Introduction

Transfer Pricing has been challenged several times by global economic recessions and slumps in business activities caused by external stimuli. Whether the burst of the dot com bubble in the early 2000s that disrupted the internet and technology sector, or the banking and financial crisis of 2008 which led to a near total collapse of the world economy, transfer pricing arrangements have been and will continue to be vulnerable to the vagaries and volatilities in the overall economic environment.

As countries around the world seek to mitigate the impact of the outbreak of novel coronavirus disease 2019 (“COVID-19”)[1], individuals and businesses alike face an uncertain future. In addition to the tremendous toll this pandemic continues to take on the health and healthcare systems of all nations, the economic impact of this outbreak will reverberate for years to come.

In these fraught times, it is imperative for us to consider the implications of this crisis on business generally. This article highlights a few of the many transfer pricing implications of the COVID-19 pandemic, but more importantly, provides direction on immediate actions Multinational Enterprises (MNEs) must take if future disputes with tax authorities are to be avoided.

Effect on Businesses

As COVID-19 spread globally, policymakers in numerous countries were faced with a grim reality. With estimates suggesting that the virus will affect anywhere from 25 percent to 75 percent of the world’s population, a decision was required: let the epidemic run its natural course and peak quickly, or slow the spread over a longer period by introducing quarantine measures.[2] Allowing the epidemic to run its natural course would lead to a higher death toll in the near-term and threaten to overwhelm healthcare systems; so, as we know firsthand, most governments have attempted to slow the spread of the disease through varying degrees of quarantine measures. With these quarantine measures come severe economic consequences.

Large MNEs with a global presence will feel the effects of the COVID-19 pandemic in every jurisdiction in which they operate. Supply chains have been disrupted, production issues and travel concerns abound, and MNEs face difficult decisions as it relates to their workforce. Against this backdrop, most businesses’ tax obligations, although deferred in many jurisdictions, have not disappeared. Now more than ever, the integrity of a business’s transfer pricing framework will be tested. Global economic turmoil stemming from COVID-19 will, in many cases, lead to operating losses for entities throughout the value chains of MNEs. Such losses will disrupt a system of targeted, routine returns, which underpins the transfer pricing frameworks that many organizations implement.

Transfer Pricing Considerations

Comparability in Testing Transactions

While a business’s financial results and forecasts will reflect current economic conditions, the same is not necessarily true for the available comparable data. Consequently, significant comparability issues may arise from the COVID-19 pandemic which will impact how comparability analyses are undertaken going forward.

Comparable Uncontrolled Price (CUP) Transactions

In times of severe economic recession, it may be difficult, if not impossible, to find adequate CUP transactions to test the arm’s length nature of certain intercompany transactions. Discounts given for bulk purchases, extended credit terms, and rebates are some examples of the factors that would impact product pricing. As a result, CUP analyses must be sufficiently detailed to account for new factors related to product pricing arising as a result of the COVID-19 pandemic.
Further, depending on specific facts and circumstances as well as availability of third party comparable data, companies may also need to consider whether using a CUP method continues to be appropriate for pricing their intercompany transactions. In some cases, mirroring third party behavior, companies may need to change the methodology applied to test their transfer pricing arrangements because the conditions required for application of the CUP method are no longer valid.

Changes in Profitability

During periods of severe economic downturn, many companies experience significant declines in sales volume and capacity utilization as a result of downward demand shocks. In the case of the COVID-19 pandemic, demand has been suppressed as a result of quarantine measures enacted around the world. This decreased demand will have significant impact on the profitability of affected companies in the short-term, requiring these companies to respond through cost-cutting measures (e.g., reduced supply, worker layoffs). An important determinant of the degree to which a given company may experience profit declines is the company’s proportion of fixed costs to its total cost base. Since many MNEs have structures that contain limited risk distributors or contract manufacturers that likely have a significant amount of fixed costs, periods of decreased demand can have major transfer pricing implications.

In considering the effect of the COVID-19 pandemic on profitability, one must consider the functions, assets, and risks profile of the ‘tested party’ of the relevant comparability analysis. Should a limited risk distributor, for example, achieve lower profitability during an economic recession, or should that decline in profitability be borne entirely by the group entrepreneur/principal? Should a contract manufacturing entity bear the cost of increased input prices or unutilized capacity entirely, or should this cost be shared with other entities in the group? These are the types of questions that tax departments need to consider.

Special consideration must also be paid to the comparable companies selected for comparability analyses. For example, typically companies with consecutive years of operating losses are screened out for benchmarking purposes. However, in a period of severe economic turmoil, such a screen may no longer be appropriate as the tested party may have faced similar circumstances. In the post-COVID-19 landscape, even the most routine comparability analyses must be heavily scrutinized, in order to ensure that the companies selected to benchmark a taxpayer’s profitability are truly comparable.

Further, in the first year of an economic downturn, the comparable data used to perform a transfer pricing analysis may not truly factor in the effects of any recession, as current year data for comparable companies is usually not available at the time of conducting the analysis. Using multiple year data covering the previous two to three years, which is a common approach, does not capture the downward impact on sales and profitability of comparable companies. Therefore in the first year, economic downturn adjustments may need to be performed on the comparable data in order to bring it on par with the data of the tested party.

Foreign Exchange

Periods of economic recession or turmoil are often accompanied by unusual foreign exchange fluctuations. This volatility is an important factor affecting a company’s profitability. In analyzing the impact of foreign exchange in comparability analyses, one should consider: i) how the tested party and comparable companies treat foreign exchange gains or losses for accounting purposes (i.e., as an operating or non-operating expense); ii) what impact foreign exchange gains or losses played on the profitability of the tested party; and iii) the functions, assets, and risks profile of the tested party and whether foreign exchange risk is a risk it should bear in light of its entity classification in a transfer pricing framework.

For companies that record a material foreign exchange loss due to recessionary conditions, consideration should be given to whether that company actually exercises economically significant decisions on account of treasury management activities and whether that entity controls the risks arising as a result of those activities. Where this is not the case, transfer pricing arrangements must be carefully evaluated to ensure that the financial implications of adverse foreign exchange movements are vested with the relevant company in the group.

Profit/ Loss Splits

Current transfer pricing analyses are largely focused on an operating profit-based comparison between a tested party and comparable companies using the transactional net margin method (TNMM). However, in a recessionary world, intercompany dealings and behaviors of companies in a MNE group may change, necessitating a shift in the most appropriate transfer pricing method to be applied to test compliance with the arm’s length principle. For example, some companies within the group may start performing greater functions and assuming greater risks in a recessionary phase. Practical limitations on adequate and reliable data availability for comparable companies could be another factor driving the change when considering the most appropriate transfer pricing method to apply during an economic downturn.

The application of a profit/ loss split method to determine arm’s length considerations in these instances may be more suitable than the use of historically-applied TNMM-based (or other) methodologies. In all such cases, the analysis should carefully consider the new data and apply a transfer pricing methodology that independent third parties would have agreed to under similar facts and circumstances.
Documentation Compliance and Future Audits

Taxpayers will face new challenges in terms of both compliance with documentation requirements and future transfer pricing audits as a result of COVID-19.

Use of Multiple-Year Data

The Canada Revenue Agency (CRA) clarifies its position on the use of multiple-year data for transfer pricing comparability analyses in its transfer pricing memoranda (TPM)-16. While a preference for single-year testing is expressed, the CRA states that:

*Multiple year data should be used in those circumstances where the additional information will improve the accuracy or reliability of the transfer pricing analysis. In this respect, data that helps to increase the breadth or depth of the understanding of the characteristics of the controlled transaction and any potential comparable transactions will generally be of value in a transfer pricing analysis.* (TPM-16, paragraph 16)

It is imperative that companies maintain detailed records of the specific impact of the COVID-19 outbreak for each jurisdiction in which they operate. Such records will assist in documenting tested party results from 2020 and the years that follow. Moreover, specific data and evidence maintained by companies will bolster the argument that multiple-year data should be considered in comparability analyses.

While multiple year data normally provides a more reliable approximation of arm’s length prices than single year data, one needs to carefully consider the impact of multiple year data usage on the accuracy of the results in a recessionary economy. Certain years during a downturn period may be more severe than others. By averaging out the comparable data over a number of years, the true impact of the current year’s economic conditions may not be duly reflected in the results. A robust transfer pricing analysis should take into account various factors like unavailability of current year data in databases at the time of performing the comparability analysis, potential adjustments to multiple year data to reflect the economic conditions in the current year, assigning appropriate weights to different years depending upon specific economic conditions prevalent in each year, etc.

Importance of Record Keeping

Given the nature of the audit cycle in Canada, it is likely that issues associated with COVID-19 will be a common focus of the CRA in the next two to four years. It is important that companies understand what data needs to be prepared and/or retained to address potential challenges from the CRA and other tax authorities regarding entity profitability issues during the COVID-19 epidemic.

Intercompany Agreements

Taxpayers should review existing intercompany agreements to determine whether these agreements contain provisions related to transfer pricing adjustments in the event of business disruptions. Alternatively, companies may consider whether existing intercompany agreements should be renegotiated in order to reflect new arm’s length realities. In drafting new intercompany agreements during this period, companies should consider whether it would be appropriate to include force majeure provisions to account for future economic disruptions.

Advance Pricing Arrangements (APAs)

Even companies that are party to existing APAs, which typically provide a level of tax certainty, are facing new uncertainty in the wake of the COVID-19 outbreak. Companies which have APAs should review the terms of these agreements to determine whether they contain provisions related to financial adjustments for unforeseen economic events. Furthermore, APA adjustments to bring entities to agreed-upon levels of profitability may increase significantly in light of losses resulting from the COVID-19 pandemic.

Another aspect that needs to be evaluated is the critical assumptions defined in the APA which may no longer hold true with a significant change in the underlying economic conditions. For some taxpayers, a critical assumption may be triggered due to sales or profits during the APA period falling drastically below a specified level which may then warrant a renegotiation of the APA with the Tax Authorities taking into account the revised set of facts and circumstances. Where an existing APA does not contain adequate critical assumptions to factor in a change in the economic circumstances of the taxpayer as a result of external unforeseen events, it may be more complex to argue inapplicability of the results agreed under the APA.

Companies facing vexed audit issues and potentially significant audit adjustments should consider initiating an APA to begin discussions with Tax Authorities on a timely basis. Deferring the decision to a later stage or waiting for the audit to commence may potentially have unfavorable implications. Tax Authorities are expected to be more amenable to objective and rational discussions of the impact of the current environment on future transfer pricing results today rather than a few years into the economic downturn.
Related Party Loans

In the approximate eight month period through February 2020 before the COVID-19 pandemic exponentially increased its impact in North America, North American corporate debt issuers had benefited from debt market liquidity and a period of low long-term fixed interest rates. This was relevant for both investment grade issuers and speculative grade issuers, and also observable in both the primary and secondary debt markets.

The low interest rate period appears to be over. In early March, a significant liquidity crunch hit both investment grade and speculative grade corporate debt markets, leading to a lower volume of new issuances placed, higher primary market offering yields, and significantly higher secondary market trading yields. In response, central banks moved quickly to implement monetary policy measures to ease the liquidity crisis (e.g., the Primary Dealer Credit Facility announced by the US Federal Reserve on March 17). These measures were primarily aimed at the investment grade market, resulting in an explosion of primary market activity among investment grade issuers over the last two weeks of March.

Although central banks are cutting interest rates and long-term yields for government debt are at historical lows, these low interest rates are generally not being passed onto investment grade issuers. Compared to February, investment grade interest rates have generally increased.

With respect to speculative grade issuers, the primary market has seen limited new issuances in March 2020 because these issuers are generally excluded from the above monetary measures.

With respect to their intercompany debt financing arrangements, MNEs should be aware of the following:

- Corporate debt markets are changing daily as illustrated in the above background. Thus, it is important to obtain and analyze the most up-to-date information and data before proceeding with any intercompany debt transaction.
- For new intercompany debt with a speculative grade borrower, it will be important to appropriately analyze and document the financial strength of the borrower in order to argue that the company would be able to issue debt at arm’s length.
- To the extent circumstances exist requiring a need to unwind or restructure certain intercompany debts, consideration should be given to the impact of the current lending environment.
- Where relevant, consideration should be given to industry nuances in the lending environment when assessing the arm’s length terms and conditions of the debt.
- Due to low government interest rates, there may be opportunities with respect to intercompany debts which accrue interest at a safe harbour rate (e.g., the Applicable Federal Rate for US dollar-denominated debt), because these rates are generally determined in reference to government securities.
- Where a related party borrower is in breach of certain covenants or unable to meet interest payments, due consideration should be given to the remedies being observed in similar arm’s length circumstances given the current unique environment.

Control of Risk

In this rapidly evolving landscape, it is important that companies understand and abide by their disaster contingency plans; namely, who is driving the response to the management of any business issues arising from the pandemic? In a transfer pricing context, this management of risk during a crisis like the COVID-19 outbreak has implications for the sharing of profit (or more likely, losses). The 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) assert that, “A party should always be appropriately compensated for its control functions in relation to risk. In circumstances where a party contributes to the control of risk, but does not assume the risk, compensation which takes the form of a sharing in the potential upside and downside, commensurate with that contribution to control, may be appropriate.” (OECD Guidelines 1.106). In the event of perceived mismanagement of the COVID-19 crisis from decisions made centrally, which entity should bear resulting losses? Years from now, it is possible that tax authorities in jurisdictions where subsidiary companies suffered significant losses during the COVID-19 pandemic may make arguments in this vein. In practice, it is likely difficult to quantify what relates to the impact of the pandemic versus the management of the response in an MNE, but this remains a topic for consideration and discussion for businesses.

Given these unexpected times, the importance of maintaining comprehensive contemporaneous transfer pricing documentation supporting the actual conduct and control of critical functions and risks relating to management of the crisis by a MNE cannot be overstated. Tax authorities would also expect taxpayers to perform a more detailed analysis of their intercompany transfer pricing arrangements, appropriately factoring in the nuances and complexities introduced by the external environment.

Business Restructurings

Many businesses will consider restructuring their global business operations during an economic recession. As the global economic landscape changes, MNEs may decide to engage in business planning by reconfiguring their supply chains and realigning functions and risks based on an assessment of commercial realities in the transformed business realm. Any business restructuring that leads to a
material reallocation of functions and risks may lead to the recharacterization of existing arrangements by tax authorities. The possibility of exit charges should be considered, in addition to a need for a review and redesign of the group’s transfer pricing policies. Furthermore, the appropriate splitting of group profits/losses between the principal/entrepreneurial entities in the group would be a key element of transfer pricing analysis in a post restructuring recessionary phase for an MNE.

Similarly, some companies in the group may be downsized or their operations ceased as a result of the economic downturn. Company closures may involve a number of financial repercussions such as contract termination costs, severance costs, disposal of assets at less than book value, etc. The appropriate treatment of these costs from a transfer pricing perspective in the jurisdiction of the concerned company is an important factor for consideration.

MNEs need to be cognizant of the potential transfer pricing implications of such business-driven restructuring and ensure that they take the required actions to comply with applicable transfer pricing rules in all affected jurisdictions. MNEs should also be vigilant in the need for maintaining the requisite level of documentation that supports the business and commercial rationale for such business restructurings and policy amendments in order to avoid potential challenge by tax authorities during audits.

**Cash Repatriation and Management**

Recessionary global economic conditions are also expected to impact the cash flow situation of many MNEs. As businesses face a sustained decline in their sales and profitability levels, and delayed payments of their receivables as customers seek to optimize their own cash positions, many companies will find themselves constrained due to inadequate cash flow. Intercompany debt arrangements would also bear the brunt of this economic situation with borrower entities within the group potentially in violation of financial covenants, being unable to service their debt and interest payment obligations to lender entities, and similar defaults on other intercompany payables. Parent companies within the group may also be unable to infuse additional capital into subsidiary companies who may be facing issues in sustaining their operations otherwise.

For intercompany debt arrangements where the borrower is in breach of a financial covenant, or the borrower is unable to make a required payment, caution should be exercised to ensure that an appropriate debtor-creditor relationship is maintained between the lender and the borrower. This may necessitate modifying or even waiving financial covenants for a period of time, and/or allowing the borrower to service the debt via a payment-in-kind option (adding accrued but unpaid interest to the outstanding balance of the loan). Ultimately, any remedies would have regard to those being observed in the market between arm’s length lender-borrower participants.

MNEs will need to pay close attention to cash management across the group in order to withstand the economic effects of the expected recession. Tax efficient cash repatriation strategies should be implemented to ensure effective utilization and deployment of cash to the more critical jurisdictions of operation to ensure continued business viability for the MNE.

**Final Thoughts**

Despite being an incipient situation, the global outbreak of COVID-19 is already arguably the most socially disruptive global event of our lifetime. As the pandemic persists, it is clear the economic impact of the crisis will worsen. Businesses will suffer, and industries may be transformed in unforeseen ways. From a transfer pricing perspective, it is important to understand the implications of this pandemic. Through careful consideration of transfer pricing and economic theory, the evaluation of heuristic approaches, and collaboration with tax advisors and operational personnel, companies can chart a course forward as the world emerges from this unprecedented event.
References


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