may be causing supply chain disruption, worker displacement, business interruption, and depressed profits or losses. While business interruption and supply chain disruption may be clear-cut causes of non-performance, depressed profits or losses are not and, thus, may not be eligible for remedy by invoking a force majeure clause. A contractual obligation to perform is not a guarantee of profits.

If the contractual provisions are satisfied, a force majeure clause may excuse a party for non-performance without compensating the other party. However, that is not always the case. Whether seeking to terminate an agreement by invoking a force majeure clause or otherwise renegotiating it, the resulting economic impact may require indemnification of (compensation for) the harmed party, depending on the circumstances. Chapter IX of the *Organization for Economic Co-Operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the "TPG") deals with the transfer pricing aspects of business restructurings, including the termination or substantial renegotiation of existing arrangements. The TPG recognizes that "business restructurings may be needed to preserve profitability or limit losses, e.g. in the event of an over-capacity situation or in a downturn economy."<sup>7</sup>

<sup>6</sup> See, e.g., *Nestle Co. v. Commissioner*, T.C. Memo 1963-14 (holding that amended licensing agreement between parent and subsidiary was arm's length).

<sup>7</sup> TPG Chapter IX.A.1.

MNEs should evaluate the potential transfer pricing impact of terminating or renegotiating intercompany agreements in the context of the facts, circumstances, functional profiles, division of risks among the parties involved, and whether behavior of the parties and underlying economic substance of the transactions matches the terms of the intercompany agreements.<sup>8</sup> The TPG indicates that, "[t]here should be no presumption that all contract terminations or substantial renegotiations should give a right to indemnification at arm's length, as this will depend on the facts and circumstances of each case." Further, such analysis must also consider the options realistically available to the parties.<sup>9</sup> The TPG recognizes that an entity may agree to a restructuring as a better option than going out of business altogether, e.g., if the restructured entity is actually being saved from the likelihood of a "loss-making opportunity."<sup>10</sup>

Sometimes, rather than terminate or renegotiate agreements, it makes better sense to maintain the current arrangement and deal with the transfer pricing consequences in other ways. For example, if agreements allow for adjustment of transfer prices within a range of arm's-length returns, the low end of the range could be targeted in anticipation of depressed profits.

Documenting and supporting lower returns and losses can be challenging, particularly when using profit-based methods, e.g., the comparable profits method under §482 and the transactional net margin method under the TPG. These methods require comparison of controlled transactions with those of uncontrolled or independent enterprises, as evidenced by the range of net operating profits earned by the independent enterprises. There typically is a delay between when companies file their statutory accounts and when the data becomes available in the databases used for benchmarking analyses. Such delay can make it difficult to support the initial periods of depressed profitability. There are a number of ways to deal

with this, including: using only the most recent data (perhaps even quarterly results); revisiting the screening criteria that may have excluded loss-making or financially distressed companies; modifying the multi-year period to capture the full business cycle; and potentially adjusting the results of the comparable companies to account for the economic recession. Perhaps most importantly, analysis of the tested party results should demonstrate, to the extent possible, that the lower profits or losses are not attributable to transfer pricing but rather are attributable to economic circumstances, the risks for which are properly borne by the loss-making party or parties.

## VI. CONCLUSION

The Covid-19 pandemic and associated government actions may qualify as a force majeure event, depending on the specific contract language, governing law, and particular facts and circumstances. Many, if not most, intercompany agreements do not contain force majeure clauses, because related parties do not necessarily require all the protective provisions that unrelated parties would insist on in dealing with each other.

In the absence of force majeure clauses in intercompany agreements, related parties can consider alternative legal remedies or renegotiating contracts to deal with non-performance issues or other extraordinary circumstances. Courts have accepted that renegotiating intercompany agreements is consistent with arm's-length dealings. Further, the TPG recognizes that an entity may agree to a restructuring as a better option than going out of business altogether.

Alternatively, MNEs may consider managing the transfer pricing consequences of the Covid-19 pandemic and economic downturn by targeting returns lower in the range of arm's-length benchmarks. Finally, many may consider documenting low profits and losses by demonstrating that such losses are not attributable to transfer pricing but rather are attributable to economic circumstances, the risks for which are properly borne by the loss-making party or parties.

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<sup>8</sup> See Reg. § 1.482-1(f)(2)(ii) regarding allocations based on company's actual transactions. All section references herein are to the Internal Revenue Code (the Code), as amended, and to the regulations promulgated thereunder, unless otherwise indicated.

<sup>9</sup> TPG ¶9.78.

<sup>10</sup> TPG ¶9.71.

## Authors



**Brian Arthur**

Partner  
New York  
Brian.Arthur@bakermckenzie.com



**Michelle Martinez**

Principal Economist  
Chicago  
Michelle.Martinez@bakermckenzie.com



**Xavier Vinyals Mirabent**

Senior Financial Analyst  
Amsterdam  
Xavier.VinyalsMirabent@bakermckenzie.com



**Kent Stackhouse**

Associate  
Washington, DC  
Kent.Stackhouse@bakermckenzie.com



**Antonio Weffer**

Partner  
Luxembourg  
Antonio.Weffer@bakermckenzie.com

# Optimizing Losses from a Transfer Pricing Perspective in the Wake of a Pandemic

## I. INTRODUCTION

Governments and central banks around the world are struggling to address the Covid-19 pandemic and its impact on the economy. While certain governments may mitigate the crisis by doing whatever it takes, businesses are still required to operate and transact with their international affiliates at arm's length as prescribed by their local transfer pricing rules.

For many companies, the Covid-19 pandemic is causing important supply chain and operational disruptions, and is reducing system-wide profits. Despite governmental measures and stimulus, the financial impact may be even greater for parent companies of local subsidiaries operating as limited-risk distributors or service providers and earning a guaranteed return. Under the current circumstances, it may be appropriate to share losses among different members of a global group depending on functional profiles and where the economic risk is ultimately borne.

This article provides companies with practical tips and identifies issues that may need to be addressed given the uncertainty caused by the Covid-19 pandemic. Companies face a number of technical challenges related to the tax treatment of losses, and should address such challenges proactively by reaching out to their tax advisor for industry-specific and specific tax and transfer pricing advice.

## II. LOSSES PLANNING CONSIDERATIONS FOR U.S. CORPORATIONS

On March 27, 2020, the U.S. government adopted the Coronavirus Aid, Relief and Economic Security

(“CARES”) Act. The CARES Act provides some measures to mitigate the financial impact of Covid-19 at the U.S.-parent level. For example, the CARES Act repeals the 80% income limitation for net operating losses (“NOLs”) carryovers arising in taxable years beginning before January 1, 2021, and allows carrybacks of NOLs arising in taxable years beginning after December 31, 2017, and before January 1, 2021. The 80% limitation on taxable income remains for taxable years beginning after December 2020. However, through the CARES Act, Congress clarified that for purposes of the 80% limitation, taxable income does not account for deductions under §172,<sup>1</sup> deductions for qualified business income under §199A, and deductions for foreign-derived intangible income (“FDII”) and global intangible low-taxed income (“GILTI”) under 250. Notwithstanding certain interactions with FDII and GILTI deductions, NOL carrybacks may be a potential source of liquidity for corporations suffering losses, and an interesting option given the higher maximum corporate tax rate of 35% in prior years (vs. 21% now).

## III. EVALUATING LOSSES FOR TRANSFER PRICING PURPOSES

Outside the United States, transfer pricing audit activity in recent years has increasingly driven some multinational enterprises (“MNEs”) to adopt return on sales transfer pricing models for their local subsidiaries, rather than cost-plus models. While local tax authorities undoubtedly like the potential financial upside that such models provide, they are less enthusiastic about the downside financial risk that materializes when local sales decline. In general, whether it is appropriate for losses to be shared among the MNE group depends on the nature of the losses, the

<sup>1</sup> All section references herein are to the Internal Revenue Code (the Code), as amended, and to the regulations promulgated unless otherwise indicated.

contractual arrangements in place within the group,<sup>2</sup> and the functions performed, assets owned, and risks managed by each member of the group.<sup>3</sup>

Losses can arise for a variety of reasons. Establishing that the losses relate to the extraordinary circumstances of the Covid-19 outbreak rather than intercompany pricing is key in supporting and defending transfer pricing positions. Companies should analyze the commercial and financial cause of the loss and distinguish between the pandemic period and recovery period. In other words, companies should demonstrate how Covid-19 is changing the commercial circumstances of the business in reducing customer demand or disrupting supply chains. The nature of this analysis will vary by industry and company, but it will often take the form of a detailed industry analysis, providing concrete examples of the many challenges the industry and company are facing due to Covid-19. It may also prove relevant to review and compare the economic impact across markets. For a number of industries, large regional markets encompassing more than one country may remain reasonably homogeneous, while for others, differences among domestic markets (or even within domestic markets) may be significant.<sup>4</sup> This information may be incorporated in the annual transfer pricing documentation to support current year results.

#### **IV. ISOLATING THE FINANCIAL IMPACT OF COVID-19**

After explaining the relation between operating and financial losses and the extraordinary circumstances of the Covid-19 outbreak, the next step is to determine what proportion of the losses a limited-risk entity should bear, and how to support the entity's financial results. Some considerations for making this determination may include evaluating the behavior of unrelated parties in comparable uncontrolled transactions and the financial results of comparable companies

during the same period (in the context of the comparable profit method/transactional net margin method).

Aside from the typical comparability adjustments to the financials of comparable companies' results, MNEs may isolate the impact of the Covid-19 crisis (and hence, isolate the loss) by adjusting the tested party and comparable companies' results based on the SG&A-to-sales ratio experienced during unaffected years. During an economic downturn, companies typically experience an increase in SG&A as a percentage of sales given that they cannot rapidly adjust their fixed costs to offset lower sales. Although they may no longer require the same amount of assets to operate their businesses, contractual arrangements like leases do not allow for short-term changes without significant penalties. In business economics, companies have an economic incentive to continue operations despite losses, as long as revenues offset variable costs.

Adjusting the tested party results may also be necessary to account for government subsidies or available tax credits. Governments across the globe are releasing stimulus plans to counteract the financial crisis. Italy, for example, committed to grant certain tax credits on sanitation expenses.<sup>5</sup> Moreover, in certain cases, companies have business interruption insurance against revenue lost and operating margins reductions. Allocating insurance proceeds among related parties may be relevant for transfer pricing purposes. This is due to the fact that this type of insurance policies is not entered at the level of each subsidiary but at the parent or the principal company level.

#### **V. ADJUSTMENTS TO CONTRACTUAL TERMS: LOOK OUT FOR COMPARABLE UNCONTROLLED TRANSACTIONS**

To avoid deductibility issues, support actions (or the absence of support actions) within MNEs (e.g., adapting payment terms, granting funding, etc.),

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<sup>2</sup> 2017 *Organization for Economic Co-Operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the "TPG"), ¶ 1.42.

<sup>3</sup> TPG ¶ 1.43.

<sup>4</sup> TPG ¶ 1.112.

<sup>5</sup> See [Covid-19 Government Intervention Schemes in Europe](#) (providing additional information on government intervention).

should follow the same principles that unrelated parties would consider before deciding whether to provide such support. Due to the Covid-19 outbreak, certain companies may seek to invoke *force majeure*, or renegotiate existing contractual terms with their suppliers, business partners, or customers. Such market transactions can serve as indicators of arm's-length behavior and provide the necessary evidence to justify a temporary change to the terms of intercompany arrangements or transfer prices. In addition, the comparable uncontrolled price ("CUP") method is typically the preferred transfer pricing method of all tax jurisdictions. Relying on the CUP method thus provides a great opportunity for implementing a coordinated and consistent global defense strategy across jurisdictions.

## **VI. FINANCIAL IMPLICATION OF LOSSES**

As a result of the Covid-19 pandemic, many companies will rely on government loans, loan guarantees, and grants, as part of the multi-trillion dollar financial stimulus plans that governments are implementing. In the United States, the CARES Act specifically grants the Treasury authority to provide up to \$500 billion in loans, loan guarantees, some of which will benefit qualifying businesses.

For MNEs, there may be significant transfer pricing implications related to the distribution of funds within the group to individual subsidiaries experiencing financial stress, whether the source of funding is external or not. While MNEs are under pressure to act quickly, it remains essential to consider the characterization and implication of intercompany financial transactions used to distribute the funds. Failure to take such steps may have significant tax consequences. This is also particularly important in an environment where some companies in a group are tax-paying while others are shielded by losses.

MNEs can provide funds to a subsidiary through various financial transactions such as an injection of equity capital, an intercompany loan, or a settlement of guarantees. While the injection of equity capital would not lead to any direct tax consequences, an intercompany loan may

constitute a better arrangement in cases where the subsidiary has unused tax capacity and the parent is shielded by losses. In the alternative, if the parent has tax capacity, a transaction that gives the parent a deduction (e.g., a settlement under a guarantee) might be an interesting option, especially if there is a formal guarantee in place. In the case of a U.S. parent with tax capacity, companies should also consider the revised §163(j) limitation on interest expenses under the CARES Act. As another measure to alleviate the financial impact of Covid-19, the U.S. government increased the deduction for business interest expense to 50% of adjusted taxable income ("ATI") for tax years beginning in 2019 and 2020. Certain companies may further increase their interest deduction by substituting their 2019 ATI for their 2020 ATI.

### **A. Loans**

While it may seem straightforward to issue an intercompany loan, the current economic environment causes some challenges. For example, would a lender be willing to make such a loan without the support, either explicit or implicit, of the group? In fact, would a lender even be willing to lend at all to the group as a whole? What interest rates are appropriate? While base rates are very low, the credit spreads will be much higher and should be considered as part of the analysis. Furthermore, the debt capacity of subsidiaries may be impacted by the application of interest limitation rules to reduced earnings. It may not be possible to make loans if the borrower has no debt capacity either now or in the immediate future. In such cases, less credit-sensitive structures such as cash pool arrangements might be useful as an alternative.

### **B. Guarantees**

Another alternative is to characterize the provisions of funds as the settlement of guarantees. For explicit guarantees, the transaction can be seen as a settlement of the guarantee to the extent there was debt in place, either internal or external. With respect to implicit guarantees, companies should carefully consider and document the process. In

the case of intercompany loans, for example, documentation will indicate whether the funds are replaced as a settlement of the implicit guarantee, or written down or written off completely. If the parent is not the same as the lender, then it should settle the loan with the lender directly and document that it is doing so under the implicit guarantee. Otherwise, it will in effect write off the loan, document the reasons, and claim a loss just as a bank would under a bad debt scenario.

## **VII. OTHER CONSIDERATIONS**

Before adjusting their transfer pricing model in response to losses associated with the Covid-19 pandemic, companies should be wary of potential customs duty or indirect tax consequences of certain types of transfer pricing adjustments. In many jurisdictions, tensions exist between transfer pricing and customs values. For example, a downward adjustment to cost of goods sold may later trigger inquiry by local customs authorities. Retrospective transfer pricing adjustments (where permitted) may lead to an adjustment to dutiable imported goods, which in turn may necessitate a voluntary disclosure to customs authorities.

## **VIII. CONCLUSION**

In summary, the Covid-19 crisis creates important challenges for companies and the urgency to react quickly. However, as governments respond to the crisis with stimulus plans and fiscal reliefs, tax and transfer pricing become important levers to manage losses and sources of liquidity within the group.

## Authors



**Thomas Brennan**  
Director of Economics  
Sydney  
Thomas.Brennan@bakermckenzie.com



**Koji Oshima**  
Associate  
Tokyo  
Koji.Oshima@bakermckenzie.com



**Jeanne Chenard-Soucy**  
Senior Economist  
Palo Alto  
Jeanne.Chenard-Soucy@bakermckenzie.com



**Chris Raybould**  
Director of Economics  
Toronto  
Christopher.Raybould@bakermckenzie.com



**Stephanie Dewey**  
Partner  
Toronto  
Stephanie.Dewey@bakermckenzie.com



**Alfonso Sancho**  
Associate  
Madrid  
Alfonso.Sancho@bakermckenzie.com



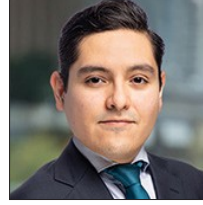
**Yukiko Komori**  
Partner  
Tokyo  
Yukiko.Komori@bakermckenzie.com



**Ivan Tsios**  
Director of Economics  
Chicago  
Ivan.Tsios@bakermckenzie.com



**Steve Labrum**  
Principal Tax Advisor  
London  
Steve.Labrum@bakermckenzie.com



**Alejandro Zavala-Rosas**  
Economist  
Amsterdam  
Alejandro.Zavala-Rosas@bakermckenzie.com



**Allan Pasalagua-Ayala**  
Tax Counsel  
Mexico City  
Allan.Pasalagua-ayala@bakermckenzie.com



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