



Tax Insights

COVID-19 impacts on transfer pricing

Snapshot

On 19 June 2020, the ATO released two pieces of guidance on transfer pricing aspects of COVID-19:

- i. How taxpayers should take into account "[COVID-19 economic impacts on transfer pricing arrangements](#)"
- ii. Concerns the ATO has on "[Changing related party agreements](#)" in the COVID-19 environment.

The ATO guidance is timely and provides an insight into how the ATO expects taxpayers to analyse and document the adverse impacts of COVID-19 for transfer pricing purposes. The guidance deals only with documentation and contractual issues and does not opine on the wider arm's length issues of restructuring or termination of related party arrangements due to COVID-19.

We have set out below the key aspects of these two ATO releases.

How is transfer pricing documentation impacted by COVID-19?

A critical issue for taxpayers to assess in preparing their transfer pricing documentation will be the economic impacts of COVID-19 on their businesses. The ATO acknowledges that many businesses will suffer substantial, adverse impacts as a result of COVID-19. However, the guidance makes it clear that the ATO expects taxpayers to analyse and document the impacts of COVID-19 in a granular way in their transfer pricing documentation, with a focus on:

i. ***Changes to the business***

Taxpayers should gather the following types of evidence to support any changes to, or impacts on, the business as a result of COVID-19:

- The function, asset and risk profile of the Australian entity before and after COVID-19
- Economic circumstances – i.e., the actual economic impacts of COVID-19 on the Australian operations, including an analysis of how the relevant industry has been affected
- 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.

ii. ***The arm's length nature of transfer pricing outcomes (is benchmarking still appropriate?)***

The ATO acknowledges that traditional comparable benchmarking may not reliably support the arm's length outcomes of current transfer pricing arrangements. This will particularly be the case in the short term, given the likely impacts of COVID-19 on the financial performance of many companies across different market sectors.

As such, the ATO has indicated that they will instead adopt a 'but for COVID-19' approach to understanding the transfer pricing / financial outcomes of companies which have been impacted by COVID-19. This will place greater emphasis on a budget vs actual comparison at both the income and expense level, an understanding of the wider industry dynamics, and an explanation of how a company has changed its business strategies in light of COVID-19. In light of this, taxpayers should consider collating the following material to support the arm's length nature of their transfer pricing outcomes:

- 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.

Is the ATO's Practical Compliance Guideline PCG 2019/1 still relevant?

The ATO has decided not to review its profit markers for inbound distribution arrangements in PCG 2019/1, in light of COVID-19. This is notwithstanding calls from the market to acknowledge this as an issue, and potentially 'suspend' PCG 2019/1 in the short term to alleviate taxpayers' compliance burden.

What this will likely mean is many taxpayers who have been adversely impacted by COVID-19 will be required to self-assess their financial performance against the ATO's historical profit markers, which may not reflect the COVID-19 reality. This will result in adversely impacted taxpayers being forced to assess themselves – e.g. for Reportable Tax Positions Schedule purposes – in the ATO's amber (medium risk) or red (high risk) zones against the historical profit markers.

What are the impacts on Advance Pricing Arrangements?

The ATO is liaising with taxpayers that have an Advance Pricing Arrangement (APA) in place or are negotiating an APA, to discuss the impacts of COVID-19 on the APA's terms and conditions, including critical assumptions.

The ATO is encouraging taxpayers that believe a critical assumption in their APA has been breached, or is likely to be breached, to proactively engage with the ATO. If a critical assumption has been breached, there are a few likely outcomes:

- The APA continues after discussion with the ATO
- The APA terms and conditions are renegotiated / modified
- The APA is suspended or terminated.

For taxpayers currently negotiating an APA, the ATO assures taxpayers they will honour their commitment to work on the APA application under the standard APA processes and analyses. Essentially, the ATO is open for business. If the business is significantly affected by COVID-19, the ATO mentioned that it may be difficult to progress the APA application without objective evidence of any impact experienced or high uncertainty around potential outcomes.

We encourage taxpayers with APAs in place to carefully consider how COVID-19 has impacted on their APA, including whether a breach of a critical assumption has occurred, and to engage with the ATO.

Should you change your related party contracts in light of COVID-19?

The COVID-19 crisis has impacted many industries in a severe way, and companies are adapting their business arrangements – including legal contracts with other market participants – to manage these impacts and protect their commercial interests. From a transfer pricing perspective, whilst it may be appropriate arm's length behaviour to change intercompany arrangements and contracts, in light of ATO comments below, we recommend that careful consideration and commercial evidence be gathered before any such changes are made.

The ATO guidance includes several examples of potential changes to related party arrangements, which in the ATO's view may produce tax benefit / withholding tax advantages or involve the contractual movement of risk and global losses, etc.

The ATO says that it will review changes made to related party arrangements in the COVID-19 environment to assess whether:

- Independent parties dealing wholly independently in comparable circumstances would have mutually agreed to change the existing related party agreements or arrangements.
- Independent parties dealing wholly independently in comparable circumstances would have entered into the terms or conditions of the new related party agreements or arrangements. For example, if the new contracts or arrangements produced detriments or limited benefits for the taxpayer.
- There is a mismatch between the substance of the actual dealings or relations, and changes made to related party agreements or arrangements.
- A purpose of the changes to the agreements or arrangements was to obtain an Australian tax benefit or a diverted profits tax benefit relevant to considering application of Part IVA of the *Income Tax Assessment Act 1936* or other anti-avoidance rules.
- The changes to the related party agreements or arrangements and the commercial justification developed in anticipation of a potential review by us, originated with a tax adviser.

Practically, if the related party transaction changed, or the services are no longer provided by an affiliate, or the commercial facts and circumstances changed, a modification to the intercompany agreement would be warranted. For a specific example, loan agreements with IBOR base rates must be amended to address the relevant fall-back language for new alternative reference rates due to IBOR reform before the end of 2020.

Key takeaways

Many taxpayers' transfer pricing policies will not have contemplated the economic stresses of COVID-19. However, these stresses are forcing multinationals to re-examine their global supply chains and whether historical transfer pricing policies remain appropriate. To the extent that adjustments are made – which will certainly happen given the enormity of COVID-19 impacts on certain industries and taxpayers – the above ATO guidance should be carefully considered and taken into account when assessing the COVID-19 impacts on your transfer pricing policies and intra-group arrangements, including intercompany agreements.

It is likely that the ATO will risk assess, review and audit the financial outcomes of multinational companies impacted over the COVID -19 period in the coming 12 to 24 months. We accordingly recommend that you gather contemporaneous information, market evidence, and commercial documents as events and decisions unfold over the course of 2020, which can be used to explain and describe the financial and operational impacts of COVID-19 on your business.

Contacts



Stan Hales
Partner
Tel: +61 447 007 929
sthales@deloitte.com.au



Geoff Gill
Partner
Tel: +61 2 9322 5358
gegill@deloitte.com.au



Ockie Olivier
Partner
Tel: +61 8 9365 7158
oolivier@deloitte.com.au



Cam Smith
Partner
Tel: +61 3 9671 7440
camsmith@deloitte.com.au



Soulla McFall
Partner
Tel: +61 3 9671 7814
smcfall@deloitte.com.au



Christopher Thomas
Principal
Tel: +61 2 8260 4539
chrisjthomas@deloitte.com.au

This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively the "Deloitte Network") is, by means of this publication, rendering professional advice or services.

Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/au/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte has in the region of 244,000 professionals, all committed to becoming the standard of excellence.

About Deloitte Australia

In Australia, the member firm is the Australian partnership of Deloitte Touche Tohmatsu. As one of Australia's leading professional services firms, Deloitte Touche Tohmatsu and its affiliates provide audit, tax, consulting, and financial advisory services through approximately 7,000 people across the country. Focused on the creation of value and growth, and known as an employer of choice for innovative human resources programs, we are dedicated to helping our clients and our people excel. For more information, please visit Deloitte's web site at www.deloitte.com.au.

Liability limited by a scheme approved under Professional Standards Legislation.

Member of Deloitte Touche Tohmatsu Limited

© 2020 Deloitte Touche Tohmatsu.