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The new transfer pricing landscape
A practical guide to the BEPS changes

Accurate delineation of the transaction and risk

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The changes to Chapter I of the Transfer Pricing Guidelines provide a revised interpretation of the arm's length principle predicated on an expanded view and analysis of the economic substance of a controlled transaction. The expanded analysis required to determine whether a controlled transaction has economic substance involves a significantly more granular functional and risk analysis, referred to as "accurately delineating the actual transaction."

Under the new guidance, a contractual allocation of risk (and associated expected return) will be respected if and only if each party contractually allocated a risk is considered, through the accurate delineation analysis, to control their allocated risk and to have the financial capacity to bear the risk. The analysis of risks and of the functional control of risks thus becomes a pivotal element of the expanded functional analysis required under the new guidance. From a practical standpoint, taxpayers will have to separately identify the various risks involved in their controlled transactions and analyze and document, for each of them, the party actually making the decisions to take on, lay off, and mitigate the risks. Financing risks are specifically called out in the new guidance as being separate and distinct from operational risks. The mere fact that a legal entity exercises control of a funding risk does not entitle that entity to the returns associated with operational risks, unless it exercises control of those operational risks as well.

Accurate delineation of transactions

The changes to Chapter I establish the concept of "accurate delineation of a transaction," which extrapolates the importance of determining the actual transaction introduced in the changes to Chapter VI on intangibles. At first glance, the concept is simple: the accurate delineation of a transaction is about assessing how the actual behavior of the parties to a transaction stacks up against what is provided in the written contract. Through the process of accurate delineation, the transfer pricing exercise focuses on pricing the "the real deal," as opposed to pricing a written contract that may not reflect the true contributions of the parties to value creation.

One particularly important element of the new guidance is the specific requirement that funding risk be distinguished from operational risk. In that context, control of funding risk is about the competent ability to assess an investment opportunity as a provider of financial capital, and about the authority to make such investment decision and direct mitigation of funding risk strategies. Funding risk receives no more than a risk-adjusted financial return, not the residual income from taking operational risk. In contrast, control of operational risk is about the competent ability to assess the implications of various operational decisions on the results of the business, and about the authority to make operational decisions and direct mitigation of operational risk strategies. Operational risks receive residual income. The result under the new guidance is the opposite of the results in many situations in which the operations were tested under the transactional net margin method/comparable profits method and the residual return was allocated to the entity providing funding.

A chief financial officer sitting on the board of a controlled foreign corporation (CFC) may, depending on the facts, be competent at assessing the funding opportunity of a development project, but would generally not be competent at assessing whether a specific third-party laboratory should be retained to perform a spectral analysis of various pieces of experimental data generated by a particular development workstream at a particular junction of the development project. The exercise of control of funding risk results in no more than a risk-adjusted financial return. If the legal entity providing the financial capital is not considered to be managing and controlling the funding risks, the returns associated with funding will be limited to a risk-free rate of return.

A deeper examination of the concept of accurate delineation reveals the challenges taxpayers will face when applying it to a complex fragmented MNE when control of activities in connection with some of the key risks that drive the return do not clearly reside within a single legal entity. For example, if sourcing is a key value driver in an MNE, and the control of sourcing functions are performed by two senior executives residing in different legal entities, the returns to the control function will be allocated to the entity with "the most control." How this is to be assessed in the context of a complex multidimensional enterprise will likely be open to considerable debate, and may have to wait for the issuance of the G20/OECD's guidance on profit splits, which has been deferred until 2016/2017.

Because of the level of granularity required by the new guidance in identifying all the specific risks affecting the MNE, in many situations multiple legal entities will share a portion of the consolidated returns commensurate with the level of risks they each assume. Taxpayers will have to manage the valuation challenges resulting from that approach.

To summarize, the new guidance prohibits the provider of financial capital to be the claimant to the residual income unless it also manages and controls the operational risks. When the provider of financial capital and the entity managing and controlling the operational and financial risks are one and the same, no adjustment is necessary. However, when that is not the case, the new guidance requires identifying who in fact (i) has access to or provides financial capital, (ii) performs operations, and (iii) manages and controls the risks of those activities. When more than one entity controls the risks that drive the returns, each may be entitled to a share of the income, depending on their respective contributions to value creation.

The process provided in the new guidance to accurately delineate the transaction is a five-step process outlined below. For each transaction, the process involves reviews of:

- The contractual terms of the transactions
- The functions, assets, and risks of each participant, including an assessment of how these relate to the wider generation of value within the MNE
- The characteristics of the property transferred or services provided
- The economic circumstances of the parties and of the market in which the parties operate
- The business strategies pursued by the parties.

The information generated by this delineation is expected to be documented, for each covered transaction, in the local file. The extent of the information and analysis required by the new guidance is so much greater and involved than before, it may result in an increase in the costs of compliance for many taxpayers.

For highly fragmented MNEs considering how to react to this new environment, the specific location of central service providers in the global MNE footprint may need to be reconsidered in light of how tax administrations in that jurisdiction adopt and implement the new guidance. For example, a consolidation of functions within fewer legal entities may be one way MNEs respond to the new environment.

The role of risk

The main goal of the new guidance is to introduce a process that provides tax administrations with a powerful two-pronged tool to disregard the contractually agreed risk-return allocation between the parties, even if their actual behavior is consistent with the letter of the contract (such as, for example, where the contract does not reflect an arm's length allocation of risk). Consider the second factor that must be identified in the process of accurate delineation of a transaction presented in the previous section. The new guidance provides a six-step process to effectuate the analysis of risk under that factor. That six-step process articulates the two-pronged control and financial capacity test under step 2.3 below. The six-step risk process is:

- Step 1: Identify economically significant risks with specificity:
- Step 2: Determine how specific, economically significant risks are contractually assumed by the associated enterprises under the terms of the transaction;
- Step 3: Determine through a functional analysis how the associated enterprises that are parties to the transaction operate in relation to assumption and management of the specific, economically significant risks, and in particular which enterprise or enterprises perform control and risk mitigation functions, which enterprise or enterprises encounter upside or downside consequences of risk outcomes, and which enterprise or enterprises have the financial capacity to assume the risk;
- Step 4: Steps 2-3 will have identified information relating to the assumption and management of risks in the controlled transaction. The next step is to interpret the information and determine whether the contractual assumption of risk is consistent with the conduct of the associated enterprises and other facts of the case by analyzing (i) whether the associated enterprises follow the contractual terms; and (ii) whether the party assuming risk, as analyzed under (i) exercises control over the risk and has the financial capacity to assume the risk;
- Step 5: When the party assuming risk under steps 1-4(i) does not control the risk or does not have the financial capacity to assume the risk, apply the guidance on allocating risk; and
- Step 6: The actual transaction, as accurately delineated by considering the evidence of all the economically relevant characteristics of the transaction, should then be priced taking into account the financial and other consequences of risk assumption, as appropriately allocated, and appropriately compensating risk management functions.

Because risk is such a central element around which contractual deference revolves, the new guidance provides taxpayers and tax administrations with a definition of risk for transfer pricing purposes; risk is defined as the effect of uncertainty on the objectives of the business.

To prevent a tax administration from rewriting a contract and reallocating risk, a taxpayer will have to demonstrate that two features are present for each specific risk when an entity claims an associated return (both upside and downside):

- The entity has the financial capacity to assume each specific risk: defined as access to funding to take on the risk or to lay off the risk, to pay for the risk-mitigating functions, and to bear the consequences of the risk if the risk materializes.

- The entity controls each specific risk: defined as having the capability to perform, and actually performing decision-making to (i) take on or lay off the risk; and (ii) respond to the risk, including risk mitigation. The risk mitigation function can be outsourced, but when this occurs, control requires the capability to determine the objectives of the outsourced activities, and the capability to hire, assess, adjust, and terminate the provider of the outsourced activities. In essence, control of risk requires both the capability and the performance of that capability.

Because this two-pronged test was specifically designed to target low -functionality entities capitalized with intragroup funding, in the context of an entity committed to funding an intangible development project through a research and development (R&D) services arrangement, the guidance requires identifying and analyzing separately the risk of funding the development activity from all other operational risks, including the R&D services arrangement. For each of those risks, an analysis of financial capacity and of control of the risk is required. If the funding entity is considered to have the financial capacity to fund the development activity and is deemed to exercise control of that funding risk, it will still not be entitled to more than a risk-adjusted return unless it is also deemed to have the financial capacity to fund and control operational risks.

For funding entities that fail either of the two requirements, each risk it is contractually allocated will be reallocated by the tax administration to the party deemed to have the financial capacity and to have control of the risk. The funding entity will receive no more than a risk-free rate of return on its funding.

The assessment of financial capacity to bear risk should be made by reference to the funding entity's ability to access the capital market and obtain third-party funding as a stand-alone entity, if needed to cover the required expenses, should the risk materialize. Just looking at the balance sheet of the funding entity is therefore necessary but not sufficient.

To satisfy the control requirement, decision-makers must be competent in the area of risk for which the decision is being made, and perform the decision-making functions in the location of the entity claiming entitlement to the profit. A mere formalizing of decisions made outside that location, including but not limited to keeping minutes of a board meeting or to signing documents executing the decisions, is specifically called out as insufficient to demonstrate decision-making. Similarly, setting the policy environment relevant for the risk is insufficient to establish decision-making.

The G20/OECD and other countries involved in the BEPS project went through an internal debate on the legitimacy of the risk/expected return trade-off, which has been upheld in the guidance. However, the guidance does not contain a clear definition of the risk-adjusted return. Is it a debt return? Is it a weighted average cost of capital return? The absence of further guidance as to how to determine the risk-adjusted return may increase the likelihood of protracted controversy.

Example

The new guidance contains a few examples to help taxpayers understand the important considerations in assessing their structures' compliance with the new guidance. In Example 1, Company A decides to pursue a development activity and engages Company B to perform the actual development functions on its behalf. The arrangement between the two companies depicts a typical contract R&D arrangement many multinational companies have and are familiar with.

The discussion of the example focuses on the applications of steps 1-3 listed above. Under step —identifying the risk— development is identified as an economically significant risk in the transaction. Under step 2—contractual allocation of risk—it is determined that the contract allocates the development risk to Company A.

Step 3—dentifying the entity controlling the risks and who has the financial capacity—is the critical step that determines whether or not the contractual risk-return allocation is respected. In this particular example,

> "Company A controls its development risk through exercising its capability and authority in making a number of relevant decisions about whether and how to take on the development risk. These include the decision to perform part of the development work itself, the decision to seek specialist input, the decision to hire the particular researcher, the decision of the type of research that should be carried out and objectives assigned to it, and the decision of the budget allocated to Company B. Company A has mitigated its risk by taking measures to outsource development activities to Company B which assumes the day-today responsibility for carrying out the research under the control of Company A. Company B reports back to Company A at predetermined milestones, and Company A assesses the progress of the development and whether its ongoing objectives are being met, and decides whether continuing investments in the project are warranted in the light of that assessment."

Company A has the financial capacity to assume the risk. Company B has no capability to evaluate the development risk and does not make decisions about Company A's activities. Company B's risk is mainly to ensure it performs the research activities competently and that it exercises its capability and authority to control that risk by making decisions about the processes, expertise, and assets it needs. The risk Company B assumes is distinct from the development risk assumed by Company A under the contract, which is controlled by Company A based on the evidence of the functional analysis.

This example illustrates some of the specific factors that a company would need to take into consideration in determining control. These factors will need to be discussed in the local file. Consider this statement:

> "Company B reports back to Company A at predetermined milestones, and Company A assesses the progress of the development and whether its ongoing objectives are being met, and decides…"

This statement is the result of evidence demonstrating that Company B regularly reports to Company A, and that more than a paper trail exists showing that the information contained in the paper trail is actually processed by Company A. Similarly, the statement that Company A assesses the progress of the development is the result of evidence demonstrating that Company A, after processing the information provided by Company B, provides actionable feedback to Company B. Notice that the activities of Company A suggested above need to be carried out in location, not merely formalized in location.

Practical implications

The new guidance is written broadly and applies to all related-party transactions. Thus, taxpayers should recognize that the new guidance is transactional, and not based on an analysis of the overall functionalities of any given legal entities. Specifically, a company may be deemed to exercise control of a risk in a transaction with an affiliate, but not in the same or similar transaction with another affiliate. Determining the allocation of returns within an MNE thus requires an application of the six-step risk process to determine the entity entitled to risk-related returns on a transaction-by-transaction basis. The accurate delineation of the material transactions, including the allocation of risk, is required to be documented in the local files.

Although some of the focus of the new Chapter I guidance relates to intangibles, it applies to more than just intellectual property transactions. Any transaction that involves an expectation of non-routine returns requires one or more claimants to the residual income that is above and beyond the sum of the routine returns. The new guidance provides the analytical framework taxpayers and tax administrations would use to determine which affiliates, at arm's length, would be entitled to what portion of that residual.

In existing arrangements governed by the 2010 Transfer Pricing Guidelines, an analysis may result in a reallocation of the party bearing risk and resulting returns. Given the complexity of the new guidance, and the extent of the information required to perform the analyses, sufficient lead time should be allowed for a thorough analysis of the facts and the adoption of required adjustments, including the updating of contracts. For companies with highly complex arrangements this process could be time consuming.

Conclusion

The new rules on delineation of the transaction and the allocation of risk provide important new guidance on the application of the arm's length standard that will have a far-reaching impact on many MNEs. MNEs with capital-rich, low-functioning entities may find the returns to those entities substantially reduced. However, the new guidance is not limited to those situations. MNEs engaged in activities that command more than a routine return in the market place that relied on TNMM/CPM to allocate non-routine returns may find that the new guidance allocates non-routine returns to different entities.

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