

Risk analysis (4/6): taking risks under contract and their functional analysis (2/28/17)

This article explores Step 4 of risk analysis according to the OECD's BEPS commentaries, namely how to determine whether the actual apportionment of risks in a transaction matches the findings of [Steps 1-3](#).

Special considerations about risks

In the first three steps of risk analysis, information about risks inherent in a related-party transaction and about how those risks are taken and managed is obtained from contracts between the parties, or where the contractual agreement is incomplete or one does not exist, from any other sources of information where the parties agreed on the terms of the transaction, such as correspondence or any other kind of communication between the parties.

Step 4 examines whether the way the risks were to be taken and managed under the contract matches how the parties actually behaved in the transaction and whether the party taking a particular risk under the terms of the contract is also managing that risk, and whether the party has the financial capacity to take it.

If Step 4 finds that the parties are taking and managing risks in the transaction as documented in the contract, we can begin to analyse the transfer price (Step 6 to be explored in our next article).

However, if there are discrepancies between the terms of the contract and how the parties actually behave in the transaction, we should determine which party is taking the risks associated with the transaction and to what extent, and then reapportion those risks according to the actual behaviour of the parties (Step 5 to be explored in our next article).

An example contract

In the example we used when we were exploring the first three steps of risk analysis, the contract between company A (the manufacturer) and company B (the distributor) provides that the distributor will purchase an agreed quantity of goods from the manufacturer for an agreed price each month for one year. The distributor is required by the contract to make an advance payment at the beginning of each month, regardless of whether he needs the agreed quantity of goods.

The terms of the contract imply that the manufacturer operates as a contract manufacturer that does not take market risk on sales to end consumers, because the contract states the quantity and price for the agreed period. And the distributor operates as a full risk distributor because he is responsible for ensuring that all the goods purchased from the manufacturer are sold to end consumers, and he undertakes to manage this market risk.

Does the behaviour of the related companies match the contractual apportionment of risks?

An assessment of the actual behaviour of the parties showed that only in some months of the contract period did the distributor purchase the agreed quantity but he stopped purchasing from the manufacturer

in the middle of the contract period because of a fall in demand from end consumers, and the distributor has not paid up front as agreed for goods not purchased in the remaining period.

This leads to the conclusion that the way the risks were to be taken under the contract is different from how the parties actually behaved in the transaction. According to the economic substance of the transaction, the manufacturer is taking market risk on sales to end consumers, because the contract guaranteed the production of an agreed quantity for an agreed price, but in fact the distributor defaulted on his contractual obligations, and accordingly the manufacturer took the adverse consequences of market risk. It was also found that –

a) the distributor originally did not even have the financial capacity to take this market risk, because when the risk materialised, he was unable to honour his contractual obligations towards the manufacturer, that is to make the agreed purchases in full;

b) the manufacturer manages this market risk by purchasing raw materials in small quantities only for a particular month's production rather than for the entire contract period, which would give him better raw material prices but would cause a loss should the risk materialise, because the purchase of raw materials would be stated in the contract.

The actual behaviour of the parties showed that the manufacturer was operating as a full risk manufacturer, not a contract manufacturer, because he actually took market risk on sales to end consumers.

Invalid apportionment of risks

Since the economic analysis of the transaction examined in the example was based on an inaccurate apportionment of risks between the parties, the transfer price should be reassessed for arm's length purposes and an adjustment may be necessary. Our next article will explore how to reapportion the risks and determine an arm's length price correctly.

Managing the apportionment of risks is key

If the economic analysis of a transfer price is based only on the terms of the contract, and the actual behaviour of the related companies is not examined, then if their actual behaviour differs from what the contract says, there is a high risk that the tax authorities will challenge the transfer price as well as the economic analysis carried out for defending an arm's length price, and will increase the company's taxable income by reference to the going market price between unrelated companies making transactions comparable to the actual behaviour of the related companies.

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