COVID-19: Impact on Transfer Pricing Benchmarking

COVID-19 presents an unprecedented /extraordinary situation impacting the economic environment, which needs to be factored, while undertaking transfer pricing analysis of transactions effected during FY 2019-2020 and also in the next financial year. India is known to be one of the most aggressive Transfer Pricing (TP) jurisdiction. TP Team at Vaish Associates Advocates has noted the following issues, which would arise in TP arena, in the aftermath of COVID-19:

1. **Challenges on Comparability due to Fall in operating margins of companies due to COVID 19(FY 2019-20 and 2020-21)**:

1.1 Comparability is the cardinal principle under Transfer Pricing. Although the fall in profitability would be across the industry and <u>the same would also get captured in the margins of the comparable companies</u>, the companies having business models dependent on imports from /exports to China, or other European countries, due to lockdown in these countries would see a greater disruption in their operations and consequently impact on their profitability in FY 2019-2020 in comparison to companies not so dependent on such imports/exports. Therefore, comparability adjustments would be warranted in the margins of such companies.

1.2 Further, the need for making comparability adjustment would have to be evaluated on a case to case basis and reasons for exceptionally high losses to be identified – Adjustment on account of capacity underutilization, loss/mark down in the value of inventory due to lock down, possible severance payments, contractual defaults/penalties and other extra ordinary expenses.

Courts in India have upheld the comparability adjustment to account for the disruption in the business caused lock out/ceiling of business premises [ref. Delhi ITAT in Transwitch India Pvt Ltd vs. ACIT (I.T.A. No. 6083/Del/2010) (approved by Delhi High Court) Smart Cube India Pvt. Ltd. vs. ACIT (6274/Del/2012)]. Similarly, courts have upheld comparability adjustments to account for underutilization of capacity [ref. ACIT vs. Fiat India Pvt Ltd (ITA no 1848/Mum/2009), Brintons Carpets Asia Pvt. Ltd. vs. ACIT (ITA No. 1296/PN/10),E.I. Dupont India Pvt Ltd vs. DCIT (ITA No 5336/D/2010)]

1.3 Related issue which needs to be taken into consideration while claiming comparability adjustment is the selection of entity in which the adjustment is to be made. [Delhi Bench of the Tribunal in the case of Claas India Pvt Ltd (ITA No. 1783/Del/2011) held that such adjustments have to be made in the margins of the comparable companies. However, Benches of Tribunal, have held that such adjustment made be made either in the margins of the tested party or the comparable companies-Pangea3 & Legal Database Systems Pvt Ltd vs ITO (ITA No 2128/Mum/2014),Ariston Thermo India Ltd vs DCIT (ITA No 1455/PN/2010) IKA India Pvt Ltd vs DCIT 98 Taxmann.com 312]. Further, the Benches of the Tribunal have held that abnormal costs are required to be excluded while calculating the normalized profit for the purpose of undertaking benchmarking analysis [ref. Delhi Bench of the Tribunal in HCL Technologies BPO Services Ltd (ITA No. 3547/Del/2010)]. The aforesaid approach is also supported by the OECD.

2. **Selection of comparable companies**: Companies with global operations (i.e. companies having high exports or imports) may be more severely impacted as compared to domestic-oriented companies. Therefore, appropriate comparable would need to be selected so that we don't compare companies with global operations (i.e. companies having high exports/imports) with domestic companies. [Delhi Bench of the Tribunal in the case of Actis Global Services Pvt Ltd (ITA No. 30/Del/2015) approved the export filter for selection of comparable companies].

3. **Captive service providers**: Captive service providers, generally characterized as risk immune/limited risk service providers, are compensated on a cost plus basis. Whether Nil or lower cost plus mark-up would have to be recovered by such captive IT/software/ITES/R&D service providers during the period of lock down considering that they are claimed to be <u>risk free entities may turn out to be a major area of dispute going forward</u>.

   In the environment of COVID-19, FAR analysis of such companies would have to be carefully documented, and inter-company agreements would need to be examined to identify as to which entity bears the risk of loss arising from the lock down.

4. **Business Restructuring**: Countries / MNEs may seek to diversify their manufacturing operations away from one particular geography (e.g. China) and instead have manufacturing bases in different countries. Local subsidiary companies which were hitherto engaged only in the distribution or low-end assembly in India may expand and start domestic manufacturing. Analysis from transfer pricing perspective would be required while deciding the business and pricing model taking into consideration the Indian regulatory environment, i.e. Contract Manufacturing or licensed manufacturing. The trend may change towards domestic manufacturing to fulfil domestic market needs instead of import dependence.

   Appropriate documentation and reporting of business restructuring to be done as per local regulations and to be appropriately documented in the master file.

5. **Intra group financial transactions**: Local subsidiary companies of MNEs may have to seek support from parent companies in these difficult times. Further, considering the volatility in the financial markets and low interest rate scenario, companies may consider opting for fixed rate of interests or may even swap/convert existing floating interest rate loan into fixed rate loans. The said arrangement may be challenged by Revenue authorities:

   a. The authorities may challenge the conversion from floating to fixed rate of interest – The Delhi Bench of the Tribunal in the case of BG Exploration & Production India Ltd (ITA No. 1170/Del/2015) upheld the conversion of floating interest rate loan to fixed-rate loan due to the 2008 financial crises.

   b. For some specific industries such as the oil and gas industry, considering the crash in oil prices, the rate of interest may actually go up due to heightened credit risk. The revenue authorities may challenge the high rate of interest even though the global /treasury rates are going down. Industry-specific analysis of credit spreads may have to be undertaken to demonstrate that transactions were at arm's length.

6. **Industries likely to be most impacted due to COVID 19;Pharma , Healthcareand medical devices**: Countries may encourage shifting of manufacture of pharma and healthcare products /Medical devices from China to other locations. India has

already announced the scheme of fiscal incentive / subsidy for local manufacturing of bulk drugs / Active Pharmaceutical Ingredients ('API') and Medical devices in the last week. In the aftermath of COVID-19, it may become increasingly necessary to advise on business and pricing models to MNEs seeking to shift base to India for manufacture and export of bulk drugs.

Additionally, companies may have to revisit the terms agreed in the existing APAs in view of the change in economic environment.

Impact of COVID 19 on profitability and value chain would be known only once the situation settles and businesses resume, however, considering the fiscal requirements of the countries, heightened TP scrutiny may be expected

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For any details and clarifications, please feel free to write to:

TP Team at Vaish Associates Advocates

Mr. Ramit Katyal : ramit@vaishlaw.com
Mr. Abhishek Agarwal : abhisheka@vaishlaw.com