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# Transfer Pricing Implications of COVID-19—No Easy Fixes Available

By Monique van Herksen and Clive Jie-A-Joen

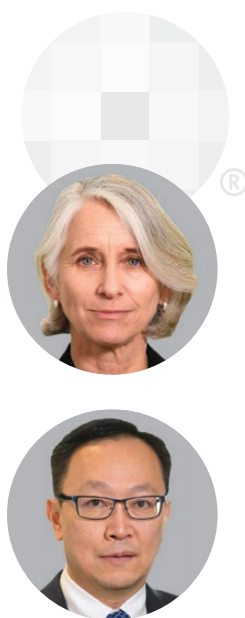
## Introduction

The COVID-19 pandemic began in March of 2020 when countries implemented lockdowns to help curb the spread of the virus and the WHO formally declared the virus outbreak a pandemic.

The pandemic, which as of March 22, 2021 had more than 2.72 million deaths attributed to COVID-19, led to draconian government interventions. These included—and continue to include—lockdowns, quarantine requirements, travel restrictions and border closures. These interventions in turn had a massive economic impact. They led to supply shortages stemming from globally increased usage of equipment to fight outbreaks, panic buying (which in several places led to shelves being cleared of grocery essentials), sudden halt of demand for certain products and services but also to total disruption of factory and logistic operations. The economic impact can differ depending on the sector and even within the same sector. And while vaccination programs are haltingly being rolled out, the pandemic continues to have a major impact on business and the global economic climate.

At the (virtual) 11th meeting of the OECD's Inclusive Framework on January 27 and 28, 2021, the global impact of the COVID-19 pandemic was discussed. OECD projections include a gradual walk to recovery that will take at least until 2022. Three major challenges to the world economy and for business in general were identified resulting from the pandemic: (i) unemployment and aggravated pressure from automation; (ii) (risk of) bankruptcies as corporate debt is close to the levels it had during the global financial crisis (of 2009); and (iii) the marked rise of public debt. In issue is when and how governments need to withdraw their stimulus programs.

So clearly, the impact of COVID-19 is worldwide and significant. It also impacts the transfer pricing practice of multinational enterprises ("MNEs"). As the world became more international, MNEs implemented global supply chains and centralized production and service functions in locations where people skills were high and costs proportionally low. However, border closings and lockdowns have dramatically frustrated and upended many of these supply



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chains. While independent enterprises will assess these developments and can act swiftly to reduce costs and reframe to cater to possible new opportunities, MNEs may find themselves caught in a tight net of corporate tax rules that govern the allocation of global income to the separate enterprises that make up the MNE: transfer pricing rules and regulations. Their global income allocation is determined by an analysis of functions performed, assets used and risks assumed. Changes to the characterization of the separate enterprises and to the previously determined income allocation are generally scrutinized, assumed to be exclusively for tax optimization purposes and often vigorously challenged by tax authorities. During a panel on COVID-19 and its impact on transfer pricing at a virtual TP Minds conference on September 1, 2020, we discussed a series of aspects that we expected to become relevant for corporates and their tax and transfer pricing directors. Subsequently, we urgently requested the OECD in an open letter supported by business representatives to issue practical guidance as to the impact on transfer pricing of the COVID-19 pandemic.<sup>1</sup>

On December 18, 2020, the OECD published its guidance on the transfer pricing implications of the COVID-19 pandemic. Issues of particular concern to business addressed by the OECD are: (i) the comparability analysis that is used to benchmark what profit margin or return qualifies as being at arm's length for associated enterprises; (ii) when will the incurrence of losses and the allocation of COVID-19 specific costs qualify as being at arm's length? For example, can so-called limited risk entities suffer losses?; (iii) what is the impact of government stimulus programs for the inter-company transaction and transfer price as seen from an arm's length perspective?; and (iv) what to do with previously agreed profit margins in so-called Advance Pricing Agreements ("APAs") when the economic circumstances change as much as they may do in the COVID-19 situation?

In its guidance, the OECD emphasizes continued application of the general transfer pricing framework to analyze the transfer pricing implications of the COVID-19 pandemic and offers no easy fixes to substantiate that COVID-19-based changes to business operations qualify as being at arm's length. Considering the lack of information on what third parties are doing to address the impact of COVID-19, it may therefore be challenging to substantiate the arm's length nature of (adjusted) inter-company transactions in COVID-19 affected years. The takeaway is

that it will be important to collect and document relevant market information currently, to help substantiate the arm's lengthy nature of (adjusted) inter-company transactions.

## 1. Comparability Analysis Considerations

At the heart of applying the arm's length principle to inter-company transactions lies the comparability analysis, which compares the conditions of the inter-company transactions with the conditions of uncontrolled transactions. An important part of this analysis is the search for comparables. The key question in the area of transfer pricing comparables is: can you adjust previously benchmarked margins that reflect historical data to anticipate 2020 (and 2021) data that are expected to show different, if not much lower, margins than benchmarked earlier or even losses for many industries?

The new guidance makes clear that the basic principles in the OECD Transfer Pricing Guidelines ("OECD TPG") regarding the use of multiple year data and averages remain fully applicable. While some pragmatic guidance is provided, there remains heavy emphasis on accurate delineation (*i.e.*, consideration of the economically relevant characteristics<sup>2</sup> of an inter-company transaction) and comparing the related party transaction with similar transactions between unrelated parties. This may make it challenging for related parties to adjust their pre-determined transfer pricing margins for 2020, as insufficient complete and reliable data may yet be available on what unrelated parties were doing. If making (reliable) adjustments to comparables used for 2020 and 2021 is being considered, diligent action will be required.

### *The Use of Comparability Adjustments*

The new guidance provides that (for example) if an inter-company agreement has a five-year term, was entered into in 2018 and provided a fixed return, there would appear to be no need to perform a comparability analysis for 2020 in particular as long as the facts and circumstances of the previously "accurately delineated controlled transaction" have not changed. This foreshadows that the terms and conditions of inter-company agreements will be considered to play an important role when assessing to what extent comparability adjustments to benchmark comparables to reflect the COVID-19 pandemic's impact may be deemed acceptable. Furthermore, whether your inter-company

agreements contain a changed circumstances clause and a (fixed) term or not may be material to be able to adjust transfer pricing margins that are based on historical data.

### *Sources of Relevant (Comparable) Information*

Several sources of information are cited by the new guidance as possibly relevant to understand the impact of COVID-19 on the economically relevant characteristics of an inter-company transaction, which is important to analyze prior to considering the transfer pricing implications. Those include amongst others: (i) any changes in sales volume during COVID-19 (and whether that is as compared to sales generated in pre-COVID-19 years or may be due to the use of other sales channels); (ii) changes in capacity utilization for the MNE Group, for the controlled transaction and with independent parties; (iii) information on incremental or exceptional costs borne by parties to the controlled transaction or by the MNE Group as a whole; (iv) the extent to which government assistance has been received and if so, the effect and type of assistance (and its accounting treatment); (v) details on government interventions that have an effect on pricing and performance of controlled transactions; (vi) macroeconomic data such as country GDP or industry indicators from central banks, industry or trade associations to the extent useful for understanding the context of the controlled transaction; (vii) a comparison of internal budgeted/forecasted data relating to sales, costs and profitability compared to actual results; and (viii) an analysis of effects on profitability or third party behavior observed in previous recessionary periods or using available data for the current year, even if partial. Importantly, the guidance on comparables explicitly provides that loss-making comparables may be used, as long as the loss-making comparables meet the comparability criteria.

### *Comparing Budgeted Financials with Actuals*

Reviewing the variance between the actual financial results and budgeted financial results that taxpayers within a controlled transaction would have expected to achieve “but for” the impact of COVID-19 is mentioned as possibly providing useful information. An analysis along these lines may include (i) a detailed profit and loss analysis showing changes in revenue and expenses with an explanation for variances resulting

from COVID-19 (this may be budgeted versus actual results); (ii) details of profitability adjusted to where it would have been if COVID-19 had not occurred; (iii) a rationale and evidence for increased allocation of costs or reduced sales to the tested party in a controlled transaction (considered functions performed, assets used and risks assumed); and (iv) evidence of government assistance provided or affecting the tested party in the controlled transaction.

Variance analyses are already used in practice by MNEs for various purposes, such as to interpret the reasons for the variance, to analyze whether the variance is due to controllable or non-controllable factors, which party has control and responsibility over a variance in the light of the commercial and financial relationship between the parties and to ultimately to assess whether the remuneration received reflects the operational functions performed and the assumed risks or whether a transfer price adjustment should be made.

### *Timing of Comparable Uncontrolled Transactions*

Transactions undertaken by comparables during the same period as the controlled transactions are considered most reliable for a comparability analysis and to assess the COVID-19 impact on controlled transactions. Internal comparables (transactions with unrelated parties) may be a good source of information in this respect, assuming those transactions could indeed qualify as comparable transactions. The guidance points out that for the Transactional Net Margin Method (“TNMM”), taxpayers and tax administrations typically rely on historical information, which is likely to not yet reflect any COVID-19 impact. The guidance indicates that taxpayers could possibly revisit the TNMM, perform a comparability analysis based on available prior year information or utilize whatever current year information they can find to support their transfer prices. Unfortunately, this guidance is subsequently offset with a rather stark statement that long-term arrangements, covering for example FY2019–FY 2022 would be “insulated” from risks that had not been assumed (including that of the pandemic) if the comparables used at the time of the negotiations were contemporaneous with the negotiation of the long-term (related party) arrangement. Considering the impact of previous crises on the market for making certain assumptions as regards to what happens with comparables is considered not acceptable. Pragmatically, the divergent conditions of the COVID-19 impact may be considered by applying

separate testing periods for the period before and for the period of the duration of the pandemic. However, a challenge to do this reliably will be the effect of government interventions (such as closures) on the price or the form of controlled transactions and whether those interventions had the same impact on the comparables that underwent the same interventions.

### *Ways to Address Information Deficiencies of Comparables*

The guidance provided here is three-fold:

1. First of all, tax administrations are encouraged to consider the complexities of obtaining contemporaneous data on comparables when performing risk assessments, evaluating transfer pricing positions during audits and considering the documentation that taxpayers prepared. Taxpayers, on the other hand, are encouraged to document the best available market evidence (currently available) of the economic impact of COVID-19 including its effect on the level of demand for goods and services and on production and supply chains in (their) particular sectors of the economy.
2. Next, it is suggested that taxpayers are allowed (if need be temporarily) to use an outcome-testing approach, using information that becomes available after the close of the taxable year to determine arm's length conditions and report results on the tax return. Considering that transfer pricing usually affects more than one entity in more than one jurisdiction, this would require flexible use of compensating adjustments before the tax return is filed, to avoid double taxation.<sup>3</sup> Access to MAP may also be required in this case and should be ensured, possibly by looking for early certainty along the lines of what was suggested during the OECD MAP Forum discussions on strengthening the minimum standard and obtaining access to Accelerated Competent Authority Procedures ("ACAP").
3. Third, it is suggested that using more than one transfer pricing method may in certain cases help corroborate the arm's length price of a controlled transaction.

### *Price Adjustments*

Finally, the guidance addresses the issue of price adjustment mechanisms. Applying these could be based on the use of force majeure or changed circumstances clauses in (inter-company) contracts, or even

temporarily be allowed. However, allowing taxpayers to do so is conditioned upon the taxpayer describing the use of such clauses in their transfer pricing documentation and supporting that this would qualify as being at arm's length. Payments resulting from price adjustments also need to be carefully reviewed for VAT/GST/Customs purposes and as regards their proper characterization.

### *Takeaway*

In our open letter to the OECD we had already noted that benchmarking is likely to become a major transfer pricing audit issue in the near future. When urging the OECD to issue guidance, we had hoped that the OECD guidance could be as modest as recognizing that within a range of arm's length comparables, a taxpayer can actually switch to the lower end of the range (as compared to the previously used median) or make the case for a switch to using one-year data where previously three- or four-years of comparable data were used. Unfortunately, no such guidance was provided. Based on the new OECD guidance, taxpayers should expect that adjusting inter-company prices and profit margins for COVID-19 impact as compared to earlier prepared transfer pricing studies will require detailed, if not elaborate documentation and substantiation, to be accepted. Therefore, it is recommended to diligently collect a broad set of data on the impact of COVID-19 to business in general and, if possible, for the taxpayer's business in particular. Positive aspects listed in the new guidance are that loss-making comparables can be used and outcome testing may be used in certain circumstances. Furthermore, reviewing inter-company contracts for the applicable term and the existence of changed circumstance clauses is also highly recommended.

## **2. Treatment of Losses and COVID-19 Specific Costs**

Because of the COVID-19 pandemic certain MNE groups may experience decrease in turnover, higher costs (e.g., exceptional, non-recurring costs) and losses/lower profits. The allocation of losses and COVID-19 specific costs between related parties can lead to transfer pricing controversy, however.

The new guidance starts out stating that allocation of losses ought to be based on the allocation of risks between parties to an arrangement. Furthermore, the characterization of an entity as being a so-called

“limited-risk” entity is not necessarily considered decisive. What is decisive is the extent to which risk, such as for example market risk or credit risk, is assumed by an entity. In principle, a “limited-risk” entity can bear part of the economic impact of the COVID-19 pandemic in case it assumes the relevant risk (*e.g.*, the market risk resulting from COVID-19 which would qualify as a hazard risk) and such a risk also materializes. That said, tax authorities may question the commercial rationale for any purported change in risk assumed by a party before and after the COVID-19 pandemic outbreak.

The OECD guidance also addresses under what circumstances inter-company arrangements may be changed to address the effects of COVID-19. Clearly independent parties may renegotiate certain terms in their existing agreements in response to the COVID-19 outbreak and associated enterprises may also consider doing so. However, in this respect, analysis of the options realistically available to the parties will play an important role for that allocation to be accepted together with any evidence of what unrelated parties would do/have done. A good starting point seems to be to analyze whether the MNE Group has revised its agreements with independent enterprises.<sup>4</sup> Unfortunately, the guidance provides that without robust modification of inter-company agreements may be assumed to not be consistent with the arm’s length principle, putting related parties essentially at a(n administrative) disadvantage.

Invoking a force majeure clause in a related party setting during the COVID-19 pandemic is subject to certain requirements. First of all, the underlying inter-company agreement should be considered and next it must be reviewed if that clause can actually be invoked considering the circumstances. Essentially, invoking force majeure to alter an inter-company agreement is no different from doing so in an unrelated party setting. It is noted that force majeure may even be invoked in situations where inter-company agreements do not contain such clause, provided domestic law would allow such remedy. But in any and all cases, tax administrations are advised to review agreements and the conduct of associated enterprises in this respect to ascertain whether such assertions or renegotiations can be respected as being at arm’s length.

As regards the incurrence and allocation of “exceptional,” “non-recurring” or “extraordinary” operating costs, similarly the (original) risk assumption of the parties is mentioned to be the starting base for analysis

and how independent enterprises would operate under comparable circumstances. These exceptional non-recurring costs present challenges, however. First of all, the party incurring the costs may not necessarily be the party destined to incur the costs. Next the costs may not necessarily be considered exceptional after all. Costs to substitute means of doing business may very well be considered regular operating costs and the competitiveness of the business will influence the extent to which costs can be passed on to customers.

To complicate matters, it is observed that exceptional costs ought to be excluded from the net profit indicator for comparability purposes to assure a reliable outcome, while information on what comparables do in this regard, whether they incur exceptional costs and how they report those, may be very limited. From a cost-basis analysis perspective, it needs to be considered if those exceptional costs are to be included in the cost base or not, or whether they qualify as passthrough costs that do not get marked up. Accounting inconsistencies of costs between the tested party and comparables need to be considered as well and possible comparability adjustments might be needed to increase comparability for such inconsistencies. This guidance assumes a level of transparency and information on third party comparables that may be non-existent, however.

### Takeaway

We had already noted in our open letter to the OECD that if companies do consider adjusting or updating inter-company contracts, they should at least look for the following aspects: (i) the presence of a force majeure or changed circumstances clause and (ii) the choice of law clause and—where applicable—whether they have chosen to reference or include soft law such as the Unidroit Principles of International Contracts.

Simply referencing the COVID-19 pandemic as main reason for incurring (exceptional) costs will not suffice to have an altered income or exceptional cost allocation accepted. According to the new OECD guidance for transfer pricing purposes, “options realistically available” and benefit analyses are required for such costs to be allocated at arm’s length.

Similarly, MNEs will need to consider if and whether comparable unrelated parties would have revised their agreements. While it is acknowledged that contractual changes based on a force majeure clause may be appropriate even in a related party arrangement, regardless whether inter-company contracts do or do not

explicitly contain such a clause, a detailed analysis and robust narrative is needed to support the commercial rationale and arm's length nature of such a contractual change.

Limited-risk entities may indeed incur part of the economic impact of the COVID-19 pandemic in case they assume the relevant risk (*e.g.*, market risk) and such a risk materializes.

### 3. Impact of Government Stimulus Programs

In our open letter to the OECD we noted that stimulus measures have been made widely available since the beginning of the COVID-19 pandemic and range from (indirect) tax deferral or full suspension to VAT/GST rate reductions, job-retention bonuses, lending support, but also retail, hospitality, leisure or health sector promotion plans or support for the transportation sector. The OECD listed an overview of the different stimulus measures on its website. While the stimulus measures available are all national and bespoke for individual country economies and industries, there has been a noted difference in measures between the respective countries. It is acknowledged in the new OECD guidance that the availability, terms and conditions, substance, duration and take-up of these government assistance programs potentially have transfer pricing implications. However, it should be considered that some situations stimulus measures come with strings attached that were not anticipated or clear from the get-go. Also, do job-retention bonuses reduce employment costs such that this reduction in cost gets considered when a cost-plus remuneration is in place for the entity where the relevant employees work? In other words, can the benefit of the subsidy or stimulus measure be passed on in the supply chain or not? While some countries may have some guidance on this (*e.g.*, Canada and the Netherlands) most do not. And even in cases where there is guidance, it is still not clear if COVID-19 support would be included or not.

#### *Are Stimulus Measures an Economically Relevant Characteristic?*

As economically relevant characteristics need to be evaluated when accurately delineating a controlled transaction and to facilitate comparison with comparable uncontrolled transactions, it is relevant to determine the impact of government assistance involved. The new OECD guidance does not draw a bright

line between what government assistance would and would not constitute an economically relevant characteristic. Reference is made to the OECD TPG section on government policies where such policies are listed as possible economic circumstances to be considered as feature of the market in which parties operate. The new OECD guidance provides that a careful comparability analysis would be required, including of how the receipt of government assistance affects the price of uncontrolled transactions. The availability, purpose, duration and other conditions of the government grant of assistance will need to be reviewed. The variation of government assistance programs is so broad, that in any case aspects such as eligibility criteria and the impact on the price of goods or services of such assistance programs should be reviewed.

The new OECD guidance warns against mechanically offsetting cost savings resulting from government assistance against the relevant cost base of a transaction on a one-sided basis, as this can lead to not at arm's length prices. The new guidance also addresses that government aid would generally not be considered to serve to modify the allocation of risk in a controlled transaction. As regards to its impact on comparability, government assistance may need to be considered however. That this will lead to significant comparability challenges is obvious, as data on the impact of long- or short-term government assistance granted to unrelated parties and unrelated comparable transactions will likely be very difficult and labor intensive to ascertain. The new OECD guidance goes as far as to suggest that a revised strategy and potential use of a corroborating transfer pricing methodology may be needed to take into account differences in comparability. The difference in accounting treatment granted to government assistance may also lead to the need for comparability adjustments.

Considering the continuation of the COVID-19 pandemic, it would seem that the issue of government assistance and its transfer pricing impact would benefit from much more pragmatic guidance. For example, the Dutch transfer pricing decree<sup>5</sup> provides more generally that subsidies that consist of a cost reduction or discount that directly relates to the service being rendered or the product being made available can be passed on and applied to reduce the cost base. An example would be a (government) subsidy for the use of acquiring environment-friendly raw materials, or subsidies for the acquisition of energy-efficient machinery and equipment. Subsidies and tax benefits that are provided to an

entity as such without any causal relationship with the entity's activities would not qualify for being passed on in the supply chain. Considering this general description, it would appear that pursuant to Dutch guidance COVID-19 measures would generally not qualify to be passed on in the supply chain, although this may need to be considered for each and every individual stimulus measure. We understand that the Dutch tax authorities are in the process of revising the transfer pricing decree to *inter alia* take into account the allocation of risk between a limited-risk entity (which receives government assistance) and the principal entity in analyzing whether government assistance can be passed on to the principal entity.

### *Takeaway*

The impact of government stimulus measures on transfer pricing may become more important than currently recognized. If a subsidy is passed on through the transfer pricing system and local auditors believe that this is incorrect, there will be adjustments and double taxation, the cost of which would undermine the purpose of granting the stimulus measure to begin with. In addition, considering the wide array of stimulus measures and government assistance, comparables are likely to be affected, yet it is unclear to what extent the fact they qualified for and received such aid can be clearly discerned. Of course, using comparables in the same geographic market between independent enterprises performing similar functions, assuming similar risks and using similar assets as the new OECD guidance suggests, would be preferred. However, in real life this may lead to such a small set of available comparables that they become statistically irrelevant leaving the tested party exposed to adjustments.

## 4. Advance Pricing Arrangements

APAs serve to provide tax certainty and generally provide for an agreement between the taxpayer and tax authorities on a unilateral, bilateral, or on occasion multilateral basis, of the arm's length nature and price/profit margin of inter-company transactions. They usually are entered into prospectively for a period of three to five years. This means that there is no benefit of hindsight. To the extent COVID-19 and its impact are not foreseen, it may be harsh and unreasonable to bind a taxpayer to pre-agreed profit margins for related party transactions, where in reality no such margins economically can be obtained. To this end, APAs usually have

a set of critical assumptions that govern its effectiveness and application.

### *The Extent of Binding Force and Effect of APAs*

APAs are destined to provide certainty to all parties to the agreement. Thus, both taxpayers and tax administrations are deemed bound by an APA and cannot disregard or alter the terms of an APA in case of changed economic circumstances, unless the agreement itself provides for a reason for cancellation or revision of the APA. Unilateral revisions or cancellations are not possible. A breach of a critical assumption included in the APA can serve as a reason for a legitimate cancellation. To the extent that the impact of COVID-19 has a dramatic effect on the economic and market conditions under which the taxpayer operates or there can be considered to be a significant business restructuring resulting from COVID-19, chances are there will be a breach of a critical (economic) assumption, allowing for cancellation or renegotiation of the APA.

### *Breach of Critical Assumptions*

In case of a failure to meet the applicable critical assumptions (and in case of non-compliance with the terms and conditions of the APA), an analysis is required of (i) the terms of the APA; (ii) any agreement between tax administrations on how to handle a breach of the critical assumptions; and (iii) any applicable domestic law or procedural provisions with respect to breach of agreements with the government. In certain circumstances the parties to the APA may agree the breach was not material and continue to apply the APA, perhaps with certain bilaterally agreed changes. The APA can alternatively be revised, cancelled or revoked. Revision may be a solution in case of material changes in conditions for which the parties can find a mutually agreeable solution. This could have the previously agreed APA remain in force until the COVID-19 consequences came into effect in 2020 and the revised APA terms apply as of the moment the COVID-19 consequences came into effect. Alternatively it could result in an agreement to evaluate the envisaged transfer pricing results over the term of the APA and allow for an aggregation of financial results of 2020 with earlier and/or later years. Cancellation of the APA may be in order in case of a major breach of the APA's critical assumptions or a material failure to comply with the any term or condition of the APA. Cancellation has the effect of ending the APA on an agreed date other than the initially envisaged expiration



date. Revocation has the effect that no APA was ever entered into, and is reserved for situations where there is misrepresentation, a mistake or an omission attributable to neglect, carelessness or willful default of a taxpayer, or where the taxpayer fails materially to comply with the fundamental terms of the APA.

*MNEs are strongly recommended to analyze the impact of COVID-19 on their business considering the new OECD guidance and substantiate and document their—adjusted—transfer pricing practices as suggested.*

### **Notification and Documentation of Failed Critical Assumptions**

Generally early notification of a failure to meet critical assumptions is suggested to avoid cancellation of the APA. The OECD guidance details examples of documentation that may be used to provide tax authorities with supporting documentation and encourages transparency and disclosure to maintain a non-adversarial spirit and environment between the parties. A distinction is drawn between a failure to comply with the terms and conditions of an agreed APA and a breach of critical assumptions. In the latter case, cancellations may be prescribed by the APA itself, in the former, parties can consider cancellation, revision or revocation.

### **Negotiating APAs During COVID-19**

According to the OECD guidance, parties can agree to refrain from negotiating APAs considering the uncertainties of COVID-19, or alternatively adopt a flexible and collaborative approach on how to account for the applicable economic conditions. For example, the term of the APA could be shortened or broken up in a COVID-19 and post COVID-19 scenario. Again, considering the uncertainty, emphasis is placed on the need for taxpayers to be transparent and disclose the impact of COVID-19 on their business. While it is acknowledged that the pandemic presents challenges to negotiating APAs, such as travel restrictions and

working from home, the value of achieving certainty in advance and effective dispute prevention may outweigh these challenges and technological solutions such as virtual meetings may make up for a relevant part of those challenges.

### **Takeaway**

The COVID-19 uncertainties do not necessarily have to keep taxpayers from coming forward and apply for APAs, according to the OECD guidance. However, it will need to be considered in particular with respect to existing APAs, whether the impact of COVID-19 leads to a breach of critical assumptions or failure to comply with critical assumptions, and what reaction is most appropriate in those scenarios: revision, cancellation or revocation.

## **5. Important Aspects Not Addressed**

While the OECD guidance does provide some helpful suggestions, it unfortunately did not address business reorganizations. We did raise this in our open letter to the OECD, however. The risk of permanent establishment exposure was addressed by OECD guidance on how international tax treaty rules could be applied in April of 2020. This guidance has been updated and was published January 21, 2021. In sum, it concludes that where, as a public health measure imposed or recommended by at least one of the governments involved, an individual teleworks from home (*i.e.*, in a home office), that would not create a PE for the employer. Under domestic law, standards may be more strict, however, and will need to be closely reviewed.

We note that (unintended) business organizations may lead to transfer pricing exposure as well. As the COVID-19 pandemic moved from the East to the West of the world, companies doing business globally noticed fall-out in their Asian manufacturing and supply chains before they did in the West. On the other hand, lockdowns lifted earlier in the East than in the West and some MNEs had the agility and the benefit to be able to shift production capacity and stock between their global sites to try to manage the impact. While the balancing of production resources, performance requirements and customer demand will likely remain an issue that requires significant managing in the near future, the experience of shifting to other production facilities for the short-term brought change, but may trigger long-term changes as well. Short-term adaptations inter-company can probably be seen as a service, and should not

constitute a business restructuring. But longer-term changes may very well be just that. If a short-term solution becomes more permanent, when did the change effectuate? In 2020? Or only in later years when formal decisions have been made to continue operating that way? And what buy-out considerations are to be made in this respect? Guidance on this would have been welcome too.

## Conclusion

The impact of COVID-19 is worldwide and significant. Based on the OECD projections presented at the OECD's Inclusive Framework meeting of January 27 and 28, 2021, economic recovery will take at least

until 2022 plus that three major challenges to the world economy and for business in general resulting from the pandemic remain: (i) unemployment and aggravated pressure from automation; (ii) (risk of) bankruptcies as corporate debt is close to the levels it had during the global financial crisis (of 2009); and (iii) the marked rise of public debt. Based on these projections it should be clear that governments will need ample (tax) revenue to finance actions to address and mitigate these challenges. MNEs are strongly recommended to analyze the impact of COVID-19 on their business considering the new OECD guidance and substantiate and document their—adjusted—transfer pricing practices as suggested. There should be little doubt that COVID-19 will impact the transfer pricing practice of MNEs for several years to come.

## ENDNOTES

<sup>1</sup> See [www.simmons-simmons.com/en/publications/ckf2je4ze4t2x0926l3xwgwcy/covid-19-oecd-transfer-pricing-guidance](http://www.simmons-simmons.com/en/publications/ckf2je4ze4t2x0926l3xwgwcy/covid-19-oecd-transfer-pricing-guidance).

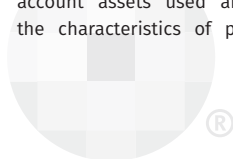
<sup>2</sup> The contractual terms, the functions performed by the related parties (taking into account assets used and risks assumed), the characteristics of property transferred

or services provided, the economic circumstances of the parties, the market in which the related parties operate and the business strategies pursued by the parties.

<sup>3</sup> It should be noted that some tax authorities may not accept compensating adjustments.

<sup>4</sup> It would be a good start to assess the impact of COVID-19 on any arrangements that the taxpayer has with independent parties.

<sup>5</sup> Decree 2018-6865 of April 22, 2018, published in Official Gazette # 26874 of May 11, 2018.



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