



Seminar on Domestic Transfer Pricing

FAR Analysis and Methods

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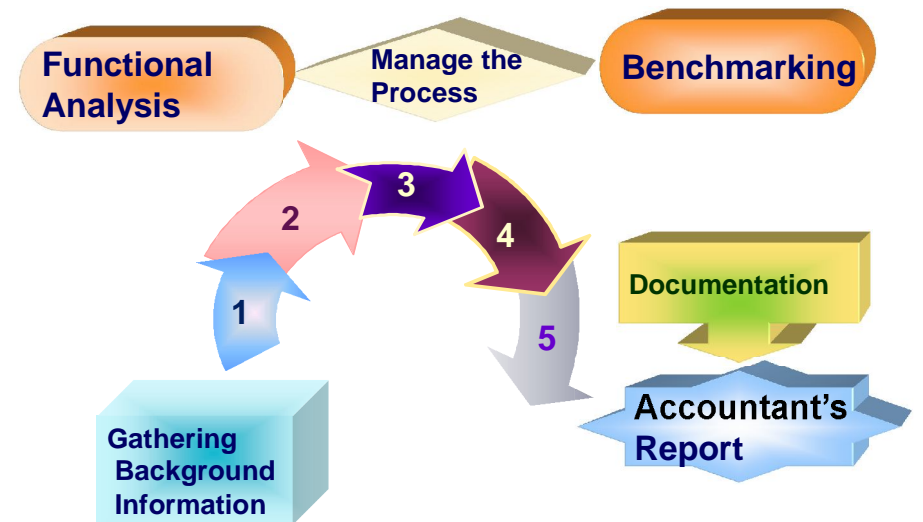
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Functional, Asset and Risk (FAR) Analysis



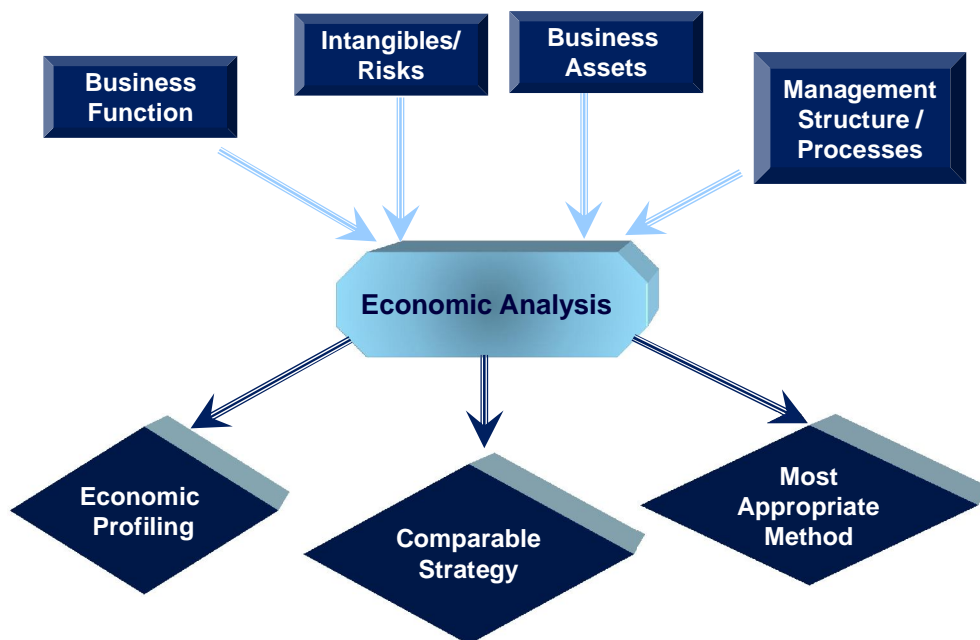
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Transfer pricing – To adhere to arm's length standard

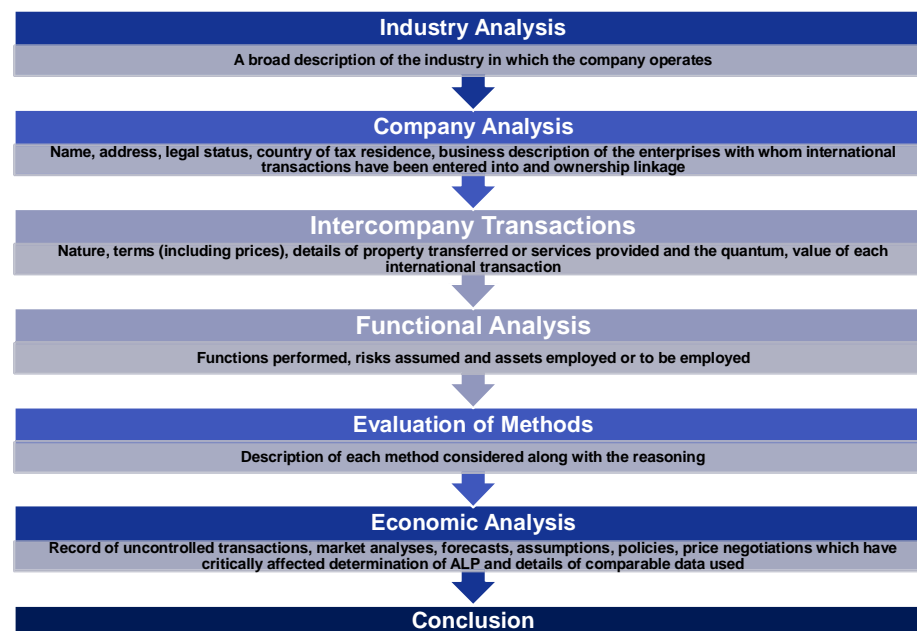


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Economic Analysis – Cornerstone of TP



Steps Involved in Documentation Process - Rule 10D



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Functions, Assets and Risks (“FAR”) Analysis

Rule 10B(2), OECD TP Guidelines, Indian Rulings

- Rule 10B(2): The comparability of an international transaction with an uncontrolled transaction shall be judged with reference to (*among others*):
 - The functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions
 - the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions
- OECD TP Guidelines (Chapter 1) lists functional analysis as one of the five factors for comparability analysis
- Indian rulings e.g. Mentor Graphics, E-gain Communication, Quark Systems, Star India emphasize the importance of functional analysis for comparability analysis

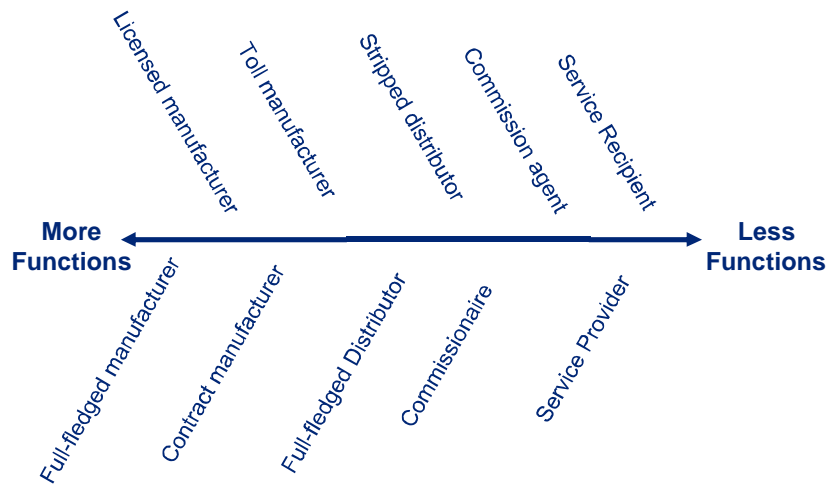
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The Basics of FAR Analysis

- FAR analysis is an invaluable tool for
 - Understanding the relative importance of economically significant activities performed by AEs
 - Comparability of controlled transaction/enterprise with independent transaction / enterprise
 - Need for performing comparability adjustments (risk / asset based)
 - Demonstrating business substance and commercial rationale
- Information sources include:
 - Client data: Interviews, presentations, site-visits, marketing materials
 - Public data: *Financial statements*, industry analysis, published articles
- Role of intercompany agreements in functional analysis

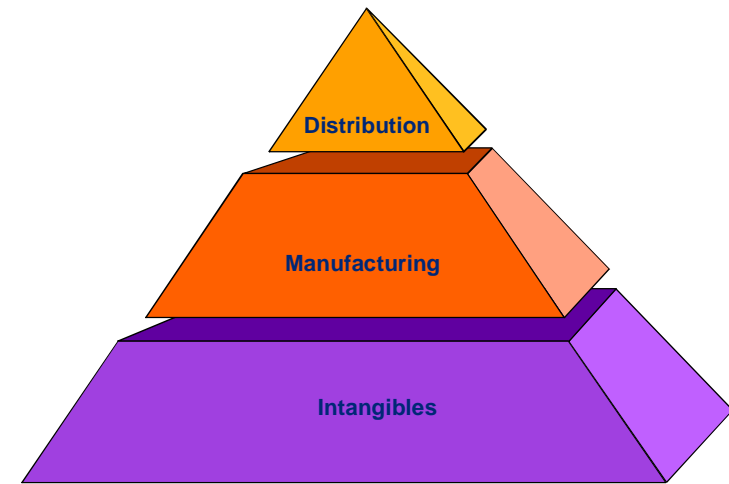
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Functional and Risk Analysis Principles



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Profit Components



In the open market, assumption of increased risk with importance of functions performed will be compensated by an increased reward

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Functional Analysis

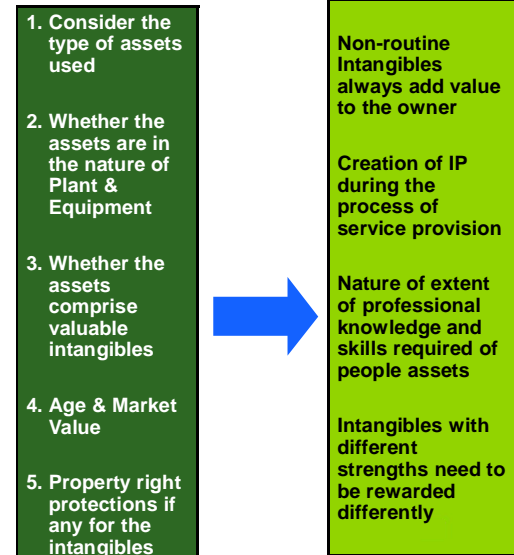
Manufacturing Concern	Marketing Activities
Develops products, process & knowhow	Supervises marketing activities
Develops product specification and design	Develops promotional themes
Incurs capital expenditure	Trains personnel & determines personnel needs
Purchases raw materials	Designs & develops packaging materials
Develops raw materials flow techniques	Plans trade conventions & shows
Manufactures components & finished goods	Ships products & provides insurance cover
Packages & labels products	Warrants product

- Sheer weight of functions performed is not decisive in determining profit
- What is relevant is the relative importance of each function
- The functions performed may be few but significant
- Identify each party's contribution to every function performed

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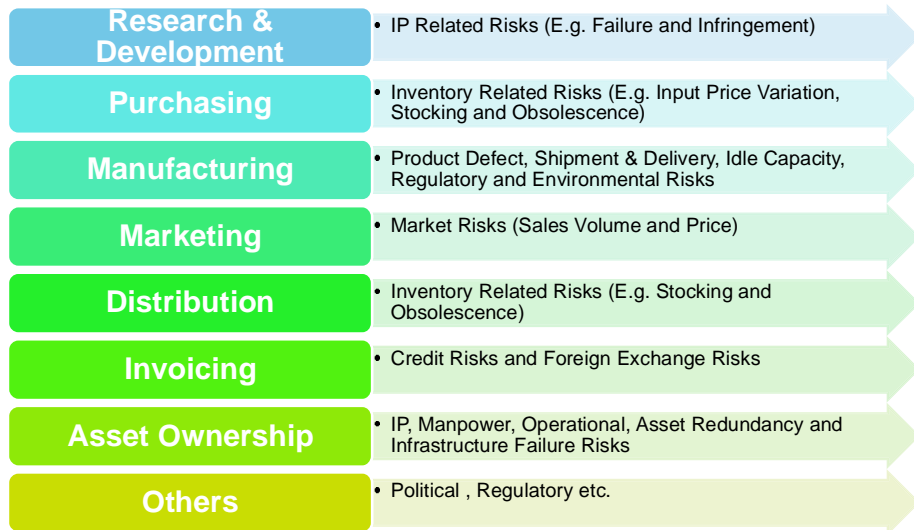
Asset Analysis

Factors to be considered



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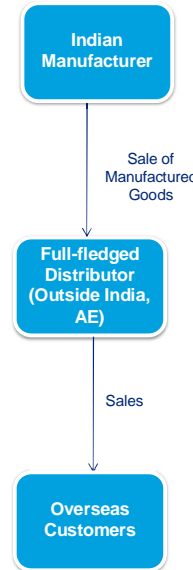
Risk Analysis: Functions and Assets Lead to Risks



- Risks should be evaluated based on degree and realization probability
- Financial statements could throw light on past risk realization

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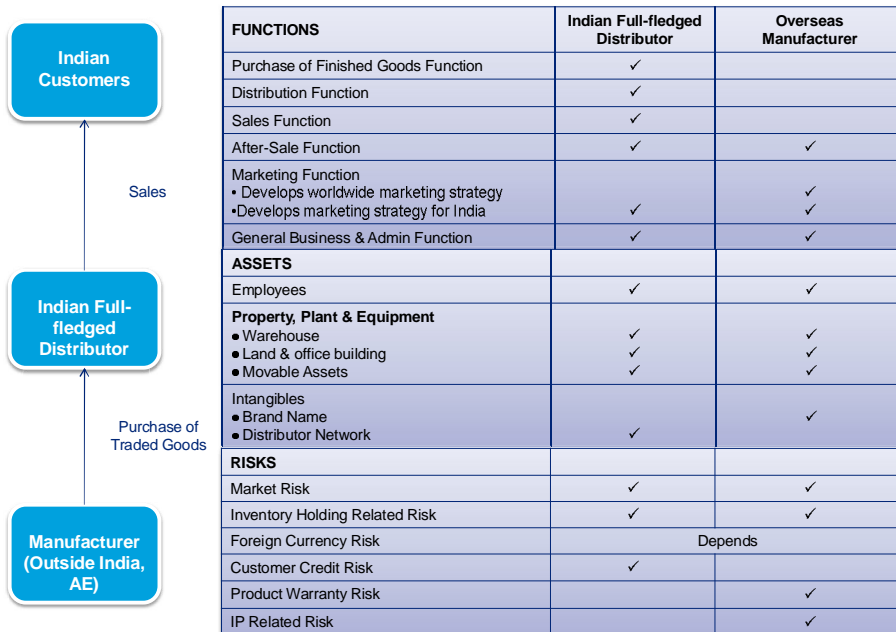
Sample of FAR Analysis ~ Manufacturing Activity



FUNCTIONS	Indian Manufacturer	Full-fledged Distributor
R & D Function	✓	
Purchase of Raw Material Function	✓	
Manufacturing Function	✓	
Distribution Function		✓
Sales Function		✓
After-Sale Function	✓	✓
Marketing Function		✓
General Business & Admin Function	✓	✓
ASSETS		
Employees	✓	✓
Property, Plant & Equipment		
• Warehouse	✓	✓
• Manufacturing facilities	✓	
• Land & office building	✓	✓
• Movable assets	✓	✓
Intangibles (brand name)	✓	
RISKS		
Market Risk	✓	✓
Technology, R & D Risk	✓	
Inventory Obsolescence Risk	✓	✓
Product Level Quality Risk	✓	
Delivery Risk	✓	✓
Customer Credit Risk		✓

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Sample of FAR Analysis ~ Trading Activity



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Transfer Pricing Methods

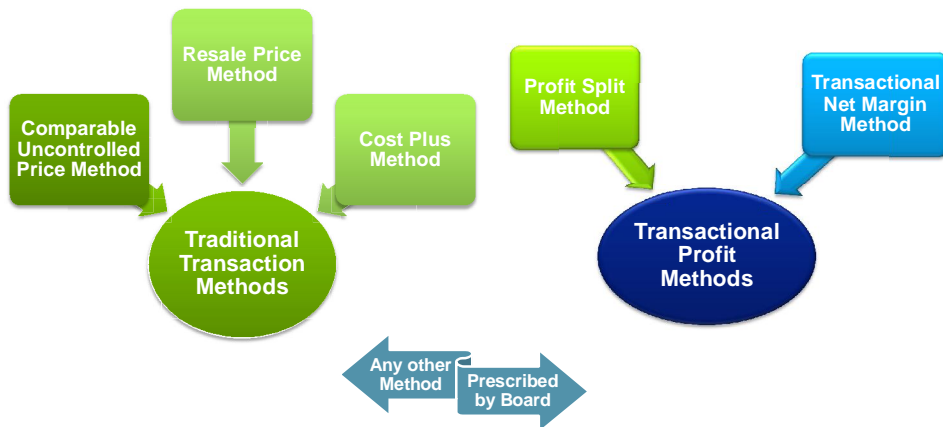


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Determination of ALP

Section 92C read with Rule 10B and 10C

- ALP to be determined by applying the Most Appropriate Method (“MAM”)
- Methods prescribed are in line with OECD TP Guidelines, 2010 (Chapter II)



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Selection of the Most Appropriate Method

Rule 10C

- Best suited to the facts and circumstances of the international transaction
- To be selected having regard to the following factors:
 - Nature and class of international transaction
 - Class of AEs, functions performed, assets utilised and risks assumed
 - Availability, coverage and reliability of data
 - Degree of comparability between controlled and uncontrolled transactions
 - Possibility to make reliable and accurate adjustments
 - Nature, extent and reliability of assumptions required

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Comparable Uncontrolled Price Method (“CUP”)

• Rule 10B(1)(a)

- Price charged or paid for transfer of goods or services in a comparable uncontrolled transaction
- Such price adjusted for material differences (controlled v. uncontrolled)

• Typical Transactions where CUP is applied include

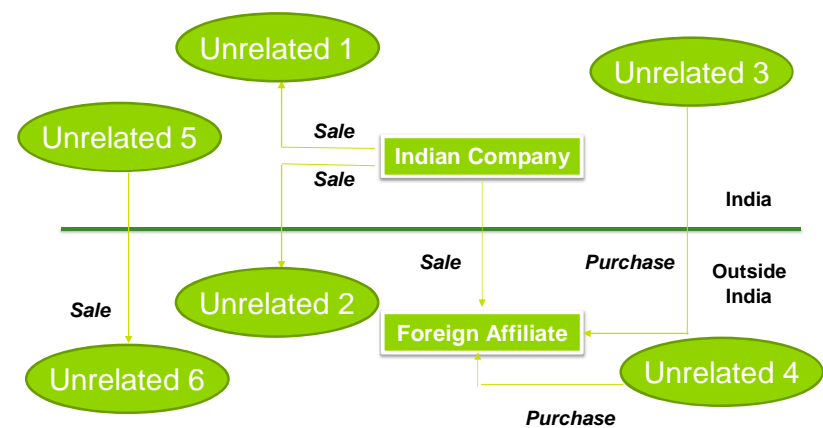
- Transfer of goods
- Provision of services
- Intangibles
- Interest on loans and guarantee fees

• Factors for comparability analysis

- Distinctive nature of property transferred or services provided
- Functions performed, assets employed and risks assumed
- Timing of the transaction
- Contractual terms
- Market conditions

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Internal and External CUP



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CUP Practical Application

• External Benchmarks

- Exchange traded prices as external CUP e.g. metals industry
- NASSCOM rates (*CIT vs 3Global Services Private Limited*)
- Typically external data not reliable (*UCB India P Ltd vs ACIT*)

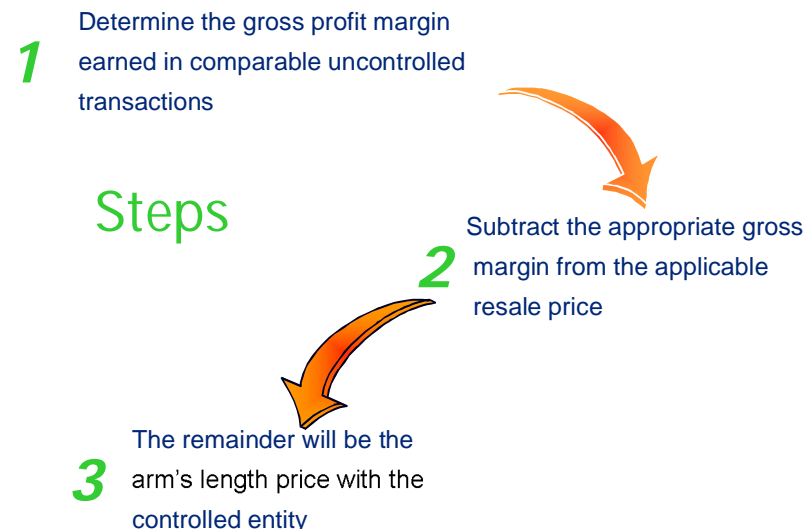
• Market Quotes typically not sufficient as CUP

• Internal CUP

- Typically available but adjustments necessary
- e.g. Mumbai ITAT upheld taxpayer rejection of internal CUP owing to geographical differences (*Intervet India P Ltd vs ACIT*)
- e.g. Mumbai ITAT accepted taxpayer's claim of lower purchase price from newly developed third party Chinese supplier vis-a-vis AE on grounds of risk associated with uncertain quality standard (*Cheminova India Ltd vs CIT*)
- e.g. Mumbai ITAT held that internal CUP would not be suitable where the quantity exported to AE is on wholesale basis while sold to third parties is on retail basis (*Gharda Chemicals Ltd vs DCIT*)

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Resale Price Method (“RPM”)



Resale Price Method

• Rule 10B(1)(b)

Particulars	Amount
Sale Price	100
Less: Gross Margins (to be benchmarked)	(25)
Less: Direct Expenses in connection with purchase e.g. customs duties	(30)
Cost of Purchases i.e. Arm's Length Price	45

• Typical Transactions where RPM is applied include

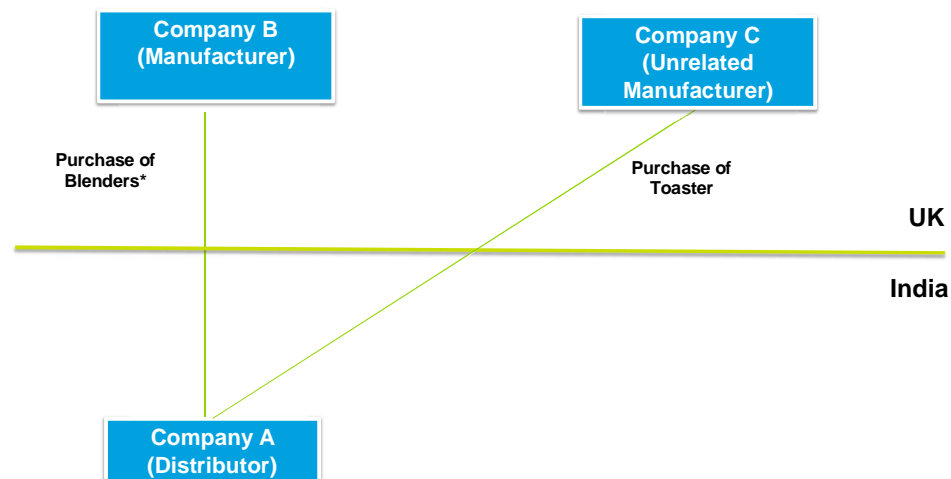
- Purchase from AE for resale where there is little or no value added by the reseller (*e.g. assembling components, creating intangibles*)

• Factors for comparability analysis

- Fewer adjustments for minor product differences than under CUP
- High degree of comparability of functions performed, assets employed, risks assumed and contractual terms (*e.g. exclusivity*)
- Consistency in accounting practices

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RPM (An Example)



* Due to product differences RPM is preferred to CUP

** The Gross Margin of Company A is 35% for distribution of blenders v. Gross Margin of 28% for distribution of toasters, hence the trading transaction is at arm's length

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Other Method

• Rule 10AB

- 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-AEs, under similar circumstances, considering all the relevant facts
- Effective from 1 April 2012
- Akin to CUP
- Quotations, Price list
- This method would mostly be used in Domestic Transfer Pricing

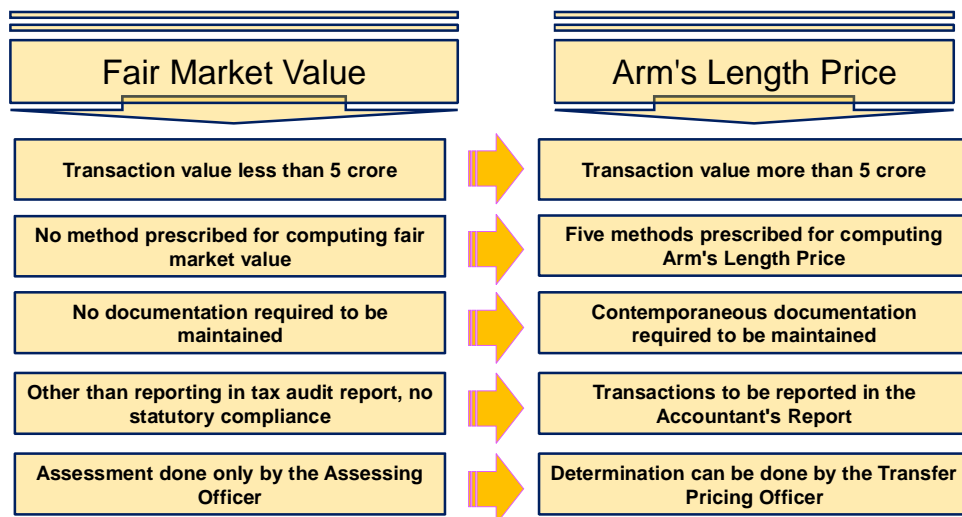
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Domestic Transfer Pricing Practical Issues



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Specified Domestic Transactions (SDT) - Implications



SDT - Coverage

Particulars	Nature	AE	Amendment
40A(2)	Expenditure	Related parties defined	Excessive or unreasonable vs ALP
80A, 80IA(8)	Income or expenditure	Between different business units of same tax payer	FMV vs ALP
801A(10)	Profits	Close connection	More than ordinary profits vs AL profits
Chp VIA, 10AA	Profits	Between units or profits earned by the eligible business unit	More than ordinary profits vs AL profits

Earlier provisions were ambiguous did not define FMV, ordinary profits.
Plus needed to be at that point exactly.
Now ALP as per the methods as well the range of upto 3% allowed.

SDT - Section 92BA

- Does Section 92BA impact the operation of basic scope of the provisions of Sections 40A(2) or 80A(6) or 80IA(8) or 80IA(10)?
- Whether SDT includes cross border transactions?
- Whether adjustments made to SDTs may lead to notional income?

Domestic Transfer Pricing

- Whether the provisions of Domestic Transfer Pricing are to be invoked in a transaction which is Revenue Neutral?
- Whether business entitled to investment link tax holiday is covered by Domestic Transfer Pricing?
- TPO's power u/s. 92CA(2A)/92CA(2B)
- Presumptive Taxation Regime
- Maintenance of Documentation

Domestic Transfer Pricing Adjustments

- Co-relative Adjustments
- Voluntary Adjustments
- Higher Deduction
- Intra-Unit Transactions
- Dispute Resolution – DRP/APA

Challenges in Benchmarking

- Director's Remuneration
- Partner's Remuneration
- Capital Expenditure
- Non-marketable Services
- Interest-free loan
- Guarantee Commission

Administrative Guidance

- Who will do the Assessment?
- Existing TPO or Any Special Cell?
- Threshold Limit for Reference to TPO?

Thank You

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