

Emerging TP adjustments in light of COVID-19: A practical standpoint

Carlo L Navarro, Vrushang Sheth, and Rishi Mehrotra of Deloitte discuss why it has become even more critical for taxpayers to be prepared to explain and defend their TP positions.

The unprecedented changes in the economic environment following the outbreak of the COVID-19 pandemic have resulted in multiple challenges for multinational enterprises (MNEs) and tax administrations.

These challenges involved government-imposed restrictions leading to decreased demand and disruptions in the global supply chain, among others. Accordingly, many businesses have suffered losses due to the operational and market pressures arising from the pandemic. This poor performance of the taxpayers had the knock-on effect of intensifying the actions of tax administrations to ensure that such losses are not attributable to TP policies adopted by the MNEs.

The OECD published the guidance on the TP implications of the COVID-19 pandemic (Guidance) on December 18 2020, which outlines mutually satisfactory solutions to address pandemic-induced TP issues and illustrations on the practical application of the arm's-length principle considering the pandemic.

Even though the Guidance contained the typical approaches, none of the countries in Southeast Asia, except for Singapore, have endeavoured to provide local guidance, which would be more practical for taxpayers. In the Philippines, the Guidance is perceived as the starting point for navigating through the effects of the COVID-19 pandemic on transfer prices.

At this point in the pandemic, it has become even more critical for taxpayers to be prepared to explain and defend their TP positions. Assessing relevant controlled transactions by evaluating the impact of contractual arrangements, delineation of functions, assets and risks, and determining where appropriate and reliable adjustments are to be performed will be beneficial in ascertaining adherence to the arm's-length standard.

Practical application of the Guidance

The Guidance provides data sources that may be used in evaluating the impact of COVID-19 on the performance of business operations and related party dealings. These include, among others, sales volume, capacity utilisation, exceptional or extraordinary costs, and forecasted versus actual data.

Given the varied impact of the pandemic across industries, coupled with concerns about the availability of data, taxpayers may consider adjustments (e.g., based on statistical analyses, econometric tools, or use of multiple-year data) to comparable companies' results or to tested party results to improve the reliability of TP analyses and to support the intragroup pricing arrangements. Through the application of the most appropriate approach, MNEs would be able to approximate their financial outcome had such an extraordinary circumstance not occurred, thereby, providing a clearer estimate of the true impact on MNE's transfer price.

It is worth emphasising that there is no one-size-fits-all adjustment applicable to and appropriate for all MNEs. Each option should be reviewed and considered on a case-to-case basis. Reliable documentation supporting the comparability adjustments to the financial results of the tested party and/or comparable companies must be maintained.

Heightened business risks

Business risks, particularly operational and market risks, materialised due to the pandemic. From a TP standpoint, it is essential to look at the allocation of risks based on the contractual agreement(s) between the related parties and to evaluate whether the tested party had the actual operational capacity and capability to bear such risks.

The allocation of operational or exceptional costs arising from COVID-19 would follow risk assumption and how third parties would treat such costs. To determine which entity should bear such operational or exceptional costs, it is first necessary to accurately delineate the controlled transaction. This will involve identifying who has the responsibility for performing activities and has control over the associated risks in relation to the costs arising from the COVID-19 pandemic.

From a practical view, taxpayers may explore adjustments that involve considering the effects of the COVID-19 pandemic on the financial results of the tested party and/or comparable companies and exclude these to arrive at a level that would have been reached had COVID-19 not occurred (e.g., analysing budgeted or forecasted data versus actual data, isolation of extraordinary and non-recurring costs incurred due to and in relation to the pandemic, etc.), subject to the availability of data.

Potential adjustments to address business risks may be executed in the form of economic adjustments, such as capacity utilisation adjustments. Capacity utilisation adjustments involve calculating the imputed cost incurred by the



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Carlo has over 20 years of experience as an International Tax and TP practitioner, giving him practical experiences in dealing with tax authorities in these countries. His clients come from diverse industries such as power, mining, telecommunications, financial services, manufacturing, distribution, and business process outsourcing, among others.

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MNE from underutilisation and excluding the same from the financial results of the MNE to arrive at the financial outcome had the utilisation of the capacity of the MNE remained unaffected by the pandemic. The imputed cost may be calculated by comparing the utilisation rates prior to and during the COVID-19 pandemic.

Operational risk: Operational disruptions

As part of the world's collective effort to contain the COVID-19 virus, many MNEs could not operate at their optimal capacity due to major shifts in their operations. These operational disruptions may have been caused by government-imposed restrictions on workforce capacity, implementation of physical social distancing measures, and other similar arrangements that attempted to address the

global health crisis. As a result, MNEs were left with a significantly reduced labor force, which led to underutilisation of their capacity and, ultimately, a decrease in revenue.

These heightened operational challenges have thrown MNEs into a confusion as to how to identify which entity should bear the costs or losses incurred due to the COVID-19 pandemic. The allocation of COVID-related costs and/or losses follows the concept of exercise of control over risks and it entails going back to the basics to determine the characterisation of each entity in the value chain.

For example, as a result of COVID-19, there was a significant decrease in employee productivity due to movement restrictions imposed by the government and the environment brought about by the work-from-home arrangement of MNEs.

Certainly, the magnitude of the drop of employee productivity at the time of a pandemic could not have been fully anticipated. Therefore, the entity that assumes the responsibility for performing activities and for bearing the associated risks that ensure employee productivity will have to assume the costs and/or losses resulting from the materialised operational risks.

As part of this approach, it must be rationalised why a certain entity should bear losses. It must be proved that such entity bears the risks that materialised during the pandemic and therefore should bear the associated losses.

Market risk: Decline in demand

Decline in demand is a manifestation of market risks that materialised during the pandemic. Similarly, costs attributable to market risks arising from COVID-19 should be allocated to the entity responsible for performing the relevant functions and managing related risks. Market risks, like demand drops, are primarily associated with the sales and marketing functions. Accordingly, the entity performing these functions and assuming such risks should be liable for losses caused by the decline in demand, which resulted from COVID-19.

To illustrate, if the Principal entity has the responsibility over sales and marketing functions as well as associated risks, any losses sustained due to its inability to undertake these functions and to manage market risks should be assumed by the Principal. Any unabsorbed variable and fixed costs will have to be charged to the Principal. However, if such unabsorbed variable costs were incurred due to the inefficiencies of any of its operating entities, these should be allocated to these entities to the extent of their functional responsibility and risk association.

Special considerations for limited risk arrangements

One of the most important TP concerns was the impact of the pandemic on the financial performance of limited risk entities (LREs), which are expected to earn routine or steady returns. There is a growing concern about whether LREs



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Vrushang has assisted clients in setting up and implementing unique TP policies in addition to preparing TP documentation. He also has extensive experience in TP litigation and devising various audit defense strategies for clients. His recent assignments have involved regional documentation for some of the major players in Deloitte's priority sectors, as well as preparing TP documentation for various conglomerates.

can incur losses due to the pandemic. This is even more critical in jurisdictions such as the Philippines where many foreign MNEs have limited risk service providers or contract manufacturers (CMs).

To illustrate, in a contract manufacturing arrangement, the Principal forecasts a certain number of units for the year, and the CM produces the number of units that the Principal determines. Due to COVID-19, there may be a decrease in the market demand for the Principal's products resulting in a decrease in the CM's sales.

Moreover, due to government lockdowns, it is also possible that the CM may fail to meet the production target. In this case, both market and operational risks are at play, and thus the underutilised costs must be allocated to both risks. Since the Principal bears market risks, a portion of the underutilised costs attributable to market risk must be charged to the Principal. Similarly, the CM must bear the underutilised costs attributable to operational risk for its failure to meet production targets.



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Rishi Mehrotra assisted clients with undertaking OECD BEPS Action Plan 13 compliances including detailed risk assessment of pertinent TP information and potential impact of the new OECD BEPS Action regime with respect to their area of business. This included formulation of advice on international tax and business expansion and restructuring.

Rishi has worked on global TP documentation assignments involving preparation of documentation for major multinational clients in various jurisdictions like US, UK, Canada and Singapore.

Limited risk, although commonly used in a TP setting, is not specifically defined by the OECD. The functions performed, assets employed, and risks assumed by LREs may vary from one LRE to another. Considering this, along with the emerging argument that LREs can suffer losses because they assume risks that materialised during the pandemic, it is not possible to establish a general rule that entities described as limited risk should or should not incur losses. It is necessary to consider the facts and circumstances when determining whether an LRE could incur losses.

Significance of intercompany agreements

As much as TP documentations and policies substantiate the arm's-length nature of intercompany transactions, these are not legally binding. Agreements must be implemented to formalise TP arrangements in legally enforceable contracts. These will serve as the first line of defense in case of an audit as tax authorities normally request copies of intercompany agreements.

As intercompany agreements have always remained a significant aspect of TP compliance, it should accommodate the unprecedented changes that arose from the COVID-19 pandemic. However, intercompany agreements often implicitly assume normal operations, and may have not taken into consideration any business disruptions.

Intercompany agreements may need to be revisited to align with any economic and commercial changes in the global supply chain and business environment, and to ensure that they reflect any re-allocation of functions, assets, and risks across their respective MNE group to mitigate the economic effects of the COVID-19 pandemic. This would involve determining whether a renegotiation of a commercial arrangement represents the best interests of the parties to a transaction, which requires consideration of the realistically available options and the long-term effects on transfer prices.

It stands that revisions to existing intercompany agreements should ensure the alignment of the form and substance of the intragroup arrangements. It is crucial for taxpayers to defend these renegotiated terms as compliant to the arm's-length principle. Tax administrations are expected to review the agreements and/or the conduct of related parties together with observations of relevant behavior of independent parties. In the absence of clear evidence that independent parties in comparable circumstances would have revised their existing agreements or commercial relations, the modification of existing intercompany arrangements and/or the commercial relationships of related parties may be deemed inconsistent with the arm's-length principle.

Taxpayers' defense

Companies are encouraged to document how, and to what extent, their operations were affected by the pandemic. In particular, taxpayers should take into consideration the following, among others:

- Any restrictions on movements of people and/or products;
- Impact of COVID-19 on productivity and/or utilisation;
- Impact of COVID-19 on profitability across MNE groups and how this is being allocated;
- How risk is assigned across MNE and any changes made in the allocation of functions, risks, and assets; and
- Changes to arrangements need to be supported by amendments to legal agreements.

These should be kept in mind as taxpayers prepare their contemporaneous TP documentations. A defense that reasonably evaluates the effects of COVID-19 will help both MNEs and tax administrations in addressing the unique circumstances surrounding the pandemic.

The post-pandemic business environment will likely force taxpayers to review existing policies and evaluate their appropriateness given the unprecedented changes brought about by the pandemic. Taxpayers may consider revising certain terms in their existing agreements and/or their conduct in their commercial relationships.

In view of this, defenses that might support revisions to existing intercompany agreements or, in some cases, relinquishment of contractual obligations may be considered.

Force majeure clause is one of the clauses on which a party to a contract may seek to suspend or terminate the performance of its obligations.

Way forward

The pandemic has created aberrant circumstances that need to be considered in ascertaining compliance to the arm's-length standard. A perfunctory application of the normal rules during these unique times can lead to disruptive results. The Guidance serves as a reliable antecedent in determining the most appropriate and sustainable approach to TP in the context of COVID-19.

MNEs are advised to be vigilant by ensuring that their intercompany dealings remain compliant with TP rules in light of COVID-19. In parallel, it is imperative for MNEs to be prepared to defend their TP positions for contemporaneous compliance and in the event of an audit. Having robust and audit-ready TP documentation, including strong supporting evidence, is key to handling potential risk exposures. In the same vein, it is highly likely that MNEs would need to re-evaluate their pre-pandemic allocation of functions, risks, and assets with respect to their related party arrangements in order to adapt to the post-pandemic business environment.