Understanding Risk in the Enterprise: The Key to Transfer Pricing for Today’s Business Models

In the public discussion about transfer pricing, and even in the official guidance, it is evident that different parties may have very different perceptions of risk. This leads to a considerable degree of confusion in the current state of transfer pricing practice. The authors present an analytical framework for understanding risk in the context of applying the arm’s length principle that takes into consideration value creation, roles and responsibilities, and bargaining positions.

1. Introduction

The public attention for transfer pricing today is triggered primarily by its tax consequences: do countries receive ‘their share’ of the income from multinational enterprises (MNEs) for tax purposes? It is remarkable that the question as to how that share, intended to be a “fair” share, should be defined and identified, remains largely in the dark. Terms and conditions for intercompany transactions (“transfer prices”) steer the allocation of profits to different entities within a multinational group and thus to the countries where those entities are active. The fairness of this allocation is to be judged by reference to the arm’s length principle: how do or would parties, in the absence of shareholder ties, agree on the conditions for transactions in similar circumstances?

MNEs usually are characterized by complex sets of circumstances, difficult to manage for insiders such as the officers of the company, and even more difficult to understand for outsiders such as tax authorities, let alone for the general public. Current discussions in the press and politics illustrate that the less one knows and understands of these circumstances, the greater the suspicion of abuse of arm’s length that may arise. Where the circumstances are not typical, the less one knows and understands of these circumstances, the greater the risk that may arise. Where the circumstances are not typical, the less one knows and understands of these circumstances, the greater the risk that may arise.

In the public discussion about transfer pricing, and even in official guidance, it is evident that different parties may have very different perceptions of risk. As long as the discussion about transfer pricing continues without an explicit and meaningful definition of risk, on the assumption that “everybody knows what we mean when we speak about risk”, it is hardly a surprise that parties struggle to come to unequivocal conclusions.

This article will therefore start with the definition of risk. Once risk in its broad sense is defined, it is possible to develop a framework for mapping the responsibilities of the individual parties for the different risk categories concerned. Having identified the responsibility of parties for the risks involved in the relationship, it is possible to fully assess the respective contributions by these parties to the joint value creation and derive the relative bargaining position of each of them. The information on the bargaining

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1. For a further elaboration of the relational dimension of the arm’s length principle, see e.g. Pim Fris & Sébastien Gonnet, ReAL Transfer Pricing: A New Paradigm for Transfer Pricing in Europe, BNA Transfer Pricing Report (June 2006).
power of the entities involved is essential for drawing conclusions as to whether, in the complex reality of the MNE, third parties would enter, or would have entered, into the transactions at the prevailing terms and conditions. Only if that conclusion is justified can the prices for intercompany transactions be deemed to be “at arm’s length”.


Transfer pricing involves a number of stakeholders, each potentially having a different perception with respect to risk, including MNE top management, tax authorities, operational management, personnel, shareholders, suppliers, customers and the public. These different views can be divergent and can lead to misinterpretation when it comes to understanding the risks at stake within an MNE and, consequently, comprehending correctly the allocation of risks among related parties involved in transactions.

Country regulations and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TP Guidelines) have yet to tackle the fundamentals of risk for transfer pricing purposes. Until now, the regulatory framework has steered heavily towards compliance with documentation requirements which have oversimplified the role of risk in the enterprise, as part of the functional analysis. Instead of focusing on the main driver for understanding risk in this context (which is the overall enterprise), efforts have been skewed toward facilitating risk assessment for tax authorities. Thus, the emphasis is placed on identifying what a specific local entity does (in terms of activities), rather than looking at the broader relational context that involves more parties than the “tested party”, and the definition of “risk” in business has remained at a relatively primitive level. The same term “risk” is used, but representing different worlds.

The framework of the OECD TP Guidelines restricts “risk” in the context of functional analysis to a static and amorphous vision of what effectively matters when looking at risk in an MNE context. The OECD labels risk along business functions such as “market risk”, “operational risk” and “credit risk”, as if all of these have a more or less similar impact. With the insights thus acquired, the OECD suggests to apply “adjustments for accounting consistency”.

These types of compartmentalization, representing enumerations rather than definitions, may well obscure rather than clarify information on responsibility for effective risk management within a multinational’s operations. The discussion of the impact of individual types of risk, and of how different risks interact, has remained underdeveloped. This is probably due to the direct emphasis of investigation being on an individual entity per se and its transactions, and on testing the outcomes, which prevents an understanding of the broader context in which parties interact. The tunnel vision resulting from this single entity focus is often, but erroneously, explained as being a consequence of the “separate entity approach”.

It is cynical that the focus of business to comply with the regulatory framework, while at the same time trying to keep the “administrative burden” as low as possible, has led to the perverse effect of apparent dissatisfaction of the authorities that issued these regulations. Increased conflict, a stormy reception by politicians and a negative image in the public perception emphasize this. This “public perception risk” appears to have increased considerably and has a huge potential downside impact for companies.

The perception of risk as presented in the OECD TP Guidelines is no longer attuned to the way businesses interact and operate. In today’s complex business environment, functions, assets and risks are not systematically aligned in a clear and easily defined pattern of entities and locations. Functions, assets and risks are spread among legal entities worldwide, and the current OECD risk analysis framework may lead to incorrect inferences about non-compliant behaviour by individual companies, thus leading to spectacular misinterpretations and never-ending discussions with and among tax authorities worldwide.

How can one acquire a more effective view on risk when one applies the arm’s length principle? To this end, the authors introduce what can be called the “enterprise view” of risk.

3. The Enterprise View: Source and Impact of Risk

The authors propose to comprehend risk in a transfer pricing context, relying on a nuanced perception of risk, based on the role of risk in the enterprise, i.e. the enterprise view. Judging “arm’s length” begins with the identification of the relevant circumstances of the case at hand. What counts in the appreciation of the concept of arm’s length is how a multinational company factually deals with the risks that shape its business.

For an enterprise, risk management is dealing with the impact of volatility on profits and value. In practical terms: how can one manage the impact of the difference between what actually happens as compared to expectations (as expressed in business plans and budgets). In order to manage risks better, a company must identify the source of volatility (internal or external) and assess the impact that such volatility can have on its business. Depending on the sources and impact of volatility, one can distinguish a number of different categories of risk as the basis for developing an appropriate enterprise perception of risks.

Risk, or the impact of volatility, is usually perceived as a threat, and almost universally the focus of risk management is on mitigating the negative effects. All businesses operate in a world of volatility. In making strategic choices, a company chooses the specific types of volatility that it

2. OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TP Guidelines), para. 1.46 (2010), International Organizations’ Documentation IBFD.
3. OECD TP Guidelines para. 3.48.
5. The view presented here is based on and adapted from D. Nadler & A. Slywotzky, Risk and the Enterprise: Creating a Risk-Competent Company in an Age of Volatility, MMC Viewpoint, issue 1 (Marsh & McLennan Companies 2008).
exposes itself to: which business segments will it enter, what business model will it employ, who will be its customers, how is it going to compete, how will it create value and how will it structure and manage operations. In this context, the conventional wisdom is challenged, as risk is no longer viewed as a threat, but also as an opportunity. The key challenge for an enterprise is how to realize the upside impact of the risks that it chooses to face.

Risk and volatility can be represented as a two-dimensional field. The first dimension is the source of the volatility (external versus internal), while the second one is the potential impact of the volatility (negative or downside impact versus upside impact). The volatility that a company encounters will expose it to certain types of risks. In this respect, five different categories of risks can be distinguished, namely strategic risks, human and intellectual capital risks, financial risks, operational risks and hazard risks, each with different sources and potential consequences, requiring different types of action to manage them:

- **strategic risks** are those external risks that offer significant upside as well as downside potential, such as the competition, the market environment and regulatory events. If a company can recognize developments and events when they are just beginning to occur, it can differentiate itself by making the appropriate strategic choices and the change can be turned into a huge competitive advantage. Thus, strategic risk spans both external and internal aspects;
- **intellectual capital risks** (including human capital risks) arise from challenges related to a company’s talent and leadership, as well as its choices to differentiate itself from competition. The related technological, intellectual and human capital systems are key to realizing the promises of the strategic choices. Failure will have a negative impact on continuity;
- **financial risks** in the form of fluctuations in financial market prices often have a negative impact. However, if a company manages its flows well, there is an upside potential to create value;
- **operational risks**, for instance internal process breakdowns, can cripple a company’s supply chain, customer service or manufacturing operations; and
- **hazard risks**, which arise from adverse external events that result in property damage and liabilities, usually have a downside impact. These risks cannot be controlled and are typically insured or outsourced to the extent possible.

Figure 1 reflects these different risk categories and their place in the field defined by potential impact and the source of volatility.

An enterprise accepts and manages risks with a view to generating (economic) profits, thus assuring its continuity. When the notion of risk is developed for risk management purposes, it is usual to think in terms of the downside impact of volatility, and of externally driven risks such as hazard risks. This is the type of risks that an enterprise, where possible, will seek to outsource and/or insure itself against. If they cannot be externalized, possible consequences should be minimized.

**Strategic risks and human and intellectual capital risks** are the key issues that relate to setting up an enterprise, to being successful and to achieving continuity. Managing these risks successfully is essential for a firm’s effectiveness (i.e. doing the right things) to realize the upside potential, which is as important as, and arguably even more important than, the downside impact. This is why these categories of risks are not inherently undesirable, but nevertheless often overlooked in risk management, and managing them is a key driver in capturing potential gains. Responsibility for these categories of risk directly relates to the entitlement to residual profits, whether negative or positive, and will typically be handled or closely monitored by top management. The “public perception risk” mentioned in section 1. can be seen as part of the strategic risks.

**Financial** and **operational risks** have a more restricted impact, and they relate to efficiency (i.e. doing things right), rather than to effectiveness.

In light of the above, risk analysis in transfer pricing can be enhanced, in order to take more realistically into consideration how firms, and their internal entities, organize themselves in order to operate, and to handle and manage their risks. Risk identification is not an aim in itself. The next question therefore is how one can apply the insights mentioned in section 1. to conclude on pricing conditions for internal transactions that are in line with the arm’s length standard.

### 4. From Risk Identification to Pricing

Risk is one of the pieces of the internal pricing puzzle. Application of the enterprise view based concept in the definition of a transfer pricing system for an enterprise and assessment of the impact in terms of profitability of group entities concerned, requires a more extensive analytical framework than usually recognized in transfer pricing practice.
The current guidance for applying the arm’s length standard can be found in section D of chapter I of the OECD TP Guidelines, while chapter III (section A) describes a process approach for comparability analysis.

A characteristic example of the guidance is given in paragraph 1.34, which states that “independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options available to them, and they will enter into the transaction only if they see no alternative that is clearly more attractive”. This statement is no doubt correct, but symptomatic of the type of guidance that is given in the OECD TP Guidelines, as it assumes implicitly that prices between related parties have already been set and applied. In other words, it is a consideration when testing the arm’s length character of a transaction after the fact. The OECD TP Guidelines concern the testing of the arm’s length character of conditions of internal transactions. But for a MNE, the challenge of the process is, in the first place, more precisely to set the prices, i.e., to define the terms and conditions for internal transactions, before the transactions take place. Guidance in that respect is simply lacking.

Because the OECD TP Guidelines focus on testing transactional conditions (and the outcomes for parties involved), it is logical that the “circumstances” of a transaction are interesting only in order to explain, when necessary, the arm’s length character of its conditions. First comes the transaction, and in the second instance the guidance looks at the circumstances as a factor in the testing process. In the reality of a MNE, transactions are a consequence of the circumstances. First, strategy is defined, then a business model is designed to apply the strategy optimally, and the roles allocated to internal parties and the transactions between them follow from that. In other words, the relations between parties involved are not a factor in explaining the given prices, but they drive the transactions, and enterprises have the challenge to define the pricing system reflecting the relations, and in the absence of prices set on the market.

So, in reality, relations come first, and transactions and their prices follow. In this respect, it is interesting to note that, in spite of the strictly transactional focus of the analysis of arm’s length according to the guidance, the definition of arm’s length in article 9 of the OECD Model speaks not of transactions, but of “conditions […] in commercial or financial relations”. Where did the guidance lose sight of that definition?

This may explain why, today, the OECD struggles to apply the arm’s length principle in more complex business models and situations involving intangibles and business restructurings. These issues simply do not show up in a strictly transactional analysis, and they can be identified, understood and analysed only in the total relational context within a MNE.

The analytical framework leading up to an appropriate definition of a company’s transfer pricing system should therefore include:

- analysis of how value is created in the intercompany relations;
- identification of responsibilities that individual parties and entities carry;
- assessment of the relative bargaining position of individual entities in light of the contributions to value creation and risks borne; and
- definition and implementation of transactional conditions, including a coherent contractual allocation of risks.

5. The Analytical Framework: Value Creation, Roles and Responsibilities, and Bargaining Positions

Once risk in its broad sense is defined, the framework described below allows the mapping of the responsibilities of the individual parties for different risk categories concerned. It begins with an understanding of how value is created within an enterprise; then relates the enterprise’s functions, risks and assets (including intangibles) to the individual value drivers; and subsequently establishes the role and responsibilities of the transacting parties in view of the identified functions, assets and risks in light of their ability to control such risks and their role in the development of (intangible) assets. As a final step it should be established how, in this pattern of value creation in the enterprise and allocation of roles therein to individual group entities, prices would be set between parties that have no shareholding ties.

5.1. Step 1: Analysing value creation

The first step of the proposed framework involves the identification and analysis of the enterprise’s value chain.

A value chain analysis consists of understanding how value is created in the enterprise. This requires identifying the key value drivers that influence the most critical success factors, and that can be held accountable for the enterprise’s major risks and for developing, maintaining and enhancing the enterprise’s intangibles. Value chain analysis is at the centre of discussions and preoccupations in transfer pricing at the global level in light of today’s complex business environment. The recent OECD report on base erosion and profit shifting (BEPS) notes that:

The rise of [global value chains] has also changed the notion of what economies do and what they produce. It is increasingly less relevant to talk about the goods or services that are exported, while it is increasingly relevant to talk about tasks and stages of production. In a world where stages and tasks matter more than the final products being produced, [global value chains] also challenge orthodox notions of where economies find themselves on the value-added curve. From an economic point of view, most of the value of a good or service is typically created in upstream activities where product design, R&D or production of core components occur, or in the tail-end of downstream activities where marketing or branding occurs. Knowledge-based assets, such as intellectual property, software and organizational skills, have become increasingly important for competitiveness and for economic growth and employment.6

5.2. Step 2: Linking the enterprise’s functions, risks and assets (IP) with value creation

The second step involves the linking of the enterprise’s functions, risks (as defined above) and assets (including intangibles) with value creation as identified within the enterprise’s value chain. To each step of the value creation (value driver) can be associated certain functions of the enterprise, certain risks (in line with the classification introduced above) and certain assets (including intangibles). In this mapping process, risks are naturally associated with functions that are influencing the risks.

The value chain, together with the related mapping of the underlying functions, risks and assets, contains information for an understanding of the enterprise’s value creation process; how this value creation is fed by functions within the entities of the enterprise; the related risks associated with the performance of said functions; and the assets (primarily intangibles) related to said functions and risks.

5.3. Step 3: Mapping roles, responsibilities and control of the individual group entities

The third step establishes the role and responsibilities of the group entities/transacting parties in the functions identified, their assumption of risks in light of their ability to control such risks and their role in the development of (intangible) assets.

In an intra-group context, a company can be held responsible only for elements that it can reasonably take responsibility for, that is, for what it is equipped to manage. In that respect, the management control concept of responsibility profiles can help in defining the role and responsibilities of group members involved in intra-group transactions. The responsibility profiles shown in Table 1 can be used.

It is one thing to identify which player contractually bears the risk associated with a certain transaction, but it is another thing to identify the player that is able to control this risk. The notion of “control” is crucial in this context. In this respect, the OECD has introduced useful concepts which are still underutilized. In order to determine which entity has “control” over risk, the significant people functions and important functions are key.

The vital aspect of the notion of significant people functions is the capability to assume responsibility for risks that are now identified as operational risks. This notion was developed in the context of permanent establishments, and is potentially relevant also in situations where it is in question whether a contractual allocation of risk between entities is realistic. The division of risks and responsibilities within the enterprise will have to be deduced from the parties’ conduct and the economic principles that govern relationships between independent enterprises.

However, it should be kept in mind that it may be exactly the notion of control that is not necessarily in the hands of the “significant people” referred to here. The role of the management in a company ranges from strategy definition (long-term) through responsibility allocation or delegation in the design of the business model (medium-term), to operational management responsibilities (with year-to-year reporting) allowing “control” and evaluation by the management level that allocated the responsibility to the operational managers. A team or an entity can be reputed as performing a significant people function only to the extent that people in the team or entity have the actual resources and competencies to manage and take responsibility for the underlying risks and assets. “Control” of how good the team or entity performs its operational role, notably in the form of “active decision making” in relation to the assumption of risks and ownership of assets, hints rather at the strategic level.

This is mirrored in chapter IX (context of business restructurings) of the OECD TP Guidelines, where paragraph 9.23 clarifies that:

In the context of paragraph 1.49, “control” should be understood as the capacity to make decisions to take on the risk (decision to put capital at risk) and decisions on whether and how to manage risk, internally or using an external provider. This would require the company to have people—employees or directors—who have the authority to, and effectively do, perform these control functions.

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<th>Table 1: Entity responsibility profiles</th>
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<td><strong>Transfer pricing responsibility profiles paradigm</strong></td>
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7. OECD, Report on the Attribution of Profits to Permanent Establishments (OECD 2010), International Organizations’ Documentation IBFD
8. OECD, Revised Discussion Draft on Transfer Pricing Aspects of Intangibles (OECD 2013).
In the context of the “important functions” (introduced as an expression in the discussion draft for chapter VI, dealing with intangibles), the key criterion is also “control”. “Control” obviously refers to a group’s value creation in a broad sense, embracing all risk categories. Important functions as elaborated in chapter VI just seem to have a narrower focus, as the concept is applied only in the context of the generation of intellectual property. “Intangibles”, however, form a broader concept than merely intangible property, whether defined by the OECD TP Guidelines as intangibles or as comparability factors.

It seems that the two terms, significant people functions (at an operational level) and important functions (at a strategic level), come very close to each other, both emphasizing the distinction between carrying out certain activities versus the control issue. That is exactly what can be captured by using the responsibility profiles introduced above, in combination with the different risk categories in the enterprise view on risk.

5.4. Step 4: Assessing bargaining positions in the internal pricing process

The fourth and final step of the proposed framework consists of the translation of contributions to value creation of group entities/transacting parties (given the responsibilities attributed to them) into their respective bargaining positions in the process of establishing transfer prices.

Transactions are the materialization of the commercial and financial relations between different parties. Commercial and financial relationships, both between independent and between associated enterprises, can take many different shapes. They can be incidental, involving one or a limited number of transactions, or can be broad and of long duration. Furthermore, relationships constitute a different context depending on the impact on investment in capacity. If one of the parties has invested heavily, and that investment turns out to be obsolete earlier than foreseen, then the impact on the price of transactions between the parties will be different depending on the relationship.

If the relationship is purely transactional, this would be the risk of the investing party. However, in the context of a long-term cooperative relationship, parties will get together and reassess their terms and conditions if and as long as they both wish to continue their relationship. In other words, they will find a way to share the consequences of an unforeseen event and of the risks arising therefrom. See Figure 2.

The relational context dictates the dynamics of the ultimate allocation of jointly achieved results to the individual parties involved (the basic transfer pricing system design). In this respect, methods play a different role than that identified for testing purposes. In the detailed design, the different relevant parameters of the system can be set, based on the bargaining positions, and solidified by – potentially a broad range of – further economic analyses. Benchmarking may give relevant orientation, but ultimate justification may have to be delivered by tools like analysis of external long-term relationships, investment-based models, game theory, compensation-based models, surveys and bargaining analyses.

The analytical process described above effectively helps to assess the respective contributions by the transacting parties in an intra-group context to the joint value creation and to derive the relative bargaining position of each of them. The information on the bargaining power of the entities involved is essential for drawing conclusions as to an appropriate pricing system for internal transactions and allows the evaluation of whether, in the complex reality within the MNE, third parties would enter into the transactions at the prevailing terms and conditions. Only if that conclusion is justified can the prices for intercompany transactions be deemed to be “at arm’s length”.

6. Conclusion

In the public perception, risk related to transfer pricing represents the risk for countries and tax authorities of missing or losing tax revenue. In transfer pricing practice, the main challenge of responsible behaviour by MNEs requires the application of the arm’s length principle, based on concepts like value creation, a meaningful definition of “risk”, an effective identification of the responsibilities within the MNE and a correct appreciation of the consequences in internal pricing. Companies must anticipate scrutiny from tax authorities and comply with documentation requirements, but must also manage the application of transfer pricing in daily operations that take place within the company. Presently, an additional challenge is emerging, namely regarding how the pricing policy and its effects can be explained to the public? While the gap in knowledge and insights between the company and tax authorities is often hard to bridge, the gap with the public perception may be explosive.

In dealing with transfer pricing for tax purposes, the arm’s length principle constitutes the vital reference. Although that principle forms a powerful conceptual starting point, applying it is not always simple. It requires understanding and mapping the often complex circumstances of a specific case and judging whether, in those circumstances, the pricing of transactions applied satisfies the test of the principle.
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