



Deloitte Africa Tax & Legal

OECD guidance on the transfer pricing implications of the COVID-19 pandemic

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On 18 December 2020, the OECD released Guidance on the transfer pricing implications of the COVID-19 pandemic (the guidance). It focuses on how the arm's length principle and OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) apply to issues that may arise or be exacerbated by the COVID-19 pandemic



Deloitte comments

The guidance recognises the practical challenges for the application of the arm's length principle as a result of the economic conditions arising from the COVID-19 pandemic and government responses. It is not an expansion of the OECD Guidelines but an application of the arm's length principle.

The guidance focuses on four priority issues: comparability analysis, losses and the allocation of COVID-19 specific costs, government assistance programmes, and advance pricing agreements (APAs).

Businesses will welcome any additional clarity as they seek to apply the transfer pricing rules for 2020, and other financial years affected by the COVID-19 pandemic. However, it remains clear that each situation and transaction is likely to have to be considered and accurately delineated, alongside an assessment of which party bears economically significant risks, in some detail. The guidance sets out the possibility that a limited risk entity might at arm's length make a loss in some circumstances.

The guidance recommends practical approaches to dealing with the difficulties that will arise in relation to comparability, including the use of comparisons with forecast information and reasonable commercial judgement. These will be helpful as businesses seek to navigate applying transfer pricing rules to COVID periods. In addition, the guidance emphasises the potential need for collaborative and flexible approaches to APAs, both existing and future, recognising many businesses' desire for certainty.

Collecting relevant contemporaneous evidence remains a priority for businesses, and will be particularly valuable in preventing or resolving any future disputes.



The OECD Guidelines should continue to be relied upon when performing a transfer pricing analysis but it is recognised that, for the financial years impacted by the COVID-19 pandemic, novel issues may arise and some transfer pricing issues may be exacerbated. The four priority issues identified should be considered together within the framework of the OECD Guidelines in order to find a reasonable estimate of an arm's length outcome. The guidance represents the consensus view of the 137 countries participating in the G20/OECD Inclusive Framework on BEPS.

Comparability analysis

The pandemic may have a significant impact on the pricing of some third party transactions such that the reliability of historical data used in comparability analyses is reduced. **Practical approaches** may need to be adopted.

If the arm's length price of a controlled transaction is determined annually, a comparability analysis is needed for the 2020 financial year. If a pre-existing intercompany agreement includes an agreed fixed return for five years, the need to perform a comparability analysis would depend on **whether unrelated parties would try to renegotiate** the agreement.

Any form of publicly available information regarding the effect of the COVID-19 pandemic on the business, industry and related party transaction may be relevant to support the performance of a comparability analysis. In addition, the guidance lists the following sources as possible support: analysis of how sales volumes and capacity utilisation have changed; incremental or exceptional costs; government assistance received; macroeconomic information and statistical methods; internal forecasts, etc.

A **comparison of forecast financial results** to those actually achieved could be used, as part of a more general approach, to approximate the effects of COVID-19 on revenues, costs and margins when supporting the setting of arm's length prices.

The most reliable information to use in a comparability analysis is that relating to contemporaneous transactions between independent parties. This is particularly challenging when applying the transactional net margin method (TNMM), because financial year 2020 information will typically not be available until much later. **Businesses will therefore need to perform a comparability analysis based on available prior year financial information but utilising any current year information.**

Practical approaches to address information deficiencies could include:

- allowing for the use of reasonable commercial judgement supplemented by contemporaneous information to set a reasonable estimate of the arm's length price;
- allowing, where feasible, for an arm's length outcome testing approach which incorporates information that becomes available after the close of the taxable year; or
- use of more than one transfer pricing method (although it is emphasised that this is not required).

These approaches are considered to be appropriate where businesses make good faith efforts to determine arm's length prices in a way that is consistent with the arm's length principle.

A **comparability analysis** must specifically delineate the related party transaction, including its **actual economic circumstances**. For example, a comparability analysis based solely on the 2008/2009 global financial crisis would raise significant concerns.

Separate testing periods (and periods considered for price setting) may be appropriate for the duration of the pandemic, or for the periods when the material effects were most evident. Data from independent comparables should be measured over a similar period. Financial data of periods affected by the pandemic **must not unduly distort results from pre- or post-pandemic periods**. Care should be taken in verifying that comparable businesses have faced similar restrictions or conditions, e.g. data should be excluded for a period where facilities were closed due to government intervention, if the comparable business remained open. In other cases, the use of combined periods (including years affected by the pandemic with those that are not) may improve reliability.



Where a business **rolls forward** an existing set of comparables it may be necessary to **review, and potentially revise, the set** based on updated search criteria.

Loss-making comparables are appropriate where the comparables assume similar levels of risk and have been similarly impacted by the pandemic.

Losses and the allocation of COVID-19 specific costs

The allocation of risks affects how profits or losses are determined at arm's length, and the existing guidance on the analysis of risks in Chapter I of the OECD Guidelines, will be particularly relevant given the increase in the frequency and magnitude of losses.

Exceptional, non-recurring operating costs arising as a result of COVID-19 should be allocated between group companies based on an assessment of how independent parties operate. Comparability adjustments may be necessary to take account of extraordinary costs recognised as either operating or non-operating items. The transfer pricing analysis is not determined by the 'label' applied to the costs but through an accurate delineation of the transaction. Financial accounting standards may provide relevant and helpful concepts in identifying the nature of costs, but it is noted that there can be uncertainty as to their characterisation.

The functions performed, assets used and risks assumed by **'limited-risk' entities** vary and therefore it is **not possible to establish a general rule to determine whether losses should be incurred**. The risks assumed will be particularly important – a limited-risk distributor that assumes some marketplace risk may, at arm's length, earn a loss if, for example, decline in demand means that the value of sales does not cover the fixed local costs. A limited-risk distributor should not however bear losses from the playing out of credit risk if it does not assume that risk. Comparables must reflect the level of risks assumed by each of the parties to the transaction.

Careful consideration should be given to the **commercial rationale for any change in the risks assumed** by a party before and after the outbreak of COVID-19. Particular attention should be given to situations where a limited-risk distributor did not assume marketplace risk and was only previously entitled to a low return, but a change in risk management due to the COVID-19 pandemic would result in the allocation of a loss. In this scenario, consideration should be given as to whether the positions taken pre- and post-pandemic are consistent. **Any new risk allocation must be supported** by an analysis of all the facts and relevant evidence should be documented.

The accurate delineation of the intra-group transaction will determine whether any **revision of intercompany agreements** in response to the COVID-19 pandemic is **consistent with the behaviours of third parties** in comparable circumstances. It is noted that independent parties may not hold another party to their contractual obligations, e.g. if a third party distributor renegotiates payment terms on a temporary basis, this could form evidence for a business to justify revised terms in intra-group agreements in comparable situations. Consideration is needed of the options realistically available and the effect on the potential profit of the entities over the long term. In the absence of clear evidence that independent parties would have made revisions, the modification of intercompany arrangements is not consistent with the arm's length principle.



Operational or **exceptional costs**, such as expenditure on personal protective equipment (PPE) or reconfiguration of workspaces, should be **allocated between group companies in line with risk assumption and the manner in which third parties would treat such costs**. Costs incurred by one party may need to be passed on to others.

Some operating costs may not be considered exceptional or non-recurring where they relate to **long-term or permanent changes to the business**, e.g. costs related to teleworking arrangements if working from home becomes more permanent. For certain businesses, the COVID-19 pandemic has led to a reduction in other types of costs (e.g. travel expenses). Expenses that relate to substitutes to the means of conducting business activities would likely be treated as operating costs.

At arm's length, whether exceptional costs are passed on to customers or suppliers may vary depending on the competitiveness of the industry and the price-sensitivity of demand.

When performing a comparability analysis, consideration may be needed of how exceptional costs arising from COVID-19 should be taken into account. Exceptional costs should be excluded from the net profit indicator except when they relate to the accurately delineated related party transactions. Consideration is needed of whether the cost base should include exceptional costs, including which party would bear the costs at arm's length. Including exceptional costs typically transfers them to the counterparty, excluding the costs allocates them to the tested party. Adjustments for accounting consistency may be required, e.g. whether the purchase of PPE is an operating cost or a cost of goods sold.

Government assistance programmes

Many governments have provided assistance through a variety of different job retention programmes and broader financial and liquidity support.

The **terms and conditions** of these programmes need to be considered when determining the **impact on related party transactions**, including whether support is temporary or ongoing.

The extent to which the receipt of government assistance is an **economically relevant characteristic** may vary. The provision of a wage subsidy, government debt guarantee or short-term liquidity support may be more economically relevant as it may have a direct impact on the related party transaction and comparable transactions between independent parties, including their prices. The provision of local infrastructure by a government may be less economically relevant. The receipt of government assistance by another party (such as a customer) may also influence the economically relevant characteristics of the transaction. Documentation should be prepared to support the transfer pricing analysis.

In line with the OECD Guidelines, **government interventions** should generally be treated as **conditions of the market** in the particular country. An analysis of the implications of the receipt of government assistance should consider: whether the receipt of government assistance provides a market advantage; the amount of any increase in revenues/decrease in costs and the duration of the assistance; the degree to which the benefits are passed on to independent customers/suppliers; and the manner in which independent parties would allocate any remaining benefits between themselves.

Government assistance does not change the allocation of risk in a transaction for transfer pricing purposes, but it may reduce the quantitative negative impact of a risk, e.g. the party assuming credit risk would not incur the losses expected if a counterparty meets its obligations because of government assistance.

It may be necessary to take into account the receipt of government assistance when reviewing potential comparables as the assistance may affect both how the parties establish their commercial or financial relations and how they price their transactions.

Different types of government assistance may affect the arm's length prices of third party transactions in different ways. Material differences, such as duration of relief, could affect comparability unless comparability adjustments can be reliably made.

The impact of different types of government assistance available in each market may impose additional challenges in obtaining suitable comparables. A revised strategy and the use of a corroborating transfer pricing methodology may be appropriate.

A comparability adjustment may be required when applying a one-sided method (such as the cost plus method, or the TNMM) where accounting treatments of the same type of assistance differ between the related party and the comparable.

Advance pricing agreements (APAs)

Existing advance pricing agreements

It is recognised that the COVID-19 pandemic has led to material changes in economic conditions that were not anticipated when many APAs were agreed and that some businesses may now face challenges in applying existing APAs under current conditions.

Neither businesses, nor tax authorities, can automatically disregard or alter the terms of existing APAs due to the change in economic circumstances. Existing APAs and their terms should be respected unless a breach of critical assumptions has occurred. However, it is acknowledged that the effects of the COVID-19 pandemic and the response of governments are likely to qualify as a breach for some businesses. This will need to be analysed on a case-by-case basis taking into account the circumstances of the business, the commercial environment and the duration of the disruption. (A mere change in businesses' results would only be a breach to the extent that this was specifically included in the particular APA).

Where there has been a failure to meet critical assumptions of an APA, domestic law or procedural provisions may prescribe the required response. In the event that the effect of the breach is not material, the business and tax authority may agree to continue to apply the APA.



In other situations, tax authorities may have more discretion:

- **Revision** – the business and the tax authorities could retain the benefit of the APA for the whole of the proposed period, but with different terms for any year(s) subject to the economic circumstances derived from the COVID-19 pandemic, e.g. the revision of specific provisions for which the breach in critical assumptions is relevant, more general revisions such as aggregating the results of financial year 2020 with more normal results of prior and future periods, or cancelling an existing APA for financial year 2020.
- **Cancellation** – the APA would end on an agreed date if, for example, there is a material breach in an APA's critical assumption as a result of a change in economic circumstances, or the business failed to materially comply with the APA.
- **Revocation** – the business is treated as if the APA had never been entered into. This has not altered and the number of revocations should remain limited.

Businesses are encouraged to adopt a collaborative and transparent approach. Tax authorities should be notified as soon as possible where material changes in economic conditions lead to the breach of a critical assumption, in order to give more time to reach agreement on revising the APA and reduce the chances of cancellation. It is noted that it may be easier to revise, rather than cancel, an APA if tax authorities defer responses until data on the magnitude and longevity of the economic impact of COVID-19 are available. Businesses should collect relevant supporting evidence.

APAs under negotiation

It is recognised that businesses may be reluctant about continuing or initiating new APA applications and that for some businesses it is not feasible to reach agreements on future APAs currently. Given the importance of APAs in securing tax certainty, and in preventing future disputes, businesses and tax authorities are encouraged to adopt a flexible and collaborative approach to minimise delays in concluding APAs, e.g. through the use of technological solutions such as virtual case conferences.

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