

# Impact of COVID-19 on advance pricing agreements 3/11/21

While some taxpayers may face challenges in applying their advance pricing agreements (“APAs”) with the tax authorities under the economic conditions resulting from the pandemic, all existing APAs and their terms should be respected unless a critical assumption is breached. This article provides an overview of how COVID-19 affects APAs in the light of the OECD’s “Guidance on the transfer pricing implications of the COVID-19 pandemic.”

## Critical assumptions defined in the APA

The COVID-19 pandemic and the governments’ response have dramatically transformed the economic conditions. As a result, taxpayers affected by the pandemic may face challenges in applying their APAs for 2020. Whether the validity of an APA can be challenged will be determined according to critical assumptions it defines. Under Latvian legislation an APA defines its critical assumptions and the circumstances in which it should be amended, as well as conditions that will make it invalid. It is important to note that a mere change in the taxpayer’s business performance for 2020 will not result in a critical assumption being breached.

The first step in assessing the impact of COVID-19 on the validity of an APA is to review its terms carefully. Whether a critical assumption has been breached should be analysed on a case-by-case basis. If there is a risk of breach, the taxpayer has a right to seek the tax authority’s approval for amending the APA.

Breaching a critical assumption can have the outcomes set out below.

**1. Revision.** The taxpayer and the tax authority can agree to revise the APA following a material change to the underlying conditions. In some cases it might be reasonable to keep some of the terms and to revise any provisions or transactions directly affected by the breach.

The OECD Guidance suggests considering these options for revision:

- Assessing the transfer pricing results over the APA period rather than annually;
- Extending the period covered by the APA;
- Separating the terms of the APA for pre- and post-pandemic years;
- Cancelling the APA and renewing it in a future period; or
- Aggregating the transactions covered by the APA and assessing whether together they are consistent with its terms.

**2. Cancellation.** The APA is treated as valid up to the date of cancellation. This option is appropriate (i) if there has been a material breach of any of the critical assumptions, or (ii) if the taxpayer substantially fails to comply with any term or condition of the APA. Cancellation is not automatic, though, and the tax authority may waive it under certain circumstances.

**3. Revocation.** The taxpayer is treated as if the APA was never entered into. Revocation is appropriate (i) if there is an error or omission attributable to the taxpayer’s inadvertent or wilful failure when filing the APA request, or (ii) if the taxpayer fails to comply with a material condition of the APA. The pandemic has not changed the standard revocation rules, so APA revocations should be limited (just like those arising in any other circumstances).

## How should the taxpayer document a breach of critical assumptions?

Early notification is encouraged to give the parties more time to come to an agreement on revising the APA. Where critical assumptions are breached, it is important for the taxpayer to provide the tax authority with relevant supporting documents, for example:

- A detailed description of the taxpayer's business segment tracked by management that encompasses the entities and transactions covered by the APA;
- The forecast and actual profits of the business segment for the financial years affected by COVID-19;
- Documents outlining any proposed or implemented modifications to pre-existing agreements or copies of new intercompany contracts related to the APA;
- A narrative explaining the anticipated effects of the current economic conditions on the agreed transfer pricing methodology (e.g. restructuring, changes in its risks and responsibilities, government actions) to demonstrate that the impact is attributable to the economic conditions during the pandemic and not a mere change in the taxpayer's business performance;
- Detailed segmentation of financial data that demonstrates the impact of COVID-19 on the taxpayer's financial results by separating exceptional operating costs and/or income from a government assistance programme;
- Information about third-party behaviours in comparable circumstances.

As for APA processes initiated during the pandemic, the parties are encouraged to take a flexible and collaborative approach. Examples of considerations include: (i) separating an APA for the period affected by COVID-19 from one covering the post-COVID period; (ii) adding a condition that the relevant effects of the pandemic should be analysed and reported annually once they are known and making retrospective amendments to the APA; (iii) extending the APA period to mitigate the short-term effect of the pandemic; (iv) using a cumulative or term test throughout the APA period.