

DOMESTIC TRANSFER PRICING

Benchmarking and Reporting requirements

Study Circle Meeting

CA Gaurav Shah

15th June 2013

Table of Contents

Domestic Transfer Pricing
Benchmarking Analysis
Transfer Pricing Audit Process
Roles and Responsibilities
Reporting Requirements
E-Filing Process
Concluding Remarks

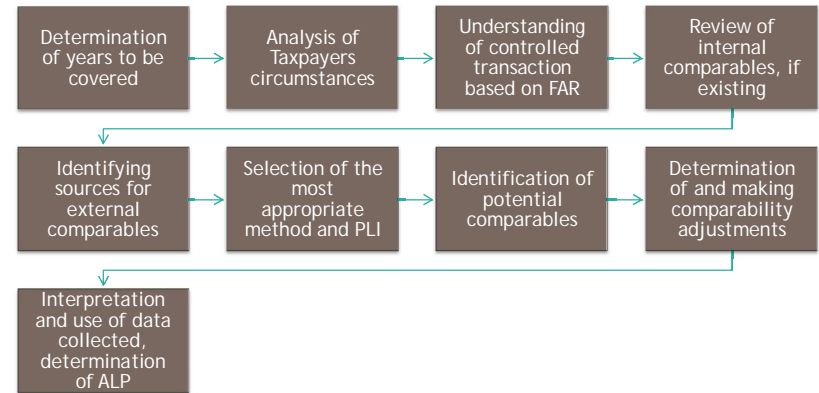
Domestic Transfer Pricing

Background of Domestic Transfer Pricing

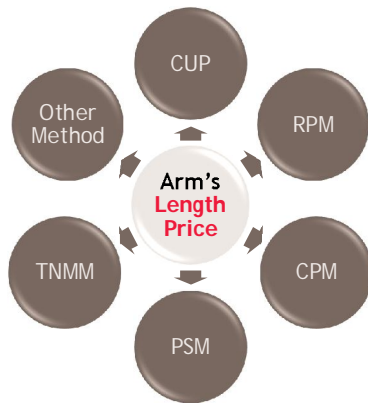
- TP provisions have been traditionally applied only to 'international transactions'
- Taking cue from Supreme Court's suggestion in case of GlaxoSmithkline Asia (P) Ltd, the Budget has extended TP provisions to 'Specified Domestic Transactions' (SDTs), including:
 - Payment to persons specified in Section 40A(2)(b)
 - Inter-unit transactions by units covered under Section 80-IA, 80-IB, 80-IC, 80-ID, 80-IE, SEZ units and SEZ Developers
 - Intra-group transactions by taxpayers covered under Section 80-IA, 80-IB, 80-IC, 80-ID, 80-IE, SEZ units and SEZ Developers
 - Other prescribed transactions
- TP Regulations apply if sum of above transactions exceed Rs. 5 Cr.
- Corresponding amendments also carried out in relevant sections

Benchmarking Analysis

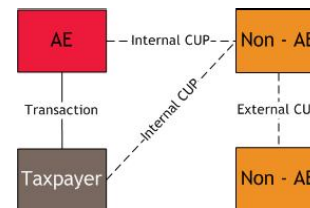
Transfer Pricing Process



Methods of Determining ALP

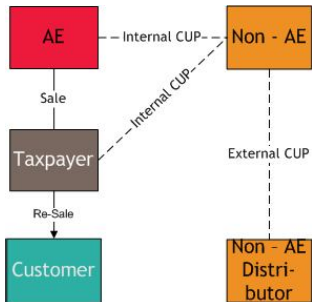


Comparable Uncontrolled Price (CUP) Method



- Compare price charged in a controlled transaction with uncontrolled transaction
 - Internal comparables
 - External comparables
 - Internal comparables are preferred over external comparables

Resale Price Method (RPM)



- Compare gross margins earned by related party purchaser / reseller with margins earned in uncontrolled transactions
 - Internal comparison
 - External comparison
 - Internal comparison is preferred over external comparison

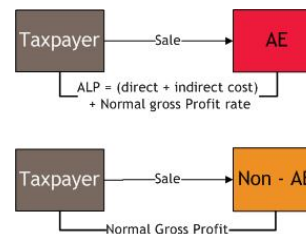
Other Method

- CBDT has prescribed a new 'other method' under the new Rule 10AB
- Rule 10AB is as under -
 - “For the purposes of clause (f) of sub-section (1) of section 92C, the other method for determination of arm's length price in relation to an international transaction or a specified domestic 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”
- Reliance on price instead of profit margins
- Permits use of proposed price/transaction
- Useful for benchmarking unique transactions
- Use of valuation methodologies permissible

Cost Plus method (CPM)...

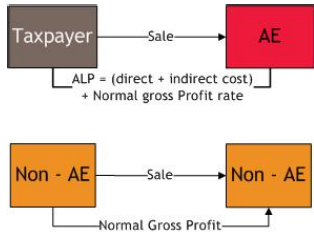
- Used when manufactured goods or services are sold to AE
- Involves comparison of Gross Margin of manufacturer / service provider
- Preferable where the entity performs manufacturing / service activities
- Product comparability not very strict
- Stress on functional comparability
- Typical transaction:
 - Provision of services
 - Joint facility agreements
 - Transfer of semi-finished goods

...Cost Plus method (CPM)...



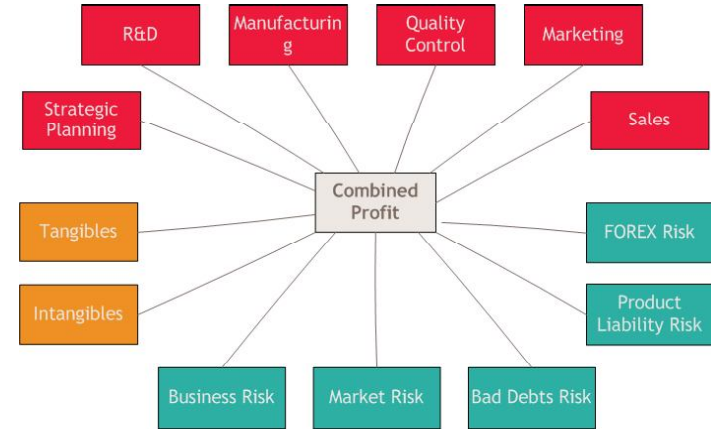
- Internal CPM
 - Uncontrolled transactions for comparison originate from the manufacturer / service provider
 - Gross Margins on products sold / service rendered to third parties used as a benchmark
 - The benchmark applied to sale of products / services to AE
 - Segmentation of accounts required

...Cost Plus method (CPM)



- External CPM
 - Uncontrolled transactions for comparison originate from third party manufacturer / service provider
 - Gross Margins on sale of products / services sold by one third party to another third party used as a benchmark
 - Benchmark applied to sale of products to AE
 - Search for comparable third party manufacturers / service providers required
 - Gross Margin workings?

Profit Split Method (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.
- Profits should be split on an economically valid basis that reflects the functions, assets and risks of the parties involved
- Typical transactions where the profit-split method may be used are transactions involving:
 - integrated services
 - E.g. in case of financial service sector, where the activities performed by Indian company and foreign AEs in relation of a merger and acquisition transaction are so interrelated that it may not possible to segregate them;
 - transfer of unique intangibles
 - E.g. two associated enterprises contribute their respective intangibles to develop a new product or process and earn income from such product or process.

...Profit Split Method (PSM)...

- Contribution Analysis Approach
 - Overall profits of the group from the international transaction under consideration, are allocated on the basis of relative contribution.
 - The steps involved are:
 - Determine the combined net profit arising from international transactions
 - Determine the relative contribution of each entity on the basis of the FAR analysis and market research
 - The combined net profit is split on the basis of the relative net contribution as above
 - **The profit so apportioned is considered to arrive at the arm's length price in relation to the international transaction.**

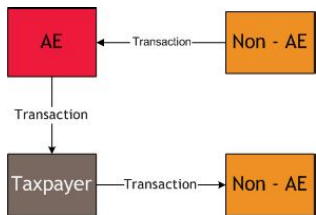
...Profit Split Method (PSM)

- Residual Profit Split Approach
 - A “basic return” is determined for each of the enterprises and profits of each such enterprise is ascertained and apportioned. This (total) amount is reduced from the combined net profits. Residual profits are allocated on the basis of relative contribution.
 - The steps involved are as follows:
 - Determine the combined net profit of the group from the international transaction involved
 - Allocate basic return appropriate to the respective activities of the AEs involved
 - Balance of the combined net profit / loss is allocated based on evaluation of the relative contribution of the AEs
 - Total net profit from such two-tier allocation is considered to arrive at the arm’s length price.

Transactional Net Margin Method (TNMM)...

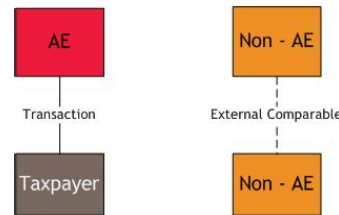
- Involves comparison of Net Margins in the hands of “Tested Party”
- Product comparability not very strict
 - Stress on functional comparability
- TNMM can be applied at the entity level or the transactional level depending on the case.
- Typical transactions where TNMM may be adopted are:
 - provision of services;
 - distribution of finished products where resale price method cannot be applied;
 - transfer of semi finished goods where cost plus method cannot be applied;
 - transactions involving intangibles where profit split method cannot be applied.

Transactional Net Margin Method (TNMM)...



- Internal TNMM
 - Uncontrolled transactions for comparison originate from either of the parties to the transaction
 - Net Margins on transactions with third parties used as a benchmark
 - The benchmark applied to transactions with AE
 - Segmentation of accounts required

...Transactional Net Margin Method (TNMM)



- External TNMM
 - Uncontrolled transactions for comparison originate from third party comparables
 - Net Margins on transactions between third parties used as a benchmark
 - Benchmark applied to transactions with AE
 - Search for comparable third parties required
 - Databases
 - Other sources

Selecting Most Appropriate Method

Rule
10C(1)

- Method which is best suited to the facts and circumstances of the case, and which provides the most reliable measure of arm's length price

Rule
10C(2)

- Relevant factors
 - Nature and class of international transaction
 - Class or classes of associated enterprises and their FAR analysis
 - Availability, coverage and reliability of data
 - Degree of comparability between
 - International transactions and uncontrolled transactions
 - Enterprises entering into such transactions
 - Extent to which reliable and accurate adjustment can be made
 - Nature, extent and reliability of assumptions required to be made

21



Tested Party

- Not defined in the Income Tax Act
- Refers to that party in the international transaction by reference to whom a particular transfer pricing method is applied
- Should be the entity for whom the most reliable data can be found and the most closely comparable transactions can be identified.
- Generally, it is the enterprise which has less complex Functional Profile

22



Profit Level Indicator (PLI)

- Not defined in The Income Tax Act
- PLI refers to the benchmark for measuring / weighing profit
- Practically, PLI is the denominator in any profit based analysis
- Items which should be excluded from the PLI
 - Non-operating items such as interest income and expenses and income taxes
 - Exceptional and extraordinary items of a non-recurring nature
- Selection of PLI should be based on the method selected, as well as the facts of the case
- **Very important step in the determination of arm's length price**

23



...Profit Level Indicator (PLI)

- Commonly used PLIs (also discussed in OECD Guidelines) are as follows:

Sr. No.	PLI	Remarks
1	Net profit/ Sales	Appropriate for distribution activity
2	Net Profit/ Operating Costs	Appropriate for service or manufacturing activity
3	Net Profit/ Operating Assets	Appropriate for a capital intensive industry

- Other PLIs can also be used based on facts and circumstances of the case
- PLI should be commensurate with the activity of the tested party
- PLI should be reasonably independent of related party transactions

24



Issues in benchmarking

- Availability of data
- Comparability differences
 - Cyclical Issues
 - Geographical differences
 - Quantity differences
 - Differences in terms of transaction
 - Currency of transactions
- Using financial statements
- Alternate sources of obtaining data
- Aggregation or standalone evaluation of transactions?

25



What if benchmarking not available/feasible?

- Exhaust all possible sources of benchmarking & documents
- Demonstrate due diligence
- Reliance on International Guidance
- Reliance on Expert Opinions
- Documentation for inter-company negotiations
- Documenting complete transactional profile
- Next best possible comparable (Lateral Comparable)
- **Earlier/subsequent year's benchmark**
- Group level transfer pricing policies
- Industry best practices
- Strong documentation is the key!

26



Transfer Pricing Audit Process

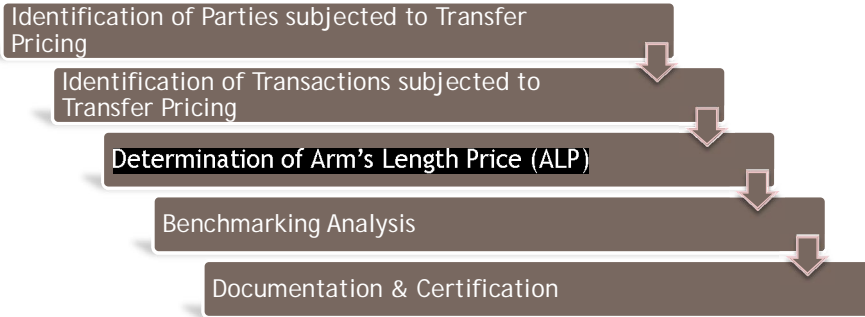
Transfer Pricing Audit Methodology



28



Steps in Transfer Pricing Audit



29

Check-Points for the TP Auditor and the taxpayer

Coverage of Relationships

- Check for completeness and correctness
- Check points
 - Previous year's form 3CEB
 - Financial Statements
 - Notes to Accounts - AS 18 disclosures
 - Form 3CD - Sec. 40A(2)(b) disclosures
 - Cost Audit Report of the company
 - Company / group website
 - Register under Section 301 of Cos Act
 - Management discussion and representation
 - Relevant Income tax forms

Coverage of Transactions

- Reconciliation with disclosures
 - Notes to Accounts [AS-18]
 - Tax Audit Report [Section 40A(2)(b)]
 - Cost Audit Report
 - Register under Section 301 of Cos Act
- Ledger scrutiny
 - Ledger of Party Concerned
 - Transaction Ledger
- Reconciliation with amounts as per Financial Statements
- Management discussion and representation

30

Roles and Responsibilities

Role and Responsibility of the Taxpayer

- Recognition of parties and transactions where transfer pricing applies
- Determination of the most appropriate transfer pricing methodology
 - Recognizing comparable transactions / entities, as much as is relevant from TP perspective
 - Providing relevant industry-level and market-level information, such as key markets, major customers, competitors etc.
 - Providing insight into price-setting mechanism
- **Determination of Arm's Length Price**
- **Compilation of relevant documents as proof of Arm's Length Price on real time basis**
- Maintenance of transfer pricing documentation (as per section 92D r.w. Rule 10D)

32

Role and Responsibility of the TP Auditor

- Independence in Audit work
- Clearly defined Scope of examination
 - Importance of signed engagement Letter
- Communication with outgoing auditor
- Adherence to Code of Conduct
- Adherence to Guidance Note
- Quality control and peer review
- **Timely issuance of the Accountant's Report (Form 3CEB) to client**
- Maintenance of client file and documentation

Model Client File for a CA

- Signed Engagement Letter
- Audit Plan
- Audit Risk Assessment
- Relevant judicial pronouncements
- Extracts of OECD Guidelines
- Extracts of ICAI Guidance Note
- Analysis and working papers
- File notes and points for next year
- Communication with outgoing auditor
- Management Representations
- Financial Statements, Form 3CEB, acknowledgement etc
- Client Transfer Pricing Documentation

Reporting Requirements - Form 3CEB

Form 3CEB Requirements

- Report from an accountant to be furnished under section 92E relating to international transactions
 - *I/We have examined the accounts and records of <<Name of Company>>, <<Address of Company>>, <<PAN of Company>> relating to the international transaction(s) and the specified domestic transaction(s) entered into by the assessee during the previous year ended on 31st March, <<year ending of relevant previous year>>.
 - In *my/our opinion proper information and documents as are prescribed have been kept by the assessee in respect of the international transaction(s) and the specified domestic transaction(s) entered into so far as appears from *my/our examination of the records of the assessee.
 - The particulars required to be furnished under section 92E are given in the Annexure to this Form. In *my/our opinion and to the best of my/our information and according to the explanations given to *me/us, the particulars given in the annexure are true and correct.
- Digital signature, Name, Membership number, Date, Firm Name and Registration number

Certification Requirements - Annexure - Part A

- Name of the assessee
- Address
- Permanent account number
- Nature of business or activities of the assessee (Code as per ITR 6)
- Status
- Previous year ended
- Assessment year
- Aggregate value of international transactions as per books of accounts
- Aggregate value of specified domestic transactions as per books of accounts

Certification Requirements - Annexure - Part C...

- List of associated enterprises with whom the assessee has entered into specified domestic transactions
 - Name, Address and PAN of the associated enterprise
 - Relationship with associated enterprise
 - Brief description of the business of associated enterprise
- Particulars in respect of transactions in the nature of payment for any expenditure to persons referred to in section 40A(2)(b)
- Particulars in respect of transfer or acquisition of any goods or services to/from eligible business of the same assessee
- Particulars in respect of any business transacted by an eligible business
- Any other transaction

Certification Requirements - Annexure - Part C...

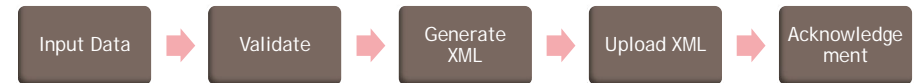
- Details of transactions
 - Name of person with whom the specified domestic transaction has been entered into
 - Description of transaction along with quantitative details
 - Total amount
 - As per books of accounts
 - As per arm's length price
 - Method used to determine arm's length price

Reporting Requirements- Key Considerations

- Expanded coverage
 - International as well as domestic transactions
 - Expanded definition of AE and Enterprise
- Change in approach due to applicability to tax holiday taxpayers
- Increased penalty exposure
- **Wide gamut of application of 'Other Method'**
- No provision for revision of Form 3CEB
- Importance of a Management Representation Letter and its coverage

E-Filing Process

E-Filing Process



Concluding Remarks

Concluding Remarks

- Detailed examination of Section 40A(2), and tax holiday sections to determine applicability / non-applicability
 - Possibility of more transactions being covered within the ambit of Domestic TP
 - Increased penalty exposure for non-disclosure / part-disclosure / incorrect disclosure
- Additional compliance burden for taxpayers
 - **Need to make taxpayers aware, and start revising related policies/ transactions from arm's length perspective.**
 - Importance of Group Transfer Pricing Policy
 - Justification of Related Party Transactions (relevance of Section 40A(2))
- Reconciliation between disclosures in Notes to Accounts (AS 18), Tax Audit Report, Form 3CEB, cost audit reporting & company law requirements
- Familiarity with new e-filing requirements

Thank you

CA Gaurav Shah

Associate Director - Direct Tax Advisory
(Transfer Pricing Services)

E: gauravshah@bdo.in

M: +91 98679 78894

D: +91 22 2439 3625

T: +91 22 2439 3600

