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# OECD takes action on Covid-19 and transfer pricing

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## 1. Comparability analysis

The Covid-19 emergency has created a different economic scenario in which multinational groups expected to operate with significant impacts on their transfer pricing policy. Depending on the sector and with different intensities, the effects of the measures for the containment of the pandemic have upset the economic assumptions underlying business choices, requiring a review and updating of the so-called “*delineation of the inter-company transaction*”.

Given the potential changes in economically relevant characteristics with respect to intercompany transactions, the terms and conditions of intra-group relationships should be reconsidered, assessing whether also independent parties would reasonably have renegotiated contractual arrangements.

While calling for greater flexibility on the part of taxpayers and tax administrations, the OECD guidance suggests a greater effort to account for the implications of the changed economic environment and a renewed sensitivity in verifying arm’s length conditions by identifying some practical solutions.

In first instance, the need for information transparency becomes even more pressing and the comparability analysis will have to include information (internal and external) as up-to-date as possible about the company and its operations, the relevant industry sector and controlled transactions, in order to outline the link of company results and decisions with the effects of the pandemic. This exercise will include, *inter alia*, a comparative analysis of sales trends (*pre-* and *post-*Covid-19), efficiency diagnostics in terms of capacity utilisation and incremental/exceptional costs, an analysis of the effects of public subsidies and government interventions, an analysis of public quarterly results of economic operators in similar circumstances, of macroeconomic indicators and regression studies aimed at measuring the variability of companies’ performance based on specific economic variables, and an analysis of the effects of previous recessionary trends (e.g., the financial crisis of 2008-2009).

### Use of provisional data

Secondly, the OECD focuses on the informative value of budget or forecast data in the definition of pricing policy, re-evaluating its relevance for the assessment of actual results impacted by the economic environment. The analysis of deviations/variances in the light of Covid-19 effects could also be extended to the estimate of profitability in the absence of the crisis (through appropriate adjustments), as well as to documented evidence of any increase in cost allocation or in revenues contraction of the tested part.

## Practical approaches to manage the information deficiency or insufficiency

The timeliness of the information will necessarily depend on their availability from public sources, therefore it will have a different scope depending on the specific transactions and methodologies applied. The use of internal comparables allows for a prompt and timely identification of Covid-19 effects, similarly to the immediate availability of up-to-date information on databases for financial transactions. Otherwise, the time delay in loading financial statements into databases will affect the application of the TNMM in the external version with the most recent data, as long as the intercompany relationship has not been contractually defined in a pre-Covid-19 period with a multi-year scope.

In light of these complications, the OECD guidance includes some pragmatic approaches to assessing arm’s length conditions in conjunction with pandemic effects.

- i. Mutual co-operation of taxpayers and tax administrations in order to share a comprehensive information overview and to flexibly verify the consistency of transfer prices, taking into account the circumstances, difficulties and operational limitations faced by enterprises. In addition to the above-mentioned broader scope of the comparability analysis, the taxpayer may also rely on specific practical solutions:
  - Use of a specific reference period for the comparability analysis, in order to isolate divergent economic conditions in the pre- and post-Covid-19 context also related to government interventions;
  - Possibility of retroactive transfer pricing adjustments to reflect more accurate and up-to-date information in the transfer pricing policy;
  - Revision of the sample of companies deemed to be comparable, also through a review of the selection criteria in view of their increased comparability to the changed environment and the different exposure to adverse effects of the crisis across sectors and geographical areas;
  - Inclusion of loss-making entities as long as they meet the comparability criteria.

In addition, the use of economic and financial information related to the effects of the 2008-2009 financial crisis on company results will necessarily require an examination within the comparability analysis, in the absence of which there are concerns about their automatic use due to the peculiarities of the Covid-19 pandemic.

- i. Increased use of analysis on actual data by tax administrations who prefer an *ex-ante* approach to ascertain the terms of controlled transactions at the time of establishing the intra-group relationship. In this spirit, flexibility is called for in granting compensatory adjustments for the filing of tax returns and in favour of access to MAPs or other double taxation resolution procedures.
- ii. Use of multiple transfer pricing methodologies to substantiate the consistency with the arm's length principle.

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## 2. Losses and allocation of specific costs resulting from Covid-19

The Covid-19 pandemic has led multinational groups (as well as independent companies) to incur losses due to both reduced profits and exceptional or non-recurring operating costs. In this context, understanding how to allocate these elements is of extreme relevance.

### Allocation of losses to low-risk entities

While the OECD Transfer Pricing Guidelines do not provide an explicit definition of what constitutes a "low-risk entity", such entities are typically "companies with a relatively lower level of functions and risks"<sup>1</sup>.

However, due to their lower level of functions and risks, such entities are not expected to generate losses over long periods of time, which, consequently, does not preclude the possibility of making losses in the short term. Therefore, losses realised during the Covid-19 pandemic, as short-term losses resulting from an adverse economic environment, may be attributed to so-called "low-risk entities", based on the specific functions performed and risks assumed.

In this regard, the OECD provides the example of a "low-risk" distributor subject to limited marketplace. Due to its specific functional structure, such distributor may report a loss associated with a significant drop in demand as a result of Covid-19. Conversely, the same allocation will not be appropriate for a "limited risk" distributor that does not assume any market or other specific risk. In summary, a low-risk entity will only be able to report losses directly related to the risks assumed, albeit in a limited way, due to its specific functional structure.

Another point that appears noteworthy in the OECD interpretation, is the moment in which the risks assumed by each entity are defined. In fact, it is specified that particular attention should be given by tax authorities to any changes in the functional structure of the low-risk entities that occurred after

Covid-19 and not justified by a business restructuring. For the purposes of loss allocation, continuity between the characterization of the entity in the *pre-* and *post-Covid-19* period is necessary. Using the example proposed by the OECD, an entity that before Covid-19 pandemic assumed limited market risk will be able to make losses arising from it. Conversely, an entity that did not previously bear the same risk, will not be able to allocate the resulting losses unless evidence is provided of a business restructuring resulting in a change in the functional structure of the low-risk entity under analysis.

*In essence, the OECD reaches the arguable conclusion that the materialization of the negative economic effects related to Covid-19 on a company part of a multinational group is not to be considered an extraordinary event and therefore to be managed based on contingent valuations, but rather an event to be assessed within the existing risk allocation framework of the entities involved in the infra-group transaction.*

### Amendment of existing arrangements between related parties

The OECD also comments on the possibility of modifying existing intercompany agreements, as well as the conduct of the parties in the related business relationships.

Specifically, it is the OECD's view that such agreements are renegotiable only when their modification is in the best interests of the parties involved, in light of all realistically available opportunities and of the long-term effects on the parties' potential profits. With this aim, relevance is given to the comparison of what would have been agreed between independent parties. According to the OECD example, any evidence of renegotiation of agreements between or with independent parties, comparable to the controlled agreements is essential to prove the convenience of the modification. Conversely, in the absence of actual evidence of convenience for independent enterprises in comparable circumstances, the modification of the intercompany agreement should not be considered consistent with the arm's length principle.

Finally, the OECD legitimates the contract renegotiation as a consequence of the modification of a contract between a company belonging to the MNE and an independent company (i.e., assume that companies X and Y are part of the same MNE group and the latter renegotiates a contract with independent company A, then companies X and Y will be entitled to renegotiate the intercompany agreement between them).

### Specific costs

Due to the Covid-19 pandemic, many companies incurred exceptional and non-recurring operational costs related to the changed operating conditions of the pandemic period. These costs may include costs for

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<sup>1</sup> Par. 9.2, Chapter IX, OECD TPG.

PPE (Personal Protective Equipment), reconfiguration of workspaces to allow for physical separation, costs related to IT infrastructure due to testing and trace and tracking requirements, and implementation of teleworking measures.

The OECD guidance states that in determining how these costs should be allocated between related parties, it should be considered how these costs would have been allocated between independent parties in comparable circumstances.

For this purpose, the following elements should be taken into account:

- i. The allocation of operating or exceptional costs normally follows the assumption of the related risk and the way in which third parties would treat such costs.
- ii. Some of the costs incurred might not be considered exceptional or non-recurring as they are related to long-term or permanent changes in the company's operations (*e.g.*, costs related to teleworking that might become more common after the pandemic). In addition, it should be taken into account that for some companies the pandemic has led to cost savings *e.g.*, lower rent or travel costs. Therefore, costs that replace regular business activities should be treated as operating costs. If an entity has incurred costs centrally, for example for the implementation of teleworking for all group companies, those costs should be recharged to the companies that have benefited.
- iii. In some cases, exceptional costs may be passed on to customers or suppliers. The accurate delineation of transaction and the comparability analysis should lead to determining who ultimately bears these costs.

### **Exceptional costs and comparability analysis**

Exceptional costs incurred may be a relevant element to be considered in a comparability analysis. In this respect, the OECD states that the following elements should be assessed:

- i. Exceptional costs should generally be excluded from the calculation of the net profit indicator, unless they relate to the controlled transaction as accurately delineated. However, the exclusion of such costs should be consistent both at the level of the controlled company and at the level of the comparables, creating data availability issues.
- ii. Consideration should be given to whether exceptional costs should be included in the cost base and, if so, whether a profit element should be

attached to them or they should be treated as pass-through costs.

- iii. Comparability adjustments may be necessary to standardise different accounting practices. However, such adjustments should only be made when they are expected to lead to more reliable results.

### **Force majeure in the allocation of losses**

Force majeure clauses may be invoked to suspend, delay or release a company from its contractual obligations without determining penalties in certain circumstances. This may result in the loss of a customer, a supplier or an ordinarily profitable contract and may also lead to the closure of business operations and associated restructuring costs.

The OECD guidance does not go into the specifics of the applicability of the concept of force majeure, but only considers the implications of its application in the context of transfer pricing. In this respect, it is stated that in order to consider force majeure clauses applicable between entities of the same group, it will be necessary to verify:

- i. Whether force majeure clauses are included in written agreements and a description of the conditions under which they may be invoked (including any interactions with other terms and conditions of the contract);
- ii. Whether, even in the absence of a specific contractual provision, it is possible to renegotiate the agreements on the basis of the conduct of the parties;
- iii. Whether the disruptions and damages caused by the Covid-19 pandemic are sufficiently significant to trigger force majeure considerations.

In general, a comprehensive analysis of the economic circumstances of the commercial agreement will be necessary to assess whether a party, in accordance with the arm's length principle, would invoke force majeure.

With respect to the possible modification of intra-group agreements to include force majeure clauses or their renegotiation due to the Covid-19 pandemic, the OECD guidance to tax authorities is to carefully consider the delineation of the transaction, in the light of third parties' conduct in comparable circumstances, in order to verify whether such modifications and renegotiations are consistent with the principles expressed in the OECD Transfer Pricing Guidelines.

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### 3. Government support programmes

During Covid-19 pandemic one of the main concerns of governments has been to help companies in managing the impact of the decline in business activity through, on one hand, guaranteed loans, deferred financing, specific contributions and tax relief and, on the other hand, to help workers who face a decline in job opportunities and income through various support instruments such as layoff freezes, wage subsidies and redundancy payments.

The terms and conditions of government support programmes related to Covid-19 will have to be considered in order to assess the potential impact on intra-group and comparable transactions.

In this context, there could be situations of non-homogeneity in the use of government subsidies between the parties used in the transfer pricing analysis, which would consequently compromise the reliability of the analysis. However, difficulties may arise in establishing the nature of government assistance received by potential comparables and assessing its economic impact, given (i) the different types of government support programmes and (ii) the practical difficulties in obtaining detailed, reliable and timely information.

In order to properly assess the implications of receiving government subsidies, a number of factors should be considered such as the availability, purpose, duration and other conditions imposed by the government in awarding the subsidies, the potential benefits in terms of increased revenues / decreased costs, the way in which the subsidies are or are not passed on to customers and suppliers.

Government support programmes may be subject to several conditions (significant drop in revenues or profitability) that could limit or even prevent the party receiving the subsidies from changing the prices of transactions with the different players along the value chain. These aspects have to be taken into account in the comparability analysis, as they might limit the effect of state subsidies on the price of the goods or services offered by the entity receiving such subsidies. It is also crucial to understand how the MNE Group has responded to the presence of government support programmes and whether they have led to a change in the pricing strategy towards unrelated parties.

Further challenges to the concept of comparability arise from the fact that government support programmes differ depending on the jurisdiction. Particular attention will also need to be paid to the accounting treatment of the economic effect of government subsidies, both on the tested party and the comparable transactions / companies used to

assess the arm's length nature of the intercompany transaction under analysis. In addition, the accounting treatment of government grants under different accounting policies may have an impact on different levels of profitability (e.g. gross profit, operating profit, net profit, etc.). Where the accounting treatments of the same type of grant differ between tested party and comparable companies, a comparability adjustment may be needed in order to improve the reliability of the analysis.

#### Relevance of the geographical market

Therefore, the most reliable approach to identifying comparables will be to refer, when possible, to data from comparable uncontrolled transactions entered into by companies operating in the same geographical market as the tested party.

When establishing transfer prices using a one-sided method (Resale Price - Cost Plus - TNMM), it is essential to avoid the use of a mechanical approach without carrying out an in-depth analysis (such as offsetting cost savings from government subsidies against the relevant cost base for the transaction; recognising the government subsidy as revenue; or recognising the subsidy as extraordinary income), as this could lead to non-arm's length pricing. In the absence of reliable data or other reliable information on how independent parties would allocate the subsidy between the parties to a transaction, caution should be exercised in assessing whether a sharing of government support programmes is consistent with the approach taken between unrelated companies. The use of multiple transfer pricing methodologies applied to corroborate the arm's length consistency are also suggested.

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### 4. Advanced pricing agreements

The OECD analyses the impact that significant changes in the economic circumstances of the relevant market resulting from the pandemic may have on:

- i. Advanced pricing agreements concluded and effective for the year 2020 and subsequent years potentially impacted by the effects of Covid-19;
- ii. Advanced pricing agreements under negotiation that, once concluded, will be applied to year 2020 and beyond.

*The guidance provided by the OECD does not seem particularly innovative with respect to what could already be deduced from the applicable rules on advanced pricing agreements.*

The most interesting points of the guidance can be

identified in the methods suggested by the OECD through examples for the incorporation of the effects of the pandemic on existing agreements and agreements under negotiation and on the type of documentation that the taxpayer should prepare in order to allow the tax administration to make its own assessment, as to the actual effect of Covid-19 with respect to the single agreement or covered transaction.

In particular, the possible approaches mentioned by the OECD with reference to agreements concluded and under negotiation are the following:

- Term test: assessment of the results over the entire period of validity of the agreement and not by single FY;
- Extension of the period covered by the agreement in combination with the term test, in order to compensate the exceptional results of 2020 with multiple years under “normal” conditions;
- Segregation by FY: distinguishing between tax periods affected and not affected by Covid-19;
- Cancellation of the agreement for 2020 with renewal for subsequent years, integrating the possibility of renegotiating its contents;
- Aggregate approach for all transactions covered by the agreement originally considered separately in order to verify whether together they can meet the conditions in terms of target margins.

In addition, with specific reference to agreements already signed, the possibility of entering into

- Two separate agreements, i.e. a “short” agreement covering only the years affected by Covid-19 and a separate agreement for the subsequent years; or
- An agreement for the normal period of time (e.g., 5 years) providing for an assessment of the impact of Covid-19 *ex-post* for each year affected, with the possibility of retroactive adjustments where possible.

The OECD, however, seems to suggest to minimize as much as possible the intervention on agreements already entered into, probably with a view to an efficient management of resources and of the instrument under analysis, also in light of the difficulties in carrying out negotiations arising from the restrictions imposed by the pandemic.

In particular, the administrations should carry out a case-by-case analysis based on the specific situation of the taxpayer and its business environment in light of

the fact that:

- not all economic sectors have been equally impacted by Covid-19 as there are also businesses that have benefited from it;
- the terms and conditions of the agreement may already be suitable to “absorb” the impact of Covid-19.

The Administrations will therefore have to assess (i) the actual divergence between the parameters agreed upon in the advanced pricing agreement and those resulting from the new economic circumstances due to Covid-19 and (ii) whether the method agreed in the agreement is already suitable to reflect such economic circumstances.

In order to allow the competent administration to make all the necessary assessments, as anticipated, the taxpayer is required to document the impact of the pandemic on the critical assumptions underlying the agreement, by the suggestion of a non-exhaustive list of examples of documents that should be prepared and provided to the administration. These are, in particular:

- i. a description of the narrowest taxpayer business segment monitored by the management that includes the entities and transactions covered by the agreement;
- ii. a comparison of forecast and actual profit data by business segment for the years affected by Covid-19;
- iii. any changes proposed or implemented with respect to existing or future intercompany agreements between related parties that may affect the transactions covered by the agreement;
- iv. an explanation of the expected effects of the change in economic conditions on the transfer pricing methodology agreed in the agreement during the fiscal years covered by Covid-19, including whether they have caused the restructuring of the transactions and/or changes in the related risks and liabilities, as well as any mitigation of the impact of such economic conditions on the tested party resulting from supportive actions by the governments or other mechanisms, such as business interruption insurance. The taxpayer will need to adequately demonstrate that this impact is attributable to the economic environment caused by the pandemic;
- v. a detailed income statement with a breakdown of COGS, selling costs, G&A and other non-interest costs for the years covered by Covid-19 in which the transactions covered by the agreement were entered into. This profit and loss account may also

include exceptional operating expenses arising from Covid-19 or revenue items arising from state-level assistance programmes, including disclosure of their accounting treatment; and

vi. Information on the behaviour of third parties.

In terms of timing, the OECD requires:

- On one hand, for taxpayers to notify the relevant change in critical assumptions as soon as possible after it occurs, or the taxpayer becomes aware of it;
- On the other hand, it acknowledges the fact that the administrations concerned may wish to wait until they are more familiar with the extent and duration of the economic effects of Covid-19 before deciding on how to proceed.

Finally, administrations and taxpayers are encouraged to make as much use as possible of IT tools for remote communication and documents exchange, including for instance when conducting functional interviews or access at the taxpayer's premises. This last aspect, which is extremely innovative with respect to the past for some administrations, could hopefully be maintained also after the end of the pandemic in order to speed up the timing of these procedures.



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#### **ROME**

Via Agostino Depretis, 86  
00184

T - +39 06 478151

F - +39 06 483755

#### **MILAN**

Galleria Passarella, 1  
20122

T - +39 02 89283800

F - +39 02 48012914

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