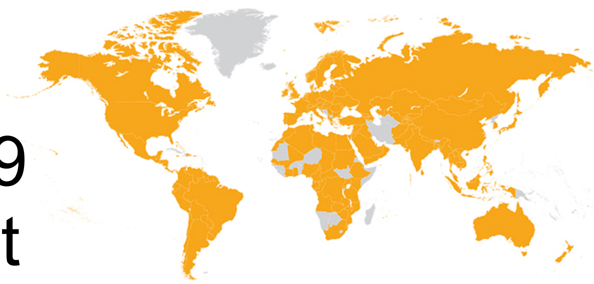
Crowe Transfer Pricing Wednesday



The worldwide Covid-19 lockdown and its impact on the interpretation of OECD Transfer Pricing Guidelines

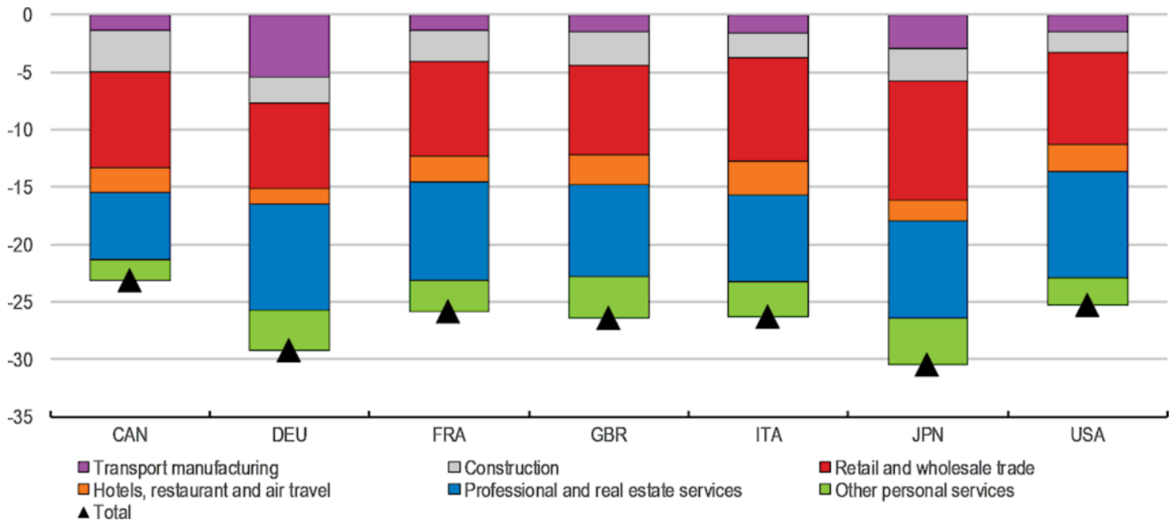
Covid-19 Effects (CORONAVIRUS/PANDEMIC) in the Transfer Pricing analysis

04/22/2020

OECD Secretary General Angel Gurría, in preparation for the G20 Virtual Summit unveiled the latest OECD estimates showing that the lockdown will directly affect sectors amounting to up to one third of GDP in the major economies. The OECD evaluated in the report dated April 14 2020 the initial impact of COVID 19 containment measures on economic activity[1] (https://www.oecd.org//coronavirus/policy-responses/evaluating-the-initial-impact-of-covid-19-containment-measures-on-economic-activity/#figure-d1e120). The evaluations shown there are frightening:

Figure 1. **The potential initial impact of partial or complete shutdowns on activity in the G7 economies**

Per cent of GDP at constant prices



In the course of the Corona crisis, the focus of interest will shift to intra-group financing instruments such as loans, cash pooling, guarantees and liquidity guarantees to secure the liquidity of the group and to bridge any shortfalls. This dramatic development of the Covid-19 pandemic could of course not be reflected in the new OECD Transfer Pricing guidelines on Financial Transactions, published on 11 February 2020[2].

[1] https://www.oecd.org//coronavirus/policy-responses/evaluating-the-initial-impact-of-covid-19-containment-measures-on-economic-activity/#figure-d1e120
[2] http://www.oecd.org/tax/beps/transfer-pricing-guidance-on-financial-transactions-inclusive-framework-on-beps-actions-4-8-10.html

After two of intense debate over the treatment of the different types of financial intra-group transactions the new OECD Transfer Pricing guidance on Financial Transactions is one of the most important contributions of the entire BEPS process.

Here the OECD Transfer Pricing Guidelines for Multinational and Tax Enterprises and Tax Administrations 2017 find the long awaited necessary supplement.

This report contains transfer pricing guidance on financial transactions, developed as part of Actions 4, 8-10 of the BEPS Action Plan. This report is significant because it is the first time the OECD Transfer Pricing Guidelines includes guidance on the transfer pricing aspects of financial transactions, which will contribute to consistency in the interpretation of the arm’s length principle and help avoid transfer pricing disputes and double taxation. Sections A to E of this report are included in the Guidelines as Chapter X. Section F is added to Section D.1.2.1 in Chapter I of the Guidelines, immediately following paragraph 1.106. The guidance describes the transfer pricing aspects of financial transactions and includes a number of examples to illustrate the principles discussed in this report.

In times of the Corona crisis and in the periods after it, nobody will want to give up the arm's length principle. This applies to the estimated interest rate of intra-group loans right up to the issue of refinancing costs, which will increase, sometimes drastically, if the credit rating of individual group companies is worsened. Higher risk premiums will become due. Also, the issue of the tax assessment of Group implicit support as described in #10.77 and #10.78 of the 2020 Report may in some cases no longer be able to be handled so restrictively in times of the Corona crisis.

We therefore recommend that all intra-group financing relationships and the associated contractual framework conditions be reviewed and, if necessary, adjusted in accordance with the new OECD Transfer Pricing Guidelines on Financial Transactions. The Group-wide use and allocation of special government loans in the context of the Corona crisis may later be critically questioned by the tax authorities.

Covid-19 generates a crisis that affects everyone and at worldwide level. The most damaged industries are as shown by the OECD Figure above:

- tourism, airline companies, maritime companies, manufacturing, finance, education, construction.
- The most benefited companies are: medicine, food, health care, internet.

We expect further significant Covid-19 effects which must be taken into account when analyzing transfer pricing systems. From today's perspective, these can be summarized as follows:

General aspects to be considered in the Transfer Pricing analysis, considering a balanced position of the arm’s length principle:

1. Funding: the companies need funds to comply with their obligations.
2. Intangible assets migration: companies need to dispose of their assets and get hold of funds.
3. Big losses or profitability drop: expenses or losses are distributed or allocated among all companies within a Multinational Group, considering the business development.
4. Demand reduction and changes in the marketing modalities.
5. Tax Authorities will establish new collection taxes or will become more efficient upon collecting current taxes.

OECD has been working on the economic conditions and the business strategies for companies. Highlights on elements to be considered:

1. Analyze the reason for the profitability drop.
2. Identify transactions conducted between related parties.
3. Observe the functions of each of the Group's companies.
4. Observe if there are any transfer pricing or risk assessment policies in force.

Independent third parties are reviewing their transfer pricing policies, conducting assets' migrations, reallocating functions.

The following additional practical aspects should be considered in the transfer pricing analysis:

- There are records of previous crisis (2001, 2008/9) tax courts' deliberations, so it is neccessary to document the situation of the companies' current business (business that has been affected by this crisis and which impacts multinational groups at worldwide level.)

- Tax Authorities already have experience with former cases that reached different stages of discussion (Tax Courts, Appeals Court, Supreme Court of Justice) and are also aware of the current situation.

- It is necessary to identify everything that relates to this Covid-19 atypical situation, and which has nothing to do with transfer pricing, that can be used as evidence for the analysis and a possible comparability adjustment for the analyzed party (local company.) For example, the comparability adjustment to a local company could be the consequence of fixed overheads which were not born due to the drop in the sales volume in both local and external markets.

- If the 2020 period (affected by Covid-19) from the analyzed party is compared with a three-year average (2019 to 2017) of comparables (which were not affected, thus present a different situation), the comparison will be difficult since all comparables have a higher profitability margin and the local Company will be placed below the interquartile range of independent companies.

- The reason being used for rejecting companies with recurring operating losses may no longer be applicable, in order to avoid leaving out companies that were possibly affected by Covid-19 or another particular business situation that is not related to transfer pricing.

- It is necessary to coordinate with the auditors how to record extraordinary issues generated as a result of Covid-19 (for example, subsidies) in the companies' financial statements. Such issues should be defined as operating, since the Tax Authority attaches importance to operating revenue, costs and expenses from the Balance Sheet and challenges items like other income and expenses, which are used in the transfer pricing analysis.

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