

Mastering the Functional Analysis

Transfer Pricing for Do-it-All Tax Managers

Susana Pujalt, Team Lead Senior

Exactera





Exactera

- Leader in tax-software solutions
- Exactera Transfer Pricing
- Exactera Tax Provision
- Exactera R&D Tax Credit Services
- Owner of the RoyaltyStat database
- Couple our software with teams of experts to help tax departments stay in compliance and maximize benefits

Susana Pujalt

Senior Transfer Pricing Lead

- Economist with more than 20 years of experience
- Transfer pricing lead specialist at Exactera's Professional Services Group for over 4 years
- Specialist in transfer pricing international tax planning and compliance
- Creator of strategic TP policy guidelines development and implementation for one of Canada's major international banks
- Former Consultant at PwC



Agenda

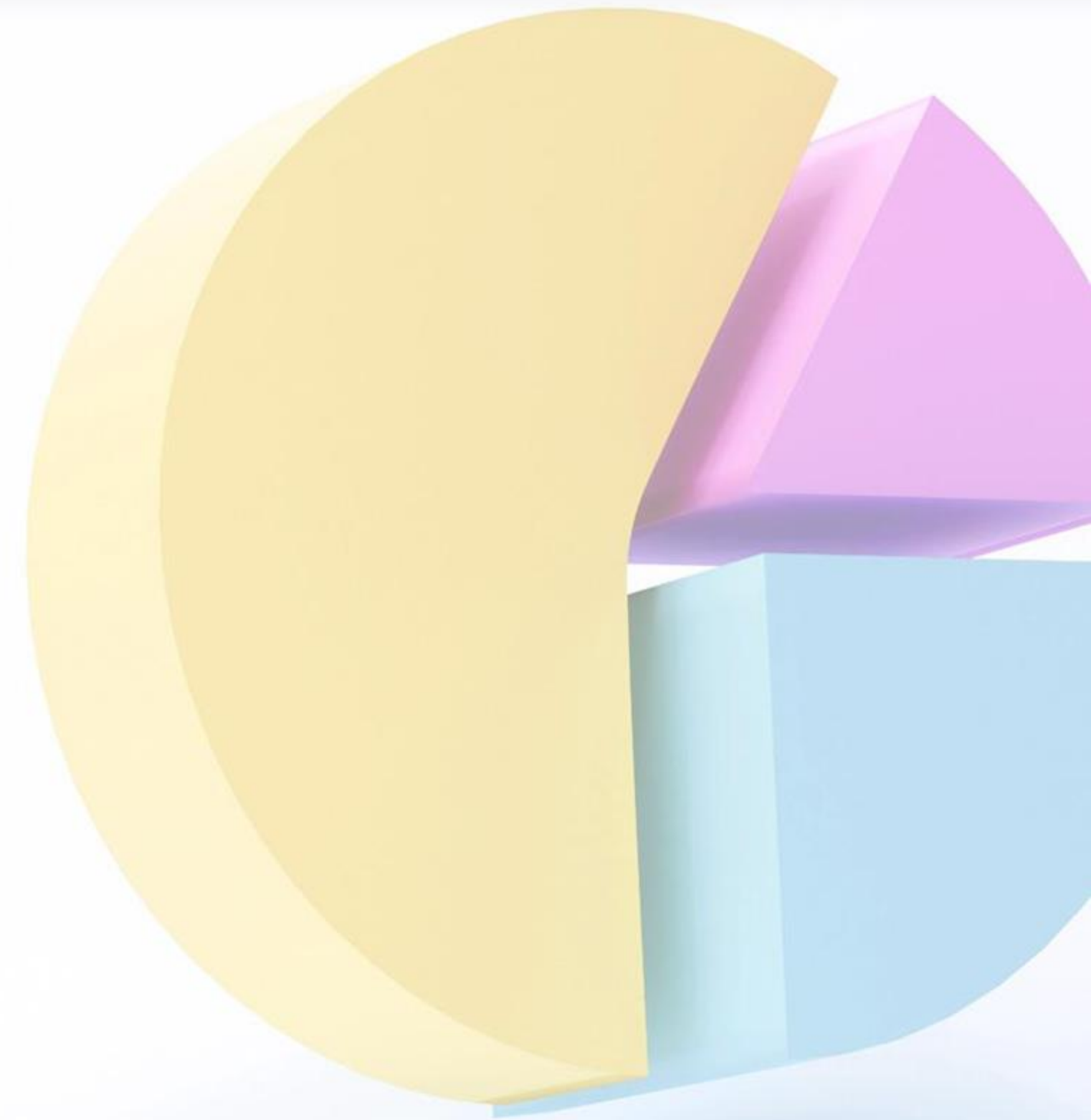
Basic Concepts

- Value Creation
- The Value Chain
- About Functions
- About Assets
- About Risks
- Characterizations
- What the FAR Analysis Reveals About the Value Chain

Poll Question #1

How do you handle transfer pricing documentation?

- A)** We outsource all of it.
- B)** We outsource some of it.
- C)** We take care of transfer pricing compliance in-house.
- D)** We use a software solution to complete documentation.



Tax Background

- Tax system developed in the 1920s
- Business profits are taxed in taxation nexus: physical presence largely based on permanent establishment rules
- OECD Model Tax Convention (2010), Article 9
 - Profits accrued and taxed
- OECD BEPS 1.0 and 2.0 – physical presence not required for digital business
 - Facebook, Google have no storefronts
- Where is taxation nexus for digital business?

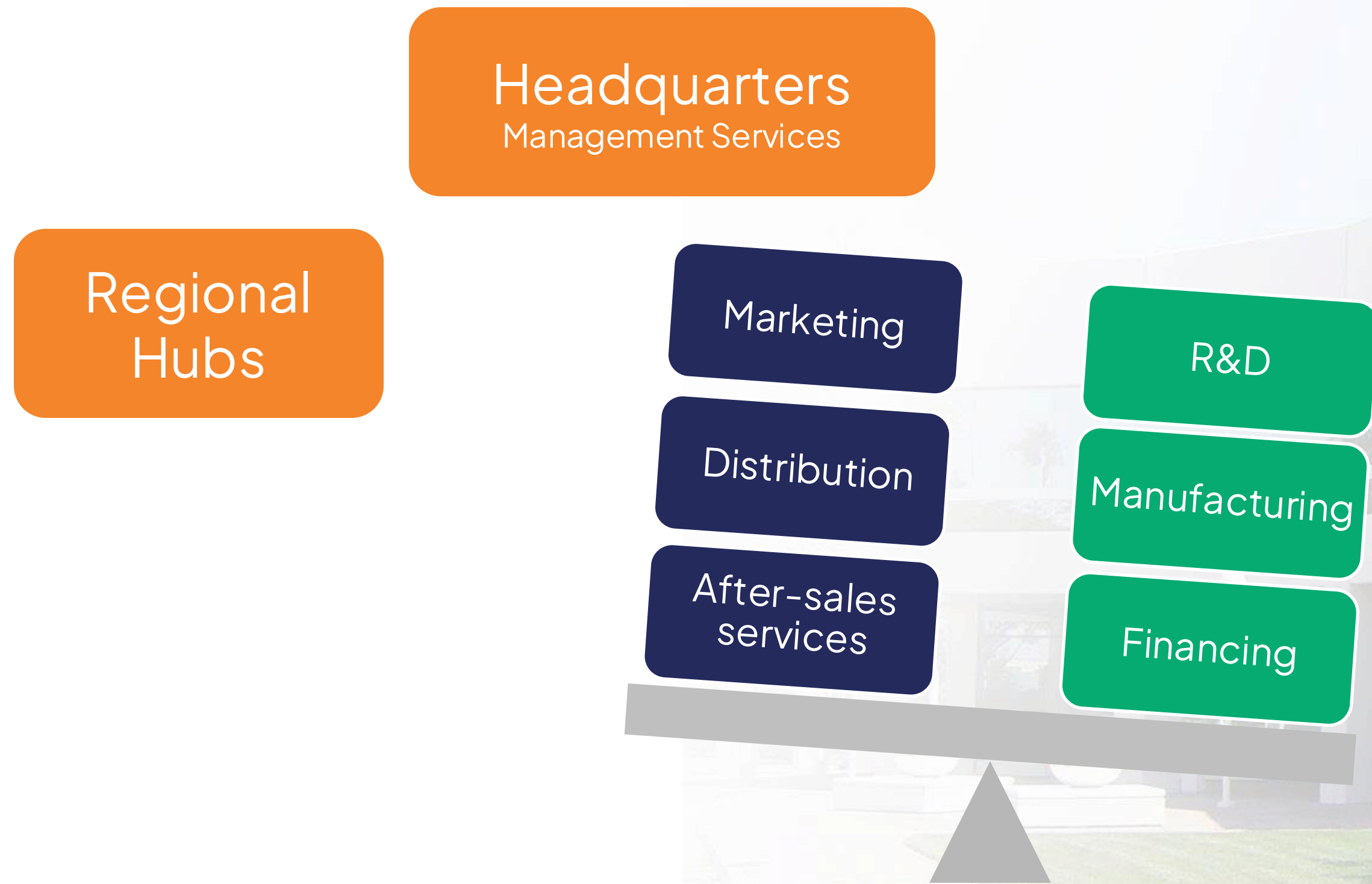


Reasons for Functional Analysis

- Factors determining comparability
 - Functions, assets and risks is one of five factors (see 2022 OECD TP Guidelines, p. 40)
 - Recent Development:
Pillar One – Amount B, OECD, 2024
- Methods – CUP, Resale price, Cost plus, Profit Split, TNMM
 - Product comparability
 - Functional comparability



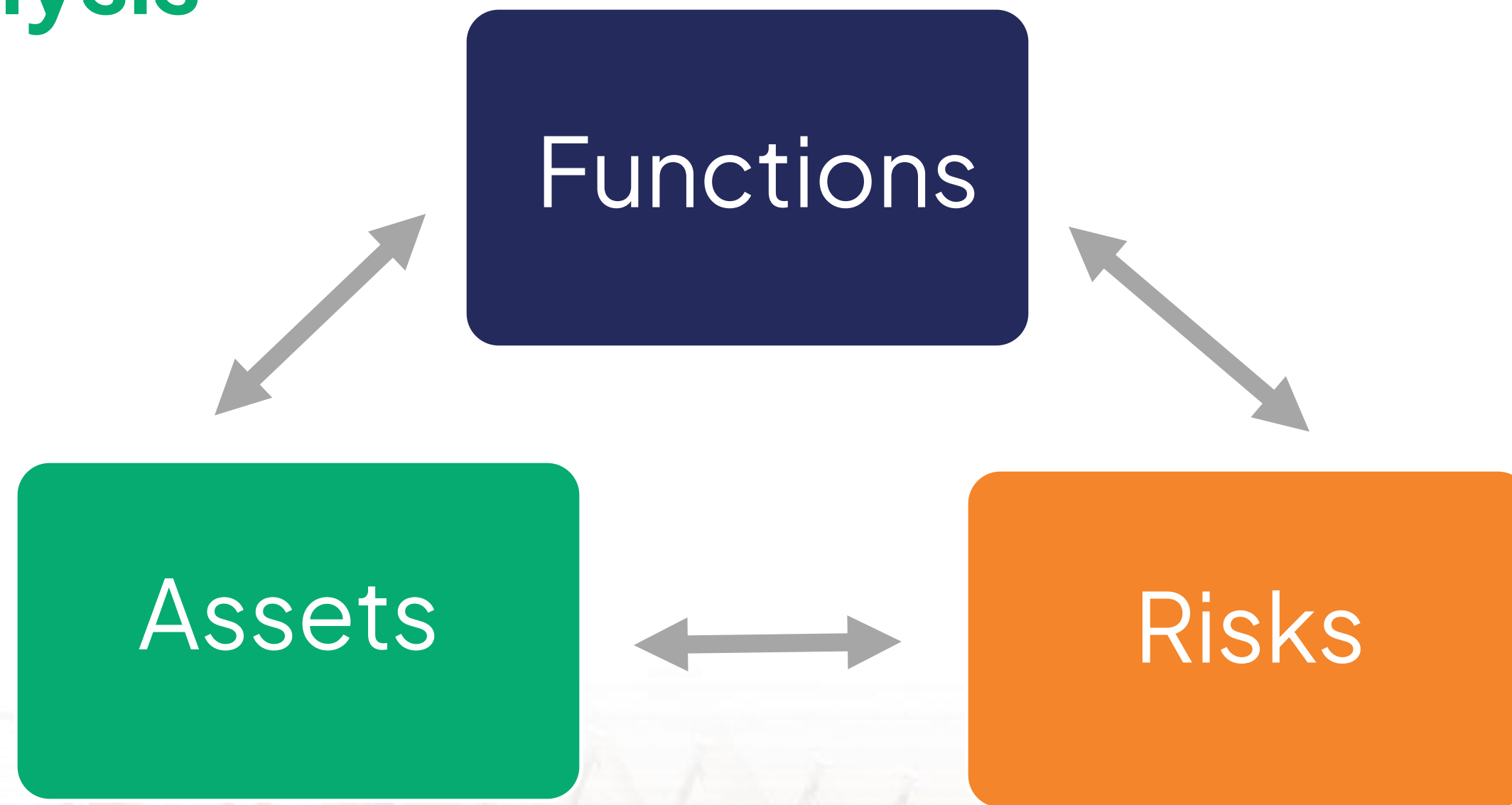
Value Chain



Value Chain Analysis

- Holistic view of the various intercompany transactions from beginning to end
- Examines how and where value is created
- Examines contributions of each entity to the overall business
- Separates a business into a series of value-generating functions
- Functions, assets, and risks should be “economically significant”
- Assigns value to functions, assets, and risks

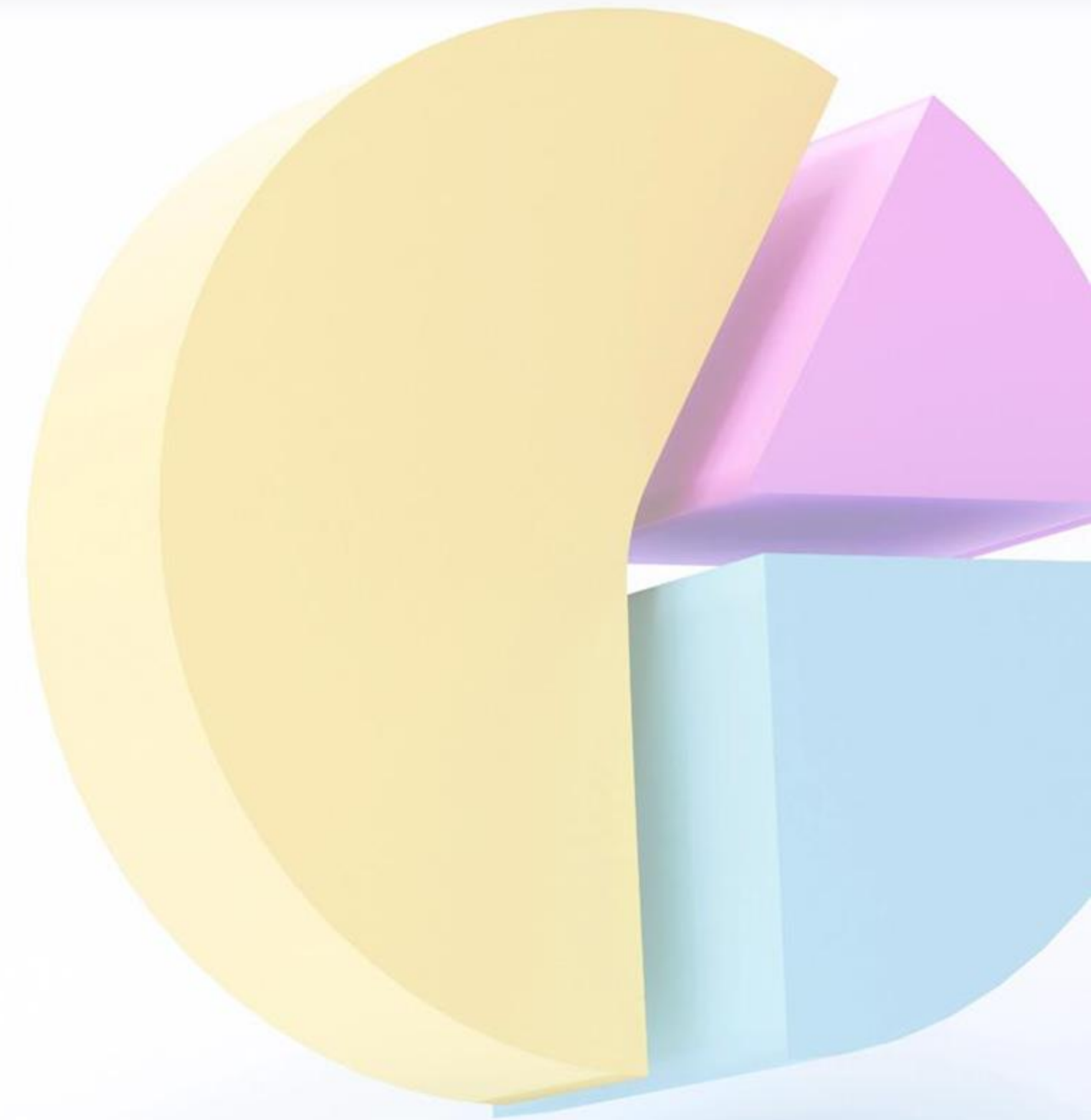
FAR Analysis



Poll Question #2

Do you prepare transfer pricing documentation contemporaneously?

- A)** Yes, for all transactions.
- B)** Yes, but for large transactions only.
- C)** Only for transactions that we are required to submit.
- D)** No, we don't prepare transfer pricing documentation contemporaneously.



Substance Over Form



- Economic reality must coincide with contracts
- Substance of a transaction is more important than its form
- Can't rely on written contracts alone
- Written contracts won't provide all the necessary information in a transaction

FAR Analysis: Collecting Data

Look at Each Party of the Transactions

- Location
- Mix of personnel by departments/roles
- What about the supply chain?
 - R&D and intangibles
 - Raw materials/inputs
 - Manufacturing/production processes
 - Inventory, warehouse, transportation
 - Marketing, sales and intangibles
 - Installation or maintenance services
 - Operational infrastructure
 - Financing





FAR Analysis: Functions

- Research and development
- Manufacturing/Production
- Marketing and sales
- Logistics
- After-sales services
- Corporate services
- Financing

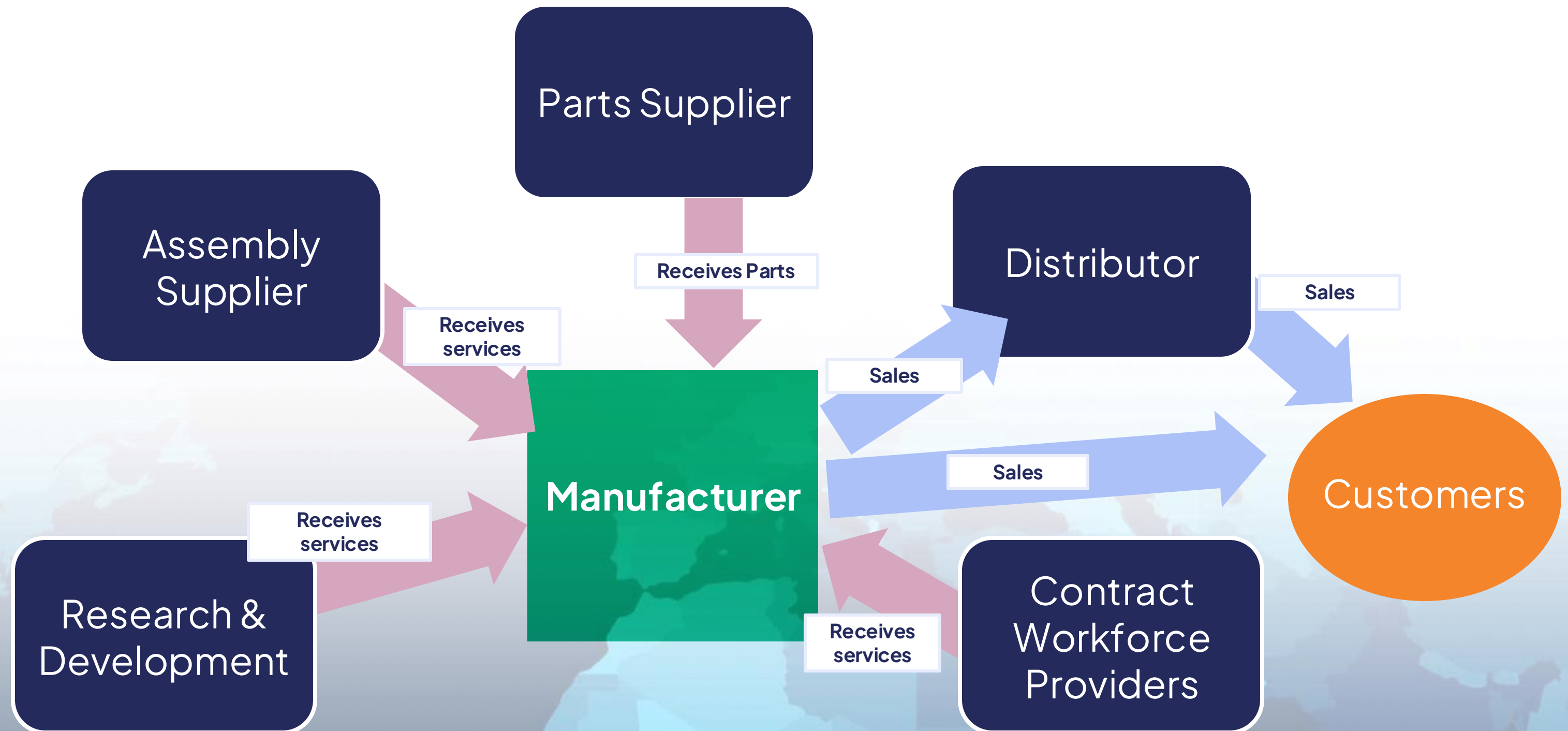


FAR Analysis: Functions – Example

Manufacturing/Production

- Inputs
- Equipment
- Operation
- Quality control
- Logistics
 - Warehousing
 - Labelling
 - Language requirements?
 - Transportation
 - Point of delivery and title transfer?
 - Customs clearance
- After-sales services

Functions: Example – Manufacturing





FAR Analysis: Functions

- Explain how each function is related to value creation for a product/service offering
- Comment on contributions of each party to the transaction
- Where are functions taking place?
- Who is responsible?
- Who is performing?
 - Transactions flow
 - Invoicing flow
- Who assumes the risk?
- Who supports?

Functions: Intangibles

Evaluating the DEMPE Functions



D EVELOPMENT

- Which entity owns developing the intangible?
- Which entity oversees strategic decision-making of the development?
- Not necessarily legal owner.
- R&D regarding the intangible.



E NHANCEMENT

- Which entities enhance/evolve the intangible?
- Who is making sure licenses are up to date?
- Who is making sure brand is still a trusted name?
- Building customer relations?
- Tracking performance issues?



M AINTENANCE

- Which entity improves manufacturing processes?
- Who updates technology?
- Who owns advertising and marketing for the intangible?
- Monitors competition?



P ROTECTION

- Which entity protects the rights to the intangible?
- Who patents manufacturing?
- Registers the brand's trademark?
- Keeps track of licensing agreements?
- Ensures customer privacy protections?



E XPLOITATION

- How is intangible used to generate profits?
- Which companies make money from the IP?
- Who owns the sales platform in which the intangible is sold?

The FAR Analysis: Intangible Tangible Assets

- Trade/manufacturing intangibles
 - Patent (proprietary manufacturing processes, design)
 - Software
 - Know-how
 - Marketing intangibles
 - Brand name, trade name
 - Trademarks, logos
 - Copyrights
 - Customer list
- Is it routine or non-routine? Can it be controlled or transferred?

The FAR Analysis: Tangible Assets

- Manufacturing facility, equipment
- Warehousing facility, equipment, inventory
- Office facility, equipment

- Where is it located?
- Is it owned or leased?

The FAR Analysis: Risks

- Market risk
 - Foreign exchange risk
 - Operational risk
 - Credit risk – Distributor risk?
 - Warranty and liability risks – Manufacturer risk?
 - Intellectual property risk – Can it be presented as part of market risk for manufacturer?
 - Inventory risk – Can it be presented as part of operational risk for distributor?
- Which entity can control risk and has financial capacity to do so?**

Functions, Assets, Risks

FUNCTIONS	Tested Party	Other Entities
R&D		X
Manufacturing		X
Marketing	X	X
Sales and distribution	X	
Logistics		X
Warranty		X
After-sales services	X	
Management		X
Administrative		X

RISKS	Tested Party	Other Entities
Market risk	X	X
Foreign exchange risk	X	
Credit risk	X	X
Warranty risk		X

ASSETS EMPLOYED	Tested Party	Other Entities
Intangible assets		X
Tangible assets	X	X

Characterizations

- Helps identify the functions and the value of those functions
- Each entity's contribution to the business can determine profit allocation
- Helps determine the most appropriate transfer pricing methodology
- Helpful in determining profit level indicator
- Helpful in directing the search for comparables

Characterizations: Sales and Distributors

- Sales Agent
 - Limited-risk Distributor
 - Full-fledged Distributor
 - Wholesale Distributor
- Sales agent versus commission agent/commissionaire?**

Characterizations: Manufacturing Activities

- Full-fledged manufacturer
 - Contract manufacturer
 - Toll manufacturer
- Contract manufacturer versus toll manufacturer?**

Characterizations: Service Provider

- Management
 - Administrative
 - Contract R&D
 - Marketing
 - Sales support
 - Call centre
 - Professional services
- Is it core or non-core? Is it value adding or low value?**
- Software maintenance service versus licensing of products transaction?**



Assigning Value to Functions

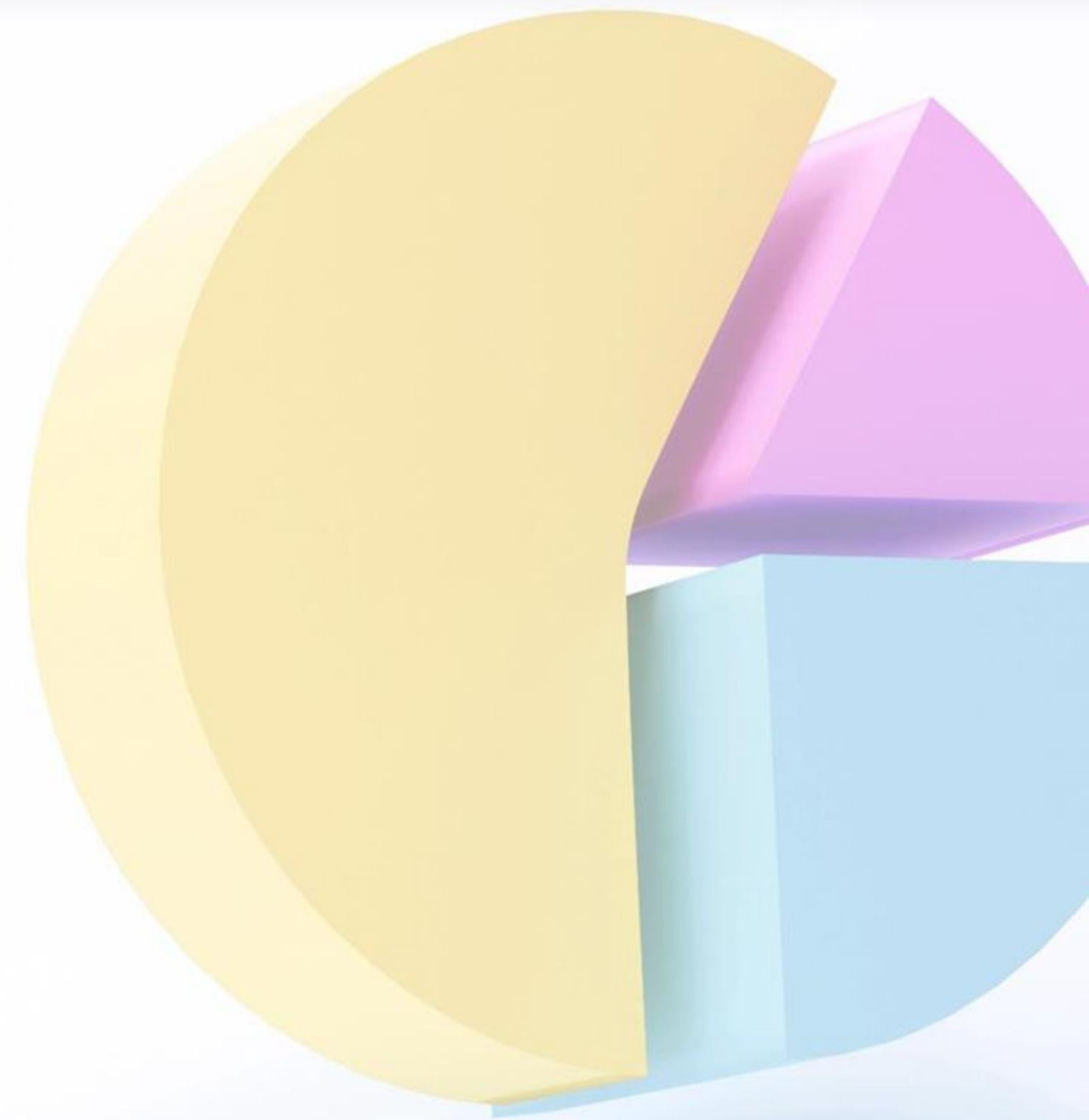
The Benefits:

- Defend transfer pricing positions
- Manage inconsistencies
- Align transfer pricing with detailed value chain analysis
- Consider opportunities for further alignment for business and value creation
- Allows you to understand the business better
 - Profit-drivers
 - Industry
 - Financials
 - Executive function roles

Poll Question #3

How confident are you that the functional analyses you prepare will be able to defend your transfer pricing?

- A)** Very confident
- B)** A little confident
- C)** Not at all confident





Review

- Profits must be aligned with value creation
- Substance over form
- Value chain analysis offers a high level look at whole group
- Functional analysis allows you to see the value drivers between entities in a transfer pricing transaction
- Examine functions, assets, risks
- Recommended by OECD
- Want to see who is contributing the most value?
- Must characterize the transaction to determine comparables and transfer pricing method
- Helps you defend your transfer pricing, understand the business, and ultimately determine stronger arm's length ranges

Thank you!

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