Impact of the "new normal" on tax enforcement in transfer pricing

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The unusual business conditions of the Covid-19 outbreak will require a more flexible approach from tax authorities when analysing transfer pricing in the 2020 year of assessment.

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The Covid-19 outbreak in late 2019 / early 2020 has impacted the way we live daily and has had a devastating impact on the global economy. While countries struggle to revive ailing economies with interest rate cuts and capital injections, tax authorities need to be more flexible when enforcing transfer pricing for affected transactions in the 2020 year of assessment.

Most transfer pricing investigations start off as a desk audit when large amounts of data are collected and analysed by the tax administration. Most of this activity can be performed remotely. With reliable technology, the functional analysis interviews can also be conducted remotely. The main change to transfer pricing enforcement is the flexibility that tax authorities will have to exhibit when applying the arm's length principle.

One of the important comparison issues will be how business operations changed during the various levels of lockdown. Many multinationals have key individuals providing high value-add activities to the supply chain and operational effectiveness of the group. These personnel were dislocated from their normal place of work and had to carry out these substantial business activities remotely.

Many countries have provided guidance on the impact these employees have on tax resident status, employees' tax and permanent establishment issues, but very few have considered the impact on transfer pricing. Tax authorities would need to consider the people affected, the location, duration and importance of the functions they perform and the potential impact the dislocation could have on transfer pricing models. For example, there would be an impact on the intra-group services provided remotely rather than from a central location, and an impact on the development of the group's intangible assets. The impact of remote working affects individual employees as well as supply chains. Many companies were forced to move aspects of their supply chains to a remote operation, for example when sales and distribution centres functioned remotely.

Tax and the digital economy

The Organisation for Economic Co-operation and Development (OECD) is grappling with taxing the digital economy in its traditional sense (for example, Google or Amazon), and now Covid-19 is likely to see a greater shift towards conducting business activities remotely. The draft guidance from the OECD seeks to assist tax authorities to identify and tax profits arising in locations where a company has a digital footprint but no physical presence. With key changes in business operations to remote activities, this draft OECD guidance could also be relevant to businesses outside the traditional digital economy.

One of the greatest challenges arising from the Covid-19 lockdowns has been the impact on the economy and the "new normal". Tax authorities usually apply the arm's length principle by determining the profits from a transaction which entity XA in Country A entered into with a related party XB in Country B based on the comparability of the terms and conditions which would have existed had XA and XB transacted independently.

To justify a transaction as arm's length, taxpayers compile transfer pricing reports using benchmarked data. Benchmarking identifies internal or external comparable data using the most appropriate transfer pricing method (such as the transaction net margin method) for the relevant years, often with comparability adjustments made to the data. Tax authorities rely on this data to determine whether the company they are auditing has transacted with connected parties at arm's length. The benchmarking data is pivotal in enforcing the arm's length principle.

Comparability issues

The challenge with comparability data is the time lag. Invariably, there is a two- to three-year lag before the data is available to be used for the year under review. An analysis supporting 2020 would normally rely on data available for 2016-2018. This data would create significant comparability issues as it would not reflect the impact of the devastating economic downturn or significant changes to business operations in 2020. Whether such data could be suitably adjusted is questionable.

Although the use of multiple-year data could provide a more reasonable comparison, it is still doubtful whether this data would truly reflect the impact of the pandemic and its associated economic recession. An alternative could be to use data from the previous recession years during the global financial crisis in 2007-2008. Although that historical data may provide a comparison for the current economic impact, it would not necessarily reflect changes in business operations as a result of more activities being carried out remotely.

Adjustments

Another alternative is to consider whether comparability adjustments could be made. Tax authorities often rely on these adjustments where there are comparability defects between the benchmark data and the tested party. Economic circumstances relating to the transaction under review are a key comparability factor.

The extent of any comparability adjustments should also consider the nature of the transaction under investigation. For example, a distributor selling a diverse portfolio of goods may be less impacted than a manufacturer that experienced significant operational downtime. The impact of the lockdown would have also been experienced differently depending on the nature of the tested party and the industry. Businesses which were already operating remotely would exhibit less dramatic changes than those which are historically bricks-and-mortar industries. Certain industries may also be more affected than others. In South Africa, the hospitality, airline, liquor and tobacco industries have been decimated, but those providing telecommunication services and online retailers are less affected.

In a benchmarking analysis, it is common to adjust the results of the comparables. However, it may be more accurate to adjust the financial performance of the tested party to "normalise" its profits for 2020. The difficulty of doing this lies in identifying and justifying the items on the income statement which should be adjusted. For example, bad debts or inventory write-offs could be considerable and significantly higher than in previous years. The company's overall costs may also have increased significantly, requiring an adjustment to the normal levels in previous years.

More scientific adjustments or analysis can be undertaken to determine how the drop in sales impacts profitability so as to apply adjustments to the comparable data. A less scientific approach could be for the tax authorities simply to accept a more appropriate point in the range, such as the lower quartile result of the data set to be an arm's length result.

It is clear that tax authorities will have to be open to differing approaches in adjustments to comparable data when investigating and enforcing transfer pricing for transactions undertaken in the 2020 year. Taxpayers should also ensure that all commercial decisions and changes in business operations which have an impact on the existing transfer pricing model should be clearly documented and justified in anticipation of an audit by the relevant tax authorities.

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