

INDIA TRANSFER PRICING

Conference By KEY MEDIA On
International Transfer Pricing,
Singapore

May 24, 2007

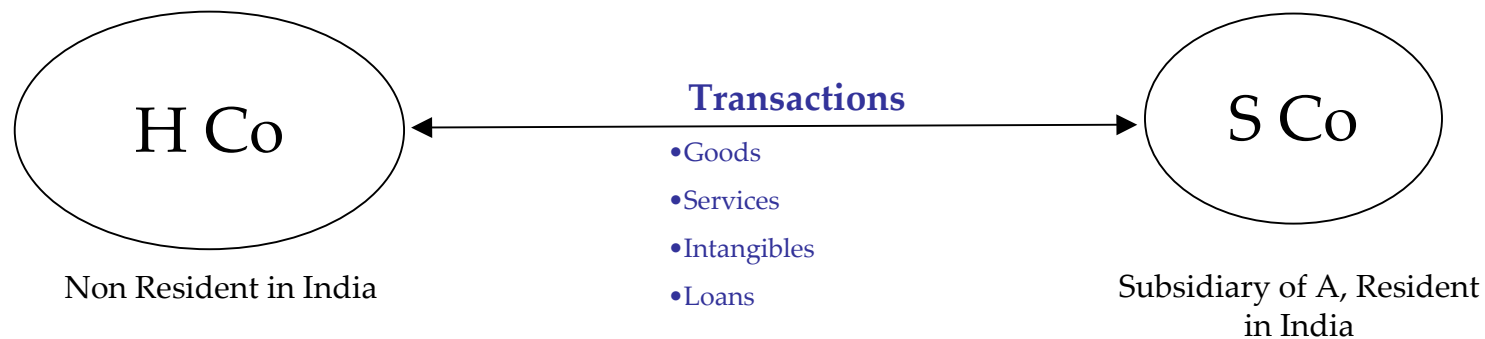
Sunil Arora, Partner

INDIA TRANSFER PRICING - FLOW OF PRESENTATION

- ▲ Applicability
- ▲ International Transactions
- ▲ Associated Enterprises
- ▲ Methods of ALP
- ▲ Key Issues Effecting TP Analysis
- ▲ Documentation
- ▲ Assessment Procedure
- ▲ Penalties
- ▲ Recent Experiences

APPLICABILITY

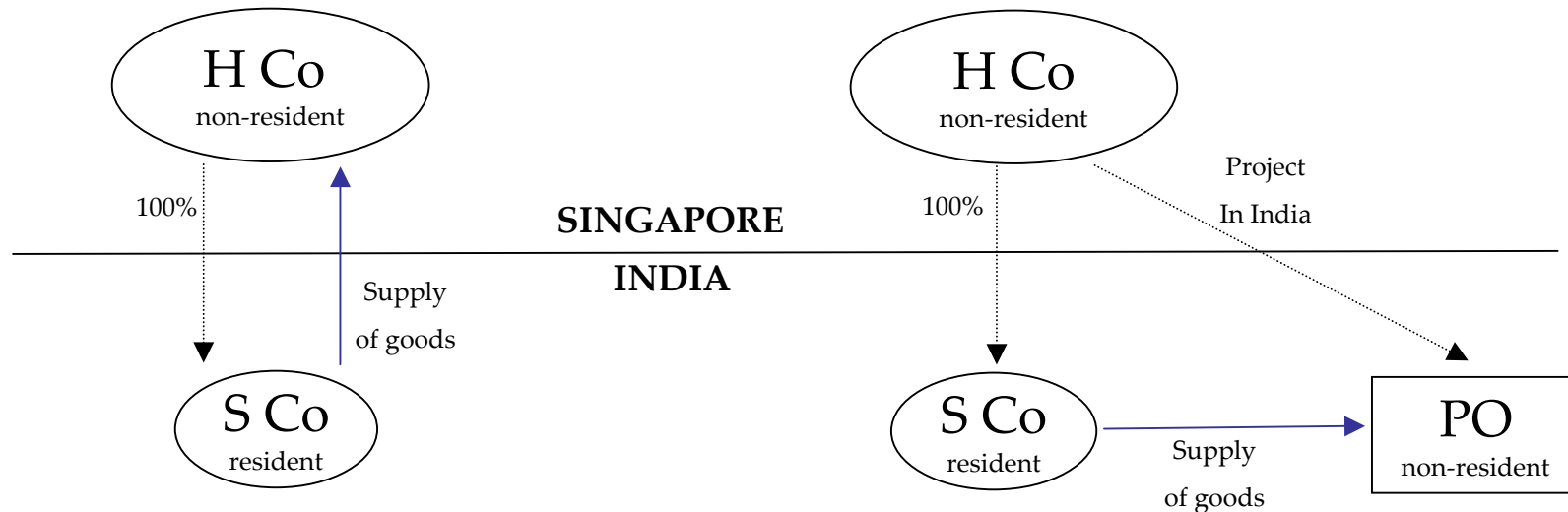
INDIA TRANSFER PRICING - APPLICABILITY



International Transactions between Associated Enterprises at Arms Length Price

INTERNATIONAL TRANSACTION

INDIA TRANSFER PRICING - INTERNATIONAL TRANSACTION

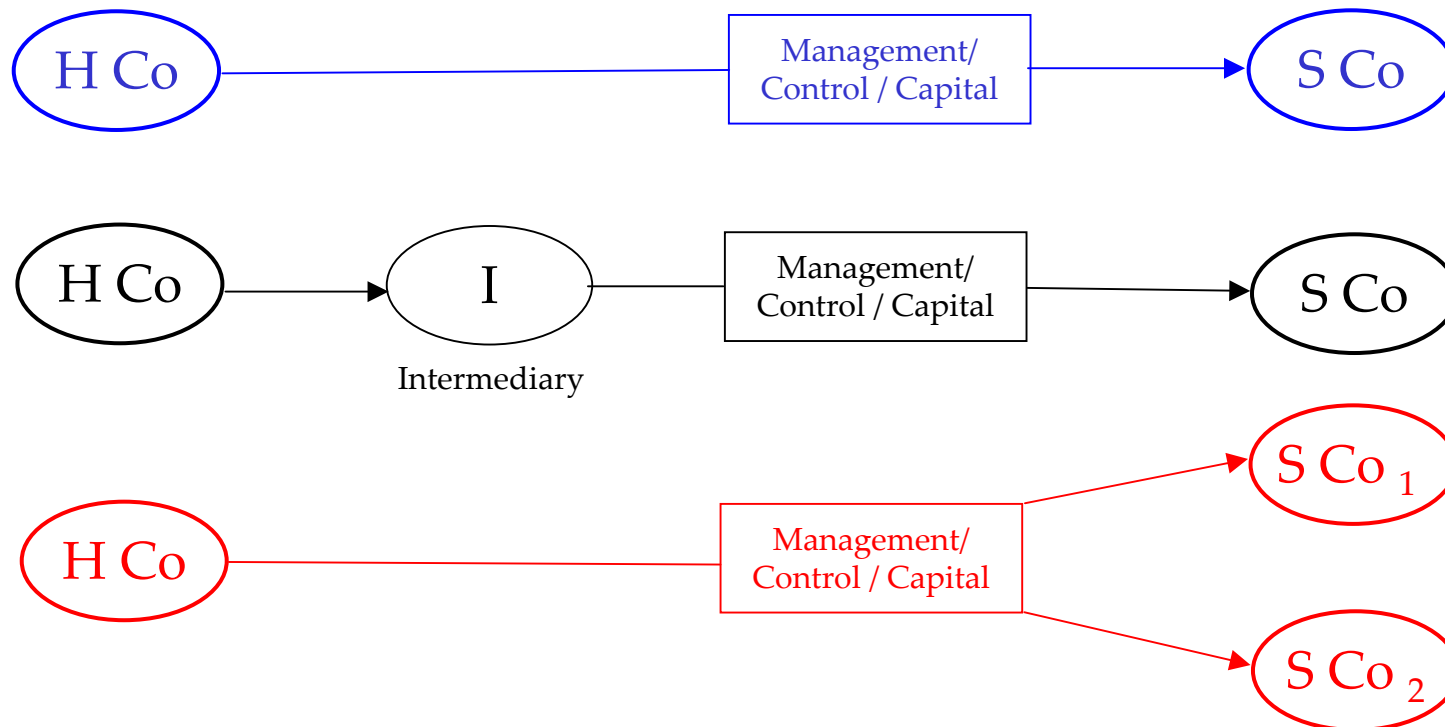


Transaction between Associated Enterprises wherein either or both enterprises are non-residents in India

ASSOCIATED ENTERPRISES

INDIA TRANSFER PRICING - ASSOCIATED ENTERPRISES

Primary Association



INDIA TRANSFER PRICING - ASSOCIATED ENTERPRISES

Secondary Association

- ▲ Direct or indirect voting power of atleast 26%
- ▲ Common parent holds voting power of atleast 26% in both
- ▲ Loan of 51% or more of value of assets
- ▲ Guarantee of 10% or more of total borrowings
- ▲ One appoints more than half of directors on board or one executive director of other
- ▲ Common parent appoints more than half of directors on board or one executive director in both
- ▲ Whole dependence on use of IPR's of the other
- ▲ Buying of bulk raw materials, Sales to one party etc

METHODS OF ALP

INDIA TRANSFER PRICING - METHODS OF ALP

- ▲ Comparable Uncontrolled Price Method
- ▲ Cost Plus Method
- ▲ Resale Price Method
- ▲ Profit Split Method
- ▲ Transactional Net Marginal Method
- ▲ Any Other Method Prescribed by CBDT

INDIA TRANSFER PRICING - METHODS OF ALP

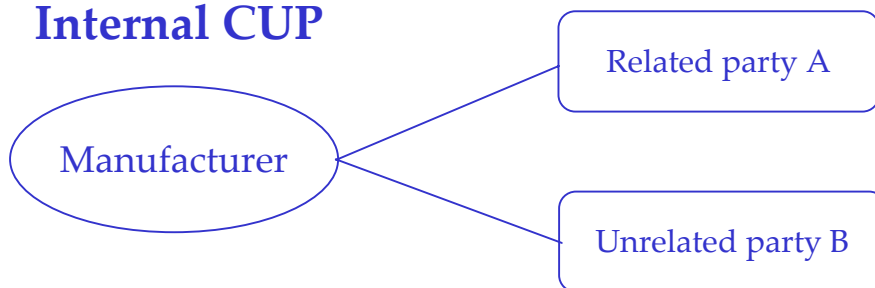
Comparable Uncontrolled Price Method

- ▲ Considered most appropriate for all transactions, if information is available
- ▲ Requires strict comparability in products, contractual terms, economic terms etc.
- ▲ Internal CUP is more prevalent in India
- ▲ Captive entities with a single customer avoid use of CUP

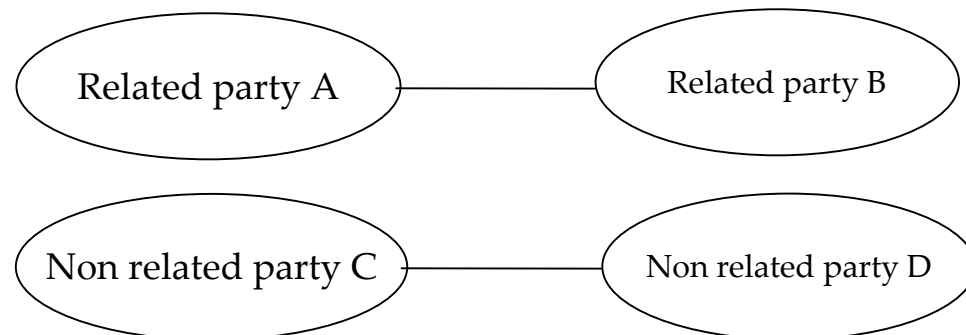
INDIA TRANSFER PRICING - METHODS OF ALP

Comparable Uncontrolled Price Method

Internal CUP



External CUP



INDIA TRANSFER PRICING - METHODS OF ALP

Cost Plus Method

- ▲ Compare the gross margin over cost of AE with gross margin over cost earned by comparable independent companies
- ▲ Degree of Comparability is reasonably high
- ▲ Preferred method for
 - manufacturer supplying semi finished goods
 - company providing services

INDIA TRANSFER PRICING - METHODS OF ALP

Resale Price Method

- ▲ Compares the resale gross margin of AE with the resale gross margin earned by comparable independent distributors
- ▲ Degree of comparability is reasonably high
- ▲ Preferred method for a distributor buying purely finished goods from a group company (if no CUP available)



INDIA TRANSFER PRICING - METHODS OF ALP

Profit Split Method

- ▲ Computes the combined operating profit resulting from a whole inter- company transaction based on the contribution of each AE to operating profit
- ▲ The contribution made by each party is determined on the basis of a division of functions performed
- ▲ Applicable for analyzing complex tangible, intangible or services issues

INDIA TRANSFER PRICING - METHODS OF ALP

Transactional Net Marginal Method

- ▲ Examines net operating profit from transactions as a percentage of certain base viz. cost, turnover, etc in respect of similar parties
- ▲ Applicable for any type of transaction and often used to supplement analysis under other methods
- ▲ Most frequently used method in India, due to lack of availability of comparable uncontrolled price method/ cost plus method/ resale price method

KEY ISSUES EFFECTING TP ANALYSIS

INDIA TRANSFER PRICING - KEY ISSUES

- ▲ Choice of appropriate method for ALP
- ▲ Selection of time period
- ▲ Availability of corporate database
- ▲ Avoid loss making companies and those with negative net worth
- ▲ Provide complete justification for extraordinary or ordinary events
- ▲ Synchronise with auditors report and notes to accounts
- ▲ Provide description of finally selected companies
- ▲ Consider past TP assessments and connected issues

INDIA TRANSFER PRICING - KEY ISSUES

- ▲ Use of secret comparables not prohibited
- ▲ Avoid use of unnecessary data in report
- ▲ Synchronise market situation with operating margin of the assessee

DOCUMENTATION

INDIA TRANSFER PRICING -DOCUMENTATION

Entity related



- Profile of Industry
- Profile of group
- Profile of Indian entity
- Profile of associated enterprises

Price related



- Transaction terms
- Functional Analysis (functions, assets and risks)
- Economic analysis (method selection, comparable benchmarking)
- Forecasts, budgets estimated

Transaction related



- Agreements
- Invoices
- Pricing related correspondence (letters, emails etc.)

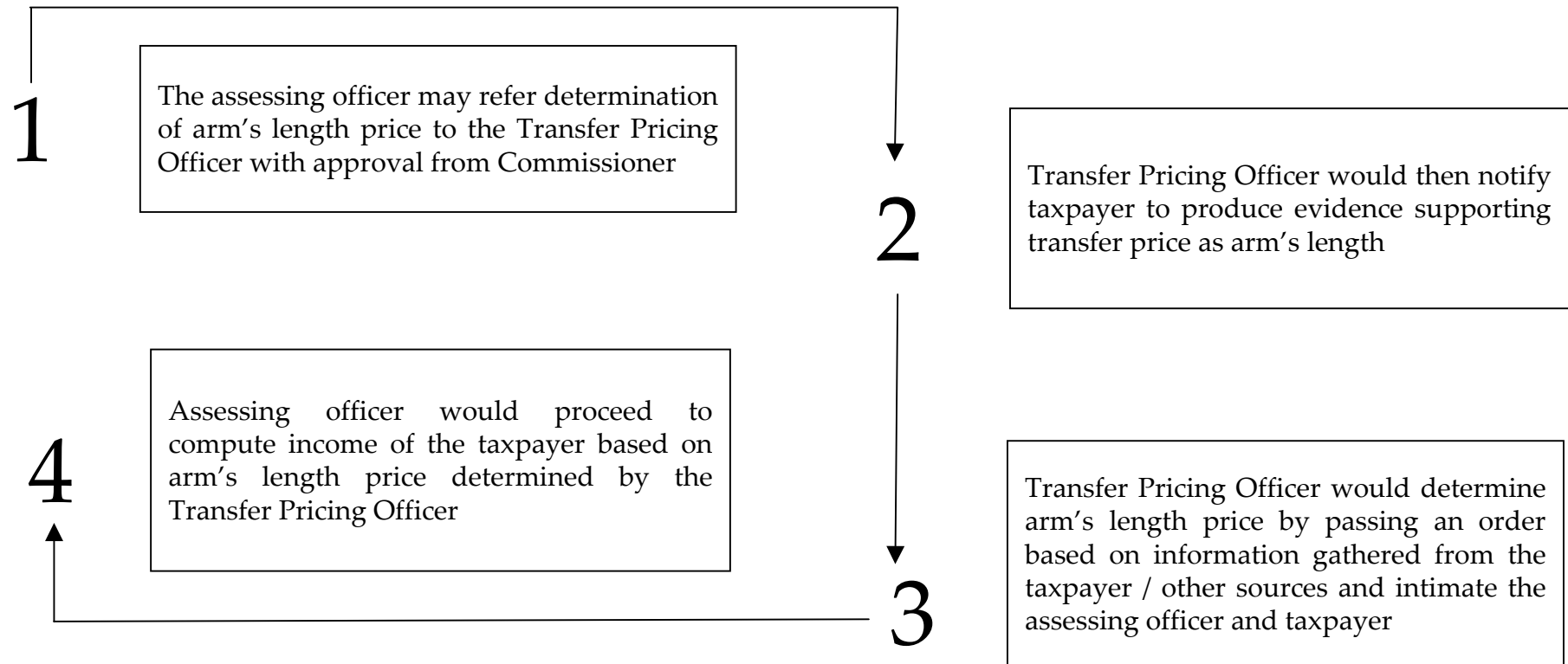
Contemporaneous documentation requirement
Documentation to be retained for 9 years

ASSESSMENT PROCEDURE

INDIA TRANSFER PRICING - ASSESSMENT PROCEDURE

- ▲ Audit teams constituted in 5 cities – Delhi, Mumbai, Bangalore, Chennai and Kolkata
- ▲ Each team consists of a Director of International Tax and Joint / Additional Commissioners as Transfer Pricing Officers (TPO)
- ▲ The TPO receives reference from Assessing Officer
 - ▶ As per the Revenue's internal guidelines for the fiscal year 2006-07, all cases where the taxpayer's aggregate value of international transactions exceed Rs 15 crore (approx SGD 5 million) were identified for compulsory TP audit

INDIA TRANSFER PRICING - ASSESSMENT PROCEDURE



PENALTIES

INDIA TRANSFER PRICING - PENALTIES

Default	Nature of Penalty
In case of a post-inquiry adjustment, there is deemed to be a concealment of income	100 – 300 % of tax on the adjusted amount
Failure to maintain documents	2% of the value each international transaction
Failure to furnish documents	2% of the value international transaction
Failure to furnish accountant's report	Rs 100,000

However, penalty for concealment of income shall not be levied if the taxpayer demonstrates that price charged or paid has been determined in 'good faith' and with 'due diligence'

RECENT EXPERIENCES

INDIA TRANSFER PRICING - RECENT EXPERIENCES

Case Study 1 - Pragmatic Approach

Facts

- ▲ Engineering company engaged in designing of moulds for automobile lamps
- ▲ First year of full production. 70% processed moulds sold to parent
- ▲ Key raw material and technical support received from related parties
- ▲ No group transfer pricing policy in existence
- ▲ Operating loss at 10%

INDIA TRANSFER PRICING - RECENT EXPERIENCES

TP Analysis

- ▲ Guiding factors
 - ▶ No group TP policy
 - ▶ Complex transaction between group companies
 - ▶ No comparables for products (moulds, designs)
 - ▶ Operating losses of Indian entity at 10%

- ▲ Identify nearest comparables i.e. engineering companies in automobile industry. All were growth companies with operating margin at 5% on sales

INDIA TRANSFER PRICING - RECENT EXPERIENCES

- ▲ Since low degree of comparability of functions, assets, risks, apply TNMM

- ▲ Under TNMM, operating margin of comparable companies adjusted for factors
 - training of personnel – 5% of sales
 - establishment cost – 3% of sales
 - low capacity utilization – 10% of sales
18% of sales

INDIA TRANSFER PRICING - RECENT EXPERIENCES

- ▲ Underutilization of assets & resources identified as major cause of difference since tax payer undergoing first year of production. Hence, margins of comparable companies adjusted to draw a common size statement

Operating Margin	- 5 %
Less - abnormal costs	- <u>(18)</u> %
	<u>13</u> % loss

- ▲ Adjusted operating loss of comparable companies at 13% was then compared to the operating loss of tax payer at 10%
- ▲ Hence, arms length justified

INDIA TRANSFER PRICING - RECENT EXPERIENCES

Case Study 2 - Non Pragmatic Approach

Facts

- ▲ Tax payer engaged in distribution of Smart Cards in India. RPM applied; tax payer's gross margin of 20% compared with industry average of 14%
- ▲ Net margin of tax payer was (-2%) i.e. below industry margin of 5%
- ▲ Included in indirect expenses, were the following abnormal items
 - ▶ **Provision** for doubtful debts - 6% of sales
 - ▶ **Provision** for stock obsolescence - 3% of sales
- ▲ Taxable profits were already enhanced by the amount of provision since these are not tax deductible

INDIA TRANSFER PRICING - RECENT EXPERIENCES

TP Analysis

- ▲ RPM was challenged on ground of functional difference in comparables and tax payer – though no evidence was produced
- ▲ Hence, TNMM was applied; net margin of -2% was compared to industry margin of 5% and TP adjustment of 7% of sales was proposed
- ▲ On this, the tax payer contended that provision be excluded while arriving at net margins for applying TNMM since
 - the comparable companies have not made provision for any expense
 - the provision have already been taxed. non-exclusion will result into double taxation

INDIA TRANSFER PRICING - RECENT EXPERIENCES

TP Analysis

- ▲ The tax officer neither provided any evidence to support difference in functions nor considered adding back of provisions to the profit of the tax payer

Hence, resulted into assessment as per TNMM and corresponding adjustment of 7% of sales

End of case Study 2

THANK YOU