Functional Analysis:

The Foundation of Transfer Pricing Compliance

RoyaltyStat

An Exactera company

Transfer pricing compliance is more important, more complex, and riskier today than it's ever been before. Finding the comparables you need to document that a transaction has been priced at arm's length—in other words, as if it had taken place between unrelated, independent entities in an open market—requires a slew of explorations, calculations, adjustments, and explanations.

The foundation of that work is the *functional analysis*—the complex task of identifying the role of each entity in an intercompany transaction, and level-setting it with those of outside entities and transactions. The functional analysis is the key to transfer pricing compliance—and the backbone of your required documentation. In this article, we illuminate this important area.

The Value of the Functional Analysis

Transfer pricing is about substance—facts and circumstances—not theory or conjecture. Price and cost data don't live in a vacuum. That's why the OECD's transfer pricing guidelines call for MNEs engaged in intercompany transactions to provide the *economic and business context* of a controlled transaction as a starting point for its transfer pricing analysis.

But how exactly do you quantify and define "context"? By conducting a rigorous analysis of the functions performed, assets contributed, and risks taken by both parties (the so-called "FAR analysis"). Essentially, you're performing a dissection of each entity's operations and allocation of risks *within the framework of a specific transaction*—not necessarily of the larger company's main line of business. You can't always compare apples to apples, but armed with this kind of contextual data, you can control for enough variables to make a credible assessment.

A well-conducted functional analysis can not only help you identify comparables and select appropriate methodologies for pricing arm's length transactions, it can also offer key strategic insights into the inner workings of an organization—its culture, profitability, methodologies, and value chain. These kinds of benefits can extend beyond transfer pricing compliance into the realm of business decision-making.

Understanding Functions, Assets, and Risks

For all its complexity, there is a method to the functional analysis—and it starts with the big picture: analyzing the larger company as a whole (aka, the taxpayer). You need to understand the enterprise's operational infrastructure in detail—its people, products, processes, technology, assets, know-how, places of business, as well as who's bearing what kind (and level) of risk. Where its employees are located, and their roles and activities. And of course, you need a handle on the company's go-to market strategy.

Next, drill down and segment the various functions and entities into digestible components—for example, R&D, product development, manufacturing, assembly, distribution, marketing, as well as back-office functions like procurement, accounting, HR, and tax.

All of this will help set the stage for grasping the larger business rationale for the transaction you're about to analyze, and which party to the intercompany transaction you would designate as the "tested party."

Functions: Role-playing

The next step is to characterize the actual *entities* involved in this controlled transaction (as opposed to the parent companies). What role does each function in each entity play in this transaction? How does each contribute to the creation of value within the transaction, and how—in a profit-driven analysis—does it affect the overall profitability of the business?

Drawing on the segmentation work you've already done, you'll create a chart that describes not only the specific activities and responsibilities associated with each function in detail, but also the broader *business context* within which it operates. (Remember that functions are not "translatable" from business to business: one company's R&D department might be an ancillary function, while to a tech company, it could be foundational.) You want to understand and document how each segmented entity supports the larger business model—and how that support is reflected in its go-to-market strategy. And of course, you want to understand how that strategy might vary across countries.

Consider a global pharmaceuticals company. Although their core business centers around drug development, manufacturing, and sales, the transaction in question might be an IT services deal with a foreign subsidiary. In this case, the functional analysis should zero in exclusively on the IT services rendered, excluding any factors related to drug development. So, you'd need to isolate IT as a distinctly segmented intercompany transaction for both entities—and get deep enough into the weeds to understand the rationale behind the allocation of responsibilities and tasks within that arrangement.

Assets: Who Owns What?

Now it's time to analyze the next element in your FAR analysis: who has (or controls) the assets involved in the transaction? Who brings what to the table?

A major wrinkle here is that assets can be tangible—fixed assets, like plant, property and equipment (PPE), computers, offices, etc.—or intangible, like intellectual property such as patents and trademarks. Tangible assets are often easier to work with: they're listed right there on the company's balance sheet, which can simplify the task of analyzing the relative value of the relationship between the components.

Intangibles are another ball of wax—they're worth whatever value entities ascribe to them. So how do you control for them in a transaction such as a licensing deal? You'd most likely turn to the DEMPE framework (Development, Enhancement, Maintenance, Protection, and Exploitation), a complex but useful system to help evaluate the value of intangibles for transfer pricing. As with functions and tangible assets, you want to isolate the circumstances of the transaction on as granular a basis as possible. Due to the special nature of intangibles (which are rarely directly comparable in the open market), this is a very tricky task—so IP is typically analyzed on a case-by-case basis.

Risks: Yours or Mine?

A basic tenet of economics is that risk equals reward. So, your goal in conducting the functional analysis is to try, as much as possible, to strip out risk from the equation. Easier said than done, when you consider that there are as many risks—and almost as many *kinds* of risks—as there are businesses. But a good starting point would be: financial risk, regulatory risk, foreign exchange risk, market risk, and operational risk. The more you can understand and document how these risks impact the decision-making of each entity—and how they are allocated (or indemnified) among the related entities—the better positioned you will be to determine a fair arm's length price or profit margin.

Foreign exchange risk, at least, is clear. If your parent company is in the U.S., and your tested party is in the eurozone, exchange-rate fluctuations will obviously play a significant role in pricing. That's one thing you can easily control for when you start your comparability analysis.

Aligning Realities with Methodologies: The Transfer Pricing Method

Once you've unraveled the functions, assets, and risks inherent in both entities, you're ready to determine the most appropriate transfer pricing method for your controlled transaction. This critical step bridges theory with practice, aligning your analysis with the realities of the business landscape.

If you're applying a profit-based economic analysis, you'd examine which entity is bearing less risk and performing fewer functions—because that's easier to control for. You'd examine all of the different activities being performed in order to understand which side of the transaction you want to benchmark from that profit-based perspective: that's your "tested party."

The functional analysis of the entities and the controlled transaction also impact your choice of profit level indicator: you want one that genuinely reflects the facts and circumstances inherent in the functional profile. If you're looking at a distributor, evaluating a return on sales is an appropriate measure of profitability. Alternatively, in the context of services, an appropriate profit level indicator might be a return on cost, given that most of its overhead is likely to be people cost.

If you opt for the Comparable Uncontrolled Price (CUP) method, your focus will be on finding potential candidates with the same characteristics that you identified from the functional analysis. Those characteristics could include questions like: Is the company holding inventory risk? Are they actually buying the goods from the related party as a distributor, or are they just drop-shipping them to the customer as a sales operation? If the related entity holds the goods within its warehouse and bears the associated inventory risk, that will have a direct impact on the type of companies you want to examine.

No matter what method you use, one thing is clear: Once you take the time and do the work to do a robust and comprehensive function analysis, everything else falls more easily in place. And that's a good thing, when you consider how impactful your transfer pricing is on the company.

Be Proactive and Thorough: You'll Thank Yourself Later

A well-executed functional analysis forms the cornerstone of sound transfer pricing methodologies. By delving deep into functions, assets, and risks, you gain the additional strategic advantage of informed decision-making. This proactive approach not only ensures compliance but also lays the groundwork for defensible and transparent transfer pricing practices.

Another benefit of doing a thorough functional analysis—and of documenting it, every step of the way: Transfer-pricing compliance is a whole lot easier when you're able to answer questions before tax authorities have a chance to ask them. A penny spent now is worth orders of magnitude more in savings later.

RoyaltyStat
An Exactera company

Why RoyaltyStat?

RoyaltyStat provides the most sophisticated and flexible platform to accelerate research and analysis related to licensing, tech transfer, IP litigation and other IP matters.

Our clients benefit from the highest quality data and unique software tools to gain insights into the IP transaction and commercialization landscape, determine reasonable royalty rates and enhance workflow efficiency.