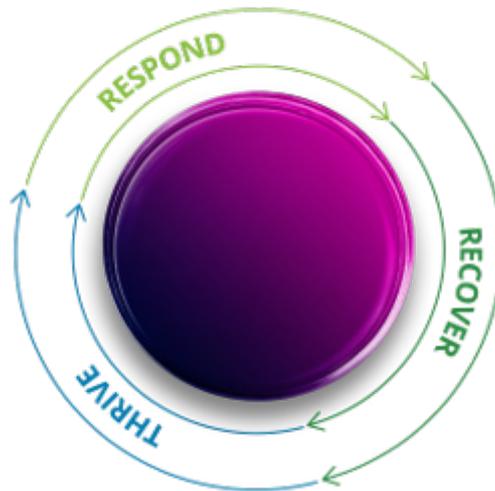


COVID-19 – transfer pricing considerations six months in



Unprecedented times has been an expression used in 2020 more than ever before. More than six months have passed since the emergence of COVID-19 and many businesses have taken steps to respond to the pandemic and are continuing to adapt and recover. The way in which businesses are affected, and the extent of that impact, varies widely. However, what is clear is that overwhelmingly businesses have faced change and that in turn raises transfer pricing questions which tax teams need to grapple with.

As with all aspects of transfer pricing, there is no 'one size fits all' answer, but for many businesses:

- All aspects of transfer pricing have the potential to be affected - from policy setting to implementation and monitoring, to documentation and to agreements with tax authorities.
- The impact on transfer pricing is very likely to extend beyond a single period. The recovery period remains to be determined but, even post-COVID-19, there may be lasting business impacts

and transfer pricing controversy will have to be dealt with in relation to COVID-19 affected periods in the coming years.

- Within a group, the impact on transfer pricing may differ by division, by location and even within a single accounting period.

There is a lot for tax teams to address. In this article, it is firstly considered what guidance is available from tax authorities and the Organisation for Economic Co-operation and Development (OECD) before some of the key transfer pricing matters which have implications for many businesses are outlined. These topics will be the subject of further in-depth consideration in turn in this series of articles.

What have tax authorities and the OECD said?

It is not just businesses that are wrestling with the consequences of COVID-19 – the OECD and tax authorities are also actively considering the impact on transfer pricing.

The OECD have noted that they have received many requests from businesses

to issue specific transfer pricing guidance on COVID-19 considerations. They have indicated that they intend to provide guidance but with the caveat that it needs agreement from the Inclusive Framework (more than 130 countries) and there may be a public consultation first. All of this of course takes time so there is unlikely to be finalised guidance from the OECD before the end of the year. Therefore businesses have been considering, and will need to continue to consider, appropriate actions prior to that guidance being made available.

What about individual tax authorities? In June, the Australian Tax Office (ATO) became one of the first OECD countries to publish guidance on the impact of COVID-19 on transfer pricing¹. The guidance is relatively limited in scope and does not address considerations where existing related party arrangements have been terminated, amended or replaced. It instead focusses on providing some guidance on how the ATO will assess the arm's length nature of transfer pricing arrangements in years affected by COVID-19. The emphasis of the guidance is

¹<https://www.ato.gov.au/Business/International-tax-for-business/In-detail/Transfer-pricing/COVID-19-economic-impacts-on-transfer-pricing-arrangements/>

on understanding the financial outcomes that would have been achieved 'but for' the impact of the pandemic.

New Zealand's Inland Revenue (IR) have also provided initial guidance on transfer pricing in the context of COVID-19. The IR have stated that transactions must continue to be conducted in accordance with the arm's length principle during the COVID-19 pandemic with existing guidance continuing to be relevant, including the OECD's Transfer Pricing Guidelines published in 2017 (the "OECD Guidelines"). However, the IR recognises that practical difficulties in applying the arm's length principle may arise during this time and provides some detail on evidence that businesses will be expected to collate in order to demonstrate the impact of COVID-19 contemporaneously.

The guidance from the ATO and the IR is informative but has no wider impact outside of those jurisdictions and many other tax authorities have to date published relatively little on the matter publicly so the fundamental guidance for transfer pricing in this period remains the "arm's length principle" as set out in the OECD Guidelines.

What are the key transfer pricing matters that need to be considered?

In a series of articles, six core topics will be explored. Introducing each in turn:

1. Economic analyses

When applying transfer pricing methods, publicly available financial information for comparable companies often has a significant lag. In particular, when using database products to underpin the Transactional Net Margin Method (TNMM) analysis, the latest available data is often up to two years out of date and it is common to use a three year period for the analysis. This means that data from five years ago could form part of the analysis. In normal circumstances, this often does not materially affect the analysis but it raises challenges when the data

from comparables is fundamentally not reflective of the economic circumstances of the current year.

How can businesses overcome this challenge? There are some lessons that can be learned from previous recessions, in particular the global recession of 2009. As was the case then, a range of approaches, from relatively simple solutions such as including loss makers in the set of results to more complex methods such as using econometric techniques to forecast how the comparables might be affected by COVID-19 may be appropriate. It may also be necessary to consider different benchmarking approaches for different periods within the same financial year for the months prior to, during and potentially into recovery from COVID-19.

The appropriateness of an approach will be dependent on the facts and circumstances but early consideration of economic support for transfer pricing arrangements should be undertaken to assess if transfer pricing adjustments are required and to provide robust evidence for documentation in due course.

2. Digital considerations

COVID-19 is likely to have accelerated the digitalisation transformation of many groups. Businesses had to react quickly to continue to be able to communicate with stakeholders, customers and employees.

This business digitalisation may result in changes to the way businesses operate, change how value is created and where, which will in turn have transfer pricing implications. Some of these changes may be temporary, whilst others may endure.

The digital transformation of businesses has already been on the agenda of tax authorities, the G20 and the OECD Inclusive Framework for

some years and the OECD Secretariat has been leading multilateral efforts to address tax challenges from digitalisation of the economy, including transfer pricing considerations. Work is ongoing and time will tell if consensus can be reached on the 'Pillar One' proposals (addresses the allocation of taxing rights between countries) the 'Pillar Two' proposals which seeks to develop rules that would provide countries with a right to top up to a minimum level of tax where other countries have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation. However, as no final position has been reached yet by countries, uncertainty on the tax treatment of digital businesses remains, which is exacerbated whilst businesses deal with the impact of COVID-19.

Tax teams should monitor both legislation and business changes prompted by digitalisation to be able to assess potential tax risks and compliance requirements. Questions around the value of data and the impact of e-commerce on potential permanent establishments may need to be considered.

3. Supply chain

Many businesses have made changes to supply chains, whether temporary or permanent, including as a result of shutdown of premises / factories or reduction in headcount.

As part of the assessment of any changes in the supply chain, intercompany agreements should be analysed thoroughly to understand to what extent breach, termination or force majeure clauses are in point. The contracts can often be the starting point for determining any pricing impact. For example, if a contract manufacturer faced a period of factory shutdown where they are not able to meet targets is that a breach of contract? Could Force Majeure clauses be triggered? The contractual

consequences will have a bearing on how its fixed costs during that period should be dealt with at arm's length.

Going beyond the contracts, it should be determined whether the expected profile of the business actually accords with what happened in practice – for example, were the expected people actually involved in making key decisions regarding the impact of COVID-19 and can that be evidenced through contemporaneous commercial evidence (emails, meeting notes, etc.). In addition to assessing the robustness of the current model, if changes to the business are being made, contemporaneous evidence gathered regarding options considered and the decision making process will be important in documentation or in an audit.

4. Displaced workers and the future of work

Due to government restrictions, many groups applied a temporary policy of remote working, whenever possible. For some employees, this may have included working from a different country to their normal working location, and the country in which their employing entity is based for corporate tax purposes.

The success of remote working arrangements has created substantial interest by businesses and employees in the future of work and a shift to some degree of remote working in the future. In some businesses and for some roles, remote working might even become permanent and permit access to a wider talent pool.

In cases where remote work flexibility might mean that employees will be based in a different country to their employer, this might have implications in terms of employment and corporate taxes (particularly where a permanent establishment of their employer is created) and the group's transfer pricing arrangements.

To assess the tax impact of displaced workers/remote working situations consideration should be given to a number of factors. Existence of a double tax treaty between the jurisdictions, the length of time the employee will be remote working, the activities performed by the employee (e.g. do they negotiate and habitually conclude contracts?), the level of seniority (e.g. are they a decision maker) and if there are other employees working for the same employer in that jurisdiction are some of the points to consider when assessing whether a permanent establishment has been created.

5. Government support

A wide range of government support packages have been made available to some businesses. When applying a transfer pricing policy, it is essential that tax teams are aware of and consider the impact of any support received. For example, if workers' salaries were reimbursed by the government during a period of factory shutdown, it may not be appropriate for these costs to also form part of the cost base recharged to another group entity under the transfer pricing policy. Tax teams need to closely monitor and assess the impact of any support received.

6. Controversy

In the coming years, tax authorities can be expected to seek to generate tax revenues to fund the government measures taken during 2020 and beyond to tackle COVID-19. This, coupled with the uncertainty that surrounds dealing with transfer pricing in the current market and the scope for disagreement, suggests that extensive transfer pricing audit activity in relation to the currently period can be expected.

Audit activity relating directly to the years affected by COVID-19 will arise in future years. However, action can and should be taken now in anticipation of such audit activity. As such, evidence gathering contemporaneously on what

is arm's length and commercially rational is recommended and will be key in dealing with future audits, this may include contemporaneous forecasts of results as business decisions and commercial restructurings are made, applications for funding or other support from governments or banks and publically available information in relation to other businesses in relevant sectors.

For businesses with existing Advance Pricing Agreements (APAs), tax authority engagement will be necessary. Bilateral APAs and any ongoing applications should be reviewed to see whether critical assumptions are still met. Businesses may also want to consider managing controversy risk through new APA processes, particularly where a business has restructured and this will have long-term implications. Even where there is no APA in place or in progress, careful consideration should be given as to how and when to communicate transfer pricing changes to the tax authorities concerned.

The impact of COVID-19 on business is varied, often extensive and ongoing, which in turn has wide ranging transfer pricing considerations. Understanding business decisions and the underlying commercial rationale continues to be vital for tax teams to be able to analyse and evidence the impact these might have in the transfer pricing model. Contemporaneous gathering of this commercial evidence is strongly recommended to enhance the robustness of documentation and assist in audit defence. In upcoming articles, further consideration will be given to each of the core topics introduced here to explore key challenges, questions and actions that can be taken by businesses to monitor and adapt their transfer pricing arrangements where needed.



Sophie Brown

Partner, Tax
Deloitte UK
+44 20 7007 8115
sophiebrown@deloitte.co.uk

Jennifer Breeze

Director, Tax
Deloitte UK
+44 20 7007 6543
jbreeze@deloitte.co.uk

Carla Lima Ribeiro

Associate Director, Tax
Deloitte UK
+44 20 3741 2278
climaribeiro@deloitte.co.uk

This publication has been written in general terms and we recommend that you obtain professional advice before acting or refraining from action on any of the contents of this publication. Deloitte LLP accepts no liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 1 New Street Square, London EC4A 3HQ, United Kingdom.

Deloitte LLP is the United Kingdom affiliate of Deloitte NSE LLP, a member firm of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"). DTTL and each of its member firms are legally separate and independent entities. DTTL and Deloitte NSE LLP do not provide services to clients. Please [click here](#) to learn more about our global network of member firms.