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COVID-19 AND TRANSFER PRICING – TOP 5 IMPACT AREAS

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Starting December, 2019, the world has witnessed the once-in-a-generation pandemic. Multinational Enterprises will have to consider the effect of COVID 19 on their transfer pricing policies due to large scale economic disruption. It will be imperative, especially in this economic environment, to adhere to and demonstrate arms length behaviour. Many MNEs have started revisiting transfer pricing policies, inter company agreements, and documentation standards.

This article highlights the top five transfer pricing impact areas arising out of Covid-19:

- Supply chain restructuring
- Renegotiation of pricing and other terms
- Cash optimisation
- Balancing business uncertainty with tax certainty
- Benchmarking

Towards the end of the article, some recommendations have also been outlined for consideration of the government authorities to make it easier for taxpayers to demonstrate compliance with arm's length principles.

1. Supply chain restructuring

MNE groups with geographically diverse supply chains are affected severely due to the pandemic. Any disruption to any part of the supply chain tends to impact the entire group, though the extent of the impact depends on the importance of the part of the supply chain which has been disrupted and the availability of alternatives.

Many MNE groups have discovered the fragility in their value chains as a result of the disruption caused by the pandemic. They are faced with one or more of the following situations:

- Longer than needed supply chain involving various countries
- Overdependence on a particular supplier / set of suppliers / region / country for materials / services / manufacturing / market
- Affiliate(s) finding it difficult to sustain their businesses owing to disruption caused by the pandemic
- Unviable non-core businesses.

MNE groups could consider this as an opportunity to revisit their existing supply chains and also potentially restructure the supply chain to achieve one or more of the following:

- Shorter supply chains involving lesser number of geographical locations
- Creation of alternate sourcing destinations for materials and services
- Setting up of manufacturing / service facilities in alternate destinations
- Closure and / or monetisation of non-core businesses / entities.

These restructuring transactions could raise multiple transfer pricing issues, including:

- Exit charges for that affiliate which will be eliminated from the supply chain / will get reduced business because of creation of an alternate destination
- New transfer pricing agreements, policies and benchmarks to be developed in case of setting up of affiliates in new / alternate jurisdictions
- Valuation issues in case non-core assets are transferred to affiliates
- Issues relating to bearing of closure costs in case some group entities or part of their businesses face insolvency / closure
- Issues around identification and valuation of intangibles involved in the restructuring exercise
- Appropriate articulation of restructuring transactions in the local files of the entities concerned and the Master File of the group.

2. Renegotiation of pricing and other terms

In arm's length dealings, businesses are in fact renegotiating prices as well as other terms, mainly with their vendors.

In the case of many MNEs it would be perfectly arm's length behaviour for different entities within the group to start discussions and re-negotiations regarding prices and other terms of their inter-company

transactions. In fact, in many cases it might be non-arm's length for companies to not renegotiate with their affiliates. In almost all cases, it would be arm's length behaviour to have inter-company agreements which mirror agreements that would have been entered into between third parties.

Renegotiations of existing arrangements / agreements could be of at least the following types:

2.1. Compensation for limited risk entities in the group

Many MNEs have entities which operate as limited risk entities, such as captive service providers, contract manufacturers, limited risk distributors, etc. As a general rule, these limited risk entities are eligible for a stable income, all residual profits or losses being attributed to the Principal affiliate. However, in today's dynamic business environment, no-risk entities do not exist and limited risk entities also bear some risks. For example, limited risks captive service providers or contract manufacturers have a significant single customer risk; therefore any adverse disruption to that single customer will adversely impact the captive as well.

In times of disruption like this, exceptions to the general rule may be warranted and compensation for limited risk activities may need to be revisited, depending, *inter alia*, on the type of activity performed, type of disruption faced and the control and decision-making capabilities of each of the parties involved.

In third party situations the service provider would be better off to agree to reduced income (or even losses in the short term) from the Principal, especially if the Principal itself is facing challenges relating to its own survival. Accordingly, on a case-to-case basis, certain MNEs may have the ability / necessity to revisit their arrangements with their captive entities for the short to medium term. The revision in the inter-company agreements could take several forms. For instance, such revised agreements may provide for compensation for only costs (without a mark-up), reduced mark-up, compensation for only 'normal' costs (with or without mark-up), etc.

2.2. Renegotiations of other terms

It is common for entities in an MNE group to negotiate prices of their inter-company transactions from time to time in line with the prevailing business dynamics. However, in emergencies like these certain other terms of the agreements between affiliates may also need to be renegotiated. For example, the commitment relating to quantities which a manufacturer will purchase from the related raw material supplier may undergo a significant renegotiation. Given the non-recovery of fixed costs due to the resulting idle capacity, the raw material cost per unit may increase which the supplier may want to pass on to the manufacturer. A higher per unit cost, on the other hand, may make the related supplier uneconomical for the manufacturer. In the interest of the long-term commercial relationship, the parties may agree to an in-between pricing mechanism, as is likely to be the case in third-party dealings. Which party would bear which types of costs would depend on the characterisation of the parties, the decision-making evidenced through capabilities of the persons involved, and the options realistically available to the parties involved.

3. Cash optimisation

Cash optimisation is currently one of the most important considerations of businesses across the world.

Many MNE groups facing a cash crunch have started looking at the cash position with different group entities and trying to optimise the cash available with them. This could lead to some new funding-related transactions and benchmarking issues such as those relating to interest and guarantee fees transactions between affiliates.

In some situations, taxpayers that have borrowed funds from their affiliates and are not in a position to honour their interest / principal repayment commitments could approach their affiliate lenders to negotiate for a reduction in interest rate / interest waiver / moratorium at least for some period of time. On the other hand, the lender affiliate may want to balance the moratorium with a revision in the interest rate. Significant movements in exchange rates of currencies primarily attributable to the pandemic could make this negotiation even more dynamic. Any kind of negotiation should take into account the perspectives of both parties and options realistically available to them.

Similarly, payment terms for goods or services purchased from or sold to AEs or other inter-company transactions, such as royalties, could also be renegotiated at least for the short term, to enable different entities within the MNE group to manage their working capital cycle more efficiently.

4. Balancing business uncertainty with tax certainty

4.1. Advance Pricing Agreements (APAs)

Globally, APAs have been an effective tool for taxpayers and tax authorities to achieve tax certainty. However, in times like these businesses go through unprecedented levels of uncertainty. Therefore, many taxpayers may find it against their interest to be bound by the terms of the APAs, especially where these provide for a minimum level of tax profits to be reported by the taxpayer.

If their circumstances warrant it, taxpayers who have already entered into an APA may consider applying for revision of the same. The law provides that an APA may be revised if, *inter alia*, there is a change in the underlying critical assumptions[1]. Most Indian APAs have a critical assumption of the business environment being normal through the term of the APA. In times like these, a request for revision may be warranted if the business environment for the taxpayer is considered to be abnormal based on the specific facts and circumstances of its case and the impact of the uncertainty on the transaction under consideration.

If the taxpayer and the authorities do not agree to the revision, the taxpayer may potentially also request for cancellation of the agreement[2]. On the other hand, in case the tax authorities believe that cancellation of the agreement is warranted due to failure on the part of the taxpayer to comply with its terms, the taxpayer should utilise the opportunity provided to it to explain the pandemic-related impact on the APA and the related reason for its failure to comply with the terms of the agreement.

For taxpayers who are in the process of negotiating for their APAs, and for whom the business impact is very uncertain right now, it may be prudent to wait to get some more clarity regarding the full impact of the pandemic on their business before actually concluding the APA.

Alternatively, taxpayers should request for an APA for a shorter term, say a period of up to Financial Year (F.Y.) 2019-20, even if it means entering into the APA for, say three or four years. Another APA could then be applied for, starting F.Y. 2021-22, based on the scenario prevailing then.

4.2. Safe harbours

The government has not yet pronounced the safe harbours for the F.Y. 2019-20. Once these are pronounced, depending on their industry, extent of business disruption, expected loss of business / margins and the safe harbours provided for F.Y. 2019-20 and onwards, taxpayers should evaluate whether or not to opt for safe harbours at least for the F.Y.s 2019-20 and 2020-21.

5. Benchmarking

The current economic situation is likely to create some unique benchmarking issues which should be borne in mind. While some of these issues are common to taxpayers globally, a few issues are specific to India given the specific language of the Indian transfer pricing regulations.

5.1. Justification of losses / low margins

Taxpayers are facing several business challenges including cost escalations / revenue reductions which are not related to their transactions with affiliates. Taxpayers in several sectors have recorded sharp declines in revenues due to lockdowns in various parts of the world, including India. Some taxpayers are faced with the double whammy of escalated costs even in times of reduced revenues. Escalated costs could include, for example, additional costs relating to factory personnel who are provided daily meals and other essentials, additional transportation costs incurred to arrange special transport for essentials owing to most fleet operators not plying, etc.

It is pertinent for taxpayers to identify and record these expenses separately from the expenses incurred in the regular course of business (preferably using separate accounting codes in the accounting system). Depending on the transfer pricing method and comparables selected, taxpayers should explore the possibility of presenting their profitability statements excluding the impact of these additional costs / reduced revenues.

Another alternative available to taxpayers is to justify their transfer prices considering alternative profit level indicators (PLIs).

In any case, given the fact that a lot of information about comparable benchmarks is not available in the public domain currently, business plans, industry reports, business estimates, etc., prepared / approved by the management of the organisation should be maintained in the documentation file and presented to the transfer pricing authorities if called for.

5.2. Loss-Making Comparables

During times of emergency like these, for many businesses the focus shifts from growth / profitability to

1 Refer Rule 10Q of Income Tax Rules, 1962
2 Refer Rule 10Q of Income Tax Rules, 1962

survival. Therefore, many businesses could try operating at marginal costing levels to recover committed costs / utilise idle capacity. Therefore, businesses operating at net operating losses could be a normal event at least in times like these. Secondly, even the taxpayer could have been pushed into losses because of completely commercial reasons and even such losses could be arm's length and commercially justifiable.

From the perspective of transfer pricing benchmarking, persistently loss-making companies are typically rejected as comparables mainly because they do not represent the normal economic assumption that businesses operate to make profits. However, in times when business losses are normal events, benchmarking a loss-making taxpayer with only profit-making comparables would lead to artificial benchmarks and, potentially, unwarranted transfer pricing additions in the hands of taxpayers.

In case loss-making comparables are indeed rejected, it could be more prudent to reject companies making losses at a gross level.

5.3. Unintended comparables

The current focus of many businesses is survival. Businesses which have created capacities to cater to their affiliates may find it difficult to sustain if the impact of the pandemic lasts longer than a few months. For example, consider the case of an Indian manufacturer whose manufacturing capacities are created based on demand projections and confirmed orders from its affiliates. Since the capacities are completely used up in catering to demand from its affiliates, the manufacturer does not cater to unrelated parties. In case there is a disruption in the demand from such affiliates expected in the medium term, in order to sustain in the short to medium term, the Indian manufacturer could start using its manufacturing set-up for other potential (unrelated) customers also. While this appears to be a purely rational business decision by the Indian manufacturer, a question arises whether such third-party dealings will be considered as comparable transactions for dealings with affiliates. The Indian manufacturer in this case would need to be able to document the business justification for entering into these transactions with unrelated parties and whether these are economically and commercially different from the routine related party transactions. Similar issues could arise in respect of other transactions such as temporary local procurement, local funding, etc.

5.4. Mismatch in years and adjustments

The Indian transfer pricing regulations provide for the use of three years' data of comparables to iron out the impact of cyclical events from the benchmarking analysis. However, data of the last two years may not be representative of the conditions prevailing in the current year (in this context, current year could be F.Y. 2019-20 as well as 2020-21, both years being impacted to different extents due to the pandemic).

Since the financial data of a lot of comparables is not available up to the due date of transfer pricing compliance, this mismatch may lead to a situation where normal business years of comparables are compared with the pandemic-affected years of taxpayers – a situation which is very likely to give skewed results.

Adjustments are regularly made to minimise the impact of certain differences between a tested party (say, taxpayer) and the comparable benchmarks. Depending on the industry in which the taxpayer operates and the manner in which its affiliates are impacted, taxpayers may need to make adjustments, including some unique adjustments, to more aptly reflect the arm's length nature of inter-company prices.

However, in the Indian context the law does not provide for the making of adjustments to the tested party and the adjustments are to be necessarily made to comparable data[3]. Given the lack of reliable data for making adjustments, the reliability of the adjustments themselves may be questioned.

It must be borne in mind that the principle which necessitates downward adjustments to comparables' margins currently being made to normal years will also require upward adjustments to comparables' margins in respect of pandemic-affected years going forward. This situation is simplistically illustrated in Table 1 below. For the purpose of the illustration, it is assumed that:

- F.Y. 2017-18 and 2018-19 are considered as normal business years
- F.Y. 2019-20 is impacted by the pandemic, but to a lesser degree
- F.Y. 2020-21 is impacted severely by the pandemic
- F.Y. 2021-22 is a normal business year
- At the time of conducting the benchmarking analysis, comparables' data is available for only the last two years.

3 Refer Rule 10B of Income Tax Rules, 1962

Table 1 – Year-wise comparability[4] and adjustments[5]

Tested Financial Year	Comparable Financial Years	Adjustments Required (say, adjustments to margins)	Remarks
2019-20	2018-19, 2017-18	Downward	Downward adjustment due to loss of business compared to normal years (2018-19, 2017-18)
2020-21	2019-20, 2018-19	Downward	Downward adjustment due to loss of business compared to normal / less impacted years (2019-20, 2018-19)
2021-22	2020-21, 2019-20	Upward	Upward adjustment due to normal business compared to impacted years (2020-21, 2019-20)

6. Recommendations to government authorities

Government authorities could consider the following recommendations by way of amendments to the law to relax adherence to transfer pricing regulations for taxpayers, especially for F.Y.s 2019-20 and 2020-21, i.e., the impacted years:

- **Expansion of arm's length range** – Since different industries and different companies in the same industry will respond to the pandemic in different ways, the margins of comparables over the next two years could be extremely varied. Therefore, for the impacted years the arm's length range may be expanded from the current 35th to 65th percentile to a full range, or inter-quartile range (25th to 75th percentile), as is used globally. Similarly, the applicable tolerance band could be appropriately increased from the current 1% / 3%.
- **Extending compliance deadline** – In case the deadline for companies to file their financial statements for F.Y. 2019-20 with the Registrar of Companies (RoC) is extended, the deadline for transfer pricing compliance should also be extended, to give the taxpayers their best chance to use comparable data for F.Y. 2019-20.
- **Extending deadlines for Master File compliance** – It is expected that companies will take time to be able to fully assess the impact of the pandemic on their business models, value chains, profit drivers, etc., and then appropriately document the same in their Master File. Therefore, the due date for Master File compliances may be extended at least for F.Y. 2019-20.
- **Adjustment to taxpayer data** – At least for the impacted years, the law could be amended to provide an option to the taxpayer to adjust its own financial data since the taxpayer will have a better level of information regarding its own financial indicators.
- **Multiple year tested party data** – As discussed earlier, the Indian transfer pricing regulations currently provide for using multiple year data of the comparables as benchmarks for current year data of the tested party. For F.Y.s 2019-20 and 2020-21, use of multiple year data could be allowed even for the tested party to average out the impact of the pandemic to a certain extent.
- **Safe harbours relaxation** – Safe harbours for F.Y. starting 2019-20 are currently pending announcement. The authorities could use this opportunity to rationalise these safe harbours to levels representative of the current business realities and reduce the safe harbour margins expected of Indian taxpayers. Safe harbours which are representative of the current business scenario will be very helpful to taxpayers potentially facing benchmarking issues discussed earlier in the article.
- **Relaxation in time period for repatriation of excess money (secondary adjustment)** – Given the cash crunch being faced by MNEs worldwide, the time period for repatriation of excess money[6] could be extended from the current period of only 90 days[7].

CLOSING REMARKS

While the pandemic has impacted almost every business in some way or the other in the short term and in many inconceivable ways in the long term, just this claim alone will not be enough from a transfer pricing perspective. Taxpayers will need to analyse the exact impact of the pandemic on their entire supply chain and to the extent possible also quantify the impact for their specific business. The impact of the pandemic, steps taken by the management to mitigate the adverse impact, negotiations / renegotiation (with third parties as well as affiliates), business plans and business strategies, government policies and interventions are some of the key factors which will together determine the transfer pricing impact of the pandemic on the taxpayer.

The pandemic has brought to the fore the importance of having robust agreements. While the current discussion revolves mostly around *force majeure* clauses in

4 Refer Rule 10CA of Income Tax Rules, 1962
5 Refer Rule 10B of Income Tax Rules, 1962
6 Refer section 92CE of Income-tax Act, 1961
7 Refer Rule 10CB of Income-tax Rules, 1962

third-party agreements, inter-company agreements are equally important in the context of transfer prices between the entities of an MNE group. Going forward, for new transactions with affiliates or at the time of renewal of agreements relating to existing transactions, care should be taken to draft / revise inter-company agreements specifically outlining emergency-like situations and the relationship between the parties in such times. Which party will be responsible for which functions and would bear what type of risks and costs should be clarified in detail. Agreements could potentially also include appropriate price adjustment clauses. MNEs could consider entering into shorter term agreements till the time the impact of the pandemic is reasonably clear. Having said that, even if the agreement permits price adjustments, any pricing / price adjustment decisions taken should also consider the economic situation and the implication of such decisions under other applicable laws, including transfer pricing laws of the other country/ies impacted by such decisions.

These times require businesses to act fast and address several aspects of their business, and often, to keep the business floating in the near term. Needless to say, taxpayers should adequately document the commercial considerations dictating these decisions on a real time basis and be able to present the same to transfer pricing authorities in case of a transfer pricing scrutiny. Further, in the Master File taxpayers should include a detailed industry analysis and a description of business strategies as well as the corporate philosophy in combating the financial impact of Covid-19, including the relationships with employees, suppliers, customers / clients and lenders.

Governments and inter-governmental organisations around the world are closely monitoring the economic situation caused by the pandemic. Organisations such as OECD are also monitoring various tax and non-tax measures taken by government authorities to combat the impact of Covid-19[8]. Taxpayers would do well to continuously monitor the developments (including issuance of specific transfer pricing guidelines relevant to this pandemic) at the level of organisations such as OECD and UN, and also look out for guidance from the government authorities. ■

8 For instance, the OECD has recently published a report on tax and fiscal policy in response to the coronavirus crisis. The OECD has also compiled and published data relating to country-wise tax policy measures. Both, the report as well as the country-wise data, can be accessed at www.oecd.org/tax

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