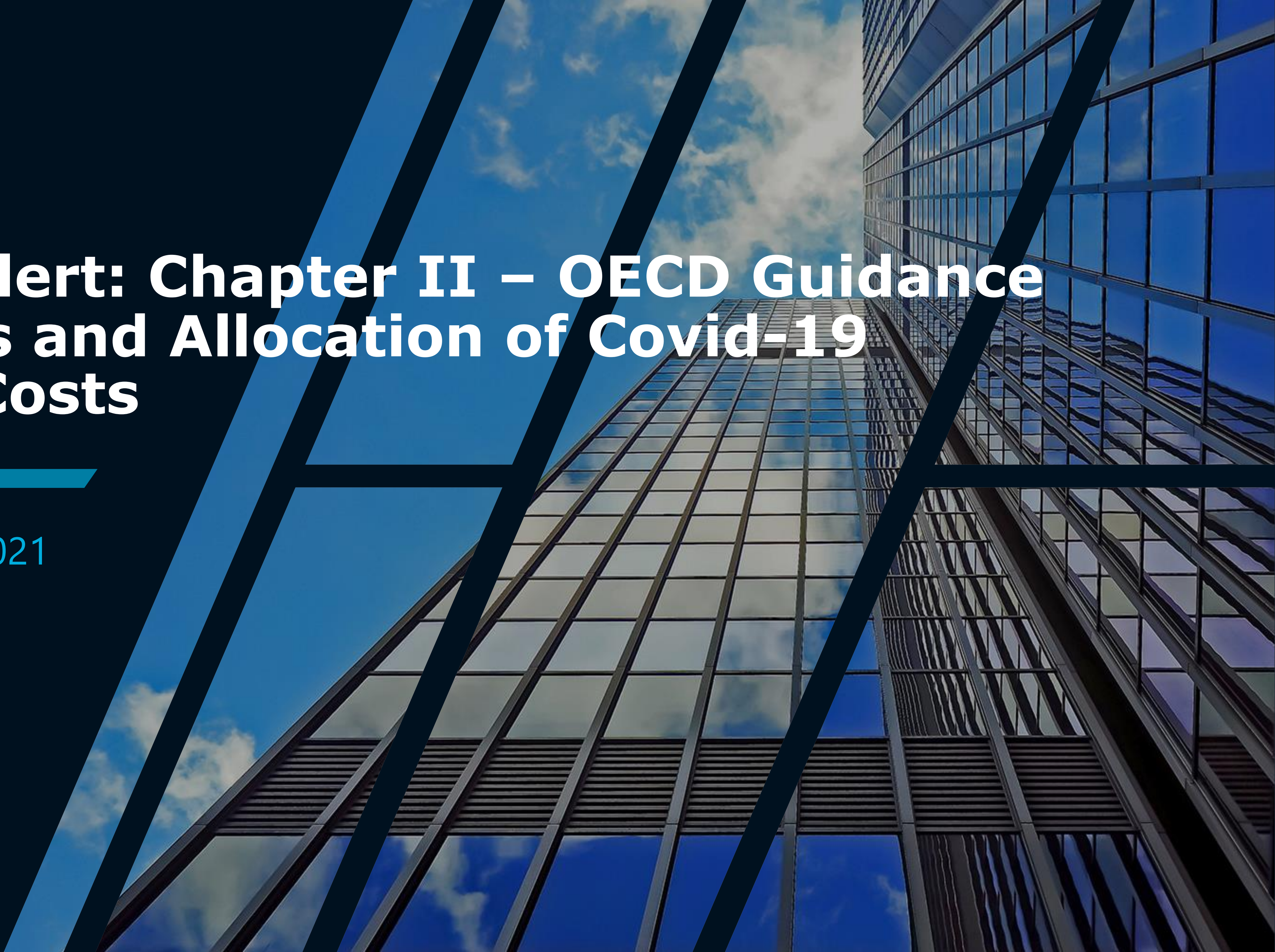
Amicus
Transcending Frontiers



Amicus Alert: Chapter II – OECD Guidance on Losses and Allocation of Covid-19 Specific Costs

November 12, 2021

Background

On December 18, 2020 the Organization for Economic Cooperation and Development (OECD) released its guidance on the transfer pricing implications of COVID-19 pandemic (hereinafter, the "Guidance"). The Guidance provides commentary on the practical application of the arm's-length principle for four main issues that a multinational enterprise (MNE) may come across while complying with transfer pricing regulations due to COVID-19. These issues are:

- Comparability analysis
- Losses and the allocation of COVID-19 specific costs
- Government assistance programs
- Advance pricing agreements (APAs)

In the first article of the Four Parts series, we discussed the first section which suggested possible approaches to undertake a comparability analysis. In the second part, we discuss allocation of losses and Covid specific costs between associated enterprises.

Amicus
Transcending Frontiers

Losses and Allocation of Covid-19 Specific Costs

Many MNEs have incurred losses and exceptional costs as a result of the pandemic. The Guidance acknowledges that the allocation of losses and Covid specific costs between associated entities can give rise to disputes and thus requires consideration. The Guidance states that there are three issues in this regard that require specific consideration:

- Risk assumption among associated entities especially with reference to limited risk arrangements
- Allocation of exceptional or non-recurring operational costs between related parties
- Circumstances under which inter-company arrangements may be modified including the use of force majeure clauses

Allocating losses to limited risk arrangements

In relation to the allocation of risks, the Guidance indicates that profits and losses are affected by risks resulting from a transaction.

According to the Guidance, in relation to the risks undertaken by a party in a controlled transaction, the reasoning for any supposed change in the risks undertaken by a party before and after the outburst of COVID-19 should be carefully considered. The Guidance state that whether a limited-risk enterprise can incur a loss will be largely informed by the risks that the enterprise generally assumes. For example, a limited-risk distributor that does not assume any marketplace risks may, at arm's length, face a loss due to the decline in demand due to COVID-19. It will not be appropriate to allocate losses associated with the decline in demand to the limited-risk entity as it does not bear the risks. Similar is the outcome in case of limited risk cost plus entities.

The Guidance suggests that any changes to the risks undertaken by a party and the allocation of losses pre and post pandemic should be re-examined and accurate delineation of the transactions should be done. The same must be supported by an updated facts-and-circumstances analysis, along with evidence of similar commercial arrangements between independent parties under comparable circumstances. In this respect, guidance in relation to business restructurings in Chapter IX of the Guidelines may be referred to.

Allocation of exceptional or non-recurring operational costs between related parties

The arm's-length allocation of "exceptional," "non-recurring" or "extraordinary" costs. should align with the delineation of the controlled transaction i.e., the party responsible for performing the activities and assuming the risks associated with such costs would typically bear such costs. These costs should be allocated based on an assessment of how independent enterprises under comparable circumstances operate, based on:

- an accurate delineation of the transaction
- an analysis of the risks assumed by the parties
- The impact of such costs on prices charged in transactions between associated enterprises

Companies should be watchful of these exceptional costs as the Guidance clarifies that certain operating costs resulting from the pandemic (e.g., teleworking costs) may not be exceptional or non-recurring if they become permanent or long-term. Reference should also be made to market conditions, such as the competitiveness of the industry, for the allocation of exceptional costs. For instance, one entity may not be able to pass on these costs to its customers without impacting the demand for its products or services, while another entity may be able to pass on these costs to its customers without a similar drop in demand. These circumstances should be part of the comparability analysis prior to allocating these extraordinary costs.

When performing a comparability analysis, exceptional costs need to be considered carefully while taking it into account:

1. They should generally be excluded from the net profit indicator of the tested party and comparables unless they are associated with the accurately delineated controlled transaction.

2. When determining a cost basis, it will be important to consider whether to include or exclude exceptional costs related to the controlled transactions, and, if included in the cost basis, whether such costs should or should not be treated as pass-through costs to which no profit element is attributed. Inclusion in the cost basis would transfer these costs to the counterparty, whereas excluding them would have the effect of allocating them to the tested party.

3. Adjustments for accounting inconsistency between the controlled and uncontrolled transactions may be required to improve comparability (e.g., when exceptional costs are accounted for as operating items in one jurisdiction and as non-operating items in another).

Circumstances under which inter-company arrangements may be modified including the use of force majeure clauses

The third issue discussed refers to the invocation of force majeure clauses and the option to modify intercompany agreements. In response to the pandemic, independent parties can opt to renegotiate specific terms in the pre-existing agreements.

Amicus
Transcending Frontiers

Where one party to a controlled transaction seeks to invoke force majeure, the agreement and underlying legal framework should form the starting point of the transfer pricing analysis. Force majeure is not defined in the context of the pandemic under the Guidance and instead refers to the contractual definition of force majeure and the conduct of the parties to determine whether the invocation of the force majeure clause is permissible under applicable law. Additionally, the Guidance notes that before invoking the force majeure clause the companies must consider short-term nature of disruptions in the context of the long-term relationships. In order to provide further clarity on this issue, the Guidance lays out an illustration which is reproduced below:

"For example, assume that Company G in Jurisdiction G provides manufacturing services to Company H under a long-term manufacturing services agreement that includes a force majeure clause. The government in jurisdiction G mandates the closure of the manufacturing facility for a certain specified short-term period, which may be extended depending on the duration of the pandemic. Given the lack of clarity on the extent of the disruption, it would be important to analyse the contract to see if the disruption qualifies as a force majeure event and consider whether, at arm's length, Company G or Company H would seek to invoke the clause. Assuming that a clause may be legally invoked under the relevant legal framework, given the long-term nature of the relationship and the short-term nature of the disruption, it may be the case that neither company would invoke the clause, even if it did qualify as a force majeure event. If the disruption was for a longer period, then the circumstances may be different, and force majeure may be more likely invoked."[1]

1. Para 58, Page 18, OECD Guidance on the transfer pricing implications of the COVID-19 pandemic, 18 December 2020.

Furthermore, the Guidance notes that associated parties may seek to renegotiate certain terms in their existing intercompany agreements in response to the COVID-19 pandemic. The Guidance stipulates that such modification of existing intercompany arrangements won’t be at arm’s length in the absence of clear evidence that independent parties in comparable circumstances would have done so. Accordingly, such modifications should be well-supported by documentation outlining how the modification is in line with the arm’s-length principle. In this regard, the Guidance provides an illustration to provide greater clarity:

“For example, assume that Distributor X purchases products, the controlled transaction, from a related party Company Y, and sells these products to third party customers. Further assume that a major customer of Distributor X does not pay for products purchased within its standard 30-day term, and that this causes a cash flow issue for Distributor X, who bears credit risk under the accurately delineated transaction. Under these circumstances, Distributor X may seek to renegotiate its payment terms on a temporary basis with Company Y. The determination of whether this renegotiation is arm’s length should be based on what independent parties would do under comparable circumstances and if there have been situations at arm’s length where contractual terms have not been enforced, or have been amended, this may form reasonable evidence for taxpayers to justify revised terms in intra-group agreements where the situations are comparable.”[2]

2. Para 44, Page 15, OECD Guidance on the transfer pricing implications of the COVID-19 pandemic, 18 December 2020.

Concluding Remarks

The pandemic has created unforeseen circumstances which have led MNEs to incur losses and exceptional costs. The allocation of these losses and exceptional costs between associated entities can give rise to disputes and thus requires consideration.

Guidance makes it unequivocally clear that unless there is a change in the functional or risk profile, limited risk arrangements - such as cost plus or limited risk distributors – should not be attributed losses. It will not be appropriate to allocate losses associated with the decline in demand to limited-risk entities as they do not bear the concomitant risks.

The Guidance recommends review of existing contractual agreements and previous year transfer pricing documentations as the starting point for ascertaining the allocation of losses and exceptional costs between associated entities. Any modification of existing inter-company agreement or invocation of force majeure should be treated with caution and be well-supported by clear evidence outlining how independent parties in comparable circumstances would have revised their existing agreements.

Stay tuned for our next editions on Parts III-IV of OECD Guidance on Transfer Pricing Impact of Pandemic

III - Government assistance programs

IV - Advance pricing agreements (APAs)

ABOUT AMICUS

Amicus is legal and tax consulting firm with focus on corporate finance, re- structuring, private equity, international taxation, transfer pricing and goods and services tax. The Firm's tax team also represents clients in assessments and litigation including Tax Tribunal and Higher Courts.

The Firm focuses on providing efficient, effective, solution- oriented advice and representation based on specialist knowledge and experience. Amicus' boutique tax practice has been consistently been ranked as a leading practice by Legal 500, Asia Law and World Tax (ITR) and Transfer Pricing.

Amicus
Transcending Frontiers

611, Tower B, Advant Business Park,
Plot #7, Noida-Greater Noida
Expressway,

Sector 142, Noida, Uttar Pradesh -
201305

Tel: +91 120 413 9212

Email: info@amicusservices.in

Web: www.amicusservices.in

Amicus

Transcending Frontiers

Amicus

I-1, Jangpura Extension
New Delhi-110014

Tel: 011-41553433
011-40541821

Key Contacts:

ashutosh@amicusservices.in

shivi@amicusservices.in

madhav@amicusservices.in