# Japan Tax Bulletin

## Guidance on the transfer pricing implications of the COVID-19 pandemic

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On December 18, 2020, the OECD released a "Guidance on the transfer pricing implications of the COVID-19 pandemic" ("Guidance"). The Guidance represents the consensus view of the 137 members of the Inclusive Framework on BEPS regarding the application of the arm's length principle and the OECD Transfer Pricing Guidelines ("TPG") to issues that may arise or be exacerbated in the context of the COVID-19 pandemic. The Guidance is helpful both for taxpayers in reporting the financial periods affected by the pandemic and for tax administrations in evaluating the implementation of taxpayers' transfer pricing policies.

The Guidance focuses on four key areas:
(1) Comparability analysis;
(2) Losses and the allocation of COVID-19 specific costs;
(3) Government assistance programs; and
(4) Advance Pricing Agreements.

It is important to emphasize that in performing a transfer pricing analysis, these topics may be interrelated and therefore should be considered together and within the analytical framework of the OECD TPG.

The COVID-19 pandemic, which constitutes a hazard risk, has led to unusual outcomes of other risks for some taxpayers, including: (i) marketplace risk, as demand for some products and services has collapsed; (ii) operational risk, as the pandemic has disrupted supply chains and inhibited production; and (iii) financial risks, as borrowing costs for some industries have spiked and customers have delayed or defaulted on payments. The following is a short summary of the Guidance, available at the OECD website.

1. *Comparability analysis*

The following sources of information may support that determination through the comparability analysis, generally by estimating the effect of the COVID-19 pandemic on the controlled transactions under review:

- An analysis of how sales volumes have changed during COVID-19, including whether the change is due to the use of other sales channels, and specifically compared to sales generated in pre-COVID years,
- An analysis of the change in capacity utilization relevant for the MNE group and the controlled transaction, and/or transactions with independent parties;
- Specific information relative to incremental or exceptional costs borne by parties to the controlled transaction (either with associated or unrelated parties) or by the MNE group as a whole
- The extent to which government assistance has been received and, if so, quantifying the effect and identifying the type of the assistance and its accounting treatment;
- Details regarding government interventions that have affected the pricing and performance of controlled transactions;
- Information from interim financial statements such as quarterly SEC filings or earnings releases;
- Macroeconomic information like country specific GDP data or industry indicators form central banks, government agencies, industry or trade associations to the extent useful in understanding the context of the controlled transaction;
- Statistical methods such as regression analysis or variance analysis that are used to predict the extent to which a certain variable will vary with reference to other variables under certain specific conditions;
- A comparison of internal budgeted/forecasted data relating to sales, costs and profitability, compared to actual results; and
- An analysis of the effects on profitability or on third party behavior observed in previous recessionary periods or using any data available in the current year, even if partial.

Since comparable data from independent comparable transactions or companies from other time periods, such as average returns in preceding years, may not provide a sufficiently reliable benchmark for the current period, the Guidance suggests several approaches to assist in determining the applicable transfer price, such as the use of reasonable commercial judgement supplemented by contemporaneous information on the market; use of more than one transfer pricing method; utilize data from other crises may be used to support price setting, and etc.

2. *Losses and the allocation of COVID-19 specific costs*

During the COVID-19 pandemic, many MNE groups have incurred losses due to a decrease in demand, inability to obtain or supply products or services or as a result of exceptional, non-recurring operating costs. The allocation of losses between associated entities can give rise to dispute and hence is an issue that requires consideration given the probable increase in the frequency and magnitude of losses in the current economic environment. When considering the issue of losses and the allocation of COVID-19 specific costs, three issues warrant specific discussion:

First, it is important to emphasize that the allocation of risks between the parties to an arrangement affects how profits or losses resulting from the transaction are allocated at arm's length through the pricing of the transaction;

Second, it is necessary to consider how exceptional, non-recurring operating costs arising as a result of COVID-19 should be allocated between related parties. These costs should be allocated based on an assessment of how independent enterprises under comparable circumstances operate.

Finally, the COVID-19 pandemic has created conditions in which associated parties may consider whether they have the option to apply force majeure clauses, revoke or otherwise revise their intercompany agreements. This may impact the allocation of losses and CPVID-19 specific costs between associated parties, and therefore also requires specific consideration in the current economic environment.

*3. Government assistance programs*

Government assistance is a monetary or non-monetary program where a government or other public authority provides a direct or indirect economic benefit to eligible taxpayers such as grants, subsidies, forgivable loans, tax deductions, or investment allowances. Governments have also provided broader financial and liquidity supports to ensure enterprises can continue to operate through the period of reduction in business activity, include: (i) loan guarantees; (ii) direct financing to business on preferential terms; (iii) loan deferrals; (iv) specific grants and (v) tax relief.

The terms and conditions of government assistance programs related to COVID-19 need to be considered when determining the potential impact of these programs on controlled transactions. If the government assistance is an economically relevant characteristic, this information should be included as a part of the documentation to support the transfer pricing analysis.

Under the guidance in Chapter II of OECD TPG, when establishing arm's length prices using one-sided methods, particular care must be taken to avoid adopting without further analysis a particular mechanical approach, since this could lead to non-arm's length prices in transactions among associated parties. Caution should be exercised in assessing whether a purported sharing of government assistance represents an arm's length outcome.

*4. Advance Pricing Agreements*

COVID-19 has led to material changes in economic conditions that were not anticipated when many APAs covering FY2020 and potentially future financial years affected by COVID-19 were agreed. Given this situation, it is important to determine to what extent, if any, the change in economic conditions affects the application of existing APAs.

Some taxpayers may face challenges applying existing APAs under the economic conditions resulting from the COVID-19 pandemic. In those instances, taxpayers are encouraged to adopt a collaborative and transparent approach by raising these issues with the relevant tax administrations in a timely manner. Taxpayers should not seek to resolve them unilaterally without consulting with the relevant tax administrations. Also, Taxpayers and tax administrations cannot automatically disregard or alter the terms of existing APAs due to the change in economic circumstances.

When considering the consequences of the failure to meet critical assumptions, tax administrations and taxpayers should consider the (i) terms of the APA; (iii) any agreement between relevant tax administrations as to how to deal with the failure; and (iii) any applicable domestic law or procedural provisions. The Guidance further describe which actions would fit under which circumstances.

Conclusion:

The Guidance provides a set of useful and (where possible) practical examples on how taxpayers and tax administrations should proceed in order to reach the most appropriate outcome, applying the arm's length principle. As noted, even though the Guidance is not considered to be an amendment of or formal addition to the existing OECD TPG, it represents a useful basis for MNEs and tax administrations on how to navigate the continuously uncertain times ahead.