

# Answering Eight Key Questions about Transfer Pricing during the COVID-19 Era

**This article analyses the impact of the COVID-19 crisis on transfer pricing matters in the form of eight key questions. Several practical examples are discussed throughout the article to make the discussions more concrete. The analysis also takes into account the OECD's recent guidance on this topic.**

## 1. Introduction

Economies, markets and, in particular, multinational enterprise (MNE) groups, have been drastically affected by the COVID-19 crisis. In this regard, the COVID-19 era has triggered an unprecedented moment of crisis with a high degree of uncertainty.

Some of the negative consequences of the crisis include a decrease in consumer demand, interruptions in supply chains and uncertainty and volatility, among others, all of which can be seen reflected in financial markets.

Although it is true that the COVID-19 crisis has impacted the global economy, not all countries and economic sectors have been affected equally. In particular, certain economic sectors (e.g. pharmaceutical, medical or technological services) have not been impacted as negatively as other sectors, and some have even experienced growth during the COVID-19 era.<sup>1,2</sup> Likewise, some countries that have not had as many numbers of confirmed infections have been able to avoid implementing drastic restrictive measures, such as partial or total lockdowns.

Given these circumstances, MNE groups have been forced to implement both organizational changes, to ensure the viability of their business, and changes in their intangible and financing policy among others.

Likewise, the COVID-19 crisis has impacted some unique aspects of transfer pricing that must be properly analysed by the MNEs; among those that stand out are (i) the methodology for preparing benchmarking studies of the financial years affected by the crisis; (ii) the issue of force majeure; (iii) the allocation of extraordinary expenses; or (iv) the impact on both existing advance pricing agreements (APAs) and those currently being negotiated. Also, the potential impact derived from the receipt of COVID-19 government assistance should be analysed.

This article will provide an answer to the main questions related to the challenges that the COVID-19 era poses to transfer pricing. Needless to say, a transfer pricing analysis is a facts-and-circumstances analysis; therefore, a change in the facts will also change the analysis.

## 2. Was the MNE Prepared for the COVID-19 Era? The Issue of Force Majeure and Exceptional/ Extraordinary Costs

The first few measures implemented by MNEs to ensure the continuity of their businesses have mainly been focused on (i) guaranteeing that supply chains are functioning; (ii) reorganizing resources to improve the MNE group's efficiency; and (iii) mitigating risks arising from the COVID-19 crisis.

Implementing such changes may require a modification to the MNE's business model. Consequently, changes to the transfer pricing policy of the MNE group may also be required in light of the new circumstances.<sup>3</sup>

In any event, it is important to note that even if the COVID-19 era has negatively impacted most MNEs, these extraordinary circumstances also provide an opportunity to revise business models and transfer pricing policies.<sup>4</sup>

Regarding changes made to an MNE group's business model, two critical aspects must be considered, namely (i) temporality – in particular, whether these implemented modifications are sporadic and transitory (and will be reviewed at a later date) or if these changes will remain in the long term; and (ii) the applicability of these measures

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1. OECD, *Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic* para. 6. (18 Dec. 2020), available at <https://www.oecd.org/tax/transfer-pricing/guidance-on-the-transfer-pricing-implications-of-the-covid-19-pandemic.htm> (accessed 31 May 2021) [hereinafter *OECD Transfer Pricing Guidance*].  
2. S. Prasanna & G.C. Cardoso, *Developing a Transfer Pricing Policy Framework for the Current Economic Crisis and Beyond*, 27 Intl. Transf. Pricing J. 5 (2020), Journal Articles & Opinion Pieces IBFD.

3. P. Solyali, *The Impact of COVID 19 Crisis on the Transfer Pricing Policies of Multinational Companies*, Nazali Tax & Legal (6 May 2020), available at <https://ceelegalmatters.com/nazali-tax-legal/13473-the-impact-of-covid-19-crisis-on-the-transfer-pricing-policies-of-multinational-companies> (accessed 31 May 2021).

4. M. D'Avossa et al., *INSIGHT: OECD Transfer Pricing Guidelines – A Practical Guide for Applying the Arm's-Length Principle During an Economic Crisis*, Bloomberg Tax (3 Apr. 2020), available at <https://news.bloombergtax.com/transfer-pricing/insight-oecd-transfer-pricing-guidelines-a-practical-guide-for-applying-the-arms-length-principle-during-an-economic-crisis> (accessed 31 May 2021).

– specifically, if these changes will affect all of the MNE group’s entities or only some of them.<sup>5</sup>

Lasting changes implemented in the MNE group’s business model that affect all or most of the group’s companies will most likely require modifications to the transfer pricing policy of the MNE group.

While the circumstances brought on by the pandemic are extraordinary, it is highly advisable that, in the event of modifications to the MNE group’s business model, the relevant changes are applied globally, if possible, as it is important to maintain consistency in the group’s transfer pricing policy.<sup>6</sup>

The main problem that MNEs will face upon implementing these changes to their business model consists of determining the arm’s length conditions regarding (i) the new intercompany transactions that will be carried out; or (ii) the intercompany transactions that the MNE group was carrying out until now but that will be changed in order to adapt them to the current market circumstances. This is due to the comparability crisis that the COVID-19 crisis has created since comparability is based on past experiences, and the circumstances associated with the COVID-19 crisis are quite exceptional.

In this sense, although the OECD Guidelines do not contain any specific rules for analysing related-party transactions in a scenario with such a high degree of uncertainty as the current one,<sup>7</sup> paragraph 3.72 of such Guidelines establishes the following:

The question arises whether and if so how to take account in the transfer pricing analysis of future events that were unpredictable at the time of the testing of a controlled transaction, in particular where valuation at that time was highly uncertain. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.<sup>8</sup>

Provided that the root of the arm’s length principle consists of analysing the behaviour of unrelated parties and applying those same principles to related-party transactions, the way in which unrelated parties behave in the current context must also be considered in light of the current extraordinary circumstances.

Usually, in these circumstances, the first action unrelated parties take is reviewing the terms of their contracts to determine if there is a possibility to revise these agreements, in accordance with the contents therein. In this

regard, many agreements contain force majeure clauses<sup>9</sup> referring to unexpected events that develop beyond the control of the parties and that cannot be prevented by them (e.g. war, terrorist act, earthquake or epidemic illness) and, therefore, that restrain contracting parties from fulfilling their obligations. In force majeure events, the parties’ obligations may be suspended, postponed or eliminated completely.<sup>10,11</sup>

Nevertheless, even if the agreement contains force majeure clauses, it cannot be automatically assumed that the COVID-19 pandemic is sufficient to invoke these clauses.<sup>12</sup> For example, assume that a contract manufacturer had been providing manufacturing services to its related principal for the past 5 years under a long-term agreement. In 2020, due to the lockdown, the production facilities were closed for 3 months. In this case, it would be unlikely that the principal or the manufacturer would invoke a force majeure clause even if they were entitled to do so under the local law given that the facilities were closed for 3 months.

Likewise, while it is true that including these types of clauses in intercompany agreements<sup>13</sup> is highly recommended, the absence of such clauses does not impede related parties from negotiating their agreements in the same way that unrelated parties would.<sup>14</sup>

In this sense, paragraph 6.184 of the OECD Guidelines establishes that “the occurrence of major events or developments unforeseen by the parties at the time of the transaction [...] which change the fundamental assumptions upon which the pricing was determined may lead to renegotiation of the pricing arrangements by agreement of the parties.”<sup>15</sup>

In conclusion, given that unrelated third parties would try to revise their agreements under these extraordinary circumstances, it follows that related entities would attempt to take similar actions<sup>16</sup> and try to (i) renegotiate and modify their intercompany agreements to incorporate clauses for allocation of losses; (ii) reduce agreed margins; and (iii) include margins based on the current market situation.

In negotiations conducted between unrelated parties, demonstrating the need for these proposed modifications and preparing certain documentation (which is essential for negotiations between the parties) are particularly important. In this sense, the revised financial projections

5. J. González, A. Insausti & R. Poza, *Multinacionales frente a la Crisis COVID-19: Perspectiva Fiscal de la Reestructuración de los Modelos de Negocio*, PwC (13 May 2020), available at <https://periscopiofiscalyalegal.pwc.es/webcast-multinacionales-frente-a-la-crisis-perspectiva-fiscal-de-la-reestructuracion-de-los-modelos-de-negocio/> (accessed 31 May 2021).

6. D’Avossa et al., *supra* n. 4.

7. E. Holzmillner, C. Cantaluppi & C. Mazzoleni, *Transfer Pricing and COVID-19: Practical Issues and Possible Approaches*, Baker Tilly (May 2020), available at <https://www.bakertilly.global/media/7679/transfer-pricing-baker-tilly-italy-tax-position-paper.pdf> (accessed 31 May 2021).

8. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 3.72 (OECD 2017), Primary Sources IBFD [hereinafter *OECD Guidelines*].

9. *OECD Transfer Pricing Guidance*, *supra* n. 1, at para. 37.

10. B. Arthur et al., *INSIGHT: Contemplating Force Majeure and Other Contractual Considerations in Intercompany Agreements*, Bloomberg Tax (10 Apr. 2020), available at <https://news.bloombergtax.com/transfer-pricing/insight-contemplating-force-majeure-and-other-contractual-considerations-in-intercompany-agreements> (accessed 31 May 2021).

11. *OECD Transfer Pricing Guidance*, *supra* n. 1, at para. 55.

12. *Id.*, at paras. 57 and 58.

13. R. Davis et al., *COVID-19: Implications and Considerations for Transfer Pricing*, KPMG (9 Apr. 2020), available at <https://home.kpmg/content/dam/kpmg/ca/pdf/tnf/2020/ca-covid-19-implications-and-consideration-for-transfer-pricing.pdf> (accessed 31 May 2021).

14. *OECD Transfer Pricing Guidance*, *supra* n. 1, at paras. 57 and 59.

15. *OECD Guidelines*, *supra* n. 8, at para. 6.184.

16. *OECD Transfer Pricing Guidance*, *supra* n. 1, at para. 42.

of the parties can be discussed, as well as the quantification of the impact of the crisis. Furthermore, if applicable, a detailed and quantifiable repayment schedule should also be settled. This documentation must also be prepared during renegotiations of the contracts between related parties.

It should also be noted that being able to prove that renegotiation is the best realistic alternative for related parties<sup>17</sup> infers a strong argument to defend that the renegotiation would have been carried out between independent parties, as only under these circumstances would unrelated parties have agreed to renegotiate.<sup>18</sup> Therefore, an entity that has been greatly affected by the economic downturn would only participate in a renegotiation or termination of an intercompany agreement if the entity strived to minimize its anticipated losses through such renegotiation.<sup>19</sup>

Contemporaneous preparation of transfer pricing documentation, including details of implemented changes, will be extremely important in the near future.<sup>20</sup> Such documentation must contain a summary of the implications of the COVID-19 crisis for the MNE group, audit trails of decision-making and the tax and transfer pricing analyses that were performed. The preparation of this documentation can save both time and effort in the event of a future tax audit.

It may also be useful (in the future) to incorporate, within the transfer pricing documentation, an industry analysis documenting the challenges arising from the COVID-19 crisis that both the business sector in which the MNE operates and the group's different entities have had to face.<sup>21</sup>

Another important aspect regarding the COVID-19 crisis involves the increase in extraordinary expenses the MNE has had to incur. These include increased labour costs (e.g. reconfiguration of workplaces to accommodate social distancing), IT infrastructure expenses or other costs associated with complying with health and hygiene protection standards.

Cases in which MNEs have assumed additional expenses to produce emergency health and medical equipment, without their business being necessarily active in the health sector, have also been identified. Such equipment could be used by the MNE for its own employees or given for free to the local government (the latter being pro bono costs).

From a transfer pricing perspective, when determining which of the MNE group's entities should bear such extraordinary expenses, the group's business model should be considered. In other words, in order to deter-

mine which entity should assume these extraordinary expenses, the group's transfer pricing policy must be analysed as the starting point. Indeed, what matters is the entity in the group that has assumed risks associated with these costs. In this sense, according to the OECD Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic, to allocate exceptional costs derived from the COVID-19 crisis, it must be determined which entity has the responsibility of performing activities related to the relevant costs and who assumes risks related to these activities.<sup>22</sup>

Take the example of exceptional pro bono costs. To resolve the issue of which entity in the group should bear such costs, quite generally a differentiation between centralized business models and decentralized business models can be made.<sup>23</sup>

In centralized models, these pro bono costs could be borne by the central entity, which acts as an entrepreneur on the assumption that this entity has generally made the relevant decisions regarding these expenses. For example, if a contract manufacturer in Country X that is normally engaged in the business of making clothes produces some equipment (e.g. masks), which is given to the local government (Country X) and other countries in which the MNE operates (Countries Y, Z, etc.) for free, then the costs of producing such equipment should be borne by the principal assuming that the latter has taken decisions to incur these expenses for the benefit of enhancing the reputation of the group (i.e. reducing its reputational risk). If these costs were initially paid by the contract manufacturer, then the principal should reimburse the manufacturer for these costs. Arguably, this should be done without a markup since these are pro bono costs incurred by the MNE.

Conversely, in decentralized models (in which the local entities enjoy a higher degree of autonomous decision-making), it could well be possible that the decisions to incur these pro bono costs are driven by the employees of these entities and, hence, the expenses could be allocated to these entities. For example, if an autonomous fully fledged manufacturer produces some protective equipment (e.g. clothes) that is given for free to local public hospitals, then the costs of producing such equipment should be borne by the manufacturer assuming that the latter has taken decisions to incur these expenses.

On the other hand, a clear distinction needs to be made between exceptional costs and costs that are operational in nature. In the latter case, it could well be possible that the costs are also allocated to low-risk entities in the MNE group. For example, if the principal incurs the costs of

17. Id., at paras. 45-46.  
 18. Prasanna & Cardoso, *supra* n. 2.  
 19. Id.  
 20. OECD *Transfer Pricing Guidance*, *supra* n. 1, at para. 6.  
 21. RSM, *White Paper: Analysis of Impact of COVID-19 on Transfer Pricing* (27 Apr. 2020), available at [https://www.rsm.global/india/sites/default/files/media/RSM%20India/Publications/2020/rsm\\_india\\_white\\_paper\\_-\\_analysis\\_of\\_impact\\_of\\_covid-19\\_on\\_transfer\\_pricing.pdf](https://www.rsm.global/india/sites/default/files/media/RSM%20India/Publications/2020/rsm_india_white_paper_-_analysis_of_impact_of_covid-19_on_transfer_pricing.pdf) (accessed 31 May 2021) [hereinafter RSM White Paper].

22. OECD *Transfer Pricing Guidance*, *supra* n. 1, at paras. 47-48.  
 23. V. Chand, *Five Questions on the Transfer Pricing Ramifications of COVID-19* (28 Apr. 2020), available at <https://www.ibfd.org/IBFD-Tax-Portal/News/Free-Webinar-Five-Questions-Transfer-Pricing-Ramifications-COVID-19> (accessed 31 May 2021). To understand this differentiation, see V. Chand & L. Stahli, *Does the Transactional Profit Split Method Apply to Centralized Business Models?*, Kluwer International Tax Blog (31 July 2019), available at <http://kluwertaxblog.com/2019/07/31/does-the-transactional-profit-split-method-apply-to-centralized-business-models/> (accessed 31 May 2021).

updating the group’s IT infrastructure to ensure seamless teleworking arrangements, then these costs could be charged out to various entities of the MNE group that have an expected economic benefit from such expenditure (i.e. the benefit test, which is contained in chapter 7 of the OECD Guidelines, applies here).

While the above could be a starting point, it is evident that a thorough analysis should be performed to determine which related parties should bear such exceptional or operational costs.

### 3. Value Chain Reorganizations: Does a Restructuring Transaction Analysis Need to Be Undertaken?

As indicated, the COVID-19 crisis has negatively impacted the supply chain of many MNEs. As a consequence of lockdowns, the closing of international borders, the scarcity of materials, the inability of workers to perform activities, MNE groups may consider a restructuring of their business models, which means a shift in activities (e.g. innovation, sourcing, manufacturing, assembling, warehouse, sales, etc.) from one country to another in order to adapt to the circumstances of the crisis.<sup>24</sup> Likewise, in times of lockdown, many MNE groups will reorient their business models to remote-servicing business models, leading to possible business restructuring consequences.<sup>25</sup>

In some cases, restructuring transactions have been made to achieve a centralization of functions in order to increase the group’s efficiency. In others, the need to adapt to the unique position of each market has implied either a decentralization of the functions of the MNE group or a reorganization of the current functions of the MNE group’s entities.<sup>26</sup>

In extreme cases, circumstances will force the MNE group to completely modify its business model to allow for a reconfiguration of its value chain and a reorganization of its operating procedures.

Upon analysing restructuring transactions from a transfer pricing perspective, the OECD Guidelines indicate that the analysis must start by identifying trade and financial relationships between the entities involved in restructuring. In this manner, a functional analysis of the companies involved in the restructuring should be done, identifying the changes undergone and comparing the circumstances before and after the restructuring.

It is also essential to analyse the business reasons for the restructuring, the primary benefits expected to be obtained and the options realistically available to the parties<sup>27</sup> in order to confirm that the restructuring trans-

action would have also been done by independent third parties under comparable circumstances.

Regarding the arm’s length remuneration that entities participating in restructuring should receive, it must be clarified that, as stipulated in paragraph 9.71 of the OECD Guidelines, not every case in which an entity experiences a reduction of its functions, assets and risks requires an indemnification.<sup>28</sup>

Particularly, the OECD Guidelines establish that “there should be no presumption that all contract terminations or substantial renegotiations should give a right to indemnification at arm’s length, as this will depend on the facts and circumstances of each case”.<sup>29</sup>

In the event that a loss-making entity is shut down, the restructured entity is actually being saved from the likelihood of a loss-making opportunity. Thus, in the event that an entity belonging to an MNE group cannot continue its activity because of the circumstances arising from the COVID-19 crisis and the MNE group decides to transfer the production capacity of this entity to another one of the group, arguably, the former should not get an indemnification given that it is not being relieved of a profit-making opportunity; rather, it would have been saved from a loss-making opportunity.<sup>30</sup>

Nonetheless, the conclusion would be radically different if the only reason for transferring the production capacity of an entity to another would be to reduce production costs. In this scenario, if the shut-down entity had other realistically available options that would have implied a profit-making opportunity for it (including continuing its production activity), in accordance with the arm’s length principle, such entity would expect to receive indemnification for the shutdown of its production activity.<sup>31</sup>

In conclusion, to determine the arm’s length remunerations that entities involved in business restructuring transactions should receive, a case-by-case analysis must be done.<sup>32</sup> In any event, it must be noted that during times of crisis, determining the arm’s length value of restructuring compensations may prove to be quite complicated due to high uncertainty and volatility.<sup>33</sup>

In this regard, Chapter IX of the OECD Guidelines analyses the question of whether the participating entities in the restructuring transaction should receive an indemnification and the way to determine such remuneration in accordance with the arm’s length principle.<sup>34</sup>

In this current context, the cases in which an MNE sporadically uses the support granted by another entity of the group must be distinguished from those cases in which a complete permanent reorganization of the group’s activities takes place.

24. RSM White Paper, *supra* n. 21.  
 25. Prasanna & Cardoso, *supra* n. 2.  
 26. E. Abad & M. Ortega, *COVID-19: The Health Crisis May Affect the Analysis, Pricing and Documentation of Controlled Transactions*, Garrigues (17 May 2020), available at [https://www.garrigues.com/en\\_GB/new/covid-19-health-crisis-may-affect-analysis-pricing-and-documentation-controlled-transactions](https://www.garrigues.com/en_GB/new/covid-19-health-crisis-may-affect-analysis-pricing-and-documentation-controlled-transactions) (accessed 31 May 2021).  
 27. *OECD Guidelines*, *supra* n. 8, at para. 9.13.

28. *Id.*, at para. 9.71.  
 29. *Id.*, at para. 9.78.  
 30. D’Avossa et al., *supra* n. 4.  
 31. *Id.*  
 32. Holzmueller, Cantaluppi & Mazzoleni, *supra* n. 7.  
 33. Prasanna & Cardoso, *supra* n. 2.  
 34. *OECD Guidelines*, *supra* n. 8, at para. 9.75.

In the first cases, sporadic support granted within the group will most likely receive the qualification of intra-group service. However, if a permanent reorganization of operations of the MNE group arises, it is likely that a business restructuring may have taken place.<sup>35</sup>

In this latter case, an analysis of such restructuring transaction should be done, following the recommendations included in Chapter IX of the OECD Guidelines.

Lastly, the need to maintain a proper level of documentation on restructuring transactions, including all its relevant aspects, should be considered.<sup>36</sup> In this sense, the OECD Guidelines highlight the need to include details of these transactions in the Master File and the Local File prepared by the MNE group and its entities.<sup>37</sup>

To illustrate the above, consider the following practical example. Faced with the imminent lockdown that will be implemented in Country X, and considering the heavy impact of COVID-19 in such jurisdiction, the MNE group (MG Group) – which produces high-value innovative surfaces – decides to transfer its manufacturing activity from Country X (where such activity has been performed by entity X) to Country Y (where entity Y will begin to perform manufacturing activities).

In this context, the MG Group transfers its machinery and equipment, inventories, patents, manufacturing processes and know-how and key contracts with suppliers and clients from Country X to Country Y. Also, several employees of the MG Group are relocated from Country X to Country Y in order to start manufacturing activities in the latter. In other words, the MG Group undertakes a transfer of all assets (tangibles and intangibles) linked with manufacturing activities from Country X to Country Y (essentially, a transfer of a business unit).

In this situation, and considering the extent of the organizational change implemented by the MG Group, it is clear that the operation must be qualified as a “business restructuring”. In addition, the restructuring involves the transfer of an ongoing concern (i.e. a functioning, economically integrated business unit).

In order to determine the arm’s length indemnification (e.g. any type of compensation that may be paid by company Y for detriments suffered by company X), if any, of such a transfer between associated enterprises, it should be compared with a transfer of an ongoing concern between independent parties rather than with a transfer of isolated assets.<sup>38</sup>

In any event, as mentioned previously, independent parties would not expect to receive remuneration in all situations. Therefore, it could be that, in comparable circumstances, an independent party would not have had any realistically available option that would be clearly more attractive to it than to accept the conditions of the termination or substantial recognition of the contract. In this regard, it could

be argued that entity X should not receive any compensation if, because of the COVID-19 crisis, it would generate a loss for performing its manufacturing activities and that the MG Group did not obtain a greater benefit by moving its manufacturing activities from Country X to Country Y.

The response would be different if entity X expected to obtain a benefit from the performance of manufacturing activities and, despite that, the MG Group decided to move manufacturing activities to Country Y to obtain greater benefits at a group level.

In this example, keeping in mind that business restructuring would be qualified as an ongoing concern, if entity X had the right to obtain compensation, valuation methods used in acquisition deals between independent parties could be useful for valuing the transfer of an ongoing concern between entities X and Y.

This is because, in the event of the transfer of an ongoing concern, determining the arm’s length compensation does not necessarily equate to the amount of separate value of each one of the elements that comprises the business transfer unit.

While the focus of the above example was on indemnification of the parties, the analysis would be completely different (from an accurate delineating standpoint) when an entity in the MNE group purports to bear a risk without any change in its functional profile. One such situation would be the case when a limited risk distributor (LRD), which hardly bears any marketplace risk, starts arguing that it bears marketplace risk and, consequently, that it should bear losses. This point is discussed in the next section.

#### 4. Should Routine Entities Bear Part of the MNE Group’s Losses?

Many MNE groups have designed structures where the main entity of the group acts as the entrepreneur in the concerned market, while the routine entities of the group are responsible for low-risk activities, such as production or distribution.

According to the transfer pricing policies of these groups, these routine entities are generally compensated with a “guaranteed return” for their activities that is determined based on benchmarking studies.

Because of the current circumstances of the COVID-19 crisis, many MNE groups will experience group-level losses. Therefore, under a significant market downturn, the fact that routine entities continue to obtain positive results could be a challenging approach.<sup>39</sup>

So, the key question is: Should a limited-risk entity achieve lower profitability (or even assume a loss) during an economic downturn or, should that decline in profitability be

35. Holzmueller, Cantaluppi & Mazzoleni, *supra* n. 7.

36. Davis et al., *supra* n. 13.

37. OECD Guidelines, *supra* n. 8, at paras. 9.32 and 9.33.

38. Id.

39. J. Sawada & L. Tanner, *COVID-19’s Impact on Transfer Pricing in Japan*, Deloitte (April 2020), available at <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dtt-tax-armslength-standard-200413.pdf> (accessed 31 May 2021).

borne entirely by the entrepreneurial entity of the MNE group?

As a starting point, it is important to keep in mind that, from a financial and tax perspective, it may not be convenient for low-risk entities of the group to assume losses, due to the risk that such entities may fall into technical bankruptcy given that they usually have a limited net working capital. If this were the case, the solution for reversing the situation could be to grant an intercompany loan to such entities, which may imply a greater complexity (e.g. additional implications for other taxes) than transferring the necessary cash to the subsidiary by a “guaranteed return”.<sup>40</sup>

Nevertheless, there are arguments against assigning losses to low-risk entities. For instance, from a transfer pricing perspective, the idea that losses should be associated with risks and the entity that assumes them (and that has the financial capacity to assume them) could be defended. If the operating entities have been considered “low-risk entities”, along this line of argument, it would be difficult to justify that such entities should assume a loss.<sup>41</sup>

Furthermore, it could be argued that the entrepreneurial entity of the MNE group, which has borne the main risks for the business activity and enjoyed the benefits generated in times of economic stability, should assume the losses during an economic downturn.<sup>42</sup>

Irrespective of the foregoing analysis, based on the arm’s length principle, if it can be shown that independent, low-risk third entities under similar circumstances would have assumed the relevant additional costs and incurred a loss, it would then be possible to act in the same way within the context of the MNE group.

Despite the OECD Guidelines establishing that simple or low-risk functions are not expected to generate losses for a long period of time, this does not mean that low risks must obtain a benefit under any circumstance.<sup>43</sup>

In this regard, the OECD Guidelines clearly establish that associated enterprises, like independent enterprises, can sustain genuine losses, among other motives, due to unfavourable economic conditions.<sup>44</sup> Therefore, the facts and circumstances surrounding the company in question<sup>45</sup> determine whether or not the low-risk entity can assume a loss in a context such as the current one.

In summary, in the OECD Guidelines, there is sufficient basis to arrive at a conclusion that low-risk entities can assume losses if circumstances justify it.

Likewise, the OECD Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic states that it is

40. Solyali, *supra* n. 3.  
 41. D’Avossa et al., *supra* n. 4.  
 42. D. Berry, M. Chadderton & E. Sporken, *INSIGHT: Transfer Pricing in the Corona Pandemic Disruption Era – A Dutch Point of View*, Bloomberg Tax (20 Apr. 2020), available at <https://news.bloombergtax.com/transfer-pricing/insight-transfer-pricing-in-the-corona-pandemic-disruption-era-a-dutch-point-of-view> (accessed 31 May 2021).  
 43. *OECD Guidelines*, *supra* n. 8, at para. 3.64.  
 44. *Id.*, at para. 1.129.  
 45. *Id.*, at para. 3.64.

not possible to establish a general rule whether or not low-risk entities should incur losses.<sup>46</sup>

Provided that the root of the arm’s length principle consists of analysing the behaviour of unrelated parties, another crucial aspect will be in determining how unrelated parties deal under similar circumstances.<sup>47</sup>

In this sense, despite the information of the 2008-2009 economic downturn seeming to be a good comparable, it should be noted that said downturn was primarily driven by a financial crisis that affected various economic sectors unequally. However, the current crisis is the result of a global health emergency with consequences that are drastically different from those of the 2008-2009 economic downturn. Therefore, when determining the behaviour of unrelated parties in circumstances such as the current one, great caution must be taken when identifying appropriate comparable circumstances.<sup>48</sup>

Lastly, another factor to consider are limitations expected in local regulations. For example, in 2008, the Chinese tax authorities issued guidance to establish that low-risk entities would not assume the risks arising from the financial crisis and, thus, preventing themselves from assuming the losses derived from the crisis.<sup>49</sup>

In light of the above discussion, consider the following practical example.

Consider the situation of a distributor that bears the country market risk. Imagine that, for the years 2017, 2018 and 2019, the distributor has sales of USD 30,000, cost of goods sold of USD 15,000 and operating expenses of USD 13,800 (e.g. labour cost, rent, selling and advertising and other administrative costs). Its operating profits are USD 1,200 and its operating margin is 4% every year (operating profits/sales). It is assumed that this is an arm’s length margin.

For the year 2020, due to a decrease in demand, the distributor has reduced third-party sales of USD 15,000, cost of goods sold of USD 7,500 (the intercompany transaction) and operating expenses of USD 11,500. Its operating loss is USD 4,000 and its operating loss margin is around 26.67% (operating profits/sales). Although the gross margins are the same for all the years, the loss mainly results from other fixed operating expenses. Moreover, assume that similar independent distributors operating in a similar industry also have losses due to the lockdown. In this situation, putting aside more nuanced approaches that bifurcate monthly data (data between pre or post lockdown or periods of crises), it is difficult to argue that the loss should not sit with the related distributor for this particular year.

Of course, a proper functional analysis needs to be done to understand the extent to which the risks are borne by the distributor. It could well be possible that the functional analysis indicates that the distributor is risk free (i.e. it does not bear the market, inventory or credit risk)

46. *OECD Transfer Pricing Guidance*, *supra* n. 1, at paras. 38- 41.  
 47. D’Avossa et al., *supra* n. 4.  
 48. *OECD Transfer Pricing Guidance*, *supra* n. 1, at para. 25.  
 49. D’Avossa et al., *supra* n. 4.

and the principal is the key risk bearer. In this case, the losses should not sit with the distributor. Indeed, the focus should be on understanding the exact functional profile of the distributor as opposed to the labels attached to it (e.g. LRD).

As another example, consider the situation of a contract manufacturer (CM) that bears inventory, operational and production-related risks but minimal market risk. Imagine that, for the years 2017, 2018 and 2019, the CM has cost of sales of USD 10,000 and operating expenses (mostly fixed) of USD 5,000 for producing 10,000 units. The arm's length return on total cost is 10%. Thus, the CM reports a revenue of USD 16,500 (the intercompany transaction) and an operating profit of USD 1,500. Put differently, the revenue per unit is USD 1.65 (USD 16,500/10,000 units).

For the year 2020, due to the lockdown, the CM's manufacturing plant was closed for half the year. Thus, the number of units produced drops by half even though there is sufficient demand for the products of the MNE group.

The CM has cost of sales of USD 5,000 and fixed operating expenses (similar to previous years) of USD 5,000. The question now is what should be the revenue of the CM? Excluding more nuanced approaches that bifurcate monthly data, from a general perspective, should it be (i) the revenue per unit as multiplied by the number of units produced (USD 1.65 × 5,000 units = USD 8,250), which would lead to an operating loss (USD 8,250 – USD 10,000 = – USD 1,750); or (ii) a return on total costs of 10%, which is USD 11,000 (USD 10,000 of total cost plus a markup of 10% assuming it is an arm's length markup for this year). The first situation would lead to a loss, and a closer examination reveals that the loss arises mostly due to the fixed costs of the CM. In this situation, it could well be possible that the losses sit with the CM. This is because the plant was not operational due to a government lockdown, and the operational and production risk sits with the CM (for comparability adjustments, see the next section).

The answer would naturally be different if there were no lockdown in the CM's location and the MNE group experienced a drop in sales due to the market conditions, i.e. the principal was not able to sell its products due to low demand (and consequently, the CM was required to operate only at half of its production capacity and produce only half of the units it normally produces). In this case, as the market risk sits with the principal, then the losses should also sit with it. In other words, the CM should be compensated on total costs.

## 5. How Could Benchmarking Studies Be Carried Out in Practice during the COVID-19 Era?

As noted previously, the COVID-19 crisis has brought a comparability crisis, as comparability is based on past experiences and the circumstances associated with the COVID-19 crisis are particularly extraordinary.<sup>50</sup>

50. OECD *Transfer Pricing Guidance*, *supra* n. 1, at para. 9.

When an economic crisis affects distinct economic sectors and the companies operating in them differently, identifying transactions that can be used as comparables and preparing reliable transfer pricing analyses can be complicated.

Particularly, during the first years of an economic crisis, the benchmarking prepared applying the same search strategy used in years prior to the crisis may not reflect the impact of the COVID-19 crisis<sup>51</sup> because the current information from the comparable companies is not available when doing the benchmarking.<sup>52</sup>

Similarly, it should be taken into consideration that some of the companies most impacted by the economic crisis (or those that were already in a delicate situation before the crisis) will cease activities and, therefore, the data regarding such companies will not be included in databases.

On the other hand, it should be noted that the impact of COVID-19 has affected each country differently. Nonetheless, the available information in databases during the first years of the crisis would not reflect this difference either.<sup>53</sup>

Another limitation that taxpayers must face is the lack of information on the impact that “stimulus packages” guaranteed by different governments<sup>54</sup> may imply for comparable companies. This information could be relevant when performing a comparability analysis.<sup>55</sup>

Therefore, given that it is not possible to prepare a reliable benchmarking using the same criteria as used in previous years, taxpayers must (among other actions) consider potential comparability adjustments being made when preparing a benchmarking analysis.<sup>56</sup>

Such adjustments would eliminate differences that, given the limitations in databases during the first years of a crisis, materially affect the comparison between the information of the tested party and the information of comparable companies.

Despite many tax authorities occasionally challenging complex comparability adjustments<sup>57</sup> being made, given the exceptional circumstances of the COVID-19 crisis, the need to make such adjustments could be more easily defended than in previous years.

The need to adjust comparables and the requirement for accuracy and reliability are pointed out in the OECD Guidelines on several occasions (as provided by paragraphs 1.40, 1.139, 1.144-1.147, 2.80, 2.84 and 3.47-3.54). The comparability adjustments made should be reason-

51. X. Ditz & C. Quilitzsch, *COVID-19 and Its Impact on Determining, Reviewing and Documenting International Transfer Prices*, 27 *Intl. Transfer Pricing J.* 4 (2020), *Journal Articles & Opinion Pieces IBFD*. See also *id.*, at para. 16.  
 52. Davis et al., *supra* n. 13.  
 53. Solyali, *supra* n. 3.  
 54. *Id.*  
 55. OECD *Transfer Pricing Guidance*, *supra* n. 1, at paras. 73 ff, 82 and 85.  
 56. *Id.*, at para. 9.  
 57. Sawada & Tanner, *supra* n. 39.

able and reliable and should be only considered if they are expected to increase the reliability of the results.<sup>58,59</sup>

There is a great range of comparability adjustments that can be made, including adjustments to account for differences in (i) idle capacity; (ii) extraordinary expenses; (iii) working capital; or (iv) inventory-level adjustments. Similarly, considering COVID-19's heavy impact on the fluctuation of exchange rates, adjustments to compensate for this type of fluctuation may also be considered.<sup>60</sup>

It is also possible to make more complex adjustments, such as those based on behavioural analysis of financial data of the tested party, and assume that the comparable entities might experience the same drop turnover as the tested party. Another possibility would be to analyse the latest published financial data (on a quarterly basis) by listed companies to determine the impact of the crisis and, consequently, make an adjustment to comparable companies.<sup>61</sup>

Following the provisions of the OECD Guidelines, only those adjustments that truly improve the comparability and reliability of the analysis should be made. Selecting the appropriate adjustments should be assessed on a case-by-case basis, especially when considering that the COVID-19 crisis has impacted the various economic sectors in different ways.

The OECD Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic mentions sources of contemporaneous information that could be used to support the performance of a comparability analysis, namely (i) how sales volumes have changed during COVID-19; (ii) change in capacity utilization; (iii) incremental or exceptional costs borne by parties; (iv) government assistance and government interventions; (v) information from interim financial statements; (vi) macroeconomic information; (vii) statistical methods; (viii) comparisons of budgeted/forecasted data and actual results; and (ix) effects on profitability or on third-party behaviour observed in previous recessionary periods.<sup>62</sup>

Another method to increase the degree of comparability and reliability of the benchmarking study consists of preparing subsets of comparable companies as similar as possible to the tested party so that the results of the entities selected as comparable reflect the impact that COVID-19 has had on the tested party.

These subsets of comparable companies can be selected in several ways, such as by refining selected comparables beforehand (thereby eliminating companies that have not been affected by the COVID-19 crisis in the same way the tested party has) and delineating by reference to economic

sectors or countries depending on their level of exposure to the crisis.<sup>63</sup>

Generally, in benchmarking, a filter for rejecting comparable companies that have incurred recurrent losses is included. Nevertheless, in a period of economic crisis, one could argue that the rejection of such companies may not be appropriate.<sup>64,65,66</sup> On the other hand, one could argue that comparable companies that sustained persistent losses over a period of time, for reasons other than the COVID-19 pandemic, should be excluded from the data set. This is because these comparable were loss making prior to the pandemic.

In any event, as previously mentioned, due to the impact of the crisis, there will be companies that cease their activities and, as a consequence, their results will not be included in the database. Therefore, the benchmarkings prepared with databases will always have a certain degree of limitation for gathering information on the effect of the COVID-19 crisis.

Upon testing the periods affected by the COVID-19 crisis, the option of using a year-by-year approach, instead of a multi-year approach, in attempting to reflect the effect of COVID-19 on benchmarking could also be considered.<sup>67</sup> This cannot logically be done in the first year affected by the crisis, due to the lag in information from databases.

According to the OECD Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic, "it may be appropriate to have separate testing periods for the duration of the pandemic or for the period when certain material effects of the pandemic were most evident".<sup>68</sup> However, in other cases, "the use of combined periods (that include both years that are impacted by the pandemic and years that are not impacted) may improve reliability".<sup>69</sup>

However, the option of considering the margins obtained by comparable entities during the 2008-2009 financial crisis to try to determine the results that such entities obtained in similar economic conditions to those that the tested party is currently experiencing<sup>70</sup> may not be appropriate because, as noted above, the characteristics of the 2008-2009 financial crisis are drastically different to those of the current crisis.<sup>71</sup>

Lastly, expanding the acceptable range beyond the interquartile range<sup>72</sup> is also an option. However, this practice is unlikely to reflect the COVID-19 effect, as it departs from the erroneous premise that companies of the lower range obtained in benchmarkings during the economically stable years look like average companies during the

58. D'Avossa et al., *supra* n. 4.  
 59. *OECD Transfer Pricing Guidance*, *supra* n. 1, at para. 54.  
 60. D'Avossa et al., *supra* n. 4.  
 61. H. Chary & T. Roques, *Transfer Pricing in the Times of COVID-19: Do's and Don'ts for Adjusting Comparable Company Searches*, MNE Tax (26 May 2020), available at <https://mnetax.com/transfer-pricing-in-the-times-of-covid-19-dos-and-donts-for-adjusting-comparable-company-searches-38783> (accessed 31 May 2021).  
 62. *OECD Transfer Pricing Guidance*, *supra* n. 1, at para. 11.

63. Abad & Ortega, *supra* n. 26.  
 64. *OECD Transfer Pricing Guidance*, *supra* n. 1, at para. 33.  
 65. Davis et al., *supra* n. 13.  
 66. Ditz & Quilitzsch, *supra* n. 51.  
 67. Solyali, *supra* n. 3.  
 68. *OECD Transfer Pricing Guidance*, *supra* n. 1, at para. 27.  
 69. Id., at para. 29.  
 70. D'Avossa et al., *supra* n. 4.  
 71. *OECD Transfer Pricing Guidance*, *supra* n. 1, at para. 25.  
 72. D'Avossa et al., *supra* n. 4.

**Table 1 – Entity Z’s financial data for financial years 2018, 2019 and 2020**

	FY 2018	FY 2019	FY 2020
Sales (EUR)	520,914.00	551,358.00	381,730.00
Cost of goods sold (COGS) (EUR)	351,646.00	370,869.12	258,331.27
Gross profit (EUR)	169,268.00	180,488.88	123,398.73
Operating expenses (EUR)	150,652.00	160,204.00	117,462.00
Underutilized production capacity costs (EUR)	0.00	0.00	35,468.00
Operating profit (EUR)	18,616.00	20,284.88	– 29,531.27
Operating margin (FCMU) (%)	3.71%	3.82%	– 7.18%
COVID-19 adjusted operating profit (excluding underutilized production capacity costs) (EUR)			5,963.73
COVID-19 adjusted operating margin (FCMU) (%) (excluding underutilized production capacity costs)			1.58%

COVID-19 crisis.<sup>73</sup> Clearly, such premise cannot be convincingly defended.

Provided that it is possible to determine the impact of the COVID-19 crisis on the financial data of the tested party, making a comparability adjustment on such information may be a valid approach. This practice can be especially useful in the first few financial years affected by COVID-19 (due to the lag in information from databases).

To illustrate the foregoing conclusion, consider a practical example of an adjustment made to the tested party.

Entity Z incorporated into an MNE group manufactures wind turbine generator (WTG) components.

Due to supply chain disruptions and the reduction in demand as a consequence of COVID-19, entity Z has experienced an abnormally low manufacturing capacity utilization in financial year 2020, which has caused production costs of WTG components to increase drastically in such year.

In order to estimate underutilized production capacity costs, entity Z calculated the difference between the average cost of production per unit of the two previous financial years and the production cost per unit of financial year 2020. To obtain the total amount of the underutilized production capacity costs, the difference obtained was multiplied by the number of components manufactured during 2020.

In the benchmarking prepared to justify (in terms of the full-cost markup (FCMU) as operating margin) the profitability obtained by entity Z in financial year 2020, the results obtained by comparable companies in previous financial years (not affected by COVID-19) will be taken into account. Therefore, it was considered reasonable to make a comparability adjustment in the financial data of the tested party to eliminate the effect of the underutilized production capacity costs, as such those are not reflected in the financial data of the companies selected as comparable.<sup>74</sup>

73. Chary & Roques, *supra* n. 61.  
 74. P. Subramanian et al., *INSIGHT: Transfer Pricing Adjustments to the Covid-19 Economic Downturn*, Bloomberg Tax (6 July 2020), available at <https://news.bloombergtax.com/transfer-pricing/insight-transfer->

Table 1 summarizes the financial data of entity Z that correspond to financial years 2018, 2019 and 2020 (after identifying the total amount of underutilized production capacity costs as described above):

Therefore, when including the corresponding comparability adjustment to exclude the effect of the underutilized production capacity costs, the operating margin (FCMU) of entity Z in financial year 2020 changed from – 7.18% to 1.58%.

After including the adjustment and eliminating the impact of the COVID-19 crisis (in this case, materialized in the underutilized production capacity costs), the adjusted results of entity Z can be compared with the unadjusted pre-COVID range.

While the above could be a possible solution, on a broader basis, we believe that tax administrations need to be flexible and pragmatic during tax audits vis-à-vis comparability analysis. The flexibility could be demonstrated by giving the taxpayer the option to resort to an outcome testing approach (ex-post testing approach) even if the local law does not explicitly provide for such an option.

**6. Is It Necessary to Re-evaluate the MNE Group’s Intercompany Financing Policy?**

The COVID-19 crisis has strongly impacted MNEs from a financial perspective. Thus, given that companies will have to continue to cope with the costs of their activities (regardless of their activity level during the crisis, companies must assume their fixed costs), the reduced revenues of companies will increase the cash flow pressure and put MNEs under financial strain.<sup>75</sup>

Because of this situation, many companies’ credit rating will be severely impacted. Additionally, due to the crisis, speculative-grade credit spreads have widened and become more volatile, changing in reference interest rates.<sup>76</sup>

pricing-adjustments-in-the-covid-19-economic-downturn (accessed 31 May 2021).  
 75. Abad & Ortega, *supra* n. 26.  
 76. R. Fan et al., *Addressing Liquidity Issues during Covid-19 Using Intercompany Pricing Tools*, KPMG (20 July 2020), available at <https://assets.kpmg/content/dam/kpmg/us/pdf/2020/07/tnf-wnit-tp-july20-2020.pdf> (accessed 31 May 2021).

The problems obtaining accurate information on credit quality of borrowers and valuing the assets that may serve as collateral to obtain funding in times of crisis make it difficult to obtain credit in the market during the COVID-19 era.

This situation will force many MNE groups to revise their intercompany financing policy and look for new structures for cash and liquidity management that will allow them to optimize their resources from a financial perspective.<sup>77,78</sup>

Among the financial measures that MNEs could implement during this crisis are (i) capital increases; (ii) loss compensation funds; (iii) a review of the terms and conditions of facility agreements and cash pool systems; (iv) extending maturity of intercompany loans; (v) increasing factoring agreements; (vi) allowing intercompany guarantees; (vii) extending intercompany receivables payment terms;<sup>79</sup> and (viii) implementing interest-free periods.

According to the Transfer Pricing Guidelines of Financial Transactions (GTF) published by the OECD in February 2020, due to current circumstances, where a company finds it difficult to meet its payment obligations linked to its intercompany financial transactions, it is reasonable that related parties renegotiate the conditions associated with said financial transactions, deciding to temporarily delay payments of interest, or recharacterize loans from short-term to long-term.<sup>80</sup>

Consider the following situation. In 2018, Company X, which is based in Country X, granted a bullet loan to its subsidiary, Y, which is based in Country Y. The loan would have to be repaid on 31 July 2020. Due to the COVID-19 crisis, Y is not in a position to repay. The loan can be prolonged by the parties (e.g. by 2 years), in which case a new interest rate is to be determined taking into account the current market circumstances.

In this regard, as per paragraph 10.60 of the GTF, a transfer pricing analysis with regard to the possibilities of the borrower or the lender to renegotiate the terms of the loan to benefit from better conditions will include the options realistically available to both the borrower and the lender.<sup>81</sup>

Similarly, if a decision is reached to renegotiate the conditions of intercompany financial transactions, according to the arm's length principle, what unrelated third parties would have agreed to under comparable circumstances should be analysed.<sup>82</sup>

It is also likely that, in this crisis context, intercompany financial guarantees to enhance the credit rating and

lower the cost of borrowing<sup>83</sup> are granted. As established in the GTF, it is important to differentiate implicit guarantees from explicit ones.<sup>84</sup> Similarly, under current circumstances, it is possible that many implicit guarantees are replaced by explicit ones granted to affiliates by the MNE group's main entity.

In the current circumstances, it is crucial to evaluate if such guarantees provide an incremental benefit (beyond implicit support) and, if so, if the agreed remuneration linked to these transactions are at arm's length.<sup>85</sup>

On the other hand, it is important to evaluate whether the COVID-19 crisis has reduced the financial capacity to face ongoing guarantee obligations of the group entity that concedes the guarantees (the guarantor). This is relevant since unrelated third parties would be unwilling to pay the same guarantee fee if the associated benefits to a guarantee were reduced.<sup>86</sup>

Consequently, as a result, a careful and detailed analysis of the guarantee transaction needs to be undertaken from the perspective of the entity providing the guarantee and the entity that receives it, in particular, concerning the benefits associated to this arrangement.

On a separate note, as a result of the difficulties to obtain funding in the market, many MNE groups will increase the use of cash pooling systems to maximize their internal financial resources.<sup>87</sup>

Regarding cash pooling systems, it should be noted that due to the need for funds by affiliates, (especially in these times of crisis), if cash pooling debit or credit balances (first considered for the short term) remain for a longer period, such balances must be recharacterized as longer-term instruments.<sup>88</sup> In this sense, in accordance with the GTF, from a transfer pricing perspective, determining the accurate delineation of financial transactions is essential.<sup>89</sup> Indeed, this seems to be a significant issue for such arrangements.

Another issue relates to a regulated cash-rich entity in the group that usually does not participate in cash pooling

77. OECD *Transfer Pricing Guidance*, *supra* n. 1, at para. 2.  
 78. D'Avossa et al., *supra* n. 4.  
 79. Abad & Ortega, *supra* n. 26.  
 80. OECD, *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10* paras. 10.59-10.61 (OECD 2020), Primary Sources IBFD [hereinafter *Guidance on Financial Transactions*].  
 81. *Id.*, at para. 10.60.  
 82. Fan et al., *supra* n. 76.

83. *Id.*  
 84. *Guidance on Financial Transactions*, *supra* n. 80, at para. 10.175 ff.  
 85. M. Bonekamp & N. Schaatsbergen, *Transfer Pricing of Financial Transactions and the Impact of COVID-19*, 27 *Intl. Transfer Pricing J.* 4 (2020), *Journal Articles & Opinion Pieces IBFD*. See also V. Averyanova & V. Chand, *Applying the Arm's Length Principle to Intra-Group Financial Guarantees in light of the OECD's Draft guidance on Financial Transactions*, *Kluwer International Tax Blog* (14 Feb. 2019) available on <http://kluwertaxblog.com/2019/02/14/applying-the-arms-length-principle-to-intra-group-financial-guarantees-in-light-of-the-oecd-draft-guidance-on-financial-transactions/> (accessed 31 May 2021).  
 86. Prasanna & Cardoso, *supra* n. 2.  
 87. A. Colangelo, *The Statistical Classification of Cash Pooling Activities*, *Statistics Paper Series No. 16*, European Central Bank (July 2016), available at <https://www.ecb.europa.eu/pub/pdf/scpsps/ecbsp16.en.pdf> (accessed 31 May 2021).  
 88. M. Malhotra et al., *Financing and Treasury: Tax and Legal Matters*, Deloitte, available at <https://www2.deloitte.com/global/en/pages/tax/covid-19/financing-treasury-tax-matters-addressing-impact-covid19.html> (accessed 31 May 2021). On this matter, see also A. Haller & V. Chand, *Application of the Arm's Length Principle to Physical Cash Pooling Arrangements in Light of the OECD Discussion Draft on Financial Transactions*, 47 *Intertax* 4, pp. 352-354 (2019).  
 89. *Guidance on Financial Transactions*, *supra* n. 80, at para. 10.15 ff.

arrangements (for example, captive insurance companies). It could well be possible that MNEs direct such companies to deposit funds in a cash pool even though the entities need to keep a certain amount of funds for themselves due to minimum liquidity requirements pursuant to local (insurance) regulations. If the captives do not act as captives and breach minimum liquidity requirements, in addition to potential exposure towards regulatory fines, the nature of such arrangements could be questioned from a local tax and transfer pricing perspective. One possibility is that tax administrations could deny deductions for insurance premiums paid to the captive or reclassify the captive arrangement, as they could argue that the captive insurer was not really an insurer (i.e. that the entity did not have sufficient funds to meet its risk shifting/risk diversification requirements). Thus, these entities need to be mindful of their participation in cash pools. Of course, such a claim would depend on the exact facts of the case.

Furthermore, the financial needs may also make MNEs consider granting new loans. However, granting loans nowadays can be challenging given the high volatility of financial markets. Determining the arm's length price in financial markets in current conditions can be very complicated.<sup>90</sup> Logically, this is also applicable to loans that expire in the short term and that will be extended.

If new intragroup loans are granted, related-party entities should consider using the latest forecasts<sup>91</sup> prepared to analyse whether the borrower could sustain borrowing in the current circumstances.<sup>92</sup>

In this way, it is highly likely that unrelated third parties planning to grant loans in the market analyse the most recent versions of the forecasts prepared by the borrowers to analyse their ability to pay back the loans (especially when considering the difficulties for determining the credit rating of the entities in current circumstances).

To resolve the scarcity of affiliates' liquidity, MNEs may also consider the inclusion of special provisions in intragroup loans to be granted in the future. Payment-in-kind loans deserve special mention. These loans allow the debtor to borrow without having the burden of a cash repayment of interest until the loan term is ended, in exchange for a higher interest rate. This type of financial instrument allows the borrower to address its cash needs in the short term during the COVID-19 era with no detriment to the lender, who will be compensated with a higher interest rate.<sup>93</sup>

Lastly, it must be borne in mind that some MNEs will receive financial support from their governments. In these

cases, and especially those in which support is provided through granted loans, the implications of such instruments for intercompany financing policy of MNE groups must be analysed. Particularly, it must be determined if the loans granted by the government could represent an internal comparable.<sup>94</sup>

## 7. What Are the Main Aspects to Analyse Regarding Intangible Property in an Economic Downturn?

Intangible assets and transfer pricing policies of MNE groups regarding intangibles have also been greatly affected by the COVID-19 crisis.

Given that royalties are generally calculated – not as a percentage of profits – but as a percentage of revenues (which, as previously mentioned, have also been affected by the COVID-19 crisis), one of the first consequences of this crisis has been the automatic reduction of royalties in MNE groups.<sup>95</sup>

Similarly, given that MNEs may have difficulties in paying royalties, intellectual property (IP) ownership entities of the group could consider reducing the royalty rates agreed with their affiliates or opting to temporarily suspend royalties.

In this sense, paragraph 6.184 of the OECD Guidelines includes an example expressly recognising that, in accordance with the arm's length principle, a renegotiation of the royalty rate agreed between related entities can be conducted when an extraordinary event occurs that lowers incentives of the licensee to manufacture or sell the licensed product.<sup>96</sup>

In any event, as stated in paragraph 6.185 of the OECD Guidelines, whether unrelated third parties would have renegotiated the agreed royalty rate under comparable circumstances should be evaluated.<sup>97</sup>

Reducing agreed royalty rates could also be justified in the context of an economic downturn when licensees do not earn a sufficient level of revenue from the exploitation of the licensed products. In these circumstances, the payment of royalties could conflict with the licensee's business value and, therefore, be inconsistent with the arm's length principle.<sup>98</sup>

Therefore, independent licensees will try to renegotiate agreed royalty rates if they are not economically sustainable. When reducing royalty rates, the renegotiation that independent third parties have made in the market should be considered, taking into account potential changes in

90. Fan et al., *supra* n. 76. Nevertheless, to understand the transfer pricing issues surrounding loans, see V. Chand, *Transfer Pricing Aspects of Intercompany Loans in light of the BEPS Action Plan*, 44 *Intertax* 12, pp. 885-902 (2016).

91. G. Condoleon, *Considerations Around Intercompany Financial Transactions During the COVID-19 Crisis*, Duff & Phelps (15 July 2020), available at <https://www.duffandphelps.com/insights/publications/transfer-pricing/transfer-pricing-times-second-quarter-2020/inter-company-financial-transactions-during-covid-19-crisis> (accessed 31 May 2021).

92. Malhotra et al., *supra* n. 88.

93. *Id.*

94. Abad & Ortega, *supra* n. 26.

95. F. Barat & F. Lubczinski, *Transfer Pricing: Will Multinational Companies Be Able to Apply the Arm's Length Principle in 2020?*, Mazars (5 May 2020), available at <https://www.mazars.com/Home/Insights/Shaping-the-agenda/Covid-19-Mazars-Global-Resource-Centre/Covid-19-Mazars-insights/Tax-and-Law/Impact-on-transfer-pricing> (accessed 31 May 2021).

96. *OECD Guidelines*, *supra* n. 8, at para. 6.184.

97. *Id.*, at para. 6.185.

98. RSM White Paper, *supra* n. 21.

business fundamentals and profitability of the intangible property during the COVID-19 era.<sup>99</sup>

To illustrate, consider the following practical example. Company X (X) has concluded a licence agreement with its subsidiary, Company Y (Y), that runs until 2023. A licence rate of 4% of the net sales generated by Y was agreed. At the end of 2020, it appears that Y will be not be able to generate a profit due to the COVID-19 crisis (because of a vast reduction in sales). The loss situation is expected to continue in the following year. In this case, it is appropriate for X and Y to renegotiate and agree to only offset a royalty rate of, for instance, 2%. A written amendment to the contract could be made. The licence rate reduction should initially be agreed for a limited period (e.g. until 2022).

As indicated, royalties are usually paid as a percentage of sales/revenues. It could well be possible that, in the near future, MNEs move towards a system where royalties are paid on profits (for decentralized businesses), and the profit split method is used as the most appropriate transfer pricing method instead of a comparable uncontrolled price analysis. This is because the COVID-19 crisis, in many cases, has shown that a royalties on sales model may not be a sustainable model, especially in economic downturns.

On the other hand, even though relatively uncommon, it is possible that related-party entities decide to increase the agreed royalty rate when the licensed intangible has increased its value during the COVID-19 era. This will occur if the MNE group benefits from the current circumstances (e.g. medical, pharmaceutical, certain digital services business sectors, etc.).

Another consequence of the COVID-19 crisis regarding intangibles is that some MNE groups may determine that, under current circumstances, it is not worth the effort to continue with their usual R&D activities and decide to develop an adjusted routine R&D level just to continue with the business activities.<sup>100</sup>

In these cases, a revision should be conducted of the entities that are performing the development, enhancement, maintenance, protection and exploitation (DEMPE) functions and their contribution to functions related to intangibles of the group.<sup>101</sup> As the OECD Guidelines indicate, determining which entities are conducting the DEMPE functions would help in understanding the contributions of each entity and determining which are ultimately entitled to share in the returns from exploiting the group's intangibles.<sup>102</sup>

99. P. Subramanian & M. Shah, *Intangible Property Transfer Pricing in an Economic Downturn*, Tax Notes International (11 May 2020), available at <https://www.taxnotes.com/tax-notes-international/currency-transactions-and-issues/intangible-property-transfer-pricing-economic-downturn/2020/05/11/2chkh> (accessed 31 May 2021).

100. RSM White Paper, *supra* n. 21.

101. For a critical analysis of the development, enhancement, maintenance, protection and exploitation (DEMPE) concept, see V. Chand & G. Lembo, *Intangible-Related Profit Allocation within MNEs based on Key DEMPE Functions: Selected Issues and Interaction with Pillar One and Pillar Two of the Digital Debate*, 3 Intl. Tax Studies. 6 (2020), Journal Articles & Opinion Pieces IBFD.

102. *OECD Guidelines*, *supra* n. 8, at para. 6.32 et seq.

Regarding the DEMPE analysis, it must be kept in mind that this analysis has been designed to ensure there is a correct attribution of the returns from the exploitation of intangibles (as well as the relative costs of such intangibles) considering the functions performed, assets used and risks assumed by the various entities of the MNE group in the development, enhancement, maintenance, protection and exploitation of intangibles.

It is important to note that, as a consequence of the COVID-19 crisis, employees of some MNE groups have been temporarily forced to work from a jurisdiction different from where they normally perform their functions.<sup>103</sup> In these cases, the MNE groups should analyse in which locations the DEMPE functions are performed.

This can be especially relevant in cases where the MNE develops new IP during the COVID-19 era or if an improvement is made to the current IP.

Furthermore, it must be considered that even though employees are performing their functions from a different jurisdiction throughout the COVID-19 era, in the majority of cases they will continue to work for the same entity that performs the DEMPE functions and so, in practice, no change will occur in the functional analysis of the entities of the MNE group. However, these employees could trigger a permanent establishment risk for their employer. Yet, the OECD has recently clarified that such risks are minimal, in several circumstances, for employees working from home.<sup>104</sup>

Notwithstanding this fact, given that the COVID-19 crisis has affected value chains of some MNE groups (in many cases, due to an increase in digitalization<sup>105</sup>), performing a DEMPE analysis considering these changes is crucial.

Thus, if the MNE group has restructured its DEMPE functions in reaction to the COVID-19 crisis, the group's transfer pricing policy regarding intangibles must be adjusted. In this sense, the returns (and costs) from the exploitation of intangibles should be attributed to the entities performing the DEMPE functions<sup>106</sup> (*see also* section 3.).

Another important question for the COVID-19 era involving intangibles is the impact that the crisis has had on the valuation of the group's intangibles. Particularly, the adverse effects of the crisis (e.g. decrease in consumer demand, supply chain disruptions, etc.) have reduced future expected profits for the exploitation of intangibles which, logically, have decreased the valuation of such intangibles.

103. M. Martin, M. Horowitz & T. Bettge, *INSIGHT: Transfer Pricing Substance in Flux—DEMPE, BEPS 2.0, and Covid-19*, Bloomberg Tax (31 July 2020), available at <https://news.bloombergtax.com/transfer-pricing/insight-transfer-pricing-substance-in-flux-dempe-beps-2-0-and-covid-19> (accessed 31 May 2021).

104. See OECD, *Updated guidance on tax treaties and the impact of the COVID-19 pandemic* paras. 14-19 (21 Jan. 2021), available at <https://www.oecd.org/coronavirus/policy-responses/updated-guidance-on-tax-treaties-and-the-impact-of-the-covid-19-pandemic-df42be07/> (accessed 5 July 2021).

105. Martin, Horowitz & Bettge, *supra* n. 103.

106. Chand & Lembo, *supra* n. 101.

This reduction in value of the intangibles could also help justify a reduction of the royalty rates charged to the group affiliates.

It is worth emphasizing also that, as a consequence of the COVID-19 crisis, some MNEs have looked for new applications of their existing IP, making it possible for new related-party transactions to arise, which should be analysed.

Lastly, it is important to note that, in times of crisis, major innovations tend to be developed. The COVID-19 crisis is not an exception given the increase in digitalization, the provision of digital services and the replacement of some people with newly created IPs. These changes require MNE groups to review their intangibles policy and create record keeping, allowing the contributions to development made by the various entities of the group to be recognized.

### 8. Do COVID-19 Special Circumstances Impact an MNE Group's APAs or APA Requests?

An APA is an arrangement (made between a taxpayer and one or more tax administrations) that determines, in advance of controlled transactions, an appropriate set of criteria for the determination of the transfer pricing for those transactions over a fixed period of time.<sup>107</sup>

The main objective of an APA is giving certainty to taxpayers. Likewise, APAs grant additional benefits, such as the reduction in documentation obligations or the elimination of double taxation in the event that the APA is involved with more than one authority (e.g. bilateral APAs).<sup>108</sup>

However, in the COVID-19 era, there is a conflict between achieving transfer pricing certainty and the difficulty of adjusting an APA to the highly unpredictable circumstances of the current crisis.<sup>109</sup>

As such, during the COVID-19 era, taxpayers can consider how their APAs are affected by (i) the changes in their transfer pricing policies (for instance, appearance or disappearance of certain related-party transactions); (ii) extraordinary expenses related to the COVID-19 crisis; and (iii) support measures implemented by different governments.<sup>110</sup>

As a starting point, it should be noted that the OECD Guidelines establish that an APA can be revised when business operations change significantly or when uncontrolled economic circumstances critically affect the reli-

ability of the methodology in a manner that independent enterprises would consider significant.<sup>111</sup>

#### 8.1. Renegotiation of existing APAs

There are many factors of an APA that can affect its adaptability during times of crisis. Among these include (i) the choice of the transfer pricing method and the profit level indicator; (ii) the APA term; (iii) the use of an arm's length range or a specific value; (iv) the use of an annual test versus a multi-year average or term test; and (v) the critical assumptions that have been included in the agreement.<sup>112</sup>

The critical assumptions are usually based on the functions, risks and assets of relevant entities for the APA, as well as the absence of relevant changes in the group's business.

The pertinent question would be determining if the critical assumptions included in the APA allow taxpayers to renegotiate the agreement during the COVID-19 era.<sup>113</sup>

Similarly, for existing APAs, it would also be prudent to analyse the provisions of the APA regarding the term test given that, in these current circumstances, many taxpayers can find it difficult to comply with the test specified in the agreement.

Under normal circumstances, if a company does not comply with the test established in the APA, the agreement can be revoked by tax authorities. However, in the current circumstances, it is likely that many tax authorities are flexible and willing to renegotiate the content of the APAs. These discussions normally imply greater complexity in cases where the agreement has been reached with more than one tax authority (e.g. multilateral APAs).

If a renegotiation is conducted with tax authorities, taxpayers can consider the option of replacing the annual test with a test calculated on a multi-year basis with the goal of spreading the effect of the COVID-19 crisis within a period of time that reflects a complete business cycle.<sup>114</sup>

Another option when renegotiating an APA with tax authorities will consist of requesting a reduction of the APA term so that the APA will end in the last year not affected by COVID-19 and renegotiating a new APA for the years affected by the crisis, thus achieving a separation of the years affected by the crisis (obtaining certainty for those years) and renegotiating a new agreement for the years affected by COVID-19 that better reflects the current circumstances and the possible consequences of the pandemic for the taxpayer business model.<sup>115,116</sup>

The APA could also be renegotiated with the aim of including a clause that obligates the taxpayer and the tax authorities to renegotiate the agreement in the future (i) if the taxpayer experiences a sales decline greater than x%; (ii) if the taxpayer suffers a large increase in input costs;

107. OECD Guidelines, *supra* n. 8, at para. 4.134.

108. G. Kumar, *COVID-19: A Cry for Relooking Transfer Pricing APAs and Safe Harbour Rules*, The Daily Guardian (28 Aug. 2020), available at <https://thedailyguardian.com/covid-19-a-cry-for-relooking-transfer-pricing-apas-and-safe-harbour-rules> (accessed 31 May 2021).

109. S. Foley et al., *Advance Pricing Agreements and COVID-19*, Tax Notes International (25 May 2020), available at <https://www.taxnotes.com/tax-notes-international/transfer-pricing/advance-pricing-agreements-and-covid-19/2020/05/25/2ck4q> (accessed 31 May 2021).

110. M. Campmajó et al., *INSIGHT: Advance Pricing Arrangements – The Quest for Certainty in Times of Uncertainty*, Bloomberg Tax (9 Apr. 2020), available at <https://news.bloombergtax.com/transfer-pricing/insight-48> (accessed 31 May 2021).

111. OECD Guidelines, *supra* n. 8, at para. 4.146.

112. Foley et al., *supra* n. 109.

113. OECD Transfer Pricing Guidance, *supra* n. 1, at paras. 92 and 93.

114. Foley et al., *supra* n. 109.

115. OECD Transfer Pricing Guidance, *supra* n. 1, at paras. 97 and 99.

116. Foley et al., *supra* n. 109.

(iii) if there is a system loss on a 3-year aggregate basis; or (iv) upon the occurrence of any other denied trigger. In this way, the APA will be renegotiated when the parties have more complete information on the impact of the crisis in the taxpayer business model.<sup>117</sup>

Therefore, the general recommendation for taxpayers with existing APAs is to be proactive when renegotiating the APAs with tax authorities and to initiate contact with them as soon as possible.

## 8.2. APAs currently being negotiated

The main problem of APAs currently being negotiated is that the current circumstances can differ considerably from the existing circumstances at the time of filing the APA request.<sup>118,119</sup> Faced with this situation, taxpayers have several options.

One option would be to continue with the negotiation, keeping in mind that a revision of the changes that have taken place since the APA request was submitted should be done. The advantage of this option is that a certain level of certainty will be obtained in an era marked by uncertainty and volatility. Likewise, the taxpayer will be in a good position to try to include the effect of the COVID-19 crisis in the new agreement. In this regard, if taxpayers decide to continue with negotiations, it is possible that they could be delayed until the parties have a better understanding of the impact that the COVID-19 crisis has had on the taxpayers' business.<sup>120</sup> Several other approaches can be considered, but it is essential that both taxpayers and tax administrations adopt a pragmatic and flexible approach.<sup>121</sup>

A second option includes requesting a deferment until circumstances begin normalizing.

The final option is a withdrawal of the process. It must be noted that, if this option is chosen, the fees that have been paid to start the process would not normally be refunded, and the information provided to tax authorities could generally be used in future tax audits.<sup>122</sup>

In any event, despite the noted difficulties, it is still highly recommended to seek these types of agreements with tax authorities in case complex related-party transactions are made.<sup>123</sup>

117. Id.  
 118. *OECD Transfer Pricing Guidance*, supra n. 1, at para. 108.  
 119. Campmajó et al., supra n. 110.  
 120. M. Kirkey, J. Wilson & J. Hejazi, *Transfer Pricing & APA Considerations during an Economic Disruption*, *Gowling WLG* (7 Apr. 2020), available at <https://gowlingwlg.com/en/insights-resources/articles/2020/transfer-pricing-during-economic-disruptions> (accessed 31 May 2021).  
 121. *OECD Transfer Pricing Guidance*, supra n. 1, at para. 109.  
 122. B. Gibert, *The Impact of the COVID-19 Pandemic on Advance Pricing Agreements*, 27 *Intl. Transfer Pricing J.* 5 (2020), *Journal Articles & Opinion Pieces IBFD*.  
 123. Abad & Ortega, supra n. 26.

## 9. Does the Support through Government Assistance Programmes during the COVID-19 Crisis Affect the Transfer Pricing Analysis of Related-Party Transactions?

Governments in many countries have implemented various support mechanisms to help companies manage the impact of COVID-19. The receipt of this government assistance may have transfer pricing implications.

Government assistance is defined as any monetary or non-monetary programme in which a government provides a direct or indirect economic benefit to eligible taxpayers.<sup>124</sup>

The granting of government assistance may be carried out through different support mechanisms, such as grants, subsidies, government-supported loan programmes, forgivable loans, tax deductions or other tax benefits and investment allowances.<sup>125</sup> The implementation of job retention programmes and employee-related payments are also noteworthy forms of support.

According to paragraph 1.132 of the OECD Guidelines, government assistance "should be treated as conditions of the market in the particular country, and in the ordinary course they should be taken into account in evaluating the taxpayer's transfer price in that market". Therefore, the receipt of government assistance may be part of the economic circumstances of the parties.<sup>126</sup> Thus, analysing the receipt of government assistance as a local market feature will be relevant in determining whether or not it affects the price of a controlled transaction.<sup>127</sup>

When determining the potential impact of receiving government assistance, the terms and conditions of that government support must be analysed.<sup>128</sup> According to the OECD Guidelines on the Transfer Pricing Implications of the COVID-19 Pandemic, several factors in particular should be taken into account, namely (i) whether the receipt of government assistance provides a market advantage to the recipient; (ii) the amount of any increase in revenues, decrease in costs, vis-à-vis those of reliable comparables that are attributable to the government assistance received; (iii) the duration of the assistance; (iv) the degree to which benefits of government assistance, at arm's length, are passed on to independent customers or suppliers; and (v) where benefits attributable to government assistance exist and are not fully passed on to independent customers or suppliers, the way in which independent enterprises operating under similar circumstances would allocate such benefits between them. Other factors that must also be taken into account include the availability and purpose of the government support, any conditions imposed by the government in granting the assistance, the allocation of the economically significant risks

124. *OECD Transfer Pricing Guidance*, supra n. 1, at para. 60.  
 125. Id.  
 126. Id., at para. 70.  
 127. Id., at para. 67 ff.  
 128. Id., at para. 65.

and the level of competition and demand within the relevant market.<sup>129</sup>

Likewise, according to the OECD Guidelines, to properly determine the implications from the receipt of the government assistance, in addition to considering the aforementioned factors, an accurate delineation of the controlled transaction and a comparability analysis must also be performed.

It should also be noted that receiving government assistance may directly affect the MNE group (if a group entity receives such government support), but it can also have a direct impact on comparable transactions between independent parties. In this way, the comparability of open market transactions may be influenced by the receipt of government assistance.<sup>130</sup>

Regardless, it cannot be assumed that receiving government assistance will affect the price of related-party transactions made by the MNE without first performing a comparability analysis. Therefore, the receipt of such assistance will not be relevant from a transfer pricing perspective in all cases.<sup>131</sup>

If it is eventually determined that the government assistance is an economically relevant characteristic, this information should be included as part of the documentation to support the transfer pricing analysis.<sup>132</sup>

Considering that receiving government assistance may affect the comparability analysis, the former may need to be considered when reviewing potential comparables.<sup>133</sup> Thus, a transaction carried out between independent third parties that could have been a comparable transaction might be considered not comparable by virtue of the fact that the transaction is subject to government assistance.<sup>134</sup>

In addition, when analysing the government assistance received by independent third parties, difficulties may arise in determining its nature given the various forms of such assistance and the practical complications in obtaining detailed and reliable information about the government support.<sup>135</sup> Therefore, it may be difficult to correctly delineate the treatment of government assistance received by independent third parties.

Likewise, when analysing the government assistance received by potential comparable companies, consideration should also be given to possible differences in the accounting treatment of such assistance.<sup>136</sup> In this sense, the government support may be deducted from costs or presented separately, even potentially affecting different profit and loss (P&L) positions (e.g. revenue, costs, finan-

cial line items, etc.)<sup>137</sup> and impacting different levels of profitability (e.g. gross profit, operating profit, net profit, etc.).<sup>138</sup>

For transactions using a cost-based transfer pricing methodology to determine the arm's length price, the key question is whether or not the government assistance should be deducted from the calculations of the transfer price.<sup>139</sup> In order to reach a conclusion in this regard, it must first be determined whether or not a link exists between government assistance and the specific intercompany transaction. In this sense, government interventions that are not related to a controlled transaction should be excluded from the calculations of the transfer price.<sup>140</sup>

If it is determined that a link exists between government assistance and the related-party transaction, the next step is determining how to settle the government assistance between the parties involved.<sup>141</sup> In order to reach a conclusion in this regard, it is helpful to gather evidence on how independent third parties act under comparable circumstances. It is also relevant to analyse the intercompany agreements to determine what, if anything, is established regarding government assistance.<sup>142</sup>

In this regard, it is important to note that the tax authorities of some countries have published guidelines regarding the treatment of COVID-19 government assistance.

For example, as a consequence of the COVID-19 crisis, the Australian Taxation Office (ATO) introduced the JobKeeper Payment scheme to maintain the level of employment in Australia and support Australian entities by funding their payroll costs. The ATO issued a guide on the treatment of JobKeeper payments in transfer pricing arrangements, concluding that Australian entities must retain the benefit of the government assistance in Australia and, therefore, the benefit derived from the government intervention should not result in a change to the transfer price.<sup>143,144,145</sup>

129. Id., at paras. 71 and 74.  
 130. Id., at para. 68.  
 131. Id., at para. 73.  
 132. Id., at para. 69.  
 133. Id., at para. 82.  
 134. Id., at para. 85.  
 135. Id., at para. 66.  
 136. Id., at para. 86.

137. K. Keser, *Transfer Pricing Guidance for MNEs in the Wake of COVID-1*, Duff & Phelps (21 Oct. 2020), available at <https://www.youtube.com/watch?v=zm4jcWaVghk> (accessed 31 May 2021).  
 138. *OECD Transfer Pricing Guidance*, supra n. 1, at para. 86.  
 139. Taxand, *Transfer Pricing Consequences of the COVID-19 Crisis*, Lexology (16 Apr. 2020), available at <https://www.lexology.com/library/detail.aspx?g=799c555a-a266-4115-ad05-76492bf7edef> (accessed 31 May 2021).  
 140. S. Haringman & P. Gerritsen van der Hoop, *Transfer Pricing & Government Interventions*, Deloitte, available at <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/gx-tax-transfer-pricing-government-interventions.pdf> (accessed 31 May 2021).  
 141. Id.  
 142. S. Fickling & T.J. Michaelson, *Applying OECD Guidance on COVID-19 Transfer Pricing*, Duff & Phelps (17 Mar. 2021), available at <https://www.duffandphelps.com/insights/publications/transfer-pricing/applying-oecd-guidance-on-covid-19-transfer-pricing> (accessed 31 May 2021).  
 143. R. Tavares de Pina & I. Wang, *Country-Specific Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic*, DLA Piper (4 Mar. 2021), available at <https://www.dlapiper.com/en/us/insights/publications/2021/03/country-specific-guidance-on-the-transfer-pricing-implications-of-the-covid-19-pandemic/> (accessed 31 May 2021).  
 144. Haringman & Gerritsen van der Hoop, supra n. 140.  
 145. J. Weise et al., *Transfer Pricing Times – Fourth Quarter 2020*, Duff & Phelps, available at <https://www.duffandphelps.com/insights/publications/transfer-pricing/transfer-pricing-times-fourth-quarter-2020> (accessed 31 May 2021).

Similarly, the Canadian Revenue Agency (CRA) has also issued a guide (Transfer Pricing Memorandum-17) stating that government assistance should be excluded from transfer pricing calculations and that the subsidy benefit must remain in Canada unless there is reliable evidence that independent parties would treat such government assistance differently.<sup>146,147,148</sup> Such guidance also applies to COVID-19 circumstances.

In the Netherlands, based on pre-existing guidelines, it is assumed that government assistance can be deducted from the cost base if there is a direct link between the government assistance and the related-party transaction.<sup>149</sup>

Finally, in relation to France, it is important to mention the decision dated 19 September 2018 of the French Supreme Administrative Court. The decision provides useful clarifications on the deduction of government assistance. In this decision, the French Supreme Administrative Court states that the mere deduction of the government assistance from the cost base (when applying cost-based transfer pricing methods) is not in itself sufficient to characterize a transfer of profits abroad. In particular, the French Supreme Administrative Court alludes to the fact that, in these types of cases, it must be analysed whether, in light of the specific conditions, the transactions undertaken by the controlled parties are consistent with transactions between independent companies.<sup>150</sup>

In conclusion, a review of these guidelines and decisions shows that there is not a unified position regarding the treatment of government assistance from a transfer pricing perspective.

To illustrate the issue of government assistance, consider the following practical example.

United Planes Group (UPG) is a multinational corporation that designs, manufactures and sells airplanes worldwide.

UPG's manufacturing activity is mainly performed in Country X through a contract manufacturer (where such activity has been performed by entity X). Entity X charges the central entity of UPG the full cost of the manufacturing activity plus a profit markup of 10%. The profit markup is based on a comparability analysis and is assumed to be at arm's length.

Due to the lockdown and restrictive measures implemented in Country X, as well as the general reduction

146. Tavares de Pina & Wang, *supra* n. 144. See also <https://www.canada.ca/en/revenue-agency/services/tax/international-non-residents/information-been-moved/transfer-pricing/17-impact-government-assistance-on-transfer-pricing.html> (accessed 31 May 2021).

147. Haringman & Van der Hoop, *supra* n. 140.

148. Weise et al., *supra* n. 145.

149. J. Dosal & M. Kratz, *COVID-19 and Transfer Pricing: Year-end Adjustments*, RSM (27 Jan. 2021), available at <https://www.rsm.global/insights/tax-news/covid-19-and-transfer-pricing-year-end-adjustments> (accessed 31 May 2021).

150. C. Silberstein & B. Granel, *The French Supreme Administrative Court Provides Useful Clarifications on the Deduction of Government Subsidies from the Cost Base in Applying Cost-Based Transfer Pricing Methods*, 26 Intl. Transfer Pricing J. 1 (2019), Journal Articles & Opinion Pieces IBFD.

in demand of UPG's products during the COVID-19 crisis, the manufacturing activity of entity X was severely affected in the 2020 financial year (in particular, outputs of company X were reduced by 25% in the 2020 financial year compared to the previous financial year).

In light of the COVID-19 economic impact, the government of Country X introduced a subsidy scheme to support companies located in Country X in the event of reduced activity due to the crisis. Entity X benefitted from the government assistance of Country X in the 2020 financial year. According to the guidelines issued by the government of Country X, the benefit from the government assistance must remain in Country X unless it can be determined that independent third parties would have acted differently under comparable circumstances.

Entity X's P&L account corresponding to the 2019 and 2020 financial years is summarized in Table 2.

	<b>FY 2019</b>	<b>FY 2020</b>
Revenue (intercompany transaction) (EUR)	177,416.80	?
Cost of goods sold (COGS) (EUR)	75,648.00	56,736.00
Operating expenses (EUR)	85,640.00	51,384.00
Government subsidy (EUR)	–	54,060.00
<i>Operating profit (EUR)</i>	<i>16,128.80</i>	
<i>Operating margin FCMU (%)</i>	<i>10.00%</i>	

As the prices associated with the direct costs of producing the goods sold by Company X remained constant in the 2020 financial year compared to the previous year, the total COGS of company X decreased by 25% (as well as the total outputs of such company). In addition, in the 2020 financial year, company X received government assistance amounting to EUR 54,060 (depending on the country, the grant could be accounted differently in the financial statements).

When determining the arm's length price associated with the sale of airplanes to the central entity of UPG, several options can be suggested, some of which are summarized in Table 3.

In Scenario 1, when determining the price associated with the intercompany transaction (sale of airplanes to the central entity of UPG), entity X deducts the total amount of the government assistance (EUR 54,060) from the cost base. In this way, the benefit derived for the receipt of the government assistance will be transferred to the country of the central entity of UPG. This is because a lower charge is made to the principal/central entity.

In Scenario 2, despite having received the government assistance (EUR 54,060), when determining the arm's length price of the intercompany transaction, entity X will not deduct the government assistance from the cost base, keeping the benefit derived from the government intervention in Country X. Likewise, the price associated

Table 3 – Possible scenarios/options for determining the arm's length price of the intercompany transaction carried out between Company X and UPG			
	FY 2020 (Scenario 1)	FY 2020 (Scenario 2)	FY 2020 (Scenario 3)
Revenue (intercompany transaction) (EUR)	59,466.00	118,932.00	89,199.00
Cost of goods sold (COGS) (EUR)	56,736.00	56,736.00	56,736.00
Operating expenses (EUR)	51,384.00	51,384.00	51,384.00
Part of the government subsidy (54,060.00) to be deducted from the cost base (EUR)	54,060.00	0.00	27,030.00
<i>Operating profit (EUR)</i>	<i>5,406.00</i>	<i>10,812.00</i>	<i>8,109.00</i>
<i>Operating margin FCMU (%)</i>	<i>10.00%</i>	<i>10.00%</i>	<i>10.00%</i>

with the sale of airplanes to the central entity of UPG will increase compared to Scenario 1.

In Scenario 3, after accurately analysing the relevant functions, assets and risks associated with the intercompany transaction between company X and the central entity of UPG, and also considering the conduct of independent third parties under comparable circumstances, entity X decides to deduct half of the government assistance received from the cost base (evenly distributing the government assistance benefit between Country X and the country in which the central entity of UPG resides).

As noted above, the guidelines implemented in some countries on the treatment of government assistance defend that Scenario 2 is the only correct one. However, in certain cases, it is possible, based on the analysis of relevant assets, functions and risks of the entities involved in the related-party transaction and considering what independent third parties would have agreed to under comparable circumstances, that a different scenario is determined to be in line with the arm's length principle.<sup>151</sup> Thus, Scenario 3 could also be contemplated.

## 10. Concluding Remarks

The COVID-19 crisis has had an unprecedented impact on MNE groups. Regarding transfer pricing, the transfer pricing policies of many MNE groups have been heavily affected, forcing these groups to implement changes to adapt to this new reality.

For this reason, it is crucial that MNE groups analyse the possible impact of COVID-19 in their value chains in general (e.g. whether it is necessary to implement organizational changes) and, particularly, in their intangible and financing transfer pricing policies.

As discussed in this article, MNE groups must also pay attention to some transfer pricing matters like the process for preparing benchmarking studies of the financial years affected by the crisis in practice, the impact on both existing APAs and those currently being negotiated, as well as the potential impact from receiving COVID-19-related government assistance.

Lastly, the importance of preparing contemporaneous transfer pricing documentation, including details of implemented changes (the documentation must contain a summary of the implications of the COVID-19 crisis for the MNE group, audit trails of decision making and the tax and transfer pricing analyses performed), has been discussed in this article. This documentation will be crucial for justifying the impact of COVID-19 on the MNE and for defending any change implemented in the MNE group throughout the COVID-19 era.

151. J. van der Zwaan & T. Dijkman, TP Impact of COVID-19, Taxand (1 Oct. 2020), available at <https://www.taxand.nl/wp-content/uploads/2020/10/Presentatie-TP-01102020-final-1.pdf> (accessed 31 May 2021).