

US OUTBOUND

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Transfer pricing implications of COVID-19: Revisiting pricing, contracts, and APAs

Mark Martin and Thomas Bettge of KPMG in the US explore certain implications of the global COVID-19 pandemic for companies' transfer pricing arrangements.

The COVID-19 pandemic has sparked a public health crisis and wrought severe disruptions in countries across the globe. On top of novel operational challenges associated with supply chain disruptions and the transition to a remote workforce, businesses must grapple with the demands of tax compliance, and tax administrations have responded with an array of measures designed to alleviate these pressures and stimulate the economy. Amidst the broader landscape of business and tax concerns, transfer pricing (TP) is one item among many, yet it presents issues that are particularly pressing during these uncertain times.

Many companies' TP policies have been based on patterns of global economic growth that generally prevailed over the past decade. These policies, which often involve subsidiaries throughout the globe with more or less limited risk profiles, were generally implemented from a perspective of profit-sharing, and may be poorly suited to the allocation of losses resulting from the COVID-19 pandemic. In particular, multinational enterprises with significant limited risk subsidiaries need to determine just how limited their risks are. For instance, can limited risk distributors bear a portion of the losses arising from the pandemic's effect on their markets, or does the affiliated entrepreneur need to ensure that they reach a specified profit level, even if this exacerbates the entrepreneur's losses?

In grappling with these and other questions, businesses should start by revisiting their inter-company agreements. Some may find that they have flexibility to adjust pricing policies to respond to unforeseen circumstances, or that a *force majeure* clause provides an exit, while others may realise they have locked themselves into a result that no longer makes economic and/or business sense. Companies in the

latter camp may be able to amend their agreements, but should be prepared to address potential challenges by tax authorities, which may argue that consideration is required for the amendment in some cases. Moreover, if a change in TP policy is not accompanied by a change in functions, assets, and risks, tax authorities might not respect the change, or might challenge prior year results on the basis of the new policy.

Changing TP policies poses another quandary: how are companies to know what is arm's-length? While comparable data showing how independent companies were affected by COVID-19 will not be available until sometime next year, Treas. Reg. § 1.482-1(a)(3) provides flexibility for U.S. taxpayers reporting transfer prices. Taxpayers may affirmatively use section 482 to report prices other than those charged on a timely, original tax return if necessary to arrive at an arm's length result. Amended or untimely returns may also be used to report corrected arm's-length prices, but only if this increases U.S. taxable income. However, such adjustments may not be respected in counterparty countries.

The doctrine of rescission may provide relief for taxpayers who wish to undo, rather than modify, related party transactions. Rev. Rul. 80-58 provides that a rescission will be respected, and the original transaction disregarded, if the rescission occurs in the same taxable year as the original transaction and the parties are returned to the status they occupied prior to such transaction. Again, whether a rescission will be respected in a counterparty jurisdiction depends on foreign law, and rescission poses other challenges as well. For example, taxpayers should exercise caution when rescinding and then entering into a substitute transaction, as the step transaction doctrine could be invoked to invalidate the rescission, though some Internal Revenue Service (IRS) letter rulings have given effect to rescissions under these circumstances.

Taxpayers who currently have advance pricing agreements (APAs) also need to take into account COVID-19's impact to the APA. The continuing viability of an APA is premised on the satisfaction of its critical assumptions, which are APA-specific but usually include an assumption that the business activities, functions, risks, and assets of the taxpayer remain materially the same as those described in its APA request. Whether or not a critical assumption is breached, taxpayers may consider seeking the IRS' and any applicable foreign tax authorities' consent to revise their APAs in response to this pandemic. Where a critical assumption is not met and the

parties cannot agree on revision, the IRS may cancel the APA. While this presents a risk for some taxpayers, it may be an opportunity for others who find that their APAs are not suited to the new realities of their business.

The TP issues raised by the COVID-19 pandemic are wide-ranging, and vary between industries and even between taxpayers. This column only addresses a few of the most significant concerns. It is to be hoped that tax authorities will take a flexible approach to addressing COVID-19's impact on TP, and taxpayers should proactively initiate discussions with tax authorities where appropriate.

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