



TED: The Finesse of TP Functional Analysis *Finer Points of Functional Analysis in Transfer Pricing*

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Doing nothing is no longer an option.

TP Documentation

Transfer pricing (TP) has remained in the limelight since the start of OECD's Base Erosion and Profit Shifting (BEPS) project. One of the key principles relating to TP arising from the BEPS project is that profits should be taxed where real economic activities generating the profits are performed and where value is created. This principle has been widely adopted in most countries in Asia. Likewise in Singapore, the Inland Revenue Authority of Singapore (IRAS) has endorsed the principle in its e-Tax Guide on [TP Guidelines](#) published on 12 January 2017.

To substantiate that profits are being taxed where value is created, contemporaneous TP documentation is key.

There is a growing realisation among business executives and tax professionals that "entering into a tax dispute with tax authorities without proper TP documentation and hoping to successfully defend your TP position is an illusion".

A typical TP document would include the company and industry analyses, the functional analysis and characterisation of entities, and the economic analysis including the benchmarking analysis¹.

In this article, we will take a closer look at functional analysis.

Functional Analysis

Essentially, a functional analysis describes the economically significant functions undertaken, risks assumed and assets used by related parties that entered into a transaction. It involves a fact-finding exercise to identify the role of each participant in a related party transaction. The goal is to provide evidential support that profits are being taxed at where the value is created. The relative compensation earned by each party should correspond to their relative contribution (in terms of functions performed, resources used and risks undertaken).

"Profit attribution should reflect the value contribution of each entity, and should be consistent with the characterisation," shared Adriana Calderon, Director, Transfer Pricing Solutions Asia, during the latest instalment of the *Tax Excellence Decoded* (TED) session organised by the [Singapore Institute of Accredited Tax Professionals](#). "It is critical to understand the functions, assets and risks to determine the remuneration for the entities."

¹ ["Breakthrough with TP Benchmarking"](#) article, Singapore Institute of Accredited Tax Professionals, 9 February 2017; <https://siatp.org.sg/images/PDF/tpbenchmarking2017-web.pdf>

PERFORMING FUNCTIONAL ANALYSIS

There are four key steps to a functional analysis.

1) Determine tested transaction and tested party

At the start of a functional analysis, it is essential for a company to have clarity on the tested transaction and tested party as this would help the company decide on the appropriate TP methodology.

The tested party is typically the least complex entity (where a TP method can be applied in the most reliable manner), and hence, it is unlikely to be the entrepreneur or the Intellectual Property (IP) owner.

2) Gather information

Interviews and questionnaires are the two common modes used for information gathering in a functional analysis. In practice, interviews are generally preferred over questionnaires as they tend to require less preparation for both the interviewers and interviewees. Interviews also facilitate communication and could arguably produce better results.

To better understand the business operations, key operations personnel (and not only in-house tax and finance personnel) should be involved. This could include general managers of the various business units.

3) Prepare write-up of the analysis

Information obtained is typically categorised into three sections in the write-up of the analysis:

- i) Functions performed by the company;
- ii) Assets (both tangible and intangible) used;
- iii) Risks assumed by the company.

4) Conclude and characterise

Once the functional analysis is completed, it is required to conclude and characterise the related parties that participated in the transaction (whether it is marketing agent, limited risk distributor, full-fledged distributor, etc.) based on the functions performed, assets used and risks assumed. The appropriate level of profit would then be allocated based on the company's characterisation.

Case Studies

CASE STUDY 1: DISTRIBUTION AND SALES ARRANGEMENT

Background

Company A, incorporated in Europe, designs and manufactures specialised floor products for different industries. The company also holds all IPs of its specialised floor products

To distribute its products, Company A set up two subsidiaries, SG Sub and MY Sub, in Singapore and Malaysia respectively. The distributors are responsible for selling and marketing the products in their respective country. Goods are shipped to the distributors' warehouses by Company A.



Adriana Calderon, Director, Transfer Pricing Solutions Asia, shared her insights on functional analysis in transfer pricing.

Functional Analysis

Based on the case facts above, the tested transaction is the purchase of finished products from Company A. The tested parties are SG Sub and MY Sub. Company A is not an ideal tested party because it is the IP owner and the two distributors are the less complex entities.

Key operations personnel who are well-versed with the business operations, such as the managing directors and heads of business units from SG Sub and MY Sub, should be interviewed. Possible questions to be posted to the interviewees include:

- How is the product price negotiated and set?
- How are the supply chain and logistics managed?
- Do the distributors keep stocks?
- How many sales and marketing staff are there in each entity?
- Do the distributors sign contracts with the customers and if so, are such contracts in the name of the distributors or the head office (that is, Company A)?
- What type of customer service is provided?
- What type of marketing campaign is carried out?
- How do the distributors interact with the head office (Company A)?

These questions seek to find out the functions performed (example, general management and administration, marketing strategy and development, warehousing and ordering, sales, logistics, quality control, and customer support services); assets used (example, inventories, warehouse, equipment and office), and risks assumed (example, credit risk, market risk, inventory risk, product risk and foreign exchange risk) by SG Sub and MY Sub.

Based on the overall matrix of the functions performed, assets used and risks assumed, the Group may then determine whether SG Sub and MY Sub are marketing agents (low functions, low risks), limited risk distributors or full-fledged distributors (high functions, high risks). The closer SG Sub and MY Sub are to a full-fledged distributor, the higher the profit that should be allocated to them.

CASE STUDY 2: SERVICES TRANSACTIONS

Background

Company B is the regional head office of a Group providing engineering and construction services. Most of Company B's 300 employees are engineers and specialists in infrastructure.

To carry out engineering projects in the region, Company B sets up two subsidiaries, TH Sub and VT Sub (each with five employees) in Thailand and Vietnam respectively. As the Group's engineering expertise resides mainly with Company B, TH Sub and VT Sub have to rely on Company B's engineering expertise to carry out their projects. On top of technical services, Company B also provides management services to its two subsidiaries.

Functional Analysis

The tested transactions in this case are the management services and technical services provided by Company B. It should be noted that the tested party would be Company B because the provider of the service would usually be the tested party for service arrangements.

In carrying out the functional analysis for the service transactions, the key information to identify is the activities being performed by the service provider and the benefits to the recipient. The starting point is the services contract as it would provide most of the basic information of the arrangement. However, interviews should also be arranged with the teams that provide the services to understand their exact scope of work and responsibilities with regard to the service transactions.

The service charge for such transaction is driven mainly by the type of service being provided. It is generally accepted in many tax jurisdictions that low-value services could be remunerated on a cost-plus basis. In Singapore, IRAS accepts a 5% cost mark-up as a reasonable arm's length charge for certain routine support services².

² For details on routine support services, refer to Annex C of IRAS' [e-Tax Guide on Transfer Pricing Guidelines](https://www.iras.gov.sg/irashome/uploadedFiles/IRASHome/e-Tax_Guides/etaxguide_CIT_Transfer%20Pricing%20Guidelines_4th.pdf); https://www.iras.gov.sg/irashome/uploadedFiles/IRASHome/e-Tax_Guides/etaxguide_CIT_Transfer%20Pricing%20Guidelines_4th.pdf

However, this concession should be applied with care as it is available only for routine services that support the main business activity of the company (also known as non-core or low-value services) such as accounting services, payroll support and legal support. Any services that are core to the business (as they add value to the main revenue-generating activities) are considered non-routine and a higher mark-up will be expected to remunerate these services.



Adriana Calderon, Director, Transfer Pricing Solutions Asia, clarifying doubts posted by the participants' during the Q&A session.

It should be emphasised that marketing services do not fall within the ambit of routine support services, and are generally able to command higher remuneration than management services. Technical services are normally linked to the core business activities of the company, and are often expected to generate a higher return than management and marketing services.

This technical event commentary is written by Felix Wong, Head of Tax, and Angelina Tan, Technical Specialist, SIATP. This article is based on SIATP's Tax Excellence Decoded session facilitated by Adriana Calderon, Director, Transfer Pricing Solutions Asia.

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Ultimately, the functional analysis should address the type of activities (for example, administrative, financial and human resources functions) being performed by Company B and the benefits that such activities bring to the service recipients (that is, TH Sub and VT Sub).

The majority of tax authorities worldwide accept that profits should be taxed where the real economic activities generating the profits are performed and where value is created. To support that a company's profit allocation is in line with this principle, the preparation of a functional analysis as part of a TP exercise is key. Hence, if you have not prepared a functional analysis, now is the time to prepare, revisit or review.

Doing nothing is no longer an option.

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