Tax Alert

14 December 2020

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Alan Seccombe
Johannesburg
+27 (0) 11 797 4110
alan.secombe@pwc.com

Michael Butler
Cape Town
+27 (0) 21 529 2393
michael.butler@pwc.com

Corneli Espost
Cape Town
+27 (0) 21 529 2171
corneli.espost@pwc.com

Archi Ramana
Johannesburg
+27 (0) 11 797 5977
archi.ramana@pwc.com

COVID-19: the impact of the pandemic on transfer pricing

In brief

The COVID-19 pandemic has been the defining event of 2020. With the extraordinary and unprecedented economic conditions under which the global economy is operating, businesses worldwide are facing innumerable challenges. In the context of transfer pricing, such challenges include how to realign existing supply chain arrangements in order to adapt to the changed environment and how to undertake arm's length comparability or benchmarking analyses in the absence of contemporaneous comparable data.

Governments around the world also face significant challenges. They are under immense pressure to fund unplanned expenditures, which include various stimulus packages that have been put in place to support the recovery of their economies. In this context, governments are, in the coming years, likely to adopt an aggressive approach in the collection of tax revenues.

While we await guidance to be issued by the OECD's Working Party No. 6 on the transfer pricing implications of the COVID-19 pandemic, this Alert highlights the transfer pricing considerations that should be top of mind for multinational corporations in the context of a potential global recession induced by the pandemic.

Comparability analysis

Under the existing South African transfer pricing guidelines, every attempt should be made to set prices on a contemporaneous basis using the best data available at the time. In practice, financial data typically used for the purposes of benchmarking only becomes available after a lag period of one to two years.

For example: the financial data for 2018 may be the most recent available point of reference for taxpayers.

When conducting comparability studies for years impacted by the effects of the pandemic, it is therefore necessary to consider whether any appropriate economic and market comparability adjustments need to be made.

Some direction may be found on possible approaches to enhance comparability from guidance issued by proactive government authorities (such as, for example, the Australian Tax Office and the Inland Revenue Authority of Singapore).

Financial transactions

Supply chain disruptions, coupled with a drop in revenue, have triggered unanticipated pressures on cash flow and liquidity.

These have forced businesses to evaluate external sources of liquidity and to revisit internal sources. This gives rise to a number of issues that require consideration, including intercompany financing (such as loans, cash-pooling arrangements and guarantees on third-party debt), as well as issues relating to loan valuation and pricing.

In this regard, critical questions that need to be answered include the following:

- How will group companies combat short-term liquidity problems? Would, for example, cash pooling arrangements assist?
- Should working capital that is comprised of irrecoverable or doubtful debt be characterised as equity?
- How should additional parental guarantees in respect of existing financial arrangements be treated?
- Does a devalued credit rating impact the level of borrowing or interest rate?
- Do existing intercompany agreements require amendment in order to cater for payment dispensation?

Functional characterisation

A common issue that will be faced by multi-national entities ('MNEs') relates to entities within the group who are functionally characterised as 'limited-risk' entities and who typically earn guaranteed margins under the Transactional Net Margin transfer pricing method.

Consideration will need to be given to whether such entities should share in the group's losses, and whether this will have any long-term implications.

Some approaches that may be considered in respect of the functional characterisation of the parties concerned include the following:

- Conducting a functional analysis of the entity and its connected persons before and after COVID-19 (to illustrate any re-allocation of functions, assets, and risks, as well as any recharacterisation);
- Documentation of who and which entities in the group were responsible for making decisions relating to the management of risks arising from COVID-19 to demonstrate the risk-bearing entities; and
- Documenting amendments in contractual agreements which may have a bearing on the functional profile of the parties concerned.

Business restructurings

Having faced significantly long periods of poor trading conditions, businesses will need to assess the impact of COVID-19 on various assets, investments, and/or business segments, and whether these are still feasible in the light of their changed circumstances.

Such an assessment may give rise to the need to implement structural changes, such as divesting of non-strategic assets, simplification of group structures, liquidations, and the winding down of non-profitable business segments. Such structural changes will bring about the need to review the relevance of the MNE's existing TP policies and to consider revising these.

Permanent establishments

Globally, during the early phases of the pandemic, various countries implemented travel restrictions and lockdowns. The inevitable result was that various business activities were required to be carried out by business personnel in the location where they were located, which may have been different to their usual place of work.

As a result of these travel restrictions and lockdowns, consideration needs to be given to whether such activities are carried out in the respective locations on a long-term basis, or purely temporarily as a direct result of travel restrictions or lockdowns.

In some instances, significant decision-makers were stranded outside of their usual working location for several months, or were unable to travel to other jurisdictions for board meetings. Under normal conditions, tax authorities may seek to delineate the transaction and use this to inform their assessment of where profit should arise during the relevant period. In this regard, recognition by the SARS that travel restrictions and lockdowns should be taken

into consideration when assessing the application of a transfer pricing policy (and in particular in delineating the underlying transactions) would be welcomed. As an aside, the *OECD Secretariat Analysis of Tax Treaties and the Impact of the COVID-19 Crisis* encourages tax authorities to adopt such an approach.

Key takeaway

The circumstances arising from the pandemic are unique and unprecedented. While uncertainty exists regarding the approaches that will be adopted and accepted by tax authorities globally, it is critical to consider what independent enterprises would have done in the circumstances. If a change in value is so fundamental that it would have led to a renegotiation of the transaction at arm's length, such a renegotiation between related parties may be warranted.