

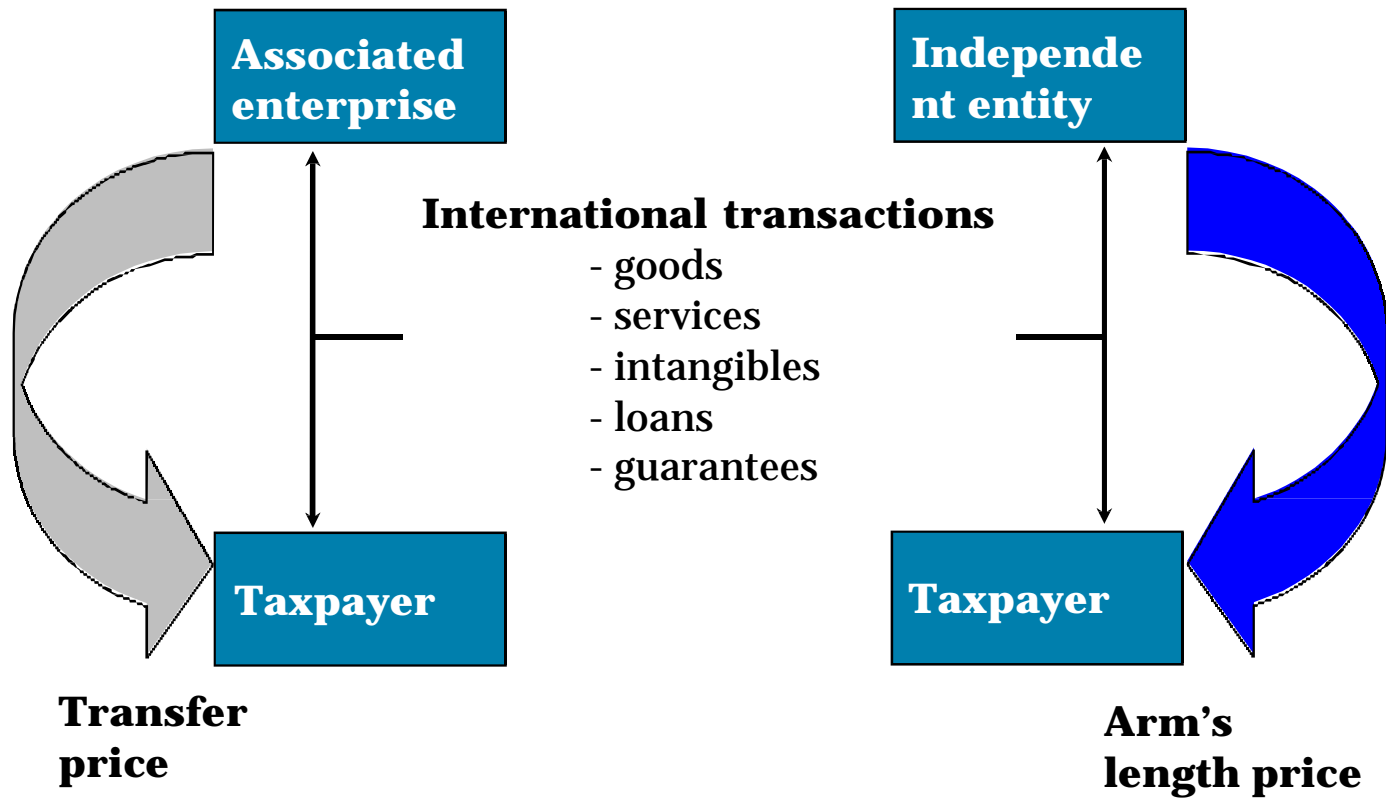
# ***Analysis of Transfer Pricing Provisions***

***23 September 2017***

CA Prasad Pardiwala

CA Mukesh Bhanushali

# Concept of Transfer Pricing (TP)



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## ***Rationale for regulating transfer prices***

- ▶ Differences in tax rates across tax jurisdictions
- ▶ Pricing flexibility (between associated enterprises)
- ▶ Presumption: prices between associated enterprises are not at arm's length
- ▶ Every government wants to prevent erosion of their tax base and plug potential tax leakages

# Applicability of transfer pricing regulations

## Applicability

- ▶ There are two or more enterprises
- ▶ The enterprises are Associated Enterprise\*
- ▶ The enterprises enter into a transaction/ notional transaction
- ▶ The transaction is an International Transaction\* or a Specified Domestic Transaction
- ▶ Value of the transaction should be at Arm's Length Price\*
- ▶ Maintenance of prescribed annual Documentation
- ▶ Obtaining of Chartered Accountant's certificate annually
- ▶ Stiff penalty provisions – Onus on taxpayer to defend Arm's Length Price

## Consequences

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

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***Associated enterprise***

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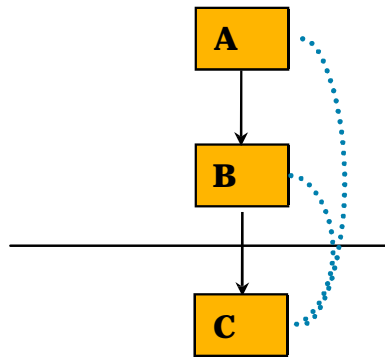
## ***Question***

A parent-subsidiary relationship is the only Association two enterprises can have.

- a) True
- b) False

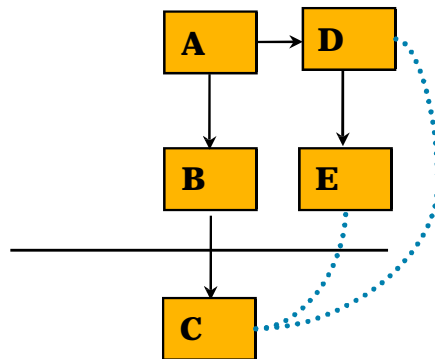
What other arrangements can you think of?

# Meaning of Associated enterprises (Sec 92A)



Both A and B are associated enterprises of C

Direct or indirect participation (through one or more intermediaries) in management, control or capital



D and E are also associated enterprises of C since they have a common ultimate parent (A)

# Deemed Associated enterprises [Sec 92A(2)]

Holding	Management	Activities	Control
1. $\geq 26\%$ direct / indirect <b>holding</b> by enterprise  <u>OR</u>	6. Appointment $> 50\%$ of <b>Directors</b> / one or more Executive Director by an enterprise  <u>OR</u>	8. $100\%$ <b>dependence</b> on use of intangibles for manufacture / processing / business	11. One enterprise controlled by an individual and the other by himself or his relative or jointly
2. By same person in each enterprise	<u>OR</u>	9. Direct / indirect supply of $\geq 90\%$ <b>Raw Materials</b> under influenced prices and conditions	12. One enterprise controlled by HUF and the other by - a member of HUF his relative or Jointly by member and relative
3. <b>Loan</b> $\geq 51\%$ of Total Assets	7. Appointment by same person in each enterprise	10. Sale under influenced prices and conditions	
4. <b>Guarantees</b> $> = 10\%$ of debt			
5. $> 10\%$ interest in Firm / AOP / BOI			



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# ***International Transaction***

## Question

Below are line-items in a P&L. How many potential 'Transactions' can you point which could impact them?

<b>Revenue</b>	<ul style="list-style-type: none"><li>• Products sold to AE</li><li>• Service income from AE</li><li>• Royalty received from AE</li></ul>
<b>COGS</b>	<ul style="list-style-type: none"><li>• Raw material/finished goods purchased from AE</li><li>• Payment for services to AEs (contract manufacturing)</li></ul>
<b>SG&amp;A</b>	<ul style="list-style-type: none"><li>• Fee for services provided by AEs (R&amp;D services)</li><li>• HQ costs allocated to AEs</li><li>• Royalty paid to AEs</li></ul>
<b>Other items</b>	<ul style="list-style-type: none"><li>• Interest paid to AEs</li><li>• Interest received from AEs</li></ul>

Is the P&L the only place where 'Transactions' can occur?

- a) True
- b) False

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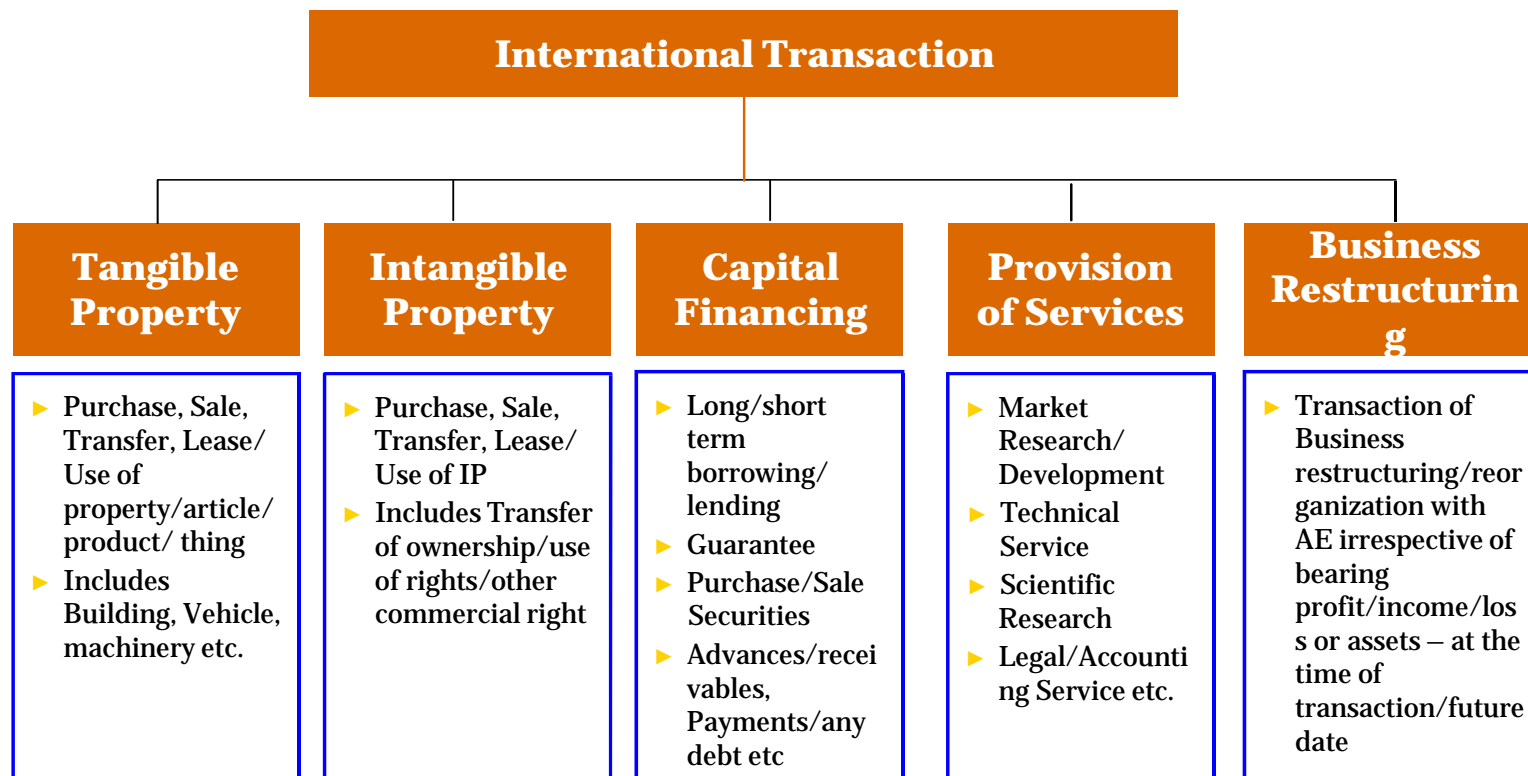
## ***International transaction (Sec 92B)***

- ▶ Transactions between two or more AEs, 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; or
  - ▶ Business restructuring or reorganization irrespective of fact that it has bearing on the profit, income, losses or assets

### **As per Section 92F(V):**

- ▶ “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 proceeding.

# ***Enhanced definition of International transaction (w.e.f. 1 April 2002)***



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# ***Definition of Intangible Clarified***

## **Marketing**

Trademarks, Trade Names, Brand Names, Logos

## **Technology**

Process Patents , Patent Applications, Technical Documentation,  
Technical know-how

## **Artistic**

Copyrights, Literary work, Musical Compositions, Maps, Engravings

## **Data Processing**

Software Copyrights, Proprietary software, Automated databases,  
Integrated circuit Masks & Masters

## **Engineering**

Industrial Design, Product Patent, Trade Secrets, Engineering  
Drawings, Blueprints, Proprietary Documentation

## **Customer**

Customer Lists, Customer Contracts, Customer Relationship, Open  
Purchase Orders

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# ***Definition of Intangible Clarified***

## **Contract**

Favourable Supplier Contracts, License agreements , Franchise agreements , non-compete agreements

## **Human Capital**

Trained & Organised work force , Employment agreements, Union Contracts

## **Location**

Leasehold interest, Mineral exploitation rights, Easements, Air rights, Water rights

## **Goodwill**

Institutional / Professional Practice / Celebrity goodwill , Personal goodwill of professional, General business going concern value

## **Similar**

Similar Item deriving its value from its Intellectual content rather than its physical attributes

## **Others**

Methods , Programmes , Systems, Procedures, Campaigns, Surveys, Studies, Forecasts, Estimates, Customer Lists or Technical data

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## ***End of section Quiz***

**Question 1:** If a non-resident company holding shares of an Indian company sells the shares to another non-resident associated enterprise outside India, whether TP provisions would still apply?

- a) Applicable to none
- b) Applicable to both seller and buyer
- c) Applicable to seller
- d) Applicable to buyer

**Question 2:** Would an oral agreement be construed as a transaction

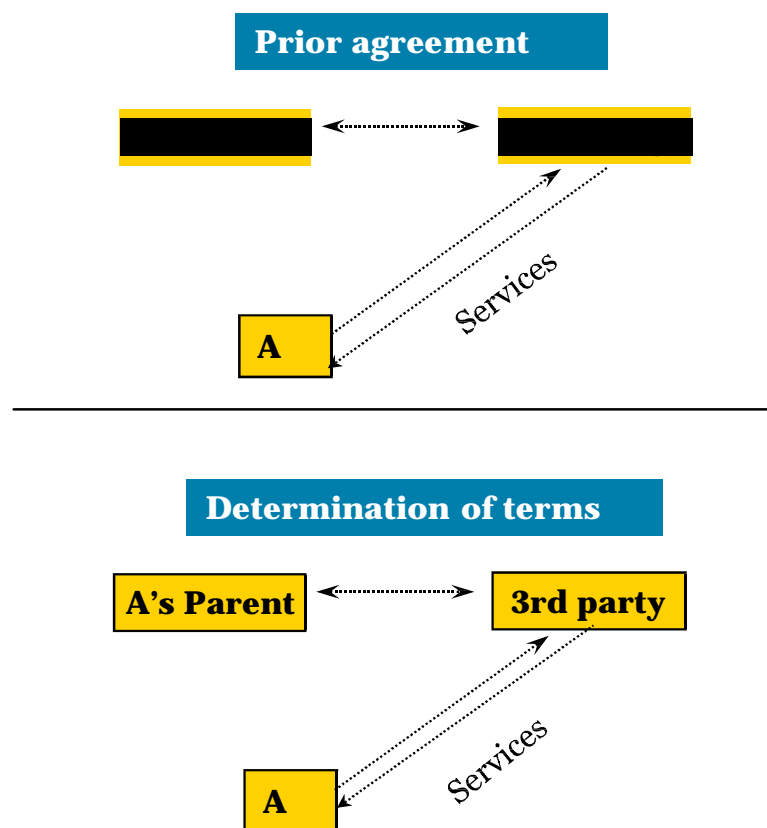
- a) No
- b) Yes
- c) On case-to-case basis
- d) Never

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# ***Deemed International Transaction***



## ***Deemed international transaction- Sec 92B(2)***



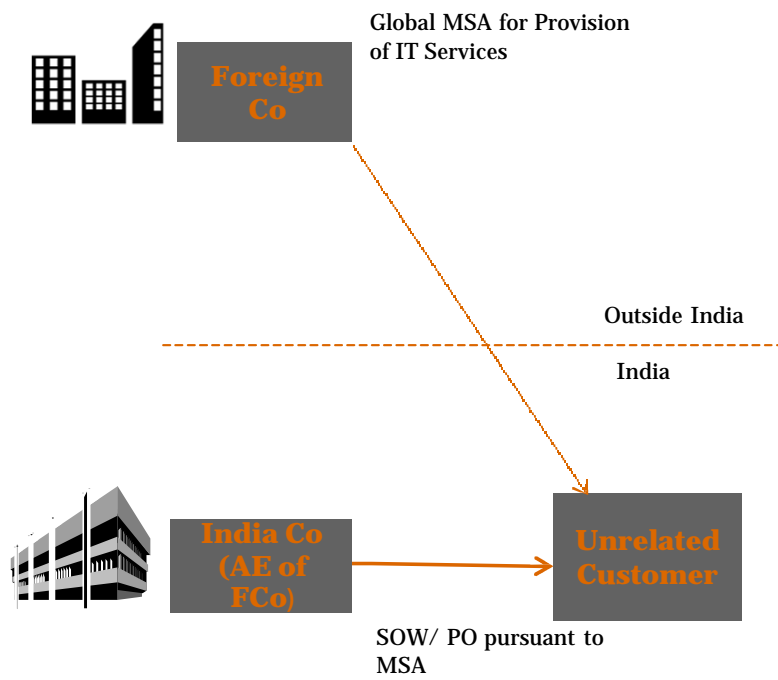
- ▶ An transaction with an unrelated company (3<sup>rd</sup> party) is deemed to be an international transaction and subject to transfer pricing regulations if
  - ▶ a prior agreement exists between A's AE and 3rd party in relation to services rendered by A to the 3rd party; or
  - ▶ terms of transaction are determined in substance by A's AE and 3rd party

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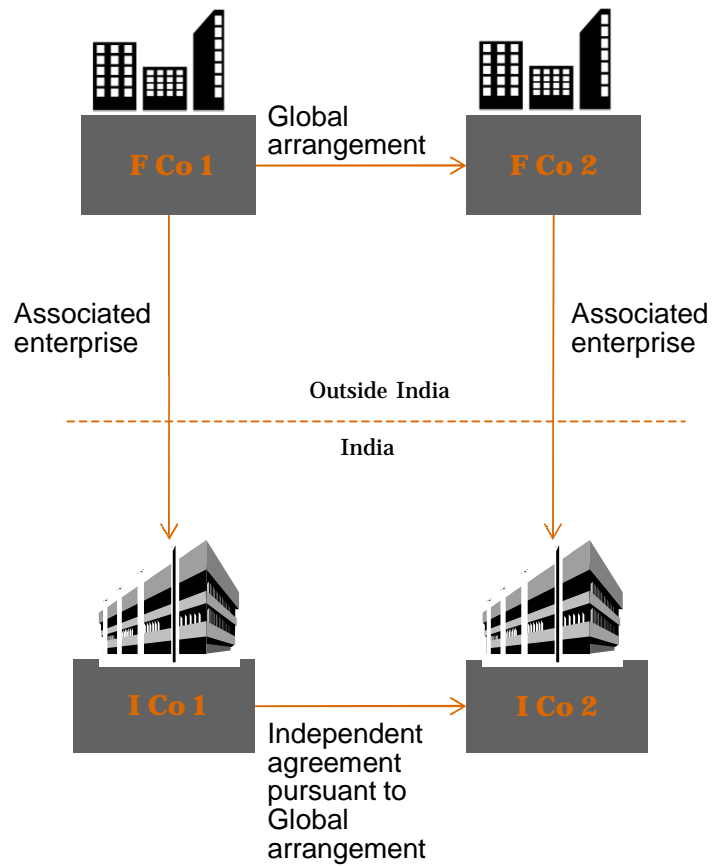
## ***Definition of "deemed international transaction" amended***

- ▶ The definition of "deemed international transaction" provides that a transaction of an enterprise with a third party shall be deemed to be an international transaction with the Associated Enterprise (AE) if there exists a prior agreement in relation to the said transaction or the terms of the said transaction are determined in substance between the AE and the third party. [Section 92B(2)]
- ▶ There had been an ambiguity as to whether 'deemed international transactions' would cover a case where both the contracting entities are Indian residents
- ▶ Hyderabad Tribunal in the case of **Swarnandhra IJMII Integrated Township Development Co. P. Ltd vs. DCIT [TS-762-ITAT-2012(HYD)-TP]** held that deeming fiction of section 92B(2) does not cover transactions between two Indian entities. Similar position taken in Kodak India Pvt Ltd (155 TTJ 69) Mum ITAT and Vodafone India Services Pvt Ltd (262 CTR 133) (Bom HC)
- ▶ Clarification provided by Finance Act 2014 that deemed international transactions would also cover cases where both the contracting parties are residents
- ▶ The amendment is in effect from 1 April 2015

# Case study 1



## Case study 2



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# ***End of section Quiz***

**Question 1:** Does TP apply to transactions between two unrelated parties?

- a) Yes
- b) No
- c) On a case-to-case basis
- d) None of the above

**Question 2:** A transaction with an unrelated company (3<sup>rd</sup> party) is deemed to be an international transaction and subject to transfer pricing regulations if -

- a) a prior agreement exists between A's AE and 3rd party in relation to services rendered by A to the 3rd party
- b) terms of transaction are determined in substance by A's AE and 3rd party
- c) a prior agreement exists between A's AE and 3rd party in relation to services rendered by A to the 3rd party **and** terms of transaction are determined in substance by A's AE and 3rd party
- d) None of the above

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# ***Specified Domestic Transaction***

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## ***Specified Domestic Transaction – Sec 92 (2A)***

- ▶ Scope of TP provisions expanded w.e.f 1 April 2013 by including “SDT” if aggregate value of such transaction exceeds INR 5 Crores. The limit is increased to 20 Crores w.e.f 1 April 2016 (FY 2015-16)
- ▶ Applicability of TP regulations (including procedural and penalty provisions) to specified transactions between domestic related parties and payments made to related parties.
- ▶ Section 92BA - “**Specified Domestic Transactions**” in case of an Assessee means any of the following transactions, not being an international transaction, namely -
  - i. Any expenditure in respect of which payment is made or to be made to a person u/s 40A(2)(b) (Removed wef FY 2016-17)
  - ii. Any transaction referred u/s 80A;
  - iii. Any transfer of goods/services u/s 80-IA;
  - iv. Any business transaction u/s 80-IA(10);
  - v. Any transaction under Chapter VI-A or u/s 10AA – to which provisions of Sec 80-IA (8) or (10) applies; or
  - vi. Any other transaction as may be prescribed.

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***Specified Domestic Transaction – Sec 92 (2A)***





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# ***FAR analysis***

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## ***FAR – What to look at***



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## ***Arm's length Price***

# ***What's cheaper?***



# *What's cheaper?*



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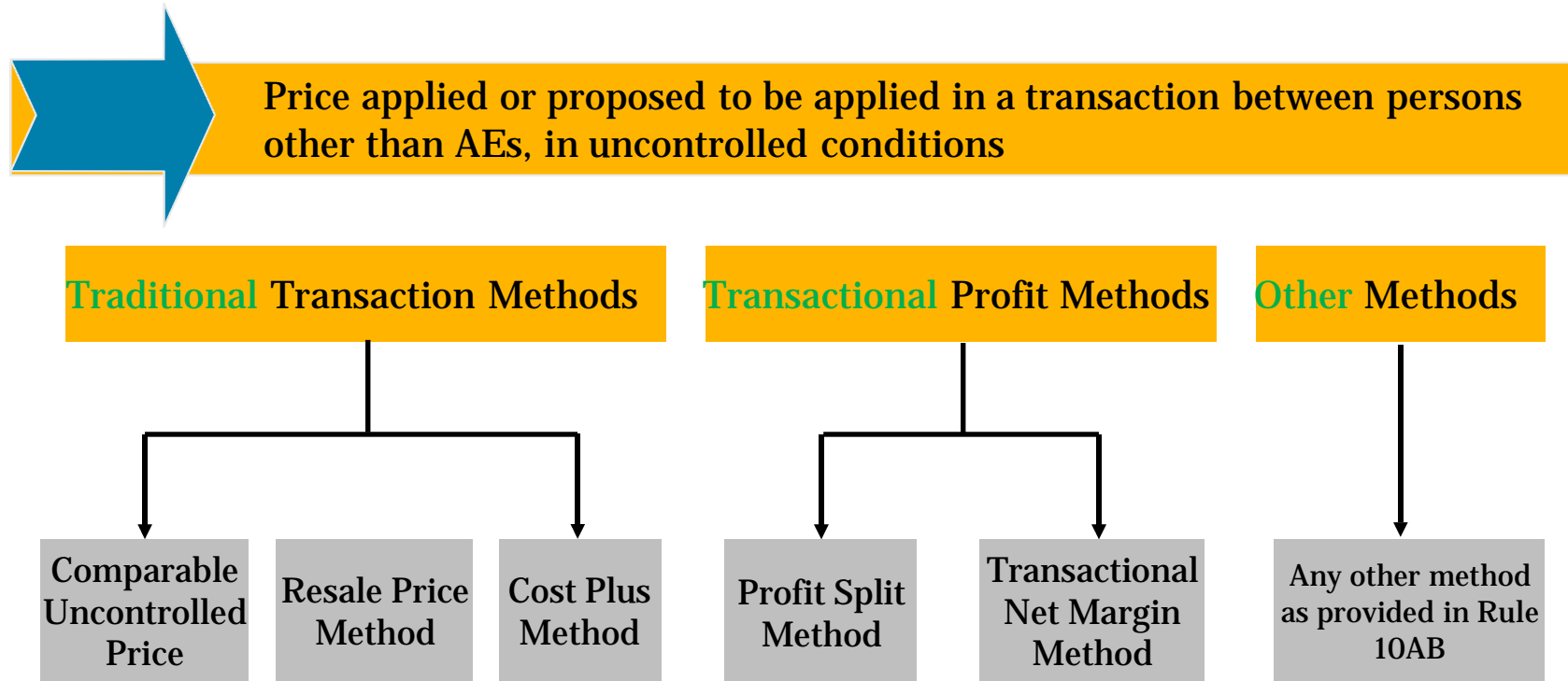
## ***Question***

Under Transfer Pricing, the only way to study arm's length nature is to compare "prices"

- a) True
- b) False

What other ways of comparing can you think of?

## ***Arm's length price***



- ▶ Tax payer may apply any of the above methods that is considered most appropriate for a transaction

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# ***Comparables***

- ▶ All methods require comparables
- ▶ Transfer price is set/ defended using data from comparable transactions
- ▶ Comparable transaction should be independent and similar to tested transactions
- ▶ Factors for judging comparability (Rule 10C(2)):
  - ▶ nature of transactions undertaken (i.e. type of goods, services etc.)
  - ▶ company functions
  - ▶ risks assumed
  - ▶ contractual terms (i.e. similar credit terms)
  - ▶ economic and market conditions



## Arm's length price



Price applied or proposed to be applied in a transaction between persons other than AEs, in uncontrolled conditions

Determination of arm's length prices using one of the Prescribed methods

Whether you arrive at a single price ?

Yes

The price thus determined is the arm's length price

No

*Earlier: The arithmetic mean of such prices, read with sec 92C(2)*

- ▶ +1% (upper ceiling) for wholesale traders; and
- ▶ + 3% (upper ceiling) in all other cases

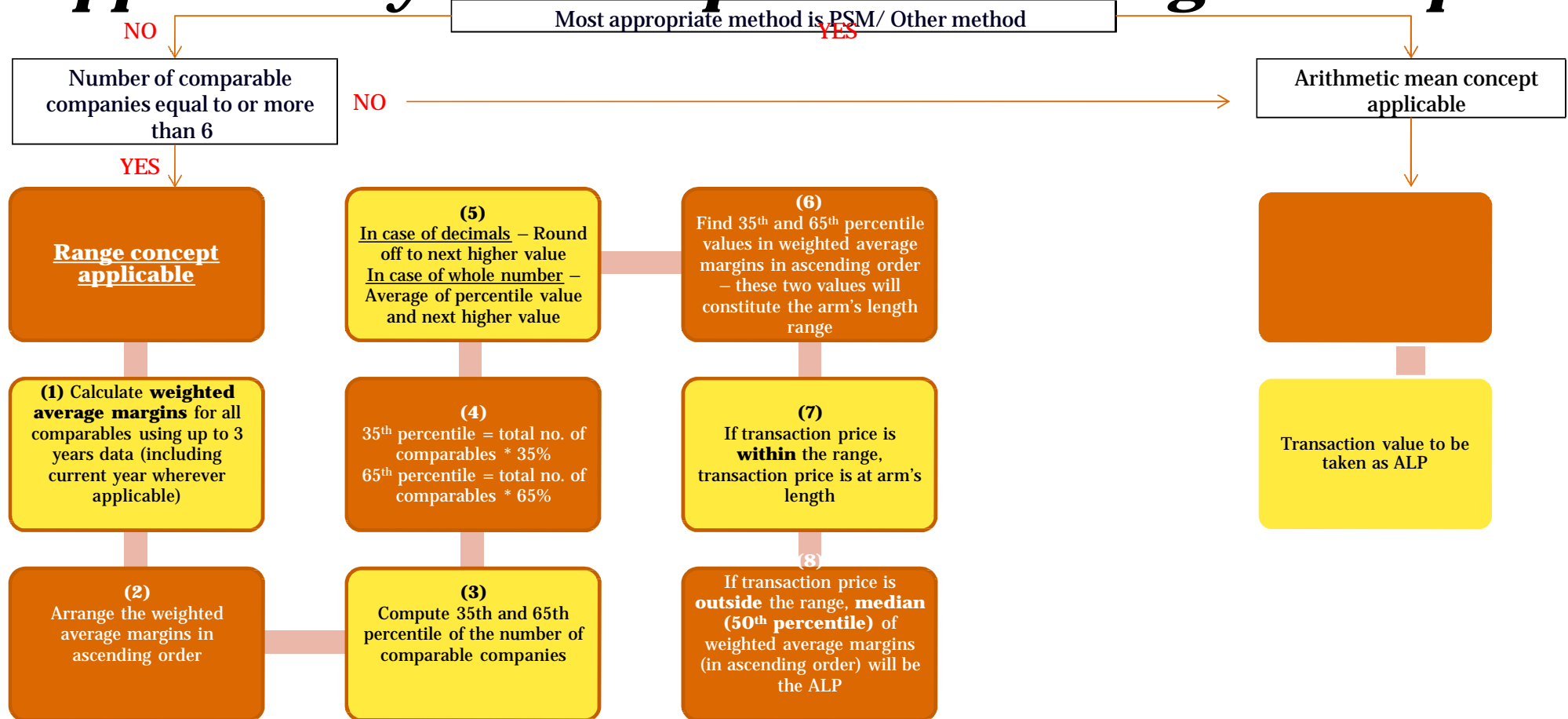
Replaced in current finance Act with a range and mean to apply only in case of inadequate comparables (less than 6)

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## ***Introduction of 'range' concept***

- ▶ Central Board of Direct Taxes ('CBDT') has introduced a notification on 19 October 2015 wherein a revised range concept has been introduced for the purpose of arm's length analysis and usage of multiple year data
- ▶ According to the notification, use of multiple year data while carrying out transfer pricing analysis is permissible
- ▶ The notification is applicable for international/ specified domestic transactions undertaken on or after 1 April 2014, i.e. from FY 2014-15
- ▶ Range concept would be used for all methods (depending on the facts) except for Profit Split Method ('PSM') and Other Method. For PSM and Other Method, only arithmetic mean concept would have to be used
- ▶ Range concept will be applicable only if 6 or more comparable companies are available. If not, arithmetic mean concept will continue to be used
- ▶ The arm's length range will constitute of the values falling between the 35<sup>th</sup> and 65<sup>th</sup> percentile of the weighted average margins of comparable companies
- ▶ If the transaction price falls outside the arm's length range, the median value of the comparable prices shall be considered as ALP
- ▶ Use of multiple year data can be split into 2 categories; first, at the time of compliance and second, at the time of transfer pricing assessment

# Applicability and computation of range concept



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# ***Permissible Tolerance Band to determine arm's length price***

- ▶ Range benefit is no more available as a standard deduction
- ▶ Amendments in Finance Act (No. 2) 2009 to be applicable to all AY pending after 1 Oct 2009
- ▶ The  $\pm 5\%$  variation allowed in determining ALP has been capped to a limit of + 1% for wholesale traders and + 3% in all other cases from 1 April 2013
- ▶ Tolerance band now substituted by range concept (if prescribed conditions are satisfied)

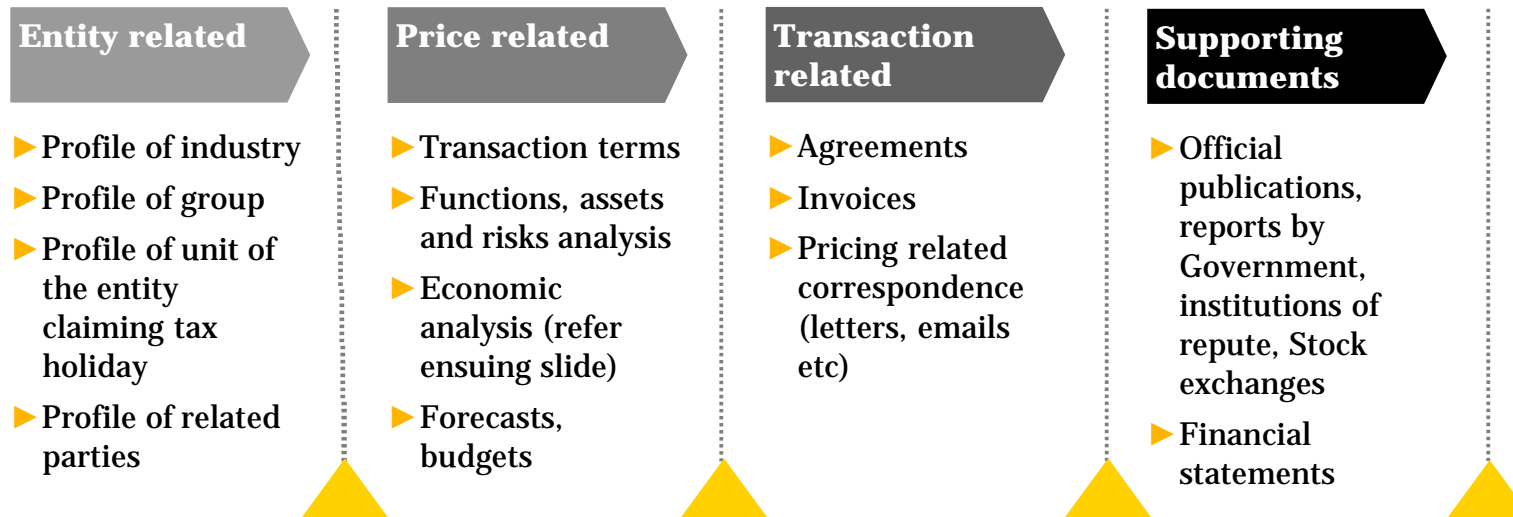
## ***Tolerance band : Tweaked with non tolerance***

<b>Position prior to amendments</b>			
<b>Particulars</b>	<b>1.4.02 to 30.9.09</b>	<b>1.10.09 to 31.3.13</b>	
Transfer price	100	100	
ALP (Arithmetic mean)	120	120	
Permissible Range	114-126 (5% of 120)	95-105	
TP adjustment	Arguably, 14 (114 -100)	Arguably, 20	
<b>Position post amendments by Finance Act 2012</b>			
<b>Particulars</b>	<b>1.4.02 to 30.9.09</b>	<b>1.10.09 to 31.3.13</b>	<b>1.4.13 onwards</b>
Transfer price	100	100	100
ALP	120	120	120
Permissible range	114 -126	95 -105	+1% (upper ceiling) for wholesale traders; and + 3% (upper ceiling) in all other cases
TP adjustment	20 (no benefit of $\pm$ 5% band)	20 (if assessment pending as of 1.10.09)	20
Remarks	Concluded assessment not to be subject to rectification reassessment		

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# ***Transfer Pricing documentation***

# Transfer pricing documentation



**Every company to whom TP is applicable is required to file a certificate\* annually, obtained by a Chartered Accountant, containing details such as:**

- ▶ **Compliance by taxpayer with the TP documentation requirements**
- ▶ **Nature/ Quantum of transactions and method used to determine ALP**

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# ***Accountant's report (Form 3CEB) - Rule 10E***

- ▶ Obtained by every tax payer filing a return in India and having international transaction or SDT
  
- ▶ To be filed by due date for filing return of income
  
- ▶ 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 transactions as per the books of account and as per the transfer pricing documentation are **"true and correct"**

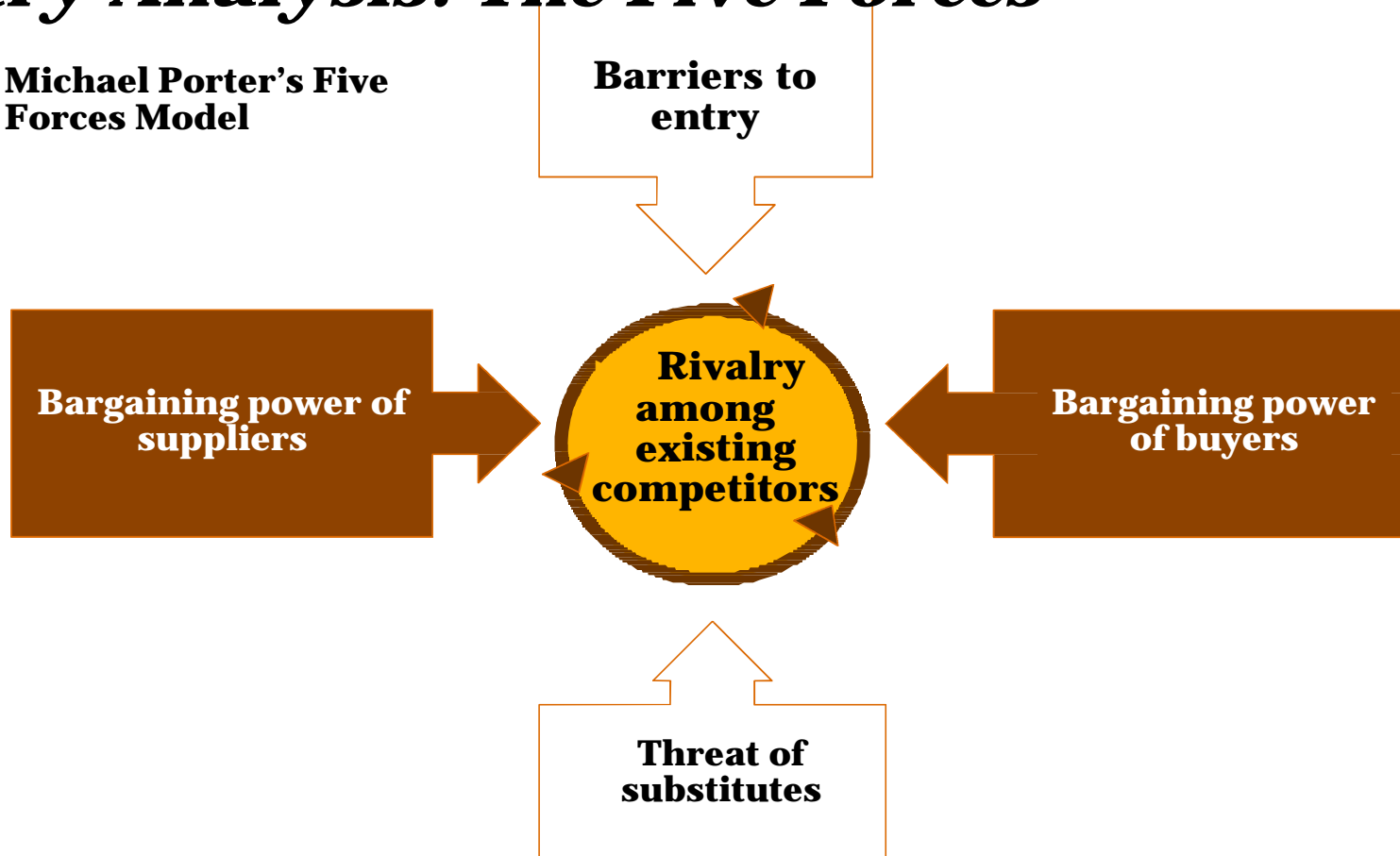


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# ***Industry overview***

# ***Industry Analysis: The Five Forces***

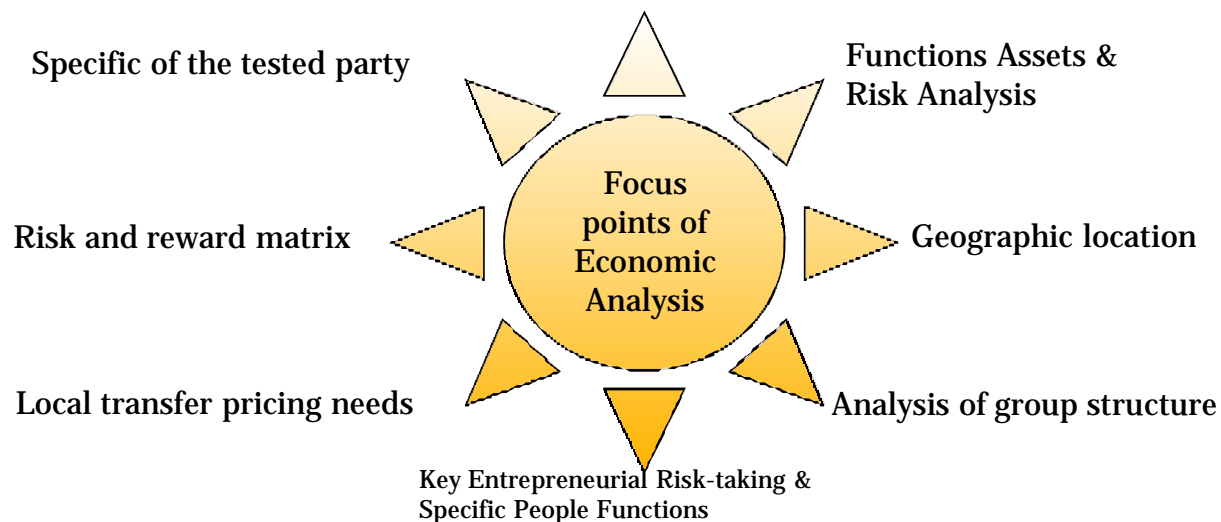
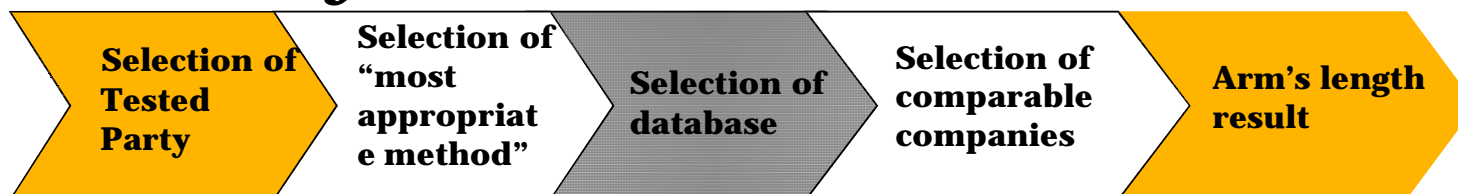
**Michael Porter's Five Forces Model**



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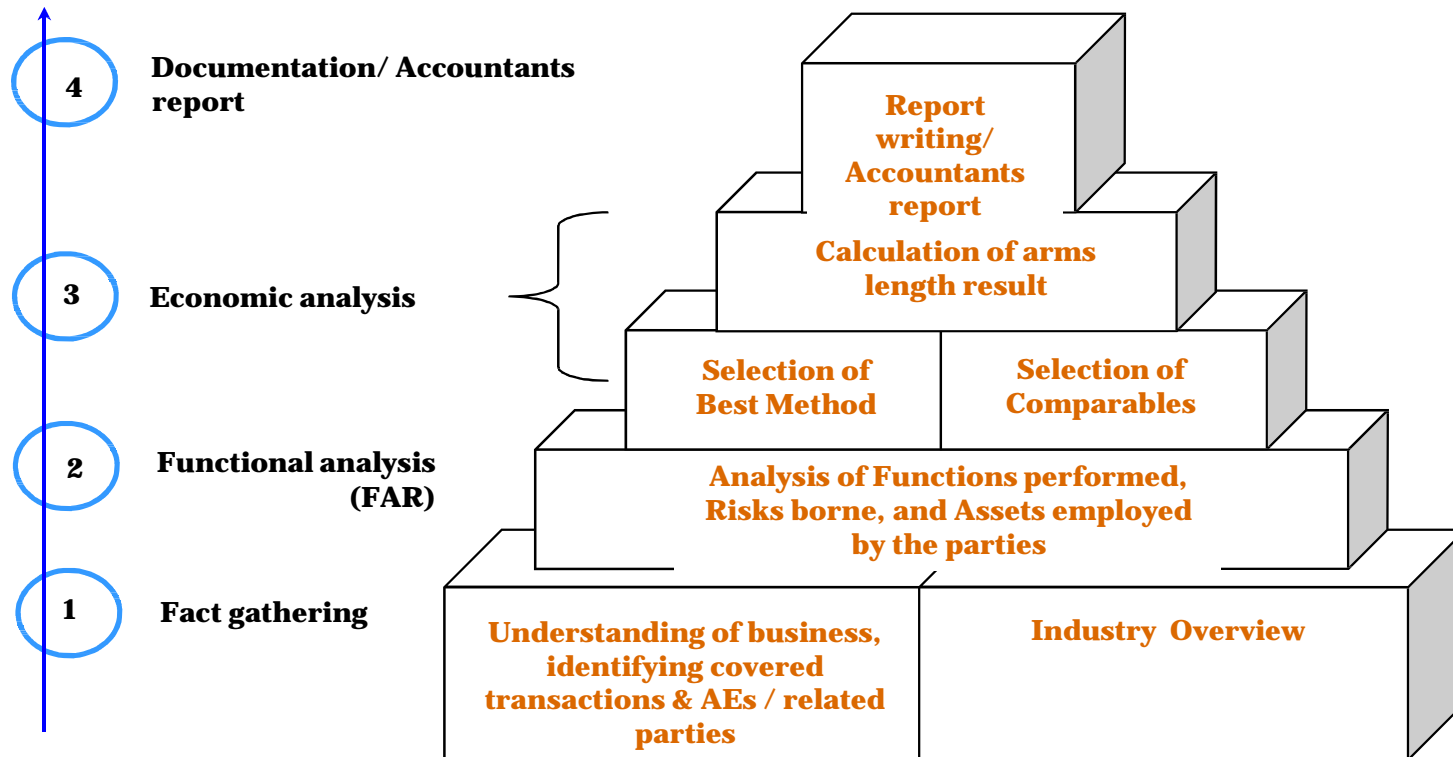
# ***Economic analysis***

# ***Economic analysis***



- ▶ Undertaking economic analysis is one of the most crucial function of TP documentation
- ▶ Exclusive databases are required to search for comparable companies
- ▶ Requires extensive understanding, analysis and expertise

# ***TP documentation approach***



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# ***Advance Pricing Agreement***

# Advance Pricing Agreement

## APA eligibility:

- For an international transaction; or
- Proposed international transaction

## Pre-filing:

- Form No. 3CEC
- No filing fee
- Optional
- Does not bind any party

## Main-filing:

- Form No. 3CED
- Filing fee range from INR 1 to 2 mn.
- Unilateral or Bi/Multilateral

## Withdrawal:

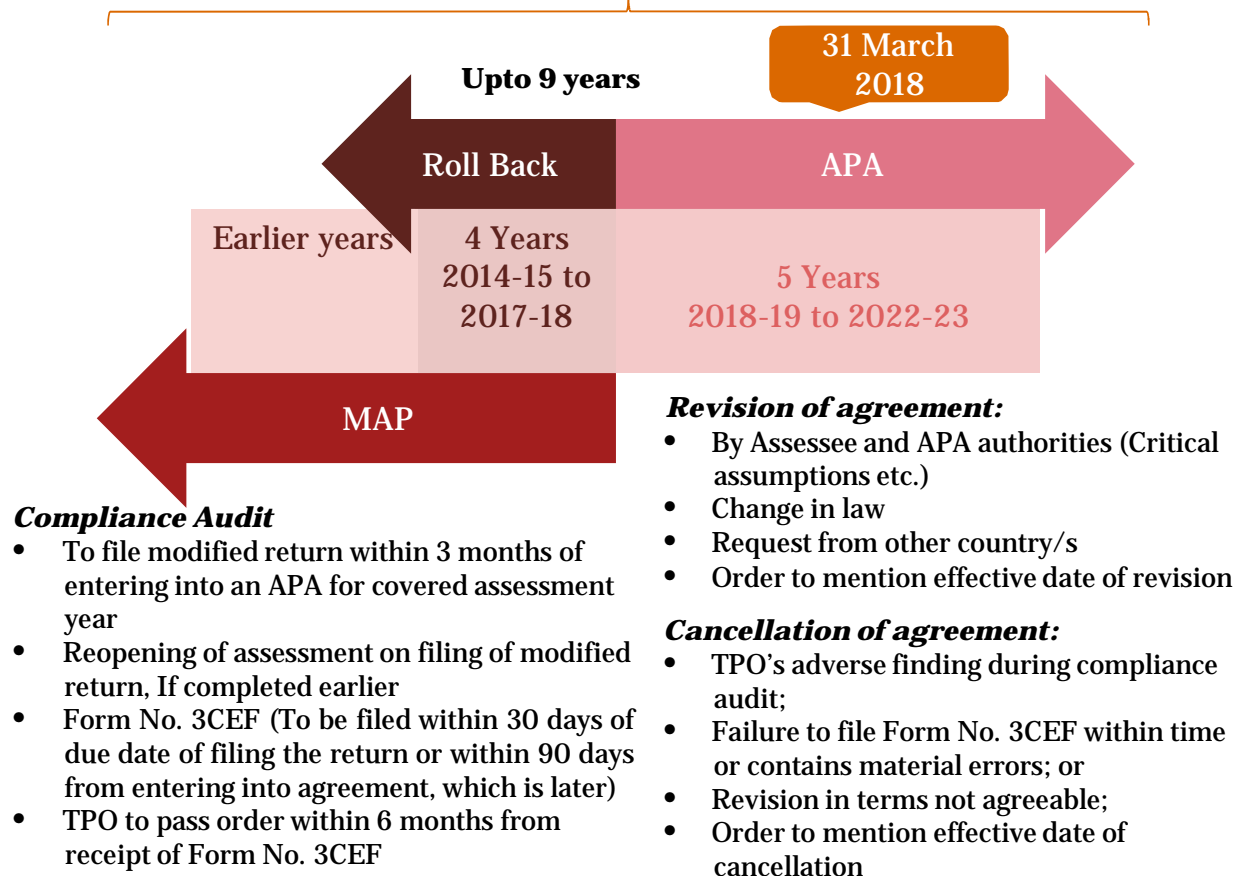
- Possible at any time before finalisation of terms
- Form No. 3CEE
- Fee not refundable

## Negotiation stage:

- Interviews and site-visit (optional on APA office's part)
- To mutually agree terms and conditions

## Terms of agreement:

- International transaction/s
- TP methodology
- Critical assumptions



## Compliance Audit

- To file modified return within 3 months of entering into an APA for covered assessment year
- Reopening of assessment on filing of modified return, If completed earlier
- Form No. 3CEF (To be filed within 30 days of due date of filing the return or within 90 days from entering into agreement, which is later)
- TPO to pass order within 6 months from receipt of Form No. 3CEF

An overview of transfer pricing

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# ***Safe Harbour***



# ***Safe Harbour Rules – Rules 10TA to 10TG***

## **Meaning**

- Safe Harbour Rules refers to determination of price margin which are acceptable to tax authorities to provide protection to taxpayers from TP scrutiny proceedings
- Prices established under such rules would be automatically accepted by the tax administrations that have expressly adopted such rules

## **Applicability**

- Rules to be applicable for a maximum period of 5 years beginning AY 2013-14 or the period opted by the Assessee
- Does not apply where the AE is located in any country or territory notified under section 94A or in a no tax or low tax country or territory

## **Compliance**

- The Assessee shall furnish a Form 3CEFA on or before 30 November of the first assessment year of the covered period for which it is seeking protection

## **Arbitration**

- Objection to Commissioner within 15 days of receipt of TPO order
- Commissioner shall pass its order within 2 months from the end of the month in which the objection is received by him

# ***Safe Harbour Rules – Rules 10TA to 10TG***

<b>Eligible international transactions</b>	<b>Circumstances</b>
Provision of: a. Software development services b. Information Technology (IT) enabled Services	$\geq 17\%$ where value of IT $\leq$ INR 1,000 mn $\geq 18\%$ where value of IT $>$ INR 1,000 mn but $\leq$ INR 2,000 mn
Provision of knowledge process outsourcing (KPO) services	Value of IT $\leq$ INR 2,000 mn, and $\geq 24\%$ - if employee cost to operating expense is at least 60% $\geq 21\%$ - if employee cost to operating expense is 40% or more but less than 60% $\geq 18\%$ - if employee cost to operating expense is $\leq 40\%$
Provision of contract R&D services wholly or partly relating to: a. software development b. generic pharmaceutical drugs	$\geq 24\%$ where value of IT $\leq$ INR 2,000 mn

# ***Safe Harbour Rules – Rules 10TA to 10TG***

<b>Eligible international transactions</b>	<b>Circumstances</b>
Manufacture and export of: a. Core auto components b. Non-core auto components	Core auto components $\geq 12\%$ Non-core auto components $\geq 8.5\%$
Advancing intragroup loan (INR denominated)	Interest rate not less than marginal cost of funds lending rate of SBI plus: 175 BPS, where CRISIL rating of AE is between AAA to A or equivalent 325 BPS, where CRISIL rating of AE is BBB-, BBB or BBB+ or equivalent 475 BPS, where CRISIL rating of AE is between BB to B or its equivalent 625 BPS, where CRISIL rating of AE is between C to D or its equivalent 425 BPS, where credit rating of AE is not available and the amount of loan advanced to the AE including loans to all AEs does not exceed INR 1,000 mn as on 31 March of the relevant PY
Advancing intragroup loan (foreign currency loan)	Interest rate not less than 6 months LIBOR of relevant foreign currency plus: 150 BPS, where CRISIL rating of AE is between AAA to A or equivalent 300 BPS, where CRISIL rating of AE is BBB-, BBB or BBB+ or equivalent 450 BPS, where CRISIL rating of AE is between BB to B or its equivalent 600 BPS, where CRISIL rating of AE is between C to D or its equivalent 400 BPS, where credit rating of AE is not available and the amount of loan advanced to the AE including loans to all AEs does not exceed a sum of INR 1,000 mn as on 31 March of the PY

## ***Safe Harbour Rules – Rules 10TA to 10TG***

### **Eligible international transactions**

### **Circumstances**

Providing corporate guarantee	≥ 1% p.a. of the amount guaranteed
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### ***Receipt of low value adding intra-group services introduced as an eligible transaction***

- Receipt of low value-adding intragroup services (LVA IGS) has been added as an eligible transaction. The definition of LVA IGS has also been provided, which amongst others includes those services which are in the nature of support services, not part of the core business of the taxpayer, not in the nature of shareholder or duplicate services, etc. A range of services which are excluded from the scope of LVA IGS are also specified.
- Entire value of international transaction (including a markup of up to 5%) should be less than or equal to INR 100 mn,
- The method of cost pooling, the exclusion of shareholder costs and duplicate costs from the cost pool and the reasonableness of the allocation keys used for allocation of costs, is certified by an accountant

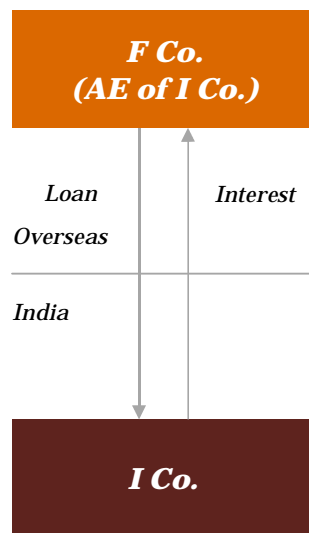
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## ***Limitation on Interest deduction***

## ***Section 94B - Why?***

- Excessive funding undertaken by means of debt / hybrid instruments (instead of equity)
- Cross border structures where the recipient of interest income (i.e., lender) is in a low tax country and the borrower is in a country where interest cost can be deducted for income-tax purposes
  - Base erosion and profit shifting from high tax jurisdiction to low tax jurisdiction
- Interest limitation rules
  - 'Anti-abuse' provision: check for excessive claim of deduction on account of interest
  - In line with the recommendations of BEPS Action plan 4

## Section 94B – Illustration



Sr. No.	Particulars	Reference	INR in crs
A	Interest expenditure on Loan taken from Non-resident AE	A	100
B	Interest expenditure on Loan taken from third party	B	50
<b>C</b>	<b>Total Interest</b>	<b>[(A) + (b)]</b>	<b>150</b>
D	EBITDA (Earnings before Interest, Taxes, Depreciation and Amortisation)	D	300
E	30% of EBITDA	D * 30%	90
<b>F</b>	<b>Interest to be disallowed</b>		
	Excess interest paid (150-90) or	[(C) – (E)]	60
	Interest paid to Non-resident AE	A	100
	<b>whichever is lower (amount to be disallowed)</b>		<b>60</b>

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## ***Secondary adjustment***



# Secondary adjustment

**Applicable for primary adjustments done from AY 2017-18**

*Exceeding INR 10 million (~USD 153k)*

A **Secondary Adjustment** follow a **Primary adjustment**

Reflect profit allocations amongst taxpayer and its AEs to be consistent with ALP determined under primary adjustment.

Secondary Adjustment required in following cases:

- Suo-moto adjustment offered by taxpayer;
- Adjustment by Tax Officer and accepted by the taxpayer;
- Adjustment determined by an APA;
- Adjustment made as per Indian safe harbour rules; and
- Adjustment arising as a result of a MAP resolution.

If secondary adjustment not received within 90 days, deemed as advance and ***interest will be computed thereon which shall form the secondary adjustment***

\* Marginal cost of fund lending rate as on 01 April of relevant year

\*\* London Inter-bank Overnight Rate as on 30 September of relevant year

## **Primary Adjustment:**

*It is the difference between the transfer price determined based on the arm's-length principle and the transfer price at which the transaction took place. This difference also represents the 'excess money' with the AE that is required to be repatriated to India.*

## **Interest computed as per denomination of transaction**

- **In INR** – MCLR\* + 325
- **In foreign currency** – six month LIBOR\*\* + 300 bps

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***Thank you***

***CA Prasad Pardiwala:***

***CA Mukesh Bhanushali:***