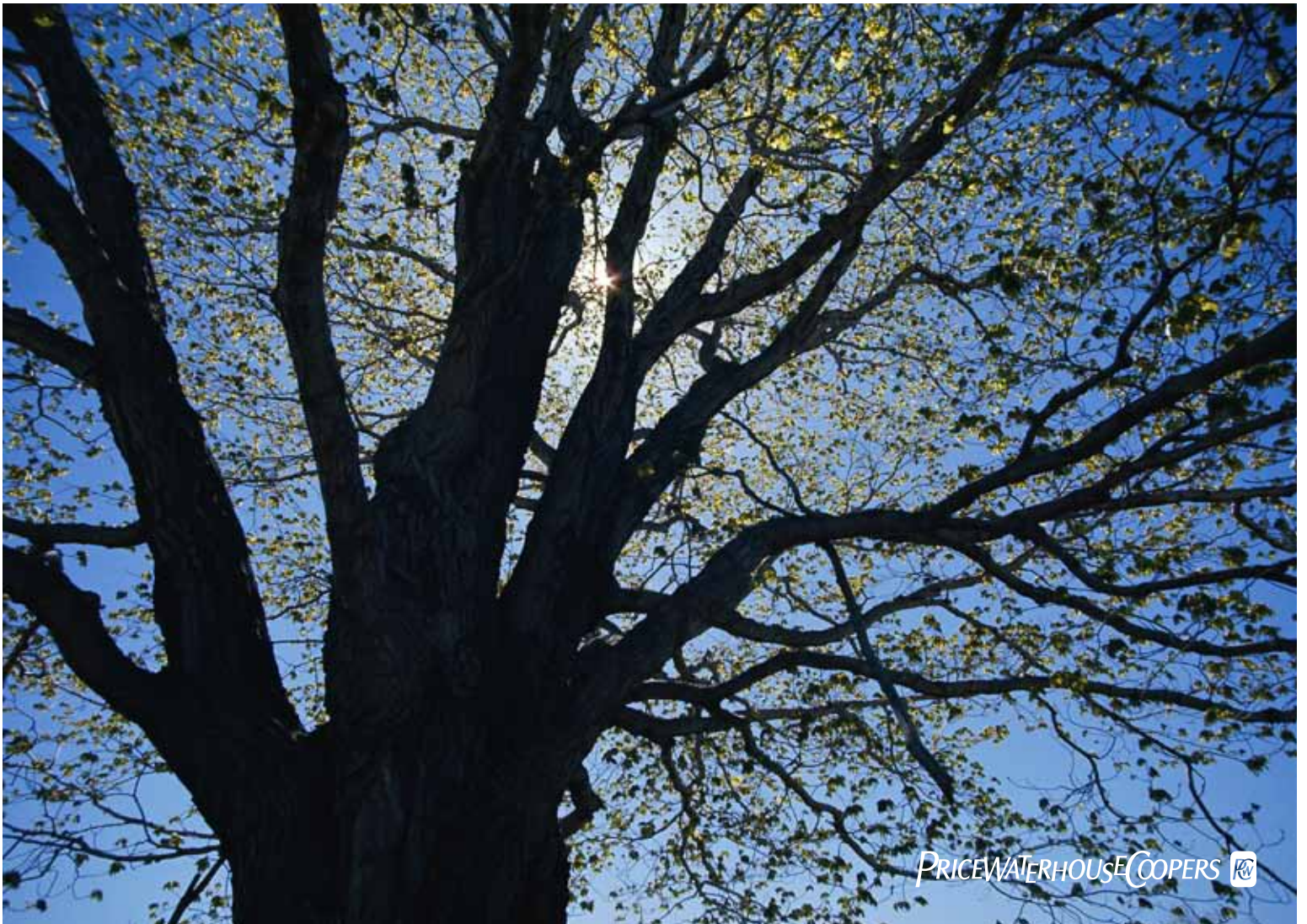


Rebalancing the functional analysis:
Functions, assets and risks

Transfer pricing perspectives

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Rebalancing the functional analysis: Functions, assets and risks

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In order to establish price according to the arm's length principle, the Organisation for Economic Co-operation and Development (OECD) and the tax authorities most active in transfer pricing are increasing focus on the 'functions' element of the functional analysis that traditionally evaluates an entity's assets and risks involved in its inter-company transactions. It is clear that part of the reason for this focus is an assumption by tax authorities that, whilst risk, capital and assets may be relatively easily moved by taxpayers who wish to manage their effective tax rate, it may be much harder to move key staff, either because they need to be close to the market or they would not have access to a suitable workforce and/or personal commitments make such moves unattractive. Clearly, at arm's length, the price that can be commanded is not a result simply of what an organisation does (functions), but the assets it owns and the risks it takes. Therefore, arguably, if the tax authorities favour one of these elements unduly, the arm's length principle is compromised. However, tax authorities and the OECD have also continued to confirm vigorously that the arm's length principle should be at the heart of appropriate transfer pricing regimes. In this article we look at how this position has developed and some of the issues it raises.

The OECD Guidelines¹³ state the following with regard to the arm's length principle:

"It may also be relevant and useful in identifying and comparing the functions performed to consider the assets that are employed or to be employed. This analysis should consider the type of assets used, such as plant and equipment, the use of valuable intangibles, etc., and the nature of the assets used, such as age, market value, location, property right protections available, etc.

"It may also be relevant and useful in comparing the functions performed to consider the risk assumed by the respective parties. In the open market, the assumption of increased risk will also be compensated by an increase in the expected return.

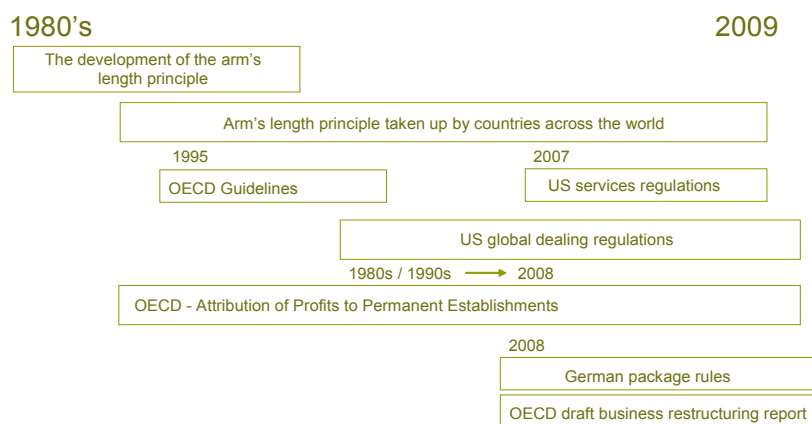
"Functional analysis is incomplete unless the material risks assumed by each party have been considered since the assumption or allocation of risks would influence the conditions of transactions between the associated enterprises".

OECD Guidelines—Chapter I, paragraphs 1.22 – 1.23

The Guidelines clearly indicate that assets and risks must be taken into account in establishing appropriate arm's length pricing. However, if one looks at what has happened in the transfer pricing arena over the past 30 years, one sees a subtle, yet inexorable increased emphasis on the functions and less placed on the assets and risks.

¹³ Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

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During the 80s and 90s, the arm's length principle was adopted by a great many developed and undeveloped countries alike. When the OECD Guidelines were first issued in 1995, they presented a balanced view on the importance of functions, assets and risks. The work of the OECD on the Attribution of Profits to Permanent Establishments,¹⁴ evolved over a long period of time. However, in the few years preceding the publication of the four papers in 2008, there was an increased emphasis placed on what are known as, in relation to the financial services sector, Key Entrepreneurial Risk Takers (KERTs) or, for the non-financial services sectors, Significant People Functions (SPFs). The OECD made it clear in relation to its work on the attribution of profits to permanent establishments (PEs) that, where a PE existed and KERTs and/or SPF's were based in that PE, it was likely they would attract assets, capital and risk in accordance with their functionality in the PE. Within an intra-entity fact pattern (e.g., head office to branch) an asset/capital attraction that was based on people functionality made sense. Different technical considerations apply however, where an inter-entity factor pattern exists (e.g., corporate to corporate).

As an example, though, the approach to capital articulated in the draft of the US global dealing regulations state that the return to capital may be "routine". However, it is a widely held view that it is not intuitive to suggest that the return to capital can be "routine", as the return to capital must, at arm's length, be commensurate with the risk at which such capital is placed. Some believe that it is important in these circumstances to distinguish the meaning of the word routine, as it is sometimes used in transfer pricing, to mean "low value", compared simply with meaning possible to be benchmarked to a market price. However, if capital is placed at risk in circumstances where that risk is clearly subject to significant uncertainty and potential volatility, then it is likely to be difficult to fix the return by reference to the market. Therefore the routine return to capital is likely to be very much the exception rather than the rule. The revised dealing regulations remain under wraps and Jeffery Dorfman's comments on the matter are telling:

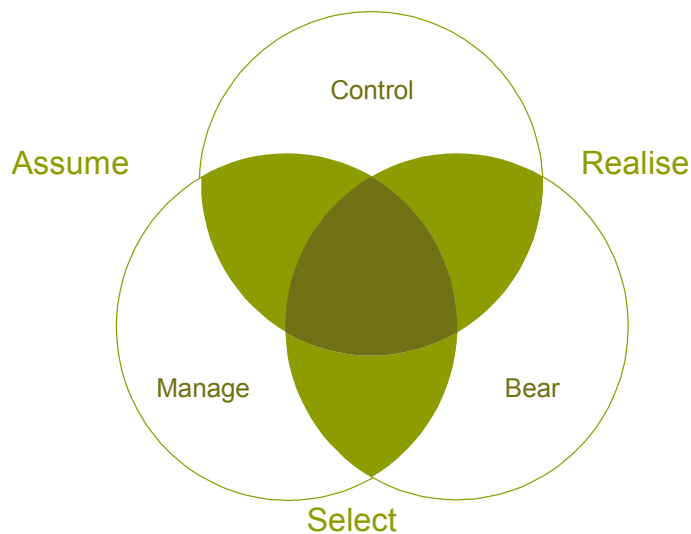
¹⁴ OECD papers I-IV Permanent Establishment 2008.

“The view of the OECD in Part III of the Attribution of Profits to Permanent Establishments Report ‘is basically that capital is routine and the trader function is non-routine. Some of the investment banks view it as just the opposite—that the trader function is routine and capital is non-routine. So there’s a spectrum of positions as to the way the profit split could work... We’re trying to gather as much information as we can before we make these decisions.”

...Jeffery Dorfman, Chief, Branch 5, Associate Chief Counsel (International)

The new German rules on businesses moving out of Germany and the OECD’s draft paper on business restructuring both encapsulate elements which do not clearly allow for a market-based division of risk between two separate entities. The German tax rules work off the assumption that the decision to move risk from a German company to a non-German company carries with it, prima facie at least, an assumption that any profit associated with that risk should be capitalised and paid to the German company. However, this is something that may not happen at arm’s length where entities regularly reconsider and rearrange their risk profile without any capital payments.

The problem with risk is that it is capable of complex analysis in many commercial settings. Often elements of risk taking and management are shared across two or more entities and it may be a third entity which ultimately bears the risk. In covering the credit crunch, journalists have been known to search for more words to describe what banks do with risk. They could do worse than to look to the OECD’s paper on Business Restructuring which contains many references to what businesses do with risk, but remains unclear with regards to the consequences.



The draft Business Restructuring paper is unclear about what happens when risk is assumed or managed in one entity and borne in the P&L/balance sheet of another. The implication is that a tax authority might try to shift the risk into the entity with more functionality; but would this happen if, for instance, the functional entity did not have the financial capacity to bear the risk?

It is also important to note that risk taking and asset ownership are often closely associated. If an entity invests in developing or buying an asset, it takes risk, and if the asset turns out to be commercially valuable, then the risk element explains, in part, why the market allows the asset owner to derive a certain level of return.

We know from experience that the process by which tax authorities within the OECD reach consensus on transfer pricing matters is tortuous. It is therefore of some concern that over the next few years we can expect a great deal of deliberation on how risk, capital and assets fit into pricing models where functionality resides in other entities. In the meantime, PE risk management and robust pricing of risk and asset related transactions will be necessary.

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BS-BS-09-0537-A.1009.DvL