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The unique and large-scale disruptions to the economic environment caused by COVID-19 have severely affected revenues and profits across industry sectors and businesses. Sudden disruptions in supply chains have forced businesses to scale down their operations with a consequent fall in production volumes. Cash flow constraints caused by lower sales and recoveries have led to new business strategies aimed at conserving cash and resources and even re-negotiation of agreements. Changes in consumption behaviour, partly necessitated by government restrictions, have resulted in the collapse of demand for several types of goods and services. These and other disruptions have posed unprecedented challenges for businesses and the industry. In the context of multinational enterprises, an additional major challenge is benchmarking intra-group transactions to set transfer prices.

Ordinarily, under the arm's length approach and particularly while using the Transactional Net Margin Method (TNMM), prices are set on the basis of historical data of margins earned by comparable enterprises operating in comparable circumstances. The assumption made is that of a certain degree of stability and continuity in business operations and in the economy at large, which would enable a reasonable estimation of the arm's length margins for the current and ongoing period based on the historical data. This critical assumption has been negated by the COVID-19 pandemic, making it difficult for enterprises to continue with these traditional ways of establishing transfer prices. The problem is especially acute for enterprises operating in India, given the emphasis in the Indian transfer pricing regulations on use of contemporaneous data in the comparability and benchmarking analysis.

It could be argued that the arm's length standard represents a principled approach to establishing transfer prices and the existing guidance, including the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines (OECD TP Guidelines), The United Nations Practical Manual on Transfer Pricing (UN TP Manual) and the Toolkits for developing countries brought out by the Platform for Collaboration on Tax, should prove to be equally effective in dealing with the COVID-19 situation. It is gathered that the OECD is, in fact, coming out shortly with a report on how the existing OECD TP Guidelines can be applied to the new fact patterns to effectively meet the practical challenges posed by the pandemic. However, considering the variety of different and often unique COVID-19-impacts encountered by businesses in India, together with the relatively high level of specificity contained in the Indian TP regulations, this existing guidance may have limited utility in enabling adequate compliance.

This paper prepared by Deloitte is a refreshing and honest attempt to find solutions to the COVID-19-induced benchmarking challenge in the Indian context. It examines the extent to which the existing guidance can provide answers, stressing on the need to maintain extensive documentation in regard to the factual matrix, the new and additional risks assumed, and the assumptions made while fixing transfer prices. It looks into the availability of contemporaneous data in the form of corporate quarterly reports and analyses; the trends noticed in different industry sectors during the current year; and their adequacy and usefulness in making ex-ante pricing analyses. While acknowledging that such contemporaneous data is available only for a limited number of large and listed companies, the paper suggests that certain economic adjustments could still be made to historical data of comparables on the basis of the current-year trends observed. Further, an analysis is made of exceptional or abnormal costs arising due to COVID-19 and how they could be dealt with to enable comparison using historical data. There is an interesting suggestion on adjusting the profit margin of the tested party itself by eliminating the impact of COVID-19-induced exceptional or abnormal items, and then benchmarking the adjusted profit against historical data of comparables. The suggestion, together with other suggestions on using a term-testing approach or the full range of arm's length price (ALP) (instead of the prescribed inter-quartile range), may not be strictly in conformity with the rules but can nevertheless be helpful in validating transfer prices established otherwise.

Finally and most importantly, the paper lays out an alternate analytical framework that uses econometric tools to analyse relationships between company-level parameters (such as profit margins) and macroeconomic indicators (such as Gross Domestic Product (GDP) growth rates). These relationships ascertained and validated for different industry sectors can then be used to predict profit margins of specific companies in those sectors on the basis of observed changes in the macroeconomic parameters over the relevant periods. This approach to transfer pricing using econometrics deserves serious consideration, not just because it offers an alternate and reasonable way of setting intra-group prices in a year impacted by a pandemic, but mainly because it has the potential to considerably reduce the inherent subjectivity in transfer pricing that is the root cause of massive litigation and increased tax-uncertainty.

Globally, transfer pricing is recognised as a major contributor to the generation of tax disputes and consequent litigations, along with being a subject of a very large number of double taxation issues awaiting resolution under bilateral tax treaties. This is especially true for developing and emerging economies, such as India, for whom transfer pricing represents the principal way of preserving and protecting the tax base, given the decided tilt of the prevailing international tax rules in favour of capital and technology exporting countries. At the same time, the emergence of new business models with their heavy reliance on digital technology and hard-to-value intangibles has shown up the inherent limitations of the arm's length principle, leading to even greater subjectivity in its application. Countries across the world are increasingly seeking standardised and formulaic solutions to complex issues of profit allocation, as can be seen from the recently published OECD report on the Pillar 1 Blueprint to meet the tax challenges of the digitalised global economy. Ongoing multilateral discussions on enhancing the efficacy of the mutual agreement procedure under tax treaties in resolving transfer pricing disputes and concluding Advance Pricing Agreements (APAs) are also exploring the use of mathematical and statistical approaches in setting objective benchmarks.

The Indian tax administration itself has not been averse to resolving transfer pricing issues through mathematical and statistical analysis. Just a few years ago, hundreds of transfer pricing disputes with the The United States of America (US) were resolved on the basis of a formula-based framework. There have also been several instances of constructive use of statistical tools, such as regression analysis, in negotiating APAs.

The global and domestic contexts are thus conducive to adopting novel approaches, including those based on econometrics as suggested in this paper for the ex-ante setting of intra-group transfer prices (particularly in the absence of adequate contemporaneous data of independent enterprises). I congratulate the Deloitte team for their innovative thinking and hard work to put together this paper – "The impact of COVID-19 on transfer pricing analysis" – and commend it to businesses and tax authorities for consideration and acceptance.