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TRANSFER PRICING DOCUMENTATION

Table of Content

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Table of Content

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Governing Regulation

Transfer Pricing documentation is governed by Income Tax Act, 1961 read with Income Tax Rules, 1962. The extract is as under:

Section 92D(1)

Every person who has entered into an international transaction or specified domestic transaction shall keep and maintain such information and document in respect thereof, as may be prescribed in Rule 10D;

Provided that the person, being a constituent entity of an international group, shall also keep and maintain such information and document in respect of an international group as may be prescribed.

Rule 10D

Rule 10D (2) provides that in a case where the aggregate value of international trans-actions does not exceed Rs.1 Crore, it will not be obligatory for the assessee to maintain the above information and documents.

OECD TP Guidelines

The above description and steps very closely follow international guidance matter laid down in Chapter 5 of the OECD TP guidelines.

It also provides guidance to assist taxpayers in identifying documentation that would be most helpful in showing that their transactions satisfy the arm's length principle and hence in resolving transfer pricing issues and facilitating tax examinations.

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Document/Information to be maintained

Rule 10D states that "Every person who has entered into an international transaction or a specified domestic transaction shall keep and maintain the following information and documents, namely:"

- Ownership Structure
- Profile of multinational group
- Business description/ Profile of industry

Entity Related

- Nature and terms (including price) of international transactions
- Description of functions performed, risk assumed and assets employed (Function, Asset & Risk – FAR Analysis)
- Records of economic and market analysis (Economic analysis)
- Record of budgets, forecasts, financial estimates
- Any other record of analysis (if, any) to evaluate comparabilityof international transaction with uncontrolled transaction(s)
- Description of method considered with reasons of rejection of other methods

Price Related

- Details of transfer pricing adjustment(s) made (if, any)
- Any other information e.g. data, documents like invoices,agreements, price related correspondence, etc.

Transaction Related

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Why TP Documentation is necessary?

Transfer Pricing (TP) Documentation is not only regulatory requirement but it also facilitates the following:

► Self review of Intercompany Transfer Pricing

► Reduce risk of penal exposure

► Basis for the selecting method in Form 3CEB

► To be prepared for Transfer Pricing Audit

► Helps in substantiating the transactions with the Tax authorities

Transfer Pricing Study Report results in effective communication of TP policy to the tax authorities for them to appreciate and approve the Arm's Length Price

Flow of TP Study Report

Executive Summary

1. The objective of this Transfer Pricing Analysis is to support the arm's length nature of international transactions and Specified Domestic Transactions entered into by the assessee.
2. Should clearly lay out the following:
- The business of the group and the taxpayer indicating the relation between the group and the taxpayer,
- The activity performed / services provided,
- Characterisation of the entities involved,
- List of all international transactions (with value and the methodology applied)
- Result of the economic analysis; and
- Conclusion
3. Also, a TP document needs to mention the fact that the results are pertinent to that financial year and the results may need to be updated based on latest financials result, change in FAR profile or the level of tangible/intangible asset owned (i.e. the need to review and update the transfer pricing policy/arrangement to reflect change in market conditions especially during assessments)
4. Flow is important and should capture all the major observations and findings of the document – it has to essentially be crisp and succinct.

Industry Background

Industry Background consists of the following:

- Overview of the Industry
- Current trends in the Industry
- Key value drivers
- Key challenges
- Key competitors
- SWOT analysis
- Regulatory Framework
- Domestic market of the Industry
- Global scenario of the Industry
- Future outlook

Intercompany Transactions

A. International transaction

•Determine international transaction u/s 92B from Form3CEB (Nature of Transaction, Name of AE and Value in currency)

•The section should list the identified international transactions

•A specimen format for international transaction disclosure is in the table stated below:

International Transactions	Name of Associated Enterprise	Value (Rs.)
XYZ Advisors Pte. Ltd	Provision of advisory services	XXX
XYZ Advisors Pte. Ltd	Provision of other services	XXX

<u>B. AssociatedEnterprises</u>

Step 1

Determine AE as per section 92A from the related party disclosure in thefinancials.

Step 2

Define the nature of relationship between the assessee and the AE.

Step 3

Determine the brief description of theAE.

A specimen format for Associated Enterprises is in the table stated below:

Name of Associated Enterprise	Nature of Relationship as referred to in section	Brief Business Description
XYZ Advisors Pte. Ltd	An enterprise which holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise – Section 92(A)(a)	Financial services - Fund Management activities
ABC Company Ltd., U.K.	The ultimate holding company of the assessee owns directly or indirectly more than 26% of the voting power of the assessee and AE - Section 92A(2)(b)	BPO Services/Market Research

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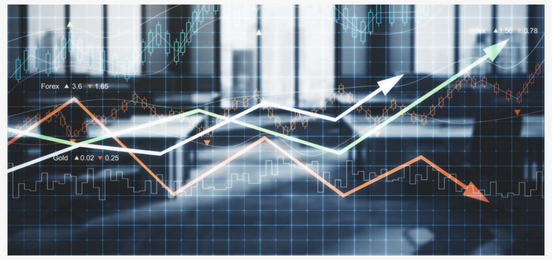

FAR Analysis

<u>Rule 10D - Documents to be maintained under section 92D</u>

"(e) a description of the functions performed, risks assumed and assets employed or to be employed
by the assessee and by the associated enterprises involved in the international transaction"

<u>OECD TP Guidelines</u>

"An analysis of the functions performed (taking into account Asset Employed and risks assumed) by associated enterprises in controlled transactions and by independent enterprises in comparable uncontrolled transactions"

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01 FAR analysis is an analysis of functions performed, assets employed and risk undertaken by an enterprise

02 FAR analysis – exercise to determine and document significant economic activities performed by the enterprise and its AEs in an international transaction.

03 The allocation of these activities between the associated enterprises involved in the transaction so that each entity can be fully characterized.

04 FAR analysis should be performed for all the international transactions, including management charges and financial transactions (if any)

05 Depending on the complexity of the transaction, the nature and scope of the functions performed and sometimes the value of the international transaction, separate chapters on the major international transactions encompassing the FAR and economic analysis could be considered

06 FAR analysis to be performed from the perspective of the international transaction in hand and not on the overall circumstances of the business of the taxpayer. Eg. Pharma company having subsidiary in U.S. performing marketing functions

Economic Analysis

1.Economic analysis is undertaken to analyze the Arm's length nature of the intercompany transactions between a company and its AEs..

2.The analysis involves the following steps:

- Selection of tested party;
- Selection of the most appropriate method;
- Selecting PLI;
- Carrying out a search, using publicly available databases, for comparable uncontrolled enterprises;
- Computing the arm’s length range/price of the broadly comparable independent companies;
- Carrying out adjustment for differences between enterprises, as may be required; and
- Conclusion.

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Method Evaluation

Selection of Tested Party

Participant in an international transaction with whose reference the international transaction is tested

Selection of tested party influences the most appropriate method to be selected

Entity performing the least complex function and not owning any valuable intangible is normally selected as the tested party.

Normally least complex entity selected as the tested party as testing of margin of such entity would require least adjustment.

Selection of comparable is based on economic characterization of the tested party

Qualitative Analysis

Financial Analysis

Quantitative Analysis

When the tested party is a foreign AE, the foreign comparables are used for benchmarking. No specific prohibition in the TP Regulations regarding use of foreign comparables. However, the tax authorities during an audit are reluctant to accept foreign comparables

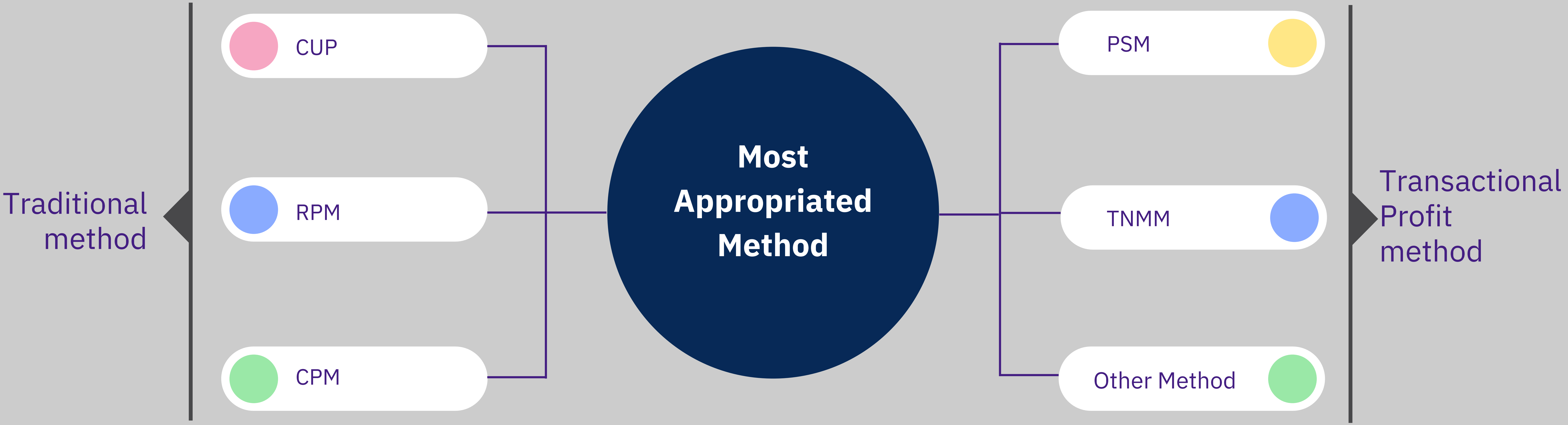
Difference in Indian GAAP vis-à-vis accounting principles and practices of other countries – major reason why tax authorities reject foreign comparables

However, Indian tax tribunals have held that if a taxpayer wishes to consider a foreign AE as the tested party, then relevant data for comparison should be available in the public domain or should be furnished to the tax administration. Some of the relevant rulings in this regard are:

-Ahmedabad Tribunal, General Motors India Pvt Ltd v. DCIT (ITA Nos. 3096/Ahd/2010 and 3308/Ahd/2011);
-Kolkata Tribunal, Development Consultants Pvt Ltd v. DCIT, [2008] 23 SOT 455(Kol.);
-Delhi Tribunal, Ranbaxy Laboratories Ltd v. ACIT, [2008] 110 ITD 428(Delhi);
-Mumbai Tribunal, Tata Motors European Technical Centre Plc v. DCIT (ITA No. 907/MUM/2015);and
-Chandigarh Tribunal, IDS Infotech Ltd v. DCIT (ITA130/Chd./2016)

Most Appropriate Method

The Act stipulates that the arm’s length price is to be determined by adopting any one of the prescribed methods u/s 92C. There should be a justification for selection of one method as the most appropriate method over other five methods



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Comparable Uncontrolled Price Method (CUP)

Most Direct Method

Prices are benchmarked without any reference to the profits

Requires strict comparability in products, contractual terms, economic terms, etc.:

- Strong similarity of products and services
- Geography of markets
- Functions and Risks
- Business strategy
- Contractual terms
- Timing of the transaction
- Volume

Two types of CUPs available –Internal CUP & External CUP

Typically Internal CUP is preferred over External CUP due to higher degree of comparability

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Resale Price Method (RPM)

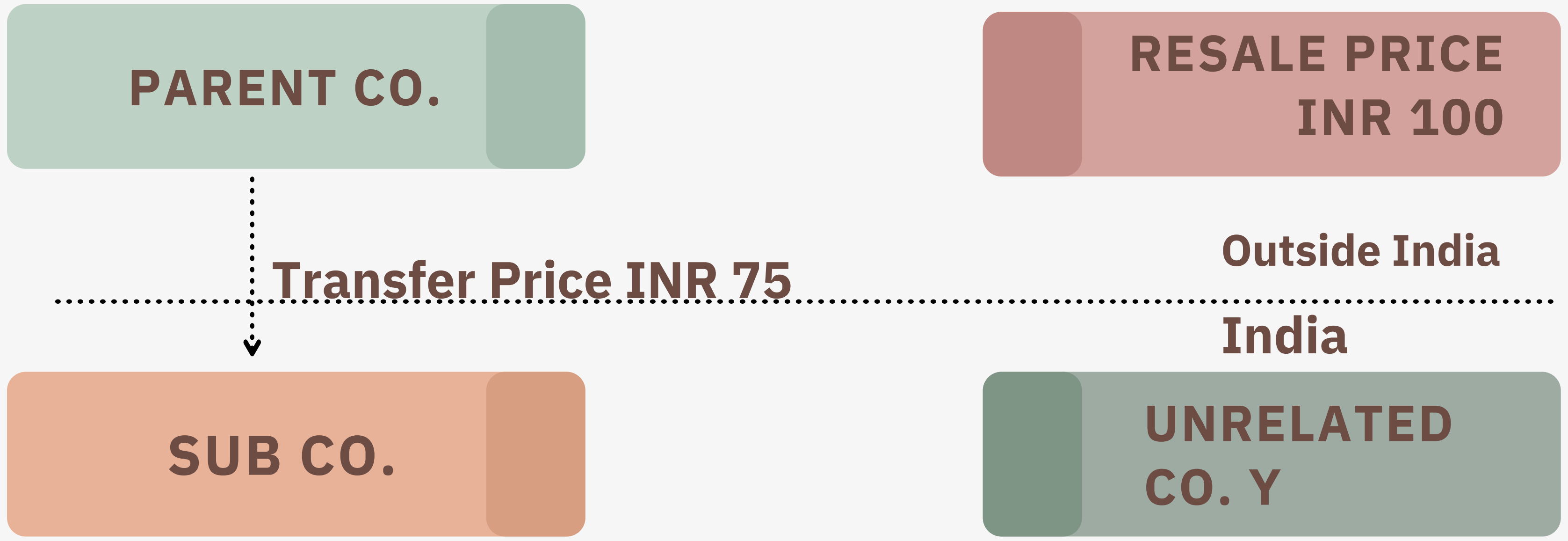
Preferred method for a distributor buying purely finished goods from a group company (if no CUP available)

Measures the value of functions performed

Ordinarily used in cases where

1. Purchase and resale of tangible property
2. Reseller has not added substantial value
3. Packaging, labeling, or minor assembly are acceptable
4. Reseller does not apply intangible assets to add substantial value
5. Difficult to apply where goods are further processed before resale

7. Comparability is relatively less dependent on strict product comparability and additional emphasis is on similarity of functions performed & risks assumed



Price paid by Sub Co. to AE is at arm's length if the 25% resale margin earned by Sub Co. is more than margins earned by similar Indian distributors

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Cost Plus Method

Compares and identifies markup earned on direct andindirect costs of production incurred with that of comparable independentcompanies

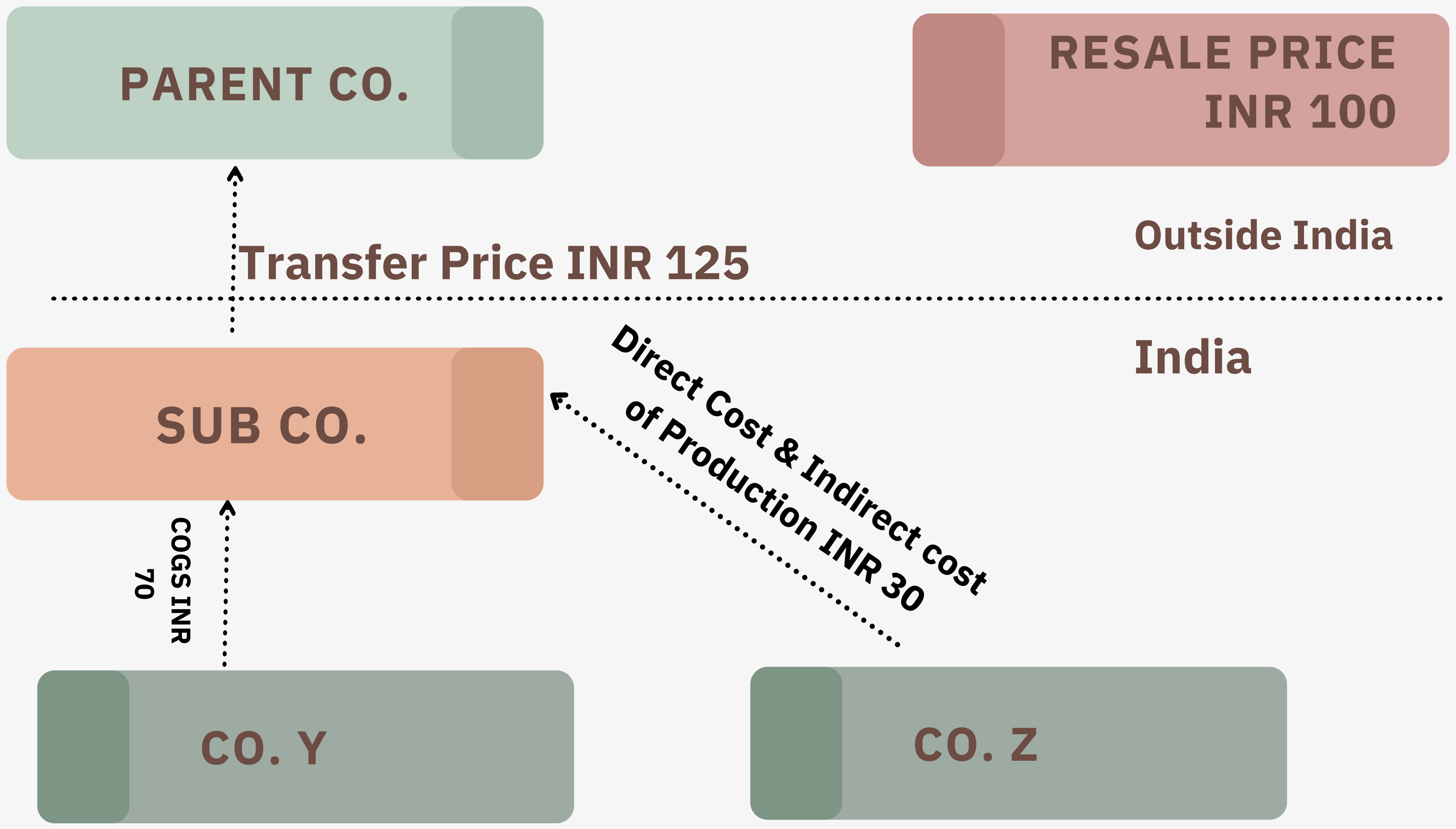
Preferred method in case-

-Semi-finished goods sold between related parties
-Contract manufacturingagreement
-Provisions of services on contractbasis

To be applied in cases involving manufacture, assembly or production of tangible products or services that aresold /provided to AEs

Comparability under this method is relatively not as muchdependent on close physical similarity between theproducts

Larger emphasis on functional comparability



Price charged by Sub co to AE is at arm's length if the 25% mark upon cost is more than that of similar Indian assemblers

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Transactional Net Margin Method

Most frequently used method, due to lack of availability of data for application of other methods

Examines net operating profit from transactions as a percentage of a certain base (can use different bases i.e. costs, turnover, etc.)

Both internal TNMM and external TNMM are possible.

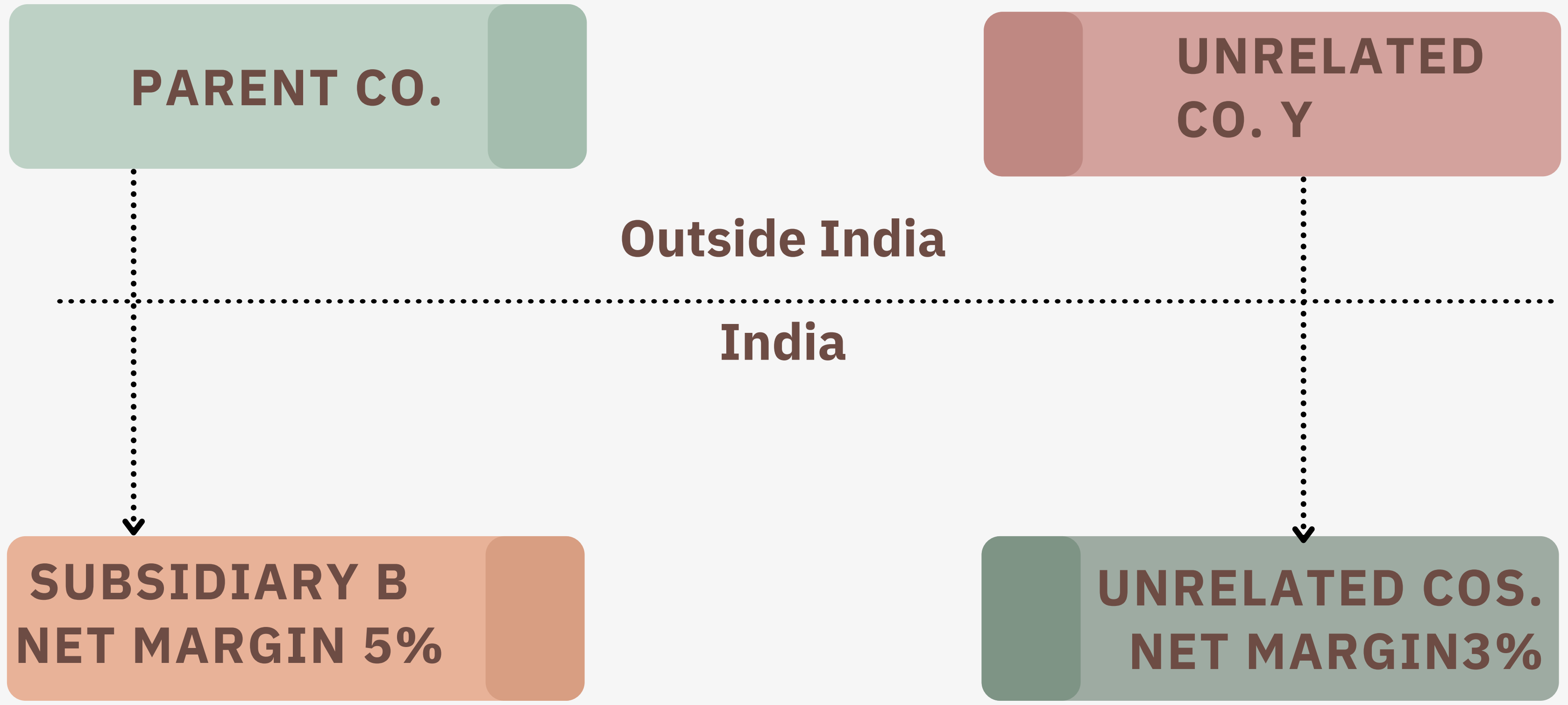
Broad level of product comparability and high level of functional comparability.

Applicable for most categories of transaction and often used to supplement analysis under other methods

Difficult to apply where goods are further processed before resale

Grouping of transaction -Relevant controlled transactions require to be aggregated to test whether the controlled transaction earn a reasonable margin as compared to uncontrolled transaction.

Usually regarded as an indirect and one-sided method, but is most widely adopted.



Transactional Net Margin Method

- Calculates the combined operating profit resulting from an inter-company transaction based on the relative value of each AEs contribution to the operating profit

- To be applied in cases involving-

-transfer of unique intangibles; or
-in multiple international transactions that cannot be evaluated separately

Other Method

- CBDT has notified the “Other method” vide a Notification
- Applicable from FY 2011-12:
- 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-associated enterprises, under similar circumstances, considering all the relevant facts."*
- Effectively this implies that “quotations” rather than “actual prices” charged or paid can also be used
- To maintain proper documentation specifying the rejection reasons for non-application of other five methods and appropriateness of the “other method”
- Other Method can be used for following transactions:

-*Valuation of shares*
-*Reimbursements*

Selection of Profit Level Indicator (PLI)

Selection of appropriate PLI depends upon:

- Nature of the activities of the tested party,
- The reliability of the available data with respect to comparable uncontrolled taxpayers,and
- The extent to which a particular profit level indicator is likely to produce a reasonable determination of the
- income that the tested party would have earned had it dealt with the controlled taxpayer at arm’s length

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

PLI	Remarks
Gross Profit Sales	Appropriate for trading activity
Net Profit/ Operating Costs	Appropriate for intending activity
Net Profit/ Operating Costs	Appropriate for capital intensive industry

Other PLIs can also be used based on facts and circumstances of the case as follows:

PLI	Remarks
Cash Profit Ratio	New Business with Heavy Investment
Return on Capital Employed	Capital Intensive Business
Return on Shareholders Fund	Highly Geared Companies
Revenue per Employee	Human Capital Based Business
Berry Ratio	Used in conjunction with other ratios for validations

The choice of the PLI is important, considering the peculiarities of the industry and the transactions involved.
During TP audits, very rarely, balance sheet ratios such as return on operating assets, were accepted and normally the analysis was carried out applying operating margin ratio as the PLI.

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Search Process

Step 1

Identification of companies engaged in activities that are potentially comparable to the activities of tested party

Step 2

Quantitative analysis – application offilters
Below are some of the primary quantitative filters applied during the search process:
–Data availabilityfilter
–Turnover filter
–Net worth filter
–Trading / Manufacturing / Service Income to total Income filter
–Related party transaction filter

Step 3

Qualitative analysis - analysis of the information contained in the databases and/or annual reports

Step 4

Final validation of the potential comparable companies through additional research and a close scrutiny of the other sources of publicly available information (e.g. through internet-basedresearch).

Step 5

Selection of PLI

Step 6

Margin of the comparable – range/weighted average

Step 7

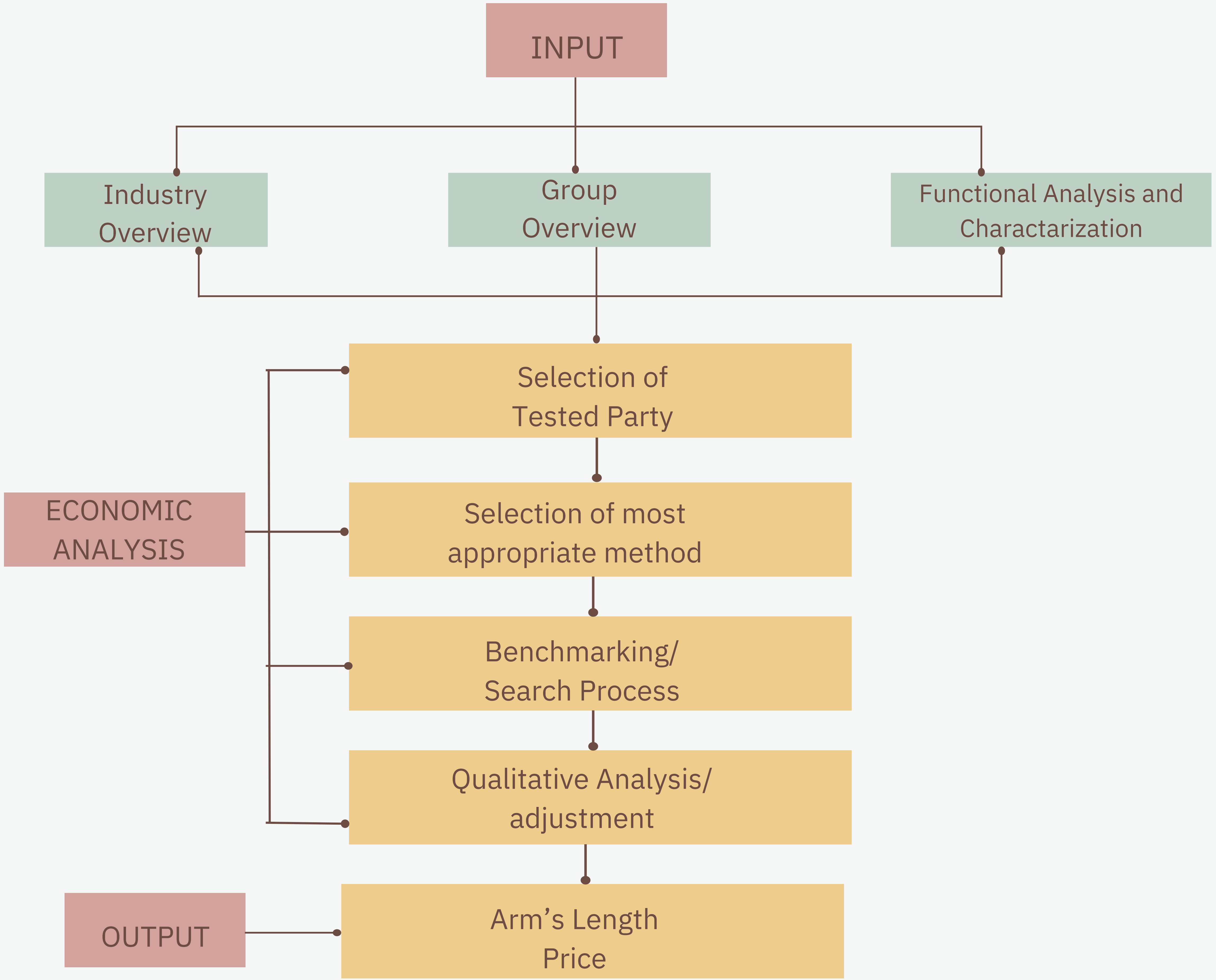
Margin of Comparable v/s tested party

Appendices

At the end of the TP report, following could be annexed as Appendices

- Abbreviations
- Indian TP regulations
- Details of international transactions
- Details of Databases used, if any
- Business Description of comparable companies
- Segmented Financial Information, if applicable
- Application of the provisions to Section 92C(2) of the Act, if applicable

Summary of entire TP Study



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About Taxpert Global Solutions

Taxpert Global Solutions is a conglomeration of multi-diverged professionals known for providing concentrated services in relation to compliance, business & regulatory structuring with respect to International Transaction. We believe in the creation of value through advising and assisting the business. The pool of professionals from different spectrum like tax, legal, costing, management facilitate the conversion of knowledge into beneficial transaction.

We offer solutions, which are backed by a broad vision and a thorough research. Our solutions are delivered to provide the highest quality of service to our clients, by listening sharply, analysing, understanding, responding promptly and living up to the commitments that we make.

We assist the business with their corporate and regulatory compliances, complex taxation issues, enhancing profitability and efficiency and corporate restructuring. Global Solutions has a team of high-calibre, dedicated and experienced professionals maintaining our hallmark of adding value with quality and commitment.

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Thank You

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