

# Transfer Pricing in the Time of COVID-19

## CrossBorder Solutions' Summary of OECD Guidance

Author: Mimi Song, Chief Economist

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## Introduction

All around the world, multinational enterprises (MNEs) have faced unique challenges brought on by COVID-19. Supply chains have been disrupted, stay-at-home orders have prompted closures, and economic demand has plummeted, in part, due to an uptick in unemployment. No doubt, 2020 has been difficult for CEOs and financial managers across all industries—and it's been extra burdensome for transfer pricing executives, as well.

Transfer pricing documentation for fiscal year 2020 (FY 2020) will be due in 2021, and COVID-19's unique effects on businesses stand to threaten the arm's-length position in related-party transactions, no doubt inviting close examinations by tax authorities. Third-party comparability—the foundation of the arm's-length principle—has been compromised due to COVID-19's volatile effects on companies and industries. Entities have failed to honor terms and conditions in intercompany agreements, and government-invoked operational mandates and assistance programs have impacted companies in different ways. Even advanced pricing arrangements—meant to benefit taxpayers by taking the wild cards out of tax uncertainty—now could be disadvantageous to the very taxpayers they were created to protect.

The OECD recognizes the unprecedented challenges brought on by COVID-19 and has published guidance on how to approach transfer pricing, with an unwavering commitment to the arm's-length principle, in these economic uncertain times. “Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic” focuses on four key transfer pricing issues made vulnerable by COVID-19—comparability analyses, losses, government assistance programs, and advanced pricing arrangements—offering pragmatic approaches for analyzing and documenting a myriad of intercompany transactions. While robust and accurate transfer pricing documentation is essential in any tax year, it will be absolutely critical for FY 2020. Of course, while country-specific requirements still trump OECD guidance, the OECD's strategies offer options on how to apply the arm's-length principle. To help digest these intricate points and apply them to country-specific requirements for FY 2020, in this report, CrossBorder Solutions highlights major concerns and solutions.

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# Section 1

## Conquering Comparability During COVID-19

Benchmark analyses are at the heart of proving arm's-length transactions, but as the OECD recognizes, COVID-19 has created unique comparability challenges. The coronavirus pandemic may have impacted third-party transactions differently than intercompany transactions, and comparability data will likely suffer as a result. Not only will taxpayers and tax administrations find themselves swimming in a sea of capricious data, but there may be a dearth of public information, as well. Yet, tax experts will still be expected to construct reliable comparability analyses that align with the taxpayer's current facts and circumstances.

Comparability challenges may vary between MNEs but supporting documentation will be imperative to taxpayers across the board. The OECD recognizes that evaluating arm's-length transfer prices in a year impacted by COVID-19 will require "good judgment and flexibility" by MNEs, and it requests that tax administrations be mindful of the need for a limber approach. In fact, the OECD urges tax authorities to consider the earnest efforts to comply with the arm's-length principle made by taxpayers, and those efforts will be evidenced in large part, by adequate supporting documentation.

What types of documentation can reinforce an arm's-length position satisfactorily? According to the OECD, "any form of publicly available information regarding the effect of COVID-19 on the business, industry, and controlled transaction" should be considered in determining the arm's-length nature of the transfer pricing policy. For FY 2020, a comparability analysis will have to assess the effect of the pandemic on the controlled transactions, and the OECD deems the following supplemental analyses to be instrumental in those determinations:

- **Sales Volumes:** Evaluate how sales volumes have changed compared to pre-COVID years. Have sales channels changed due to COVID? What are the effects of those changes?
- **Capacity Utilization:** Look at the group's total capacity for production and manufacturing. How much of that was used during COVID-19? How has that change affected the controlled transaction and/or transactions with independent parties?
- **Costs:** Many companies have incurred COVID-19-related costs as businesses have had to absorb the expense of masks, plexiglass dividers, hand-sanitizers, gloves, and sometimes, restructuring offices or factories to accommodate social distancing. Include information related to incremental or exceptional costs and the impact they have on entities in the controlled transaction, or on the MNE group as a whole.

## Section 1: Conquering Comparability During COVID-19

- **Government Assistance:** Has the taxpayer received government assistance? Explain the type of assistance and how it has benefitted the taxpayer. Quantify that assistance and explain how it impacts the financial statement.
- **Financial Statements and Market Information:** Financial and market information can help defend the taxpayer's performance and provide context of actual market conditions. The OECD recommends including quarterly SEC filings or earnings releases; country-specific GDP data; or industry indicators from central banks, government agencies, industry or trade associations.
- **Regression Analysis:** Market conditions can impact profits and the effects of economic circumstances may vary between jurisdictions and also, industries. It's in the best interest of the taxpayer to show how conditions affected profits or other economic variables. The OECD recommends using statistical methods, like regression analyses, to show how a business has been impacted during other economic downturns. Variance analyses, which examine a company's economic forecast against reality, can explain how market conditions—as opposed to transfer prices—can be attributed to changes in profitability.
- **Analysis of Profitability:** Comparing FY 2020 to economic performances in years that haven't been impacted by COVID-19 may not prove useful. Instead, the OECD suggests comparing 2020 profitability against third-party performance in recessionary periods, or using the 2020 data that's available, even if partial.

### The XBS Takeaway: Conquering Comparability During COVID-19

- Companies will be affected uniquely
- Reliable comparable data may not exist
- Taxpayers need a flexible approach to analyze arm's-length pricing
- Document COVID-19's impact on the business



### Budgeted Financial Information and Setting Arm's-Length Prices

In defending arm's-length pricing between related parties, the overall goal is simple: To prove that any changes in revenues, costs, and margins are due to the implications of COVID-19—not base erosion and profit shifting (BEPS). “The financial outcomes that taxpayers within a controlled transaction would have achieved ‘but for’ the impact of COVID-19 may provide useful information, particularly when assessing the financial impacts from COVID-19 (e.g. reduced sales volume or increased operating expenses) and determining, in light of contractual terms and risk assumption of the parties, any appropriate resulting impact on intercompany prices.”<sup>1</sup>

Transparency in how the pandemic impacted the business will be the ultimate weapon. Juxtaposing financial forecasts against financial results can demonstrate the unique effects of the virus on diminished sales or bloated expenses. A detailed profit-and-loss analysis, including a variance analysis of pre-COVID forecasts versus actual results, can be invaluable supporting documentation. The OECD also advises showing the impacts of government programs and how they are reflected on the balance sheet. Include, of course, explanations in terms of how profitability adjustments—positive and negative—were determined to reflect non-COVID-19 market conditions.

#### The XBS Takeaway: COVID-19's Effects on Financials

- Goal: To prove volatility is related to COVID-19, not BEPS
- Transparency is key
- Financial forecasts against financial reality can illustrate effects of the virus
- Explain financial statement adjustments of government assistance, if applicable



### Timing is Everything

In a perfect world, taxpayers would compare controlled transactions to contemporaneous uncontrolled transactions—in other words, independent transactions taking place at the same time as related-party transactions. Contemporaneous comparability is ideal because it shows how independent and unrelated parties fare in the same economic environment. If FY 2020 presents opportunities to use contemporaneous or “near contemporaneous” uncontrolled transactions to benchmark a transaction, the taxpayer should make use of it. Refer to data on recent financial transactions in public databases as reliable information representing current economic conditions. Internal comparables are another source of reliable contemporaneous information, and taxpayers should consider setting prices against a related party’s transaction with a third party.

Of course, the OECD recognizes that FY 2020 will present times when contemporaneous comparability is more challenging or simply not possible, as is the case with the transactional net margin method (TNMM). The TNMM requires historical data from commercial databases to determine transfer prices, and that 2020’s market conditions won’t be reflected until mid-2021 at the earliest due to database lag times. Taxpayers may need to perform comparability analyses based on the price-setting year and use supporting information from FY 2020 to support adjustments, as needed. Long-term arrangements may not require the same treatment. If an arm’s-length price has been established based on contemporaneous comparables at the time of a contract negotiation, then the tested party may already be protected from risks derived from the pandemic.

## Section 1: Conquering Comparability During COVID-19

The OECD stresses that any approach to benchmarking or setting arm's-length pricing should depend on the accurate delineation of a particular controlled transaction, and there are many applications worth considering. For instance, while the arm's-length principle doesn't typically require using more than one method to analyze a transaction, given FY 2020's extraordinary circumstances, taxpayers may want to apply other methods in support of their arm's-length position. Most countries advocate the use of multiple-year data and multiple-year averages for comparability analyses, and the advantages—assuaging the differences in accounting, measuring profitability based on product life cycles, and increasing the overall reliability between the comparisons—can still be applicable in terms of COVID-19 transfer pricing. However, for FY 2020, taxpayers may consider evaluating two separate testing periods—one that spans the entire pandemic and for when the effects of the pandemic were most conspicuous. Of course, independent comparables would have to be treated the same way.

Government interventions impose their own set of challenges—perhaps a plant was shut down for two months—and taxpayers will need comparable companies who were affected in the same way to ensure reliable benchmarking. Existing comparable sets may not be suitable to roll forward and in some cases, may require a fresh set. If market comparability, for example, is the leading comparability factor during the pandemic, then a new sample from a particular market may be needed. Companies showing losses may be appropriate comparables for FY 2020, if they have similar levels of risk and have been impacted by the pandemic in similar ways. Price-adjustment mechanisms, transfer pricing methods, comparables, and the parameters of the testing periods may all need consideration, and the OECD advises that taxpayers and tax administrations look at each transaction on a case-by-case basis to determine how and why.

### The XBS Takeaway: Timing is Everything

- Contemporaneous local comparables are a preferred choice
- Show how independent parties and related parties fare in the same economic environment
- Make use of contemporaneous data, both internal and external
- TNMM has a timing lag, which may require additional atypical adjustments
- Multiple-year data and averages may still apply to transfer pricing affected by COVID-19
- Separate testing periods could provide better market context



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## Section 2

# The Treatment of Losses and COVID-19 Related Costs

### Which Entities Can Absorb Losses?

The topic of losses is always a tricky one in terms of arm's-length transfer pricing, as tax authorities can always argue that losses belong outside of their jurisdictions. No doubt, in FY 2020, companies will be reporting losses across all industries and markets thanks to a slip in demand or failure to provide products or services, and multinational companies will be saddled with justifying the allocation of losses, especially during the pandemic.

Many tax experts, for instance, have been wondering if limited-risk distributors can assume some of the group's losses and still operate at arm's length. A "limited-risk entity" is a characterization used to accommodate a reduced-risk transfer pricing policy, which is not clearly defined in OECD Guidelines, and not necessarily observed between third parties. As such, the OECD doesn't recommend a general rule as to whether one can absorb losses. The accurate delineation of a particular transaction dictated by the facts and circumstances should determine what is appropriate.

The OECD Guidelines do stipulate that "simple or low-risk functions in particular are not expected to generate losses for a long period of time."<sup>2</sup> The statement begs the question, 'could low-risk functions generate losses for a short period of time?' Taxpayers will be expected to make a judgment call based on risks borne and potential functional shifts through the evaluation of the most appropriate transfer pricing method and associated supporting benchmarks.

## Section 2: The Treatment of Losses and COVID-19 Related Costs

The level of risk an entity assumes is instrumental in determining its potential to swallow losses. The OECD highlights the example of a limited-risk distributor, which holds some inventory risk, and could theoretically assume some of the losses at arm's length based on that risk. However, the amount it can absorb will depend on the economic conditions and the specific transaction compared to uncontrolled transactions. The most appropriate transfer pricing method could be determined by those same means, as well. The OECD is very clear that a limited-risk distributor devoid of risk—market risk or otherwise—should not bear any portion of losses related to that risk. For example, if a limited-risk distributor doesn't bear credit risk, it cannot absorb losses arising from credit risk.

“ **If a limited-risk distributor doesn't bear credit risk, it cannot absorb losses arising from credit risk.** ”

Tax administrations are urged to consider the taxpayer's position before and after the pandemic. If a limited-risk distributor didn't assume any marketplace risk before the pandemic but assumed some during, and therefore absorbed losses, tax authorities will want to investigate deeper. The OECD advises looking into the company's risk profile pre-pandemic—did it really assume zero risk? What risk materialized during the pandemic? No question, inconsistency will beg attention from tax authorities and taxpayers would be wise to show that the accurate delineation of a transaction supports the original and subsequent risk allocation. A robust functional analysis can help validate the position.

### **The XBS Takeaway: Which Entities Can Absorb Losses?**

- No general rule about the ability of limited-risk entities to absorb losses
- A limited-risk entity can only absorb losses related to the risk it assumes
- Tax authorities will notice a reallocation of risk pre- and post-pandemic
- Taxpayers should demonstrate that facts and circumstances warranted the reallocation of losses to reinforce its arm's-length position

### Can Existing Intercompany Agreements be Renegotiated?

Thanks to the economic uncertainty brought on by the coronavirus pandemic, related companies may find themselves unable to honor the responsibilities that were assigned by intercompany contracts. Perhaps they won't be able to meet payment deadlines or maybe stay-at-home orders have affected their abilities to supply products or services. The obvious answer for associated entities is to renegotiate intercompany contracts—but will those renegotiations be considered arm's length? Yes, provided the economic environment has forced independent parties to renegotiate theirs, too.

Given the global impact of COVID-19, it's likely that independent companies may show leniency when it comes to contractual obligations, especially if renegotiating those contracts benefits all parties involved. Contracts may be renegotiated to help a much-needed counterparty survive. If intercompany contracts are renegotiated along the same lines as agreements between independent companies, then those negotiations may very well be at arm's length. The same views should be considered for renegotiations—say, deferred payments—that happen for the sake of long-term profitability. Clear evidence that third parties are taking the same necessary steps to rework contracts is essential—without it, renegotiated intercompany contracts won't be seen as arm's-length agreements.

#### The XBS Takeaway: Which Entities Can Absorb Losses?

- No general rule about the ability of limited-risk entities to absorb losses
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- Taxpayers should demonstrate that facts and circumstances warranted the reallocation of losses to reinforce its arm's-length position

## Section 2: The Treatment of Losses and COVID-19 Related Costs

Force majeure clauses may be included in intercompany contracts, but COVID-19 may or may not be reason enough to invoke them. That said, taxpayers who have not included such legal exit strategies in contracts may still be able to find legitimate outs. The OECD advises taxpayers to examine intercompany contracts, along with the magnitude of the disruption, before invoking the force majeure clause. Terms of the controlled transaction will also play a role in determining if renegotiation or a breach in contract is an arm's-length move. "Care should be taken to assess whether the magnitude of the disruption caused by COVID-19 in the specific related-party situation qualifies as a force majeure event, and to review the force majeure clause in the context of the overall relationship and contractual agreement."<sup>3</sup>

“If intercompany contracts are renegotiated along the same lines as agreements between independent companies, then those negotiations may very well be at arm's length.

### **The XBS Takeaway: Can Existing Intercompany Agreements be Renegotiated?**

- Related parties may have trouble honoring intercompany contracts
- Renegotiations are considered arm's length, so long as comparable third parties are also renegotiating similar contracts
- Intercompany contracts should be revised along the same lines as comparable third-party contracts
- COVID-19 impact may or may not be reason to invoke force majeure clauses
- Consider the significance of the disruption before invoking exit strategies



### Cost Allocation for COVID-19 Expenses

In the last year, companies have had to purchase personal protective equipment, like face shields and masks, and many have reconfigured workspaces to enforce social distancing. The question is how should these unique costs be allocated between related parties? The answer lays in how these costs would fall between independent parties in the same circumstances.

The OECD follows a systematic approach to assigning exceptional costs between related parties. Taxpayers are advised to examine how third parties would treat these costs and also, to accurately delineate the controlled transaction and see where risks associated with the costs lay. In fact, the OECD goes so far as to note that an entity may initially bear the exceptional expenses related to COVID-19, however, such costs should shift to the risk-bearing entity to be considered arm's length.

One of the pandemic's unique challenges lays in determining which expenses are actually "exceptional." For some companies, COVID-19 may have created new costs that will become permanent. For example, costs related to work-at-home may become a fixed part of the future business plan. On the flip side, some expenses may go away: If more employees are working remotely, companies may not have to budget as much—or at all—to rent office space. If expenses will be recurring, they should be treated as operating expenses when delineating the transaction and in the analysis. Facts and circumstances should figure into decisions regarding cost allocation, as there could be instances where one entity has to make a significant investment in the IT infrastructure to support telecommuting employees, as an example. Such expenses may be allocable to the entities that employ the staff utilizing the enhanced infrastructure. In those situations, it may be suitable to charge those expenses to the benefitting party.

## Section 2: The Treatment of Losses and COVID-19 Related Costs

Taxpayers are advised to treat exceptional costs consistently in comparability analyses, and the OECD advises they be excluded from the net profit indicator except when they relate to the controlled transaction. Exclusions, as well as accounting and comparability adjustments, must be consistent between the tested party and the comparables. Entities may assign exceptional costs as pass-through costs, which won't affect profits, but that determination is subject to the terms of the controlled transaction.

“ One of the pandemic's unique challenges lays in determining which expenses are actually 'exceptional.' ”

### The XBS Takeaway: Cost Allocation for COVID-19 Expenses

- Take a systematic approach to determine where COVID-19 unique costs belong
- Examine how third parties would treat those same costs
- Recurring expenses should be treated as operating expenses, not exceptional costs
- Expenses should generally lay with the benefitting party
- Exclusions, as well as accounting and comparability adjustments, must be consistent between the tested party and the comparable companies



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## Section 3

# Government Assistance Programs

### Government Aid and the Challenges it Presents

Governments have helped multinational companies weather the COVID-19 pandemic in a variety of ways—grants, subsidies, tax deductions, investment allowances, loan guarantees, financing, to name just a few. The programs were helpful in keeping businesses operating through the pandemic, but the transfer pricing implications are complicated. Related parties may have taken advantage of one type of government aid, meanwhile comparable companies may have benefited from others. Even if third parties were operating in the exact same manner as the tested party, it could be hard to obtain reliable information to prove their similar treatment.

The OECD's concern is the economic impact of the assistance on the controlled transaction. Economic characteristics must always be considered in a transfer pricing analysis, but does government assistance qualify as an economically relevant characteristic? In certain circumstances, yes.

Government relief in the form of a wage subsidy, a government debt guarantee, or short-term liquidity support may be economically relevant, if the assistance directly affects the controlled transactions and the third-party comparables, including pricing. Another situation to consider is when a related party does not receive assistance, but a third party does. Taxpayers will have to determine if government assistance is economically relevant based on the controlled transaction and a robust comparability analysis. If the taxpayer concludes that it is, then the information should be included in the transfer pricing documentation package.

## Section 3: Government Assistance Programs

Per OECD Guidelines, government interventions should generally be treated as part of local market conditions and should always be examined. Taxpayers should analyze how the aid impacts the transfer price between related parties. In doing so, the OECD recommends consideration of the following:

- “Whether the receipt of government assistance provides a market advantage to the recipient;
- The amount of any increase in revenues, decrease in costs, vis-à-vis those or reliable comparables, that are attributable to the government assistance received, and the duration of the assistance;
- The degree to which benefits of government assistance at arm’s length, are passed on to the independent customers or suppliers; and,
- Where benefits attributable to government assistance exist and are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate such benefits between them.”<sup>4</sup>

Shrewd taxpayers will perform robust analyses to determine the effects of government assistance. Merely assuming government help impacts a transfer price between related parties does not comply with the arm’s-length principle. All aspects must be considered in a comparability analysis—even the exclusions of assistance based on stringent criteria and how aid is quantified. To determine if government assistance has impacted transfer pricing, taxpayers should analyze “the availability, purpose, duration, and other conditions imposed by the government in granting the assistance; the allocation of the economically significant risks; and the level of competition and demand within the relevant markets.”<sup>5</sup>

The taxpayer has much to consider in determining if accepting government assistance affects arm’s-length pricing in a controlled transaction. As such assistance represents local market conditions, the taxpayer must consider the competition, the availability of benefits to competitors, and the demand for them. It’s also important to look at markets where MNE groups have sold products to third parties, and whether government help has influenced the group to implement new pricing strategies in those transactions. Ultimately, the economic relevance of government assistance in controlled transactions depends largely on the allocation of risks caused by the pandemic and the relationship between the assistance and risks. The OECD also cautions taxpayers using one-sided methods to take an analytical approach to the effects of the aid. The guidance suggests, for example, that “offsetting cost savings achieved through government assistance against a relevant cost base for the transaction,”<sup>6</sup> could lead to transfer prices that do not comply with the arm’s-length principle.

### Government Help and Comparability Analyses

The OECD makes no pretenses about the relationship between pandemic-induced risk and assistance and how that impacts arm's-length pricing, however, does assistance itself negate at least some level of risk? Not necessarily. OECD Guidelines suggest that government assistance does not alter the allocation of risk for an associated party. The OECD offers the example of a distributor that buys inventory from a related-party manufacturer and sells it in its local market. Normally, the distributor bears the risk of a decrease in product demand. Should the distributor receive a cash grant from the government to stay afloat during a COVID-19-induced downturn, that cash grant doesn't alter the distributor's risk profile. The distributor would still hold marketplace risk and decision-making functions related to that risk, independent of the cash grant.

Given that government assistance comes in many forms and covers various time periods, third-party pricing may be impacted by it and so, relief packages need to be factored into comparability analyses. For example, a company that receives short-term subsidies for hourly employees who lost wages due to shutdowns may not be comparable to a company that has received a domestic wage subsidy under a job-retention program—even if their comparability factors aligned in the past. The variables are endless and according to the OECD, the most reliable approach will be to benchmark comparables in the same geographic market against companies with assumingly similar functions, assets, and risks.

## Section 3: Government Assistance Programs

Government assistance will pose many challenges in terms of comparability. Certain transfer pricing methods and comparables that may have aligned in the past, may no longer be eligible if one company has benefitted from government assistance and the other has not. Employing a corroborative transfer pricing method to validate the arm's-length range may be wise. Taxpayers employing one-sided methods, like the resale price method, the cost-plus method, or the transactional net margin method, will want to look carefully at government aid accounting treatments by not only the tested party but also, comparable companies, as the P&L line items can impact profitability.

“Third-party pricing may be impacted by government aid and so, relief packages need to be factored into comparability analyses.

### The XBS Takeaway: Government Assistance Programs

- Complications arise between related parties and comparable companies that have received different types of assistance—or no assistance at all
- Reliable information may be hard to come by
- Treat government assistance as part of local market conditions
- Aid must be part of the comparability analyses



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## Section 4

# Advance Pricing Arrangements

### Are Taxpayers Still Bound by Advance Pricing Arrangements?

Taxpayers have come to see advance pricing arrangements (APA) as a form of tax certainty. These agreements, between taxpayers and tax administrations, lay out in advance what constitutes arm's-length pricing in specific transfer pricing transactions, and they're meant to benefit the taxpayer. However, what was advantageous to related-party entities before COVID-19 may no longer provide the same benefits, so is the contract still binding?

For the OECD, the answer is simple: Yes. Taxpayers should still adhere to the contractual terms presented in an APA—and in fact, are obliged by it. Economic circumstances do not obliterate terms of the contract. If the taxpayer fails to meet the agreed-upon conditions, then the consequences of the breach listed in the agreement should be enforced. The taxpayer may also face additional penalties imposed by domestic law.

Operational and economic conditions may affect the transactions and critical assumptions reflected in an APA, but the OECD advises to look at potential breaches on a case-by-case basis. Businesses have been impacted in unique ways and these circumstances, along with commercial environments, must be individually evaluated.

## Section 4: Advance Pricing Arrangements

“The COVID-19 pandemic has not had the same impact on all enterprises. While many industries and businesses have experienced a drop in demand and revenues because of forced lockdowns, others have expanded their consumer-base or benefitted from new business opportunities. Whether a breach has occurred may also depend on the duration of the disruption.”<sup>7</sup>

What happens if a breach has occurred? Tax administrations are advised to look at the extent of the breach in terms of the APA and the COVID-19 landscape. Tax authorities will also have to consider whether the prescribed transfer pricing methodology in the APA will reflect reliable arm’s-length pricing. If a breach of critical assumptions has not occurred, it’s expected that the taxpayer will conduct related-party transactions based on the APA’s terms. Taxpayers who cannot adhere to the agreements should seek guidance from the tax administration involved.

### How Should Tax Administrations Respond?

Tax authorities will no doubt have some discretion over how to treat taxpayers who fail to meet the terms of the APA. However, the OECD advises tax officers to consider agreements between relevant tax administrations on how to handle the situation, and what the local law dictates. Some APAs may include the answer themselves, listing steps to take in the event of a contract breach due to a failure to meet critical assumptions. In those situations, the answer may be easy for tax administrations, as they merely have to follow the protocol that they originally agreed upon.

In more complex situations, taxpayers and tax authorities may opt to revise the APA, which would mean they are still protected by—and bound— to the APA, though on new terms. They may also choose to cancel the APA, and then its benefits would only apply up to the cancellation date. A more severe option is revocation, which would annul the agreement altogether, as if it had never existed in the first place.

## Section 4: Advance Pricing Arrangements

The trick here is to know when each solution is appropriate. Revisions work best when all agree on the contract stipulations up to a certain date but need them to change for FY 2020 and after. Revisions can include some of the original terms and changes only where the breach in the critical assumptions comes into play. For instance, a transfer pricing method may apply to a series of transactions and only one may require the use of another method.

There are other options as well: The OECD notes that tax administrations may consider evaluating the results of a method over multiple years, instead of annually, which would bury FY 2020's results in with other normal years. Tax authorities could also separate the agreement into years that have and have not been affected by COVID-19.

Cancelling an APA may be the best option if a taxpayer cannot comply with any part of the contract and if there's been a material breach in the critical assumptions. Perhaps the contract was created based on fixed functions, assets, and risks, and due to COVID-19, functions, assets, and risks, have relocated in the supply chain. Tax authorities and taxpayers would have to agree on a cancellation date, which could be a specific day, tax year, or accounting period.

The cancellation of an APA has serious drawbacks. Taxpayers and tax authorities spend considerable time—often, years—and effort negotiating these contracts, and a cancellation negates those painstaking endeavors. Also, APAs, and the mediation needed to construct them are incredibly expensive, and taxpayers absorb those costs. Once an APA is cancelled, those exorbitant expenses become money down the drain.

Revocation should be reserved for when a taxpayer fails to comply with a fundamental condition of the APA. This could be a deliberate move by the taxpayer or due to neglect or carelessness. The OECD recommends a limited use of this option, and the pandemic's role in these failures in less significant.

Whichever solution is deemed best, it would behoove the taxpayer to notify the tax authorities as soon as an issue arises—or the taxpayer has become aware of it. The goal is to give all involved more time to agree on revisions, as opposed to cancelling the APA altogether. Given that economic conditions will remain uncertain until the end of 2020, tax administrations may wait until more data is available before responding to a breach. That information may allow taxpayers and tax authorities to revise the contracts instead of cancelling them.

## Section 4: Advance Pricing Arrangements

### Documenting

If the critical assumptions of an APA are ruptured, it's the responsibility of the taxpayer to document how and why. Again, supporting documentation is crucial. The OECD suggests including forecasts and actual profits for the financial years affected by COVID-19; copies of modifications to pre-existing agreements, or new intercompany contracts, and a robust narrative explaining the expected effects of current economic conditions on a transfer pricing method in the APA during the financial years affected by COVID-19. A profit-and-loss statement detailing line items—costs of goods sold; selling, general, and administrative expenses; and other non-interest expenses—for the financial years impacted by COVID-19 and encompass the transactions listed in the APA, can be helpful, as can information about third-party practices.

## Section 4: Advance Pricing Arrangements

### APAs Under Negotiations

Taxpayers who are currently in the process of negotiating APAs may be reluctant to solidify them given the economic uncertain environment. The OECD advises to keep agreements flexible. Consider an APA that only covers the period affected by COVID-19 and a separate contract for subsequent years. Create an APA with a provision that specifies the impacts of COVID-19 will be analyzed annually once they are known and that amendments may be made after the fact, when necessary. A term test throughout the life of the APA could also be implemented. Being transparent and working collaboratively with tax authorities—be it by virtual case conferences, functional interviews, site visits, and electronic documentation sharing—is the gateway to acceptance of APA applications.

“If the taxpayer fails to meet the agreed-upon conditions, then the consequences of the breach listed in the agreement should be enforced. The taxpayer may also face additional penalties imposed by domestic law.”

#### The XBS Takeaway: Advanced Pricing Arrangements

- Changes to economic conditions do not necessarily breach critical assumptions
- Domestic law may impose additional penalties on contract breaches
- Transfer pricing methods in APAs may no longer present an arm's-length result based on current market conditions
- Taxpayers who won't be able to fulfill the terms of the APA should consult with the tax administration as soon as issues arise
- Taxpayers are responsible for documenting how and why they cannot apply the terms of the APA

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## Footnotes

1 (Paragraph 12 of Chapter 1 OECD Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic).

2 (Paragraph 3.64 of Chapter 1 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017).

3 (Paragraph 57 of Chapter II OECD Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic).

4 (Paragraph 71 of Chapter III OECD Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic).

5 (Paragraph 74 of Chapter III OECD Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic).

6 (Paragraph 78 of Chapter III OECD Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic).

7 (Paragraph 93 of Chapter IV OECD Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic).

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## Chief Economist Mimi Song

CrossBorder Solutions' Mimi Song is a transfer pricing expert with more than 20 years of experience developing innovative and intelligent transfer pricing solutions for multinational corporations. As a practitioner with both consulting and industry know-how, she understands the administrative burdens imposed on taxpayers and the delicate balance between long-term sustainability and external risk management of international tax compliance. Her experience developing the end-to-end transfer pricing framework across people, processes, and technology uniquely positions her to understand how technology can be effectively applied to maximize budgets and minimize risk.

As Chief Economist of CrossBorder Solutions, Song is responsible for managing client relationships and ensuring the successful completion of all work. At the original iteration, she served as Vice President of Professional Services. Following the sale to Thomson Reuters, Song was a Vice President at Duff & Phelps and served as the Head of Transfer Pricing at the Bank of Tokyo-Mitsubishi UFJ.

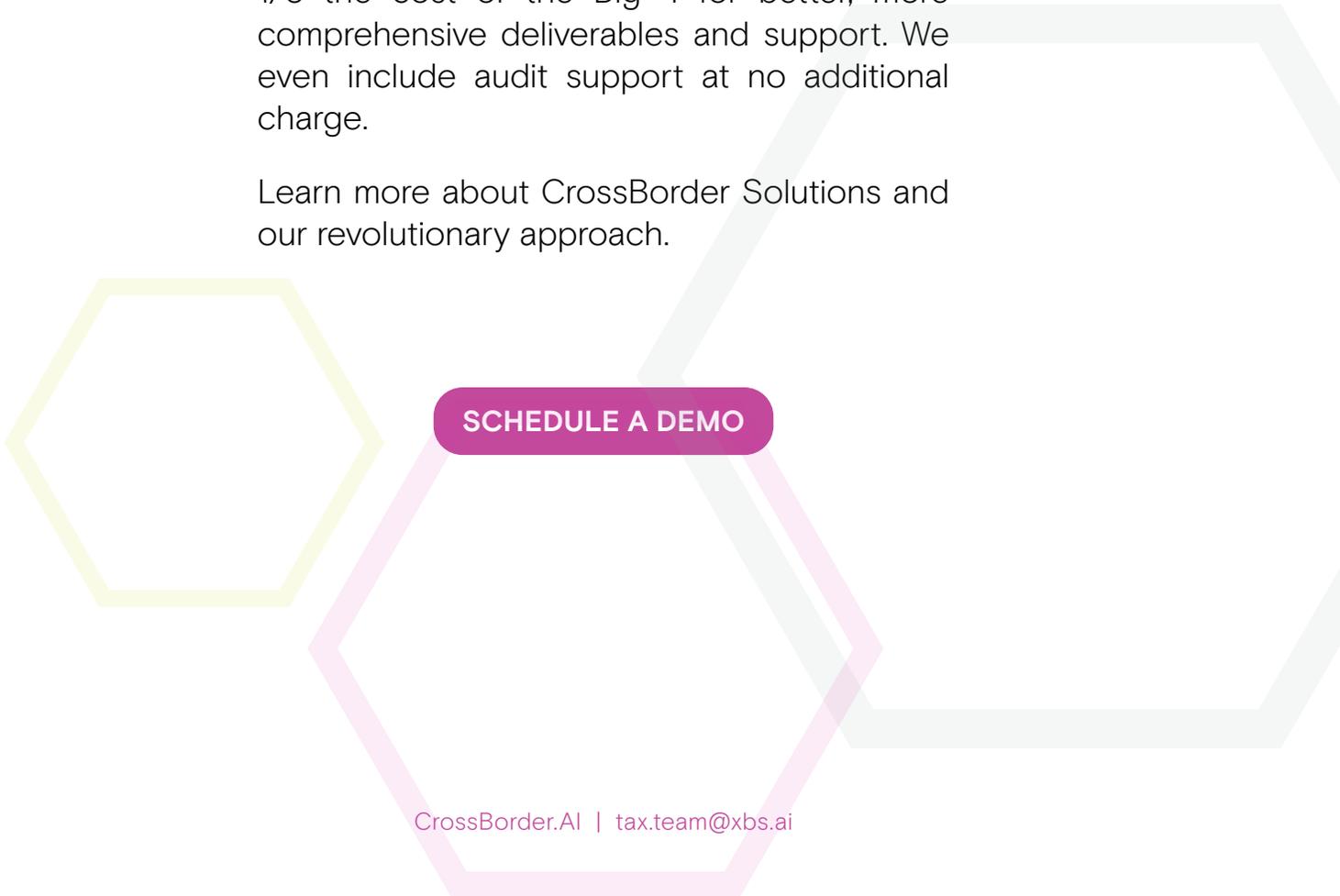


## About CrossBorder Solutions

CrossBorder Solutions is the global leader in AI-driven tax solutions. Over 2,000 CFOs of multinational corporations rely on CrossBorder Solutions to manage their transfer pricing compliance and R&D tax credits.

Because we use AI to complete your work, CrossBorder Solutions is able to charge a fraction of the cost. Our clients often pay 1/3 the cost of the Big 4 for better, more comprehensive deliverables and support. We even include audit support at no additional charge.

Learn more about CrossBorder Solutions and our revolutionary approach.



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