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Subcommittee

Transfer Pricing during the COVID-19 Economic Downturn

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Executive summary

The economic downturn caused by the COVID-19 pandemic creates unique challenges in the application of the arm's length principle as guided by the United Nations Practical Manual on Transfer Pricing for Developing Countries (the UN TP Manual). Taxpayers and tax administrations are faced with various uncertainties during the years impacted by the COVID-19 economic downturn, including the post-pandemic phase of economic recovery. Detailed guidance on practical solutions to be found by tax administrations and taxpayers remains scarce. This guidance focuses on the fundamental application of the arm's length principle within the scope of the UN TP Manual and provides practical examples focusing on (a) the accurate delineation and recognition of the actual controlled transaction between associated enterprises, (b) the selection and application of the most appropriate transfer pricing methods, including comparability analysis, (c) effective approaches in applying existing dispute avoidance and resolution tools to enhance tax certainty and (d) potential approaches to improve standardization and simplification during the years impacted by the COVID-19 economic downturn.

1. Introduction

There is no universally adopted definition of economic downturns. The terminology is loosely used to denote adverse implications to the economy,¹ characterized by currency crises, economic shocks, debt crises, and banking crises and/or a combination of trigger events. Impacts of economic downturns widely vary based on supply-side and demand-side factors. Supply-side factors are firms' inability and/or lack of willingness to produce, while demand-side factors are characterized by customers' inability and/or lack of willingness to purchase from firms. The impact of economic downturns cascades upon MNE value chains due to the exogenous connection between countries impacted by the downturn.²

Transfer pricing (TP) rules and regulations apply primarily to the cross-border business operations of MNEs.³ Economic conditions are encapsulated in the standard steps in applying the arm's length principle (ALP) for controlled transactions. Distortions to intercompany commercial and financial relations are increasingly common during economic crises resulting in the need for potential review of the TP analysis and the outcome of applying the ALP.

The COVID-19 pandemic has had far-reaching economic consequences with characteristics that are differentiated from other economic downturns (see section 2). Guidance on the targeted impact of COVID-19 economic downturn on TP analyses is still scarce. In 2020, the OECD issued guidance on TP implications of the COVID-19 economic downturn (OECD COVID-19 Guidance).⁴ The OECD COVID-19 Guidance was provided during the first year of the pandemic while the trajectory of the economic downturn was largely unclear.

The aim of the current guidance is to provide a principle-based analysis, including practical examples to investigate the impact of economic downturn caused by the COVID-19 pandemic on TP and identify possible solutions that could be adopted by developing countries. It is important to highlight that a TP analysis in times of economic downturns should follow the analytical framework set forth in the UN TP Manual and this guidance should be read only in conjunction with the UN TP Manual. Indeed, the guidance provided in the UN TP Manual continues to be relevant for developing countries also during the COVID-19 economic downturn. Further, the aforementioned OECD COVID-19 Guidance can be considered to the extent that it caters to the

¹ Cardini F. (2014). Analysing English Metaphors of the Economic Crisis. *Lingue e Linguaggi* 11, 59-76.

² Parry. D. (2020). The Role of Multinationals in Propagating Economic Downturns, National Bureau of Economic Research, Digest: No. 12.

³ UN TP Manual, section 1.1.1.

⁴ OECD (2020). Guidance on the transfer pricing implications of the COVID-19 pandemic. Paris, OECD Publishing. The Guidance was developed and approved by the members of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (Inclusive Framework).

distinctive issues faced by developing countries and taxpayers operating in developing countries.

First, economic downturns may not always necessitate changes to a TP analysis. In this context, the following scenarios might materialize:

- Scenario 1: intragroup commercial or financial relations entered into prior to the COVID-19 economic downturn where facts and circumstances have not changed due to the pandemic;
- Scenario 2: intragroup commercial or financial relations entered into prior to the COVID-19 economic downturn where facts and circumstances have changed due to the pandemic;
- Scenario 3: intragroup commercial or financial relations entered into during or after the COVID-19 economic downturn.

Scenario 1 may not result in amendments to TP analyses concluded before the COVID-19 economic downturn. However, scenarios 2 and 3 might necessitate changes to the TP analysis concluded before the COVID-19 economic downturn. This guidance will focus on scenarios 2 and 3 wherein changes to the TP analysis are required, whether contractually agreed or otherwise.

Second, a TP analysis is grounded in the specific facts and circumstances of each case. The COVID-19 economic downturn may have varying degrees of impacts on MNE groups, separate legal entities and intragroup transactions. Therefore, this guidance should be viewed in the context of each specific case, based on the application of the ALP (see Sections 3 and 4).

Third, in times of an economic downturn, some businesses suffer negative consequences, additional costs and losses, while certain others may capitalize on new business opportunities, achieving additional revenues and profits. The same applies to the COVID-19 economic downturn.

Section 2 briefly touches upon some differences between the COVID-19 economic downturn and other downturns. Section 3 discusses the application of the ALP in case of the COVID-19 economic downturn. Section 4 examines the effect that the COVID-19 economic downturn might have on mechanisms to avoid/minimize as well as resolve disputes. Section 5 explores some ideas for potential standardization and simplification. Finally, Section 6 provide some conclusions.

2. Differentiating the COVID-19 economic downturn from other economic downturns

2.1. General differences

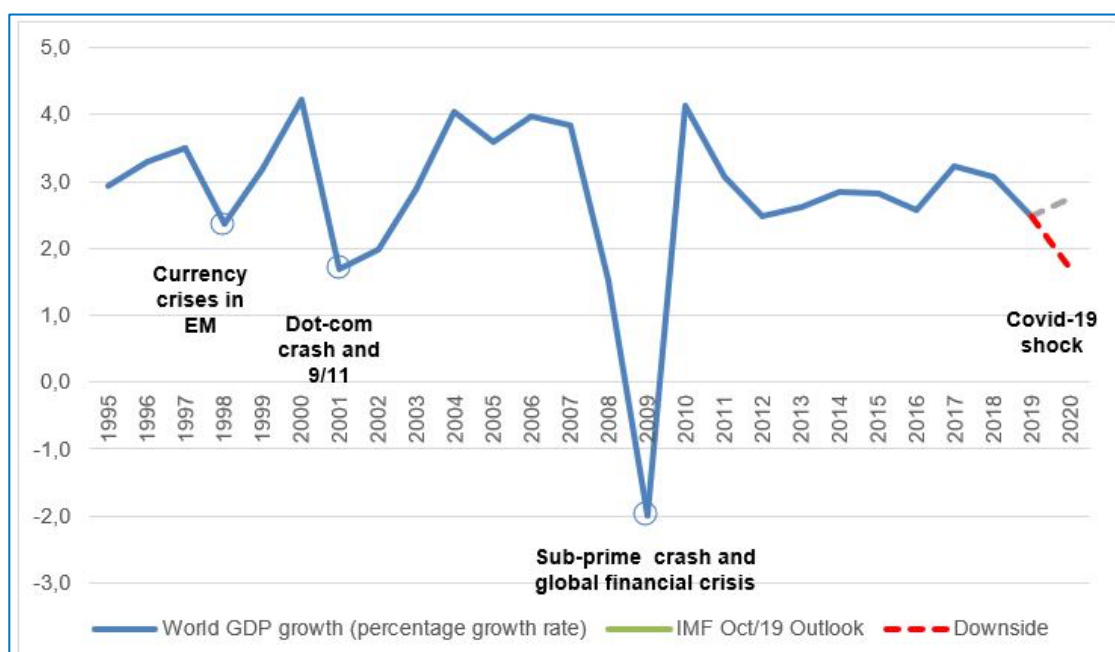
The COVID-19 economic downturn is unique in several respects. Primarily, the downturn does not have an economic origin and instead traces its roots to a health emergency. The nature of the crisis required a set of economic responses that were

unique in implementation, scale and scope, that were both coordinated and uncoordinated. The differentiation between the COVID-19 economic downturn and other downturns can be summarized as follows:

- Origins – The COVID-19 economic downturn was caused by a global pandemic.
- Uncertain economic outcomes – The COVID-19 economic downturn has a wide range of outcomes dependent on unpredictable non-economic factors.
- Global scale – The COVID-19 economic downturn is global, though many countries did not experience the same degree of adverse effects.
- Uneven impact on profitability – The COVID-19 economic downturn did not impact MNE profitability uniformly across all industrial sectors, with certain sectors outperforming others, thereby experiencing higher than normal profits, while others experiencing significant adverse effects.
- Governmental regulations – The COVID-19 crisis led to unprecedented governmental regulations regarding the movement and assembly of people to contain the spread of the virus, which impacted businesses differently across jurisdictions.
- Timing: The COVID-19 economic downturn affected different jurisdictions at different times.

The following graph provides a comparable overview of the impact of the COVID 19 economic downturn, in the context of other economic crises.

Figure 1: Impact on world GDP growth during previous economic downturns⁵



⁵ UNCTAD (2020). The economic impact of COVID-19: Can policy makers avert a multi-trillion-dollar crisis? Available from: <https://unctad.org/fr/node/20418>

However, the COVID-19 economic downturn has certain similarities to other crises. For instance, downturns can result in increase in public and private debt. Due to the poor performance of the economy, as well as the low profitability of specific businesses, the necessary financial resources must be sourced externally. Consequently, costs of debt (including agency costs and bankruptcy costs) may significantly increase, while access to debt financing may be significantly reduced. Accordingly, similar to other economic downturns, the COVID-19 economic downturn resulted in many governments across the world “bailing out” certain MNEs / sectors and / or provide MNEs with liquidity through governmental loan programs and other means, such as deferring of tax obligations.

2.2. Impact on conducting TP analyses for developing countries

Developing countries have historically been faced with specific challenges in applying the TP rules based on the ALP.⁶ Such challenges have been aggravated during the times of economic downturns and more specifically during the years of the COVID-19 economic downturn. Some of the challenges are identified as follows:

TP challenges faced by developing countries during normal economic times	TP challenges faced by developing countries during the COVID-19 economic downturn
Identifying comparable data through commercial databases, incomplete information, and lack of information containing developing country data. ⁷	The impact of economic consequences of the COVID-19 economic downturn may affect one or more parties to the transaction disproportionately. Further, comparable uncontrolled transactions may not have a consistent accounting treatment of the relevant expense/income impacted by the COVID-19 economic downturn. This may result in the need for comparability adjustments. However, in practice, contemporaneous data may not be available to perform such adjustments reliably.
Experience and skill set for applying TP rules. ⁸	Developed countries may have gained experiences in applying TP rules from previous economic downturns (such as the financial crisis of 2008-09) while certain developing countries that have introduced TP rules more recently may face capacity constraints to adapt quickly to new realities, often resulting in increased

⁶ UN TP Manual, section 2.5.2.

⁷ UN TP Manual, section 2.5.3.2.

⁸ UN TP Manual, section 2.5.5.

	controversies or distorted tax revenue collections from TP audits.
Increasing complexity in controlled transactions and tax structures of MNEs requiring robust information sources (databases) and expertise to handle information. ⁹	This challenge may be exacerbated due to MNEs attributing changes in pricing of inter-company transactions to the COVID-19 pandemic. The COVID-19 economic downturn may adversely impact general revenue collections and shortfalls in government resources to finance the subscription to databases or skilled professionals. Further, advanced dispute resolution and prevention mechanisms such as MAPs or APAs, requiring significant resources and active participation, may face practical difficulties, thereby increasing the MAP/APA inventory significantly.
Increasing reliance on automation and technology to audit MNEs.	This challenge may have been exacerbated during the COVID-19 economic downturn due to increasing reliance on technology in light of governmental regulations limiting the movement of people to contain the spread of COVID-19.

2.3. MNE-specific impacts and actions during the COVID-19 economic downturn

The COVID-19 pandemic adversely affected MNEs focused on brick-and-mortar business, retail and tourism, even though some of them, such as tourism have revived during the recovery phases. Specifically, sectors such as transport and storage, physical retail stores, hospitality, manufacturing and supply chain, aviation, entertainment and recreation were adversely affected.¹⁰ On the other hand, the COVID-19 pandemic provided new opportunities for pharmaceutical companies or firms with digitalized business models, at great and unexpected cost and efforts.¹¹ While supply chain disruptions are a common feature of most economic downturns, the COVID-19 economic downturn might be considered to have led to a more significant impact on single source supplier models and highly concentrated manufacturing models. Some

⁹ UN TP Manual, section 2.5.6.

¹⁰ Office for National Statistics (2022). Effects of the coronavirus (COVID-19) pandemic on 'high-contact' industries. Available from [Effects of the coronavirus \(COVID-19\) pandemic on "high-contact" industries - Office for National Statistics \(ons.gov.uk\)](https://www.ons.gov.uk/economy/governmentandbusiness/othergovernmentandbusiness/effectsofthecoronavirus(covid-19)pandemiconhighcontactindustries)

¹¹ Santos, A. & et.al (2021). The impact of COVID-19 and of the earlier crisis on firms' innovation and growth: a comparative analysis. European Commission JRC Working Papers on Territorial Modelling and Analysis No 03/2021.

MNEs were compelled to source materials using alternate means, thus disrupting their existing supply chains in select geographies, business segments, and product/service lines. In certain cases, MNEs modified existing intragroup and third-party relationships to optimize their existing supply chains and operating models with minimal disruptions or to seek new business opportunities. MNEs with wider and more diverse global footprints may have been more likely to face the downturn with relatively higher resilience as compared to their domestic localized counterparts, due to advantages in synergistic benefits and internal alternatives typically present in MNEs' business models.

3. TP analyses during the COVID-19 economic downturn

To assess the arm's length nature of intra-group transactions, a thorough analysis of the commercial or financial relations, including the accurate delineation of the transaction as well as the application of TP methods is of utmost importance.¹² During those years impacted by the COVID-19 economic downturns, the proper analysis of these elements may become more difficult but, at the same time, remains paramount to analyze the appropriate arm's length nature of transactions. Sudden changes of economic circumstances as well as other economically relevant characteristics in times of distress may alter the factors affecting the arm's length analysis which would necessitate changes in existent MNEs' TP policies.

The application of the ALP to intra-group commercial or financial relations should consider the nature of variability in the impact of the COVID-19 economic downturn as part of the following aspects:

- (i) Accurate delineation and recognition of actual transactions
- (ii) Selection and application of the most appropriate TP methods

3.1. Accurate delineation and recognition of actual transactions

3.1.1. Accurate delineation of actual transactions during economic downturns

The accurate delineation of actual transactions derives from the identification of commercial and financial relations, based on an analysis of the economically relevant characteristics or comparability factors (i.e., contractual terms, functional analysis, characteristics of property and services, economic circumstances, and business strategies) underlying the transactions. The actual conduct of the parties and the options realistically available to them are considered in the process of accurate delineation.¹³ The steps described in section 3.3.2 of the UN TP Manual are to be followed in

¹² Petruzzi R., et al. (2021). Fundamentals of Transfer Pricing: General Topics and Specific Transactions. Also UN TP Manual, section 3.1.1.

¹³ UN TP Manual, section 3.2.

identifying commercial and financial relations and the accurately delineation of actual transactions.

It is understood that the COVID-19 economic downturn might influence several intercompany arrangements, especially those that are relevant for multiple years, such as licensing arrangements, contract manufacturing arrangements, agency arrangements, etc. Thus, the impact of the COVID-19 economic downturn may alter the nature of the activities, the related risk allocation and the re-examination of contractual terms. The changes may alter the understanding of the accurately delineated transactions that existed before the onset of the COVID-19 pandemic, during the COVID-19 pandemic and after the COVID-19 pandemic. Furthermore, new transactions entered during the pandemic years should also be subject to accurate delineation.

3.1.1.1. Contractual terms

Contracts between two or more enterprises indicate the division of responsibilities, obligations and rights, assumption of identified risks and pricing arrangements.¹⁴ The COVID-19 economic downturn may result in the parties departing from contractually agreed terms or parties carrying out activities that are not defined in contracts, eliciting changes to responsibilities and allocation of risks. Such changes may not be captured in legal agreements, or not fully captured, unless the parties have agreed expressly to make amendments to account for the COVID-19 economic downturn impacts and consequences. Unrelated enterprises under similar circumstances may or may not renegotiate contractual terms to reflect the new market realities. In an intra-group scenario, it is imperative to analyze whether third parties, under similar economic circumstances, would agree to modify contractual relations, considering the options realistically available to each party. Tax administrations may have to carefully review the changes to the arrangements or the lack of changes, especially in situations where there is evidence of third parties' behaviors.¹⁵

Assessment of a contract that is applicable for the COVID-19 pandemic years may involve the verification of whether parties to the contract have actually followed the contractually agreed conditions. Contractual terms, whether updated or not, always form only the starting point of a TP analysis, then the actual conduct of the parties must be tested against those contractual terms. For both contracts pre-existing the COVID-19 pandemic as well as the new contracts, there could be unforeseen influences that may lead the actual conducts of the parties to deviate from the contracts. In such cases, to the extent that the conduct or other facts are inconsistent with the written contract, the parties' conduct (rather than the terms of the written contract) should be taken as the best evidence of the transaction(s) actually undertaken.¹⁶

¹⁴ UN TP Manual, section 3.4.3.3.

¹⁵ UN TP Manual, section 3.4.3.4.

¹⁶ UN TP Manual, section 3.3.2.1.

The COVID-19 economic downturn may have had parties engage in non-fulfilment of contractual obligations. This could be the case both between related as well as unrelated parties. As part of the TP analysis, it will need to be carefully considered whether non-fulfilment or frustration of contractual conditions may lead to an alteration of the TP analysis.

Example

Company A (resident in Country X) and Company B (resident in Country Y) are part of the ABC Group, engaged in the manufacturing and sale of toys. Company A buys products manufactured by Company B as well as by Company C (an unrelated-party manufacturer of toys in Country Y) and sells them in Country X. Company B and Company C perform the same activities and are comparable manufacturers.

Before the COVID-19 pandemic, Company A and Company B have entered into an intra-group agreement. The same agreement was concluded under similar circumstances also between Company A and Company C.

During the COVID-19 pandemic, Country Y implements a strict lockdown. Company B and Company C have to close their manufacturing facilities.

Company C realizes that it cannot fulfil all the conditions of the agreement with Company A, due to the closing of its manufacturing facilities. Therefore, Company A and Company C decide to re-negotiate some conditions of the original agreement.

Under the above circumstances, it might need to be verified whether Company B will also have to deviate from the conditions originally agreed with Company A.

Force majeure clauses

Force majeure clauses, if included in contracts, merit particular attention during the COVID-19 economic downturn. When used, parties may establish overarching force majeure clauses in their contracts. The party invoking the force majeure clause would require demonstrating that:

- the impediment is beyond the party's control
- the impediment could not reasonably have been foreseen when the contract was concluded; and
- the effects of the impediment could not have been avoided or overcome by the party.

Whether the impact encountered because of the COVID-19 economic downturn qualifies as force majeure for the parties will depend on the wording of the clause and the facts and circumstances. An economic downturn per se may not fall under the scope of the force majeure clause. Historical evidence from the 2008-09 financial crisis

suggests that major insurance companies did not consider the crisis should trigger the use of the force majeure clause.¹⁷

Related parties, while invoking force majeure clauses, should be mindful of the options realistically available to them. The decision should be made considering the separate entity approach and the commercial interest of each concerned entity. However, such available options may or may not entail maintaining the status quo. In times of COVID-19 economic downturn, maintaining status quo could be detrimental for the business if such inaction may result in adverse economic consequences. Independent enterprises are likely to only enter into or change the terms of a particular transaction if other available options are not more attractive. However, these options realistically available should be taken into account, considering the current economic circumstances surrounding the transaction, competitors' behavior, and, if applicable, the long-term nature of business relationships, all while keeping in mind the interests of the parties as separate entities. A force majeure clause is considered invoked and/or accepted in an uncontrolled transaction only if other available options or the inaction would put the party/s in an equally bad or a worse-off situation. It is entirely possible, however, that unrelated parties value their supplier-relation or commercial relationship such that they are willing to accept or grant leniencies not foreseen or governed in the agreements they have in place. Accurate delineation of the actual transaction would determine whether invoking and/or accepting the terms of the force majeure clause is in the interest of both parties. However, it is possible that the parties may not come to an agreement whether the COVID-19 economic downturn is covered by the force majeure clause. Options realistically available need to be analyzed thoroughly, considering, inter alia, economic circumstances, competitors' behavior and, if appropriate, the long-term nature of business relationships. Throughout the analysis it is important to keep in mind the interests of the parties as separate entities.

Under a third-party scenario, it is also possible that only one party involved in the transaction is inclined to invoke the force majeure clause. In an arm's length situation, when there is dispute, the resolution will typically require a thorough examination of the force majeure clause, aiming to address a matter that combines both factual and legal aspects.

Example

Company A (resident in Country X) and Company B (resident in Country Y) are part of the ABC Group, engaged in the manufacturing of automobiles. Company A buys microchips manufactured by Company B and uses them in its production process.

¹⁷ Oosterhoff, D. (2009). Transfer Pricing Practice in an Era of Recession. *International. Transfer Pricing Journal*, 5.

Before the COVID-19 pandemic, Company A and Company B have entered into an intra-group agreement, based on which Company B should supply Company A with 100 microchips per week. The intra-group agreement also includes a force majeure clause.

During the COVID-19 pandemic, global supply chain constraints mean that Company B can only supply 50 microchips per week to Company A.

Under the above circumstances, it should be assessed whether the global supply chain shortages qualify for invoking the force majeure clause as specified in the intra-group agreement, as well as whether unrelated parties would have invoked such a clause.

3.1.1.2. *Functional analysis*

Functions performed

Functions performed consist of the activities carried out by the entities in a transaction. During the COVID-19 economic downturn, some entities might undertake more functions (or less functions) than in normal economic circumstances, to remain profitable or reduce losses. Accurate delineation of the transaction and analysis of the economically relevant characteristics of the transaction would aid in determining the arm's length nature of changes in functions performed by the parties.

Example

Company A (resident in Country X) and Company B (resident in Country Y) are part of the ABC Group, manufacturer of household appliances.

Before the COVID-19 pandemic, they have entered into a distribution agreement, whereby Company B distributes in its local market the products manufactured by Company A. Company B performs limited marketing activities.

During the COVID-19 pandemic, reduction in households' purchasing power and a reduction in demand of appliances in Country Y have caused Company B to undertake additional marketing efforts and activities to sell the products locally.

Company A and Company B need to assess whether the performance of new marketing functions by Company B amends the understanding of the functions performed by Company A and Company B in the intra-group transaction.

Assets used

Tangible and intangible assets used or transferred in commercial or financial relations between related parties need to be carefully identified. Depending on the nature of the business, it should be assessed how the employment of these assets contribute to the performance of the transaction. During the COVID-19 economic downturn, certain tangible assets such as unused machinery may be disposed by the entities that own them,

to help with liquidity while, in the case of intangible assets, the useful life and intrinsic values may require a closer than usual review.

Example (continues from previous example)

Company A and Company B need to assess whether the performance of new marketing functions by Company B amends the understanding of the assets used by Company A and Company B in the intra-group transaction.

Risks assumed

Risks analysis is an essential part of the functional analysis. It is important to first identify the economically significant risks, and then determine which entity/ies within the MNE assumes them. In this context, it is relevant to analyze parties that make decisions to take on, lay off or decline a risk-bearing opportunity together with the actual performance of that decision-making function, parties that perform risk materialization functions, and parties with financial capacity to assume the risks.¹⁸

The impact of the COVID-19 economic downturn on risk allocation between related parties can be far reaching. It can, for example, result in modifications to credit and bad-debt risks. Slowing supply chains could alter the way inventory risks may actually materialize while contracts or performance of functions in past years may indicate otherwise. In certain industries, delayed shipments that lead to alterations in product characteristics could create quality control risks.

Example (continues from previous example)

Company A and Company B need to assess whether the performance of new marketing functions by Company B amends the understanding of the risks assumed by Company A and Company B in the intra-group transaction.

3.1.1.3. Characteristics of goods or services

Characteristics of goods and services may undergo important changes due to the impact of the COVID-19 economic downturns. For tangible property, the physical features, quality, reliability, and availability of goods constitute important characteristics thereof. For instance, in the case of the COVID-19 economic downturn, many apparel manufacturers including designer brands switched to supply masks and clinical suits. Similarly, fragrance and alcohol manufacturers started manufacturing sanitizers and disinfectants. Moreover, if the economic distress is regional or country-wide, the sales volume of non-essential products could also plummet. In the case of services, the nature and extent of such services constitute important characteristics. One well-known impact of the COVID-19 economic downturn was that many companies were forced to allow

¹⁸ UN TP Manual, section 3.4.4.21 to section 3.4.4.43.

workers to render services remotely due to local regulations to curb the spread of the pandemic.

In the case of intangibles, degree of protection, duration, and future anticipated benefits could be affected. For instance, with specific reference to the COVID-19 economic downturn, certain pharmaceutical companies have waived patent protection related to ingredients necessary for manufacturing vaccines for the greater public good.

3.1.1.4. Economic circumstances

An understanding of the economic circumstances on which transactions are entered into forms a critical element for determining the arm's length commercial and financial relationship.¹⁹ In this regard, due consideration should be given to shifts in the market places and customer preferences, reduction or expansion of market size due to the COVID-19 economic downturn; whether the business is business-to-business (B2B) or business to customer (B2C) and to what extent customer preferences may have changed; increasing competition and digital disruptors capitalizing on the market changes resulting from the COVID-19 economic downturn; the possibility of products or services being substituted by alternatives; special rules and regulations in countries that may prohibit business conduct or closure of factories; higher inflation rates reducing customer purchasing power and geo-political issues that may influence supply chain choices, among various similar economic factors. For instance, certain location specific advantages that may have existed before the pandemic such as lower labor costs, location rents, transport costs and availability of subsidies may be influenced or not be available as a result of the COVID-19 economic downturn or vice versa.

3.1.1.5. Business strategies

The business strategy of an MNE is dependent upon the structural characteristics of its industry, subject to specific firm's resources.²⁰ Strategies are often a response to industry practices and may vary as a result of the actual impact of the COVID-19 economic downturn on the relevant industry, and the extent to which the business model is resilient enough to handle extraneous challenges. Business strategies during the COVID-19 economic downturn may focus on seeking new business opportunities from the pandemic or sustaining existing strategies to preserve profits and limit losses. For instance, automobile manufacturing assembly lines were diverted to vaccine manufacturing during periods of public emergencies in specific countries.

Allocation of costs associated with the strategy should be considered and could be based on the entities devising the strategy, beneficiaries of the strategy, whether any specific types of strategies such as market penetration are followed, developing of new intangibles and cost-sharing arrangements to implement the strategy and the

¹⁹ UN TP Manual, section 3.4.5.

²⁰ UN TP Manual, section 3.4.6.

corresponding legal ownership of newly created intangibles and cost-sharing arrangements.

3.1.2. Recognition of the accurately delineated actual transaction

Recognition of the accurately delineated actual transactions requires that a transaction between two or more controlled entities must be established in relation to transactions actually undertaken. This includes an assessment of whether the intercompany arrangements are consistent with the conduct of the parties and other relevant facts, taking into account the options realistically available in entering into intercompany arrangements.

During the COVID-19 economic downturn, companies operating at arm's length may rationally adopt strategies that maximize their chances of survival in the short term, even where such strategies may not be optimal in the longer term. For example, MNEs may undertake business restructurings to relocate assembly lines to geographical locations where manufacturing is possible. MNE financing entities might also grant new financial resources to other group entities or temporarily suspend the payment of interest or waive partial debt to allow financed entities to survive to the downturn.

Tax administrations may or may not accept the taxpayer's characterization of intercompany arrangements and, in exceptional circumstances, may disregard transactions resulting in non-recognition or substitution of transactions, if such transactions are not commercially rational.²¹ Since the COVID-19 economic downturn may give rise to many unique circumstances, best efforts should be made by tax administrations to determine the actual nature of the transaction and not disregard or modify the transactions as structured for lack of identifiable comparable uncontrolled transactions.

3.2. Selection and application of the most appropriate TP methods

Selection and application of the most appropriate methods involves the use of prescribed TP Methods and performing comparability analyses.

In general, the TP methods as described in the UN TP Manual continue to be applicable during the COVID-19 economic downturn with due consideration for changing economic circumstances surrounding controlled and uncontrolled transactions. The modified conditions surrounding the controlled and uncontrolled transactions may influence the selection of the most appropriate TP methods and their subsequent application.

During the COVID-19 economic downturn, the selection of the most appropriate TP methods could benefit from a re-assessment of the respective strengths and weaknesses

²¹ UN TP Manual, Glossary.

of each method; the nature of the controlled transaction; the availability of reliable information needed to apply specific methods; and the degree of comparability between the controlled and uncontrolled transactions. In some cases, selecting traditional transaction methods that are price-sensitive to economic shocks could be more challenging as compared to transactional profit methods that typically eliminate the impact of operational differences. The result of the review could impact one or more of the following:²²

- Changes to the accurate delineation and recognition of the actual transaction may in certain circumstances render a TP method that was appropriate before the COVID-19 economic downturn, to be deemed inappropriate. However, the fact that the accurate delineation and recognition of an existing transaction may change during the COVID-19 economic downturn may not automatically necessitate changes to the selected TP method.
- Changes in the accurate delineation and recognition of the actual transaction may entail a change in the application of the most appropriate TP method. However, the fact that the accurate delineation and recognition of an existing transaction may change during the COVID-19 economic downturn may not automatically necessitate changes to the application of the TP method.
- Changes to the economically relevant characteristics may render an uncontrolled transaction, which was previously non-comparable, to be considered as comparable during the COVID-19 economic downturn. Conversely, changes to the economically relevant characteristics may render an uncontrolled transaction, which was previously comparable, to be deemed non-comparable during times of the COVID-19 economic downturn.
- Comparability adjustments that were applied to uncontrolled transactions to minimize or eliminate material differences with controlled transactions could be reviewed to verify whether (a) the TP method considered most appropriate before the COVID-19 economic downturn would be sustained during the COVID-19 economic downturn, and (b) the actual application of the steps in comparability adjustments would lead to differing outcomes, including non-arm's length results.

In evaluating the need for comparability adjustments due to the impact of COVID-19 economic downturn, the following factors should be considered:

- (1) Differences that are non-material could be ignored, as such differences do not qualify as the basis for disqualifying a TP method.

²² UN TP Manual, section 4.1.2.

(2) Differences that are material but that can be reliably accounted for could be alleviated by applying the relevant comparability adjustment(s) instead of resorting to disqualification a TP method.

(3) Material differences that cannot be reliably accounted for reduce the reliability of the TP method should lead to the question of whether a TP method would qualify as the most appropriate TP method for the relevant controlled transaction.

3.2.1. Common issues

3.2.1.1. *One-sided vs two-sided methods*

During times of the COVID-19 economic downturn, particular care should be taken to evaluate whether one-sided TP methods result in distortions to arm's length outcomes, due to the differing treatments of (say) extraordinary costs or income of associated enterprises engaged in the controlled transaction. For instance, one of the associated enterprises to a controlled transaction may receive government assistance while another may not. The use of one-sided TP methods to determine the arm's length prices may not consider the differing impact on associated enterprises located in different countries with differing economic conditions that may materially affect controlled transactions. On the other hand, two-sided TP methods may, in certain cases, capture the differing impact of the COVID-19 economic downturn on parties to the controlled transaction.

However, there is no automatic preference for two-sided TP methods over one-sided TP methods as the choice continues to be dependent on the facts and circumstances of each case. The general principles in adoption in the choice of the most appropriate TP method would be based on the steps involved in accurate delineation and recognition of the actual transaction, which indicates the differences in the composition of the transaction and the impact of the COVID-19 economic downturn on the controlled transaction and parties to the transaction.

3.2.1.2. *Reevaluating the validity of comparable data sets*

Comparable uncontrolled transaction(s) requiring a financial update may need to be reconsidered. This is because the nature of impact arising from the COVID-19 economic downturn on uncontrolled transaction(s) vis-a-vis the controlled transaction could reduce or eliminate comparability. In this regard, comparable uncontrolled transaction(s) may need to be reevaluated. A simplified assessment could be undertaken to assess the financial comparability of uncontrolled versus controlled transactions using financial ratios that measure operating margins, fixed and variable costs, capacity utilization, and other industry-specific standards.

3.2.1.3. *Updating existing comparable data sets*

Qualitative and quantitative information of comparables may not be available at the time of price-setting or the outcome-testing phases, based on the approach adopted by the

taxpayer. In certain taxpayer cases, the price setting approach, and budgeted arm's length prices (ex-ante) established prior to the COVID-19 economic downturn may not be compatible with the outcome testing results and/or corresponding year-end adjustments (ex-post). Interim financial results, quarterly results, and independent third-party financial forecasts on firm profitability could provide indicative results but may not be sufficient to assess the choice, reliability and application of the TP methods. Under such constraints, taxpayers and tax administrations may consider various information to substantiate the transfer pricing analysis, including but not limited to the use of multiple year data and reliable comparability adjustments. Once the financial information for the years impacted by the COVID-19 economic downturn is captured within databases, the available data could be utilized to the extent that such data is reliable.

3.2.1.4. Multiple-year data

Use of multiple-year data irons out the effect of business cycles. Increasing the number of years of comparable data by 2 or 3 additional years to the years before and after the years impacted by the COVID-19 economic downturn could increase the robustness of the economic analysis. However, this could lead to major mismatches if appropriate economic linkages to the COVID-19 economic downturn is not established. This may mean identifying the financial years (FY) impacted by the COVID-19 economic downturn and aligning these with the general accounting practices for each year. Accordingly, overall, with the appropriate analysis, the use of multiple year data should generally strengthen the outcome of comparability analyses in the context of the distortions caused by the COVID-19 economic downturn.

3.2.1.5. Comparability adjustments

Existing guidance on comparability adjustments could be classified broadly²³ as: (1) accounting adjustments that arise due to differences in accounting practices between comparables and the tested party; (2) balance sheet/working capital adjustments to account for inventories, receivables, payables, interest rates such as working capital adjustments; and (3) any other material differences between controlled and uncontrolled transactions. As discussed in Para 3.2, comparability adjustments are to be applied during the COVID-19 economic downturn, subject to facts and circumstances, based on the criteria provided.

Comparability adjustments may involve modifications to financial data to address differing economic conditions by adjusting for differences between controlled and uncontrolled transactions due to capacity utilization, government subsidies, volume effects, differences in cost structures, inventory and foreign exchange risks.²⁴ Other

²³ UN TP Manual, section 3.5.3.3.

²⁴ Mori, N. et al. (2009). Transfer Pricing in Troubled Times. Tax Management Transfer Pricing Report, Vol 18 No 1.

adjustments could account for differences in the ratio of fixed costs (or inventory costs) to total costs between the tested party and the comparables.²⁵

3.2.1.6. Additional considerations

There are existing constraints for many developing country tax authorities such as access to sources of data, including reliable local country comparables that often require taxpayers to elaborate on the source and rationale underlying the data used.²⁶ Countries that have adopted the arm's length interquartile range concept may accommodate challenges in identification of appropriate comparables for the COVID-19 economic downturn impacted years, by permitting the use of comparable results that are closer to the lower quartile (25th percentile) or the upper quartile (75th percentile) to determine whether the controlled transaction is in line with the arm's length principle. This approach will allow for due considerations of higher/lower profitability experienced by the relevant tested party.

In cases where there is a general lack information on comparable transactions, guidance provided in the Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses,²⁷ may be useful. In general, the use of comparables from wider geographical locations or regions with similar economic conditions and comparables from the broader industry sector in which the tested party operates could provide a reasonable basis to determine the arm's length nature of controlled transactions.²⁸ However, when considering the adoption of comparables from broader geographical locations, caution should be exercised to evaluate the effects of the COVID-19 economic downturn in those regions. Since the impact of the COVID-19 economic downturn differs across countries and regions, the use of comparables from different regions should be carefully deliberated.

3.2.1.7. Treatment of exceptional costs/revenue

During the COVID-19 economic downturn, companies may need to address an increase/decrease in costs, with corresponding effects on their profitability. Depending on the accurate delineation and recognition of the actual transaction and based on the observations of how independent enterprises under comparable circumstances would have behaved, it should be considered how such exceptional costs/revenue should be treated between related parties to the transaction, based on the relevant risks assumed by the parties.

²⁵ Sciacca, R. et al. (2001). Adjusting Transfer Pricing Analyses for Economic Downturns. Tax Management Transfer Pricing Report, Vol 10 No 16.

²⁶ UN TP Manual, section 3.1.7.

²⁷ Platform for Collaboration on Tax (2017). A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses. Available from World Bank Document (tax-platform.org)

²⁸ UN TP Manual, section 3.1.6.

Accounting principles, to the extent aligned with the TP rules, could be useful to determine whether costs/revenue are exceptional. Factors, such as the relative competitiveness of the industry in which the enterprises operate and the extent to which the third parties are price sensitive may be issues to consider.

Enterprises that can pass on the costs to third parties, with no corresponding decline in sales, might assume market risks, and the corresponding excess costs that arise due to the COVID-19 economic downturn. Further, in markets that are price sensitive and normally competitive, suppliers and market-facing entities may face a relatively uniform increase in cost pressures, resulting in excess costs being passed on to third parties.

3.2.1.8. Limited risk entities and loss-making situations

There is no definitive definition of limited risk/low-risk entities in the UN TP Manual since the degree of risks assumed by such entities may vary based on facts and circumstances of the taxpayer. However, the UN TP Manual identifies possible profit (or loss) shifting issues with the use of limited risk entities, wherein “for example, an entity may, during a period of economic upturn, be classified as a limited risk distributor and be rewarded with a fixed (but relatively low) profit margin, when it is in reality fulfilling the role of a fully-fledged marketer/distributor and should be sharing in the economic profits earned by the MNE as a whole.”²⁹ Therefore, addressing the question of whether limited risk entities may or may not incur losses during the specific period of COVID-19 economic downturn will require careful consideration. First, the accurate delineation and recognition of the actual controlled transaction, resulting in the identification of risks borne by a specific legal entity is to be applied contemporaneously. The extent of the loss that could be incurred by the limited risk entity at arm’s length is determined based on the conditions and the economically relevant characteristics of the accurately delineated transaction compared to those of comparable uncontrolled transactions. Incurring losses could be limited to the extent of the economically significant risks identified with specificity and consistency. For instance, if a limited risk entity has been assuming limited market risks or limited credit risks, prior to the impact of the COVID-19 economic downturn, the materialization of such risks may result in incurring of losses. However, limited risk entities that do not bear any market risks or credit risks prior to the COVID-19 economic downturn, may not incur losses. Therefore, due consideration should be given to whether a taxpayer is taking inconsistent positions regarding the assumption of risks before, during and after the pandemic and whether such positions are aligned with the accurate delineation of the transactions.

²⁹ UN TP Manual, section 13.2.2.11.

3.2.2. TP Methods

3.2.2.1. Traditional Transactional Methods

Comparable Uncontrolled Price Method

Since the Comparable Uncontrolled Price (CUP) method relies on contemporaneous price information of uncontrolled transactions, comparable data used in applying CUP method may have certain advantages over profit-based methods in times of high uncertainty. Between external and internal CUP methods, the use of internal-CUP method during the COVID-19 economic downturn reduces reliance on external price information (such as in the case of commodity exchange traded prices) subject to price sensitivities.

Further, the CUP method, being a two-sided method is less affected by operational issues exacerbated by the COVID-19 economic downturn, such as increases in direct and indirect costs, resulting in entity-wide loss-making circumstances for parties to the transaction. While increase in costs and corresponding losses could be extrinsic to the controlled transaction, the use of certain TP methods such as profit-based TP methods, particularly when applied using entity-wide profit level indicators, may not be useful to differentiate between losses arising from intra-firm controlled transactions and inter-firm third-party transactions. On the other hand, the CUP method provides a relatively accurate view on the pricing of controlled transactions, regardless of the parties' loss-making circumstances.

However, the CUP method relies on the application of a strict comparability analysis. Availability of contemporaneous uncontrolled transactions undertaken during the same period as that of the tested party, and the reliability of such information, may affect the choice of the CUP method. Transactional prices are generally more sensitive to distortions due the impact of the COVID-19 economic downturn, while transactional profits may have minimized the distortions to prices.

To the extent necessary and reliable, comparability adjustments in applying the CUP method could include, but not limited to, minimizing material differences in pricing terms (premium or discounts), volumes and product characteristics among other comparability factors.

Example

Company A (resident in Country X) and Company B (resident in Country Y) are part of the ABC Group, engaged in the refining and sale of copper metals. Company A imports crude metals from Company B and from Company C, an unrelated party. Company A has chosen and applied the CUP method as the most appropriate TP method and the uncontrolled transaction with Company C is considered as a precise comparable due to similarities in purchase volume, discounts received, credit period, similarities in interest rates, freight terms, and the characteristics of the goods.

However, during years of the COVID-19 economic downturn, the terms of the transactions differed as follows:

- Purchase volume from Company B is for 10,000 MT at a price of CUR 30,000 per MT while purchase from Company C reduces to 2,500 MT at a price of CUR 40,000 per MT.
- Quantity discount of CUR 500 per MT is continued to be offered by Company B while third-party supplier Company C cannot provide discounts during downturn.
- Credit period allowed by Company B is one month while Company C terminates credit periods and requires real-time payments due to severe credit crunch. Interest rates during the economic downturn are at 1.25% per month.
- Transaction with Company B are on FOB basis whereas Company C insists upon CIF terms wherein Freight & Insurance cost is CUR 1,000.
- The alloy mix (per MT) for purchase from Company A is 0.5 kg Gold and 1 kg Silver. The alloy mix (per MT) for purchase from Company C is 1 kg Gold and 1 kg Silver. Cost of the Gold is CUR 2,000 per kg

The table below summarizes the above differences.

Terms	Controlled transaction	Comparable uncontrolled transaction	Quantifying the impact of economic downturn	Comparability adjustment
Purchase Volume (MT)	10,000 MT	2,500 MT		
Purchase Price (per MT)	CUR 30,000	CUR 40,000		
Volume discount	Yes	No	CUR 500 per MT	Possible
Credit period	30 days	No	Interest 1.25% per month	Possible

Alloy mix (per MT)	0.5kg gold	1 kg gold	Cost of gold at CUR 2000 per kg	Possible
Deliver terms	FOB	CIF	F&I 1000 per kg	Possible

Determination of arm's length prices comparability adjustments owing to economic downturn:

Details	Uncontrolled Transaction - Price per MT
Price per MT - Arm's length price during normal years	40,000
Less: Adjustment for differences in quantity discount	(500)
Less: Alloy mix – Gold content (0.5 X 2000)	(1000)
Less: Freight and insurance	(1000)
Add: Interest for differences in credit terms	500
(New) Arm's length price during years of downturn	38,000

Based on the above example, the CUP method could still be considered the most appropriate method if reliable adjustments could be performed to address differences among comparability factors. If reliable comparability adjustments are not possible in applying the CUP method, taxpayers may consider the possibility of applying transactional profit methods as corroborative methods or a secondary analysis to demonstrate the arm's length nature of controlled transactions.

Resale Price Method

Regarding the use of the Resale Price Method (RPM) during the COVID-19 economic downturn, the RPM could be less sensitive to price distortions in the open market having an impact on gross margins. Application of RPM is most appropriate when the relevant (tested) party performs routine reselling activities. Since gross profit margins represent

gross compensation, after the cost of sales for specific functions performed, risks assumed, and assets used, product-specific differences are less significant, and consequently product-specific pricing impact from the COVID-19 economic downturn is relatively minimized, in comparison to the CUP method. Subject to reliable gross (margin) information of comparables being available, the RPM could be used to address operating losses that may arise due to economic circumstances, such as the COVID-19 economic downturn, that may not be connected to the controlled transaction.

However, since the RPM relies on a one-sided analysis, it may not be possible that the analysis considers the change in economic circumstances of the associated enterprise(s), if any. Further the RPM relies on functional similarities between the controlled and uncontrolled transaction, while comparables in the open market may often add significant value as part of the sales/distribution functions, challenging the reliable application of the RPM.

The applicability of the RPM may be constrained due to the lack of reliable information on gross margins on a transaction-by-transaction basis. A genuine lack of data might be a challenge to the applicability of the RPM. Moreover, just by relying on the gross margin of the comparables, it may be difficult to ascertain the other important functions undertaken by them to sustain the shocks due to the COVID-19 economic downturn. As product comparability is less important for the applicability of RPM, a slight change in the product can affect in times of COVID-19 economic downturn.

Example

Company A (resident in Country X) and Company B (resident in Country Y) are part of the ABC Group, engaged in the medical devices industry. Company A exports medical equipment to Company B. Company B is a reseller of the medical equipment, not responsible for any value addition to the products, and is engaged in sales to unrelated parties. Company B is not engaged in significant advertising and marketing activities. Before the COVID-19 economic downturn, Company B applies the RPM as the most appropriate method and determines arm's length intercompany prices based on gross margins of comparable resellers in the medical devices industry performing similar forwarding functions.

Due to an increase in demand for the medical equipment during the COVID-19 economic downturn, Company B is tasked with the role of performing additional functions such as advertising and marketing in the local market. However, additional functions performed by Company B do not involve creation of marketing intangibles or value-added products that bear special risks.

Company B continues to apply the RPM, however, considering the increase in functions performed, risks assumed, and assets used, it bases its transfer pricing analysis on arm's length gross margins of comparables engaged in similar intensity of advertising, marketing and selling functions.

Material comparability differences may arise due to accounting issues, particularly that of inclusion or exclusion of certain items of income and expenses as direct or indirect expenses, and their impact on gross profits may differ between controlled and uncontrolled transactions.³⁰ Further, accounting policies regarding such income/expenses during the COVID-19 economic downturn (e.g., government assistance) could impact the gross margin results. Where accounting practices differ from the controlled transaction to the uncontrolled transaction, appropriate adjustments could be made to comparable data to ascertain reliable gross margins.

Comparability mismatches may also arise due to the impact of the COVID-19 economic downturn on the ability of resellers to provide discounts, offering complementary products to the core product, and warranty services, if any. Application of the RPM may involve adjusting for such differences that may have a material impact on intercompany prices.

Example

Company A (resident in Country X) and Company B (resident in Country Y) are part of the ABC Group, engaged in manufacture and sale of wrist watches. Company A sells watches to Company B and to Company C, an unrelated party. Company B and Company C resell goods to third party customers within the same geography.

- Company A sales to Company B: CUR 60;
- Company B direct expenses for import from Company A: CUR 20;
- Company A sale price to Company C: CUR 79;
- Company B resale price to third party: CUR 100; Opening Inventory 10, Closing Inventory 20;
- Company C resale price to third party: CUR 100; Gross Profit Margin 21%

Company C provides complementary products (retail offers) and warranty services for six months (at a cost of CUR 200 per unit) during the COVID-19 economic downturn years, which impacts its sales volume. However, Company C rolls back certain offers and is unable to offer any additional discounts. On the other hand, Company B engaged in reselling imported goods and enjoys the ability to offer a quantity discount to boost customer purchases. The differing terms of the transactions are as follows:

Terms	Controlled transaction	Comparable uncontrolled transaction	Quantifying the impact	Comparability adjustment

30. UN TP Manual, section 4.3.2.2.

			of economic downturn	
Quantity discount	Cost equivalent to 1% gross profits margin	No	Value equivalent to 1% Gross profit margins	Yes
Complementary products	No	Roll-back of offer due to COVID-19 pandemic	No impact on sales price due to roll back	No effect
Warranty services	No	Roll back of 6 months warranty due to COVID-19 pandemic	No impact on sales price due to roll back	No effect

Determination of the arm's length price comparability adjustments, due to the COVID-19 pandemic downturn, are as follows:

Company B	Amount (CUR)
Resale price charged by Company B to third party	100
Less: Adjusted uncontrolled gross profit margin	(20)
<ul style="list-style-type: none"> • Company C gross profit margin before COVID-19 economic downturn = 21% (A) • Quantity discount to be adjusted = 1% (B) • Adjusted GP margin: (A) - (B) = (C) <p style="text-align: center;">21% - 1% = 20%</p> <ul style="list-style-type: none"> • Adjusted GP = 20% X CUR 100 = CUR 20 	

Company B cost of sales	80
Change in inventory (closing 20 – opening 10)	10
Less: Direct charges	(20)
(New) Arm’s length price	70

Similar to the application of a supplementary TP analysis using profit-based methods for an unreliable CUP method, the use of another method as a corroborative analysis could be used to support an imperfect RPM. However, unlike the Transactional Net Margin Method (TNMM) where net operating losses could be substantiated based on comparables that are net loss-making, substantiation of an RPM resulting in gross losses using comparables that are gross loss making, could be more challenging to substantiate.

Cost-Plus Method

Some consideration is needed regarding using the Cost-Plus Method during the COVID-19 economic downturn. For example, the COVID-19 economic downturn might severely impact a company’s cost structure due to a drop (loss) in sales/service revenue. This drop could increase the fixed costs per unit of sales/service revenue.³¹ Furthermore, if companies incur constant fixed costs (i.e., costs that a business has regardless of its volume of sales) the resulting cost structure could entail significant losses due to under recovery of sales and idle capacity (utilization).

Companies operating under unforeseen economic circumstances such as the COVID-19 economic downturn may not be able to react immediately to address such capacity issues. However, an increased awareness of the impact over time could result in modified capacity planning and recovery of fixed costs. It is important to consider the cause of the economic downturn in the light of the speed at which a recovery of costs may occur.

Similar to RPM the applicability of the Cost-Plus Method may also face the difficulty of the availability of reliable information. The available data on gross margins and its accuracy is one of the limitations even during normal economic times. The COVID-19 economic downturn may add a layer of complexity in this exercise. Moreover, just by relying on the gross margin of the comparables, it may be difficult to ascertain the other important functions undertaken by them to sustain the shocks due to the COVID-19

31 Hayri, A. & Clark, R. (2002). Firm Profitability in Recessions: Part I. Tax Management Transfer Pricing Report, Vol. 10 No 21.

economic downturn. As product comparability is less important for the applicability of Cost-Plus Method, a slight change in the product can affect in times of COVID-19 economic downturn.

Example

Company A (resident in Country X) and Company B (resident in Country Y) are part of the ABC Group. Company A provides contract manufacturing services, producing semi-finished automotive components, for Company B, a global manufacturer and distributor of automotive goods. Company A has historically adopted the Cost-Plus Method as the most appropriate TP method based on availability of reliable information on costs incurred by independent manufacturers operating under comparable circumstances with broadly similar functional, risk and asset profile.

During the COVID-19 economic downturn, Company A is faced with fixed cost overruns from idle employee costs, depreciation from fixed installations, and fixed rental costs. Company A includes the excessive fixed costs as part of the cost base when applying the Cost-Plus Method, passing on the extraordinary costs to Company B.

However, comparable companies that were considered to have broadly similar functional, risk and asset profiles as that of the tested party (Company A) before the COVID-19 economic downturn, are found to incur significant losses during the relevant years, as they are unable to pass on the excess costs to customers. Further investigation of the specific comparability factors, based on comparison of certain financial ratios identified from annual reports/ financial statements, indicates the following:

Comparability criteria using financial ratios	Company A	Comparable Manufacturers
Plant and machinery/ Total fixed assets	20%	25%
Raw material/ Total costs	10%	5%
Inventory/ Sales	10%	5%

Material differences in raw material/total costs, inventory/sales and fixed installation costs (depreciation) explain the rationale for losses incurred by comparables, although comparables are engaged in broadly similar manufacturing activities.

To address the issues identified above, Company A could: (a) aim to address the material differences by applying comparability adjustments if reliable; or (b) carry out a transfer pricing comparability analysis with the above financial ratios as screening criteria for identifying potential comparables that are closer to Company A in terms of functions, risks and assets.

Limitations in applying the Cost-Plus Method continue to apply during the COVID-19 economic downturn. Accounting treatment of costs reflected in applying the Cost-Plus Method are as critical as in the case of RPM. Accounting inconsistencies could be overcome by using published third-party quarterly data that may contain such information, if available.

3.2.2.2. Transactional Profit Methods

Transactional Net Margin Method

The general familiarity of taxpayers and tax administrations with the TNMM provides opportunities for coordinated jurisdictional approaches. This is subject to a consistent understanding of the facts and circumstances of the taxpayer, including the common understanding of the impact of the COVID-19 economic downturn on the taxpayer. Accounting inconsistencies with respect to the treatment of income/expenses in connection with COVID-19 economic downturn that materially impacts the RPM and the Cost-Plus Method may not impact the TNMM to the same extent. TNMM may also provide further flexibility in choosing appropriate profit level indicators (PLI) that best reflect the changes to the tested party/taxpayer's functional, risk and asset profile.

However, the reliability of arm's length prices based on the TNMM is subject to the availability of updated financial information in public databases. The data used for determining arm's length prices for FY 2020 (impacted by the COVID-19 economic downturn) may not be available until FY 2021 or later. The analysis may require updating before accurate conclusions on the outcome the TNMM can be made.

Notwithstanding its limitations, during the COVID-19 economic downturn, TNMM may provide flexibility to apply various comparability adjustments and permit the inclusion of net loss making comparables.

Example

Company A (resident in Country X) and Company B (resident in Country Y) are part of the ABC Group. Company A determines the TNMM as the most appropriate TP

method and applies working capital adjustments to address material differences in comparability factors involving balance sheet items such as inventory, receivables and payables of comparable companies that are otherwise functionally comparable.

During the financial years before the COVID-19 economic downturn, the results of TNMM analysis, including the application of the working capital adjustment, results in the following outcome:

Working Capital Adjustment	Tested Party	Comparables
Sales (A)	100	120
EBIT (B)	5	7
EBIT/Sales (C)	5.0%	5.8%
Accounts Receivable (D)	100	110
Add: Inventory (E)	20	40
Subtract: Accounts Payable (F)	50	20
Net Working Capital (G)	70	130
NWC/Sales (H)	70%	108%
Difference (I)		(-) 38%
Interest rate (J)		5%
Adjustment (K) = (I) X (J)		(-) 1.9%
Adjusted PLI (L)		3.9%

During the financial years impacted by the COVID-19 economic downturn, the following changes are identified by company A:

- Increase in Receivables for Company A; while reduced for comparables
- Decrease in Payables for Company A; while increased for comparables
- Decrease in Inventory for Company A; while increased for comparables

Overall, an increase in the net working capital position of the tested party, while a reduction for comparables.

Considering the above, Company A applies a working capital adjustment for the relevant period seeking to minimize material differences. The result, from application of the working capital adjustment, is as follows:

Working Capital Adjustment	Tested Party	Comparables
Sales (A)	90	110
EBIT (B)	4	4
EBIT/Sales(C)	4.5%	4%
Accounts Receivable (D)	120	90
Add: Inventory (E)	30	10
Subtract: Accounts Payable (F)	40	60
Net Working Capital (G)	110	40
NWC/Sales (H)	122%	36%
Difference (I)		(+) 86%
Interest rate (J)		10%
Adjustment (K) = (I) X (J)		(+) 8.6%
Adjusted PLI (L)		12.6%

Application of the working capital adjustment during the COVID-19 economic downturn, in the above case, indicates that the working capital position plays a significant role and is an essential comparability factor which may alter the arm's length results.

The extraordinary increase in the level of net working capital of Company A relative to the comparables implies underlying differences in functions, risks and assets. Therefore, a mandatory or routine application of working capital adjustments may not be appropriate in the above case. The impact of the COVID-19 economic downturn on working capital is highly significant on the comparables, vis-à-vis, the tested party, such that the net working capital should be considered as part of the analysis of functions, risks and assets. Particularly, during times of the COVID-19 economic downturn, the actual interest rates prevailing in the market (a key financial input used in the above comparability adjustment) is much lower. Due consideration should therefore be given to specific interest rates prevailing in the respective country/region where the analysis is applied.

Company A could perform a contemporaneous transfer pricing analysis that considers net working capital as a key determinant in economically significant risks, functions performed, and assets used, followed by a more accurate comparability analysis considering net working capital as a key comparability factor (used in the screening

process) to identify functionally similar comparables, as applicable for the years impacted by the COVID-19 economic downturn.

In applying the TNMM during the COVID-19 economic downturn, taxpayers and tax administrations could exercise caution to avoid simplistic financial updates to pre-existing comparable datasets, thereby failing to consider the specific impact of the COVID-19 economic downturn contemporaneously.

Transactional Profit Split Method

Transactional Profit Split Method (PSM) as a two-sided method considers the economic conditions and contributions of all parties to the transaction. The PSM is considered most appropriate where:

1. each related party to the transaction makes unique and valuable contributions;
2. highly integrated business operations; and/or
3. shared assumption of economically significant risks or a separate assumption of closely related risks by each related party to the transaction.³²

Application of the PSM is based on a profit allocation mechanism considering economic fluctuations to various metrics that often constitute a PSM model adopted by the taxpayer. Adopting the PSM in the conditions of the COVID-19 economic downturn, where it had not been selected as the most appropriate method previously, would require a careful consideration of whether the functions, risks and assets of the participating related parties have changed. PSM is less dependent on comparables vis-à-vis other methods, except and to a limited extent, in cases where a residual approach is adopted and in exceptional cases where comparable agreements may be found to apply contribution profit split analysis. The degree of comparability is less stringent as compared to the other methods.

In using a firm's internal information to determine the relative contributions of associated enterprises for a contribution analysis, due regard is necessary to ascertain the impact of the COVID-19 economic downturn on the quality of data, even while such information is more easily accessible. Determination of profit splitting factors and the relative value of the contributions before and after the COVID-19 economic downturn could indicate differences in functional profiles and consequently differences in splitting factors determined prior to the COVID-19 economic downturn.

Residual analysis may rely on external information that may not be readily available during the COVID-19 economic downturn, particularly regarding the arm's length compensations for routine functions performed by associated enterprises. Accordingly, factors to consider in the choice and application of the TP methods for routine

³² UN TP Manual, section 4.6.1.4.

transactions are not considered in this PSM analysis. Rather, this analysis focuses on the splitting of the residual profits.

Regarding splitting residual profits, if the allocation is based on capitalized cost of developing intangibles (minus amortization across the useful life of the intangibles), the impact of the COVID-19 economic downturn on the useful life of the asset and the amortization policy is necessary. If the allocation is based on actual intangible costs, the impact of increase or decrease in developmental costs, and their reliable measurement could be useful to determine the continued suitability of the residual approach or whether any adjustments to the allocation might be necessary.

Material differences may also arise in applying the PSM, due to currency differences and accounting inconsistencies. Such differences may warrant appropriate adjustments to the PSM model that is adopted and maintained by the taxpayer(s). The impact of such adjustments to the arm's length profit allocation outcomes to each of the parties to the transaction requires careful examination.

Example

Company A (resident in Country X) and Company B (resident in Country Y) are part of the ABC Group. Company A and Company B are jointly responsible for products and services to unrelated party. Activities of Company A and Company B involve product development, R&D, engineering, production and installations. Company B concludes contracts with third parties and books sales, while Company A provides products and services to Company B. The corresponding costs are borne by Company A and Company B respectively.

Based on the accurate delineation of the transaction, PSM is chosen as the most appropriate method for allocation of profits between Company A and Company B. The first step in the application of PSM, using a residual analysis, involves the determination of the relevant profits to be split. In this example, the relevant profit is deemed to be the expected profits of Company A and Company B in connection with the relevant projects. The second step would involve the determination of routine returns commensurate with routine functions. The third step would consist of determining the profit to be attributed to each party based on an arm's length expected split of profits. The residual profit (or loss) is split between the related parties based on appropriate splitting factors that represent, for instance, the efforts of Company A and Company B to develop, enhance, and maintain the value of the unique contribution of the parties to the transaction.

During the years impacted by the COVID-19 economic crises, the functions, risks and assets of Company A and Company B do not vary, while the actual application of the PSM is impacted due to the following factors:

- The PSM model is operated based on expected costs to be incurred, while the actual costs incurred increase for both Company A and Company B. During the COVID-19 economic downturn, Company A and Company B could choose to adopt a model

that applies actual costs as opposed to budgeted costs, to reflect the actual risks assumed between the enterprises.

- Comparability factors applicable to determine the routine returns of Company A and Company B are consistent with the guidance provided for the relevant TP methods provided in this guidance.
- Company A and Company B may evaluate the use of alternate allocation keys that better reflect the actual risks that materialize.

Furthermore, in the case of losses that may arise due to project failures, the following questions could be evaluated by Company A and Company B:

- Whether the intercompany agreement and relevant pricing terms (including pre-agreed formula) permit the loss-split, commensurate to the risks assumed.
- To what extent is the portion of routine returns recoverable for both Company A and Company B. Whether comparability adjustments to routine returns could be necessary.
- Whether the intercompany agreements should be updated to reflect the changing economic realities.

In summary, the adoption of PSM as the most appropriate TP method, and the approach to using a residual approach may remain unchanged, while impact on specific steps in its application requires a detailed review.

4. Dispute avoidance and resolution

The goal of dispute avoidance and resolution procedures is to facilitate fairness, certainty and equitable processes (including audits) for the determination of taxes.³³ This should continue to apply also during the COVID-19 economic downturn. The following considerations could be made in this context.

4.1. Avoiding TP disputes during economic downturns

4.1.1. Documentation

Depending on local regulations, taxpayers could be required to carry out appropriate analyses to assess the impact of the COVID-19 economic downturn on intra-group supply chains and transactional relationships that are prone to changes. The changes in transactional models could enable fundamental assessments on whether certain legal entities in the MNE group continue to qualify as related parties under respective domestic laws, based on which the reporting requirements could be modified.

33 UN TP Manual, section 15.1.2. See also United Nations (2021). Handbook on Dispute Avoidance and Resolution. Available from United Nations Handbook on Dispute Avoidance and Resolution | UN DESA Publications

Transactional linkages could be the starting point to determine whether a specific transaction requires to be reported for local compliance purposes.

Notwithstanding the data constraints, MNE groups should make all available efforts to ascertain the changes occurring on a continuous basis, to gauge the sequence of changes to facts and circumstances in which operations are conducted. To the extent possible, evidence from the market is to be gathered at each stage of applying the arm's length principle, starting with changes in the comparability factors. Efforts could be made to identify internal and external comparables that could best demonstrate the compliance with the arm's length principle. Guidance provided in Sections 2 and 3 could be useful in this regard. The impact of the COVID-19 economic downturn on the relevant industry of the taxpayer, corresponding functional and economic analyses should capture the effects of government interventions, including the specific impact on intra-group profitability, if any.

Further, taxpayers may choose to apply price adjustment mechanisms, if domestic laws permit. Where it could be further demonstrated that third parties may have entered into similar price adjustments under comparable circumstances, the TP documentation is expected to capture the ex-ante and ex-post price differences, when the relevant information is available subsequent to the closure of a particular financial year. The price adjustment mechanism as such would require a detailed description to demonstrate compliance with the ALP.

Tax administrations are suggested to view the documentation in the context of complexities in obtaining contemporaneous information, in performing risk assessments and evaluating taxpayer positions for tax audits (see section 4.2 for dispute resolution).

4.1.2. Advance Pricing Agreements (APA)

The COVID-19 economic downturn may alter the critical assumptions governed by a static understanding of contracts, functional profile, business strategies, economic circumstances, characteristics of products and services, at the time of signing APAs between taxpayers and tax administrations. The impact of the COVID-19 economic downturn on MNE business models may alter the essential conditions and critical assumptions that underpin APAs.

Regarding existing APAs that cover pandemic years as part of the scope, the primary question is whether changes in essential conditions and critical assumptions of the APA constitutes a breach of APA terms. From a taxpayers' perspective, there could be unintended changes arising from extraneous reasons that ultimately modify the critical assumptions, while in certain cases there could be a directional change altering the operating model. Therefore, tax administrations and taxpayers could demarcate circumstances that involve mere changes in business results that do not require revisions, cancellations, or revocation of APAs. While revisions in APA terms and renegotiation could be considered as a cooperative step, the process could be time consuming, requiring thorough analysis of the modified facts and circumstances, effectively

providing the same result as that of a cancellation followed by a renewed fact-finding exercise. Lack of resources, piling inventory and costs may act as roadblocks. Changes to the facts and circumstances of the taxpayer, may not automatically result in cancellations or revocation of the APA. Experiences from developed countries (such as the United States, the United Kingdom and Australia) indicate that there could be a cooperative approach wherein the tax administration could seek collaborative feedback from specific taxpayers and offering discussions to understand whether there are material changes to the facts and circumstances, particularly since a similar approach was adopted during the 2008-09 financial crisis.³⁴

Although many jurisdictions did not officially modify their APA programs in response to the COVID-19 pandemic, some countries issued guidance to provide additional clarity. Following are some countries which communicated specific guidance with respect to APAs:

Jurisdiction	Guidance
Austria	For requests currently in process, it is recommended to analyze whether the facts and circumstances described in the request need to be updated. If yes, this should be proactively discussed with the tax authorities.
Canada	For APAs already negotiated, the tax authorities may revisit the APAs on a case-by-case basis to see if the critical assumptions are breached. On APAs currently under negotiation, the tax authorities will consider the impact of the COVID-19 pandemic on the applicant on a case-by-case basis.
Netherlands	Tax authorities to consider a case-by-case analysis.
New Zealand	Taxpayers to notify Inland Revenue at the time they expect to breach the terms of an

34 Gibert, B. (2020). The Impact of the COVID-19 Pandemic on Advance Pricing Agreements. *International Transfer Pricing Journal*, Vol. 27, No. 5.

	<p>APA. This would apply to COVID-19 related breaches. Immaterial breaches of APAs can be disclosed in the APA annual compliance report.</p>
<p>Singapore</p>	<p>Taxpayers with APA applications under review are advised to promptly inform the Inland Revenue Authority of Singapore (IRAS) if they identify TP implications resulting from COVID-19, such as changes in functional profiles. For ongoing bilateral/multilateral APAs, the IRAS to engage with other Competent Authorities to reach a mutually agreeable resolution. In the case of existing APAs, if taxpayers believe there may be a breach in terms and conditions due to COVID-19, they should notify the IRAS, provide an impact analysis, explain the breach, and suggest the next steps. The IRAS to collaborate with other Competent Authorities for ongoing bilateral/multilateral APAs. Taxpayers seeking new or renewed APAs should only proceed if there is a high level of certainty regarding factors affecting the determination of arm's length transfer prices, and they are encouraged to engage with the IRAS early for discussions in cases of uncertainty.</p>

The disproportionate impact of the COVID-19 economic downturn on developed and developing countries (discussed in Section 2) is an additional factor in addressing APAs. The COVID-19 economic downturn could significantly alter the conditions of one of the legal entities (and corresponding jurisdiction) that is party to the APA while having minimal effects on the counterparty entities (and corresponding jurisdiction). In the case of APAs under negotiation or APAs that include roll-back provisions (i.e., covering past years involving the pandemic years), the changes to conditions could be considered part of the discussion processes. However, the disproportionate impact of the COVID-19 economic downturn could elicit differing expectations, bargaining powers, and could be impacted by the level of government subsidies that affect the transactions within the scope of the APA. Further, the allocation of resources, timing of completion and lower revenue collections could have a bearing on the outcome of the APAs. As for APAs closer to expiry, the COVID-19 economic downturn could create challenges for the

renewal processes. Depending on the domestic law and administrative practice of certain jurisdictions, taxpayers may not have an opportunity to withdraw an application and to recover the cost of application.

In all the above circumstances, tax administrations, competent authorities and taxpayers may consider a cooperative approach to consistently apply the arm's length principle with objectivity and prudence. Due consideration could be given to unique taxpayer situations on a case-by-case basis, with a particular focus on hardships, if any for small and medium enterprises (SME).

4.2. Preventing and resolving TP disputes during economic downturns

Data on the inventory of mutual agreement procedure (MAP) cases published by the OECD indicates that cases were actively negotiated and concluded during 2020 and 2021, despite the impact of the COVID-19 economic downturn constraining in-person meetings between competent authorities.³⁵ Procedural bottlenecks aside, pandemic years that would be subjected to tax audits could hold particular bearing on whether MAP inventory for the years such as 2022 and 2023 may increase due to uncertain tax positions and disputed conclusions.

The approach to tax audits typically includes a high-level risk assessment of taxpayer facts and circumstances and evaluating TP positions including relevant documentation. The impact of the COVID-19 economic downturn could be considered in the initial stages of the tax audit to determine whether certain red-flags such as loss-making circumstances are triggered solely due to the pandemic based on the taxpayers' history. An appropriate due diligence at this stage to discard cases that score poorly under the risk-assessment process could help in diverting resources towards taxpayer cases that may warrant robust assessments. From taxpayers' perspective the due diligence is based on the demonstrable ability to comply with the arm's length principle to account for the effects of the COVID-19 economic downturn, including documentation and burden of proof requirements. In situations where the adoption of an outcome testing approach is required, if permissible under relevant laws, if it is revealed that the taxpayer would indeed be in compliance with the arm's length standards but for the lack of such rules, then due regard could be provided to the efforts of the taxpayer.

In cases where taxpayer income warrants adjustments, taxpayers could consider MAP as an opportunity to resolve the disputes. Tax administrations may provide access to the MAP or similar procedures leading to amicable and negotiated settlements that caters to

35 OECD (nd). Mutual Agreement Procedure Statistics per jurisdiction for 2020. Available from <https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics-2020-per-jurisdiction-all.htm>.

OECD (nd). Mutual Agreement Procedure Statistics of transfer pricing cases per jurisdiction for 2021. Available from <https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics-2021-per-jurisdiction-transfer-pricing.htm>.

the unique circumstances and challenges faced by each jurisdiction (and corresponding legal entity/entities) subject to the MAP process to avoid or alleviate double taxation.

In suitable cases, developing countries may consider joint audits as an alternative approach to resolve highly uncertain tax positions, such as the ones that may arise due to the COVID-19 economic downturn. Since the process may directly involve two or more tax administrations to work on shared information, the process could alleviate some of the standard difficulties identified concerning resources and costs. Developing countries could explore the possibility of pooling resources, particularly if it involves developed country or mature country counterparties. In this regard expertise and skills could also be shared. Joint audits may also reduce the overload of MAP inventory.

5. Potential standardization and simplification

Standardization and simplification practices could benefit taxpayers and provide greater tax certainty in uncertain times of economic downturns. Simplification measures under the ALP may involve special safe-harbors, extraordinary fixed margin ranges or comparability adjustments that could be applicable for specific years of economic downturn. Tax administrations may determine and define the covered years for which the specific rules may apply. For instance, a tax administration could determine 2020 (Year 1), 2021 (Year 2) and 2022 (Year 3) as years impacted by an economic downturn and may permit measures to support taxpayers. Safe-harbor measures typically reduce tax compliance costs for taxpayers and contribute to an efficient tax administration. Data collected from mechanisms such as APAs, could aid in determining evidence-based safe-harbor rules and the years to which such safe harbor should apply. Tax administrations may also engage with industry bodies to arrive at cooperative outcomes on fixed margins or comparability adjustments that are agreeable between specific industry sectors and governments, depending on the industries subjected to better performance vis-à-vis industries that performed poorly. Countries with existing safe-harbor regimes could make specific adjustments to the range of margins to account for the COVID-19 economic downturn.

Besides the standardization of statistical results and profitability margins, tax administrations may also exempt certain taxpayers from compliance burdens based on numerical thresholds for aggregate transaction values, applicable solely for the COVID-19 economic downturn years to protect SMEs as well as industries critical to public welfare. Domestic laws may permit the use of outcome testing approaches and year-end adjustments if the rules may not explicitly permit them under normal circumstances. The set of measures suggested are non-exhaustive and should be treated in the specific context of years affected by the COVID-19 economic downturn.

6. Conclusions

A crisis such as the COVID-19 economic downturn, which had economic ramifications across various sectors, requires MNEs to assess changes to their global supply chain. As a significant share of global transactions is realized between related parties of MNEs,

the focus on TP is naturally augmented in times of economic and financial distress. Even though the applicability of TP rules seems challenging in such times, the fundamental tenets of the ALP would equally be applicable even in times of the COVID-19 economic downturn. All the four steps of the TP analysis need to be carefully evaluated and, if required, reassessed in such extraordinary times due to various factors affecting intercompany transactions.

From the above guidance, it is clear that accurate delineation of the transaction holds the key to identifying the functions and critical risks shared by the entities, which is the bedrock of any TP analysis. Changes in functional and risk profiles may take place between the entities. However, these changes would vary according to industry and region and the response of the management to handle a particular crisis. Based on the analysis above, the ALP should be applied more contextually in times of the COVID-19 economic downturn, considering its specific features and its resultant impact on the economically relevant characteristics of a transaction.

The challenges faced by the developing economies are peculiar in nature. Also, there can be no one size fits all solution applicable to all events of economic and financial distress. The nature of business and decision-making activity would have a great influence on risks arising from a downturn. Considering the economic circumstances that were affected by the COVID-19 economic downturn and other comparability factors that were influenced by the COVID-19 economic downturn should aid taxpayers and tax administrations to assess the conduct of controlled enterprises and determine whether the ALP has been effectively complied with.

Emphasis should also be laid on documentation reflecting the TP rationale of the MNEs during the times of the COVID-19 economic downturn. It is advisable to properly document the commercial reasons for the challenges produced by the crisis by using contemporaneous data. The description of the methodology and data used to conduct the economic analyses should also receive considerable attention, especially when statistical tools have been utilized. From the perspective of providing certainty, dispute prevention mechanisms should be encouraged. Moreover, in MAP cases, the tax authorities should strive to resolve the dispute considering the extraordinary circumstances and the surrounding conditions.

Given that the effects of the COVID-19 economic downturn on various countries, economies, and companies, it will be of outmost importance for tax administrations and taxpayers to constantly monitor and discuss their TP policies, provide clarifying guidance, and build strong and cooperative relations, to survive the effects of this crisis.