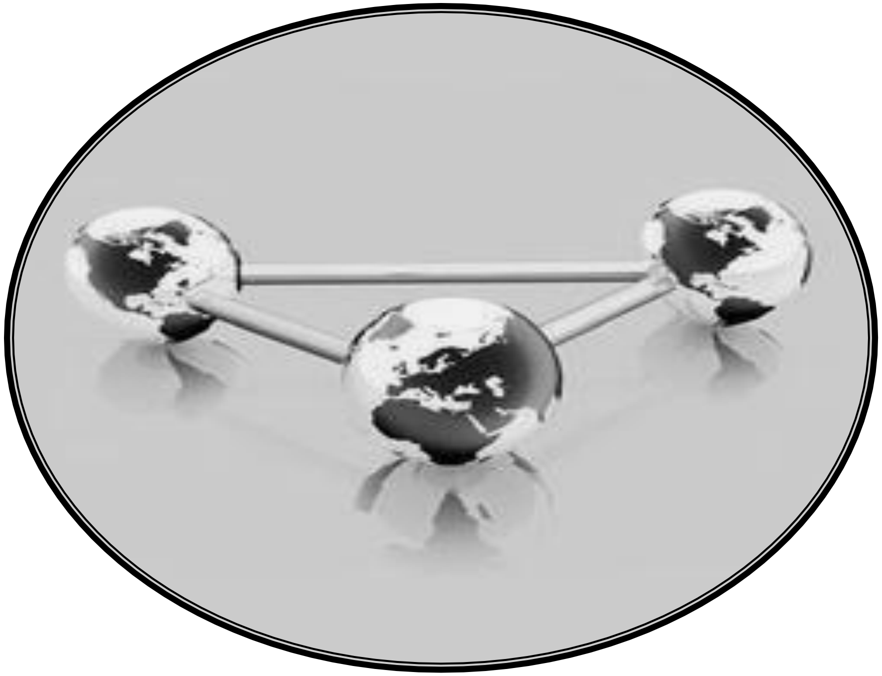


TRANSFER PRICING

By Naresh Rinwa J

Presentation's Bird's Eye View

- Brief History and Introduction
- Scope and Applicability
- International Transaction
- Associated Enterprise
- Arm's Length Price
- Methods of determing ALP
- Documentation
- Assessment Procedure
- Penalties

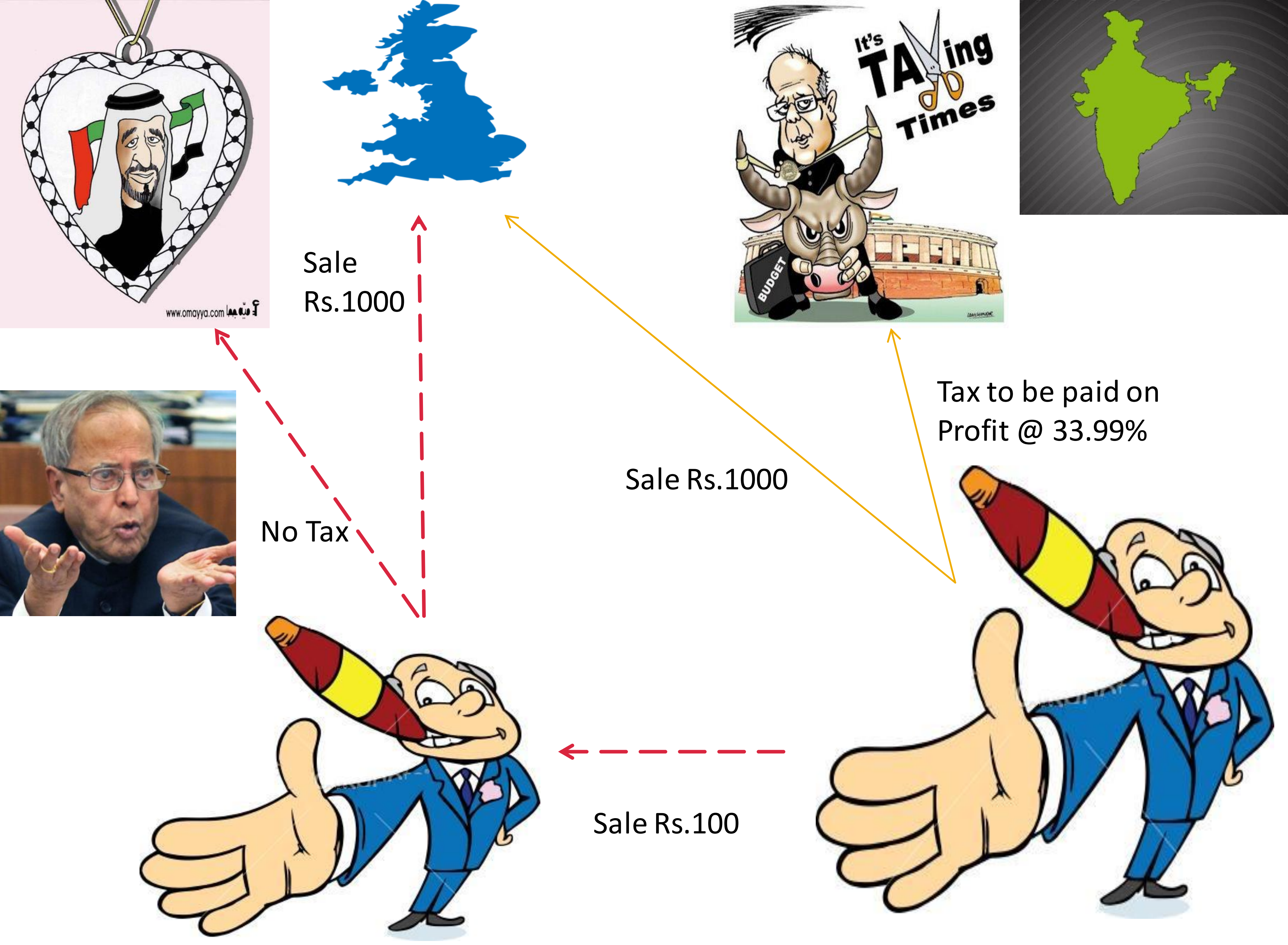

FUTURE
PAST
PRESENT

Why there is a need of Transfer Pricing?

- Transfer Pricing regulations are required since there are:
  - Cross border transactions in the nature of
  - Intra Group transactions and
  - Tax rates in two countries are different and
  - Management of an enterprise is likely to *avoid tax* in a particular country by *manipulating transfer prices.*
- Hence, to prevent such avoidance of tax in India by manipulation of transfer prices, the government has introduced the detailed transfer pricing regulations in India.

Let us understand with example

- Mr. manufactures goods, Total cost is Rs. 500.
- Tax Rate in India – 33.99%
- Tax Rate in UAE – Nil
- Normal Selling Price (Non AE) – Rs. 1000
- Selling Price to Mr. B (AE) – Rs. 100



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BUDGET
Sale
Rs.1000
Sale Rs.1000
Tax to be paid on
Profit @ 33.99%
No Tax
Sale Rs.100

- Impact if there are no Transfer Pricing Regulations in India:

  In respect of sale to Mr. B (AE), taxable income will be Rs. NIL (Since loss of Rs. 400).
  Tax liability = NIL.

- When Transfer Pricing Regulations are applied:

  - ALP = Price charged by A Ltd. to UAE. (Non AE) i.e. Rs.1,000.
  - Taxable income will be Rs. 500 (i.e. Rs. 1,000 – Rs. 500)
  - Tax liability = Rs. 170 [500*33.99%]
  - In absence of TP regulations, tax evasion in India = Rs. 170

They Took Advantage Of Me

Section 92 of the then Income Tax Act which dealt with the provisions of International Taxation were found to have the following flaws:

- Use of the words “Estimation of reasonable profits” – which was general in nature and limited in scope
- Applicable to Residents only (Hence, Branch of foreign company in India were not covered)
- Reference to foreign associate as “Close Connection” which was undefined
- Requires adjustment to profit
- Rules prescribed lacked scientific approach
- Did not apply to transactions which were not part of regular business. (**E.g.:** Royalty)
- Detailed rules were not prescribed for documentation requirement.

The Introduction of Chapter X

1991	Integration of Indian economy with Global economy leading to increased cross border transactions
March 1999	The Standing committee on Finance realized that existing tax provisions (Section 92) may not be effective to curb Transfer Pricing abuse in India
November 1999	Central Board of Direct Taxes ('CBDT') constituted an Expert Group on TP for suggesting necessary amendments in the Act and regulatory framework
January 2001	Expert Group submitted its report to CBDT
February 2001	Finance Ministry introduced **Chapter X** to deal with transfer pricing issue.

What!? Chapter “Axe”???

Principle Of Taxation And Definitions (Relating to TP)

Structure of the Indian TP can be shown as

Coverage	Relevant Section / Rule
Definitions	Section 92A, 92B, 92F and Rule 10A
Methods	Section 92C and Rules 10B and 10C
Documentation	Section 92D and Rule 10D
Accountants report	Section 92E and Rule 10E
Penalties	Section 271AA, 271BA, 271G and explanation 7 to Section 271(1)
Administrative	Section 92C(3) and (4) and 92CA

Whom does Transfer Pricing Regulation apply to?

- Transfer Pricing Regulations ("TPR") are applicable to the all enterprises that enter into an '*International Transaction*' with an '*Associated Enterprise*'. Therefore, generally it applies to all cross border transactions entered into between associated enterprises.

- It even applies to transactions involving a mere book entry having no apparent financial impact. The aim is to arrive at the comparable price as available to any unrelated party in open market conditions and is known as the *Arm's Length Price* ('ALP').

- As per section 92(1) of the Act, it is required that *any income* arising from an *International Transaction* is to be computed having regard to the *Arm's Length Price*

- It is also provided that allowance for expenses should also be determined having regard to the ALP (Eg: Imports from AEs).
- Further, it is provided that cost sharing arrangements between two or more AEs in connection with a benefit, service or facility provided by one or more enterprise is to be determined having regard to the ALP.
- Example: If contribution is made by the Indian subsidiary towards the cost of centralized R & D activity conducted by the US parent company for the benefit of all subsidiaries, then the same needs to be determined having regard to the ALP.

- In a nutshell, it can be said that the TP regulations are applicable when:
  - There are two or more *Associated enterprise*
  - Either or both of whom are *non-residents*; and
  - They enter into an *international transaction*
- TP regulations are also applicable w.e.f 1st April 2013 to Specified Domestic Transactions

Before getting into the concept

- Indian TP regulation has defined certain important terms such as
- International Transaction
- Associated Enterprise
- Arm's Length Price, etc.
- It is important to understand these definitions since the meaning of these terms should be interpreted specifically as per these definitions.

What is an International Transaction?

- An international transaction is essentially a cross border transaction between *Associated Enterprises* in any sort of property, whether tangible or intangible, or in the provision of services, lending of money etc.
- At least one of the parties to the transaction must be a non-resident entering into one or more of the following transactions:
  - Purchase, sale or lease of Tangible or Intangible Property
  - Provision of services
  - Lending or borrowing of money
  - Any transaction having a bearing on profits, income, losses or asset
  - Mutual agreement between AEs for allocation/ apportionment of any cost, contribution or expense.

Deemed International Transactions

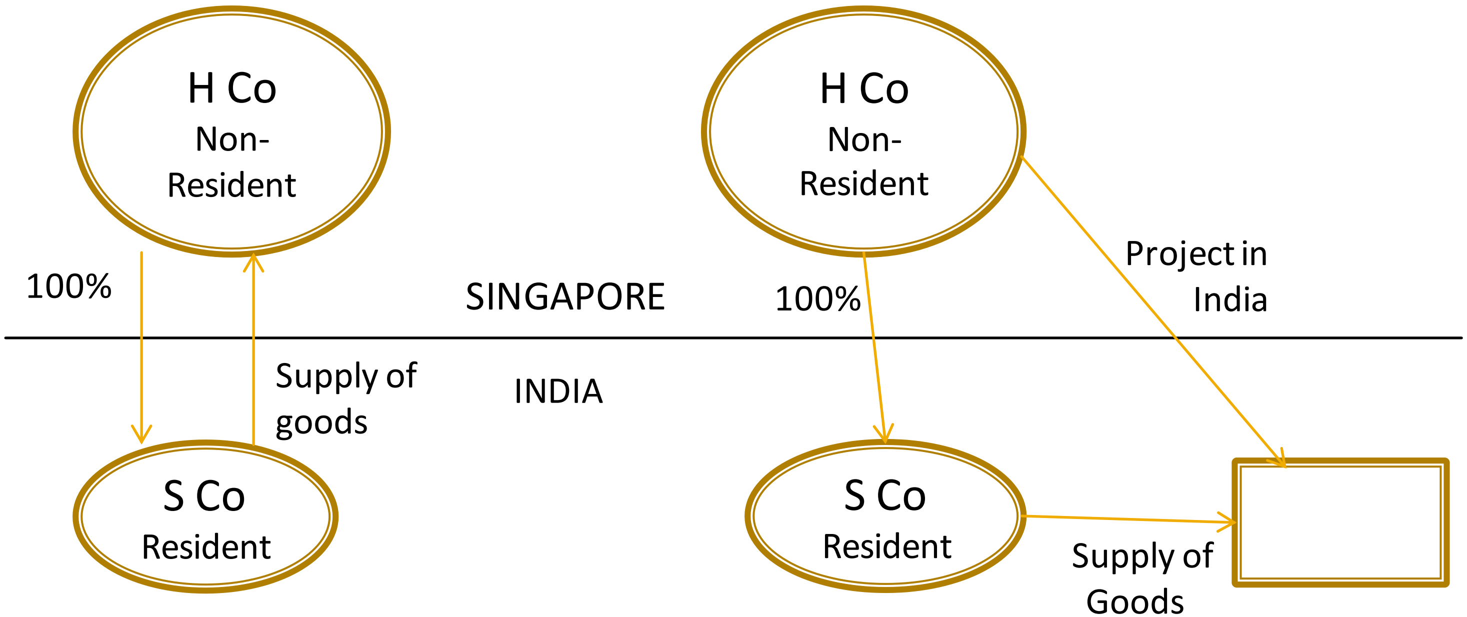
In addition to the above, a transaction entered into by an enterprise with *an independent third party* can also be *deemed* to be an international transaction entered into between two AEs if either of the following condition is satisfied:

- There is a prior agreement in relation to the relevant transaction between such independent third party and the AE; or
- The terms of the relevant transaction are determined in substance between such independent third party and the AE.

Example of Deemed IT:

Where a resident enterprise exports goods to an unrelated person abroad, and there is a separate arrangement or agreement between the unrelated person and an AE which influences the price at which the goods are exported. In such a case the transaction with the unrelated enterprise will also be subject to TPR

International Transaction – Pictorial Representation



Meaning of Enterprise as per Act

- The term 'Enterprise’ has been exhaustively defined in section 92F(iii) of the Act and covers almost every business activity.
- The term 'Enterprise' also includes Permanent Establishment ('PE') of such person.
- The term PE for this purpose is defined to include a fixed place of business through which the business of enterprise is wholly or partly carried on.
- Thus, Indian branch of a foreign bank will be treated as Enterprise (Fixed place PE).

Meaning of Associated Enterprise

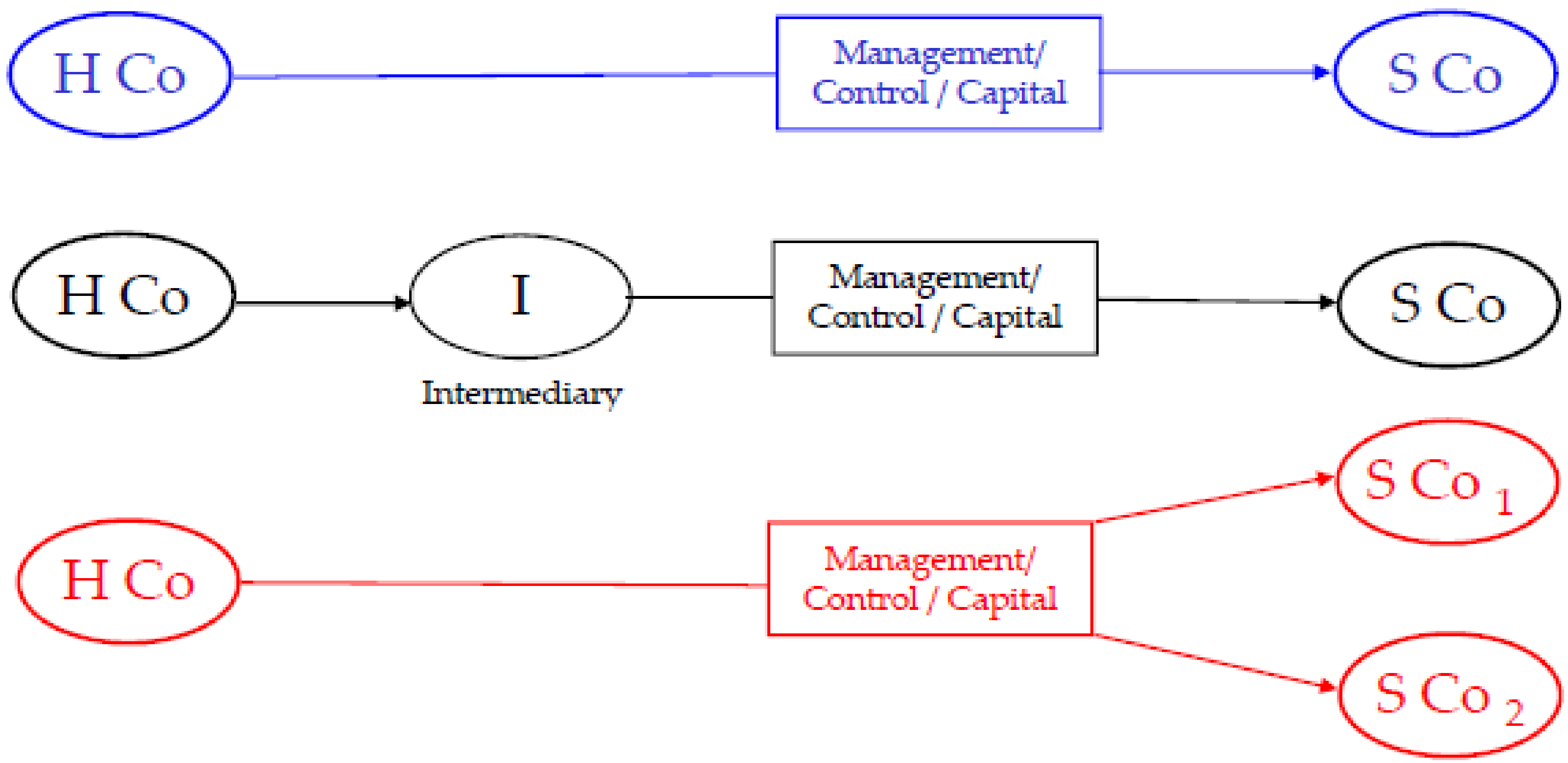
- The basic criteria to determine an AE is the participation in management, control or capital (ownership) of one enterprise by another enterprise. The participation may be direct or indirect or through one or more intermediaries.

- The concept of control adopted in the legislation extends not only to control through holding shares or voting power or the power to appoint the management of an enterprise, but also through debt, blood relationships, and control over various components of the business activity performed by the taxpayer such as control over raw materials, sales and intangibles.

- It appears that one may go to any layer of management, control or ownership in order to find out association, which includes:
  - Direct Control
  - Through Intermediary

AE – Primary Association

For instance, if enterprise S Co is managed, controlled or owned either directly or through an intermediary (I), then Enterprise S Co is said to be an AE of enterprise H Co and vice versa.



AE – Secondary Association

- Direct or indirect voting power of atleast 26%
- Common parent holds voting power of atleast 26% in both
- Loan of 51% or more of value of assets
- Guarantee of 10% or more of total borrowings
- One appoints more than half of directors on board or one executive director of other
- Common parent appoints more than half of directors on board or one executive director in both
- Whole dependence on use of IPR’s of the other
- Buying of bulk raw materials, Sales to one party etc.

Food for Thought

Whether Agency PE, Service PE and Construction PE will be treated as Enterprise?

Since the definition of Enterprise is inclusive and not exhaustive, it appears that even Agency PE, Service PE and Construction PE will be treated as Enterprise.

Arm's Length Price

- In accordance with internationally accepted principles and section 92(1) of the act, the TPR have provided that any income arising from an international transaction between AEs shall be computed *having regard to* the *Arm's Length Price (ALP)*.
- ALP is the price that would be charged in the transaction had it been entered into between *unrelated parties* in similar conditions.
- The ALP is to be determined by any one or more of the *prescribed methods*.
- The taxpayer can select the most appropriate method to be applied to any given transaction, but such selection has to be made by taking into account the factors prescribed in the TPR.
- With a view to allow a degree of flexibility in adopting the ALP, a variance allowance of 5 percent has been provided under the TPR.

Precautions while arriving ALP

- It is to be noted that income arising from international transactions need to be computed *having regard to ALP* and not *at ALP*.
- This is because various adjustments for differences on account of Functions, Assets and Risk Analysis (FAR analysis) of the entities need to be made.
- Further, Transfer Pricing is not an exact science and it is possible that an enterprise may incur losses due to genuine business reasons.
- Hence, while determining the ALP, such economic and commercial factors should be considered.

In a Nutshell

ALP denotes price which is applied or proposed to be applied

- In a - Comparable transaction
- Between - Unrelated independent entities
- Under - Uncontrolled conditions
- Usually corresponding to market price

Selection of Comparables

- For the purpose of comparability analysis the factors which are considered are the specific characteristics of the property transferred, functions performed, contractual terms and other conditions prevailing in markets in which respective parties operate - Rule 10B (2)
- Rule 10B(2) stipulates that besides other criteria the comparability between the controlled and uncontrolled transactions shall be judged taking into consideration the functions performed, risks assumed and assets employed by the parties.
- Rule 10B(3) provides that an adjustment should be made for differences in transaction or differences in enterprises.
- Rule 10B(4) provides that data relating to the financial year in which the international transaction has been entered into should be used for comparability purpose unless the earlier year data (2 year prior data) has an influence on determination of ALP

- Internal v/s External comparables
- In India, the commonly used databases are “Prowess” and “Capitaline” for search of external comparables
- Search filters/ criteria's(quantitative and qualitative filters) – based on size, export turnover v/s domestic turnover, assets (tangible, intangible), RPT transactions, Ratio of costs like salary cost etc., R&D activities, active/inactive companies, data sufficiency, abnormal profits, consistent loss making companies, companies in start up phase etc.
- Aggregation of transactions
- Department Approach – Use of power u/s 133(6), secret comparables, cherry picking, etc.

Methods Of Determining ALP

As per section 92c(1), ALP is to be determined by applying one of the following methods being the Most Appropriate Method(MAM):

- Comparable Uncontrolled Price Method
- Resale Price Method
- Cost Plus Method
- Profit Split Method
- Transactional Net Margin Method
- Any Other Method Prescribed by CBDT

Rule 10C(1) lays down the general guidelines in the selection of the most appropriate method. The Rule states that the method to be selected shall be the one best suited to the facts and circumstances of each international transaction and that provides the most reliable measure of the arm’s length price.

Comparable Uncontrolled Price Method (CUP Method)

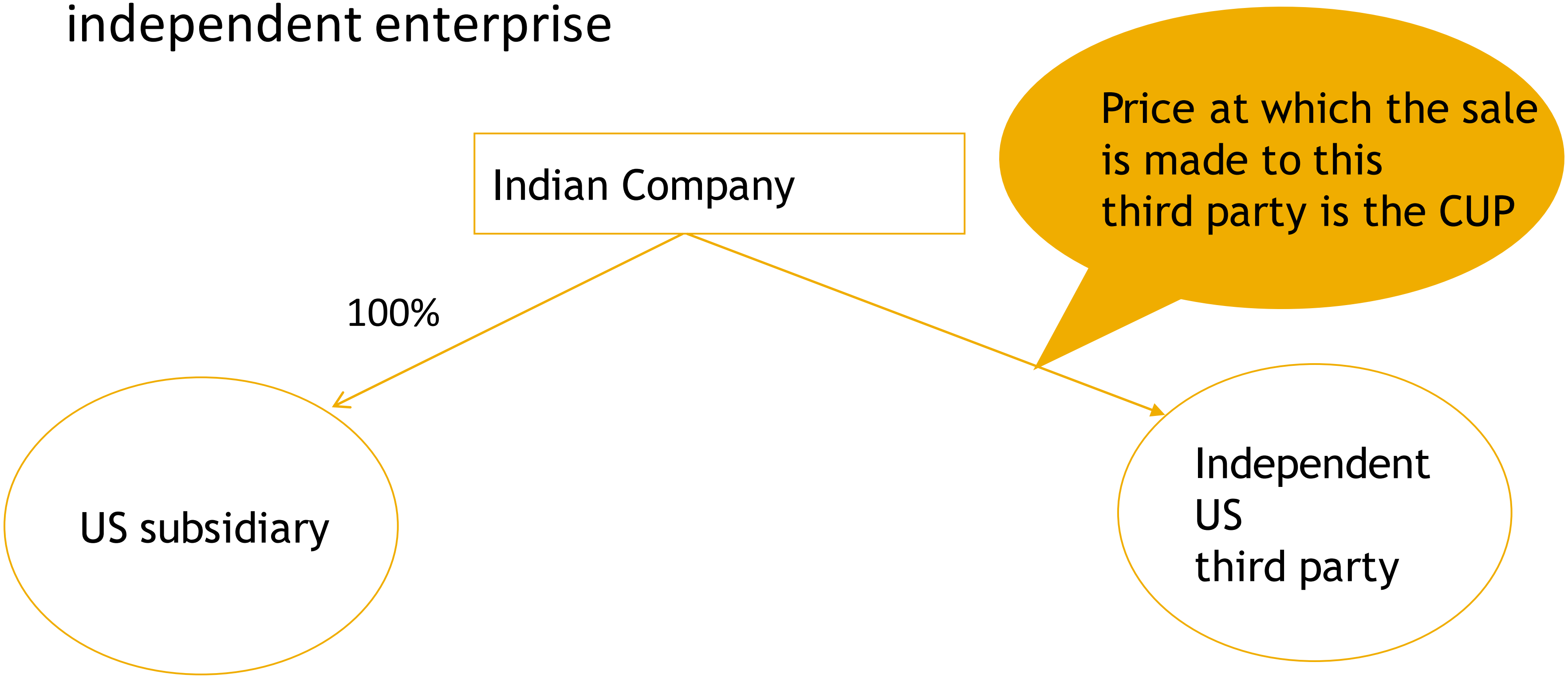
Rule 10B(1)(a)

Comparable uncontrolled price method compares price charged for property or services transferred in a controlled transaction to price charged in a comparable uncontrolled transaction. It is price for identical or nearly identical property traded between two independent parties under the same or similar circumstances

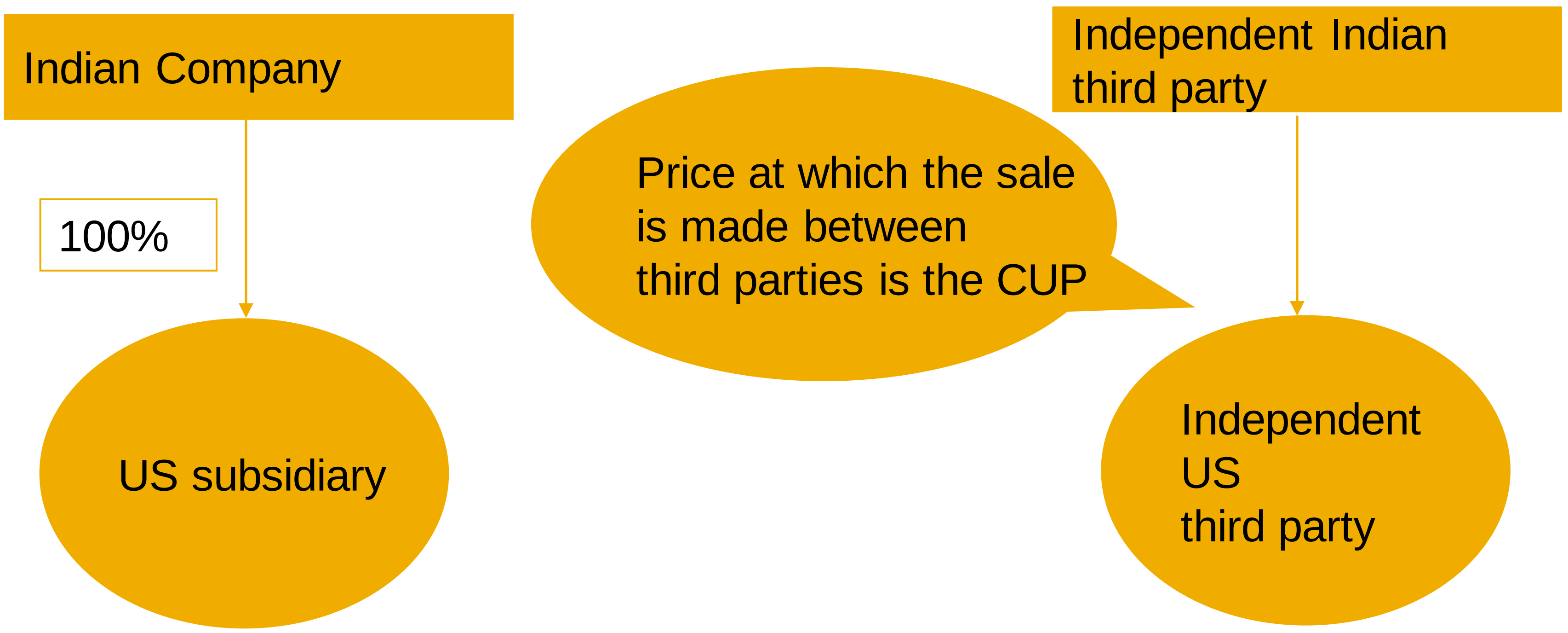
- Determining ALP under CUP Method
  - Identify the price charged or paid in a comparable uncontrolled transaction.
  - Adjust such price to account for material differences which would affect the price in open market.
  - Price so adjusted is taken as the arm's length price in relation to international transaction.

CUP Method-Illustration

- Internal CUP - Under this scenario, the price attached to a controlled transaction is compared to the price charged in a comparable transaction between one of the parties and an independent enterprise



- External CUP- Under this scenario, the price attached to a controlled transaction is compared to the price of a comparable transaction between third parties



Resale Price Method (RPM)

Rule 10B(1)(b)

RPM is generally used to test transactions involving distribution function, i.e., when the tested party purchases products / acquires services from a related party and resells the same to independent parties.

- The method begins with the price at which a product purchased from an associated enterprise is resold to an independent enterprise.
- The price is then reduced by uncontrolled GP margin (computed with reference to uncontrolled transaction)
- The price so arrived is further reduced by expenses incurred in relation to purchase.
- The price so arrived is adjusted for differences and the residuary price is ALP

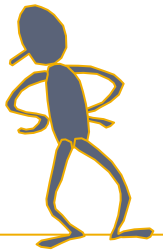
Resale Price Method- Illustration

Independent supplier, Germany

Goods

Independent Indian distributor

Turnover = 200



End customer

(India)

Turnover	200
(Cost of goods)	(120)

Gross margin = 80/200 = 40%

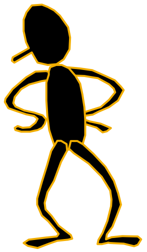
Parent, Germany

Goods

TP = 60

Indian Subsidiary

Resale price = 100



End customer

(India)

Resale price	100
(Transfer price)	(60)
Gross profit	40

Hence, Transfer price
= Resale price x (1-40%)
= 100 x 60% = 60

Cost Plus Method (CPM)

Rule 10B(1)(c)

CPM is the most appropriate method where related parties undertake transactions in respect of sale of semi-finished goods, joint facility agreements, long term buy and supply arrangements and provisions of services

- Under CPM, as a first step, the direct and indirect cost of production or rendering services to AE should be determined
- Normal GP, having regard to same base, in uncontrolled transactions should be determined. Normal GP is to be adjusted for differences
- The direct and indirect costs are increased by adjusted GP to arrive at the ALP for goods sold or services rendered

Cost Plus Method - Illustration

Indian service provider → Third Party service Recipient, US

Gross Profit = Turnover – (Direct + Indirect Cost) = 200 - 150 = 50

Operating profit = GP - Op. Exp = 50-30 = 20

Cost plus markup = GP/(DC+IDC) = 33.33%

Indian subsidiary → US Parent

DC+IDC = Rs 240

Op. Exp = Rs 60

Transfer price = (DC+IDC) X (1+Markup)

Transfer price = 240 X 1.33 = Rs 320

Profit Split Method (PSM)

Rule 10B(1)(d)

PSM is generally applied in transactions involving transfer of unique intangibles or in cases involving multiple transactions which are so interrelated that they cannot be evaluated separately.

- Under this method the arm's length price is determined through a division of the consolidated profits of the associated enterprises.
- First combined net profit of all the AE's determined
- The relative contributions of each enterprise towards earning of profits based on functions performed, assets employed and risks assumed is determined
- The combined net profits is split in proportion to relative economic contributions
- The profit so apportioned is taken into account to arrive at ALP.

Transactional Net Marginal Method

Rule 10B(1) (e)

TNMM compares the net profit margin relative to an appropriate base (for example costs, sales, assets) that the tested party realizes from controlled transaction with net profit margin relative to the same base realised by the comparable enterprises from the comparable uncontrolled transactions

- Compute net profit margin realized from AE transactions.
- Compute net profit margin in comparable uncontrolled transactions.
- Adjust net profit margin in uncontrolled transactions for material differences.
- The net profit so established is taken into account to arrive at the arm’s length price

TNMM - Illustration

Indian service provider → Third Party service Recipient, US

Gross Profit = Turnover – (Direct + Indirect Cost) = 200 - 150 = 50

Other operating expenses = 30

Net profit = GP - Op. Exp = 50-30 = 20

Profit margin on cost = NP/operating cost = 11.11%

Indian subsidiary → US Parent

DC+IDC = Rs 240

Other Op. Exp = Rs 60

Transfer price = (operating) X (1+Markup)

Transfer price = 300 X 1.11 = Rs 333.33

Benefit of 5% range

- As per section 92C, if more than one price is determined, the ALP shall be arithmetic mean of such prices

- It is further provided that the variation is within 5%, no TP adjustment to be made

- Proviso to section 92C, amended by Finance Act (No. 2), 2009 with effect from 1.10.09

- Proviso to section 92C, again amended by Finance Act, 2011 with effect from 01.04.2012 – range to be prescribed instead of current 5% benefit.

Key Issues Effecting TP Analysis

- Choice of appropriate method for ALP
- Selection of time period
- Availability of corporate database
- Avoid loss making companies and those with negative net worth
- Provide complete justification for extraordinary or ordinary events
- Synchronize with auditors report and notes to accounts
- Provide description of finally selected companies
- Consider past TP assessments and connected issues
- Use of secret comparables not prohibited
- Avoid use of unnecessary data in report
- Synchronize market situation with operating margin of the assessee

Burden Of Proof - Taxpayer Or Tax Officer?

Primary Onus of the Assessee to

Determine ALP

Substantiate it with Prescribed Documentation

Onus if Discharged

There can be no intervention by the Tax officer

And That's How You Do It!

The tax officer may reject the ALP adopted by the assessee and determine the ALP by referring the matter to a Transfer Pricing Officer (TPO) (a special post created for valuation of ALP) who would determine the ALP after hearing the arguments of the taxpayer, if the Tax Officer is of the following views:

Price charged in the International Transaction	Not determined in accordance with the methods prescribed
Information & Documents relating to International Transaction	Have not been kept & maintained in accordance with the TRPs
Information or data used in computation of the ALP	Is not reliable or correct
Information or document which was required to be furnished	Assessee has failed to furnish it

Documentation

- As per section 92D every person entering into an international transaction is required to keep and maintain such information and document in respect there of, as may be prescribed.

- Rule 10D provides the nature of documents that should be maintained in case of an International Transactions.

- Rule 10D (4) provides that tax payer should as far as possible maintain contemporaneous documentation and such documentation should exist latest by the specified date

- Rule 10D provides that the information and documents specified must be kept and maintained for a period of eight years from the end of the relevant assessment year.

Effects Of Adjustment To The Alp

- In case the ALP determined by the TPO indicates understatement of income by the taxpayer, it could result into the following

1) Adjustment to reported income of the taxpayer
2) Levy of penalty

Adjustment to the Reported Income

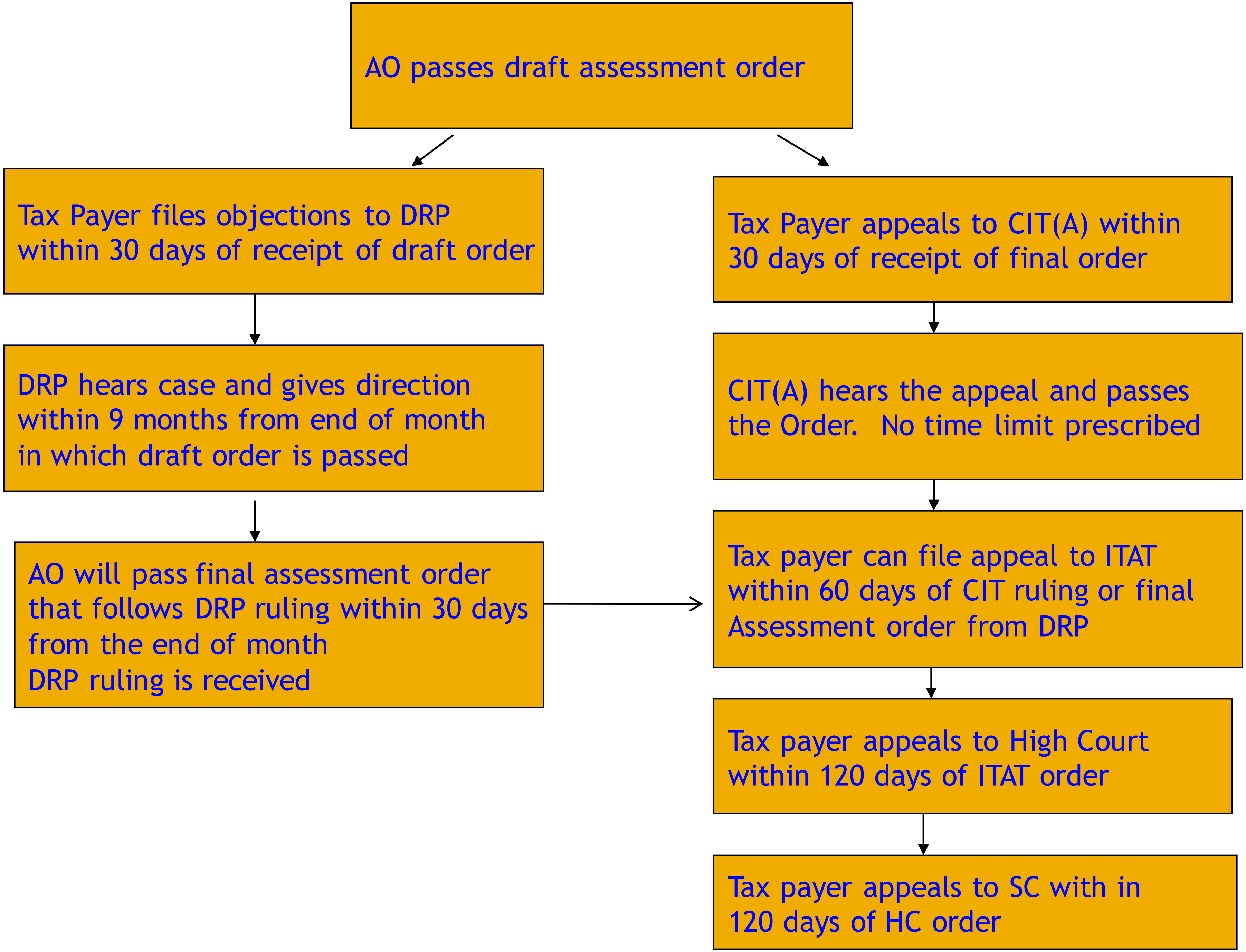
- The tax officer is bound to adjust the reported income of the taxpayer with the amount of adjustment proposed by the TPO.
- This would have an effect of increasing the assessed income or alternatively decreasing the assessed loss.
- Furthermore, the eligible deductions available to the taxpayer under section 80 could not be availed on the enhanced income.
- However, those taxpayers who are eligible for deductions under section 10A and 10B remain unaffected as these deductions remain available on the enhanced income.

Assessment Procedure

- Audit teams constituted in 5 cities – Delhi, Mumbai, Bangalore, Chennai and Kolkata
- Each team consists of a Director of International Tax and Joint / Additional Commissioners as Transfer Pricing Officers (TPO)
- The TPO receives reference from Assessing Officer
- As per the Revenue's internal guidelines for the all cases where the taxpayer's aggregate value of international transactions exceed Rs 15 crore were identified for compulsory TP audit

Reference, Assessment & Appeal proceedings

- If the AO considers it necessary or expedient to do so, he may make reference to TPO for computation of ALP
- The TPO shall give opportunity of being heard to the assessee
- The TPO shall determine the ALP and pass an order
- The copy of TPO order shall be forwarded to AO and the assessee
- The AO shall then compute total income of assessee in conformity with the ALP so determined by the TPO
- By virtue of section 144C, the AO shall pass draft assessment order
- The assessee can file its objections against the draft assessment before DRP. Based on the directions from DRP, the AO to pass final assessment order
- Alternatively, the assessee may file appeal before CIT (Appeals) against the order of AO


AO passes draft assessment order
Tax Payer files objections to DRP within 30 days of receipt of draft order
DRP hears case and gives direction within 9 months from end of month in which draft order is passed
AO will pass final assessment order that follows DRP ruling within 30 days from the end of month DRP ruling is received
Tax Payer appeals to CIT(A) within 30 days of receipt of final order
CIT(A) hears the appeal and passes the Order. No time limit prescribed
Tax payer can file appeal to ITAT within 60 days of CIT ruling or final Assessment order from DRP
Tax payer appeals to High Court within 120 days of ITAT order
Tax payer appeals to SC with in 120 days of HC order

Penalties

- Penalties have been provided as a disincentive for non-compliance and the procedural requirements are as follows:

Default	Penalty
Concealment of income	100 to 300 Percent on tax evaded
Failure to maintain/furnish prescribed documentation	2 Percent of the value of the International Transaction
Non-furnishing of accountants report	Rs. 100,000

The above penalties can be avoided if the taxpayer proves that there was reasonable cause for such failures.

Determine whether Associated Enterprise

Determine whether International Transaction – Section 92B

International Transactions with AE – Transfer Pricing Study required

Transfer Pricing Study involves:

1. Functional, asset and risk analysis of the international transactions
2. Comparability with uncontrolled transactions
3. Selecting and applying Most Appropriate Method ('MAM')

Factors affecting comparability - Rule 10B(2)

1. Specific characteristics of property / services
2. Functions performed, risk assumed and assets employed
3. Contractual terms of the transactions
4. Conditions prevailing in the market (including geographic location, size of the market, etc.

Factors affecting selection of MAM – Rule 10C

1. Nature and class of international transaction
2. Class of AE and functions performed, assets employed and risk assumed by them
3. Availability, coverage and reliability of data
4. Degree of comparability existing between international transaction and uncontrolled transaction
5. Extent to which reliable and accurate adjustments can be made
6. Nature, extent and reliability of assumptions required in application of method

To be supported by documentation and Accountant's Report (Rule 10D,10E and section 92D, 92E)

Summary of main changes in Finance Act, 2012

- Specified domestic transactions to come under TP regime
- Increase in scope of powers of TPO
- Increased penalty provisions
- Allow "re-opening" of certain TP assessments
- Arms length range is restricted to 3% tolerance band from FY 2012-13
- Retrospectively deny taxpayers benefit of 5% variation as standard deduction from 01.04.2002 though no reopening of cases completed before 01.10.2009.
- Retrospectively enlarge the scope of 'international transactions' to include guarantees, any debts, business restructuring etc.,
- Power of DRP to enhance TP variations
- Power of appeal by department against DRP order
- GAAR introduced but postponed
- APA introduced

ANY QUESTIONS

Thank you