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Transfer Pricing and Covid-19: How to adapt your TP policies?

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The impact of the Covid-19 pandemic on global economic activity is a major challenge for multinational enterprises. This crisis caused sales outlet closures, plant closures and changes in consumption habits which highlighted **issues related to the allocation of risks/losses within groups and raised questions about intra-group remuneration based on certain transfer pricing models.**

Therefore, multinational groups will have to consider the **need to adapt their transfer pricing model** in order to **reflect the specific economic circumstances related to this unprecedented crisis**. These transfer pricing issues must be considered by groups as soon as possible in compliance with the OECD Guidelines and local regulations, as tax authorities may intensify tax audits for the year 2020. This article is the second focus of our set of four and completes our June 10 webinar: "*How to adapt intra-group contracts and transfer pricing policies*".

❖ Allocation of overall losses

The OECD Guidelines provides that « *associated enterprises, like independent enterprises, can **sustain genuine losses**, whether due to (…) **unfavourable economic conditions**, (…) or other **legitimate business reasons.*** » (§*1.129*).

There is no doubt that the Covid-19 crisis will be considered as constituting unfavourable economic conditions, but the real question is whether this crisis will be sufficient on its own to justify the losses being incurred by an entity. The OECD Guidelines require that **the remuneration of an entity should reflect its functions performed, risks assumed and assets used.** Therefore, it will be difficult to reconsider intra-group remuneration when (i) the losses are related to a risk assumed by the entrepreneur and (ii) the transfer pricing model reflects the functional profiles of each entity of the group.

However, limited risk entities may be attributed a certain level of loss if it can be demonstrated that **independent parties in similar circumstances have incurred similar costs and losses.** This will obviously require a detailed case-by-case analysis.

❖ What about the remuneration of limited risk entities?

According to the current models, routine entities are guaranteed a level of margin. At this stage we would like to remind that a **functional profile with limited risk does not mean no risk at all.** Thus, the remuneration of entities with limited risk could be **adjusted**, based on the facts and circumstances of the case, by taking into account:

***Intra-group agreements*:**

- To determine whether the **allocation of risks is contractually envisaged** (the written contract is the legal basis for the allocation of responsibilities and risks);
- To consider when appropriate, the **suspension of the contract** (force majeure clause) when the routine entity cannot supply the intra-group goods or services. The costs assumed by these routine entities, even when the activity is suspended, could be borne by the entrepreneur in order to ensure the company's post-crisis sustainability;
- To consider, when appropriate, the **renegotiation of the contract** on the basis of unpredictability (without, however, reconsidering the functional profile of the routine entity).

***The methods of calculation of the transfer prices*:**

Some transfer pricing models are based on **budgeted revenues/costs**. Since the budgets have been established on the basis of normal activity, **adjustments** may be contemplated to take into account **losses due to the exceptional circumstances of the crisis.**

In addition, **local regulations** have enabled companies to benefit from some measures (short-time working, deferral of charges, etc.). Therefore, those expenses have not been borne by the routine entity and should not be included in the cost base for the calculation of intra-group remuneration (de facto reducing the cost borne by the entrepreneur).

❖ Adaptation of the economic analyses

The comparables used to justify the intra-group margin left at the level of the routine entities **do not reflect the new economic conditions caused by the crisis**. Indeed, these economic analyses are based on previous financial years since the most recent financial data available in databases is currently related to 2018.

At this stage and in order to reflect the 2020 financial year, it would be possible to:

- **include loss-making companies or companies with a lower turnover** in the set of comparable companies;
- **extend the covered period** (a three-year period is often used in practice) to reflect a full business cycle;
- adjust the financial data of the selected comparables based on **periods of economic slowdown** (as the economic crisis of 2008);
- use a **different point in the arm's length range** to reflect an arm's length remuneration.

All these possibilities will have to be considered and discussed in order to reflect the economic situation as closely as possible. On the other hand, it will be necessary to avoid any risk of challenge in the case of a tax audit.

❖ Preparation of a transfer pricing documentation

It will be necessary to ensure the **existence of a contemporaneous transfer pricing documentation** that will be able to justify the intra-group remunerations and any adjustments made as a result of the Covid-19 crisis.

To ensure that the analyses are representative of the functions performed and risks assumed during the different phases of the crisis, it could be envisaged to distinguish the losses incurred and to quantify them at different times (pre-pandemic, during the pandemic and during the post-pandemic recovery period).

Contacts

Pascal Luquet
Attorney-at-Law, Partner

E pluquet@avocats-gt.com
T +33 1 41 16 27 41
M+33 6 10 12 12 17

Nadia Boudaoud
Tax Advisor

E nboudaoud@avocats-gt.com
T +33 (0)1 41 16 27 17
M +33 (0)7 57 44 26 48

Jetlira Kurtaliqi
Tax Advisor

Grant Thornton Société d'Avocats

Grant Thornton Société d'Avocats
29, rue du Pont
92200 – Neuilly-sur-Seine, France
www.avocats-gt.com

LinkedIn

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