

Transfer Pricing - An Analysis

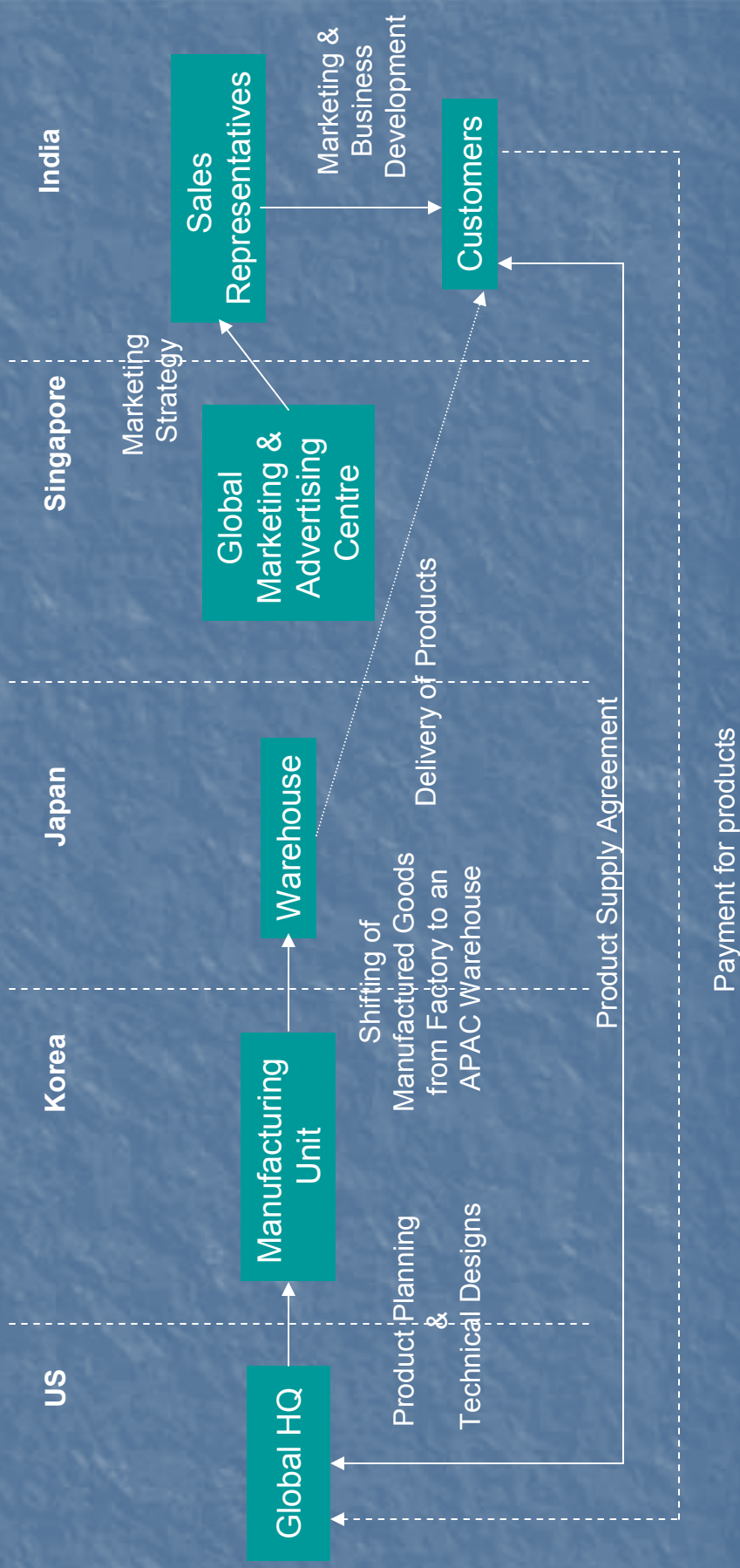
By

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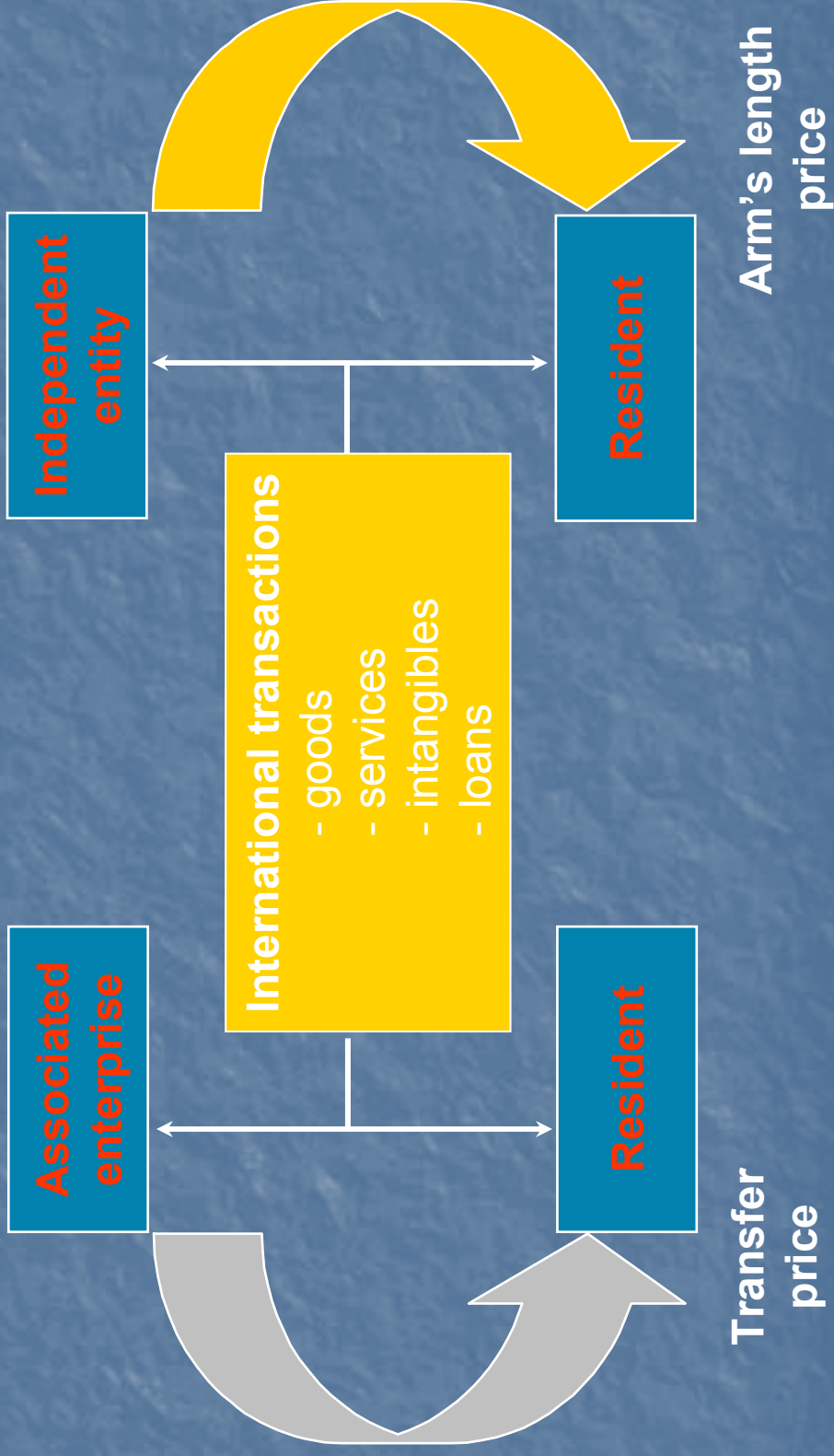
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- Transfer Pricing Regulations
- Recent Change in TP Assessment
- Arm's length price
- Prescribed methods
- Recent Case Laws

A Typical Global Supply Chain



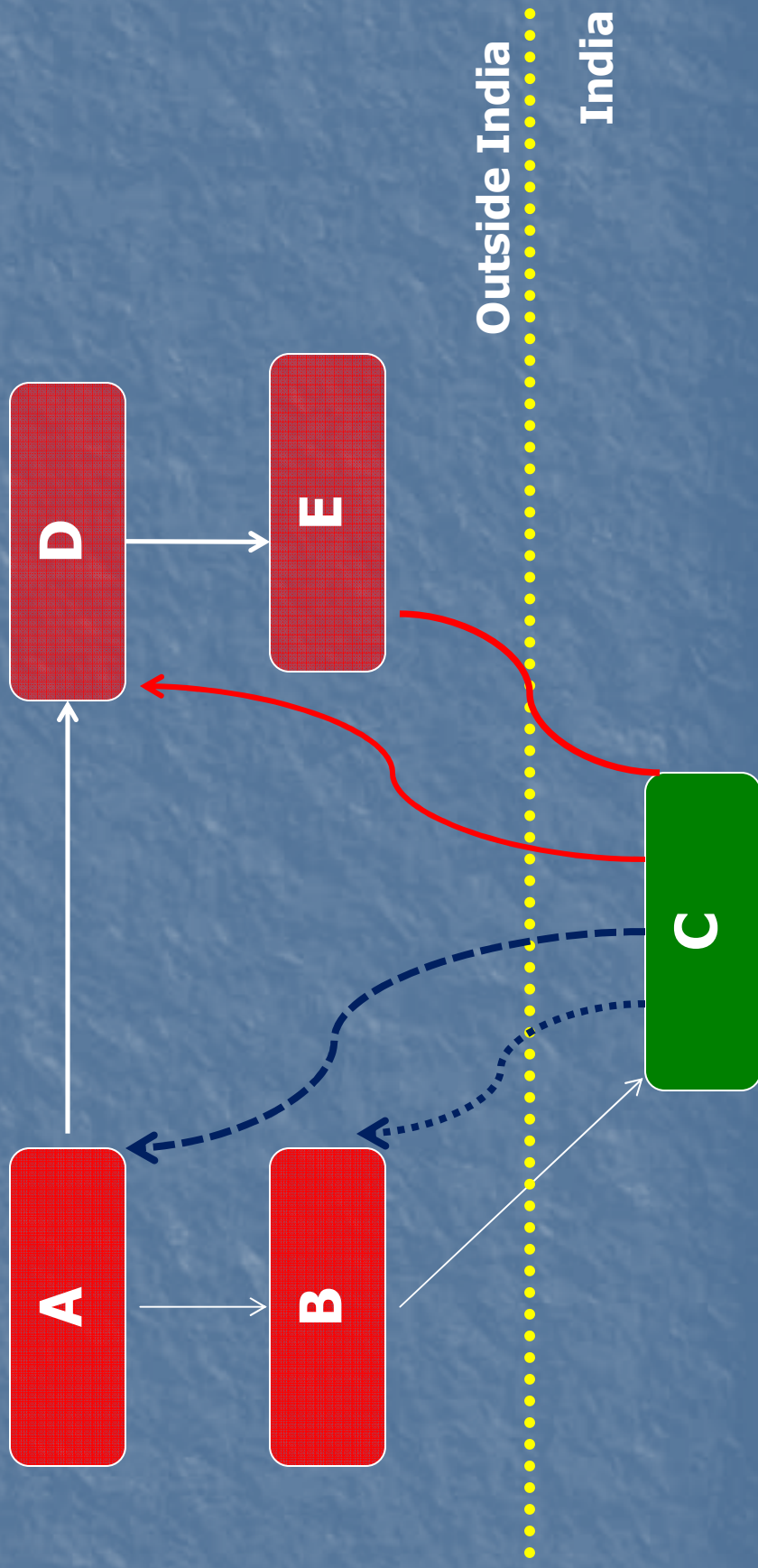
Concept



Associated Enterprises (AEs)

- Direct or indirect participation (through one or more intermediaries) in management control or capital – **Sec 92A(1)**
- The above section is further supplemented by 13 clauses which enlist various conditions under which two enterprises shall be deemed to be AE's under **Sec 92A(2)**

Associated Enterprises (AEs)



Associated Enterprises (AEs) Deemed

Power to
appoint more
than half of
directors

Loans in
excess of 51%
of total assets

Common
executive
director(s)

Existence
of common
control

Guarantees
in excess of
10% of total
borrowings

Supply of
raw materials
(90% or more)

Complete
dependence
on IPRs

Relationships
of mutual
interest

Deemed
AEs

Arm's length price

Arm's length price

Price applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions

Determination of arm's length prices using one of the **Prescribed methods**

Whether you arrive at a single price ?

Yes

The price thus determined is the arm's length price

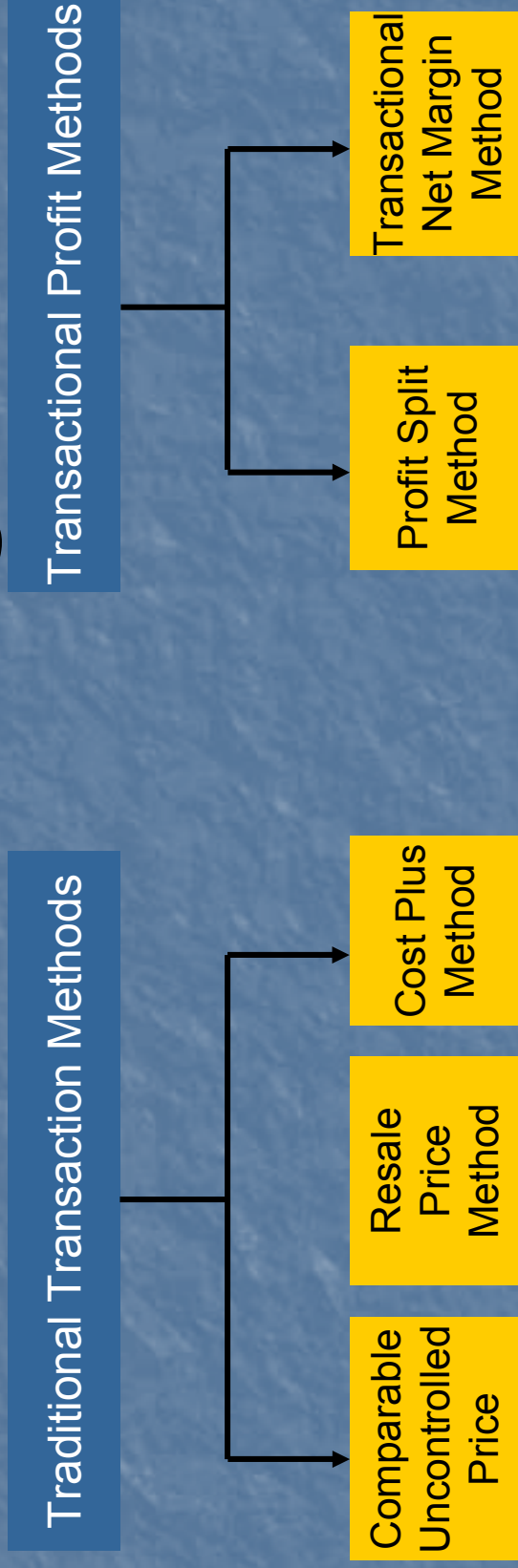
No

The arithmetic mean of such prices or a price is the arm's length price (92C(2))

The Arm's Length Range - How it works

- Mostly not possible to identify a single arm's length price
- Overall range may contain extremes
- Indian legislation recognizes only arithmetic mean
- If Arm's Length Price falls within +/- 5% range of transfer price, pricing should be defensible as arm's length

Prescribed methods OECD Transfer Pricing Methods



- OECD prefers traditional methods over transactional methods
- Indian rules prescribe no guidance – legal view it to follow chronological order of the methods in the Act
- Any other method prescribed by the Central Board of Direct Taxes- None as of now

Comparables

- All methods require comparables.
- Transfer price is set/ defended using data from comparable companies which should be independent and similar to the entity.
- Following factors are generally used in judging comparability (Rule 10C(2)):
 - ✓ nature of transactions undertaken (i.e type of good, service etc.)
 - ✓ company functions
 - ✓ risks assumed
 - ✓ contractual terms (i.e similar credit terms)
 - ✓ economic and market conditions

Comparable Uncontrolled Price Method -Rule 10B(1)(a)

- ➔ Comparable Uncontrolled Price (“CUP”) method is considered as the most appropriate method, for all transactions, if information is available.
- ➔ CUP method compares the price charged in a controlled transaction with the price in an uncontrolled transaction.
- ➔ It requires strict comparability in products, contractual terms, economic terms, etc.

Comparable Uncontrolled Price Method

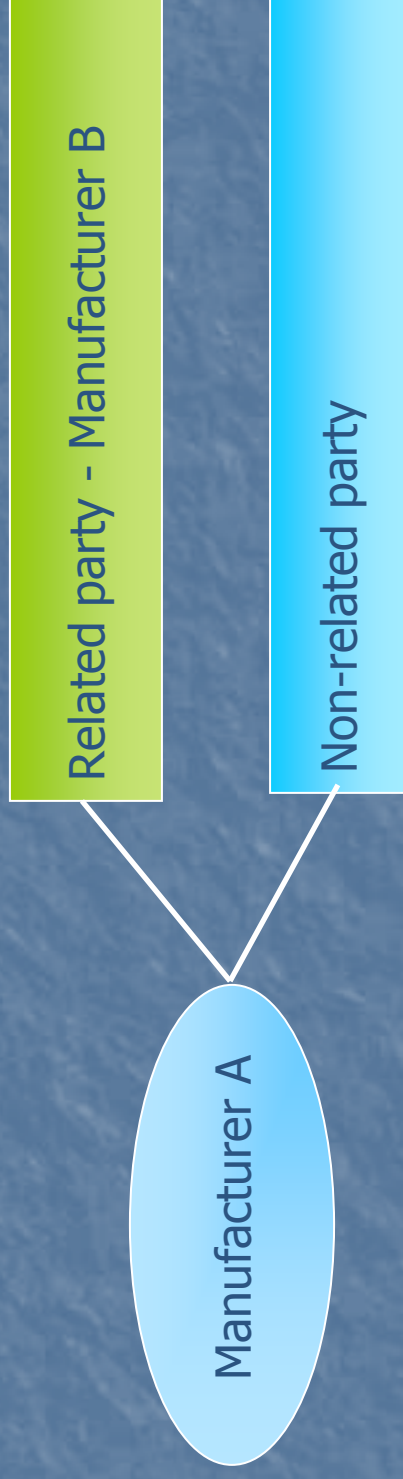
Identification of price charged or paid in comparable transaction(s)

Such price adjusted to account for differences if any between international transaction and uncontrolled transaction(s)

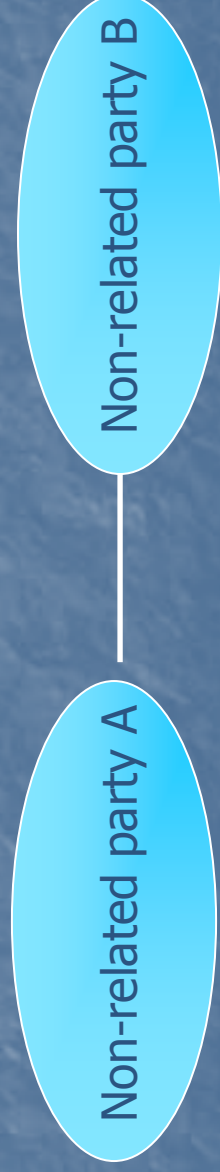
Adjusted price arrived above taken to be arm's length price

Comparable Uncontrolled Price Method

⇒ Internal CUP

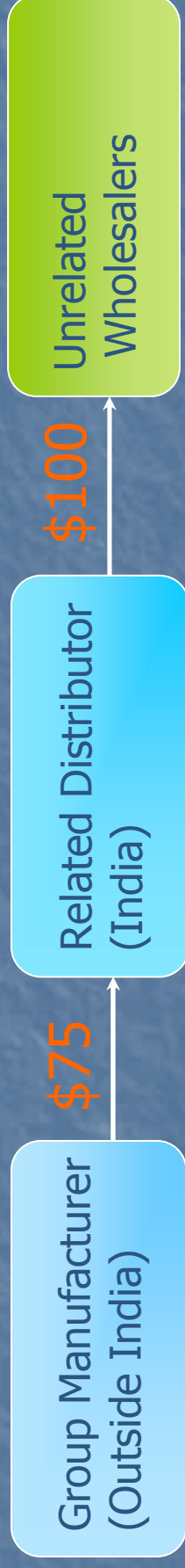


⇒ External CUP



Resale Price Method- Rule 10B(1)(b)

- ➔ Resale Price Method (“RPM”) compares the resale gross margin earned by AEs with the resale gross margin earned by comparable independent distributors.
- ➔ An arms’ length gross margin should be sufficient for a reseller to cover its operating expenses and make an appropriate operating profit (in light of its functions and risks).
- ➔ Preferred method for a distributor buying purely finished goods from a group entity (if no CUP available).



Resale Price Method

Identification of resale price by tested party

Resale price reduced by normal gross profit with reference to uncontrolled transaction(s)

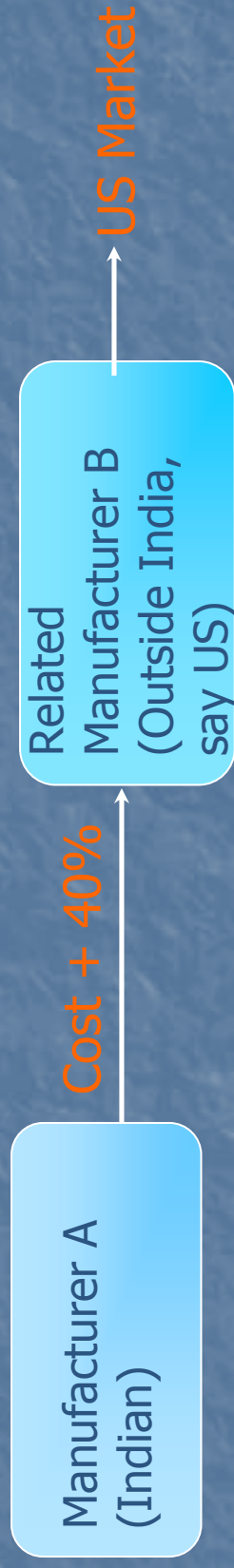
Such price reduced by expenses incurred (customs duty etc.) in purchase of the product/ services.

This price may be adjusted to account for functional and other differences if any

Adjusted price arrived above taken to be arm's length price

Cost Plus Method Rule 10B(1)(c)

- Cost Plus Method (“CPM”) compares the gross profit on costs the AEs earns with the gross profit on costs earned by comparable independent companies.
- Preferred method for:
 - ✓ manufacturer supplying semi-finished goods
 - ✓ entity providing services



Cost Plus Method

Identification of direct and indirect costs of production incurred in tested party transactions

Identification of normal gross profit with reference to uncontrolled transaction(s)

Normal gross profit adjusted to account for functional and other differences if any

Adjusted gross profit added to total costs identified in step 1

Sum arrived above is taken to be arm's length price

Profit Split Method-Rule 10B(1)(d)

- ➔ Profit Split Method (“PSM”) is appropriate for transactions which are not capable of being evaluated separately.
- ➔ Calculates the combined operating profit resulting from the whole inter-company transaction based on the relative value of each AE's contribution to the operating profit.
- ➔ The contribution made by each party is determined on the basis of a division of functions performed, valued, if possible using external comparable data.
- ➔ Applicable for analysing tangible, intangible or services issues.

Profit Split Method

Determination of combined net profit of the AEs arising out of international transaction

Evaluation of relative contributions by each enterprise on the basis of functions performed, risks assumed and assets employed

Splitting of combined net profit amongst enterprises in proportion to their relative contributions

Profit thus apportioned to the tested party is used to arrive at the arm's length price

Transactional Net Margin Method-Rule 10B(1)(e)

- ➔ Transactional Net Margin Method (“TNMM”) examines net operating profit from transactions as a percentage of a certain base (can use different bases i.e. costs, turnover, etc) in respect of similar parties, as the profit level indicator.
- ➔ Ideally, operating margin should be compared to operating margin earned by same enterprise on uncontrolled transaction – Internal TNMM
- ➔ TNMM can also be used to compare the “comparable transactions” between independent parties – External TNMM.
- ➔ It is applicable for any type of transaction and can also be used to supplement analysis under other methods.
- ➔ It is the most frequently used method in India, due to:
 - ✓ lack of availability of data to apply other methods.
 - ✓ evens out business cycles, product dissimilarities.

Transactional Net Margin Method

Computation of net profit as a percentage of a certain base realised from the international transaction.

Computation of net profit realised by the tested party or an unrelated enterprise in a comparable uncontrolled transaction

Net profit from uncontrolled transaction adjusted to account for differences if any

The net profit thus established is taken into account to arrive at an arm's length price for the international transaction

TP Study Layout

[Name of the company]

Transfer Pricing Study

Financial Year _____

Assessment Year _____

Privileged and Confidential

Draft Report Dated _____

Chartered Accountants

TP Study Layout

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2	Overview 2.1 General 2.2 Profile of AE Group 2.3 Profile of the company 2.4 Relationship structure between INC & AE	

TP Study Layout

S. No.	Particulars	Page No.
3	Industry Overview	
4	Applicability of Transfer Pricing Regulations	
5	Functional Analysis 5.1 Objective 5.2 Analysis of Transactions 5.3 Risk Analysis	
6	Economic Analysis 6.1 Selection of most appropriate method 6.2 Search process for comparables 6.3 Conclusions	

TP Study Layout

List of Appendices

Appendix A : *Scope and Limitation*

Appendix B : *Indian Transfer Pricing Regulations*

Appendix C : *Accept Reject Matrix*

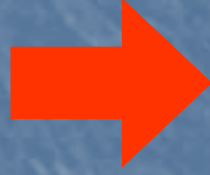
Appendix D : *Results of Selected Comparable Companies*

Appendix E : *Brief about the selected companies*

Appendix F : *Financial Information of the company to compute its margins*

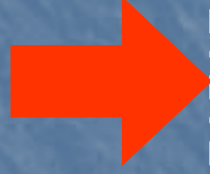
Documentation-Rule 10D

Entity related



- Profile of industry
- Profile of group
- Profile of Indian entity
- Profile of associated enterprises

Price related



- Transaction terms
- Functional analysis (functions, assets and risks)
- Economic analysis (method selection, comparable benchmarking)
- Forecasts, budgets, estimates

Transaction related

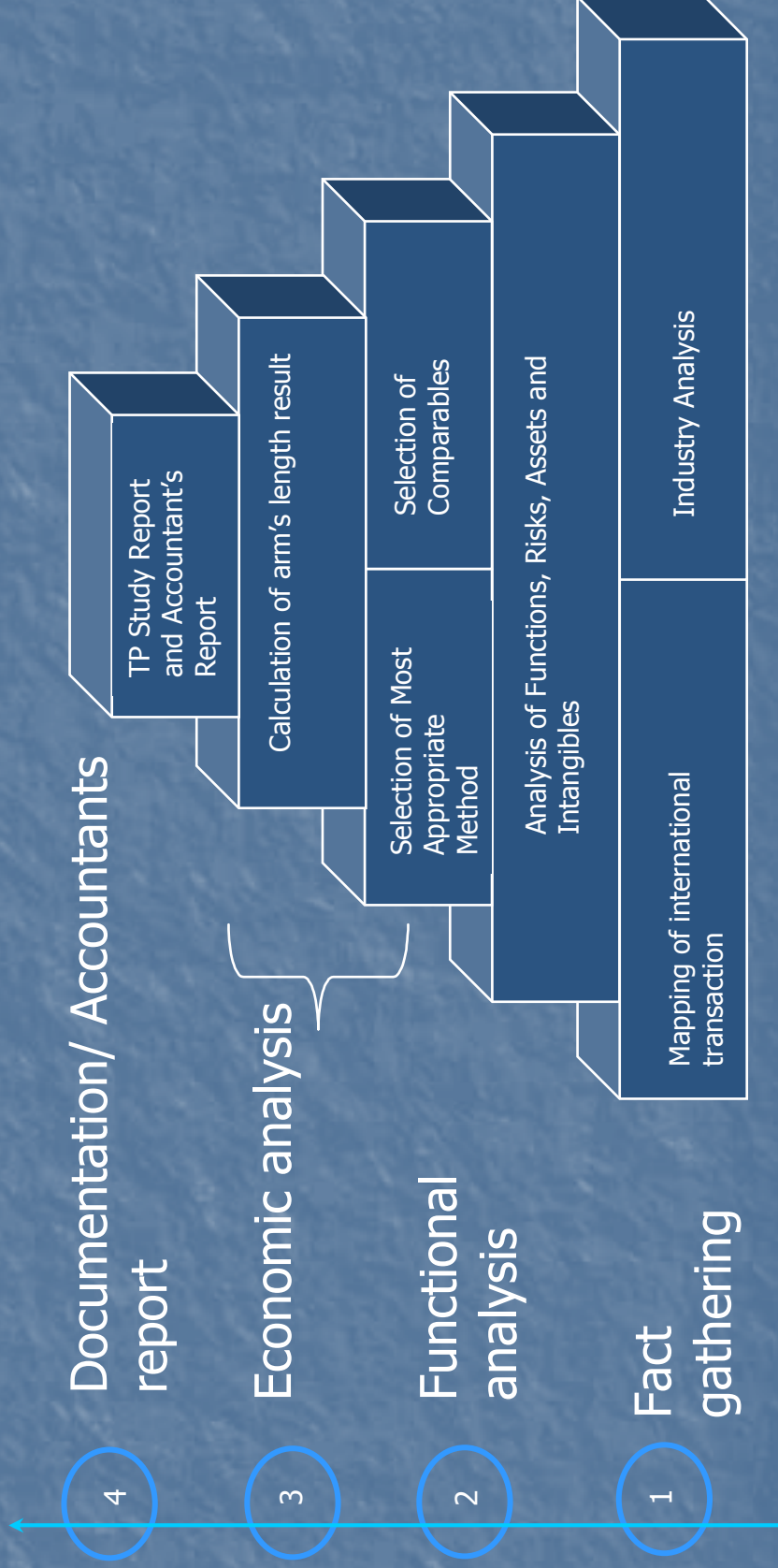


- Agreements
- Invoices
- Pricing related correspondence (letters, emails etc)

- Documentation to be retained for 9 years from financial year
- Documentation is not required to be maintained if the **aggregate value** of all international transactions does not exceed **one crore rupees**

Documentation – Rule 10D

The approach for TP documentation may be summarised in the following phases of work:



Accountant's report (Form 3CEB)

- Rule 10E

- Essentially comments :
 - whether the tax payer has maintained the transfer pricing documentation as required by the legislation,
 - whether as per the transfer pricing documentation the prices of international transactions are at arm's length, and
 - certifies the value of the international transactions as per the books of account and as per the transfer pricing documentation are "true and correct"

TP Penalties-Section 271

Default	Penalty
Post-inquiry adjustment (deemed concealment of income)	100-300% of tax on the adjusted amount
Failure to maintain documents	2% of the transaction value
Failure to furnish documents	2% of the transaction value
Failure to furnish accountants report	Rs 100,000

Recent Case Laws

- Skoda Auto India – Pune ITAT
 - **2009-TIOL-214-ITAT-PUNE**
Transactions between Associated Enterprises ('AEs') cannot be considered for determining the existence of an internal Comparable Uncontrolled Price ('CUP')
 - Assessee cannot be expected to get details and particulars, which are not available in public domain
- SDRC India – Delhi ITAT
 - **2009-TIOL-185-ITAT-DEL**
If Assessing Officer ('AO') was convinced that there was an arrangement to avoid tax, he should have referred the case to TPO under section 92(C)

Recent Case Laws

■ Honeywell Automation – Pune ITAT

2009-TIOL-104-ITAT-PUNE

- Only current year data to be used, if the Appellant is not be able to reveal any facts to bring the case to the proviso to Rule10B(4)

■ UCB India – Mumbai ITAT

2009-TIOL-184-ITAT-MUM

- Penalty not leviable for non-provision of documents beyond taxpayer's control
- Detailed Functions, Assets & Risks ('FAR') analysis required for application of CUP method

Recent Case Laws

- Moser Baer India & Others – Delhi High Court
2008-TIOL-647-HC-DEL
 - Provisions of section 92CA(3) casts an obligation on the TPO to afford a personal hearing to the Appellant before proceeding to pass an order determining the Arm's Length Price ('ALP')
- Coca Cola India – Punjab & Haryana High Court
2008-TIOL-656-HC-P&H
 - Permission granted by the Reserve Bank of India ('RBI') under the Foreign Exchange Regulation Act ('FERA') cannot control the provisions of the Income-tax Act, 1961 ('the Act')

Recent Case Laws

- Philips Software – Bangalore ITAT / Karnataka High Court

2009-TIOL-123-HC-KAR

- AO / TPO required to demonstrate tax avoidance before / during assessment proceedings
- TPO cannot reject taxpayer analysis without due reasons
- Recognized importance of economic adjustments
- Karnataka High Court has admitted revenue's appeal against the ITAT order and stayed the order of ITAT

Recent Case Laws

- Development Consultants – Kolkata ITAT
2008-TIOL-150-ITAT-KOL
 - Taxpayer analysis to be accepted if not controverted by the TPO
- Cargill India – Delhi ITAT
2008-TIOL-94-ITAT-DEL
 - Penalty not leviable for non-provision of documents beyond taxpayer's control

Recent Case Laws

■ Ranbaxy Laboratories – Delhi ITAT

2008-TIOL-75-ITAT-DEL

- Powers to Commissioner to re-open case if not examined properly by TPO

■ I Gate Global – Bangalore ITAT

112 TTJ 1002

- Voluntary TP adjustment eligible for Section 10A benefit

■ Aztec Software & Technology Services Ltd.

- **Bangalore ITAT Special Bench**

- AO should use current year data for comparability analysis even if such data was not available to the assessee in public database at the time of preparation of TP Study

Thanks