
Impact of COVID-19 on transfer pricing policy

Legal flash; Finance and Tax

April 6, 2020



Key aspects

- Transfer prices are not indifferent to crises; therefore, the current global health emergency makes it necessary to review policies in force and their validity, and to proactively approach possible adjustments.
- The main areas to review are as follows:
 - the impact on intragroup debts and guarantees;
 - the validity of expected returns for limited-risk entities and those arising from the provision of services;
 - the need to reassess advance pricing arrangements (APAs) already in force;
 - transaction documents and the evaluation of comparables; and
 - the consequences of supply chain disruptions and of possible functional changes.



Impact of COVID-19 on transfer pricing policy

COVID-19, and particularly its effects on the global economy, is the main concern of companies since the World Health Organization officially declared on March 11 the outbreak a pandemic.

With unknown perspectives in the short- and long-term, the measures that the different countries have implemented to date have already had a huge impact on global economic activity.

In this context of business activity affected by force majeure causes, companies are reevaluating their transactions and renegotiating their contractual obligations. Transfer prices are not indifferent to the ups and downs of the economy and to crises; therefore, reevaluation and renegotiation should also apply to multinational group's related-party transactions.

The current circumstances make it necessary to review the transfer pricing policies implemented by multinational groups to confirm their validity and, where necessary, to proactively make the corresponding adjustments. Although a case-by-case analysis is always necessary, the main areas of focus are as follows:

1. Intragroup debts and guarantees

The current liquidity pressures foster recourse to intragroup debts, requests for additional guarantees by independent financial backers, changes in the standard positions in cash pooling systems, and perhaps maturity or expiry dates relating to intragroup transactions may even be disregarded.

When it comes to assessing how to adjust these types of transactions to the current circumstances and the conditions that must govern them, factors such as the increase in credit risks, country risks and exchange rate risks, or comparables, must be considered. Also, any new agreements entered into must consider the new trends in the financial markets, which already foresee clauses arising from the current circumstances.

The challenge these transactions pose from a transfer pricing perspective is the difficulty in using past transactions as comparables because of the substantial changes in market conditions.



2. Low-risk companies and remuneration for routine activity

Multinational groups have often implemented structures with low-risk entities. The risk-return relationship determines that, in usual conditions, these entities can expect to obtain minimum but stable returns for performing their routine functions. In the current circumstances, it must be assessed whether this expected return continues to be reasonable or whether these entities must also assume part of the financial damage generated at group level.

The same would apply to other types of routine activities that are remunerated by adding a margin to the costs incurred; in many cases, these costs will remain unaltered while less benefit is derived from the activity.

This particularly occurs in service provision activities, in relation to which the current circumstances may reduce the service level or lead to reduced use by service recipients.

In this context of crisis, it seems justified for multinational groups to be able to adapt their agreements; in the same way as independent parties, under a criterion of opportunity cost, may be willing to reduce margins to cover fixed costs or assume controlled losses to guarantee the future viability of the business. In short, it is about distributing the subactivity costs between the related parties in the same way that independent third parties do.

In any case, the impact of the public health emergency on the business must be quantified and documented.

3. Advance pricing arrangements

The objective of APAs is to offer, through negotiation with the tax authorities, certainty for valuating related-party transactions. However, their validity depends on the maintenance of the existing economic or technological circumstances, as well as on the possible specific assumptions agreed on in each case.

These conditions or critical assumptions could be affected by the current situation without the related-party transactions having undergone any change. Therefore, it is essential to carry out the appropriate analyses and forecasts to determine whether it would be worthwhile bringing forward negotiations with the tax authorities about the validity of APAs or to renegotiate them, and to identify possible areas for future discussion.



4. Transaction documents and evaluation of comparables

As the public health emergency has changed the transactions of most industrial sectors, the current market conditions cannot be classified as normal. In these circumstances, the process for obtaining valid comparables to prepare the mandatory transfer pricing documents is very difficult, if not impossible.

The data on transactions from past fiscal years, not affected by these exceptional circumstances, cannot be used as valid comparables to prepare the documents for this fiscal year. Similarly, current transactions cannot be used as valid comparables for future fiscal years.

Maybe the most reasonable approach would be to calculate ratios based on budgetary accounts, adjusted according to the impact of the current crisis, or through the justification of a comparability analysis applying financial-economic reasonableness criteria to the detriment of the use of market comparables.

Whatever the case, the documents must reflect the decision-making process behind the transfer pricing policy, so the tax authorities can see the continuity of the policy and the logic behind the decisions.

5. Other matters

Supply chain disruptions and the different pace at which countries have introduced measures may have led to temporary or permanent changes in the activity of the companies that make up the multinational group.

The fact that these changes were determined by external adverse circumstances does not mean we do not have to consider whether the transfer of duties and risks, or the consequent arising of synergies, must be remunerated, and if so, how.

An initial analysis of the impact of the pandemic on the transfer pricing policy and a proactive attitude regarding the documents needed in the multinational group's new economic circumstances will (i) mitigate the possible future risks, and (ii) enable efficient reorganization of resources. These actions are particularly important in this scenario of uncertainty in which, more than ever, the comparables available will not adequately reflect the conditions in which the activity has developed.



For additional information, please contact Cuatrecasas.

©2020 CUATRECASAS

All rights reserved.

This legal flash is a compilation of legal information prepared by Cuatrecasas. The information and comments in it do not constitute legal advice.

The intellectual property rights to this document belong to Cuatrecasas. Any reproduction, distribution, assignment or any other full or partial use of this newsletter is prohibited, unless with the consent of Cuatrecasas.

