

Introduction to Transfer Pricing Regulations

BCA



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Agenda

- ∞ Transfer Pricing Regulation in India
- ∞ Practical applicability of the Transfer Pricing Regulation and Case Study
- ∞ Way forward for harmony



Transfer Pricing – An Introduction

- ⌘ Evaluation of the price charged by one related party to another related party for goods, services, etc.
- ⌘ Objective of the Revenue is to check the erosion of the tax base and plug the leakage of the revenue;
- ⌘ Foundation of the Transfer Pricing Regulations are embedded in the Double Taxation Avoidance Agreements Article 9 of the OECD Model Convention;
- ⌘ The OECD Report on Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (OECD TP Guidelines) are the foundation



Transfer Pricing – An Indian Perspective

- ⌘ Income arising to “Associated Enterprises” from “International Transactions” shall be computed having regard to the “Arm’s Length Price”
- ⌘ OECD TP Guidelines lays the foundation of the Transfer Pricing Regulation in India
- ⌘ Preconditions:
 - ⌘ Two or more associated enterprises;
 - ⌘ Enter into an international transactions
- ⌘ Consequence:
 - ⌘ Income to be computed having regard to the arm’s length price



Associated Enterprises

- ⌘ Means direct or indirect participation in management control or capital:
 - ⌘ by one enterprise into another enterprise; or
 - ⌘ by the same person in both the enterprises
- ⌘ Equity holding, Control of Board of Directors / Appointment of one or more Executive Director, mutual interest will also constitute Associated Enterprise
- ⌘ Either or both of Associated Enterprises should be non-residents



Associated Enterprises (Cont..)

- ⌘ “Deemed Associated Enterprises” includes:
 - ⌘ Holding of 26% of voting power
 - ⌘ by one enterprise into another enterprise; or
 - ⌘ by the same person in both the enterprises
 - ⌘ Dependence on intangible assets
 - ⌘ Sale of goods
 - ⌘ influence on price and conditions of supply by buyer
 - ⌘ Control by individual or his relative
 - ⌘ Financial transaction
 - ⌘ Loan - 51% or more of book value of total assets of the borrowing enterprise
 - ⌘ Guarantee - 10 % or more of the total borrowings of an enterprise



Associated Enterprise (Cont..)

- ⌘ Term of wide import - following parties also covered:
 - ⌘ VC investors with 26% stake
 - ⌘ FI's advancing loans exceeding 51% stake of assets of borrowing enterprise
 - ⌘ Franchisers, licensees, technical collaborators, etc
- ⌘ Term of wide import- is your company covered?



International Transaction

⌘ Means “transaction” between 2 or more Associated Enterprises:

- Transaction between two or more associated enterprises (at least one of which will be non-resident) of purchase, sale or lease of tangible and intangible property, provision of services, financing, cost sharing / cost contribution arrangements

OR

⌘ affecting profits, losses, income, assets or liability of the enterprise



Arm's Length Standard and Arm's Length Price

- ⌘ The Arm's length Standard (ALS) is the Universal Standard that is applicable to the various intra-group transactions of a Multinational Enterprise (MNE). It is based on the separate – entity approach and is enshrined in the DTAAAs signed by the various countries.
- ⌘ The Arm's Length Price (ALP) denotes price which is applied or proposed to be applied in a
 - ⌘ comparable transaction between
 - ⌘ unrelated independent parties in
 - ⌘ uncontrolled conditions
 - ⌘ Usually corresponds to the open market price



Computing Arm's Length Price

⌘ Arm's Length Price to be computed as per “Most Appropriate Method”, to be selected out of:

⌘ Transaction based method

⌘ Comparable Uncontrolled Price Method (CUP)

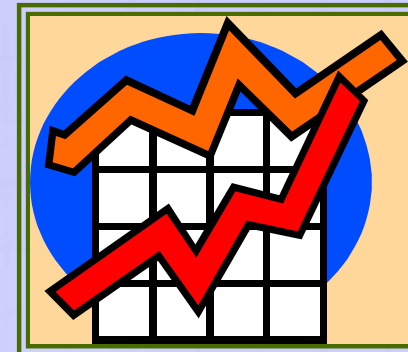
⌘ Resale Price Method (RPM)

⌘ Cost Plus Method (CPM)

⌘ Profit based method

⌘ Profit Split Method

⌘ Transactional Net Margin Method (TNMM)



Transfer Pricing Adjustment

- ∞ Absence of arm's length price in international transaction, or failure to maintain the prescribed documentation, or use of unreliable data can lead to adjustment
- ∞ Arithmetic mean vs. Range of results
- ∞ Tax exemption will not be available for the amount of adjustment(10A, 10B, Chapter VI A)



Transfer Pricing Assessments -TPA

∞ The revenue authorities across the globe in their wanting to safeguard their country's tax base, require strict compliance from the taxpayers to the TP rules and regulations



TPA.....

∞ Documentation is the key to demonstrate adherence to the Arm's Length Standard



Documentation....Seven steps Approach

- ⌘ Understanding the Business Model of the Corporate Body
- ⌘ Analyzing the International Transaction(s)
- ⌘ Functional & Economic analysis
- ⌘ Assessment of comparables
- ⌘ Selection and application of methodology
- ⌘ Benchmarking the transaction
- ⌘ Reviewing the process



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

- ⌘ This is the mandatory documentation required by law
- ⌘ a. Description of Ownership Structure (Step I)
- ⌘ b. Profile of Multinational Group (Step I)
- ⌘ c. Description of Business (Step I)
- ⌘ d. Nature & Terms of International Transactions (Step II)
- ⌘ e. Description of Functions, Risks & Assets (Step III)
- ⌘ f. Record of Economic & Market Analyses, if any (Step III & IV)



Documentation Requirements.....

- ⌘ g. Record of Uncontrolled Transactions (Step V)
- ⌘ h. Comparability Analysis (Step V)
- ⌘ i. Description of Methods considered (Step V)
- ⌘ j. Record of Actual working (Step VI)
- ⌘ k. Assumptions, policies, Price negotiations, if any. (Step II & III)
- ⌘ l. Any other information, data or document (Company Specific information, if any)



A Transfer Pricing Case Study



Facts of the Case.....

Constitution

Solutions U.K. limited

100% shareholding

Outside India

In India

Solutions India Limited



Facts of the Case.....

⌘ Marketing Services

⌘ Networking

⌘ Profiling Demand and Supply needs

⌘ Back Office Processing



Facts of the Case.....

⌘ Company's AE & Marketing Centres

⌘ Associated Enterprise Solutions U.K. Ltd.

⌘ Marketing Centres

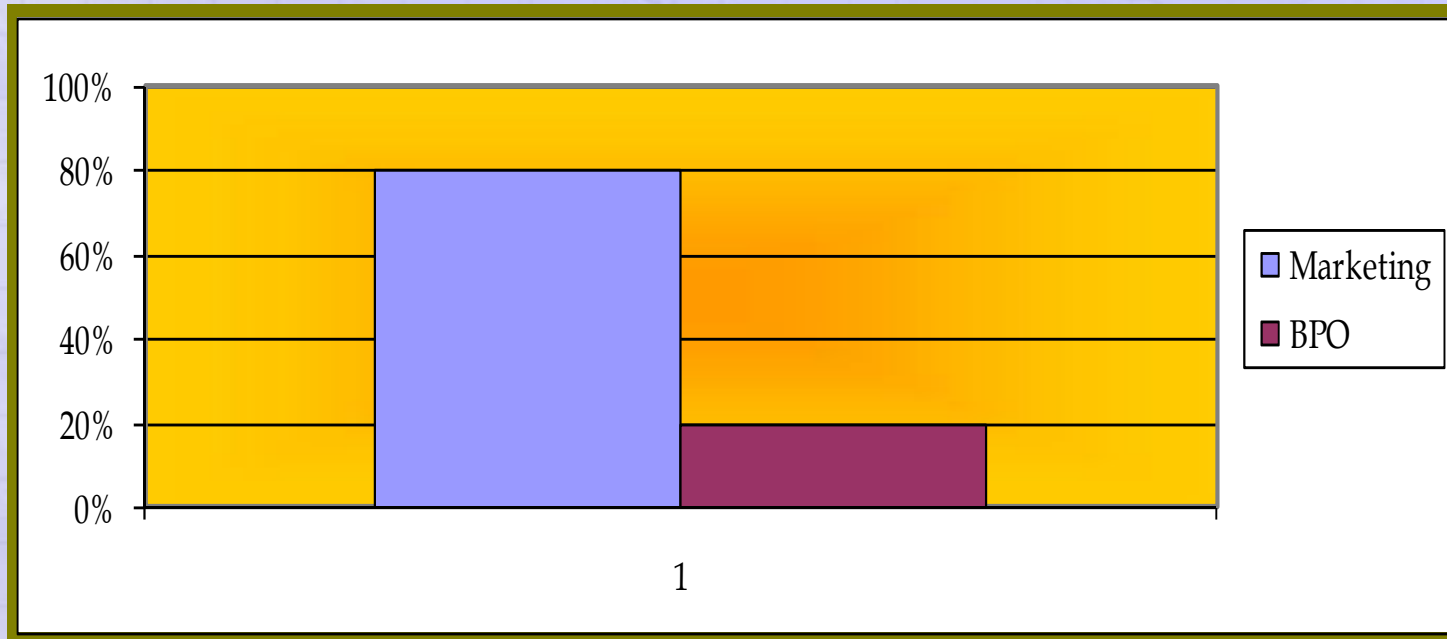
⌘ Maharashtra- Mumbai

⌘ Andhra Pradesh- Hyderabad

⌘ Punjab - Chandigarh



Facts of the Case.....

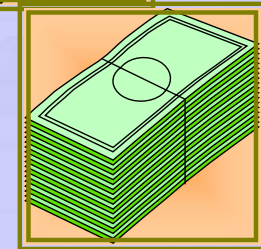
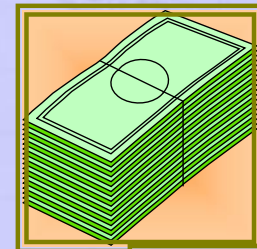


Financials

Solutions India Limited

(figures in crores)

| Particulars | |
|-----------------------------|-----|
| Income | |
| Fees | 100 |
| Expenditure | |
| Salaries & Wages | 30 |
| Communication Cost | 15 |
| Administration & other cost | 25 |
| Selling & Distribution | 5 |
| Depreciation | 10 |
| EBIT | 15 |



Description of Business Activities

Tomorrow's Visual Role of Solutions India

- ⌘ Hub for Asia-Pacific Region
- ⌘ Intelligent Hub Marketing
- ⌘ Online Services
- ⌘ Data mining for New Customers
- ⌘ Setting up of Distribution Channels
- ⌘ Play of Marketing Intangibles



Identification of International Transactions

Services provided

Solutions U.K. Ltd

Marketing Services

Back office

Outside India

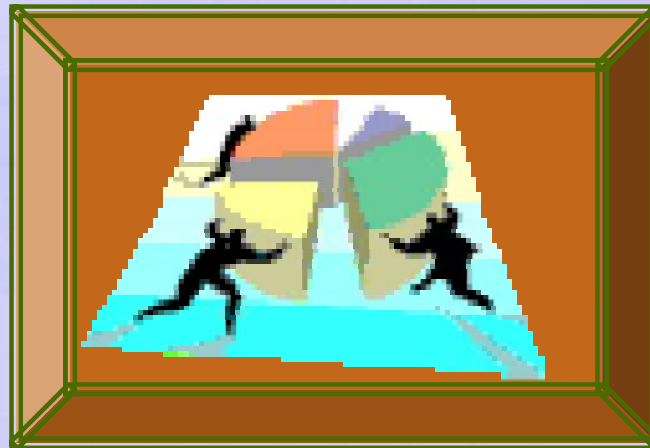
In India

Solutions India Limited



Which Way Forward....?

Slicing Based
On "Functions"



Which Way forward.....?

Understanding the Business Model of the Company



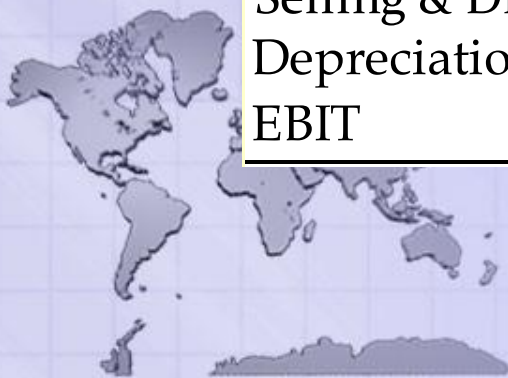
Marketing Services

Back office

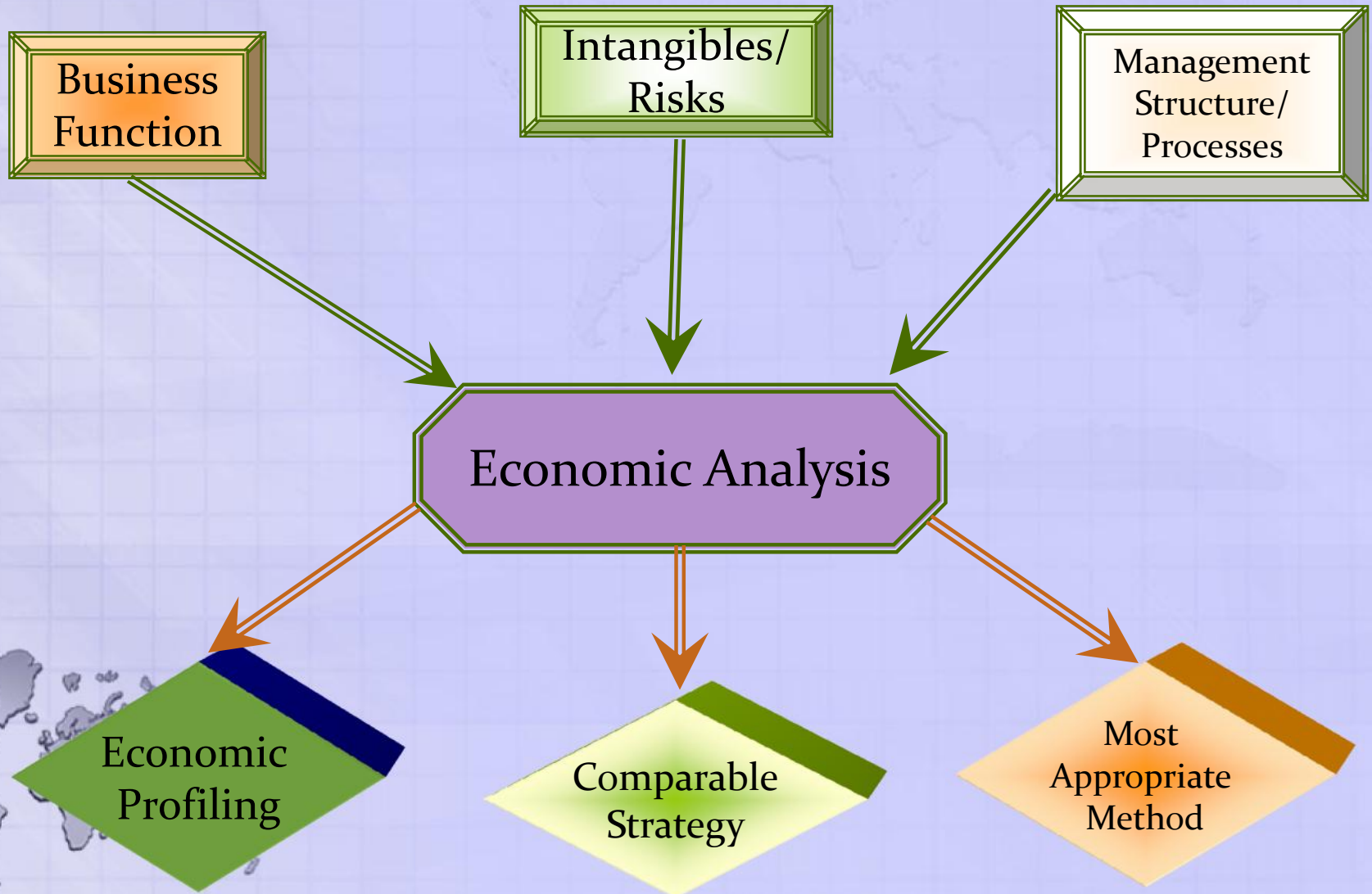
Operating Income

Profit & Loss Account

| (Rs.in crores) | | | |
|-----------------------------|-------|--------------------|-------------|
| Particulars | Total | Marketing Services | Back Office |
| Income | | | |
| Fees | 100 | 77 | 23 |
| Expenditure | | | |
| Salaries & Wages | 30 | 25 | 5 |
| Communication Cost | 15 | 14 | 1 |
| Administration & other cost | 25 | 23 | 2 |
| Selling & Distribution | 5 | 0 | 5 |
| Depreciation | 10 | 8 | 2 |
| EBIT | 15 | 7 | 8 |



Economic Analysis ?



FAR Analysis

∞ Services Rendered

∞ Functions performed

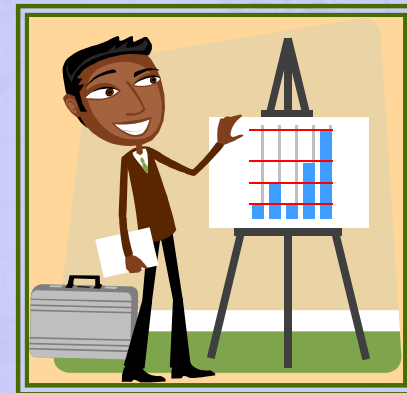
- Sales team
- Networking
- Identification of Customers
- Coordination for dispatch
- Back Office Processing

∞ Assets used

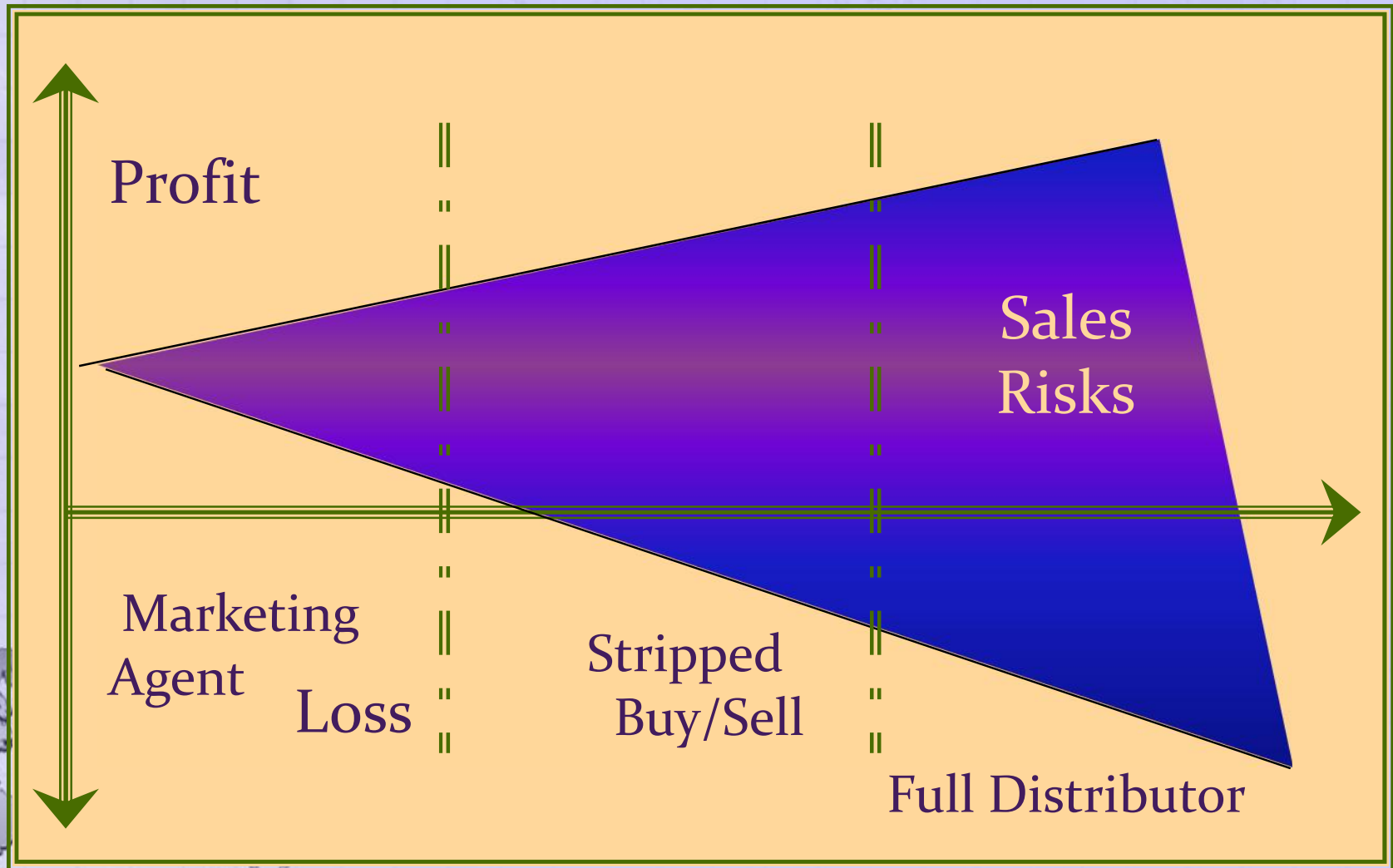
- Employee skills
- Intangibles – In-house processes
- Property, Plant & Equipment

∞ Risks assumed

- Service standard Quality Risk
- Other collateral risks
- Other entrepreneurial risks assumed by parent



Industry Overview.....Sales & Distribution – Hierarchy



Search for Comparables

⌘ Steps for Comparison

- ⌘ Service Sector
- ⌘ Courier Company
- ⌘ Administrative Services
- ⌘ Low end service provider
- ⌘ Identifying comparables in Back office processing
- ⌘ Use of appropriate search criterion
- ⌘ Rejection on qualitative basis



Facts of the Case.....

Competition

✧ Marketing Services

- ✧ DHL Limited
- ✧ Maruti Couriers
- ✧ Global services Ltd
- ✧ Sun Traders

✧ Back office Processing

- ✧ HCL Ltd
- ✧ Houston Technologies Ltd
- ✧ Wipro Ltd
- ✧ Technology Computer Services Ltd.



Methodologies



☞ Pricing Method Selection

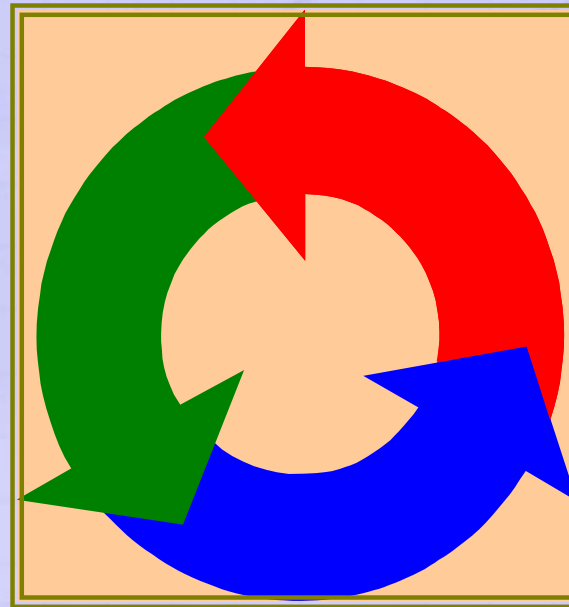
- ☞ Transaction Based Methods
- ☞ Comparable Uncontrolled Price (CUP)
- ☞ Resale Price
- ☞ Cost Plus

- ☞ Profit Based Methods
- ☞ TNMM
- ☞ Profit Split
 - Comparable
 - Residual



CUP Method

Product/Service



Economic Conditions

Contractual terms

- ⌘ Like to Like comparison – almost impossible
- ⌘ Hence, CUP is rejected as most appropriate method



Resale Price Method

1 Determine the gross profit margin earned in comparable uncontrolled transactions

Steps

2 Subtract the appropriate gross margin from the applicable resale price

3 The remainder will be the arm's length price with the controlled entity



Resale Price Method- Trading

Expenses = 17

Revenue=20

XYZ
India

ABC Parent
Company

Independent
distributors
margin-12%

Independent
Distributor

Retail

Independent
Distributor

Price
Unknown

Transfer price
using
RP Method

Revenue -20

Less Cost - 17

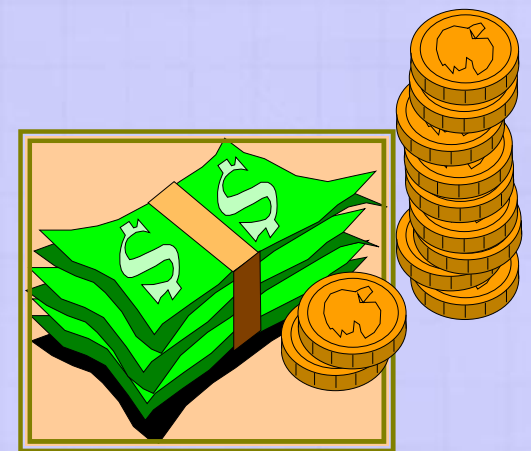
Margin = 3

i.e.3 divided by 20



Cost Plus Method

- ∞ Transfer Price is determined by adding appropriate gross profit mark-up to controlled seller's costs of producing the property or provision of service
- ∞ Indian disclosure norms are not uniform for classifying expenses that should come before GP and after GP. Hence exact matching of GP with the comparables will not be possible.
- ∞ Hence, C+ is rejected as the most appropriate method.



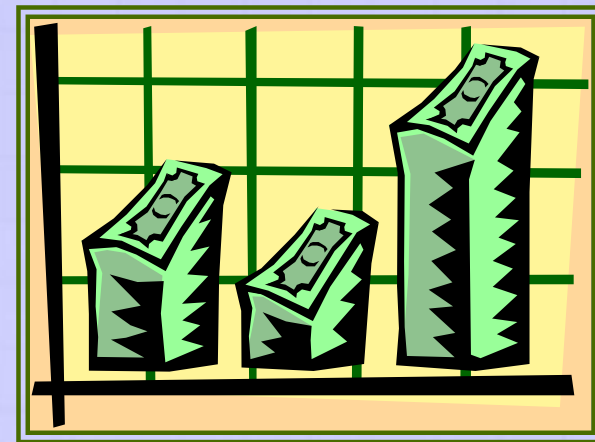
Profit Split Method

- ∞ Compares allocation of profit (loss) to allocation between uncontrolled parties in similar activities
- ∞ Applicability
 - Transfer of unique intangibles
 - Multiple interrelated International Transactions
- ∞ Relies on market data
- ∞ Few taxpayers qualify for this method - difficult to get a comparable
- ∞ Rejected as the Most Appropriate Method



TNMM

- ∞ Determine arm's length price by comparing financial results of tested party and selected uncontrolled parties
- ∞ Apply Profit Level Indicators (PLIs)



TNMM

Cost
Structures

Comparability
Factors

Resources

Risks



TNMM

TNMM – For Marketing Services

Profit level Indicator: Operating Margin (OM)

EBIT

Total Cost

“Compare OM of Solutions India Limited with that of Independent Marketing Services Companies”



TNMM

∞ TNMM – For Services (Outsourcing)

∞ Profit level Indicator: Operating Margin (OM)

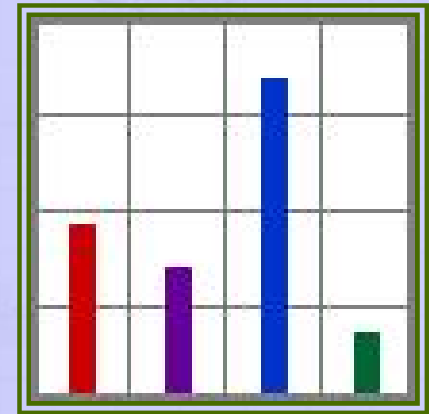
$$= \text{EBIT} / \text{Total Cost}$$

∞ “Compare OM of Solutions India Limited with that of Independent Companies”



To Sum up

- ∞ Marketing and BPO Services
 - TNMM with OM as PLI





Thank You

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