First published in Tax Journal on 15 March 2024. Reproduced with permission.

Analysis

HMRC's new transfer pricing guidance on risk and reward

Speed read

New transfer pricing guidance issued by HMRC reinforces the importance of granular analysis of control of economically significant risks when designing and documenting transfer pricing policies for UK entities. When contractual risk allocation is respected under the accurately delineated transaction, the new guidance emphasises that all contributions to control of economically significant risks need pricing and may participate in upside and downside outcomes arising from the playing out of the relevant risks. The guidance states that in cases where key risks are managed through highly integrated control activities, a profit split method may be appropriate.

Phil Roper
KPMG
Phil Roper is a Partner in KPMG's Global Transfer Pricing Services team. He has over 20 years of corporate tax advisory experience, including over 10 years with KPMG and prior to that over 5 years working in industry with AstraZeneca. Email: phil.roper@kpmg.co.uk.

Charles Havisham
KPMG
Charles Havisham is a Senior Manager in KPMG's Global Transfer Pricing Services team. He has over 15 years' transfer pricing experience, including preparing UK and global TP documentation and advising on the developing implications of the OECD's Two-Pillar responses to BEPS. Email: charles.havisham@kpmg.co.uk.

On 26 January 2024, HMRC published new transfer pricing guidance (in their *International Manual* at INTM485025) on how risk allocation should be analysed when delineating controlled transactions, and the consequences for pricing transactions in accordance with the arm's length principle. HMRC's guidance sets out its views on a number of contentious interpretative issues pertaining to the OECD Transfer Pricing Guidelines (TPG).

Background to risk control framework

The *BEPS 2015 Final Report* on Actions 8–10 made important changes to the TPG including the introduction of a new six-step framework for analysing risk assumed in a controlled transaction, in order to delineate the actual transaction – essentially involving identifying its actual characteristics and true terms. The objective was to ensure that inappropriate returns do not accrue to an entity solely because it has contractually assumed risks or provided capital.

The six-step framework effectively takes control of risk and financial capacity to assume the risk a mandatory requirement before an enterprise can be treated as bearing an economically significant risk for transfer pricing purposes. Where an enterprise has contractually assumed an economically significant risk, but does not control it or lacks the financial capacity to assume it, the risk is reallocated to the party (or parties) which in actuality exercises control over the risk and has sufficient financial capacity.

In practice, the control of risk guidance has not just been used to challenge arrangements that left significant returns with entities that were not exercising control over economically significant risks. Since 2015 we have seen HMRC increasingly challenge transfer pricing models that remunerate activities of senior UK employees with routine returns (i.e. returns on sales or cost). The cases have involved in-depth enquiries from HMRC on the control of risk framework – and specifically whether UK employees are performing control functions.

HMRC has adopted a granular approach to testing control of risk in audits, which has surprised many taxpayers, placed significant pressure on resources and assumes risk management that may not be consistent with how a business actually operates

Why is the risk control framework problematic?

The risk control framework raises a number of conceptual challenges, most fundamentally whether it is actually consistent with the arm's length principle. However, it is the practical challenges that have caused the most problems for taxpayers. The guidance might be straightforward to apply when looking at a single decision about whether or not to invest in a new venture or project, but quickly becomes unwieldy in multinational groups with multi-layered governance structures spanning different countries where investment decisions are constantly revisited and revised.

HMRC has adopted a granular approach to testing control of risk in audits, which has surprised many taxpayers, placed significant pressure on resources and assumes risk management that may not be consistent with how a business actually operates. Some commentators have raised concerns about this approach, and this has prompted HMRC to set out the technical basis for its views in extensive new guidance.

The thinking underlying the new guidance

A central principle of the guidance is the relationship between risk and profit potential. HMRC expands upon the TPG and posits that (i) taking on economically significant risks and the effective control of those risks explain MNEs capacity to generate excess earnings or 'residual profits'; and (ii) effort to control economically significant risks is proportional to the profit that derives from their successful control. Taken together, this suggests HMRC's view is that the entities contributing to the control of the group's economically significant risks should be entitled to a commensurate share of residual profits. The guidance can be read as a defence of this position interspersed with commentary on less controversial aspects of the risk control framework.

Effective risk management is important but it is questionable whether this truly generates excess earnings.

First published in Tax Journal on 15 March 2024. Reproduced with permission.

Warren Buffett attributes certain multinationals' ability to sustain excess earnings to 'economic moats', which would include assets (including legal rights), unique capabilities and synergies arising from scale and/or integration. The depth and width of these moats, rather than measures of risk, have greater explanatory value for profitability and bargaining power. For example, a digital services business's economic moat might take the form of a large, diverse, and highly engaged user base, coupled with high customer switching costs, built off first mover advantage in developing a new technology underpinning the service. The development and marketing of that new technology would entail investment and entrepreneurial risk taking, but the risks would not necessarily be commensurate with the resulting valuation of the business and its assets, as this reflects the market opportunity and strength of the competitive advantage as opposed to the riskiness of the enterprise.

Why does this matter? Overemphasising the importance of risks, and underemphasising the importance of assets, as key profit drivers may lead HMRC to overestimate the returns due to important UK staff where key assets are owned overseas.

HMRC's guidance does not suggest assets are irrelevant. The guidance reiterates the language in the TPG that the risk control framework should not be interpreted as meaning risks are more important than functions and assets and also acknowledges that contractual rights arising from the terms of a contract may have inherent value (for example, exclusivity rights in a third party agreement). But the strong emphasis is on decision-making on risk control and the close association between risk and profit potential. HMRC also stresses that the control of risk framework is part of the comparability analysis required under Chapter I, which includes accurately delineating the transaction to be priced – the selection of pricing method is dealt with later under Chapter III. However, that close association between risk and profit potential can appear to pre-empt the decision on pricing method and favour the adoption of a profit split.

What are the key takeaways from the new guidance?

Economically significant risks

HMRC's guidance makes it clear that economically significant risks should be identified 'with specificity' – they should not be bundled together unless this reflects the way those risks are controlled under the group's actual decision-making structures. In practice we know that businesses see at least some degree of overlap among business risks and significant difficulty in assessing the upside and downside financial consequences of individual risks.

HMRC considers an economically significant risk to be one which has a significant impact on the profit potential of a business activity taking into account the scale and likelihood of the risk materialising. The guidance then goes on to state that an economically significant risk is 'one which cannot be substantially mitigated without significantly eroding a business's profit potential'.

This more restrictive definition seems at odds with the fact that business risks could be mitigated not by a heavy cost to the business, but by management's execution of judgement and skill in their own areas of expertise. For example, a company that has strong bargaining power with its suppliers may mitigate raw material supply continuity risks by putting in place dual sourcing arrangements; mitigating the risk but without materially eroding the profit potential.

Consideration of the economic significance of a risk based on its likelihood and severity prior to mitigation actions (i.e. before decisions made by the business on what resources to allocate to risk management and actions taken to mitigate risk including outsourcing and insuring against risk) would seem to make more sense than putting the cart before the horse.

Contractual assumption of risk

Contractual assumption of risk remains a key part of the analysis but it must be tested against the conduct of the parties and their financial capacity to bear the risk, as explained below. HMRC's guidance recognises the importance of contractual terms but suggests they have no greater importance than any of the other economically relevant characteristics. This approach stands in contrast to a recent Upper Tribunal decision on transfer pricing that placed significant emphasis on formal legal agreements (*HMRC v Blackrock Holdco 5, LLC* [2022] UKUT 199 (TCC)), and the approaches we see from other tax administrations.

> Overemphasising the importance of risks, and underemphasising the importance of assets, as key profit drivers may lead HMRC to overestimate the returns due to important UK staff where key assets are owned overseas

Control of risk requirement

Economically significant risks that have been contractually assumed by a group member that is not capable of exercising, or does not in fact exercise, control are subject to reallocation. This is entirely clear from the TPG's risk framework. What is far less clear is what it means to be exercising control of a risk.

HMRC's guidance again expands on the TPG and suggests that capability to control a risk covers: (1) the competence and experience in the area of the particular risk; (2) an understanding of the impact of the decision on the business; and (3) access to the relevant information to support decision making. HMRC goes on to say that competence implies 'practical capability', meaning broadly that the individual must have the necessary time and information to make all the decisions that are ascribed to them.

Control must be defined for each of the economically significant risks relevant to a transaction based on a multinational's actual control structures. HMRC considers it is not sufficient to say that with respect to the contract as a whole the party allocated key risk exercises some element of risk control; rather this analysis must be conducted for each individual risk based on the actual conduct of the parties. Businesses will want to consider this when reviewing their governance arrangements against the risk control framework.

A frequent thorny issue is the relative importance of a multinational's main board and executive committee versus the management for specific business units and functions. One of the difficulties that HMRC and transfer pricing practitioners face in this area is the limited number and simplistic nature of examples included in the TPG.

First published in Tax Journal on 15 March 2024. Reproduced with permission.

In para 1.70, there is an example where an investor appoints a discretionary investment manager who makes the day-to-day buy/sell decisions related to the investment portfolio without assuming the risk of losses in relation to the investments. The conclusion is that the investor is controlling the investment risk through its decision to hire and retain the fund manager, on the degree of authority given to the fund manager and the decision on how much money to invest. The TPG describe the day-to-day investment decisions of the fund manager as risk mitigation with control of the investment risk remaining with the investor.

By contrast, the example at para 1.76 relating to inventory risk suggests that where there are central policy-setting decisions this should not be regarded as the relevant risk control decision for a specific intercompany transaction. The example discusses a scenario where a board sets a policy for the management of inventory risk, but where the manufacturer's decisions around production volumes determine the inventory risk that arises from the specific intercompany transaction. A key difference between the examples is that in para 1.70 the investor makes a decision that puts capital at risk whereas in para 1.76 it is the manufacturer which puts capital at risk (when making the decisions on production levels) rather than the central policy setter.

HMRC does not assume that risk control sits with a particular level of management. In practice we tend to see that HMRC wants to peel back multiple layers of governance to establish what the overall contribution of UK parties are. This is reflected in later comments in the guidance that emphasise the importance of specificity. Where a board sets the policy parameters within which line management make decisions, the latitude given to line management is relevant in identifying the individuals that are controlling the relevant risks.

In the authors' view, these things need not be mutually exclusive: paras 1.94 and 1.98 of the TPG recognise that in some cases more than one party to the transaction may exercise control over a specific risk. If a party contractually allocated a risk was exercising control through delegation of authority within prescribed parameters or taking lower level decisions under the delegated authority, either could potentially satisfy the control test for a risk.

The key takeaway here is that each case should be considered on its own merits but HMRC's expectations on the level of specificity in the risk control analysis are a daunting prospect for businesses.

Financial capacity

In addition to testing risk control, it is necessary to determine whether the party allocated the risk under the contract has the financial capacity to assume the risk. The TPG have much less to say about financial capacity than about control of risk. The TPG refer to 'access to funding'. The HMRC guidance notes that the TPG do not limit this capacity to the finances of the legal entity itself that assumes risk, but extend it to include 'options realistically available' to access additional liquidity.

HMRC states that where a legal entity has the capability to control the risks in an opportunity, 'it is reasonable to suppose that capital could move to exploit that opportunity'. This indicates HMRC takes the view that a lightly capitalised UK service company set up to employ senior managers undertaking risk control functions could still have the financial capacity to assume risk. There are reasons to question this position, particularly in regulated sectors where specific capital requirements must be met by persons contractually assuming risk. It is recognised in the TPG, both in Chapter I when introducing the control of risk framework and in Chapter X 'Financial Transactions', that due regard should be given to the regulatory approach to risk allocation for regulated entities.

Rewarding the risk

Much of the guidance relates to step 6 on pricing the transaction taking account of risk allocation, and in particular how to approach contributions to the control of risk that do not lead to the risk being attributed to the party performing that function.

HMRC cites specific paragraphs in the TPG as clearly indicating that 'all risk management functions relevant to an economically significant risk must be identified, regardless of whether the contractual allocation of risk is respected as the pricing of all contributions to control is required.' This has important ramifications for transfer pricing documentation as HMRC is effectively saying that a contribution by one party to the control of a risk assumed by another is *prima facie* an economic relationship between the two which must be rewarded at arm's length, and therefore it is necessary to consider what reward that contribution would earn.

> Economically significant risks that have been contractually assumed by a group member that is not capable of exercising, or does not in fact exercise, control are subject to reallocation

A particularly contentious area is how to apply paragraph 1.105 of the TPG which states that in circumstances where a party contributes to the control of risk, but does not assume the risk, compensation which takes the form of a sharing in the potential upside and downside, commensurate with that contribution to control, may be appropriate. There is no further guidance given as to when this type of reward would or would not be appropriate and what the actual reward should be. There has been considerable debate in recent years as to the validity of rewarding non risk-bearing contributions to risk control through a profit split. When considered through the lens of an operating loss situation it seems counterintuitive that a 'loss split' would apply where the loss in question results from the materialisation of a risk assumed by another party under the accurately delineated transaction.

The most logical explanation would seem to be that para 1.105 provides scope for the use of incentivised pricing structures. These are observed between independent companies and help ensure that where services are bought in and the service provider manages operational risks, the service provider has 'skin in the game' via interests aligned with those of the asset owner. An example would be where an oilfield services company enters into an agreement with an asset owner to co-manage production under a long-term agreement on a fee-per-barrel basis for incremental production that it helps deliver above an agreed baseline. Incentivised pricing arrangements differ from profit splits as they pay more in good years and less in bad years but without

First published in Tax Journal on 15 March 2024. Reproduced with permission.

directly splitting profits or losses.

In the guidance, HMRC states that it 'accepts that, in most cases, it will be appropriate to price contributions to control of risk, without the assumption of risk, using a "one sided method"'. The authors understand this to refer to both comparable uncontrolled transactions as well as the transactional net margin method. The guidance goes on to say that whilst there should not be a default assumption that contributing to the control of risk leads to the application of a transactional profit split method (TPSM) 'where there is a high degree of integration of business operations, and specifically control functions, it is more likely that contributions to control of risk don't result in a reallocation of risk but require pricing using the TPSM'.

The guidance does not consider the impact of asset ownership and its associated bargaining power on pricing models when independent enterprises transact. Many organisations do not have a single method of pricing their services and alternative pricing models may be offered to meet the needs of customers. In a competitive market where the service provider does not possess unique assets or capabilities of its own that are deployed as part of the service, then the likelihood is the asset owner can negotiate a pricing structure based on its preferences.

One area where HMRC has helpfully recognised the bargaining power concept is the situation where there may be a very small number of employees in the UK contributing to risk control. In such cases, there may be a lack of critical mass to support a profit split.

Finally, there is an inconclusive discussion in the guidance about whether a profit split should be based on *ex-ante* or *ex-post* profits. It is difficult to understand the logic for rewarding a risk control contribution, by a party that has not assumed the risk, based on a share of *ex-ante* profits. It seems easier to understand that performance-based fees may bear some relationship to factors linked to deviations between the risk-taking party's anticipated and actual profit outcomes.

Conclusion

Businesses should consider carefully how this additional explanation of HMRC's approach could be applied to their own circumstances and be alert to the fact that the thrust of the guidance is to reject robustly the notion that a profit split shouldn't be used to reward risk control contributions.

Businesses should consider whether their transfer pricing documentation clearly identifies the economically significant risks and the decision-making processes relating to those risks. Undertaking a case study based approach to reviewing risks and decision making for key assets or investment projects and gathering information now to be future audit-ready may be useful. Where this analysis, considered in light of the new guidance, indicates a substantial risk of challenge, businesses may consider risk mitigation options including Advance Pricing Agreements and/or changing transfer pricing policies. ■

For related reading visit taxjournal.com

- HMRC manual changes (1.2.24)
- How to handle HMRC transfer pricing enquiries (P Daly & B Henton, 26.6.19)
- The substance of transfer pricing (P Daly & B Henton, 27.7.17)