

Fundamental principles of Transfer Pricing and Transfer Pricing audit under the Income-tax Act, 1961

Borivali (Central) CPE Study Circle
of WIRC of
The Institute Of Chartered Accountants
Of India

Vispi T. Patel
Vispi T. Patel & Associates

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Transfer Pricing (TP) – Indian Perspective



TPR in India – Section 92

Any income

arising from

an international transaction

shall be computed

having regard to

arm's length price



TPR in India

- ◆ Income under any head is covered under the ambit of TPR

- ◆ Section 4 – Income must be chargeable to tax

- ◆ Preconditions:
 - Two or more associated enterprises
 - Enter into an international transaction
 - Specified Domestic Transaction (w.e.f. AY 2013-14)

- ◆ Consequence:
 - Income/ Expenditure to be computed having regard to the arm's length price



Arm's Length Price

Section 92F(ii) of the Indian TPR

“arm's length price means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions”

Under Rules 10A to 10E of Income-tax Rules, 1962 (Rules);

“Uncontrolled transaction” – transaction between enterprises other than associated enterprises, whether resident or non-resident



Arm's Length Price

- ◆ The ALP under Section 92F of the Act denotes price which is applied or proposed to be applied in a:
 - comparable transaction between
 - unrelated independent parties in
 - uncontrolled conditions
 - Usually corresponds to the open market price



Associated Enterprises as per Indian TPR [Section 92A]

- ◆ Means direct or indirect participation in management control or capital:
 - by one enterprise into another enterprise; or
 - by the same person in both the enterprises
- ◆ Equity holding, Control of Board of Directors / Appointment of one or more Executive Director, mutual interest will also constitute Associated Enterprise
- ◆ Either or both of Associated Enterprises should be a non-resident



Meaning of AEs

- ◆ “Deemed Associated Enterprises” includes:
 - Holding of 26% of voting power
 - ◆ by one enterprise into another enterprise; or
 - ◆ by the same person in both the enterprises
 - Dependence on intangible assets
 - Purchase of 90% or more of raw materials and consumables
 - Sale of goods
 - ◆ influence on price and conditions of supply by buyer
 - Control by individual or his relative
 - Financial transaction
 - ◆ Loan - 51% or more of book value of total assets of the borrowing enterprise
 - ◆ Guarantee - 10 % or more of the total borrowings of an enterprise



Associated Enterprise

Term of wide import

◆ Following parties also covered:

- Venture Capital investors with 26% stake
- FI's advancing loans exceeding 51% stake of assets of borrowing enterprise
- Franchisers, licensees, technical collaborators, etc

◆ Is your company covered?



International transaction

- ◆ Means “transaction” between two or more Associated Enterprises:
 - ◆ Transaction between two or more associated enterprises (at least one of which will be non-resident) of purchase, sale or lease of tangible and intangible property, provision of services, financing, cost sharing / cost contribution arrangements

OR

- ◆ Any other transactions affecting profits, losses, income, assets or liability of the enterprise



International Transactions

(Amendments by Finance Act, 2012)

- ◆ The expression “International Transaction” was amended by Finance Act, 2012 w.e.f 1.04.2002 to specifically include:
 - ◆ Inter-company Guarantees,
 - ◆ Advance payments, deferred payments, receivables,
 - ◆ Capital Financing/ Business restructuring / reorganisation,
 - ◆ Purchase / sale/ use of intangibles such as customer lists, customer contracts, customer relationships,
 - ◆ Transfer / secondment of trained employees, etc.

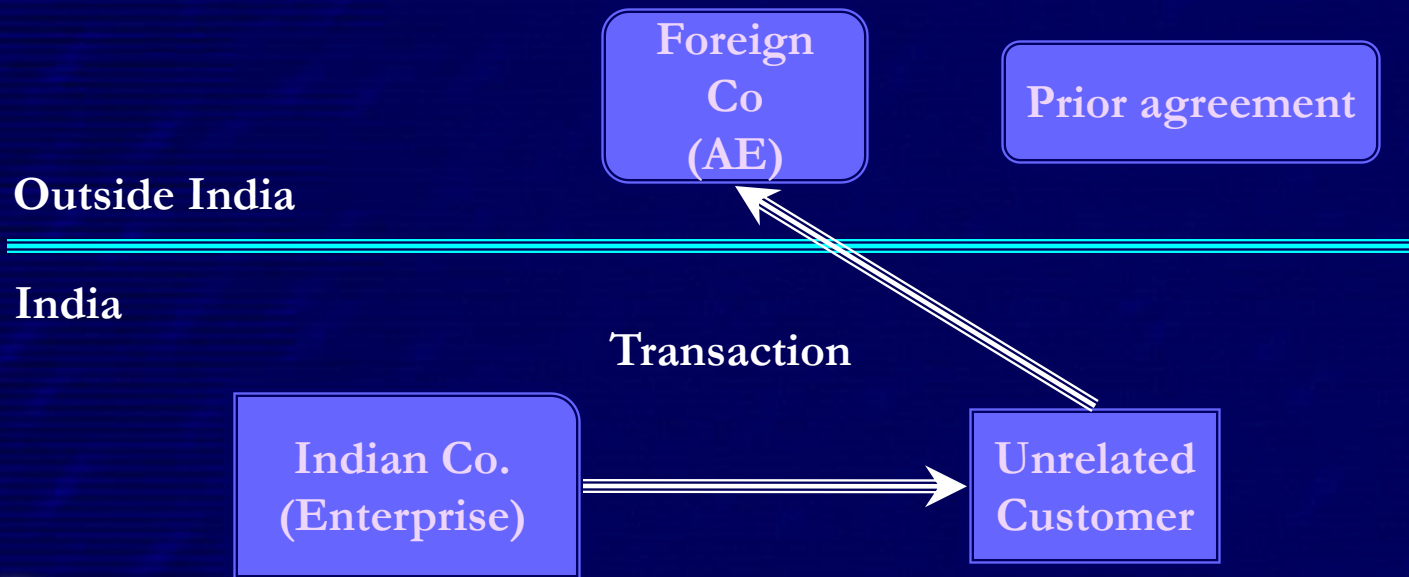


Definition of Deemed International Transaction (Amendments by Finance Act, 2014)

- ◆ The Finance Act 2014, has broadened the scope of international transaction. Further, the amendment is effective from 1 April 2015
- ◆ Where a transaction is entered into by an enterprise with a person other than an AE and
 - ◆ There exists a prior agreement in relation to the relevant transaction between such other person and the AE or,
 - ◆ Terms of the relevant transaction are determined in substance between such other person and the AE, and
 - ◆ Either the enterprise or the AE or both of them are non-resident *whether or not such other person is a non-resident*
 - ◆ Such transaction *will be deemed to be an international transaction*



Definition of Deemed International Transaction



Deemed International Transaction



Definition of Deemed International Transaction

- ◆ The Hyderabad Tribunal in the case of Swarnandhra IJMII Integrated Township Development Co. P. Ltd vs. DCIT [2013-TII-152-ITAT-HYD-TP] held that deeming fiction does not cover transactions between two Indian entities
- ◆ Similar position taken in Kodak India Pvt Ltd (155 TTJ 69) (Mum ITAT) and Vodafone India Services Pvt Ltd (Bom HC) (262 CTR 153)



Specified Domestic Transactions

- ◆ The Finance Act, 2012 has introduced TPR for specified domestic transactions under section 92BA

- ◆ Specified Domestic Transactions to include :
 - ◆ Expenditure in relation to which payment has been made to related party as specified in section 40A(2)(b)
 - ◆ Transfer of goods or services between two units, undertakings or companies which are related and one of them is eligible to avail deduction under Chapter VI-A, 80IA
 - ◆ Any transaction in Chapter VI-A or section 10AA to which the transfer pricing clause under section 80IA are specifically made applicable
 - ◆ Any other transaction as may be prescribed



Applicability to SDT w.e.f. AY 2013-14

- ◆ To file Form No. 3CEB in respect of Specified Domestic Transactions entered into with their related parties
- ◆ Minimum Threshold: INR 200 millions w.e.f. AY 16-17
- ◆ May amount to double taxation in certain cases
- ◆ All existing TP compliance requirements, mandatory documentation, TP audits (assessments) and penalty provisions will be applicable

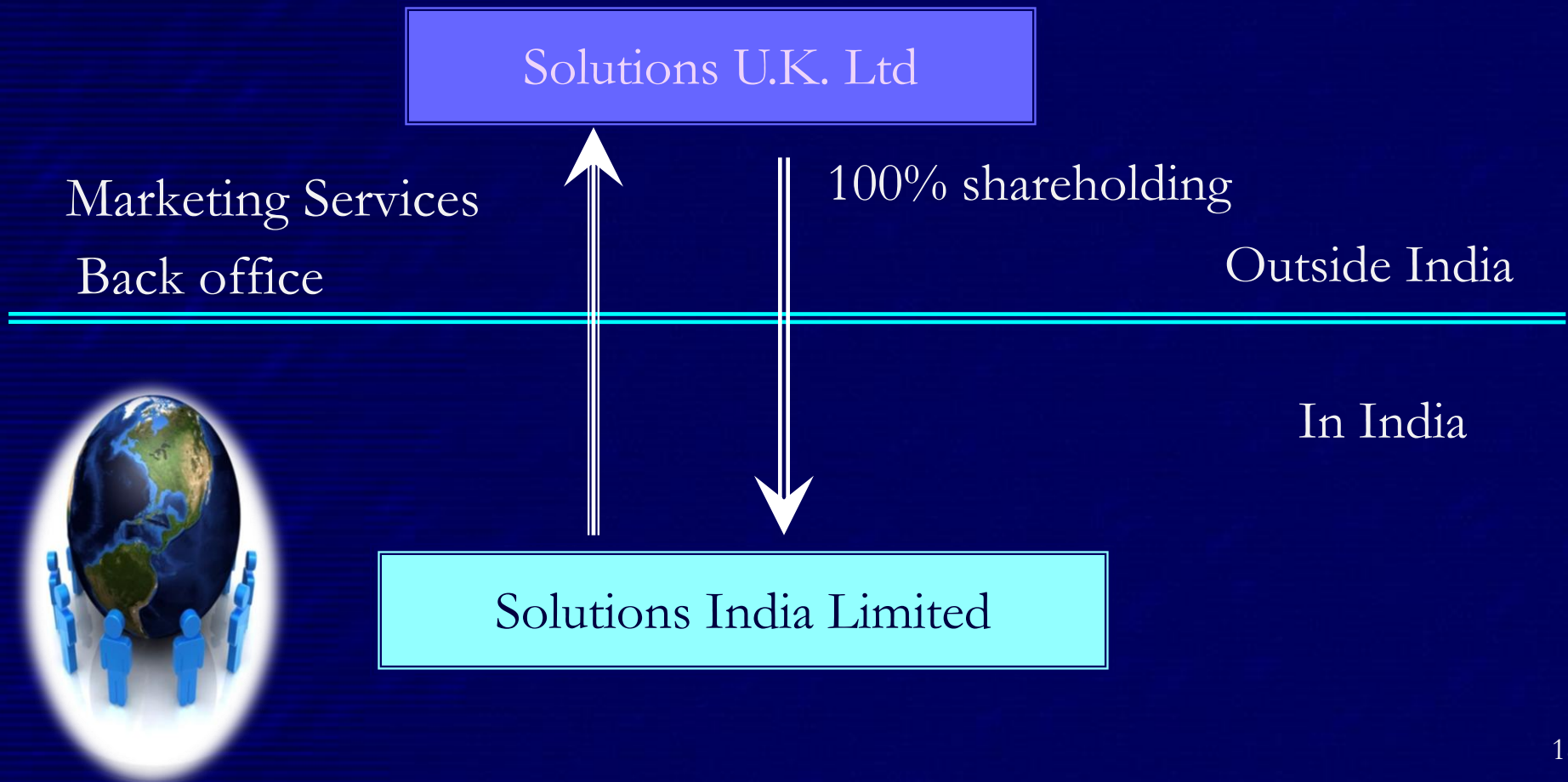


CASE STUDY



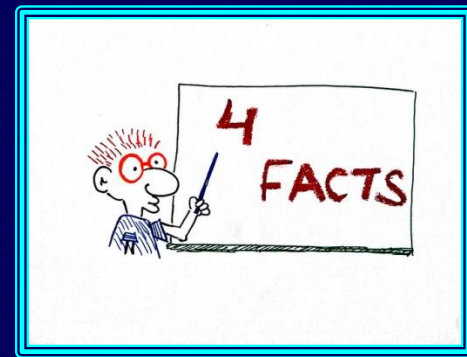
Identification of International Transactions

SERVICES PROVIDED

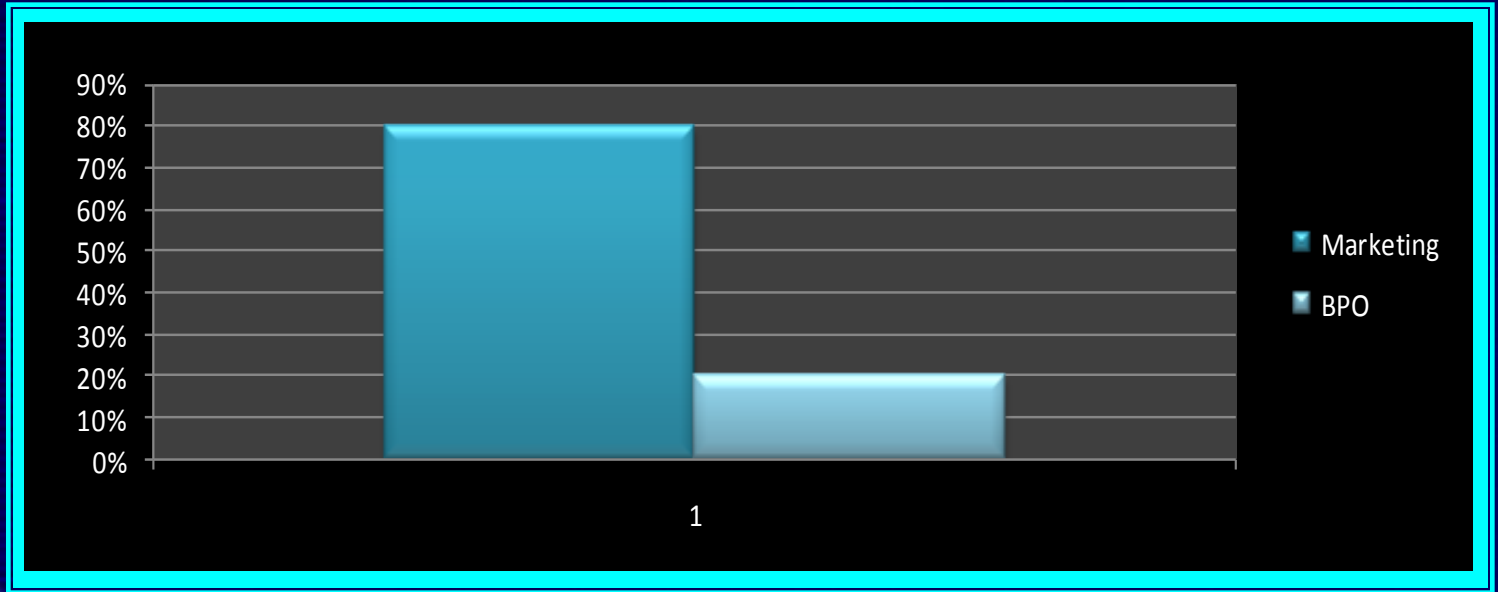


Facts of the Case.....

- ◆ Marketing Services
- ◆ Networking
- ◆ Profiling Demand and Supply needs
- ◆ Back Office Processing

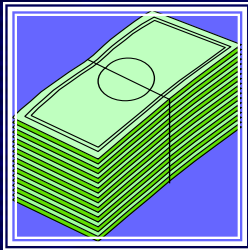


Facts of the Case.....



Financials

Solutions India Limited



<i>(figures in crore)</i>	<i>Column</i>
Particulars	
Income	
Fees	100
Expenditure	
Salaries & Wages	30
Communication Cost	15
Administration & other cost	25
Selling & Distribution	5
Depreciation	10
EBIT	15

Which Way Forward....?

Slicing Based
On "Functions"



Which Way Forward....?

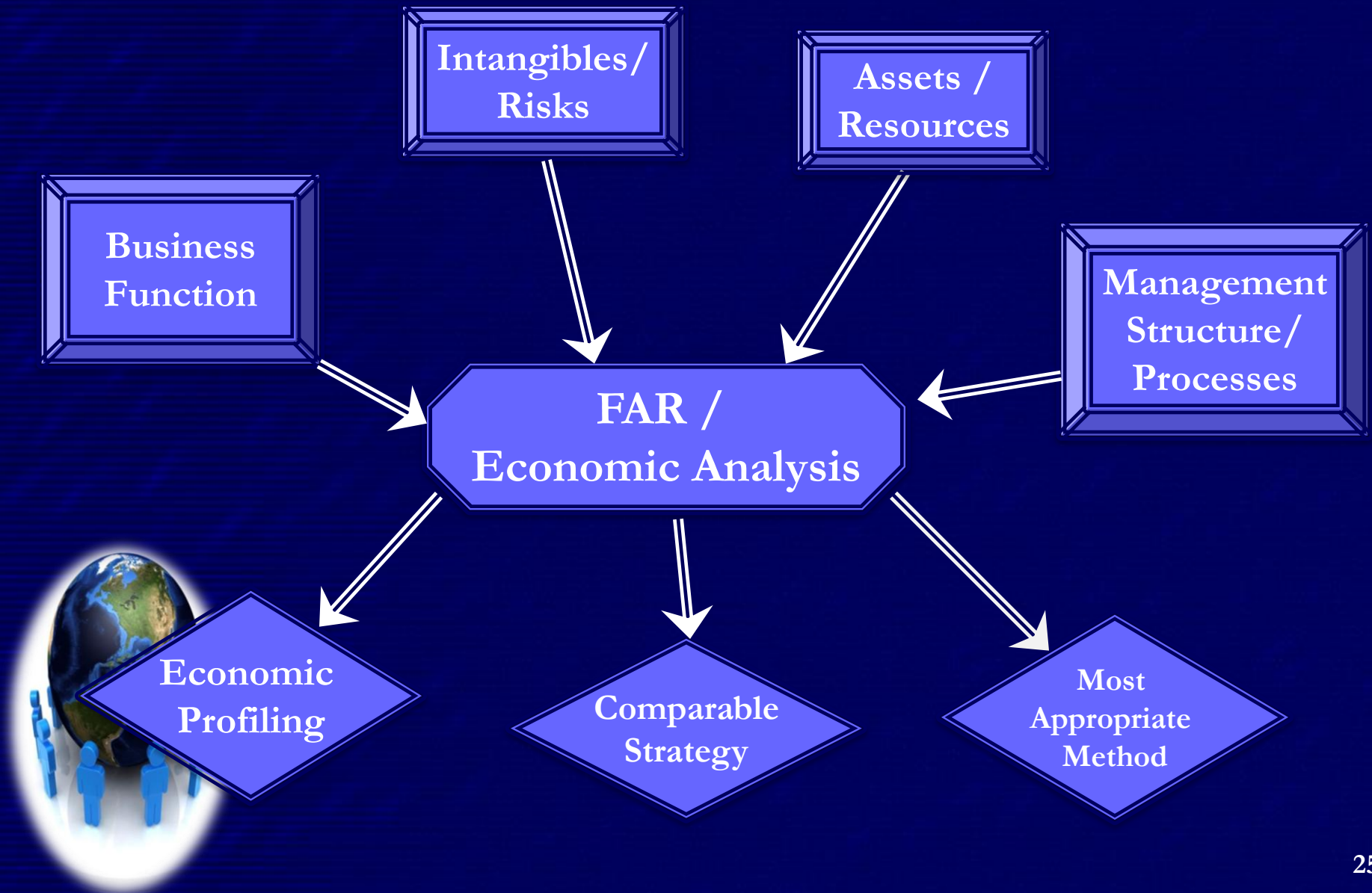
Understanding the Business Model of the Company



Profit & Loss Account

Column1	Column2	(Rs.in crore	Column
Particulars	Total	Marketing Services	Back Office
Income			
Fees	100	77	23
Expenditure			
Salaries & Wages	30	25	5
Communication Cost	15	14	1
Administration & other cost	25	23	2
Selling & Distribution	5	0	5
Depreciation	10	8	2
EBIT	15	7	8

Importance of Economic Analysis



FAR Analysis

◆ Functions performed

- Sales team
- Networking
- Identification of Customers
- Coordination for dispatch
- Back Office Processing

◆ Assets used

- Employee skills
- Intangibles – In-house processes
- Property, Plant & Equipment

◆ Risks assumed

- Service standard Quality Risk
- Other collateral risks
- Other entrepreneurial risks assumed by parent



Search for Comparables

◆ Steps for Comparison

- Service Sector
- Courier Company
- Administrative Services
- Low end service provider
- Identifying comparables in Back office processing
- Use of appropriate search criterion
- Rejection on qualitative basis



TNMM

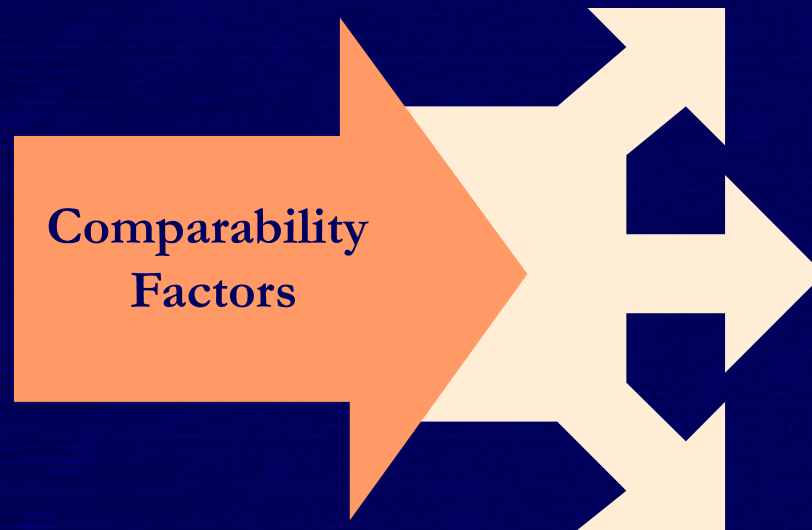
◆ Determine arm's length price by comparing financial results of tested party and selected uncontrolled comparable instances

◆ Apply Profit Level Indicators (PLIs)



TNMM

Cost
Structures



Resources

Risks



TNMM

TNMM – For Marketing Services

Profit level Indicator: Operating Margin (OM)

$$OM = \frac{EBIT}{\text{Total Cost}}$$

“Compare OM of Solutions India Limited with that of Independent Marketing Services Companies”



TNMM

- ◆ TNMM – For Services (Outsourcing)
- ◆ Profit level Indicator: Operating Margin (OM)

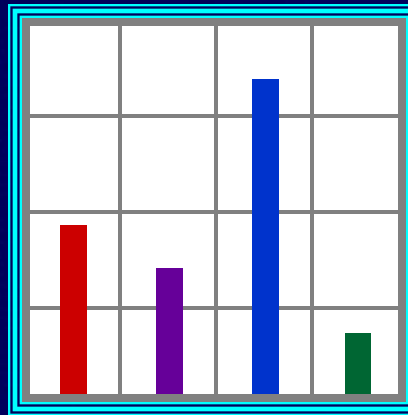
$$\text{◆ OM} = \text{EBIT} / \text{Total Cost}$$

- ◆ “Compare OM of Solutions India Limited with that of Independent Companies”



To Sum up

- ◆ Marketing and BPO Services
 - TNMM with OM as PLI



Functions, Assets and Risks

Comparability

Search Process

Arm's Length Price

Total Income



Documentation & FAR Analysis – Why take the trouble?

- ◆ To comply with law - i.e. legislation
- ◆ To be prepared for a Transfer Pricing audit
- ◆ As a contemporaneous record
- ◆ To justify the rationale of economic adjustments, if any
- ◆ To show that you did adopt arm's length principle
 - Split of remuneration between the taxpayer and the AEs
- ◆ To avoid / minimise penalties



Comparability Analysis



Comparability Analysis

- ◆ Arm's length principle is generally based on comparison of the conditions in controlled transaction with the conditions in transaction between independent enterprises
- ◆ For comparison, *economically relevant characteristics of the situations being compared must be sufficiently comparable*
- ◆ In case of material differences, appropriate adjustments to be made to establish arm's length conditions.
- ◆ For making adjustments, it is necessary to compare attributes of the transactions or enterprises that would affect conditions in arm's length dealings



Comparability Analysis is the Heart of transfer pricing analysis

Factors Determining Comparability

Rule 10B(2) of Rules recognise FIVE KEY FACTORS –

- ◆ Characteristics of Property or services
- ◆ Functional Analysis
- ◆ Contractual Terms
- ◆ Economic Circumstances
- ◆ Business Strategies



Most Appropriate Method (MAM)

◆ Selection of the MAM from the six specified methods; having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe;

- a) Comparable Uncontrolled Price Method (CUP)
- b) Resale Price Method (RPM)
- c) Cost Plus Method (CPM)
- d) Profit Split Method (PSM)
- e) Transaction Net Margin Method (TNNM)
- f) Rule 10AB - Any other method prescribed by CBDT



Transfer Pricing Methods

- ◆ Section 92C of Indian TPR does not prescribe preference for any particular method

- ◆ However, Tribunals in the following cases have laid down preference on traditional methods over transactional profit methods
 - a) *ACIT v MSS India (P.) Ltd.* [Pune ITAT - 32 SOT 132]
 - b) *Serdia Pharmaceuticals Pvt. Ltd. v ACIT* [Mumbai ITAT - 44 SOT 391]
 - c) *ACIT v Sonata Software Ltd.* [2012-TII-118-ITAT-MUM-TP]
 - d) *M/s. Twilight Jewellery Pvt. Ltd v DCIT* [2013-TII-202-ITAT-MUM]



Documentation....Seven steps Approach

- ◆ Understanding the Business Model of the Corporate
- ◆ Analyzing the Transaction(s)
- ◆ Functional & Economic analysis
- ◆ Assessment of comparables
- ◆ Selection and application of methodology
- ◆ Benchmarking the transaction
- ◆ Reviewing the process



Documentation Requirements - Rule 10D(1)

This is the mandatory documentation required by law

- a. Description of Ownership Structure (Step I)
- b. Profile of Multinational Group (Step I)
- c. Description of Business (Step I)
- d. Nature & Terms of Transactions (Step II)
- e. Description of Functions, Risks & Assets (Step III)
- f. Record of Economic & Market Analyses, if any (Step III & IV)



Documentation Requirements.....

- g. Comparability Analysis (Step IV)
- h. Record of Uncontrolled Transactions (Step VI)
- i. Description of Methods considered (Step V)
- j. Record of Actual working (Step VI)
- k. Assumptions, policies, price negotiations, if any (Step II & III)
- l. Any other information, data or document (Company specific information, if any)



Overview of Indian Databases

◆ Prowess

- ◆ A database of large and medium sized companies in India
- ◆ More than 27,500 Indian companies (Listed & Unlisted)
- ◆ Developed by Centre for Monitoring Indian Economy (CMIE)
- ◆ A highly reliable database built by researchers at CMIE under a rigorous system of normalisation and validation

◆ Ace TP

- ◆ More than 38,000 Indian companies (Listed & Unlisted)
- ◆ Developed by Accord Fintech Pvt. Ltd.
- ◆ Historical data of over 15 years
- ◆ More than 25,000 products/services
- ◆ 1,750 unique financial data field
- ◆ Financials as reported by the company with Annual Report link facility

Transfer Pricing Adjustment

- ◆ Absence of arm's length price in international transaction, or failure to maintain the prescribed documentation, or use of unreliable data can lead to adjustment
- ◆ Arithmetic mean vs. Range of results
- ◆ Tax exemption will not be available for the amount of adjustment (10A, 10AA, 10B, Chapter VI A)



Transfer Pricing Assessments

- ◆ The revenue authorities across the globe in their wanting to safeguard their country's tax base, require strict compliance from the taxpayers to the TP rules and regulations



Advance Pricing Agreements (APA)

- ◆ The Finance Act, 2012 introduced ‘APA Mechanism’
- ◆ Salient Features –
 - ◆ Seeks to provide assurance of certainty and unanimity in transfer pricing approach followed by the tax authorities and taxpayers
 - ◆ Validity: Upto subsequent five years and four previous years as well (rollback brought by Finance Act 2014)
 - ◆ Binding on tax authorities as well as taxpayers unless there is a change in the law or facts of the case
 - ◆ Pre – Consultation process (with anonymous application option)



APA...

- ◆ Following are important points to be considered:
 - ◆ Each year Annual Compliance Report in Form No. 3CEF needs to be filed before DGIT (IT)
 - ◆ The APA can be cancelled/revised if critical assumptions are violated or conditions are not met, subject to which the agreement has been entered into
 - ◆ If the Compliance Audit results in a finding that the assessee has failed to comply with the terms of the agreement, the agreement can be cancelled
 - ◆ Non filing of Compliance Report or the report contains material errors, it may result in cancellation of the agreement



According to industry sources, approximately 700 APA applications have been filed, out of which CBDT has already signed 103 (99 unilateral and 4 bilateral)

Safe Harbour Rules

- ◆ Safe Harbour provisions were introduced in the Finance Act, 2009 in order to reduce transfer pricing disputes, however, no rules were prescribed to the effect
- ◆ CBDT released final Safe Harbour Rules on 18th September 2013, as regards various financial parameters for the prescribed sectors/activities performed by an eligible assessee



Summary of Safe Harbour Rules

Eligible international transaction	Safe Harbour Rules	
	Threshold limit prescribed	Safe Harbour margin
Provision of software development services (other than contract R&D) and information technology enabled services	INR 500 crores or less	20 percent or more of Operating Costs
	Above INR 500 crores	22 percent or more of Operating Costs
Provision of knowledge process outsourcing services	None	25 percent or more of Operating Costs
Interest on advancing of intra-group loans	Loan amount INR 50 crores or less	SBI base rate + 150 basis points
	Loan amount more than INR 50 crores	SBI base rate + 300 basis points
Providing corporate guarantee (other than comfort letter, performance guarantee, etc.)	INR 100 crores or less	2 percent p.a. or more
	Above INR 100 crores*	1.75 percent p.a. or more

*Credit rating done by an agency registered with SEBI, is of the adequate to highest safety

Summary of Safe Harbour Rules

Eligible international transaction	Safe Harbour Rules
Provision of contract research and development services wholly or partly relating to software development	30 percent or more of Operating Costs
Provision of contract research and development services wholly or partly relating to generic pharmaceutical drugs	29 percent or more of Operating Costs
Manufacture and export of core auto components	12 percent or more of Operating Costs
Manufacture and export of non-core auto components	8.5 percent or more of Operating Costs

Summary of Safe Harbour Rules

◆ Procedural Aspects

- ◆ Eligible taxpayers must furnish a self-attested form i.e. Form No. 3CEFA, containing various details of the eligible transactions on or before the due date for filing the income tax return
- ◆ The Assessing Officer may make a reference to the Transfer Pricing Officer to verify the validity of option exercised by the taxpayer
- ◆ Various other procedural aspects have been provided by the relevant Rules



Multiple Year Data

- ◆ Use of multiple year data (current year and preceding two financial years) is permissible only in case of specified methods of determining ALP. In such cases, the weighted average price of the comparable entities has to be computed in a specified manner and shall be used to benchmark the transactions entered into by the taxpayer
- ◆ In cases where the list consists of less than six data sets, the arithmetical mean of such weighted average will be regarded as ALP
- ◆ It is expected that the use of multiple year data would even-out the variations in the analysis of the transactions
- ◆ The amended Rules are applicable to both international transactions as well as specified domestic transactions from FY 2014-15, i.e. AY 2015-16



Range Concept

- ◆ Under the range concept, if the price at which the transaction has been undertaken is within the range, such price shall be deemed to be ALP and no adjustment will be made
- ◆ The range concept will be applicable only in case of CUP, CPM, RPM and TNMM methods of determining ALP and where there exist six or more entities
- ◆ The range will begin with the 35th percentile and end with the 65th percentile of the list of entities
- ◆ When the price at which the transaction has been entered into does not fall within the range, the median of the list will be taken as ALP, for computation of adjustment



Range v Mean

- ❖ However proviso to section 92C require computation of arithmetic mean (AM) if more than one price is determined by MAM
- ❖ The second proviso to Section 92C says that there will be no adjustment if variation between AM and international transaction or specified domestic transaction does not exceed; 1% for wholesale traders, and; 3% in all other cases



Can business transaction be conducted at a single utopian mean price?

1%/3% arm's length range retained “Wholesale Trading” defined

- ◇ The CBDT via Notification No. 86/ 2015/F. dated 29.10.2015 (AY 2015-16); Notification No. 57/2016, dated 14.07.2016 (AY 2016-17):
 - ◇ retained transfer pricing variation range, i.e.
 - ◇ 1% in case of wholesale trading and
 - ◇ 3% in other cases;
 - ◇ Defined the term ‘wholesale trading’ i.e.
 - ◇ Purchase cost of finished goods is eighty percent or more of the total cost pertaining to such trading activities; and,
 - ◇ Average monthly closing inventory of such goods is ten percent or less of sales pertaining to such trading activities



1. Whether ‘Purchase cost’ shall mean price paid or it shall also include other incidental charges like custom duty or freight inwards etc.?

2. Whether ‘Total cost pertaining to such trading activities’ shall only be a sum of all operating costs or it shall also include financial costs pertaining to trading activity?

Range – An illustration

Scenario 1 – Benchmarking sale of goods

Three-year weighted average margin of comparable companies	1	2	3	4	5	6	7	8	9
	10	15	16	-4	5	25	30	6	13
Ascending Order	-4	5	6	10	13	15	16	25	30
Arithmetic mean	12.89%								
Range 35 th to 65 th percentile	10% to 15% (calculated)								

Scenario 2 – Benchmarking sale of goods

Three-year weighted average margin of comparable companies	1	2	3	4	5	6	7	8	9
	10	15	16	-4	5	40	30	6	13
Ascending Order	-4	5	6	10	13	15	16	30	40
Arithmetic mean	14.56%								
Range 35 th to 65 th percentile	10% to 15% (calculated)								

Range – An illustration

	Presumed Margin of assessee	+/- 3%	Arithmetic Mean	Range	Whether at AL under old law	Whether at AL under new law
Scenario 1	9.75	13.04	12.89%	10-15%	Yes	No
Scenario 2	10.50	13.82	14.56%	10-15%	No	Yes

- ◆ Arithmetic mean deviated from 12.89% to 14.56% when a smaller data point (i.e. 25) was replaced with a higher data point (i.e. 40), whereas the range remained static at 10% to 15% under both the scenarios.
- ◆ This illustrates that the arithmetic mean reacted to the extreme values, whereas the range remained indifferent.
- ◆ As a result, compared with the arithmetic mean, one advantage of the range is that it indicates the spread or concentration from the middle of the distribution, ignoring the extremes of the distribution.



Emerging international tax issues and effect on tax policies

- ◆ Increasing concern for both developed and developing countries on 'base erosion and profit shifting (BEPS)', double non-taxation
- ◆ Impact of BEPS report and other changes on existing structures and proposed commercial transactions
- ◆ In the 2016 Budget, GOI has proposed introducing rules in relation to CbC reporting and the master file requirement that are in line with BEPS Action 13 (rules have yet not been prescribed)



Action 13 – TP Documentation and CbC Reporting

Three Tier documentation structure proposed for all countries

Template for master file – To provide the MNE’s blueprint	The group’s organisation structure
	A description of the group’s business, intangibles, intercompany financial activities and financial and tax positions
Template for local file – To provide material transfer pricing positions of the local entity/ taxpayer with its foreign affiliates	Demonstrates arm’s length nature of transactions
	Contains the comparable analysis
Country-by-Country (CbC) Report	Jurisdiction-wise information on global allocation of income, taxes paid/ accrued, the stated capital, accumulated earnings, number of employees and tangible assets
	Entity-wise details of main business activities which will portray the value chain of inter-company transactions

Country-by-Country Reporting...

- ◆ Introduction of section 286 - Additional reporting requirement with regards to furnishing of report in respect of international group with
- ◆ Section 92D of the Act has been amended to require a constituent entity of an international group to keep and maintain such information and documents in respect of an international group as may be prescribed
- ◆ The CbC Reporting will be applicable only for taxpayers having an annual consolidated group turnover of over INR 53,950 for FY 2015-16; applicable from financial year 2016-17



THANK YOU

Vispi T. Patel

Vispi T. Patel & Associates

Chartered Accountants

Contact no : +91 22 2288 1091/1092

+91 -98 6763 5555

Email id : vispitpatel@vispitpatel.com

