



AGENDA

- ◆ Arm's Length Price and its computation
- ◆ Functional, Asset and Risk Analysis
- ◆ Comparability Analysis
- ◆ Case Study



Income from International Transaction & Specified Domestic Transaction

- ◆ Obligation to compute income/ expenses at arm's length price of all international transactions or specified domestic transactions
- ◆ Arm's length price (ALP)-“Price between unrelated parties in uncontrolled conditions”





Arm's Length Price

- ◆ Section 92F(ii) of the Indian Transfer Pricing regulation (TPR)
- ◆ “Arm's length price means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions”
- ◆ Under Rules 10B to 10E of Income-tax Rules, 1962 (Rules)
- ◆ “Uncontrolled transaction” – transaction between enterprises other than associated enterprises, whether resident or non-resident



Functional Analysis - Approach

- ◇ Understanding the business model of the taxpayer
 - Functional interview with Company's personnel

- ◇ Study the characteristics of the transactions
 - Assists in determining the contribution of the taxpayer vis-a-vis the AEs in the international transaction and specified domestic transaction
 - Identify suitable comparables

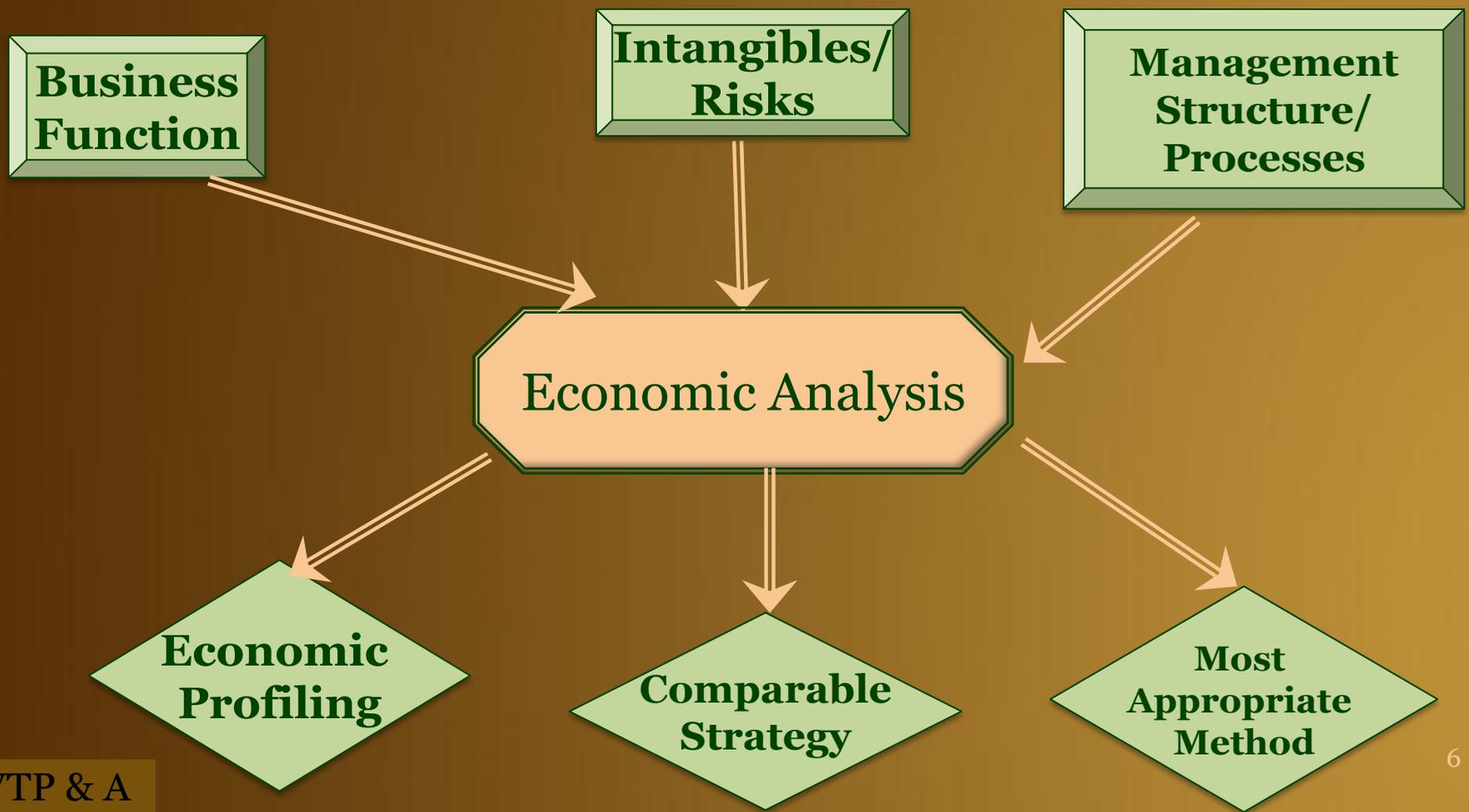
- ◇ Benchmarking with uncontrolled comparables
 - Economic adjustments for functional differences based on FAR analysis

- ◇ Determination of arm's length price





Economic Analysis ?





Documentation & FAR Analysis – Why take the trouble?



- ◆ To comply with law - i.e. legislation
- ◆ To be prepared for a Transfer Pricing audit
- ◆ As a contemporaneous record
- ◆ To justify the rationale of economic adjustments, if any
- ◆ To show that you did adopt arm's length principle
 - Split of remuneration between the taxpayer and the AEs
- ◆ To avoid / minimise penalties



Comparability Analysis





Comparability Analysis

- ◆ Arm's length principle is generally based on comparison of the conditions in controlled transaction with the conditions in transaction between independent enterprises
- ◆ For comparison, *economically relevant characteristics of the situations being compared must be sufficiently comparable*
- ◆ In case of material differences, appropriate adjustments to be made to establish arm's length conditions.
- ◆ For making adjustments, it is necessary to compare attributes of the transactions or enterprises that would affect conditions in arm's length dealings

Comparability Analysis is the Heart of transfer pricing analysis



Factors Determining Comparability

Rule 10B(2) of Rules & OECD TP Guidelines –

FIVE KEY FACTORS –

- ◆ Characteristics of Property or services
- ◆ Functional Analysis
- ◆ Contractual Terms
- ◆ Economic Circumstances
- ◆ Business Strategies





Factors.....

- ◆ Differences in specific characteristics of property or services often account at least in part, for differences in value in open market
- ◆ Important characteristics to be taken into account
 - ◆ Physical features of property
 - ◆ Its Quality & Reliability
 - ◆ Availability
 - ◆ Volume of supply
 - ◆ Nature and extent of services rendered



Factors.....

- ◆ For Intangible Property, factors to be considered to establish comparability...
 - ◆ Form of transaction i.e. licensing or sale
 - ◆ Type of Property (patent, trademark or know-how)
 - ◆ Duration & Degree of protection
 - ◆ Anticipated Benefits from use of intangible property



Factors.....

- ❖ Contractual terms of transaction define explicitly or implicitly how responsibilities, risks and benefits are to be divided between parties
- ❖ Thus analysis of contractual terms is not only important for comparability analysis but also for FAR analysis
- ❖ Economic circumstances are relevant to determine market comparability



Factors....

- ◆ To establish market comparability, factors like
 - geographic location
 - size of market
 - extent of competition
 - relative competitive positions of buyers and sellers
 - availability of substitute goods and services
 - level of demand and supply
 - consumer purchasing power, government regulations



Factors....

- ◆ Business strategies to be examined in determining comparability for TP purposes

- ◆ Business strategies would take into account
 - ◆ Innovation, New product development
 - ◆ Risk Aversion & Diversification
 - ◆ Market Penetration schemes





Factors.....

- ◆ Some Key Issues –
 - ◆ What if a particular strategy leads to reduction of current profits in anticipation of future profits?
 - ◆ Taxpayer's strategy vis-à-vis strategy followed by comparables?
 - ◆ What if business strategies fail and future projected benefits don't realize?

- ◆ Hence it is important for taxpayer , not only to demonstrate before Revenue Authorities, the projected benefits arising out of particular business strategy but also establish viability of such strategy from an uncontrolled perspective





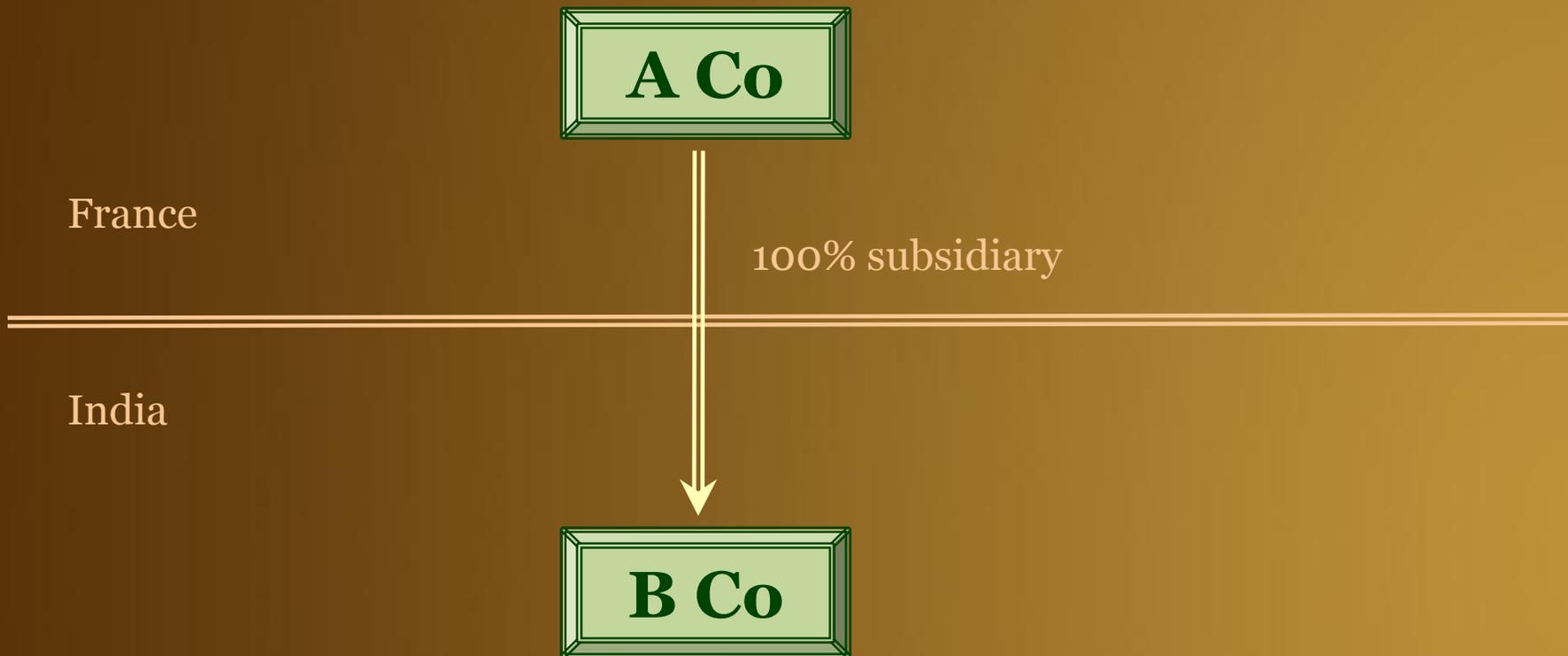
Case Study 1

Aggregation v. Segregation



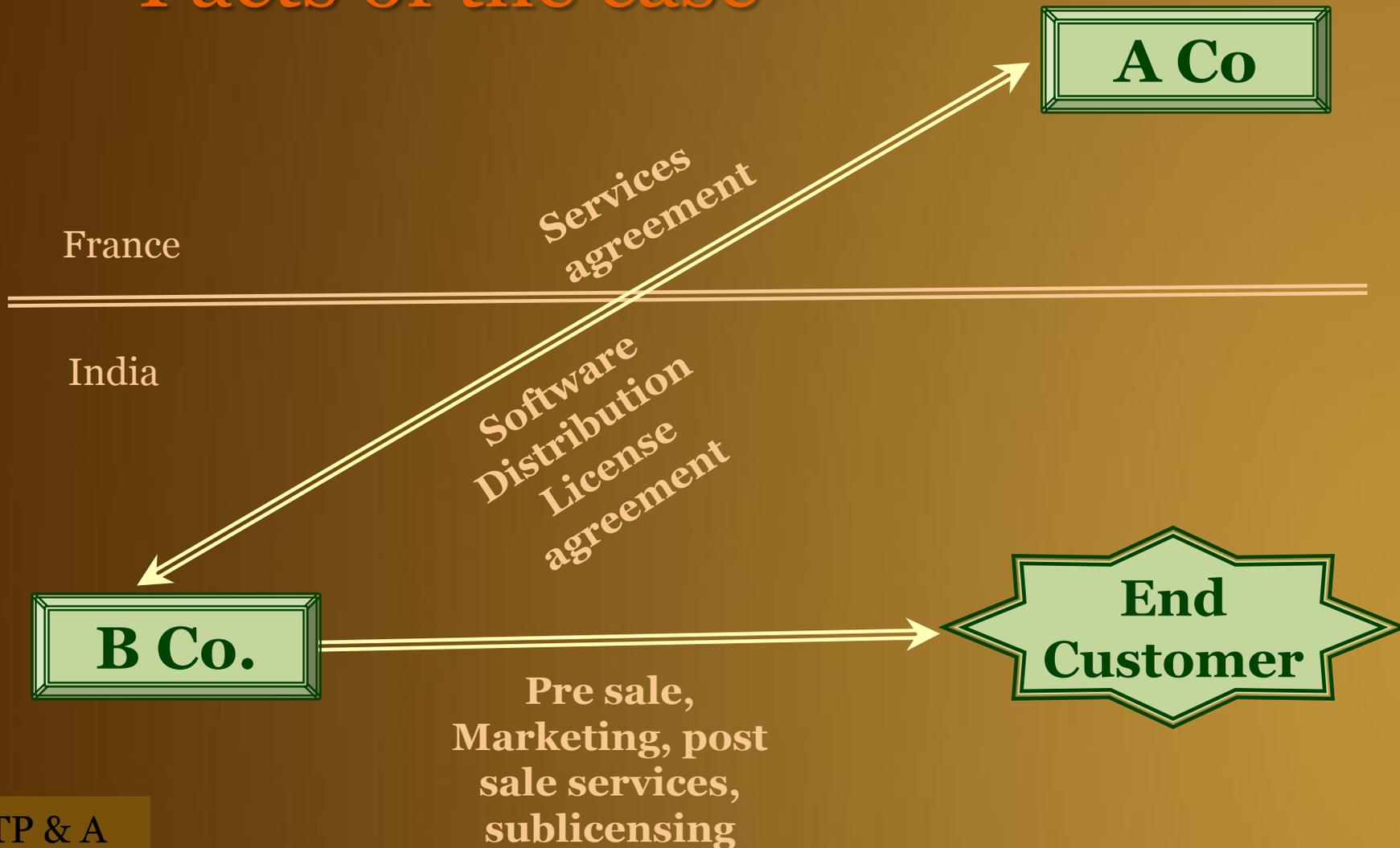


Facts of the Case





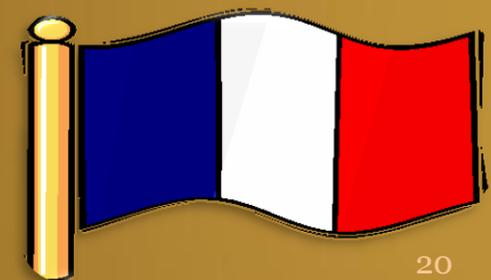
Facts of the case





Facts of the case

- ◆ A Co., is a France resident Co., has 100% subsidiary in India B Co India
- ◆ A Co. develops software entirely in France and hence also retains IP of the software
- ◆ A Co. (AE) enters into software distribution licensing agreement with B Co. whereby it grants B Co. a license to sublicense its software in India. For this B. Co. would pay annual license fee to AE





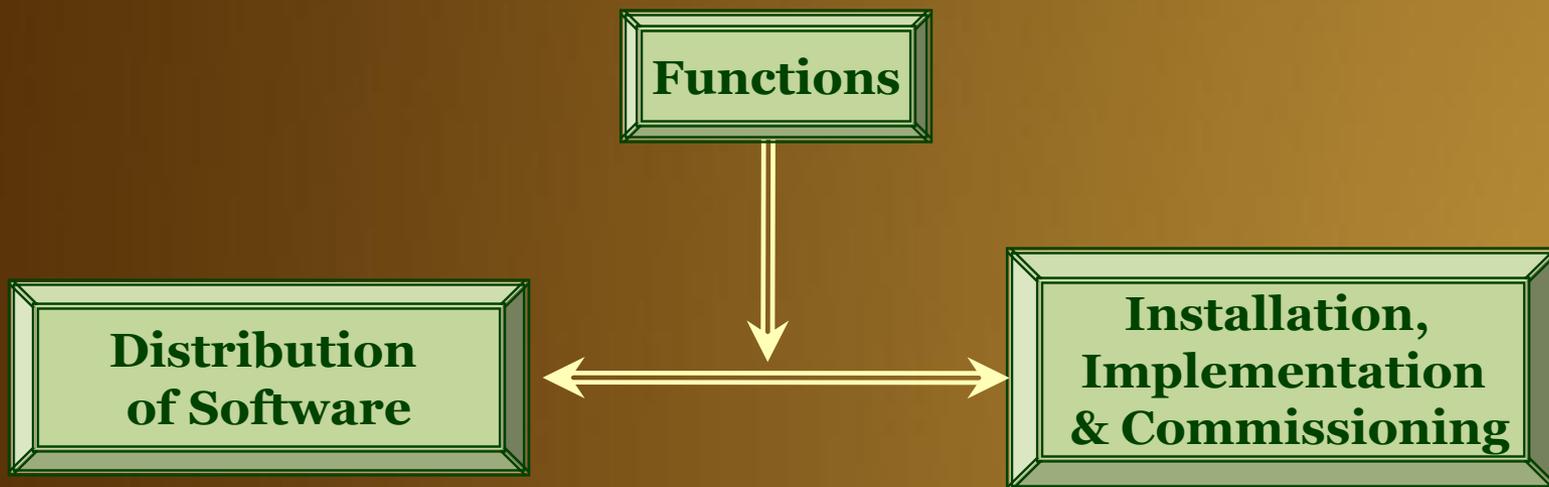
Facts of the Case

- ◆ B Co. also performs pre sale marketing and post sale client support and maintenance services.
- ◆ B Co then enters into service agreement with AE whereby AE 's employees fly down to India for installation, implementation and commissioning of software at B Co's client place
- ◆ AE charges 'Employee Cost + 20%' on installation services performed as per service agreement



Benchmarking

Benchmarking is to be done by segregating activities performed



This is done by Working-out separate profit & loss Account for each of the functions based on appropriate cost- allocations



Benchmarking

- ❖ Assessee segregated functions of distribution of licensed software and Installation & commissioning of software to benchmark the international transactions with AE
- ❖ Assessee proposed to apply Resale Price Method (RPM) to benchmark the distribution of licensed software
- ❖ To benchmark the transaction of commissioning and installation of software, Cost Plus Method (CPM) was proposed to be applied

P&L Account of Software Distribution function (RPM)

Particulars	Debit (Amt)	Particulars	Credit (Amt)
Distribution License Cost to AE	800	Sale of Software License	1600
Gross Margin	800		
% Gross Profit on Cost	100 %		

P&L Account of Software Installation & Commissioning (CPM)

Particulars	Debit (Amt)	Particulars	Credit (Amt)
Cost to be paid to employees of AE	200	Installation Fee	200
Employee Cost (Commissioning & Installation support)	150		
Gross Loss	(150)		
% Gross Loss on Cost	(42.85%)		



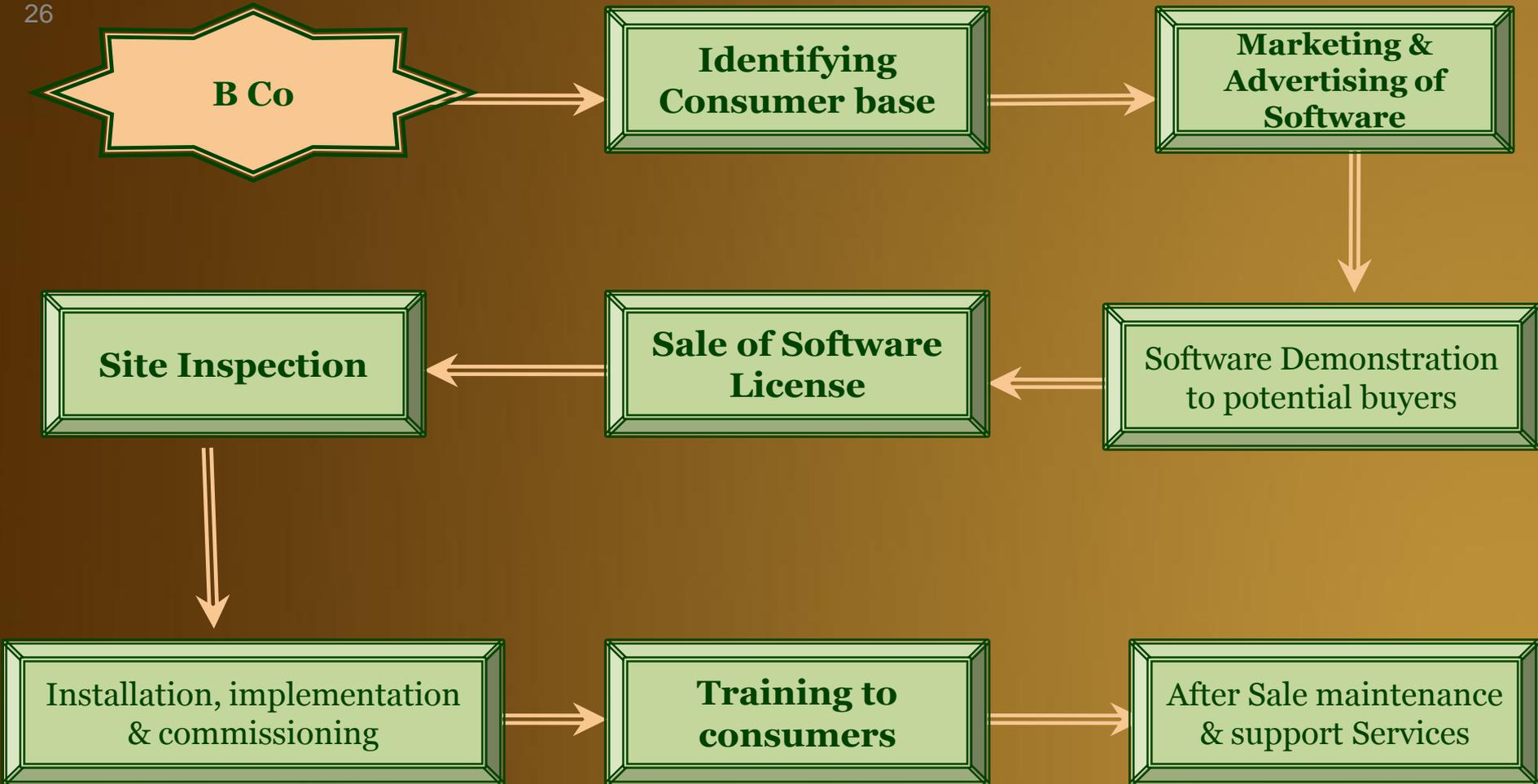
Benchmarking

- ◆ Results of Benchmarking due to Segregation of functions :
 - ◆ Huge Profits in Software Distribution Function
 - ◆ Huge Losses in Software Installation & Commissioning function
- ◆ This is because the price to end customer is function of market dynamics





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The Way Forward

- ◆ The functions of distributing the software licenses and installing & commissioning the same are integrated & intertwined
- ◆ Hence, it would be necessary to adopt “Whole Entity Approach” to benchmark these integrated functions
- ◆ The functions are to be aggregated and benchmarked by using TNMM on whole entity basis





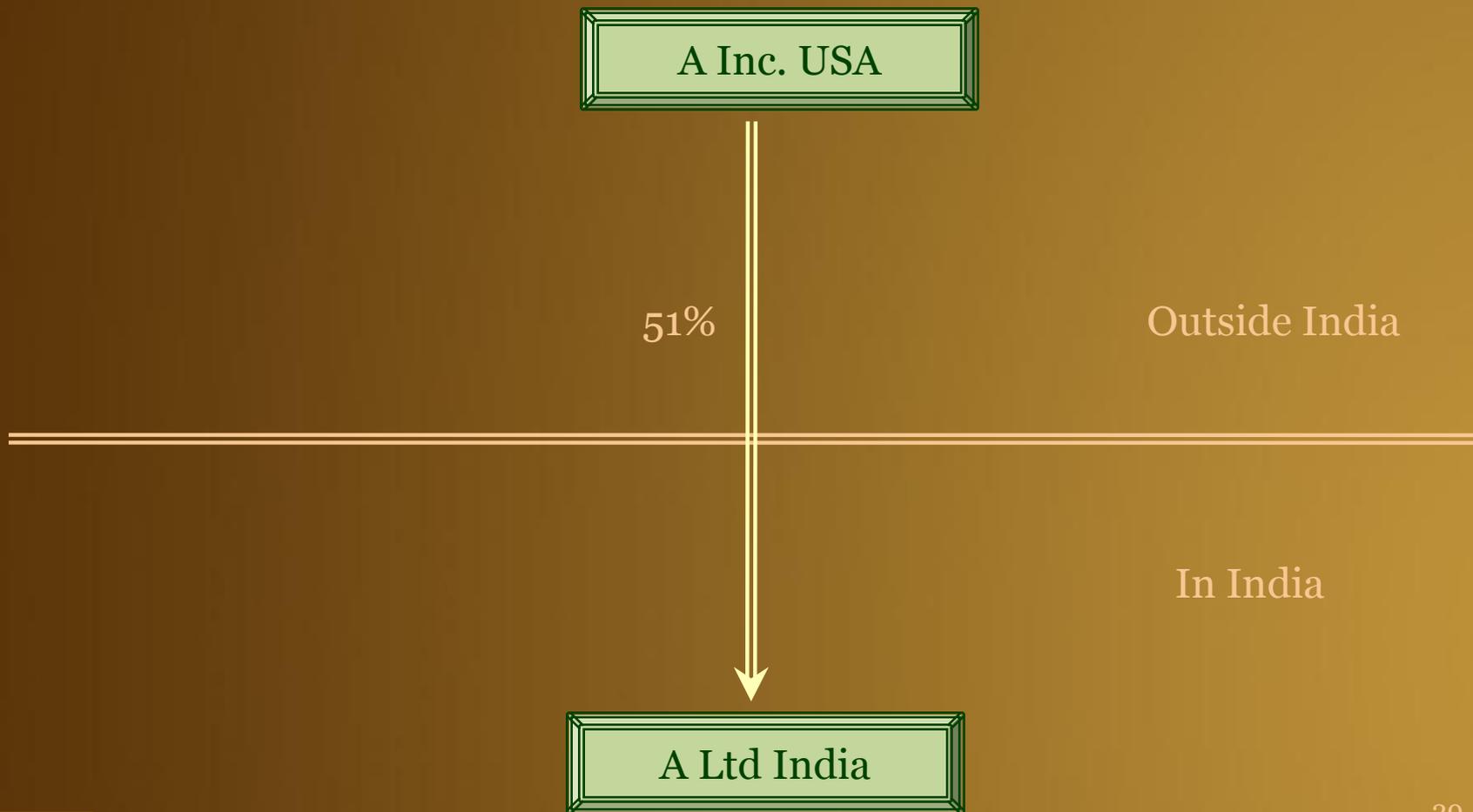
Case Study 2

Advertising, Marketing and Brand Promotion Expenses





Case Study...





Case Study...

- ◆ A Inc USA was in the business of manufacturing fruit juices under brand name 'X'
- ◆ A Inc incorporated a subsidiary A Ltd. to enter Indian markets
- ◆ A Ltd manufactured juices and sold them in Indian market under brand name 'X'
- ◆ A Ltd paid royalty on sales to A Inc. (AE) for use of brand 'X'
- ◆ A Ltd incurred huge marketing expenditure to advertise and spread awareness about juice 'X' in Indian market





Case Study

- ◆ Actions by TPO :
 - ◆ He noticed the huge marketing expenditure incurred by A Ltd
 - ◆ Entire royalty payment to AE was disallowed on the premise that such payment was not required in light of huge marketing expenditure incurred by A Ltd.
 - ◆ It was held that A Ltd incurred such marketing expenditure in order to build AE's brand in India. TPO was of the view that A Ltd had provided a brand building service to its AE
 - ◆ A markup was added on such expenditure as such expenditure was termed as an international transaction



Case Study

- ◆ Finance Act, 2012 has inserted explanation to Section 92B, thus retrospectively amending the definition of International Transaction to include:

“provision of services, including provision of market research, market development, marketing management, administration, technical service, repairs, design, consultation, agency, scientific research, legal or accounting service;”



Case Study

- ◊ Was disallowance of royalty payment in light of marketing expenditure warranted?
- ◊ Is marketing expenditure a service to AE?
- ◊ Did such expenditure benefit AE?
- ◊ Did A Ltd. provided a service to its AE by incurring such expenses?



Sony Ericsson - Delhi HC

- ◇ Assessee itself had accepted that AMP expenditure was an international transaction
- ◇ AMP expenditure does not necessarily result in brand building but it may also result in increase in sale volumes and higher profits
- ◇ Application of bright line test is not permissible, especially in the absence of any statutory recognition.

Maruti Suzuki - Bombay HC

- ◇ However, in Maruti's case the HC held that AMP expenditure cannot be re-characterised as an international transaction, unless it can be shown otherwise
- ◇ Maruti's case demonstrates that the functionality of a manufacturer and distributor needs to be distinguished



THANK YOU

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