

Basics of Transfer Pricing

P Hari Prasad Guru
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Introduction

Transfer Pricing in India

Prior to April 1, 2001

- Basic provisions existed but were rarely applied
- Expert Group set up in November 1999 to study global transfer pricing practices

April 1, 2001 onwards

- Comprehensive legislation introduced in Union Budget 2001
- Special Provisions relating to avoidance of tax [Chapter X] [Sections 92 to 92 F of the Income Tax Act 1961]
- Provisions relating to Specified Domestic Transactions ('SDT') were introduced vide Finance Act, 2012
- Detailed Rules providing guidance for application of the legislation framed [Rules 10A to 10E of the Income Tax Rules 1962]

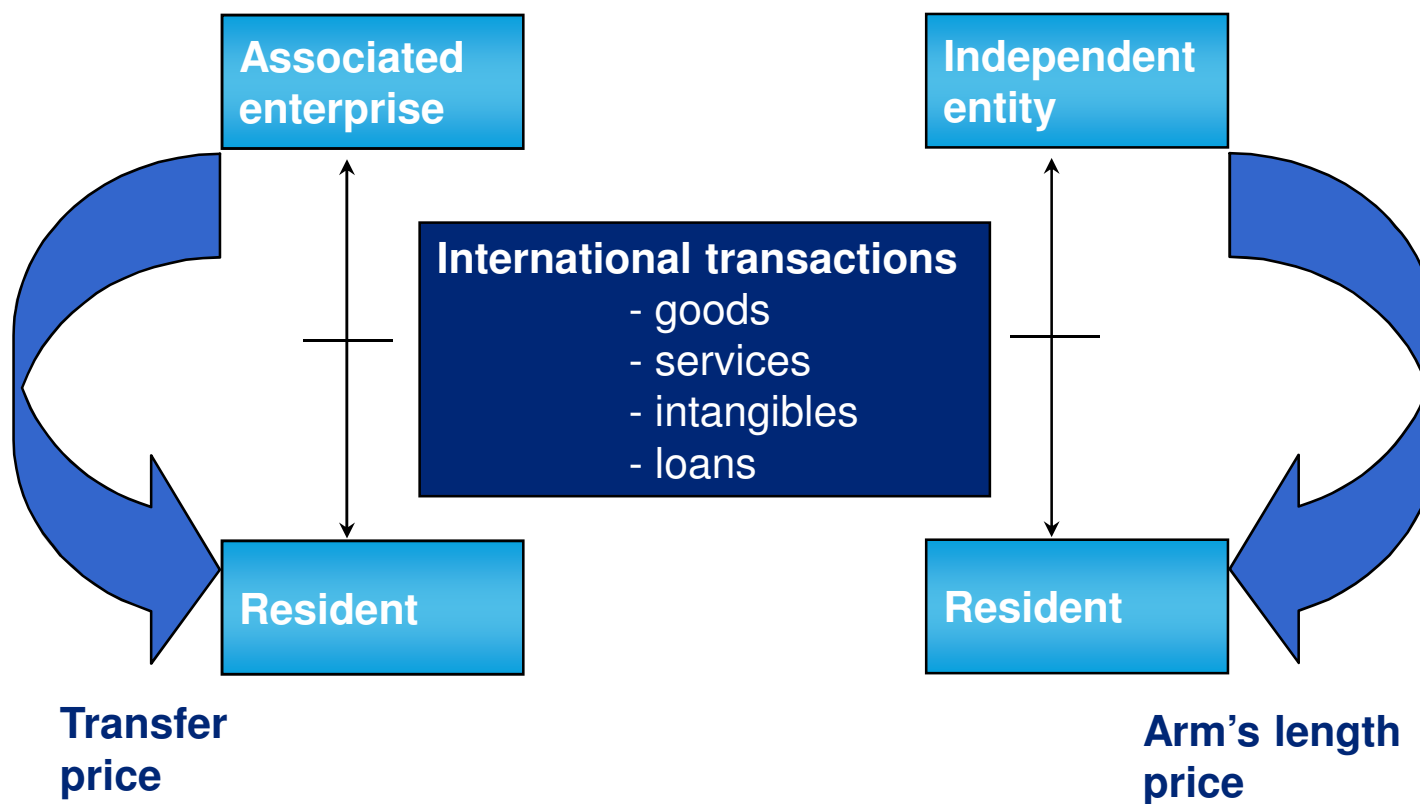
Provisions – An overview

- Sec 92
 - Computation of any income from an international transaction **having regard** to arm's length price ('ALP")
- Sec 92A
 - Associated Enterprise ("AE")
- Sec 92B
 - International Transaction
- Section 92BA
 - Specified Domestic Transaction
- Sec 92C & Rule 10B and 10C
 - Methods for Computation of ALP & variation from ALP
- Sec 92CA
 - Reference to Transfer Pricing Officer ("TPO")
- Sec 92CB
 - Safe Harbour rules
- Sec 92CC & 92CD
 - Advance pricing agreement
- Sec 92D & Rule 10D
 - Documentation
- Sec 92E & Rule 10E
 - Accountant's Report
- Sec 92F & Rule 10A
 - Definitions (ALP, Enterprise, Transaction)

Transfer Pricing - Concept

- Transfer Pricing refers to the pricing of international transactions / SDT between two associated enterprises
- Due to special relationship between related parties, the transfer price may be different than the price that would have been agreed between unrelated parties
- Provisions require demonstration of “transfer price” is at “arm’s length”

Transfer Pricing – Concept contd..



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](#)



Yes

Whether you arrive at a single price ?

No

The price thus determined is the arm's length price

The arithmetic mean of such prices or a price which varies from such arithmetic mean by +/- 3% (or 1% as the case may be) is the arm's length price (92C(2)). It is pertinent to note that the range concept has been introduced vide Finance Act, 2014

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 or SDT (defined in Sec 92B & Sec 92BA)

- 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, stiff Penalties have been prescribed

Section 92F & Rule 10A(d) – “Transaction Definition”

Section 92F – “Transaction” includes an arrangement, understanding or action in concert, -

(A) Whether or not such arrangement, understanding or action is formal or in writing; or

(B) Whether or not such arrangement, understanding or action is intended to be enforceable by legal proceedings.

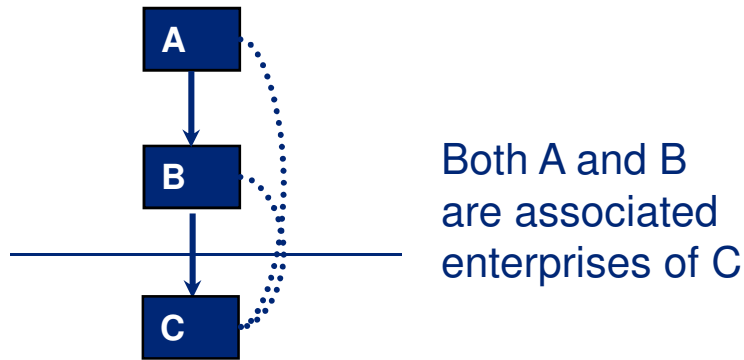
Rule 10A(d) – “Transaction” includes a number of closely linked transactions

Section 92 – Income from International Transaction

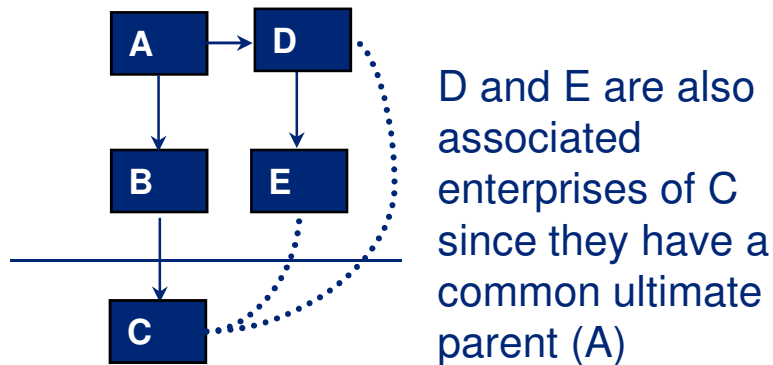
- 92(1) –Any **income** arising from an **international transaction** [including expenditure / interest] shall be computed having regard to the **arm's length price**
- ALP is the price applied or proposed to be applied between non-AE's
- Sharing of costs or expenses among AE's shall be in accordance with ALP of benefit / service or facility
- 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
(Also relevant in this regard are provisions of Circular 14 /2001)

Associated Enterprise – Meaning (Section 92A)

Associated enterprise means an enterprise which directly or indirectly participates through one or more intermediaries in the management, control or capital of the other enterprise. For example,



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)

International Transaction & Specified Domestic Transaction

International transaction (Sec 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

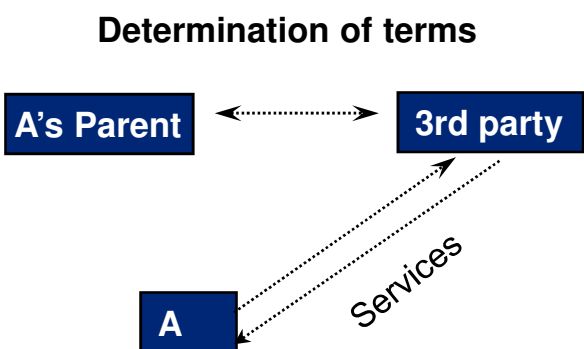
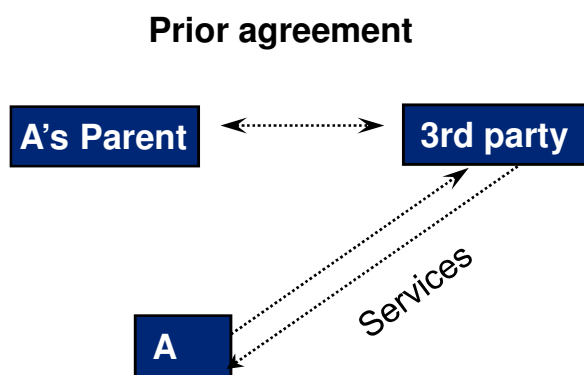
International transaction (Sec 92B) - Explanation

The expression 'International transaction' includes -

- a) Purchase, sale, transfer, lease or use of tangible property
- b) Purchase, sale, transfer, lease or use of intangible property
- c) Capital financing, any type of borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payment or deferred payment or receivable or any other debt arising in the course of business
- d) Provisions services
- e) Transaction of business restructuring or reorganization entered irrespective of the fact that it has a bearing on the profit, income, losses or assets of such enterprises at the time of the transaction or at any future date

Deemed International transaction – Sec 92B(2)

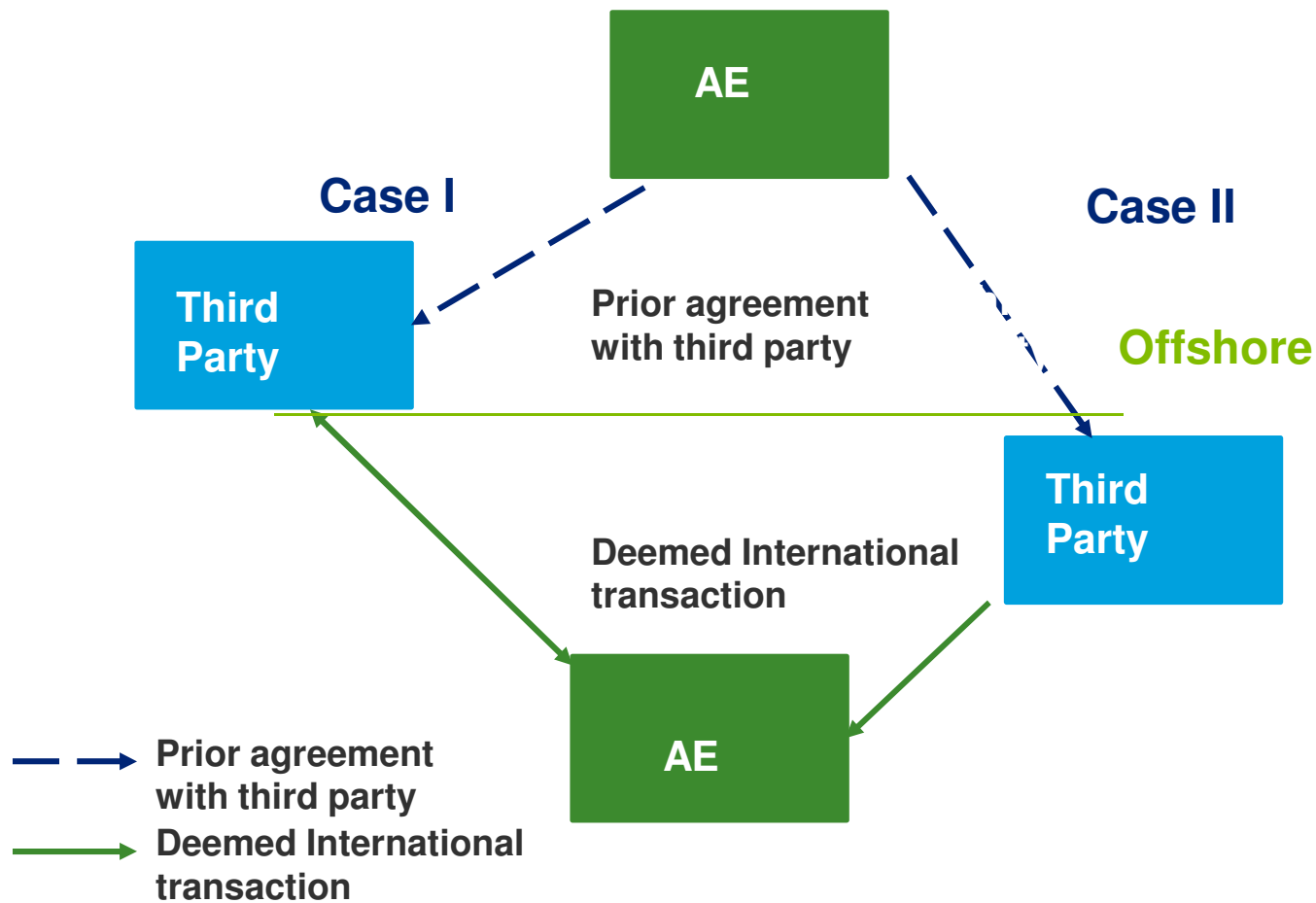
- Transactions with non-associated enterprises shall be deemed to be transactions between AEs and shall be subject to transfer pricing regulations in certain cases



- 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

Deemed International transaction – Sec 92B(2)

Amendment as per Finance Act 2014 - Deeming provision would also apply to cases where the third party is an Indian resident



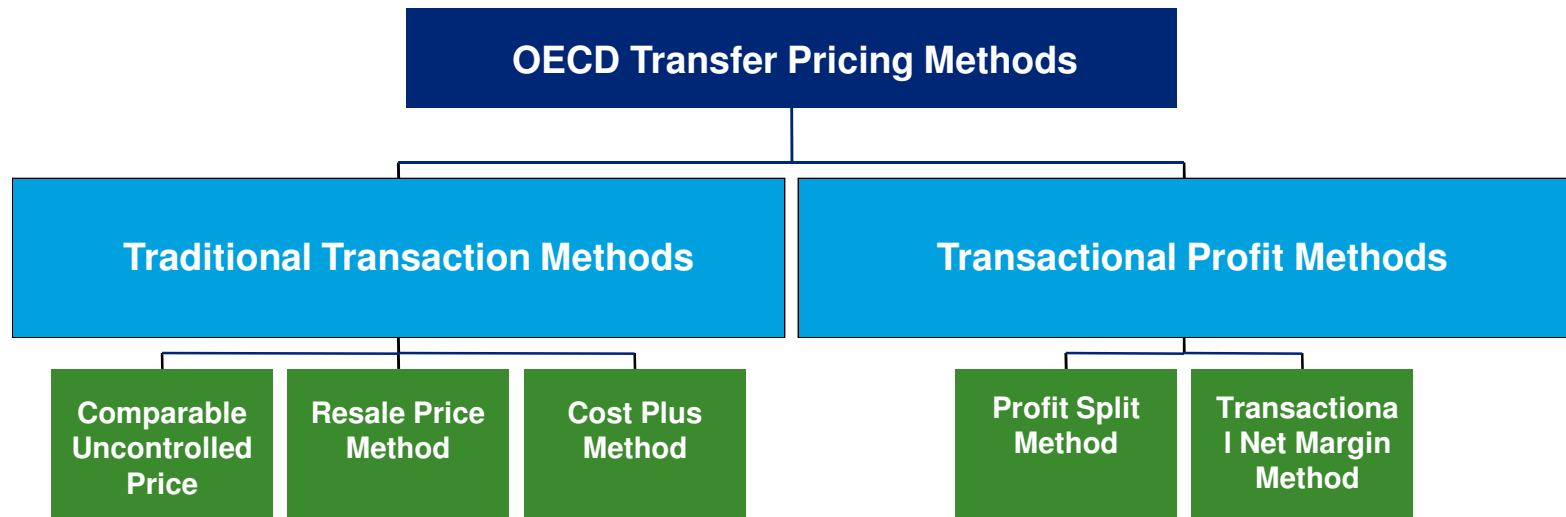
Specified Domestic transaction (Sec 92BA) ['SDT']

- Any of the specified transactions, not being any international transaction, namely
 - Expenditure in respect of which payment has been made is to made to person referred to in Section 40A(2)(b) ;
 - Transaction referred to in Section 80A ;
 - Transfer of goods or services referred to in sub-section(8) of Section 80-IA
 - Any business transacted between the assessee and other persons as referred to in sub-section (10) of section 80-IA
 - Any transaction, referred to in any other sections under Chapter VI-A or Section 10AA, to which provisions of sub-section (8) or sub-section (10) of section 80-IA are applicable
 - Any other transaction as may be prescribed

Note: The provisions of SDT would be applicable if the aggregate value of the transaction exceeds INR 5 Crore

Most Appropriate Method

Prescribed methods - OECD



Prescribed Methods as per Sec 92C read with Rule 10B

- **Traditional transaction methods**

- Comparable Uncontrolled Price Method (CUP) -10B(1)(a)
- Resale Price Method (RPM) - 10B(1)(b)
- Cost Plus Method (CPM) - 10B(1)(c)

- **Transactional profit methods**

- Profit Split Method - 10B(1)(d)
- Transactional Net Margin Method - 10B(1)(e)

- **Any other method prescribed by the Central Board of Direct Taxes**

- Other Method – 10B(1)(f)

Selection of the Most Appropriate Method “MAM”(Rule 10C)

- **Nature and class** of the international transactions
- The **class of associated enterprises** entering into the transaction and the functions performed by them **taking into account assets employed and risks assumed** by such enterprises
- **Availability, coverage and reliability of data** necessary for application of method
- **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** on account of any differences between the international transactions and the comparable uncontrolled transaction or the enterprises entering into these transactions
- The **nature, extent and reliability of assumptions** required to be made in application of a method.

Functional & Economic Analysis

Functional & Economic Analysis

- Undertake detailed Functions, Assets and Risk analysis ('FAR')
- Characterize the transaction
- Identify the tested party
- Look internally for third-party transactions
- Formulating the search strategy
- Perform an external search – research comparables based upon characterization of the related-party entity/transaction
- Assess comparability – by applying quantitative and qualitative filters
- Review and finalize comparables
- Adjust comparable data (if required)
- Selection of Profit Level Indicator ('PLI')
- Computation of Arm's Length Price

Arm's Length Range & PLI

The Arm's Length Range

- 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 transactions 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 specified variation – 1% to 3%).
- However, with effect from 01 April 2014, vide Finance Act 2014, it is proposed to adopt inter-quartile range. Detailed regulations are yet to be prescribed.
- If transfer price falls within the specified range, pricing should be considered to be at arm's length.

Choosing a PLI

Types of PLIs specified in the regulations

- Return on sales
 - Gross Margin
 - Operating Margin
- Return on costs
 - Berry Ratio
 - Net Cost Plus
- Return on capital employed
 - Return on Operating Assets

Available PLIs – Return on sales (Contd..)

Operating Margin (“OM”) :

$$\text{OM} = \frac{\text{Operating Profit}}{\text{Net Sales}}$$

- Measures profit/return earned on sales after covering COGS and operating expenses (i.e., SG&A expense)

Available PLIs – Return on costs

Berry Ratio (“BR”) :

$$BR = \frac{\text{Gross Profit}}{\text{Operating Expenses}}$$

- Measures the return earned on operating expenses
- Operating expenses = SG&A + Depreciation and Amortization
- Most often used to test distributors

Available PLIs – Return on costs (Contd..)

Net Cost Plus (“NCP”) :

$$\text{NCP} = \frac{\text{Operating Profit}}{\text{Total Costs}}$$

- Measure the return earned on total costs
- Total Costs = COGS + Operating expenses
- Most often used to test service providers

Available PLIs – Return on capital employed

Return on Operating Assets

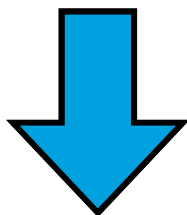
$$\text{ROA} = \frac{\text{Operating Profit}}{\text{Operating Assets}}$$

- Measures return earned on capital employed
- Most often used to test manufacturers

Transfer Pricing - Compliances

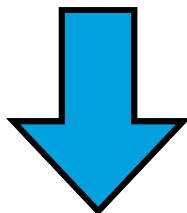
Documentation – Sec 92D and Rule 10D

Entity related



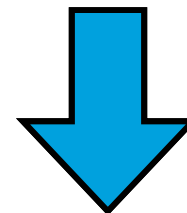
- Profile of industry
- Profile of group
- Profile of Indian entity
- Profile of associated enterprises

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

Needs to be filed within 30 or 60 days when called for

Detailed 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

- Accountant's report in Form No.3CEB to be filed by due date
- 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/specified domestic transactions as per the books of account and as per the transfer pricing documentation are “true and correct”

Consequence of TP non-compliance

Punitive consequences in the event of non-compliance with TP provisions include:

- Additional tax on income arising from TP adjustment
- Denial of 'tax holiday' on income arising from TP adjustment (Proviso to Sec 92C)
- Deemed tax evasion, resulting in a penalty of 100% to 300% of tax arising from the adjustment, unless good faith and due diligence is demonstrated – Sec 271 (1)(c)
- 2% transaction value penalty for not maintaining prescribed documentation/ furnishing of incorrect information – Sec 271AA
- 2% transaction value penalty for not furnishing prescribed information within specified time – Sec 271G
- Rs.100,000 penalty for non-filing/belated filing of Accountant's Report – Sec 271BA

Safe Harbour Rules

Safe Harbour Rules – Background

- Law introduced in India in Finance (No.2) Act, 2009
- Rangachary Committee set up to recommend Safe Harbour Rules for a number of sectors
- Draft Rules, released by Central Board of Direct Taxes in August 2013, are based on the Committee's report
- Consultative approach adopted by the Government in finalizing rules – certain changes were made based on stakeholders comments
- Final rules have been notified in September 2013
- Provide that the transfer price declared by the “eligible taxpayer” in respect of “eligible transaction”, shall be accepted by tax authorities in specified circumstances

Safe Harbour Rules – Snapshot (1/2)

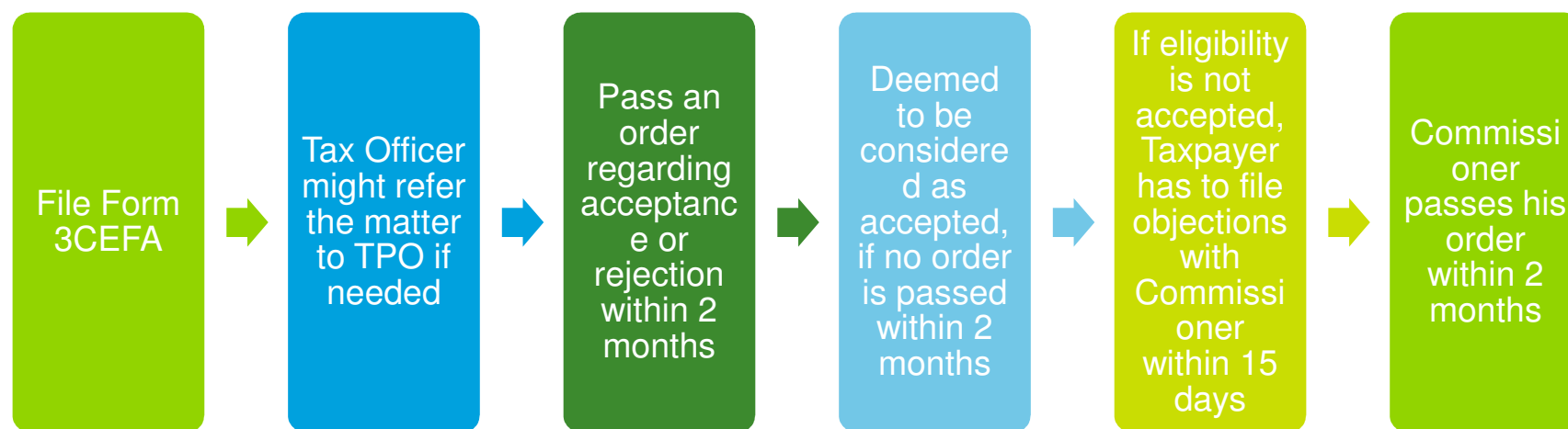
Nature of international Transaction	Condition	Safe Harbour operating margin on operating expenses
I. Software development services with insignificant risk	Aggregate value of transactions does not exceed Rs.500 crores (Approx USD 80 Mn)	Not less than 20 per cent
II. IT IT enabled services with insignificant risk	Aggregate value of transactions exceeds Rs.500 crores (Approx USD 80 Mn)	Not less than 22 per cent
III. Knowledge Process Outsourcing (KPO) services with insignificant risk	No turnover threshold	Not less than 25 per cent
Contract R&D services (wholly or partly), with insignificant risk, relating to <ul style="list-style-type: none"> • software development • Generic pharmaceutical drugs 	No turnover threshold	<ul style="list-style-type: none"> • Not less than 30 per cent • Not less than 29 percent
Manufacture and export of <ul style="list-style-type: none"> • core auto components • non-core auto component 	90 per cent or more of total turnover are in nature of Original Equipment Manufacturer sales	<ul style="list-style-type: none"> • Not less than 12 per cent • Not less than 8.5 percent

Safe Harbour Rules – Snapshot (2/2)

Nature of international Transaction	Condition	Safe Harbour operating interest rate / fee
Advancing intra-group loan	<ul style="list-style-type: none"> To wholly owned non-resident subsidiary Loan sourced in Indian Rupees Excludes loans by enterprises engaged in lending or borrowing in the normal course of business 	<p>Interest rate is not less than base rate of SBI as on 30th June of the relevant previous year plus</p> <ul style="list-style-type: none"> 150 basis points [where amount of loan does not exceed Rs. 50 crores (approx USD 8 Mn)] 300 basis points [where amount of loan exceeds Rs. 50 crores (approx USD 8 Mn)]
Providing explicit corporate guarantee	<ul style="list-style-type: none"> On behalf of wholly owned non-resident subsidiary Amount of guarantee does not exceed Rs.100 crores (Approx USD 16 Mn) Amount of guarantee exceeding Rs.100 crores ((Approx USD 16 Mn)) and the credit rating of the borrowing AE done by an agency registered with SEBI is of adequate to highest safety excludes performance guarantees and letters of comfort 	<p>Commission or fee at the rate of not less than 2 per cent per annum on the amount guaranteed</p> <p>Commission or fee at the rate of not less than 1.75 per cent per annum on the amount guaranteed</p>

Safe Harbour Rules – Procedure:

- For exercising the safe harbour option, a taxpayer would need to furnish Form 3CEFA on or before the due date for furnishing return of income for the relevant year (in case option is exercised for one year) or for the first year (in case option is exercised for more than one year).
- A validly exercised safe harbour option will continue to remain in force for a period of 5 years or period opted by the taxpayer (in Form 3CEFA), whichever is less.



Advance Pricing Agreement (APA)

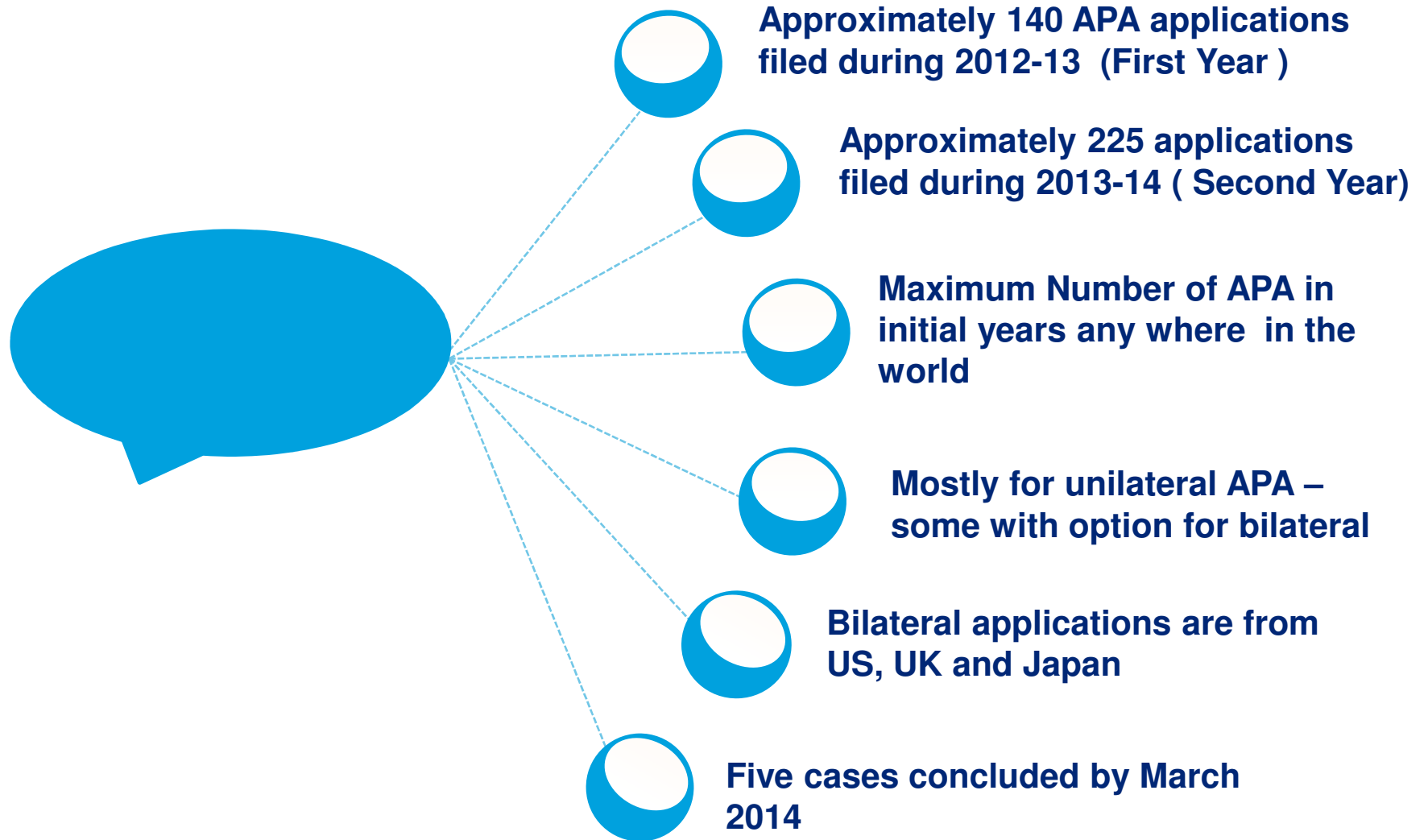
Overview of APA process



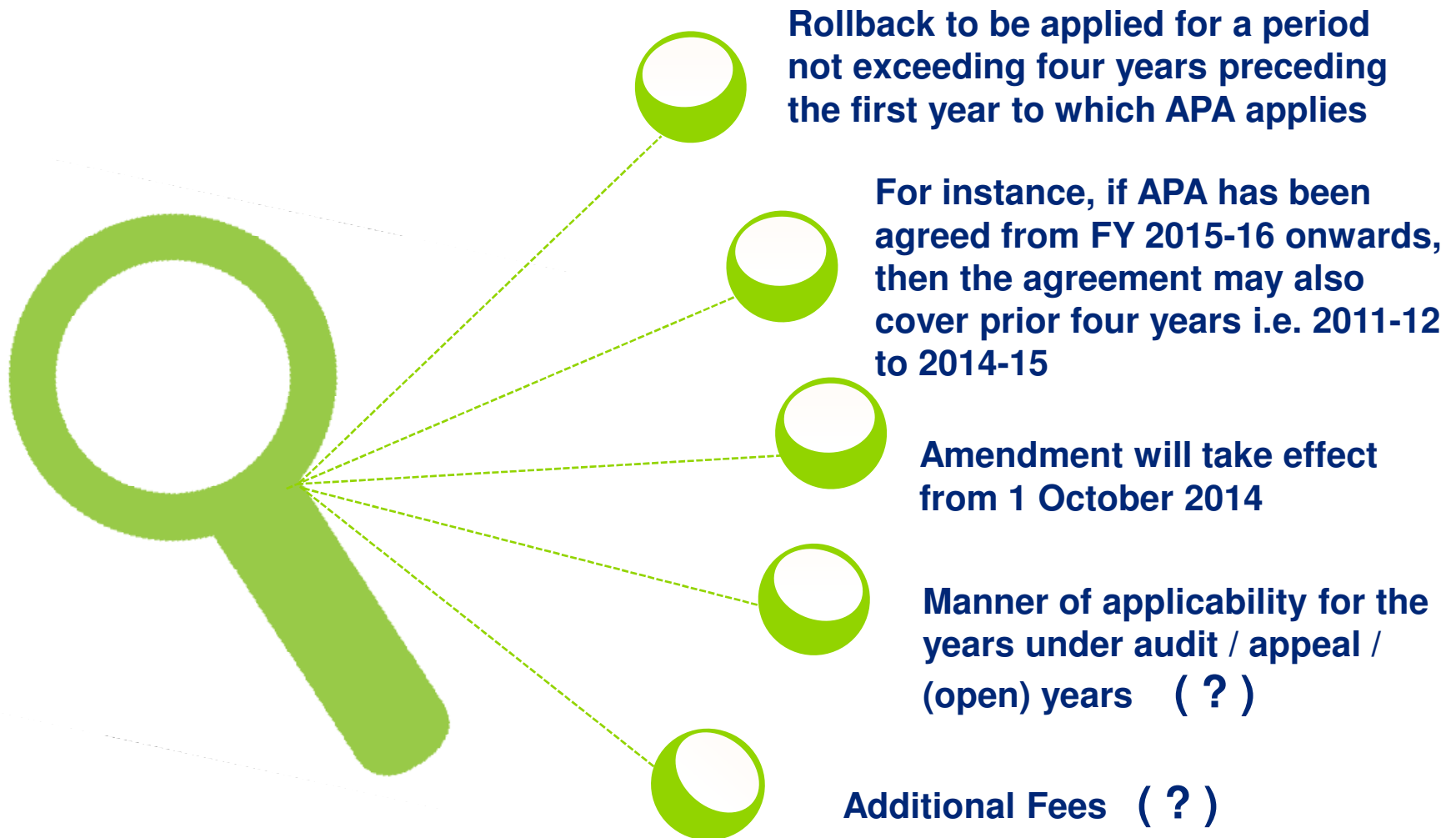
* The APA authorities are also open to have a pre 'pre-filing' meeting with the taxpayers

Renewal of APA: Process similar to original APA, no pre-filing required

Initial year of APA rollout...



Roll back provision



Thank you