Transfer Pricing Regulations (Part I)

Tri Nagar Keshav Puram Study Circle
Of
North India Regional Council

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Agenda

- Warm-up
- Indian TP Regulations
- Arm's Length Principle
- The Tax Treaty Aspect
- Meaning of Associated Enterprises
- Meaning of International Transaction
- Transfer Pricing Methods
- Data – Current year vs. Multiple year
- Working Capital Adjustment
- Arm's Length Range
- Other Issues

Warm-Up...

- What is Transfer Price ?

  A Price at which one person transfers physical goods and intangibles or provides services to another person.
- What is Transfer Pricing ?

  Transfer Pricing is the act of pricing physical goods and intangibles or services when the same is transferred to another person.
- What is Transfer Price from tax perspective ?

  A Price at which one person transfers physical goods and intangibles or provides services to another associated person.

…Warm-Up

- What is Transfer Pricing from tax perspective ?

  Pricing of the intercompany transactions that take place between two associated enterprises.

Indian TP Regulations…

Provision	Reference
Computation of income from international transaction having regard to arm's length price	Section 92 of the Income tax Act, 1961 ('the Act')
Meaning of associated enterprises	Section 92A of the Act
Meaning of international transaction	Section 92B of the Act
Computation of arm's length price	Section 92C of the Act
Reference to transfer pricing officer	Section 92CA of the Act
Power of Board to make safe harbour rules	Section 92CB of the Act
Maintenance and keeping of information and document by person entering into an international transaction	Section 92D of the Act

..Indian TP Regulations..

Provision	Reference
Report from an accountant to be furnished by person entering into international transaction	Section 92E of the Act
Definitions of various terms	Section 92F of the Act
Penalty consequent to re-determination of arm's length price	Explanation 7, Section 271(1)(c) of the Act
Penalty for failure to keep and maintain information and document in respect of international transaction	Section 271AA of the Act
Penalty for failure to furnish report under section 92E	Section 271BA
Penalty for failure to furnish information or document under section 92D	Section 271G

...Indian TP Regulations

Provision	Reference
Meaning of certain expressions	Rule 10A of the Income tax Rules, 1962 (‘the Rules’)
Determination of arm’s length price under section 92C	Rule 10B of the Rules
Most appropriate method	Rule 10C of the Rules
Information and documents to be kept and maintained under section 92D	Rule 10D of the Rules
Report from an accountant to be furnished under section 92E	Rule 10E of the Rules

Arm's Length Principle…

- Prices set for transactions between group entities should, for tax purposes, be derived from prices which would have been applied by unrelated parties in similar transactions under similar conditions in the open market.
- Section 92 of the Act

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

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

...Arm's Length Principle

- Section 92F (ii) of the Act

  "arms length price means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions"

- The arm's length principle has two different origins;
  - Adjustment to income of shareholders, mostly followed in European countries
  - Specific transfer pricing provisions with an international focus were first introduced during World War I in the United Kingdom and the United States.

- Both approaches are based on the concept of equal treatment or in the neutrality principle

The Tax Treaty Aspect…

- The arm's length principle was included in treaties concluded by France, the United Kingdom and the United States as early as the twenties and thirties of this century.
- In a multilateral context the arm's length principle was formulated for the first time in Article 6 of the League of Nations draft Convention on the Allocation of Profits and Property of International Enterprises in 1936.
- It was incorporated as Article VII in the Mexico Draft of 1943 and in the London Draft of 1946.

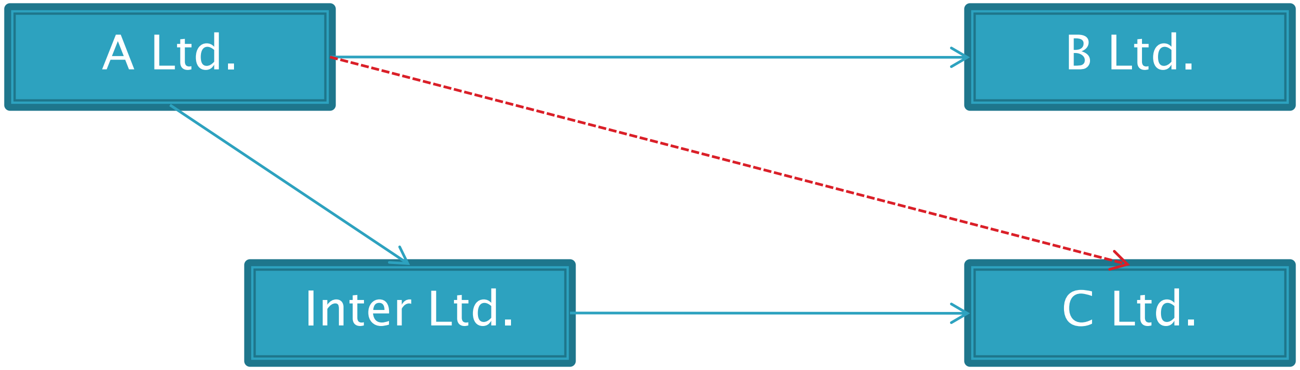
..The Tax Treaty Aspect..

- These articles are substantially similar to Article 9 of the 1963 OECD Draft Convention and Article 9, paragraph 1 of the present OECD and UN Model tax treaties.
- Articles 9 of the OECD and UN Models are identical.
- Article 9 confirms in a treaty situation
  - the (domestic) right of a contracting state
  - to adjust the profits of an enterprise located on its territory, which is managed, held or controlled directly or indirectly by an enterprise of the other contracting state
  - if the conditions in their relationship differ from the conditions which would have been stipulated between independent enterprises

Meaning of Associated Enterprises…

- Section 92A (1) (a)

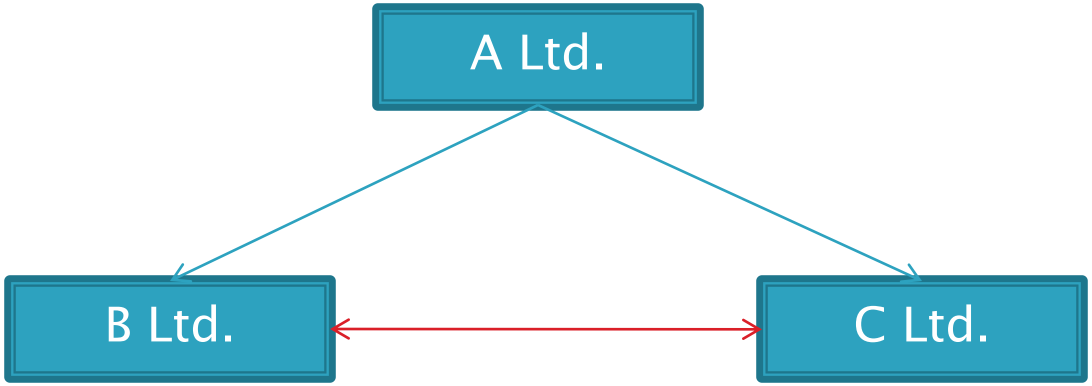
  "an enterprise which participates directly or indirectly or through one or more intermediaries, in the management or control or capital of the other enterprise shall be regarded as an associated enterprise."



..Meaning of Associated Enterprises..

- Section 92A (1) (b)

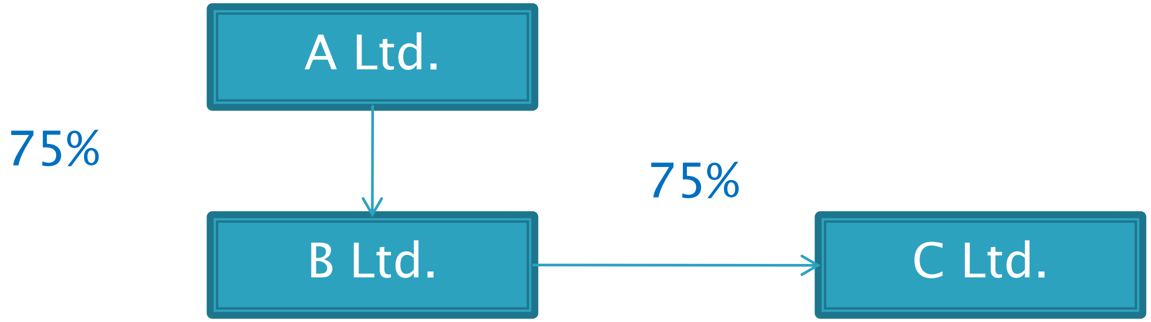
  "in respect of which one or more persons who participate, directly or indirectly , or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries , in the management or control or capital of the other enterprise."



..Meaning of Associated Enterprises..

- Section 92A (2) (a)

  "One enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise."

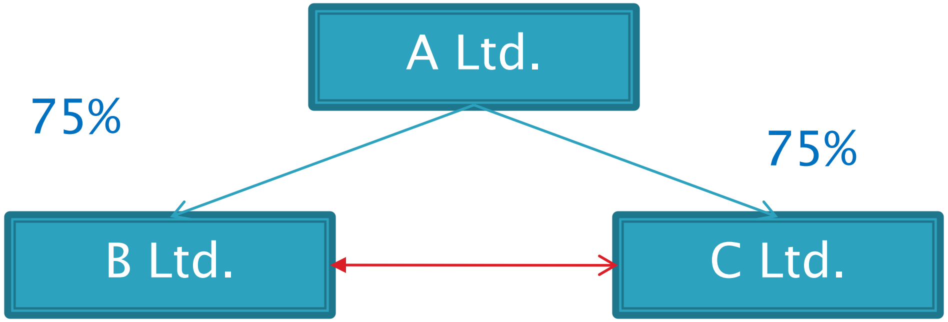


  - only to those cases where the investee enterprise is a company

..Meaning of Associated Enterprises..

- Section 92A (2) (b)

  "Any person or enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in each of the such enterprise."

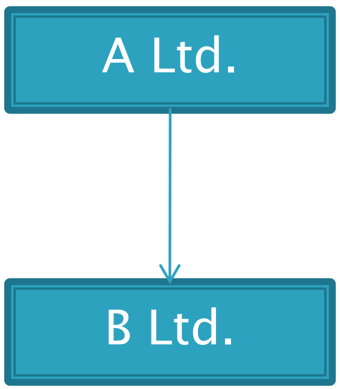


  - only to those cases where the investee enterprise is a company

..Meaning of Associated Enterprises..

- Section 92A (2) (c)

  "A loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise."



- B's book value of asset Rs.10cr
- Loan from A Ltd. Rs.6cr

..Meaning of Associated Enterprises..

- Section 92A (2) (d)

  "One enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise."

..Meaning of Associated Enterprises..

- Section 92A (2) (e)

  "More than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise."

  - As per section 2(6) of the Companies Act, 1956, the term "board of directors" would refer to the board of directors of a company.
  - The term "governing board", correspondingly, would refer to a body or council that has the executive authority to manage the affairs of the enterprise to which it relates.
  - These enterprises could be artificial juridical non-corporate bodies.

..Meaning of Associated Enterprises..

- Section 92A (2) (f)

  "More than half of the directors or members of the governing board, or one or more executive directors or executive members of the governing board of each of the two enterprises, are appointed by the same person or persons."

..Meaning of Associated Enterprises..

- Section 92A (2) (g)

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

..Meaning of Associated Enterprises..

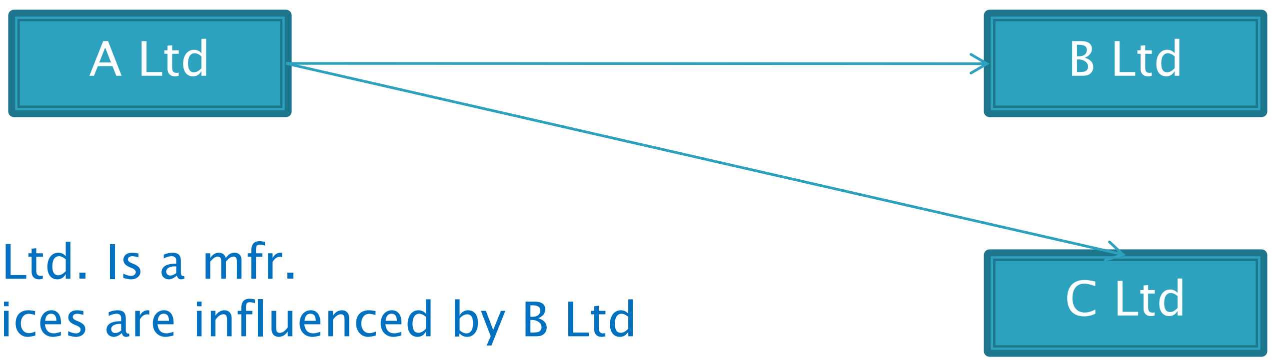
- Section 92A (2) (h)

  "Ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise."

..Meaning of Associated Enterprises..

- Section 92A (2) (i)

  "The goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise."



A Ltd. Is a mfr.
Prices are influenced by B Ltd

..Meaning of Associated Enterprises..

- Section 92A (2) (j)

  "The Where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual"

- Section 92A (2) (k)

  "Where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family, or by a relative of a member of such Hindu undivided family, or jointly by such member and his relative."

…Meaning of Associated Enterprises

- Section 92A (2) (l)

  "Where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association or body of individuals"

- Section 92A (2) (m)

  "There exists between the two enterprises, any relationship of mutual interest, as may be prescribed."

Meaning of International Transaction…

- Section 92B (1)

  For the purpose of this section and section 92, 92C, 92D and 92E, "international transaction" means

  - *a transaction between two or more associated enterprises*
  - *either or both of whom are non-residents*
  - *in the nature of purchase, sale or lease of tangible property………….*

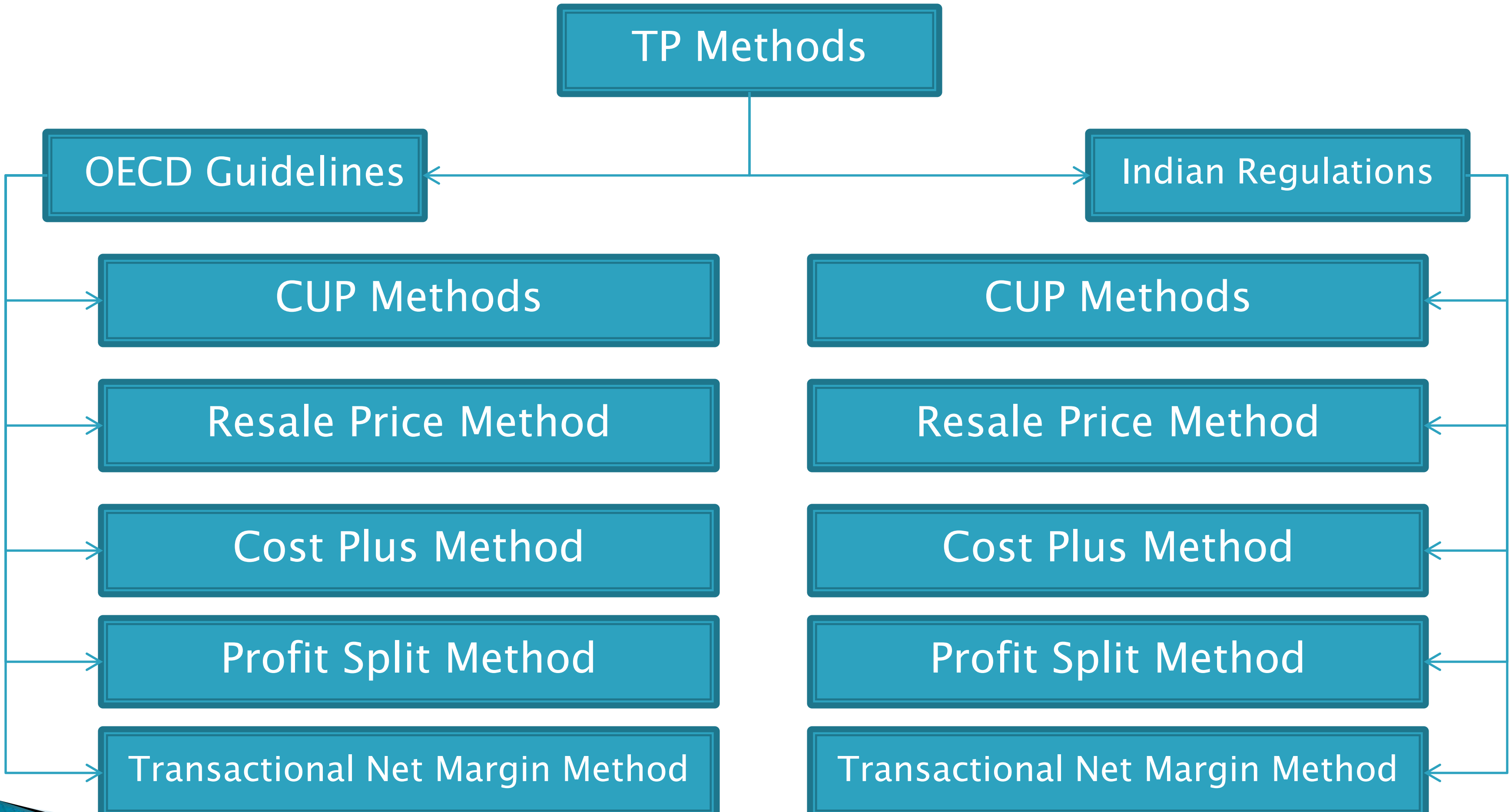
Meaning of International Transaction…

- Section 92B (2)

A transaction entered into by an enterprise with a person other than an associated enterprises shall for the purpose of sub section (1),

  - *be deemed to be a transaction entered between two associated enterprises*
  - *if there exists a prior agreement*
  - *in relation to the relevant transaction between such other person and the associated enterprises, or*
  - *the terms of the relevant transaction are determined in substance between such other person and the associated enterprise.*

Transfer Pricing Methods…



..Transfer Pricing Methods..

- In general
  - CUP Method compare prices
  - Resale Price Method compares gross margins
  - Cost Plus Method compares profit mark-ups on costs
  - Profit Split Method refers to the (total) profits from transactions and splits them among the parties based on the level of contribution
  - Transactional Net Margin Method analyses net profit in relation to an appropriate base, such as costs, sales or assets

..Transfer Pricing Methods..

- Applicability
  - Not every method can be applied to each taxpayer and business transaction
  - Applicability depends on
    - the characteristics of property or services
    - functions performed (including asset and risk assumed)
    - contractual terms
    - economic circumstances
    - business strategies
    - also depends upon the availability of information and reliability of assumptions

..Transfer Pricing Methods..

- Priority among methods
  - Indian Regulations does not prescribe any priority
  - As per OECD Guidelines issues in 1995 “traditional transaction methods” are given priority over “residuary method”
  - However, draft OECD guideline on related issue d for comments has done away with preferential status of traditional transactional methods remove

..Transfer Pricing Methods..

- Most Appropriate Method
  - which is best suited to the facts and circumstances of each particular international transaction, and
  - which provides the most reliable measure of an arm's length price in relation to the international transaction.

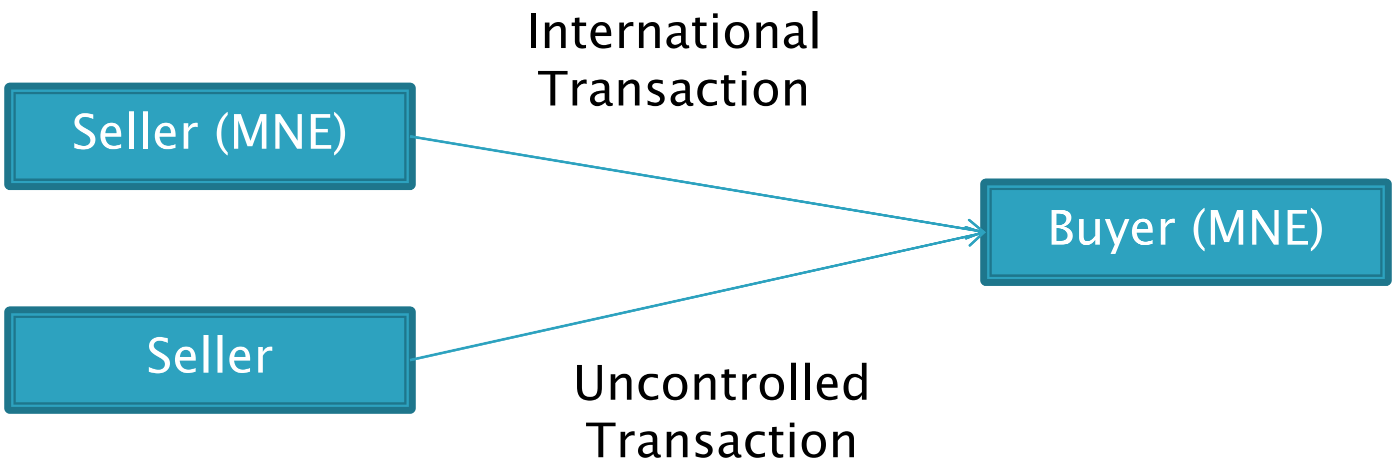
Transfer Pricing Methods – CUP…

- CUP Method
  - Most direct way of determining an ALP
  - It compares the price charged for goods or services transferred in an international transaction to the price charged for property or services transferred in a comparable uncontrolled transaction.
  - Price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market.

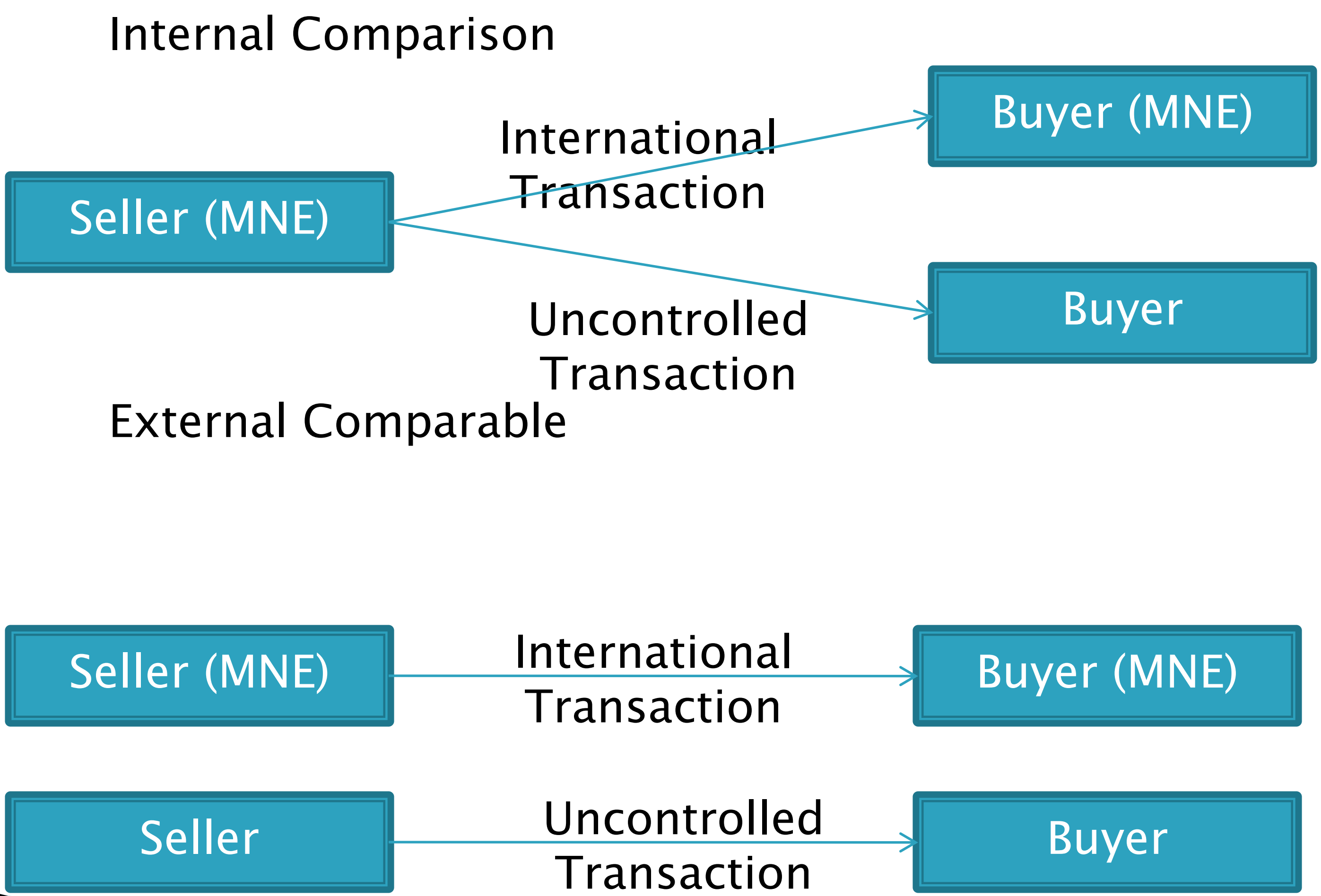
..Transfer Pricing Methods – CUP..

- Types of comparison
  - Internal comparison
  - External comparison

Internal Comparison



..Transfer Pricing Methods – CUP..



..Transfer Pricing Methods – CUP..

- Comparability
  - The comparability of property transferred in an international transaction and an uncontrolled transaction is most decisive for the application.
  - Intended purpose of use, branding or customer perception and preference would impact applicability.
  - Market comparability is another important factor to be considered.
  - Contractual term including quantity of property sold or acquired, volume discounts, applicable currency, marketing, advertising, after sale support, duration of contract, terms of delivery, terms of payment etc can not be ignored.

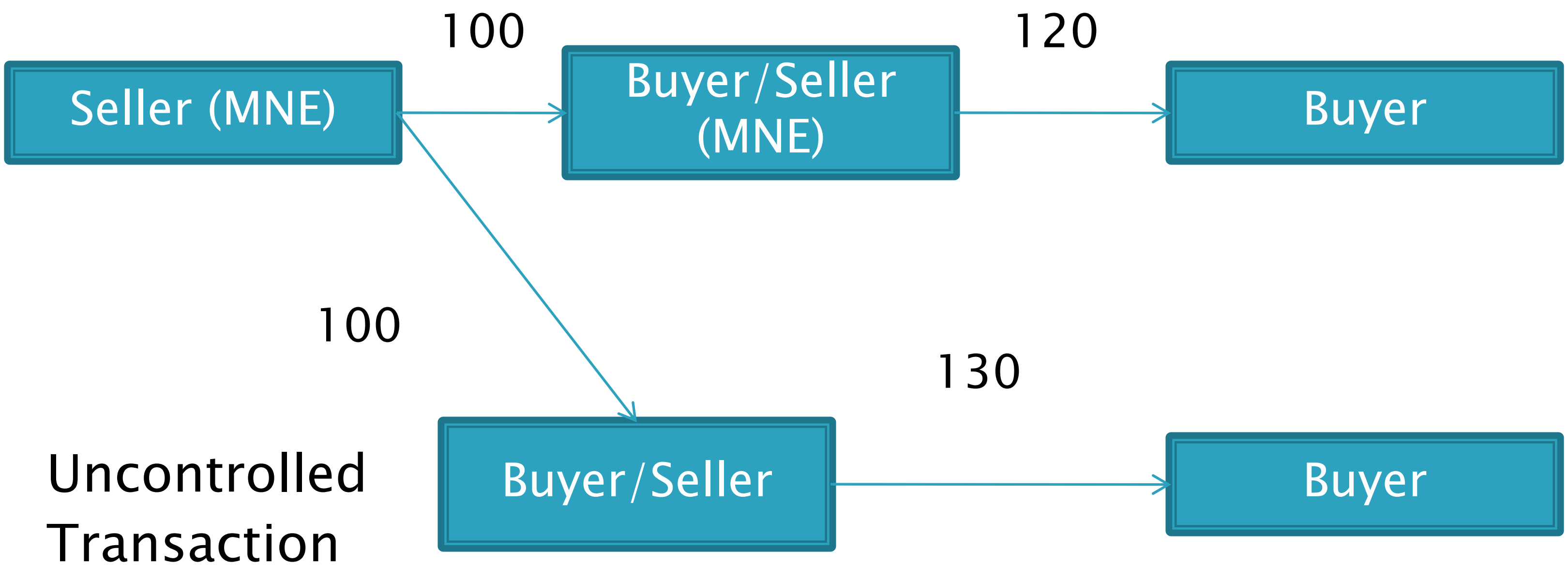
Transfer Pricing Methods – RPM…

- Resale Price Method (‘RPM’)
  - The resale price method measures an arm's length price by subtracting the appropriate gross profit from the applicable resale price for the property involved in the controlled transaction under review.
  - The price is adjusted to take into account the functional and other differences, including differences in accounting practices, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market.

..Transfer Pricing Methods – RPM..

Example 1

International Transaction



Uncontrolled Transaction

...Transfer Pricing Methods – RPM

- Applicability
  - Reseller should not make any material alterations to the product traded

- Comparability
  - Product comparability not very important, however better the product comparability better would be the results
  - More functions and asset, higher risk would require higher gross margin
  - Accounting variations should be taken care
  - Other factors like geographical differences, volume, high operating cost may effect comparison

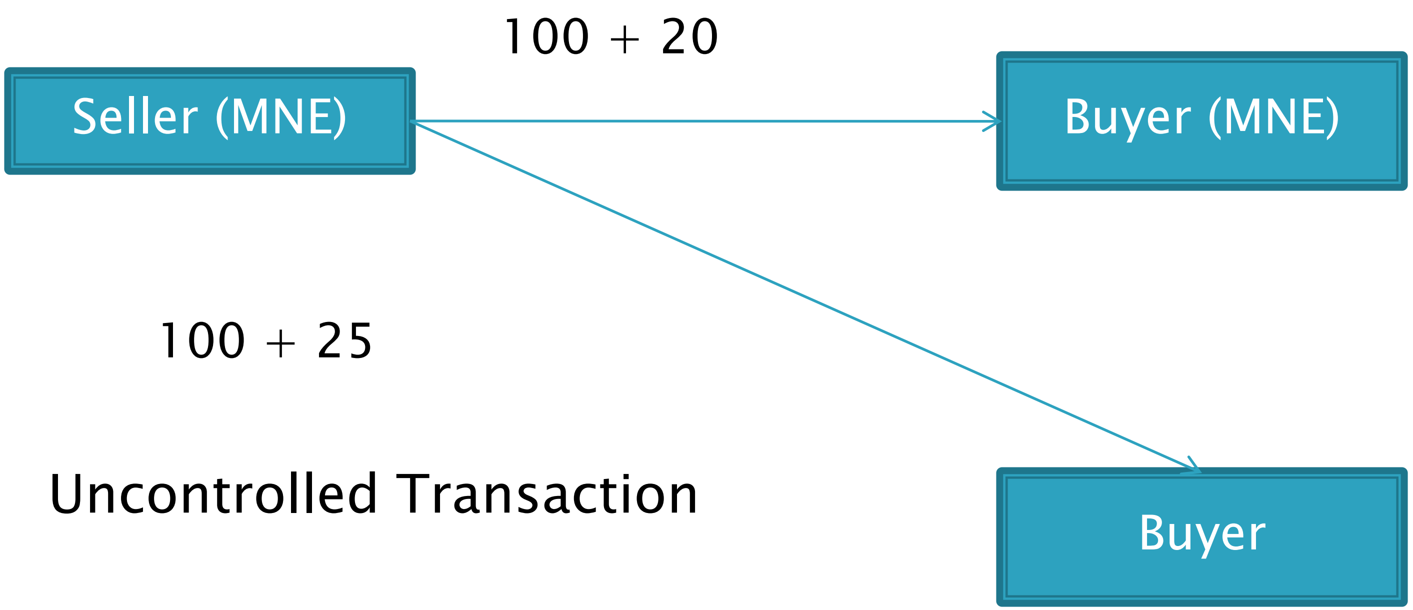
Transfer Pricing Methods – CPM…

- Cost Plus Method ('CPM')
  - The cost plus method tests whether a profit mark-up charged in a international transaction is at arm's length by reference to the mark-up charged in uncontrolled transactions.
  - Transfer pricing is calculated by adding a mark-up, earned in uncontrolled transactions, to a direct and indirect cost of production/ services relating to international transaction.

..Transfer Pricing Methods – CPM..

Example 1

International Transaction



Uncontrolled Transaction

...Transfer Pricing Methods – CPM

- Applicability
  - CPM is useful in case of long-term buy-and-supply agreements, pricing of semi-finished goods, toll or contract manufacturing, services of purchasing agents, contract research etc.

- Comparability
  - Product comparability not very important, however better the product comparability better would be the results
  - More functions and asset, higher risk would require higher gross margin
  - Accounting variations should be taken care
  - Other factors like geographical differences, volume, high operating cost may effect comparison

Transfer Pricing Methods – PSM…

- Profit Split Method ('PSM')
  - This method aims to determine what division of total profits independent enterprise would expect in relation to the relevant transactions.
  - The profits should be split on an economically valid basis that reflects the functions and risks of each of the parties.
  - In order to apply this method, it is necessary to identify the total profit arising from the related party transactions and split that profit between the parties according to their respective contributions.

..Transfer Pricing Methods – PSM..

- Applicability
  - In certain very complex trading relationships involving very interrelated transactions, it is sometimes genuinely difficult to evaluate those transactions on a separate basis.

- Approaches
  - There are two approaches to this method;
    - Total profits split, and
    - Residual profit split

…Transfer Pricing Methods – PSM

- Total Profit Split
  - Total profits from the controlled transactions made by all the enterprises involved in earning those profits are split between those enterprises based on the relative value of the functions that each carries out.
- Residual Profit Split
  - Total profit of the overall trade made by the associated enterprises is considered.
  - Firstly, each participant is allocated sufficient profit to provide it with a basic return appropriate to the functions carried out.
  - Secondly, any profit (or loss) left after the allocation of basic returns would be split as appropriate between the parties – based on an analysis of how this residual would have been split between third parties.

Transfer Pricing Methods – TNMM…

- Transactional Net Margin Method (‘TNMM’)
  - The TNMM examines the net profit margin relative to an appropriate base that a tax payer realizes from an international transactions vis-à-vis comparable uncontrolled transactions.
  - Thus, the TNMM operates in a manner similar to the cost plus and resale price methods.
  - The TNMM is based on the economic theory that returns earned by an enterprise operating under similar conditions, in the same market and industry, tend to become more equal after some time.

Transfer Pricing Methods – TNMM…

- Applicability
  - If other methods are not applicable

- Procedure
  - Selection of Tested Party
  - Data – Current year vs. Multiple year
  - Aggregation of transaction
  - Identification of comparables
  - Profit level indicator
    - Operating Margin = OP/Sales X 100
    - Net Cost Plus = OP/ Total Operating Expenses X 100
    - Berry Ratio = GP/ Operating Expenses
    - Return on Asset = OP/ Operating Asset X 100

Arm's Length Range...

- Proviso to (2) of Section 92 C (as substituted by the Finance (No.2) Act, 2009)
  - "Where more than one price is determined by the most appropriate method
  - the arm's length price shall be taken to be the arithmetical mean of such prices
  - Provided further that if the variation between the arm's length price so determined
  - and price at which the international transaction has actually been undertaken
  - does not exceed five percent of latter
  - the price at which the international transaction has actually been undertaken shall be deemed to be the arm's length price."

..Arm's Length Range..

- Example 1

Comparable	ALP (in Rs.)
Comparable 1	100
Comparable 2	102
Comparable 3	101
Comparable 4	101
Comparable 5	103
Mean ALP	**101.4**

..Arm's Length Range..

- Example 2

Comparable	OP/ OC Margin
Comparable 1	6%
Comparable 2	2%
Comparable 3	7%
Comparable 4	8%
Comparable 5	5%
Mean OP/OC Margin	**5.60%**

..Arm's Length Range..

If OC = Rs.1,000

Comparable	ALP
Comparable 1	1060
Comparable 2	1020
Comparable 3	1070
Comparable 4	1080
Comparable 5	1050
Mean ALP	**1056.00**

..Arm's Length Range..

- Example 3
  Transaction Value = Rs.100
  Mean ALP = Rs. 104
  Variation = Rs. 104- Rs.100 = Rs.4 = 4%

- Example 4
  Mean RPM = 10%
  Sale Price = Rs.100
  ALP of Imports = Rs.100 – Rs.10 = Rs.90
  Transaction Value = Rs.95
  Variation = Rs.95 – Rs.90 = Rs.5 = 5.55%

..Arm's Length Range..

- Example 4
  Mean CPM = 15%
  Direct & Indirect cost of Production= Rs.1,000
  ALP of Exports = Rs.1,000 + Rs.150 = Rs.1,150
  Transaction Value = Rs.1,025
  Variation = Rs.1,150 – Rs.1,025 = Rs.125 = 12.20%

..Arm's Length Range..

- Example 5

  Mean OP/ OC = 10%

  Total OC= Rs.10,000

  Sales made to third parties = Rs.2,000

  Sales at Mean OP/OC = Rs.10,000 + Rs.1000
  = Rs.11,000

  ALP Sales = Rs.11,000 – Rs.2,000 = Rs.9,000

  Transaction Value = Rs.8,000

  Variation =Rs.9,000 – Rs.8,000 = Rs.1,000
  = 12.5%

...Arm's Length Range

- Proviso to (2) of Section 92 C (as per the Finance Act, 2002)
  - "Where more than one price is determined by the most appropriate method
  - The arm's length price shall be taken to be the arithmetical mean of such prices
  - Or, at the option of the assessee
  - A price which may vary from an arithmetical mean
  - By an amount not exceeding five percent of such arithmetical mean"

Other Issues

- Downward adjustment
- Timing issue in comparability
- Uncontrolled transactions
- Loss making situation
- Economic downturn

Thank You

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