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Transfer Pricing Backdrop in India

Glimpse on International Transactions

CA Utpal Doshi and CA Harshil Shah

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Presentation Outline

- Introduction
- Transfer Pricing Regulations in India
- Arms Length Price Computation - Methods
  - Comparable Uncontrolled Price Method
  - Resale Price Method
  - Cost Plus Method
  - Profit Split Method
  - Transactional Net Margin Method
  - Other Method
- Transfer pricing methods – Comparative statement
- Accountant’s report in Form 3CEB
- Transfer Pricing Documentation
- Important developments
- Any Question's

Introduction

Transfer pricing in a challenging business environment

- Transfer pricing is consistently cited by tax managers/CFOs as their number one tax issue
- The number of countries with transfer pricing rules and documentation requirements has grown
- Aggressive positions being taken by tax authorities lead to risks for MNEs, including:
  - The potential for double taxation
  - Non-deductible penalties and interest
- Currently huge adjustments are being made for share transactions, royalty transactions, marketing intangibles, financial and guarantee transactions

Transfer Pricing Regulations in India

Section & Rules	Provisions
92	Computation of income having regard to ALP
92A	Meaning of Associated Enterprise
92B	Meaning of International transaction
92BA	Meaning of specified domestic transactions
92C (1) (Rule 10B, 10C)	Methods of computation of ALP *Rule 10AB – Any other method for determination of ALP
92CA	Reference to Transfer Pricing Officer (TPO)
92CB	Safe harbour rules
92CC	Advance Pricing agreement
92CD	Effect of advance pricing agreement
92D (Rule 10D)	Maintenance of information and documents by persons entering into an international transaction or specified domestic transaction
92E (Rule 10E, Form 3CEB)	Accountant's Report entering into an international transaction or specified domestic transaction
92F (Rule 10A)	Definitions: Accountant, ALP, Enterprise, PE, Specified date, Transaction *

* Sec 92F – Definitions does not define terms relevant for domestic TP transactions

Transfer Pricing Regulations – International transactions

Section 92(1) of the Act

- Any **income**
- arising from an **international transaction**
- To the **associated enterprises**
- shall be computed
- having regard to the arm's length price

International Transaction (Explanation to sec. 92B of the Act)

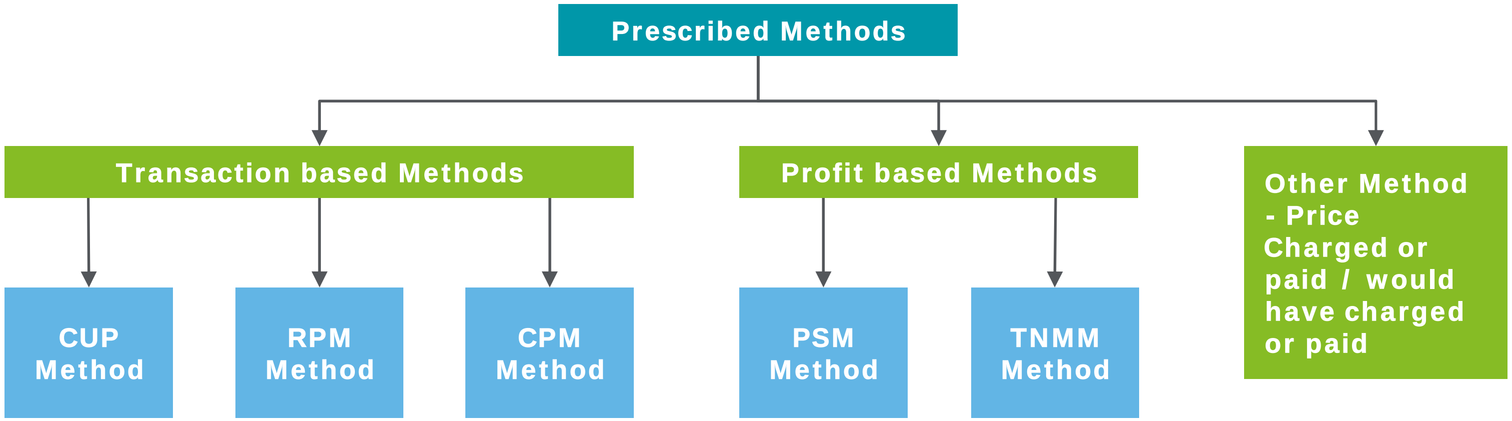
- purchase, sale, transfer, lease or use of tangible property;
- the purchase, sale, transfer, lease or use of intangible property;
- capital financing;
- provision of services;
- a transaction of business restructuring or reorganization.

Associated Enterprises – Sec. 92A(2) of the Act

- Holding shares >= 26% of voting power
- Loan advanced >= 51% of book value of assets
- Guarantee given >= 10% of total borrowings
- Appoints more than half of board or one or more executive member
- Business of one enterprise is dependent on intangibles of other
- Raw materials procured >= 90% from other enterprise
- The goods are sold to other enterprise or any specified enterprise
- Control by individual or by its relatives
- Control by HUF and other by its members or relatives
- Holding interest >= 10% in firm, AOP, BOI
- Any mutual interest, as prescribed.

ALP computation - Overview of Methods

ALP Computation - Overview of Methods



No hierarchy or preference of methods prescribed under the Act

The methods applicable for determining ALP for SDT transactions are same as those for international transactions

Comparable Uncontrolled Price ('CUP') Method

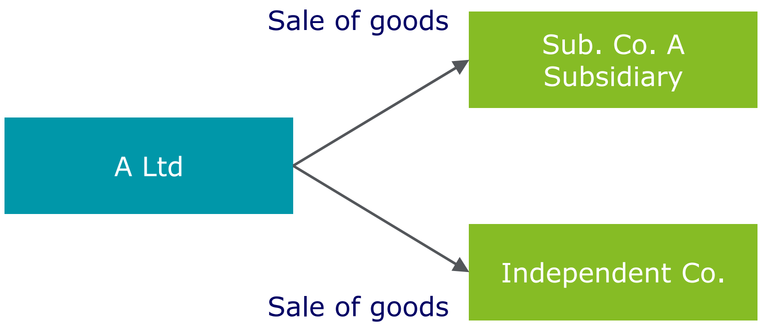
- Comparison of controlled transaction with the uncontrolled transaction(s)
- High degree of comparability of products or services
- Direct and reliable

Comparability Factors

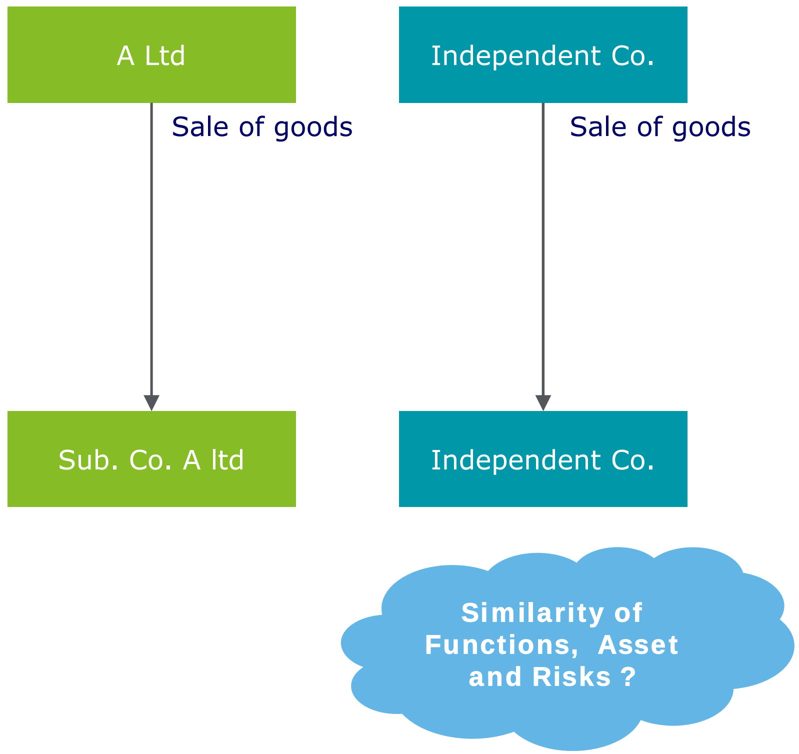
- Similarity of products and services
- Geography of markets
- Functions performed, Assets deployed and Risks borne
- Contractual terms
- Economic Circumstances
- Business strategies

CUP Method - Examples

Internal CUP



External CUP



Internal CUP is preferable

CUP Method – Practical Perspective

- Due to the increased market volatility and increased complexity in related party transactions it is often difficult to obtain identical transactions under similar facts and circumstances
- Indirect evidences of CUP – Can Industry average data / commodity exchanges / quotations be used?

Resale Price Method (‘RPM’)

- Measures the value of functions performed
- Ordinarily used in cases involving the purchase and resale of tangible property
- Reseller has not added substantial value
- Packaging, labeling, or minor assembly are acceptable
- Reseller does not apply intangible assets to add substantial value
- More reliable if internal comparables are present

RPM – How to arrive at ALP?

Steps

Step 1

Determine the gross profit margin earned in comparable uncontrolled transactions

Step 2

Subtract the appropriate gross margin and expenses from the applicable resale price

Step 3

The remainder will be the arm's length price with the controlled entity

RPM – Example

Facts:

- A Ltd, is a leading manufacturer of laptops selling the laptops only through its related party B Ltd in India.
- There are no direct sales by A Ltd.,
- B Ltd, a wholly owned subsidiary of A Ltd, acts as a distributor of the products;
- X Ltd. a company with similar functions, assets and risks have also undertaken a similar transaction through Y Ltd, a third party. in India.

Particulars	A Ltd. P.U.	X Ltd P.U.
Purchase price by B, Y	1000	750
Sale price by B,Y in India	1150	950

RPM – Case Study

Particulars	3^{rd} party transaction	Related party transaction
Sale price of Desktops (A)	950	1150
Purchase Price from 3^{rd} party (B)	750	
Margin earned (C=B-A)	200	
Resale Margin (C/A)	21%	21%
ALP (A - A*21.05%)		909
Purchase price from related party		1000

Is the Transaction at Arms Length?

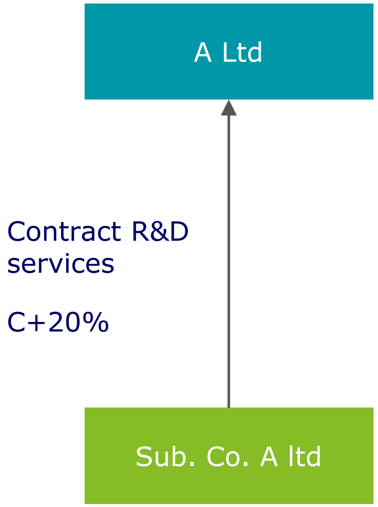
RPM – Practical Perspective

- Tolerant to minor product difference. However, high degree of functional comparability required
- Impact of intangibles to be duly considered
- RPM is most useful when applied to selling and distribution operations wherein the reseller/ distributor does not add substantial value to the "product" through use of tangible or intangible property.
- Where accounting practices differ from the controlled transaction to the uncontrolled transaction, appropriate adjustments should be made to the financial data for ensuring the same type of costs are used in each case to arrive at the gross margin.

Cost Plus Method (‘CPM’)

- Similarity of products/services transferred – not a prerequisite
- Similarity of functions is a prerequisite for applying CPM
- Gross margins are more sensitive to difference in functions and risks
- Most useful method where, interalia, related parties undertake transaction in respect of:
  - Sale of semi-finished goods
  - Joint facility agreements
  - Long term buy and supply arrangements
  - Provisions of services on contract basis

CPM – Example



- A Ltd Provides directions for the manner in which research has to be carried out
- A Ltd assumes all risks associated with Research
- A Ltd also owns all intangibles developed through Research
- Sub Co. A agrees to carry-out Contract Research

All costs for Research is compensated alongwith mark up

CPM – Practical Perspective

- Similarity of products/services transferred – not a prerequisite
- Similarity of functions is a prerequisite for applying CPM
- Gross margins are more sensitive to difference in functions and risks
- Most useful method where, interalia, related parties undertake transaction in respect of:
  - Sale of semi-finished goods
  - Joint facility agreements
  - Long term buy and supply arrangements
  - Provisions of services on contract basis

Profit Split Method ('PSM') - Applicability

- The PSM is typically applied in complex situations when other available methods (such as the CUP or the TNMM) are not sufficient to price the functions performed
- Profit split methods are usually appropriate when:
  - Transactions are very interrelated it might be that they cannot be evaluated on a separate basis
  - Valuable, non-routine intangibles exist in transactions and profit arising to the group cannot be assigned to one of the entities of the group
  - Significant differences between controlled and uncontrolled transactions are attributable to economies of horizontal/vertical integration
  - Adequate comparables are unavailable to set margins for all the entities

PSM is contribution analysis, rather than comparability analysis

How to apply Residual Profit Split Method?

Particulars	Rs.	Rs.
Combined Group Profits		100
Assign basic return to each entity		
• Entity A	30	
• Entity B	20	
• Entity C	10	60
Residual profit		40
Contribution analysis (based on relative contribution of the entities)		
• Entity A		30
• Entity B		10

Contribution Analysis – Element of subjectivity

PSM – Practical Perspective

Typical example of Industries, where PSM can be applied:

- Telecommunications
- Pharmaceuticals
- Courier/logistic

Implementation Issues:

- External market data
- Identification of value drivers
- Measurement of value drivers contributed by each entities in the group
- Assignment of weight to value drivers

Transactional Net Margin Method ('TNMM')

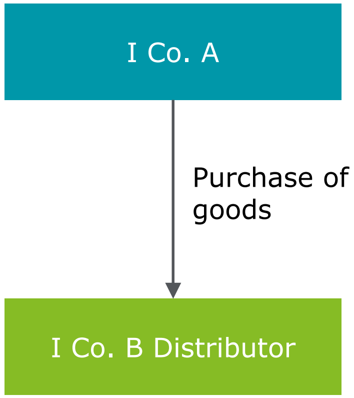
- Most practical and widely used method
- Broad level of similarity of Functions, Assets and Risks
- TNMM can be applied as internal TNMM as well as external TNMM
- Comparison is at net operating margin with the application of appropriate Profit Level Indicators (PLIs)

Profit Level Indicators

Method	PLI	Formula	Typically used for
TNMM	Return on Total Costs	Operating profit / Total Costs	Contract Manufacturer / Toll Manufacturer / Service Provider
	Return on Sales	Operating Profit / Sales	Manufacturer / Distributor
	Return on Assets	Operating Profit / Operating assets	Manufacturer / Asset Intensive business
	Return on Capital Employed	Operating Profit / Capital Employed	Financial Transactions
	Return on Value Added Expenses	Operating Profit / Value Added Expenses	Agents

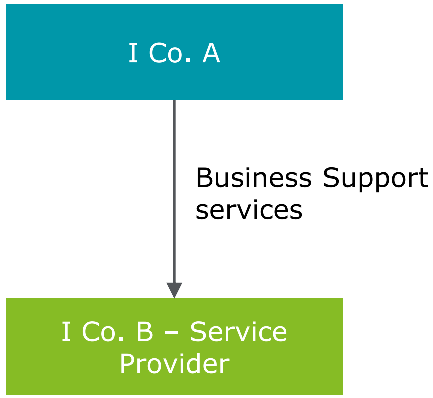
TNMM - Example

PLI of OP / Sales



Particulars		Rs.
Purchase from I Co. A	(A)	800
Sales to 3rd party	(B)	1000
Profit	(C = B – A)	200
OP / Sales		20%

PLI of OP / Cost



Particulars		Rs.
Services provided to I Co. A	(A)	1100
Operating Exps.	(B)	1000
Profit	(C = B – A)	100
OP / Sales		10%

TNMM – Example

Segmental – AE and Non AE business

Particulars	AE	Non – AE	Total
Sales	110	100	210
Purchases	85	80	165
Other Administrative Expenses	12	10	22
Operating Profit	13	10	23
OP/Sales	11.81%	10%	10.95%

Comparability when:

- Internal comparability exists - Internal TNMM
- No internal comparability exists - External TNMM

TNMM – Practical Experience

- Net profit margins may be influenced by some factors that have less or no effect on the price or gross margins
- Net profit margins may be affected by varying cost structures, business experience, management efficiency, etc.
- Net margins are less affected by the transactional differences e.g. difference in contractual terms, credit period, etc.
- In absence of applicability of CUP, RPM, CPM and PSM, TNMM is applied

Other Method

- Rule 10AB

  "For the purposes of clause (f) of sub-section (1) of section 92C, the other method for determination of the arms' length price in relation to an international 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."

- Other Method can be used for following transactions
  - Revenue split
  - Valuation of intangible property
  - Valuation of shares
  - Cost allocation

Notification No. 18 of 2012 dated 23rd May 2012 effective AY 2012-13

Transfer Pricing Method – A comparative statement

Method	Measurement Focus	Comparability Requirements	Indicative difference requiring adjustments
CUP	Price	• Similar products • Similar conditions	• Product quality • Contractual terms • Level of market • Intangible property • Transaction date • Foreign Exchange
RPM	Gross Income	• Similar functions • Risk • Contractual terms • Similar product group	• Inventory levels • Turnover rates • Operating expenses • Foreign currency risks • Accounting differences
CPM	Gross Income	• Similar functions • Risk • Contractual terms • Similar product group	• Operating Complexity • Operating expenses • Foreign currency risks • Accounting differences

Transfer Pricing Method – A comparative statement

Method	Measurement Focus	Comparability Requirements	Indicative difference requiring adjustments
TNMM	Operating Income	• Functions • Asset • Risks	• Asset intensity adjustment • Economic risk adjustment • Accounting differences • Foreign currency risk
PSM	Profit	• Functions performed – Routine & non-routine • Value drivers • Industry value indicators • Multiple transactions	

Accountant’s report in Form 3CEB

Form 3CEB – Section 92E of the Act

Accountant's Report as per Section 92E of the Act – Form 3CEB

- Every person entering into International Transaction (even Re. 1 transaction) or entering into Specified Domestic Transaction is required to obtain Accountants report in Form 3CEB
- Stringent penalties have to be prescribed for non-compliance of Transfer pricing provisions including penalty for non furnishing of Form 3CEB can extend to 2% of the value of each international transaction or specified domestic transaction
- Some of the key transactions that are required to be reported in Form 3CEB are – details of tangible and intangible property, provision and availing of services, lending, borrowing, guarantee transactions, details of purchase and sale of securities, etc.

Due date for furnishing Form 3CEB for AY 2016-17 is 30 November, 2016

Form 3CEB

Transfer Pricing Documentation

Transfer Pricing Documentation – Sec 92D

How convincing is your story

Entity related

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

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 – Rule 10D
- Documentation to be retained for 8 years
- No specific documentation requirement if the value of international transactions is less than one crore rupees.
- Compulsory requirement of maintenance of documentation if SDT is applicable.
- Penalty for non maintenance, non furnishing of documentation or furnishing incorrect information or document
- Enforcement of compliance through increased scrutiny – more than half of the cases picked up for scrutiny were adjusted in the previous audit cycle

Statutory Requirement – Rule 10D

Threshold Limit :

- If the aggregate book value of 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 30th of the following financial year.
- Documentation to be retained for 8 years

Relaxation of requirements :

- If an international transaction has effect for more than one financial year, 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

Important developments

Range and Multiple Year Data

Range and Multiple year data

Condition	Cumulative condition	Manner of determination of ALP
In case RPM, CPM and TNMM is applied as the most appropriate method	Number of comparables are six or more	• Multiple year data would be used for constructing a dataset (weighted average needs to be used) • The ALP would be prices falling within 35th to 65th percentile of the dataset • If the transaction price does not fall within the range of 35th to 65th percentile, the median of the dataset shall be regarded as ALP
In case RPM, CPM and TNMM is applied as the most appropriate method	Number of comparables are less than six	• Multiple year data would be used for constructing a dataset (weighted average needs to be used) • The ALP would be the arithmetic mean of prices forming part of the dataset • In addition, tolerance band of 3 per cent or 1 per cent would be applicable
In case Comparable Uncontrolled Price ('CUP') Method has been applied as the most appropriate method	Number of comparables are six or more	• Only single year data would be used for constructing a dataset • The ALP would be prices falling within 35th to 65th percentile of the dataset • If the transaction price does not fall within the range of 35th to 65th percentile, the median of the dataset shall be regarded as ALP

Range and Multiple year data

Condition	Cumulative condition	Manner of determination of ALP
In case CUP Method has been applied as the most appropriate method	Number of comparables are less than six	• Only single year data would be used for constructing a dataset • The ALP would be the arithmetic mean of prices forming part of the dataset • In addition, tolerance band of 3 per cent or 1 per cent would be applicable
In case PSM or the Other Method has been applied as the most appropriate method		• Only single year data would be used for constructing a dataset • The ALP would be the arithmetic mean of prices forming part of the dataset • In addition, tolerance band of 3 per cent or 1 per cent would be applicable

Range Concept – Illustration

- Assessee company ("XYZ") is engaged in the business of manufacturing of fiber glass;
- However, in the FY 2015-16, the profitability of XYZ declined due to low demand for its major Product K; The operating margin earned by XYZ in FY 2015-16 was 9%

Comparable Company	FY 2013-14	FY 2014-15	FY 2015-16	Average of 3 years
Company A	2.45%	6.32%	4.16%	4.31%
Company B	6.78%	7.15%	7.03%	6.99%
Company C	5.34%	4.69%	5.43%	5.15%
Company D	8.92%	10.23%	10.97%	10.04%
Company E	10.24%	9.77%	9.23%	9.75%
Company F	15.87%	16.31%	17.34%	16.51%
Company G	21.47%	23.22%	24.18%	22.96%
Company I	3.67%	3.54%	1.61%	2.94%
			Mean	9.83%
			Lower Quartile	**5.15%**
			Upper Quartile	**10.04%**

As can be seen, if arithmetic mean is applied, there might have been a TP Adjustment, whereas, if range is applied, XYZ's margin falls within the arm's length range of 5.15% to 10.04% and thus, the international transactions of XYZ would be at arm's length.

Multiple Year Data – Illustration

- Assessee company ("XYZ") is engaged in the business of manufacturing of fiber glass;
- However, in the FY 2015-16, the profitability of XYZ declined due to low demand for its major Product K;
- The operating margin earned by XYZ in FY 2015-16 was 9%
- The comparable companies engaged in the similar activities as that of the XYZ revealed the following operating margin for a three year average:

Sr. No	Name of the comparable	FY 2013-14	FY 2014-15	FY 2015-16	Average
1	Comparable A	5%	6%	14%	8.30%
2	Comparable B	4%	9%	15%	8.70%
3	Comparable C	6%	5%	10%	7%
	Mean of Comparables	5%	6.67%	13%	8%
	Margin of Assessee				9%

- As it is evident from the above table, although the margin of XYZ was low i.e. 9% as compared to the margins of the comparable companies i.e. 13% for FY 2015-16, however when compared to the three years average of the margins of comparables i.e. 8%, the same can be concluded to be at arm's length

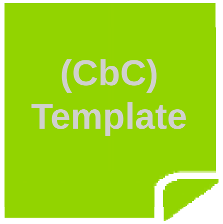
Country-By-Country Reporting

Compliance Documentation 3-tiered approach

Tier	Document	Purpose
Tier 1	**Country-by-country report** • Aggregate tax jurisdiction-wide information • 2 main tables + 1 for additional information • Available to each relevant tax administration / Filing Process to be agreed • To be finalized maximum 1 year following the last day of FY of the Ultimate Parent	Information on the global allocation of income, the taxes paid and certain indicators of the location of economic activity among tax jurisdictions in which the Group operates List of entities per tax jurisdiction
Tier 2	**Master File** • "Blueprint" of the Group as a whole • 5 main categories • Available to each relevant tax administration / Filing Process to be agreed • To be reviewed / updated by the Ultimate Parent tax return due date	Provide an high level overview on Group business, including: • Nature of global business operations; • Overall TP policies
Tier 3	**Local File** • Focus on specific intercompany transactions • 3 main categories • To be delivered directly to local tax administrations • To be finalized no later than the due date for the filing of the local tax return	Provide more detailed information relating to specific intercompany transactions Ensure that the taxpayer has complied with the arm's length principle

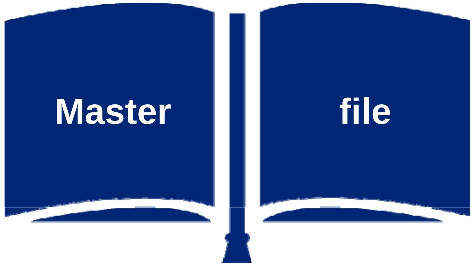
Action 13 – Re-examine TP Documentation

Tier 1



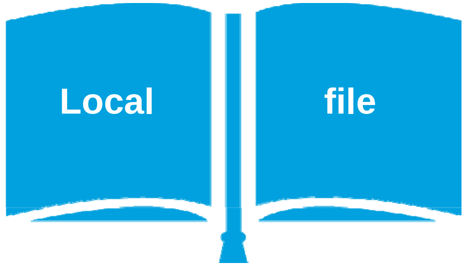
1. Revenue (3rd party and intercompany)
2. Earnings before taxes
3. Cash tax paid
4. Current tax accrual
5. Capital
6. Retained earnings
7. Tangible assets
8. Number of full time equivalent employees
9. A list of entities and permanent establishments, and activity codes for each entity and permanent establishment

Tier 2



- Prescribed global level management and transfer pricing management items (transactions, agreements, policies, rulings, unilateral Advance Pricing Agreement (APA)) covering the following areas
  - Major business lines
  - Intangibles
  - Intercompany financing
  - Finance and tax positions
- The Master file may be prepared on a global or product / business line basis

Tier 3



- Information that has traditionally been contained in entity specific documentation reports
  - Reporting line information
  - Disclosure of transactional amounts
  - Disclosure of financial results
  - Disclosure of unilateral or bilateral APAs potentially relevant to the transaction
  - Reconciliation of transactional amounts to financial results

Country-by-Country Report
CbC Reporting Introduced

Amendments proposed to align domestic legislation with BEPS Action 13:

- Requirement to file CbC report introduced with effect from Assessment Year 2017-18 (FY 2016-17)
- Threshold to file CbC in line with BEPS i.e INR 5395 Cr
- Indian parent of an international group resident in India
  - Report to be filed with Indian tax authorities on or before due date of filing return of income
- Indian entity of a non-resident parent entity is required to only provide details of the country of residence of its parent to Indian tax authorities – manner, form, date to be prescribed
- Indian entity of a non-resident parent entity to furnish CbC report to Indian tax authorities, if the parent is resident in a:
  - country with which India will not have an arrangement for exchange of CbC report; or
  - country which fails to automatically exchange such information and such failure is intimated to the Indian entity
- Alternate reporting entity resident in India
  - Report to be filed with Indian tax authorities on or before due date of filing return of income

Country-by-Country Report - Penalties

Sr. No	Particulars	Default	Penalty
1.	Non-furnishing of CbC report by Indian parent or the alternate reporting entity resident in India	Less than a month from due date	INR 5,000 per day
		Beyond a month from due date	INR 15,000 per day for period exceeding a month
		Continuing default beyond service of penalty order	INR 50,000 per day from date of service of penalty order
2.	Non-submission of information	Before initial request date	INR 5,000 per day
		Continuing default beyond service of penalty order	INR 50,000 per day from date of service of penalty order
3.	Provision of inaccurate information in CbC report	Knowledge of inaccuracy at time of furnishing the report but fails to inform the prescribed authority	INR 500,000
		Inaccuracy discovered after filing and fails to inform and furnish correct report within fifteen days of such discovery	
		Furnishing of inaccurate information or document in response to notice issued	

Country-by-Country Report - Penalties

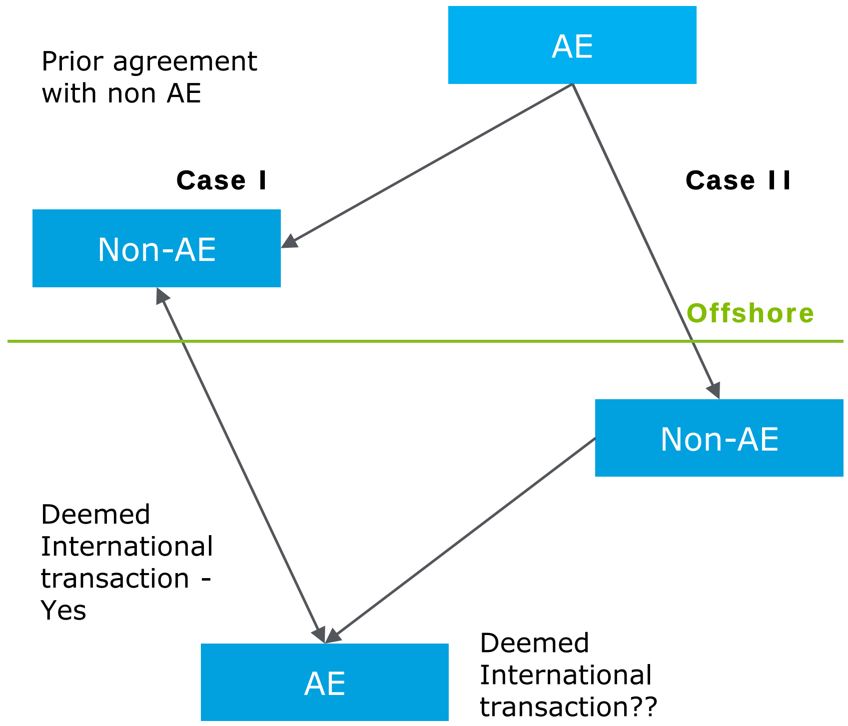
Sr. No	Particulars	Default	Penalty
4.	Non-furnishing of prescribed information and document as required under Section 92D(4)	Fails to furnish the information and document with the prescribed authority	INR 500,000

Deemed International Transactions

Deemed International Transaction

Rationalization of definition

- A transaction entered into by an enterprise with a third party is deemed to be a covered transaction, if
  - There exists a prior agreement between such third party and the AE, or;
  - The term of the transaction is determined in substance between such third party and the AE.
- Whether transaction with resident third party in such cases covered under the ambit of the TP?



Deemed International Transaction Contd…

Amendment in section 92B(2):

- Section 92B(2) has been amended to provide that relevant transaction shall be deemed to be an international transaction where:

  "the enterprise or the associated enterprise or both of them are non-resident, **whether or not 'such other person' is a non-resident**"

- Thus, deeming provision would also apply to cases where the third party is an Indian resident
- The provision is proposed to be applicable from Financial Year 2014-15.

Thank You