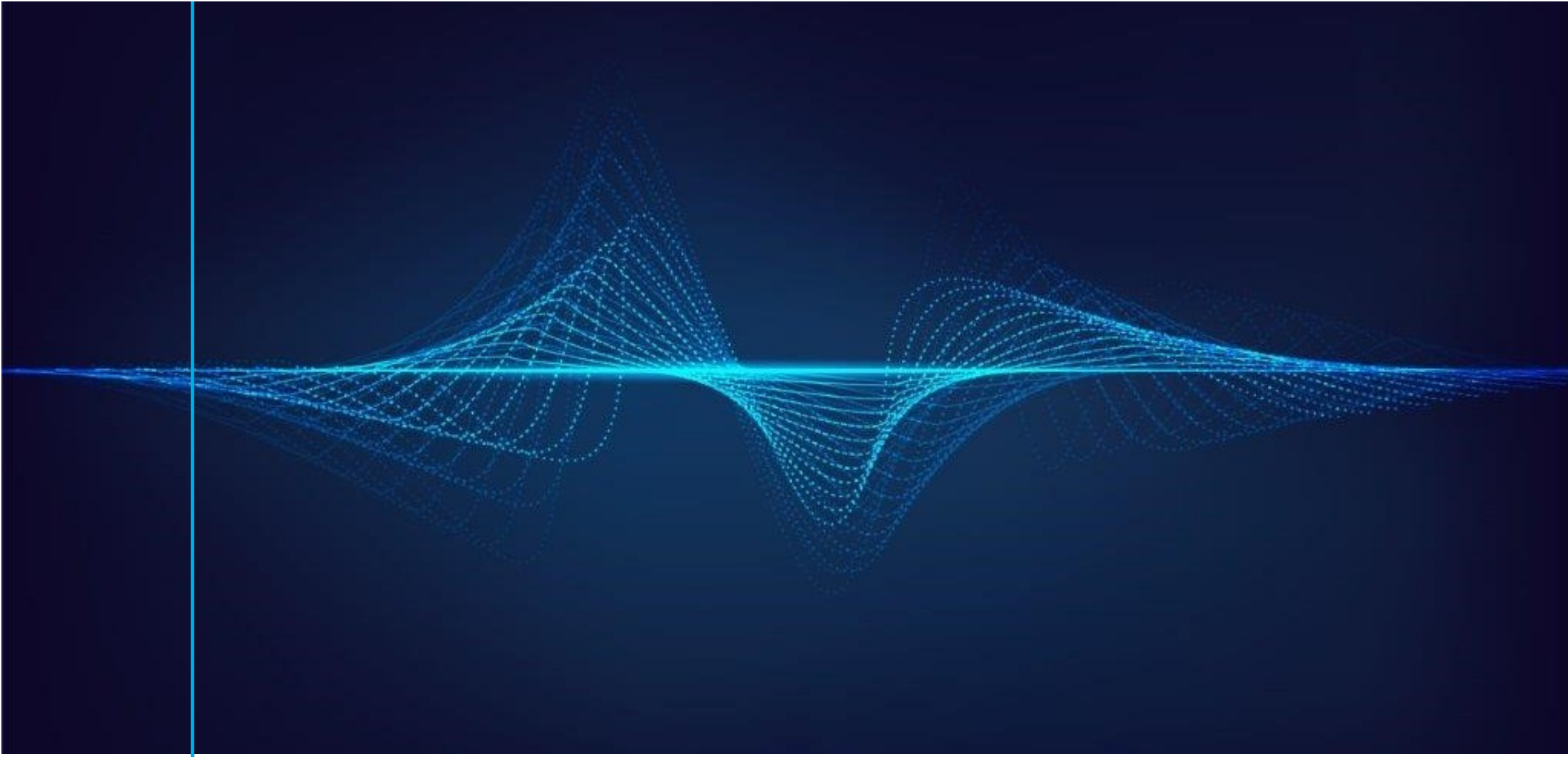

Covid-19: Impact on (the Other) TP

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

Bloomberg Tax & Accounting

Baker McKenzie.

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*[1] (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"),[2] 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,

[1] Issued in July 2017.

[2] Issued in February 2020.

reliable, and improve comparability.[3] 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,[4] 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[5] could be another useful technique in countries where such an approach is permitted.[6]

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.[7]

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

[3] TPG ¶ ¶ 11.40,.139, 1.144-1.147, 2.80, 2.84, 3.47-3.54.

[4] 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.

[5] TPG ¶ ¶ 3.75-3.79; GFT ¶ 10.32.

[6] It might be the case that comparables that are outliers of the range could have suffered from similar consequences to the tested party.

[7] 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.[8]

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,[9] 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[10] 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,[11] 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.[12]

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).[13]

[8] 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."*).

[9] GFT ¶¶ 10.59 - 10.61.

[10] 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.*"

[11] 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.

[12] GFT ¶¶ 10.67-10.68.

[13] 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.[14]

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.[15]

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

[14] GFT Section C.2.

[15] 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.[16]

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.[17] 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,[18] 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

[16] TPG ¶ 3.72.

[17] TPG ¶ 6.194.

[18] 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.[19] 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 predicable).

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

[19] 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

About Baker McKenzie

Baker McKenzie helps clients overcome the challenges of competing in the global economy through a new type of thinking and a different mindset. We understand that in a rapidly changing legal market, clients have new expectations, constantly evolving choices and operate in an environment of heightened reputational and commercial risk. Our strength is our ability to solve complex legal problems by collaborating across borders and practice areas, using transformative technology and dealing with people with empathy..

We are The New Lawyers.
Official: **bakermckenzie.com**
Careers: **bakermckenzie.com/careers**

About Bloomberg Tax & Accounting

Bloomberg Tax & Accounting provides comprehensive global research, news, and technology services enabling tax professionals to get the timely, accurate, and in-depth information they need to plan and comply with confidence. Our flagship Bloomberg Tax platform combines the proven expertise and perspectives of leading tax practitioners in our renowned Tax Management Portfolios with integrated news from the industry-leading Daily Tax Report®, authoritative analysis and insights, primary sources, and timesaving practice tools. Bloomberg Tax Technology solutions on our proprietary Advantage platform help practitioners simplify complex processes to better control risk and maximize profitability.

For more information, visit **pro.bloombergtax.com**.

Bloomberg
Tax & Accounting

Baker
McKenzie.