

Transfer Pricing Documentation: How far can the FAR go?

It has been almost two decades since the Transfer Pricing (TP) provisions were introduced in the Indian tax landscape. Being a fairly new law for India Inc, it has taken its due course to mature and evolve gradually. The Indian TP Regulations (ITPR) have also matched the pace of international guidance by introducing the additional compliance requirements, such as Master File and Country-by-Country-Reporting (CbCR) as prescribed by the Organisation for Economic Cooperation and Development (OECD) under its Action Plan 13 of the Base Erosion and Profit Shifting (BEPS) project. However, one would agree that the TP documentation / study report still remains a vital and most critical repository of documentation when one looks at the entire scheme of intercompany pricing arrangements of a Multi-National Enterprise (MNE). Needless to say, functional analysis is the backbone of any TP documentation outlining the Functions performed, Assets employed, and Risks assumed (FAR analysis) by each of the parties associated with a particular international transaction within the MNE.

Recent guidance by OECD

Apart from the Action Plan 13, which introduced the Three-Tiered TP documentation, i.e. CbCR, Master File and Local File (country-specific



TP documentation), it is worthy to note that the OECD came up with a substantial guidance in the form of Action Points 8 to 10 on the TP matters, with the stated objective of “aligning the TP outcomes with value creation”. To achieve this objective, the OECD prescribed a guidance to identify the “substance over form”. Specifically Work under Action Plan 9 of OECD’s BEPS has focused and ensured the following:

- Devising mechanism to iron out the differences in the contractual allocation of risks and resulting allocation of profits to those risks which in fact may not correspond with the activities actually carried out by the parties,
- Reallocation of profits in cases where risks are contractually assumed by parties who cannot in fact exercise meaningful and specifically defined control over such risks or do not have the financial capacity to assume such risks, and
- Contractual allocation of risks is respected only when they are



CA. Amit
Dhadphale



CA. Mohit
Agrawal

The authors are members of the Institute. They can be reached at board@icai.in

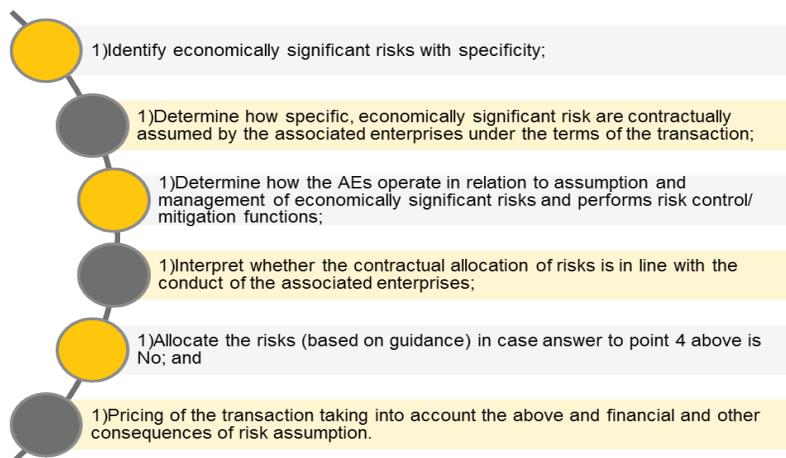
supported by actual decision making.

The OECD guidance emphasizes on the importance of substance over form while conducting the FAR analysis of the intercompany transactions. The analysis should ideally focus on what the parties actually do and the capabilities they provide. Such activities and capabilities should include decision making, including decisions about business strategy and risks. In addition to this, the legal rights and obligations of each party while performing functions would be relevant. While one party may provide a large number of functions relative to that of the other party to the transaction, *it is the economic significance of those functions in terms of their frequency, nature and value to the respective parties to the transactions that is important.*

The OECD guidance has also provided impetus on analysing risks while accurately delineating the actual transaction. The OECD has provided a 6-step approach which can be summarised as follows¹:

¹ Para 1.60 of the BEPS Action Plan report on Action Points 8-10

International Taxation



Inference from the OECD guidance

Basis reading of the above, it can be observed that focus has now been placed more on the *Risk Controlling² Functions (RCF)* rather than the actual performing of the functions. When we talk about 'Control over risk', the same primarily involves the following:

- Capability to make decisions, that is to say – Take on/ lay off/ decline a risk bearing opportunity, together with the actual performance of that decision-making function; and
- Capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function.

The OECD also introduced a concept of DEMPE³ controlling functions to identify the entity which should be entitled to the residual results from the ownership of Intangibles.

Impact of the OECD guidance on FAR

Thus, it would be now more and more important to identify the contractual arrangement between the parties, map the actual conduct with the contractual arrangement, identify the gaps and then conclude on the characterisation of the entity, thus, deepening and widening the scope of fact finding, i.e. FAR analysis. While this is not really a new requirement, but to ensure the correct capturing of substance and identify the entity(/entities) performing risk controlling

functions, the entity (/entities) controlling the DEPME functions and the entity (/entities) creating value for the Group as a whole, one would agree that the FAR *has really gone so much far* that it would warrant additional efforts to reach to the essence of the arrangement by correctly capturing the “substance over form”.

Accordingly, the preparators of the TP documentation may need to work with additional tools and with additional efforts to capture the FAR that, by far may not have been captured to such crystal-clear details.

Responsible	Accountable	Consulted	Informed
Entity who performs a function/ undertakes an activity	Entity who is ultimately accountable and has the say i.e. Yes/ No/ Veto;	Entity that needs to feedback/ contribute to the function/ activity	Entity that needs to know of the decision or action

RACI framework/ analysis

One of the interesting tools used in project management is the responsibility assignment matrix which describes the participation by various roles in completing tasks or deliverables for a project or business process. It is used for clarifying and defining roles and responsibilities in cross-functional or departmental projects and processes⁴. This responsibility matrix is also referred to as a RACI chart, where RACI is an acronym derived from the four key responsibilities most typically used: Responsible, Accountable, Consulted, and Informed. The following chart explains the responsibility matrix under the RACI chart in more details:

The **Annexure I** to this article provides an illustration of actual mapping of the functions under the RACI charts.

It would be worthy to note that the entities entrusted with responsibility and accountability roles would be the entities performing the RCF, whereas, the entities which are consulted or informed are more involved in the process, without any RCF responsibility. Such micro analysis of functions and identification of the correct shade of function / responsibility may assist in correctly identifying the “substance over form” and assist in bring the FAR with the clarity that by-far may not have been possible.

Potential consequences of not having an appropriate FAR analysis in place

With the ink still drying on many legislative changes prompted by the BEPS, an even more fundamental revisit of the FAR analysis is inevitable. Considering the changing global landscape around transfer pricing and Indian Revenue Authorities ('IRA') looking at more consistent approach with the global approach with regards to TP documentation, it is more important

than ever to embrace the required change and shift to a FAR 2.0, i.e. a detailed FAR analysis based on the RACI / similar charts to bring out the “substance over form”.

The IRA have started deliberating on some of the key guidelines of the OECD Action Plans (viz DEMPE functions for evaluation of intangibles) and accordingly, could deep dive into substance of the functions rather than a simple scrutiny of intercompany agreements and FAR analysis typically submitted by the tax payer. Further, considering the fact that Masterfile would also include FAR analysis for major group transactions, it is important to have consistent FAR for the similar

² Including the managing and / or risk mitigating functions

³ Development, Enhancement, Maintenance, Protection and Exploitation

⁴ https://en.wikipedia.org/wiki/Responsibility_assignment_matrix

transactions across jurisdictions which should be commensurate with the Masterfile.

GAAR provisions

The General Anti Avoidance Rules, (Section 95 of the Income-tax Act, 1961) echo the OECD guidance placed above in principle and prescribe that an arrangement entered into by an assessee may be declared to be an impermissible avoidance arrangement and consequence in relation to tax arising therefrom may be determined subject to the provisions of Chapter X-A. Some of the situations mentioned are as follows:

- The substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part;
- Location of an asset of a transaction which is without any substantial commercial purpose, other than obtaining a tax benefit.

The emphasis given by the revenue authorities while laying out the above rules is to identify such transactions which lack substance over form.

Accordingly, it is need of the hour to streamline the FAR analysis with the actual conduct of parties failing which the entire intercompany arrangement of the tax payer could be considered as a means to avoid tax and the same could result in disregarding of the transaction.

Concluding thoughts and suggested way forward to reach the FAR 2.0:

The taxpayers would need to take care of the following aspects going forward while preparing a TP documentation more importantly while putting together FAR 2.0 analysis:

- Delineating transactions with due consideration of actual substance over form;
- More emphasis to be given on identifying parties performing RCF, rather than looking at the contractual allocation of functions/ risks;
- Actual conduct of parties and responsibility in relation to each of the activities involved in the international transaction should be taken into consideration – This can be aptly done by RACI charts;

- Recharacterisation of parties – taxpayers may be required to consider changing and aligning business structures based on value creation – to achieve group synergies;
- For complex international transactions, new models such as Variable Royalty / Cost Contribution Arrangements or unconventional benchmarking methodologies such as Profit Split Methods / Residual Profit

Split Method could be the need of the hour;

- From a certainty perspective, it is always advisable to apply for Unilateral Advance Pricing Agreements ('UAPAs') / Bilateral APAs ('BAPAs') upfront and deliberate in detail with tax authorities in relation to the roles and responsibilities of each party involved in the transaction. ■

Annexure I: Illustrative example of use of RACI chart for mapping the FAR analysis:

The RACI analysis could be drawn out in a following manner for a typical captive software development service provider who is engaged in rendering low end software development services to its associated enterprise:

Functions	Responsible	Accountable	Consulted	Informed
Strategic management/ decision making	F Co	F Co	-	-
Marketing/Business development	F Co	F Co	I Co	I Co
Research and development	F Co	F Co	-	-
Budgeting	F Co	F Co	I Co	I Co
Conceptualization and design of the product/ service	F Co	F Co	I Co	I Co
Functional specification and requirement analysis	F Co	F Co	I Co	I Co
Coding	I Co	F Co	F Co	F Co
Testing and delivery	I Co	F Co	F Co	F Co
Project management and supervision	I Co and F Co	F Co	-	-
Quality of services	I Co and F Co	F Co	-	-
Documentation	I Co	F Co	F Co	F Co
Employee trainings	I Co and F Co	F Co	I Co	I Co
Corporate function	F Co	F Co	-	-
HR functions	F Co	F Co	I Co	I Co
Payroll function	F Co	F Co	I Co	I Co

I Co – Indian captive software development service provider

F Co – Foreign company receiving services from I Co

From the above analysis it is relatively clear that for most of the functions F Co is responsible apart from coding, testing, documentation and trainings which are typically performed by a captive service provider, i.e. I Co. However, as far as the accountability of the functions is concerned, the same is borne by F Co for all the functions.

Accordingly, F Co performs all the risk controlling functions whereas I Co does not perform any risk controlling function. Considering the same, to say that I Co should earn a routine mark-up for the costs incurred by it and the residual profits from the overall value chain should be retained by F Co would be appropriate from a transfer pricing perspective.

Further, in case there is a situation wherein multiple risk controlling functions are performed by both the entities involved in the transaction, weights could be assigned for each function based on the contribution of each function to the entire value chain.