UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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VIA EMAIL
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Dear Mr. Andrew:

USCIB is aware that the OECD is preparing guidance on the application of the OECD Transfer Pricing Guidelines ("the Guidelines") [1] to business arrangements and financial results which have been impacted by the COVID-19 pandemic. While there is no discussion draft or other solicitation of public comment, USCIB believes it would be useful to provide the perspective of our membership on certain critical transfer pricing issues in advance of the publication of guidance by the OECD.

The COVID-19 crisis has resulted in substantial shock to the global economy. The crisis has and will continue to impact companies, industries and regions differently. Due to the unprecedented challenges from this once-in-a-100-year event, providing comprehensive guidance will be an exceptionally difficult endeavor. In the view of USCIB, such guidance is necessary in order for businesses and tax administrations to strive to achieve tax certainty and reduce the incidence of double taxation. With this in mind, the OECD should encourage tax authorities to work with taxpayers to understand current business conditions, promote flexibility and agree efficient and market-based approaches to transfer pricing matters.

USCIB believes that the Guidelines already incorporate essential concepts and principles relevant to transfer pricing in the current environment, but that OECD Secretariat clarification of <u>how</u> those principles apply to the unique fact patterns that taxpayers are currently facing – and that tax authorities will soon confront as corporate income tax returns for the pandemic period are filed and scrutinized – would help to prevent a wave of transfer pricing controversies in the post-pandemic period.

[1] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 2017).

This document offers the views of USCIB's membership on transfer pricing issues enshrined in the Guidelines that are of the highest importance to businesses during these turbulent times. In some instances, specific recommendations are included within the body of the letter. In general, our comments and recommendations are organized around several common principles:

1. Consistent application of the Guidelines and the arm's length principle, including additional clarity regarding whether and when responses to COVID-19 should be subject to the OECD's guidance for business restructuring;
2. Market-based approaches to comparability analyses, including the treatment of government subsidies;
3. Flexible and pragmatic solutions tailored for the uncertain economic conditions; and
4. Heightened focus on the avoidance of double taxation and expedited dispute resolution.

I. Introduction

1. As the Secretariat has acknowledged, the COVID-19 pandemic has forced governments to take unprecedented measures, such as restricting travel, implementing quarantine requirements, broadly subsidizing employment, and taking other, creative and unusual steps to stimulate faltering economies. In many cases, the pandemic has also presented unprecedented challenges for companies, including dramatic and prolonged supply chain disruptions and wild swings in costs and revenue. But the impacts of the pandemic have not been consistent – some business sectors have benefitted from the rapid change in business conditions.

2. The economic disruption caused by the COVID-19 crisis has affected business in numerous ways. Governments' imposition of "stay-at-home" orders and other travel restrictions and quarantine requirements led to substantial reductions in consumer demand for some products and services and substantial increases in demand for others. For some sectors, locations, and individual companies, the partial or complete reopening of societies has not fully mitigated these demand effects. COVID-related government restrictions have also disrupted supply chains, resulting in factory closures, conversion of production facilities to PPE, and shipments of products (perishable or otherwise) stranded at sea or across borders. Companies have further incurred new and unforeseen types of costs for the protection of their employees and customers. Additionally, some companies have received direct or indirect support from governments.

3. The economic consequences of the pandemic and of government and company responses to it raise myriad transfer pricing issues. These issues will manifest themselves in various ways as the pandemic continues, and as companies adapt (or refrain from adapting) their transfer pricing policies to a highly unpredictable "new normal."

4. The following sections of this document provide the perspectives of USCIB's membership on transfer pricing conceptual and comparability issues raised by the pandemic and by actors' responses to it – including government interventions – and explains how USCIB believes the Guidelines apply to those issues. It also describes operational transfer pricing and documentation and audit considerations for the COVID-19 environment for which Secretariat clarification of the Guidelines' application would enhance tax certainty.

II. Conceptual Issues

Arm's Length Principle and Identification of Risk

1. The COVID-19 crisis has raised many questions regarding the appropriate identification and allocation of risk among members of multinational enterprise ("MNE") groups and the related transfer pricing and economic consequences. The answers to such questions will largely depend upon the facts and circumstances of each individual company and/or MNE group. However, the arm's length principle, as embodied in the Guidelines, must remain as the relevant and reliable guidepost that should govern the transfer pricing implications of business and financial consequences of the COVID-19 pandemic.

2. As described in the Guidelines, experiences under the arm's length principle have become sufficiently broad and sophisticated to establish a substantial body of common understanding among the business community and tax administrations. Even in times of economic crisis and market turbulence, this shared understanding is of great practical value in achieving the objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation.[2]

3. At its core, the arm's length principle seeks to ensure that the profits of MNE group members are consistent with the pricing and other conditions that would have

[2] Guidelines ¶ 1.15

obtained between independent enterprises in comparable transactions and comparable circumstances.[3] The baseline principles and tools enshrined in the Guidelines have been applied in prior economic crises and downturns. These principles and tools remain relevant in the current COVID-19 pandemic; they simply need to be adapted to the facts and circumstances at hand.

4. Identification, categorization, and allocation of risk is a critical step in the accurate delineation of the actual transaction and thus in a robust transfer pricing analysis. The array of potential business risks arising from the COVID-19 pandemic are broad in their nature and will impact MNE groups in multiple aspects of their operations. For example, while the pandemic might be defined as a "hazard risk" which may broadly impact an entire MNE group, the day-to-day implications of the pandemic could give rise to other risks, such as marketplace risks, operational risks, financial risks, and transactional risks for particular affiliates.[4] Moreover, it should be acknowledged that the pandemic, a once-in-a-century event, represents an extraordinary risk not ordinarily considered and allocated in advance by commercial parties.

5. MNEs and tax administrators should view COVID-19 related risks in its proper context, as a once-in-a-100-year event that has given rise to a wide range of unforeseen economic consequences. In this regard, a flexible, pragmatic, and transparent interpretation of the Guidelines is necessary to achieve transfer pricing results that are aligned with business reality and the arm's length principle.

General Application of the Guidelines

6. A basic principle of the Guidelines (and transfer pricing, in general) is that the terms, conditions, and commercial rationale of a transaction and the related pricing must be based upon what is generally observed in the open market under comparable economic circumstances.[5] In some circumstances, the COVID-19 pandemic has brought rapid and unexpected changes to the external environment in which MNE groups operate. As a result of these changes in the external environment, MNE groups may modify their existing internal business arrangements, which may necessitate a change in the transfer pricing analysis.

[3] Guidelines ¶ 1.6
[4] See Guidelines ¶ 1.71 to 1.106
[5] Guidelines ¶ 1.123

7. In many instances, uncontrolled parties have modified existing contractual arrangements in response to the COVID-19 pandemic. In our experience, such modifications include:

   - "True-up" clauses designed to retrospectively adjust contractual compensation downward or upward;
   - Reduction in the amount of contractual compensation in order to "share the pain" and ensure the survival of an industry, value chain, or important business relationship;
   - Deferral of payments due under a contract in order to provide enhanced liquidity to badly impacted MNEs or industries

8. The contractual modifications described above are consistent with the concept of "options realistically available" described in the Guidelines. In each case, independent enterprises have compared the proposed contractual modification to other options realistically available and have elected to enter into a new transaction only if they see no alternative that offers a clearly more attractive opportunity to meet their commercial objectives.[6]

9. Many MNE groups may require similar modifications to intra-group relationships, not for the purpose of managing tax liability, but simply to ensure fiscal solvency and business survival during the pandemic. To remain within the stated objectives of the arm's length principle, MNE groups that adjust their transfer pricing as a result of the COVID-19 pandemic should demonstrate a substantive change in the business relationship or economic position of affiliated group members that is comparable to observations from similar uncontrolled transactions. Likewise, tax administrators should refrain from proposing transfer pricing adjustments in the absence of an identified shift of functions, assets, or risks within an MNE group that results in a transfer pricing outcome that is not arm's length in nature.

10. In many instances, MNE groups establish their transfer pricing on an *ex ante* (e.g. "arm's length price-setting") approach. This price-setting approach is based upon comparable transactions from previous years as well as information on economic and market changes that have occurred in the current financial period. Due to the rapidly evolving business and economic impacts of the COVID-19 pandemic, relying solely on an arm's length price-setting approach may result in a transfer pricing outcome that

[6] Guidelines ¶ 1.38

is not aligned with the arm's length standard. With this in mind, MNEs and tax administrators should redouble their efforts to also test transactions on an *ex post*[7] (e.g. "arm's length outcome-testing") basis. Applying an arm's length outcome-testing approach is consistent with the Guidelines and should also serve to reduce the risk of double taxation resulting from turbulent economic and business conditions.[8]

Application of Chapter IX of the Guidelines

11. Many changes to existing business arrangements, such as the termination or renegotiation of a contract, are addressed by Chapter IX, Transfer Pricing Aspects of Business Restructurings. For Chapter IX purposes, business restructuring are defined broadly as "the cross-border reorganisation of the commercial or financial relations between associated enterprises, including the termination or substantial renegotiation of existing arrangements."[9] Guidance on the application of Chapter IX is particularly important in light of COVID-19, as "business restructurings may be needed to preserve profitability or limit losses, e.g. in the event of an over-capacity situation or in a downturn economy."[10]

12. As a threshold matter, it is important to distinguish restructurings within the scope of Chapter IX from new arrangements which, although they may be made between the same parties, are inherently separate from existing arrangements. While such new arrangements may supplement existing structures, they do not modify them and thus do not rise to the level of restructurings for purpose of Chapter IX. However, it is important to note that in many cases, this distinction may not entail a practical difference, as Chapter IX may not permit that any compensation be paid or received for a restructuring, assuming the arrangements satisfy the arm's length principle.

13. This distinction may be illustrated by the following two examples.

- Example 1: To mitigate business risks arising from the COVID-19 pandemic, the parent of a multinational enterprise establishes a new Pandemic Response Team which performs control of risk and risk mitigation functions on behalf of the enterprise's foreign affiliates, and is paid a fee

[7] See page 22 for a more detailed discussion of this issue.
[8] Guidelines ¶ 3.69 – ¶ 3.71
[9] *Id.* ¶ 9.1. *See also id.* ¶¶ 9.66-9.67, 9.75-9.79 (indicating that modification or termination of a contract qualifies as a business restructuring).
[10] *Id.* ¶ 9.4.

> by the affiliates for this service. Existing transfer pricing arrangements with the affiliates (e.g., manufacturing and distribution agreements) remain in place and are not modified. Compensation for the Pandemic Response Team is commensurate with the benefits realized by the affiliates and conforms to the provisions of the Guidelines. Because the Pandemic Response Team transaction supplements but does not alter the existing arrangements, it is not within the scope of Chapter IX.

Example 2: To address decreases in demand resulting from the COVID-19 pandemic, the parent of a multinational enterprise agrees with its foreign subsidiary, which performs contract manufacturing functions, to decrease the compensation the subsidiary will receive. Because this change alters a fundamental term of an existing arrangement (i.e., price), it could be a business restructuring within the meaning of Chapter IX. The OECD could provide guidance as to whether and under what circumstances such changes should appropriately be evaluated under Chapter IX, and concerning any special facts and circumstances that should be considered in light of COVID-19, such as consistency with commercial objectives and other characteristics that might be considered consistent with arm's length arrangements.

Compensation

14. As noted above, the mere qualification of a course of action as a business restructuring subject to Chapter IX neither indicates nor implies that compensation is required. The notion that a restructuring inherently requires the payment of compensation by one party is at odds with the arm's length principle, which is the controlling principle under the Guidelines.

15. The Guidelines recognize that, in some cases, a party acting at arm's length would have no more attractive option realistically available to it than to accept the conditions of a restructuring, such as contract termination, without compensation.[11] Whether compensation is payable therefore requires an additional inquiry:

> An independent enterprise does not necessarily receive compensation when a change in its business arrangements results in a reduction in its profit potential or expected future profits. The

[11] *Id.* ¶ 9.29. *See also id.* ¶ 9.78 ("There should be no presumption that all contract terminations or substantial renegotiations should give a right to indemnification at arm's length, as this will depend on the facts and circumstances of each case.").

> arm's length principle does not require compensation for a mere decrease in the expectation of an entity's future profits. When applying the arm's length principle to business restructurings, the question is whether there is a transfer of something of value (an asset or an ongoing concern) or a termination or substantial renegotiation of existing arrangements and that transfer, termination or substantial renegotiation would be compensated between independent parties in comparable circumstances.[12]

16. In every case, therefore, reference must be had to evidence of arm's length behavior to ascertain whether compensation is due for all or part of a restructuring. Where there exists evidence that parties acting at arm's length would not have required (or one or both parties would not have been in a position to require) compensation, no compensation may be required between associated enterprises in accordance with the arm's length principle.

17. Since the beginning of the COVID-19 pandemic, there have been indications in a number of different contexts that parties acting at arm's length are willing to restructure their business arrangements without payment of compensation. The arm's length principle requires that taxpayers and tax authorities take such evidence into account when determining whether compensation is due between associated enterprises. Where such evidence is not be available in a given industry or context, evidence regarding the conduct of unrelated parties in analogous circumstances may be considered. The existence of the pandemic alone should not cause compensation to be paid or received when taxpayers restructure if compensation would not otherwise be paid or received under Chapter IX.

18. In considering whether compensation is due in connection with a business restructuring, and in determining its quantum (if any), consideration should be given to the permanence of the restructuring. While a temporary alteration of business arrangements may qualify as a restructuring per the above guidance, such an alteration is essentially different from a restructuring that contemplates a permanent change in business relations. For example, temporary additional presence in a jurisdiction may be due to the COVID-19 pandemic and result in differences in local payroll without the intention to alter functional profiles. Parties at arm's length might not require compensation for a temporally limited

[12] *Id.* ¶ 9.39.

deviation from normal arrangements in response to short term disruptions, but might require compensation for the same deviation if it were not so limited.

Tax Benefits

19. The Guidelines note that, "[u]nder Article 9 of the OECD Model Tax Convention, the fact that a business restructuring arrangement is motivated by a purpose of obtaining tax benefits does not of itself warrant a conclusion that it is a non-arm's length arrangement."[13] Restructurings undertaken in response to the pandemic, as well as the institution of new business arrangements which do not qualify as restructurings under the above guidance, may entail tax benefits as well as operational advantages. This is practically inevitable in some cases, as altering business structures will generally have tax effects, which may be advantageous or disadvantageous to the enterprise in question.

20. The mere incidence of some tax benefit should therefore have no relevance to the treatment of a transaction with a *bona fide* business purpose. Tax administrations should not regard the existence or non-existence of a tax benefit as dispositive.

III. Comparability Issues

<u>Evaluating Risk</u>

1. Some tax authorities may take an initial view that related party "limited risk" or "routine" suppliers, which typically assume little business risk, should receive the compensation required under their contracts, regardless of whether the group as a whole is profitable or incurs losses, and regardless of prevailing economic conditions in the industry.

2. Although this view might generally be correct under normal economic conditions and may also be correct in the case of business sectors not yet seriously affected by the pandemic, it would not be appropriate for all business sectors. In accordance with the relevant provisions in the Guidelines, including those applicable in comparability analysis, tax authorities and taxpayers should assess transfer pricing outcomes based on the taxpayer's specific facts and circumstances, including the circumstances

[13] *Id.* ¶ 9.38.

affecting its specific business sector and independent enterprises operating in that sector.[14]

3. The Guidelines address how similarly-situated enterprises operating at arm's length respond to risk, including during periods of economic downturn where risk may be beyond the taxpayer's control.[15] As the Guidelines observe, risk is inherent in any business activity.[16] Thus, the fact that a controlled taxpayer, based on standard functional analysis, may be considered to perform "routine" functions[17] and face limited business risk, does not mean it is effectively insulated from adverse economic conditions and therefore guaranteed to earn a profit. A "routine" distributor, for example, might be compensated with a return on sales rather than a return on costs and could fail to cover its expenses in the event of a dramatic sales decline.

4. As a result of the pandemic, in many hard-hit business sectors, all participants, controlled and uncontrolled, have been adversely impacted, and many are expected to incur losses so long as the current economic conditions persist. In these circumstances, unrelated parties are adjusting to adverse business conditions through mutual accommodations intended to manage unanticipated and possibly existential risk. The pricing reflected in contracts between related parties and unrelated parties ordinarily does not contemplate the unique and widespread disruption caused by the current pandemic. So, for example, a related party contract for distribution services that compensates the provider with a mark-up on costs implicitly assumes some normalized level of demand for the services. If demand suddenly and precipitously decreases, unrelated operators in the industry may not realize sufficient demand to cover costs and incur losses. In keeping with sound comparability analysis, tax authorities should focus on financial outcomes of comparable businesses in the relevant industry, and adopt a flexible approach to pricing modifications by related parties.[18] In that regard, depending on the facts and circumstances, it may be appropriate for related parties to modify the risk allocations

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[14] Guidelines ¶ 3.7
[15] Guidelines ¶ 1.67
[16] Guidelines ¶ 1.57
[17] In the parlance of the Guidelines, "routine" activities are those that are readily benchmarked. *See, e.g.*, ¶ 3.18. There is no connotation that such activities are entitled to a guaranteed return.
[18] The pricing reflected in contracts between related parties and unrelated parties ordinarily does not contemplate the unique and widespread disruption caused by the current pandemic. So, for example, a related party contract for distribution services that compensates the provider with a mark-up on costs implicitly assumes some normalized level of demand for the services. If demand suddenly and precipitously decreases, unrelated operators in the industry may not realize sufficient demand to cover costs and incur losses.

implicit in their contracts, and for such modifications to be reflected in the relevant transfer pricing documentation.

Use of single-year data

5. Depending on the facts and circumstances, contemporaneous data or multi-year averages may produce the most reliable results. Both approaches are authorized by the Guidelines and are in common use.[19] There is a concern that tax authorities or taxpayers may apply inconsistent approaches to assess financial results during the periods affected by the pandemic, thereby introducing bias in results.

6. The pandemic and its unprecedented adverse impact on many business sectors presents unique challenges in applying comparability analysis. Based on real-time progress reports and commentary, it is reasonably certain that the pandemic is having a similar impact on both controlled and uncontrolled businesses that are competing in adversely affected industry sectors. Although the duration of current economic conditions is unpredictable, presumably at some point conditions will revert to "normal." These circumstances present difficult timing issues around data collection and the use of historical data. See Section VI below for further discussion.

7. Under the Guidelines, contemporaneous uncontrolled transaction data, at least in principle, provides the most reliable information for comparability analysis "because it reflects how independent parties behaved in an economic environment that is the same as the economic environment of the taxpayer's controlled transaction."[20] The Guidelines note, however, that the timing of data collection sets a practical limit on this principle. Unrelated party transaction data for the current period (*i.e.*, 2020) will not be generally available through public sources until well after the close of the year. The time lag may be even more pronounced for the EMEA and APAC regions, where many jurisdictions have later financial reporting deadlines. If, however, a taxpayer does have access to contemporaneous data, such as through internal comparable uncontrolled transactions, such data should have a high degree of reliability, all else equal. As previously noted, tax authorities are encouraged to apply a flexible approach, such as by allowing taxpayers to adjust book results taking into account data that becomes available after the close of the year.

[19] Guidelines ¶¶ 3.37, 3.75 *ff*
[20] Guidelines ¶ 3.68

8. It should be noted that taxpayers and tax authorities should be consistent in how they select data over time (i.e., no "cherry-picking"). Depending on the facts and circumstances, as well as practical considerations, the most reliable approach may be to view the period impacted by the pandemic in isolation. If, however, a multi-year average is considered most reliable under the circumstances, then that approach should be applied for pandemic and post-pandemic periods. Tax authorities should not insist on using a multi-year average for the period affected by the pandemic, but then exclude data from that period (such as by reverting to the use of single-year data) when the economy begins to recover. Similarly, taxpayers should not "leverage the downturn" by using current data for the term of the pandemic, then switching to multi-year averages post-pandemic (such that outcomes are artificially deflated).

<u>Loss companies as comparables</u>

9. It is common practice in screening potential independent comparable companies and transactions to eliminate "outliers," including companies that are extremely profitable or are loss-making/bankrupt. There is a concern that tax authorities may take the position that potential comparables that incur losses during the pandemic, including comparables that may have been included in comparables sets in prior years, should be excluded from comparables sets for the period including the pandemic.

10. A core principle of Chapter III of the Guidelines is that "comparability analysis always aims at finding the most reliable comparables."[21] Under the Guidelines, the comparability analysis begins with a delineation of the transaction in question and the identification of the economically relevant characteristics or comparability factors. In the current environment, the economic conditions in which the tested party and potential comparable companies operate is a particularly important component of the analysis.[22]

11. Tax authorities and taxpayers should bear in mind that, in the current environment, the exclusion of otherwise comparable companies on the basis of adverse financial outcomes, without an assessment of the reasons for such outcomes, would be inconsistent with the Guidelines and likely would undercut the reliability of the analysis. In that regard, the Guidelines provide explicitly that "[a]n extreme result may be excluded on the basis that a previously overlooked significant comparability

[21] Guidelines ¶ 3.2
[22] Guidelines ¶ 3.7; see also ¶ 1.110

defect has been brought to light, not on the sole basis that the results arising from the proposed 'comparable' merely appear to be very different from the results observed in other proposed 'comparables'."[23]

12. More fundamentally, the Guidelines make clear that although taxpayers performing "routine" activities or simple functions generally are not expected to generate losses for an extended period of time, that does not mean that loss-making transactions cannot serve as reliable comparables. Indeed, in assessing comparability, "it is the facts and circumstances surrounding the company in question that should determine its status as a comparable, not its financial result."[24]

13. Accordingly, comparability analysis should be agnostic as to the financial success or failure of an otherwise comparable company. The risk of a biased analysis increases when, as is currently the case, certain unrelated competitors face potentially calamitous financial results, or even insolvency, yet may be excluded by initial screening based on those results. Certainly, potential comparables, whether or not they were used in prior years, should not be rejected solely on the basis that they are not profitable or became insolvent during the pandemic. If the relevant business sector experiences a wave of insolvencies, that fact should be acknowledged in evaluating results for the tested party. For example, where only a relatively limited number of comparables can be identified due to a high rate of pandemic-driven business failures in a particular sector, use of an alternative to the interquartile range, such as a full range, could enhance the reliability of the analysis.

14. It may be that the impact of the pandemic will mandate a fresh assessment of the taxpayer's specific circumstances (*e.g.*, the impact of the pandemic on the entire supply chain; the level of market demand in the specific business sector) and those of potential comparables. For example, a company that was accepted as a comparable pre-pandemic on the basis that it performed similar functions in a comparable market may no longer qualify as comparable if the market in which it operates was affected to a significantly different degree than the taxpayer's market.

IV. Government interventions (including support)

1. Paragraphs 1.132-1.136 at Chapter I, Section D.4. of the Guidelines address the effect of government policies on arm's length pricing. The types of governmental market

[23] Guidelines ¶ 3.63
[24] Guidelines ¶ 3.64

interventions envisioned by Section D.4. include interventions "such as price controls (even price cuts), interest rate controls, controls over payments for services or management fees, controls over the payment of royalties, subsidies to sectors, exchange control, anti-dumping duties, or exchange rate policy."

2. In response to COVID-19, governments around the world have intervened in various ways in the markets. Some interventions have been aimed primarily at consumers (*e.g.*, eviction moratoriums, rent assistance); others have been aimed primarily at businesses. Many of these interventions fall squarely within the scope of Section D.4., but there is a clear outlier: widespread, government-mandated shutdowns of entire segments of the real economy in response to COVID-19. Indeed, the Guidelines do not address government-mandated closures, other than indirectly through general comparability principles. Paragraphs 1.134-1.136, which address "blocked income", articulate principles that may be useful to keep in mind when evaluating government-mandated shutdowns but, like Section D.4., do not directly apply because "blocked income" does not produce the same changes in cost structure.

3. In the vast majority of relevant cases, shutdowns occurred in tax jurisdictions having genuinely free markets, in which reasonable market participants did not expect transactional impediments by governments. These shutdowns were truly unexpected at the time the terms of 2020 controlled transactions were agreed, and it will be particularly important to address their effects in transfer pricing analyses, including those of very routine controlled transactions (i.e., those widely observed in an uncontrolled context). Such very routine transactions tend to involve mostly variable costs (and low fixed costs). However, during a shutdown, certain variable costs become fixed (*e.g.*, continued payments to employees until the shutdown is over) because the recognition of income is artificially interrupted by the government policy and may encourage MNEs to prioritize cash preservation over profit. The more fixed costs a business experiences as a percentage of total costs, the riskier its cash-flow, and the greater its cost of capital. It is thus reasonable to expect wide volatility in the financial results of routine uncontrolled businesses in 2020.

4. Many other COVID-related interventions, however, do fit within the rubric of Section D.4. For example, in the United States, since March 2020, the Federal Reserve Board ("FRB") has:

- **Driven interest rates to near zero by**
    - Slashing the Federal Funds Rate; and

- Offering forward guidance that "rates will remain low" (breaking with the historical posture that inflation control is the primary role of the FRB).

- **Supported the functioning of the financial markets by**
  - Purchasing massive amounts of Treasuries and mortgage-backed securities ("quantitative easing");
  - Lending through the Primary Dealer Credit Facility to 24 large financial institutions at reduced rates for 90 days;
  - Backstopping money market mutual funds; and
  - Conducting unlimited repo operations.

- **Encouraged banks to lend by**
  - Reducing the discount window for overnight loans; and
  - Temporarily relaxing certain regulations.

- **Supported corporations and small businesses by**
  - Lending directly to major corporate employers through the Primary Market Credit Facility (PMCF)[25] and Secondary Market Credit Facility (SMCF);
  - Making purchases through the Commercial Paper Funding Facility;
  - Supporting companies too large to benefit from the Paycheck protection Program but too small to benefit from the PMCF or SMCF through the Main Street Lending Program;
  - Supporting loans to non-for-profit institutions; and
  - Re-starting the Term Asset-Backed Securities Loan Facility.

- **Supported state and municipal borrowing by**
  - Lending directly to states and municipalities; and
  - Supporting municipal bond liquidity.

- **Cushioned U.S. money markets from international pressures by**
  - Creating international swap lines (i.e., making dollars available in currency swaps); and

[25] PMCF loans typically provide for deferred interest and principal repayment for the first six months as long as the money is not used for stock buy backs or dividend distributions

- Creating the Temporary Foreign and International Monetary Authorities (FIMA) repo facility for countries that do not have a swap line with the United States.

5. In addition to these actions by the FRB, the U.S. Federal government has invoked the 1950 Defense Production Act (Pub.L. 81–774) ("DPA") to compel a number of private companies to manufacture certain goods and provide certain services (*e.g.*, personal protective equipment, ventilators, defense products). As an example, on July 10, 2020, the Department of Defense announced *"$84.4 Million for Production Act Title III Covid-19 Actions*." Companies compelled under the DPA find themselves in different circumstances than companies that are not. Similar laws may have been invoked in other countries.[26]

6. Since transfer pricing always involves controlled participants located in different tax jurisdictions, and because, for transactions involving U.S. companies, the tested party in an application of the transactional net margin method (the most often used transfer pricing method) is often a foreign participant, it is necessary but not sufficient to understand the various ways the U.S. government had intervened in markets. One must also understand the nature of any such government interventions in the tax jurisdiction of the tested party; and one, often, will have to deal with the unavailability of 2020 data concerning certain foreign comparable companies until after the 2020 U.S. tax return is due. In fact, according to Chapter I of the Guidelines, one must really understand the nature and context of any government interventions in every tax jurisdiction in which a controlled or uncontrolled participant in the supply chain involving a controlled transaction is located. An accurate delineation of a controlled transaction requires a holistic view of the circumstances of the entire MNE. The complexity and granularity of the information required for a meaningful analysis of such market circumstances for transfer pricing purposes is apparent from the succinct summary of U.S. interventions presented above.

7. Section D.4 provides: "As a general rule, these government interventions should be treated as conditions of the market in the particular country, and in the ordinary course they should be taken into account in evaluating the taxpayer's transfer price in that market."[27] Moreover, "MNEs in practice may make no adjustment in their

[26] It is important to note that other jurisdictions may have implemented fiscal and monetary policies distinct from those enacted in the United States. A thorough transfer pricing analysis must identify and evaluate these policies as crafted and deployed.
[27] Guidelines ¶ 1.132.

transfer prices to take account of such controls, leaving the final seller to suffer any limitation on profit that may occur, or they may charge prices that share the burden in some way between the final seller and the intermediate supplier. It should be considered whether or not an independent supplier would share in the costs of the price controls and whether an independent enterprise would seek alternative product lines and business opportunities. In this regard, it is unlikely that an independent enterprise would be prepared to produce, distribute, or otherwise provide products or services on terms that allowed it no profit."[28] Thus, controlled enterprises are expected to re-evaluate their transfer prices in reaction to a new market intervention by the government.

8. The Guidelines recognize that such re-evaluation may involve the sharing among participants of some of the costs and benefits associated with the intervention. The uncertainties associated with the spread and lethality of COVID-19 compounded by the uncertainties faced by controlled taxpayers in understanding the mechanics and consequences of various government market interventions, as well as the expected commitment of governments to the success of such interventions, has created a highly uncertain environment for controlled taxpayers. The partial resolution of these uncertainties is still unfolding, as evidenced by market reactions to unemployment reports and other economic metrics that have shocked market participants (*e.g.*, the announcement of the contraction of U.S. GDP in the second quarter of 2020). The Guidelines recognize that "a highly uncertain transaction" could lead to a renegotiation of contract.[29]

9. Such interpretation as to the genesis of an observed change in the risk allocation concerning a controlled transaction in reaction to COVID-19 would be different and distinct from that under a Chapter IX business restructuring transaction. In the former interpretation, pandemic risks were not specifically allocated in the original contract. When such risks did materialize, parties had to determine how that new source of contractual risk would be shared. To the extent the source of risk is sufficiently material to the business as to render the controlled transaction highly uncertain, the Guidelines suggest that a contract renegotiation could be expected.[30]

[28] Guidelines ¶ 1.133.
[29] Guidelines ¶ 3.73.
[30] Guidelines ¶ 3.73.

10. Indeed, Chapter IX compels an accurate delineation of the transaction under Chapter I of the Guidelines.[31] This analysis will include the identification of new sources of risk created by government interventions. Such accurate delineation of the transaction will consider the circumstances that existed at the time the contract was entered into (pre-COVID-19 in numerous cases), at the time COVID-19 hit, and at each time a relevant government intervention altering the overall risk profile of the controlled transaction was announced. Thus, the accurate delineation of the controlled transaction likely may require analysis of contractual amendments under the framework described above rather than through the lens of a business restructuring, unless it is determined that an economic quantum other than unexpected risk (resulting from the hit of COVID-19 and related government interventions in markets) has been reallocated.

11. The Guidelines indicate that how uncontrolled participants would react to government interventions should inform an analysis of responses by controlled participants (comparability).[32] As a practical matter, several data-related considerations (including reliability of such data) are relevant in evaluating the viability of comparability adjustments to account for differences in controlled and uncontrolled parties' experiences of such interventions:

    - As a threshold matter, such adjustments require sufficiently granular (at the company level for the tested party and for the comparable companies) and reliable data about the form and expected impact of government intervention or assistance;

    - When the costs and benefits of government intervention will be recognized in financial statements will vary, and may be uncertain—but is highly relevant to the comparability analysis;

    - If a loan is provided at a below-market interest rate (or otherwise on non-market terms), the cost of capital of the entire enterprise (including subsequent uncontrolled and controlled loans) may benefit from the below-market financial leverage caused by the government loan—thus, uncontrolled transactions not directly affected by COVID-19 (*e.g.*, the interest charged on a third-party loan) may be indirectly affected by COVID-related government intervention; and

[31] Guidelines ¶ 9.78.
[32] *See* Guidelines ¶ 1.132.

- Similarly, the use of productive capacity by a government contract under the DPA absorbs fixed costs of a business that may otherwise only be partially absorbed by collapsing private demand (*e.g.*, liquor companies re-purposing production lines to manufacture hand-sanitizer). Understanding the productive technology (variable costs and fixed costs) of businesses compelled to produce under the DPA is thus important in considering comparability adjustments.

12. COVID-19 and government responses across the world have impacted (and are still impacting) controlled taxpayers in extremely specific ways depending on their circumstances. This puts tremendous pressure on transfer pricing methods whose reliability is predicated on comparability of circumstances. While the direct impact of certain forms of government intervention on the profitability of a controlled taxpayer may, in some cases, be reliably measured, the indirect impact of such intervention on the profit of companies may be much more challenging to reliably measure (*e.g.*, a government loan at a below-market rate of 1 percent resulting in a separate controlled loan at a below-market rate, but an arm's length rate considering the balance sheet of the borrower of 2 percent because of the below-market financial leverage caused by the government loan). Broadly, however, heeding the guidance at Chapter I of the Guidelines to accurately delineate a controlled transaction considering the overall circumstances of a MNE (going above and beyond the controlled transaction itself) should help to contemplate all direct and indirect impacts of government intervention. Comparability criteria should then be carefully developed and applied to ensure that uncontrolled data is reliably adjusted to account for material differences in the circumstances of controlled and uncontrolled taxpayers.

V. Operational Transfer Pricing Considerations

<u>Mechanics of intra-year price adjustments</u>

1. For controlled taxpayers affected by the pandemic, either negatively or positively, the time lags that arise among (1) price-setting for budgeting purposes in advance of or at the beginning of the year, (2) refinements to prices to reflect revised forecasts during the year, and (3) testing the results of such prices as the year-end approaches, present significant intra-year pricing difficulties from an operational perspective. Although these difficulties may be most apparent with regard to pricing of tangible

goods, such difficulties extend to pricing for other intercompany transactions, including services and intangibles.

2. The Guidelines recognize the challenges that controlled taxpayers face due to time lags relating to pricing. For example, the Guidelines note that, in setting prices, controlled taxpayers may not have sufficient information on uncontrolled transactions at the time of the controlled transactions.[33] In addition, certain data needed to determine revenue, gross profit, and operating expenses for the controlled transactions to evaluate appropriate profit level indicators, may not be available.[34] In the context of profit splits, the Guidelines also clearly state that controlled taxpayers should not be held to a more rigorous standard than parties acting at arm's length in terms of being able to foresee the level of actual profits (or losses).[35]

3. The difficulties arising from such time lags are particularly acute during a pandemic which has severely affected supply and demand, and thus, revenues, costs of goods, operating expenses, receivables, payables, inventories, etc., for many sectors and companies. Controlled taxpayers should be afforded the ability to address intra-year transfer pricing issues through various means, such as price adjustments, etc., and should not be expected to address such pricing issues in a more rigorous manner than a party acting at arm's length that was similarly unable to foresee the impact of COVID-19 on its operations.

4. For example, depending upon the length of the supply chain and accounting method for inventory, there could be a several-month lag before transfer price changes for tangible goods impact the profit and loss statement of a tested entity. By the time such price changes impact the tested entity's profit margin, market conditions may have evolved such that another price change may be required. The result is a never-ending cycle in which price adjustments cannot catch up with a rapidly changing (and likely deteriorating) business forecast. Moreover, such price adjustments may have a carryover effect to the subsequent fiscal year which may need to be corrected via another round of significant price adjustments in the opposite direction if the business forecast improves.

5. As an additional example, the economic effects of the pandemic present unique challenges in the context of hard-to-value intangibles ("HTVI"). Controlled parties to

[33] Guidelines ¶ 2.71.
[34] Guidelines ¶ 2.72.
[35] Guidelines ¶ 2.134.

license arrangements involving HTVI may face particular challenges in setting royalty rates during the pandemic period, when forecasts may be highly uncertain. For arrangements that pre-date the pandemic, parties may confront questions regarding whether uncontrolled parties would modify their *ex-ante* royalties in light of extraordinary *ex post* outcomes. For HTVI license arrangements spanning the COVID-19 pandemic period, tax administrations should consider that deviations from forecasts may be attributable to the occurrence of this unforeseeable event.

6. MNEs with advance pricing agreements also face challenges in addressing intra-year price adjustments due to abrupt changes in market conditions. Although each MNE's situation and APA may be unique, tax authorities, whether in a unilateral, bilateral or multilateral context, should be encouraged to work cooperatively to apply flexible approaches to permit temporary deviations from transfer pricing method testing approaches that may not reflect arm's length terms due to COVID-19. For example, an APA with a single-year testing approach using comparable uncontrolled data that does not reflect the impact of COVID-19 may not be representative of arm's length dealing, and the agreed-upon critical assumptions may not, on their face, provide the ability to address the issue.

7. Intra-year price adjustments can also raise implications from a VAT and customs perspective. Given the impact of COVID-19 on companies and controlled taxpayers' results, the need for intra-year price adjustments to comply with arm's length pricing requirements has increased. The Guidelines recognize the interaction between transfer pricing and customs valuation and the potential need to increase coordination to limit the number of cases in which, for example, valuations for transfer pricing purposes are unacceptable for customs purposes.[36] In light of COVID-19, such coordination should be afforded to controlled taxpayers attempting to comply with arm's length pricing requirements, including by simplifying customs requirements for adjusting valuations due to year-end or post-year-end transfer pricing adjustments (or by clarifying that such adjustments should not fall within the scope of customs legislation), acknowledging that legitimate operational factors may exist that cause customs valuations to differ from transfer pricing valuations, and encouraging more coordination between tax and customs authorities. The conflict is especially acute in a scenario described above where there are significant changes in prices of opposite direction. In these cases, customs valuation issues and controversy can carryover for multiple years.

[36] Guidelines ¶¶ 1.137-1.138.

Mechanics of post-year-end adjustments

8. Controlled taxpayers face time lag issues with regard to post-year-end adjustments that are similar to those discussed above concerning intra-year price adjustments, and the Guidelines provide support for addressing post-year-end adjustments during COVID-19 consistently with intra-year adjustments.

9. Although controlled taxpayers may test their controlled transactions during the year and apply intra-year price adjustments, rules in many jurisdictions require controlled taxpayers to test the arm's length nature of their results for the entire tax year. Relevant internal or external uncontrolled transaction data that may incorporate the economic effects of COVID-19 and be used to apply TPMs to test the arm's length nature of the controlled transactions may not be available to controlled taxpayers until after year-end. The Guidelines emphasize the importance of identifying the economic circumstances of the controlled and uncontrolled transactions.[37] COVID-19 is clearly an important economic circumstance to be evaluated for transfer pricing purposes, and therefore, controlled taxpayers should be permitted and encouraged to incorporate data and information relating to COVID-19 in complying with arm's length requirements and to implement year-end adjustments as necessary based upon such data and information through various means, such as credit notes, secondary adjustment mechanisms, etc.

10. The mechanics of and need for post-year-end adjustments can also be affected by whether testing is conducted on an *ex ante* or *ex post* basis, or some combination of both. An *ex ante* testing approach typically focuses on price setting at the time the controlled transaction is undertaken (so-called "arm's length price-setting" approach), whereas an *ex post* testing approach evaluates the results of a controlled transaction (so called "arm's length outcome-testing" approach).[38] The Guidelines reinforce that tax authorities should strive to resolve any double taxation that may result from one tax authority's applying an arm's length price-setting approach and another tax authority's applying an arm's length outcome-testing approach.[39] In situations in which COVID-19 has affected controlled taxpayers, tax authorities should strongly consider applying arm's length outcome-testing approaches that are more likely to reflect the impact of COVID-19 and allow post-year-end adjustments.

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[37] Guidelines ¶¶ 1.110, 3.7.
[38] Guidelines ¶¶ 3.69-3.70.
[39] Guidelines ¶ 3.71.

11. In certain scenarios where a post-year-end adjustment is required, it may only be possible to make such an adjustment on the tax return filed in the jurisdiction of the tested entity (e.g., in scenarios where debit / credit notes are not legally allowed). In such cases, it would be appropriate (and necessary) for a corresponding adjustment to be allowed on the tax return of the affiliated trading partner to avoid double taxation. Tax administrations should therefore work together to design accelerated dispute resolution programs to ensure that the tax effects of post-year-end adjustments are addressed in a timely manner that reduces the incidence of double taxation. The Forum on Tax Administration could support these efforts by developing model frameworks, best practices, and other tools. Without such an accelerated program, it is likely that the backlog of MAP cases will rapidly increase, especially cases focused on compensation of distribution entities.

VI. Documentation and Examination Considerations

1. As outlined above, revenue and cost fluctuations and/or the receipt of government support may affect a MNE's results in some or all of the jurisdictions where it operates. Moreover, some companies may have modified or otherwise adapted their transfer pricing policies in light of the pandemic's various effects or may do so in the coming months.

2. Some companies are concerned about whether and to what extent their internal data and the external data sources typically relied upon for transfer pricing purposes will reflect the presence or absence of these various effects. Tax authorities may share these concerns. Companies are also considering how to best substantiate and otherwise document any COVID-related effects. Meanwhile, tax authorities may be considering how to best conduct transfer pricing examinations of tax years affected by the pandemic, and what information will be needed to reliably evaluate the pandemic's effects on transfer pricing results.

3. The objectives for transfer pricing documentation outlined in the Guidelines provide a framework for evaluating documentation practices and requirements in respect of COVID-related effects. The Guidelines articulate three objectives for transfer pricing documentation: for companies, documentation helps to create a culture of compliance with transfer pricing rules; and for tax authorities documentation both provides information necessary to conduct an informed transfer pricing risk

assessment and also, if needed, provides the basis for conducting an appropriately thorough transfer pricing audit.[40]

4. In general, documentation should articulate a well thought-out basis for a company's transfer pricing policies. Nevertheless, as the Guidelines acknowledge, costs, time constraints, and competing demands for the attention of relevant personnel necessarily limit the scope and level of detail of a company's transfer pricing documentation. Therefore, documentation requirements must be kept reasonable and focused on material transactions.[41]

5. In the pandemic environment, the forgoing admonition of reasonableness is particularly important. Although certain types of data and information may be relevant to evaluating COVID-related effects on a company's transfer pricing results, it would be unreasonable for governments to levy material new documentation requirements in the present environment. The pandemic has only exaggerated the cost and time constraints and competing demands for tax department attention cited above. It would be reasonable for governments to expect companies to engage in good faith efforts to collect and preserve relevant data. However, it would generally not be reasonable to impose formulaic documentation requirements or, during an audit, to issue unduly burdensome demands for documents. As the Guidelines observe, taxpayers should not be expected to incur disproportionately high costs and burdens in producing documentation, and where the cost of locating certain data would be disproportionately high relative to the amounts at issue, a taxpayer should not be required to incur costs in searching for such data.[42]

6. At the same time, companies should also make reasonable, good faith efforts to document information relevant for transfer pricing. It may not be possible to preserve or document certain COVID-related information in a customary or formal manner, and both taxpayers and tax authorities should be flexible in this regard. Generally, as is also true when conducting a comparability analysis,[43] companies should aim to gather, and tax authorities should accept, the most reliable information and data that are reasonably and realistically available under all the facts and circumstances.

[40] Guidelines ¶¶ 5.5, 5.7.
[41] Guidelines ¶ 5.9.
[42] Guidelines ¶ 5.28.
[43] *See, e.g.,* Guidelines ¶¶ 3.38, 3.50.

7. For example, whereas a company likely could not realistically obtain, and a tax authority should not reasonably expect, detailed financial evidence of pandemic-related effects on the company's industry competitors, a company might more readily obtain minutes of a trade association meeting reflecting the experiences and concerns of other companies in the same sector. Likewise, a company might not be realistically able to preserve detailed, contemporaneous documentary evidence of certain extraordinary costs, such as for "stranded" employees or raw material spoilage due to short-fused border closures or confusion among local officials or suppliers about transit restrictions. In such circumstances, notes from later-in-time interviews with pertinent personnel might be relied upon as a supplement to any available contemporaneous materials.

8. The Guidelines encourage the contemporaneous development of transfer pricing documentation and reliance on it in filing corporate tax returns.[44] Pandemic conditions have presented companies with peculiar challenges in gathering and preserving even routine elements of transfer pricing documentation. Therefore, if and to the extent tax authorities determine that additional information on COVID-related effects is needed to reliably risk-assess a company's transfer pricing, they should consider accepting otherwise reliable, non-contemporaneous documentation if it is the only material reasonably available. Good faith efforts on the part of companies and flexibility on the part of tax authorities are appropriate in the present environment.

9. In a similar vein, tax authorities should take the pandemic and its effects into account when conducting transfer pricing audits. For example, in jurisdictions where audits may cover multiple years, it may be most efficient to audit tax years ending in 2020 and 2021 (and perhaps later years) together rather than considering them independently. This approach would promote consistent treatment of pandemic-related effects across tax years and limit the scope of any additional taxpayer or tax authority resources needed to address them. Further, while governments face an acute need for revenue as a result of the pandemic, tax authorities should carefully consider whether penalties are appropriate where mispricing results from COVID-related drivers, such as deviation from forecasts. To the extent such penalties are discretionary, imposing them may not serve the interests of principled and effective tax administration but may instead have the effect of punishing a taxpayer for events beyond its control.

[44] Guidelines ¶ 5.27

VII. Conclusion

As discussed throughout this paper, both businesses and tax administrators will confront (and to some extent are already confronting) a high degree of transfer pricing uncertainty as a result of the COVID-19 pandemic. The OECD's forthcoming guidance is critical to mitigating that uncertainty, and USCIB urges that it be issued as soon as possible.

Furthermore, USCIB would like to emphasize the importance of the following recommendations, which are embedded in the body of this document:

- Taxpayers and tax administrations should apply the arm's length principle, as it is embodied and explained in the Guidelines, to business conditions which are the result of the COVID-19 pandemic;

- Taxpayers and tax administrations should recognize that COVID-19 is a once-in-a-100-year event that requires flexible and pragmatic transfer pricing solutions, including a focus on *ex post* (as opposed to *ex ante*) transfer pricing results, reliance on market-based and symmetrical comparability analyses, and a flexible application of Chapter IX;

- Taxpayers and tax administrations should determine equitable and market-based transfer pricing solutions for unique and/or temporary business arrangements (including government subsidies and business restructurings); and

- Tax administrations should design and offer accelerated dispute resolution programs to ensure that the tax effects of post-year-end adjustments are addressed in a timely manner, thereby reducing the incidence of double taxation.

In conclusion, USCIB appreciates the opportunity to provide perspective on the issues we believe are most critical in applying Guidelines to the economic uncertainties which confront business as a result of the COVID-19 pandemic. USCIB is ready and willing to engage directly with the OECD to provide any assistance or additional perspective on the matters discussed within this document.

Sincerely,

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