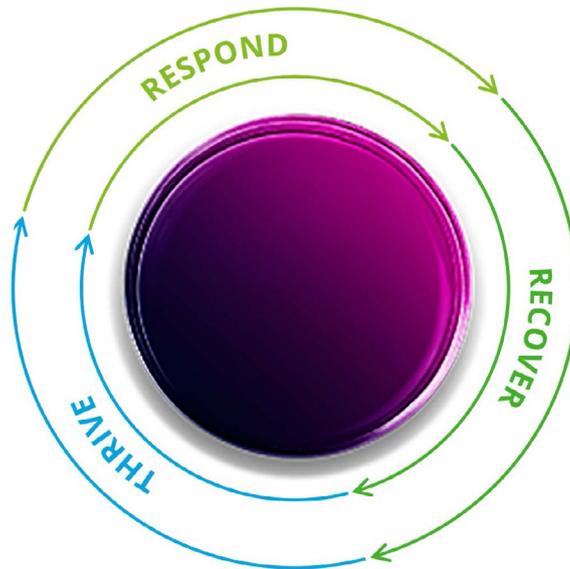


Transfer pricing & government interventions



Introduction

Since it was first identified in late 2019, COVID-19 has affected countries around the world. In addition to its health and human toll, the pandemic has left its mark on the global economy.

Governments worldwide have intervened in many ways as part of their responses to COVID-19, to bridge the drop in demand caused by lockdowns and continued social distancing. The availability, substance, duration and take-up of these assistance programmes potentially might have transfer pricing implications.

In this article we will address dealing with the effect of government interventions for transfer pricing purposes in general, and also in relation to COVID-19 responses. Some countries have already provided transfer pricing guidance prior to the OECD's released [Guidance on the transfer pricing implications of the COVID-19 pandemic](#) of December 18, 2020.

Dealing with the effect of government interventions in general

As a general rule, government interventions¹ should be treated as conditions of the market in the particular country and in the ordinary course they should be taken into account in evaluating the business's transfer price in that market.²

Further to the above general rule, the question then presented is whether in light of these conditions of the market the transactions undertaken by the controlled parties are consistent with transactions between independent enterprises. After all, the arm's length principle dictates that conditions made or imposed between the controlled parties in their commercial or financial relations should not differ from those which would be made between uncontrolled parties.

Ideally these commercial or financial relations are analyzed by conducting a search for uncontrolled comparable parties through data and process driven tax analysis tools determining arm's length results. However, based on most common data available it is rare to actually be able to delineate the treatment of government interventions by uncontrolled parties. Determining "reasonably accurate adjustments" may present particular challenges, given data available is not detailed enough and more than often uncontrolled comparable parties likely receive a distinct mix of government grants from national governments.

For this reason, an extensive analysis of economically relevant characteristics or comparability factors is required to accurately delineate the actual treatment of government interventions. These characteristics or comparability factors can be broadly categorized as follows per the OECD Transfer Pricing Guidelines:³

1. Such as price controls (even price cuts), interest rate controls, controls over payments for services or management fees, controls over the payment of royalties, subsidies to particular sectors, exchange control, antidumping duties, exchange rate policy etc.

2. See OECD Transfer Pricing Guidelines 1.132.

3. See OECD Transfer Pricing Guidelines 1.36.

- The contractual terms of the transaction;
- The functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the multinational group to which the parties belong, the circumstances surrounding the transaction, and industry practices;
- The characteristics of property transferred or services provided;
- The economic circumstances of the parties and of the market in which the parties operate; and
- The business strategies pursued by the parties.

Considerations in relation to (COVID-19) government intervention

Since COVID-19, many governments have provided assistance through a variety of different job retention programs, and broader financial and liquidity support. The terms and conditions of these programs need to be considered when determining the effect on related party transactions, including whether support is temporary or ongoing.

The treatment of government interventions may be considered a sensitive topic in addition to the overall sensitivity around transfer pricing. For example, consider the situation in which the benefit of a government assistance programme effectively transfers to an offshore controlled party. Such an outcome would be difficult to explain within the politics of a country and is therefore subject to increased scrutiny by tax authorities.

Notwithstanding the beforementioned comparability analysis, there are certain aspects that deserve extra attention. One should check carefully whether there is i) an actual link between government interventions and the intercompany pricing and if this is the case ii) to what extent adjustments should be made. Therefore specifically consider the following when performing a transfer pricing analysis:

1. There must be a causal relationship between the relevant government intervention and the business's transfer price. Additional costs and revenues following government intervention that are not related to a certain controlled transaction should be excluded from intercompany pricing. Needless to say, this requires a case by case analysis.
2. If a government intervention can be attributed to an intercompany transaction, the next question is how to settle (part of) the government intervention between the parties involved. In this case, the starting point is that the parties would only be willing to include a government intervention in the transaction, if both parties are provided with an economic or commercial value which enhances or maintains their business position. Such a benefit should in principle be demonstrated as a return at least equal to the increase / decrease of the price as a result of the government intervention.

Furthermore per the OECD guidance, some of the aspects to consider in analysing the impact, if any, of the receipt of government assistance on the price of a controlled transaction include the availability, purpose, duration and other conditions imposed by the government in granting the assistance; the allocation of the economically significant risks; and the level of competition and demand within the relevant markets.

From the perspective of both parties, the arm's length assessment should also consider whether both parties have other realistic options available that are more attractive to them. In the situation a realistic attractive option is available for both the providing party (seller) and the receiving party (buyer) it may not be beneficial to enter into a transaction.⁴ Such a transaction between related parties does not comply with the arm's length principle.

Summarizing the above, and as indicated in the OECD's Guidance on the transfer pricing implications of the COVID-19 pandemic, the potential effect of the receipt of government assistance on the pricing of a transaction will depend on economically relevant characteristics, including but not limited to: the availability, purpose, duration, and other conditions imposed by the government; the allocation of economically significant risks; and the level of competition and demand in the market.

Country specifics on government incentives

To date, not many countries have issued explicit guidance in relation to transfer pricing implications of the COVID-19 related government involvement.

Australia, a country that usually offers additional guidance in the area of transfer pricing, provides explicit guidance in relation to transfer pricing implications of the COVID-19 related government involvement. Other countries such as the Netherlands and Canada provide more general guidance in relation to transfer pricing and government involvement which was already present prior to the COVID-19 outbreak. Below, we briefly discuss these policies for illustrative purposes. These policies described, are not an exhaustive list of guidance in relation to transfer pricing and government involvement.

Australia

In light of the COVID-19 economic impact, the Australian government introduced the JobKeeper Payment which is intended to help keep Australians in jobs and supports Australian businesses which are significantly affected by COVID-19 through funding the businesses' payroll costs.

With the JobKeeper Payment scheme, guidance on the treatment of JobKeeper payments in transfer pricing arrangements was published by the Australian Taxation Office (ATO).⁵ Generally, the ATO would expect that independent parties in comparable circumstances would not share all or part of the JobKeeper benefit. The ATO has not observed independent parties sharing government assistance payments. Therefore, it is expected that Australian entities will retain the benefit of the JobKeeper payment they receive.

4. See OECD Transfer Pricing Guidelines 1.38.

5. Australia - COVID-19 Pandemic: Tax Authority Advises on Transfer Pricing Treatment of JobKeeper Payroll Subsidies 22 July 2020.

Netherlands

A similar subsidy scheme in regard to wages was introduced by the Dutch government, namely a temporary subsidy scheme known as the Temporary Emergency Bridging Measure for Sustained Employment (also known as "NOW").^{6,7} The purpose of this scheme is to allow employers to pay the wage costs in the event of an acute drop in turnover, due to a reduction in activity as a result of extraordinary circumstances that cannot reasonably be regarded as part of the normal business risk. In this way, employers can keep employees in service for the hours they worked before this decline occurred.

Considering the NOW aims to cover wage costs for which there is effectively no (intercompany) turnover and the foregoing considerations, it should be determined whether there is an actual link between the government involvement and the intercompany pricing.

Dutch transfer pricing regulations note that, especially in situations in which cost-related remunerations are used to determine the arm's length price, the question is regularly asked whether subsidies and tax benefits received (government involvement) should be deducted from the cost base. A general starting point is that subsidies may be deducted from the cost base if there is a direct connection between the subsidy and the delivery of the product or provision of the service and the relevant subsidy is granted in the form of a discount on or a compensation for costs.

Non Covid related examples include a subsidy for the use of more expensive but more environmentally friendly materials, a premium on the purchase of an energy-efficient business asset etc. Subsidies and tax benefits that are granted to an entity as such and are not causally related to the activity to which a cost-related remuneration is attributed are not to be deducted from the cost base. To the extent that these subsidies and tax benefits are deducted from the taxable profit, they are to be credited separately to the profit and loss account and not taken as part of the cost base or can be credited in the Dutch Corporate Income Tax depending on the kind subsidy.

Canada

In Canada, the arm's length principle is also applied as policy when calculating the cost base for transfer pricing purposes in case of government assistance such as government assistance, such as scientific research and experimental development (SR&ED) credits or wage subsidies. The guidance of the Canada Revenue Agency (CRA) states that the transfer price for the transaction that a Canadian taxpayer and an associated enterprise enter into should reflect the outcome that would have resulted had the parties been dealing at arm's length. In this case, the cost base should not be reduced by the amount of the government assistance received, unless there is reliable evidence that arm's length parties would have done so given the specific facts and circumstances.⁸

Although the above policies provide some direction on how to deal with government assistance in the end an extensive analysis of economically relevant characteristics or comparability factors is required to accurately delineate the actual treatment of government interventions.

Financial Accounting Treatment

Most transfer pricing methods depend on financial accounting data from uncontrolled comparable companies.⁹ The accounting treatment of subsidies and tax benefits may differ per country due to the local accounting standards and practices. Besides the accounting treatment, the type of subsidy or tax benefit also needs to be taken into consideration. There are various types of subsidies and tax benefits, such as general grants (e.g., subsidies) and tax credit on specific OPEX item (i.e., "payroll tax credits", reduction in VAT on certain items, assistance or credits in respect to the rentals, forgiven/ reduced excise taxes, etc.). The functional profile (e.g., toll manufacturer, limited-risk manufacturer, a fully-fledged risk bearer or a principal) of the entity receiving the subsidy or tax benefit can also play a role.¹⁰ In the below table, we have provided general and simplified examples on how to calculate government assistance.

Examples¹¹

Group X has a production entity which is located in Country A. The principal of Group X is located in Country B. The production entity receives an arm's length mark-up of 10% for the production activities it performs. The net income and taxable profit of the production entity is calculated as follows:

Costs	100
Mark-up	10%
Charge to principal	110
Net income and taxable profit production entity	10

6. Since March the temporary emergency bridging measure has been extended multiple times with various conditions.

7. Please note that receiving NOW also includes Transfer Pricing specific requirements.

8. <https://www.canada.ca/en/revenue-agency/services/tax/international-non-residents/information-been-moved/transfer-pricing/17-impact-government-assistance-on-transfer-pricing.html>

9. COVID-19 and Government Subsidies, John Breen.

10. SurveyGov Assistance_27Oct2020.

11. In all the examples referenced in this section it is assumed that there are no other factors that could affect the intercompany prices, whether this be COVID-19 related or not.

As a result of COVID-19, Country A grants government assistance to companies which are negatively affected by COVID-19. This government assistance is granted in order to bridge the drop in demand caused by lockdowns and social distancing. The same production entity had to reduce its production capacity and therefore applied and received government assistance from Country A. The calculation of the net income and taxable profit of the production entity is as follows:

Costs	100
Government assistance Country A	10
Costs after receiving government assistance of 10	90
Mark-up	10%
Charge to principal	99
Net income and taxable profit production entity	9

In the above calculation, the receipt of government assistance affected the transfer price of the production entity. The government assistance which the production entity received, resulted in a lower charge to the principal and therefore in a change of the production entity's transfer price. However, the tax administration of Country A could determine that the government assistance should solely be granted to companies which are located in Country A and should not be allocated to cross-border related Group entities. The calculation of the net income and taxable profit of the production entity would then be as follows:

Costs production entity	100
Mark-up	10%
Charge to principal	110
Government assistance	10
Net income and taxable profit production entity	20

This calculation shows that the transfer price remained similar to when the production entity did not receive government assistance. This illustrates that depending on how to deal with receiving government assistance from an accounting perspective, this can have an impact on the transfer price in different ways, depending on local legislation. The accounting treatment of the government assistance needs to be specifically identified. In some cases, the government assistance may be deducted from the costs under the relevant accounting standard, however it can also be presented separately.¹² The impact of the government incentive should therefore be treated with caution and well-supported by documentation, as also stated in the OECD's [Guidance on the transfer pricing implications of the COVID-19 pandemic](#).

Summary

COVID-19 resulted in worldwide government interventions in order to limit the negative impact of COVID-19 on the global and national economies. In this respect and as indicated by the OECD, in dealing with government assistance, the arm's length principle should be adhered to. As such it is critical the arm's length principle is considered when receiving government assistance. Although some countries have general guidance related to the transfer pricing implications on government involvement, ultimately an extensive analysis of economically relevant characteristics or comparability factors is required to accurately delineate the actual treatment of government interventions.

¹². See OECD's [Guidance on the transfer pricing implications of the COVID-19 pandemic](#) paragraph 86.



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