

# **WORKSHOP ON TRANSFER PRICING**

**THE WESTERN INDIA REGIONAL COUNCIL OF  
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA**

## **Documentation For Arriving At Transfer Price** - A Practical Insight

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# *Overview*

1. Setting the Tone
2. OECD Guidelines on Documentation
3. Overview of Indian Regulations
4. Documentation Process
5. Documentation in case of Specific Transactions
6. Issues

# Setting the Tone

# Legislative Overview

- ✚ **Mandatory contemporaneous documentation requirements (S. 92D)**
  
- ✚ **The statute requires information / documents in relation to international transaction to be:**
  - ✚ Kept and maintained in by every person >INR 10 M / For SDT < INR 50 MI
  - ✚ Kept and maintained for a prescribed time – 8 years from the end of relevant assessment year
  - ✚ Furnished within 30 / 60 days of Revenue's request.
  
- ✚ **Stringent Penal Consequences on Non-compliance coupled with TP adjustments**

# What is Documentation?

## ➤ Standard Documentation

- Inter Company Documents
- Transfer Pricing Study report
- Audited Statements of Account
- Form 3CEB with Annexures
- Form 3CD Annexures

## ➤ Additional Documents

- Annual Reports
- Website Grabs
- FAR Analysis
- Media Coverage
- Analyst Reports
- Quarterly/ Half Yearly Presentations
- Budgets
- Plans & Projections
- Cost Records
- Analyses
- Other supporting material which record information.



# One Size Doesn't Fit All

✚ Cost Vs. Benefits

✚ Customized Approach - Every industry has unique need

Particulars	Costs	Allocations	Margins	Comparables	FAR/ Documentations
Service Companies	*	*	-	*	√
Manufacturing Companies	*	-	*	*	√
Trading Companies	-	-	*	*	√
Hybrid Companies	*	*	*	*	√

# OECD Guidelines

# Documentation- OECD Guidelines

## Chapter V of OECD Guidelines

*“ Documentation obligations may be affected by rules governing burden of proof in the relevant jurisdiction.”*

*“without adequate information the tax administration would not be able to examine the case properly.”*

## Documentation should be

*“.....based upon information reasonably available at the time of the determination.....before the pricing is established”*

## OECD Guidelines state

*“..... the taxpayer must take into consideration that adequate record-keeping practices and the voluntary production of documents can improve the persuasiveness of its approach to transfer pricing.*



# Documentation- OECD Guidelines

- Review & revision of existing TP analysis and documentation, if conditions change.
- Standard of analysis and documentation should be from a prudent businessmen point of view- Materiality matters.
- Written materials preferred to justify arm' length pricing and production of same in the course of examination.
- Information / records not in possession of taxpayer shall not be required.
- Use of Exchange of Information Article by Tax Administration.
- Limitation on post transaction documents.
- Requirement for concurrent information only.
- Confidentiality of information furnished.

# Documentation- OECD Guidelines

- Information related to AEs.
- How the product/services involved in transaction flow among AEs.
- Information on Pricing – Basis, nature & terms of the transaction
- Information on Special Circumstances
- Information on management strategies and type of business.
- General Commercial or Industry Condition affecting taxpayer.
- Functional Analysis.
  - Functions Performed
  - Risks Assumed
  - Assets Used / Employed.
- Economic characterization
- Financial Information
- Information on transaction negotiation.
- Details of external / internal comparable uncontrolled transactions.

# Overview of Indian Regulations

# What are the Documentation Requirements?

## Entity related

- Ownership structure of Indian entity
- Profile of group (AEs)
- Business description of Indian entity
- Overview of industry

## Price related

- Transaction terms
- Functional analysis (*functions, assets and risks*)
- Economic analysis (*method selection, comparable benchmarking*)
- Forecasts, budgets, strategies, estimates
- Record of uncontrolled transactions taken for ~~Comparability Analysis~~

## Transaction related

- Agreements
- Invoices
- Pricing related correspondence (*letters, emails etc*)
- Details of external/ internal CUPs

- **Other Supporting Documents [Rule 10 D(2)]**
- Analysis performed to evaluate comparability of Uncontrolled transactions with international transactions
- Methods considered and selection of MAM with explanations
- Actual working carried out for determination of the arm's length price
- Assumptions, policies, price negotiations which have critically affected determination of arm's length price
- Adjustments, if any & other relevant information

# Statutory Requirement under Rule 10D

Particulars	Documents Required
<b>Organisational Structure</b>	<ul style="list-style-type: none"><li>• Details of Shares / other ownership interest held by other enterprise</li><li>• Profile of the MNE Group</li><li>• Name , Address, Legal status, ownership linkages &amp; country of tax residence of each of the enterprises in the group</li></ul>
<b>Nature of business / industry &amp; Market Condition</b>	<ul style="list-style-type: none"><li>• Broad Description of the business of the tax payer</li><li>• Industry background</li><li>• Business of the AE</li></ul>
<b>Controlled Transactions</b>	<ul style="list-style-type: none"><li>• Nature &amp; terms of the international transactions</li><li>• Details of property transferred/service provided</li><li>• Quantum &amp; Value of the International Transactions</li></ul>

# Statutory Requirement under Rule 10D

<b>Particulars</b>	<b>Documents Required</b>
<b>Background Documents</b>	<ul style="list-style-type: none"> <li>• Record of Economic and Market Analysis</li> <li>• Forecasts, budgets or any other financial estimates</li> </ul>
<b>Comparability, functional &amp; risk analysis</b>	<ul style="list-style-type: none"> <li>• Record of uncontrolled transactions</li> <li>• Record &amp; evaluation of comparability of the transactions</li> <li>• Description of Functions performed, risk assumed and assets employed</li> </ul>
<b>Selection of TP method</b>	<ul style="list-style-type: none"> <li>• Description of methods considered for determining ALP</li> <li>• Most Appropriate Method selected along with reasons for selection</li> </ul>
<b>Application of TP method</b>	<ul style="list-style-type: none"> <li>• Record of actual working of ALP</li> <li>• Details of actual working of comparables w.r.t ALP</li> <li>• Details of differences between comparable data &amp; uncontrolled transaction &amp;</li> <li>• Mode of adjusting the factors</li> </ul>

# Statutory Requirement under Rule 10D

<b>Particulars</b>	<b>Documents Required</b>
<b>Assumptions, Strategies, Policies</b>	<ul style="list-style-type: none"><li>• Assumptions , Policies and price negotiations , which have critically affected determination of the ALP</li></ul>
<b>Supporting Information</b>	<ul style="list-style-type: none"><li>• Official reports , publications, etc.</li><li>• Databases &amp; studies from the government in the country of residence of the AEs, or any other country, relevant to the international transaction.</li><li>• Market research studies and technical publications brought out by institutions of national and international repute.</li><li>• Correspondence documenting the terms negotiated between the AE's.</li></ul>

# Statutory Documentation Requirements

## **Threshold Limit :**

- If the aggregate book value of the international transactions < INR 10 million – NO need to maintain the prescribed documentation

## **Period of maintenance of documentation:**

- The Prescribed information & documentation should be contemporaneous and must be in existence by the specified date – November 30<sup>th</sup> of the following financial year – Rule 10D(4).
- Documentation to be retained for 9 years ( eight years from the end of relevant assessment year) – Rule 10D(5).

## **Relaxation of requirements :**

- If the international transaction has effect on more than one financial year, a fresh documentation need not be maintained separately, unless there is significant change in :
  - The nature or terms of the international transactions.
  - Assumptions made
  - Any other factor which could influence the transfer price



# S. 271- Penalty Implications

Sr. No.	Nature of default	Section	Penalty
1	<b>a) Failure to maintain prescribed information/ Documents</b>	271AA	2% of transaction value
	(b) Failure to report any such transaction or		
	(c) Furnishing incorrect information		
2	<b>Failure to furnish information/ documents during assessment u/s 92D</b>	271G	2% of transaction value
3	Adjustment to taxpayer's income during assessment	271(1)(c)	100% to 300% of tax on successful adjustment amount
4	Failure to furnish accountant's report u/s 92E	271BA	INR 100,000

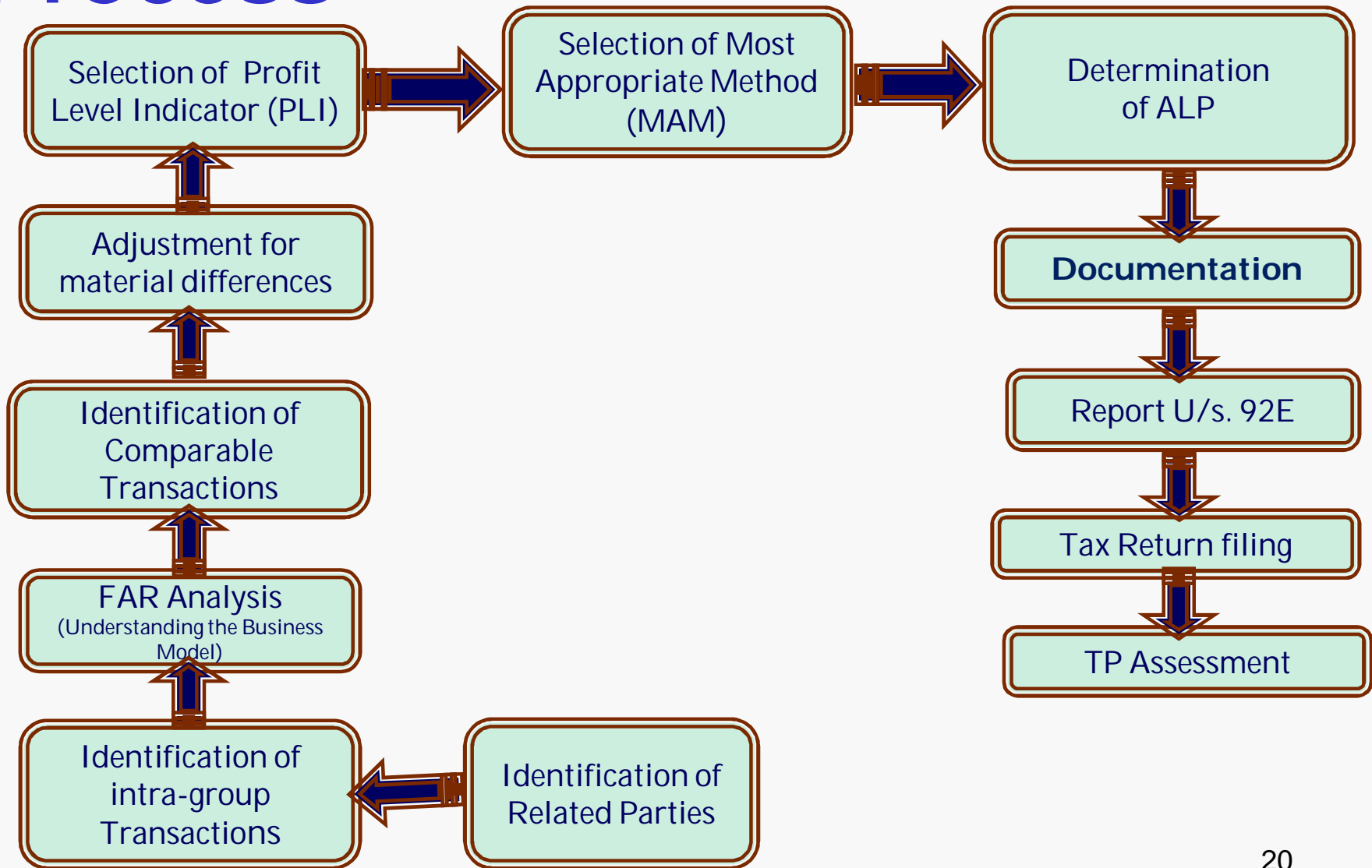
# Maintenance of Transfer Pricing Documentation

## Indian Statute of Limitation – An illustration – Year Ended March 2013

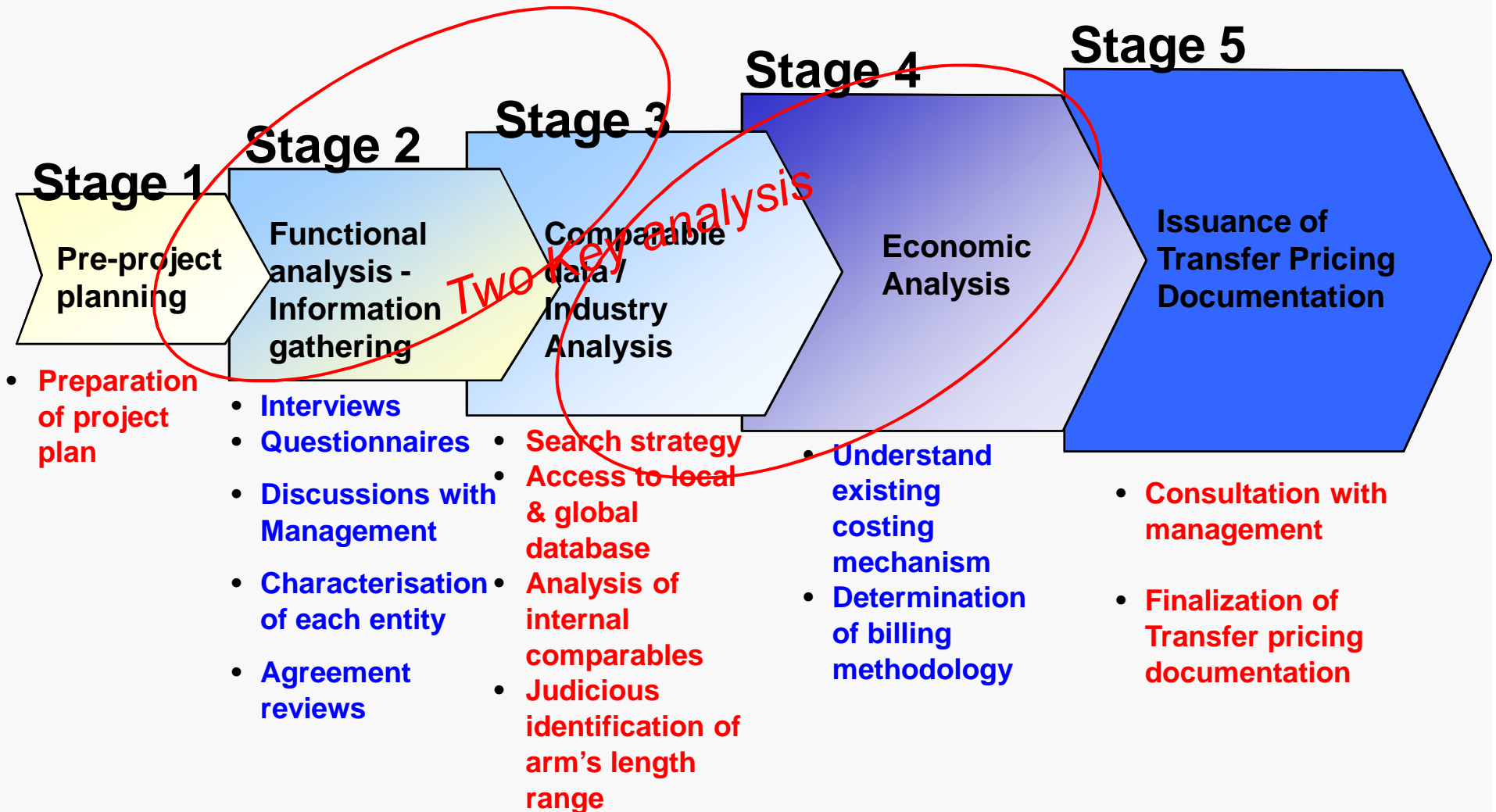
S. No	Timeline	Compliance	Relevant Provision
1	30-Nov-13	Deadline for maintaining documentation, filing tax return and accountant's report	Section 139(1) read with Section 92E
2	30-Sept-14	Limitation for initiating Scrutiny/ Audit by AO	Proviso to section 143(2)(ii)
3	31-Jan-17	Limitation for completion of the transfer pricing audit by TPO upon reference by AO	Section 92CA(3A) read with Second Proviso to Section 153(1)
4	31-Mar-17	Limitation for completion of scrutiny by AO	Second Proviso to Section 153(1)
5	31-Mar-18	Limitation for reassessment (where income escaping assessment is less than INR 100,000)	Section 149(1)(a)
6	31-Mar-20	Limitation for reassessment (where income escaping assessment is equal to or greater than INR 100,000)	Section 149(1)(b)
7	31-Mar-22	Date till which documentation is required to be maintained	Section 92D and Rule 10D(5)

# Documentation Process

# Steps in Transfer Pricing Process



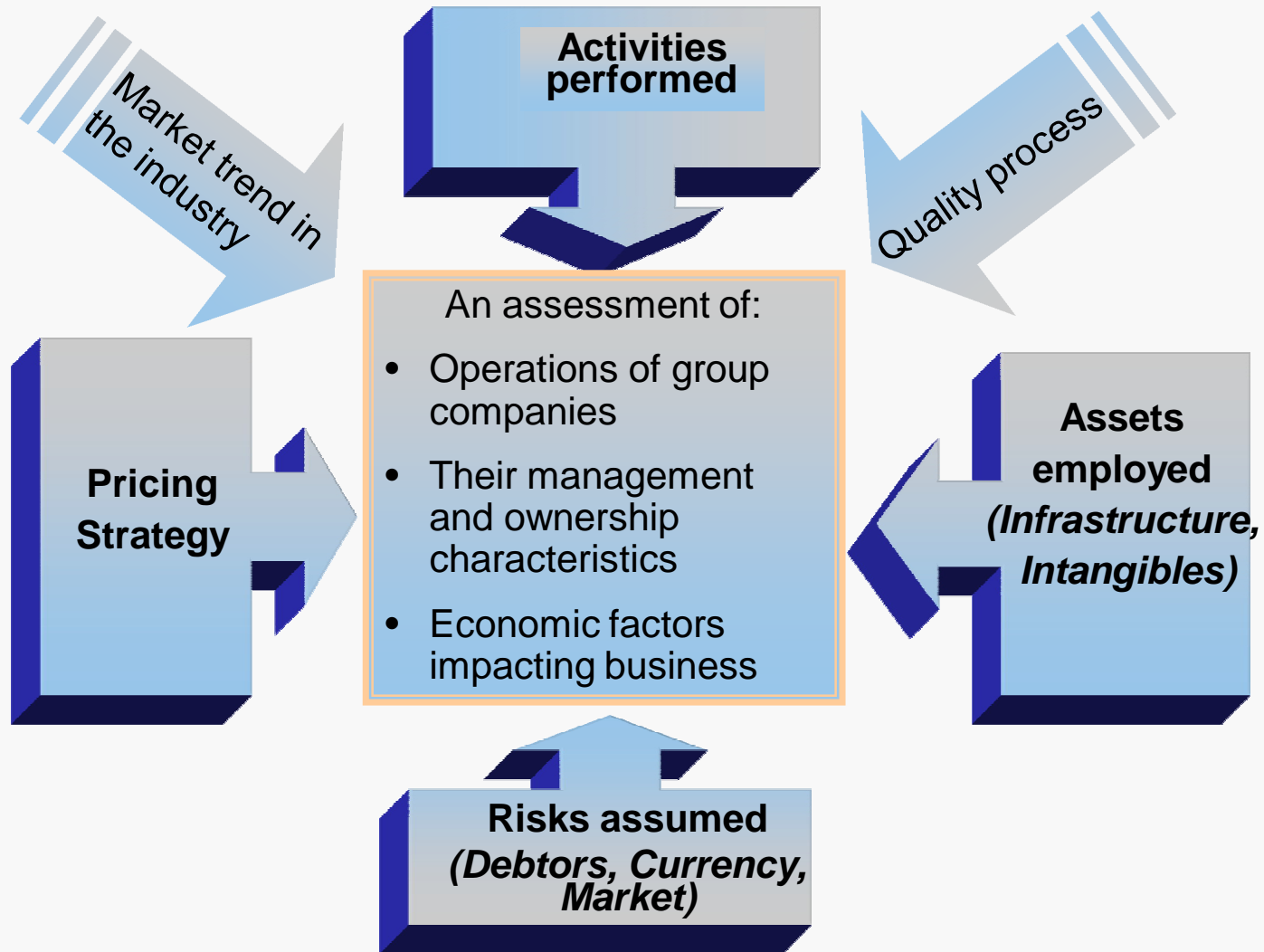
# Key to dos before finalizing Documentation



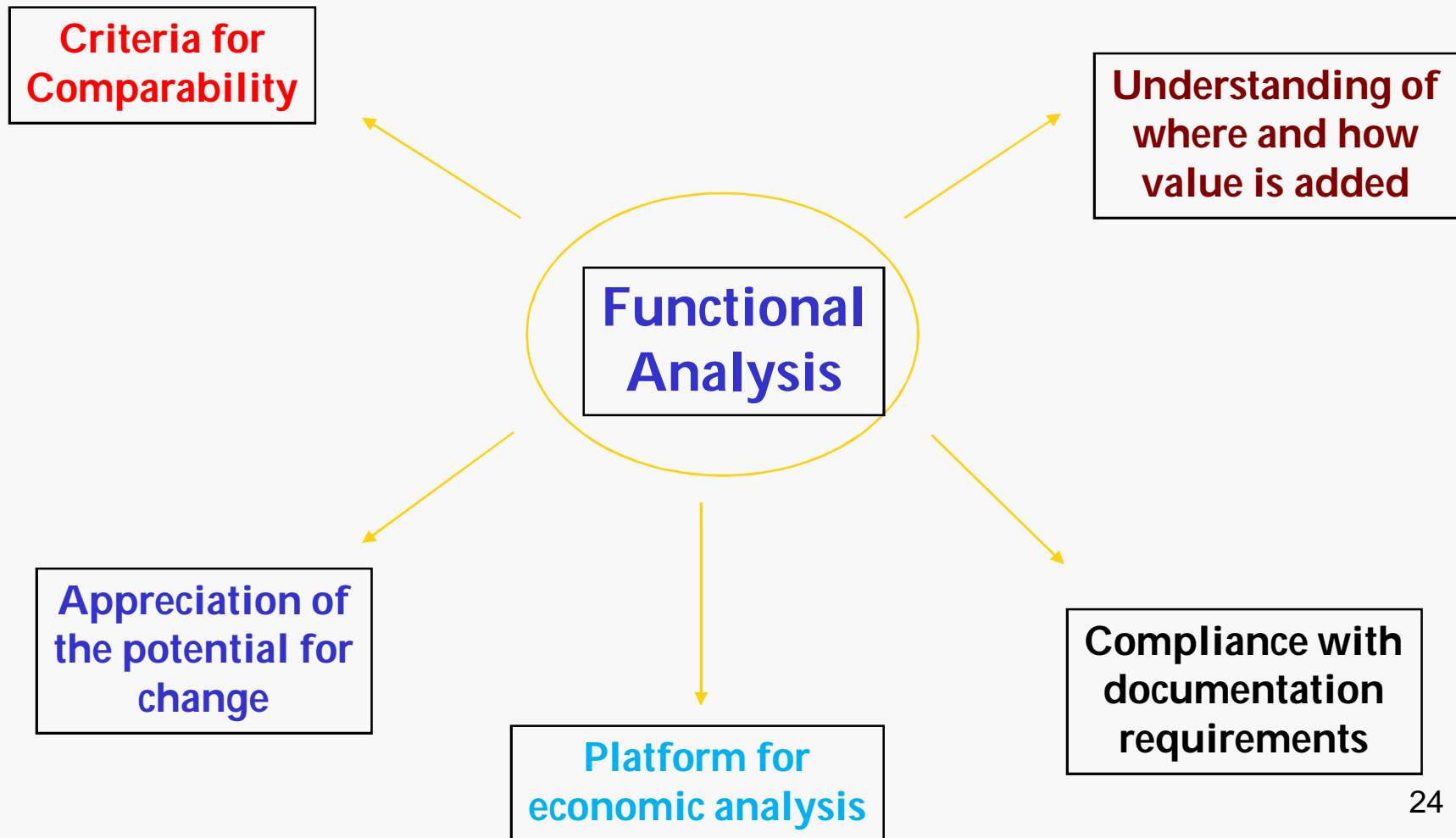
# Elements of FAR Analysis

Functions	Assets	Risks
Research & Development	Product intangibles	Business risks
Purchasing	Manufacturing intangible	Market risks
Manufacturing	Property	Manufacturing risk
Assembling and Packaging	Marketing Intangibles	Foreign exchange risk
Warehousing and Logistics	Loans & Advances	Inventory risk
Engineering	Guarantees	Credit risk
Quality Control		Research & Development risk
Labour Management, Training		Warranty risk
Marketing		
Sales & Distributions		
After Sales Services		

# FAR Analysis



# What comes out of FAR Analysis ?





# What comes out of FAR Analysis ?

Functional Analysis	Contract Manufacturer	Full- Fledged Manufacturer
<b>Functions</b>		
Research & Development	-	√
Purchasing	√	√
Manufacturing	√	√
Assembling and Packaging	√	√
Warehousing and Logistics	√	√
Engineering	√	√
Quality Control	√	√
Labour Management, Training	√	√
Marketing	-	√
Sales & Distributions	-	√
After Sales Services	-	√
<b>Risks</b>		
Business risks		√
Market risks	√(volume)	√
Manufacturing risk	√	√
Foreign exchange risk	?	√
Inventory risk	√	√
Credit risk	√	√
Research & Development risk	-	√
Warranty risk	-	√
<b>Assets</b>		
Product intangibles	-	√
Manufacturing intangible	?	?

# Comparability Factors

- While identifying comparables, FAR and terms of business can be determined from Financials. Indicative list is discussed below

Financial Item	FAR & Terms
Sales / Net Worth	Size of Operations
Export Sales	Market Conditions
Non Operating Income	Non Core Functions
Advertising & Marketing Exp	Marketing Function
Bad Debt & Provision for Doubtful Debt	Business Risk
Exchange Gain/Loss	Foreign Currency Risks
Research & Development Exp	R&D Function, R&D Risk
Debtors & Creditors Turnover Ratio	Credit Risk
Land & Building and Depreciation thereon	Asset Base
Goodwill & Other Intangible Assets	Intangible Assets

# Contractual Terms

## Factors Affecting Comparability

- ▶ How risks, benefits and responsibilities are divided?
- ▶ Analyze terms whether written or oral, explicit or implied
- ▶ Independent parties will hold one another to terms and only rarely will modify
  - ▶ Less incentive to do so in controlled transaction → therefore examination necessary
- ▶ Analysis to follow the actual conduct of the parties

# Economic Circumstances

## Factors Affecting Comparability

- ▶ Prices vary across different markets even for same products
- ▶ Essential to identify relevant market(s) related to transaction
- ▶ Whole variety of factors to take into account:
  - Location, size, competitive position, availability of substitute goods/services, level of supply and demand, purchasing power, regulation and local costs, level of market (retail or wholesale), date and time of transactions etc.

# Business Strategies

## Factors Affecting Comparability

- Business strategies may include
  - start up (entering a new market)
  - marketing strategy to increase the market share;
- Business strategy may sacrifice current profits for higher anticipated profits
- What happens if anticipated profits are not in fact realized?
  - evaluate position critically to see if strategy is credible: e.g. look for consistent behavior and see who bears costs and is intended to reap rewards
  - would independent enterprise have entered into such a scheme and would it have continued long after anticipated profits have not materialized?

# Economic Adjustments

- While carrying out adjustments, it is important to demonstrate the need and basis of such adjustments
- Following is the indicative list of adjustments which can be made based on the information available in the Financial Statements
  - Differences in FAR
  - Idle Capacity
  - Credit Period
  - Return on Resources – FA/Employees/Intangibles, etc

# Selection of the Tested Party

- Tested Party
  - A participant to the international transaction with reference to whom the international transaction is tested
  
- Factors for selection of tested party
  - Least complex FAR and does not own significant intangibles
  - Selected Transfer Pricing method can be applied in most reliable manner
  - Availability of reliable comparable data
  - Requiring least adjustments

# Selection of the Profit Level Indicator

- In case where TNMM has been selected as the Most Appropriate Method, a Profit Level Indicator (PLI) is used for Benchmarking
- Normally Operating Profit/Sales or Operating Profit/Operating Cost are considered
- Situations may warrant use of alternate/multiple PLI

## Cash Profit Ratio

New Business with Heavy Investment

## Return on Capital Employed

Capital Intensive Business

## Return on Shareholders Funds

Highly Geared Companies

## Revenue per Employee

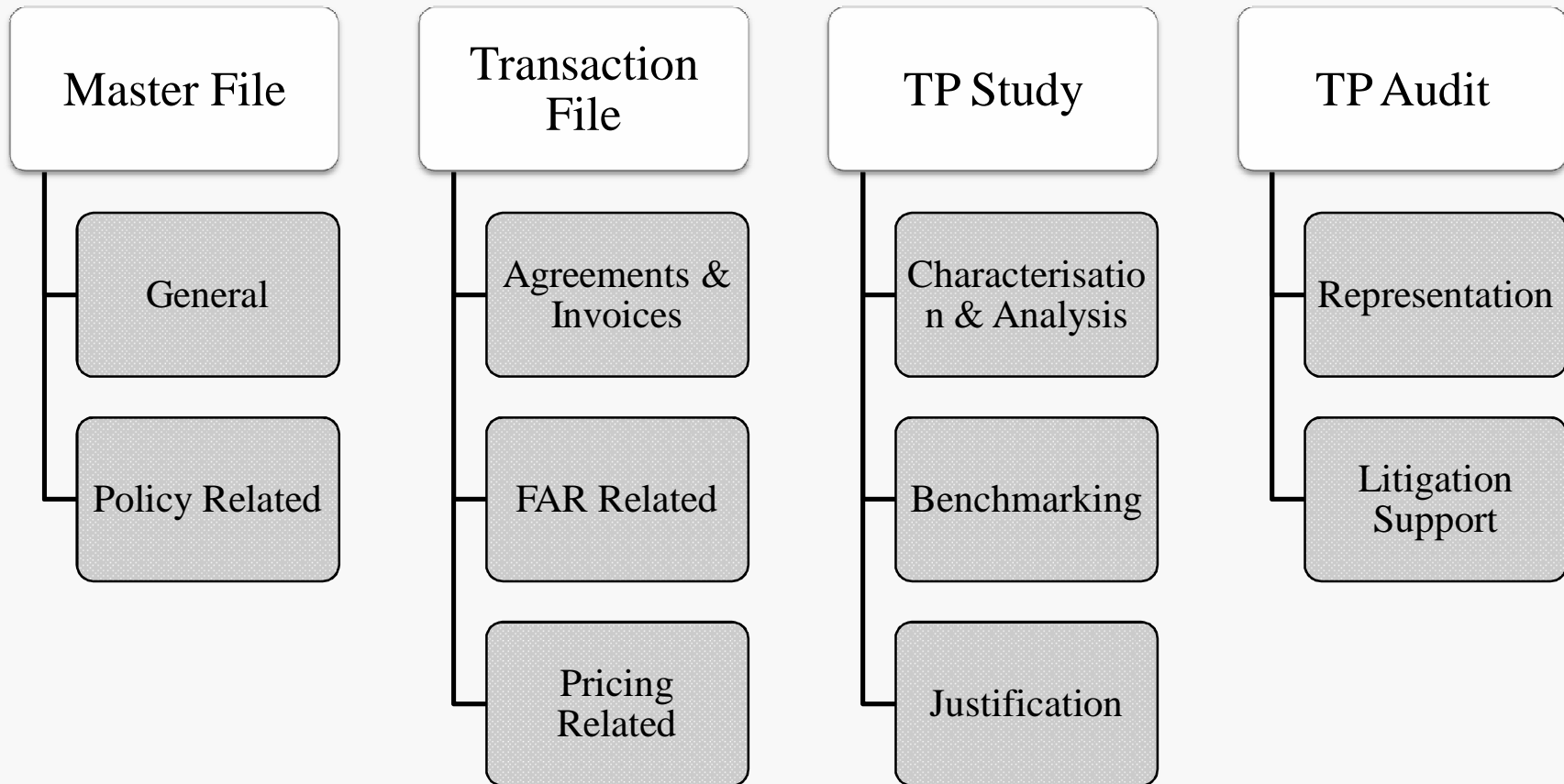
Human Capital Based Business

## Berry Ratio

Used in conjunction with other ratios for validations



# Documentation Best Practices



# Documentation in Case of Specific Transactions

# Royalty payouts

## Issues relating to Royalty pay-outs:

Royalty is widely adopted appropriate mechanism to compensate for use of manufacturing intangible

### Benchmarking Issues:

- Aggregation approach under TNMM – Challenged and general lack of availability of comparables
- Transaction specific approach has been adopted by revenue – examine the ‘**cost – benefit**’ analysis
- Non acceptance of Foreign Comparables / Databases

### Possible Solutions on Valuation:

- **Market approach** – Value based on current purchase / sale of such intangible
- **Income approach** – Calculating the present value of future benefits
- **Cost approach** – Replacement cost of similar intangible

## Documentary evidence / analysis to substantiate Royalty:

- Copies of license agreement
- Benefits received / receivable by the tax payer and quantification of the benefit
- Unique nature of the intangible, market where it is used and strategic advantage achieved
- Rights of the taxpayer to receive upgrades .
- Comparative profits before and after the use of intangible.
- Whether there are any geographic restrictions such as to export based on the licensed technology
- Details of patents / intangibles registered by taxpayer in India
- Quote of a comparable independent technology recipient for the intangible.
- Rates at which the royalty is paid for use of similar intangibles by any other concern / subsidiary of the AE / Group.

Is Royalty Payment justified in case of loss situation?

# Management Fees

## Issues / justifications relating to management fee payouts

- Was there service received from Group
- Why not from third party
- Would there be same payment if rendered by third party
- Services rendered by group are not in the nature of stewardship, duplicative services
- Services in nature of back-office like accounting / payroll etc., being questioned that while others are off-shoring to India why taxpayer has to receive such service from Group

**Challenge:** Inadequate comparable data in the public domain

## Documentary evidence to substantiate management fees

- Business reports
- Training manuals
- Marketing brochures
- Time sheets / logs
- Copies of emails
- Minutes of meeting confirming receipt of services
- HR Schemes
- IT network / e-mail systems

**Payment justified for services not in the nature of shareholding services, duplicative services and passive association benefits.**

# Management Services – Illustrative Model Documentation

Documentation requirement specific to certain services

## Strategic Planning

- ▣ Business Reports / Plans
- ▣ Trainings
- ▣ E-mails
- ▣ Telecon-notes
- ▣ Corporate Governance initiatives

## Information Technology Support

- ▣ IT Security Policy and Manual;
- ▣ Details of trainings received;
- ▣ E-mail system
- ▣ Intranet
- ▣ Servers including Remote Servers

## Accounting and Finance

- ▣ Accounting system
- ▣ Accounting manual
- ▣ Business Reporting system
- ▣ Trainings

## Human Resources

- ▣ HR Manuals
- ▣ Appraisal and Evaluation
- ▣ Welfare Schemes
- ▣ Trainings

## Sales and Marketing

- ▣ Details of any marketing strategic inputs
- ▣ Details of sales converted due to marketing assistance
- ▣ Brand and Sales Promotion Material
- ▣ Trainings

## Supply chain Management ('SCM')

- ▣ SCM Manual and Policies
- ▣ Write-up on inventory management
- ▣ Daily distribution plan
- ▣ Demand forecasting and production scheduling

# Cost Contribution Arrangements

As per **OECD** the following information would be relevant and useful :

- A list of participants
- A list of any other associated enterprises that will be involved with the CCA activity or that are expected to exploit or use the results of the subject activity
- The scope of the activities and specific projects covered by the CCA
- The duration of the arrangement
- The manner in which participants' proportionate shares of expected benefits are measured, and any projections used in this determination
- The anticipated allocation of responsibilities and tasks associated with the CCA activity between participants and other enterprises
- The form & value of each participant's initial contributions, and a detailed description of how the value of initial & ongoing contributions is determined & how accounting principles are applied consistently to all participants in determining expenditure and the value of contributions
- The procedures for & consequences of a participant entering or withdrawing from the CCA and the termination of the CCA
- Any provisions for balancing payments or for adjusting the terms of the arrangement to reflect changes in economic circumstances

# Sustained Losses

- The taxpayer has to show that the objective of the business strategy at the time of entering was to make profits
- The taxpayer had taken sufficient steps to avoid the loss
- **Documentation must include:**
  - Analysis of business strategy
  - Comparative studies showing the period in which comparable independent enterprises would have been prepared to endure losses
  - Comparative studies showing the prices at which independent enterprises dealing at arm's length would have been prepared to sell in the same or similar circumstances ;
  - Comparative studies showing the prices at which independent enterprises dealing at arm's length would have been prepared to buy in the same or similar circumstances.

# Issues

- Contemporaneous Documentation
  - Aztec Software & Technology Services ITA No. 584/ Bangalore/2006
- Importance of FAR Analysis
  - Philips Software Centre Private Ltd- ITA No. 218/Bangalore/2008
- Comparables having related party transactions upto 25%
  - Actis Advisers (P) Ltd ITA No. 5277/Del/2011
  - Cases referred- Sony India Limited ITA No. 1189/Del/2005 & S. T. Micro Electronics Pvt. Ltd. ITA No. 1806& 1807/Del/2008
- Corporate Guarantees
  - Mahindra & Mahindra Ltd ITA No. 7999/Mum/2011



# **Thank You**

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