



TRANSFER PRICING – Introduction, Issues & Recent Developments

CA Avinash Gupta

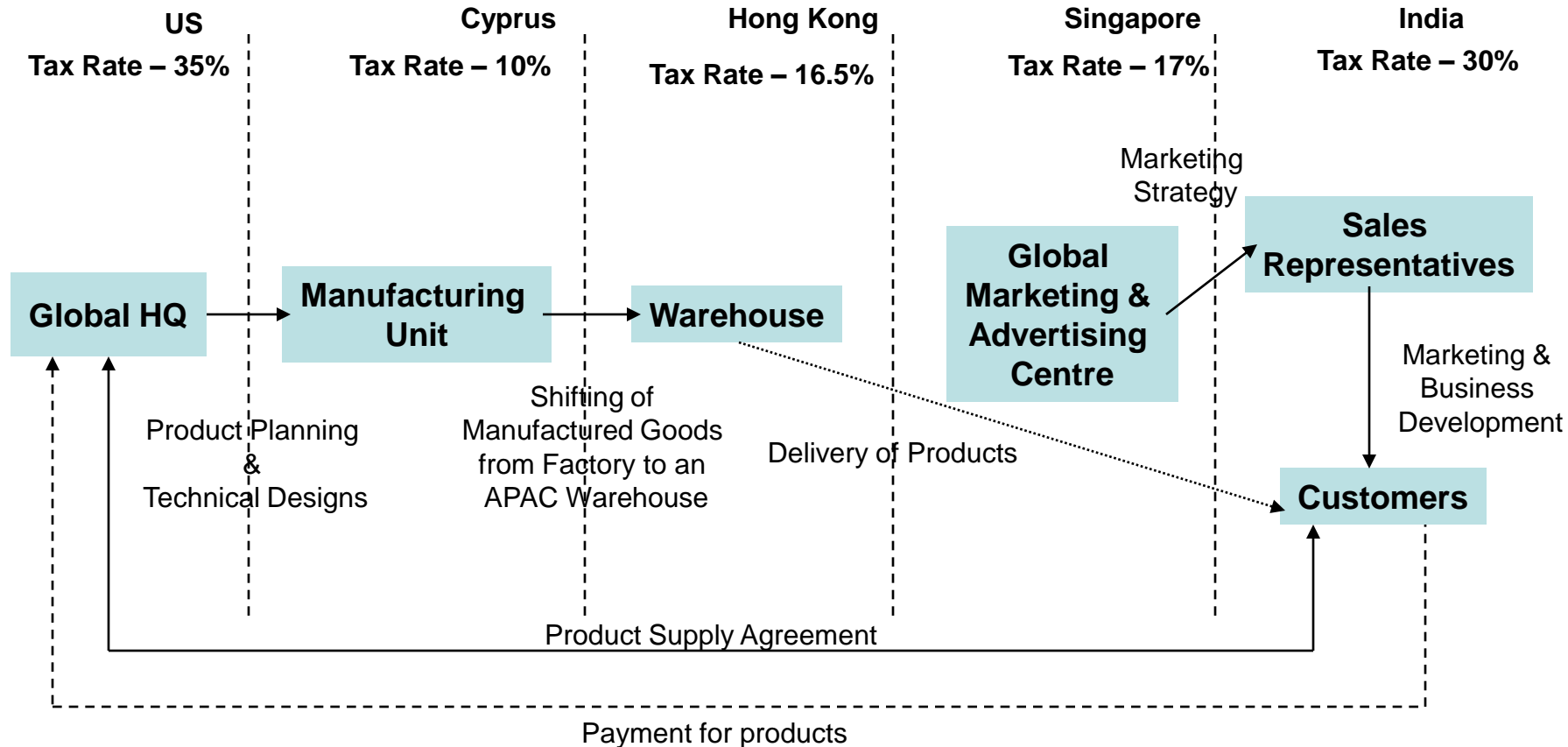


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UNDERSTANDING TRANSFER PRICING



A Typical Global Supply Chain



TOTAL REVENUE = USD 500,000

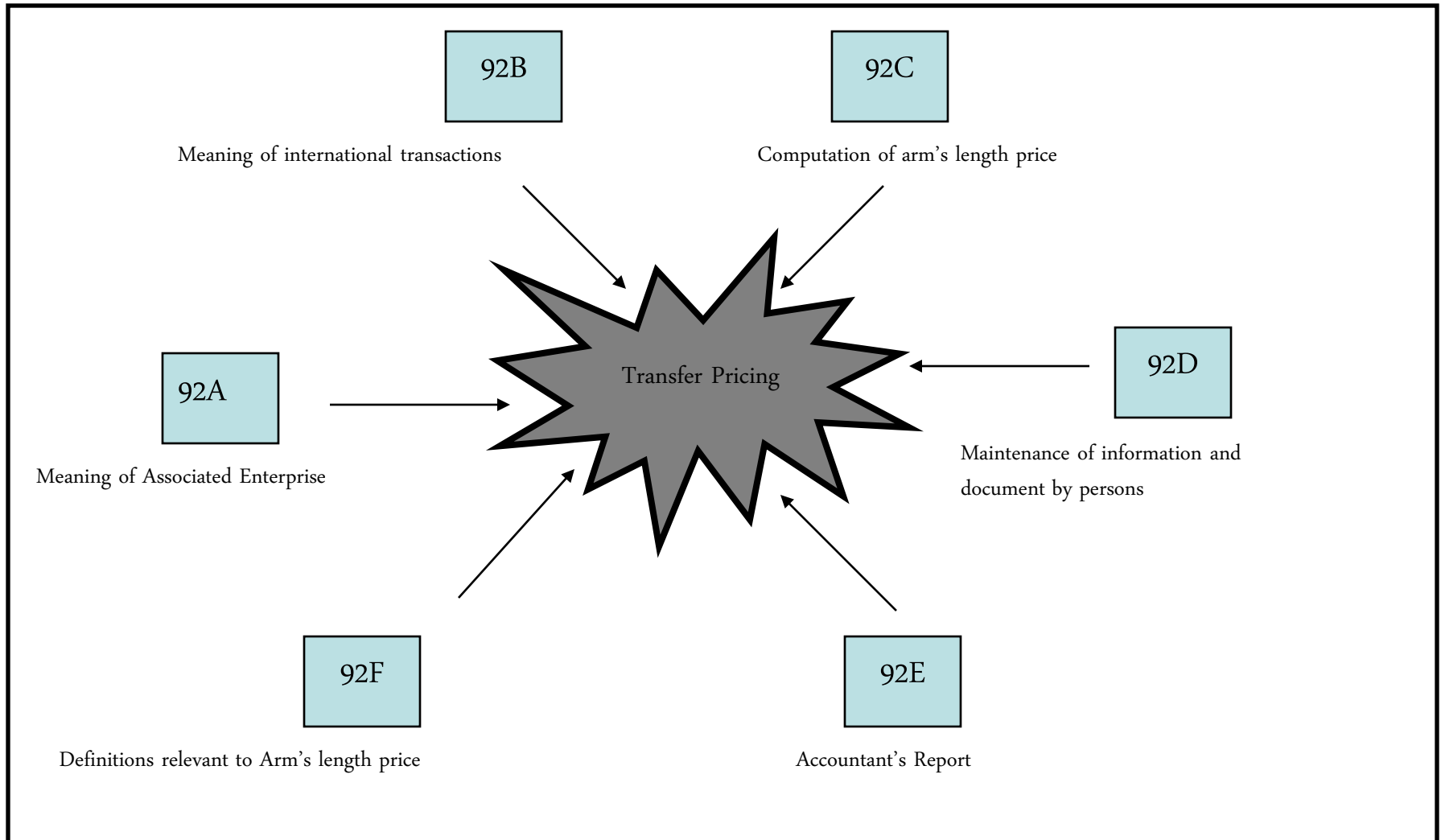
TOTAL GLOBAL COST = USD 400,000

TOTAL PROFIT = USD 100,000 - How to tax it?????



Overview of Indian Transfer Pricing Regulations

Sec 92 – Special Provisions



Transfer Pricing Definition

“Prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises” [OECD]

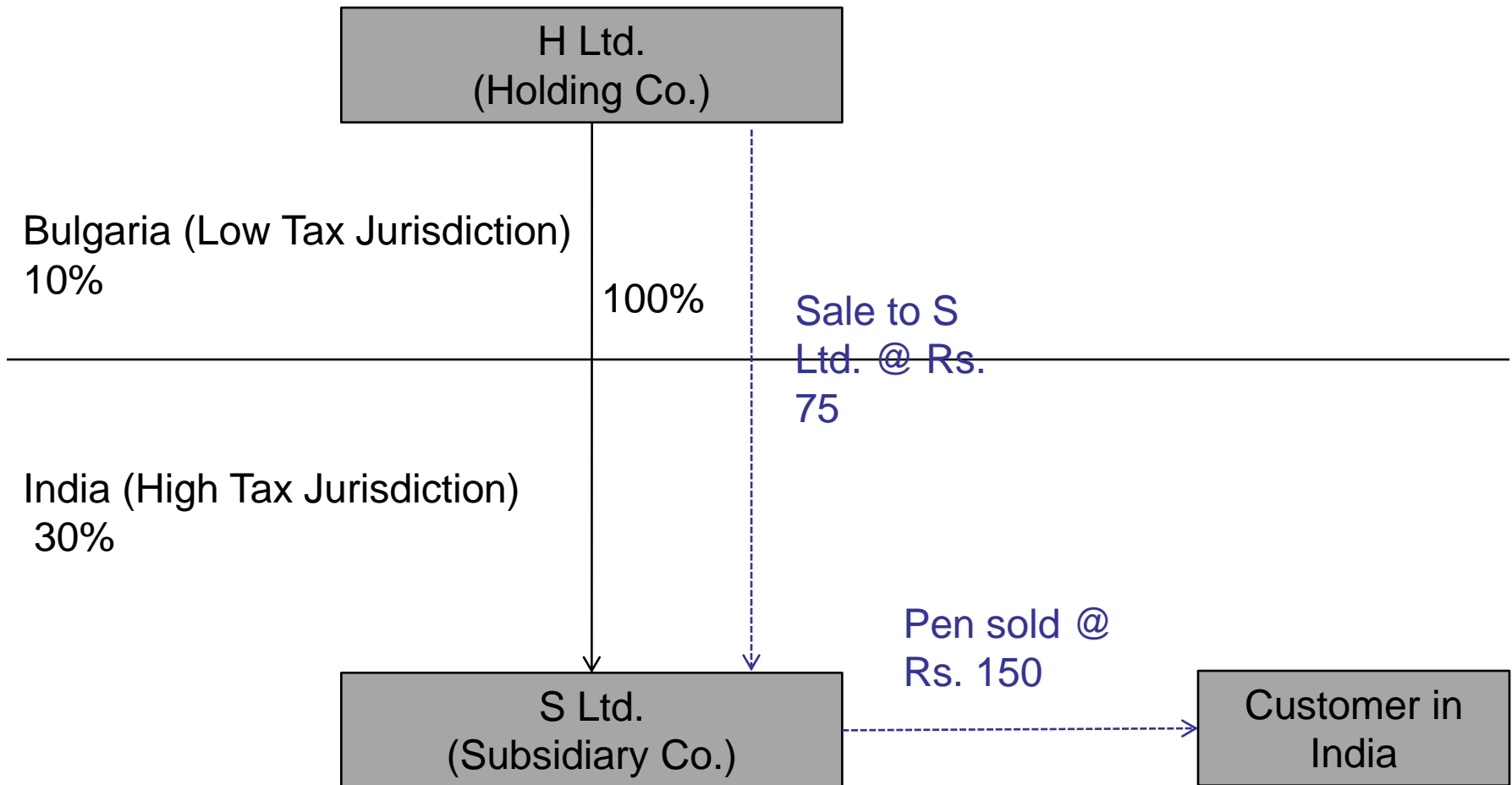
Relates to the system of pricing the transfer of goods, services and intangibles between associated enterprises of a multinational enterprise.

Case for Transfer Pricing – Example

Let us consider the following facts:

- H Ltd. manufactures pens in a low tax country say Bulgaria where tax rate is 10%.
- It forms a subsidiary in India (Tax rate 30%) - S Ltd.
- S Ltd. Purchases pens from H Ltd. and sells them in Indian Market.
- Cost of 1 pen to H = Rs. 50
- S Ltd. sells the pens in the Indian market for Rs. 150
- Such pens can locally be acquired @ Rs. 75

Case I – Purchase @ 75 from H Ltd.



Implication of Case I

H Ltd.

Profit = 75 less 50 = Rs. 25

*Tax payable = 25 * 10% = Rs. 2.50*

S Ltd.

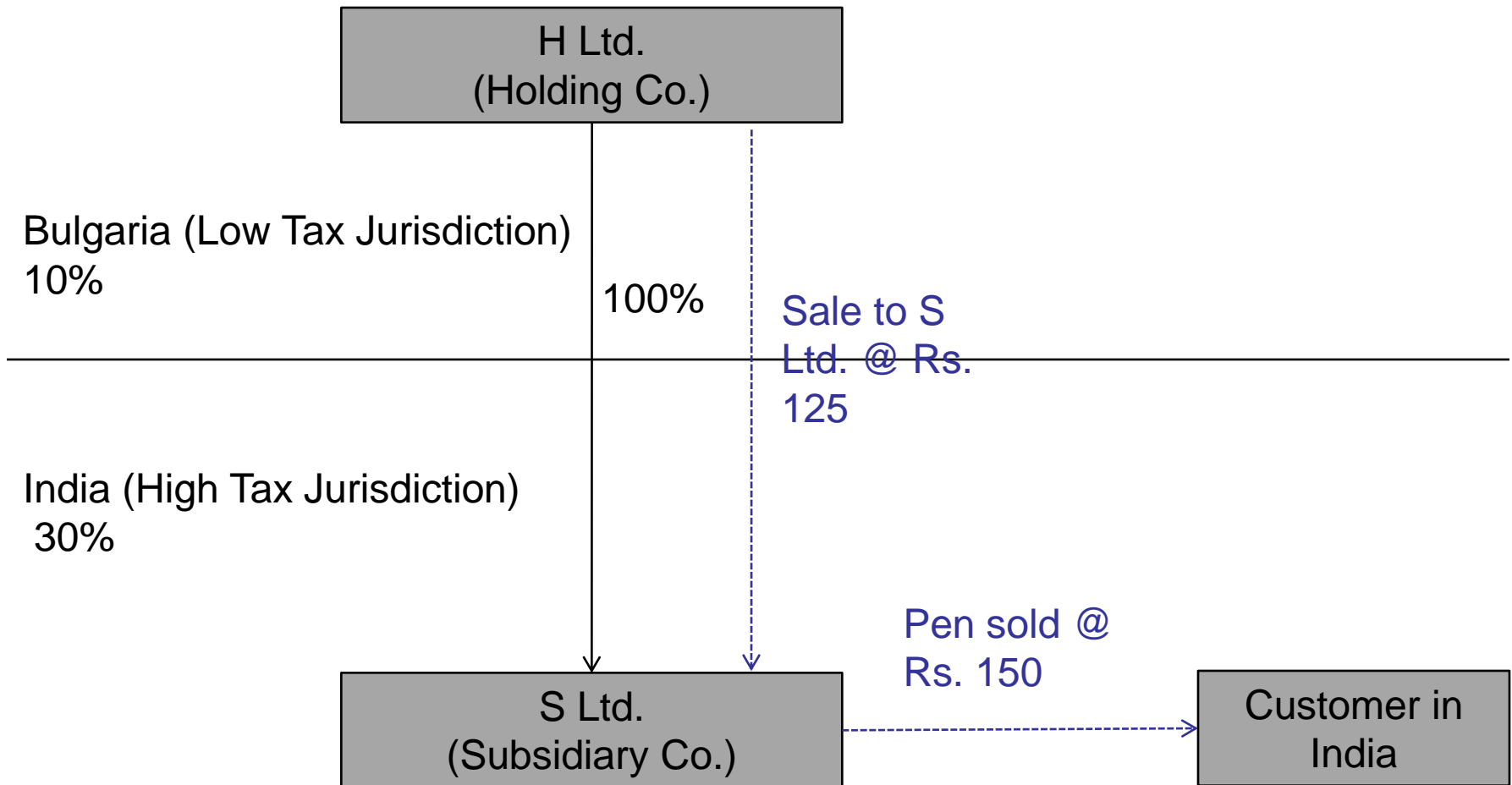
Profit of S = 150 less 75 = Rs. 75

*Tax payable = 75 * 30% = Rs. 22.50*

Total Profit = Rs. 100

Total Tax payable = Rs. 25

Case II – Purchase @ 125 from H Ltd.



Implication of Case II

H Ltd.

Profit = 125 less 50 = Rs. 75

*Tax payable = 75 * 10% = Rs. 7.50*

S Ltd.

Profit of S = 150 less 125 = Rs. 25

*Tax payable = 25 * 30% = Rs. 7.50*

Total Profit = Rs. 100

Total Tax payable = 7.5 + 7.5 = Rs. 15

Analysis of the Example

- Total profits of the group remain the same
- Tax Payable reduced = 25 less 15 = Rs. 10
- Profits Shifted from India to Bulgaria
- Loss of revenue to Indian Revenue Department

In order to curb such shifting of profits from high tax countries to low tax countries Transfer Pricing Legislation was introduced by Finance act 2001

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TRANSFER PRICING LAW



Rationale

- Providing a statutory framework for computation of reasonable, fair & equitable profits and tax.
- Protect the right of a country to collect its due share of tax in respect of transactions between related entities.
- Preventing MNEs from shifting profits to low tax jurisdictions by manipulating prices of intra-group transactions

The Law

Section 92 of the Income tax act deals with Transfer Pricing which states:

“Any income arising from an international transaction shall be computed having regard to the arms length price

Explanation: For the removal of doubts, it is hereby clarified that the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arms length price.”

**Terms to be understood:
International Transaction & Arm’s Length Price**

International Transaction

Section 92 B defines International Transaction as:

“a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of 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 such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.”

Takeaways:

- Transaction to be between Associated Enterprises (AEs)
- At least one of the AE be NR
- Transactions to have a bearing on profits, income, losses & Assets

International Transaction

Section 92B (2) International Transaction as:

“a transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purposes of sub-section (1), be deemed to be a transaction entered into deemed to be a transaction entered into between two associated enterprises, if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise.”

What is an Associated enterprise?

Associated Enterprise

Meaning of AE (Section 92A).

An enterprise

- (a) which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or*
- (b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.*

For the purposes of sub-section (1), two enterprises shall be deemed to be associated enterprises if, at any time during the previous year,

- (a) one enterprise holds, directly or indirectly, shares carrying not less than **twenty-six per cent** of the voting power in the other enterprise; or*
- (b) any person or enterprise holds, directly or indirectly, shares carrying not less than **twenty-six per cent** of the voting power in each of such enterprises; or*
- (c) a loan advanced by one enterprise to the other enterprise constitutes not less than **fifty-one per cent of the book value** of the total assets of the other enterprise; or*

Contd...

Associated Enterprise

*(d) one enterprise guarantees not less than **ten per cent** of the total borrowings of the other enterprise; or*

*(e) more than **half of the board of directors** or members of the governing board, or **one or more executive directors** or executive members of the governing board of one enterprise, are appointed by the other enterprise; or*

(f) more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons; or

*(g) the manufacture or processing of goods or articles or business carried out by one enterprise is **wholly dependent** on the use of know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights; or*

*(h) **ninety per cent** or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise; or*

Contd...

Associated Enterprise

Meaning of AE (Section 92A) (Contd..)

- (i) the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the **prices** and other conditions relating thereto are **influenced** by such other enterprise; or*
- (j) where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or*
- (k) where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or jointly by such member and his relative; or*
- (l) where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association of persons or body of individuals; or*
- (m) there exists between the two enterprises, any relationship of mutual interest, as may be prescribed.*

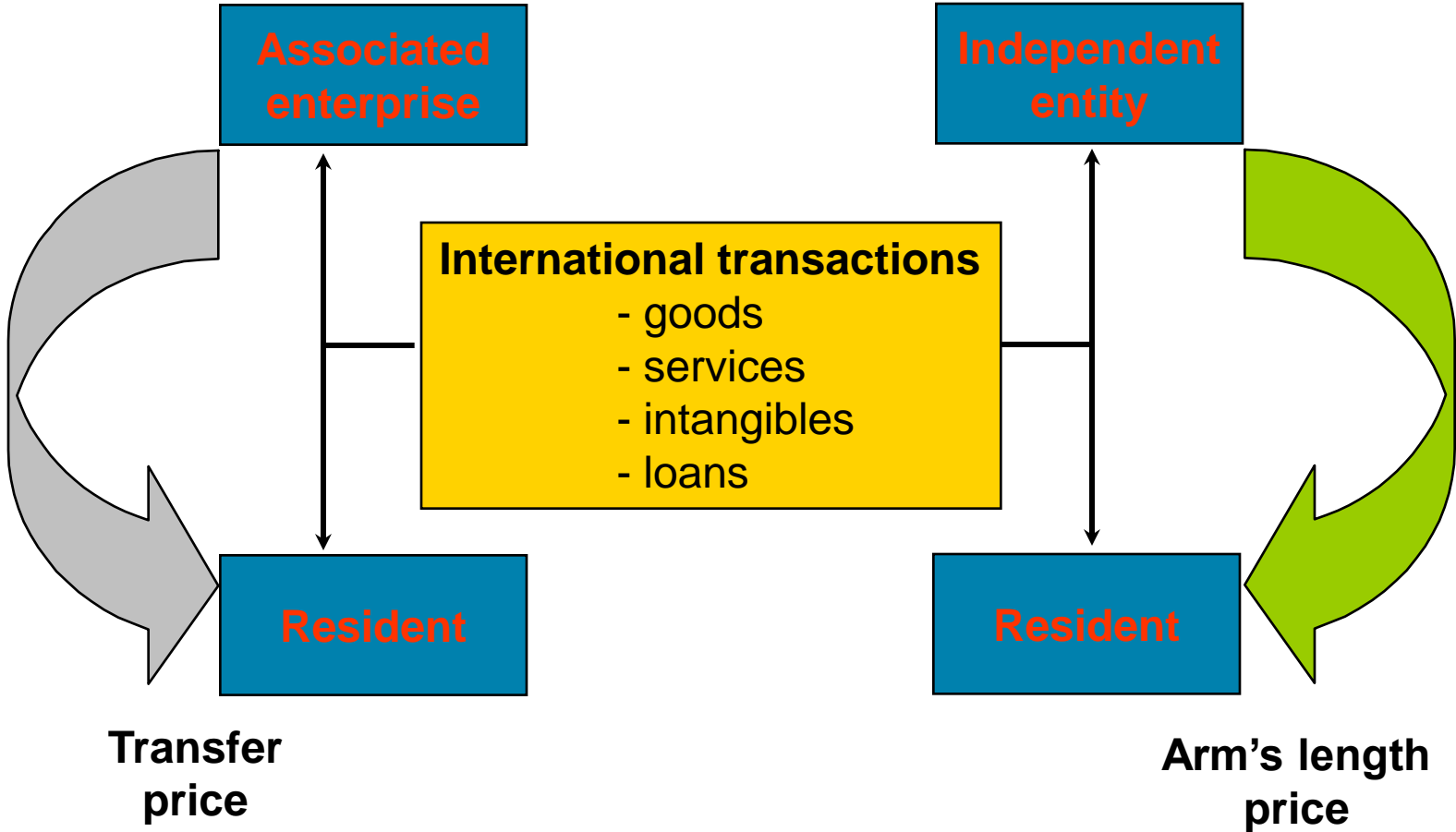
Arm's Length Price

- **Meaning of Arm's length price (ALP) (Financial Definition)**

The price at which a willing buyer and a willing unrelated seller would freely agree to transact or a trade between related parties that is conducted as if they were unrelated, so that there is no conflict of interest in the transaction.

In our example ALP was Rs. 75 being the price at which S Ltd. could have procured the pen locally

Conclusion



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TRANSFER PRICING METHODS



How to arrive at the ALP

Choice to be made from the following methods (Section 92C):

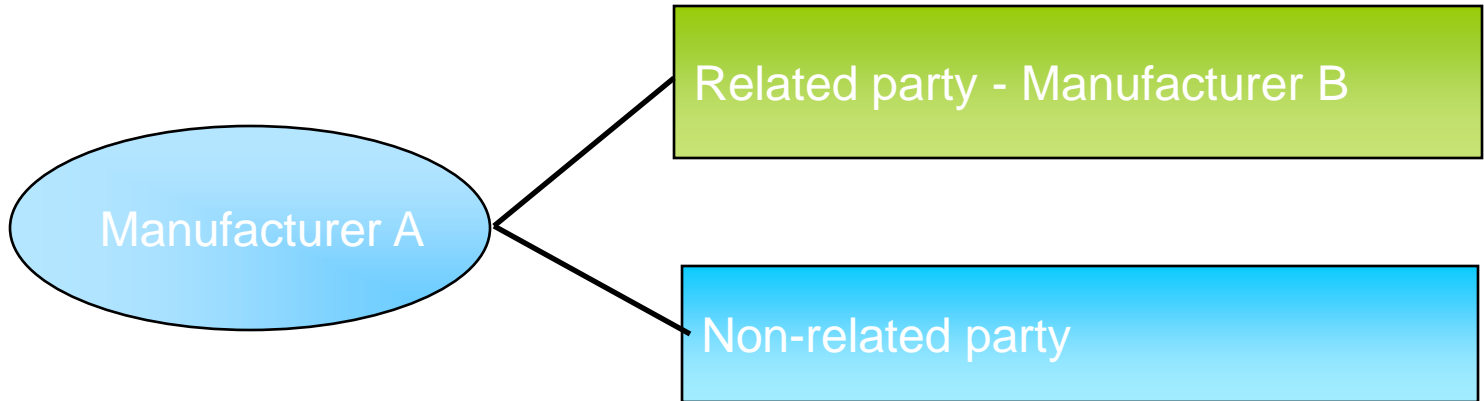
- (a) comparable uncontrolled price method (CUP Method);
- (b) resale price method (RPM);
- (c) cost plus method (CPM);
- (d) profit split method (PSM);
- (e) transactional net margin method (TNMM);
- (f) such other method as may be prescribed by the Board.

CUP Method

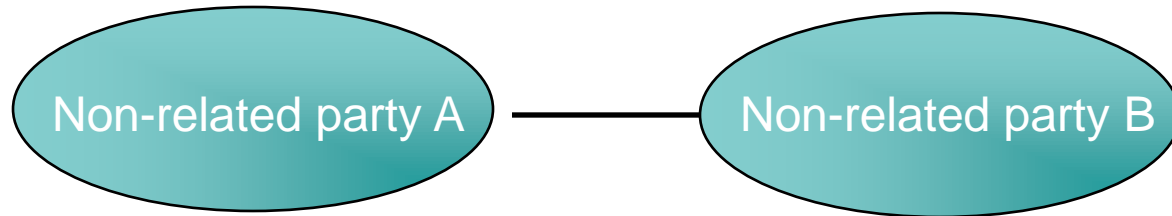
- Price charged for property or services transferred in a controlled transaction is compared to price charged in a comparable uncontrolled transaction.
- Price for identical or nearly identical property traded between two independent parties under the same or similar circumstances.
- Sources of CUP:
 - Internal (Inter Company Data)
 - External (Price Lists, Website, Trade Directories etc.)

Comparable Uncontrolled Price Method

➔ Internal CUP



➔ External CUP



RPM

- Method begins with the price at which a product purchased from an associated enterprise is resold to an independent enterprise. This price is reduced by appropriate gross margin or resale price margin. This represents the amount out of which a reseller would cover its other costs and selling expenses. The residuary figure is the arm's length price.
- The resale margin may be determined by reference to margin that may be earned by a reseller in comparable uncontrolled transactions or margin earned by an independent enterprise in comparable transactions.

CPM

- This method begins with the costs incurred by the supplier of property or services in a controlled transaction.
- An appropriate markup is added to the cost in the light of functions performed and market conditions.
- The price after adding the cost plus mark up to these costs is arm's length price of the controlled transaction.

PSM

- ALP is determined through a division of the consolidated profits of the AEs. Commonly applied methods are Contribution Analysis and Residual Analysis.
- The method is applicable in cases involving multiple transactions which are so interrelated that they cannot be evaluated separately.

TNMM

- Net profit margin realized by taxpayer from a controlled transaction is determined by reference to the net margin earned in comparable uncontrolled transactions.
- Net margin is calculated with reference to appropriate base say costs, sales assets etc.
- Comparability of transactions is judged with reference to specific characteristics of the property or services, functions performed, contractual terms or conditions prevailing in the market.

Selection of most appropriate method

Method selected taking into account-

- Nature and class of the international transaction
- Class or classes of associated enterprises
- The availability, coverage and reliability of data
- The degree of comparability existing between the international transaction and uncontrolled transaction
- Extent to which reliable adjustments can be made
- The nature, extent and reliability of assumptions required to be made

Making adjustments to the ALP

- Working capital adjustment
- Capacity Utilization adjustment
- R&D Adjustment

Documentation-Rule 10D

Entity related



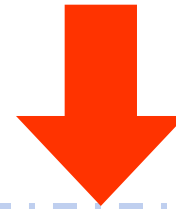
- Profile of industry
- Profile of group
- Profile of Indian entity
- Profile of associated enterprises

Price related



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

Transaction related

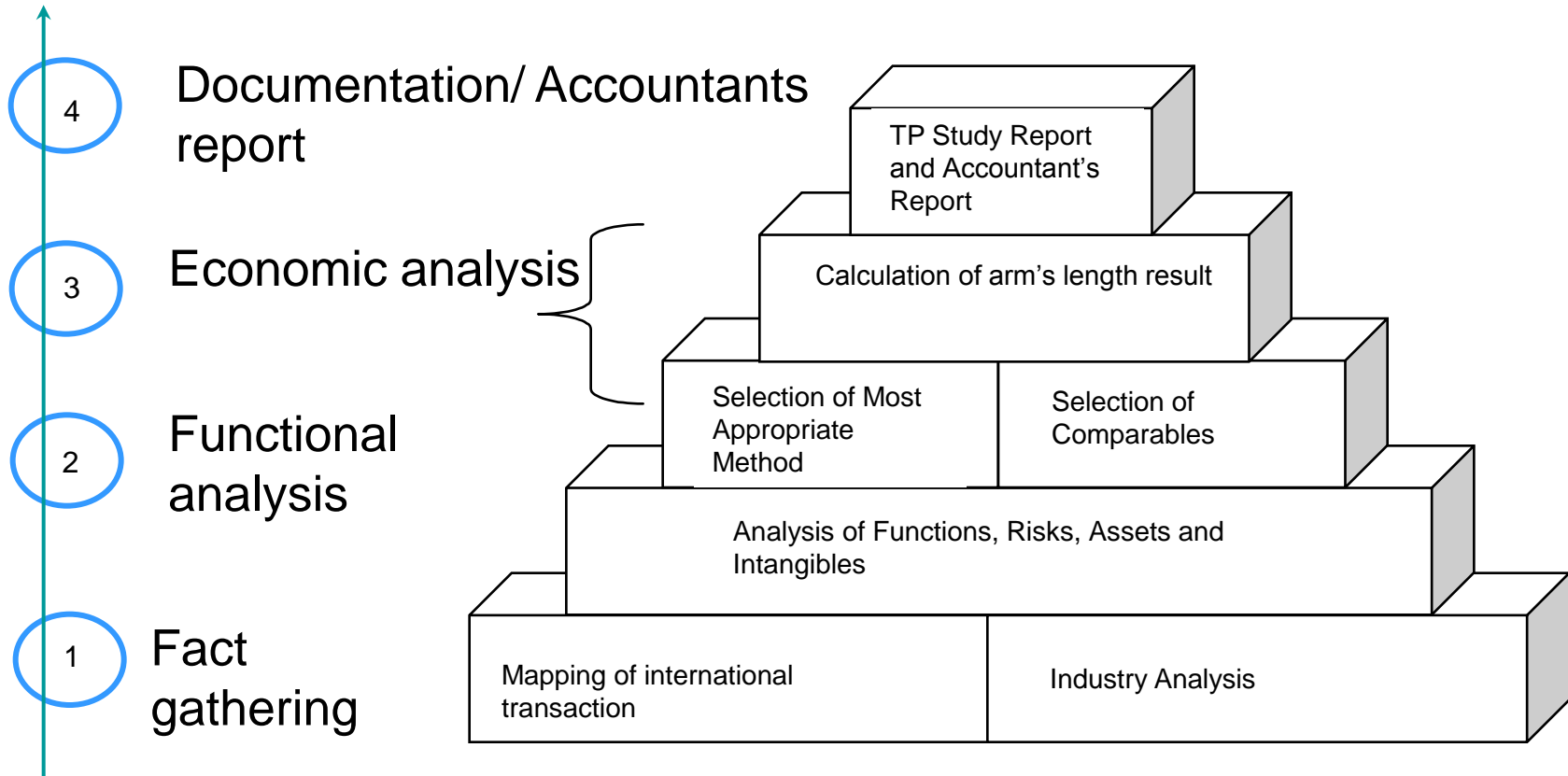


- Agreements
- Invoices
- Pricing related correspondence (letters, emails etc)

- 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:



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ISSUES IN TRANSFER PRICING



Issues

- Use of multiple year data vs Current year data
 - *TNT Communications Pvt Ltd.*
 - *Mentor graphics*
- Abnormal Profit / Loss making comparables –
 - *Quark Systems Pvt. Ltd.*
 - *Sapient corporation Pvt. Ltd.*
- Transactions involving intangibles
 - *Maruti Suzuki case*
- Computation of 5% range whether to be allowed as a standard deduction or not?
 - *Sony India Pvt Ltd.*

Issues

- 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

- Cargill India – Delhi ITAT

2008-TIOL-94-ITAT-DEL

- Penalty not leviable for non-provision of documents beyond taxpayer's control

Issues

- 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

Issues

- 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')
- Adjustments to comparable data
- Benchmarking difficulties in case of unique services where comparables are not available

Issues

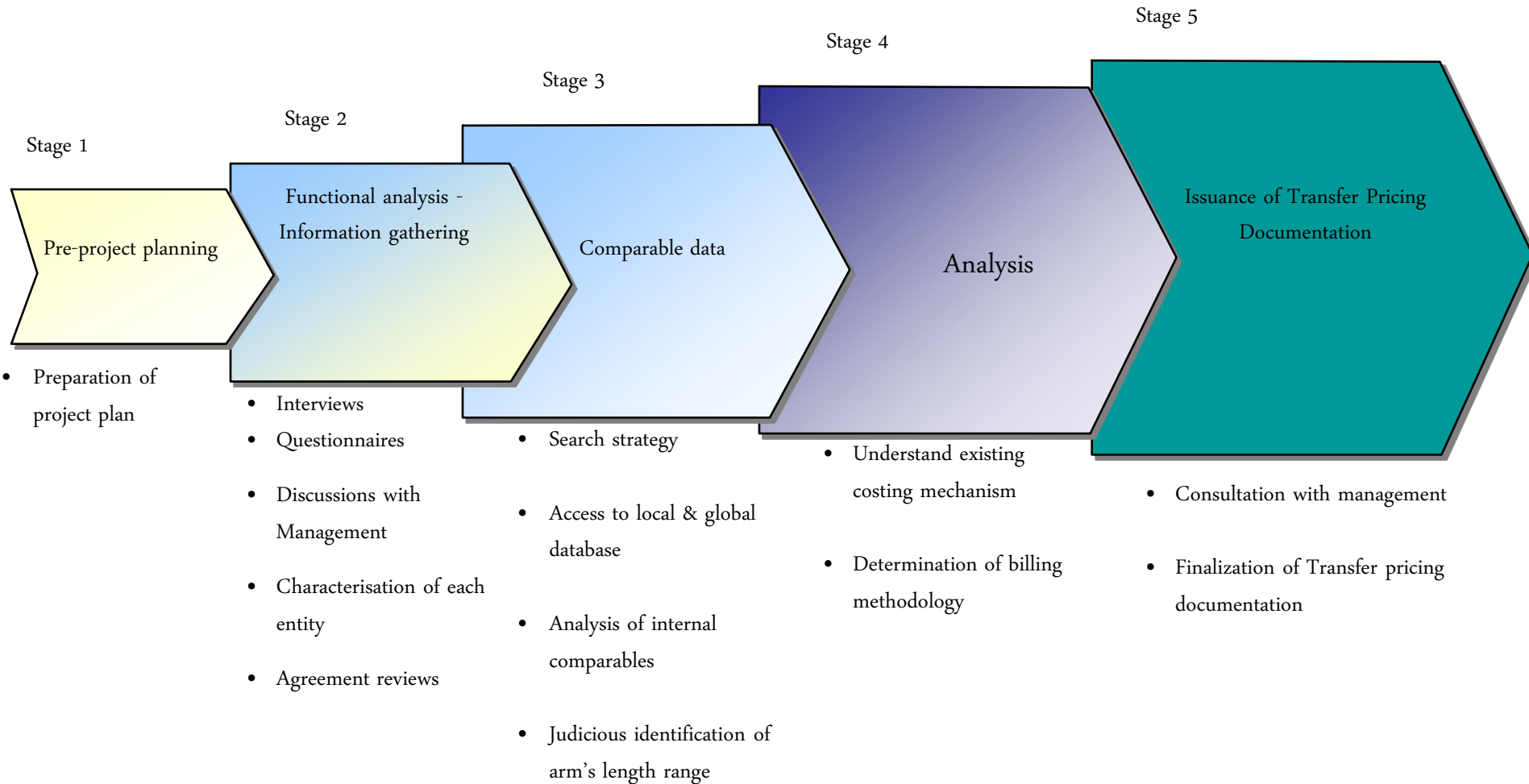
- Justification for use of unspecified method for determining arm's length price
- Use of foreign database to which access not available to the Transfer Pricing Officer
- Acceptance of prices approved by other Govt. Departments like Custom valuation
- Use of Secret Comparables

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OUR ROLE



Compliance – A step by step approach



Transfer Pricing Planning

- Assistance in framing the transfer pricing policy
- Suggesting remuneration model
- Computing arm's length margins

Transfer Pricing Documentation

- Statute to file Transfer Pricing report and to maintain TP Documentation substantiating the above report when international transactions exceed 1 crore
- Documentation includes:
 - Executive summary
 - Group overview
 - Details of international transactions
 - Functions, Assets and Risk analysis
 - Economic Analysis
- Penal Provisions:
 - Failure to file TP report = Rs. 100,000
 - Failure to maintain TP documentation = 2% of value of international transactions

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

CONTENTS		
S. No.	Particulars	Page No.
1	Executive Summary 1.1 Introduction & Scope 1.2 Brief on INC 1.3 Brief on AE Group 1.4 Use of Comparables 1.5 Economic Analysis	
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*

Transfer Pricing Assessments

- Attempt made by revenue to enhance the Taxable income by making TP additions
- We can defend the clients at -
 - First level Assessments i.e. TPO level
 - DRP or CIT(A) level
 - ITAT
 - High Court
 - Supreme Court
- Penal Provisions:
 - Failure to furnish / submit any information / document to the TPO = 2% of international transaction
 - Transfer Pricing adjustment = 100 to 300 % of Tax sought to be evaded

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

A magnifying glass with a silver handle and frame is positioned over a document. The document contains several columns of text, with some words like "LIMITATION OF LIABILITY" and "AND ALL OTHERS" visible through the lens. The background is a soft, out-of-focus grey.

TP of Marketing Intangibles

Marketing Intangibles

- Big issue in mature economies
- Applied on transaction between principals and distributors
 - Where advertisement, marketing and promotion expenses is incurred by distributors **though they do not own trade marks.**
- It refers to the benefits like brand name, customer lists, unique symbols, logos, distribution network, etc.
- Bright Line Test is to be applied for determining ALP
 - Maruti Suzuki Ltd. – Delhi HC

A photograph of three business professionals sitting around a glass conference table. The table is highly reflective, showing a clear mirror image of the people and the papers on it. The person in the center is wearing a light blue shirt and a red patterned tie, and is holding a pen. The person on the left is wearing a dark suit jacket. The person on the right is wearing a light blue shirt and a dark tie. The background is a bright, slightly blurred office setting.

Questions ???

Let's Discuss



Acclaim Management Solutions
Private Limited
D – 10,
Kailash Colony
New Delhi: 110 048

Ph: +91 11 2410 8838
Fax: +91 11 40556069
W: www.acclaimindia.com

Avinash Gupta:
+91 98107 51999
avinash.gupta@acclaimindia.com
caavinashgupta@gmail.com