Editorial

Helmut Becker, Düsseldorf, West Germany

The functional analysis – a new wave from the USA

Trends, an inherent feature of fashion, influence international tax law too. But whereas the fashion trendsetters are found in Paris and Milano, the USA sets the scene for international tax law. This may be observed in the Transfer Pricing issue when, after their introduction of regulations to Section 482 IRC in 1968, the OECD was to deal with the subject several times and many countries came up with their own regulations or at least guidelines. Efforts by the USA to cut off access to tax havens with their Subpart – F law was followed by Switzerland and several other countries with anti-avoidance legislation and the same pattern emerges with thin capitalisation and finally treaty shopping. In all these cases the United States was the trendsetter.

The latest trend to come our way from across the Atlantic is the concept of Functional Analysis. Initiated by the amendment of IRC Section 482, via the Tax Reform Act of 1986, the Functional Analysis concept was introduced to justify the so-called 'super royalty'. However, it now seems that this was only the beginning. The Treasury Department, together with the Internal Revenue Service, has just published a 130 page – double that if one includes the appendices – White Paper on Transfer Pricing entitled 'A Study of Intercompany Pricing' which draws attention to the Functional Analysis. Already it looks as becoming not only the fourth but the leading price method. This is not just because of the practical limitations of the original three price methods – the comparable, the resale and the cost plus price methods – but is also due to the Functional Analysis' made-to-measure characteristics.

Based on the Functional Analysis approach, each line of business is broken down into component activities or functions and a return assigned to each of the functions. The purpose of this breakdown is to identify measurable factors which are carried out by a wide range of unrelated parties and for which information will be simpler to obtain than for the comparable elements of the transaction itself. The essence is that instead of evaluating the transaction itself, Functional Analysis seeks to identify assets and other production factors that are used by the parties in the line of business concerned and tries to assign market returns to them.

Not only the United States but all industrial countries will be effected by this new method. It is to be expected that Functional Analysis, and the determination of the functional return, will be discussed and maybe considered by all major tax authorities and those industries engaged in international business. The outcome of any such discussion might cause some excitement because the creation of Functional Analysis is linked with the super-royalty provision. Whilst allowing that this is hard to defend under the arm's length principle, the Functional Analysis stands its own rendering more precision where the three conservative price methods cannot be applied.

It will therefore be worthwhile considering and discussing this new avenue. *Intertax* opens this discussion in its next edition with a Special on Transfer Pricing and Intangibles.