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Transfer Pricing Forum

Transfer Pricing for the International Practitioner

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Australia

Benedicte Olrik
Duff & Phelps, Australia

COVID-19 has paralyzed most countries, including Australia. We have looked at the impact from the COVID-19 pandemic through an Australian transfer pricing lens and discuss our findings in this article. The key take-aways from our observations and recommendations to affected companies are the following:

- In comparing the impact of COVID-19 with past shocks to the economy there are similarities between the current crisis and that of the Global Financial Crisis (GFC) in 2008-09. However, both the speed and scale of the COVID-19 shock are already more substantial than the shock to the economy from the GFC, and it is now very likely to bring the Australian economy into a recession before the end of 2020.
- The Australian government has implemented temporary measures to assist businesses with cash flow issues and to dampen long-term unemployment rates. These packages will cease in September 2020 and it is expected that the insolvency rate for business in certain sectors will increase and further exacerbate the Australian economic downturn.
- The Australian Taxation Office (ATO) has already provided some minor transfer pricing compliance relief and have paused audit activities temporarily. Other than these measures, we are not sure at this stage whether the ATO will provide further transfer pricing related concessions. However, as COVID-19 likely will not alleviate taxpayers' statutory obligations to file arm's length tax returns and comply with the arm's length principle, we expect that the ATO's activities will resume to business as usual as soon as they are able. Accordingly, affected businesses should prepare now by beginning to address any changes to their business from COVID-19 which result in non-arm's length outcomes or material changes to their business.
- Although the Australian Government has acted swiftly to support Australian businesses through the lock-down period, the Government will have massive debts post COVID-19. Given that the ATO is already perceived as one of the most aggressive and advanced revenue authorities in the world, we may expect additional targeting of multinationals after the pandemic in an effort to recoup some of the governmental investment in Australian businesses so far in 2020.
- For companies where business performance has been impacted by COVID-19, the following transfer pricing matters should be considered:
 - Contemporaneously document any impact from COVID-19 to support decisions taken, changes to transfer pricing policy or pricing, drop in revenue, increase in costs, loss of key staff, evidence of how other entities in the industry are responding to COVID-19, etc. This could be captured in a real time documentation file to support future audit, review activities from the ATO or assist with the commercial justification of a potential lower profit outcome in 2020 and going forward.
 - Carefully consider the risk profile of the supply chain, transfer pricing agreements, pricing, models, and policies. Evaluate whether these arrangements are still adequate after the crisis or if they need to be revised accordingly. In particular, companies should consider whether limited risk entities in their centralized structure and guaranteed profit outcomes are appropriate, or whether these entities may appropriately realise losses due to the extreme shock to the economy.
 - Benchmarking and comparability issues: Further analysis and adjustments of comparable sets will be required to determine the margin for impacted entities and to test the profit outcomes derived. Most benchmarking data will not be available until 12-18 months from now. It is important to keep records of any impact and potential change to risk profile characterization to support commercial justification for lower profit outcome and losses. Adjustments to existing benchmarking sets is highly recommended to commercially support lower profit outcomes or losses. Such adjustments should be appropriately documented to ensure robust support to be used in a potential audit defense or at least included in annual transfer pricing documentation reports.
 - MNEs with an advance pricing agreement (APA) also need to consider any impact that COVID-19 could have on the APA. Considering what we are already experiencing with changes to businesses and profit outcomes as a consequence of the lock-down, it is likely that many APAs will have to be revisited and potentially renegotiated with the ATO and any other relevant tax authorities.
- Australia is still in the midst of the lockdown and it is difficult to predict what exactly will happen and how the ATO will react post-crisis. Regardless of the ATO's approach, the Australian transfer pricing guidelines will most likely not change dramatically

and it is recommended for MNEs to prepare and plan for the future now.

The GFC and COVID-19

The OECD predicts that the impact of the COVID-19 pandemic on economic activity would far outweigh anything experienced during the global financial crisis in 2008-09. This will most likely also be the situation for Australia. Whilst there are similarities between the impact on the Australian economy from the GFC and COVID-19 in terms of the decline in consumer and business sentiment, decrease in consumers' discretionary income and in business profits, and increase in bankruptcies and unemployment, there are significant differences in the speed and scale of the current lockdown on the economic decline in Australia.

The Australian Government enforced a close to complete lockdown across the country in mid-March 2020, which instantaneously affected the economy with similar if not worse unemployment rates than the experience post-GFC. However, as the post-GFC aftermath only gradually hit Australia over a more prolonged period, the current crisis has already gone beyond the impact post-GFC and now it can with certainty be predicted that the COVID-19 aftermath will be much more significant to the Australian economy.

The economic downturn of 2008-09 was primarily driven by a financial crisis and, in particular, for the U.S., the bursting of the housing bubble. In contrast, the current economic downturn is the result of a global public health emergency, which is affecting different industries differently. As seen in most countries, certain sectors have been impacted more than others. This is also the case for Australia, where the lockdown has paralyzed industries such as the hospitality, certain brick & mortar retail, and travel industries, whereas others, including supermarkets, some online retailers and delivery services, IT services, manufacturers of personal protective equipment or hygiene product etc., have experienced a surge in demand for their products and services. However, due to supply chain constraints, not all of the companies that have experienced an increase in demand have been able to benefit in these unique circumstances.

Australian Government's Response to COVID-19

The economic downturn caused by the lockdown has resulted in immediate actions by the Australian Government to protect jobs and to provide businesses with support to lower the prospects of a sharp rise in long-term unemployment and to decrease the number of businesses going into bankruptcy due to cash-flow issues and other bottle-necks. These significant fiscal packages include the JobKeeper Payment and a boost in cash-flow to employers by lump-sum payouts ranging from \$10,000 - \$200,000, depending on the size and needs of a business. At present, these support packages will only run through September 2020.

As with the OECD's recommendation on measurements for temporary tax policy and tax administration changes to keep economies afloat during the pandemic, the ATO has implemented the following temporary concessions:

- Lodgement of tax return deferrals;
- Tax payment deferrals;
- Lodgement assistance, including guidance on applying for remitting penalties and interest for late filing or payment, providing early tax certainty where appropriate; and
- Audit and risk review activities paused during the crisis (except in cases of fraud).

In addition, transfer pricing specific compliance concessions are available temporarily. The availability of each measure is based on whether the business, upon application or direct com-

munication with the ATO, is meeting certain criteria. These measures are considered to be somewhat small and will only provide minor administrative relief to taxpayers. The administrative concessions affect the following areas:

- Transfer pricing documentation and penalty protection;
- Thin capitalisation and safe harbour;
- Significant global entity (SGE) penalty; and
- Central management and control (CM&C), PAYG withholding, and permanent establishment rules are relaxed if compliance issues are caused by travel restrictions during the lockdown.

Transfer pricing matters in Australia as a result of the COVID-19 pandemic

It is difficult to predict at this stage what the ATO's transfer pricing strategies and activities will be after the lockdown. The OECD is planning to prepare transfer pricing guidance relating to the COVID-19 pandemic with the aim of giving businesses the assurance that they will not come into conflict with tax authorities when the years affected by the crisis are examined in the future. However, considering that the ATO is known to be one of the most aggressive and advanced tax authorities in the world, it is more likely than not that businesses in Australia with international dealings will experience increased attention from the ATO post COVID-19. Specifically, it is predicted that the likelihood of ATO challenges around the transfer pricing practices of foreign-owned MNEs may increase in this period. Indeed, past experience shows that the ATO significantly increased its assessments of MNEs in the post-GFC period.

Irrespective of the approach the ATO might take post-lockdown, it will be certain that Australian taxpayers' statutory obligations to file arm's length tax returns and comply with the arm's length principle will still unquestionably be requirements. Affected businesses will have to assess and document what has changed in their circumstances to support the outcome of their business during the pandemic and after. Below are some transfer pricing considerations outlined for situations that are likely to be impacted by the COVID-19 crisis.

Contemporaneous Documentation:

Bearing in mind the ATO's tendencies and behavior post-GFC, it is important to be able to document in a contemporaneous manner any impact from COVID-19 to support decisions taken, changes to transfer pricing policy or pricing, drop in revenue, increase in costs, loss of key staff, evidence of how other entities in the industry are responding to COVID-19 etc. Such evidence could be captured in a real-time documentation file to support future audit or review activities from the ATO.

In addition, any pricing adjustments of related party dealings should be done on a contemporaneous basis. Changes to prices should be done in advance, on the basis of information known or knowable, at that point in time and documented. This is to be able counter argue in case the ATO are using hindsight in the future in challenging any pricing decisions.

Changes to Supply Chains, Transfer Pricing Agreements, Pricing, Models, and Policies:

This pandemic has implications for traditional supply chains where risk allocations tend to follow centralized entrepreneurial models with supply chains built on limited risk models.

The challenge for businesses is how to deal with losses in these structures arising from constrained demand, supply issues and abnormal expenses and losses being incurred by limited risk entities. As a result of the economic shock produced by COVID-19, we are expecting these entrepreneurial entities to incur substantial losses. In the first instance, limited risk entities could incur abnormal or extraordinary costs such as inventory write-offs, inability to recover fixed costs fully due

to lower utilization, higher marketing and advertising costs, and employee redundancy costs. Companies need to consider whether it is appropriate to reward the limited risk distributors with a guaranteed return and exacerbate the losses of the entrepreneur in the chain. These impacts raise the questions of whether transfer pricing policies and infrastructure are fit to deal with the current crisis and how to support these outcomes from a transfer pricing compliance perspective.

Third party evidence of events occurring in the industry as a result of the pandemic would be important to capture for purposes of supporting any renegotiations and potential amendments to existing transfer pricing policies. Further, the ATO would expect to see any changes in policies or risk profiles in the supply chain to be aligned with underlying contemporaneous documentation to support these changes.

Benchmarking, Comparability and Genuine Losses:

The OECD Transfer Pricing Guidelines clearly provide that “associated enterprises, like independent enterprises, can sustain genuine losses” due to unfavorable economic conditions, inefficiencies, or other legitimate business reasons. COVID-19 would certainly constitute an unfavorable economic condition. However, that alone does not justify the legitimacy of losses. How third parties deal with the same or similar conditions will be key here to use as supporting evidence or commercial justification of losses. Losses, in the Guidelines, are largely associated with risk and the control of such risk. If an entity has been set up as a low-risk entity and has been compensated using corresponding transfer pricing methods (like cost-plus), it might be difficult to justify losses in that entity. That said, if companies can prove that unrelated parties in the same or similar situations have borne the relevant costs/expenses and incurred losses, then it may be possible to book losses in such “low-risk” entities. This, obviously, would be expected by the ATO to be documented by detailed analysis of the facts and circumstances and supporting benchmarking analysis.

Another important aspect is to consider the margin used to reward limited or low-risk entities. The difficult challenge is how to determine what is arm’s length in the midst of a significant economic crisis. Statistical tools such as an interquartile range may have been used in the past to determine a margin to apply in rewarding these entities. Likely comparable companies will not show any impact from the pandemic for a year or two due to the lag in data availability. Instead, simulating existing benchmarking studies into the current situation could sup-

port lower profit outcome prior to knowledge of actual results. By simulating the following factors should be considered:

- Including rejected loss-making companies from previous searches back into the benchmarking set;
- Focus on comparable industries facing similar economic impacts;
- Applying filters based on similar declines in revenue;
- Screening out highly profitable companies not impacted by the pandemic;
- Consider a point in the range of the highest comparability rather than an interquartile range;
- Alternatively consider the lower quartile only or just a lower point in the inter quartile range.

Advanced Pricing Agreements:

MNEs with APAs also need to consider any impact that COVID-19 could have on the APA. The continuing viability of an APA is based on compliance with a preset number of critical assumptions agreed to with the ATO in case of a unilateral APA. Critical assumptions are typically based on business activities, functions, risks, assets and business performance remain materially the same over the duration of the APA. If a critical assumption is triggered, it is necessary to contact the ATO (and relevant other tax authorities involved if the APA is bilateral or multilateral). Considering what we are already experiencing with changes to businesses and profit outcomes as a consequence of the lockdown, it is likely that many APAs will have to be reassessed and possibly renegotiated with the ATO and relevant tax authorities involved.

We understand that some tax authorities have stated they will help companies to deal with the impacts of the crisis on existing APAs. However, the ATO has not yet commented on this. Thus, affected MNEs should be monitoring their critical assumption compliance and taking the appropriate actions.

Finally, since Australia and most countries are still either in the midst or gradually coming out of the lockdown, it is difficult to predict what exactly will happen, and in particular how the ATO will react after the lockdown and in the next coming years. Regardless of ATO’s approach on how to administer its powers following this period, the Australian transfer pricing guidelines are not likely to change dramatically, and it is recommended for MNEs to prepare and plan for the future now.

Benedicte Olrik is a Director with Duff & Phelps.

She may be contacted at:

Benedicte.Olrik@duffandphelps.com

www.duffandphelps.com

United Kingdom

Andrew Cousins

Duff & Phelps, London, United Kingdom

1. Per the OECD, the impact of the COVID-19 pandemic on economic activity would far outweigh anything experienced during the global financial crisis in 2008-09. What similarities and differences do you see between the 2008 crisis and the current pandemic so far on the practice of transfer pricing in your jurisdiction?

While all economic contractions share parallels, the differences between the COVID-19 pandemic and the financial crisis of 2008-09 are more striking than the commonalities. The 2008-09 crisis originated in the financial system, driven by highly aggressive sub-prime lending, combined with ineffective risk-management and levels of debt that were unsustainable. A crisis of bank liquidity hit availability of credit and spread to the real economy. The current crisis is of a different character, a deliberate shut-down of economic activity worldwide in response to the global spread of the coronavirus, hitting the real economy immediately on both the supply and the demand side, resulting in the total suspension of business for many companies and industries. Airlines, tourism, hospitality and education are just a few of the many sectors hit perilously hard in the UK at this early stage of the pandemic. The UK economy has shrunk by 2.2% in the first quarter of 2020, the worst quarterly fall in 41 years, and conditions are expected to be worse in the second quarter, with the UK economy shrinking by 20.4% in April alone.¹ Losses are likely to be much larger than in the financial crisis of 2008-09 and recovery could take longer.

The financial crisis generated its own particular transfer pricing challenges, e.g. lack of bank liquidity hitting availability of credit, sending interest rates soaring. MNEs seeking to refinance internally were forced to assess and to adapt their transfer pricing policies in extraordinary circumstances, to document their response to the severely altered economic environment in anticipation of challenge from HMRC and other tax administrations. The uncertainty surrounding the current crisis has had an impact on financing too but has produced other unique consequences. For example, the lockdown measures imposed by an increasing number of governments around the world

have required some highly globalised British MNEs to shut down a significant proportion of their factories for varying lengths of time. Other factories have been called in to fill the gaps, resulting in widespread disruption to manufacturing and trade routes. Resolving the allocation of compensation attributable to each will pose a complex challenge.

Both in the 2008-09 financial crisis and in the current pandemic, the British government has stepped in with a substantial rescue package, even larger this time than in the financial crisis. Ultimately, this package will need to be financed and, as before, we can expect pressure to be placed on HMRC to deliver increased tax revenues from a variety of sources. Among the predicted outcomes, one may anticipate an increase in focus from HMRC on corporate income tax, with additional scrutiny on losses. Although we are only just over 3 months into the start of the crisis in the UK, there is a similar need for MNEs, as in 2008-09, to react to the changed circumstances and to document contemporaneously the business's responses and outcomes in anticipation of future transfer pricing challenge.

2. Business performance as a result of the COVID-19 pandemic:

a. What do you see as the impact of the COVID-19 pandemic on low-risk entities (which typically bear limited risks, and record limited profit margin when the principal entity incurs a loss) in your jurisdiction? Do you see your jurisdiction accepting that such entities can lose money during this unusual economic downturn?

HMRC has as yet issued no guidance on the effect of the COVID-19 pandemic on transfer pricing arrangements and, while the OECD is known to be working on such guidance, nothing is expected from that quarter before the year-end. In the absence of official statements, one may speculate that HMRC will adopt a similar approach to that described by the Australian Taxation Office (ATO) on COVID-19 economic impacts on transfer pricing arrangements.² Like the ATO, HMRC can hardly fail to recognize that "some

businesses will be negatively affected by COVID-19, which may lead to a reduction in revenues, increased expenses and changes to profit outcomes.”

As examined further in the next section, the impact of COVID-19 on specific industries and businesses may be expected to vary enormously. While certain online suppliers of services and merchandise and providers of hygiene and health products may be expected to thrive, industries such as the airline sector and bricks-and-mortar retailing will be hard hit. How MNEs respond to the effect on their transfer pricing will be driven by individual experience.

MNEs seeking to argue that low-risk does not mean no-risk and that losses are to be spread out among low-risk entities need to be conscious of the consequences. The corollary of low profit in prosperous times is shielding from loss in more difficult times. If a low-risk entity continues to make a small profit during difficult times, it is easier to justify its making a small profit in prosperous times. If the entity shares in the loss in difficult times, the MNE may face a difficult conversation with HMRC in future years, attempting to justify why the entity should not take a larger share of the profits when it has participated in the risk of bearing losses.

MNEs considering amending or terminating and replacing their existing transfer pricing arrangements as a result of COVID-19 would be strongly advised to engage with HMRC as early as possible to assess whether the changes would satisfy arm's length requirements. Expect a detailed examination of the contractual arrangements and the historic and forecast performance of the structure to be factored into an assessment of whether the current crisis can justify low-risk entities' incurring losses at arm's length.

b. Are there MNEs in your country who are experiencing or likely to experience increased or expanded business opportunities despite the current pandemic? What strategies should these entities be mindful of with regards to their transfer pricing models?

As in any crisis, there are winners as well as losers. Certain businesses in the UK are experiencing booming sales, both in response to the characteristics of the pandemic itself and as a consequence of the government lockdown (which simultaneously closed down most bricks-and-mortar retailers and restricted most consumers to their homes). In particular, online sellers, streaming services and video-conferencing providers have seen demand for their products soar, as have sellers of health and hygiene products and personal protective equipment. Supermarkets also experienced a surge in demand as consumers engaged in panic-buying. Among early indicators of the effect on businesses well placed to benefit from the pandemic, British online fashion retailer Boohoo reported a 45% year-on-year rise in sales in the three months to May 2020. British multinational Reckitt Benckiser reported exceptional consumer demand for its health and hygiene products, with like-for-like sales up 13% in the first quarter of 2020 alone.

Increased sales, however, do not necessarily translate into increased profits, likely to be a major concern for those MNEs trading in the UK that will be subject to the UK's Digital Services Tax (DST). Amazon, for example, reported increased international sales of 18% year-on-year for the first quarter of 2020, while subscription services (Amazon Prime) were up 28% in the first quarter and its advertising business was up 44%. However, Amazon's profits were down as it experienced in-

creased expenses in respect of COVID-19, both in ensuring that its products reached customers and in keeping employees safe.

While the OECD's progress on the Pillar 1 and Pillar 2 digital economy project is currently less certain following the US proposal to pause discussions while dealing with COVID-19, the multinational companies potentially targeted by the proposals and by countries' unilateral digital tax measures will need to be mindful that their expanding business models are likely to prove an irresistible target for populist politicians. The evidence of dwindling taxes from UK-resident bricks-and-mortar businesses, deprived during lockdown of their customers (driven online through government intervention), will inevitably be used to justify increasing taxes on those businesses that have benefited.

The UK's DST was scheduled to have come into effect as from April 1, 2020, but only received Royal Assent on July 22, 2020. The Finance Bill's progress through parliament was delayed, first by the parliamentary paralysis related to Brexit and the suspension of parliamentary activity during the general election in late 2019 and then by the disruption caused by the COVID-19 outbreak. Now that the bill has at last been enacted as Finance Act 2020, multinationals operating search engines, online marketplaces and social networks are going to find themselves targeted, adding a 2% charge to those MNEs affected on revenues deemed derived from UK users. Many of the qualifying businesses that are experiencing the biggest revenue increases as a consequence of the pandemic, such as Amazon, will find themselves, in the absence of an OECD solution, facing additional revenue-based taxes in the UK, even in the absence of a commensurate rise in profits.

c. How are MNEs in your jurisdiction addressing comparability issues, or how would you advise them to address comparability issues? How should they treat loss-making comparables, to ensure that any adjustments factor in the current global epidemic and adequately reflect economic reality?

As in other countries, MNEs in the UK face the common challenge of identifying comparables for a situation vastly different from the circumstances pertaining in the years from which most comparable data originate. Even if loss-makers are included, comparable data for the last three years may, in many industries, still prove inadequate to capture conditions similar to those of the pandemic. This year's data will not be available until, for practical purposes, it is too late. Reference to outcomes during the financial crisis may or may not prove valid.

At present, no specific transfer pricing guidance has been issued by HMRC on acceptable comparability measures for supporting existing transfer pricing arrangements. As a proxy, it will again be advantageous for MNEs to consider the guidance that has been issued by the ATO:

“Analyses of comparable company benchmarking may not reliably support arm's length outcomes of continuing transfer pricing arrangements where they are impacted by COVID-19, particularly in the short term.

On this basis, we will seek to understand the financial outcomes you would have achieved 'but for' the impact of COVID-19. This analysis may include:

- *a detailed profit and loss analysis showing changes in revenue and expenses, with an explanation for variances resulting from COVID-19 — this may include a variance analysis of budgeted (pre-COVID) versus actual results*

- details of profitability adjusted to where your outcome would have been if COVID-19 had not occurred — this should consider all factors that have a positive or negative impact on your profits and should be supported by evidence
- the rationale and evidence for any increased allocation of costs or a reduction of sales (and subsequent changes in operating margins) to the Australian entity, taking into consideration its function, asset and risk profile
- evidence of any government assistance provided or affecting the Australian operations.”

Similar guidance is likely to be valid for companies operating in the UK in their dealings with HMRC. In the absence of reliable contemporaneous comparable information, MNEs would be wise to gather evidence to support any comparability adjustments to or changes to the transfer pricing as a result of COVID-19. HMRC can be expected to examine carefully the individual circumstances of the taxpayer and any adjustments applied.

d. How likely are the tax authorities in your jurisdiction to consider “economic circumstances” as a relevant comparability factor?

The UK’s transfer pricing legislation is formally tied to the OECD’s Transfer Pricing Guidelines,³ which identify “the economic circumstances of the parties and of the market in which the parties operate” as one of the five economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations between associated enterprises in order accurately to delineate a transaction.⁴

In the context of the economic impacts of COVID-19 on transfer pricing arrangements, HMRC has issued no specific guidance, in the absence of which reference may again usefully be made to the ATO statement that, when undertaking transfer pricing compliance activities, it will seek to understand the facts and the individual circumstances by assessing:

- the function, asset and risk profile of the Australian entity before and after COVID-19
- economic circumstances, where the actual economic impacts of COVID-19 on the Australian operations should be outlined and evidenced — this may include a broader analysis of how the relevant industry has been affected
- the contractual arrangements between the Australian entity and its related parties, and if any obligations or material terms and conditions have been varied, amended or terminated
- evidence of the impact (if any) of COVID-19 on the specific product and service offerings of the Australian entity and how this has affected the financial results
- evidence of changes in business strategies as a result of COVID-19, including decisions made, outcomes sort and actions taken to give effect to those strategies.

One may assume that a very similar approach will be adopted by HMRC.

3. How do you see the pandemic affecting APAs? What adjustments are MNEs making – or what adjustments should they make – to ensure that they will be considered to be in compliance with their agreements? Are companies looking to amend (or should they look to amend) their APAs, or are they just documenting changes in anticipation of possible future amendments?

For MNEs with an APA in place, the negative impact of COVID-19 could potentially result in a breach of the critical assumptions in the APA. HMRC have issued no specific guidance on the impact of COVID-19 on existing APAs or ongoing APA discussions, but again ATO advice, encouraging taxpayers to engage with the tax administration proactively as soon as the taxpayer becomes aware a breach of the APA terms has occurred or is likely to occur, is likely to be very similar to HMRC’s position. Bilateral APAs will need to be considered in consultation with the corresponding jurisdictions.

Just like the ATO, HMRC are likely to seek to understand the impact on the APA of the breach and to consider appropriate outcomes, which may include:

- Business as usual;
- Renegotiating the APA over the time period of the demonstrable impact;
- Suspending or modifying the APA for a set period.

As in Australia, one may anticipate that APA applications in process significantly affected by COVID-19 may be difficult to progress in situations where either objective evidence of any impact experienced is lacking or uncertainty around potential outcomes is high, in which case the APA application may be placed on hold until the taxpayer has a greater level of certainty on the impact.

4. Do you think there is a “silver lining” or bright spot about this economic situation that MNEs should be mindful of? What are possible opportunities that otherwise would not be sustainable in the absence of an economic crisis? Reset possibilities? Location-specific advantage?

As already acknowledged, there are beneficiaries of every crisis, but, with recession or depression imminent, and levels of unemployment soaring, the MNEs that prosper in the current economic circumstances will be outnumbered by those that find themselves seriously disadvantaged. Most groups are going to suffer disruption, but a few, possessing qualities suited to the characteristics of the global response, will find themselves in a much stronger position as they take advantage of the changed conditions. The British government’s response towards the pandemic (lockdown, suspension of economic activity and the imposition of social distancing) appears to be playing out to the advantage of a number of online businesses that were already in the ascendant before the pandemic and have accelerated penetration of a literally captive market. Digital companies that have benefited from consumers’ inability to leave home are likely to see long-term advantage in a legacy of changed customer behaviour, commensurately detrimental to many traditional bricks-and-mortar retailers.

Nevertheless, the pandemic has introduced added confusion to the progress of the OECD's work on the digitalizing economy, greatly enhancing the risk that no global solution to the challenge will be agreed upon this year, with the result that unilateral digital taxes such as the UK's DST (likely to fall predominantly on US MNEs), plus the associated risks of retaliatory tariffs in a trade war with the US, contribute to stifling economic growth at a time when stimulus is most needed.

*Andrew Cousins is a Director in Duff & Phelps' London office.
He may be contacted at the following email address:*

andrew.cousins@duffandphelps.com
www.duffandphelps.com

NOTES

- ¹ Source: Office for National Statistics — GDP monthly estimate.
² Australian Taxation Office (19 June 2020), *COVID-19 economic impacts on transfer pricing arrangements*.
³ TIOPA 2010, s.164.
⁴ OECD Guidelines, 1.36.

United States

Justin Radziewicz *and* Fabian Alfonso
Duff & Phelps, United States

1. Per the OECD, the impact of the COVID-19 pandemic on economic activity would far outweigh anything experienced during the global financial crisis in 2008-09. What similarities and differences do you see between the 2008 crisis and the current pandemic so far on the practice of transfer pricing in your jurisdiction?

When contrasting the impacts of COVID-19 and the global financial crisis on the practice of transfer pricing, the most prominent similarities stem from the large-scale shocks to the broader economy and general uncertainty about its recovery. The primary differences stem from the additional regulatory framework in place on a global level, increased data availability leading to better visibility of real-time financial data affording companies more proactive responses to the crisis.

This economic turmoil has led clients to similar initial responses in some ways, for instance, focusing on reducing operating expenses and scaling back on non-critical workstreams. However, while both crises resulted in reduced demand for most products and services, particularly in certain industries, the COVID-19 pandemic has also hit the supply side of the value chain. State-imposed lockdowns and travel restrictions have shut down factories and distribution facilities throughout the world. This exogenous supply shock has put significant additional pressure on one-sided transfer pricing models where one party to an intercompany transaction receives a target

margin, with the other realizing residual profit or loss. These supply-side shocks mean that, in the absence of specific considerations to the contrary, the entrepreneur will bear not only downside demand risk but also the risks associated with idle capacity and broken supply chains. In these circumstances, it would be expected that even lower-risk parties would suffer declining profits in arm's length dealings. Taxpayers are well served to reexamine their transfer pricing positions and to determine how to best align their transfer pricing methods with appropriate allocations of risk.

We are seeing an immediate focus on undertaking these types of analyses, as well as modifying pricing in the current year to account for lower target margins that would be expected of comparable companies. The increased desire for cash preservation and increasing cash flows for business needs is also leading to increased levels of intercompany financing. With the newly released OECD Transfer Pricing Guidance on Financial Transactions, it will be important for companies to take additional steps to ensure their debt will remain characterized as debt upon audit. This involves a more nuanced analysis than companies may have previously undertaken. Compared to 2008, companies are moving faster to address these issues more proactively to ensure that their transfer pricing results are considered arm's length.

The OECD BEPS initiatives will play a key role in informing the practice of transfer pricing during the COVID-19 pandemic. Chapter I of the OECD Transfer Pricing Guidance provides a framework for undertaking the accurate delineation of a transaction, particularly as it relates to the allocation of risk for transfer pricing purposes. This guidance should be given strong consideration by taxpayers wrestling with the

appropriate allocation of unfavorable outcomes associated with COVID-19.

Further, the level of data and global transparency made available through country-by-country reporting will force companies to consider their transfer pricing models more thoughtfully than during the global financial crisis. For example, inconsistent pricing changes, such as the decision to bear losses in limited-risk entities in certain jurisdictions but not others, will be more transparent than they were in 2008. Likewise, losses incurred in various limited-risk entities, while principal entities in lower tax jurisdictions show profits or more limited losses, this will trigger red flags upon audit.

2. Business performance as a result of the COVID-19 pandemic:

a. What do you see as the impact of the COVID-19 pandemic on low-risk entities (which typically bear limited risks, and record limited profit margin when the principal entity incurs a loss) in your jurisdiction? Do you see your jurisdiction accepting that such entities can lose money during this unusual economic downturn?

We see COVID-19 making certain businesses unprofitable on a global scale, bringing significant stress to transfer pricing policies associated with low-risk entities in structures with more centralized risk-bearing. In situations where no adjustments have been made to intercompany pricing established at the beginning of 2020, it would not be surprising to see losses beginning to accrue in some of these low-risk entities. For example, companies targeting distribution margins through tangible property pricing will likely experience a reduction in sales, facing longer inventory turn times and sustained expenses, leading to lower profitability or even losses. For U.S. purposes, the determination of whether these entities should be in a low profit or loss position will come down to facts and circumstances through an examination of functions, risks, and assets of the limited-risk entity in question.

Recently, the IRS issued a FAQ on transfer pricing documentation that provides insights to this situation.¹ One example described in the document may indicate the IRS' willingness to accept losses in situations where an entity, operating under a one-sided transfer pricing model, enters a loss position due to unexpected changes in the market conditions. This may provide some comfort in situations where both the principal entity and the limited risk entity incur a loss. It may be accepted that a limited-risk entity also share in losses incurred during the economic crisis, given that risk in such entities is limited, not non-existent. However, there is an essential distinction in the FAQ example; the pricing policy was set to earn a fixed return under *normal business circumstances*. The example provides a situation where the demand for the distributor's products drops unexpectedly and losses sustained are acceptable. This situation would most certainly apply to the COVID-19 pandemic in many instances. However, it stands to reason that if demand has unexpected growth (as it has for certain types of companies), additional profits would be anticipated.

If the intercompany agreements and actual behavior of the principal and the limited-risk entities did not allow for sharing in the upside during unexpected increases in demand, it seems less likely the IRS would be willing to accept losses associated with similar sudden decreases. However, if taxpayers can prove

that comparables with similar risk profiles have also experienced operating losses as a result of this economic downturn, it will be difficult for the IRS to reject this argument based upon their guiding principles under Treas. Reg. § 1.482. Limited risk entities' bearing losses could have unintended consequences for open tax years prior to 2020. Following the logical thread regarding upside and downside risk sharing, it may stand to reason there are potential retroactive adjustments if there was a period of increased demand in prior open tax years. In other words, if prior positions in the documentation of limited-risk entities indicated profits were limited through intercompany adjustments during the business upside, sharing lower profits or losses during times of economic turmoil could present inconsistencies that may lead to adjustments.

The allocation of risks (and associated losses) should be assessed against an examination of the functions, assets, and risks of the entities involved in the transaction, as well as the language of any intercompany agreements, and pre-pandemic behavior surrounding both pricing and associated transfer pricing adjustments. If the facts and circumstances prove that external factors were responsible for the losses and the transfer pricing policies are structured to allow for sharing of risks and the associated upside, then the IRS should be willing to accept losses associated with limited risk entities, especially if the principal is also operating in a loss position as indicated in this example.

b. Are there MNEs in your country who are experiencing or likely to experience increased or expanded business opportunities despite the current pandemic? What strategies should these entities be mindful of with regards to their transfer pricing models?

Certain U.S. MNEs are experiencing or likely to experience increased demand in business opportunities as a result of the current pandemic. For example, it is easy to see how companies well positioned in e-commerce would see increased demand as many individuals self-quarantine and brick and mortar retail operations are temporarily shut down or operate under restrictions. Additionally, companies providing digital transformation services also appear well-positioned to see increased demand. The transfer pricing strategies and models these businesses should follow are those any growing company should follow.

When expanding, MNEs should examine their transfer pricing and consider whether their current structures are suited to provide correct returns for each entity and assume the proper sharing of risks. As COVID-19 accelerates the digitalization of operations, MNEs will have to think more about digital taxation (Pillar One and Two) initiatives, quantifying its impact on their businesses and their existing transfer pricing structures.

Many other transfer pricing considerations will mirror those under a less volatile economic landscape. MNEs will have to track which entities own intellectual property and the legal entities performing the related development, enhancement, maintenance, protection, and exploitation ("DEMPE") functions associated with such intangible property. Growing MNEs should consider potential permanent establishment and nexus issues arising from expansion, as well.

c. How are MNEs in your jurisdiction addressing comparability issues, or how would you advise them to address comparability issues? How should they treat loss-making comparables, to ensure that any adjustments factor in the current global epidemic and adequately reflect economic reality?

We are advising MNEs that it will be necessary to revisit existing comparables with a renewed focus on both industry and geographical similarity. COVID-19 has had varying degrees of impacts on countries and industries that may have previously been comparable under normal economic circumstances. Taxpayers will need to consider certain business conditions more in-depth than they may have in the past. For example, the level of excess capacity or idle production assets, comparability in periods of dormancy (i.e., forced shutdowns), and the impact of the deterioration in the expected realization of AR balances, will play a large role in helping establish arm's length ranges using comparable companies.

In the case of incorporating loss-making comparables, it will be necessary to understand and explore what contributed to the financial distress of the comparables. If companies are genuinely comparable based on their functions, assets, and risks, whether profitable or not, they should be included in the determination of an arm's length range. As previously mentioned, this determination will require an assessment of what level of losses can be sustained under the existing transfer pricing policies based on an analysis of risks shared by the related parties.

Finally, given the unprecedented economic impact of the COVID-19 pandemic, 2020 results for companies will likely deviate significantly from prior-year results. In these cases, it will be worth exploring the time period under analysis. The U.S. regulations provide for the examination of multiple or single year analyses. While historically, a reliance on a 3-year period may have been reflective of a normal business cycle, it may be necessary to consider alternatives to more appropriately reflect the impacts of COVID-19.

d. How likely are the tax authorities in your jurisdiction to consider "economic circumstances" as a relevant comparability factor?

In the U.S., Treasury Regulations § 1.482-1(d) guides comparability and lists certain important factors that are required to examine when determining the reliability of a method and the selection of comparables. Economic conditions are specifically identified as a required factor, and specific factors are presented in Treas. Reg. 1.482-1(d)(3)(iv). More specifically, this

section of the regulatory text indicates the economic condition of the particular industry as a relevant comparability factor.

3. How do you see the pandemic affecting APAs? What adjustments are MNEs making – or what adjustments should they make – to ensure that they will be considered to be in compliance with their agreements? Are companies looking to amend (or should they look to amend) their APAs, or are they just documenting changes in anticipation of possible future amendments?

We believe it is imperative that taxpayers proactively assess the implications of the COVID-19 pandemic and its resulting economic downturn on the continued viability of their existing APAs. We expect to see an increasing number of requests related to amending APAs or otherwise resolve questions related to the pandemic consequences on existing and in-process APAs.

The continuation of APAs is predicated on the satisfaction of certain "critical assumptions," which can vary agreement to agreement but generally include the continuity of business activities, functions, risks, and assets of the taxpayer.² Taxpayers need to assess their current APAs, paying attention to the guidance surrounding amending the agreement and the provisions in place for one-time extraordinary events. Given the unprecedented scale of government intervention, taxpayers need to consider how any government aid should be treated within the context of an APA.

The IRS has recently announced certain modifications for filing documents under Rev. Proc. 2015-41, 2015-35 IRB 263 related to APA requests. In addition, it has noted that the Advance Pricing and Mutual Agreement program ("APMA") is "actively discussing various substantive and procedural issues with various treaty partners, including such technical issues as the application of transfer pricing methods in periods of economic distress and the impacts of current economic conditions on specific industries, types of taxpayers, regions, etc."³

Taxpayers looking to amend or cancel an existing APA should be proactive in preparing a separate document to support changes for the years they want to move away from the APA, along with keeping active lines of communication open with the relevant taxing authority. Specifically, guidance from the IRS has noted that APMA will discuss concerns with taxpayers directly but requests that all submissions of questions be made to the APMA Assistant Director to prioritize better and coordinate consultations. APMA will determine whether and when meetings would be productive and preparation should include "background information (such as a narrative about issues and concerns being raised and current and forecast financial infor-

mation) as well as any specific request or proposal concerning an executed or pending APA, be provided in writing at least two weeks in advance.”⁴

4. Do you think there is a “silver lining” or bright spot about this economic situation that MNEs should be mindful of? What are possible opportunities that otherwise would not be sustainable in the absence of an economic crisis? Reset possibilities? Location-specific advantage?

We believe the current crisis exposed the precarious nature of highly specialized supply chains, as manufacturing bottlenecks were experienced by many firms as early as January when China began imposing lockdowns. As such, there has been a renewed focus on how to structure supply chains better so that they will be more flexible to handle any future disruptions. As with any restructuring, this will afford MNEs functional and risk recharacterization opportunities aligned with their business goals. This will provide MNEs the opportunity to reset or restructure their transfer pricing systems in a manner that is better aligned with their new supply chain while also optimizing its effective tax rate in a way that is consistent with the global transfer pricing frameworks.

Similarly, restructuring of IP ownership rights at lowered values due to the current economic conditions and the future outlooks (including a potential looming recession) may provide opportunities to consolidate and move intangible property to

better align with business and tax outcomes. Reduced values may present opportunities that, under a pre-pandemic scenario, would not have been feasible.

Finally, in instances where taxpayers shield low-risk entities from losses, they can point to this treatment as an effective argument against possible future or retrospective adjustments where tax authorities propose to increase the taxable base of low-risk entities to share in upside benefits of the MNE.

Justin Radziewicz is a managing director at Duff & Phelps’ Chicago office, and Fabian Alfonso is a managing director at Duff & Phelps’ office in Miami.

They may be contacted at:

justin.radziewicz@duffandphelps.com

fabian.alfonso@duffandphelps.com

<https://www.duffandphelps.com>

NOTES

¹ <https://www.irs.gov/businesses/international-businesses/transfer-pricing-documentation-frequently-asked-questions-faqs>

² The IRS’s model APA agreement includes (as the only) critical assumption “[t]he business activities, functions performed, risks assumed, assets employed, and financial and tax accounting methods and classifications [and methods of estimation] of Taxpayer in relation to the Covered Transactions will remain materially the same as described or used in Taxpayer’s APA Request.”

³ <https://www.irs.gov/businesses/competent-authority-filing-modifications-and-apma-apa-consultations>

⁴ *Ibid.*