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TaxNewsFlash

Canada

COVID-19 — OECD Urges Flexibility for Transfer Pricing

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Multinational enterprises may want to review the new OECD guidance on the transfer pricing implications of the pandemic. The new guidance, released on December 18, 2020, discusses how the arm's-length principle and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 apply to certain issues resulting from the pandemic.

The guidance, which represents the consensus view of the 137 members of the Inclusive Framework on BEPS (including Canada), encourages both taxpayers and tax administrations to consider practical approaches consistent with the taxpayer's transfer pricing policy over time. However, it's not yet clear how tax authorities in Canada and other jurisdictions will consider the guidance in dealing with taxpayers. In particular, the guidance focuses on issues related to:

- Comparability analysis
- Losses and the allocation of COVID-19-specific costs
- Government assistance programs (such as grants, subsidies, forgivable loans, tax deductions, or investment allowances)
- Advance pricing arrangements (APAs).

Background
The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 are intended to help tax administrations and multinational enterprises find mutually satisfactory solutions to transfer pricing cases. However, COVID-19's unique challenges have led to significant financial and operational risks for companies, including practical challenges in applying the arm's-length principle. For

taxpayers applying transfer pricing rules for the financial years affected by the COVID-19 pandemic, there is an urgent need to address these practical questions.

Comparability analysis

The guidance encourages tax administrations to allow for an arm's-length outcome testing approach where feasible (instead of a "price-setting" or ex ante approach) to incorporate information that becomes available after the close of the tax year in reporting results on the tax return. The guidance also recommends using more than one transfer pricing method to corroborate the arm's-length price, given that one of the major challenges that taxpayers may face is the lack of contemporaneous uncontrolled transactions data for 2020 until mid-2021.

However, the guidance also notes that not every application of the transactional net margin method (TNMM), requires contemporaneous information for 2020, such as where a long-term arrangement insulates the tested party from risks related to the pandemic. As the pandemic has created economic conditions that differ from those of previous years, entities that roll forward an existing set of comparables to cover 2020 may need to review the suitability of these comparables. Further, loss-making comparables that satisfy the comparability criteria in a particular case should not be rejected on the sole basis that they suffer losses in periods affected by the COVID-19 pandemic.

In addition, the guidance notes that any form of publicly available information regarding the effect of COVID-19 on the business, industry and controlled transaction may be relevant in determining the arm's-length nature of the transfer pricing policy for 2020, for example, an analysis of how sales volumes or capacity utilization have changed during COVID-19, the government assistance received or specific information on exceptional costs.

Establishing the period of data used to evaluate arm's-length pricing

The guidance notes that the principles outlined in the Transfer Pricing Guidelines regarding the use of multiple-year data and averages still apply. However, as a pragmatic approach, it may be appropriate to have separate testing (or price setting) for the duration of the pandemic or for the period most affected by the pandemic, depending on the circumstances. In other situations, the use of combined periods (i.e., years that are and are not affected by the pandemic) may improve reliability.

KPMG observations
In general, the CRA outlines its position on the use of multiple-year data for transfer pricing comparability analyses in Transfer Pricing Memorandum TPM-16. While the CRA's view expresses a preference for single-year testing, it also states that taxpayers should use multiple year data in 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.

Price-adjustment mechanisms

The guidance advises that domestic price adjustment mechanisms that allow the adjustment of prices relevant for 2020 in a later period may provide for flexibility. However, care would need to be taken with their appropriate characterization, such as how the payment may affect the comparability analysis for 2021, and their potential resultant VAT/GST and customs duty implications.

Losses and allocation of COVID-19-specific costs

The new guidance provides general principles on the allocation of losses between associated entities.

First, the guidance states that the allocation of risks between the parties to a transaction affects how profits or losses resulting from the transaction are allocated at arm's length. For example, when determining whether a "limited-risk" entity could incur losses at arm's length, it is important to consider the risks assumed by the entity (e.g., marketplace risk) , depending on the specific facts and circumstances, and whether the position is consistent with the accurate delineation of the transaction. The Transfer Pricing Guidelines provide for the possibility that simple or low-risk functions may incur losses in the short run.

Further, the guidance notes that exceptional, non-recurring operating costs arising as a result of COVID-19 should be allocated based on an assessment of how independent enterprises under comparable circumstances operate. In addition, these costs should generally be excluded from the comparability analysis, to be consistent with the net profit indicator of the comparables, except when those costs relate to the controlled transaction as accurately delineated. In the latter case, if included in the cost base, it is important to consider whether such costs should be treated as pass-through costs. In addition, adjustments for accounting consistency may be required to improve comparability when exceptional costs arising from COVID-19 may be accounted for, as either operating or non-operating items by different taxpayers in different transactions.

The guidance notes that determining whether a renegotiation is arm's length should include:

- Careful consideration of the options realistically available
- The long-run effects on the parties' profit potential of the parties, or
- Whether the economic impact resulting from the renegotiation may require indemnification.

The guidance emphasizes that, without clear evidence that independent parties in comparable circumstances would have revised their existing agreements or commercial relations, taxpayers should treat the modification of existing intercompany arrangements with caution. In addition, taxpayers should ensure these arrangements are well-supported by documentation outlining how the modification is in line with the arm's-length principle.

Force majeure and the allocation of losses

The guidance advises that it cannot be automatically assumed that the COVID-19 pandemic is sufficient to invoke an intercompany contract's force majeure clause. Further, the guidance advises that it cannot be automatically assumed in the absence of a force majeure clause that a renegotiation with a potentially similar outcome at arm's length would be inappropriate.

Government assistance programs

The guidance acknowledges that government assistance programs potentially have transfer pricing implications. The economic impact of these programs (e.g., an increase in revenues or decrease in costs) on the accurately delineated transaction needs to be considered in a transfer pricing analysis and properly documented.

Further, the guidance advises that, in the absence of reliable information regarding how independent parties would allocate government assistance, caution should be exercised in assessing whether a purported sharing of government assistance represents an arm's-length outcome. The guidance also notes that taxpayers should ensure that providing government assistance to an associated party will not change the allocation of risk in a controlled transaction for transfer pricing purposes.

Since government assistance and the specific circumstances of the COVID-19 pandemic may vary across different markets, it may affect the comparables and the arm's-length prices of uncontrolled transactions in different ways. Further, when applying a one-sided method (e.g., the TNMM), the accounting treatment of the government assistance in both the tested party and any comparable may need to be specifically identified, especially when the tested party and the comparables apply different accounting standards.

KPMG observations
The CRA is generally of the view that the benefit of government assistance provided by the Canadian government should be retained by the Canadian taxpayer (e.g., for intra-group services provided by a Canadian service provider, the fully loaded cost base would not be reduced by the benefit of wage subsidy under this approach). However, the CRA recognizes in Transfer Pricing Memorandum TPM-17 that there may be particular situations where arm's-length parties would agree to share the benefits of government assistance.

Advance Pricing Arrangements (APAs)

The guidance says that existing APAs and their terms should be respected, maintained, and upheld, unless a condition leading to the cancellation or revision of the APA has occurred (e.g., breach of critical assumptions).

If a taxpayer believes that the terms of the APA are no longer appropriate, they should approach the relevant tax administration in a transparent way to discuss their concerns in a timely manner in order to understand if any revision, cancellation or revocation of the APA is at stake.

The guidance acknowledges that tax administrations are likely to respond differently to the failure to comply with the terms of an APA than to the failure to meet critical assumptions in terms of whether they cancel, revoke, revise or enforce an APA.

APAs under negotiation

In considering APAs under negotiation, the guidance encourages all parties to adopt a flexible and collaborative approach and provides practical examples to determine how to account for the current economic conditions.

KPMG observations
Multinational enterprises may have other potential year-end implications and considerations for transfer pricing that may arise as a result of the COVID-19 pandemic. For a summary of these issues, see our *TaxNewsNow* article "Transfer Pricing — Year-End Implications & Considerations".

We can help

Your KPMG adviser can help you assess the effect of the OECD's guidance and discuss how this might affect you going forward. For more details on the COVID-19 guidance issued by the OECD, contact your KPMG adviser.