

BASICS OF INTERNATIONAL TRANSFER PRICING

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Organised by –

Western India Regional Council of ICAI

SCOPE

⦿ Background

⦿ Objective

⦿ Legal Framework

- OECD Framework
- Indian Regulations

⦿ Overview

- Identifying AEs
- International Transactions
- Selection of Most Appropriate Method
- Tested Party
- Benchmarking
- Compliance

INTRODUCTION

BACKGROUND

- ⊙ Transfer price refers to “price” charged for “transfer” – of goods, services, tangible or intangible property, etc.
- ⊙ Several economic factors affect determination of transfer prices –
 - Nature of product
 - Market price
 - Cost
 - Target profitability – ROS, ROCE, ROI
 - Capacity Utilisation
 - Opportunity Cost

BACKGROUND

- ◎ Current regulations introduced in Finance Act, 2001
- ◎ Prior to that, Section 92 read as under –

“Where a business is carried on between a resident and a non-resident and it appears to the Assessing Officer that, owing to the close connection between them, the course of business is so arranged that the business transacted between them produces to the resident either no profits or less than the ordinary profits which might be expected to arise in that business, the Assessing Officer shall determine the amount of profits which may reasonably be deemed to have been derived therefrom and include such amount in the total income of the resident.”

OBJECTIVE

⦿ Relevant extract of the Budget Speech

“The presence of multinational enterprises in India and their ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions has made the issue of transfer pricing a matter of serious concern. I had set up an Expert Group in November 1999 to examine the issues relating to transfer pricing. Their report has been received, proposing a detailed structure for transfer pricing legislation. Necessary legislative changes are being made in the Finance Bill based on these recommendations.”

OBJECTIVE

- ⦿ M Co. Mauritius owns 100% equity stake in I Co. India.
- ⦿ Effective Tax Rates : India – 30.9%, Mauritius – 3%
- ⦿ M Co. supplies raw material to I Co. at Rs. 15 mn., which can be procured by the latter from indigenous parties at Rs.10 mn.
- ⦿ I Co. sells finished goods to M Co. at Rs. 40 mn. Buyers in US are ready to buy the same goods at Rs. 55 mn.
- ⦿ Profits are understated in India and overstated in Mauritius to the extent of Rs. 20 mn.
- ⦿ Effective tax reduction = $20 \text{ mn} * (30.9 - 3)\% = \text{Rs. } 5.58 \text{ mn.}$

OBJECTIVE

- As per Para 1.2 of OECD Guidelines –

“Tax administrations should not automatically assume that associated enterprises have sought to manipulate their profits. There may be a genuine difficulty in accurately determining a market price in the absence of market forces or when adopting a particular commercial strategy. It is important to bear in mind that the need to make adjustments to approximate arm's length transactions arises irrespective of any contractual obligation undertaken by the parties to pay a particular price or of any intention of the parties to minimize tax....”

OBJECTIVE

...Thus, a tax adjustment under the arm's length principle would not affect the underlying contractual obligations for non-tax purposes between the associated enterprises, and may be appropriate even where there is no intent to minimize or avoid tax. The consideration of transfer pricing should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes.”

LEGAL FRAMEWORK

SOURCE OF TRANSFER PRICING

OECD Framework

- ⦿ Article 9 of OECD Model Tax Convention – Associated Enterprises
- ⦿ OECD Transfer Pricing Guidelines 2010

Indian Regulations

- ⦿ Sections 92, 92A to 92F of the Income Tax Act
- ⦿ Rules 10A to 10E of the Income Tax Rules.

OECD FRAMEWORK

ARTICLE 9 - ASSOCIATED ENTERPRISES

“1. Where

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

OECD FRAMEWORK

ARTICLE 9 - ASSOCIATED ENTERPRISES

2. Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.”

OECD TRANSFER PRICING GUIDELINES

- ⦿ Guidelines for Multinational Enterprises and Tax Administrations issued in July 2010.
- ⦿ Justifies and emphasizes on use of “Arm’s Length Principle”, while rejecting any alternative approaches to Transfer Pricing.
- ⦿ Provides guidance for applying Arm’s Length Principle.
- ⦿ Describes five transfer pricing methods and their applications.
- ⦿ Describes process of comparability analysis.

OECD TRANSFER PRICING GUIDELINES

- ⊙ Suggests administrative approaches to avoiding and resolving TP disputes, including MAP, Safe Harbour, APAs and arbitration.
- ⊙ Provides recommendations on maintenance of documentation.
- ⊙ Deals with special considerations relating to –
 - Intangible Property
 - Intra-Group services
 - Cost Contribution Arrangements
 - Business Restructuring

COMPUTATION OF INCOME AS PER ALP

- ⊙ 92(1) – Any income, expense or interest arising from an international transaction to be determined having regard to arm's length price.
- ⊙ 92(2) – Any cost or expense allocated or apportioned or contributed under a mutual agreement to be determined having regard to the ALP of the benefit, service or facility provided under such agreement.
- ⊙ 92(3) – This section not to apply where it results in reduction of taxable income or increase in loss.

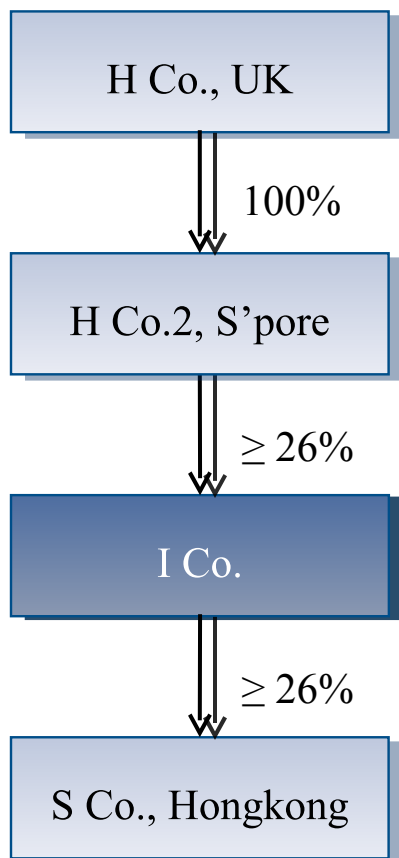
ASSOCIATED ENTERPRISE

- ⊙ 92A(1) – General conditions : Direct or indirect participation in management, control or capital.
- ⊙ 92A(2) – Specific conditions : Deemed AE relationship based on conditions linked to shareholding, board of directors, loans, guarantees, etc.

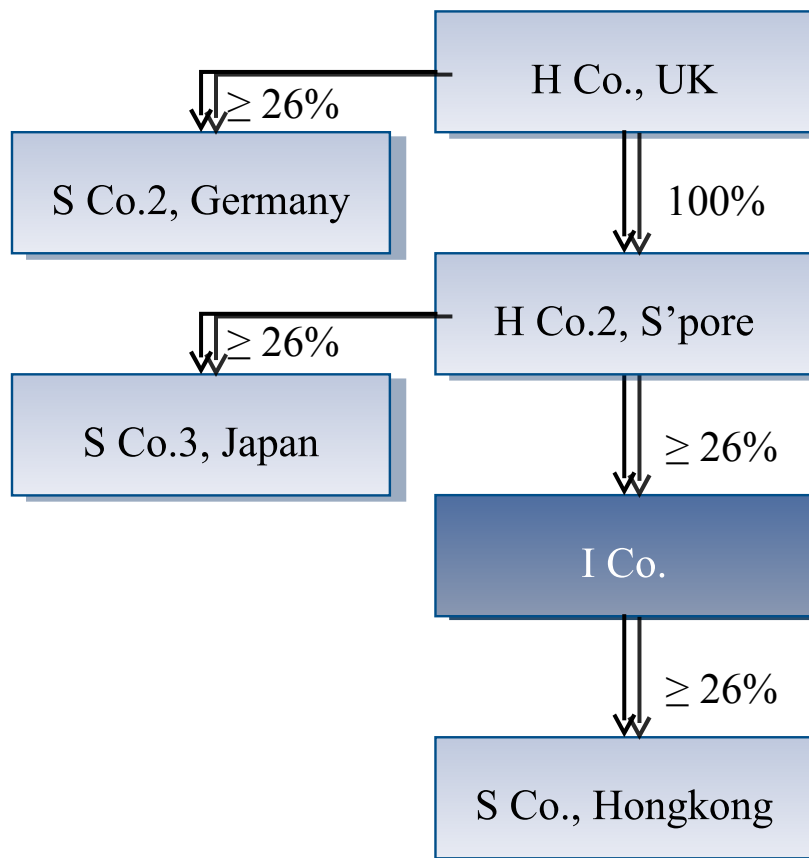
S. 92A(1) not to apply in isolation of S. 92A(2).

ASSOCIATED ENTERPRISE

◎ 92A(2)(a)

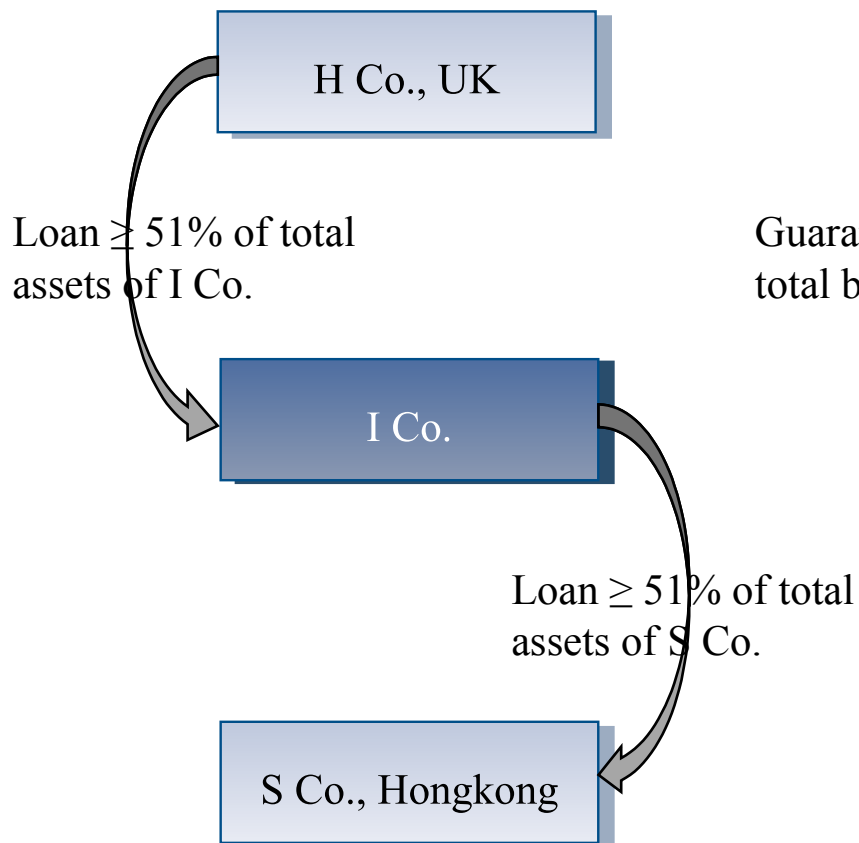


◎ 92A(2)(b)

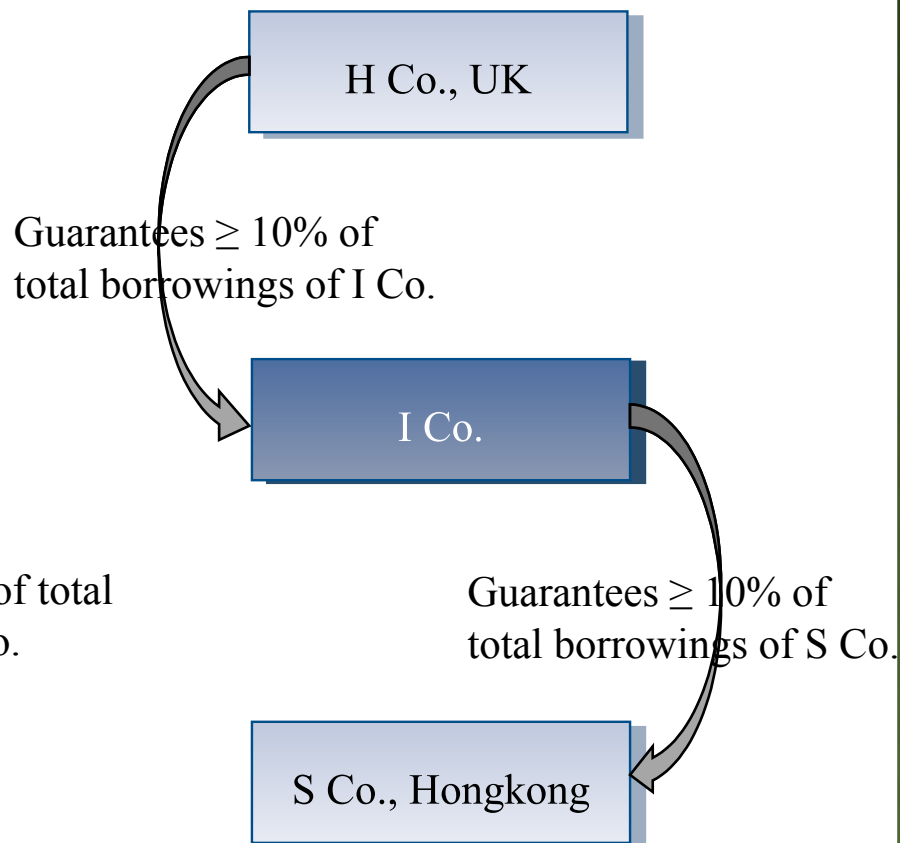


ASSOCIATED ENTERPRISE

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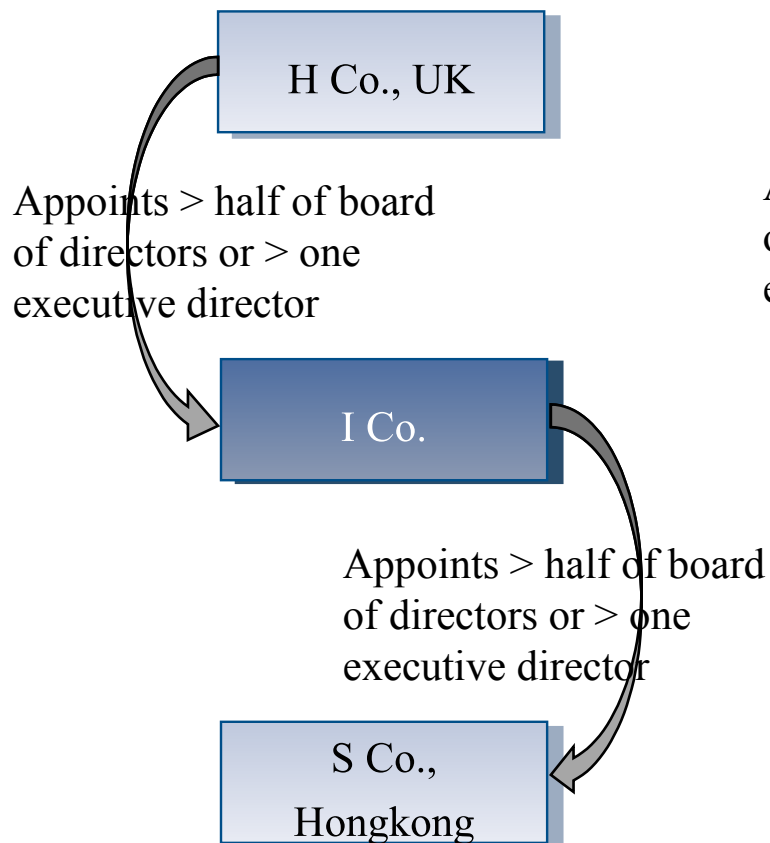


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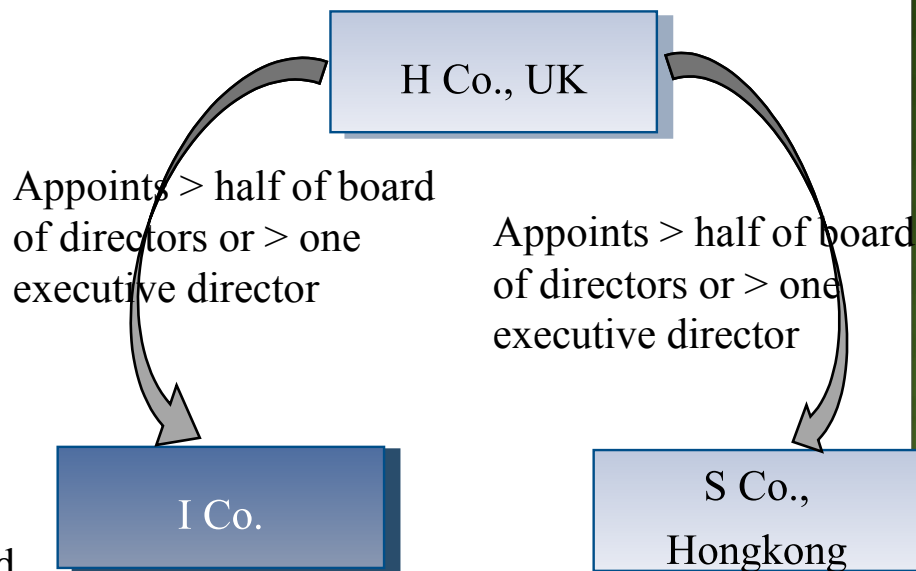


ASSOCIATED ENTERPRISE

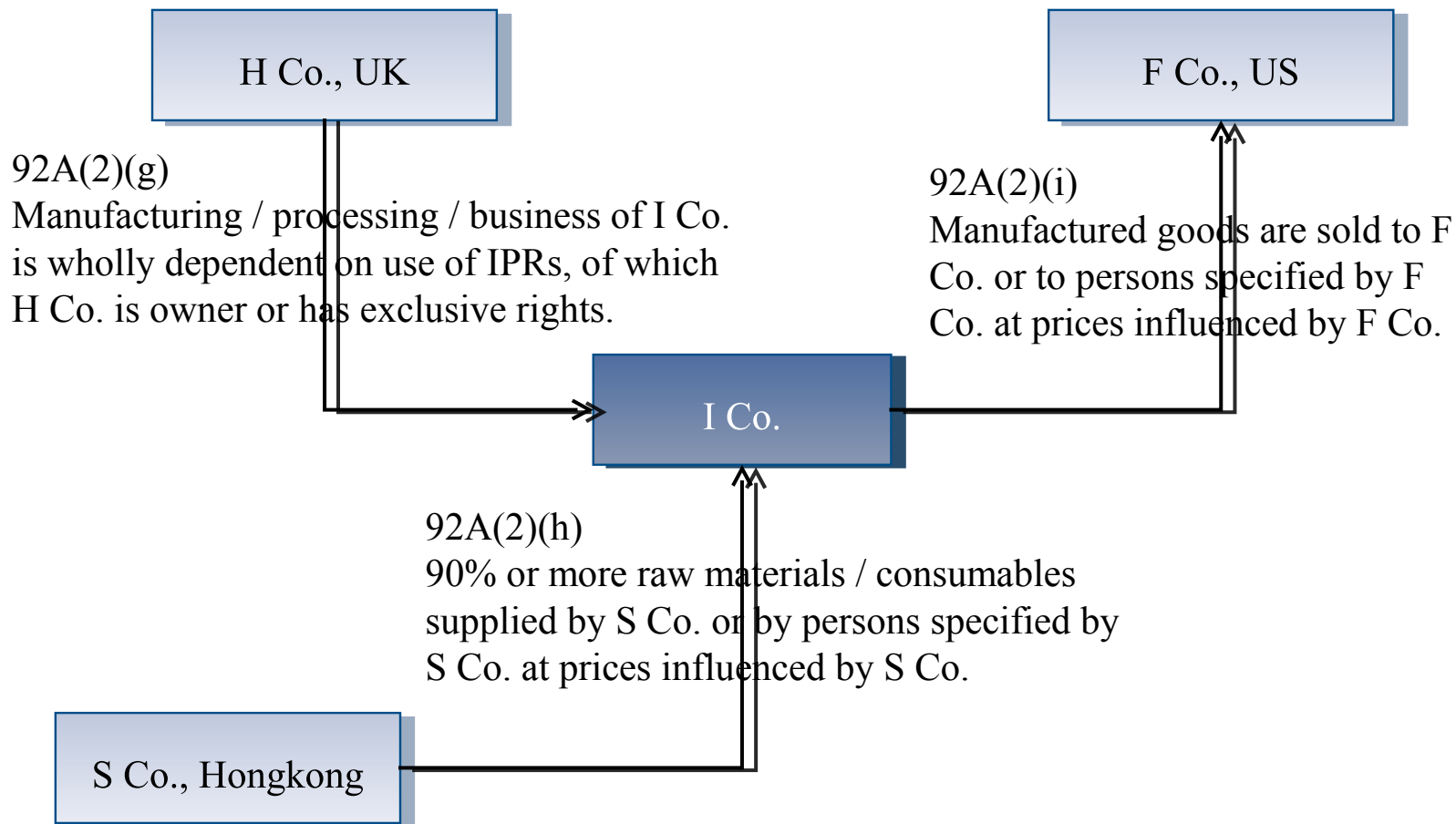
© 92A(2)(e)



© 92A(2)(f)



ASSOCIATED ENTERPRISE



ASSOCIATED ENTERPRISE

⊙ 92A(2)(j) and 92A(2)(k)

Control by Mr.
A / A(HUF)



I Co.

Control by –

- Mr. A and/or his relative;
- Member of A(HUF) and/or his relative



H Co., UK

⊙ 92A(2)(1)

H Co., UK

≥ 10% interest

I & Co.

[Firm / AOP / BOI]

ASSOCIATED ENTERPRISE

- ⦿ Whether covered?
 - Foreign Company and Indian branch
 - Indian Company and Foreign branch
- ⦿ Aithent Technologies (P.) Ltd. V. ITO - (2015) 54 taxmann.com 261 (Delhi - Trib.)

INTERNATIONAL TRANSACTION

- ◎ S. 92B(1) - International transaction means
 - A transaction between two or more AEs, 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
 - Includes a cost allocation / apportionment / contribution arrangement

INTERNATIONAL TRANSACTION

- ◎ S. 92B(2) – Transaction with a non-AE deemed to be international transaction if
 - there exists a prior agreement in relation to the relevant transaction between such other person and the AE, or
 - the terms of the relevant transaction are determined in substance between such other person and the AE

S. 92B(2) creates deemed international transaction without creating deemed AE relationship.

COMPUTATION OF ALP

- ⊙ 92C(1) – ALP to be determined using the most appropriate method out of –
 - Comparable Uncontrolled Price (CUP) Method
 - Resale Price Method (RPM)
 - Cost Plus Method (CPM)
 - Profit Split Method (PSM)
 - Transactional Net Margin Method (TNMM)
 - Other prescribed method

COMPUTATION OF ALP

- ◎ 92C(2) – Most appropriate method (MAM) to be adopted as per R. 10C
 - ALP to be determined at arithmetical mean, where more than one price is determined as per most appropriate method.
 - In case MAM is PSM or Any other Method, or if number of comparables are less than 6, tolerance range of 1% (in case of wholesalers) or 3% (for other assesseees) is available
 - In all other cases, arm's length range will be determined as between 35th and 65th percentile of the comparable prices

Most countries accept the Inter-Quartile Range as the permissible range within which Arm's Length Price can lie.

COMPUTATION OF ALP

- ⦿ S. 92C(3) – AO to determine ALP on the basis of material available with him
- ⦿ S. 92C(4) – AO to compute total income of assessee on the basis of ALP determined u/s. 92C(3)
 - No deduction u/s. 10A / 10AA / 10B in respect of enhanced total income
 - No corresponding relief in computing income of AE.

MOST APPROPRIATE METHOD

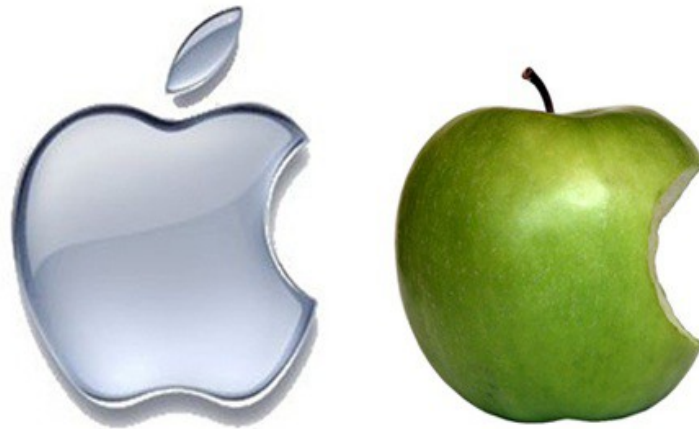
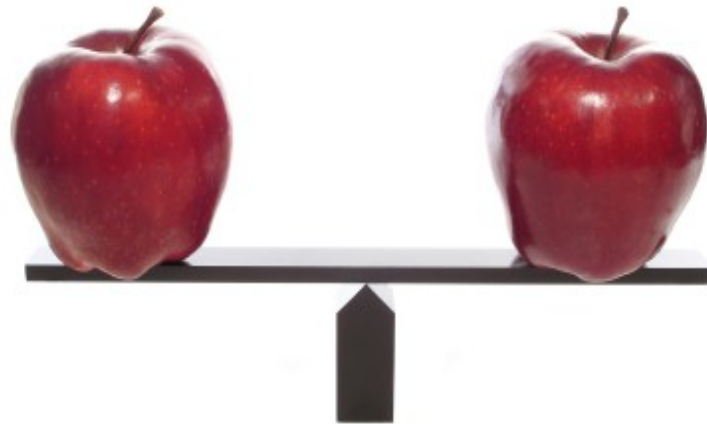
- To be adopted based on facts of each transaction, taking into account –
 - nature and class of the international transaction;
 - the class or classes of AEs entering into the transaction and the functions performed by them taking into account assets employed and risks assumed;
 - the availability, coverage and reliability of necessary data;
 - the degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;
 - the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;
 - the nature, extent and reliability of assumptions required to be made in application of a method.

COMPARABLE UNCONTROLLED PRICE

Price charged for property transferred / services provided in comparable uncontrolled transaction(s)	Xxxx
Adjustments for any differences, (which could materially affect the ALP) - <ul style="list-style-type: none">• between international transaction and comparable uncontrolled transaction, or• between enterprises entering into the transactions.	xx
Arm's Length Price	Xxxx

COMPARABLE UNCONTROLLED PRICE

- ⦿ Application of CUP requires high degree of comparability of products and functions
- ⦿ Adjustments for –
 - Product quality
 - Contractual terms
 - Geographic market
 - Foreign currency risks, etc.
- ⦿ May be internal - between one of the related parties and a third party; or external - between two third parties.

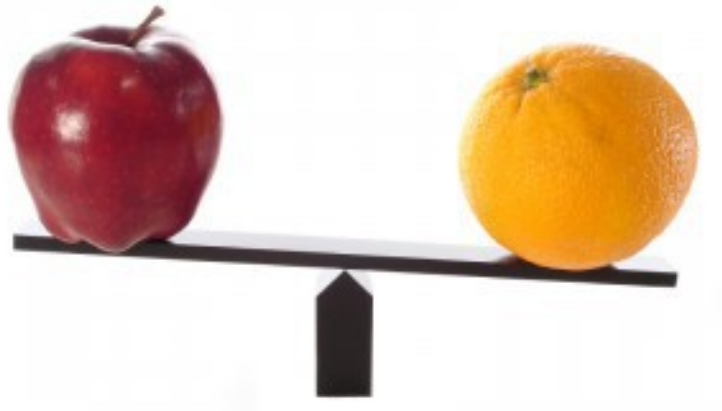


RESALE PRICE METHOD

Price at which property purchased or services obtained from the AE is resold to an unrelated enterprise	XXXX
Less: Normal GP accruing from resale of the same or similar property or services, in comparable uncontrolled transaction(s)	(xx)
Less: Expenses incurred by the enterprise in relation to purchase of property or obtaining services	(xx)
Adjustments for any functional and other differences, including different accounting practices, which could materially affect the GP margin in the open market – <ul style="list-style-type: none">•between the international transaction and the comparable uncontrolled transactions, or•between the enterprises entering into such transactions	xx
Arm's Length Price	XXXX

RESALE PRICE METHOD

- ⦿ Used for distributors who resell products without physically altering them or adding substantial value.
- ⦿ Less rigid than CUP, yet high degree of comparability required in respect of functions performed, risks borne, level of market, etc.
- ⦿ Adjustments for –
 - Inventory turnover
 - Contractual terms
 - Transportation costs, etc.



COST PLUS METHOD

Direct and indirect costs of production in respect of property transferred or services provided to an AE		XXXX
Add: Adjusted GP mark-up to production costs		
Normal GP mark-up to such costs (computed using uniform accounting norms) arising from sale of same or similar property or services in comparable uncontrolled transaction(s)	xx%	
Adjustments to normal GP mark-up for any functional and other differences, which could materially affect the GP mark-up in the open market, <ul style="list-style-type: none"> • between the international transaction and the comparable uncontrolled transactions, or • between the enterprises entering into such transactions 	xx%	xx%
Arm's Length Price		XXXX

COST PLUS METHOD

- ⦿ Used in case of manufacturers and service providers.
- ⦿ Requires detailed comparison of products, functions performed, risks borne, manufacturing complexity, cost structures, and intangibles.
- ⦿ Internal CPM, where the assessee sells to third parties also, is more reliable than external CPM.
- ⦿ Difficulty in availability of reliable cost and gross margin data in public domain.

PROFIT SPLIT METHOD

Contribution Method

Combined net profit of the AEs arising from the international transaction in which they are engaged	XXXX
Relative contribution made by each of the AEs to the earning of such combined net profit <ul style="list-style-type: none">• on the basis of the functions performed, assets employed and risks assumed by each enterprise and• on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances;	xx%
Proportionate amount of profit on the basis of relative contribution	xxx
Arm's Length Price (Costs + Proportionate Profit)	XXXX

PROFIT SPLIT METHOD

Residual Method

Combined net profit of the AEs arising from the international transaction in which they are engaged	a	XXXX
Less: Basic Return appropriate for the nature of international transaction of each AE	b	(xxx)
Residual Profit	c=a-b	XXXX
Relative contribution made by each of the AEs to the earning of residual net profit <ul style="list-style-type: none"> • on the basis of FAR of each enterprise and • on the basis of reliable external market data 	d	xx%
Proportionate amount of profit on the basis of relative contribution	e=c*d	xxx
Arm's Length Price (Costs + b + e)		XXXX

PROFIT SPLIT METHOD

- ⊙ Applicable mainly in international transactions involving transfer of unique intangibles or in multiple international transactions which are so interrelated that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction.
- ⊙ Key issues include computation of combined profits, restating profit of AEs using uniform accounting policies, determining appropriate allocation keys, obtaining third party data, etc.

TRANSACTIONAL NET MARGIN METHOD

NP Margin realised by the enterprise from an international transaction entered into with an AE calculated in relation to costs incurred or sales effected or assets employed or any other relevant base		xx%
NP Margin realised from a comparable uncontrolled transaction(s) having regard to the same base	xx%	
Adjustments to comparable NP margin for any differences, which could materially affect the NP margin in the open market – <ul style="list-style-type: none"> • between the international transaction and the comparable uncontrolled transactions, or • between the enterprises entering into such transactions 	x%	
Arm's Length NP Margin		xx%

TRANSACTIONAL NET MARGIN METHOD

- ⊙ Method of last resort
- ⊙ Least rigid method in terms of product comparability.
- ⊙ Comparison focused on functions performed and risks assumed.
- ⊙ Adjustments required for –
 - Difference in accounting classifications and treatments
 - Credit terms
 - Inventory levels
 - Currency risk, etc.

TRANSACTIONAL NET MARGIN METHOD

- ◎ Steps in application of TNMM –
 - Determination of a tested party in the controlled transactions under analysis;
 - Determination the appropriate level of aggregation for the purposes of testing the controlled transactions;
 - Search for comparable companies performing similar functions and incurring similar business risks as the tested party;
 - Adjusting the tested party and the comparable companies' financial results to increase the reliability of the analysis; and
 - Selection of a single most reliable profit level indicator with which to make the comparison between the tested party and the comparable companies

OTHER METHOD - RULE 10AB

10AB. *For the purposes of clause (f) of sub-section (1) of section 92C, the other method for determination of the arm's length price in relation to an international transaction or a specified domestic transaction shall be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts.*

TESTED PARTY

- ⊙ Party which is the point of reference for comparison of the international transaction with uncontrolled transactions.
- ⊙ Normally, tested party is the one,
 - Whose operations are less complex
 - Who bears the least risk
 - Who does not own significant intangibles.

Foreign tested party, though not prohibited, are not easily accepted by the department for lack of comfort.

BENCHMARKING ANALYSIS

⦿ Industry Analysis

- Nature of industry – capital intensive or labour intensive; industry returns; competitive, oligopolistic or monopolistic, etc.
- Gestation period
- Current phase of business cycle
- Cost drivers and profit drivers

⦿ Entity Analysis

- Business model of the assessee and its AEs
- Functions, Assets and Risk Analysis of all AEs

BENCHMARKING ANALYSIS

- ⊙ Transaction Analysis
 - Nature of transaction
 - Price and other contractual terms
- ⊙ Selection of the Tested Party
- ⊙ Selection of the Most Appropriate Method
- ⊙ Selection of the Profit Level Indicator
- ⊙ In case of methods other than CUP, use of database for search of comparable companies.

USE OF MULTIPLE YEAR DATA

- ⦿ Prior to amendment w.e.f 19th October 2015, only contemporary data was to be used for benchmarking analysis.
- ⦿ However, data for earlier 2 years could be used only if it could have an influence on the determination of prices.
- ⦿ For transactions entered into after 31st March 2014, use of weighted average price of multiple years is permitted if MAM is RPM, CPM or TNMM

BENCHMARKING ANALYSIS

- ⊙ Computation of appropriate profit level indicators of comparable companies.
- ⊙ Making reliable and accurate adjustments for differences in –
 - Functions performed, assets employed and risks assumed
 - Contractual terms of the transaction
 - Special circumstances applicable to the assessee – such as start-up costs, under-utilisation of capacity, etc.
 - Geographical location, size of market, etc.
- ⊙ Compare ALP with actual price / profit.

DOCUMENTATION

S. 92D r.w. R. 10D –

⦿Mandatory documentation requirements in case where aggregate of international transactions, as recorded in the books, exceeds Rs. 1 crore.

⦿Even in cases where aggregate value of transactions is below Rs. 1 crore, assessee is required to maintain adequate material to substantiate the arm's length nature of the transactions.

⦿Documents to be maintained for 8 years from the end of the assessment year.

DOCUMENTATION

- ◎ Mandatory documentation requirement includes –
 - ownership structure of the assessee with details of shares or other ownership interest held therein by other enterprises;
 - a profile of the multinational group of which the assessee enterprise is a part;
 - broad description of the business of the assessee and the AEs and the industry in which the assessee operates;
 - the nature and terms (including prices) of international transactions entered into with each AE, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction;

DOCUMENTATION

- description of the functions performed, risks assumed and assets employed by the assessee and by the AEs;
- record of the economic and market analyses, forecasts, budgets or any other financial estimates prepared by the assessee, which may have a bearing on the international transactions;
- record of uncontrolled transactions considered for comparability analysis, including nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the international transactions;
- record of the comparability analysis performed;

DOCUMENTATION

- description of the methods considered for determining the ALP, the method selected as the most appropriate method along with explanations, and how such method was applied in each case;
- record of the actual working carried out for determining ALP, including details of the comparable data and financial information used, and adjustments made for differences;
- the assumptions, policies and price negotiations, if any, which have critically affected the determination of the ALP;
- details of the adjustments made to transfer prices to align them with ALP;
- any other information, data or document relevant for determination of the ALP.

DOCUMENTATION

- ◎ Supporting documents to be maintained –
 - official publications, reports, studies and data bases from the Government of the country of residence of the AE, or of any other country;
 - reports of market research studies carried out and technical publications brought out by institutions of national or international repute;
 - price publications including stock exchange and commodity market quotations;
 - published accounts and financial statements relating to the business affairs of the AEs;

DOCUMENTATION

- ◎ Supporting documents to be maintained –
 - agreements and contracts entered into with AEs or with unrelated enterprises in respect of transactions similar to the international transactions;
 - letters and other correspondence documenting any terms negotiated between the assessee and the AE;
 - documents normally issued in connection with various transactions under the accounting practices followed.

DOCUMENTATION

- ⦿ All documentation to be contemporaneous as far as possible.
- ⦿ In case of an international transaction having effect over more than one year, fresh documentation need not be maintained unless there is any significant change affecting the price.
- ⦿ Documentation to be produced before the AO or Commissioner (Appeals) within 30 days of receipt of notice for the same.

ACCOUNTANT'S REPORT

- ⦿ Accountant's Report to be obtained in Form 3CEB and submitted before due date of filing return of income.
- ⦿ Due date in case of assesseees to whom S. 92E applies is 30th November
- ⦿ Form 3CEB has to be filed electronically, in a manner similar to filing of tax audit report.

PENALTIES

Section	Penalty for	Amount of penalty
S. 271AA	<ul style="list-style-type: none">- Failure to keep & maintain specified documents;- Failure to report any transaction;- Maintaining or furnishing incorrect information or documentation	2% of value of international transaction
S. 271BA	Failure to furnish audit report u/s. 92E	Rs. 1,50,000

Penalty u/s. 271AA proposed to be replaced with a flat penalty of Rs. 5,00,000 by Financial Bill 2016

OTHER ASPECTS

- ⦿ Safe Harbour Rules
- ⦿ Advanced Pricing Agreements
- ⦿ Base Erosion and Profit Shifting (BEPS)



THANK YOU

CA NAMRATA DEDHIA