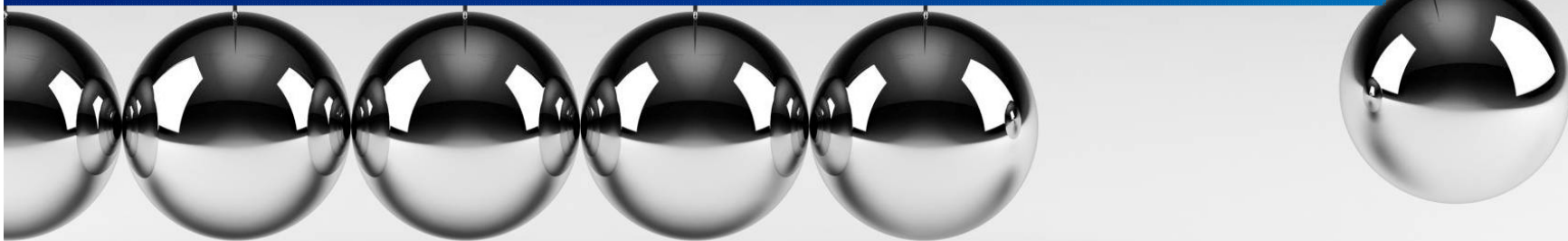


FAR Analysis

Workshop on Transfer Pricing (Organised by WIRC)

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Background – What is Transfer Pricing?

- When two unrelated companies trade with each other, the price at which they undertake their transactions is simply known as the ‘price’
- But when supply of goods, services or finance is made to another related company, the negotiated price is called the ‘transfer price’
- Implicit Assumption: Due to the special relationship between related companies, the transfer price may be different than the price that would have been agreed between the unrelated companies
- And such price charged between unrelated parties in uncontrolled conditions is referred to as the “arm’s length” price (ALP)

Background – What is an ALP?

- As laid out in the Act transactions between two associated enterprises need to be computed having regard to the ALP
- ALP has been defined under the Act as a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions

The process of determination of ALP involves various stages such as analysis of functions, assets and risks (or FAR analysis), determination of most appropriate method, tested party, profit level indicator and carrying out a detailed comparability analysis

Determination of an ALP

Law prescribes extensive contemporaneous documentation to be maintained covering:

Ownership structure and group profile

Prescribed details of AEs, with whom there have been transactions, and ownership linkages

Business description of tax payer and AE with whom the taxpayer transacts

Broad industry overview

Functions performed, risks assumed and assets utilised by the taxpayer and the AE

Methods considered for determination of ALP

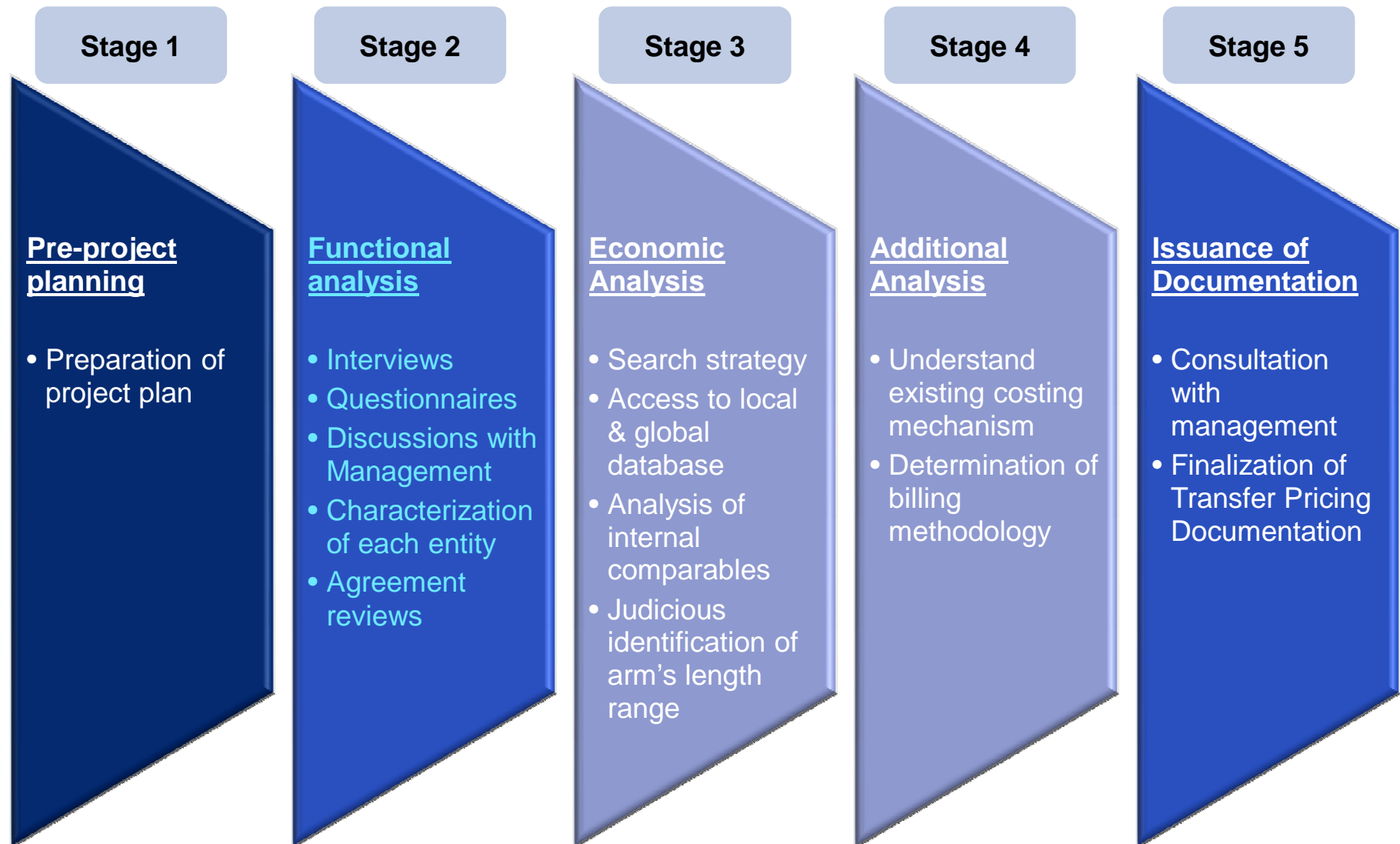
Comparability analysis

Detailed computation of ALP, data used and record of economic adjustments

Determination of an ALP – Importance of FAR analysis

Sr . No	Details
1.	Analysis of Functions, Assets and Risk
2.	Determination of tested party
3.	Determination of most appropriate method
4.	Determination of Profit Level Indicator (based on the method selected)
5.	Search for the comparable data and comparability analysis
6.	Determination of arm's length price

Transfer Pricing Process – Position of FAR analysis



FAR Analysis - Backdrop

- Mapping of economically relevant facts and characteristics of inter-company transactions with regard to their Functions, Assets and Risks
- Involves careful analysis of functions performed by each of the transacting entity, assets employed and risks assumed by them
- An essential element of any transfer pricing study
- Analysis allows a full understanding of the economic value-added activity carried out by each entity and their characterisation
- This understanding then allows one to judge
 - Comparability
 - Economic rationale of the transaction with related par

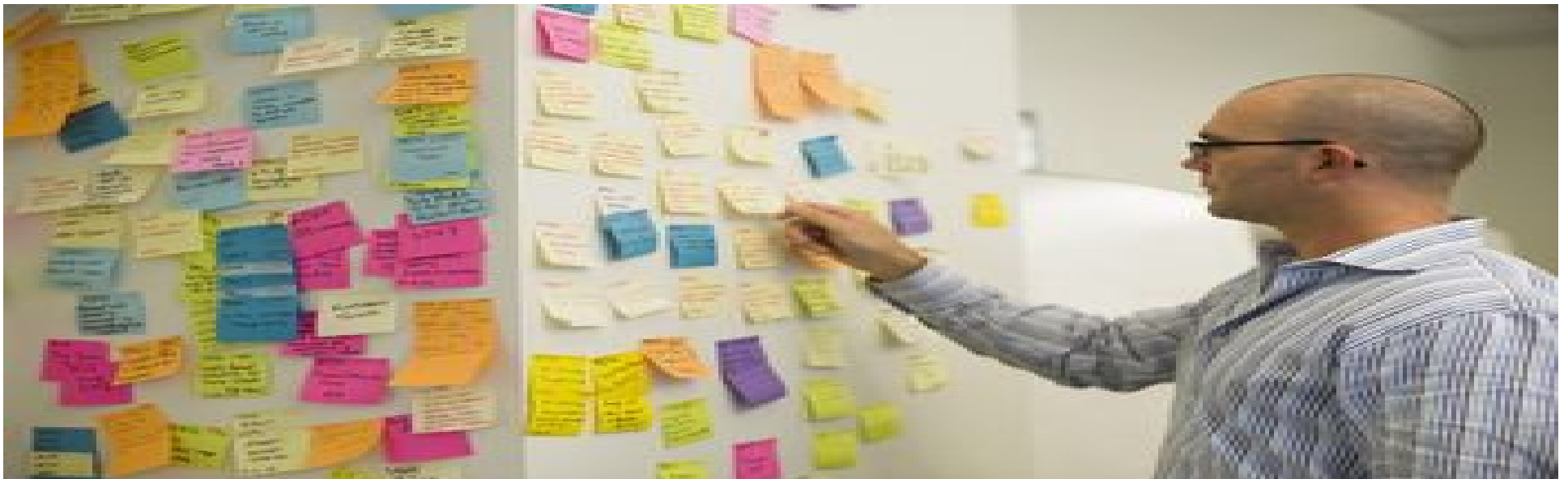
Purpose of FAR

- Gathering and organizing facts needed to analyze intercompany prices
- To identify an appropriate level of profit that related parties should earn with respect to intercompany transactions under review
- To identify effects of functions, risks and assets on its profitability
- 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 accurate characterisation of an entity

Functions Performed

- Analysis of activities carried out by each of the parties to the transaction
- Focus should be on identification of critical functions which add value to the transaction
- Assists in comparing principal functions performed by the entities in a controlled transaction with the functions performed in uncontrolled transactions



Broad Categories of Business Functions

- Manufacturing
- Research and Development
- Marketing
- Sales and Distribution
- Administration
- Execution of services

Example (Manufacturing)

- Purchasing materials, supplies and equipment
- Developing and administering budgets
- Production of finished goods
- Packaging and labelling of products
- Quality control
- Shipping of products to customer



Assets Employed

- Analysis of the 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 profit margin to be earned by them

Broad Categories of Assets

➤ Tangible Assets

Production Equipment & Machinery

Buildings

Office equipment

Vehicles

➤ Intangible Assets

Patents

Unpatented technical know-how

Formulae, trade marks and brand names

Licences & Copyrights

Technical data

Customer lists

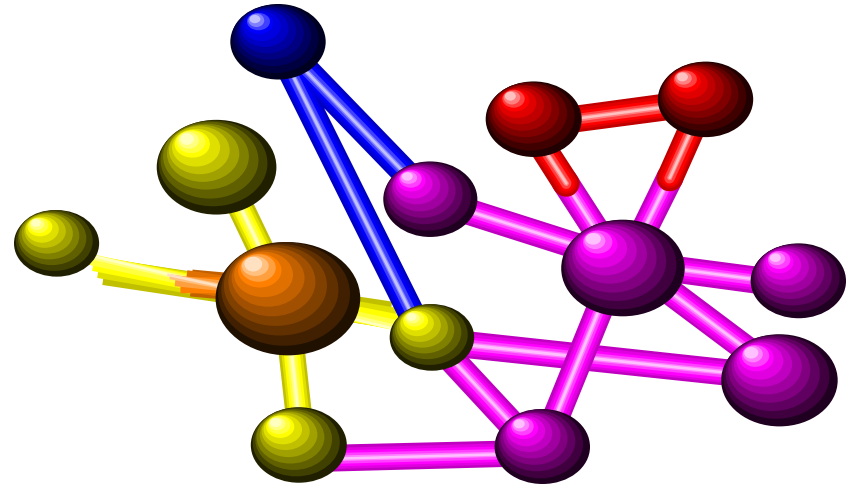


Risks Assumed

- Analysis of risks undertaken by each transacting entity
- As the risk increases, the expected return should increase as well
- The potential risks are company and industry specific
- Only important risks should be described and quantified
- Important to distinguish between which entity bears risks as per legal terms and which one bears as per the economic substance of the transaction

Broad Categories of Risks Assumed

- Credit Risk
- Market Risk
- Product / service liability risk
- Technology risk
- Foreign Exchange Risk
- Employee Turnover related Risk





Case Study

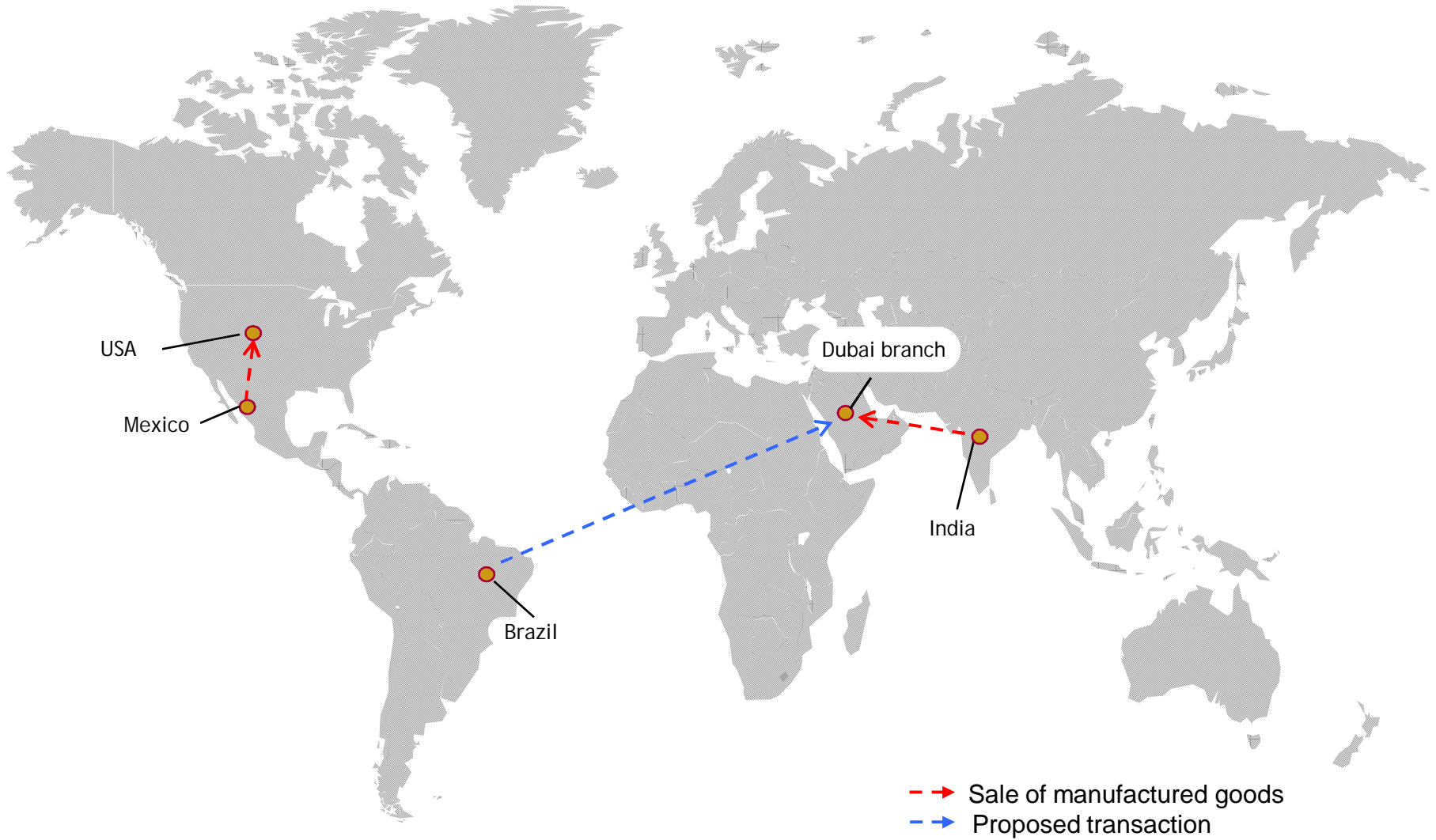
Case Study – Global TP Planning Analysis

- An MNE Group proposes intra-group transactions in the nature of:
 - Supply of manufactured goods
 - Trade of goods
 - Use of corporate brand name / trademark

These transactions are described in the following slides

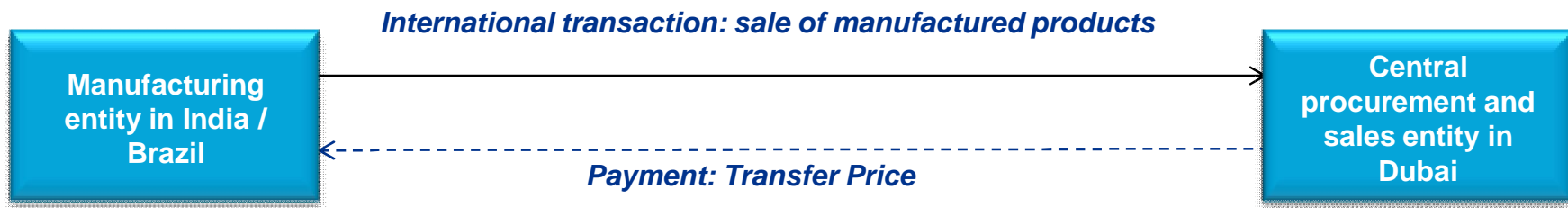


Supply of Manufactured Goods



Supply of Manufactured Goods

flow of international transaction

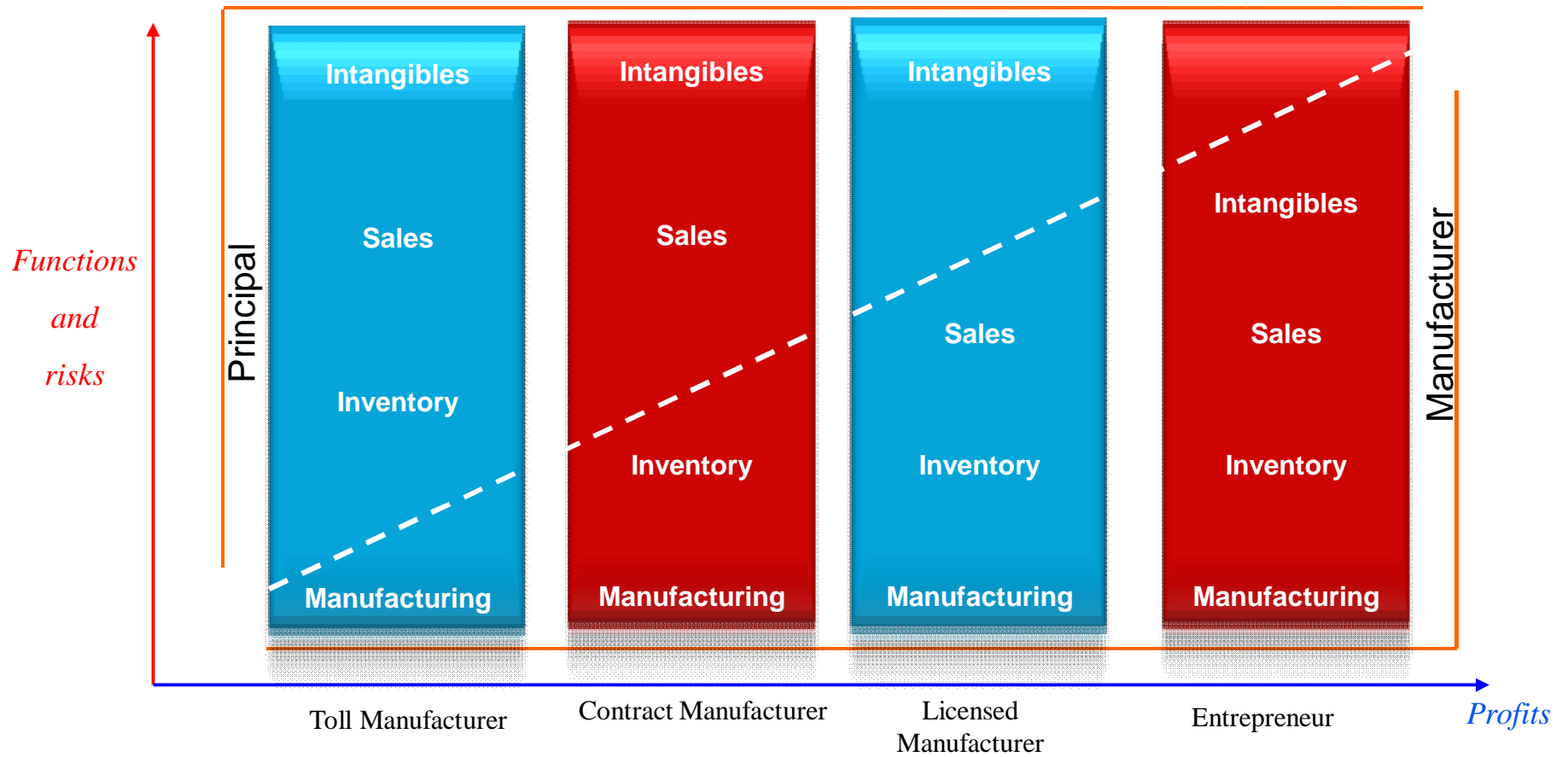


- Entities in India and Brazil to manufacture razor blades / other products and supply the same to central procurement and sales entity located in Dubai
- In this case the Transfer Pricing analysis would involve:
 - Functions Assets and Risks ('FAR') analysis of international transaction involving sale of manufactured products from an end-to-end perspective
 - Determination of transfer price having regard to the FAR analysis and availability of comparable data

Determining an appropriate transfer price for the manufacturing function is crucial from an Indian Transfer Pricing perspective

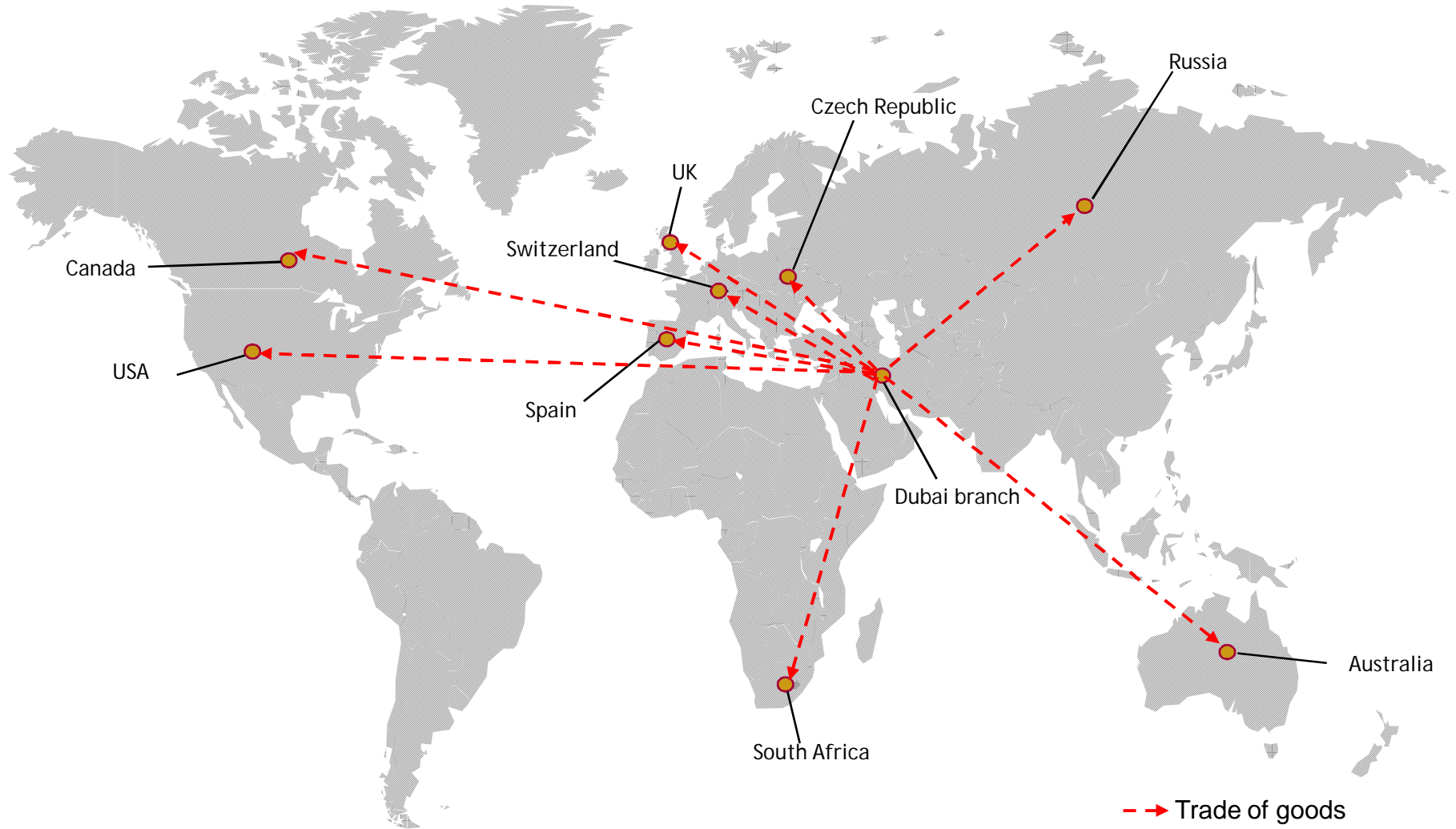
Manufacturing FAR – How it Assists in Characterisation

Possible variations for entity characterization



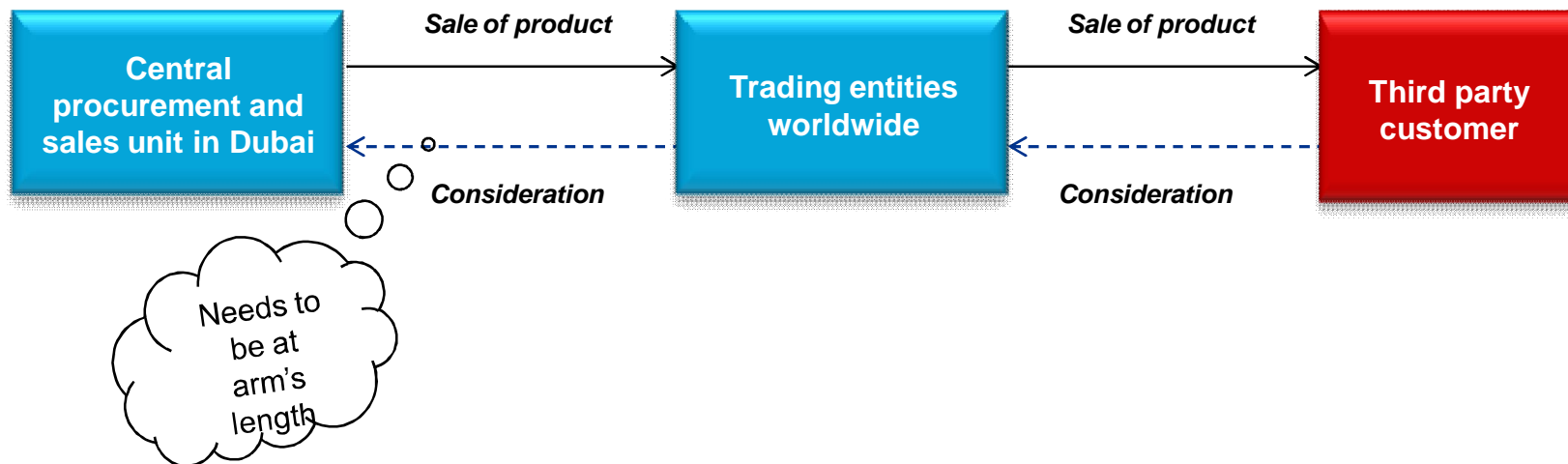
FAR Analysis is useful in characterising a manufacturing entity

Trade of Goods



Trade of Goods

flow of international transaction



- The Central Sales Unit in Dubai to sell products (procured from India and Brazil) to the trading units worldwide
- These trading units would in turn sell the products to third party customers in their respective jurisdictions

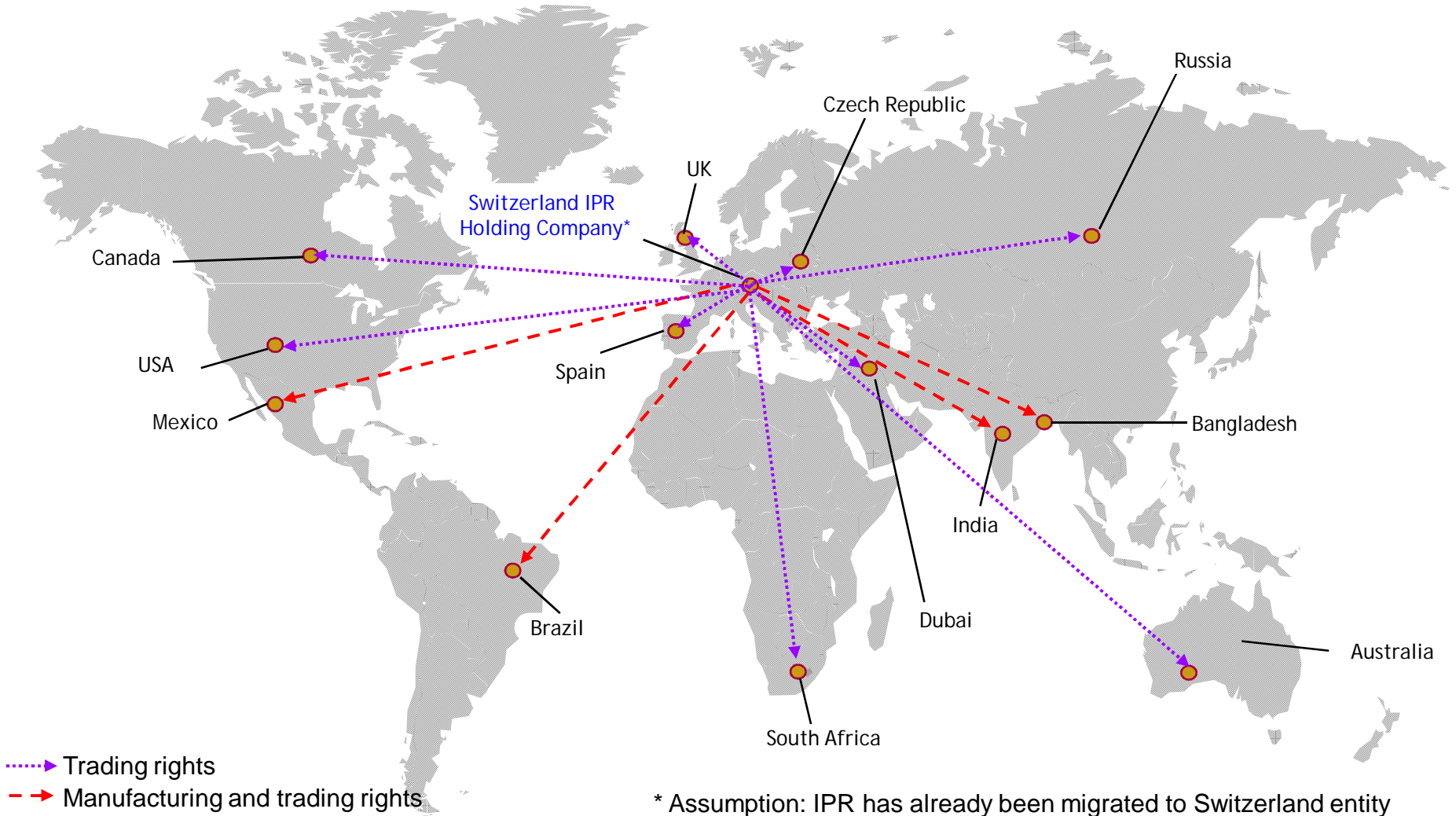
Determining an appropriate transfer price for purchase of goods by trading entities from the Dubai entity is crucial. Again, FAR analysis is the key to characterise trading entities

Distributor FAR and Characterisation

Possible variations for entity characterization

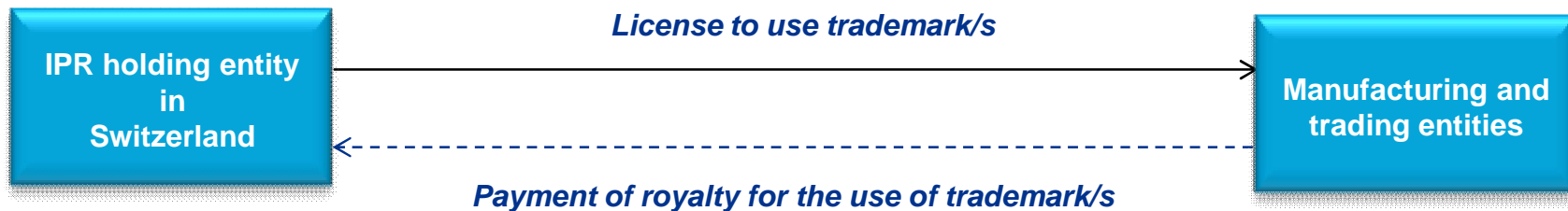
Full Fledged Distributor	Low Risk Distributor	Sales Support Services	Commission Agent
<ul style="list-style-type: none"> • Takes titles to the goods • Buys and sells goods in its own name and undertakes all risks including risks of product obsolescence, bad debts, etc. • Earns a profit or loss from trading activities, based on its ability to sell its products to others and to tap unexplored markets 	<ul style="list-style-type: none"> • Takes title to the goods • Sells in his own name • No approval of Principal required for sale/ price • Compensated by resale price • Low level of risks • Assured returns 	<ul style="list-style-type: none"> • Does not take title to goods • Merely facilitates sale by the foreign Principal • Principal's approval required for sale/ price • Compensated by way of operating cost plus fixed mark-up arrangement • Insignificant level of risks 	<ul style="list-style-type: none"> • Does not take title to goods • Sells in name of Principal • Principal's approval required for sale/ price • Compensated by way of commission • Insignificant level of risks • Principal legally bound

Use of Corporate Brand Name / Trademark



Use of Corporate Brand Name / Trademark

The flow of international transaction



- IPR Holdings AG, Switzerland is the owner of the Trademarks
- Switzerland to allow manufacturing and/or trading units to use trademarks in their respective jurisdictions
- In return all manufacturing and trading units would pay a royalty to Swiss entity

Payment of royalty should be at arm's length

FAR - Conclusion

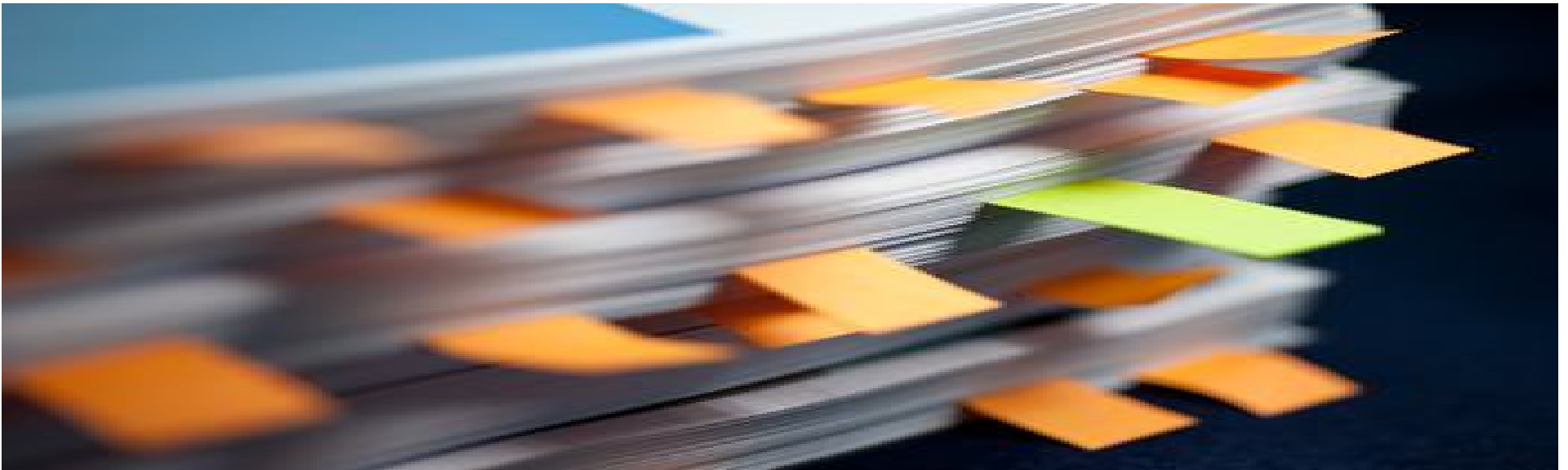
Manufacturing function	Trading function	Use of IPR
<ul style="list-style-type: none"> ▪ Determination of the type of manufacturer ▪ Application of Methodology – CUP / Cost plus / TNMM? ▪ Application of TNMM method – Dealing with losses ▪ Economic adjustments 	<ul style="list-style-type: none"> ▪ Type of distributor ▪ Most appropriate method - RPM Vs. TNMM ▪ Different margins for low/high value products ▪ Creation of market intangible ▪ Allowance of risk adjustment to facilitate better comparison between commissionaire, low risk distributor and full fledged distributor 	<ul style="list-style-type: none"> ▪ Rate of royalty ▪ Benchmarking



Key Takeaways

Key Takeaways

- Robust FAR analysis is the foundation of a sound Transfer Pricing Analysis
- Choice of the tested party should be consistent with the functional analysis of the controlled transaction



Questions??





Thank You

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Glossary

- AE – Associated Enterprise
- ALP – Arm's length Price
- FAR – Functional, Assets, Risks Analysis
- MNE – Multinational Enterprises
- The Act – The Income-tax act, 1961
- TPR – Transfer Pricing Regulations