White Paper:

Analysis of Impact of COVID-19 on Transfer Pricing

27 April 2020

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The impact of COVID-19 outbreak and the subsequent restrictions on economic activity on account of lockdowns have been profound. Economies and markets have been hit by the COVID-19 outbreak, and businesses are making contingency plans to ensure their operations continue. The worldwide virus outbreak is causing substantial shifts in financial markets and the macro economy, with direct adverse implications on global supply chains and profitability. The pandemic has already alarmed for global recession with huge dip in the supply and demand. Most of the multi-national enterprise ('MNE') have already started to analyse the impact and shifting of supply chain, production, target market, customers etc. which would have large impact on Transactions between entities of such MNEs. The MNEs needs to carefully evaluate change in transfer pricing policies and methodologies considering the tax jurisdictions of enterprises. In this paper we have tried to highlight some of key areas that should be actively reviewed and monitored from a Transfer Pricing ('TP') perspective.

1. Transfer Pricing Policies

Existing transfer pricing policies may have to be reviewed and adjusted in the light of global economic impact of COVID-19. There is requirement to re-assess the existing intercompany arrangement/ agreement which may need to be cancelled or modified in the pandemic disruption. MNEs should evaluate the potential transfer pricing impact of terminating or renegotiating intercompany agreements in the context of the facts, circumstances, functional profiles, division of risks among the parties involved, and whether behaviour of the parties and underlying economic substance of the transactions matches the terms of the intercompany agreements.

2. **Business Restructuring or Reorganization**

Some companies may shut shops or scale down their operations in various jurisdictions, both voluntarily and involuntarily. Due to lockdown and sealing of international borders MNEs facing disruption in supply chain, shortage of material and labour, may consider to shift the existing manufacturing, assembling, research and development, supply chain function, captive support functions from one jurisdiction to another. These restructurings could be temporary or permanent. In light of above, the changes in functional profile of entities involved and transfer pricing regulations of corresponding tax jurisdiction needs to be critically examined well in advance to avoid any adverse inference at latter stage. In order to mitigate the crisis impact, MNEs may consider use of IoT or block chain technology to pace-up the supply chain, accordingly functional characterisation may need to be revisited appropriately. The change or shift in value addition in supply chain and corresponding impact on profitability would necessitate the re-evaluation of functional profile and remuneration mechanism

3. **Transfer Pricing Methodology**

The change in macro and micro economic factors like shift in geographical location, fiscal stimulus and other government intervention, demand and sales may result in pragmatic shift in the nature of business activities performed by tested party and comparables. The reliability of data and applicability of particular TP methods may need to be reconsidered. In the event of exceptional circumstances of economic slowdown traditional transaction based or price based method may not provide the appropriate Arm's Length Prices and other methods may be considered as possible selection. For Ex: Changes in pricing due to government intervention, custom valuation may be useful to substantiate ALP.

4. **Cash crunch and revisiting Inter group financial arrangements -** The temporary disruption of business would lead to cash flow pressures which will impact existing inter group financing arrangements. The subsidiaries of the MNE could be under huge financial strain and may struggle to pay salaries, other expenses and find difficult to meet their payment obligations on

intercompany loans. In order to maintain the cash and liquidity management, existing intra-group financing arrangement may need to be revisited. It may be reasonable to renegotiate more favourable loan terms than would usually be available, delay interest payments on a temporary basis, or re-characterize short-term loans as long-term loans. All these measures would need to be well documented by the MNEs. While renegotiating the terms of financing arrangement, exchange control regulations and transfer pricing regulations of parties involved would need to be examined. The economic stimulus packages by governments and COVID - 19 crisis mitigate measures and relief provided by tax jurisdiction will be helpful tool in redefining the intragroup financing arrangement. MNEs may consider providing moratorium on the interest payments, corporate guarantee charges, recharge towards treasury functions etc. under exceptional circumstances particularly from captive service providers.

5. Stranded Research & Development and return on Intangibles

Research and development of intangible is generally a cost centre till attainment of recognition and incurred by the company to derive extraordinary profits through first mover advantage of developed intangibles. Amid this economic crisis certain MNEs may not find it worthwhile to continue research and development of such nature and only expend on routine research and development required to sustain business. Many of Indian affiliates of MNEs are engaged in ‘contract research & development’ for their global parent, specifically in Software development/ Information Technology space. Further, there may be revision in Development, Enhancement, Maintenance, Protection and Exploitation (‘DEMPE’) functions, overall contribution in value creation and risk profile of entities engaged in such R & D process and same needs to be realigned from transfer pricing perspective.

Manufacturing affiliates of MNEs generally rely on technological knowledge and other intangibles owned by parent or any other group entity against which license fees or royalties are charged. These royalties or license fees are generally part of passive income for global parents of MNEs. Accordingly, Group entity may provide moratorium on payment of royalty/ licence fees in this crisis period. In periods of economic shocks, the licensee does not earn profits deriving from the exploitation of licensed intangible assets. Consequently, payment of the royalties could be in conflict with the value of the licensee’s business and could therefore reflect non-compliance with the ALP.

Similar reconsideration may arise on payment made towards intra group services like management fee, for which the ALP is generally justified on the bases of actual ‘performance of services' by service provider and 'benefit test' on part of recipient. However, during stranded business environment, the actual 'performance of service' may be questioned by tax administration. Accordingly, any payment of such kind may be supported through appropriate documentation.

6. Uncertainty on agreed or under negotiation Advance Pricing Agreements ('APAs')

APA or any such arrangements are executed with tax administration to provide the certainty on Arms-Length price and resulting tax of particular transactions with related parties. The APA are signed after detailed examination of facts, economic circumstances prevailing at the time of negotiation and on the basis of critical assumptions under normal business environment. COVID 19 may result in extraordinary economic crisis and may result in huge differences in functional profiles of parties involved, deviation in critical assumptions and also in certain cases huge impact on profitability. In those cases where the APA has been agreed upon a fixed mark-up, the taxpayer maybe unable to meet the mark-up or range specified in the APA. Accordingly, MNE may consider renegotiating already signed APAs with tax authorities. Indian tax laws provides for revision of negotiated APAs. The taxpayer may opt to revise the APA by carrying out negotiations with tax authority for one or more APA years or at times may consider cancelling the APA from a specified date.

Further, the COVID-19 epidemic could potentially impact current APA negotiations. The current economic environment that many companies are facing could be quite different from the earlier economic environment prevailing at the time of filing the APA request. Therefore, on account of these uncertain economic conditions and due to changes in functional and risk profile and critical assumptions in the APAs filed it is also possible that certain companies may undertake new transactions and terminate existing transactions carry out. In such a situation, the tax payer may opt to revise the APA filing to take into effect these situations.

7. Limited Risk Entities

The entities engaged as limited risk distributors, toll/ contract manufacturers and captive service providers are typically remunerated on a cost plus basis. These entities are cost centres for the MNEs and since, MNEs may face significant dip in overall profitability or losses due to the coronavirus outbreak, they may consider to make changes in its TP Policy. Although, these captive entities are bearing limited risk and are least complex in functional characterisation and economic analysis perspective, it can be argued that while these entities are protected from risks and they need to bear the negative effects of this crisis. This may be in the form of reduction of remuneration or alternatively, such entities can also revisit the definition of 'operating cost' in the extraordinary circumstances and certain fixed cost may be excluded while recharging along with mark-up. Generally, reduction of remuneration or exclusions of certain cost in case of these entities, may be difficult to substantiate, however the reduced profits or losses incurred at group level during the COVID-19 crisis with appropriate documentation may help to substantiate reduced margins. Whilst tax authorities may argue that losses can be incurred in independent situations due to unfavourable economic conditions or other legitimate business factors, some of the factors that may be considered are the impact of social distancing and work from home arrangements, productivity, disruptive supply chain as well as lock down affecting movement of goods and employees. It is pertinent to note that quantification of these factors is always a challenge and one possible argument is 'substance over form' to contend and prove commercial rationale.

8. TP Documentation under 'Substance over form approach'

Documenting and maintaining TP policies and substantiating the Arms- Length Prices in adverse economic environment can create a number of difficulties, depending on the particular market or transaction concerned. While maintaining the documentation one need to rely on the concept of 'substance over form' and traditional documentation or replication of earlier years may be reconsidered. Some of the essential areas to be re-evaluated and reconsidered may be as under:

- ***Contemporaneous Evidence Gathering*** - To substantiate the changes in TP policies, intragroup supply chains, valuation approaches, or other TP matters, contemporaneous documentation (e.g., email correspondence, board minutes, presentations, memos, reports, government guidelines policies, etc.) needs to be maintained.

- ***Functions Assets and Risks ('FAR') re-characterisation*** **-** In case of change in FAR, It may be necessary to re-define the economic characterisation of entities.

- ***Critical overview of Industry*** **–** TP documentation may appropriately provide the impact of COVID 19 on industry impact on key business drivers, supply and demand shortage, time span of impact, etc. The Taxpayer may carry out a detailed industry analysis, providing concrete examples of the many challenges the industry and company are facing due to COVID-19.

- ***Benchmarking with limited data*** **-** The more diverse the effects of an economic crisis between companies, industries, or markets, the lower the chances of finding appropriate comparable transactions and conducting a reliable TP pricing analysis. COVID disruption may result in delayed closure of books of accounts and availability of comparables data in the public databases in planning and compliance stage. The organisation may be required to benchmark the transactions with limited data available in comparison to previous year data. Further, the taxpayer may decide to revisit the financial data of the comparables as and when they maybe available and if possible carry out a single year analysis as opposed to a multiple year analysis to analyse the impact of COVID 19 on the comparables. This alternative can be resorted to in case the CBDT provides for such an option by carrying out an amendment by a circular maybe for FY 2020-21 and FY 2021-22.

- **Selection of tested party** **-** In the time of revision of inter –company agreements , functional characterisation, degree of economic impact in different countries and availability of contemporaneous data, selection of tested party may be relooked into.

- ***Transfer Pricing Adjustments*** – In the current circumstances, adjustments to account for differences in idle capacity or extraordinary expenses (e.g. inventory write-offs, or restructuring expenses), forex fluctuation, may be considered. Documentation to substantiate the unquantifiable adjustment shall be maintained.

- ***Group Master Fie ('MF') and Country by Country Report ('CbCR')*** **-** COVID 19 may have significant impact on MF and CbCR as all the business restructuring needs to be analysed and reported carefully. The local files of each jurisdiction shall also be re-aligned with MF and CbCR to ensure synchronised information.

COVID -19 pandemic has already resulted in economic crisis and hit the world economy when it was facing instability and heading for slowdown. MNEs should proactively analyse the tax impact of revision of intra group arrangements and TP policies. The COVID-19 impact may leave MNEs with heavy multijurisdictional tax burdens if not managed appropriately. In order to mitigate any additional tax and administrative costs on MNEs, the various tax administrations should also come together with MNEs and assess the related party transactions with prudent viewpoint. It may be noted that, economies are also impacted, so each country tax authorities may have close eye on MNEs for tax collection. However as the circumstances are extraordinary, in order to charge appropriate tax and reduce the profit shifting cumulatively, extraordinary multilateral collaboration particularly in dispute resolution and exchange of information from cross border tax authorities is expected. It is also expected OECD may come up with certain guidance for revising transfer pricing policies and computation of ALP under extraordinary crisis to bring consensus among MNEs and tax administrations.

The above document only provides general guidance based on our understanding of potential impact of COVID-19. Any changes in Transfer Pricing policy should be done only after evaluating the impact on particular industry and impact on MNEs, keeping in view the global TP policies. It may be mentioned that any change, would be subject to scrutiny of tax authorities and generally ground level of tax authorities may not agree to such changes unless specific guidance in issued by Government in this regard.

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This white paper has summarized and highlighted the impact that the outbreak of COVID-19 had on transfer pricing in India. It may be noted that nothing contained in this newsflash should be regarded as our opinion and facts of each case will need to be analyzed to ascertain applicability or otherwise of the said notification and appropriate professional advice should be sought for applicability of legal provisions based on specific facts. We are not responsible for any liability arising from any statements or errors contained in this newsflash.

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