



# Dealing with risk & control functions in a dynamic people environment

The OECD Guidelines place the control of risk at the heart of the accurate delineation of a transaction. This means that risk-control functions are central to any transfer pricing methodology. How should the role of these functions be assessed, and what is the impact when the people who undertake them move from one territory to another?

## Background

Actions 8-10 of the OECD Base Erosion and Profit Shifting (BEPS) initiative introduced the concept of 'accurate delineation'. Specifically taxpayers are required to test the activities/decision making undertaken by the parties to an intra-group transaction and to determine whether that aligns with the contractual terms adopted and with the way in which third parties would have made decisions with respect to the arrangement.

Where alignment is achieved, the contractual arrangement will be respected. If alignment is not achieved, then we need to consider how that arrangement would have otherwise been constructed at arm's length.

There are several practical challenges involved in applying this framework, including the determination of (amongst other things):

- Who are the key decision makers?
- Which decisions matter the most?

Also central to Actions 8-10 was the concept of value creation, which has cross-linkages to the same questions around key decisions / key decision makers but at the same time requires us to look at which functions / activities within the group actually drive value and whether these may be due a share of residual or entrepreneurial profits.

The combination of the delineation and value creation concepts means that a heavy emphasis is placed on people and this in turn leads to related questions:

- What is relative value of a decision maker versus legal ownership of the asset itself?
- How valuable are decisions that were made some time ago / how do you determine the relative value of older/newer decisions?
- What happens when individuals move - does that move with it all residual profit that they previously attracted?
- How much people substance is required to sustain your entrepreneurial transfer pricing "core"?

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## How can we help?

We have been working with a number of groups to create policies and governance frameworks that provide a pragmatic way of dealing with what is a complex area. Our approach follows a three-stage process:

1. Determining value driving functions
2. Assessing the appropriate remuneration mechanism for each value driving function (including adaptation for individuals / assets that sit outside of the entrepreneurial core)
3. Determining / providing parameters as to when the entrepreneurial core can no longer be sustained / has 'tipped'

## ***Determining value driving functions***

Through our Value Chain Analysis (VCA) methodology which utilises empirical marketplace evidence, we can isolate the key value driving activities within a group relative to your industry peers.

## ***Assessing the appropriate remuneration mechanism for each value-driving function***

Shaping the remuneration for the entrepreneurial core (be that residual profit, licence payments, franchise payments or otherwise) is key, but so is valuing the activities that happen outside of that core and rewarding those activities in an appropriate manner.

## ***Determining / providing parameters as to when the entrepreneurial core can no longer be sustained / has 'tipped'***

Increasingly tax authorities are asserting that senior individuals located in their territory should attract premium returns, or a share of any residual profit in the system.

The mere fact that an individual has moved, however, does not necessarily mean that a transfer pricing model should cease to be respected, and that entitlement to residual profit has moved.

In practice an evidence-based judgement will be required. Our "Economically Significant Functions" - ESF - framework is one tool which can support such a judgement, using real-time organisational data, providing documentary evidence as part of your transfer pricing compliance process.



*Determining value driving functions*



*Assessing the appropriate remuneration mechanism for each value driving function*



*Determining / providing parameters as to when the entrepreneurial core can no longer be sustained*

## Contacts

Please reach out to Steve Lord ([steve.lord@pwc.com](mailto:steve.lord@pwc.com)) who is our UK Transfer Pricing Network Driver and can help to find you the right contact, or alternatively please feel free to reach out to your regular PwC UK transfer pricing contact.

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