

# Transfer Pricing In The Time Of COVID-19



Many Canadian businesses have closed the books on their 2020 fiscal year, having faced an unprecedented economic shock wrought by the pandemic. 2020 fiscal year results will undoubtedly be affected, in many cases to the downside, though positively for those businesses serving customers working and learning in a virtual environment and filling strong demand for PPE. As enterprises prepare 2020 income tax filings, there are special considerations for those multi-national enterprises (MNEs) subject to Canada's transfer pricing (TP) rules. In this Bennett Jones blog, we summarize recently released guidance from the Organization for Economic Development and Cooperation (OECD) on COVID-19-impacted TP, drawing attention to relevant statements by the Canada Revenue Agency (CRA).

## OECD Pandemic Guidance & Canadian Application

On December 18, 2020, the OECD released their guidance on the transfer pricing implications of the COVID-19 pandemic. The guidance is intended as an interpretive guide to the OECD's 2017 Transfer Pricing Guidelines. Canada is an active participant at the OECD on tax matters and CRA generally follows the guidelines but it is important to remember that the guidelines and the guidance do *not* have the force of law in Canada. The guidance clarifies the guidelines in the following four areas:

1. comparability analysis;
2. losses and the allocation of COVID-19 specific costs;
3. government assistance programs; and
4. advanced pricing agreements.

## Comparability Analysis

Comparability analysis is at the heart of TP since it is the essence of the TP rules that the terms and conditions of transactions and arrangements between non-arm's length parties be comparable to those that would have been made between persons dealing at arm's length. Helpfully, the guidance encourages a practical approach to dealing with the unique challenges for performing comparability analysis created by COVID-19, implicitly encouraging tax administrations not to be too demanding or inflexible when performing a risk assessment or judging the reasonableness of a taxpayer's efforts to comply with the arm's length principle.

Good data sources are essential for taxpayers to substantiate their TP and the

guidance provides that any form of publicly available information regarding the effect of COVID-19 on the business, industry and particular transaction or arrangement at issue within the MNE may be relevant. Recognizing that detailed data may not be available, the guidance helpfully allows that data sources may be supplemented with reasonable commercial judgement. The guidance does caution against the use of historical data from other economic crises that had dissimilar impacts.

The guidance recommends using more than one transfer pricing method to determine the arm's length price and provides that the use of multiple year data and multiple year averages for comparability analyses may have certain advantages. The guidance also encourages an arm's-length outcome testing approach where feasible (instead of a "price-setting" or *ex ante* approach) and discusses the value of price adjustment mechanisms as a potential solution to address the issue of the lack of contemporaneous information. While CRA has endorsed the use of multi-year data where it improves reliability, caution is necessary in applying the guidance in the Canadian context, since downward price adjustments are not automatic under Canadian TP rules and require consent of the Minister.

## **Losses and the Allocation of COVID-19 Specific Costs**

With respect to the allocation of losses between associated entities and COVID-19 specific costs, the OECD discusses three particular areas of concern: allocation of risk, exceptional and non-recurring operating costs and force majeure clauses.

With respect to the allocation of risk, the guidance outlines that existing risk allocation principles still apply and that "limited risk" distributors may be found to incur losses; however, the guidance cautions taxpayers against taking inconsistent positions pre- and post-pandemic on risk allocation.

On exceptional and non-recurring COVID-19 related costs, such as expenditures on PPE, the OECD provides that the allocation of such costs should follow risk assumption and how third parties would treat such costs. Additionally, the guidance discusses that it will be important to consider whether any pertinent cost basis should include or exclude exceptional costs, and if included, whether they be treated as "pass-through" costs without markup/profit element.

On the third and final prong, the OECD discusses the invocation of force majeure clauses and states that the particular agreement and underlying legal framework should form the starting point of a TP analysis. The guidance recognizes that arm's length parties may choose not to strictly enforce all contract terms where it is not in their interest to do so (such as jeopardizing the survival of a key customer or supplier). This is an important acknowledgement by the OECD and where an intercompany agreement does not contain a force majeure clause or it was not formally invoked, a departure from the terms may be permissible if arm's length parties in comparable circumstances would have agreed to such modifications.

## **Government Assistance Programs**

Many governments responded to the economic shock with assistance programs for businesses as well as individuals. Canada was a leader in the amount of assistance provided to the economy and the Canada Emergency Wage Subsidy (CEWS)

alone represents \$60 billion in subsidy.

The guidance provides that government assistance should be generally considered as a market condition and factors to consider include:

- whether the receipt of government assistance provides a market advantage to the recipient;
- the amount of any increase in revenues, decrease in costs, vis-à-vis those of reliable comparables, that are attributable to the government assistance received, and the duration of the assistance; and,
- the degree to which benefits of government assistance, at arm's length, are passed on to independent customers or suppliers.

The guidance also notes that it would be contrary to the arm's length principle to assume that the mere receipt of government assistance would affect the price of the accurately delineated controlled transaction (without performing a careful comparability analysis). Again, caution is required in applying this guidance in the Canadian context, as CRA has stated publicly their expectation that the Canadian taxpayer would keep the benefit of assistance from the Canadian government and not effectively share it through a pricing formula or adjustment. Taxpayers should also be aware that the CRA is actively auditing CEWS recipients, often with onerous demands for information.

### **Advance Pricing Arrangements (APAs)**

The guidance states that APAs cannot simply be disregarded by taxpayers or tax administrations. Not surprisingly, it encourages taxpayers to raise APA issues with the relevant tax administrations promptly and to develop supporting documentation addressing unique pandemic circumstances.

### **Conclusion**

The COVID-19 pandemic has created the biggest economic shock in generations, with very material consequences to business. Parsing how these consequences impact TP reporting and compliance in 2020 and subsequent years is a complex exercise. While the OECD has provided some largely helpful guidance to taxpayers, it is general in nature and does not have the force of law in Canada. Taxpayers need consider whether and how to adjust their TP reporting, taking into account not only recent statements from the CRA on pandemic impacts, but also recent developments in Canadian case law, changes in CRA's assessing practices and changes to Canadian TP legislation that have the potential to increase penalties.

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