

COVID 19: TAX AND TP

The impact of a pandemic crisis for International Tax
Practitioners, Multinational Groups and Tax Administrations

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INTRODUCTION



The COVID-19 pandemic has raised several concerns among the tax practitioners, the MNE and the Tax Authorities around the world:

- residence status of individuals;
- cross border workers;
- residence status of a company (place of effective management);
- creation of permanent establishments;
- effects on the application of the OECD PPT and some national GAARs and/or SAARs;
- effects on Transfer Pricing.

RESIDENCE STATUS OF INDIVIDUALS

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The COVID-19 pandemic has forced governments to take unprecedented measures such as restricting travel and implementing strict quarantine requirements. As a result of these restrictions, many cross-border workers are unable to physically perform their duties in their country of employment. They may have to stay at home and telework or may be laid off because of the exceptional economic circumstances.

RESIDENCE OF INDIVIDUALS

RESIDENCE STATUS OF INDIVIDUALS

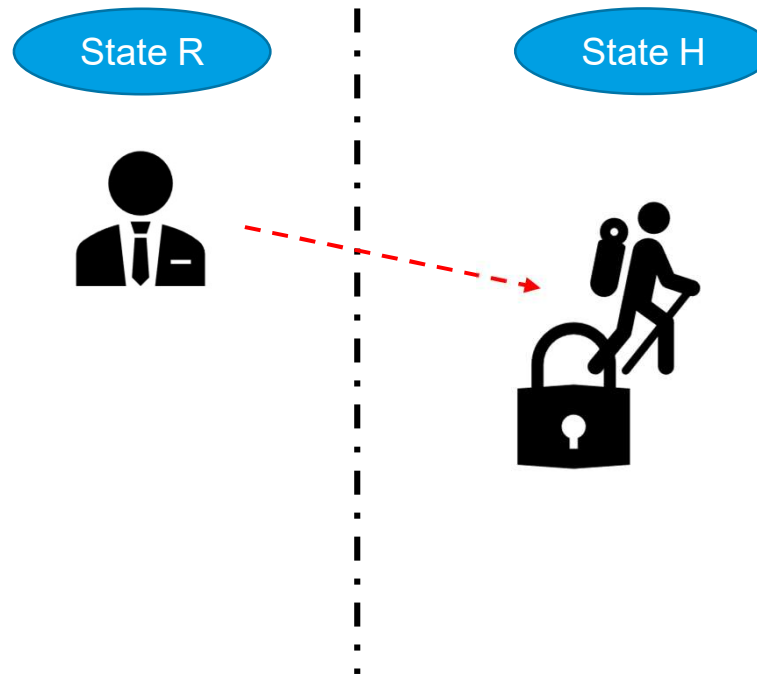
According to the OECD, it is unlikely that the COVID-19 situation will affect the treaty residence position.

Some countries (e.g. UK, Australia, Ireland) have already issued useful guidance and administrative relief on the impact of COVID-19 on the domestic and tax treaty determination of the residence status of an individual.

RESIDENCE STATUS OF INDIVIDUALS

CASE 1

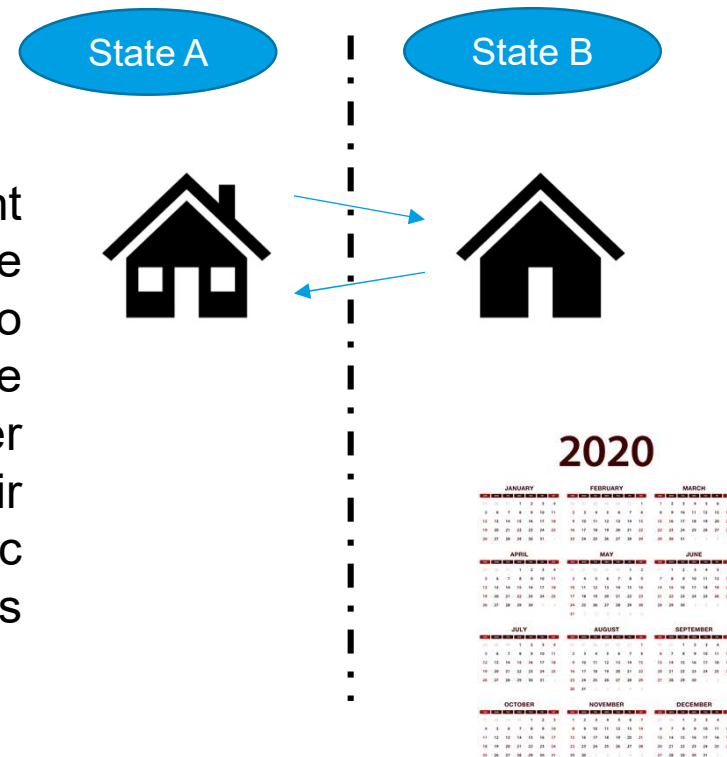
A person is temporarily away from their home (perhaps on holiday, perhaps to work for a few weeks) and gets stranded in the host country by reason of the COVID-19 crisis and attains domestic law residence there.



RESIDENCE STATUS OF INDIVIDUALS

CASE 2

A person is working in a country (the “current home country”) and has acquired residence status there, but they temporarily return to her/his “previous home country” because of the COVID-19 situation. They may either never have lost their status as resident of their previous home country under its domestic legislation, or they may regain residence status on their return.



The background of the slide features a vibrant aurora borealis (northern lights) in shades of teal, green, and purple against a dark, starry night sky. A large, white, semi-transparent 'X' shape is overlaid on the image, with its center point located near the text.

CROSS BORDER WORKERS

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CROSS BORDER WORKERS

Where a government has stepped in to subsidise the keeping of an employee on a company's payroll during the COVID-19 crisis, the income that the employee receives from the employer should be attributable, based on the OECD Commentary on Article 15, to the place where the employment used to be exercised. In the case of employees that work in one state but commute there from another state where they are resident (cross border worker - "frontaliers"), this would be the state they used to work in.

CROSS BORDER WORKERS



Article 15 (Income from employment) of the OECD Model Convention governs the taxation of employment income, distributing the right to tax between the employee's state of residence and the place where they perform their employment.

According to § 2.6 of the OECD-Commentary on Article 15, wage subsidies designed to keep workers on the payroll during the Covid-19 crisis should be attributable to the place where the employee used to work before the Covid-19 crisis.

Special provisions: OECD is working with countries to mitigate unplanned tax implications if the cross-border worker status is dependent on the number of days spent in the non-residence-state.

A person wearing a hat and a plaid shirt is seen from behind, looking out over a vast, misty landscape of rolling hills and tea plantations. The scene is bathed in soft, golden light, suggesting dawn or dusk. The foreground is filled with lush green tea bushes. The background shows layers of hills and valleys shrouded in mist, creating a sense of depth and tranquility. The overall mood is peaceful and contemplative.

RESIDENCE STATUS OF A COMPANY (PLACE OF EFFECTIVE MANAGEMENT)

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RESIDENCE STATUS OF A COMPANY (PLACE OF EFFECTIVE MANAGEMENT)

The COVID-19 crisis may raise concerns about a potential change in the “place of effective management” of a company as a result of a relocation, or inability to travel, of chief executive officers or other senior executives. The concern is that such a change may have as a consequence a change in company’s residence under relevant domestic laws and affect the country where a company is regarded as a resident for tax treaty purposes.

It is unlikely that the COVID-19 situation will create any changes to an entity’s residence status under a tax treaty. A temporary change in location of the chief executive officers and other senior executives is an extraordinary and temporary situation due to the COVID-19 crisis and such change of location should not trigger a change in residency, especially once the tie breaker rule contained in tax treaties is applied..

RESIDENCE STATUS OF A COMPANY (PLACE OF EFFECTIVE MANAGEMENT)



PRE-2017 OECD MC

In situations where the treaty contains the pre-2017 OECD Model tie-breaker rule, the place of effective management will be the only criterion used to determine the residence of a dual-resident entity for tax treaty purposes. According to § 24 of the Commentary on Art. 4 of the 2014 OECD MC, the place of effective management is **the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made**. All relevant facts and circumstances must be examined to determine the place of effective management.

§ 149 of the Comm. on Art. 29 of the 2017 OECD MC explains that the concept of “place of effective management” was interpreted by some States as being ordinarily the place where the most senior person or group of persons (for example a board of directors) made the key management and commercial decisions necessary for the conduct of the company's business.



CONCERNS RELATED TO
THE CREATION OF
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Some MNEs may be concerned that their employees dislocated to countries other than the country in which they regularly work, and that working from their homes during the COVID-19 crisis will create a “permanent establishment” (PE) for them in those countries, which would trigger new filing requirements and tax obligations.

- **Home office**
- **Agency PE**
- **Construction site PE**

CONCERNS RELATED TO THE CREATION OF PERMANENT ESTABLISHMENTS



HOME OFFICE

It constitutes a PE for the employer only if it has

- a certain *degree of permanency*,
- it is *at the disposal of the enterprise* and
- the enterprise must *require the individual to use that location to carry on the enterprise's business*.

However, Covid-19-crisis is “*force majeure*” and not an enterprise's requirement. It could be different if the home office continues being a working place after the end of the Corona-crisis.

CONCERNS RELATED TO THE CREATION OF PERMANENT ESTABLISHMENTS



AGENCY PE

The question may also arise whether the activities of an individual temporarily working from home for a non-resident employer could give rise to a dependent agent PE.

Under Article 5(5) of the OECD Model, the activities of a dependent agent such as an employee will create a PE for an enterprise if the employee habitually concludes contracts on behalf of the enterprise. Thus, in order to apply Article 5(5) in these circumstances, it will be important to evaluate whether the employee performs these activities in a “habitual” way.

CONCERNS RELATED TO THE CREATION OF PERMANENT ESTABLISHMENTS



CONSTRUCTION SITE PE / INSTALLATION PE

Many activities on construction sites are being temporarily interrupted by the COVID-19 crisis. The duration of such an interruption of activities should however be included in determining the life of a site and therefore, according to the OECD, **will affect the determination whether a construction site constitutes a PE**. In general, a construction site will constitute a PE if it lasts more than 12 months (OECD MC) or more than 6 months (UN MC).

§ 55 of the Commentary on Article 5(3) of the OECD MC explains that *a site should not be regarded as ceasing to exist when work is temporarily discontinued* (temporary interruptions should be included in determining the duration of a site). Examples of temporary interruptions given in the Commentary are a shortage of material or labour difficulties.

CONCERNS RELATED TO THE CREATION OF PERMANENT ESTABLISHMENTS



CONSTRUCTION SITE PE / INSTALLATION PE (personal view)

The interruption caused by Covid-19 in some countries seems not being a “temporary cessation”, but rather an abandonment or cessation of the activities, which is much more severe and lasting than “temporary interruptions”. In short, when a situation or its effects, prevails for an uncertain future period, it would be incorrect to regard it as “temporary” or “temporarily.” The current distress situation has led to “abandonment” or “cessation of activities” for an uncertain period thereby restricting the carrying on of activities.

KLAUS VOGEL in *Commentary on Double Taxation Convention* subscribed to the view that **long interruptions lead to a suspension of the minimum time period**

CONCERNS RELATED TO THE CREATION OF PERMANENT ESTABLISHMENTS



CONSTRUCTION SITE PE / INSTALLATION PE (personal view)

In order to constitute a “construction PE” it is essential that the contractor has **access/use/control of the site**. If at any time, the contractor does not have access/use/control of the site, it is axiomatic that such duration should be excluded in computing the 12 months or the threshold under the respective tax treaties provided such disruptions are not “temporarily” in nature.

The suspension or cessation of activities, on account of pandemic and/or consequential invoking of force majeure clause, has led to suspension or cessation of construction activities for an uncertain period at least as it appears today. Thus, the disruption period caused by Covid-19 pandemic does not warrant inclusion in the minimum time period, which is required to constitute a construction PE.

EFFECTS ON THE APPLICATION OF THE OECD PPT, GAARs AND (SOME) SAARs



EFFECTS ON THE APPLICATION OF THE OECD PPT, GAARs AND (SOME) SAARs



- Many States have incorporated GAARs into their tax laws to prevent tax avoidance;
- Within the EU, a GAAR is even mandatory for corporate taxation;
- States are recommended both in the OECD MC and in the UN MC to include a Principal Purpose Test in their tax treaties;
- States also include SAARs in their national laws or tax treaties.

May the COVID-19 pandemic affect the application of GAARs, the OECD PPT and/or any SAARs?

[prof. DENIS WEBER Wolter Kluwer Blog]

EFFECTS ON THE APPLICATION OF THE OECD PPT, GAARs AND (SOME) SAARs



- GAARs and the OECD PPT have in common that the subjective intention a taxpayer has with an arrangement or transaction is taken into account for the question of whether there is tax avoidance.
- The subjective intention a taxpayer has with an arrangement or transaction is often derived from objective circumstances.
- Both tax administrations, as well as the national legislator, prefer to rely on objective circumstances.

But what if there is not enough substance in a country because the COVID-19 pandemic does not allow persons to carry out economic activities in a certain State and/or cannot travel due to work/travel or quarantine restrictions ?

EFFECTS ON THE APPLICATION OF THE OECD PPT, GAARs AND (SOME) SAARs



We can have three possible situations:

1. Suppose that pre-COVID-19 a company did meet the substance requirements, but during the pandemic it lacks substance.
2. Suppose that a company did not have sufficient substance pre-COVID-19 and did also not have sufficient substance during the COVID-19 pandemic.
3. Suppose that a company is currently being established, i.e. during the COVID-19 pandemic.

EFFECTS ON THE APPLICATION OF THE OECD PPT, GAARs AND (SOME) SAARs



An additional circumstance that has to be taken into account for the question whether the main purpose of the lack of substance is the protection of the health, is that restrictions created by the COVID-19 pandemic can be divided into public, private and own taxpayer restrictions:

1. *Public measures*: restrictions imposed by *governments*.
2. *Private measures*: restrictions caused by restrictions in *private sector services*, especially in aviation.
3. *Own taxpayer measures*: a *company's policy* itself could affect the substance in a particular State.

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EFFECTS ON TRANSFER PRICING

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WHO HAS TO BEAR THE LOSSES?

Only the “entrepreneur/strategic company” or even the affiliates with routine functions?

Normally the companies can be divided into three categories:

- 1. Routine companies:** They perform routine functions only. They assume low risks and employ a limited volume of (intangible) assets. In the normal course of business, routine companies generate small but relatively stable profits, no losses. The TP methods most commonly applied here are the cost-plus method for manufacturing or low value-added services and the transactional net margin method (TNMM) for sales (most rarely Resale Price method).
- 2. Entrepreneur/strategic companies:** They have the tangible and intangible assets essential for conducting business, perform key functions and bear significant entrepreneurial risks. Residual profits or losses resulting from a transaction are allocated to strategic companies.
- 3. Hybrid companies:** They cannot be classified as routine or strategic companies as they have characteristics of both the previous groups.

EFFECTS ON TRANSFER PRICING

MANUFACTURER LOSSES

Fully fledged manufacturer

When a fully fledged manufacturer is classed as a strategic company, the residual profit – or residual loss – is attributed to it. In times of crisis, it is therefore the fully fledged manufacturer that bears the business losses.

Contract or toll manufacturer

Both contract manufacturing and toll manufacturing are classified as routine functions for various reasons. Most common method: cost plus. A capacity risk triggered by a crisis, normally must be borne solely by the principal, not by the contract or toll manufacturer. Similarly, the principal must bear any startup costs or losses, otherwise the contract or toll manufacturer would generate losses that are incompatible with its role as a routine company. Given the exceptional nature of the current crisis, the tax authorities ought to accept a temporary absence of the profit element.

EFFECTS ON TRANSFER PRICING

DISTRIBUTOR LOSSES

Fully fledged distributor

This is comparable to the situation with a fully fledged manufacturer. Due to the COVID-19 crisis, sales prices have generally dropped, or sales have even fallen to zero. A distributor acting as a strategic company will have to accept these losses, since they would also be incurred in an arm's length relationship with an unrelated party.

Low-risk distributor

The same remarks seen on determining TP for contract and toll manufacturers apply. In principle, low-risk distributors have the right to reimbursement of their full costs plus a small net margin, even in times of crisis. However, a net distributor margin may be temporarily suspended in the current pandemic if the group or the industry as a whole can no longer generate profits.

EFFECTS ON TRANSFER PRICING

RELEVANCE OF COMPARABLES FOR DETERMINING TRANSFER PRICES IN A LOSS PERIOD

Reliability of using comparables

What about benchmark analyses of other companies' performance in financial years affected by the COVID-19 crisis? Are the database comparables really comparable? And if not, can they be used at all?

It is debated whether benchmark analyses are even allowed to include loss-making companies.

- Impact on IP/ Brand royalties
- Need Analysis for High-value intragroup services

Impact on completed Advance Pricing Agreements

Revoked or renegotiated?

EFFECTS ON TRANSFER PRICING

OTHER EFFECTS OF COVID 19 CRISIS ON TP YET TO EVALUATE

1. Relocation of facilities / transfer of functions (temporary ?)
2. Restructuring of financing arrangements including deferment of payments (capital contribution or debt? See OECD Guidelines on Financial Transactions 2020)

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