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# Transfer pricing and the Covid-19 economic downturn



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# Foreword

In our globalised world, the Covid-19 pandemic has triggered an international health crisis that is still far from finished and will continue in the foreseeable future. The necessary lockdown measures have resulted in a global economic crisis marked by a huge and concomitant drop in supply and demand. A number of production and service facilities have had to close down and individuals have had to limit their movements, resulting in reduced consumption of those goods and services still available. In countries where the lockdown measures have been eased, the challenge is now to avoid a second wave while enabling the economies to restart as quickly and strongly as possible.

Though each industry will be hit differently by this economic crisis, supply chain disruptions, reductions in cross border movement of goods, services and people and hence, financial flows, will all have an impact on the margins made by businesses and on the value of their assets. Companies will therefore need to review whether they need to adapt their transfer pricing policy given the current economic downturn.

The CMS Transfer Pricing Group has therefore prepared this thought leadership document to assist companies in proactively approaching these issues and ultimately making appropriate decisions to secure their transfer pricing policies in these unprecedented times.

To that end, this publication provides high-level analyses of certain issues raised by the current situation. The three topics discussed initially are the determination of arm's length compensation or prices for routine distributors, intra-group service providers

and intra-group financing in these exceptional times. The fourth topic deals with the impact of the downturn on the valuation of assets for tax purposes. Finally, we look at the preparation of transfer pricing documentation (which will be key in view of the next tax audit) and the impact of the crisis on advance pricing agreements.

We hope you find this guide a useful and valuable resource. Should you require more information or more specific advice, please approach your usual CMS contact.



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# How to compensate limited risk distributors during the crisis

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How should a company remunerate a routine distributor for its fiscal year ending in December 2020? Exceptional circumstances require exceptional adjustments.

The current, unprecedented economic crisis has already had a major impact on market conditions and must be taken into account in the transfer pricing policies of multinational enterprises (MNEs) to reflect an arm's-length situation for the fiscal year 2020. In this respect, and considering the fact that economic analyses are by nature carried out on the basis of historical data (which will be pre-crisis in this case), it is interesting to analyse how the exceptional economic circumstances currently faced by market players could be integrated in transfer pricing studies to properly remunerate routine companies – and more particularly routine distributors – for their fiscal year ending in December 2020.

It is fairly common practice among MNEs to organise transfer pricing operations around a principal operating company (also called “main entrepreneur”) and routine entities. More specifically, the main entrepreneur is the company that assumes the main risks (whether or not they materialise), makes the strategic decisions, performs complex functions and, in general, owns the key intangible assets (trademarks, patents, know-how, etc.) and bears the related expenses (research and development, trademark management and marketing). Conversely, routine entities perform limited functions, bear non-significant risks, and hold non-strategic assets. As such, the main entrepreneur receives the residual profit, the profit (or loss) remaining after all the routine entities have been appropriately remunerated.

In order to determine the remuneration to be given to the routine entities, and in application of the transactional net margin method, MNEs conduct searches for independent comparable companies (comparables) on public databases (also called “benchmarking studies”) and compute an appropriate profit level indicator for each of the identified comparables to determine an arm's-length range of margins in which the remuneration of the routine entities must fall.

These benchmarking studies necessarily rely on the use of historical financial data since there is a time lag between the closing date of the comparables' financial statements and their availability in public databases. For example, the most up-to-date financial data of comparables that will be available to determine the remuneration of a routine entity for its fiscal year ending December 2020 will usually cover their fiscal year ending December 2019.

In a stable economic environment, the use of historical financial data of comparables usually allows reliable approximation of the remuneration to grant to routine entities.

However, given the current economic crisis, the remuneration of routine entities, when assessed at year-end on their 2020 performance, may be relying on comparables' (pre-pandemic) results that do not reflect the exceptional economic circumstances currently facing the market players.



This situation could lead to granting non-relevant (and, most likely, excessive) profits to routine entities, while, at the same time, main entrepreneurs will, through the application of the transfer pricing method, suffer from the amplified effects of the crisis.

Consequently, in an unstable economic period, estimating the remuneration to grant to routine entities using pre-crisis financial data of the comparable companies may deviate from the arm's-length standard, since the economic circumstances of the markets in which the parties operate are key to conducting reliable comparability analyses.

The question raised in these circumstances is how to determine the remuneration to attribute to routine entities for their fiscal year ending December 2020 while taking into account the impact of the economic crisis related to Covid-19.

This article will focus on the remuneration to grant to routine entities acting as distributors and which use the operating margin as an appropriate profit level indicator.

## Exceptional Circumstances Require Exceptional Adjustments

Considering the exceptional market circumstances, comparability adjustments that mitigate the timing issue described above are made possible by the Organisation for Economic Co-operation and Development (OECD), which states that comparability adjustments should be considered to increase the reliability of the results of a

comparability analysis (OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2017, Section 3.50 (the OECD Transfer Pricing Guidelines<sup>1</sup>)).

As such, comparability adjustments applied directly to the 2019 financial data of the comparable companies, with the objective of simulating the impact of the economic crisis on their accounts, might be considered. The adjusted operating margins obtained for each comparable company would then be regarded as appropriate and would allow for a reliable comparison to determine the remuneration to be granted to a routine entity acting as a distributor (also referred to as the "tested party") for its fiscal year ending in December 2020.

### A Possible Four-Step Approach

To do so, a four-step approach could be used. Firstly, the decrease in turnover (if any) observed at the level of the tested party between its fiscal year ended in December 2019 and its fiscal year ending in December 2020 could be applied to the 2019 turnover of the comparables (Step 1).

Next, the impact of this sales decrease must be simulated on the operating costs for each comparable company. This is where complexity comes into play. Indeed, a distinction needs to be made between variable costs (primarily purchases of goods) and fixed costs (in particular rents and wages/social security charges) since these two categories of costs evolve differently in relation to sales volume. Specifically, while variable costs vary almost proportionally to the

<sup>1</sup> [read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2017\\_tpg-2017-en#page1](http://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2017_tpg-2017-en#page1)

sales, fixed costs may well only be moderately affected by variations in turnover, at least in the short run.

Regarding variable costs, an analysis of the historical gross margin of each comparable company could potentially be considered as a reliable indicator to anticipate the decrease of the purchase of goods in correlation with the previously simulated decrease in turnover (Step 2). Regarding fixed costs, a regression analysis of historical operating costs below the gross margin in relation to sales for each comparable company may provide a relevant approximation of the evolution of fixed costs in relation to the previously simulated decline in turnover (Step 3).

After carrying out these adjustments one would be able to assess the likely impact of the current crisis on the adjusted operating profit of each comparable company (Step 4). This would then lead to the definition of an arm's-length range of adjusted operating margins which could then determine the remuneration to be allocated to the tested party for its fiscal year ending in December 2020.

#### Case-by-Case Analysis Required

In any event, such exceptional comparability adjustment – in effect, a crisis adjustment – is only one of many possible approaches, and must result from a thorough study of the tested party's situation and its economic environment. Specifically, a case-by-case analysis is necessary to determine what types of adjustments should be made in order to obtain the best possible understanding of the market conditions observed between third parties and to determine as reliably as possible the remuneration to be granted to the routine entity.

Furthermore, due to the significant decrease in sales volume in certain industries, while substantial fixed costs would be maintained on a short-term basis, it is expected that the ranges of adjusted operating margins obtained by applying the approach described above might lead to observing loss-making positions at the level of the comparables.

Whatever the case may be, one should use extra caution in determining the relevance of situations where routine entities would be facing a loss-making position while assuming only simple functions and/or bearing only limited risks. Be careful to determine whether such a situation would be considered as conflicting with the application of the concept of "main entrepreneur," pursuant to which it might be expected that the consequences of major economic risks crystallising in the market would have to be borne by the main entrepreneur, in a crisis period as well as in more regular times.

As regards this specific issue, it is vital to determine whether the exceptional economic circumstances caused by Covid-19 allow one, on a case-by-case basis, to develop a convincing economic justification, and provide arguments to demonstrate, that the losses incurred by the tested party at a local level reflect an arm's-length situation.

For example, in cases where it could be shown that gross margins of comparable independent parties were not impacted, it could be argued that, at an equivalent gross margin level between 2019 and 2020, the losses generated by the tested party are not the consequence of a change in the transfer pricing policy but result from risks inherent in distribution activity (such as the volume risk, the price risk and the bad debt risk) which naturally materialise in a period of crisis and which are therefore attributable to the tested party.

Similarly, in a period of severe recession, it could be accepted that third parties agree to share losses to avoid a potential bankruptcy, short-term losses are in some cases necessary to preserve profits in the long term. In this respect, the OECD Transfer Pricing Guidelines (Section 3.75 to Section 3.79) provide for interesting guidance as regards transfer pricing analysis over multiple years, in situations where a long-term view would prevail, between independent parties in comparable circumstances, over a strictly short-term one.

As regards the above, the OECD Transfer Pricing Guidelines (Section 1.129) also accept that associated enterprises, like independent ventures, can sustain genuine losses due to unfavourable economic conditions. In any case, if the application of a particular transfer pricing policy in 2020 leads to allocation of losses to routine entities – which, as discussed above, should be considered with extreme caution – then this situation would also need to be assessed over time to determine whether or not, notwithstanding these genuine losses, the routine entity would be able to generate a positive overall profit over a multi-year period (if it can reasonably expect to offset these losses with sufficient past or future profits, while at the same time generating an overall multi-year result in line with the arm's-length principle).

Ultimately irrespective of the comparability adjustments made on the basis of historical financial data, a corroborative analysis should be conducted ex-post (i.e. at the end of 2021) when comparable financial data for 2020 will be available, in order to confirm the relevance of the adjusted results obtained a priori, and to support the reliability of the adjustments performed.

## Conclusion

Even though the Covid-19 crisis is widely understood, MNEs will still have to thoroughly justify any reduction of remuneration for their routine entities. Particular attention will have to be paid to transfer pricing documentation, which should contain detailed explanations of performed adjustments, the reasons for the adjustments, how they were calculated, how they changed the results for each comparable, and how the adjustment improves comparability.

In this respect, and considering that the financial data of comparable companies for 2019 will be available in public databases as of September/October 2020, MNEs should hopefully have the time to analyse, in advance of their 2020 closing, the situation of their affiliates on a case-by-case basis with the objective of making reliable comparability adjustments that are necessary to reflect the market conditions associated with the crisis.

In addition, even though the current exceptional economic circumstances require exceptional adjustments, it is to be hoped that the Covid-19 crisis will only last for a few years. Hence, in the event of a recovery in economic activity and a return to a "normal" situation in 2021, for instance, MNEs that have made crisis adjustments similar to those described above, will have to display intellectual consistency and perform similar adjustments in the opposite direction for their 2021 results. (So, when basing an analysis on 2020 market data, due to the aforementioned time lag, MNEs should simulate an increase of the sales of the comparables or use historical data that reflect a "normal" economic situation).

Finally, this economic crisis could be an opportunity for MNEs to review their inter-company agreements in order to ensure that the determination of the arm's-length remuneration of routine entities can – as far as possible – be adapted to the occurrence of exceptional events.

# Services providers and contract manufacturers: no risk means taxable profit?

*Xavier Daluzeau, Partner, CMS France*  
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Provision of services is one of the main categories of intra-group transactions within multinational enterprises. Services provided within groups may be of various kinds (e.g. research and development, contract manufacturing, administrative or marketing activities) and may involve both low and high value-added activities.

In most cases, the transfer pricing method applied to intra-group transactions of services consists of applying a profit margin (or *mark-up*) on the costs incurred by the contractor to provide the services concerned (the cost plus method or the transactional net margin method, also known as the net cost plus method). The arm's length nature of the policy is generally tested by comparing the net margin achieved by the intra-group service provider with that achieved by functionally comparable independent companies (publicly available data often do not allow the gross margin to be tested on the direct costs incurred to provide a service).

Considering the impact of the Covid-19 pandemic on their activities and profitability, many multinational groups are questioning the relevance of their transfer pricing policy vis-à-vis their entities acting as service providers and, if necessary, the adaptations that can be made in these exceptional circumstances.

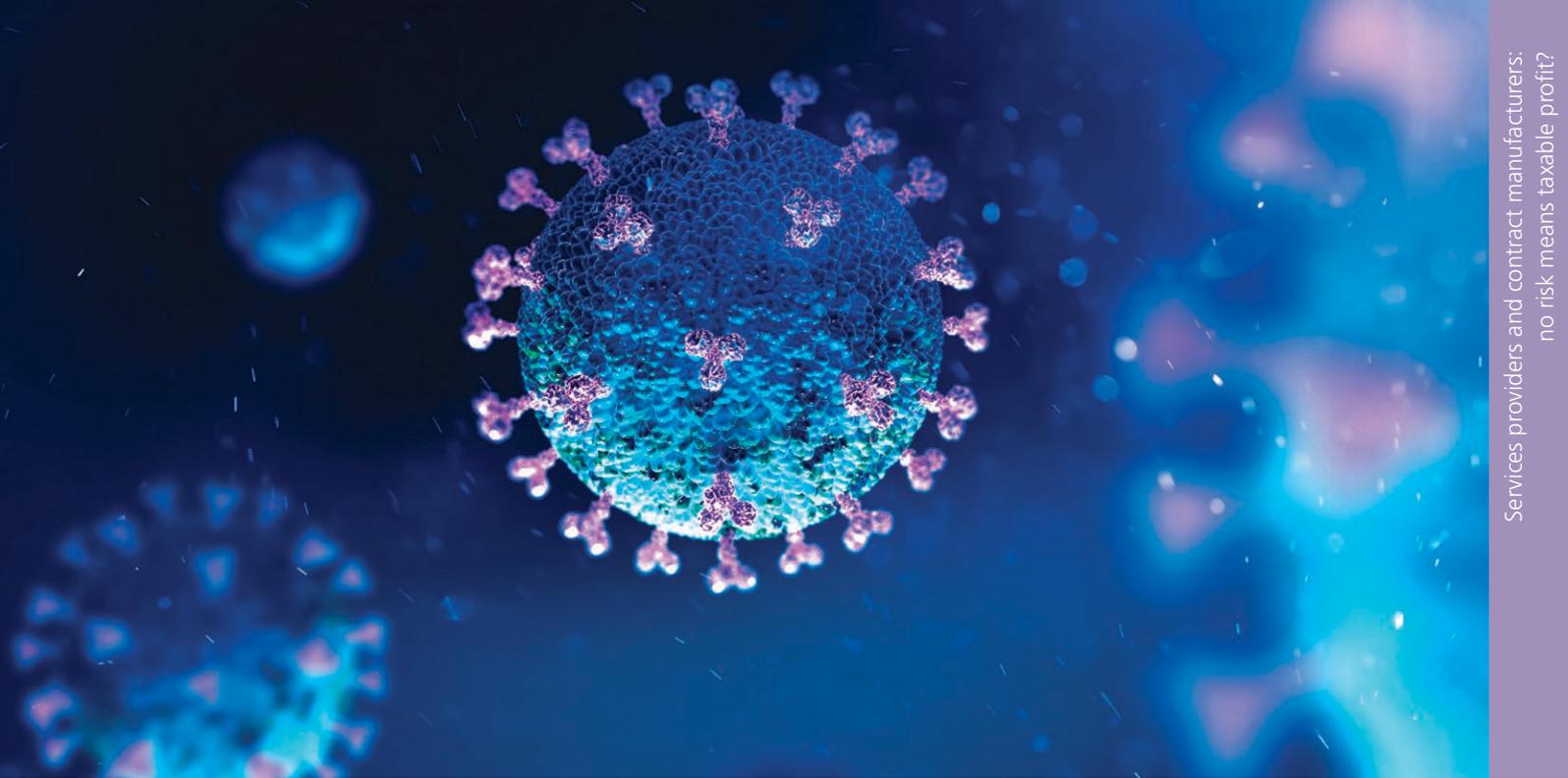
A priori, the crisis we are going through may have led to a sharp drop in service providers' revenues and/or an increase in their costs. As with any transfer pricing analysis, it is first necessary to rely on the functional analysis of the service provider concerned and, in particular, on the risks it is supposed to bear. Likewise, attention should be paid to the intra-group contracts that must formalise this functional analysis. Thus, intra-group service providers may be to differing

degrees subject to market or volume risk and therefore subject to margin erosion or a decline in the volumes of services provided.

## On the margin that an intra-group service provider can achieve in times of crisis

In order to determine the margin to be attributed to companies providing services, searches of independent comparable companies in public databases are usually carried out, thus making it possible to determine arm's length margin intervals which set the upper and lower bounds within which the margin of intra-group service providers must be included.

This research necessarily relies on the use of historical data insofar as there is a time lag between the moment when the accounts of independent comparable companies are closed and the availability of this information in public databases. The latest financial data of comparable companies that will be available to determine the remuneration of companies providing services for their financial year ending 31 December 2020 will be (at best) those related to the financial year 2019.



Without adjustment, there is a risk that the remuneration of service providers will be determined on the basis of comparable independent companies' pre-crisis results, which do not reflect the exceptional economic circumstances experienced by market participants in 2020. This situation could thus lead to intra-group service provider companies being attributed profits that may be too high (because they are built on pre-crisis figures). The challenge is therefore to determine a level of arm's length profitability for the financial year 2020 impacted by the Covid-19 crisis and for which information on comparable companies will not be available in public databases.

To date, neither the French tax authorities nor the OECD has provided guidance on the recommended approach to this. However, in a webinar on 4 May 2020, the OECD indicated that it had received requests from both states and multinational groups to publish guidance on the tax implications of the Covid-19 crisis, including transfer pricing, and that it was considering publishing specific recommendations by the end of the year.

While awaiting possible clarifications, and in application of the OECD Guidelines, it seems to us, however, that a comparability adjustment, based on the pre-crisis accounts of comparable companies, is justified. The OECD Guidelines indicate that such a process can be used to correct differences that have a significant effect on comparability<sup>3</sup> and that the economic circumstances of the parties and the market in which

they operate are key factors for comparability<sup>4</sup>. If the principle of adjustment appears to be well justified, the precise modalities of the adjustment should then be determined, with the objective of trying to assess the impact of the economic crisis on the comparable companies' accounts.

In this regard, there is no method particularly recommended by the OECD Guidelines. However, the OECD Guidelines recognise<sup>5</sup> the difficulty and make it clear that this is a matter of interpretation. Depending on the case, the following approaches seem to us to be possible:

- Where comparable companies with long-term losses had previously been excluded from the study (which can sometimes be done when the provider is considered to bear limited risk), it may make sense to reinstate them in the study if they are otherwise sufficiently comparable.
- It may also be reasonable to aim for a margin in the first quartile of the comparable companies, study (instead of the median rate), or even to consider that the in-house provider may make losses. The OECD Guidelines recognise that a company in a group may – for a reasonable period of time – incur losses due to adverse economic conditions<sup>6</sup>. Making losses in 2020 therefore, when many groups have had to close some of their operations for several months, seems entirely conceivable.

<sup>3</sup> OECD Guidelines, §3.50.

<sup>4</sup> OECD Guidelines, §1.36.

<sup>5</sup> OECD Guidelines, §3.47.

<sup>6</sup> OECD Guidelines, §1.129.

— Finally, and although it is more difficult to carry out, a regression analysis – to simulate the effect on comparable companies’ results of the difficulties encountered by the in-house service provider – could be another way of estimating the level of comparable companies’ profit for the financial year ending in 2020.

## On the effect of a fall in volumes of the intra-group service provider

The current crisis may also have led to a fall in the volumes of services rendered. At an unchanged transfer price, such a decline may reduce, or even render negative, the intra-group service provider’s margin. Depending on the analysis of the risks borne by that provider and the intra-group contracts, it may be appropriate for that decline to be borne by the provider or, alternative, by other companies in the group.

An independent service provider which experiences a drop in turnover – for example because he or his clients have had to close their facilities for several months – would undoubtedly see its margin deteriorate and eventually become negative. Since the arm’s length principle is based on the concept that intra-group relations should reflect market relations, it may be normal for an intra-group service provider subject to market risk, to also experience such difficulties, and therefore similar results.

The issue is likely to be more sensitive when the service provider is, according to the functional analysis, protected against market risks. In such a hypothesis, the service provider should *a priori* be guaranteed the support of the service taker(s). The question then arises as to how far this support can go: should the recipient(s) of the services cover all the provider’s costs (possibly with a margin) or

only part of them, bearing in mind that these may be recurring costs or even restructuring costs? Moreover, this question applies not only from the point of view of the service provider, but also from the point of view of the recipient of the services. If this is not provided for in a contract, why should a recipient of services – even intra-group – support his supplier? Perhaps in order to continue to benefit from his services once the crisis is over?

## Conclusion

A case-by-case analysis is therefore necessary to try to assess the effects of the crisis on an intra-group service provider. Regardless of the approach ultimately adopted, robust documentation should be prepared, including (i) illustrations of the economic downturn for the concerned group and its impact on the intra-group service provider, (ii) justifications that this downturn is indeed the result of Covid-19 and is not due to the decisions of other companies within the group, and (iii) economic justifications supporting the choices made.

Furthermore, in 2021, a corroborative approach could possibly be carried out using 2020 data from the selected comparable companies. Such an a posteriori approach could help to support the decisions that were taken in 2020 on the basis of pre-crisis data.

Finally, this crisis could also be an opportunity for groups to review their intra-group contracts, possibly with the aim of including provisions applicable in the event of a future crisis.



# How to manage current and new intra-group financings during the crisis

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In the context of the Covid-19 crisis, multinational enterprises (“MNEs”) must finance their subsidiaries to ensure the continuity (and above all, the recovery) of their activity. Even though markets are facing a major economic downturn, the arm’s length principle still prevails and MNEs have to manage their intra-group financings accordingly.

The current crisis will inevitably lead to an increase of financing needs. Since MNEs are generally structured through an entity performing central financing functions (the “Central Financing entity”) and act as an intermediary between independent financial institutions and affiliated enterprises, intra-group financing is expected to also increase.

The challenge for MNEs is to ensure, in the current economic downturn, that the conditions applied to intra-group financial transactions, and particularly the interest rates, comply with the arm’s length principle, notably in the case where the borrowing entity is located in France and where, whatever the nationality of the lender, the provisions of Article 212 I a. of the French Tax Code (“FTC”) apply and thus where the burden of proof of arm’s length conditions is on the taxpayer. In particular, it is important for MNEs to consider whether it is necessary to review current intra-group financial transactions concluded before the crisis and how to apply the arm’s length principle to new intra-group financial transactions concluded during the crisis.

## Impact of the Covid-19 crisis on current intra-group financial transactions

For ongoing financial transactions, the OECD indicates that an independent borrower considers the potential impact of changes in economic conditions, notably the risk of not being able to make timely payments of interest and principal on a loan<sup>7</sup>. Therefore, it may be appropriate for a borrower to renegotiate the original conditions of its existing intra-group financial transactions, and specifically the amounts of the debts and/or the repayment terms.

Further to these issues concerning the renegotiation of the intra-group loans, accurate attention must be paid to financial covenants provided in the intra-group loan agreements and to any potential intra-group guarantees that may apply.

<sup>7</sup> §10.59 - OECD (2020), Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10, OECD, Paris (hereinafter “OECD Guidance on FT”).

## Challenges in determining an arm's length interest for new intra-group financial transactions

With regard to the financing needs of their operating subsidiaries, MNEs will have to search for new sources of financing through their Central Financing entity which is then responsible for allocating funds among the group's affiliates and thus determining an arm's length interest rate.

To do so, the Comparable Uncontrolled Price method ("CUP method") is largely used since this method is considered the most direct and reliable way to apply the arm's length principle and, as such, is preferable to all other options.

With regards to financial transactions, the CUP method consists of comparing the interest rate applied in an intra-group transaction with the interest rate applied under comparable conditions between independent enterprises using publicly available data on other borrowers with the same credit rating.

However, due to the current economic situation, MNEs are likely to face some issues when trying to apply the CUP method correctly, specifically the following:

- **Regarding the determination of the borrower's credit risk:** the credit risk (i.e. creditworthiness) of a borrower is generally based on his or her historical financial data at the time of the analysis. Since the Covid-19 crisis is expected to have a significant impact on the financial performance and ratios of borrowing entities, analysing a borrower's creditworthiness and defining their credit rating based on their historical financial data may not reflect the current economic circumstances they face and thus could lead to overestimating their repayment capabilities.
- **Regarding the identification of comparable transactions:** in the same way as during the 2008 crisis, MNEs are likely to face a significant decrease in the number of comparable transactions on the market, particularly in the context of risky investments (non-investment grade).
- **Regarding the particular circumstances related to French State-guaranteed loans:** the question of whether the guarantee granted by the French State may indirectly benefit the foreign group's affiliates financed by a French Central Financing entity (by applying to the foreign intra-group borrowers the same interest rate as the lender obtained from the State-guaranteed bank loan) may arise.

## Conclusion

The current crisis will create more complexity for the application of the arm's length principle for both ongoing and new intra-group financial transactions, which will require specific attention on a case-by-case basis. Any decision taken during the current crisis will have to be well-documented and appropriately justified to anticipate a potential tax audit.

Finally, the Covid-19 crisis will inevitably impact the affiliates' financial and debt ratios, with potential consequences on the limit for deducting net financial expenses and the risk of being subject to thin capitalisation rules. The use of debt to finance group's affiliates will therefore have to be the subject of an overall analysis of the group's situation in order to ensure the full deductibility of the financial expenses.

# Economic downturn and valuation of assets

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In France, the Covid-19 crisis will have an impact on asset tax valuation if the event giving rise to tax (depending on the individual cases) occurred at a date when the crisis had started to have a critical impact.

However, if the beginning of the pandemic can be dated quite precisely in a given country, the moment when one should have foreseen the economic consequences of the crisis and its duration are more difficult to assess.

In this context, how do we take the Covid-19 crisis into account in valuation work?

## The difficulties arising from this crisis

According to some stable case law, French judges favour the **comparable uncontrolled method** which takes as reference the price at which other transactions occurred in the recent past regarding the shares of the same company<sup>8</sup>. Taxpayers should thus firstly establish an inventory of past transactions and collect relevant data to support, if necessary, the rejection of said transactions as non-comparables, in case they occurred prior to the Covid-19 crisis.

With regard to **retrospective methods** (restated assets method, capitalised earnings method, capitalised dividends method, etc.), issues arise from the fact that the financial data on which these methods are grounded do not reflect the current situation.

As for **prospective methods** like the 'Discounted Cash Flow' method, they are based on a business plan which is supposed to integrate the consequences of the crisis on the future profits of the company. It may however be difficult to determine financial forecasts with enough certainty without knowing the real scale and duration of the crisis, which may also depend on the particular industry.

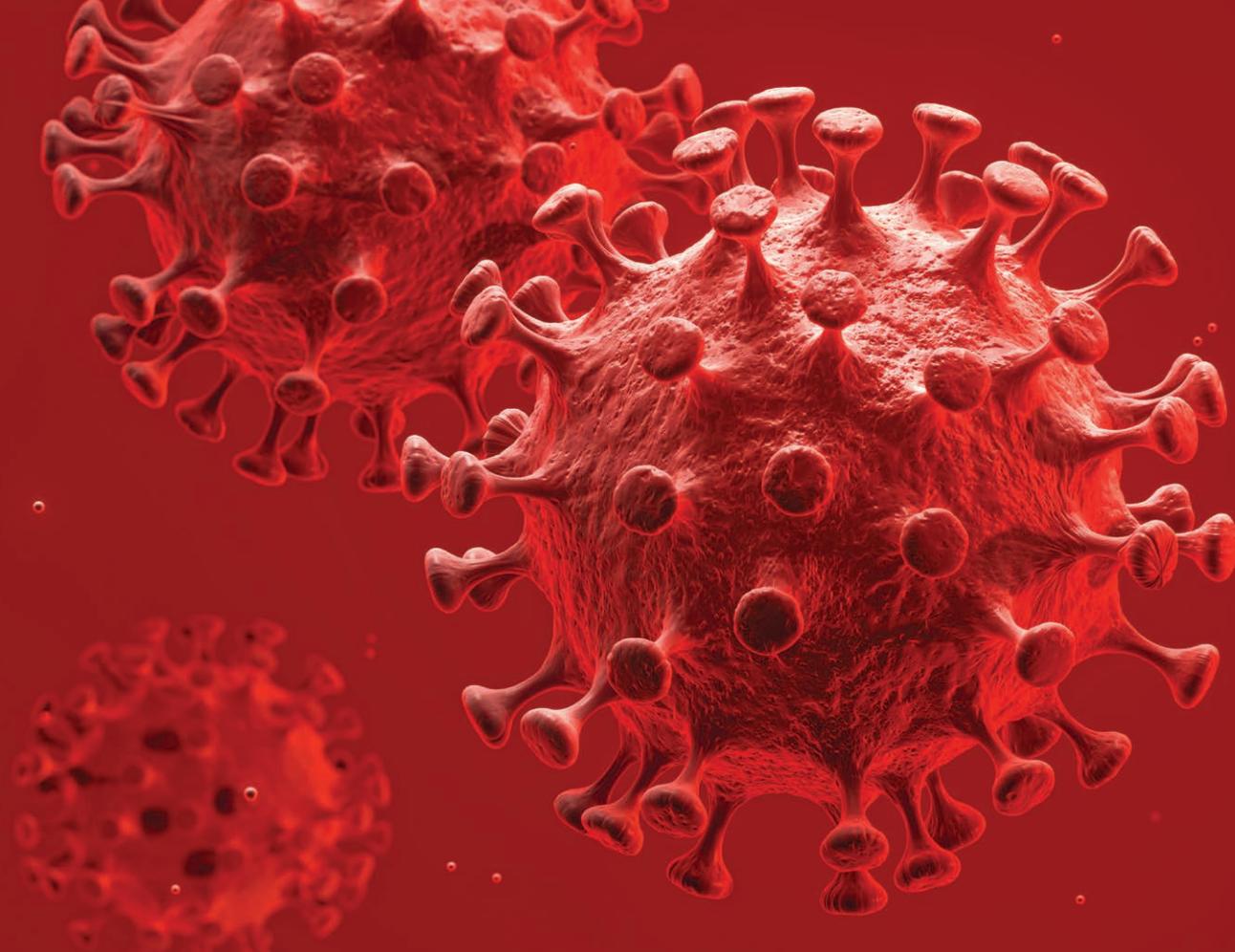
## Overcoming obstacles in valuation works

As a preliminary observation, the uncertainties of the period should spur taxpayers all the more to combine several methods, pursuant to the guidelines of the tax authorities, in order to **corroborate the outcome of a valuation**.

With regard to **retrospective methods**, one solution that can be envisaged to take into account the temporary impact of the crisis would be to weight financial data differently to the standard practice. This could be done by revising the usual weighting which regards the most recent financial year as the most representative one, and instead favour another past year (or years) which would best represent the business performance to be expected in the near future.

Before using **prospective methods**, it is first necessary to determine whether it is plausible that the crisis is challenging the very survival of the company, in which case this type of method would have to be ruled out (and be replaced by a liquidation value method). Apart from this rather exceptional situation, it should be assumed that the normative financial data that

<sup>8</sup> French Supreme Court (*Conseil d'Etat*), November 19, 1975, #92041



forms the basis for the terminal value should not be significantly altered as, in many cases, one might expect the consequences of the economic crisis to vanish in the long run, once the health crisis itself has been overcome. On the other hand, short term forecasts may be more significantly altered, on a case-by-case basis, and circumstances may also require expanding business plan time frames as it may take longer to recover from the crisis and regain the level of normative long-term cycles. In addition, it could be relevant to implement multiple business plan scenarios. Such use of different scenarios could also be combined with a weighting approach.

Regarding the determination of discount rates which requires the use of various market data, depending on the selected valuation methodologies (risk-free rate, inflation rate, market or size risk premium, etc.), the consequences of the crisis may vary. However, currently available past data for these parameters may appear irrelevant in determining appropriate discounted rates, as the historical data do not yet integrate the effects of the current crisis. One solution may be to study the evolution of these parameters during previous crises and then build several scenarios that will simulate the plausible evolution of these parameters from 2019 to 2020.

In any case, whatever method is used, applying an overall discount factor on the value of a business or company due to the crisis would appear to be a perilous strategy because it would be particularly difficult to establish its quantum with sufficient reliability.

## Conclusion

The general principle of prudence must be applied when carrying out valuation work during this transitional period.

In any event, in line with the Hérail judgement of 3 July 2009, it seems certain that a difference of less than 20% between the fair market value estimated by the French tax authorities and the one determined by the taxpayer would not be considered as significant enough to justify a tax reassessment in France.

# During the storm, don't forget compliance!

*Stéphane Gelin, Partner, CMS France*

Earlier articles have shown that the Covid-19 crisis and its economic consequences are likely to impact the implementation of transfer pricing policy of multinational companies. Consolidated profits are likely to decrease in 2020 and also, for certain industries, over the coming years, and such a decrease is likely to be observed also for independent companies which are used to benchmark the intercompany transactions. The same holds true for financial transactions where State guarantees could be provided to secure financing for local MNCs which, in turn, could refinance their foreign affiliates with competitive interest rates. Such circumstances may lead MNCs to amend their transfer pricing policy, or at least reduce prices or margins to take into account the new environment. While such changes are perfectly valid from an economic standpoint, it is necessary to translate them into the supporting documents which would be requested in the case of a tax audit three years from now. Doubtless, when the economy is then booming, precious little time or resources will be available to document what happened during the previous gloomy years. As for APAs, action is required now!

## Transfer Pricing Documentation

It may first be necessary to amend the Master File and local files to take into account the change in circumstances. We refer below to the items described by the OECD Transfer Pricing Guidelines, Annexes I and II to Chapter V (July 2017).

In the Master File, the “drivers of business profit” should be reviewed. In the case of significant decrease in sales, the “group’s five largest products and/or services offering by turnover” may have changed for the description of the corresponding supply chain. “Important business restructuring transactions, acquisitions and divestures” may occur in 2020 or 2021. The “description of how the group is financed, including important financing arrangements with unrelated lenders” is likely to be amended.

In the Local File, the “description of the business and business strategy pursued by the local entity including an indication whether the local entity has been involved in or affected by business restructurings ...” and the “summary of the important assumptions made in applying the transfer pricing methodology” would need to reflect the impact of the Covid-19 crisis. If applicable, “an explanation of the reasons for performing a multi-year analysis” may be added. Most importantly, “a list and description of selected comparable uncontrolled transactions” and “a description of any comparability adjustments performed and an indication of whether adjustments have been made to the results of the tested party, the comparable uncontrolled transactions or both” should be the main item to be modified.

Intra-group legal agreements may also need to be amended, mostly for the pricing provisions. When a distributor of the group is the tested party under a TNMM approach, it is generally expected that a year-end adjustment of prices applied for intra-group transactions is realised. For instance, in the present context, retailers of the group in the fashion industry will see a significant decrease in sales while most of the fixed costs will keep on accruing even if a payment holiday can be agreed upon with landlords and other suppliers. This mismatch will, of course, create a loss for the year, but it may also be that the intra-group supplies are significantly reduced. There could then be a situation where the year-end adjustment would be higher than the cost of goods sold. It is unlikely that accountants and statutory auditors would accept negative COGS, so an alternative transaction should be implemented to account for the year-end adjustment, such as a subsidy or a transfer of costs. If this option is not provided by the distribution agreement, it should be included, otherwise the tax deductibility of the subsidy or the cost recharge could be challenged at the level of the supplier.

Also, in most cases, the profit range expected for the distributor will be provided in an appendix to the distribution agreement, generally applicable for three years. If it is decided to apply a cap to the profits of the distributor which would be lower than the profit range provided by the agreement, then it would be necessary to amend the corresponding provision. This would be also applicable to cost plus compensation for contract manufacturers or service providers.

## Advance Pricing Agreements

The Covid-19 crisis may have an impact on APAs, not only on covered transactions, which may be terminated or amended, but also on the agreed pricing. The crisis may create change in the functional analysis or in the supply chain, in market conditions, or in subsidies, whether provided by States or by the group.

The first question is whether an economic crisis in itself justifies the renegotiation of APAs.

All APAs list "critical assumptions" for the application of the agreement. Generally, they refer to the functional analysis, the significant functions, the strategic assets and the business risks, to accounting and tax methodology and the group's activities. OECD Guidelines (4.146) state that APA could include a provision that provides for a possible revision or cancellation of the arrangement for future years when business operations change significantly or when uncontrolled economic circumstances critically affect the reliability of the methodology in a manner that independent enterprises would consider significant. In the Appendix applicable to MAP APAs (Appendix II to Chapter IV), the guidelines further provide (E.3.3 - §83) that a revision can be made when there has been a material change in conditions noted in a critical assumption. Yet, they state that in many cases, the terms and conditions of the APA may be sufficiently flexible to account for the effects of such changes without the need for a revision.

It thus depends on whether the economic situation is listed in the critical assumptions of the APA. The IRS provides a model for APA negotiated by the USA, which clearly includes the economic situation in critical assumptions. But not all of APAs replicate all critical assumptions provided by the model. In France, there is no public template. In this respect, the French APA office indicated that critical assumptions for APAs signed by France generally did not refer to market conditions. Yet they indicated that TP methods that are implemented take into account profit level indicators that are based on data reflecting the actual market conditions. As a consequence, the outcome of the TP policy would be in line with the business conditions.

The French tax administration thus cites the above-mentioned OECD guidelines, referring to the flexible conditions of the APA: if profit range applied by the taxpayer is in line with arm's length conditions, a revision should not be necessary. Yet, when the APA provides for a set price range, an amendment should still be necessary.

## Conclusion

Generally, it is quite difficult to change an APA because of economic circumstances, but the UK and Australia have recently expressed an openness to APA revision. The IRS have reported that the US has been amending APAs in the context of the 2008 financial crisis.

In any event, companies which want to amend their existing APA should directly contact the competent authority and should not wait for the filing of the annual compliance report. It is, of course, easier to amend an APA which is under discussion, but this will raise timing questions. For instance, not only should delays be anticipated but will the filing deadline be amended for the APA? In this respect, tax administrations have proven to be flexible by organising video conferences with taxpayers and other competent authorities.

However, MNCs need to take decisions in 2020 while tax administrations are busy dealing with general tax policy. It is difficult for taxpayers to receive timely responses and general guidance from the OECD would be most welcome.



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