Transfer Pricing Audit – Documentation and Benchmarking

BCA

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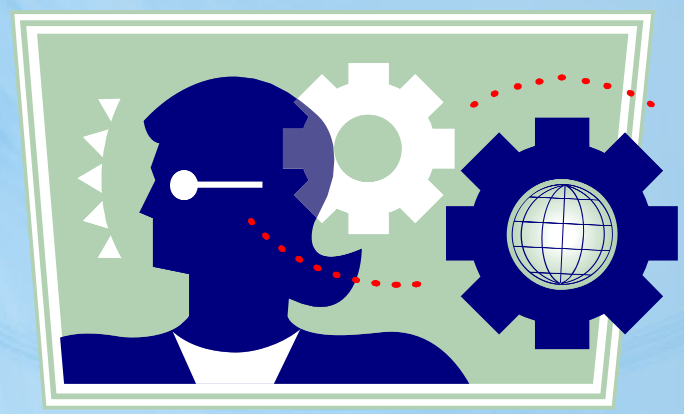
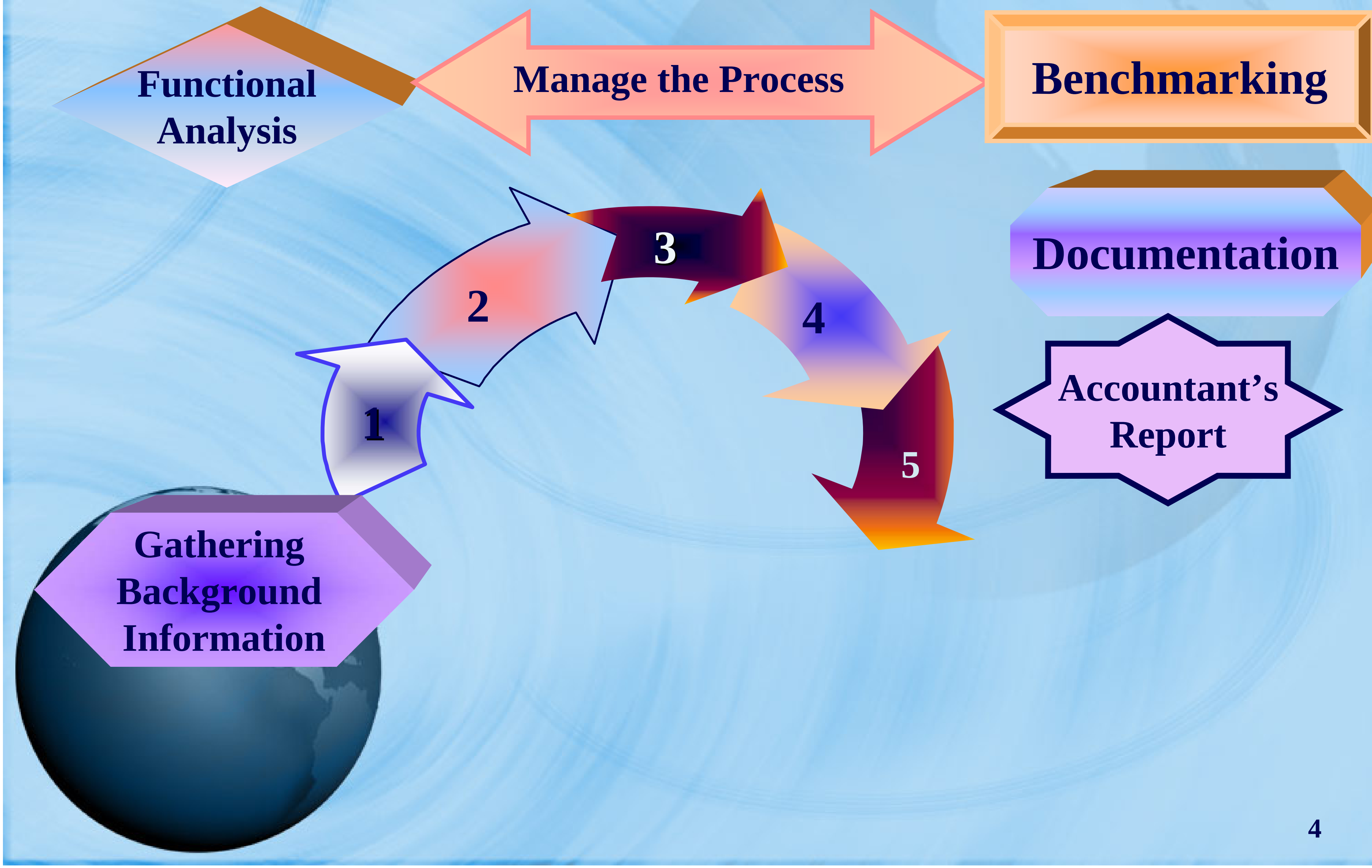
Presentation Overview

- Transfer Pricing Process
- Documentation
- Benchmarking
- Ratio of judicial pronouncements
- Case studies
- Recent developments

Transfer Pricing Process



Transfer Pricing Process



Documentation requirements and its interplay with benchmarking analysis

Factual and Functional Analysis
- Group Structure
- Industry analysis
- Business Model
- International transactions
- Functional analysis

Economic Analysis
- Characterization of the entity and international transactions
- Selection of most appropriate method
- Selection of PLI
- Comparable Search / analysis

Implementation
- Adoption of Pricing methodology or
- Justification of ALP of international transactions

Benchmarking

Implementation

DOCUMENTATION

Documentation

Documentation Requirements

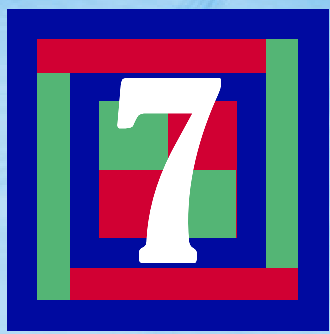
Characterization of Transacting entities & international transaction

Selection of the Most Appropriate Method

Functional Analysis

Economic Analysis, Industry Analysis & Comparability Analysis (Benchmarking)

Documentation under Indian TPR



- **Seven Steps**
  - **Shareholding structure**
  - **Understanding the Business Model**
  - **Description of International Transaction(s)**
  - **Functional analysis**
  - **Search & Assessment of comparables**
  - **Selection and application of methodology**
  - **Benchmarking**

Documentation Requirements to be verified --- Rule 10D(1)

- **This is the mandatory documentation required by law**
  - **Description of Ownership Structure (Step I)**
  - **Profile of Multinational Group (Step II)**
  - **Description of Business (Step II)**
  - **Nature & Terms of International Transactions (Step III)**
  - **Description of Functions, Risks & Assets (Step IV)**

Documentation Requirements to be verified --- Rule 10D(1)

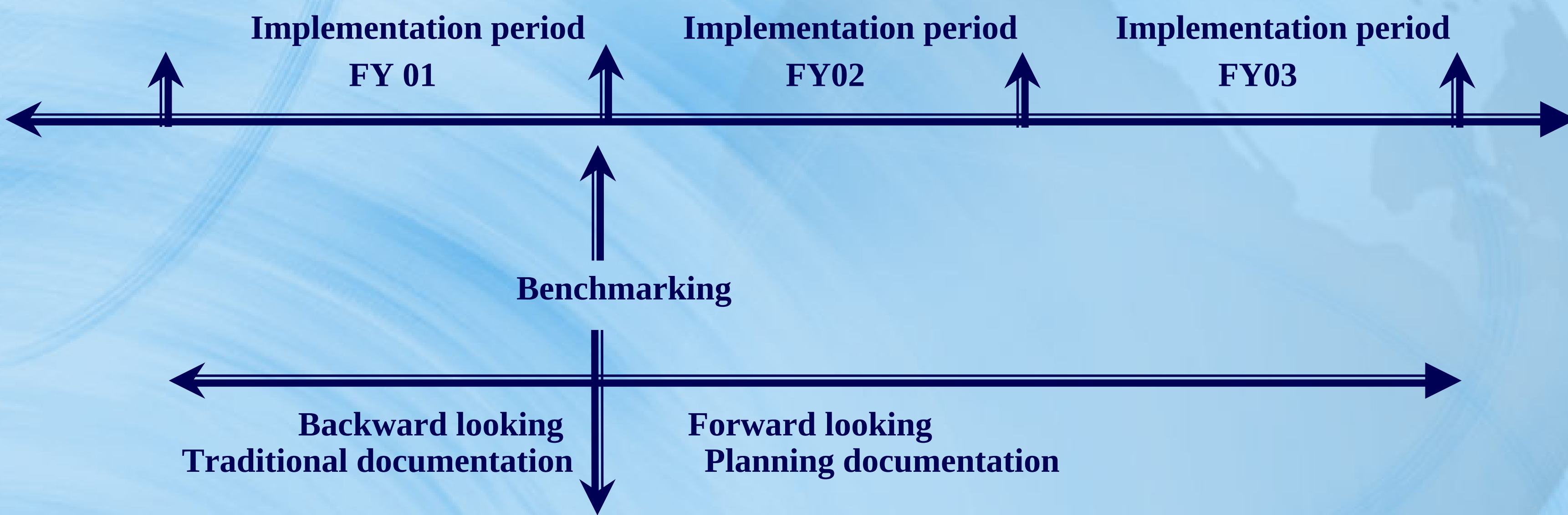
- Record of Economic & Market Analyses, if any (Step III & IV)
- Record of Uncontrolled Transactions & Comparability analysis (Step V)
- Description of Methods considered (Step VI)
- Record of Actual working (Step VII)
- Assumptions, policies, Price negotiations, if any. (Step II & IV)
- Any other information, data or document (Company Specific information, if any)

Benchmarking

Benchmarking Concepts

- **Benchmarking Methodology**
  - **Methodology for comparing international transaction of a tested party to that of comparable transaction**
- **Methods – CUP, RPM, CPM, PSM, TNMM**
- **Choice of benchmarking methodology**
- **Depends on availability of data**
- **Depends on comparability of data**
- **Depends on reliability of data**
- **Depends on adjustability of data**

Application of Benchmarking Analysis



Benchmarking analysis can be used as a tool both for justification of historical transactions as well as setting price in a forward looking transaction

Ratio of judicial pronouncements

Ratio of judicial pronouncement

- **Analysis of tested party's accounts – whether accounts are to be split vis-à-vis international transactions or profits of entity as a whole to be analyzed**

  - **<u>Judicial pronouncements</u>**

    – **Maintenance of split financials warranted for justification of functionally different activities - use of whole entity approach not appropriate (Manufacturing and trading can't be aggregated for benchmarking purposes – UCB India)**

    – **ALP of each class of international transactions to be considered separately unless the different classes of transactions are interlinked and cannot be evaluated separately (Development Consultants and Star India)**

Ratio of judicial pronouncement

- **Documentation to be maintained for justifying arm's length price**
  - **<u>Judicial pronouncements</u>**

UCB India

-- Documentation maintained to be the extent relevant – Sufficient compliance with Rule 10D.

--Documentation mentioned in all clauses of Rule 10D need not be maintained if not relevant

--What needs to be seen is the substantial compliance by the taxpayer with regard to maintenance of documents (UCB India)

Ratio of judicial pronouncement…..

- **Cargill India**
  - **Documents and information to be kept and maintained as per Rule 10D:**
  - **Voluminous, and all the sub-clauses attracted very rarely**
  - **Taxpayer and tax authorities are required to consider only relevant information and documents needed for determining ALP**
  - **Not possible to casually ask for information under all the clauses**

Ratio of judicial pronouncement

- **Benchmarking**
  - **Judicial pronouncements – Functional Analysis**
    - Functional analysis of potential comparable companies should be taken into consideration and compared with that of the tested party (Aztec India, E-gain Communication, Skoda, UCB India)
    - In case of differences in the functional profiling of the comparable companies vis-à-vis the tested party adjustments should be made to the comparable companies (E-Gain, Sony India, Skoda Auto)

Ratio of judicial pronouncement

- **Selection of the tested party is important for the purpose of determining of the Most Appropriate Method. The selection of the tested party depends on the following:**
  - **Least complex of the entities i.e. entity performing simpler functions, assuming lesser risks, owning routine assets; and**
  - **Comparable data with regard to the entity is easily available (Development Consultants)**
  - **Foreign entity can be selected as the tested party if it’s the least complex entity;**
  - **However comparable data in this regard need to be provided by the taxpayer (Ranbaxy India)**

Ratio of judicial pronouncement

- **Benchmarking**
  - **<u>Judicial pronouncements – Selection of Method</u>**
    - **It is imperative for the department to reject the taxpayer's analysis vis-à-vis the selection of the most appropriate method, before selecting any other method as the most appropriate method (MSS India)**

Ratio of judicial pronouncement

✵ Application of CUP Method

- ✵ While comparing tested party’s prices with comparable prices, regard must be had to other broader business functions as well . (Price of branded product cannot be compared with the price of an unbranded product, if the difference is irreconcilable - UCB India)
- ✵ Adequate Documentation needs to be maintained for justifying rejection of CUP
  - ✓ Quality and quantity difference;
  - ✓ Difference in geographical market;
  - ✓ End user difference;
  - ✓ Timing difference;
  - ✓ Difference in the level of market vis-à-vis utilization (trader v manufacturer) etc.

Ratio of judicial pronouncement

- Benchmarking
  - <u>Judicial pronouncements – Selection of Method</u>
    - MSS India
    - Transaction based methods are to be preferred over profit based methods (The aforesaid observation is not in consonance with Indian TPR which does not provide any hierarchy amongst the methods)
      - Loss incurred by taxpayer does not lead to foregone conclusion that the taxpayer's international transactions are not at arm's length.
        - ✓ However, the taxpayer needs to demonstrate the reasons for the loss and will be required to justify based on documentation in this regard.
        - ✓ Status of the company vis-à-vis industry performance / economic slowdown;
        - ✓ Business strategy – market penetration, diversification etc.;
        - ✓ Start-up phase;
        - ✓ Capacity utilization;
        - ✓ Management inefficiency ????
        - ✓ Government Policy

Case Studies

Case study – 1 (System Sale)

- **Facts of the case**
  - **Company A engaged in selling of a product which comprises of two separate components Component X and Component Y;**
  - **With a view to sustain the competition, Company A has to sell Component Y along with Component X;**
  - **Component X is manufactured by Company A for which raw material is imported from Associated Enterprise;**
  - **Component Y is purchased (in finished form) from Associated Enterprise;**

Case study – 1

- **Company A as a whole**

Company A P&L A/c

Costs	87	100	Receipts from BHUS
Margin	13		

the margin is at AL

- **Segmental Accounts**

Company A (Component X) P&L A/c

Import of raw material	45	80	Sale of Component X
Other manufacturing costs	21		
Margin	14		

the margin is at AL

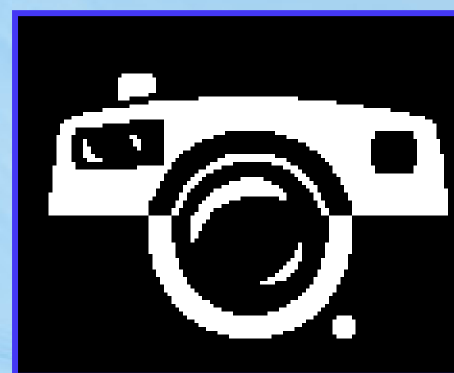
Company A (Component Y) P&L A/c

Import of Component Y	21	20	Sale of component Y
Margin	(1)		

the margin not at AL

Whether an adjustment can be made to profitability from Component Y ?

Recent Developments



Recent Developments – Direct Tax Code

- **Proposed Transfer Pricing Provisions**
  - **The threshold limit for two enterprises to be treated as AEs has been changed**
    - **Direct or indirect participation in share capital or voting power proposed to be reduced to 10% from erstwhile 26%;**
    - **Loan advanced as a % of the book value of the assets of the borrower to other enterprise proposed to be reduced to 26% against erstwhile 51%;**
    - **Appointment of Board of directors of other enterprise or both the enterprises proposed to be reduced to more than one third against erstwhile half**

Recent Developments – Direct Tax Code

- **The Accountant's Report will be required to be filed with the TPO as against with the AO**
  - **DTC it is provided that the TPO will select the transfer pricing cases based on its own and inform the same to the AO**
- **Safe harbor rules proposed to be introduced;**
- **Advance Pricing Agreement proposed to be introduced (5 years validity)**

Recent Developments – Finance Act 2009

Proposed Transfer Pricing Provisions

- Methodology for computation of 5% range amended
  - to be computed on the value of transactions as against on the arithmetic mean of the comparables
  - Has nullified various judicial pronouncements
- Alternate Dispute Resolution Mechanism (ADRM) introduced
  - Faster resolution of transfer pricing dispute and also to foreign companies;
  - Alternate to CIT(A)
  - Direction to be issued by three members committee as against one CIT(A)
  - Direction to be issued within 9 months
  - Binding on the AO; tax payer has a right to prefer appeal to ITAT

Thank You

Questions