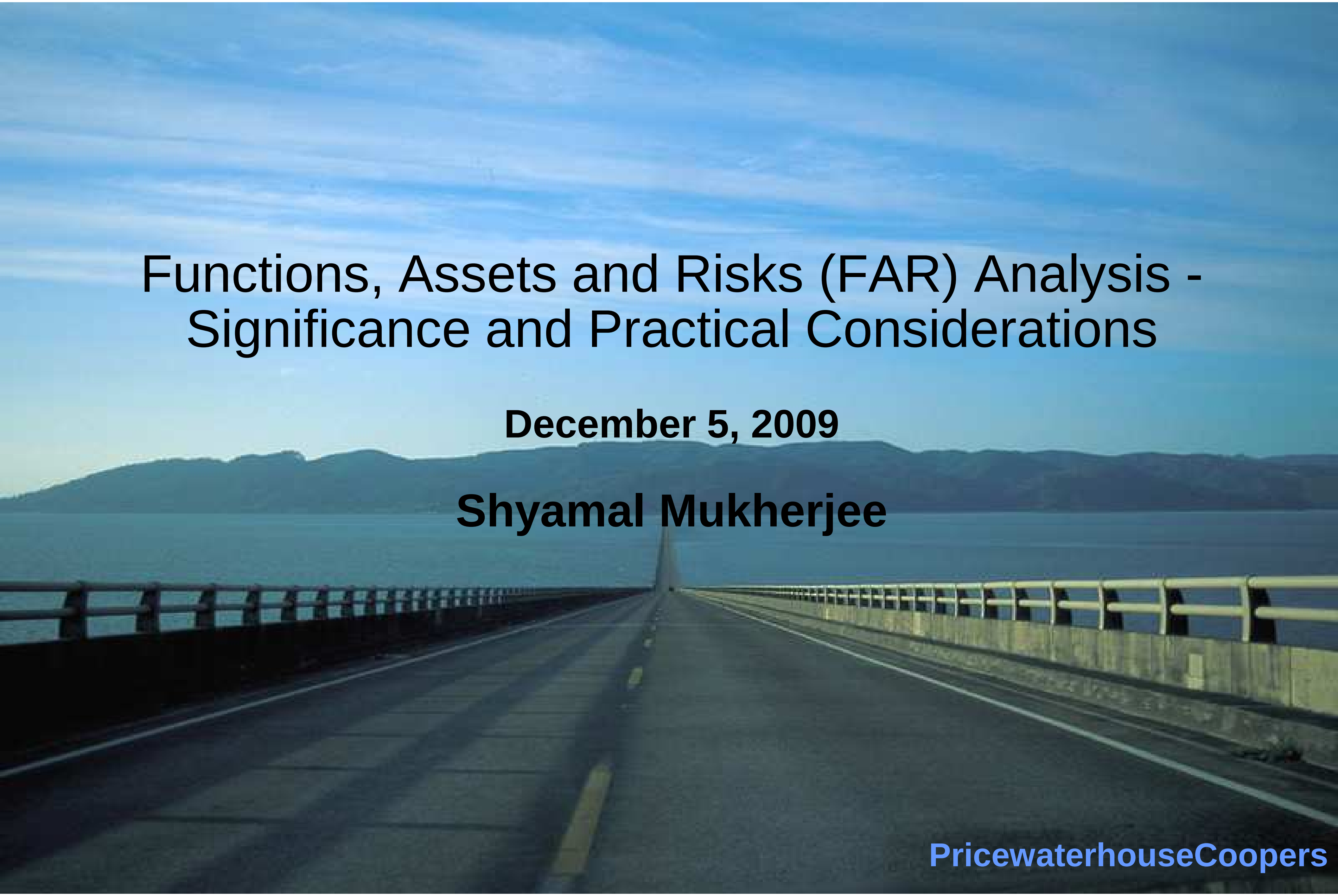
Functions, Assets and Risks (FAR) Analysis - Significance and Practical Considerations



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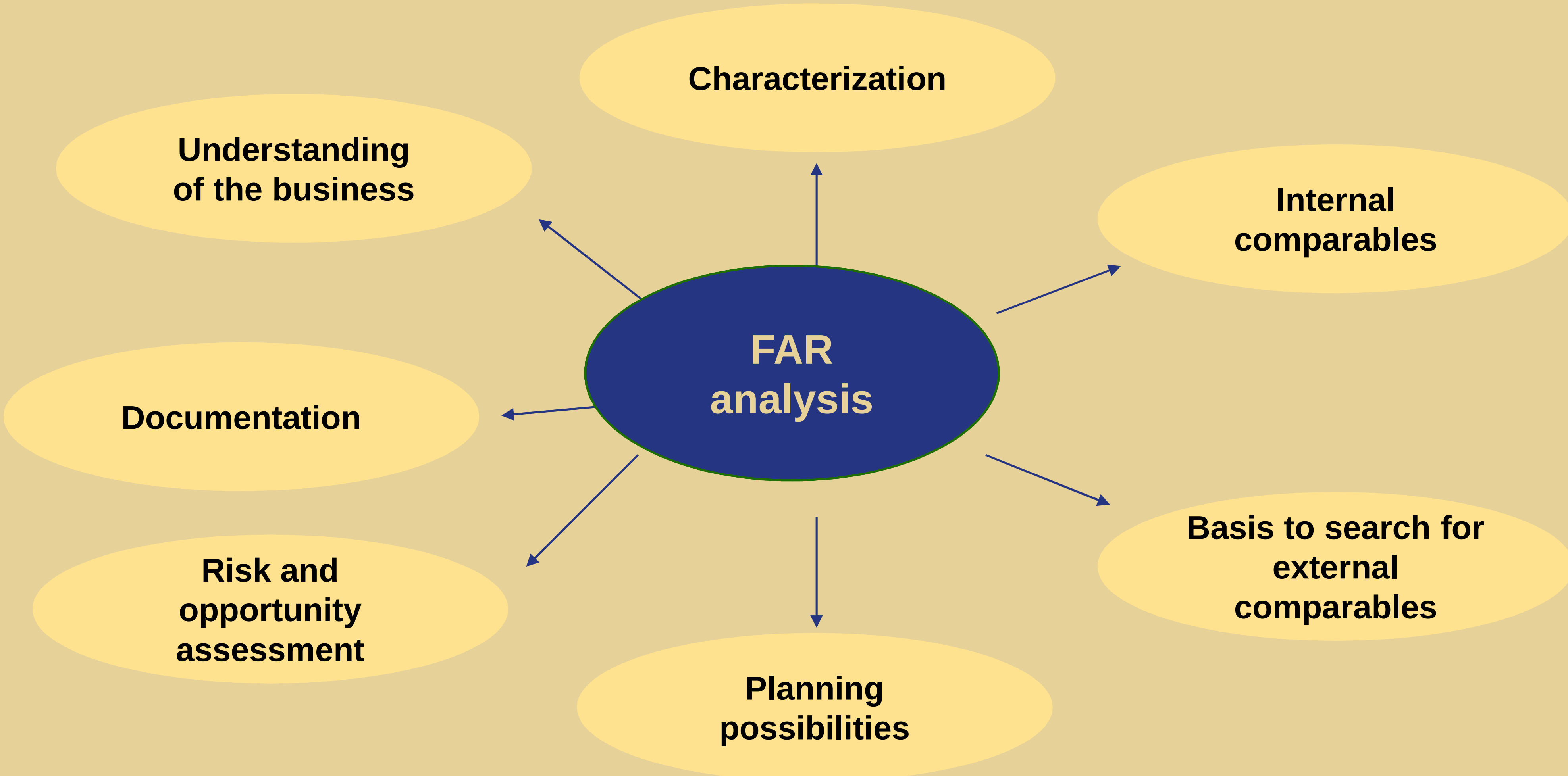
Agenda

- Importance of a FAR analysis
- Practical considerations in specific cases
  - High Value Services
  - Marketing Intangibles
  - Business Restructuring
  - Management Service fee
  - Permanent Establishment
  - Risk Adjustment
- Conclusion

Importance of FAR analysis

What goes into a FAR analysis?

What comes out of a FAR analysis?



Importance of a FAR analysis

Low function / Low risk		High function / High risk
Contract IT/ITE Services	→	Full fledged service provider
Contract Manufacturer	→	Manufacturer/ Developer
Sales Agent	→	Marketing/ Distribution

Low function
Low risk

High function
High risk

- Comprehensive FAR leads to in-depth understanding of the business and related commercial considerations
- Allows correct characterization of the business
- Helps setting up of an appropriate pricing model for inter company transactions
- Robust FAR analysis- foundation of a sound economic analysis

Practical considerations in specific cases

High Value Services

<u>Evaluate Key People Functions- Responsibilities and decision making Activities</u>

- Nature of service- Conceptualization/Discovery/Invention vs. Executionary services
- Profile and seniority of personnel – viz. skill-set, educational background, experience
- Special/ unique capabilities of employees
- Compensation of personnel – fixed or success based?
- Authority for GO – No GO decisions
- Research strategy, scheduling, prioritizing, budget decisions
- Capex funding and acquisition decisions
- Fitment of India set up in group's overall R&D programme
- Group's role in set-up & extent of technology transferred/ technical assistance provided/skill set development, etc.

Risks follow people/functions

Marketing Intangibles

- Significance of local marketing in taxpayer's industry - specific characteristics and competition
- Evaluate contribution of each entity in the development of marketing intangibles:
  - do efforts/ costs lead to increase in value of IP owned by overseas group company ; or
  - merely enhance value of its own rights/ benefits - sole distributor/ seller
- Key decision making activities – development of marketing strategy, authority to take decisions, evaluate/ approve budgets, compensation model of personnel
- Business/ commercial expediency of the marketing efforts and costs in relation to the benefits/ returns
- Is the business substance properly captured in the contracts?
  - Legal vs. economic ownership
  - Economic substance in case IP development is bundled / embedded with other transactions
- Robust upfront documentation covering FAR analysis and economic/ commercial realities– utmost necessity

Business Restructuring

- Restructuring involving transfer of functions:
  - transfer of a process/ function
  - Who undertakes the key decision making activities in the business value chain?
- Restructuring involving transfer of assets:
  - transfer of intangibles viz. contracts, know-how, methodologies, customer lists, transfer/ giving up of skilled workforce(?)
  - is there transfer of unprotected or protected IP? - deemed disposition of intangibles
  - is there loss/ migration of future profit potential? - transfer/ termination/ novation of contracts
- Documentation/ articulation of business rationale for restructuring at the group level – not adequate
- Involvement of operational teams to document local rationale for change
- Inter-company agreements for the restructured business model
- TP documentation – to cover detailed FAR analysis to address transition aspects

Permanent Establishments (PE)

- Attribution of profits to a PE based on TP principles - a settled position (Morgan Stanley)
- Detailed FAR analysis – more critical in case of PE in view of its nebulous nature
- If the Remuneration of an associate enterprise (that also creates a PE) takes into account FAR of the PE, no further profits attributable to the PE
- FAR assumes more significance – involves analysis/ splitting of FAR between the legal entity and the PE
- PE– distinct and separate enterprise (OECD approach)
- Inter-company agreement
- Mitigation strategy– robust TP documentation determining profits attributable to PE

Management Fees

- Demonstrate services received do not qualify as:
  - Shareholder activities
  - Duplicative activities
  - Services resulting in incidental benefits from passive association with a group
- Maintain documentary evidence of the receipt of services e.g.- mail, reports, correspondence, memos, manuals, usage records, screen shots demonstrating access to proprietary/ third party tools, etc.
- Evaluate the job profile and strength of in house resources- to substantiate there is no duplication/ of activities/ functions
- Maintain detail description of commercial and economic value derived from receipt of such services
- Demonstrate why it is willing to pay for such services?
- Undertake industry analysis to highlight importance of such services in the industry and the competitive dynamics involved
- Maintain legal agreements

Substantiate actual receipt of services and qualify the benefit test

Risk Adjustment

- Identify the risk assumed by each entity in a transaction- market, inventory, manpower, capacity, technology, price, credit, forex fluctuations, service/ product liability, performance, legal, etc risks
- Necessary to carry out and document a detailed comparability analysis - compare risks of the assessee vis-à-vis comparables in order to identify risks which have an impact on the profitability
- Carry out a comprehensive economic analysis for quantification of risk and document the same
- Robust upfront documentation covering FAR analysis and economic analysis – utmost necessity

Conclusion

- Critical to have robust annual TP documentation with indepth FAR analysis and sound economic analysis (including adjustments)
- Comparability strictly based on FAR- intangibles, risks play important role
- Adjustments to comparables necessary to account for differences in FAR
- Carefully analyze service operations in India – identify High Value/ IP generating services
- Evaluate marketing activities and business restructuring in detail
- PE attribution – focus on FAR analysis and attribution of profits using TP principles by way of upfront analysis
- Upfront documentation of a comprehensive FAR analysis followed by a sound economic/ comparability analysis - key to mitigation of risks, passes the onus on Revenue authorities

Robust FAR analysis is the foundation of a sound Transfer Pricing Analysis

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