Overview of Transfer Pricing
Contents

► Legislative framework

► Transfer pricing study

► Assessment and Litigation

► Key Recent Developments
Transfer Pricing in India - Background

April 1, 2001 onwards

- Comprehensive legislation introduced in Union Budget 2001

- Detailed Rules providing guidance for application of the legislation framed
Concept of transfer pricing

- Transfer Pricing refers to the pricing of international transactions between two associated enterprises.

- Due to the special relationship between related parties, the transfer price may be different than the price that would have been agreed between unrelated parties.

- A price between unrelated parties is known as the “arm’s length” price.
Concept

International transactions
- goods
- services
- intangibles
- loans

Associated enterprise
Resident

Independent entity
Resident

Transfer price
Arm’s length price

Transfer price
Arm’s length price
Applicability

The provisions of Section 92 to 92F of the Act are applicable only if:

- There are two or more enterprises (defined in Sec 92F)
- The enterprises are Associated enterprises (defined in Sec 92A)
- The enterprises enter into a transaction (defined in Sec 92F)
- The transaction is an International transaction (defined in Sec 92B)

Provisions do not apply in certain cases (Section 92(3))

Further w.e.f. 1 April 2012, TP provisions shall also apply to specified domestic transactions (SDT) (defined in Sec 92BA)
Applicability

Consequences of these provisions:

- Computation of income/ expenses having regard to the Arm’s length price (Section 92(1))
- Maintenance of prescribed Documentation (Section 92D read with Rule 10D)
- Obtaining of Accountant’s report (under Form 3CEB) (Section 92E)
- To ensure compliance with the arm’s length principle, stringent Penalties have been prescribed
Applicability

► Section 92(1) –

Any *income* (or expense or interest) arising from an *international transaction* shall be computed having regard to the *arm’s length price*

► Section 92(3) -

The provisions are not intended to be applied in case determination of arm’s length price reduces the income chargeable to tax or increases the loss as the case may be
Meaning of Associated enterprises (Section 92A)

Direct or indirect participation (through one or more intermediaries) in management, control or capital

Both A and B are associated enterprises of C

D and E are also associated enterprises of C since they have a common ultimate parent (A)
## Deemed Associated enterprises (Section 92A(2))

<table>
<thead>
<tr>
<th>Equity Holding</th>
<th>Management</th>
<th>Activities</th>
<th>Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. &gt;= 26% direct / indirect holding by enterprise</td>
<td>6. Appointment &gt; 50% of Directors / one or more Executive Director by an enterprise</td>
<td>8. 100% dependence on use of intangibles for manufacture / processing / business</td>
<td>11. One enterprise controlled by an individual and the other by himself or his relative or jointly</td>
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<tr>
<td>OR</td>
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<tr>
<td>2. By same person in each enterprise</td>
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<td>3. Loan &gt;= 51% of Total Assets</td>
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<td>4. Guarantees &gt; = 10% of debt</td>
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<tr>
<td>5. &gt; 10% interest in Firm / AOP / BOI</td>
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<tr>
<td>6. Appointment &gt; 50% of Directors / one or more Executive Director by an enterprise</td>
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<tr>
<td>7. Appointment by same person in each enterprise</td>
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<tr>
<td>8. 100% dependence on use of intangibles for manufacture / processing / business</td>
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<tr>
<td>9. Direct / indirect supply of &gt; = 90% Raw Materials under influenced prices and conditions</td>
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<tr>
<td>10. Sale under influenced prices and conditions</td>
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<tr>
<td>11. One enterprise controlled by an individual and the other by himself or his relative or jointly</td>
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<tr>
<td>12. One enterprise controlled by HUF and the other by</td>
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<tr>
<td>- a member of HUF</td>
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<tr>
<td>- his relative or</td>
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<td></td>
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<tr>
<td>- Jointly by member and relative</td>
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</table>
International transaction (Section 92B)

- Transactions between two or more associated enterprises
- Either or both of whom are non-residents
- Transaction relates to:
  - purchase, sale or lease of tangible or intangible property; or
  - provision of services; or
  - lending or borrowing money; or
  - any other transaction having a bearing on the profits, income, losses or assets of the enterprises; or
  - mutual agreements or arrangements for allocation or apportionment of, or any contribution to, any cost or expense incurred
- Scope expanded in Finance Act, 2012 to include - intangibles like marketing intangibles, human capital, Business restructuring, inter-company guarantees, capital funding, etc.
Deemed international transaction Sec 92B(2)

Transactions with non-group companies deemed to be international transactions subject to transfer pricing regulations

Prior agreement

- A's Parent
- 3rd party
- A

Transaction between A and 3rd party also subject to transfer pricing norms, if:
  - a prior agreement exists between A's parent and 3rd party (both non-residents) in relation to services rendered by A to the 3rd party; or
  - terms of transaction are determined in substance by A's parent and 3rd party

Determination of terms

- A's Parent
- 3rd party
- A
Specified Domestic Transactions (SDT)

Scope of transfer pricing provisions expanded (effective FY 2012-13 and onwards)

► Applicable to **specified domestic transactions** if aggregate value of such transactions exceeds **INR 5 crores**

► Transactions that could be impacted include
  ► Transfer of goods/services between related domestic companies wherein either of them is eligible for tax holiday benefit
  ► Transfer of goods / services between tax holiday eligible business / units and other businesses / units of the taxpayer in India
  ► Payments made to persons specified u/s 40A(2)(b) [definition amended]

► All provisions applicable for determination of ALP for international transactions would apply in case of SDT also. Also penal provisions applicable to international transactions would apply to SDT
Which ones of these entities are associated enterprises of ABC India?

ABC, Japan

100%

ABC, Japan

100%

XYZ, Taiwan

74%

ABC India
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 which varies from transfer price (not exceeding 3% (upper ceiling) is the arm’s length price (92C(2))
The Arm’s Length Range - How it works

In most cases, it is not possible to identify a single price that can be considered to be an uncontrolled price.

It may be that a number of different comparables are equally comparable. Several comparable transactions can therefore define an arm’s length range of possible transfer prices.

Overall range may contain extremes. Indian legislation recognizes only arithmetic mean (with a +/-5% variation) though statistically and internationally an inter-quartile range may be more appropriate.

If transfer price falls within a +/- 5% range, pricing should be defendable as arm’s length from tax authority audit perspective.
Taxpayer may apply any of the above methods that is considered most appropriate for a transaction.
Comparables

► All methods require comparables

► Transfer price is set/ defended using data from comparable companies

► Comparable company should be independent and similar to an associated enterprise.

► 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)

- Compares the price charged in a controlled transaction with the price in an uncontrolled transaction

- 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**

  - Manufacturer A
    - Related party - B
    - Non-related party

- **External CUP**

  - Non-related party A
  - Non-related party B
Resale Price Method- Rule 10B(1)(b)

- Compares the resale gross margin earned by associated enterprise 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 company without any value addition (if no CUP available).

![Diagram](chart.png)
Resale Price Method

1. Identification of resale price by tested party
2. Resale price reduced by normal gross profit with reference to uncontrolled transaction(s)
3. Such price reduced by expenses incurred (customs duty etc.) in purchase of the product/ services.
4. This price may be adjusted to account for functional and other differences if any
5. Adjusted price arrived above taken to be arm’s length price
Cost Plus Method Rule 10B(1)(c)

- Compares the gross profit on costs the associated enterprise earns with the gross profit on costs earned by comparable independent companies

- Preferred method for:
  - manufacturer supplying semi-finished goods
  - company providing services

Diagram:
- Manufacturer A (Indian) → Cost + 40% → Related Manufacturer B (US) → US Market
Cost Plus Method

1. Identification of direct and indirect costs of production incurred in tested party transactions
2. Identification of normal gross profit with reference to uncontrolled transaction(s)
3. Normal gross profit adjusted to account for functional and other differences if any
4. Adjusted gross profit added to total costs identified in step 1
5. Sum arrived above is taken to be arm’s length price
Profit Split Method-Rule 10B(1)(d)

► Appropriate for transactions which are not capable of being evaluated separately

► Calculates the combined operating profit resulting from a whole inter-company transaction based on the relative value of each associated enterprise'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 analyzing tangible, intangible or services issues
Profit Split Method

1. Determination of combined net profit of the associated enterprises arising out of international transaction

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

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

4. 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)

- 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
- Ideally, operating margin should be compared to operating margin earned by same enterprise on uncontrolled transaction
- Can compare to “comparable transactions” between independent parties
- Applicable for any type of transaction and often used to supplement analysis under other methods
- Most frequently used method in India, due to lack of availability of comparable uncontrolled prices and gross margin data required for application of the comparable uncontrolled price method/ cost plus method/ resale price method
Transactional Net Margin Method

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

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

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

4. The net profit thus established is taken into account to arrive at an arm’s length price for the international transaction.
Which method applies?

Pharma Company USA

100kgs at Rs 100 per kg

Pharma Company India

10kgs at Rs 100 per kg

Third parties

Sale of tablets

Which method applies to this transaction and why?
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)

Contemporaneous documentation requirement – to be maintained by November 30 of relevant Assessment Year

Documentation to be retained for 9 years from financial year

Comprehensive Documentation is not required to be maintained if the aggregate value of all international transactions does not exceed one crore rupees
Accountant’s report- Rule 10E

- Obtained by every tax payer filing a return in India and having international transaction
- To be filed by due date for filing return of income (30 November)
- Essentially comments on the following:
  - 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”
<table>
<thead>
<tr>
<th>Default</th>
<th>Penalty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Post-inquiry adjustment (deemed concealment of income)</td>
<td>100-300% of tax on the adjusted amount</td>
</tr>
<tr>
<td>Failure to maintain documents; report transactions; Maintains or furnishes incorrect information/ documentation</td>
<td>2% of the transaction value</td>
</tr>
<tr>
<td>Failure to furnish documents</td>
<td>2% of the transaction value</td>
</tr>
<tr>
<td>Failure to furnish accountants report</td>
<td>Rs 100,000</td>
</tr>
</tbody>
</table>
Reading references

► OECD guidelines and commentary
► Guidance note from the Institute of Chartered Accountants
► BNA daily tax and transfer pricing reports
► ITS worldwide weekly updates
► For international case laws – Intranet (riacheckpoint.com)
► www.ibfd.org
Our Approach to Transfer pricing

Our proposed approach for transfer pricing review will be based on the following phases of work as described in detail below:

1. Fact gathering
2. Functional analysis
3. Economic analysis
4. Documentation/ Accountants report

- Mapping of international transaction
- Industry Analysis
- Analysis of Functions, Risks, and Intangibles
- Selection of Best Method
- Selection of Comparables
- Calculation of arms length result
- Report writing/ Accountants report

Our proposed approach for transfer pricing review will be based on the following phases of work as described in detail below:
Steps in a transfer pricing study

1. Investigation & data collection
   - Questionnaire
   - Interview

2. Documentation
   - Industry overview
   - Functional analysis
   - Economic analysis

3. Others
   - Assist in implementation
   - Litigation support
Assessment Procedure

1. U/s 92CA the AO may refer determination of ALP to the TPO, with prior approval of Commissioner.

2. TPO would then notify the taxpayer to produce evidence supporting transfer price as arm’s length.

3. TPO would determine ALP by passing an order based on information gathered from the assessee/other sources and intimate the AO & taxpayer.

4. AO would proceed to compute income of the taxpayer in conformity with ALP determined by the TPO and pass a draft order.
The AO to provide “draft” order to assessee, in case any adjustment is proposed.

The assessee has to file the objections within 30 days of receipt of the draft order;

Directions of the DRP to be issued within 9 months of the end of month draft order forwarded to Assessee;

The directions issued by the DRP Panel are appealable in the ITAT by the Assessee.

The department can appeal against the DRP directions for objections filed after 1 July 2012.
Advance Pricing Arrangement (‘APA’) regime

► Introduced with effect from 1 July 2012
► Framework enables unilateral, bilateral and multilateral APAs
► APA to be binding on both the taxpayer and the tax authority for a period not exceeding five years
► APA team constitution notified. Unilateral APAs to lie with APA directorate headed by DGIT and bilateral/ multilateral APAs to be handled by the Competent Authority
► Detailed process guidelines released:
  ► APA applications have a minimum filing fee based on value of international transaction
  ► APA framework includes mandatory pre-filing consultation
  ► Provisions allow rejection, amendments and withdrawal of APA applications
  ► Provisions contain Annual Reporting norms to monitor adherence to the terms of the APA
  ► Roll-back not allowed
  ► Framework do not contain ‘firewall’ provisions in respect of information shared with APA authority during negotiations