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Global Transfer Pricing Business Solutions with passion - 11 years anniversary

GTP® Model on the Relationship between the

Function and Risk Pattern and the Arm's Length Nature of Transfer Pricing

General Description of the Relationship between Functions & Risks and Transfer Pricing Logic

1 Introduction and General Remarks

Cross-border transfer pricing requires the arm's length analysis and the corresponding documentation for tax purposes. It is the common understanding among international tax experts that the so-called function and risk analysis is the pivotal point for a transfer pricing documentation. Both the prevailing OECD Transfer Pricing Guidelines 2010, the new OECD/G20 BEPS Action Plans – in particular Action Plan 13 on Transfer Pricing Documentation and Country-by-Country Reporting – and specific national provisions such as the German Regulations on Income Allocation and Documentation¹ refer to the function and risk analysis in the context of transfer pricing documentation and arm's length assessment.

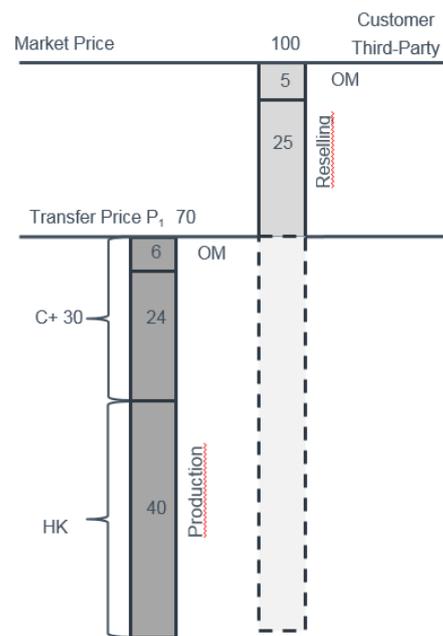
However, we experienced throughout our projects that there is need for some discussion, at least, and modification what purpose the function and risk analysis is for and what makes up the difference between so-called "routine" functions and "non-routine" functions.

Given the following position, we believe this discussion is necessary because quite many experts opine that non-routine functions ought to receive larger profits in absolute terms and ought to result higher profitability in relative terms as compared to routine functions. We believe that such "theory" is not straightforward because it does not reflect business economics and economic theory.

This short article is conceived to illustrate the role of the function and risk analysis for purposes of operative transfer pricing and OECD arm's length testing. The distinction of both areas of transfer pricing analysis is already discussed in the GTP® Notification on the OECD Transfer Pricing Methods.

Graph 1 below shows the basic fact pattern of a two-party transfer pricing system. For example, the manufacturer and the sales unit of a related-party structure agree to execute the

transaction of an asset for a transfer price of 70, while the sales party resells that asset to the third-party customer for a sales price of 100.



Graph 1: Default transfer pricing pattern.

2 Basis of Analysis: Contracts

The basis of the function and risk analysis is the contractual agreement under the law of obligation (*schuldrechtlicher Vertrag*) between the related parties considered by the arm's length analysis. Referring to the graph above, it is the contract determining the transfer price of 70. The most suitable starting

¹ Gewinnabgrenzungsaufzeichnungsverordnung (GAufzV, 12.04.2015), as well as various other Regulations, such as on base shifting, permanent establishments, etc.



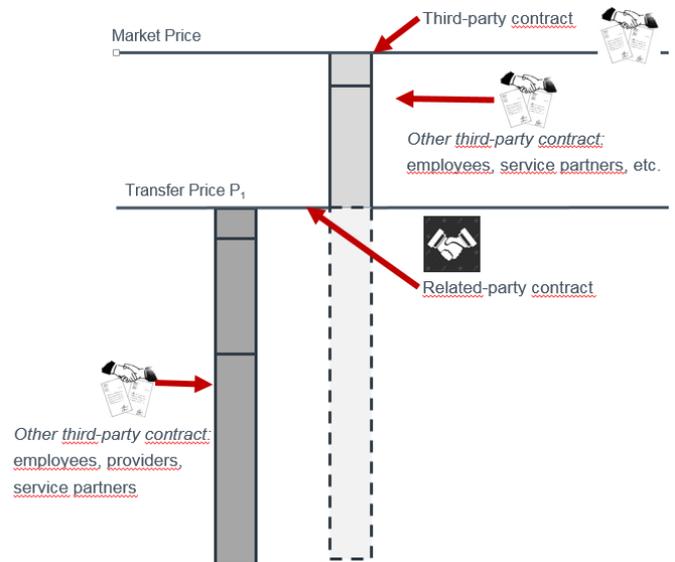
point for such contractual understanding is the written contract as signed by the parties. If such signed contract is not available – which is the case, according to our project experience, for a large portion of the intra-group transaction volume – there might be available any draft version of such contract. Also note that quite often the contractual relationship is defined by a set of documents such as the main contract, appendices, amendments, and other documents (e.g. orders, installments, invoices), and such documents might help to understand the definition of the contractual relationship.

Sure, quite often contractual relationships between related parties are not yet formalized in written form. Nevertheless and undoubtedly, they have been executed over years on a contractual understanding between such parties and, consequently, they will have to be deemed as “contracts”, or contractual arrangements under the law of obligation. Between third parties such non-formalized contracts come into existence on a daily basis and often several times a day: purchases in the bakery, shopping, fueling, grocery purchases, second-hand purchases, and the like. Even in *big business*, non-formalized contractual relationships exists ubiquitously and around the world: supplies to automotive manufacturers are usually performed without written contract papers, and in the agri-food sector hand-shake contracts are daily business.

With regard to intra-group transactions between related parties of multinational groups, the contract – or agreement – is usually only one type of document among others such as orders, general terms and conditions, instalments, and invoices which altogether should be studied to understand the nature of the contractual relationship between related parties. Referring to the function and risk analysis, it is to explore the contractual content regarding the allocation of functions, risks (and damages) to either contracting party. The key question to be addressed in such effort to understand the contract is **which party will have to face the damages if the contractual relationship fails**. It follows that in most cases it is necessary to have an understanding of the other contractual relationships of that tested party, too. Such other contracts might be third-party contracts (e.g. inbound purchases) or other related-party contracts (e.g. intra-group services). See also red-marked arrows in Graph 2.

3 The Sum-up of Functions

Some transfer pricing experts believe that, if one contracting party (e.g. the deliverer of a manufactured product – in the graphical presentations the lower part of the value chain) performs various functions in order to deliver the output to the other transaction partner, that first party will have to show a higher profitability compared to such parties which do perform only one single function. In our GTP logic, we think that this sum-up model is questionable and we do believe it is not



Graph 2: Contracts with the related party and third parties.

correct in the logic of the economics of organization theory and transaction cost economics.

The scope of functions allocated at one transaction partner does neither indicate the absolute or relative profitability of that party, nor of the other party. While the so-called “*Function and Risk Analysis*” is an integral part of the arm’s length analysis on transfer pricing issues, any model like “*the number of functions allocated at one side was indicating the size of profitability*” does not hold. And such logic can not be transferred to the area of risk, nor to the area of assets. Similarly, any rule like “*the more risk allocated to one unit, the higher the profit*”, apparently practiced in some transfer pricing studies, is not suitable. In addition, “*the more risk assumed by the tested party, the higher its profitability rate*” cannot be hold.

Rather it is crucial to understand which contractual partner will have to suffer the damages from such contract if contractual disruptions and disturbances arise. In other words, the transfer pricing analyst needs to understand which party is the residual claimant behind this transactional and contractual relationship – and this will have to be reflected under the features of the law of obligations rather than the corporate law.

4 Routine vs. Non-Routine

Given this notion of what contracts define with regard to the allocation of functions, duties, risk and damages, the term “routine function” and “routine risk” in the course of transfer pricing analyses is understood as follows:

The testing party is “routine” if the significantly greater part of the risk behind the contractual relationship is



allocated at the other contracting party. Such other party so becomes “entrepreneurial” in this transaction – and, consequently, can be characterized non-routine.

From this, we conclude that the tested party which performs routine functions and bears routine risks bears little consequences of a malfunction of the transactional relationship AND any other contractual relationship the tested party executes. Vice versa, that corporate unit (e.g. legal entity of a multinational group, permanent establishment, profit center, cost center) which is defined as non-routine bears the risk of malfunctioning, damages, costs of underperformance, or even loss and ruin.

Bankruptcy can be the ultimate status of such risk taker and, as an interpretation, *non-routine* is synonymized with *entrepreneurial*. Of course, this unit shall enjoy the other side of the coin as well, that is any excess profits if risk assigned, or uncertainty governed, did not result in damages but rather in success. In such situation, not only will this unit show default profits, but also excess profit if, and when, risk was assumed within the corresponding cost calculation as a kind of risk premium markup which finally results as additional profit. Note that this kind of analysis is on the level of the transaction, and the synopsis of all transactions of a legal entity might result in a fuzzy picture on the function and risk pattern of that entity.

5 Profits and Profitability

In practice, the arm’s length analysis on transfer pricing fact patterns is predominantly established on relative profitability indicators such as operating margins or gross margins. An exception is the comparison of a transfer price with third-party prices which, then, reflects the Comparable Uncontrolled Price method (CUP). In general, however, absolute profits of entities or center units of a multinational group are never seen as being compared with third-party comparables.

Referring to Graph 1, the operating margin of the reselling unit is 5 out of 100 and the gross margin is 30 out of 100, while the operating margin of the manufacturer is 6 out of 70 and the gross margin accounts for 30 out of 70.

Our experience from hundreds of projects on transfer pricing and arm’s length analysis is that a large portion of related parties are embedded in a contractual setting with other related-parties, and with third parties, which does not allow to deem such tested-party unit as simple and “routine”. Not only does the specific contractual setting prevent from drawing this conclusion but also the profitability development across periods of analysis contradicts the characterization of the function and risk pattern as being “routine”.

Hence, our working hypothesis is that entities performing routine functions do not result in extreme low nor extreme

high profitability rates. The implicit reason for this hypothesis is that being a routine unit does not permit to bear significant risk. In other words, units which allocate significant risk in their contractual portfolio will have excess profits if that risk did not materialize in damages, and they will show extreme losses if risk turned out to become such damages, and they will show moderate profits if some risk caused damaged and other risk did not. Excess profitability (plus or minus) indicates that this unit has assumed such risk while a routine unit is understood as a transaction partner which does not have to bear the risk of wrongful calculation and wrongful budgeting. In the case of a routine unit, such consequences will have to be borne by one or more of the other contracting partners.

Given this notion on the nature of profitability of a corporate entity or unit, we conclude that the function and risk analysis will have to explore the contractual assignment of residuals in order to assess the routine / non-routine character of a related-party structure.

6 Hybrid Functions

In some countries like Germany, the tax authorities have defined an intermediate type of function & risk pattern, additionally to “routine” and “non-routine”. This intermediate model is assumed to reflect a function and risk setting somewhere between routine and non-routine, and it should supplement the either/or pattern. Such type is called “hybrid” (in German language: *mittleres Unternehmen*) and it stands for a function and risk allocation to the respective unit in the sense of “more than routine” and “less than non-routine”. A hybrid model is often more representative in real-world situations than a routine pattern. Please note that this definition is provided for by the tax authorities in the respective *Administrative Principles*² and, hence, in the German context, it is a definition not binding to the taxpayer, the courts, or the tax authorities of other jurisdictions.

In GTP language the term “hybrid” is translated in a two-step model as follows:

- First, the arm’s length profitability is assumed by the respective budget calculations and costs per piece and volumes are assumed. The business model presents a target profitability which is supposed to finally satisfy the shareholder of such unit; the default minimum profitability shall result in dividend contributions to compensate the shareholder with a market capitalization of a low-risk investment.
- Second, the ordinary and prudent businessman will continue to run its business model as in the previous year, if the actual figures reflect the budgeted model; if, however, actual figures significantly diverge from budgeted figures, s/he would modify its business model for the upcoming budgeting period. For example, if profitability

² comp. Par. 3.4.10.2 / IV B 4 - S 1341 - 1/05



turns out to be negative, (a) operative costs (internal costs) might be reduced by cost cutting measures, (b) customer sales volumes might be shifted upwards by marketing measures, or (c) transfer prices for inbound or outbound transactions with related parties could be renegotiated downwards (inbound) or upwards (outbound).

7 Consequences on Arm's Length Analysis

The consequences for the arm's length analysis and the arm's length assessment of related-party structures appear straightforward. Please note that the following statements are applicable for any unit of analysis such as legal entity, profit center, or cost center:

- A related-party unit (tested party) with little functional and risk attribution will have to show moderate profitability rates, instead of extreme losses or excess profits;
- A related-party unit with an extreme profitability situation cannot be of "routine" character. Rather, they are embedded in a contractual setting which is either hybrid or even non-routine (strategic). The start-up situation of a newly found entity represents a special fact situation beyond this general rule (e.g. start-up losses).
- Any transfer pricing system requires at least one strategic player as an integral part to make this transfer pricing system working. Such player can be understood as "entrepreneurial"; other entrepreneurial units may also exist in a group. Often, the entrepreneur in a transfer pricing system is represented by the headquarters unit – yet not always.
- Other units in a multinational group which are deemed rather hybrid or non-routine – instead of routine – can be characterized as local entrepreneurs which corresponds to the notion of "*mittleres Unternehmen*" as exercised by German tax authorities in assessing the function and risk pattern of multinational groups.
- While it seems sufficient to assess the arm's length nature of the profitability of "routine" units by measuring the actual figures of that unit, hybrid units will have to refer **actuals** to **budgets**. It is important that the transaction is the level of analysis. Any significant distance between such actuals and budgets, say more the actual profitability is 15 percent below the budget profitability, may trigger that the budgeting assumptions for the upcoming budgeting period will have to be reconsidered and modified (e.g. pieces, volumes, costs, transfer prices). Otherwise, one may assume that the transfer

pricing system is guided by objectives other than the arm's length principle (e.g. constructive dividends).

- To our knowledge, there is no legally binding provision in the international tax arena around the globe which undoubtedly and coercively indicates any threshold of when a related-party unit can be deemed routine, hybrid, or non-routine. Likewise, it is popular among tax authorities not to issue a clear positioning on any relative profitability threshold such function pattern should show to be deemed routine, hybrid, or non-routine. The ubiquitous 5 percent markup on routine services – often accepted by tax authorities – might be such safe harbor. Of course, some countries have defined thresholds or safe harbors which, however, are for the purpose of documentation relief rather than being a must for transfer price setting.

8 GTP Positioning

The GTP® Expert Team is of the opinion:

- Routine units ought to result in actual profitability which corresponds to the respective interquartile range defined for the fact pattern. In 95 percent of all benchmark analyses, such interquartile ranges are somewhere between +1% and +10% EBIT profitability. Exceptions exist and often they can be argued by specifics in the given industry (e.g. access barriers to such industry for new market entrants).
- Given the principal-agency problem, routine units with cost-plus transfer pricing systems will have to be monitored and controlled by the principal (e.g. headquarters unit) in order to avoid mal-allocation of costs within agency unit. Contract manufacturers or shared service providers are such units within an international group.
- Hybrid units ought to show a budgeted profitability which falls within that interquartile range of comparable set of companies performing similar functions in a comparable industry setting.
- The multi-year profitability, as for example across the business plan cycle, on actual figures of such hybrids should fall within the interquartile range of profitability of comparable companies.
- Units with entrepreneurial functions, i.e. the non-routine units, may result in excess profits and, as the other side of the coin, will have to suffer from extreme losses if the overall business model does not function. By the nature of the contracts, such unit is the residual claimant.
- A legal entity of a multinational group can show various function and risk types across the transactions engaged.