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CLIENT UPDATE



The OECD Publishes New Guidance on Transfer Pricing Implications of Covid-19

December 23, 2020

On December 18, 2020, the OECD released its [Guidance](#) on the Transfer Pricing Implications of the COVID-19 Pandemic (the "[Guidance](#)"), regarding practical challenges to the application of the arm's length principle and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 ("[OECD TPG](#)"). The [Guidance](#) focuses on how the arm's length principle and the OECD TPG apply to issues that may arise or be exacerbated in the context of the COVID-19 pandemic. We have addressed these and other transfer pricing planning points in [our recent publication](#) Covid-19 and Transfer Pricing.

General

Transfer pricing legislation, including Section 85A of the Israeli Tax Ordinance, regulations and the circulars issued by the Israeli Tax Authority ("[ITA](#)") are generally designed for a stable business environment. Covid-19 and the economic turmoil that has followed have been affecting functions, assets and risks in transactions between unrelated parties with the result that the transfer pricing strategy of MNEs should consider those changes for their intercompany transactions. The [Guidance](#) acknowledges the profound impact of the Covid-19 pandemic and the unprecedented disruptions to the global economy. The global economic impact, though, varies widely across economies, industries and businesses and requires revisiting some of the traditional paradigms. As a result, the [Guidance](#) underscores the importance for business to [contemporaneously document](#) how, and to what extent they have been impacted by the pandemic.

The [Guidance](#) focuses on four priority issues:

1. Comparability analysis,
2. Losses and the allocation of COVID-19 specific costs,
3. Government assistance programs, and
4. Advance pricing agreements ("APAs").

Comparability Analysis

While a [cornerstone](#) of determining an arm's length rate involves analysis of comparable transactions, the [Guidance](#) acknowledges that the pandemic may have a significant impact on pricing between independent enterprises. As a result, the ability to rely on historical data when performing comparability analysis could be significantly reduced. Such analysis may require adjustments to take into account the economically relevant characteristics of the particular related party transaction.

In principle, [any form of publicly available information](#) may be relevant to determining the impact of COVID-19 on a particular business, industry or related party transactions. The [Guidance](#) identifies a number of sources of information that may be relevant in ascertaining the arm's length nature of a transfer pricing policy for FY 2020, such as (but not limited to) the following:

- An analysis of how sales volumes have changed during COVID-19;
- An analysis of the change in capacity utilization relevant for the MNE group and the related party transaction, and/or transactions with independent parties;
- Specific information relative to incremental or exceptional costs borne by parties to the related party transactions or by the MNE group as a whole;
- The extent to which government assistance has been received and, if so, quantifying the effect and identifying the type of the assistance and its accounting treatment.

The [Guidance](#) also provides a number of [practical approaches](#) to addressing the impact of the pandemic. For example, enterprises may compare budgeted or forecasted financial results to those actually achieved to measure the pandemic impact on revenues, costs and margins. The [Guidance](#) also makes it clear that loss-making companies may serve as comparables. Furthermore, the [Guidance](#) provides practical approaches to addressing the difficulties in determining arm's length conditions due to the lag in time between the occurrence of the related party transactions and the availability of data regarding uncontrolled transactions.

Finally, the [Guidance](#) acknowledges that the unprecedented economic impact of the pandemic may require enterprises to review their analyses of existing comparables rather than simply rolling forward existing models.

Losses and the Allocation of COVID-19 Specific Costs

The second issue addressed in the [Guidance](#) relates to the incurrence of losses and extraordinary costs to many MNE's due to a decrease in demand, inability to obtain or supply products or services or as a result of exceptional, non-recurring operating costs.

The [Guidance](#) discusses the ability to modify intercompany agreements. Some intercompany agreements have a force majeure or similar clauses allowing for the suspension, termination or revision of the intercompany transaction. Absent such a clause MNEs could still consider, consistent with the concept of realistically available options (also cited by the ITA and Israeli court decisions), an amendment or revisions to existing agreements on the basis that they should be at arm's length and it follows the conduct of and transactions between unrelated parties (for example, because one of the parties would be willing to bear additional expenses when the alternative is insolvency).

Notably, the [Guidance](#) addresses the concern of 'limited risk' entities and whether even they may incur losses on their related party transactions. Limited risk entities – distributors, manufacturers, development centers – are typically compensated with a fixed margin on a cost plus basis (or return on sales for distributors) using the CPM / TNMM. While the [Guidance](#) does not provide a general rule in those situations, it does [acknowledge the possibility that such a limited risk entity could incur losses in the short term](#). A robust analysis of the particular facts-and-circumstances of each entity's functions, assets, and risks would be required. Furthermore, controlled distributors should find data for comparable uncontrolled limited risk distributors to support such results.

The [Guidance](#) also addresses the question of how MNEs should [allocate the exceptional, non-recurring costs](#) they have experienced due to the pandemic. In general, the approach should be to allocate in the same way that independent parties operating in comparable circumstances would allocate such costs and [assumption of risk](#). For example, costs that relate to a particular risk would therefore be allocated to [the party that assumed such risk](#), even if it is not the party that initially bears the cost associated with such risk.

Government Assistance Programs

The third area addressed by the [Guidance](#) relates to the extensive and varied government assistance programs that were enacted in different jurisdictions to mitigate the economic impact of the COVID-19 pandemic. These programs, however, have raised a number of issues such as whether the economic assistance to one controlled party should be [economically relevant](#) to the determination of the price for related party transactions. The [Guidance](#) in effect answers that question affirmatively and provides that the [terms and conditions of these programs need to be considered](#) when determining the impact on related party transactions. To the extent that competitiveness and elasticity of demand in a particular market or industry may be impacted by these programs, they would typically influence the behavior and pricing of unrelated parties, and therefore, should be relevant in determining an arm's length price for related party transactions.

Advance Pricing Agreements

In general, advance pricing agreements (APAs) are intended to provide tax certainty to taxpayers and tax administrations by ensuring predictability in the treatment of international transactions. Therefore, such agreements should generally be ["respected, maintained and upheld"](#) despite the pandemic, unless a critical assumption has been breached. The [Guidance](#) acknowledges that the pandemic, the various governmental responses, and the dramatic effect on the global economy and market conditions are likely to qualify as a breach of critical assumptions in an APA. In doing so it follows the initiatives taken by certain tax administrations such as the IRS that announced on May 11, 2020 certain filing modifications for mutual agreement procedures and application of tax treaties.

However, the impact on a taxpayer must be demonstrated by numerous factors, and any breach in a critical assumption should be analyzed on a case-by-case basis, taking into account the particular circumstances of that enterprise and the relevant commercial factors. Further analysis would be required to determine whether an APA should be revised (going forward), cancelled (applicable up until the cancellation), or revoked altogether (retroactively treating the APA as if it had never been entered into).

As a practical matter, the [Guidance](#) stresses the importance of MNEs collecting and providing tax administrations with relevant supporting documentation, and engaging in a transparent manner and disclosing all relevant information in a timely manner.

Summary

Since the overriding principle underlying transfer pricing systems is the arm's length standard, the consequences of the Covid-19 pandemic surely impacts transfer pricing analyses. The challenge is to find practical approaches for quantifying that impact, and the [Guidance](#) is a helpful tool toward that end. While the ITA has not published any guidance thus far on the impact of the pandemic on transfer pricing, Israel generally follows the OECD TPG.

MNEs should be actively [collecting data and documenting the economic impact](#) of the pandemic on a contemporaneous basis. The [Guidance](#) also engage in a robust [review of their intercompany agreements](#) and [transfer pricing documentation](#) and consider whether pandemic related adjustments are warranted and supported by the external data. We note that the ITA has recently published Circular 1/2020 on transfer pricing documentation and the burden of proof (click [here](#) for our alert on the ITA Circular on the Burden of Proof in Transfer Pricing Matters) and new proposed regulations on documentation requirements and adoption of CbC filing were published just a couple of months ago (click [here](#) to our alert on Proposed New Israeli Legislation on Transfer Pricing Documentation).

Our firm has vast experience in advising multinational entities on properly setting the relationship between various group entities, putting in place proper documentation and manuals to support such structures, carrying out business model changes and in representing international and domestic clients before the ITA and the Israeli courts in transfer pricing controversies.

Contact Information

Eldar Ben-Ruby Partner Tax Group Leader	Meir Akunis Partner Tax Group	Shaul Grossman Partner Tax Group	Keren Shitrit Partner Tax Group
Dr. Michael Bricker Partner Tax Group	Omri Davidov Partner Tax Group	Nathalie Anvar Hammer Partner Tax Group	Joel Wine Senior Associate Tax Group

For additional information about our firm's Tax group, click [here](#).

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