Transfer pricing and the Corona pandemic

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In my last blog, I looked at the immediate impact of Covid 19 Lockdowns on key elements of double tax treaties – residence, permanent establishment and employment income. Many tax administrations have published guidance on their approach to these issues. Indeed, almost immediately after the OECD also published helpful comment on them too. The general thrust is that circumstances forced on taxpayers by the pandemic will, within legal limits, not be taken to prejudice affected taxpayers. Those factors largely deal with taxing jurisdiction.

Unanswered questions remain about the allocation of income and profits in light of the pandemic. Allocation issues are primarily governed by article 7 (attribution of profits to permanent establishments) and article 9 (transactions between associated enterprises). Guidance has so far been less forthcoming on the application of the arm's length principle to these articles in current circumstances.

Two questions arise for cross-border business

- Legal: What impact does the pandemic have on my existing transfer pricing policy?
- Practical: Do I need to change anything as a result of the pandemic?

The 2017 OECD Transfer Pricing Guidelines at first blush appear to address this: "whether and if so how to take account in the transfer pricing analysis of future events that were unpredictable at the time of the testing of a controlled transaction" (para 3.73). The obvious answer is "what independent enterprises would have done in comparable circumstances."

The difficulty with this apparently sage advice, is the context in which it was written, that is, BEPS Action 8. Action 8 included developing transfer pricing rules or special measures for transfers of hard-to-value intangibles. Initially the focus was on transactions where value is uncertain at the time of the transaction, usually in a transfer to a low tax jurisdiction, but subsequent events, including commercialisation of the intangible resulted in huge returns on the asset. The addition of unpredictable subsequent events was intended to be an elaboration of the treatment of such transactions. Nothing in the Guidelines deals explicitly with the economic disruption that everyone now faces.

Contract and legal analysis

The starting point must be an examination of existing transactions. Since the pricing is determined by reference to economically relevant characteristics applicable at the time the transaction was undertaken, the period a transaction is agreed to last is a key question. The pricing of a longer-term agreement is in a different and more stable position compared to short term transactions or those that are contractually or otherwise legally required to be revised during the crisis. Contracts may include provisions that permit or require changes or termination in extreme circumstances such as force majure. Legislative reliefs announced might also impact on the terms of transactions.

Nonetheless, even longer-term arrangements may be under the microscope. The post 2017 OECD Guidelines (para 1.33) obligation to "accurately delineate the actual transaction" to determine whether the transaction is in fact as contractually recorded and documented may be taken to require a re-evaluation in light of current economic circumstances. Independent enterprises are attempting to renegotiate agreements or, simply not perform them strictly, usually to reduce costs or conserve cash in order to deal with closures or reduction in demand which affect their revenues. Thus, a distributor or service business may seek a rent reduction. The landlord who agrees (or is faced with a bankrupt tenant) may, in turn, seek a revision of its loan from a bank.

Functional analysis

Functions

My previous blog considered the effect of personnel being in locations that are imposed by the lockdown. This will also impact on functional analysis if significant people functions are undertaken in places that are different from where they were intended or normally undertaken. Functions may also shift between personnel in different locations. This is facilitated by remote and home working possibilities or requirements. Functions may also cease as a result of the lockdown or other interruption to existing supply chains.

Shifts in DEMPE (development, enhancement, maintenance, protection and exploitation) functions relating to intangibles may produce very different profit allocations. The same is true in relation to the management and control of risks.

Risks

Risk analysis was significantly expanded and elaborated in the 2017 OECD Guidelines. New risks have emerged in the pandemic, such as supply chain disruption due to shortages of raw materials, labour and other inputs. Existing risks may change in significance, such as credit or inventory risk in relation to customers.

Economic circumstances

The change is unprecedented in almost every working person's lifetime. This means that firstly, most transactions entered into in earlier, in more benign times, will be rendered uncomparable to current transactions. Secondly, the existing OECD Guidelines focus on the comparability of markets; the challenge faced by businesses today are universal, increasing the range of possible comparables. Thirdly, government policies are likely to have a big impact: financial, fiscal and regulatory measures to protect national economies are announced every day. Although governments may be the financiers of last resort to business, that status means the terms on which government provided or supported finance is given is unlikely to provide comparables for intra-group financing.

Highly uncertain value transactions in intangibles were an important issue in BEPS Action 8. Price and value volatility in relation to goods, services and intangibles across the board is a feature of the current crisis.

Business strategies

There are few business, domestic or cross-border, whose main aim at present is not survival. This may entail changes both as buyer and seller to reduce costs and conserve cash on one side and to preserve revenue or market share on the other. Others in high demand fields, such as communications technology, may be seeking to expand.

Many businesses will restructure to meet the various challenges thrown at them. Chapter IX of the OECD Guidelines, like the discussion on hard to value intangibles was written in response to business models that member countries were unhappy with because tax revenues were eroded thereby (and which subsequently gave birth to the BEPS project). The chapter is however written in neutral terms and applies regardless of whether a restructuring is tax motivated or, indeed, produces an overall net tax benefit to the business.

Key Practical takeaways

An orthodox view of transfer pricing would suggest that re-evaluation of inter-company pricing policies is mandated by current circumstances. A multilateral approach, co-ordinated by the OECD and Forum on Tax Administration, to allow this to be managed in a proportionate way and to facilitate businesses focus on important priorities is needed.

Traditional databases are of limited use immediately as a source of external comparables for the current circumstances. Look instead at what businesses are actually doing, as described in the financial and business media.

Transfer pricing alignment with business strategies is even more essential. Opportunistic behaviour is unlikely to be tolerated and resisting opportunistic behaviour by tax administrations depends on it.

Uncertainty brings its own risks of disputes between taxpayers and tax administrations and among tax administrations. Taxpayer preparation for this will include careful contemporaneous documentation and record keeping. Minimisation of such disputes as well as efficient and fair dispute resolution is in the interest of businesses and fiscs. Again, a multilateral approach, co-ordinated by the OECD and Forum on Tax Administration has never been more necessary.