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HMRC Guidance: A New Transfer Pricing Risk to Control

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Businesses should review HMRC's recent guidance clarifying their interpretation of the OECD's control of risk framework to determine what risks they might face, say KPMG practitioners.

Transfer pricing does not get much more complex than the control of risk framework — which different tax authorities interpret in different ways. But the punchline of new guidance, published by HMRC is simple: where businesses have senior personnel in the UK and those personnel are responsible for making decisions about key business risks, they should be thinking about what implications recent HMRC guidance has for their transfer pricing policies.

Background

In January 2024, HMRC — the UK's tax authority — released guidance on their approach to applying the 6-step process for analyzing risks that has been part of the OECD's Transfer Pricing Guidance since 2015. The 6-step process provides a framework to assess how the economically significant risks that arise in connection with intragroup transactions should be allocated between entities for the purposes of transfer pricing; also referred to as the control of risk framework.

The control of risk framework has been controversial since it was first published. The guidance was written to counteract concerns that businesses had been able to shift corporate profits out of higher-tax-rate jurisdictions into lower-tax-rate jurisdictions by using contractual terms to transfer risk and associated profits. This was addressed by amendments to the Transfer Pricing Guidelines that introduce new requirements to test the contractual assumption of risk against conduct, with a focus on key risk control decisions and financial capacity. Where the contractual arrangements are incomplete or are not

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supported by the conduct then the allocation of risk follows the conduct. This prevents the allocation of the reward for bearing a risk to a location that does not perform the activities required to control the risk.

There has been much debate as to whether the guidance also supports reallocation of reward for risk in other more complex cases where several entities (including the entity that has assumed the risk) play a meaningful role in risk control procedures. Since 2017, a series of articles have been published on this issue — and this January 2024 guidance can be seen as a response by HMRC to those articles.

What Does the Guidance Say?

The stated focus of the guidance are the first 5-steps of the control of risk framework, which is relevant for:

1. Identifying the economically significant risks associated with a transaction;

2. Determining which party to a transaction should be allocated a given risk when pricing that transaction; and

3. More broadly identifying entities that contribute to the control of a given risk.

The guidance then goes on to discuss step 6 of the framework, with a focus on how entities that contribute to the control of a given risk should be rewarded, in circumstances where they are not allocated a risk under steps 1-5.

The guidance makes a number of key points:

- Economically significant risks must be identified with specificity. Particular emphasis is given to "specificity" both in the identification of risks and the performance of control functions.

- Different parties may contribute to the control of significant risks. The guidance includes a series of examples where employees of two companies are part of a committee that control development risk and discusses when one or other party may control this risk.

- In most cases where a party does not assume an economically significant risk (based on the contract or allocation due to control) it will be appropriate to price contributions to control of risk using a one-sided method. This is a reassuring conclusion, for businesses that have senior decision-makers in the UK and currently remunerate the activities performed by these personnel using a one-sided method.

- For highly integrated business operations where control functions are performed by multiple parties, but the contributions to control of risk do not result in a reallocation of risk, it is more likely that pricing should be based on a profit split. This is a less reassuring conclusion and one that it is important businesses take into account.

How Should Businesses Respond?

This guidance is most relevant for groups that currently remunerate their UK operations using a one-sided transfer pricing method, such as a return on cost or sales, and have key decision makers located in the UK. We have already seen these types of arrangements come under challenge through the UK's Diverted Profits Tax and Profit Diversion Compliance Facility, so it's important to understand this guidance within this broader context.

For businesses with these facts there are two things that are helpful about this guidance. First, it gives businesses a clear sense of HMRC's starting point. Not everyone will agree with that starting point, but at least you know where the other side is coming from. Second, it gives businesses a clear sense of the analysis they could (or should) be doing to head off questions from HMRC. It is important that UK transfer pricing documentation contains adequate explanation of the economic significance of individual business risks and the control procedures in place within the group to manage those risks and all contributing parties.

What Might Come Next?

Business should also be watching out to see whether HMRC's guidance is adopted (formally or informally) by other tax authorities, and whether any of these issues may be addressed in future guidance from the OECD.

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