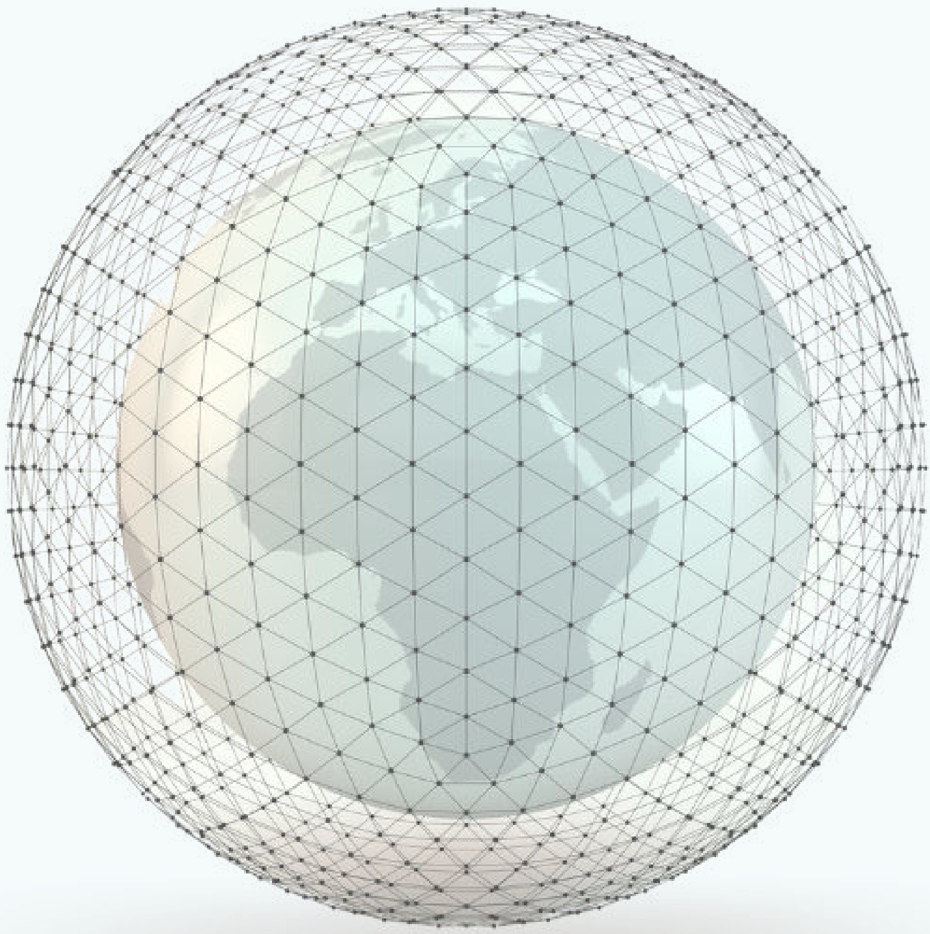
J P Chawla & Co. LLP
Chartered Accountants

Impact of COVID-19 on Transfer Pricing



www.jpc.co.in

Introduction

The economic impact of the COVID-19 pandemic in India had been devastating, with lot of industrial sector recording negative growth, although few sectors like Pharmaceuticals and Information technology is booming like never before.

Recently Industrial and commercial activities have started picking up in a gradual manner after various waves of the pandemic, but there is still a long way to go to make it business as usual and revive India's growth story.

Things are getting normalized in terms of certain industries, but still, a large number of sectors such as entertainment, brick and mortar retail and transportation and travel remain impacted.

The Indian economy contracted in FY 2021 and then again contracted in the first quarter of FY 21-22, and growth became negative in the first two quarters of fiscal 2020-21. The government has done its bit by bringing various relief packages, but there are instances of large lay-offs and salary cuts, due to falling or nil demand of goods and services.

The growth forecast has been cut and changed again and again by various agencies such as IMF, world bank, credit rating agencies and RBI. The measures to pump prime the economy is on, but the fear of low growth and unemployment is becoming a new reality. Although as a surprise, the first-quarter growth of Indian GDP at Current Prices in the year Q1 2021-22 is estimated at ₹ 51.23 lakh crore, as against ₹ 38.89 lakh crore in Q1 2020-21, showing a growth of 31.7 per cent as compared to the contraction of 22.3 per cent in Q1 2020-21.

There are certain industries such as Information technology, Information technology-enabled services and Ecommerce that have grown beyond expectations in this covid economy, but industries such as hospitality, tourism, aviation and travel, automobile, real estate, which have been affected in a negative way.

In fact, on the positive side, India has received a record FDI during the pandemic, with digital entities like Facebook investing in Reliance Jio etc.

The value chain in an international transaction has been completely disrupted due to COVID-19. The changing business environment due to covid-19 and the change in the value created by each associated enterprise should be economically justifiable in the MNE's value chain in order to consider a related party transaction with a substance and at arms-length.

In context with the transfer pricing policy prepared by an MNE having various associated enterprises to envisage a basis for transfer pricing in the MNE group and respective value drivers in the value or supply chain of the MNE's business model needs to be revised by the MNE group to take care of the impact of Covid-19 disruption.

Transfer pricing policy should be adequately changed with an assumption of independent conditions which would prevail if the associated parties would have not been related accordingly resulting in the performance of independent functions by various associated entities in the whole supply chain of the MNE, further resulting in accurate capturing of profits with each associated enterprise and taxation of such profits in respective tax jurisdictions.

The changes in services such as work from home or anywhere model – disrupting office spaces, the entities who used centralized sourcing model had to decentralize their sourcing, increase in capital risk due to disruption of cash flows leading to change in financing needs, change in the business model for retailers from brick & mortar to e-commerce and various functions in an entity becoming redundant suddenly due to lockdowns.

The disruption in the value chain of an entity effecting the function, assets and risk analysis needs to be analyzed and robustly documented in the respective local transfer pricing files so that any change in the arm's length price in the affected years can be justified to the tax authorities.

The requirement of documentation arises from the fact that transfer pricing regulations require a thorough audit trail for justification of arms-length pricing between two associated enterprises. Another reason for extensive transfer pricing documentation is risk mitigation for corporate governance purposes, the board of directors of an entity are more comfortable if an entity has appropriate transfer pricing documentation, which can be used as a tax risk mitigation tool.

Due to Covid 19 related impact, there is an expectation of increased scrutiny from the Income-tax department leading to increased risk of transfer pricing adjustments, so changes due to Covid disruption should be adequately analysed and recorded in the whole transfer pricing documentation life cycle, which generally consists of transfer pricing policy, transfer pricing planning file, transfer pricing local file, transfer pricing master file and country by country reporting.

The challenges in economic analysis are expected in respect of lack of availability of comparable data, method selection, lack of guidance on adjustments, use of loss comparable, timing issues, allocation of operational or exceptional cost, the impact of invocation of force majeure clauses etc.

According to OECD some of the challenges in transfer pricing arising due to COVID-19 related disruption can be mitigated by:

- Allowing use of reasonable commercial judgement supplemented by contemporaneous information to set a reasonable estimate of the arm's length price.
- Where feasible, allow for an arm's length outcome testing approach.
- Use of more than one transfer pricing method.
- Use of data from other crisis to support price setting.
- Use of multiple year data to evaluate arm's length pricing.
- When considering the risks assumed by a party to a controlled transaction, tax administrations should carefully consider the commercial rationale for any purported change in the risks assumed by a party before and after the outbreak of COVID-19.
- In response to the COVID-19 pandemic, independent parties could seek to renegotiate certain terms in their existing agreements. Associated parties may also consider revising their intercompany agreements and/or their conduct in their commercial relationships. Tax authorities should therefore review the agreements and/or the conduct of associated enterprises.
- Existing APAs and their terms should be respected, maintained and upheld, unless a condition leading to the cancellation or revision of the APA (e.g. breach of critical assumptions) has occurred. Taxpayers and tax administrations cannot automatically disregard or alter the terms of existing APAs due to the change in economic circumstances.
- Whether there has been a breach in a critical assumption in an APA, it should be analysed on a case-by-case basis, and it should take into account the individual circumstances of the taxpayer and commercial environment.
- When considering the consequences of the failure to meet critical assumptions in an APA, tax administrations and taxpayers should consider the (i) terms of the APA; (ii) any agreement between relevant tax administrations as to how to deal with the failure; and (iii) any applicable domestic law or procedural provisions.
- Where taxpayers and tax administrations are negotiating APAs that are intended to cover the period effected by COVID-19, all parties are encouraged to adopt a flexible and collaborative approach to determine how to take into account the current economic conditions.

To conclude the Indian tax authorities should either come out with adequate guidance to deal with COVID-19 related challenges on transfer pricing or should allow Indian taxpayers to apply the guidance of OECD without any risk of transfer pricing adjustments in a tax assessment.

ABOUT JPC

JPC is a professional services firm based in Noida- National Capital Region and New Delhi, India. We were established in the year 1974 with the aim to create value for our clients by delivering quality, comprehensive, timely, practical and innovative services. We offer a comprehensive range of services, including taxation services, regulatory services, transaction advisory services, financial & management consultancy services, assurance & risk services, and outsourcing services. Over the past several decades, we have established significant competitive presence in the country. Our vast and diversified client base includes Multinational enterprises, domestic companies, high net worth individuals, government companies and institutions in all leading industry verticals. We are a team of distinguished Chartered Accountants, Management Accountants, Corporate Financial Advisors and Tax Consultants. Our team has the requisite skills and experience to provide complex business, financial, assurance, tax and regulatory services to our clients. Our strength lies in our timely performance-based, industry-tailored and technology-enabled services which are delivered by some of the most talented professionals in the country. For more information about JPC's service offerings, visit www.jpc.co.in

In this document, "JPC" refers to J P Chawla & Co. LLP Chartered Accountants (a limited liability partnership firm regulated by the Institute of Chartered Accountants of India, FRN : 001875N/N500025).

J P Chawla & Co. LLP

Chartered Accountants

New Delhi office:
43 Darya Ganj,
New Delhi - 110002
INDIA

Noida office:
B-151, 3rd Floor, Sector 6,
Noida - 201 301 (U.P.), INDIA
Phone: +91-120-4573207
General Email: info@jpc.co.in

Main Partners Hand Phone & Email

Rajat Chawla	+91-9871494499 | rajatchawla@jpc.co.in
J.P. Chawla	+91-9811028918 | jpchawla@jpc.co.in
Richa Chawla	+91-9990509709 | richajuneja@jpc.co.in

For further information, please email your details to rajatchawla@jpc.co.in or call +91-9871494499.

Delievering Business Solutions Through Constant Innovations