Executive summary

COVID-19 has created a spell of disruptions and changes that have left practically no facet of business untouched. The impact of the pandemic has extended to multinational corporations and their entities across the globe, including India. In this context of COVID-19, we are pleased to present our thought leadership publication on determination of arm's length margins. The pandemic has unsettled the normal price-setting mechanism that is predominantly based on historic (multiple year) data, thereby calling for a forward-looking approach to set transfer price amongst associated enterprises in a multinational group. **This paper sets out the framework for an advance determination of transfer prices using a multi-pronged approach of predictive modelling, quarterly trends, and adjustments to costs.** This paper is divided into three parts:

Part 1 examines the relevance of the ex-ante (i.e., proposed) price setting analysis during the COVID-19 period. It also covers guidance from Indian regulations, OECD, and the UN, and explains how to determine transfer prices using regression analysis and corroborating it with quarterly data pertaining to the COVID-19 period. It is the why, how, and now.

Part 2 considers the adoption of the ex-ante analysis for transfer pricing documentation purposes. It suggests how the basis of price setting could be used to demonstrate adherence to the arm's length standard. It simultaneously recommends making adjustments to the tested party for items of exceptional costs or revenues, supported by judicial precedents. It is the what is to be.

Part 3 shares the conclusion and provides approaches to audit defence and key recommendations for the ex-ante basis to come together.

In this way, the paper attempts to provide a tool kit to key stakeholders to address the determination of transfer prices in an ex-ante, contemporaneous setting, during unusual circumstances (comprising quarterly data analysis, regression analysis, and adjustments to comparables/tested party).

Being the last quarter of the financial year (FY) 2020-21, the next three months are decisive and we are certain that the techniques outlined in this publication (drawn from the legislation in other jurisdictions, jurisprudence in Indian tribunals, transfer pricing guidelines, and economic analyses) would enable Multinational Enterprises (MNEs) to arrive at a reasonable understanding of the comparable companies' trends. This would allow them to take conscious decisions on their transfer pricing positions and changes, if required. A key question arises pertaining to the timing of an ex-ante analysis. In our view, the analysis has to be performed concurrently with the transaction and should be implemented at the same time, without having to wait for results to come in post-facto. Specifically, the regression analysis, which predicts the margins of comparable companies based on an independent variable, is a trend-setting exercise that requires to be adopted and factored in to the transfer pricing reset exercise without delay and before the end of the FY 2020-21. This is because the exercise helps taxpayers in discharging their obligation to demonstrate a contemporaneous attempt to set their transfer prices.

Indian transfer pricing regulations, and for that matter global guidelines, have been developed without a direct reference point or experience of such a pandemic. However, regulations and guidelines did keep the door open on the possibility of using budgets and forecasts, and laid emphasis on the adoption of contemporaneous documentation. The ex-ante application of the TP guidelines will be put to test for the COVID-19 period. We believe that this paper will serve to enable multinational corporations to plan their transfer pricing policies and defend their approaches on various forums.

Illustrative framework for COVID-19 TP analysis

01
Determine variances in operations and the financial impact thereof at the entity/transaction level.

02
Identify group impact of the pandemic on revenue and credit flows.

03
Assess impact on current TP arrangements and benchmarking strategy to assess if any changes are required.

04
Prepare a robust ex-ante analysis to determine the expected arm's length range for FY ending March 2021.

05
Undertake an analysis of the quarterly data to comprehend contemporaneous financial performance trends, to arrive at an arm's length range.

06
Determine exceptional costs that would otherwise not have been incurred but for COVID-19 situations, that could call for adjustment.

07
Make economic adjustments to the operating results of the tested party or the comparable companies.

08
Consider undertaking an estimate of the margins of comparable companies by applying statically robust regression models.

09
Establish the arm's length range to determine any updates to the transfer prices for FY 2020-21.

10
Put in place intercompany agreements or addendum to reflect the ex-ante change in transfer prices,if any.

11
Document the ex-ante analysis in the annual TP report.

Taking a cue from the OECD TP Guidelines on documentation, the ex-ante arm's length analysis during COVID-19 is time-sensitive. Hence, taxpayers should be aware that the aforesaid framework needs to be put in place by the end of the current FY, i.e., 31 March 2021 to reflect good faith and due diligence. We hope that you find this paper useful and timely, and would be pleased to receive your comments.