



# Functions, Assets and Risk Analysis under Transfer Pricing

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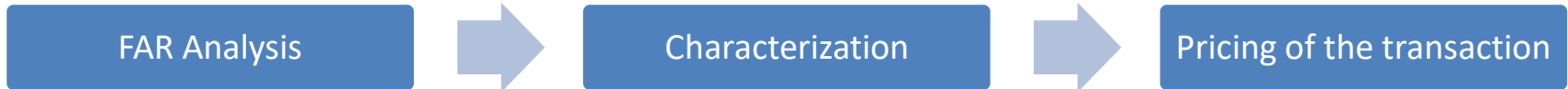
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# What is Functions, Assets and Risk ('FAR') analysis

# What is FAR Analysis

- FAR Analysis is an exercise to determine and document significant economic activities performed by the enterprise and its associated enterprise ('AEs') in an International Transaction
- Allocation of significant economic activities between those entities involved in the transaction, so each entity can be appropriately characterised
- **Price charged** in any transaction should reflect the functions performed (taking into account the risks assumed and assets used)



# Components of FAR...

## Functions performed

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



# ...Components of FAR...

## Assets employed

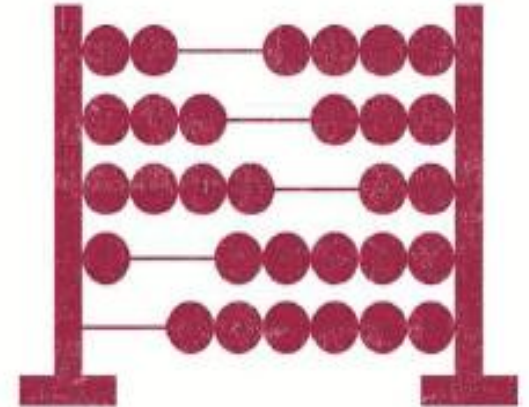
- **Type** of assets and their **nature** needs to be understood
- Helps in determination of their **contribution** to the business process / economic activity
- Facilitates understanding of respective **roles** played by the entities participating in the International transaction
- Knowledge of assets owned and employed by the entities facilitates determination of the returns to be earned by them



# ...Components of FAR

## Risks Assumed

- Probable **variability** of future outcomes or returns
- As the risk increases, the vulnerability to earn profit **increases** as well
- 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 conduct of the transaction



# Why do a FAR analysis



# Why do a FAR analysis – Regulations Perspective

1. **Rule 10B(2)** of the Income Tax Rules, 1962 asserts on **Importance of FAR Analysis:**

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

- i. Functions performed, taking into account assets employed and risks assumed, by both the parties to the transactions
- ii. 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

2. Para 1.36 (Chapter 1) 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”*

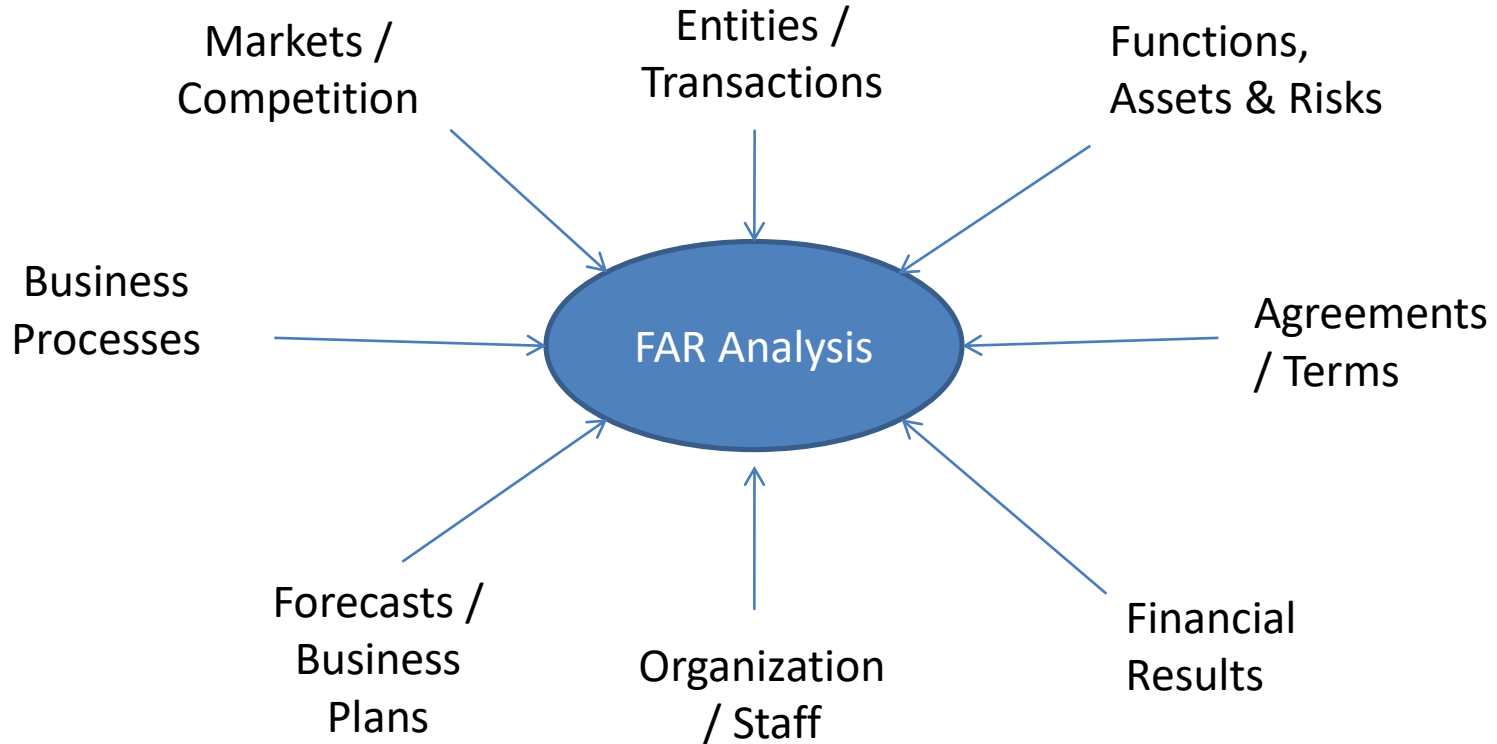
# Importance of FAR Analysis...

- To **identify an appropriate reward** that each of the related parties should earn with respect to intercompany transactions under review
- To **determine the economic characterization** of the entities in the transaction and to **select a tested party**
- To **determine the most appropriate method** for benchmarking the transaction
- To **identify any uncontrolled transaction** involving one of the controlled parties

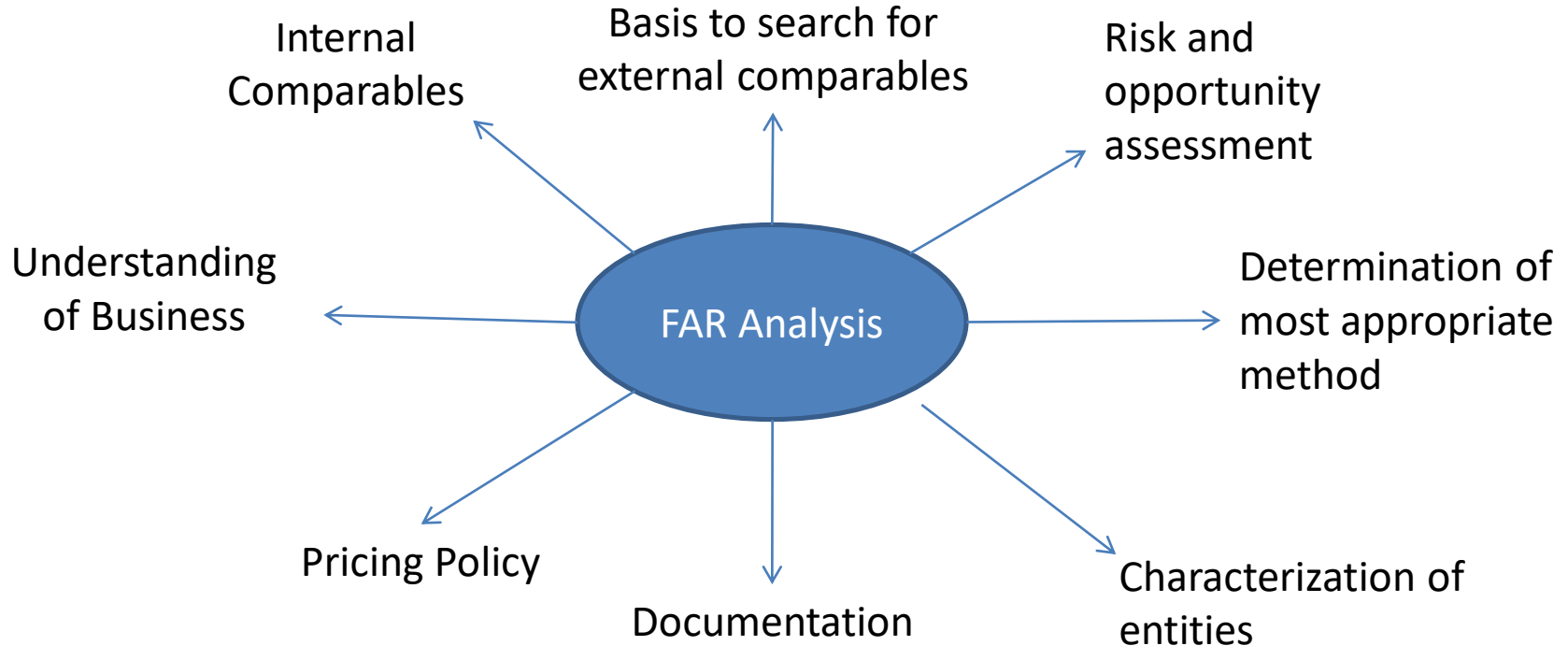
Detailed FAR analysis provides **in-depth understanding** of the business and assists in appropriate characterization of an entity

# How to do a FAR analysis

# Inputs of FAR Analysis



# Outputs of FAR Analysis



# Process of undertaking FAR analysis

## FAR planning process

- Identify relevant and transacting entities
- Industry and group background
- Review available internal/external documents

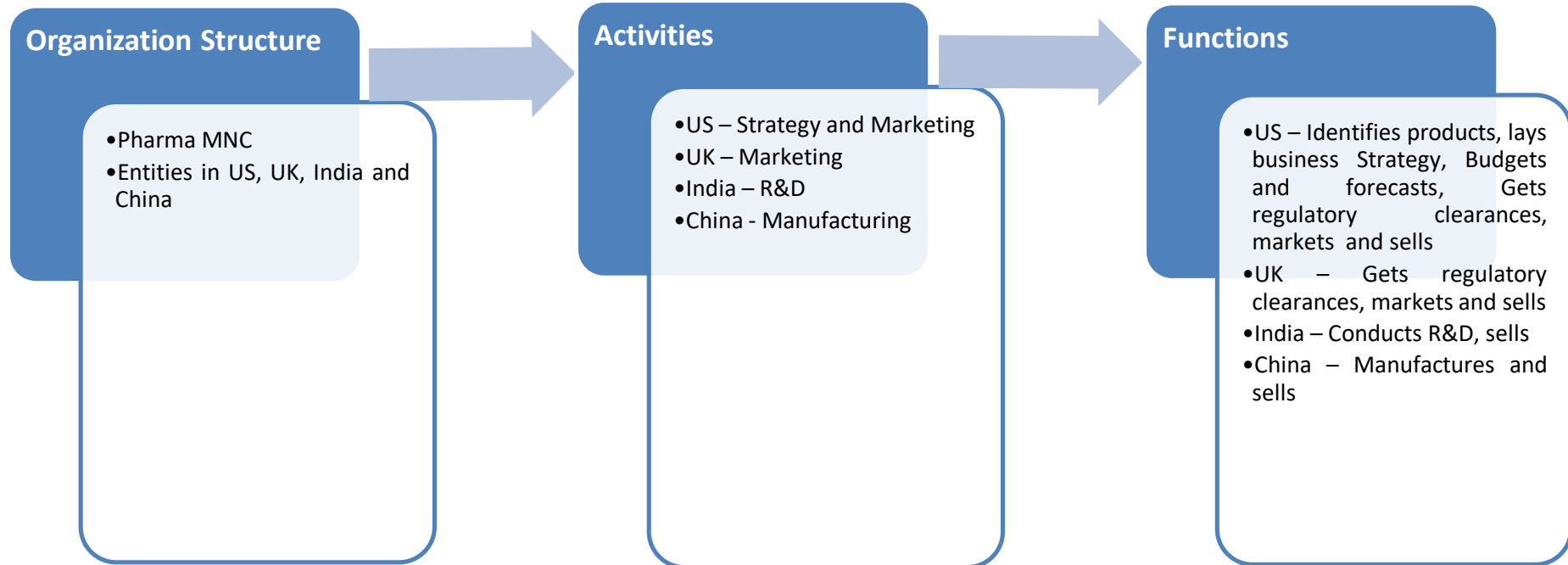
## FAR Interviews

- Prepare Questionnaires & identify interview contacts
- Create detailed FAR questionnaire
- Conduct Interviews and make notes

## FAR Documentation

- Summarizing FAR findings in the documentation report

# Functional analysis – Process Flow



# Fact Finding process...

## Gathering basic information

- Background information about the enterprise to understand its business operations and activities – (*Sources: Annual Report, Product brochures, Websites, internal reports*)
- Description of the ownership structure of the enterprise
- Profile of multinational group of which the enterprise is a part
- Broad description of the business of the enterprise
- Broad description of the industry to which the enterprise belongs

## Gathering specific information

- Functions generally performed by each party to the transaction.
- Assets generally employed in a transaction
- Risks generally assumed by each party to the transaction
- Contractual terms that have effect on transfer prices are also to be examined (*Sources: Written contracts, agreement, correspondence / communication between the parties*)

## Gathering relevant documents

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



# FAR Questionnaire – Typical Distributor

**Below are certain important questions for FAR analysis of a Distributor**

- Who is responsible for market surveys? Who monitors market demand?
- Who is responsible for devising advertising and promotion strategies? Who formulates the budget? Who bears the costs?
- Who is responsible for scheduling the distribution of the products in the market? Who is responsible for holding the inventories on hand?
- Who determines the product pricing? Do these require approval from the manufacturer/ principal distributor?
- Is there an existing distribution network or the distributor is engaged in developing of a distribution network for the product?
- Who owns the intangibles in the products distributed? Who undertakes the DEMPE functions in relation to the brand
- Is there a need for installation and after-sales services? Who is responsible for providing these services?
- Who formulates warranty policies? Who bears the warranty costs?
- Who bears the risk on account of bad debts
- Who would bear the risk in case the product does not perform as per standards?
- Who takes title of the merchandise distributed?

# Key Factors in FAR Analysis

# Key Factors in FAR analysis

- Sheer volume of functions performed is **not decisive** - What is relevant is the **relative importance of each function**
- Functions performed may be few but significant
- Identify **each party's contribution (Taxpayer & AE)** to every function performed
- Functions are the *terra firma* for identifying and assigning risks to an entity
- Aggregation of International Transactions - **only if FAR analysis of such transactions is aligned**

# OECD Guidelines – Importance of FAR analysis

# OECD Guidelines – Importance of FAR

## **Section D of Chapter I of the OECD Guidelines, 2017 states:**

- Accurately delineate the actual transactions by analyzing the contractual relations together with evidence of the actual conduct of the parties
- Detailed guidance on analyzing risks as integral part of a functional analysis, including six step analytical framework
- Party assuming risk should control the risk and have the financial capacity to assume the risk
- Capital-rich MNE group member without any other relevant economic activities (“cash boxes”) that provides funding, but cannot control financial risks in relation to the funding, will attain no more than a risk-free return, or less if the transaction is commercially irrational

Shift focus from the legal form to the economic reality of a transaction

# Six-step analytical framework

1. Identification of economically significant risks
2. Determination of contractual assumption of the specific risk
3. Functional analysis in relation to risk
4. Interpreting steps 1-3
5. Allocation of risk
6. Pricing the transactions taking into account the allocation of risks

If AE (contractually) assuming the risk does not exercise control over the risk or does not have the financial capacity to assume the risk, **then risk should be allocated to enterprise exercising control and having financial capacity to assume risk**

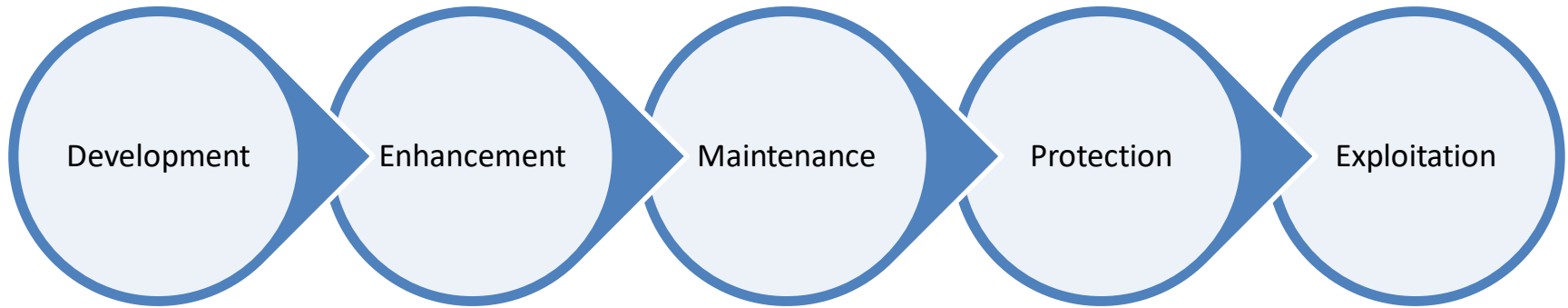
# FAR Analysis of Intangibles

# FAR Analysis of Intangibles

1. Identify the intangibles used or transferred in the transaction
2. Identify the full contractual arrangements, with special emphasis on determining legal ownership of intangibles
3. Detailed functional analysis (DEMPE functions, assets and risks)
4. Confirm consistency between the terms of the contractual arrangements and the conduct of the parties (focus on DEMPE functions and risks, etc.)
5. Determine arm's length prices for contributions
  - Allocation of returns from the exploitation of intangibles should especially be based on which parties perform the DEMPE functions, assume the risks and provide funds or other assets
  - Legal ownership becomes less important



# DEMPE Functions are the key



# Case Studies

# Typical FAR of Manufacturers

FAR	Types of Manufacturer			
<i>Functions and Assets</i>	<i>Full Fledge</i>	<i>Licensed</i>	<i>Contract</i>	<i>Toll</i>
Owns non-routine technology i.e. IP (R & D)	Yes	No	No	No
Owns Material	Yes	Yes	Yes	No
Manufactures for himself	Yes	Yes		
Manufactures on behalf of others			Yes	Yes
Marketing	Yes	Yes	No	No
Sales & Distribution	Yes	Yes	No	No
<i>Risk</i>	<i>Normal</i>	<i>Less than Normal</i>	<i>Limited</i>	<i>Minimal</i>
Market Risk	Yes	Yes	N(Minimal)	N(Minimal)
Price Risk	Yes	Yes	No	No
Inventory Risk	Yes	Yes	Yes	No
Capacity Risk	Yes	Yes	Limited	No
Product Liability Risk	Yes	Yes	No	No
Warranty Risk	Yes	Yes	Limited to re-work	Limited to re-work
Technology R & D Risk	Yes	No	No	No

# Typical FAR of Distributors

FAR	Types of Distributor		
<i>Functions and Assets</i>	<i>Marketer Distributor</i>	<i>Normal Distributor</i>	<i>Limited Risk Distributor</i>
Marketing	Yes (Extensive)	Yes (within industry standards)	Minimal
After Sales Services	Yes	Yes	Yes
Inventory Management	Yes	Yes	Minimal
Furniture / Fixtures / Communication facilities	Yes	Yes	Yes
Warehousing facilities	Yes	Yes	Yes
Marketing Intangibles	Yes	No	No
Customer List	Yes	Yes	No
<i>Risk</i>	<i>Normal</i>	<i>Less than normal</i>	<i>Limited</i>
Market Risk	Yes	Yes	Minimal
Price Risk	Yes	Yes	No
Inventory Risk	Yes	Yes	Minimal
Product Liability Risk	Yes	No	No
Credit Risk	Yes	Yes	No
Warranty Risk	Yes	Yes	No

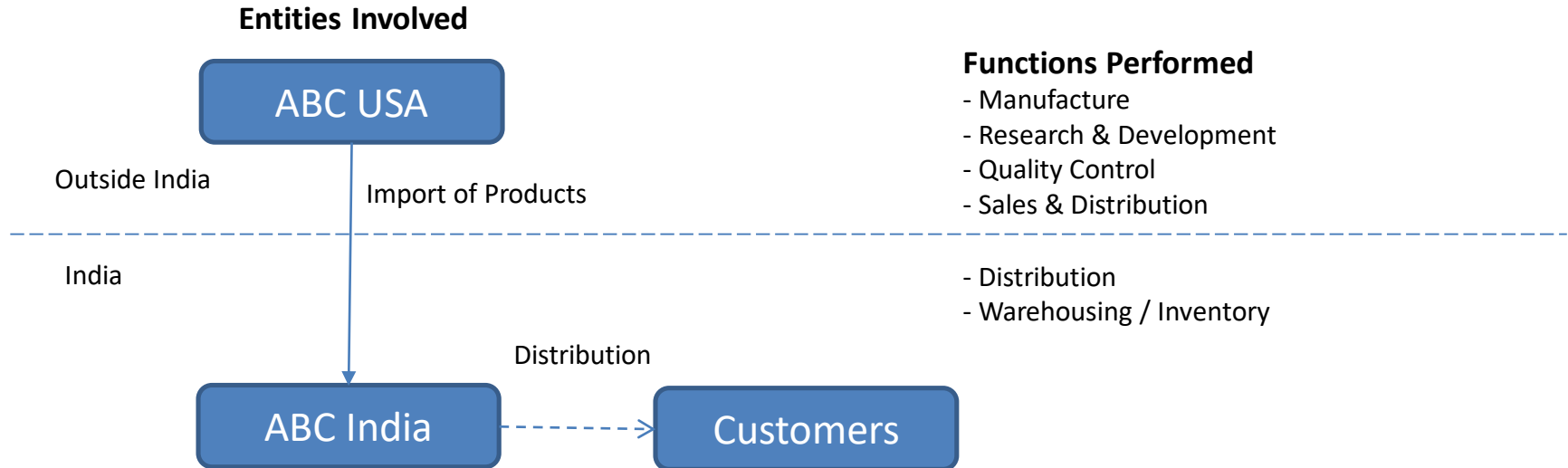
# Typical FAR of Service Providers

FAR	Types of Service Providers		
<i>Functions and Assets</i>	<i>Entrepreneur / Normal risk service provider</i>	<i>Low risk service providers</i>	<i>Limited risk / Captive service providers</i>
R & D	Yes	No	No
Significant People functions	Yes	No	No
Quality	Yes – assume overall responsibility	Limited to the extent of services performed	Limited to the extent of services performed
Marketing	Yes	Yes	No
<i>Risk</i>	<i>Normal</i>	<i>Less than normal</i>	<i>Limited</i>
Man Power recruitment / attrition	Yes	Yes	Yes
Service liability	Yes	To the extent of service performed	No
Capacity utilization risk	Yes	No	No
Regulatory	Yes	Yes	Yes
Foreign Exchange	Yes	Yes	No
Credit Risk	Yes	No	No – Advances

# Case Study 1

## Facts

- ABC USA develops, manufactures and markets cancer related products
- ABC India is engaged in the business of import and resale of these products in India



# Case Study 1

Types of Assets	ABC India	ABC USA
Employees	Yes	Yes
Property, Plant & Equipment	Yes	Yes
Intangibles such as trade licenses, know-how, etc.	No	Yes
Types of Risk	ABC India	ABC USA
Product Development Risk	No	Yes
Market Risk	Yes (limited)	Yes
Manpower Risk	Yes	Yes
Credit & Collection Risk	Yes	Yes
General Business Risk	Yes (limited)	Yes
Foreign Exchange Risk	Yes	No

# Case Study 1

## Economic Characterization – Based on the FAR analysis

- ABC USA should be characterized as the 'Entrepreneur'; and
- ABC India as 'Limited Risk distributor'



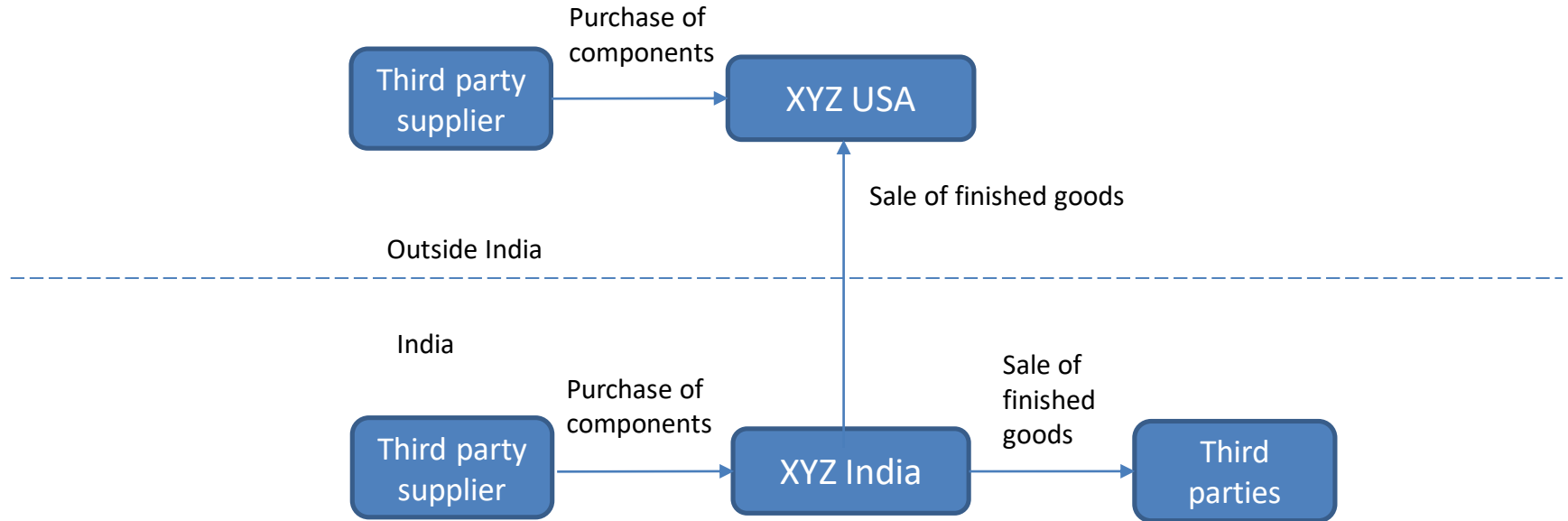
## Case Study 2

XYZ India and XYZ USA performs the following functions:

XYZ India	XYZ USA
Procurement & Warehousing	R & D
Manufacturing	Manufacturing
Design and Engineering	Marketing & Promotion
Quality Assurance	Procurement & Sales
Export of Finished Goods	Invoicing & Collection

## Case Study 2

### Scenario 1: When XYZ India sells components to AE as well as third parties



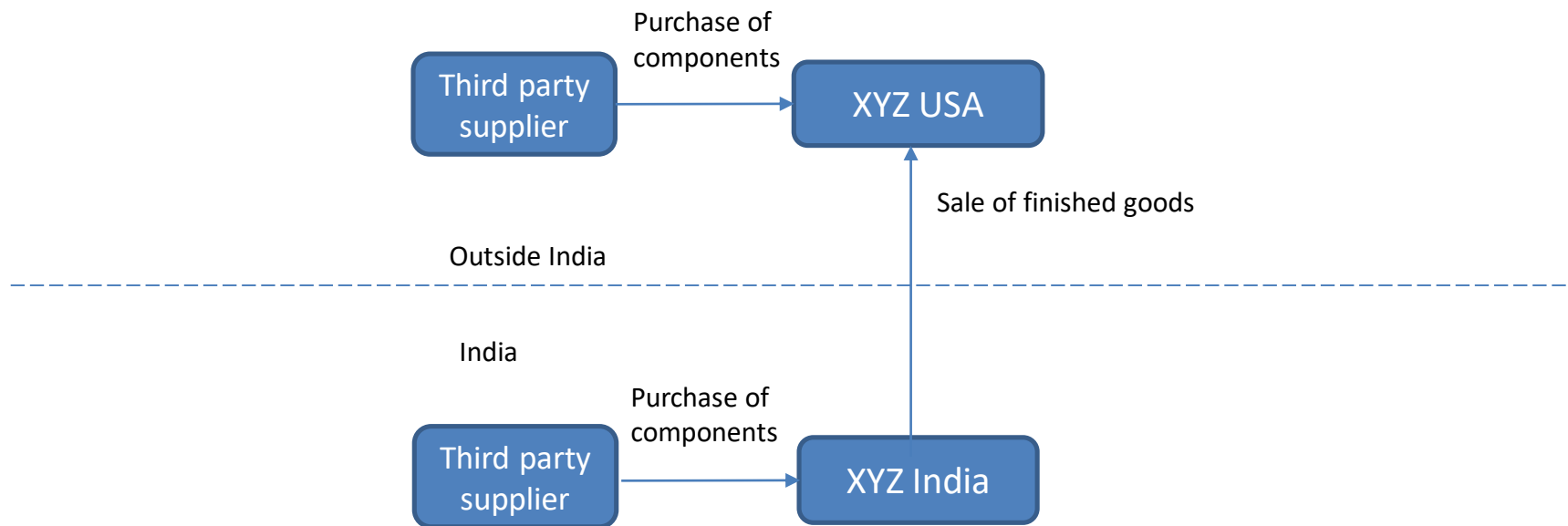
## Case Study 2

### Economic Characterization

- XYZ India: Normal Risk Manufacturer
- XYZ USA: Normal Risk Manufacturer

## Case Study 2

### Scenario 2: When XYZ India sells components to only to its AE



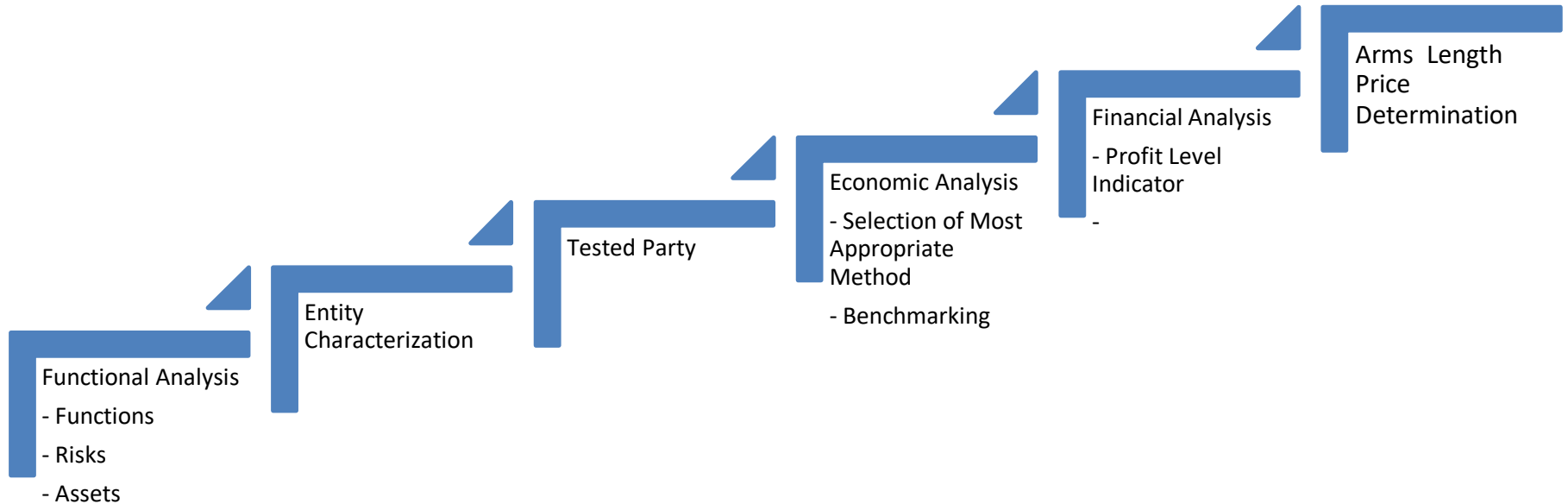
## Case Study 2

### Economic Characterization

- XYZ India: Right to right to sell to AE only - Characterized as a contract manufacturer
- XYZ USA: Entrepreneur

# Economic Analysis

# Economic analysis – Process Flow



# Key Takeaways



## Key Takeaways

- Robust FAR analysis is the foundation of a sound Transfer Pricing Analysis
- Comparability strictly based on FAR- intangibles, risks play important role
- Adjustments to comparables necessary to account for differences in FAR

**Thank You**

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