

Impacts of Covid-19 pandemic in terms of transfer pricing practices

This study discusses the possible problems in terms of transfer pricing which may be encountered by companies due to Covid-19, in the wake of its first anniversary as of the writing date of this text and related solutions based on Guide/“Guidance on the Transfer Pricing Implications of the Covid-19 Pandemic” (Guideline) published in December, 2020 by OECD and several analysis conducted by EY globally regarding the case.

1. Operating losses and allocation of costs specific to Covid-19 pandemic

Many enterprises have made a significant loss as a result of both declining demand and disruptions in the supply chains during the pandemic. It is clear that allocation of such loss among companies comprising multinational enterprises may be criticized by tax administrations that of which these companies are in jurisdiction. Three main principles are presented regarding this issue in the Guideline.

Firstly, the manner of allocating and undertaking functions and risks between related parties directly affects the distribution of losses arising from the transaction. On the distribution of operating losses and costs specific to Covid-19, the Guideline states that “simple or low risk functions in particular are not expected to generate losses for the long term” in relation to group companies operating with limited risks to undertake group losses, however, it also holds open the possibility that simple or low risk functions may incur losses in the short-run.

Secondly, the allocation of “exceptional,” “non-recurring” or “extraordinary” costs, arising due to Covid-19, should be made based on an assessment of whether independent enterprises operating under comparable circumstances may incur such costs or not. In case of allocation of such costs among related parties, The Guideline states that primarily an analysis demonstrating which enterprise is responsible for the activities that create the costs and which enterprise bears the risks related to these activities is required.

Finally, for the allocation of related losses it should also be reviewed whether related enterprises have the options to apply force majeure clause, revoke or revise intercompany agreements. The Guideline emphasizes that in case there are no substantial evidence of revisions in current agreements or commercial relations of third parties under comparable conditions, any amendments in intercompany arrangements must be made with scrutiny and be supported with documents demonstrating its conformity with the arm’s length principle.

2. Benchmarking studies and comparability analysis

The change in economic conditions in periods following Covid-19 pandemic has caused significant challenges for conducting benchmarking studies and comparability analyses. In this regard, it is clear that any comparability analysis conducted without taking into account the impacts of the pandemic will not yield accurate outcomes in neither the documentation nor the plans for future studies.

In principle, any form of publicly available information regarding the effects of COVID-19 on the economy, a specific industry or a commercial transaction should be taken into

account in the arm's length price analysis. These can be mainly listed as a decline in sales volumes, comparison of fluctuation of sales during the pandemic with previous periods, changes in capacity usage compared to pre-pandemic period, extraordinary income/expense as a result of the pandemic that may directly affect the profitability of related party transactions, government aids and support received in the pandemic period and their effect on profitability, legal regulations implemented during the pandemic that directly affect the profitability of related party transactions (e.g. limitation of sales of certain products), macroeconomic trends specific to industry for which data is received from central banks, statistical institutions and professional chambers and analysis of crises in the past that had similar impact on global economy.

The Guideline has also offered three distinct suggestions towards arm's length price studies such as price adjustment mechanisms, evaluation of comparables set and inclusion of loss-making comparable companies. Price adjustment mechanisms foresee the readjustment of prices determined during the pandemic when the arm's-length price and profitability becomes more attainable. Evaluation of comparable data set emphasizes on reviewing determined comparables in the light of most up-to-date macroeconomic data and being flexible with the search criteria in order to reach the most accurate comparables. Finally, it is mentioned that comparable firms making loss during the pandemic but meeting the comparability criteria should not be omitted from comparable data set in order to increase accuracy and reliability of benchmarking studies.

3. Government assistance programs

According to the Guideline, economic impacts of government assistance programs regarding Covid-19 pandemic such as grants, subsidies, forgivable loans, tax deductions or investment allowances on accurately defined transactions are required to be reviewed in transfer pricing analysis. The Guideline specifically mentions that government assistance which directly impact the profitability and the price of related party transaction should be taken into consideration. The potential impact on pricing is based on the economic characteristics of the transaction, accurate definition of controlled transaction and the conducted comparability analysis. Since government assistance and special conditions of the Covid-19 pandemic differ in different markets, arm's length price and profitability analysis could be seriously affected as a result. Characteristics of government assistance and competition and demand level in related markets are some of the issues which are required to be examined while analysing the impact of government assistance on the price of controlled transactions.

4. Advance Pricing Agreements

The Guideline states that unless a condition which may lead to the cancellation or revision of the Advance Pricing Agreement ("APA") occurs (e.g., breach of critical assumptions), existing APAs and their terms should be maintained and upheld. If a taxpayer believes that the terms of the APA are no longer appropriate, the taxpayer should approach the tax administration transparently to discuss its concerns. Tax Administrations and taxpayers should consider the domestic law or procedural provisions which shall be applicable in case of failure to fulfil the terms of the APA. Breach of a critical assumption regarding APAs may cause three potential outcomes: revision, cancellation and revocation. The Guideline encourages taxpayer for early notification where material changes in economic conditions lead to the breach of one or more of the critical assumptions as soon as practicable after the change occurs or the taxpayer becomes aware of the change.

Conclusion

Since impact of Covid-19 pandemic varies from one enterprise to another, each enterprise is required to examine, understand and monitor impact of the pandemic in the context of the industry in which it operates and on the basis of global economy.

Our recommendations in this scope are as follows:

- To compare impacts of the pandemic on the company with its impacts on the industry in general,
- To monitor all extraordinary and/or exceptional costs arising due to pandemic closely,
- To define changes in business strategies and decisions that are taken and applied,
- To discuss the option not to pay royalties and management fees temporarily,
- To discuss allocation of loss arising in the group level,
- To maintain compliance to arm's length principle and not to disregard it due to the pandemic and at the same time to consider the effects of the pandemic in comparability analyses,
- To determine the amendments made in the agreements between related parties due to the pandemic,
- To follow institutions, primarily OECD, publishing up-to-date studies and regulation regarding this matter.

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