

# Function, Asset & Risk Analysis

Nikhil Dhariwal | November 09, 2019

# About the Session



## AGENDA

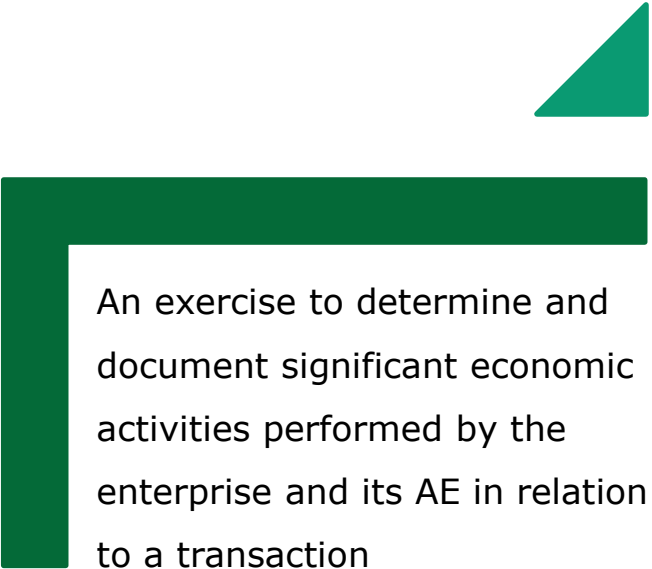
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- Introduction to the concept
- Discussion in the context of Business models - Key structures with case studies
  - - Manufacturer
  - - Distributor
  - - Service provider
- Recent developments
- Experience sharing / Questions & Answers

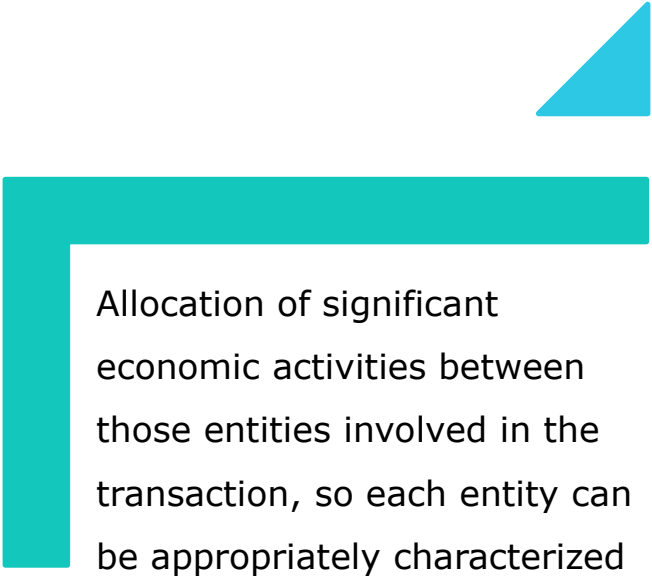
# **Introduction & context**

# What is Functional Analysis ?

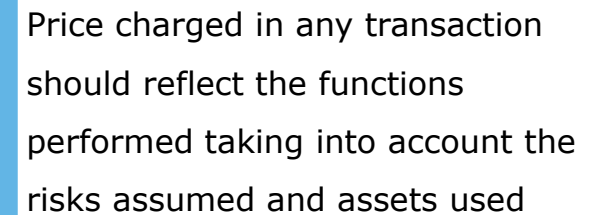
About in gist



An exercise to determine and document significant economic activities performed by the enterprise and its AE in relation to a transaction



Allocation of significant economic activities between those entities involved in the transaction, so each entity can be appropriately characterized



Price charged in any transaction should reflect the functions performed taking into account the risks assumed and assets used

# What are the components of FAR

3 critical aspects



## Functions Performed

- **Activities** carried out by each of the parties;
- Focus should be on identification of **critical functions** which add value;
- Principal functions performed by the entities in a controlled transaction are **compared** to uncontrolled transactions

## Assets Deployed

- **Type** of assets and their **nature** needs to be understood. Also, helps in determination of their **contribution** to economic activity;
- Facilitates understanding of respective **roles** played by the entities;
- Knowledge of assets owned and employed helps determine returns

## Risks Assumed

- Probable **variability** of future outcomes or returns. Higher the risk, higher the return probability as well as potential losses;
- The potential risks are **company and industry specific**. Focus should be on **important risks**;
- Important to **distinguish** between which entity bears risks as per legal terms and which one bears as per the actual conduct

# FAR Analysis – Whether a mandate ?

Regulations perspective – Income Tax Act / Rules

## Section 92C - Computation of arm's length price

*"The arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors ..."*

## Rule 10C(2) - Most appropriate method

*"In selecting the most appropriate method, the following factors shall be taken into account, namely:*

*(b) the class or classes of AEs entering into the transaction and the **functions performed by them taking into account assets employed or to be employed and risks assumed** by such enterprises;..."*

## Rule 10B(2) - Determination of arm's length price under section 92C

Comparability of an international transaction with an uncontrolled transaction shall be judged with reference to (among others):

- Functions performed, taking into account assets employed and risks assumed, by both the parties to the transactions
- Contractual terms (*whether or not such terms are formal or in writing*) which lays down explicitly or implicitly how the responsibilities, risks and benefits are divided between parties to the transactions

# FAR Analysis – Whether a mandate ?

Regulations perspective - OECD

**Para 1.36 (Chapter1) of OECD TP Guidelines, 2017** lists **functional analysis as one of the five factors for comparability analysis:**

*"The functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices"*

**Rule 10D (1) - Documents to be maintained under section 92D**

*"(e) a description of the **functions performed, risks assumed and assets employed** or to be employed by the assessee and by the associated enterprises involved in the international transaction"*

## **Action Plan 13: 2015 Final Report by the OECD – TP Documentation & Country-by-Country Reporting**

The Annexure 1 to the Chapter V lists **functional analysis as one of the critical aspects to be documented in Master File of a MNE's business:**

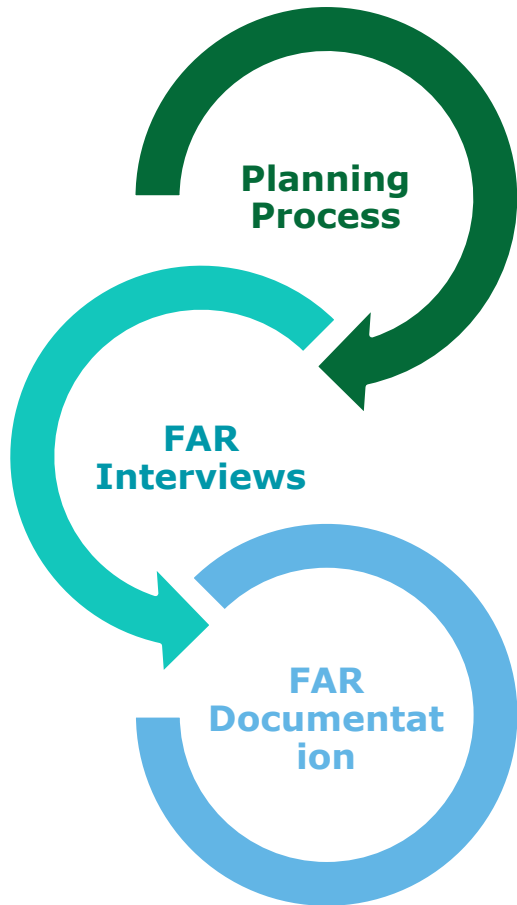
*"A brief written functional analysis describing the principal contributions to value creation by individual entities within the group i.e. key functions performed, important risks assumed and important assets used"*

**Rule 10DA (1) - Documents to be maintained and furnished under section 92D(4)**

*"(VIII) a description of the **functions performed, risks assumed and assets employed** by the constituent entities of the international group that contribute at least ten per cent of the revenues or assets or profits of such group"*

# About the FAR Process

A step-by-step approach



## Step 1

- 1) Identify relevant transactions and transacting entities
- 2) Industry and group background
- 3) Review available internal/ external documents

## Step 2

- 1) Prepare questionnaires and identify interview contacts
- 2) Create detailed FAR questionnaire
- 3) Conduct interviews and make notes

## Step 3

Summarizing FAR findings in the documentation report/benchmarking memo



# About the FAR Process

How to gather factual information



**Basic  
Information**

- 1) Background information about enterprise to understand its business operations and activities – (Sources – Annual report, website, internal reports)
- 2) Description of ownership structure of the enterprise;
- 3) Profile of multinational group of which the enterprise is a part
- 4) Broad description of the business of the enterprise

**Specific  
Information**

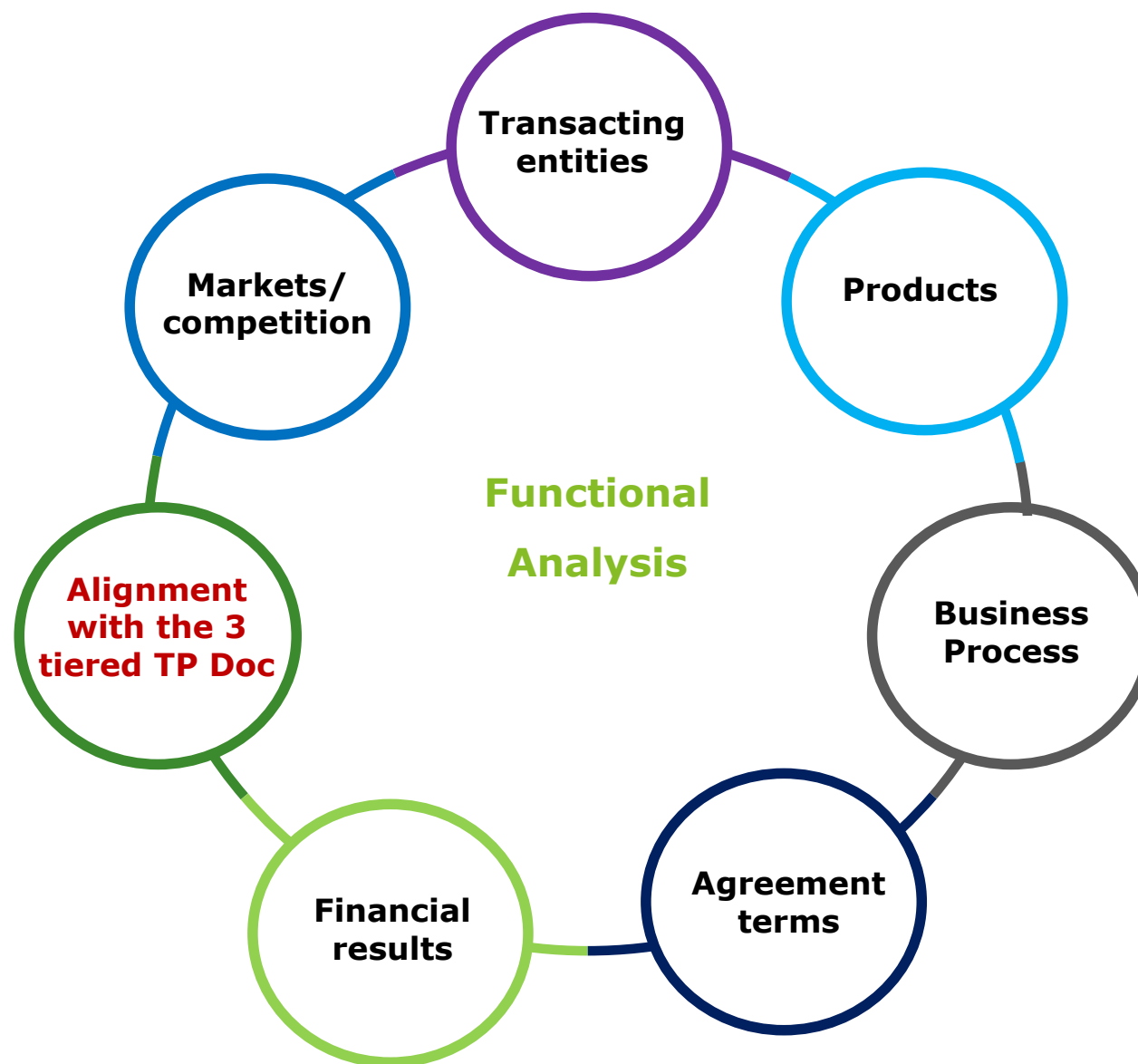
- 1) Functions generally performed by each party to the transaction
- 2) Assets generally employed in a transaction
- 3) Risks generally assumed by each party to the transaction
- 4) Contractual terms that have effect on transfer prices are also to be examined Sources – written contracts, agreements)

**Other  
Relevant  
Insights**

- 1) Agreements, common group policies
- 2) Product brochures, marketing materials
- 3) Documents providing information such as marketing strategies, pricing strategies
- 4) Information about major competitors, customers, market etc.

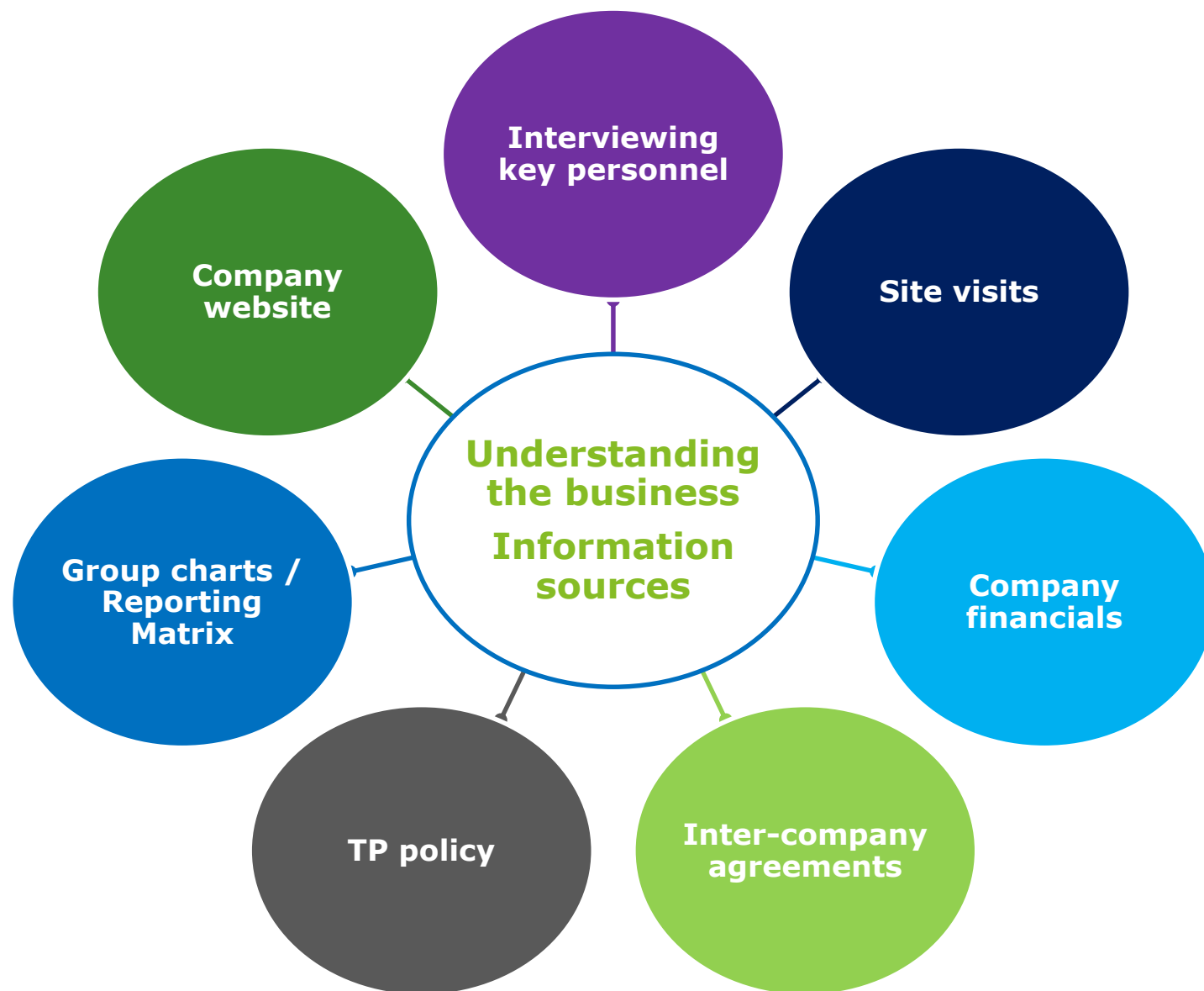
# What are the critical aspects to be considered under FAR ?

Key considerations



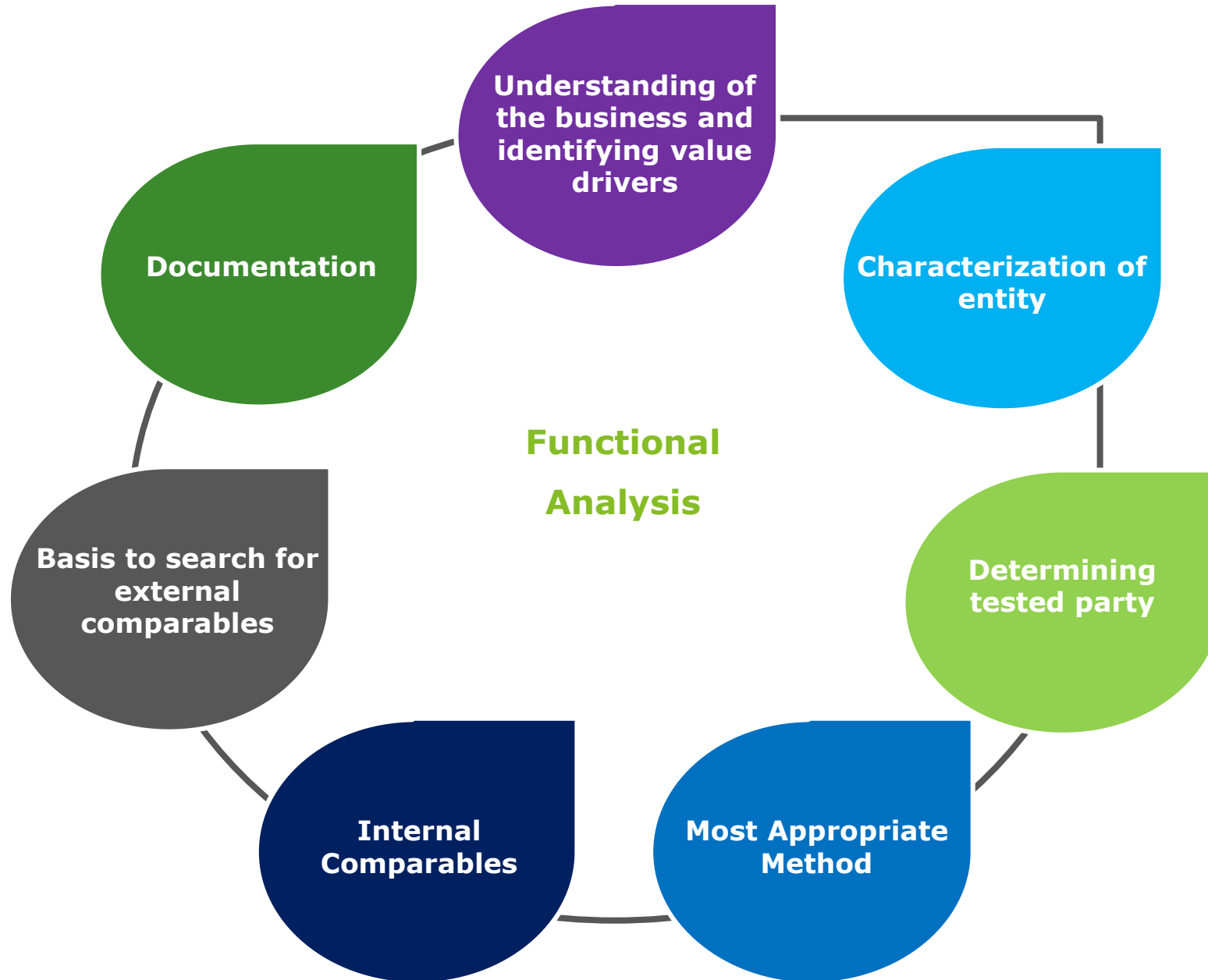
# What are critical sources for fetching information w.r.t FAR ?

Key data points



# What is FAR Analysis important ?

Key implications



# What are the key factors in FAR Analysis ?

**01** Sheer volume of functions performed is **not decisive** -What is relevant is the **relative importance of each function**

**02** Functions performed may be few but significant

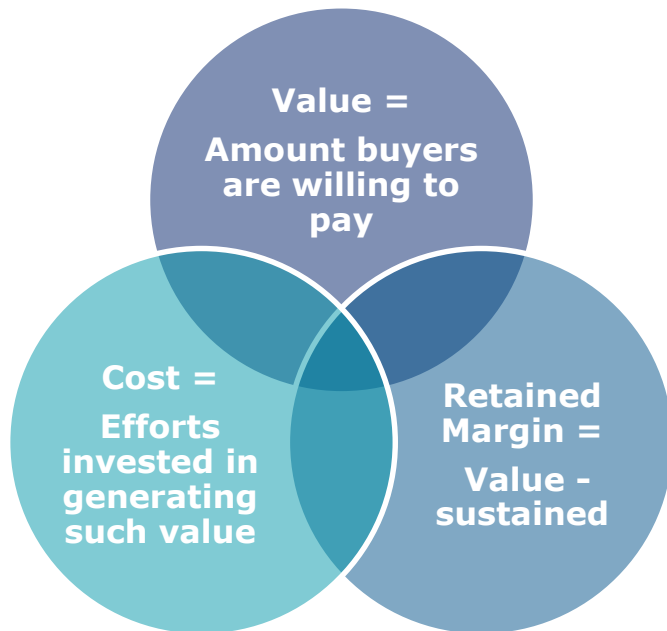
**03** Identify **each party's contribution (Taxpayer & AE)** to every function performed

**04** Functions are the main domain for identifying and assigning risks to an entity

**05** Aggregation of International Transactions **-only if FAR analysis of such transactions is aligned**

# What is Value Chain Analysis ?

Genesis and meaning



VCA – 1<sup>st</sup> coined  
by Mr. Michael  
Porter in 1985

“A set of activities  
that a firm  
operating in a  
specific industry  
performs in order  
to deliver a  
valuable product  
or service to the  
market”

Series activities  
that build value at  
every stage of  
doing business

***VCA – Tool to understand how the value is being created by an Enterprise through in due course of its business operations; by analyzing relative value of FAR by group entities towards each other***

# Distinguish - Functional, Supply Chain and Value Chain Analysis

A snapshot

## Value Chain Analysis

1. Value focused, end-to-end FAR;
2. Deep dive analysis – Value drivers of the industry & company;
3. Evaluate how FAR interacts in relative terms;
4. What are the functions that demarcate b/w success & failure

## Supply Chain Analysis

1. Focuses end-to-end processes of how the products are made, moved and delivered;
2. Misses on activities that may likely be part of the value chain;
3. No direct attention to relative value of supply chain components

## Functional Analysis

1. Focuses on what business uses i.e. FAR – Often in context of a particular transaction;
2. No direct attention to relative value of FAR

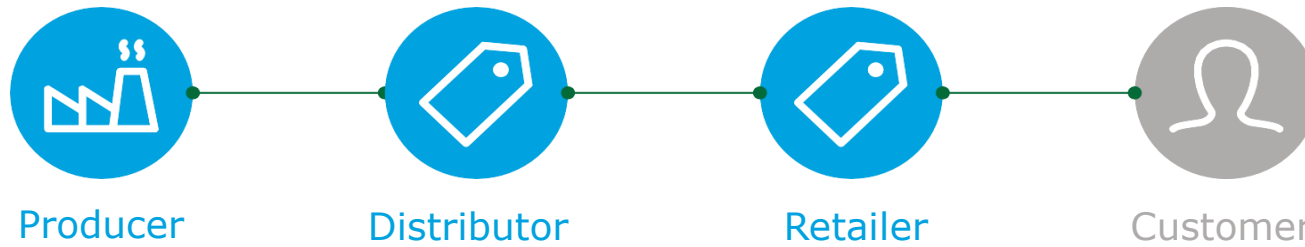
# **Business models - Key structures**



# Business Model

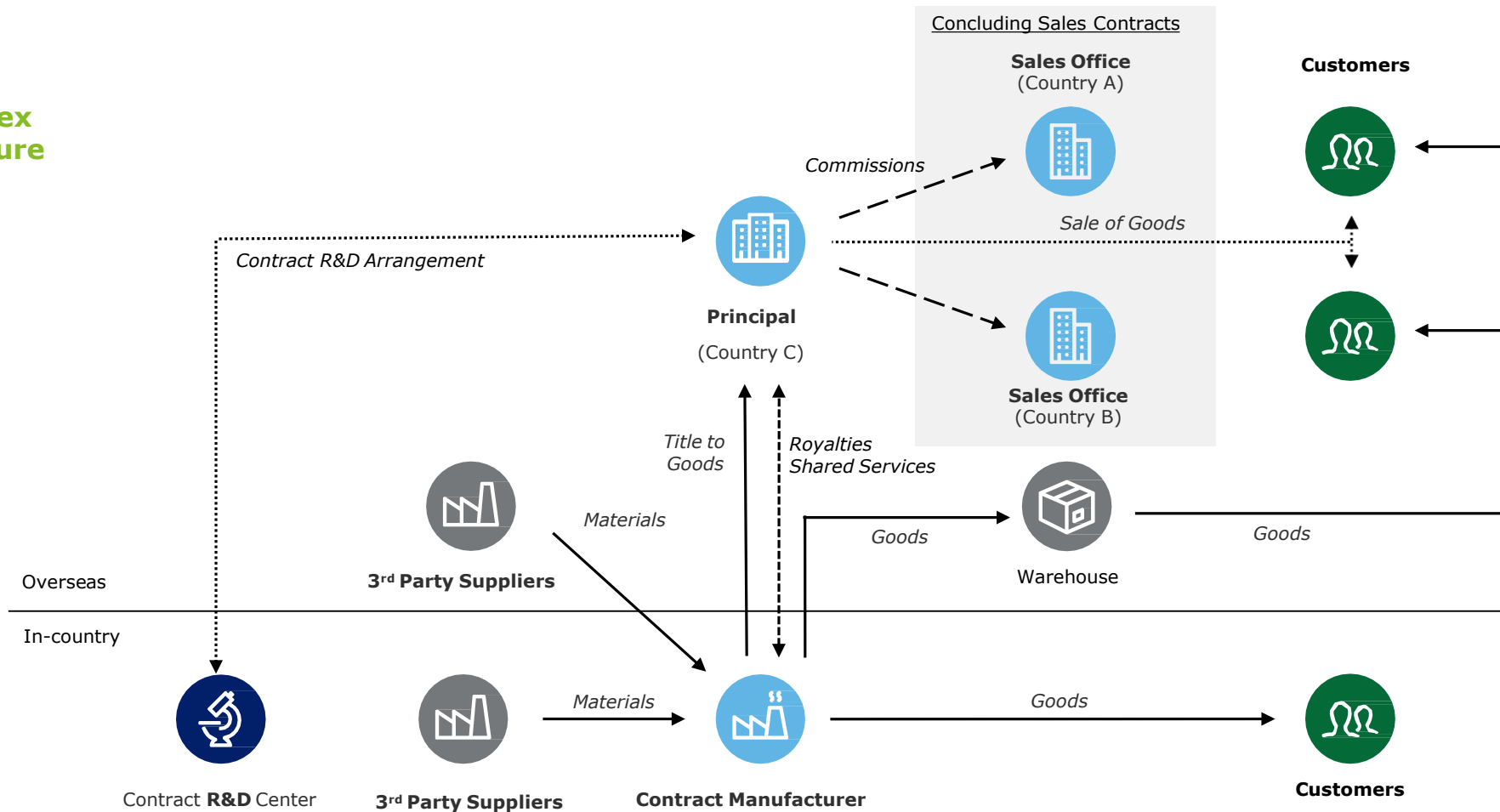
## Typical structures

### Linear Structure



V/S

### Complex Structure



# Characterization of an Entity under the FAR

01

Entity characterization is one of the main objectives of functional analysis

02

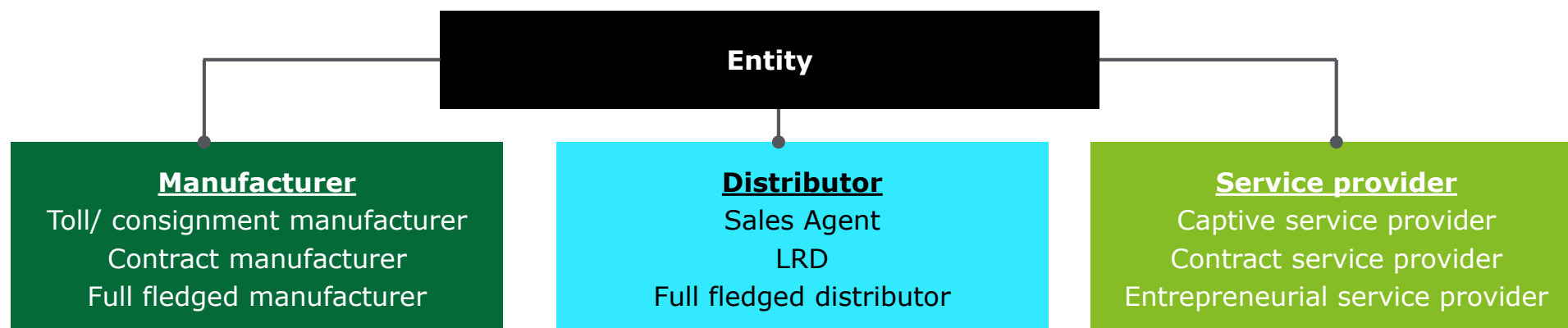
Entity characterization is a link between the business processes, and the way the entities participate in them. It focusses on the key feature of the various entities, regarding how they do business

03

Characterization of the related parties is an important component to a transfer pricing analysis and is typically used as the foundation in developing economic analysis

04

It is a summary of the crucial characteristics which defines the type and nature of an entity and provides insight on type of comparables that will be required to benchmark the related party transaction



# Business Models

## Central Entrepreneur / Principal

- Operates as the **central risk bearing entity** with **entrepreneurial risk taking activities**
- Intention is for residual profits to accrue to this entity
- Historically contractual allocations were used to form basis for earning residual
- New guidelines on risk allocation make this more challenging



### Key activities

- Taking key decisions for business, using own judgement – not just a rubber stamp
- Directing strategy and research
- Deciding on investment, expansion and closure plans

# Business Models

## Manufacturers

- Produce products for the group – can be third party or related party
- Different models available depending on business needs:

<b>Toll manufacturing</b>	<b>Contract manufacturing</b>	<b>Licensed manufacturing</b>	<b>Full fledged</b>
Only acts as a processor without taking title to inventory	Limits exposure to market and other entrepreneurial risks	Licenses IP to be used for its manufacturing operations and also undertakes sales and distribution of its products	With responsibility for IP development

- Need to ensure **understanding about permitted models and practical implications as per the local laws**, when considering different options :-

*"In China toll manufacturers should be remunerated as is they were contract manufacturers"*



### Key activities

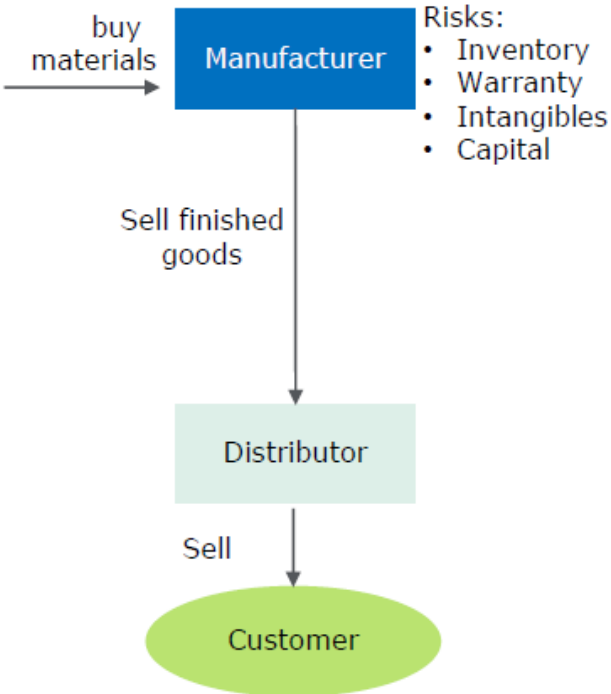
- Organizing factory management and workforce for production
- Operating factories and managing subcontractors
- Storing inventory, work in progress and raw materials

# Business Models

## Manufacturers

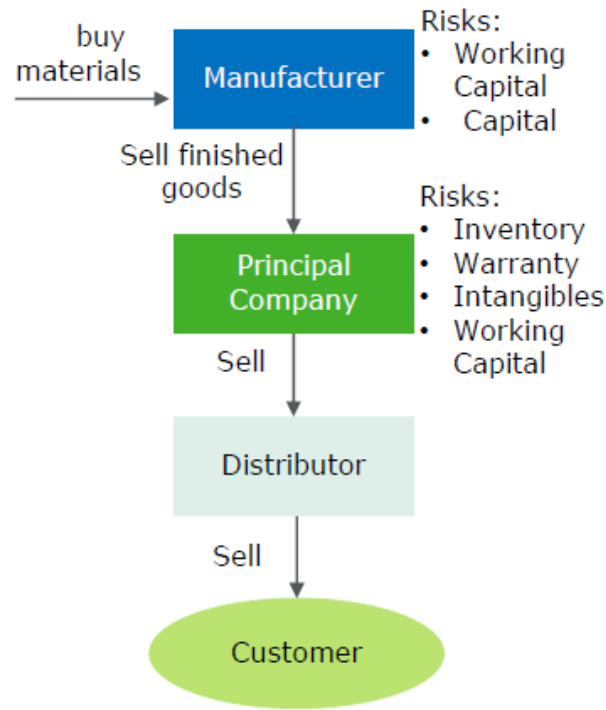
### Traditional / "Fully fledged" Manufacturing

The manufacturer owns intangibles and manufactures product for its own risk and reward



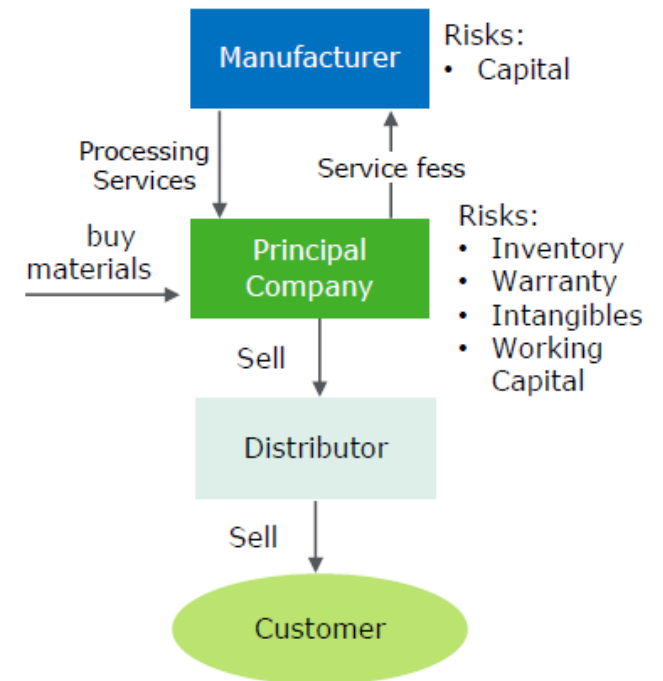
### Contract Manufacturing

A contract manufacturer produces goods to order for and for the risk of the principal company. A contract manufacturer buys materials and sell finished goods to principal. However, it has less risk and earns a lower profit than a traditional manufacturer.



### Toll / Consignment Manufacturing

A toll / consignment manufacturer processes goods belonging to the principal company and never takes ownership. It assumes less risk and earns a lower return than a traditional manufacturer.



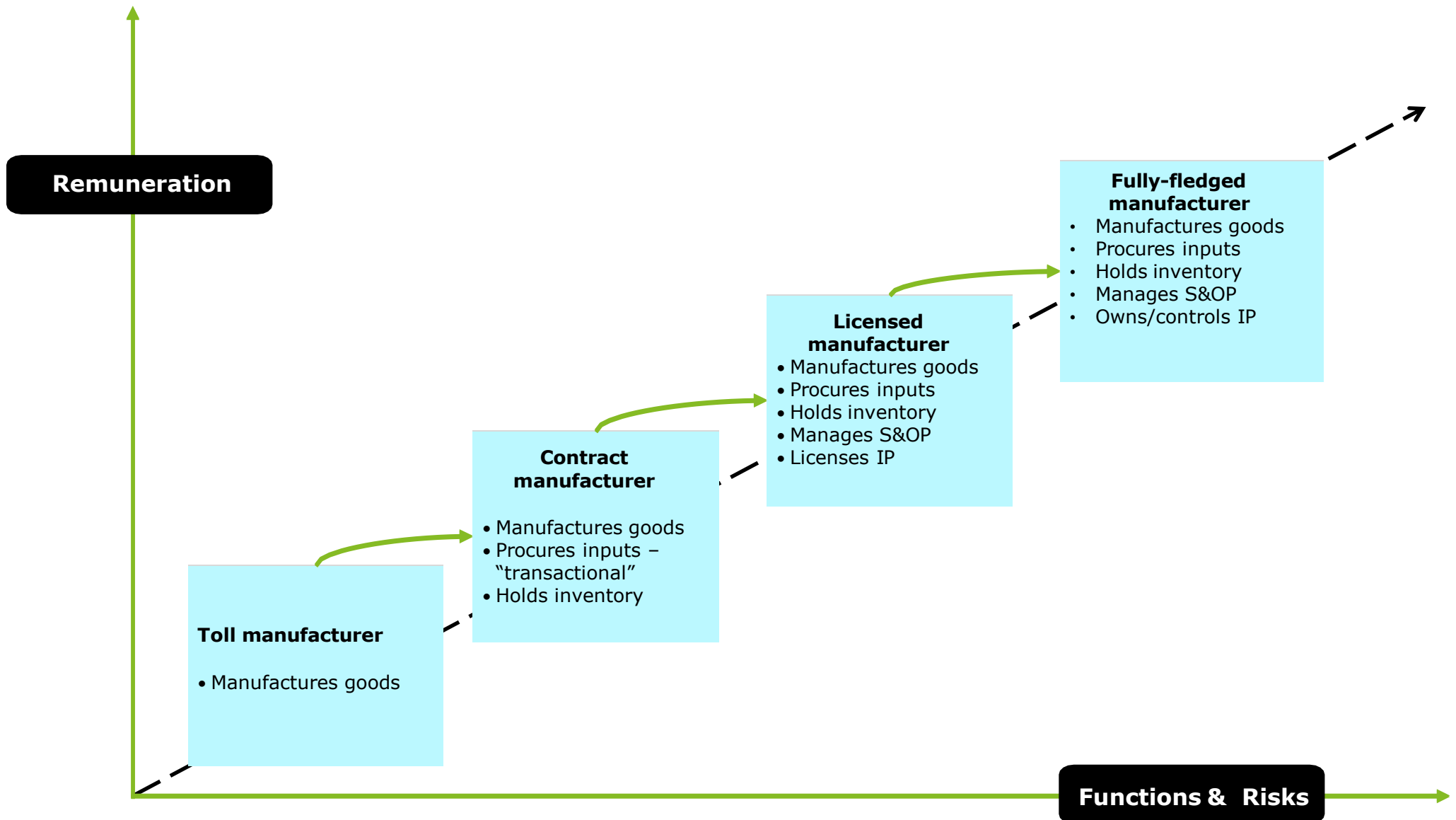
# Business Models

## Manufacturers – Functional and risk profile of typical manufacturers

	<b>Toll manufacturing</b>	<b>Contract manufacturing</b>	<b>Licensed manufacturing</b>	<b>Full fledged</b>
<b>Functions</b>				
Produces on behalf of	Somebody else	Somebody else	Own behalf	Own behalf
Intellectual property	Does not own IP	Does not own IP	Licenses the IP	Owns the IP
Materials	Does not own	Owns	Owns	Owns
Marketing	No	No	Yes	Yes
Sales & Distribution	No	No	Yes	Yes
<b>Risk Exposure</b>				
Market risk	No (Minimal)	No (Minimal)	Yes	Yes
Price risk	No	No	Yes	Yes
Inventory risk	No	No	Yes	Yes
Capacity risk	No	No	Yes	Yes
Product liability risk	No	No	Yes	Yes
Warranty risk	No	No	Yes	Yes
Technology R&D risk	No	No	Yes	Yes

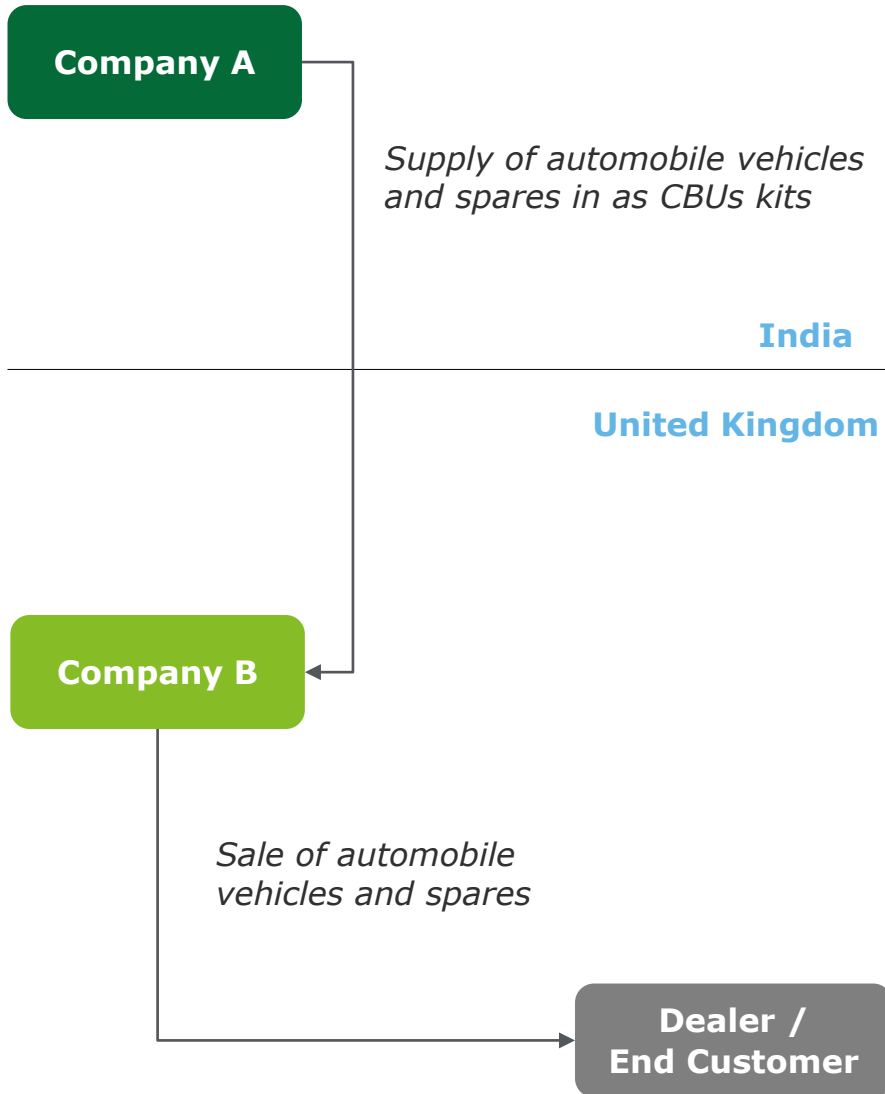
# Business Models

## Manufacturers



# Business Models

## Manufacturers – Case Study 1



### Facts

- Company A undertakes manufacturing of automotive vehicles in India.
- Pursuant to its manufacturing operations, Company A assumes roles and responsibilities for R&D of its products, planning strategy and operations, procurements, warehousing and inventory management, marketing etc. among others.
- Thereafter, Company A supplies the Completely Built Units of automobile vehicles to Company B in United Kingdom.
- Company B has an assembly line / facility set-up in United Kingdom.
- It procures certain materials / spares in United Kingdom and undertakes last mile assembling activities on the products imported, prior to selling it to the end customers in the open market.
- Pursuant to its business operations, Company B also undertakes warehousing and inventory management, limited procurement, marketing activities in its own capacity etc. among others.

### Conclusion about the type of business model

**Whether Company B can be characterized as a Manufacturer or a Distributor ?**

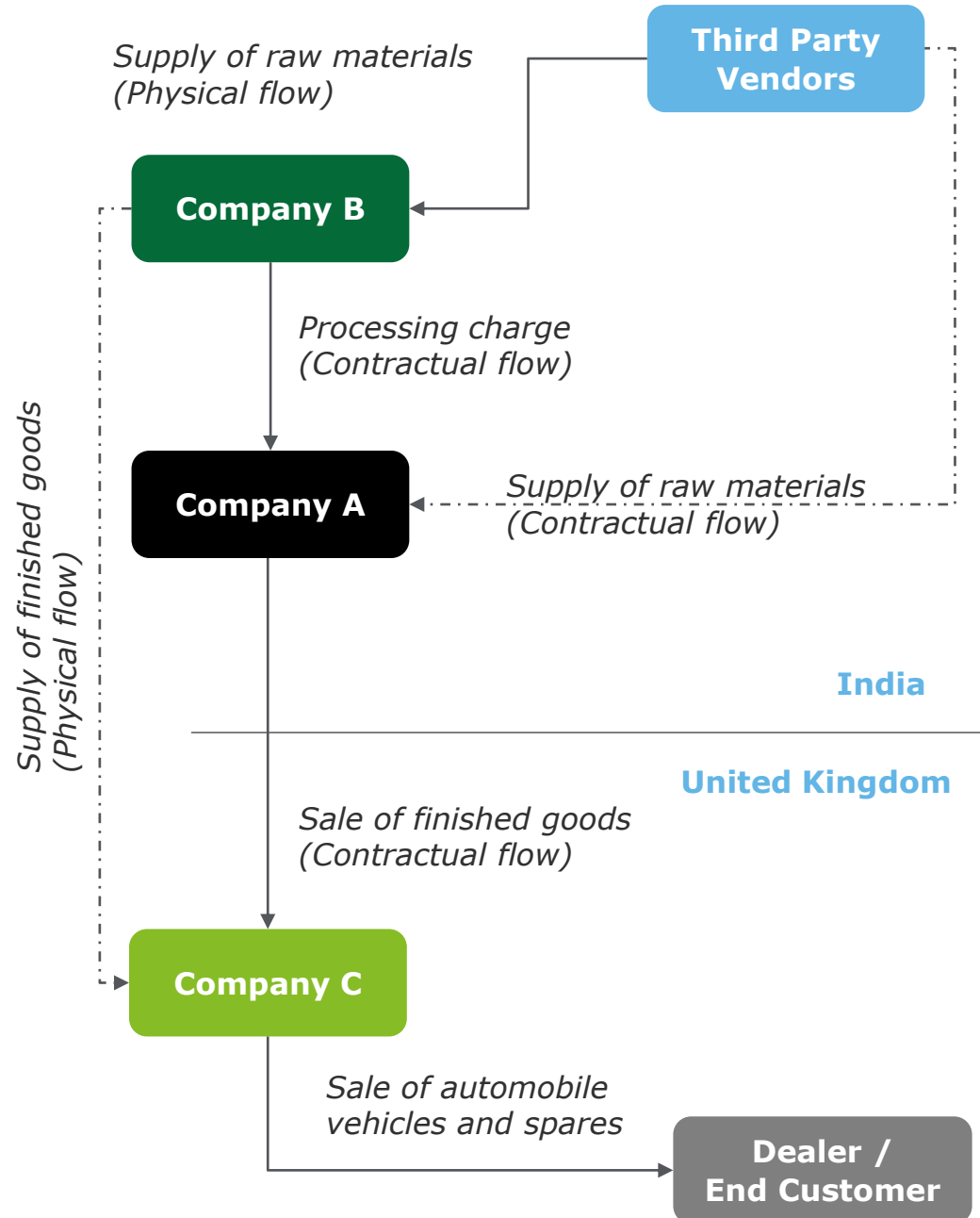
**Who will be the tested party?**

**What type of comparable to be considered?**



# Business Models

## Manufacturers – Case Study 2



### Facts

- Third party vendors in India, physically supplies raw material to company B on behalf of Company A (contractual).
- Company B agrees to manufacture large quantity of finished goods for an agreed fees, on behalf of Company A
- Company A provides a royalty free license of the patent and trademark to Company B, permitting to manufacture the finished goods pursuant to the patent and to place the trademark
- After completing the manufacturing process, the finished goods are warehoused by Company B for several days under the instructions from Company A
- Thereafter, Company B supplies the finished goods to Company C physically, based on instruction from Company A.

### Conclusion about the type of business model

**Whether Company A as well as Company B can be construed to be manufacturing entities to the said supply arrangement with Company C ?**

**Related party transaction, both between Company A and Company & also Company A and Company C**

- **Which party to transaction should be considered as tested party ?**
- **What benchmarking to be done to satisfy arm's length ?**

# Business Models

## Distributors

- Responsible for identifying and building distribution networks for the group in different countries and markets
- Employ or contract out sales and marketing functions to build such networks
- Different models available depending on business needs

Commission agent	Limited risk	Full fledged
May receive commissions for finding clients and receive payments when sales are made	Limit scope of role of in- country team, with principal entity taking key risks (need to be able to prove it is actually the case)	With responsibility for IP and marketing strategy & development

- Need to ensure **understanding about permitted models and practical implications as per the local laws,** when considering different options



### Key activities

- Establishing network of retailers and other customer channels
- Undertaking marketing and sales activities

# Business Models

## Distributors

### Fully fledged Distributors

A full distributor bears market risk, holds inventory for its own risk and sells to the customer as principal. The distributor's profit margin reflects its risks and functions.

### Limited Risk Distributors

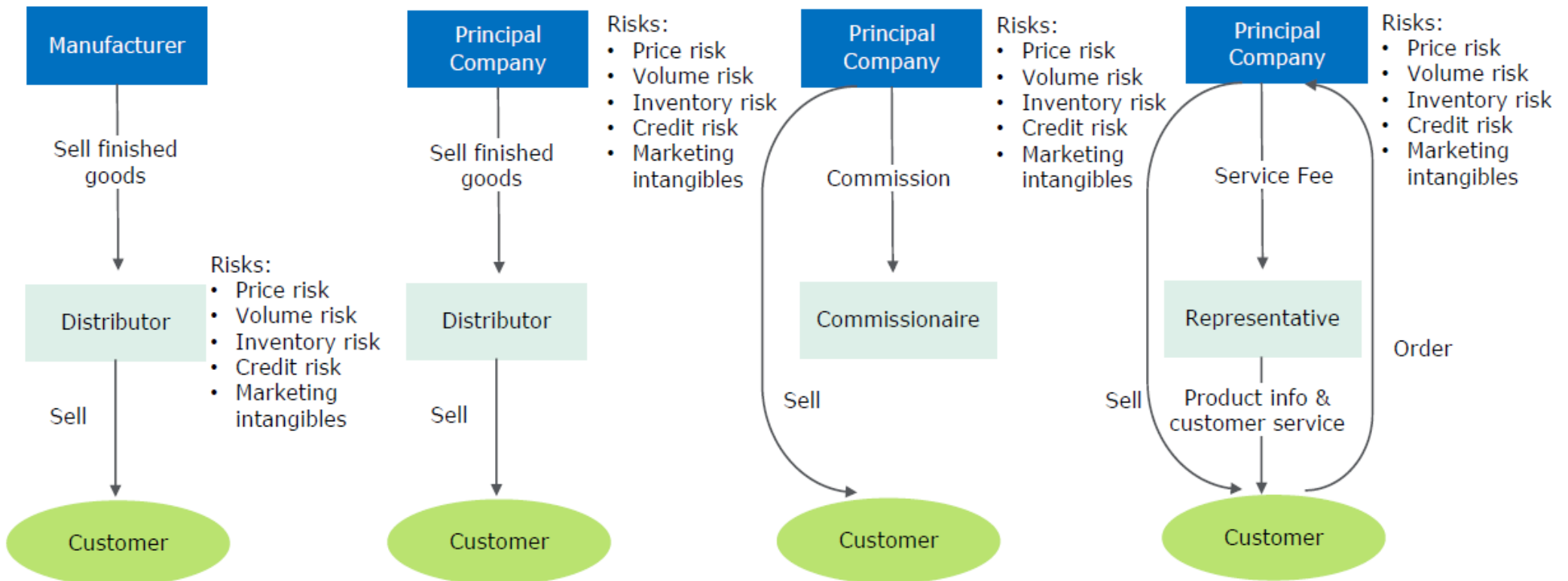
A master distributor bears market risk and inventory risk. The local limited risk distributors buy product from the master distributor and resell the product to the customer. The limited risk distributors earn a lower profit than a full distributor, consistent with their reduced functions and risks.

### Commissionaire

A civil law concept whereby the commissionaire sells product in its own name but for the account of the principal. The risks and benefits of the sale (and the profit) rest with the principal. The commissionaire receives a commission which provides it with a lower profit than a full distributor, consistent with its reduced functions and risks.

### Representative

The local sales company acts as a representative that is not directly involved in making sales. It merely provides product information and performs customer service. The principal receives sales orders directly from customers - either in a call centre or electronically. The local representative earns a lower profit than a full distributor, consistent with its reduced functions and risks.



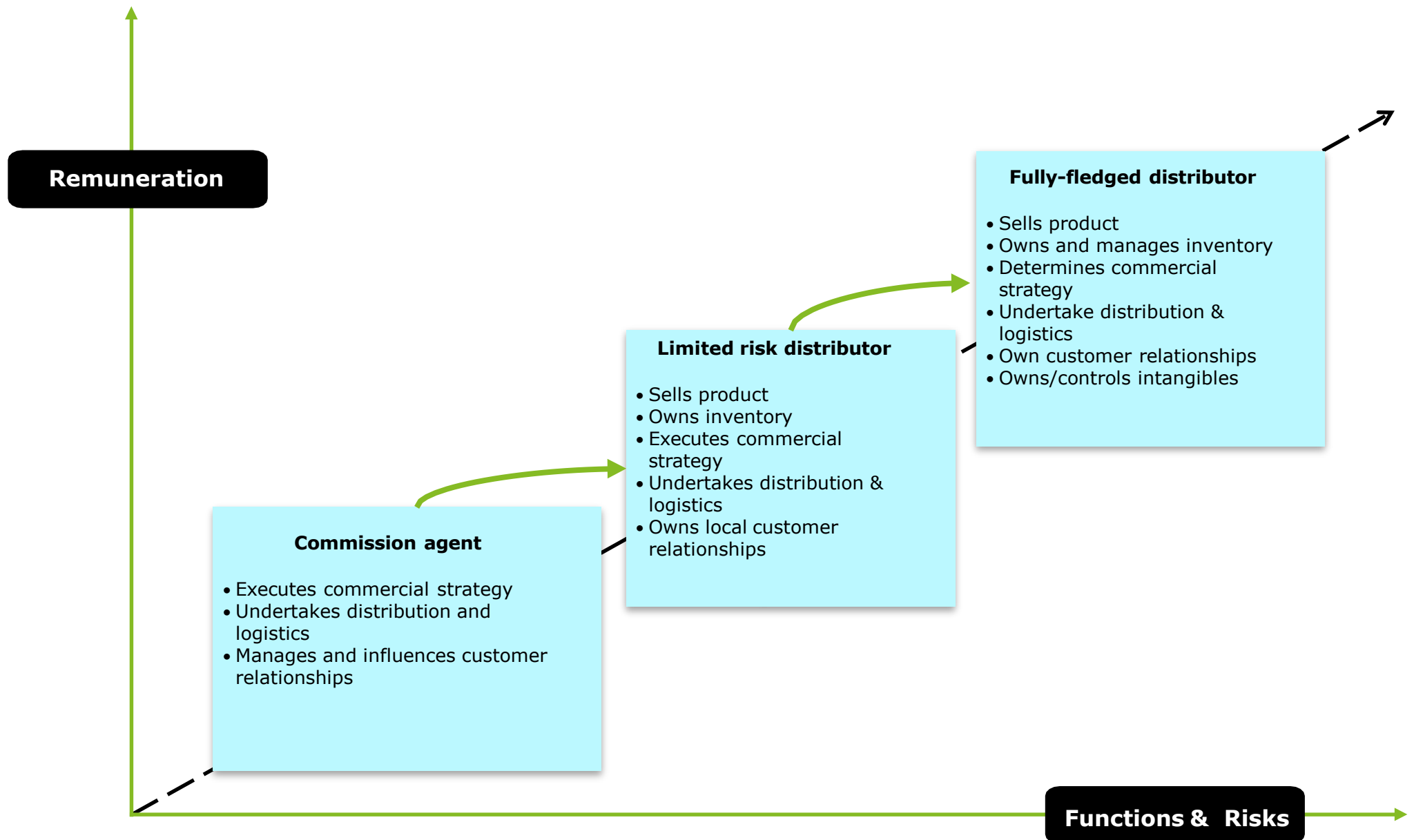
# Business Models

## Distributors – Functional and risk profile of typical distributors

	<b>Commission Agent</b>	<b>Limited Risk Distributor</b>	<b>Full-Fledged Distributor</b>
<b>Functions</b>			
Marketing	Minimal	Minimal	Yes
After sales service	No	Yes	Yes
Inventory management	No	Minimal	Yes
<b>Risk Exposure</b>			
Market risk	Minimal	Minimal	Yes
Price risk	No	No	Yes
Inventory risk	No	Minimal	Yes
Product liability risk	No	No	Yes
Warranty risk	No	Recourse available with the principal	Yes

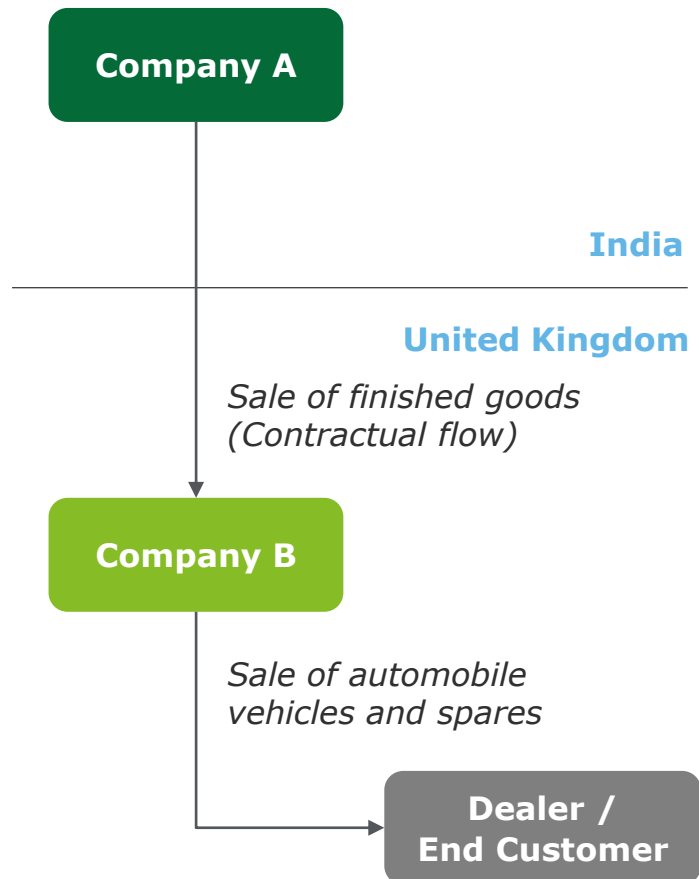
# Business Models

## Distributors



# Business Models

## Distributors – Case Study 1



### Facts

- Company A owns the trademark and intellectual property rights in relation to the automobile vehicles developed by it
- Thereafter, Company B shall market, advertise, propagate automotive products in United Kingdom.
- The marketing strategies are guided, under guidance and directions of Company A and all the expenses in relation to marketing activities are being reimbursed by Company A to Company B, at actuals.

### Conclusion about the type of business model

Sr. No.	Alternative Scenarios
1	Company B buys from Company A on stock & sale basis (Take inventory risk and market risk)
2	Company B buys only against confirmed orders from dealers / end customers (minimal inventory risk and market risk)
3	Company B places order on Company A & Company A ships directly to dealer / end customers

# Business Models

## Entrepreneurial Service Providers

- Develops and markets its own services to its own clients
- Usually has the strategic marketing and operational responsibilities of its operations;
- May also develop marketing intangibles such as customer relationships, trademark recognition and specialized customer service expertise
- Risks borne include service quality risk, market risk, credit risk etc.
- Entitled to residual profit



### **Key activities**

- Rendering services;
- Market research & strategic marketing;
- Developing intangibles / Service expertise

# Business Models

## Contractual Service Providers

- Performs services not for itself but on behalf of other entities under following contractual terms and conditions:
  - The contractor, i.e. entity performing the service, will bear no market risk - Developer / Service recipient entity will agree to purchase the output under the contract service agreement
  - The developer will provide the contractor with detailed specification based on its know-how and intellectual property developed as a result of research and development
  - The contract service provider will bear all the risk associated with the ownership, maintenance and operation of the equipment it uses
- Normally compensated in following models:
  - a cost-plus mark-up model; or
  - a standard rate card model.
- Enjoys relatively lower though stable margins; principal is entitled to residual profits



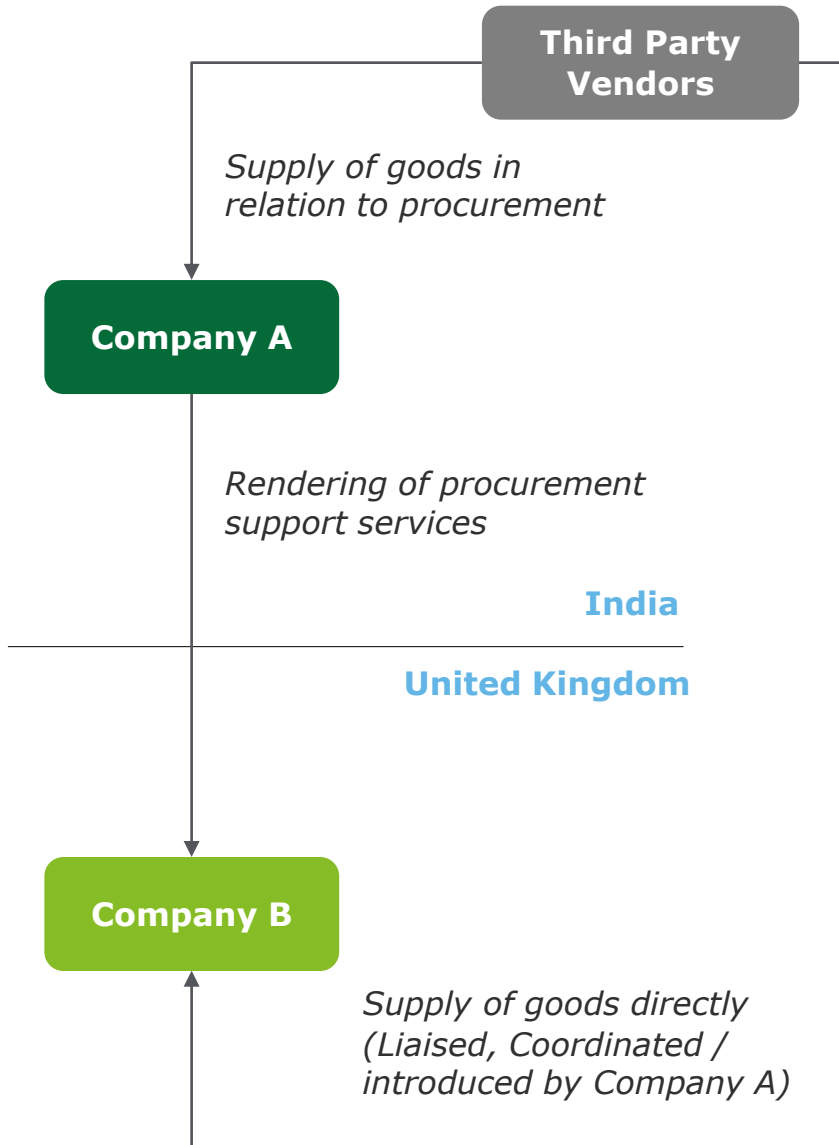
### Key activities

- Works under the strategic guidance and instructions from principal;
- Does not engage in development of intangibles independently



# Business Models

## Service Provider – Case Study 1



### Facts

- Company B is an entrepreneur company engaged in manufacturing of automobile vehicles
- Company A is in the business of rendering procurement support services. Pursuant to its business operation it has a strong network of third party vendor network and renders such services to Company B.
- Domestic third party suppliers sell raw materials / finished goods to Company directly, or otherwise.





### Conclusion about the type of business model

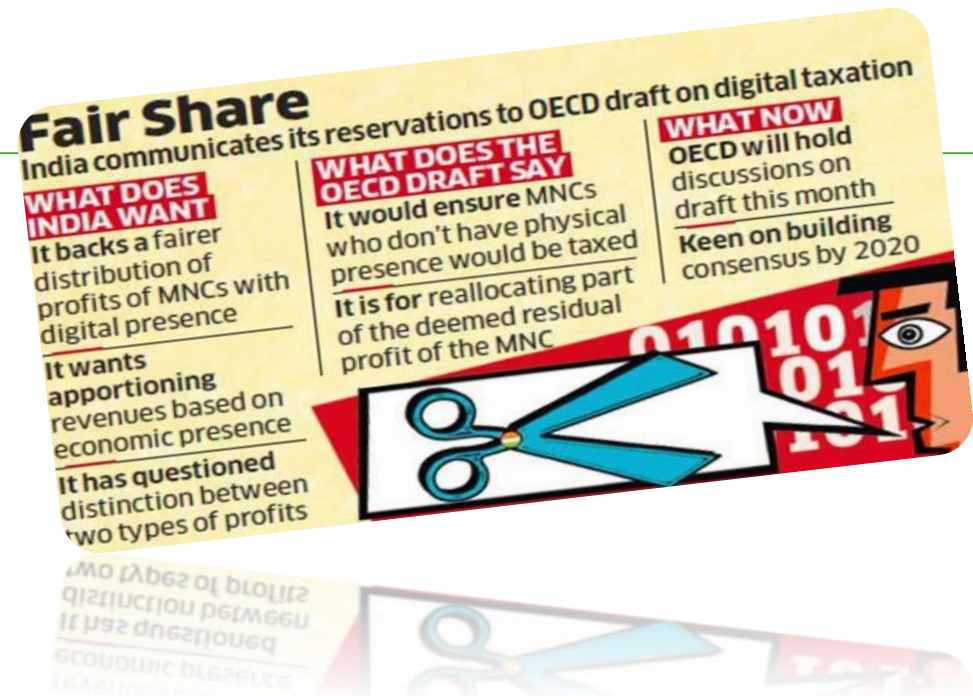
Sr. No.	Alternative Scenarios
1	Company A performs identification of vendors & negotiation with an intent to achieve cost savings
2	Company A merely performs liaison & co-ordination function vis-à-vis vendors
3	Since, Company A has strong third party vendor network it has introduced the same to Company B. On going forward basis, Company B directly sources / procures goods from them.

# Recent Developments

# Recent Developments

## Key Highlights

-  **Aligning functional profile of transacting entities with the characterization as documented in newly introduced the three-tiered documentation regime by BEPS i.e. Master File and CbyCR**
-  **A paradigm shift for attributing contribution to the transacting entities, with emergence of concepts like Digital economy - Diverging from functional analysis to formulaic approach (e.g. based on economic presence through number of users / customers etc.)**
-  **Substance shall prevail over the Form – Contractual allocation of roles, responsibilities and risk is no longer enough to substantiate functional analysis**
-  **With the introduction of Multilateral Instrument – Amendment to PE rules under DTAA – taxpayers may have to revisit certain models – Ensuing implications on the “Functional Analysis” with the change in business structures**



**Experience Sharing / Queries ?**

**Thank You !**

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