

Transfer Pricing Audit – Documentation and Benchmarking



BCA

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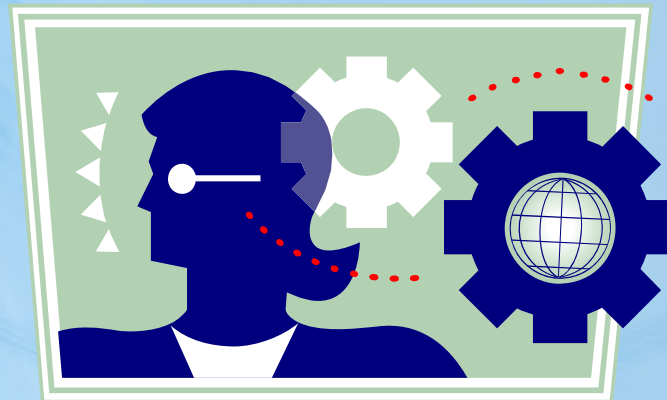
Presentation Overview



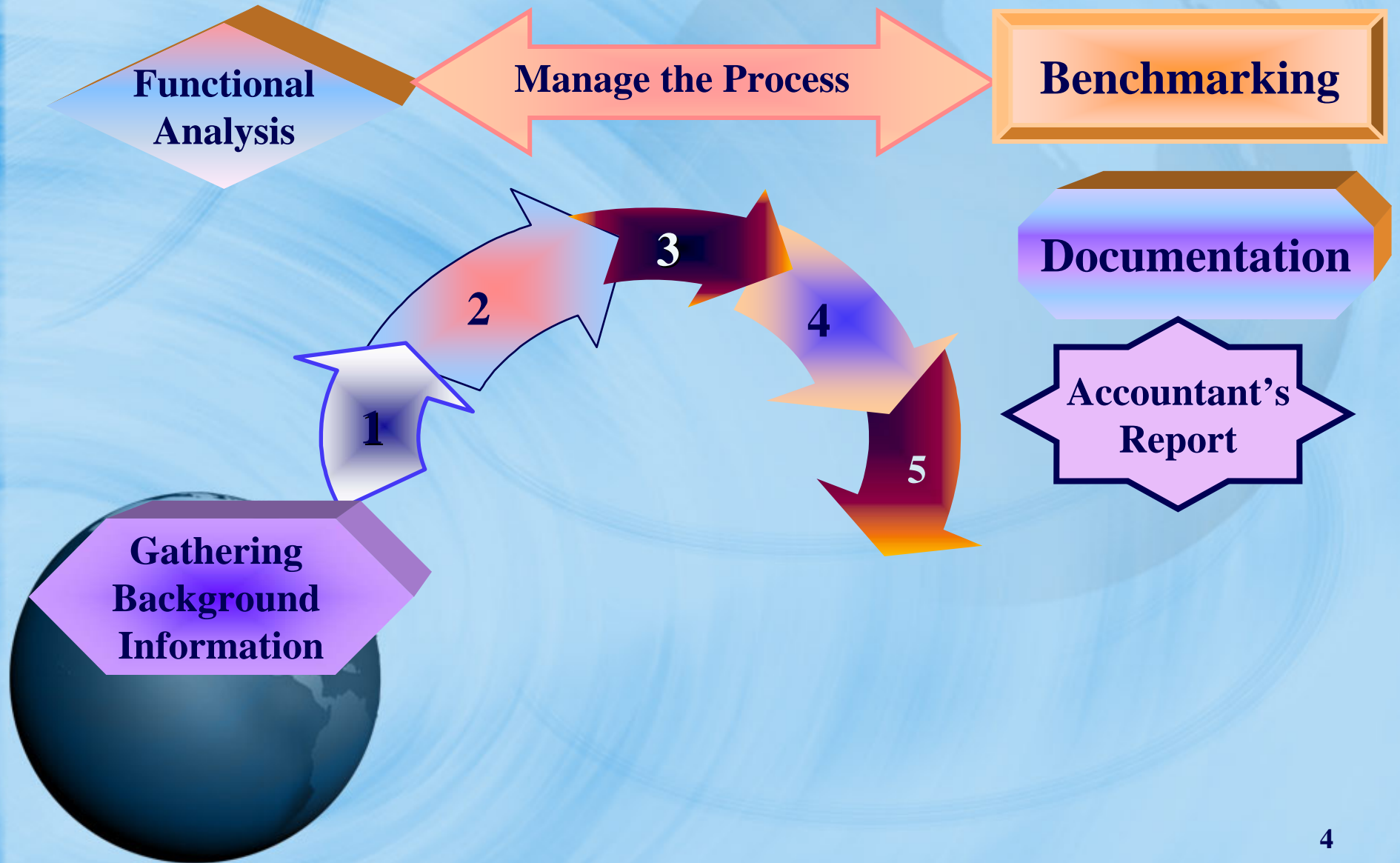
- ✧ **Transfer Pricing Process**
- ✧ **Documentation**
- ✧ **Benchmarking**
- ✧ **Ratio of judicial pronouncements**
- ✧ **Case studies**
- ✧ **Recent developments**



Transfer Pricing Process



Transfer Pricing Process



Documentation requirements and its interplay with benchmarking analysis

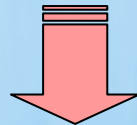
Factual and Functional Analysis

- Group Structure
- Industry analysis
- Business Model
- International transactions
- Functional analysis



Economic Analysis

- Characterization of the entity and international transactions
- Selection of most appropriate method
- Selection of PLI
- Comparable Search / analysis



Implementation

- Adoption of Pricing methodology or
- Justification of ALP of international transactions

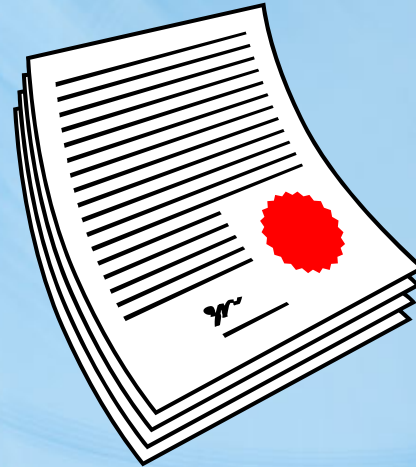
Benchmarking

Implementation

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Documentation



Documentation Requirements

**Characterization of
Transacting entities
& international
transaction**

**Selection of the Most
Appropriate Method**

Functional Analysis

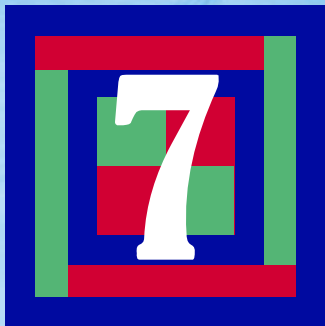
**Economic Analysis,
Industry Analysis &
Comparability
Analysis
(Benchmarking)**



Documentation under Indian TPR

✧ Seven Steps

- ✧ Shareholding structure
- ✧ Understanding the Business Model
- ✧ Description of International Transaction(s)
- ✧ Functional analysis
- ✧ Search & Assessment of comparables
- ✧ Selection and application of methodology
- ✧ Benchmarking



Documentation Requirements to be verified

--- Rule 10D(1)

✧ This is the mandatory documentation required by law

✧ Description of Ownership Structure (Step I)

✧ Profile of Multinational Group (Step II)

✧ Description of Business (Step II)

✧ Nature & Terms of International Transactions (Step III)

✧ Description of Functions, Risks & Assets (Step IV)



Documentation Requirements to be verified --- Rule 10D(1)

- ✧ **Record of Economic & Market Analyses, if any (Step III & IV)**
- ✧ **Record of Uncontrolled Transactions & Comparability analysis (Step V)**
- ✧ **Description of Methods considered (Step VI)**
- ✧ **Record of Actual working (Step VII)**
- ✧ **Assumptions, policies, Price negotiations, if any. (Step II & IV)**
- ✧ **Any other information, data or document (Company Specific information, if any)**



Benchmarking



Benchmarking Concepts

✧ Benchmarking Methodology

✧ Methodology for comparing international transaction of a tested party to that of comparable transaction

✧ Methods – CUP, RPM, CPM, PSM, TNMM

✧ Choice of benchmarking methodology

✧ Depends on availability of data

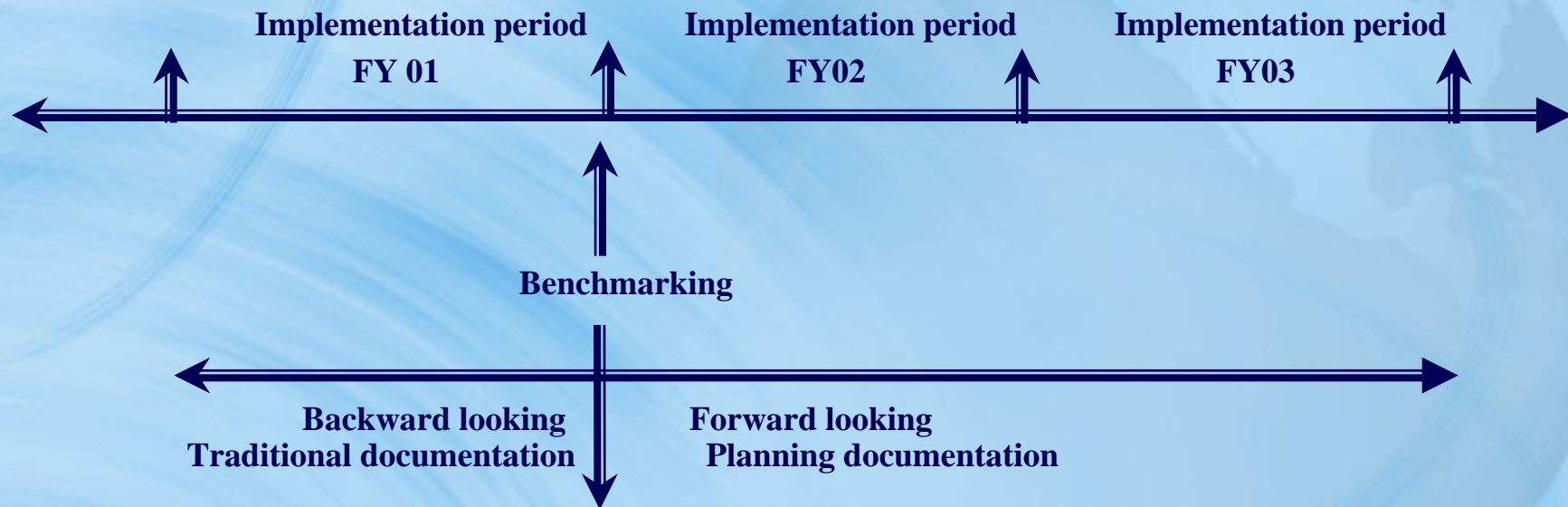
✧ Depends on comparability of data

✧ Depends on reliability of data

✧ Depends on adjustability of data



Application of Benchmarking Analysis



Benchmarking analysis can be used as a tool both for justification of historical transactions as well as setting price in a forward looking transaction

Ratio of judicial pronouncements



Ratio of judicial pronouncement

✦ **Analysis of tested party's accounts – whether accounts are to be split vis-à-vis international transactions or profits of entity as a whole to be analyzed**

✦ **Judicial pronouncements**

- **Maintenance of split financials warranted for justification of functionally different activities - use of whole entity approach not appropriate (Manufacturing and trading can't be aggregated for benchmarking purposes – UCB India)**
- **ALP of each class of international transactions to be considered separately unless the different classes of transactions are interlinked and cannot be evaluated separately (Development Consultants and Star India)**



Ratio of judicial pronouncement

✧ Documentation to be maintained for justifying arm's length price

✧ Judicial pronouncements

UCB India

-- Documentation maintained to be the extent relevant –

Sufficient

compliance with Rule 10D.

--Documentation mentioned in all clauses of Rule 10D need not be maintained if not relevant

--What needs to be seen is the substantial compliance by the taxpayer with regard to maintenance of documents (UCB India)



Ratio of judicial pronouncement.....

✧ Cargill India

- Documents and information to be kept and maintained as per Rule 10D:
- Voluminous, and all the sub-clauses attracted very rarely
- Taxpayer and tax authorities are required to consider only relevant information and documents needed for determining ALP
- Not possible to casually ask for information under all the clauses



Ratio of judicial pronouncement

✧ Benchmarking

✧ Judicial pronouncements – Functional Analysis

- Functional analysis of potential comparable companies should be taken into consideration and compared with that of the tested party (Aztec India, E-gain Communication, Skoda, UCB India)
- In case of differences in the functional profiling of the comparable companies vis-à-vis the tested party adjustments should be made to the comparable companies (E-Gain, Sony India, Skoda Auto)



Ratio of judicial pronouncement

- ✧ Selection of the tested party is important for the purpose of determining of the Most Appropriate Method. The selection of the tested party depends on the following:
 - ✧ Least complex of the entities i.e. entity performing simpler functions, assuming lesser risks, owning routine assets; and
 - ✧ Comparable data with regard to the entity is easily available (Development Consultants)
 - ✧ Foreign entity can be selected as the tested party if it's the least complex entity;
 - ✧ However comparable data in this regard need to be provided by the taxpayer (Ranbaxy India)



Ratio of judicial pronouncement

✧ Benchmarking

✧ Judicial pronouncements – Selection of Method

- ✧ It is imperative for the department to reject the taxpayer's analysis vis-à-vis the selection of the most appropriate method, before selecting any other method as the most appropriate method (MSS India)



Ratio of judicial pronouncement

✧ Application of CUP Method

- ✧ While comparing tested party's prices with comparable prices, regard must be had to other broader business functions as well .
(Price of branded product cannot be compared with the price of an unbranded product, if the difference is irreconcilable - UCB India)
- ✧ Adequate Documentation needs to be maintained for justifying rejection of CUP
 - ✓ Quality and quantity difference;
 - ✓ Difference in geographical market;
 - ✓ End user difference;
 - ✓ Timing difference;
 - ✓ Difference in the level of market vis-à-vis utilization (trader v manufacturer) etc.



Ratio of judicial pronouncement

✧ Benchmarking

✧ Judicial pronouncements – Selection of Method

✧ MSS India

✧ Transaction based methods are to be preferred over profit based methods (The aforesaid observation is not in consonance with Indian TPR which does not provide any hierarchy amongst the methods)

✧ Loss incurred by taxpayer does not lead to foregone conclusion that the taxpayer's international transactions are not at arm's length.

- ✓ However, the taxpayer needs to demonstrate the reasons for the loss and will be required to justify based on documentation in this regard.
- ✓ Status of the company vis-à-vis industry performance / economic slowdown;
- ✓ Business strategy – market penetration, diversification etc.;
- ✓ Start-up phase;
- ✓ Capacity utilization;
- ✓ Management inefficiency ????
- ✓ Government Policy



Case Studies



Case study – 1 (System Sale)

✧ Facts of the case

- ✧ Company A engaged in selling of a product which comprises of two separate components Component X and Component Y;
- ✧ With a view to sustain the competition, Company A has to sell Component Y along with Component X;
- ✧ Component X is manufactured by Company A for which raw material is imported from Associated Enterprise;
- ✧ Component Y is purchased (in finished form) from Associated Enterprise;



Case study – 1

- Company A as a whole

Company A P&L A/c

Costs	87	100	Receipts from BHUS
Margin	13		

the margin is at AL

- Segmental Accounts

Company A (Component X) P&L A/c

Import of raw material	45	80	Sale of Component X
Other manufacturing costs	21		
Margin	14		

the margin is at AL

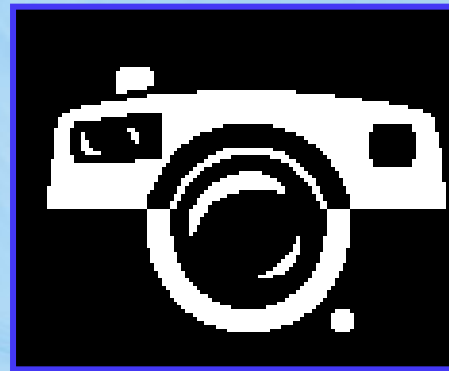
Company A (Component Y) P&L A/c

Import of Component Y	21	20	Sale of component Y
Margin	(1)		

the margin not at AL

Whether an adjustment can be made to profitability from Component Y ?

Recent Developments



Recent Developments – Direct Tax Code

✧ Proposed Transfer Pricing Provisions

- ✧ The threshold limit for two enterprises to be treated as AEs has been changed
 - ✧ Direct or indirect participation in share capital or voting power proposed to be reduced to 10% from erstwhile 26%;
 - ✧ Loan advanced as a % of the book value of the assets of the borrower to other enterprise proposed to be reduced to 26% against erstwhile 51%;
 - ✧ Appointment of Board of directors of other enterprise or both the enterprises proposed to be reduced to more than one third against erstwhile half



Recent Developments – Direct Tax Code

- ✧ **The Accountant's Report will be required to be filed with the TPO as against with the AO**
 - ✧ **DTC it is provided that the TPO will select the transfer pricing cases based on its own and inform the same to the AO**
- ✧ **Safe harbor rules proposed to be introduced;**
- ✧ **Advance Pricing Agreement proposed to be introduced (5 years validity)**



Recent Developments – Finance Act 2009

✧ Proposed Transfer Pricing Provisions

- ✧ Methodology for computation of 5% range amended
 - ✧ to be computed on the value of transactions as against on the arithmetic mean of the comparables
 - ✧ Has nullified various judicial pronouncements
- ✧ Alternate Dispute Resolution Mechanism (ADRM) introduced
 - ✧ Faster resolution of transfer pricing dispute and also to foreign companies;
 - ✧ Alternate to CIT(A)
 - ✧ Direction to be issued by three members committee as against one CIT(A)
 - ✧ Direction to be issued within 9 months
 - ✧ Binding on the AO; tax payer has a right to prefer appeal to ITAT



Thank You



Questions