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NEWSLETTER

OECD PANDEMIC RECOMMENDATIONS: TRANSFER PRICING

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SUMMARY

The Organisation for Economic Co-operation and Development (OECD) has published a document containing several new recommendations that aim to clarify how the Arm's Length Principle and the transfer pricing rules that arise from it can be applied to transactions that are directly affected by the Covid-19 pandemic.



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BACKGROUND

On December 18th, 2020, the OECD published a document containing several new recommendations that aim to clarify, in practical terms, how the Arm's Length Principle can be applied to transactions that have been directly affected by special circumstances arising from the COVID-19 pandemic.

Considering the changes that markets and transactions have been subject to during this crisis, and despite considering that its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 2017) is still up-to-date and able to provide a solution to most situations, the OECD still found that new instructions were due.

As such, the new recommendations, which have been developed and approved by the OECD's 137 member states (which are also a part of the Inclusive Framework on Erosion and Profit Shifting or BEPS), while not revoking or conducting changes to the 2017 Guidelines, still aim to provide tax administrations and multinational corporations with directions regarding transfer pricing rules in the context of the pandemic.

Through the new recommendations, the OECD seeks to provide a pragmatic approach to solving pandemic-related issues, shed light on the need to adapt transactions between related parties, all while maintaining the belief that the Arm's Length Principle is, at its core, fully applicable under the new circumstances.

These new recommendations are based around four key aspects which ensure that the Arm's Length Principle and the transfer pricing rules are applicable in this new economic context:

- Comparability analysis;
- Covid-19 Specific Losses and Costs;
- Government assistance programs; and
- Advance pricing arrangements.

COMPARABILITY ANALYSIS

The pandemic has affected the pricing of transactions in a major way, which in turn has reduced the reliability of the information being used in transfer pricing comparability analysis.

In this context, the OECD's new recommendations also seek to promote the search for alternative sources of quality comparable information.

To this end, comparability analysis should be carried out on the evolution of turnovers and extraordinary expenses since the pandemic began, regarding similar transactions from both related and unrelated entities.

In addition, and beyond the usual macroeconomic information available, the following sources should also be considered:

- how government policies introduced in response to the pandemic may influence transaction pricing;
- the information contained within interim or quarterly tax returns and financial statements;
- statistical comparisons to previous periods of crisis or recession; and
- comparisons between estimated or budgeted expenses and real expenses.

Regarding comparability analysis, the OECD's recommendations stress out a core aspect: time. In any circumstances, financial data chosen for comparison should refer to the same period. In some cases, this information can be instantly obtained.

When applying the Arm's Length Principle and transfer pricing rules,

comparable data from the same period as the controlled transaction should be used, as it is usually the most accurate.

As such, the OECD's new recommendations state that taxpayers should have a critical approach to the available data to overcome any defects that may arise from the fact that most information regarding 2020 has only become available from 2021 onwards.

In this sense, and seeking to avoid any distorted analysis, the OECD recommends a separation of pre-pandemic and pandemic periods.

In addition, due the added difficulties regarding comparability analysis, the OECD suggests that tax administration be more flexible to avoid transfer pricing-related litigation.

Furthermore, to overcome this obstacle, the OECD suggests that tax administrations allow taxpayers to utilize information that only becomes available after they file their income tax return for 2020, in a retroactive fashion.

As such, this should be foreseen by a country's national legislation, and duly documented in the taxpayers' transfer pricing file.

In this context, the OECD states that substitute or corrective tax returns should be allowed, and tax administrations should be flexible up to the point of allowing for transfer pricing adjustments to take place after tax returns are filed, or at the very least, hold mutual agreement procedures (or similar mechanisms).

Regarding data from previous economic crisis, the OECD recommends that the 2008-2009 financial crisis should not be the only comparable used, as the differences between that and the current crisis are deemed too great.

As such, and beyond the available data from the 2008-2009 financial crisis, comparable analysis should always be carried out with a clear distinction between pre-pandemic and post-pandemic periods, considering the significant change of circumstances between both periods.

In light of the above, the OECD recommends that comparable data always be adjusted by the taxpayer while keeping in mind the different circumstances between the comparable and the controlled transaction.

The OECD also reminds taxpayers that comparisons with entities that have had negative results is not excluded and should be included in the analysis if the comparability criteria are verified.

Concerning benchmarks, it is relevant to point out that under normal circumstances, annually compiled comparable data may be utilized for a three-year period. However, under the current circumstances, the OECD suggests that data is more frequently updated.

Finally, the OECD also recommends that more than one method of comparable analysis is used in order to better apply the Arm's Length Principle.

COVID-19 SPECIFIC LOSSES AND COSTS

Multinational corporations have registered major losses during the pandemic, having been hit by diminishing demand, turnover, supply chain interruptions, inability to provide services and additional costs and losses.

In this sense, the OECD states that these extraordinary losses should be split between the various entities within a corporate structure, even though this may trigger litigation with tax administrations.

As such, the OECD recommends that pandemic-related cost reallocation is conducted as it would be between independent entities, with the necessary adjustments.

The new recommendations include some examples of this method of reallocation, which should always be carried out with caution and duly considered during comparability analysis, as it could have a significant impact on this process.

As such, the net profit of a related party under analysis should include these extraordinary expenses, except if they are deemed to be strictly related to that operation.

To face this challenge, the OECD's new recommendations include the following warnings:

- the allocation of risk between parties in a transaction is directly related to the distribution of the resulting profit between them, and as such, the risk analysis should be conducted under the Arm's Length Principle;
- a special consideration of COVID-19 specific expenses should be carried out before cost reallocation;

- the parties should check if any *force majeure* clauses are applicable in the context of their contractual relationship; and
- the multination corporation as a whole should review any internal agreements that refer to extraordinary cost reallocation.

In light of the above, the OECD recommends that any changes made to existing contracts be clearly documented and justified by taxpayers, so as to guarantee that the Arm's Length Principle and transfer pricing rules are being observed.

GOVERNMENT ASSISTANCE PROGRAMS

The OECD defines government assistance programs as those in which a government or public authority grants an economic benefit to its taxpayers, which may or may not be of a financial nature.

These programs can have a significant impact on transfer pricing, as they may apply to either multinational corporations or independent entities.

In this context, the OECD recommends that a specific analysis of each program is carried out, in order to ascertain its

economic impacts, whether direct (e.g., payroll subsidies, short-term government bonds or public debt securities and loans) or indirect (e.g., making local public infrastructure available to taxpayers).

In this sense, and considering its relevance, the impact of government assistance programs should be considered in comparability analysis as a way to outline the controlled transaction. As such, it should always be well-documented in the taxpayer's transfer pricing file.

Regarding risks, the OECD recommends that government assistance programs be disregarded in terms of risk assessment in controlled transactions.

ADVANCE PRICING ARRANGEMENTS

Advance Pricing Arrangements currently in force between OECD member states were signed under significantly different circumstances than the ones the world currently faces.

These arrangements sought to provide taxpayers and tax administrations with a certain degree of certainty regarding

the tax treatment of international controlled transactions.

In this regard, the OECD states that these arrangements should remain in force, unless circumstances force their review, cancellation, or revocation, namely when the critical assumptions contained therein can no longer apply.

In order to find out if the critical assumptions no longer apply, both the arrangements themselves and the national legislation should be taken into account, in a case-by-case analysis that considers pandemic-specific impacts in a particular field or geographic region.

When a violation of an arrangement's critical assumptions is verified, there are several paths that can be taken towards a solution.

Firstly, many arrangements foresee specific procedures to follow in case a critical assumption no longer applies.

If the issue at hand is considered to be immaterial, a compromise can be reached between the taxpayer and the tax administration that allows the Advance Pricing Arrangement to remain in force.

If neither Advance Pricing Arrangement, nor the national legislation foresee any

procedures to follow in case critical assumptions no longer apply, the OECD's 2017 Transfer Pricing Guide already foresaw three possible paths to solution:

- reviewing the Advance Pricing Arrangement's terms;
- cancelling the Advance Pricing Arrangement, which means that it would cease its effects for the future (*ex nunc*); or
- cancelling the Advance Pricing Arrangement, thus retroactively annulling its effects from the moment of signature (*ex tunc*).

Through the new recommendations, the OECD advises taxpayers to not only notify tax administrations when a critical assumption is violated, but to do it as soon as they believe that a critical assumption is likely to no longer apply.

As for tax administrations, the OECD believes that, once notified, they should respond with caution, making sure they have access to all available information before deciding on the review, cancellation, or revocation of an Advance Pricing Arrangement.

CONCLUSION

It is the OECD's intention that these new recommendations make it easier

for taxpayers and tax administration to keep respecting the Arm's Length Principle and transfer pricing rules in the context of international controlled transactions that are affected by the COVID-19 crisis, thereby avoiding a substantial increase in transfer pricing related litigation.

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