

OECD's Guidance on transfer pricing implications of Covid-19: allocation of losses and extraordinary costs 2/14/21



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Many multinational enterprises have suffered losses from a drop in demand, a supply chain delay or extraordinary operating costs during the period of Covid-19 restrictions. The allocation of such losses and extraordinary costs between related companies is likely to attract the tax authority's scrutiny so these issues require special attention. This article explores the allocation of losses and Covid-19 specific costs in the light of the OECD's Guidance on the transfer pricing implications of the Covid-19 pandemic.

According to the Guidance, three issues should be considered before losses and Covid-19 specific costs are allocated between related companies:

1. Analysis of risks taken by the parties;
2. Evaluation of extraordinary activities and one-off costs;
3. Changes to contract terms and the possibility of invoking the force majeure clause.

Risk analysis: can a limited-risk company incur losses?

The arm's length principle dictates that the allocation of risks affects how the profit or loss from the transaction will be apportioned. According to the Guidance, the parties may revise their mutual risk allocation in special cases during the pandemic but the new allocation should be supported by commercial substance and relevant evidence because the tax authority is likely to scrutinise such cases.

A company performing limited-risk activities should not absorb any long-term loss but it could incur losses over shorter periods. So in determining whether a limited-risk company can incur a loss we need to consider the facts and circumstances of the transaction as well as the risks taken by the parties.

For example, a distributor that uses a drop shipping model and does not take inventory risk but partially takes market risk is considered a limited-risk distributor within the group. If the pandemic triggers a drop in demand, the group distributor may suffer a loss through market risk regardless of how his functional profile is named. Whether the loss is arm's length can be measured in an analysis of comparable uncontrolled transactions.

Allocation of Covid-19 specific costs

One-off or specific costs arising because of the pandemic (e.g. workplace reconfiguration, IT infrastructure, remote working) should be allocated in proportion to the functions performed and risks taken by the parties.

It is possible that a company having initially incurred extraordinary costs has not taken the associated risks, so the costs may have to be allocated to companies that have taken those risks. For example, if

costs associated with remote working are centrally borne by one group company, then other companies that benefit from receiving these services may have to reimburse the provider's costs.

Depending on the risk allocation, in some cases extraordinary costs can be passed on to customers or suppliers. This option should be assessed in the light of industry conditions and the company's ability to dictate prices to customers.

Effects on comparability analysis

When it comes to analysing data comparability it is necessary to consider ways of accounting for extraordinary costs caused by the pandemic.

The Guidance states that first of all, extraordinary costs should be omitted from the net profit calculation unless they are linked to the controlled transaction. Extraordinary costs should be consistently excluded at the level of comparable companies as well as the company being tested.

Secondly, it is important to consider whether extraordinary costs can be added to the cost base and credibly distinguished.

Thirdly, it may be necessary to adjust accounting to avoid any effects arising from disparities in accounting for controlled and uncontrolled transactions. Yet adjustments should be considered only if they make the results of the comparability analysis more credible. Taxpayers may account for costs caused by the pandemic, for instance, as business costs or non-business costs, as well as above or below the gross profit level, depending on the situation.

Contractual changes and the force majeure clause

In response to the pandemic, unrelated companies may revise their terms of business. Related parties may also consider revising their intragroup agreements and/or behaviours in their financial or commercial dealings, for instance, by agreeing on changes to payment terms to ensure the optimal availability of funds. In that case the taxpayer should consider the real opportunities and their long-term effects on profitability (e.g. losing the main customer or supplier). If the company lacks clear evidence of the commercial rationale behind any contractual changes and how they fit in with the behaviour of independent companies, the tax authority may revise such adjustments as out of line with the arm's length principle.

In extraordinary cases the company can claim that the circumstances justify a default under the force majeure clause. The ability of related parties to invoke this clause during the pandemic will depend on how it is formulated and whether unrelated companies would have invoked it in similar conditions.

In summary, any losses and costs incurred during the period of Covid-19 restrictions should be allocated in proportion to the functions performed and risks taken by the parties. To make sure the allocation of losses and costs meets the arm's length principle, the risks as well as the facts and circumstances of the transactions should be analysed in detail. The risk analysis should take account of the parties' behaviours and mutual relations and include an analysis of their current/revised intragroup agreements. Any changes made to the dealings between related parties must be commercially sound.