Review of Inter-Company Pricing Policy vis-a-vis COVID-19

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Amidst COVID-19, the world's economy is shattered and there is no visibility by when the things would be back on track. As per the Organization for Economic Cooperation and Development ("OECD"), the COVID-19 virus outbreak presents the greatest danger to the world economy since the 2008 global financial crisis.

Undoubtedly, the businesses are experiencing unprecedented global disruption and are concerned with future economic impact. There is complete shutdown of the commercial operations, shortages in labour availability due to restricted people movement, supply chain interruptions has escalated the costs of the materials, inventory stockpiles due to lack of demand, financial exposure has increased and for some industries, business continuity plan and going concern would become a question.

Multinational Enterprises (MNEs) undertake transactions with associated enterprises and the transactions are executed as per transfer pricing policy of the group. The transactions could be of sale of tangible goods, provision of services, loans and advances, royalties, guarantees, transfers of intangible property etc. The policy is subjected to the arm's length test in various jurisdictions in form of transfer pricing audit. With these disruptions due to pandemic, in all likelihood, the MNEs would be forced to change their inter-company transfer pricing policies. The question arises whether the tax authorities would be considerate towards these changes. Would there be any relaxations while scrutinizing the period of disruption as the companies would see erosions of profit margins. Perhaps, these questions cannot be answered now but what can be done is to build up a strong case by taking COVID-19 impact on operating profits.

The fundamentals of transfer pricing suggest a robust and contemporaneous documentation. Considering the following may help you in mitigating the transfer pricing challenges

Far analysis and contemporaneous documentation

- ✓ Keeping a continuous track on the changed business operations and detailed documentation of the functions performed, assets employed and risks assumed by MNEs in current year in comparison to years before pandemic.
- ✓ Documenting the disruptions caused by the pandemic relating to capacity utilisation, market demand, supplier negotiations, ease in availability of raw material, labour and other utilities, time required in completing a business cycle, financing requirements etc.
- ✓ Continuous analysis of the respective industry so as to know after-effects of the outbreak on industry's behaviour.

- ✓ Special consideration should be given to the extra efforts taken by MNEs to combat pandemic. This could be in the nature of extra cost incurred on branding, advertising cost, extra cost incurred to hire unskilled personnel.
- ✓ Actions and measures taken by the Government in this regard like reduction in interest rates, relaxation in realising export receivables etc. should be considered
- ✓ Any revisions made in intra group policies on account of intra cost allocation, guarantee fee etc.

These qualitative factors would have an impact on profitability of MNEs. Proper analysis and documentation may help MNEs in reaching arm's length price of cross border transactions with AEs in a lucid manner which can be placed before income-tax authorities during assessment proceedings.

Review of policy on intra-group services

MNEs generally have intra-group arrangement for provision of services, guarantees, allocation of various costs etc. These type of arrangements are now widely accepted by various countries including India. Agreement governing these transactions should be reviewed in light of the financial weakness caused by pandemic. The transactions may also invite special attention of tax department in this situation when payments made by MNEs towards intra group services fails 'benefit test'. The tax department may question allowability of such expenditure in entirety as it would be quite difficult for foreign companies to function normally amid this global disruption.

In such a situation, MNEs are advised to revisit their intra group policies and develop an appropriate explanation to provide for the impact of COVID-19.

Advance Pricing Agreements and Safe Harbour Rules

The Advance Pricing Agreements and Safe Harbour Rules are widely considered alternative by MNEs to minimize litigation. Under both these mechanism, there is a consensus amongst taxpayer and tax authorities on arm's length price. However, with COVID-19, these mechanism may turn into a matter of concern for MNEs as they may not be in a position to comply with the requirements contained in the arrangement and there is a possibility of breach.

Under the circumstances, those who have opted for Safe harbour, may look for withdrawal of application as per the provisions of the Act. And cases where APA has been signed, the taxpayers are advised to look into the critical assumptions and may build upon a case to be filed along with annual compliance report.

COVID -19 adjustment

The disruption caused by outbreak will result into various adjustments so as to reach out arm's length price.

Differences that materially affect the comparison will need to be adjusted to the extent that these adjustments are reasonable, reliable, and improve comparability. Under the current circumstances, adjustments to account for differences in idle capacity or extraordinary expenses (*e.g.*, increased advertising expenses, severance pay, inventory write-offs, or restructuring expenses) that may not be reflected in the financials of the comparables, could be worth considering a COVID -19 adjustment. Similarly, to account for unprecedented fluctuations in exchange rates or the potential lack of foreign exchange risk demonstrated by comparables, adjusting for foreign exchange could also warrant consideration.

Selection of comparables for benchmarking - multiple year v. single year analysis

Owing to the global disruption, the comparable companies may either have stopped their operations or have not been operating under normal circumstances. Their operations and profitability for the affected years may dramatically fall. The law provides for benchmarking of company's margin with average margins of comparable companies for past 3 years. Generally, the use of multiple-year averages or pooled financial results for years could help to develop a more reliable range. However, the selection of an appropriate timeframe for carrying out the analysis will assume importance in COVID times. Considering the impact on business operations of companies worldwide, it may not be appropriate to use multiple years average margins to determine arm's length price.

Given the economic conditions, MNEs and tax administrations may evaluate whether the use of a year-by-year approach could better capture the effect of events causing dramatic changes in the market.

Receivables management

Due to the halt in business operations worldwide it would be difficult for entities to realise their inter-company outstanding's. Although, in India, period of realisation of export proceeds has been extended from 9 to 15 months under FEMA but how it will be seen at the time of transfer pricing audit is uncertain. MNEs may prepare ageing analysis of inter-company receivables in support of their claim.

While the above could be helpful in strategizing the businesses, it is also worth noting that there is high possibility that MNEs may have to modify their supply chains and may look for more diversification in terms of countries. India is being seen as an attractive jurisdiction with 15% tax on manufacturing companies under the new tax regime. India has also shown its pro-activeness in implementing action plans and simultaneously encouraging a non-adversarial tax regime. Unilateral and Bilateral Advance Pricing Agreements (APAs) has provided tax certainty to MNEs and has led to win the confidence of investor. A considerate approach of tax administrative officers for the audit of period covered by COVID-19 is much desired.

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