Performing a comparability analysis during an economic downturn

Federico Vincenti and Carola Valente of Valente Associati GEB Partners/Crowe Valente explain how businesses should seek to perform comparability analyses to reflect the COVID-19 outbreak.

Sponsored by

By Carola Valente

By Federico Vincenti

April 23 2020

Since December 2019, countries have witnessed the widespread impact of COVID-19 on economic activity, global value chains and profitability across most industries and geographical areas.

As is the case in all periods of uncertainty, as governments try to tackle the crisis with measures that stimulate economic growth such as tax reliefs and investment incentives, tax authorities have focused to a greater extent on setting transfer pricing (TP) policies in order to verify the reason and the nature of the contraction registered in the financial statements of firms.

Hence, companies undertaking inter-company transactions should adapt their TP models to the current economic and financial conditions, in order to ensure that internal policies reflect the potential reallocation of functions, activities and risks within the multinational group.

Likewise, when reviewing tax audits, authorities must necessarily take into account the exceptional circumstances in which the companies operated during the period under review, as well as the uncertainty in which they have determined the TP policies.

Such a principle is also pointed out by the OECD TP Guidelines (paragraph 3.69) which provides evidence that, in some cases, taxpayers establish their TP documentation on ex ante basis (the so called arm's-length price setting approach).

Following such an approach, taxpayers are able to demonstrate that they have made reasonable efforts to comply with the arm's-length principle at the time their intragroup transactions were undertaken.
Such information includes not only details on comparable transactions from previous years, but also information on economic and market changes that may have occurred between those previous years and the year of the controlled transaction. In effect, independent parties in comparable circumstances would not base their pricing decision on historical data alone.

Strategies to carry out a comparability analysis

Conducting a comparability analysis and searching for comparable transactions (or subjects) is more challenging during periods of prolonged economic and financial turbulence due to the absence of suitable comparables and due to the two-year lag that exists between the end of the fiscal year and the time when the financial data of multinational companies is publicly available on the databases.

Thus, companies may adopt the following strategies when identifying comparables in order to make the comparability analysis consistent with changing economic conditions:

- Including loss-making companies in the set of comparables to determine the true arm's-length price. The elimination of loss-making companies may not be appropriate in periods of recession and crisis as they do reflect the actual market conditions;
- Choice of an appropriate time period – the application of a time period of three years before the tax year under review, which is conventionally used for the selection of the comparables, may not be appropriate during periods of downturn. In case of a tax audit related to the tax year 2020, the use of the comparables data related to the time period 2017-2019 could not be correct since such years were not impacted by COVID-19. Alternatively, it could be used the data of comparables referring to previous recessionary periods or it is necessary to consider specific adjustments to the search strategy. The application of such approaches may not be straightforward due to the lack of available data or inappropriate because the previous period of downturn may be distant in time and/or not comparable due to specific economic circumstances;
- Choice of reference markets – the economic recession may have a global impact as well as being limited to some countries, which implies the need to carefully assess the choice of the country in which the comparables operate;
- Make specific adjustments to the financial data of comparables to take into account of the actual economic circumstances.

It should be emphasised that in such contexts it is inevitable that the assessment of compliance with the arm's-length principle conducted by tax authorities ex-post differs from the analysis and results conducted by the taxpayer at the time of the transaction. Therefore, tax authorities should not employ information that was not available to the taxpayer at the time of the transactions to construct the TP analysis.

More specifically, the assessment of the tax authorities should respect the approach followed by the taxpayer and try to evaluate whether the results obtained by the taxpayer are justifiable and respecting the arm's-length principle, given the information available at the time of the TP analysis.

For the reasons depicted above, it is clear that the benchmark analysis related to periods of economic downturn requires greater attention both for companies and for tax authorities, regarding a thorough assessment of the context as well as in the choice of the approach to follow, which must take into account the consequences and impact of the economic recession.
In such context, it is necessary to prepare proper TP documentation, which could support any deviation from arm's-length results due to the impact of COVID-19 as well as any change in the value chain and TP policies applied.

Federico Vincenti
T: +39 02 762 6131
E: f.vincenti@crowevalente.it

Carola Valente
T: +39 02 762 6131
E: c.valente@crowevalente.it