



# Insights: Transfer Pricing

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## OECD issues guidance on transfer pricing implications of COVID-19 pandemic

On December 18, 2020 the Organisation for Economic Co-operation and Development (OECD) issued its much-anticipated Guidance on the transfer pricing implications of the COVID-19 pandemic (Guidance).<sup>1</sup> True to the expectation that had been set in advance, the Guidance reaffirms the belief that the arm's length principle (ALP) as set forth in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 (TPG) is robust enough to deal with the economic conditions arising from the global pandemic. As such, the Guidance is intended to provide pragmatic approaches to apply the ALP in the extreme circumstances that some taxpayers have experienced as a result of the COVID-19 pandemic. The OECD cautions that the Guidance neither expands nor revises the TPG and that it cannot be relied upon in "normal" economic conditions. The Guidance is not prescriptive and leaves solutions to the issues that it raises unanswered. We note that the Guidance is not binding on tax administrations and gives deference to domestic laws which may not provide for the full flexibility of the TPG in the application of the ALP.

### Key takeaways

1. Gather evidence and document how the COVID-19 pandemic has impacted your business (including commercial relationships with third parties) and transfer pricing policies.
2. Comparable companies and search criteria may need to be reconsidered when an existing set of comparables is rolled forward to 2020.
3. The transfer pricing impacts arising from the pandemic should be evaluated in accordance with the delineation of the transaction pre-pandemic and any changes in the risk profile of the parties to the transaction may be a business restructuring under Chapter IX.
4. Tax administrations are encouraged to work with taxpayers who make good faith efforts to address the benchmarking issues raised in the pandemic period.
5. The potential for disputes with (or between) tax authorities remains high.

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<sup>1</sup> See OECD, "Guidance on the transfer pricing implications of the COVID-19 pandemic," December 18, 2020, at <http://www.oecd.org/tax/transfer-pricing/guidance-on-the-transfer-pricing-implications-of-the-covid-19-pandemic.htm>.

## A closer look

The OECD acknowledges the extent of the demand- and supply-side impacts that the pandemic has had on businesses, as well as the resulting changes in the operating posture of companies and industries, e.g. increased remote working and an acceleration toward the adoption of digital business models. The Guidance comprises 112 paragraphs and is structured in the following four chapters: (I) Comparability Analysis; (II) Losses and Allocation of COVID-19 Specific Costs; (III) Government Assistance Programmes; and (IV) Advance Pricing Agreements (APAs).

For companies looking to implement this guidance into practice for 2020, the following items are important to consider.

### 1. Gather robust documentation

A common theme in Chapters I and IV is compiling a defense file of information relating to the impact of the pandemic period on the business and/or a specific controlled transaction, especially when a taxpayer intends to change a transfer pricing policy.<sup>2</sup> Information should include:

#### Internal data

- An analysis of demand-side factors such as how sales volumes, sales channels, and prices have changed;
- An analysis of supply-side factors such as the change in capacity utilization and government interventions impacting performance;
- Quantification of incremental or exceptional costs borne due to the COVID-19 pandemic and consideration of whether these expenses relate to temporary measures or enable a new working model;
- The amount of government assistance that has been received and its accounting treatment (if applicable);
- A comparison of financial forecasts and actual financial results.

#### External data

- Financial data released by benchmark companies (including partial year data if available);
- Information about third party behavior in commercial transactions, e.g. relief from or deferral of royalties, loan forbearance, extension of credit terms, support payments, etc.

#### Macroeconomic factors

- GDP data and relevant industry indicators.

The Guidance emphasizes adhering to the delineation of the transaction<sup>3</sup> to identify which entity to the controlled transaction bears the economically significant risks<sup>4</sup> and performing the benchmarking analysis accordingly based on the comparability criteria. Though often used in transfer pricing contexts, the term “limited-risk” is not defined in the TPG and the entity that bears specific risks, including the risks that manifested as a result of the COVID-19 pandemic, needs to be determined via an accurate delineation of the transaction. The Guidance reinforces this point, stating that “*neither the*

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<sup>2</sup> Guidance, Paragraphs 11 and 104.

<sup>3</sup> Guidance, Paragraph 8.

<sup>4</sup> Any change in the risk profile of the entities during the pandemic-period would be considered a business restructuring and analyzed under Chapter IX of the TPG.

*mere labelling of activities as “limited-risk” nor the fact that an entity receives a fixed remuneration means by itself that an entity operates on a limited risk basis in a controlled transaction.”<sup>5</sup>*

Transfer pricing methods fall into two categories: transactional methods and profit-based methods. The impact of the COVID-19 pandemic on transfer pricing policies based on transactional methods should follow the delineation of the controlled transaction and the arm’s length behavior of the uncontrolled parties in the benchmarked arrangements (if observable). For profit-based methods, the selection of comparable companies may need to be reconsidered.

## **2. Re-evaluate comparable companies**

The selection of comparable companies should factor in economic conditions as a comparability criterion as the impact of the pandemic and government interventions have differed greatly across jurisdictions, industries, and individual companies. The Guidance notes that where a taxpayer rolls forward an existing set of comparable companies to cover FY2020, it may be necessary to review their continued suitability and potentially revise the set based on new search criteria.

The Guidance suggests refocusing comparable sets on specific geographic markets with a corresponding relaxation of other comparability criteria, as necessary.<sup>6</sup> The Guidance also discusses ways of isolating or smoothing out the impact of the COVID-19 pandemic period by benchmarking the pre- and post-pandemic periods separately (or in combination) while testing the acute period of the pandemic in isolation or, alternatively, extending the multi-year period over which the benchmarking analysis is performed.<sup>7</sup>

## **3. Analyze specific COVID-19 costs**

Companies have incurred a variety of expenses that can be traced to the pandemic, e.g. expenses relating to equipment and infrastructure to facilitate work from home, personal protective equipment for employees, additional janitorial services, touchless equipment, agreements with secondary suppliers, etc. These costs may be temporary, duplicative, or relate to permanent changes in the work environment which may in turn impact the accounting classification of the expenses as operating or non-operating, e.g. exceptional, costs.

The Guidance provides that the *“(a)llocation of operating or exceptional costs would follow risk assumption and how third parties would treat such costs. [...] For example, if a cost directly relates to a particular risk, then the party assuming that risk would typically bear the costs associated with that risk. Furthermore, the party initially incurring an exceptional cost may not be the party assuming risks associated to that cost at arm’s length, and consequently such costs may need to be passed on to parties that do assume such risks.”<sup>8</sup>* From a benchmarking perspective, *“(t)he exclusion of exceptional costs must be done consistently at the level of the tested party and comparables”<sup>9</sup>* which poses issues regarding the level of detail in the notes to the financial statements of the comparable

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<sup>5</sup> Guidance, Paragraph 38.

<sup>6</sup> Guidance, Paragraphs 31 and 32.

<sup>7</sup> Guidance, Paragraphs 27–29.

<sup>8</sup> Guidance, Paragraph 48.

<sup>9</sup> Guidance, Paragraph 52.

companies.<sup>10</sup> The Guidance discusses that whether third parties bear or price-in exceptional costs is also a factor in the analysis, citing examples whereby a manufacturer in a competitive industry may not be able to pass exceptional costs through to its customers whereas a manufacturer in a relatively uncompetitive market may be able to do so.<sup>11</sup>

#### 4. Track local tax administration guidance

The Guidance is not binding on tax administrations and gives deference to domestic laws which may not provide for the full flexibility of the TPG in the application of the ALP. The Guidance acknowledges that access to timely and granular data will be pronounced in the application of the Transactional Net Margin Method (TNMM) and urges tax administrations “to minimise disputes where taxpayers are making good faith efforts to determine the arm’s length prices in the context of information deficiencies.”<sup>12</sup> Potential approaches mentioned include a “but for” methodology<sup>13</sup> as well as various statistical methods to forecast the benchmark results, e.g. regressions based on GDP or other industry indicators,<sup>14</sup> while warning that relying on “financial information from the global financial crisis 2008/2009 would raise significant concerns.”<sup>15</sup> However, the extent to which this Guidance will be adopted by local tax administrations remains to be seen.

#### 5. Analyze treatment of government assistance for transfer pricing purposes

Similar issues abound in the consideration of government assistance on transfer pricing. There have been a wide variety of assistance programs (even within countries) each with its own characteristics and resulting accounting treatment. Notwithstanding the fact that certain tax administrations have said that government assistance is for the benefit of its own economy and should not be exported to other entities in a multinational enterprise,<sup>16</sup> the Guidance states that each instance of government assistance should be evaluated on its own merits and in certain circumstances the benefit could be passed on through the group’s supply chain.<sup>17</sup> From a benchmarking perspective, “(w)here accounting treatments of the same type of assistance differ between the tested party and the comparable, a comparability adjustment may be required.”<sup>18</sup>

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<sup>10</sup> For transfer pricing methods that rely on gross profit, consistency of accounting treatment of operational costs between cost of goods sold and operating expenses is also required.

<sup>11</sup> Guidance, Paragraph 50.

<sup>12</sup> Guidance, Paragraph 20.

<sup>13</sup> Guidance, Paragraph 12. This is consistent with the advisory issued by the Australian Taxation Office in July 2020, see “COVID-19 economic impacts on transfer pricing arrangements,” at <https://www.ato.gov.au/Business/International-tax-for-business/In-detail/Transfer-pricing/COVID-19-economic-impacts-on-transfer-pricing-arrangements/>.

<sup>14</sup> Guidance, Paragraph 11.

<sup>15</sup> Guidance, Paragraph 25.

<sup>16</sup> The Australian Taxation Office has issued guidance stating that the “correct transfer pricing treatment” of the country’s JobKeeper payments received by a cost plus subsidiary operating in Australia is that the “JobKeeper payments should not result in a reduction of the price of the service provided to the offshore related party,” i.e. the JobKeeper payments should not benefit offshore affiliates of the multinational enterprise, see “Transfer pricing arrangements and JobKeeper payments,” <https://www.ato.gov.au/Business/International-tax-for-business/In-detail/Transfer-pricing/Transfer-pricing-arrangements-and-JobKeeper-payments/>.

<sup>17</sup> Guidance, Paragraphs 73–79 .

<sup>18</sup> Guidance, Paragraph 86.

## Conclusion

The Guidance is a welcome document as taxpayers grapple with the transfer pricing ramifications of the COVID-19 pandemic and the resulting government actions and economic impact. The OECD highlights many issues but does not provide specific answers to the practical challenges such as the lack of transparency into accounting policies of benchmarked companies which can lead to decreased precision in the quantum and consistent treatment of COVID-19 specific expenses and government assistance. The Guidance reinforces that the ALP is a flexible framework and that the foundation of any transfer pricing analysis starts with the accurate delineation of the transaction even in these extreme circumstances.

Please reach out to your CRA Transfer Pricing practitioner with any questions. We wish you good health in 2021.

## About CRA's Transfer Pricing Practice

Our consultants help clients navigate every phase of implementing and supporting international tax structures including: intellectual property (IP) and acquisition planning, documentation, and audit defense. We also provide litigation support and expert testimony services in tax and transfer pricing litigation.

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