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# The impact of the 2022 economic crisis on transfer pricing

## Introduction

The impact of the economic crisis on transfer pricing will cover the following subjects:

- How does the 2022 crisis impact the profitability of limited risk affiliated entities?
- Can comparability studies take into consideration the effects of the crisis?
- What are the consequences of the 2022 crisis on the intragroup financing?
- How should multinational entities (MNEs) manage the consequences of the crisis during tax audits?

Mazars' position is taken in light of the OECD Transfer Pricing Guidelines published in January 2022, and the OECD Guidance on the transfer pricing implications of the Covid-19 pandemic published on 18 December 2020, which provides comments on the application of the arm's length principle and the OECD Transfer Pricing Guidelines to issues that may arise or be exacerbated in the context of the crisis (hereinafter "OECD Guidance").[1]

[1] Although this document focuses on the OECD's published guidance, our recommendations would be considered appropriate and relevant to transfer pricing in most countries, including countries with transfer pricing regulations not based on the OECD Guidelines and countries that are not OECD Member countries).

## How does the crisis impact the profitability of limited risk affiliated entities?

### 1. Root causes of the crisis

The root causes of the 2022 crisis can be summarised as follows:

- Significant inflation in some countries leading to an increase in payroll costs for MNEs.
- A shortage of employees to fill vacant positions within MNEs due to travel restrictions/curbs.
- Disruption in the overall supply chain leading to lack of availability of certain raw materials and finished products, leading to delays in production and employment costs for certain MNEs.
- Rising energy prices and risk of partial employment.
- Increased logistics costs.
- Lack of opportunity to transfer all price increases to end consumers.
- Difficulty in reducing operating costs, particularly fixed costs.
- Danger of reduced demand as a result of inflation and other related factors.

These issues will contribute to a reduction in profitability of MNEs in 2022.

With this in mind, how can profit reduction be allocated to limited risk affiliated entities?

### 2. The OECD's position

Regarding the possibility for limited-risk companies to incur losses, the OECD Guidance (§39) states:

"*In all circumstances it will be necessary to consider the specific facts and circumstances when determining whether a so-called "limited-risk" entity could incur losses at arm's length. This is reflected in the OECD TPG which states that "simple or low risk functions in particular are not expected to generate losses for a long period of time", and therefore holds open the possibility that simple or low risk functions may incur losses in the short-run. In particular, when examining the specific facts and circumstances, the analysis should be informed by the accurate delineation of the transaction and the performance of a robust comparability analysis*."

Regarding the allocation of exceptional costs, the OECD Guidance (§48) states:

"*Allocation of operating or exceptional costs would follow risk assumption and how third parties would treat such costs. Thus in order to determine which associated enterprise should bear exceptional costs, it would be first necessary to accurately delineate the controlled transaction, which would indicate who has the responsibility for performing activities related to the relevant costs and who assumes risks related to these activities. For example, if a cost directly relates to a particular risk, then the party assuming that risk would typically bear the costs associated with that risk*."

### 3. Our recommendations

We recommend MNEs implement the following:

- Adapt and adjust the functional profile of limited-risk subsidiaries to share the deterioration of their margins or losses between them. This modification will require a preliminary and thorough examination of the specific facts and economic circumstances (including the actual activities/operations) of each company/MNE and their overall contribution to the value chain.
- Document and justify the changes occurring in transfer pricing policy in 2022, backed by solid commercial rationale and supporting documentary evidence or analysis.
- Renegotiate and appropriately amend contracts with third-party customers and

affiliates to include, for example, a price adjustment clause due to inflation.

## Can comparability studies take into consideration the effects of the crisis?

1. **The difficulties raised by the current crisis**

MNEs will no longer be able to use financial data from the previous three years of comparable companies, because they do not reflect the current economic situation as the operating profitability of all companies has been impacted by the Covid-19 pandemic.

These challenges impact both the application of the transactional net margin method and the resale price method (with external comparables), as these methods primarily test the profitability of the legal entity.

Therefore, MNEs will need to adjust financial data using:

- Macro-economic information: adjustments according to inflation in each country, specific sector data or industry figures, etc.; and
- Micro-economic data: adjustments based on each subsidiary case, depending upon the local regulations.

It will also be necessary to determine which financial data must be adjusted:

- Those of comparable companies; or
- Those of the tested party.

2. **The OECD's position**

Regarding the timeframe to be used, the OECD Guidance (§16 and 29) states:

"*[The difficulties] suggests that in these circumstances taxpayers will need to perform a comparability analysis based on available prior year financial information and, depending on the facts and circumstances of the case, utilising whatever current year information is available to support their transfer prices*."

"*Just as it may improve reliability to use separate or more carefully circumscribed testing periods (or price setting periods) in some fact patterns, in other fact patterns the use of combined periods (that include both years that are impacted by the pandemic and years that are not impacted) may improve reliability.*"

Regarding the adjustments, the OECD Guidance (§21 and 30) states:

"*MNE groups should document the best available market evidence currently available, which may be in the form of internal comparables, external comparables, or other relevant evidence of the economic impact of the COVID-19 pandemic, including its effects on the level of demand for goods and services, and on production and supply chains in particular sectors of the economy*."

"*One potential solution to the uncertainty caused by the COVID-19 pandemic would be to allow for the inclusion of price adjustment mechanisms in controlled transactions. This may provide for flexibility while maintaining an arm's length outcome*."

3. **Our recommendations**

Adjust comparable studies based upon macro and micro economic data, specific to the sector in which the company operates in and subject to the acceptance by the local tax authority.

Carry out a final additional review when the 2022 financial data of the comparables will be available and consider a new adjustment at that time if necessary, depending upon the facts and circumstances of the case.

## What are the consequences of the crisis on intragroup financing?

### 1. Difficulties associated with the crisis

It is expected that interest rates will continue to rise in the second half of 2022.

This, along with the deterioration of the margins of certain companies, will limit the borrowing and lending capacity of MNEs.

It will also increase their default risk, and relatively deteriorate their credit rating and position.

### 2. The OECD's position

Regarding the assessment of the borrower's creditworthiness, the OECD Principle (§10.54) states:

"*An independent lender will carry out a thorough credit assessment of the potential borrower to enable the lender to identify and evaluate the risks involved and to consider methods of monitoring and managing these risks. That credit assessment will include understanding the business itself as well as the purpose of the loan, how it is to be structured and the source of its repayment which may include analysis of the borrower's cash flow forecasts and the strength of the borrower's balance sheet*."

Regarding the lender's interest, the OECD Principle (§10.57) states:

"*In deciding whether a prospective loan is a good commercial opportunity, a lender will also consider the potential impact of changes which could happen in economic conditions affecting the credit risk it bears, not only in relation to the conditions of the borrower but in relation to potential changes in economic conditions, such as a rise in interest rates, or the exposure of the borrower to movements in exchange rates*."

### 3. Our recommendations

When concluding intra-group financing contracts (whether short or long-term), it will be necessary to:

- Ensure that the borrower and lender both has the capacity to borrow and lend.
- Ensure the term and payment terms of the loan are in line with the repayment capacity of the borrower.
- Adjust credit ratings in the event of a significant deterioration in the solvency of intra-group borrowers during 2022. Credit ratings are computed based upon N-1 P&L and balance sheet.
- In case of any potential or unforeseen default by the borrower, appropriate back-up or financial cushioning should be available with the lender.
- Carry out a financial study to determine the interest rate prior to the conclusion of an intra-group loan agreement.
- Ensure the interest rates used in intra-group financing are aligned with those practiced in the country of the borrower.

The interest rates used in short-term intragroup financing should be based on floating rate. Fixed interest rates will likely have to be increased before the fiscal year-end.

Intra-group contracts will also have to be amended appropriately, considering the specific facts and circumstances.

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## How should MNEs manage the consequences of the crisis during tax audits?

1. **The impact of the crisis on the number of tax audits**

To finance the cost of the crisis since 2020, tax administrations are increasing the number of their tax audits around the world.

Most MNEs have had to manage several tax audits at the same time throughout 2022; often ongoing in different jurisdictions.

As a result, the risk of double taxation of MNEs is also growing rapidly.

Tax administrations also focus on cross-border intra-group transactions, and look for specific instances of possible profit shifting.

Some tax audits specifically relate to the Covid-19 period.

Some companies have incurred losses since the start of the crisis in 2020, or have had to deal with a significant deterioration in their margins which must be justified.

The increase in interest rates, which started in 2022 along with the ease of reassessing intra-group loans and guarantees, will lead tax authorities to focus on this type of transaction in the coming years.

2. **Our recommendations**

- Undertake a detailed diagnostic review of the existing pricing policies to identify potential transfer pricing risks ahead of tax audits and develop strategies to reduce them.
- Document the economic context of the years audited and its impact on your group or certain subsidiaries.
- Justify any changes in transfer pricing policy with appropriate reasons and supporting documentary evidence.
- Update intra-group legal documentation.
- Adjust intragroup financing strategies. If the MNEs are no longer able to deduct their intragroup interest charges from their taxable results, they ought to switch to equity injection in order to finance their operations.

We hope that tax authorities will follow the OECD Guidance (§21) that "*tax administrations are encouraged to keep these complexities in mind when performing risk assessments, evaluating transfer pricing positions on audits and considering the support and documentation taxpayers provide that might demonstrate reasonable efforts and care when trying to comply with the arm's length principle*."

## Conclusion

As a conclusion, MNEs need to take the following actions in 2022

- Adjust the functional profile of their limited-risk subsidiaries.
- Enhance the content of their economic context and TP documentation with sufficient back-up documentary evidence.
- Adjust their comparable studies to take into consideration the effects of the crisis, both in terms of their operations and profitability.
- Consider the interest rates increases in 2022 in the setting up of their intragroup interest rates.
- Diagnose potential transfer pricing risks ahead of tax audits, and develop robust and holistic strategies to reduce them.
- Justify any changes in transfer pricing policy with proper rationale and documentary evidence.
- Update intra-group legal documentation.
- Reassess intragroup financing strategies. If MNEs are no longer able to deduct their intragroup interest charges from their taxable results, they ought to switch to equity injection to finance their operations.

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