Risk analysis (3/6): risks taken under contract and their functional analysis (2/18/17)

To continue the series of Flash News on risk analysis, this article explores steps 2 and 3 of the risk analysis according to the OECD's BEPS comments. Step 2 determines how related companies contractually take particular economically significant risks under the terms of the transaction. Step 3 uses a functional analysis to find out how the related companies operate in terms of taking and managing the economically significant risks. To gain an insight into these steps, let us consider an example transaction between a manufacturer and a distributor who are related parties.

Step 2. Taking contractual risks

In evaluating how risks are apportioned according to their legal form between the parties and in identifying a particular risk, the first thing to consider is contracts whose risks need to be assessed:

- Risks can be described expressly, by identifying their type and determining which party takes a particular risk and in what manner.

For example, the contract provides that the distributor takes inventory risk and customer credit risk on sales to unrelated parties, while the manufacturer takes product quality risk.

- Risks can also be implied, i.e. they are not described in the contract but are understood from the context.

For example, the distributor agrees with the manufacturer that the distributor will buy an agreed quantity of goods for an agreed price and make a prepayment on a monthly basis. This agreement places market risk on the distributor, who might not gain the expected income as a result of falling demand. The manufacturer takes financial risk should the market see a rise in the prices of raw materials required for manufacturing.

Where the parties have not entered into a written agreement (contract) or where their agreement is incomplete, it might be possible under step 3 below to identify risks according to information from any other sources where the parties have agreed on the terms of the transaction (such as email correspondence or any other form of communication) and according to the conduct of the parties and the economic substance of the transaction.

However, the parties are advised to enter into a written agreement (contract) because this will clearly define the various risks and limit the tax authority's scope for interpreting the risk apportionment, assuming the parties act in accordance with the contract.

Step 3. Functional analysis of risks

Once it's clear what risks the related companies take under their written agreement, a functional analysis of those risks should be conducted to find out which party in fact manages the risks, by mainly answering three questions:

1. Which party performs the function of managing and mitigating the risk?
2. Which party faces the good and bad consequences of the risk outcome?
3. Which party has the financial capacity to take the risk?

The functional analysis of the transaction shows that the distributor manages the significant risks associated with gaining income from sales (i.e. market risk, inventory risk, and customer credit risk) because according to the functional analysis, the distributor determines the technical specifications, design and quantity of the goods being ordered, and organises sales (including marketing campaigns, customer solicitation, and deliveries). The distributor also faces the good and bad consequences of these risks. Market risk, for example, means that falling demand will reduce the distributor's income; in the case of customer credit risk, the distributor may lack the funds needed for buying new goods should customers be late with payments or fail to pay for the goods. And the distributor has the financial capacity to take these risks because he controls the pricing and receives payment from customers.

An assessment of the manufacturer shows that he manages risks associated with manufacturing, i.e. financial risk (the pricing of raw materials) and quality risk, because the manufacturer performs functions such as sourcing the raw materials and components, drawing up production schedules, controlling the quality of manufacturing processes and products. The manufacturer also faces the consequences should he be unable to produce the quantity ordered or should he produce inferior goods. It was also found that the manufacturer does not take credit risk towards the distributor because the latter makes a prepayment for the goods being ordered under the written agreement.

In view of this, the functional analysis of the companies shows that –

- the manufacturer acts as a contract manufacturer, and
- the distributor acts as a full risk distributor.

We will continue to analyse this example in our upcoming articles.