Tax
Insights from Transfer Pricing

HMRC release important guidance on identifying and pricing contributions to risk control by decision-makers

February 2024

In brief

What happened?

On January 26, 2024, HMRC published new chapters within its International manual: 'INTM485023' **Transfer pricing operational guidance: Accurate delineation of the actual transaction: Risk allocation**' and 'INTM485025' Transfer pricing operational guidance: Accurate delineation of the actual transaction: Risk.' The former provides a summary of the key aspects of the guidance on analysing risk in a controlled transaction within Chapter I of the 2022 OECD Transfer Pricing Guidelines (TPG), including the six-step process set out at paragraph 1.60.

Why is it relevant?

Accurate delineation and risk is at the heart of many HMRC audits, and it explains their particular focus on senior decision-makers, and the forensic attention given by HMRC to decisions themselves. This topic will be of relevance to many taxpayers, particularly in light of the recently-introduced UK transfer pricing documentation rules, in which the burden of proof sits with the taxpayer.

Many Multinational Enterprises (MNEs) charge out senior management or R&D services on a cost-plus basis, or treat manufacturers and distributors as tested parties entitled to a routine return. The counterparty to these transactions often will own intellectual property (IP), or carry out entrepreneurial functions, or both, and in consequence will bear the associated risk. In models like this, the profit of the tested party is fixed, and the risk-taking counterparty earns the residual profit (or loss).

HMRC have been focusing their attention on transfer pricing arrangements of this kind, in particular on UK tested parties, and often will take the view that decision-makers in the UK contribute to the control of risk in a way that makes a fixed, routine return — derived by the Transactional Net Margin Method (TNMM) — inappropriate, instead seeking a premium based on commission-style Comparable Uncontrolled Transaction ('CUTs' or Comparable Uncontrolled Prices or 'CUPs') or, more commonly, a share of the residual profit using headcount-based profit-splits.

The guidance in HMRC's International Manuals (the manual) sets out HMRC's interpretation of the TPG, explaining why they think this approach is appropriate.

Note: The manual is guidance for inspectors, not law, and HMRC's position is not necessarily reflective of an international consensus on how the TPG should be interpreted. This is, however, a notoriously controversial part of the TPG, and, whilst it is the case that many will disagree with HMRC's interpretation, the fact that they have made their position explicit brings some clarity. It is to be hoped that international consensus will now be sought as a priority.

The guidance is long and conceptually challenging, and the practical ramifications are significant. Most taxpayers will not have deemed it necessary to parse out risks in the way that the manual specifies, nor to investigate decision-making structures separately for each risk. Some may find it difficult to implement HMRC's suggested TP approaches. For already-stretched tax departments, the stipulations here will represent further burdens, and some people will view them as disproportionate. Taken together with the new documentation rules in the UK (see our other Tax Insights here), and the possible lack of counterparty agreement on HMRC's interpretation, taxpayers are presented with difficult choices in how to approach this issue in a proportionate manner.

In detail

Background and overview

HMRC's manual covers the application of Chapter I of the TPG, including the six-step risk process (paragraph 1.60 of the TPG). The manual notes that since the OECD's Base Erosion and Profit Shifting ('BEPS') Action Plan and the revisions to the TPG in 2017, risk, and the process of risk allocation in the context of pricing related party transactions has been an area of extensive discussion across all impacted stakeholders.

HMRC's interpretation of this chapter of the TPG is the subject of considerable dispute. While it is to be welcomed that HMRC have published their views on the interpretation of Chapter 1 and risk allocations, their views will be seen as controversial by many.

HMRC is the first tax authority to publish what amounts to a 'conceptual framework' which attempts to make sense of fundamental inconsistencies in the TPG. Unlike many jurisdictions, the UK imports the TPG directly into its legislation, and so the need for guidance has become particularly pressing.

The fundamental area of contention, which is not immediately obvious from the manual itself, relates to the role and value of contracts, assets and capital relative to the role and value of decisions about risk.
The aspects of the TPG that HMRC are interpreting here was developed as part of the OECD's BEPS Action Plan. This explicitly targeted the situation where an MNE's valuable assets, and the associated risks were contractually anchored in a low-substance, low-tax jurisdiction, while the key control decisions about these assets and associated risks were made by senior employees elsewhere in the business.

To address situations like this, the 'six-step process' tests whether the contractual framework should be respected, by reference to the location of risk-control decisions. Put simply, if there are enough risk-control decisions in the location which contractually bears the risk, then the contract will be respected. If not, then the relationship between the parties must be 'accurately delineated', and re-priced accordingly.

The motto of the BEPS project was 'aligning profit outcomes with value creation', and because the six-step process tests the location of risk control decisions it gave rise to a general sense that senior decision-making was essentially synonymous with 'value creation'. This sentiment apparently fed into further changes to the TPG in subsequent years, and also informs HMRC's thinking.

Put very simply, the essence of HMRC's interpretation of the TPG is that:

1. Every economically significant risk must be analysed separately;
2. The exercise of accurate delineation allocates risk away from the location specified in the contract to the location of control, but does not require a re-writing of any contractual terms; and
3. Even where contractual allocations of risk are respected, 'contributions to control' may participate in upside and downside outcomes.

The fundamental way in which HMRC ascribes value to decisions about risk is to allocate the economic consequences of the risk to the decisions. This has required HMRC to be more explicit than the TPG about their view on the relationship between risk and profit, and their view on the meaning of accurate delineation. Taking each in turn

In detail (continued)

HMRC's view on the relationship between risk and profit

The idea that risk explains profit is at the heart of HMRC's logic, and they refer to it throughout the manual (sections of the manual are added for emphasis):

- 'The TPG…emphasises **the close association between risk and profit potential**' (paragraph 25)
- 'Companies are likely to devote considerable attention to identifying and **managing economically significant risks in order to maximise the positive returns** from having pursued the opportunity in the face of risk' (paragraph 27).
- 'Arm's length pricing will tend to **correlate value with effective control of risk**' (paragraph 57) and 'this is the basis for the risk control framework in Chapter I, and the explicit emphasis on alignment with value creation in BEPS Actions 8-10' (paragraph 58).
- **Where an entity has the ability to control risk…it is reasonable to suppose that capital could move to exploit that opportunity**' (paragraph 56).
- A profit split methodology which splits residual based on a class of decision makers 'implicitly assumes that the effort placed in control of economically significant risks is proportional to the profit that derives from their successful control, which may be a reasonable assumption' (paragraph 126).

Despite the manual stating that 'it should not be interpreted that HMRC view the delineation of risk as having more significance than functions or assets' (Paragraph 4).

HMRC's approach relies on this idea that risk-taking is the wellspring of residual profit, and that the location of decision-making anchors that risk. The reason that this gives rise to difficulties is that many MNEs will have taken the view that unique capabilities, assets and rights are the source of their competitive advantage and explain their residual profit. HMRC's guidance does not dismiss assets, but nor does it explain the relationship between risk and assets, or the role of ownership in the overall conceptual construct. In some ways there is an inference that assets and risks are capable of separate analysis, but the same residual profit can not logically be explained separately by both at once.

The disconnect is present in the TPG, but it makes it particularly difficult to determine what the consequences are where, say, asset ownership is undisturbed but HMRC deem a risk to be independently valuable and to be ascribed to a decision maker located in a separate company from the asset owner. If the decision-maker is to be allocated an income stream, how does that affect the rights of the asset owner and the value of the asset itself?

Other knock-on issues arise if we are to allocate profit outcomes to decision-makers. What is the bargaining power of the decision maker? What gives rise to options realistically available? Bargaining power is typically understood to stem from the unique assets and capabilities of the participants.

The overarching challenge for taxpayers in seeking to understand and apply HMRC's guidance will be compounded by the fact that other tax jurisdictions do not necessarily align with HMRC's interpretation and application of the TPG.

Other tax authorities often emphasise to a greater extent the role that assets, underpinned by contracts, legal ownership and rights play in explaining and anchoring residual profits. The consequences of such a disconnect will need to be carefully evaluated and managed. Additionally, this will have wider ramifications for determining asset values, exit tax considerations, and the consequences of increasingly mobile workforces.

HMRC's view on accurate delineation

The second, related, position underpinning HMRC's theory is their view on the process of accurate delineation. The process of accurate delineation has widely been understood to be an elaboration of the process set out in earlier versions of the guidance by which the 'true terms' (see paragraph 1.53 of the 2010 TPG) of a transaction between related parties may be gleaned by reference to control decisions. Specifically, this would entail replacing the relevant terms of the contract between the parties. This revised contractual landscape would then provide the new rights-based 'anchor point' from which the transfer pricing analysis would proceed. Whilst HMRC's guidance recognises that contractual terms may have value, they deem the process of accurate delineation to be a much broader exercise which amounts to gaining an understanding of all economically relevant factors (including contractual rights) that does not require any editing of contractual terms.

In detail (continued)

This is crucial because contractual terms determine who owns what interests in assets, and can constitute assets in their own right. HMRC's view that the process of accurate delineation does not require them to revisit these terms is an extension of, and compounds their view that assets and rights, whilst important, do not fully explain why residual profit arises and who should be entitled to it.

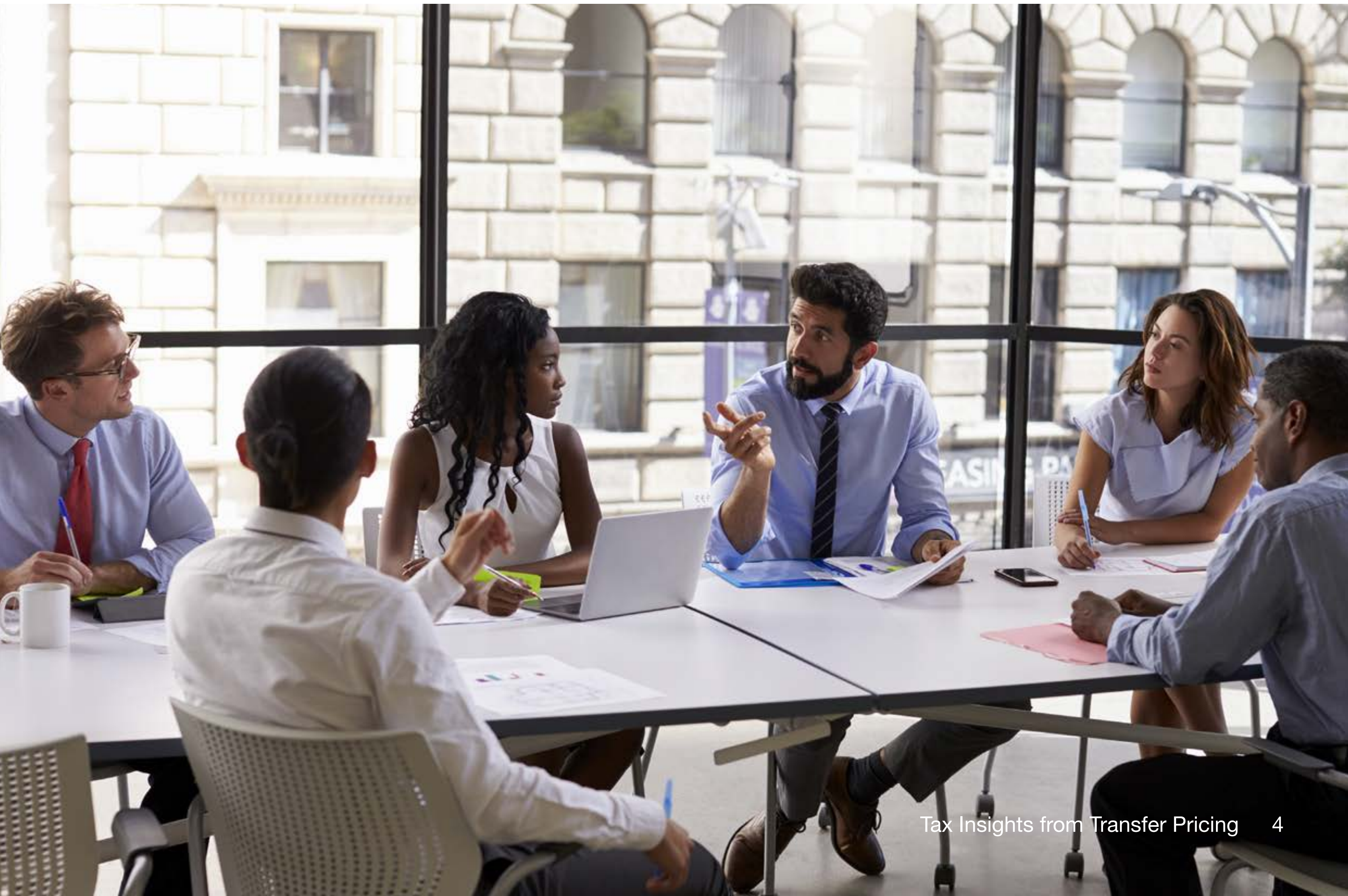
The erosion of rights and assets as anchor points for transfer pricing analysis has very meaningful consequences. In particular, despite several general comments, including a particularly welcome comment that for 'contributions to control' the profit split method will not be applicable in all cases (Paragraph 111) and that in most cases a one sided method will be appropriate (Paragraph 78), the only specific method that HMRC do elaborate on is a headcount-based profit split (Paragraph 125).

For most MNEs the idea that a headcount based profit split can be accommodated within the conceptual framework of their existing transfer-pricing analysis will be problematic.

The knowledge that HMRC's interpretation (and their consequent expectations in terms of taxpayer compliance) may not fit with a taxpayer's own interpretation, and may not be shared by other tax authorities poses a dilemma for taxpayers who invest very significant resources in developing, implementing, monitoring and documenting globally consistent transfer pricing policies.

HMRC's publication of their interpretation of the guidelines will, one hopes, prompt this topic to be revisited internationally, but in the meantime carefully-considered judgements will be required about the appropriate steps to be taken in understanding and responding to HMRC's expectations.

The following paper provides a walkthrough of each section of the manuals, notably INTM485025 Transfer pricing operational guidance: Accurate delineation of the actual transaction: Risk, and outlines our interpretation of the guidance and the key takeaways for taxpayers.



In detail (continued)

Scope of the guidance, executive summary, and the arm's length principle

HMRC introduces the manual with a summary of the scope of the guidance, an executive summary of the manual, and a summary of their view of the arm's length principle. These three sections ultimately set the tone for views and applications proposed throughout the manual.

The scope of the guidance is clear – HMRC are seeking to clarify their interpretation of the six-step process per the TPG and its place within a transfer pricing analysis. Because the TPG emphasise that there are inherent complexities with analysing risks, which is why expanded guidance was issued in the 2017 version of the TPG, HMRC have sought to provide clarity in its interpretation of this area. HMRC reaffirms the point made in the TPG that risk assumption is only one of several aspects that are relevant to accurate delineation, and this does not have more significance than other economically relevant characteristics, such as functions or assets. Furthermore HMRC has stated that the manual's primary focus is accurate delineation and not pricing. Step 6 in the TPG talks about factors to consider when pricing contribution decision making in respect of risks. As this is recognised as a particular area of disagreement between taxpayers and HMRC, the manual does discuss HMRC's view as to what transfer pricing methods may be applied, including the Transaction Profit Split Method ('TPSM'). The manual also mentions here and frequently throughout that in case of dispute of any aspect of the accurate delineation and pricing process, case teams should consult the Transfer Pricing Team in Customer Strategy & Tax Design ('CS&TD') Business, Assets & International for advice.

In the executive summary, HMRC states that risks and related functions should not be considered in isolation from assets and related functions. It gives the example of the case of intangible assets, and that the Development, Enhancement, Maintenance, Protection and Exploitation ('DEMPE') functions can, but not always, overlap with risk management functions. HMRC lay down their view, and disagreement with some commentators, that even when there is no reallocation of risks, other parties that contribute to control of a risk may be compensated by taking a share in the potential upside and downside commensurate with their contribution to control (as stated in the TPG paragraph 1.105). HMRC recognises that other one-sided methods may be used, but states that the TPSM may also be considered the most appropriate method. This point is further emphasised at the end of the sub-section 'the arm's length principle and accurate delineation' which the manual states provides examples illustrating arm's length rewards for contribution to risks, again referring to paragraph 1.105 of the TPG.

Observations

Whilst there is welcome recognition from HMRC that other economically relevant characteristics must be considered alongside risks, the tone of the manual from the outset sends a clear message that HMRC will continue to place significant emphasis on the identification of, and control of risk as part of any transfer pricing analysis. Similarly, HMRC stresses that risks and assets should not be considered in isolation from one another but, as noted above in our general overview, they do not elaborate on how the two are connected, and their analysis proceeds without any significant exploration of the relationship between assets, bargaining power and residual profit.

HMRC make it clear that even in situations where contractual assumption of risk and control over risk are aligned, if contribution to control is spread between parties, then the parties who do not contractually assume the risk, but who make a 'contribution to risk control' may need to be assigned 'upside and downside' outcomes associated with the risk. The TPG does envisage that this is a possible outcome, but HMRC's guidance seems to take a more definitive view, and while it is mentioned in passing that a cost plus method will often be appropriate for pricing contributions to control, most of the emphasis in the guidance is on CUTs and, more significantly, the TPSM.

HMRC is one of the first jurisdictions to make interpretation of these aspects of the TPG and its philosophy so explicit. Taxpayers will need to understand HMRC's requirements and decide what steps they are going to take to accommodate HMRC's view alongside the potentially conflicting views of other tax authorities. HMRC's guidance is particularly complex conceptually and technically, and subjective judgements are called for at every stage of the process. This may lead to challenging audits, and ultimately to unpredictable MAP outcomes. From a compliance perspective this is a highly unsatisfactory position.

In detail (continued)

Step 1
Identify economically significant risks

Economic significance

The overall starting point for the analysis is the identification of economically significant risks. HMRC's manual states that the threshold for a risk to be considered 'economically significant' is based on the significance of that risk's impact on the profit potential of a business activity. HMRC notes that economically significant risks can not normally be outsourced to third parties (i.e., by insurance or similar) without significantly eroding their profit potential. The manual states that the identification and analysis of economically significant risks should be based on the facts and circumstances of each case, including taking into account the nature of the industry and sector the MNE (and/ or the parties therein) operate within. The guidance also notes that the scale and likelihood of a risk materialising, as well as the ability and willingness of a party to control and manage the risk, are important factors to consider when determining economic significance. HMRC makes reference to the TPG in stating that there is a correlation between risk and profit potential, and assert that it is the assumption of economically significant risks that generates residual profits (or losses). The TPG provides a list of sources of risk, such as market, operational, financial, and strategic risks, as a framework to assist the transfer pricing analysis, but cautions that the list is not exhaustive, hierarchical, rigid, or biased towards externally driven risks.

Specificity

The manual states that economically significant risks should be identified with specificity, and not bundled, as this risks potentially conflating or obscuring the risk control function. HMRC views bundling to be permissible only when there is commonality of control structure for two or more distinct risks. The actual commercial practice and control structures in a group can help inform the analysis of the economic significance of risk(s) with specificity – a business's attention will naturally be targeted at those risks that are most economically significant.

The exercise of identifying specific economically significant risks requires balance and pragmatism. It is equally inappropriate to be too granular as it is to generalise. The manual provides some illustrative examples of how different groups may subdivide or aggregate risks according to their actual business practices and the potential upside and downside consequences of each risk.

Observations

In HMRC's analysis, as in the TPG, 'economic significance' of a risk is linked to its profit potential. Economically speaking, significant (i.e., residual) profit potential stems not from risk per se, but from competitively differentiated assets, capabilities and market positions. An appreciation of the role of risk in creating sources of competitive advantage is fundamental to transfer pricing analysis, but in HMRC's guidance, economically significant risks need to be analysed separately. It is not clear that it is possible to put a boundary around separate risks and to specify their individual economic potential when many different risks are at play in relation to a particular set of profit-generating assets and capabilities.

The decision-making processes which most organisations employ to build and protect their profit-generating assets will inevitably consider risk, but they will very rarely be structured based primarily on risk considerations. HMRC acknowledge this, and concede that in such cases 'bundling' of risks may be acceptable but the door is left open for HMRC to argue, for example, that commercial risk and product development risk are separate, and that, in a contract R&D agreement if the main technical control decisions are made in the R&D service entity, but the decisions in the R&D recipient are primarily commercial in nature, then the technical development risk (and its consequences) should be allocated to the R&D service provider, in which case a cost plus return would not be appropriate.

The 'boundaries' in the transfer pricing structures of most MNEs, i.e., between a manufacturer and a distributor, or between an IP owner and a licensee, will generally be based on an evaluation of a 'best-fit' model, taking many factors into consideration, but normally the ownership of unique and valuable IP is the most determinative. Often the way that risk is borne contractually by the relative counterparties will follow from the ownership, or otherwise, of the organisation's IP, with a recognition that the success or failure of the investment that IP is the central risk that the organisation takes. Most MNEs would find it difficult to envisage how they would deconstruct their transfer pricing model by splitting out risks, and in particular by separating them from IP assets, and how they would administer such a model, but this is what HMRC's approach potentially entails.

A thoughtful assessment of how risk is identified and managed within the MNE, how it relates to profit potential and how it is reflected in the transfer pricing model is likely to become an essential component of the UK documentation package.

In detail (continued)

Step 2 - Contractual assumption of risk

The contractual assumption of risk is an ex-ante agreement to bear some or all of the potential costs and benefits associated with the ex-post materialisation of risk outcomes in a transaction. Determining the contractual assumption of risk is an important step of the analysis as this must be compared with the conduct of the parties and their financial capacity to bear risk. HMRC recognise the importance of contractual terms as part of assessing all economically relevant characteristics underpinning a transaction, but they state that no one characteristic has greater importance than another. They note that contractual terms may have inherent value, irrespective of underlying functions or control. For example, exclusivity options acquired via an uncontrolled transaction may impact an intra-group controlled transaction.

Observations

For most tax authorities and courts, contracts continue to play the primary role in transfer pricing analyses, given that they exhibit an ex-ante agreement around ownership, rights, obligations and assumption of risks, as well as in anchoring the value of those rights. At arm's length contracts are a completely essential part of the economic system. The six-step risk control process is the centrepiece of the BEPS solution to perceived transfer pricing abuse, and at its heart is the validation (or otherwise) of contractual anchoring of assets and risks. In that context, HMRC's analysis of this step seems surprisingly short, and their assertion that contracts are just one of several meaningful characteristics lies at the heart of the conceptual difficulty with their guidance.

If it was generally understood that contractual anchoring was just one factor of several, rather than the primary anchor-point for transfer pricing analysis, then what does the six-step process really accomplish? This is an area where international consensus is particularly pressing.

Irrespective of HMRC's perspective on this issue, robust contracts remain of fundamental importance for transfer pricing compliance.

Step 3 - Functional analysis to determine which entities control risk

Control of risk

The manual reiterates the TPG, specifying that control of risk involves two elements: the capability to make decisions on whether and how to take on, lay off, or decline a risk-bearing opportunity, and the actual performance of that decision-making function. Control of risk also requires the capability to make decisions on whether and how to respond to the risks associated with the opportunity, and the actual performance of that decision-making function. Control of risk does not necessarily require the capability to mitigate risk, which can be outsourced, but it does require the capability to monitor and assess the performance of the risk mitigation provider.

The manual goes on to state that control must be defined at the level of each economically significant risk, and that different parties (including those outside of a given contract) may contribute to control over decisions relating to a particular risk, sometimes over a period of time. HMRC makes clear that they see no bias towards any level of management, and the relevant control decisions will be based on the facts and circumstances of the case.

The manual provides examples under slightly different sets of (limited) facts to show how control over a particular risk could be at the level of the board of the ultimate parent entity under one scenario, or at the level of line management in other scenarios.

Observations

This is one of the most contentious areas of the TPG, and the boundary between control decisions and mitigation decisions is highly contested. HMRC's examples provide an indication of how they will expect this analysis to be undertaken, but the idea that a granular assessment of the kind described here will be expected for each economically significant risk will be a surprise for most taxpayers.

Financial capacity

The TPG defines financial capacity to take on a given risk as the ability to access funding to take on or lay off the risk, to pay for risk mitigation functions and to bear the consequences of the risk if it materialises. This access to funding depends on the available assets and the realistic options to obtain additional liquidity, taking into account the potential benefits of group membership, such as implicit support (as discussed in Chapter X of the TPG). HMRC states that the ability to control economically significant risks effectively can enhance capital value, and therefore create opportunities for funding, which they state supports the argument that at arm's length the pricing will correlate value with effective risk control, and that essentially, capital will naturally migrate to the location of the control.

In detail (continued)

Importantly, the TPG states that the provision of intragroup funding does not necessarily mean the funding provider, in addition to potentially assuming the financial risk that arises from providing funding, assumes the specific operational risk which gives rise to the need for additional funding, as such an operational risk is distinct from the funding risk. This is difficult to understand from an economic perspective, and this bifurcation (which is in the TPG) again separates assets (in this case capital) from other sources of residual profit (in HMRC's view, risk decisions).

Observations

Whilst the manual provides some useful guidance of how to determine whether or not a party has the financial capacity to assume a risk, in practice this is another challenging aspect of the TPG. HMRC recognise the importance assets play in determining a party's realistic options for obtaining funding, distinct and separate reference is made to the fact that effective control of risks is what is important, despite the fact that paragraph 1.64 of the TPG (which HMRC refer to in the manual) states [underlining added for emphasis] '… **exploitation of rights in an income-generating asset could open up funding possibilities for that party.**' Again, HMRC messaging appears to see risk control and rights to or ownership of assets as separate considerations.

Step 4 & 5 - Consistency between contract and conduct and allocation of risk

Threshold for control

Control of risk should be assessed with specificity, taking into account the nature and complexity of the risk, the decision-making process, and the capabilities of the parties involved. Control of risk does not necessarily encompass risk mitigation activities, which may be outsourced or shared, with due consideration of whether such outsourcing or sharing is observable in uncontrolled transactions. The manual makes it clear that there is no de-minimis level of control envisaged within the TPG when determining whether assumption of an economically significant risk aligns with the control of that risk. If a party assuming a risk exerts any level of control, then it will be allocated the risk. HMRC emphasises the point that whilst contributions to a decision around a risk may be observed, '**where the decision is made should be a matter of fact**', with the contributions to the control of that risk and the value in those contributions needing to be considered separately and remunerated accordingly.

The manual provides some illustrative examples of how to apply the threshold for control of risk in the context of a hypothetical case involving the development of IP owned by one entity and controlled by a committee of senior employees from various affiliates within an MNE group. The examples highlight the factors that may affect the determination of control of risk, such as the composition and authority of the committee, the role and expertise of the participants, the delegation and oversight of risk mitigation functions, and the interrelation of financial and development risks.

In detail (continued)

Allocation across entities

The manual addresses some practical difficulties and questions raised by commentators on how to identify relevant control, such as:

1

The relative importance of different types of decisions and frequency of control activities for different risks and transactions, e.g., a one-off investment decision versus ongoing oversight of an innovative product development;

2

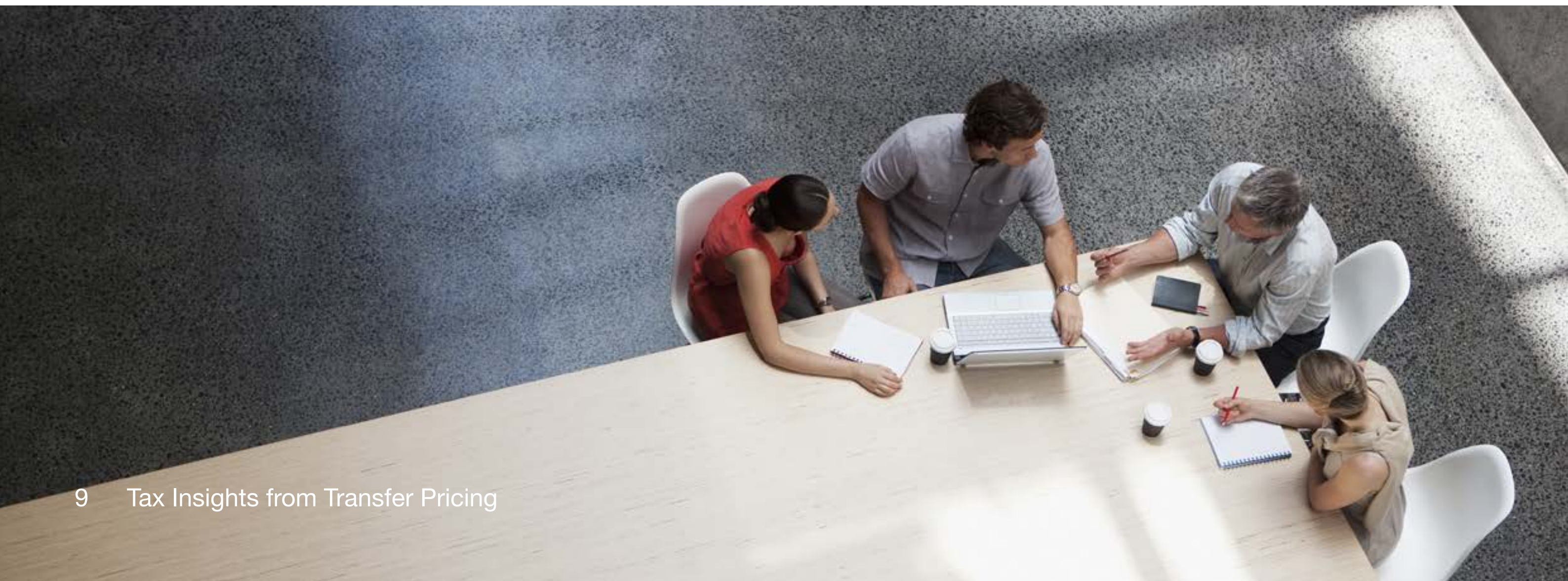
The challenges of tracing control in complex MNE groups with matrix management structures, collaborative processes, and globally mobile workforces, e.g., where and when a decision is actually made and by whom.

The manual advises that the control analysis should be based on the specific facts and circumstances of the transaction and the industry, and that there is no fixed threshold for a contribution control in another party that does not contractually assume the risk. The manual, again, notes that any remaining entities performing control activities should be remunerated as appropriate.

Observations

HMRC's guidance confirms the fact there is no de-minimis threshold for the level of control which will be 'enough' to respect the contractual anchoring of risk. In other words, the contractual allocation of risk will be respected even where there is a relatively low level of control in the risk-taking party. **However, they go on to state that '...the delineation of where control of risk sits differs from the question of value inherent in contributions to control of that risk.**' again emphasising the fact that contributions to control by parties not contractually allocated risk may participate in 'upside and downside outcomes'. The general effect of the guidance is to dilute the relative importance of the contractually-anchored risk, and to practically render much of the six-step risk process redundant.

A further challenge for taxpayers is neither HMRC's manual, nor the TPG provide any guidance as to how a risk should be reallocated if a contractual allocation is not respected. As mentioned in our introductory comments above, in HMRC's view the process of reallocating risk or 'accurate delineation' does not require a respecification of the terms of the contract. This then amplifies the pricing challenges under step 6 of the six-step risk framework and broader transfer pricing analysis as there is no clear understanding of how the established economically relevant characteristics would manifest themselves in a contract, or the role they would play in dictating a transfer pricing method. This is exacerbated by the requirement of HMRC to undertake this assessment on a risk-by-risk basis, which involves a level of complexity well beyond what has hitherto generally been deemed to be required under the TPG.



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Pricing the transaction, taking account of risk allocation

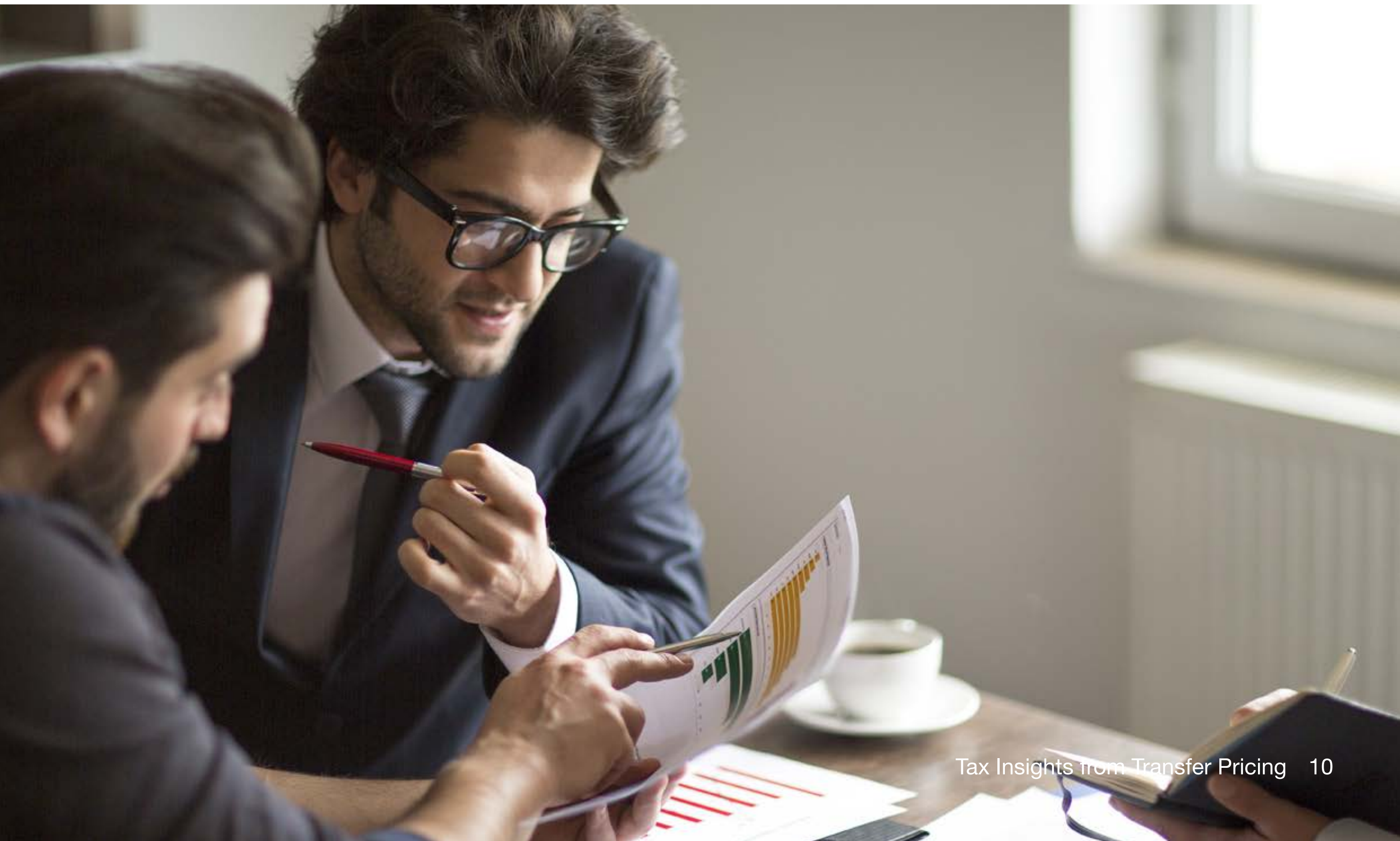
The manual emphasises that all risk management functions relevant to an economically significant risk must be identified and priced, regardless of whether the contractual allocation of risk is respected or reallocated. HMRC goes on to state that a party that contributes to the control of a risk, but does not assume or bear the risk, may still be entitled to a share of the potential upside and downside, commensurate with its contribution to control, although recognises that others part of TPG might be relevant, including Chapter VII on intra-group services.

The manual specifies that the tools and methods set out in Chapter II and following of the TPG should be applied to price the contributions to risk control, taking into account the nature and extent of the functions performed, the assets used and the risks assumed by each party.

Observations

HMRC, in the preamble before discussing 'risk control contributions' states that it is '**counterintuitive for a party assuming an economically significant risk to be rewarded using the transactional net margin method ('TNMM') as this can have the practical effect of 'dampening' the impact of risk outcomes within an arm's length range determined by that party through benchmarking**' (Paragraph 72), which implies that only parties that are deemed 'non-complex', rather than being the 'least complex', warrant use of TNMM. Whilst throughout this interpretation of step 6, HMRC state that other transfer pricing methods, as outlined in Chapter II of the TPG, may be appropriate including cost-plus methods, it is clear that when there is any level of complexity in two or more parties, the TPSM will be in point from HMRC's perspective. CUTs are also mentioned, as a possible method for pricing contributions to control, and while many taxpayers may find this surprising, it is quite common for HMRC to assert that commission-based CUTs could be a valid basis for pricing UK-based contributions to control, despite a general tendency to challenge them in inbound scenarios (procurement CUTs being a classic example).

Although HMRC's guidance is ostensibly about accurate delineation, Step 6 of the six-step risk framework (pricing contributions to control) represents almost half of its content, which is possibly indicative of HMRC's focus on pricing aspects. This is certainly where most of HMRC's audit activity is primarily directed.



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How to price contributions to control: when is it appropriate to use the TPSM?

The manual explains how to price contributions to control of risk in a controlled transaction. Very helpfully, and notwithstanding all of the surrounding commentary which gives a very different impression, it says that usually a one-sided method including cost-plus will be suitable, unless the profit split method is more reliable. Note, however, that CUTs are included in one-sided methods. The TPSM is not a default option, but may be used in situations where there are unique and valuable contributions, a high degree of integration, or shared or related risk assumption. If there is no risk assumption by the party making contributions to the control of risk, the TPSM may be used if there are no comparables or reliable adjustments cannot be made. The manual also discusses the case of intangible assets, where important functions such as DEMPE or risk control (which can overlap) may justify a share of profit or loss.

Observations

Despite the helpful observation that a one-sided method will usually be suitable, HMRC elaborate on their interpretation of the TPG in a way which seems designed to provide the maximum scope for asserting that a profit-split will be most appropriate. For example, the standard of comparability for third party companies to be accepted into a TNMM sample goes beyond that which most readers of the TPG would deem practical, and is in keeping with HMRC's general approach in audit. Lack of comparables would then point to the TPSM being appropriate.

Similarly, the guidance on what might be deemed to be 'a high degree of integration', indicating that a profit split might be appropriate, seems to describe decision-making processes that will be common in most MNEs.

Ex-ante or ex-post

This section of the manual seeks to address the issue of whether to use projected (ex-ante) or realised (ex-post) profits when applying a profit split. The manual specifies that this will depend on how the transaction is accurately delineated and which parties assume, control, and bear the economically significant risks. The manual states that ex-post profits should be used only when the parties share or separately assume closely-related risks, and should share in the outcomes. Otherwise, ex-ante profits might be appropriate to use when parties are either highly integrated or make unique and valuable contributions. However, there may be situations where a party contributes to the control of risk, but does not assume it, and therefore may deserve a share of ex-post profits, if there is evidence of such in an arm's length arrangement.

Observations

This guidance here is conceptually difficult. HMRC states that certain contributions to risk control might warrant a slice of the anticipated residual irrespective of whether the residual materialises. The guidance does not specify how and why, economically, part of an integrated decision-making function would capture a meaningful slice of residual and yet not participate in profit volatility.

Similarly, where HMRC notes that third party arrangements might specify that a party contributing to control might participate in ex-post profits, they do not explain how they would conclude that such a contractual arrangement should be preferred over one presented by the taxpayer, and whether that would constitute a recharacterisation.

Relevant profits

The manual explains how to allocate the reward for the financial risk assumed by a party in a controlled transaction, based on its level of control over that risk and the characteristics of the funded activity. HMRC discusses the challenges of measuring the reward for the financial risk, especially when it is intertwined with the business risk, and the factors that may affect the selection of the transfer pricing method. The guidance emphasises the need to analyse the facts and circumstances of the actual transaction and to identify the economically significant risks and the parties that control and bear them. It is once again that the TPSM may be suitable in some cases where the parties make unique and valuable contributions and share closely related risks.

Observations

Whilst it is helpful the manual recognises the challenges with separating financial risk from the relevant operational risk, it provides limited guidance as to how to price 'risk-adjusted' returns for a financial risk. Additionally, in some third party scenarios, it may be seen that a funder may not have the sufficient capability to have deemed control of operational economically significant risks, but would still require a risk adjusted return for having made the commitment to provide funding.

In detail (continued)

Application

The manual explains how to apply the TPSM. The guidance covers four main aspects: the control of risk, the choice of ex-ante or ex-post profit split, the identification of relevant profits, and the allocation of relevant profits. HMRC emphasises that a profit split is not suitable for all cases, and that it requires careful analysis of the facts and circumstances, the availability and reliability of data, and the degree of uncertainty involved. Reference is made to situations where particular entities only employ a limited number of the employees who contribute to the control of risk, such that there is a deemed lack of 'critical mass', as well as consideration of how unique and valuable such contributions are. These factors together could limit the options realistically available to the party employing these few employees, its resulting bargaining power and its likely participation in a profit split.

The manual provides a hypothetical example to illustrate the different outcomes that may arise depending on the uniqueness and value of the employees' contribution and the degree of integration between the entities. The guidance also acknowledges that profit split calculations are not simple, and that there is no one approach to identifying and splitting relevant profits. The guidance advises that the choice of method should be based on the facts and circumstances of each case, and that the method should be applied in a consistent and reasonable manner.

Observations

Overall the extensive attention which the guidance pays to the application of the TPSM, despite the caveats, is indicative of the HMRC's general approach to these issues. The reference to bargaining power in this section is welcome. As mentioned in the introduction to this analysis, HMRC's approach to risk is difficult to reconcile with the need to consider options realistically available to the respective parties. Here, HMRC notes that the bargaining power of a small number of individuals may be limited, and where there is insufficient 'critical mass' a profit split may not be appropriate.

Within this section (and elsewhere), HMRC do not provide any meaningful direction around how to practically identify the relevant profits (or losses) attributable to a given risk in a situation where there are a lot of interrelated risks, and therefore suggest that simple allocation methods, such as headcount based profit splits, might be applied to total residual profits as a proxy. Given the fundamental practical and conceptual difficulties in isolating the profit consequence of specific risks, and the very high likelihood that for most organisations risks will be highly integrated, the absence of pricing suggestions other than an (essentially formulary) headcount-based profit split will concern many taxpayers.

Recognition of the accurately delineated transaction

The manual recognises that in exceptional cases, a transaction can be disregarded if it does not reflect the economic reality of the parties' behaviour and the options realistically available to them. This could be the case if the transaction is not commercially rational, or if it is designed to avoid tax or exploit regulatory or market imperfections. HMRC goes on to caution that non-recognition should not be applied simply because finding comparable transactions is difficult, or because the accurately delineated transaction is not observed between independent parties. These factors alone do not imply a lack of economic rationality, unless there is evidence that the parties would have chosen a different arrangement in the absence of their relationship.

Observations

In practice, the line between accurate delineation and non-recognition is not distinct. In practice we see transactions being totally disregarded and reestablished under the premise of 'redelineation', on the other hand, we see contracts being respected, but pricing outcomes being asserted based on non-contractual factors. In either case, the practical guardrails established by the TPG to avoid situations where contractual arrangements are, essentially, ignored become fairly meaningless. As a general point, regardless of terminology used, it is important that taxpayers can evidence clear commercial rationality behind their transactions. This will normally require consideration of the options realistically available to the parties, which, as alluded to above, will require determining the sources of competitive advantage and how these are anchored to each party.

The takeaway

On the basis of this guidance, taxpayers should consider how they plan to defend transfer pricing policies which involve remunerating a simpler tested party as a result of determining that control of a risk (or ownership of a residual generating intangible) lies elsewhere, particularly where it could be argued that there are contributions to risk decisions in the tested party. In particular contract R&D arrangements and distribution and marketing arrangements and service contracts for senior employees which are priced using the TNMM will be a particular area of focus.

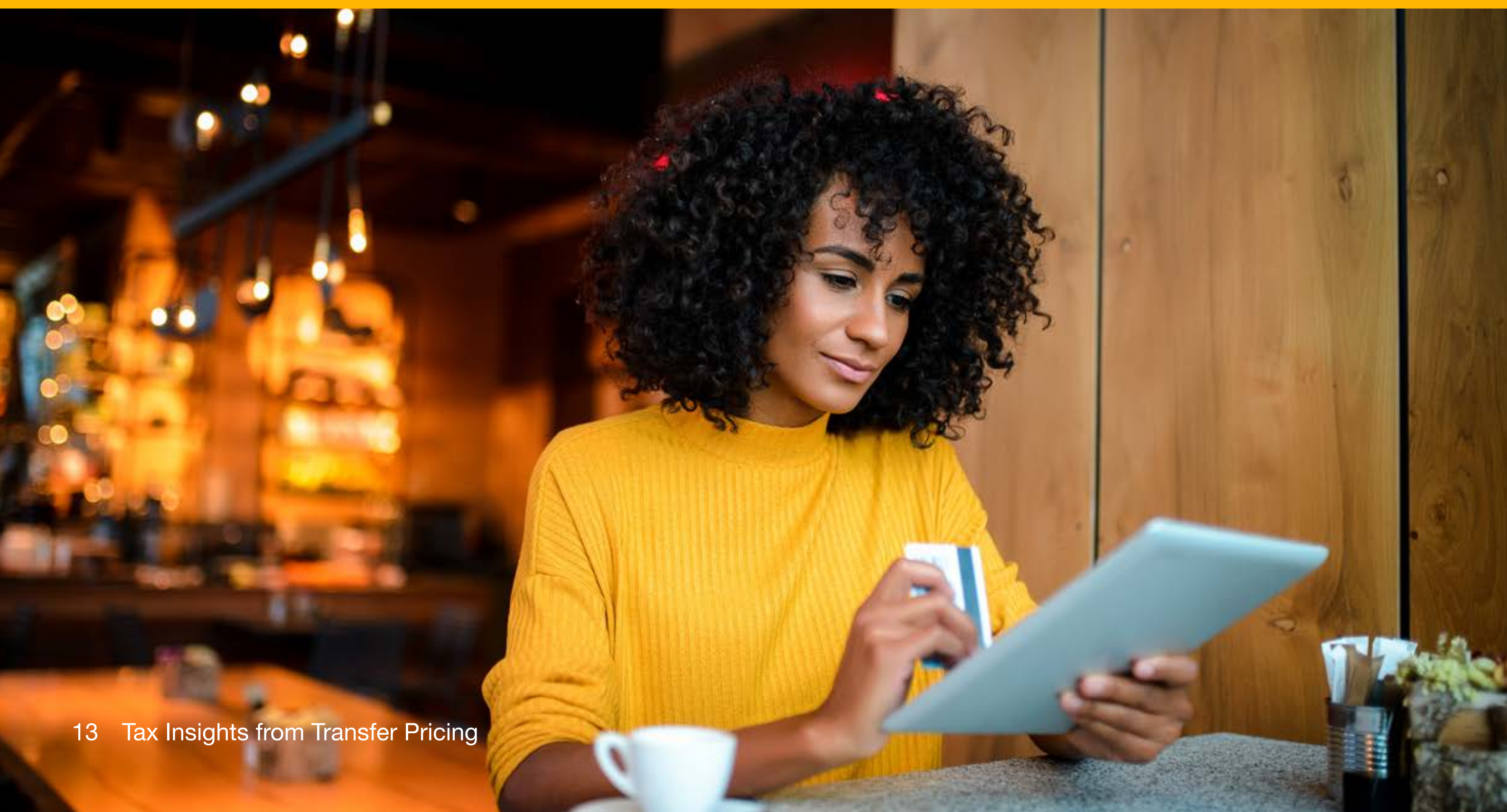
HMRC's view is not necessarily reflective of an OECD consensus interpretation, but the manual provides a clear indication of what taxpayers may expect on audit, and indeed is in keeping with our experience of the focus areas of recent HMRC audits.

In our view, HMRC are specifying that there is a direct relationship between decisions about risk and profits, and HMRC's theory does not require the specification of sources of competitive advantage as drivers of residual profits (or loss). This seems to imply that assets and risks are potentially separate sources of residual. The consequences this has for asset ownership, asset valuation, options realistically available analysis, and other related areas are very significant and will require consideration.

Due consideration should be given to the current processes and governance in place for obtaining and documenting evidence, particularly in relation to performing functional analysis to identify economically significant risks, contributions to control of those risks, including key decision points.

This is alongside the consideration of other economically relevant characteristics, and the impact all those factors have on the determining the options realistically available and bargaining power of the parties, which will ultimately inform the approach to pricing. PwC have and continue to look at alternative approaches to one-sided pricing, particularly in situations where there is senior management/ decision maker involvement.

Ultimately, with a more explicit appreciation of HMRC's interpretation of the TPG, and their consequent expectations on audit, taxpayers will have to determine the extent to which HMRC's view aligns with the principles underpinning their global transfer pricing approach and a decision will be required as to the appropriate steps necessary to demonstrate compliance, to prepare for audit, and to understand the routes available to achieve bilateral agreement.



Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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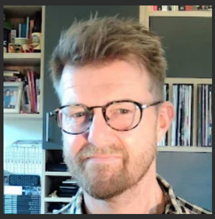

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