OECD releases final transfer pricing guidance on risk and recognition under Actions 8-10

Executive summary

On 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final report on aligning transfer pricing outcomes with value creation (Actions 8-10) under its Action Plan on Base Erosion and Profit Shifting (BEPS). This report was released in a package that included final reports on all 15 BEPS Actions.

The document Aligning Transfer Pricing Outcomes with Value Creation (the Final Report), contains revisions to section D of Chapter I of the OECD Transfer Pricing Guidelines, guidance on commodity transactions, revisions to Chapter VI of the OECD Transfer Pricing Guidelines regarding intangibles, revisions to Chapter VII of the OECD Transfer Pricing Guidelines regarding low value-adding intra-group services, revisions to Chapter VIII of the OECD Transfer Pricing Guidelines regarding cost contribution arrangements, and scope of work for guidance on the transactional profit split method.

This Alert discusses the revisions to section D of Chapter I of the OECD Transfer Pricing Guidelines relating to risk analysis, recognition of the accurately delineated transaction, and cash boxes.

The key guidance includes:

• The importance of accurately delineating the actual transactions between associated enterprises through analyzing the contractual relations together with evidence of the actual conduct of the parties.

• Detailed guidance on analyzing risks as an integral part of a functional analysis, including a new six-step analytical framework. For transfer pricing purposes, the party assuming a risk should control the risk and have the financial capacity to assume the risk.
A capital-rich multinational enterprise (MNE) group member without any other relevant economic activities that provides funding, but cannot control financial risks in relation to the funding, will attain no more than a risk-free return (and less if the transaction is commercially irrational).

In exceptional circumstances of commercial irrationality, a tax administration may disregard the actual transaction. The main question is whether the actual transaction has the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances.

The Final Report contains significant changes compared to the discussion draft on risk and recharacterization in December 2014\(^1\) and compared to the 2010 OECD Transfer Pricing Guidelines.

EY is hosting a series of webcasts that will provide a comprehensive review of the final BEPS reports and outlook for country action. The final report on Actions 8–10 will be addressed in a webinar on Transfer Pricing and BEPS Actions 8-10, on 12 November, 10am EST.

**Detailed discussion**

**Background**

BEPS Actions 8, 9 and 10 relate to assuring that transfer pricing outcomes are in line with value creation. This includes the development of rules on a number of closely related topics, including:

1. Development of rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members

2. Development of rules to prevent BEPS by engaging in transactions that would not, or would only very rarely, occur between third parties, including implementing transfer pricing rules or special measures to clarify the circumstances in which transactions can be recharacterized

3. Transfer pricing rules or special measures for transfers of hard-to-value intangibles

The Final Report contains specific revisions to section D of Chapter I of the OECD Transfer Pricing Guidelines following work under BEPS Actions 9 and 10. To deal with the perceived focus on contractual allocations of functions, risks and assets under the current guidance, the Final Report provides that the revisions clarify and strengthen the guidance on the arm’s length principle to ensure that transfer pricing outcomes are consistent with the economic activity conducted by MNE group members. The report highlights the importance of accurately delineating the actual transactions, provides a new six-step framework to determine which party assumes risk and updates the guidance on recognition of the accurately delineated transaction, including criteria for determining when it would be appropriate for the actual transaction not to be recognized.

**Identifying the commercial or financial relations**

The Final Report extends the comparability analysis, an important element of a transfer pricing analysis, with an important first step. The Final Report notes two aspects of a comparability analysis: (i) the identification of the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated; and (ii) a comparison between the conditions and the economically relevant circumstances of the controlled transaction as accurately delineated, with the conditions and the economically relevant circumstances of comparable transactions between independent enterprises. The first aspect is dealt with in Chapter I of the OECD Transfer Pricing Guidelines, while Chapters II and III focus on the second aspect.

The Final Report states that the economically relevant characteristics or comparability factors of a transaction between associated enterprises should be identified in order to accurately delineate the actual transaction. These comparability factors can be broadly categorized as follows: (i) contractual terms, (ii) functions performed taking into account assets used and risks assumed, (iii) characteristics of property and services, (iv) economic circumstances of the parties and market, and (v) business strategies.\(^2\)
Where a transaction has been formalized by the taxpayer through written contractual agreements, those agreements provide the starting point for identifying the commercial and financial relations between the associated enterprises. However, information from the written contracts should be clarified and supplemented by considering evidence of the commercial and financial relations provided by the other four economically relevant characteristics. An analysis of all five characteristics provides evidence of the actual conduct of the parties. In case the economically relevant characteristics of a transaction are inconsistent with contractual terms, the actual transactions should in general be identified based on the actual conduct of the parties. The Final Report provides that where no written terms exist, the actual transaction would need to be deduced from the evidence of actual conduct provided by identification of the economically relevant characteristics of the transaction.

The Final Report states that features of the parties, such as capabilities and actual contributions, can affect the options realistically available to the parties. Therefore, the process of identifying the economic circumstances of the commercial and financial relations should include consideration of the capabilities of the parties, how under the arm’s length hypothesis such characteristics affect options realistically available, and whether similar capability is reflected in potentially comparable arm’s length arrangements.

**Analysis of risks in commercial or financial relations**
The Final Report contains additional new guidance on the analysis of risks, which is an integral part of a functional analysis. Because the assumption of increased risk would be remunerated by an increase in expected return, it is key to determine what risks are assumed, what functions are conducted in connection with the assumption or impact of the risks and which party or parties assume these risks. Risk assumption is defined as “taking on the upside and downside consequences of the risk with the result that the party assuming the risk will bear the financial and other consequences if the risk materializes.” The report provides that the detailed guidance on risks does not mean that risks are more important than functions and assets, but arises from the practical difficulties introduced by risks.

The Final Report provides the following six-step analytical framework for analyzing risk:

**Step 1: Identification of economically significant risks with specificity** - The Final Report introduces a materiality threshold by focusing on identifying economically significant risks with specificity. Risk is defined as the effect of uncertainty on the objectives of the business. The significance of a risk depends on the likelihood and size of the potential profits or losses arising from the risk. Risks can be categorized in various ways, but a relevant framework in a transfer pricing analysis should consider the sources of uncertainty which cause risk. These sources may include, but are not limited to, strategic or marketplace risks, infrastructure or operational risks, financial risks, transactional risks, and hazard risks. The nature of the risk may inform which party in the group would be expected to perform the decision making related to the risk.

**Step 2: Determination of contractual assumption of the specific risk** - Written contracts between the parties to a transaction may describe the party or parties assuming the specific risks. Ex ante contractual assumption of risk provides clear evidence of a commitment to assume risk prior to the materialization of risk. The Final Report provides that it should not be concluded that the pricing arrangements in contractual arrangements alone determine which party assumes risk.

**Step 3: Functional analysis in relation to risk** - This step analyzes the functions that the parties to the transaction perform
in relation to risks. This analysis provides information about how the associated enterprises operate in connection with the assumption and management of the specific, economically significant risks. In particular, the analysis should look at which enterprise or enterprises perform control functions and risk mitigation functions, which enterprise or enterprises experience upside or downside consequences of risk outcomes, and which enterprise or enterprises have the financial capacity to assume the risk.

The Final Report defines risk management as the function of assessing and responding to risk associated with commercial activity. According to the report, risk management comprises three elements: (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function; (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function; and (iii) the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation.

Control over risk requires the first two elements of risk management. Both capability and functional performance are needed to exercise control over risk. Performing the day-to-day risk mitigation is not required in order for a party to have control over the risk. It is possible to outsource the day-to-day risk mitigation. However, where these day-to-day risk mitigation activities are outsourced, control of risk would require the capability to determine the objectives of the outsourced activities, to decide to hire the party conducting the risk mitigation functions, to evaluate whether the objectives are sufficiently satisfied, and where necessary, to decide to adopt or terminate the contract with the provider, together with the performance of such assessment and decision-making. Risk mitigation refers to measures taken that are expected to affect risk outcomes (e.g., quality control audits), which include measures that reduce uncertainty or measures reducing consequences if the downside impact of risk materializes.

References to control over risk should not necessarily be taken to mean that the risk itself can be influenced or that the uncertainty can be nullified. Therefore, control is relevant also for risks that cannot be influenced, for example through the timing of investments, the nature of development programs, the design of marketing strategies, or the setting of production levels.

Financial capacity to assume a risk is defined as access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of risk materialization. Access to funding should consider the available assets and options realistically available to access additional liquidity, if required. The assessment of the access to funding should be made on the basis that the party assuming the risk is operating as an unrelated party operating in similar circumstances.

Step 4: Interpreting steps 1–3 - Based on information collected in Steps 1–3 regarding the assumption and management of risks, Step 4 determines whether the contractual assumption of risk is aligned with the conduct of the parties and other facts by analyzing (i) whether the parties follow the contractual terms; and (ii) whether the party assuming the risk controls the risk and has the financial capacity to assume the risk.

If the party contractually assuming the risk controls the risk and has the financial capacity to assume the risk, the next step of the analysis is Step 6. If it does not, the analysis continues with Step 5. In contrast with the discussion draft of December 2014, which generally ignored the financial capacity to assume the risk, this factor has been added as relevant, on par with control over risk.

The Final Report provides that the mere formalizing of the outcome of decision-making (e.g., meetings organized for formal approval of decisions made in other locations, minutes of board meetings, and signing of agreements regarding the decision) or the setting of the policy environment relevant for the risk (e.g., the board and executive committees of the group may set the risk level of the group) are not sufficient to conclude there is control over risk.
Step 5: Allocation of risk
If the associated enterprise (contractually) assuming the risk does not exercise control over the risk or does not have the financial capacity to assume the risk, then the risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk. If multiple parties exercise control over risk and have the financial capacity to assume the risk, then the risk should be allocated to the party or group of associated enterprises exercising the most control.

Step 6: Pricing the transaction, taking into account the consequences of risk allocation
The accurately delineated transaction should then be priced in accordance with the tools and methods available to taxpayers and tax administrations set out in Chapters II (transfer pricing methods) and III (comparability analysis) of the OECD Transfer Pricing Guidelines and taking into account the financial and other consequences of risk assumption, and the remuneration for risk management. This basically entails the selection of the most appropriate transfer pricing method and the identification of comparable transactions, based on the accurately delineated transaction.

“Cash Boxes”
The Final Report aims to ensure that capital-rich entities without any other relevant economic activities (so-called cash boxes) will not be entitled to any excess profits. A “cash box” that provides funding, but cannot control financial risks in relation to the funding, will attain no more than a risk-free return, or less if the transaction is commercially irrational and may be disregarded or recharacterized. By imposing the requirement for companies to exercise control over risk assumed, a “cash box” would have to perform the functions controlling the risks in order to be entitled to the risk related return. If not, the risk (and the related returns) would be allocated to the group entity that is performing such control functions. The profits the “cash box” is entitled to retain will be equivalent to no more than a risk-free return for the funding itself. Additionally, non-recognition rules may also be applicable. As a result, a “cash box” with no or low functionality would get no more than a risk-free rate of return for the funding itself. The guidance and examples are not limited to “cash box” companies investing in intangible assets, but are equally applicable to investments in other assets.

Other BEPS measures that could impact “cash boxes” include interest deductibility (BEPS Action 4), controlled foreign company rules (BEPS Action 3), and the minimum standard on treaty abuse (BEPS Action 6), as well as application of domestic anti-abuse rules.

The BEPS Action Plan indicated that special measures might be introduced. However, the Final Report indicates that the newly developed transfer pricing rules are such that there was no need to develop special measures outside the arm’s length principle.

Recognition of the accurately delineated transaction
This section of the Final Report has been significantly changed compared to the December 2014 discussion draft.

The guidance emphasizes that every effort should be made to determine the pricing for accurately delineated transactions under the arm’s length principle. It recognizes that non-recognition can be contentious and a source of double taxation and it highlights that associated enterprises may have the ability to enter into a much greater variety of arrangements than independent enterprises can. Where the same transaction can be seen between independent parties in comparable circumstances, non-recognition would not apply. The guidance emphasizes that the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognized.

The transaction as accurately delineated may be disregarded in exceptional circumstances. This would be the case if the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances. This would prevent the determination of an arm’s length price. The main question is whether the actual transaction has the commercial rationality of arrangements that would be agreed between unrelated
parties under comparable economic circumstances. In this respect it is also relevant to consider whether the multinational group as a whole is left worse off on a pre-tax basis as a result of the transaction.

The consequence of non-recognition is the replacement of the taxpayer’s structure by an alternative structure that corresponds closely with the facts of the actual transaction and achieves a commercially rational expected result arriving at an acceptable price. Examples are provided. The first example describes an internal insurance arrangement of a risk that a third party insurance company would not accept, due to great uncertainties. The second example describes the sale for a lump sum payment of all the future outcome of research and development activities.

Implications
In summary, the Final Report clarifies that arm’s length pricing should be based on accurately delineated transactions. This requires an analysis of the contractual relations together with evidence of the actual conduct of the parties, including control over risks. There is a shift from the legal form to the economic reality of a transaction. Based on the final guidance, in case the economically relevant characteristics of a transaction are inconsistent with contractual terms, the actual transactions should in general be identified based on the actual conduct of the parties.

Global businesses should further substantiate the activities conducted and value created by the group entities in various countries to support their transfer pricing. A more thorough functional analysis may be needed. Transfer pricing policies merely based on the contractual arrangements and legal ownership should be reviewed. Global businesses should evaluate the implications of the final guidance for their transfer pricing structure and the documentation thereof.

Webcasts
EY is hosting a series of eight tax webcasts that will provide a comprehensive review of the final BEPS reports and the outlook for country action:

• OECD BEPS Project Outcomes: Highlights and Next Steps - 15 October, 10am EDT
• New Reporting under BEPS Action 13 - 20 October, 10am EDT
• Digital Economy Developments and BEPS Action 1 - 27 October, 12 noon EDT
• Permanent Establishment Developments and BEPS Action 7 - 5 November, 10am EST
• Transfer Pricing and BEPS Actions 8-10 - 12 November, 10am EST
• Anti-abuse Measures under BEPS Actions 3, 5, 6 and 12 - 19 November, 10am EST
• Financial Payments and BEPS Actions 2 and 4 - 3 December, 10am EST
• Dispute Resolution and BEPS Action 14 - 10 December, 10am EST

For more information and to register for the webcast series, click here.

Endnotes
1. See EY Global Tax Alert, OECD releases discussion draft under BEPS Actions 8-10 on risk, recharacterization, and special measures, dated 24 December 2014.
2. The information on the comparability factors of the actual transaction should be included in the local file as discussed in Chapter V of the OECD Transfer Pricing Guidelines.
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