

Virtual CPE Meeting on Transfer Pricing ICAI

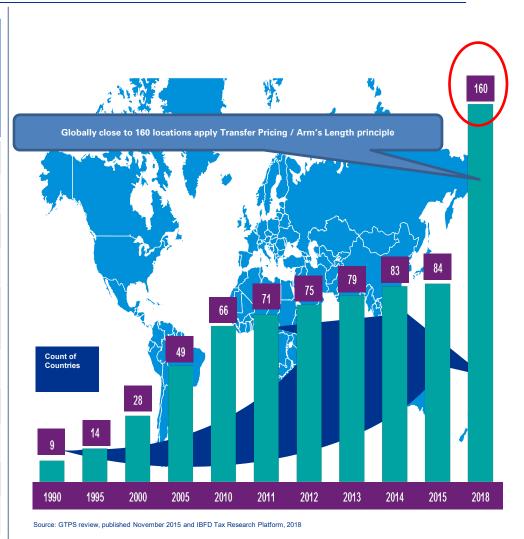
CA. Rishi Harlalka September 2021

Global Outreach of Transfer Pricing

- Transfer pricing is emerging as a significant largest tax risk globally
- Tax evasion through TP is largely invisible to the public and difficult and expensive for tax officers to detect.
- 80+ countries have adopted fullfledged transfer pricing regimes.
- Tax authorities in the ASPAC region are extremely active in transfer pricing.
- The global base of knowledge and experience is ever expanding (including the collection of relevant taxpayer information).
- India, Australia, China, Korea and Japan have all seen an increase in audit activity with indications of further stepping up of compliance and field work activity.

Toughest Tax-TP **Authorities Globally** China Brazil Turkey India United States Japan Australia Malaysia Korea

Vietnam





Functional Assets and Risk ('FAR') Analysis-Backdrop

Mapping of economically relevant facts and characteristics of inter-company transactions with regard to their Functions, Assets and Risks

Involves careful **analysis of functions performed** by **each** of the transacting entity, assets employed and risks assumed by them

An **essential element** of any transfer pricing study

Analysis allows a full **understanding of the economic value-added activity** carried out by each entity and their characterization

This understanding then allows one **to judge**:

- Comparability
- Economic rationale of the transaction with related parties

Relevant provisions /guidance on FAR analysis

Income-tax Act, 1961

- Section 92C(1) of the Income Tax Act, 1961 read with Rule 10B(2) and Rule 10C(2) of the Income Tax Rules, 1962, requires comparability of FAR analysis to determine ALP.
- Rule 10D(1)(e) requires FAR analysis to be a part of statutory TP documentation

OECD TP Guidelines

 Para D.1.2 provides for the TP documentation to be based on a detailed functional analysis [Chapter 1 of the OECDTP Guidelines]

UN Manual on TP

 Para B.2.3.1 - Understanding the Economically Significant Characteristics of the Industry, Business and Controlled Transactions provides for a detailed discussion on the FAR analysis, including a detailed FAR checklist [Part 3 of Appendix 1 to the UNTP Manual]

ICAI Guidance Note

 Para 7.33 of the Guidance Note describes the FAR analysis stipulated under Rule 10D(1)(e) as part of TP documentation.

General Principles to Conduct FAR (Step-Wise Analysis)

Step 1
Activities
Undertaken

- Understand full process flow
- Identify and analyze the key functions performed by parties from
 Top level to Operating Level
- Key Performance Indicator (KPI), Significant People function

Step 2
Financial Attributes
/Assets Employed

- Assets mapping with functions performed
- Reference to Tangible assets and Intangible assets employed
- Analyze special financial attributes in the financial statements
- Understanding MIS Reporting, TP Policy

Step 3
Risk Assumed

- Contractual Relationship, Key Entrepreneurial Risk
- Industry Specific Risk- to be identified
- Business risks such as Currency Risk, Capacity Risk & Market Risk
- Consistency of risks assumed with the functions performed

Broad framework of FAR components

Functions performed

- Core business functions (manufacturing, trading, IP generation)
- Management functions (strategic decision making, critical business decisions)
- Business support and non core functions (day-to-day operational decisions)

Assets employed

- Tangible assets (Relevant for asset intensive operations)
- Intangible assets (distinguish between routine and non-routine IP)

Risks assumed

- Significant business risks (IP development, market risks etc.)
- Transactions risks (Fx risk, credit risk, employee attrition etc.)
- Specific market risk (regulatory risk, country specific risk etc.)

Other Related Parameters

Modes of collecting information:

- FAR interviews and discussions with the functional personnel of taxpayer
- Relevant agreements / contracts with Group entities

Other background information that supports the FAR analysis :

- Commercial rationale / pertinent facts surrounding the international transaction most important in special cases like losses, start-ups, market penetration, etc.
- Internal comparables (if any), external comparables / competitors of the taxpayer in the
 - market
- Pricing policy of the taxpayer or its international group
- Facts gathered should be documented clearly and unambiguously
- Financial overview of the existing international transactions

Other important considerations

- Consistency between
 - FAR analysis,
 - Actual conduct of parties,
 - Contractual obligation; and
 - capacity of the parties
- Evaluate economic significance of the function
- Evaluate and document risk that are economically relevant and significant

Typical business models

Manufacturer

- Toll Manufacturer
- Contract Manufacturer
- Licensed Manufacturer
- Full fledged Manufacturer

Distributor

- Low Risk Distributor
- Normal Distributor

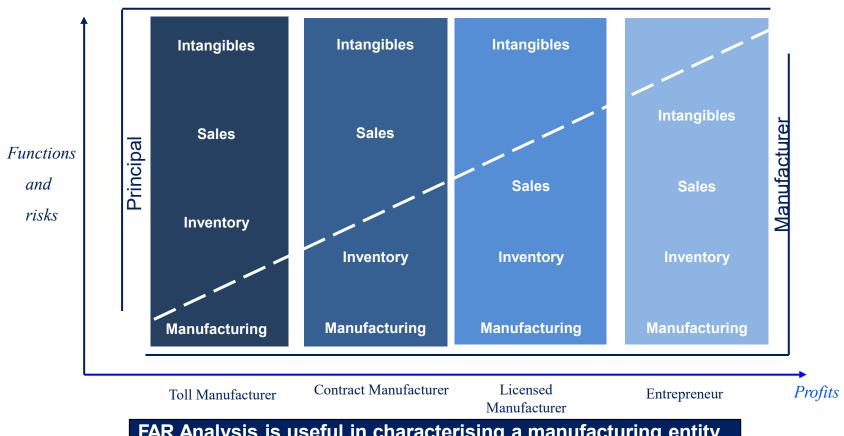
Service Provider

- Captive Service Provider
- Limited Risk Service Provider
- Entrepreneur Service Provider



How does the FAR assist in Characterization?

Possible variations for entity characterization in the manufacturing sector



FAR Analysis is useful in characterising a manufacturing entity

FAR Analysis - Case Study

Continued...

Provision of non-binding investment advisory services

A. Functions Performed

i. Functions performed by ABC India

ABC India is engaged in rendering non-binding investment advisory services to its AE primarily with respect to the Indian market. ABC India performs the following functions for providing the non-binding investment advisory services to AE:

a. Identification of potential acquisition targets

<<Brief description of the activity>>

b. Analyzing and evaluating prospective investment opportunities, acquisitions and divestments

<<Brief description of the activity>>

c. Non-Binding recommendations to AE

<<Brief description of the activity>>

d. Providing advice relating to the divestment of investments

<<Brief description of the activity>>

e. Monitoring of completed investments

<< Brief description of the activity>>

FAR Analysis - Case Study

Continued...

ii. Functions performed by Associated Enterprise

ABC India provides non-binding investment advisory services to its AE, which uses the advice to either manage the investment funds or provide recommendations to asset management companies located outside India. The broad functions performed by the AE are as follows:

- a. Identification of Investment Opportunities
 - <<Brief description of the activity>>
- b. Opportunity Analysis

<<Brief description of the activity>>

- c. Investment Decision Process
 - <<Brief description of the activity>>
- d. Monitoring of Investments

<<Brief description of the activity>>

- e. Exit Strategy
 - <<Brief description of the activity>>

FAR Analysis - Case Stud

Continued...

B. Assets Employed

ABC India is a limited risk service provider and does not employ any non-routine intangible assets. ABC India employs routine tangible assets required to discharge its services to its associated enterprise.

C. Risks Assumed

A summary of risks assumed by ABC India is as provided below:

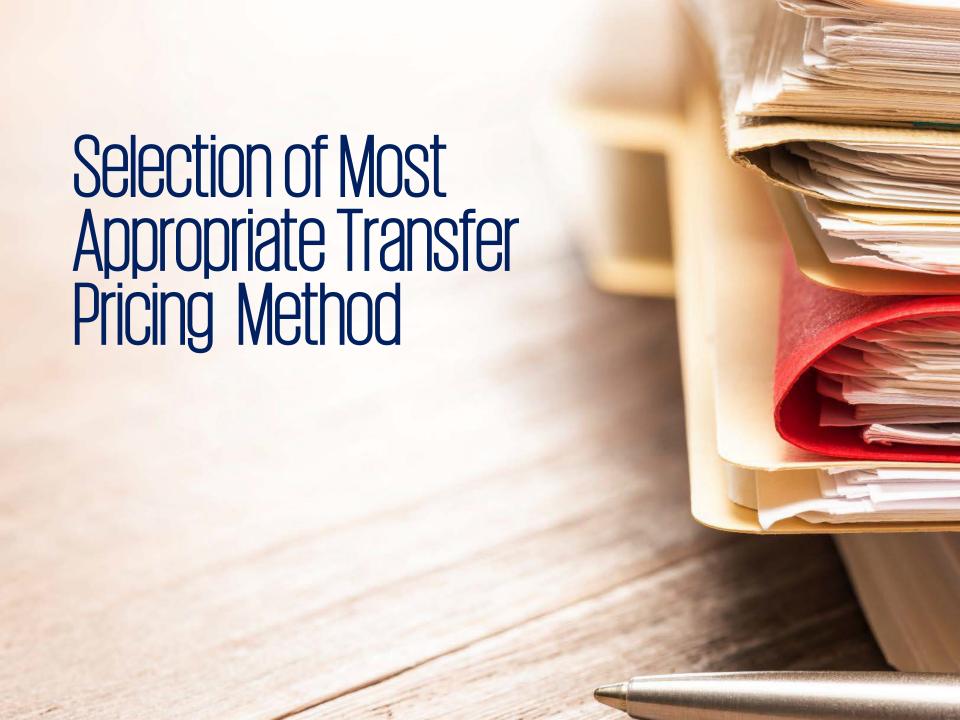
Sr. No.	Risk Category of description	Exposure of ABC India	Exposure of AE
1	Market Risk Market risk arises for a business due to increased competition and relative pricing pressures, change in demand patterns and needs of customers, inability to develop / penetrate in a market, etc.	plus mark-up basis, irrespective of the gains earned or losses incurred	market risk as there may be situations where it is not able to convert the investment opportunities
2	Credit Risk Credit risk arises from non-payment of amounts due from customers. This risk also relates to managing receivables and the performance of the credit checks on customers.	ABC India provides services only to the AE and it is compensated on a costplus mark-up basis and hence, does not bear any credit risk.	risk

FAR Analysis - Case Study

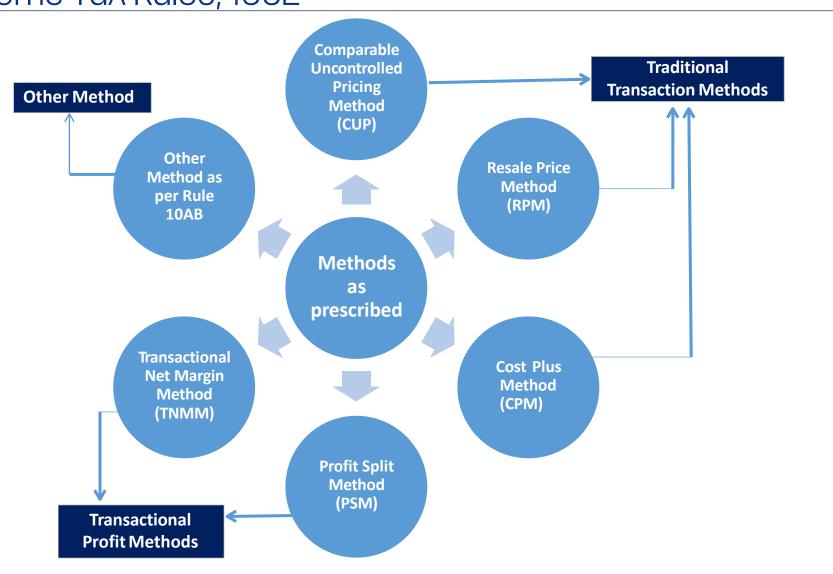
Sr. No.	Risk Category of description	Exposure of ABC India	Exposure of AE
3	Foreign Exchange Risk This risk relates to the potential impact on profits that may arise because of changes in foreign exchange rates.	from its AE, hence, ABC India	fluctuation risk is borne by the AF.
4	Manpower risk Any enterprise which is largely dependent, for its success, upon quality personnel with superior technical knowledge is faced with this risk. Competitive market forces expose such an enterprise to the risk of losing its trained personnel	ABC India to AE entails retaining appropriately qualified staff having the requisite analytical skill sets. Thus, ABC India assumes manpower risk.	The AE also bears limited manpower risk.
5	Loss on investment risk This is the risk of diminution in the value of investments.	Since ABC India will not invest its own funds but only provide non-binding recommendation on investments to its AE, it will not bear any risk of loss on investments. Hence, ABC India does not bear investment risk.	of

Entity Characterization:

• Based on the above analysis, ABC India can be categorized as a Limited Risk Service Provider



Transfer Pricing Methods as per Rule 10B and Rule 10AB of Income Tax Rules, 1962



Most Appropriate Method (MAM)

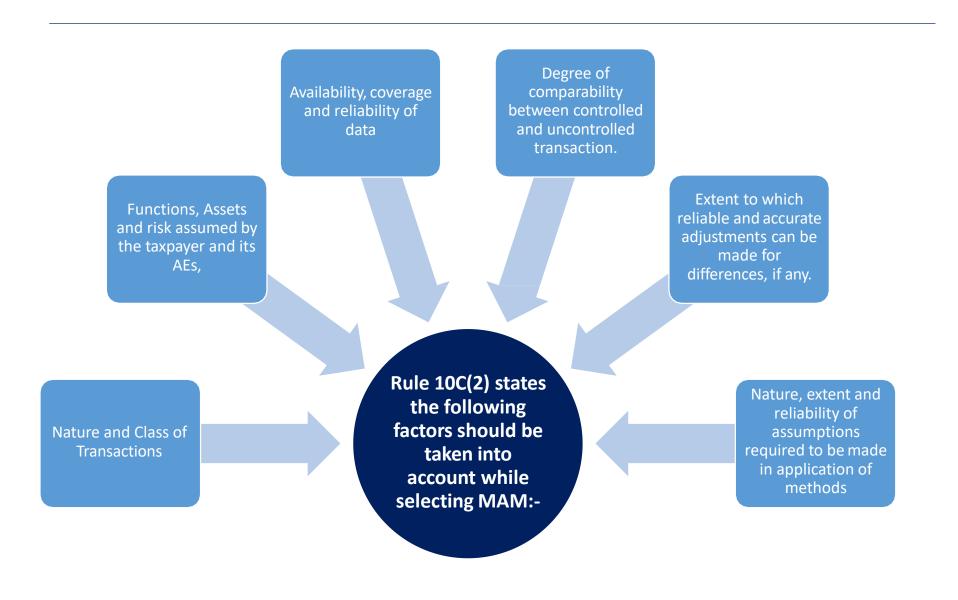
Rules 10C(1) of Income Tax Rules requires two primary conditions for selection of MAM.

It should be best suited on the facts and circumstances of the each particular international transaction / SDT; and

The method should provide the most reliable measure of an arm's length price in relation to the international transaction / SDT

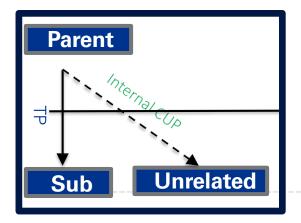
Indian transfer pricing regulations do not prescribe a hierarchy of methods for determining ALP.

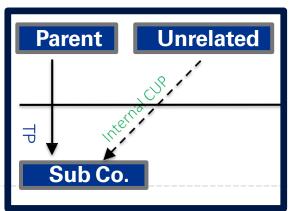
Most Appropriate Method (MAM)

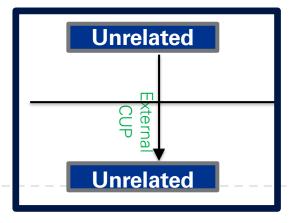


Comparable Uncontrolled Price Method

- Most Direct Method
- > Prices are benchmarked without any reference to the profits
- Requires strict comparability in products, contractual terms, economic terms, etc.
 - Volume/ quantity of product
 - Credit terms
 - Geographic market
 - Other terms of contract
- > Two types of CUPs available Internal CUP & External CUP
- > Typically Internal CUP is preferred over External CUP due to higher degree of comparability

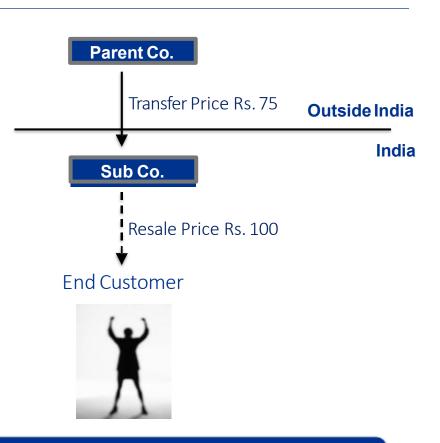






Resale Price Method

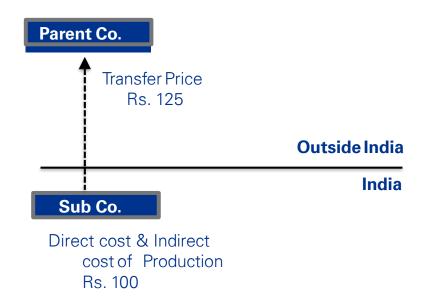
- Compares resale <u>Gross Margin</u>
- Preferred method for a distributor buying purely finished goods from a group company
- ➤ Comparability is relatively less dependent on strict product comparability and additional emphasis is on similarity of functions performed & risks assumed
- ➤ Used when reseller does not add substantial value to the goods and does not apply intangible assets to add value
- Difficult to apply where goods are further processed before resale



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

Cost Plus Method

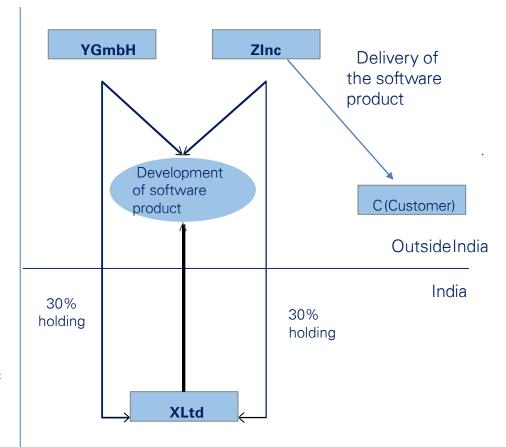
- ➤ Compares and identifies mark-up earned on direct and indirect costs of production incurred with that of comparable independent companies
- > Preferred method in case-
 - Semi-finished goods sold between related parties
 - Contract manufacturing agreement
- ➤ To be applied in cases involving manufacture, assembly or production of tangible products or services that are sold/ provided to AEs
- Comparability under this method is relatively not as much dependent on close physical similarity between the products.
- > Larger emphasis on functional comparability



Price charged by Sub Co. to AE is at arm's length if the 25% mark-up on cost is more than that of similar Indian assemblers

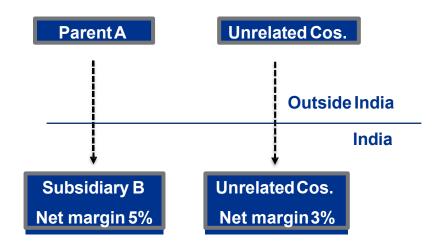
Profit Split Method

- To be applied in cases involving-
 - transfer of unique intangibles; or
 - in multiple international transactions that cannot be evaluated separately
- ➤ Calculates the combined operating profit resulting from an inter-company transaction based on the relative value of each AEs contribution to the operating profit
- Evaluates allocation of combined profit/loss in controlled integrated transactions
- The contribution made by each party is based upon a functional analysis and valued, if possible, using external comparable data
- Applicable for analyzing tangible, intangible or services issues



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



Transactional Net Margin Method

- ➤ Grouping of transaction Relevant controlled transactions require to be aggregated to testwhether the controlled transaction earn a reasonable margin as compared to uncontrolled transaction
- Selection of tested party Least complex entity
- Selection of Profit Level Indicator such as OperatingMargin, Return on Value added expenses, Return on assets Unaffected by transfer price
- Benchmarking exercise (on Databases)
 - Entity with similar industry classification to the tested party through search in Prowess and Capitaline plus databases
 - Screen entities by applying appropriate quantitative filters
 - Review financial and textual information available in the public database of the selected entities – for qualitative filters
 - Computation of ALP

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

Other Method - Rule 10AB

....(1/2)

"Rule 10AB - For the purposes of clause (f) of subsection (1) of section 92C, the other method for Determination of the arms' length price in relation to an international 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."

- ➤ Operative from 1 April 2012 and applicable for Assessment Year ('AY') 2012-13
- ➤ CBDT does not provide either clarity or guidance in terms of the manner of benchmarking a transaction under this method



Applicability

- Where the application of the five specific methods is not possible due to difficulties in obtaining comparable data or due to uniqueness of transactions
- ➤ Intangibles or business transfers, transfer of unlisted shares, sale of fixed assets, revenue allocation/splitting, guarantees provided and received, etc.

Possible manner of Application of 'Other method'

- Third party quotations
- Valuation reports
- Commercial & economic models

Choice of MAM - Consideration

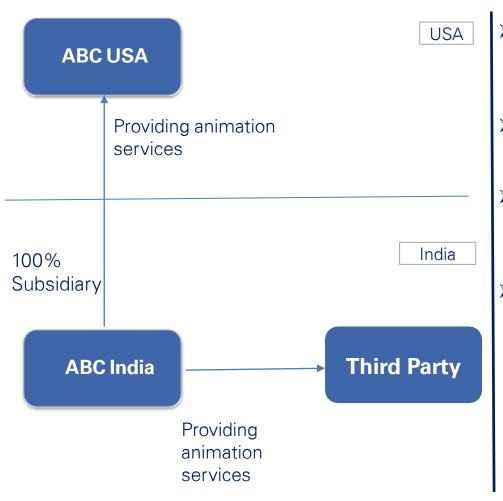
	Method	Product Comparability	Functional Comparability	Approach	Remarks
(a)	CUP	Very High	Subsumed in product	Prices are benchmarked	Very difficult to apply as very high degree of comparability required
(b)	RPM	High	High	GPM (on sales) benchmarked	Difficult to apply as high degree of comparability required
(c)	CPLM	High	High	GPM (on costs) benchmarked	Difficult to apply as high degree of comparability required
(d)	PSM	Medium	High	Profit Margins	Complex Method, sparingly used
(e)	TNMM	Medium	More tolerant	Net Profit Margins	Most commonly used Method
(f)	Other	High	High	Price	Generally used in absence of comparable transaction

Summary of Methods

Profit & Loss Account— used as a base

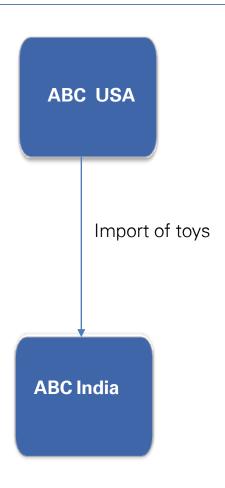
Particulars	Amount (In INR)	Comparable	Incontrolled
Manufacturing Income	XXX	Price	Method
Trading Income	XXX		nounou
Total Income	xxx	Gross Profit	
Purchase of raw material	XXX	Resale Price	Cost Plus
Purchase of finished goods	XXX	Method	Method
Change in Stock	XXX		
Personnel Cost	XXX	Net	
Selling & Distribution Expenses	XXX	Profit	
Administrative Expenses	XXX		Profit Split
Finance Cost	xxx	TNM Method	Method
Depreciation	XXX		
Total Expenses	XXX		
Profits	XXX		
Taxes	XXX		





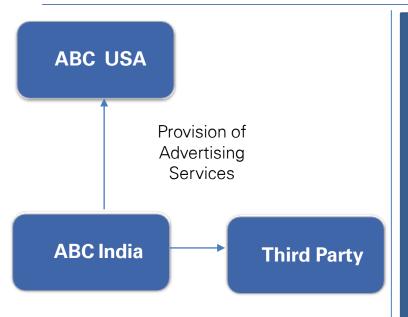
- ➤ ABC India is engaged in providing visual animation services to ABC USA and third party
- ➤ ABC India charged on Man days basis to AE and third party
- ➤ There is no third parties in the Current year but was prevalent in the previous year
- ➤ ABC India incurred losses in the current year.

Can CUP be adopted as the Most Appropriate Method?



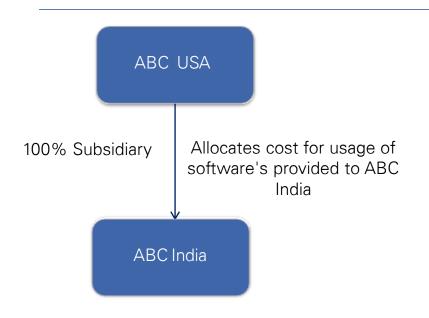
- > ABC USA is engaged in manufacturing of toys
- ➤ ABC India is engaged in importing toys from ABC USA and distributing the same in India market
- > ABC India incurs marketing and administrative cost for selling toys in India
- > ABC India is incurring losses at Net levels as represented below

ABC India financials			
Particulars	Amount INR		
Sales	200		
COGS	150		
Gross profit	50		
Salary and administrative expenses	20		
Marketing expenses	30		
Other expenses	15		
Net loss	- 15		



- ➤ ABC India provides advertising services to its AE viz: ABC USA
- ABC India and ABC USA both are entrepreneurial entity
- ➤ ABC India engages in following types of contracts while rendering advertising services to ABC USA and third parties :
 - Fixed fee (Project based billing)
 - Retainer Fee project
 - Per hour based projects

...continued



Software cost allocation by AE			
List of Software's	Basis of allocation	Quantity	Per unit Cost allocated
А	No. of License	10	100
В	No. of User	20	150
С	No. of Installation	40	50

- ➤ ABC India receives software from ABC USA which helps in day to day operations.
- ABC USA charges ABC India on cost to cost basis.
- ABC USA claims that since it procures these software from third party for all the group entities it is able to negotiate well and achieve economies of scale in terms of better pricing from third party.

Considering the facts above. How can we benchmark the cost allocated for the software by the ABC USA?

ABC India can procure quotation for the software provided by ABC USA from third party in India.

The quotation from third parties received can be compared with prices charged by the AE for justification of arm's length price

Since the quotation received from third parties are higher as compared to prices charged by AE it can be concluded that cost allocated by ABC USA is at arms length

Quotation of Software's from Third Party				
List of Software's	Basis of quotation	Quantity	Cost per unit	
А	No. of License	10	120	
В	No. of User	20	180	
С	No. of Installation	40	90	

However, it is important to note that need – benefit test demonstrating the need of the software's provided by ABC USA and benefits received by using the software

Questions?

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