

Covid-19: transfer pricing impact 2/42/20



Director, Transfer Pricing, PwC Latvia
Tatjana Koncevaja

An adverse economic environment poses certain difficulties in maintaining transfer pricing ("TP") policies. However, a global economic crisis does not cancel the requirement that controlled transactions be arm's length. Following our article on Covid-19 and financial transactions, this one explores some other implications of the pandemic for TP outcomes and provides suggestions for TP analysis.

Benchmarking studies

The main issue is how to approach evaluation of the taxpayer's deteriorated financial performance in the absence of reliable benchmarking studies, given the lag in the disclosure of comparables. In such circumstances, it is advisable to adjust the available comparable data in order to reflect the adverse economic impact. The following steps can be considered:

- Adjusting comparables for extraordinary expenses (e.g. increased advertising expenses and inventory write-offs) or restructuring expenses and the foreign exchange impact;
- Including only companies that have been affected by the pandemic to a similar degree (broaden the search criteria to include companies with a similar decline in sales and exclude non-affected companies);
- Avoiding the multiple-year approach to the market range;
- Using the market range from minimum to maximum instead of the interquartile range, depending on the amount and comparability of the selected comparables;
- Selecting comparables from years in which the company faced similar crises.

The goal is to demonstrate that lower profits or losses are due to economic circumstances and not TP.

Changes in TP methodology

Generally, in the absence of material factual or economic changes, the TP methodology should remain consistent. Covid-19 may warrant changes to methodology assumptions, allowing the taxpayer to change the TP method applied. A shift to the profit split method may be appropriate in the present situation, since it relies primarily on the distribution of the actual profit or loss, rather than benchmarking against external data. It should be noted that the group should be consistent across all jurisdictions when changing TP practices and assumptions because of the impact of Covid-19, and should carefully evaluate the functions and risks of the companies before assessing whether a change of TP method is appropriate.

Taxpayer data analysis

To account for losses caused by the pandemic, it is advisable to prepare a detailed financial data segmentation that separates any extra costs incurred or any profits unearned because of Covid-19, such as lease termination costs and workforce and supply-chain disruptions.

Taxpayers can also simulate their profitability without Covid-19 (so-called EBITDAC¹) and use it as an argument. The “Covidless” operating performance can be estimated by reviewing initial business plans and budget estimates for the year and must be supported by direct business evidence.

Practical recommendations

When evaluating the TP of 2020, taxpayers are advised to profoundly analyse the impact of Covid-19 on their business, comparables and TP policies. A good practice is to prepare a defence file early with evidence supporting the Covid-19 impact on the business.

It is also advisable to look for TP guidelines released around the world. For instance, Australian tax authorities have introduced a “but-for” test in TP analysis, which accurately defines the company’s TP had the pandemic never happened. The key in such analysis is to provide legitimate business assumptions.

The impact of Covid-19 on advance pricing agreements will be explored in a future article.

You are welcome to attend our TP seminar at PwC’s Academy:

- Transfer Pricing Masterclass on 22 October 2020 (in Latvian)

¹ Earnings Before Interest, Taxes, Depreciation, Amortisation and Coronavirus