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COVID-19 response
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Transfer pricing considerations in light of COVID-19

The catastrophic impact of the COVID-19 pandemic will be far reaching, and the serious implications for many multinational groups' transfer prices, analysis and documentation is yet another thing to consider. We have outlined below some key areas that should be actively managed and monitored from a transfer pricing perspective while businesses deal the operational impacts of COVID-19.

Existing transfer pricing policies will be put under pressure with any economic downturn. One element of this is that any adversely affected companies will be required in the future to explain low operating profits or losses to tax authorities for both the current, and coming years. It may be prudent to model the impact of COVID-19 on operating results now and over the next couple of months, to help demonstrate in the future the commercial rationale for changes in transfer pricing and other planning decisions, and ultimately show that low profits or losses were not the result of non-arm's length transfer pricing policies.

Transfer pricing models may need to be adjusted to come in line with any commercially driven changes made to the global supply chain, and to ensure they reflect any re-allocation of functions, assets and risks across the group. Companies will have to review whether the actual conditions experienced are synonymous with previous transfer pricing policies, and legal agreements become critical (and may need to change) to show actual versus economic allocation of functions, assets and risks.

As things transpire there will be a number of aspects to think about, but as a starting point some of the changes that may arise, include:

- **Travel restrictions** that result in inadvertent changes to service arrangements and other functional profiles. Existing cross border related party service arrangements and support needed may change based on movements in focus and supply chain.

- Similarly, **temporary relocation of business functions** to limit the spread of COVID-19 may impact the company's functional profile and transfer pricing policies will need to be tweaked accordingly.

- **Existing funding arrangements could be restructured**, or interest rates re-priced and adjusted in line with the central bank/other third party interest rates being lowered which could help free up cash flow.

- **Intra-group goods** could be transferred at cost temporarily to reduce potential losses in offshore distributors and reduce cash transfers and customs duties. Judgements on profit allocations would need to be commercially justified, and made before year-end.

- There may be **IP/brand impacts** that could change the arm's length amount of royalties due. It may be appropriate to put **royalty payments** on hold temporarily.

- Some additional **services** from a head office entity provided during the pandemic may not pass the **benefit test** in the service recipient's jurisdiction. In this case, they may be considered akin to shareholder services and potentially shouldn't be on-charged as no deduction would ultimately be provided in the recipients' jurisdiction.

New or increased **cross border financial support** may be required during this period. These arrangements will need to result in an arm's length outcome (arm's length rates of interest charged) for the associated parties involved. In addition, many jurisdictions have interest and debt limitation rules that will need to be considered and of course withholding taxes.

In future, it may become more difficult to support returns in instances where **comparables are in loss making positions**, i.e. if pricing is carried out under transfer pricing policies already in existence before the COVID-19 pandemic. Publicly available data for comparables is not available in real time so there will also be a time lag in testing and supporting positions taken.

Consideration should be given as to whether a **loss split model** might be appropriate in the current economic climate if the facts and circumstances allow. However, while a loss split model might be an option in some fact patterns, head offices looking to pass along some of those losses should be cautious if those associated parties have been categorised as routine or low risk entities under previous transfer pricing analysis, as this will be difficult to support without substantive changes to the subsidiaries' functional profiles.

Should routine service providers bear some of the group's losses?

A range of questions need to be considered in answering this question:

- Did the associated party record increased profits during profitable years?

- Are such losses consistent with the function, asset and risk profile of the associated party?

- Is there a justified commercial reason that allows the associated party to record a reduced level of profit (versus previous years) in the current environment?

- Should associated parties renegotiate their arrangements as third parties may be doing in the current environment?

The pandemic could potentially impact current **Advanced Pricing Agreements (APA) negotiations, as the effect of the pandemic on the economy is uncertain, and conceivably** independent

comparables could be in loss making positions over the next few years. Agreeing appropriately wide critical assumptions will be key to managing the ultimate impact.

There is the potential for **current APA** terms to be breached as a result of the impacts of the epidemic. Helpfully, Inland Revenue (IR) has confirmed the following with respect to APAs currently in place:

- IR input or permission is not required where you make a business decision that results in an APA breach.
- If an APA breach occurs, you should advise IR in the Annual Compliance Report (ACR).
- When reviewing an APA breach disclosed in the ACR, IR will have regard to the exceptional circumstances faced by the business and IR anticipate that there will be some circumstances where the arm's length outcome during the COVID-19 pandemic may differ from that agreed in the APA.

So, what should you do to prepare?

Consider if your current transfer pricing policies remain appropriate given the changes within your business and the new economic environment.

Documentation is critical to evidence why it is appropriate to maintain the same transfer pricing policies or move away from them. In particular, the following should be considered and supported:

- Any restrictions on movements of people/product;
- The impacts of COVID-19 on productivity/ any drop in services being provided;
- The impact of COVID-19 on profitability across the multinational group and how this is being distributed;
- How risk is assigned across the group and any changes made in this area;
- How any restructuring costs/amortisation are treated during this time;
- Changes to arrangements need to be supported by changes to legal agreements; and
- Consideration of the impacts on any existing APA.

Considering these implications upfront, and collecting evidence now to prepare contemporaneous documentation to support the change in economic circumstances, will be critical.

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