

# COVID-19

## The effects of COVID-19 pandemic on transfer pricing policies Preliminary notes

The limits imposed to mobility and the ordinary performance of the business activity, introduced by the urgent provisions issued by the Governments of the main industrialized countries in order to combat COVID-19 pandemic, have already caused disruptive effects on the global economy. The latest estimations published by the International Monetary Fund show a perspective reduction of global GDP for 2020 of about 3% with a varied trend (Italy's estimated GDP is -9.1%); however basically very negative, for the world's major economies.

Given this general picture, it is necessary to provide some preliminary comments regarding the transfer pricing policies implemented by multinational Groups. It is undeniable that we currently are in the transition from a stage of ordinary management of transfer pricing dynamics and of the conditions determining intercompany transactions to a stage of management of an emergency, in which a thorough analysis of the current situation is required in order to take the most adequate measures.

First of all, we should point out that the solutions developed, by the OECD as well, in order to cope with 2008 economic crisis cannot be simply applied to the current case: the preconditions and the extent of the problem as well as its spread are very different. Taking actions simply consisting of revised benchmark analyses or adjustments to certain economic data, relevant for the purposes of the analysis, would not be adequate to face the issue.

The direct effect of the limits introduced to free market conditions is the reduction of sales volumes and, although on account of the effects of the policies to reduce the costs, of global profits, thus even leading to net losses on the value chain. However, the issue for a multinational Group is determining the procedures to allocate the reduction of profits (or the losses) among the companies of the Group, involved in one single value chain.

In this complex and quite new framework, it is necessary to adjust the current conditions by adopting, if necessary, long-established procedures and in any case to carry out a structured analysis. The contents and results of such an analysis depend on the Group structure and the

transfer pricing method adopted, taking into due account the need to adequately demonstrate the actions taken, in order to reduce the risks related to future tax assessments by the Tax authorities of the countries involved.

## **IDENTIFYING THE CHANGES TO THE FUNCTIONAL ORGANIZATION**

First of all, it is necessary to analyze the organizational structure of the Group and the distribution of the functions and risks in the hands of each single company along the value chain.

If we assume that the analysis of the ordinary functional status (described in the transfer pricing policies and properly demonstrated in the documentation) is correct, it could be necessary to state a different distribution of functions, as a result of the new situation due to the limits to the business introduced in certain countries.

In fact, the contingent needs, caused by the impossibility to operate in a certain territory, may have led the Group to identify a subsidiary (or an independent entity, as well) as the entity in charge of a given function. By way of example only, this can happen when a company which usually is in charge of the supply for the entire Group is not able to operate by virtue of the lockdown imposed by the authorities of the country of residence and this function is given to a company resident in a country where no lockdown is in force.

However, it is necessary to point out that, beyond the cases in which an actual and significant change to the normal functional organization of the Group is effective, it is not possible to introduce amendments. The changes to the market conditions and the reductions of sales volumes do not allow per se a distribution of the business risks other than that of the reference model.

We cannot however draw any conclusion on this matter without taking into consideration a thorough analysis of the conditions in which a Group actually operates.

## **CRITICAL AREAS RELATED TO THE ADOPTION OF CERTAIN METHODS**

Transfer pricing methods and, in particular, the Transactional Net Margin Method, represent basically an adequate criteria to simulate market, without however fully replicating its conditions.

On this regard, please consider the normal organization where strategic decisions, significant business risks and the risks related to intangibles' development (as varied as they are) are centralized in the hands of a company of the Group: it is quite clear that such company is responsible for a significant portion of the aggregate profit (or loss), generated through the value chain. The other companies of the Group, in charge of simple, routine functions or anyway characterized by the assumption of moderate or low risks, will be remunerated by way of target margins, determined by a benchmark analysis regarding independent operators conducting similar businesses.

In situations with a highly turbulent economy, i.e. a systemic crisis like that we are experiencing, the above described method does not enable to fully replicate, at least at this time, the normal market conditions. In view of a margin guaranteed in the hands of the entities which perform simple functions, the entity in charge of complex key functions will fully undergo the negative effects of the crisis.

This however does not allow to reverse the effects to the entities in charge of the simple functions, of which remuneration is established as a result of the benchmark analysis.

This is the case of a limited risk distributor which, as such, is entitled to receive a remuneration in line with that of independent entities bearing limited risks regarding the distribution only. As such, it will bear the effects arising from the lockdown solely in respect of its own sale functions and with specific reference to the (limited) risks of the market (final consumers, wholesale or retail trade) in which it operates.

Likewise, the contract manufacturer will suffer the effects arising from the (even significant) reduction of the production volumes but it will not suffer the negative effects arising from the Group's impossibility to enter end markets. Neither, on the contrary, could the Group be regarded as responsible for the losses arising because of the impossibility to partly or fully continue the production. If it takes actions similar to those usually taken by independent entities, it will have to adopt measures on its own with regard to minimization of variable costs and reduction of fixed costs, as far as it is possible.

It is however clear that, in the cases described above, the main problem is to set out the reference margins for entities performing simple functions, bearing specific risks, however limited.

## **BENCHMARK ANALYSES IN PERIODS OF CRISIS**

The determination of margins for simple functions is usually made, as it is well-known, by way of a benchmark analysis, through the use of databases publicly available.

By disregarding any consideration regarding the specific procedures to carry out the analysis, it is evident that the publicly available information included in the databases (usually based on approved financial statements) refer to tax periods prior to the crisis and do not reflect the effects thereof. The use of ordinary selection criteria based on the available information therefore leads to set out arm's length margins not in line with the trend of the economic conditions of the reference period.

This however is a consequence of the *ex post* check made by way of the comparability analysis, which is not easily removable, provided that corrective measures are adopted.

On this regard, it might be adequate to carry out a comparability analysis including the tax period verified, even if the information related thereto will be available after the date of approval of the financial statements. The arising of differences, if any, in respect of the estimated values shown in

the financial statements, should be included in the tax return (which is filed after the date on which such information is available).

Moreover, including along with the procedure explained above, it could be explored the possibility to utilize other values of the interquartile range arising from the benchmark analysis, by overriding the approach focused on the median. Thus adopting a criterion (which is however accepted by the OECD and, in principle, by the Italian Revenue Agency) which enables to utilize any value included in the interquartile range.

However, due to the extraordinary situation and its deep effects on the business, the use of correctives based on the information on the trend of the reference economic sectors, approved and published by Italian and foreign institutions, could be considered. It is clear that such information cannot be indiscriminately utilized, but it will have to be thoroughly assessed in order to verify the applicability to the case at issue and, in particular, the compliance of the functional profile with the model taken as a reference to process the information.

The possible solutions explained above are of course not exhaustive and, however, cannot disregard, at the time of their application, a thorough analysis of the specific case. In view of the different policies adopted to limit the pandemic by each single country and in each single economic sector, it is indeed not possible to adopt standardized policies for “normal” and uniform economic crises (as it was the case in 2008 with the crisis caused by Lehman Brothers’ bankruptcy).

## **REVIEWING THE INTERCOMPANY CONTRACTS AND TP DOCUMENTATION**

The above described potential impacts of the economic crisis resulting from the measures to fight the pandemic will immediately and significantly affect the contractual relationships between the companies of the Group and above all on the documentation prepared for transfer pricing purposes.

If changes were made to the functional organization of the companies belonging to the Group, by attributing or deleting functions (although on a temporary basis), it will be necessary to critically review and adjust the contracts in force to the new organization. Likewise, an adjustment will be required if the economic conditions governing the transactions will significantly change.

All the more a review will be required in respect of the transfer pricing documentation, by not only explaining the changes, if any, made to the functional organization of the companies of the Group and defining the target margins, but also by properly explaining the reasons therefor.

The reasons cannot only consist of the reference to the Italian and global economic crisis, but they will necessarily refer to the specific situation of the Group, the procedures by which it usually operates, the direct and indirect economic consequences arising from the provisions to fight COVID-19 and the crisis resulting from the lockdown. This is all the more necessary in the cases where a derogation from the ordinary transfer pricing criteria or a major change to the method adopted, in respect of the previous years, are required.

## **IMPACTS ON THE APAs AND PATENT BOX AGREEMENTS**

A sudden and significant change to the reference scenario, with the resulting determination regarding the transfer pricing policies adopted, might require a review of the pricing agreements entered into with the Tax authority.

In this case as well it is necessary to carefully evaluate the contents of the agreement, the method adopted on which the policy agreed upon is based and the procedures, agreed as well, to execute the benchmark analysis. Solely the change to one of the critical assumptions on which the agreement is based, justifies the review of the agreement.

Similar considerations can be made for patent box agreements, in particular in the case where the residual profit split method is adopted for determining the income attributable to the intangibles, should the margin attributable to the simple functions result from a comparability analysis.

With regard to the above described issues, it would anyway be desirable that the OECD takes actions which, if necessary by way of derogation from certain provisions included in the Transfer Pricing Guidelines, enable multinational companies and the Tax authorities to adopt a shared and uniform approach, in order to avoid contrasting interpretation and, ultimately, disputes regarding tax assessments.

**For additional information, please contact:**

**Pirola Pennuto Zei & Associati**

◆ **Guido Doneddu:** [guido.doneddu@studiopirola.com](mailto:guido.doneddu@studiopirola.com)