B S R & Co.

Transfer Pricing

Institute of Cost & Works Accountants of India

30 April 2009

Aravind Srivatsan
A Pradeep
Abhishek Jain

What we would discuss today…

- Introduction to Transfer Pricing
- Overview of Transfer Pricing in India
- Documentation Requirement & Form 3CEB
- Transfer Pricing Process & Audit Procedure
- Industry Challenges & Recent Judicial Rulings
- Key Takeaways & Unanswered issues
- Transfer Pricing in a Recessionary Economy
- Emerging Trends

B S R & Co.

Introduction to Transfer Pricing

Introduction of Transfer Pricing Regulations

- Transfer pricing refers to the pricing of cross-border transactions between two related entities
- When two related entities enter into any cross-border transaction, the price at which they undertake their transaction is called **transfer price**
- Due to the **special relationship** between related companies, the transfer price may be different than the price that would have been agreed between the unrelated companies
- Price between unrelated parties in uncontrolled conditions is known as the **"arm's length price"**

Finance Minister's speech on the rational for introducing Transfer Pricing Regulations

"The presence of multinational enterprises in India and their *ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions* has made the issue of transfer pricing a matter of serious concern. I had set up an Expert Group in November 1999 to examine the detailed structure for transfer pricing legislation. Necessary legislative changes are being made in the Finance Bill based on these recommendations."

- Mr Yashwant Sinha
Finance Minister, Government of India
February 28, 2001

Synopsis of Indian Transfer Pricing Regulations

- Legislation introduced with effect from April 1, 2001.
- Generally in line with the OECD guidelines
- Compliance Requirements
  - Maintenance of contemporaneous documentation
  - Annual filing of Accountant's Report
- Steep Penalties
- Downward adjustment prohibited
- Arithmetic mean concept (+/- 5percent range permitted)
- No safe harbor provisions
- No provisions for Advance Pricing Agreements

End of Part I


Overview of Transfer Pricing in India

Applicability of Transfer Pricing Regulations

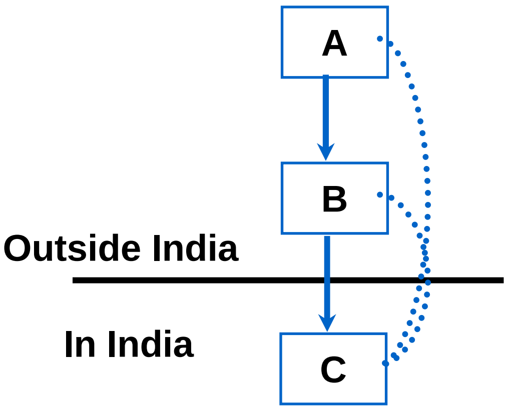
- Any **income** arising from an **international transaction** shall be computed having regard to the arm's length price
- **A price between unrelated parties is known as the "arm's length price"**
- **Transfer Pricing refers to the pricing of international transactions between two associated enterprises**

Transfer Pricing

- **International Transactions**
- **Associated Enterprise**
- **Arm's Length Price**

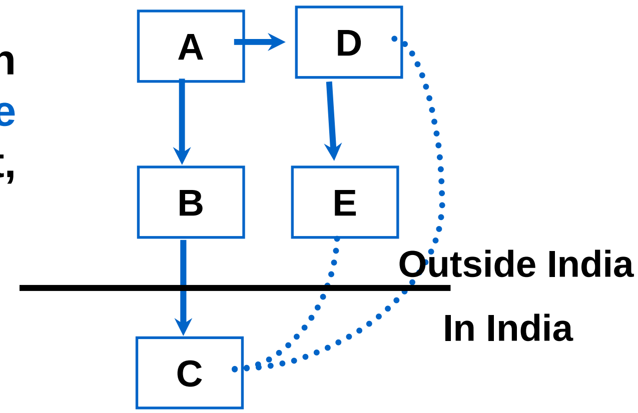
Sec 92 shall not apply in a case where the computation of income has the effect of reducing the income chargeable to tax or increasing the loss

Associated Enterprises



Both A and B are associated enterprises of C

Direct or indirect participation (through one or more intermediaries) in management, control or capital – Sec 92A(1)



D and E are also associated enterprises of C since they have a common ultimate parent (A)

The above section is further supplemented by 13 clauses which enlist various situations under which two enterprises shall be deemed to be AE's – Sec 92A(2)

Deemed Associated Enterprises

Deemed Associated Enterprises

- Loans in excess of 51% of total assets
- Power to appoint more than half of directors
- Common executive director(s)
- Existence of common control
- Guarantees in excess of 10% of total borrowings
- Complete dependence on IPRs
- Supply of raw materials (90% or more)
- Relationships of mutual interest

International Transactions

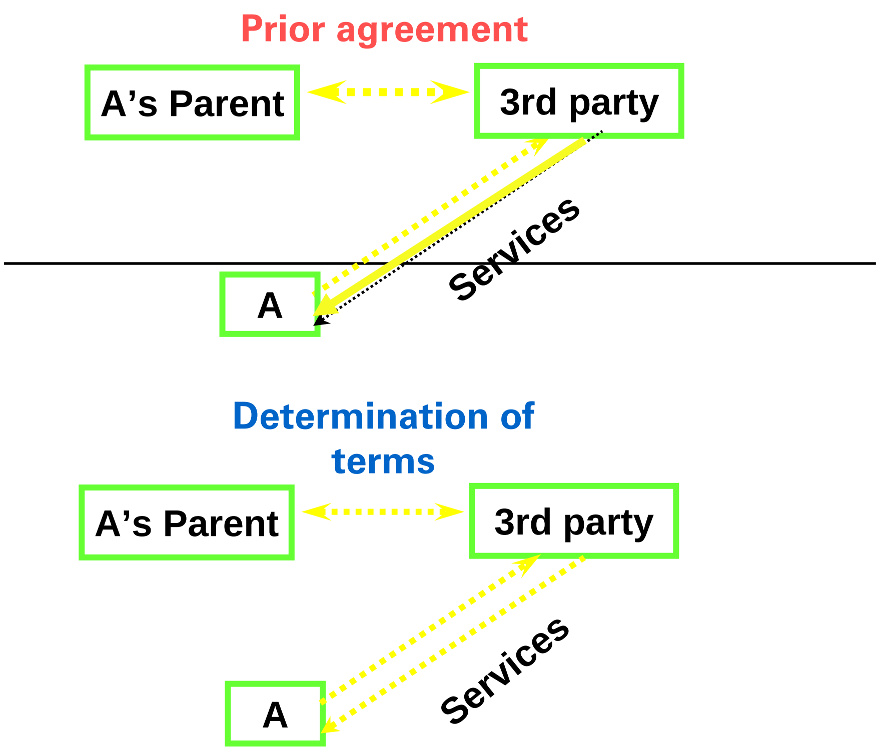
- Transactions between ***two or more*** associated enterprises
- ***Either or both of whom are non-residents***

Transaction relates to:

- purchase, sale or lease of tangible or intangible property; or
- provision of services; or
- lending or borrowing money; or
- any other transaction ***having a bearing on the profits, income, losses or assets of the enterprises***; or
- mutual agreements or arrangements for allocation or apportionment of, or any contribution to, any cost or expense incurred

Deemed International Transactions

Third parties transactions deemed to be international transaction - Sec 92B(2)

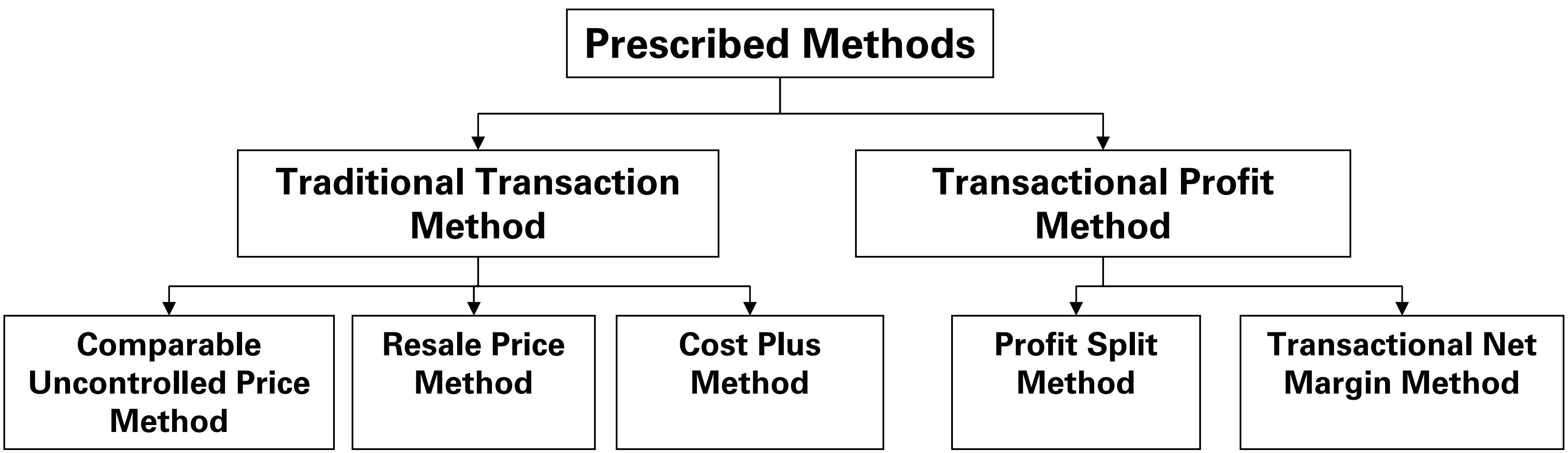


Transaction between A and 3rd party also subject to transfer pricing norms, if:

- **a prior agreement exists between A's parent and 3rd party; or**
- **terms of transaction are determined in substance by A's parent and 3rd party**

Arm's Length Price (ALP)

- **Price applied or proposed to be applied in a transaction between persons *other than associated enterprises, in uncontrolled conditions***
- **Computation of ALP –**
  - **Determination of arm's length prices using one of the Prescribed methods**
  - **In case of more than one price – ALP = Arithmetic Mean of such prices**
  - **+/- 5% variance to arm's length "price" permitted – (Safe Harbor)**



Selection of Transfer Pricing Methods

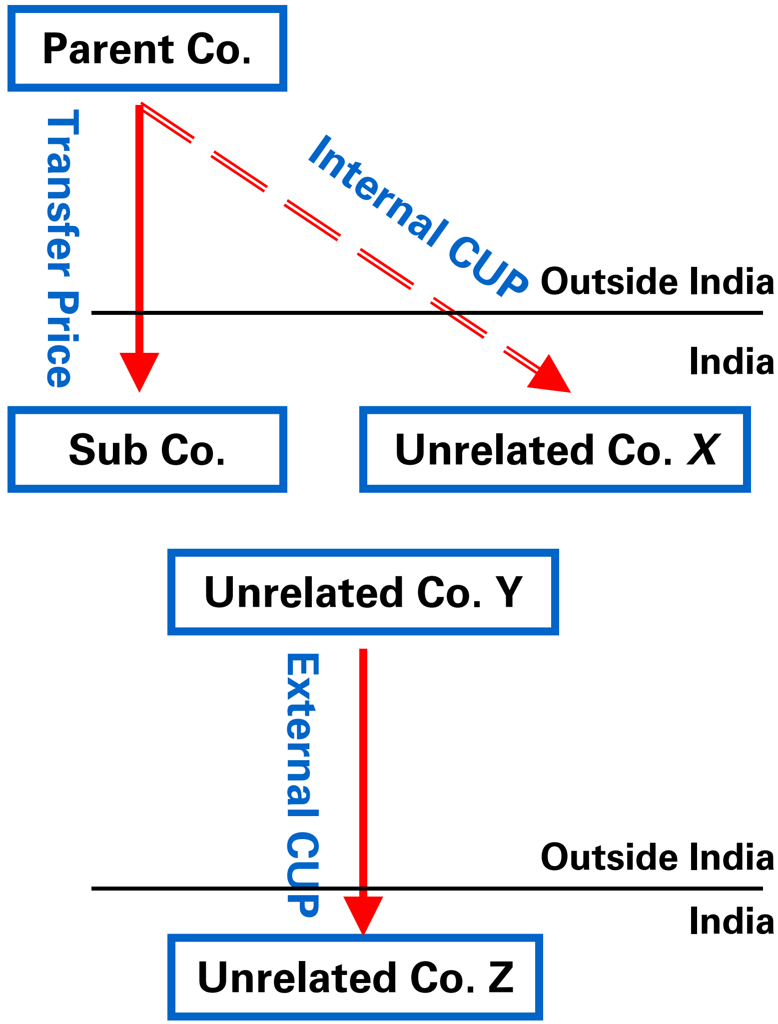
- **Most appropriate method** shall be the method best suited to the facts and circumstances of each particular international transaction and which provides the most reliable measure of an arm's length price in relation to the international transaction

- Factors considered for selection of the most appropriate method:
  - Nature and class of international transaction
  - Class of associated enterprise and functions performed
  - Availability, coverage and reliability of data
  - Degree of comparability between the International transaction
  - Extent to which reliable and accurate adjustments can be made
  - The nature, extent and reliability of assumptions for application of the method

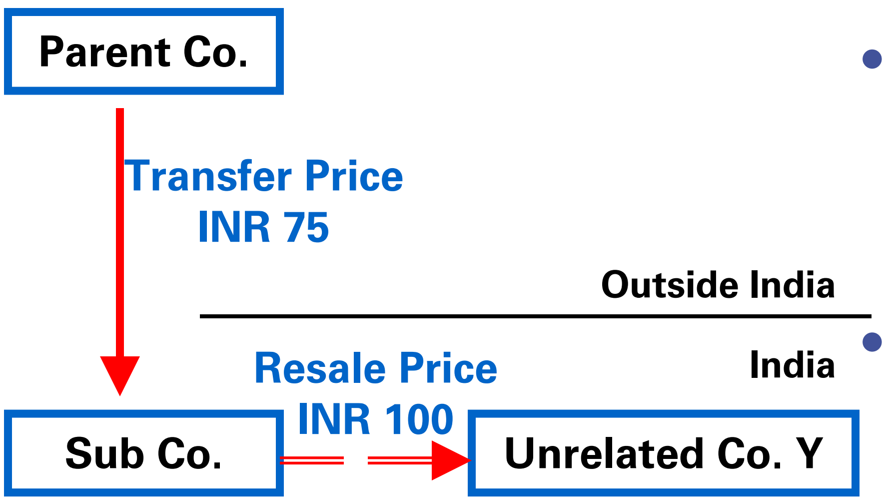
Choice of transfer pricing method
(TNMM – 72%, CUP – 19%, Others – 9%)

Comparable Uncontrolled Price Method (CUP)

- **Most Direct Method for testing ALP and the Prices are Benchmarked**
- **Requires strict comparability in products, contractual terms, economic terms, etc.**
- **Two types of CUPs available - Internal CUP & External CUP**
- **Calls for adjustments to be made for differences which could materially affect the price in the open market *e.g.*:**
  - Difference in volume/quality of product
  - Difference in credit terms
  - Risks assumed
  - Geographic market
- **OECD - Priority to Internal CUP over External CUP due to higher degree of comparability**



Resale Price Method (RPM)

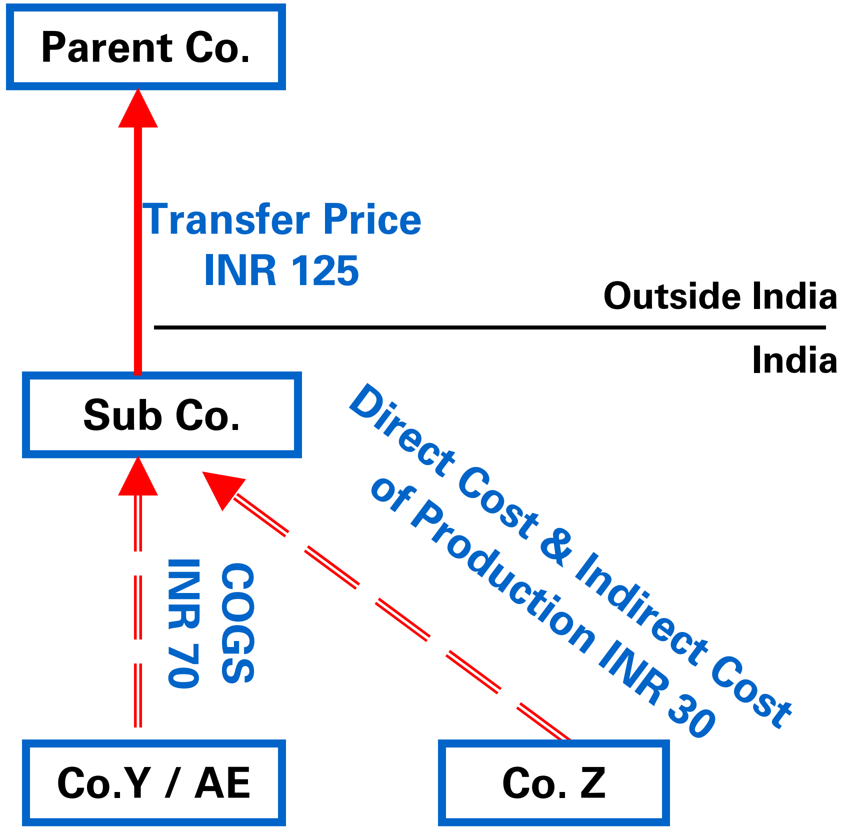


Price paid by Sub Co. to AE is at arm's length if the 25% resale margin earned by Sub Co. is more than margins earned by similar Indian distributors

- Compares the *resale gross margin* earned by associated enterprise with the resale gross margin earned by comparable independent distributors
- Preferred method for a *distributor* buying purely finished goods from a group company (if no CUP available)
- To be applied when a goods purchased or service obtained from an AE is *resold* to an unrelated enterprise.
- Under this method comparability is less dependent on strict product comparability and additional emphasis is on similarity of functions performed & risks assumed

Cost Plus Method (CPM)

- Compares the *mark up earned on direct and indirect costs incurred* with that of comparable independent companies
- Preferred method in case
  - Semi finished goods sold between related parties
  - Contract/toll manufacturing agreement
  - Long term buy/supply arrangements
- To be applied in cases *involving manufacture, assembly or production of tangible products or services that are sold/provided to AEs*
- Identifies direct and indirect costs of production of goods/services
- Comparability under this method is 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 (PSM)

- 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
- The two methods discussed by OECD Guidelines
  - Contribution PSM Analysis
  - Residual PSM Analysis

Transactional Net Margin Method (TNMM)

- Examines net operating profit from transactions as a percentage of a certain base (can use different bases i.e. costs, turnover, etc) in respect of similar parties
- Ideally, operating margin should be compared to operating margin earned by same enterprise on uncontrolled transaction – ***Internal TNMM***
- Most frequently used method in India, due to lack of availability of comparable uncontrolled prices and gross margin data required for application of the comparable uncontrolled price method / cost plus method / resale price method
- Broad level of product comparability and high level of functional comparability
- ***Applicable for any type of transaction*** and often used to supplement analysis under other methods
- The application of the TNMM to a specific tested party breaks down when factors other than transfer prices have a material impact upon profits

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

Steps involved in application of TNMM

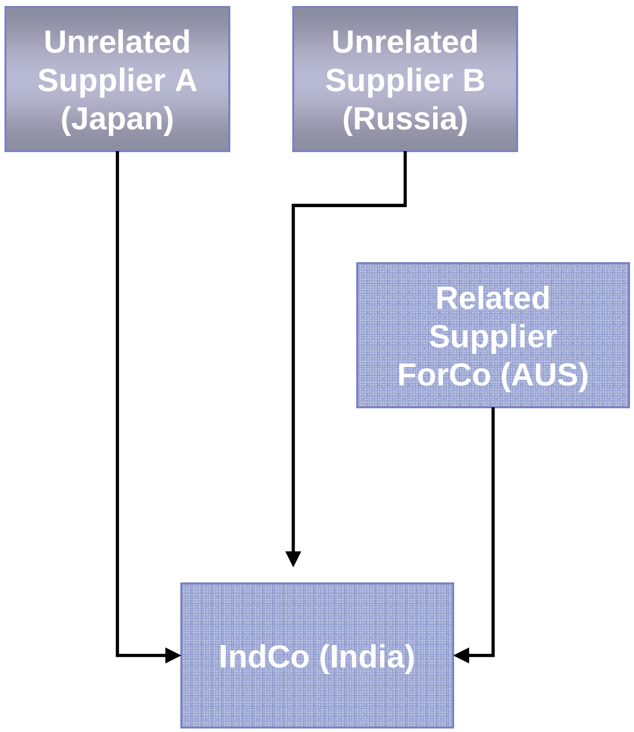
- **Grouping of transaction -** Relevant controlled transactions require to be ***aggregated*** to test whether the controlled transaction earn a ***reasonable margin*** as compared to uncontrolled transaction
- **Selection of tested party -** Least complex entity
- **Selection of Profit Level Indicator** such as Operating Margin, Return on Value added expenses, Return on assets – Unaffected by the transfer price
- **Benchmarking exercise**
  - Entity with similar industry classification to the tested party – thru search in Prowess and Capitalineplus databases
  - Screen entities by applying appropriate quantitative filters, such as mfg sales >75%, R&D exp >5%, Advertisement exp >5%.
  - Review financial and textual information available in the public database of the selected entities – for qualitative filters
- **Computation of ALP**
  - Usage of single year data / multiple year data
  - Computation of arithmetic mean

Summary of Methods

Methods	Product Comparability	Functional Comparability	Approach	Remarks
CUP	Very High	Medium	Prices are benchmarked	Very difficult to apply as very high degree of comparability required
RPM	High	Medium	GPM *(on sales)* benchmarked	Difficult to apply as high degree of comparability required
CPLM	High	High	GPM *(on costs)* benchmarked	Difficult to apply as high degree of comparability required
PSM	Medium	Very High	Profit Margins	Complex Method, sparingly used
TNMM	Medium	Very High	Net Profit Margins	Most commonly used Method

Case Study I - Application of CUP Method
Facts

- **An Indian company ('IndCo'), mainly engaged in the refining and sale of copper metal**
- **IndCo purchases crude metal from both related and unrelated parties**
- **Critical factors that affect the crude copper price are –**
  - Volume;
  - Tenure of supply contract (long terms, short-term)
  - Alloy mix of product (copper crude come with or without small quantities of other metal alloys like gold and silver)
  - Other terms of contracts (FOB vs CIF, port of shipment etc.)

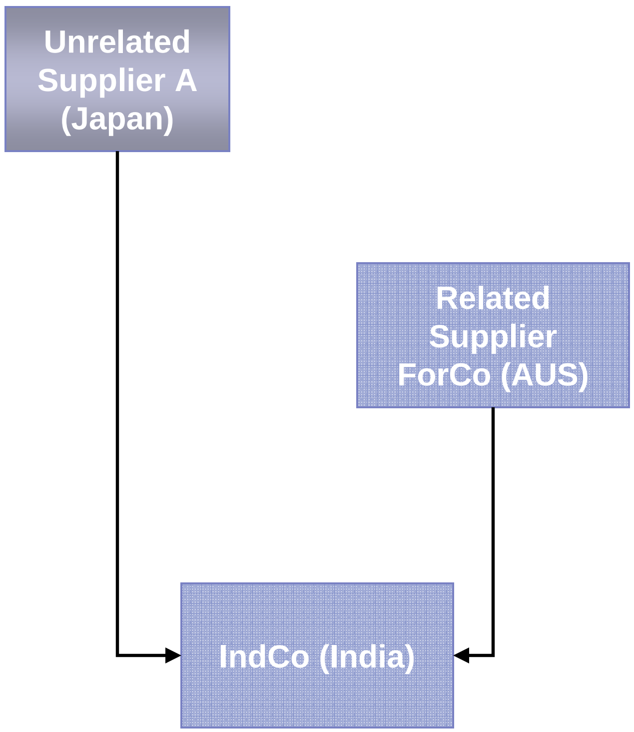


Case Study I - Application of CUP Method
Comparison of Various CUPs

Criteria	Related Party ForCo (Australia) *Controlled*	Unrelated Party A (Japan) *Uncontrolled*	Unrelated Party B (Russia) *Uncontrolled*
Tenure of Contract	**Long Term (10 yrs)**	**Long Term (8 yrs)**	**Short Term (2 yrs)**
Volume during year under consideration	**2200 MT**	**3000 MT**	**9000 MT**
Alloy Mix	**0.5% Gold, 1% silver**	**1% Gold, 1% silver**	**None**
Port of shipment	**Australia**	**Japan**	**Russia**
Price **(per MT)**	INR 29,500 **(applicable for entire year)**	INR 32,000 **(applicable for entire year)**	INR 28,500 **(applicable for entire year)**
Other Terms	**FOB basis**	**CIF basis**	**FOB basis**

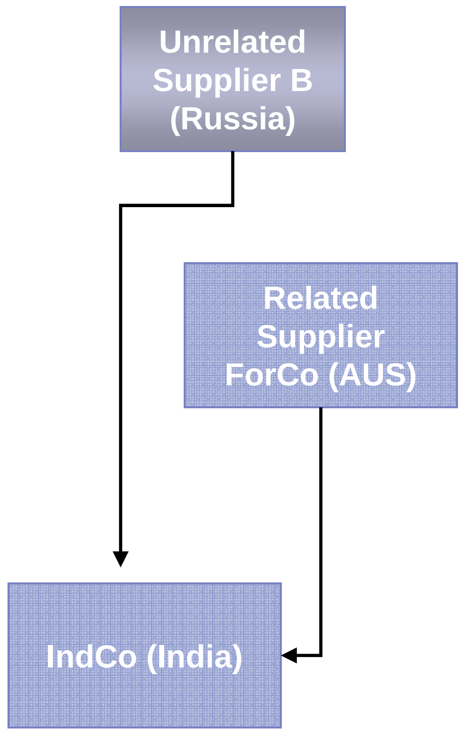
Case Study I - Application of CUP Method
Applicability of CUP – Unrelated Supplier A

- **The controlled and uncontrolled arrangements are comparable except in following areas**
  - Different alloy mix: Supplier A's copper crude contains a higher mix of gold, making the product more expensive
  - Difference in terms of supply: Supplier A sells on CIF basis, whereas ForCo sells on FOB basis.
- **Other differences, including the difference in volume and the term of contracts (10 yrs vs 8 yrs) is not expected to influence the prices**



Case Study I - Application of CUP Method
Applicability of CUP – Unrelated Supplier B

- **The controlled and uncontrolled arrangements have following differences**
  - <u>Difference in volume</u>: the difference in volume purchased from ForCo and from Supplier B is significant (2200 MT and 9000 MT)
  - <u>Different alloy mix</u>: Supplier B's copper crude does not contain any gold or silver
  - <u>Different port of shipments</u>: Russia vs. Australia



Case Study I - Application of CUP Method
Conclusion

- **Best Method: given the availability of required data, CUP is the most appropriate method**
- **Rejection of CUP related to Supplier B: the significant difference in volume render the Supplier B transactions unreliable as suitable adjustments cannot be made to account for the difference**
- **Acceptance of CUP related to Supplier A: the uncontrolled transaction with Supplier A is comparable with the controlled transactions with ForCo. Although, certain adjustments need to be made**
- **Adjustments**
  - ***Difference in pricing basis (FOB vs CIF)*** – add freight and insurance cost to ForCo transaction
  - ***Difference in alloy mix*** – adjust Supplier A's price to exclude price for higher content of gold

Case Study II - Application of the TNMM
Facts

- Indian Auto Manufacturer
  - Full fledged manufacturer
  - R&D and IP with overseas parent
- Limited international transaction - ***Import of clutch assembly***
- Financial Data of Indian entity:
  - Revenues from end customers = INR 100
  - Other operating costs = INR 13

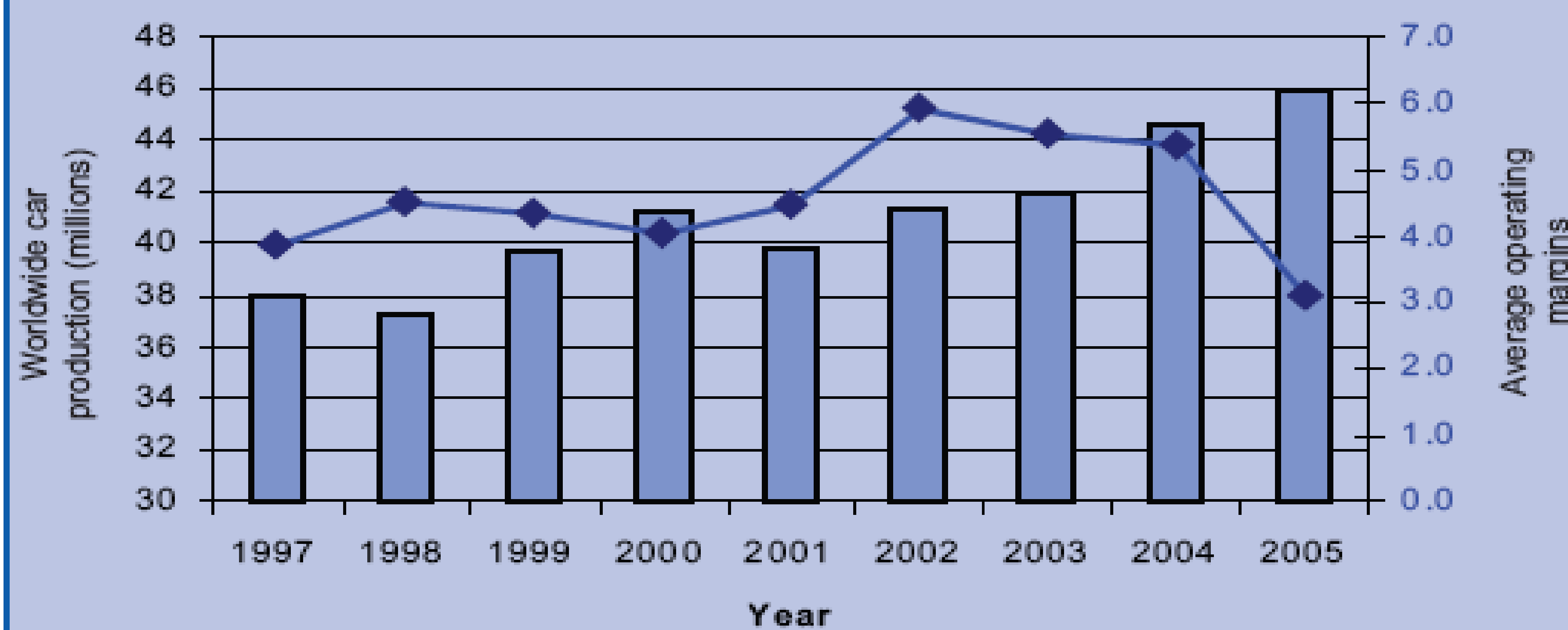
Case Study II - Application of the TNMM

Analysis

- **<u>Most Appropriate Method</u>: given the availability of required data, the TNMM is the best method**
- **While applying the TNMM method, due consideration must be given to the following -**
  - Industry characteristics
  - FAR analysis
  - Differences if any for which adjustments need to be made
- **Industry Characteristics**
  - Overcapacity
  - Capital Intensive - Plant & Machinery, R&D
  - Pressure on Innovation / Product Launches
  - Global scale v/s local requirements
  - Extreme Volume and Price risks
  - Complex supply chains

Case Study II - Application of the TNMM
Industry Analysis

Diagram 1: Decline of top 10 manufacturers' margins and rise of global production



Source: Bloomberg DTI auto unit

Case Study II - Application of CUP Method
Conclusion

- **Indian entity being the simpler entity is the tested party**
- **Net Profit Margin (Net operating profits/sales) seems to be the most appropriate profit level indicator**
  - Cost based PLI can't be used as the cost is affected by transfer prices
  - Asset based PLI can't be used as sufficient information of comparable companies' asset base is not available
- **Internal TNMM not possible because of given facts and circumstances**
- **External benchmarking suggest that the Indian entity should earn net profit margin of 5 percent**
- **Transfer Price = Final sales price – arm's length net profit margin – operating expenses of tested party.**
- **Therefore, transfer price = INR 100 – INR 5 - INR13 = INR 82**

B S R & Co.

Documentation Requirement & Form 3CEB

Documentation Requirements

Entity related

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

Price related

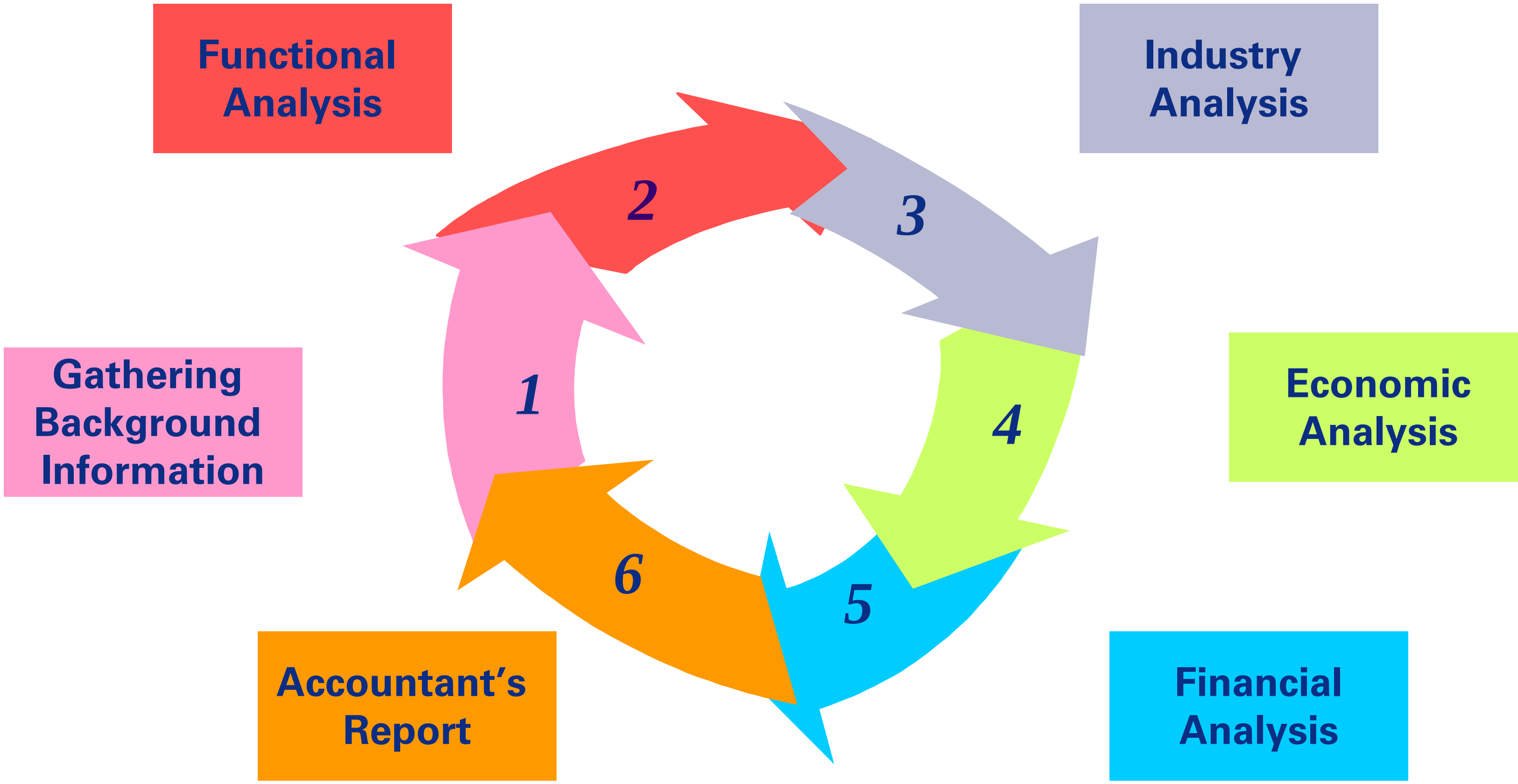
- Transaction terms
- Functional analysis (functions, assets and risks)
- Economic analysis (method selection, comparable benchmarking)
- Forecasts, budgets,

Transaction related

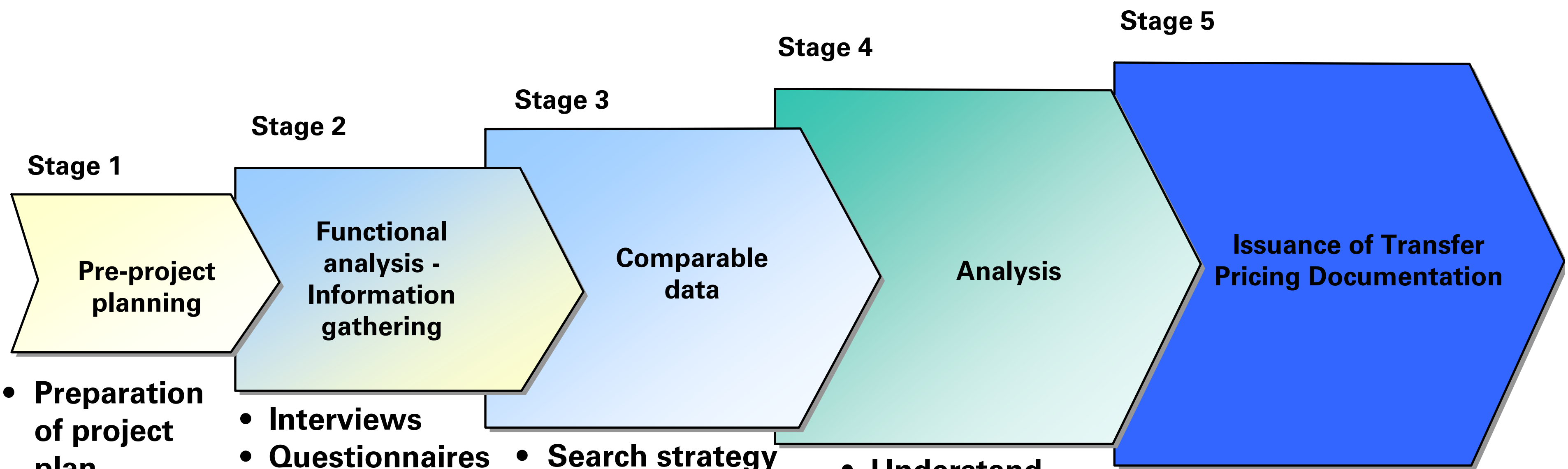
- Agreements
- Invoices
- Pricing related correspondence (letters, emails etc)

Contemporaneous documentation – Applicable only if the value of the International transactions exceeds INR 1 Crore

Transfer Pricing Process



Key to dos before finalizing TP Documentation



Stage 1
- Preparation of project plan

Stage 2
- Interviews
- Questionnaires
- Discussions with Management
- Characterisation of each entity
- Agreement reviews

Stage 3
- Search strategy
- Access to local & global database
- Analysis of internal comparables
- Judicious identification of arm's length range

Stage 4
- Understand existing costing mechanism
- Determination of billing methodology

Stage 5
- Consultation with management
- Finalization of Transfer pricing documentation

Accountant's report

- Obtained by every person entering into an international transaction
- To be filed by the due date for filing return of income
- Opinion whether
  - Prescribed documents have been maintained
  - The particulars in the report are true and correct

Form No. 3CEB

[See rule 10E]

Report from an accountant to be furnished under section 92E relating to international transaction(s)

1. **We have examined the accounts and records of** ENTITY NAME AND POSTAL ADDRESS - PAN No. **relating to the international transactions entered into by the assessee during the previous year ending on 31st March 2009.**

2. **In our opinion proper information and documents as are prescribed have been kept by the assessee in respect of the international transaction(s) entered into so far as appears from our examination of the records of the assessee.**

3. **The particulars required to be furnished under section 92E are given in the Annexure to this Form. In our opinion and to the best of our information and according to the explanations given to us, the particulars given in the Annexure are true and correct.**

Place :

Date :

For

Chartered Accountants

Stringent Penalties

Default	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 of each international transaction
Failure to furnish documents	2% of the value of the 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’.

B S R & Co.

Transfer Pricing Audit Process & Experience

Transfer Pricing Audit Process

File tax return & Accountant's Report **(30th September)**

Reference to be made to TP Officer ('TPO') by the Assessing Officer ('AO'); Compulsory Reference to be made by AO if international transactions **exceed Rs 150 million** for AY 2005-06 onwards (Internal guidelines)

AO making adjustments if international transactions are less than Rs 150 million & stay typically rejected

Notice to be issued by the TPO – TPO calls for supporting documents & evidence

TP Audit

Based on results of above mentioned procedure assessing officer passes the order

Rectification application can be made against the order of TPO for apparent mistakes

Appeal can be made against the order of AO as order of TPO included within the order of the AO

Appeal Procedure

Appeal to Commissioner of Income Tax

↓

Passes an order

↓

Income Tax Appellate Tribunal

↓

High Court – only on matters related to law

↓

Supreme Court

↓

Constitutional Bench

TP Assessment
Some important statistics (ESTIMATED)

AY 2002-03
Cases assessed = 1081
Cases adjusted = 239
Total adjustment = USD 305 Mn

AY 2003-04
Cases assessed = 1501
Cases adjusted = 337
Total adjustment = USD 572 Mn

Cases adjusted heading northwards but
only a handful cases have managed to get past tribunal.
Is it just the tip of the Iceberg?

AY 2004-05
Cases assessed = 1768
Cases adjusted = 471
Total adjustment = USD 858 Mn

AY 2005-06
Cases adjusted = 25 percent
Total adjustment = USD 1100 Mn

TP Assessment
Increased Administrative Focus

- Steep expansion of administration [No. of Transfer Pricing Officers (TPOs) from 18 to 80]
- Coordinated All-India Transfer Pricing (TP) approach
- Creation of special TP administration at CIT (A) and Tribunal level
- Training to TPOs on international TP laws and practices
- Increase in audit threshold (from USD 1.25 million to 3.75 million)
- Scrutiny audit time increased from 33 months to 45 months from the end of financial year
- Co-ordination between Customs and Transfer Pricing authorities

TP Assessment
Triggers for Detailed Scrutiny

- Consistent losses / low margins of the assessee attributable to inter-company transactions
- Significant changes in profitability of the assessee and its AEs
- High value of royalty pay outs
- Unjustifiably large payment of management charges not passing the ‘benefit test’
- Losses incurred by routine distributors
- Low mark-ups for services

Transaction Value	Remarks
> INR 1 Crore	Mandatory Documentation Requirements
< INR 15 Crore	Scrutiny by Assessing Officer
> INR 15 Crore	Scrutiny by Specialized Transfer Pricing Officer

TP Assessment Challenges

- Use of multiple year data
- Arithmetical mean and + / - 5 percent range
- Use of adjustments – Idle capacity, risk adjustments etc
- Use of secret comparables and confidentiality of information
- Foreign comparables challenged – local comparables preferred
- Understanding the business/operations of the company – at times business heads being called/ examined
- Information being sought on transactions by AEs with other AEs – even though these may not be strictly 'uncontrolled' comparables
- Indiscriminate usage of CUP Method – Localized product – CUP for imports – use of NASSCOM rates for IT/ITES industry
- Materiality not applied
- Genuine cost allocation and Head office charges are probed with suspicion

TP Assessment
Key Points for success in Transfer Pricing audits in India

- Proactive TP analysis
- Detailed FAR analysis
  - Assessee
  - Associated Enterprises
  - Comparables
- Evaluating potential risk adjustments
- Determination of income attributable to a Permanent Establishment in India
- Strong and robust Transfer pricing documentation
- Global TP Policy – Need for localization and regular review
- Proactively determining the audit strategy
- Leveraging on the favorable evolving TP judicial decisions
- Strategically, ensuring the furnishing of adequate evidence / supporting documentation to effectively stake claims during initial TP audits

End of Part II

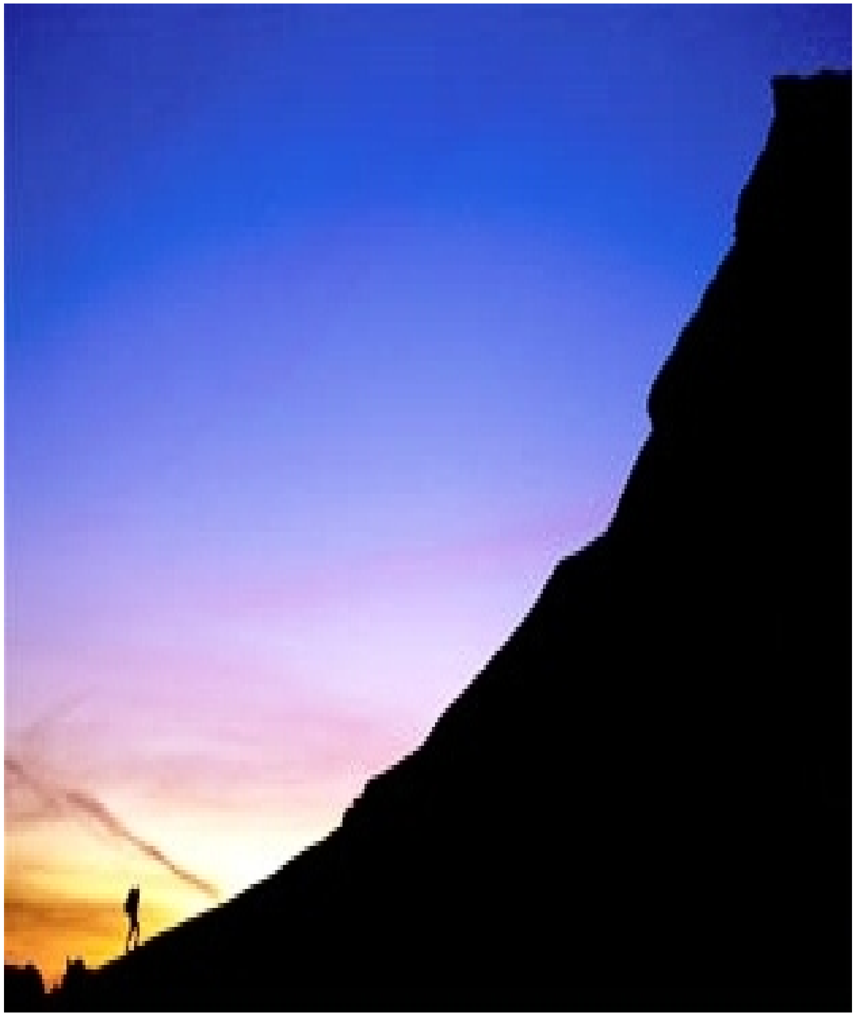
B S R & Co.

Industry Challenges & Synopsis on Recent Judicial Rulings

Transfer Pricing Challenges – Manufacturing

- Type of manufacturing (toll manufacturer, contract manufacturer, licensed manufacturer and full fledged manufacturer)
- Royalty – Legal ownership Vs. Economic Ownership
- Import of components (proprietary in nature); Internal pricing policy disregarded;
- Localized product – a CUP for imports
- Economic adjustments for start up companies always questioned

Transfer Pricing Challenges – Trading / Distribution



- Most appropriate method - RPM Vs. TNMM
- Use of GPM as a PLI - Absence of definition of direct cost under IGAAP
- How Important is product comparability
- Different margins for low/ high value products
- Creation of market intangible
- Allowance of risk adjustment to facilitate better comparison between commissionaire, low risk distributor and full fledged distributor

Transfer Pricing Challenges – IT / ITES

- Captives are risk mitigated – Cannot incur operating losses
- Value chain analysis for service providers
- To whom do locational savings belong?
- Use of standard benchmarking sets for IT/ITES companies
- What are costs and mark-up?
- Allowance of risk adjustment (Captive Vs full fledged service provider) & adjustment pertaining to varying accounting policies and forex gain/loss.

Skoda Auto India Private Limited

Skoda Auto India
Facts of the Case

- Incorporated on December 1999, started commercial production in November 2001;
- FY 2002-03 – 1st full year of operations; Assessment Year 2003-04
- Engaged in the business of manufacturing and selling passenger cars – Turnover – INR 383 Cr , Loss – INR (2.61) Cr;
- Loss incurred due to incurrence of high start up cost and low utilisation
- International transactions
  - Purchase of raw materials - INR 224.3 Cr
  - Payment of royalty and fees for technical know how for INR 44.5 Cr
  - Other International transactions – INR 1.08 Cr
- Assessee adopted TNMM for both transactions & Internal CUP selected as supplementary method for material purchase.
- CUP furnished was EURO 6800 / kit which was the ex-factory selling price of the kits by the parent company to other AEs across various jurisdictions

Particulars	Tested Party	PLI	Financial Period	Comparable Companies	ALP
Skoda Auto	Skoda Auto	NPM	2000-01 to 2002-03	**6** (GM, Ford, Maruti, Honda, Hyundai & HM)	Loss Vs Loss
TPO	Skoda Auto	NPM	2002-03	**4** (Maruti, Honda, Hyundai & HM)	5.47%

Skoda India's objections

- Comparables should be selected based on the functional comparability;
- Skoda's business model is different from the other 4 comparables also as Skoda is only an assembler
- Skoda India is in the start-up phase - while the comparables are well established companies and therefore, the comparison is absurd;
- Due to imported raw material content being 99% there is a material cascading effect on account of customs duty unlike that of the comparables (25% to 56%). Hence should be adjusted for the same;
- Carried out adjustment for eliminating CD effect based on reasonable approximation
- Appellant should be granted a relaxation of up to 5% from the arm's length price.

Department's Arguments

- Internal CUP rejected due to irreconcilable geographical differences and the transaction being between associated enterprises
- TPO noted that GM had incurred continuous losses for three years which were indicative of certain abnormalities
- The TPO further sought for details on CD adjustment carried out and rejected the same on account of approximations and assumptions made by Skoda India
- TPO also stated that Skoda India should have negotiated the purchase price to eliminate the burden of non-cenvatable CD or should have ideally passed it on to the customer.
- TPO rejected the 5% benefit on the ground that the variation in ALP is beyond 5%
- TPO rejected all contentions and made adjustment for INR 23.59 crores towards purchase transaction.
- TPO did not make any adjustment towards Royalty & Fees for technical know how as any excessive expenditure would be adequately covered in NPM of Skoda India.

AO made assessment in conformity with the TPO's order.
CIT(A) dismissed all contentions of Skoda India for non-cooperation and want of details in general terms and concurred with AO's decision

Tribunal's Observations

Skoda India's contentions

- Argued for usage of multiple year data (submitting data on the peculiarities of the automobile market)
- Inclusion of GM on account of similar product profile
- Difference in capacity utilisation
- Since Skoda India is in start up phase its share of imported components is higher resulting in higher customs duty payout and fall in profitability.
- Inherent difference in business models
- Benefit of 5% to be granted

DR's contentions

- Benefit of 5% not to be granted as the variation is beyond 5% from the ALP
- Since Skoda India did not cooperate at the CIT(A) level, the tribunal should not deal with the matter on merit.
- Apart from objecting to Skoda India's technical arguments, it also objected to the fact that the assessee has raised new matters which were not raised in earlier proceedings

ITAT rejected revenue's contention that is should not deal with the matter on merits; since the information sought by the CIT(A) was not available in the public domain

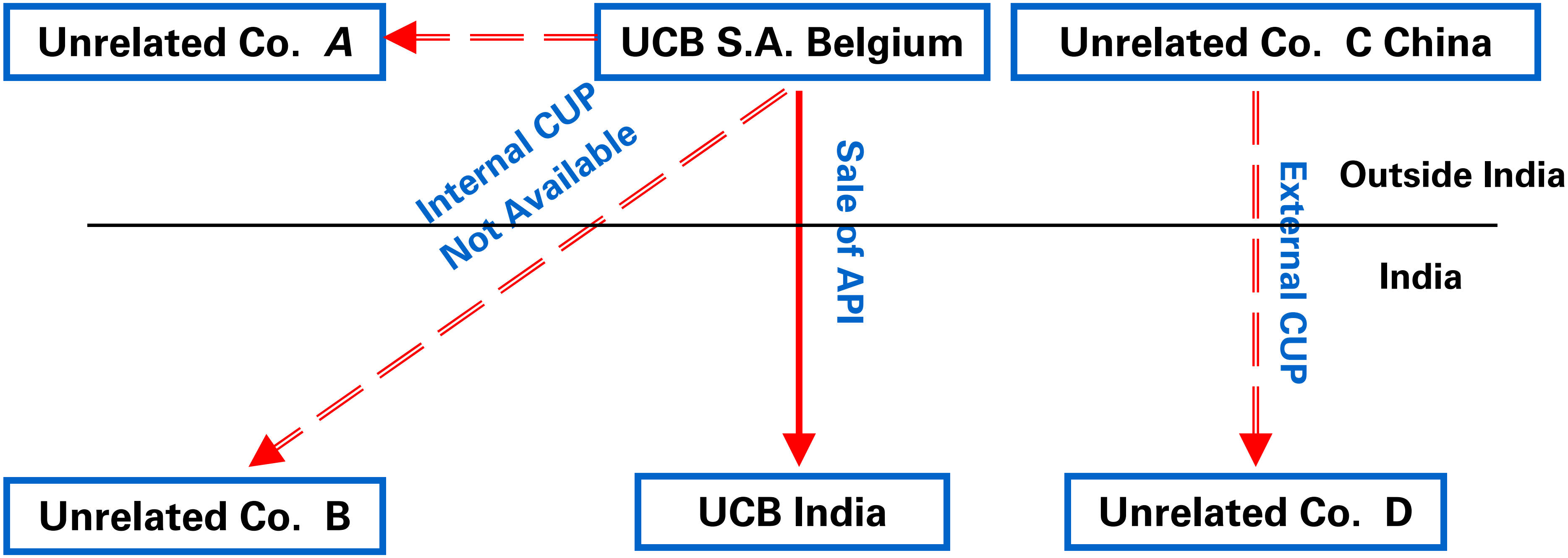
Tribunal's Ruling

- Internal CUP rejected as benchmark prices used are also controlled transactions.
- Since the business model of Skoda India and comparable companies is different, an adjustment in the operating margins to eliminate the impact of higher import content needs to be made to eliminate the functional differences
- If the business model are the same the unusual costs incurred during start up phase needs to be eliminated to enhance comparability
- Reasonable assumptions and approximations is acceptable in case of non-availability of information in the public domain
- Allowance of the multiple year data hinges on acceptance of the theory of product cycle having a material effect on the ALP.
- 5% benefit should be granted to Skoda India
- **Remanded back the file to the TPO for fresh adjudication with following instructions to consider:**
  - **Impact of additionally borne non-cenvatable import duties**
  - **The analysis of imports for the subsequent years to verify reduction in imports**
  - **The relevance of product cycle and its impact on operating profit margins**
  - **Other options to neutralize the impact of higher costs during setup phase;**

UCB India Private Limited

Facts of the Case

Assessment 2002-03 & 2003-04



Assessee used TNMM with UCB India as Tested party

UCB India at 27.54% operating margins vis-à-vis Comparables at 8.84%.

Transfer Pricing Officer's CUP workings

Active Ingredient	Quantity purchased	Rate of purchase (Rs. Kg)	Comparable Price per Kg	Difference	Adjustment
Piracetam	15,500 Kgs	1,700	381*	1,319	2,04,44,500
Mesna	100 Kgs	32,385	27,075	5,310	5,31,000
Total					**2,09,75,500**

* This is the Wt. Average rate of Piracetam from Torrent Pharma and Microlabs India.

Value of international transaction disclosed (A)	Rs. 4,57,06,389
Adjustment as proposed above (B)	Rs. 2,09,75,500
Arm's length price (A) - (B)	**Rs. 2,47,30,889**

TPO adopted CUP & made adjustment for INR 2.09 & 3.00 Cr in the AY 2002-03 & 2003-04 respectively.

UCB's Objections

Selection of TNMM

- Robust FAR analysis done by UCB India & complied with all requirements as stipulated in Rule 10D.
- UCB India further contended that TNMM as the most appropriate method as a result of robust analysis.

Non-applicability of CUP

- Absence of information in public domain;
- TPO's comparables hinges entirely on three letters from the competitors and no further analysis carried out by the TPO;
- Irreconcilable differences on parameters like purity, potency, standards, research activity, market share, pricing, efficacy, etc.; and
- The department failed to carry out functional analysis

Department’s Arguments

Rejection of TNMM

- UCB India failed to furnish documentation as required by Rule 10D. Hence, Onus to satisfy ALP still on the assessee;
- UCB India considered the net profit of the whole entity rather than transactional level profit; and
- UCB India failed in demonstrating the functional comparability of the 36 comparable companies selected as to whether they manufactured licensed and patented drugs, employed intangibles, etc.

Adoption of CUP

- UCB India had not produced any document / supplied any information to demonstrate non-comparability of the transactions selected by the Department;
- UCB India failed to maintain proper documentation and the information and data relied on by UCB India were not reliable; and
- Rule 10D requirements not fully discharged.

Tribunal’s observation

- Tribunal held that 92C(3)(a) has been attracted since UCB India has not determined the ALP in accordance with 92C(1) and 92C(2) – i.e., rejection of TNMM

Tribunal's Ruling

Rule 10D compliance

- What needs to be seen is whether the assessee has substantially complied with the law in relation to maintenance of records.
- Deficiency should be seen in light of fact that whether such non-maintenance fundamentally affects or distorts the computation of ALP.

Entity level Vs. Transactional level

- International transaction under consideration comprised only 50% of UCB India's sales & hence it was held that UCB India's approach of entity level TNMM is not appropriate.

Comparability Analysis

- Functional comparability of comparables needs to be documented to demonstrate that the companies selected manufactured licensed and patented drugs, employed intangibles, etc. similar to UCB India.
- Even if CUP is selected regard should be had to the effect on price of broader business functions and not just the product comparability and adjustment should be made to eliminate any material effect on the transfer prices.

Sent to AO for adjudication of the issue afresh

The ITAT allowed UCB to adopt any method prescribed. It also allowed UCB to submit additional evidences, information and fresh transfer pricing study to support its case


Philips Software Centre Private Limited

Philips Software

Facts of the case

- Business: Software development services to its associated enterprises.
- Taxpayer enjoying Tax Holiday u/s 10A
- Remuneration Model:
  - From 1 April 2002 to 31 December 2002 – Cost plus 5% mark-up
  - From 01 January to 31 March 2003 – Cost plus 10% mark-up

(Cost– All costs including personnel, travel, infrastructure and depreciation)

- Arm's length margin proposed by TPO – 21.14%. Resulted in adjustment of Rs. 221,080,792

Approach in the TP Study

- Cost-plus method as the most appropriate method (gross profit mark up); and, TNMM as the secondary approach with Philips India as the tested party
- Classified as risk insulated captive software development service provider bearing minimal risks
- Performed benchmarking using Capitaline only using data for FY 2002-03
- Various Filters used - Fin NA; < 12 m Fin data; 250<T/O<5 cr; Export T/o<75% of Total sales; RPT, loss making at gross level, diversified services – Final set of 9 comparable companies
- Claimed adjustment related to depreciation
- Comparables GPM- 13.27%, NCP- (6.75%); Philips- GPM- 28.86%, NCP- 6.61%

Philips Software

Issue discussed	Tribunal's Decision
Trigger points for TP assessment	TPO required to substantiate during assessment proceedings that the taxpayer had manipulated prices to shift profits outside India
Fresh Search	TP study carried out by the taxpayer cannot be disregarded unless there are serious deficiencies therein
Contemporaneous documentation	TPO cannot conduct a fresh search using data beyond the 'specified date'
Related Party transactions	Comparables having controlled transactions of even a single rupee of transaction should not be used as the basis for a comparability analysis
Adjustments to improve comparability	Adjustments need to be made to comparable companies on account of risk profiles, working capital position and accounting policies (including for depreciation).
Safe Harbor Provisions	Standard deduction of +/- 5 percent on ALP is available at the option of the taxpayer

Sony India Private Limited

Sony India

Facts of the case

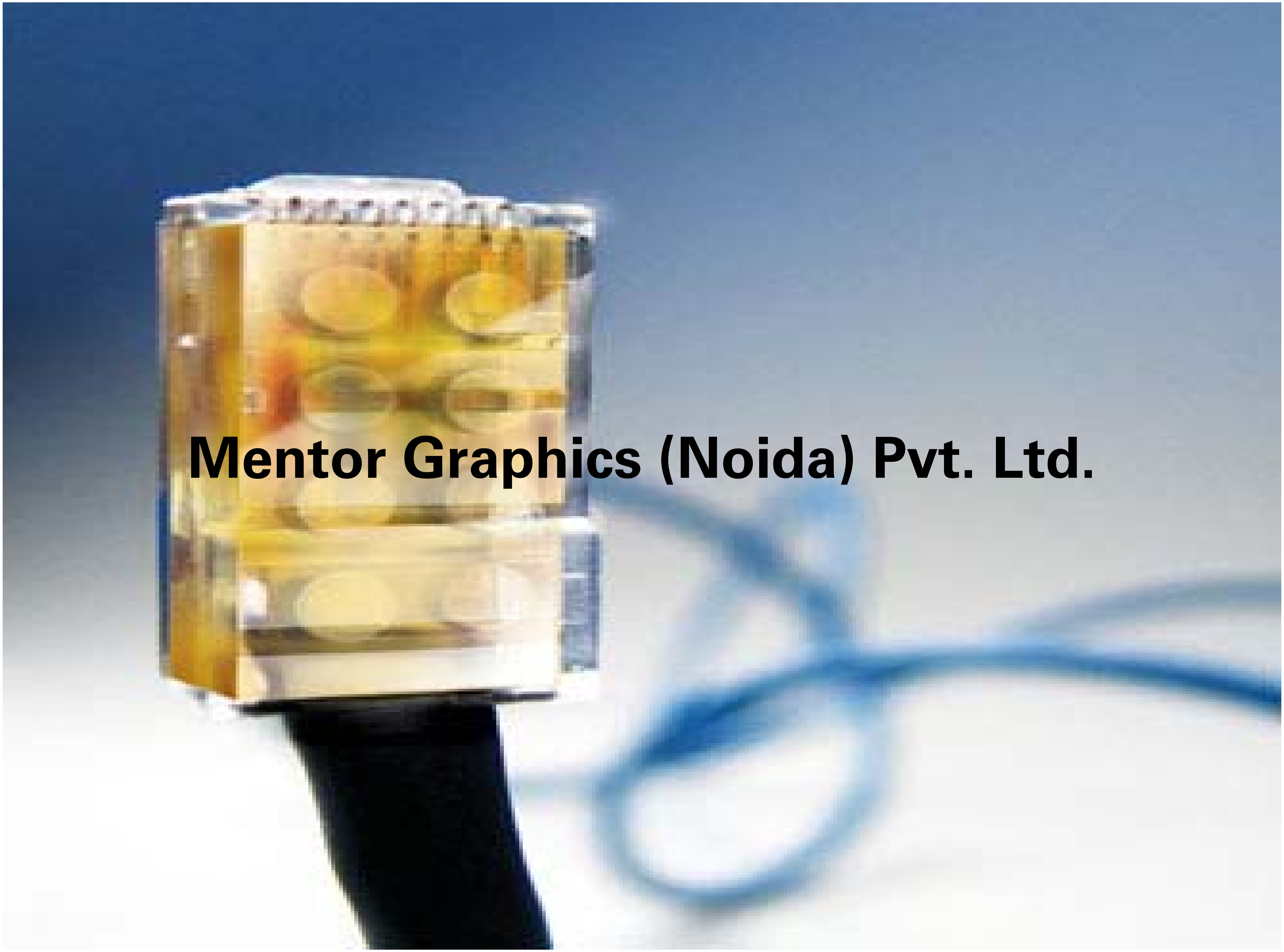
- Sony India was engaged in assembly and distribution of colour televisions and audio products including certain high-end electronic goods
- International Transactions – Import of electronic components, exports of television sets and receipt of reimbursement of advertisement expenses.

TPO's comments

- Trading and manufacturing activities of the taxpayer were not interlinked and should be considered separately.
- AEs cannot be taken as tested parties while determining ALP of imported electronic components and finished goods.
- Excluded comparables on the basis of "having related party transactions"
- Rejected the use of marginal costing criteria for pricing to AEs on account of unutilized idle capacity
- Reimbursement of advertisement expenditure received from AEs was considered as a capital subsidy and removed while computing the operating profitability of the taxpayer.
- Did not allow the benefit of 5 % range to the taxpayer while computing the ALP.

Sony India

Issue discussed	Tribunal's Decision
Related Party transactions	An entity can be taken as **uncontrolled** if its related party transaction do not exceed 10 to 15 percent of total revenue.
Adjustments to improve comparability	**Allowed deduction of 20%** from the mean margin of comparables on account of difference in risk profile, ownership of intangibles, working capital and R&D.
Safe Harbor Provisions	The benefit of the 5% range is available to the taxpayers in all the cases and the TP adjustment should be restricted only on the net amount remaining after allowing the benefit of 5% range
Pricing based on MC to AEs to improve recovery of FC	Under-utilization of capacity, burden of overheads and motive to reduce them cannot justify export of products at a price less than the price to any unrelated party.
Recognition of transaction	Actual transaction entered into between the parties is to be considered. Revenue authorities were not justified in equating this reimbursement with equity or windfall gain or subsidy or some ad hoc payment


Mentor Graphics (Noida) Pvt. Ltd.

Mentor Graphics

Facts of the Case

- Mentor Graphics was a wholly owned subsidiary of IKOS Systems Inc. USA
- Mentor Graphics renders software development and marketing services to IKOS Systems Inc.
- Software developed by Mentor Graphics is used by IKOS Systems Inc. for integration with the other software components developed by the latter.
- The whole software in turn supports the hardware manufactured by IKOS Systems Inc.

Tested Party	Mentor Graphics
MAM	TNMM
PLI	Net Cost Plus mark up
Financial data	1999-2000 to 2001-02
Filters Used	Mfg Sales >25% Trading Sales > 25% Operating Loss > 10%
Comp. of ALP	16 Comparables- 13.41% Vs. Mentor Graphics- 11.07%(within 5% range)

International Transaction	Value of IT INR	Method of remuneration	Method of computing ALP	TPO's Adjustment INR
Software Development Services	88,866,320	Time & Material basis	TNMM	14,573,857
Export of marketing support services	3,436,194	Time & Material basis	TNMM	Nil

Mentor Graphics
Arguments & Final Verdict

TP Assessment and CIT(A)

- TPO rejected comparables selected by Mentor Graphics' and conducted a fresh search
- TPO considered **single year data** and determined an arithmetical mean of **24.53%** (5 Comparables)
- AO confirmed the TPO's order and on appeal, CIT(A) confirmed the AO's order

Cost of Service	83,064,464
Add: Margin @ 24.53%	20,375,713
ALP of revenue	103,440,177
Adjustment ***(103.44 Mn less 88.86 Mn)***	**14,573,857**

ITAT's Observations & Ruling

- Comparables selected should be rejected only if they are ***deficient or insufficient***.
- Comparable companies having ***related party transactions*** should not be accepted and assessment should be based on material on record, not on unsound presumptions
- Adjustment for normal open market risks, from which the taxpayer is insulated from, being a **captive service provider** should be provided such as working capital, risk & growth and R&D expenses.
- If taxpayer's margin falls anywhere in the 'range' it would be sufficient compliance (ALP is not the highest price or the highest profit margin in a range)
- FAR analysis should also be done of comparable companies in a comprehensive manner

Snapshot of Recent Rulings

Ruling	Law	Doc Compliance	Selection of MAM	Aggregation of IT	Tested Party
Aztec	✓				
Mentor Graphics					
Ranbaxy				✓	✓
Cargill	✓	✓			
Develop. Consult.	✓		✓	✓	✓
Star India	✓			✓	
E-Gain					
Sony India					
Philips Software	✓	✓	✓		
UCB India		✓	✓	✓	
Honeywell					
Skoda Auto					

Snapshot of Recent Rulings

Ruling	Comparability Standard	Adjustment	Multiple year data	RPT	Safe Harbour
Aztec			✓		
Mentor Graphics	✓	✓		✓	
Ranbaxy	✓				
Cargill					
Develop. Consult.					✓
Star India	✓	✓			
E-Gain	✓	✓			
Sony India	✓	✓		✓	✓
Philips Software	✓	✓		✓	✓
UCB India	✓				✓
Honeywell	✓	✓	✓		
Skoda Auto	✓	✓	✓	✓	✓

B S R & Co.

Key Takeaways

&

Unanswered Issues

Key Takeaways from Recent Rulings

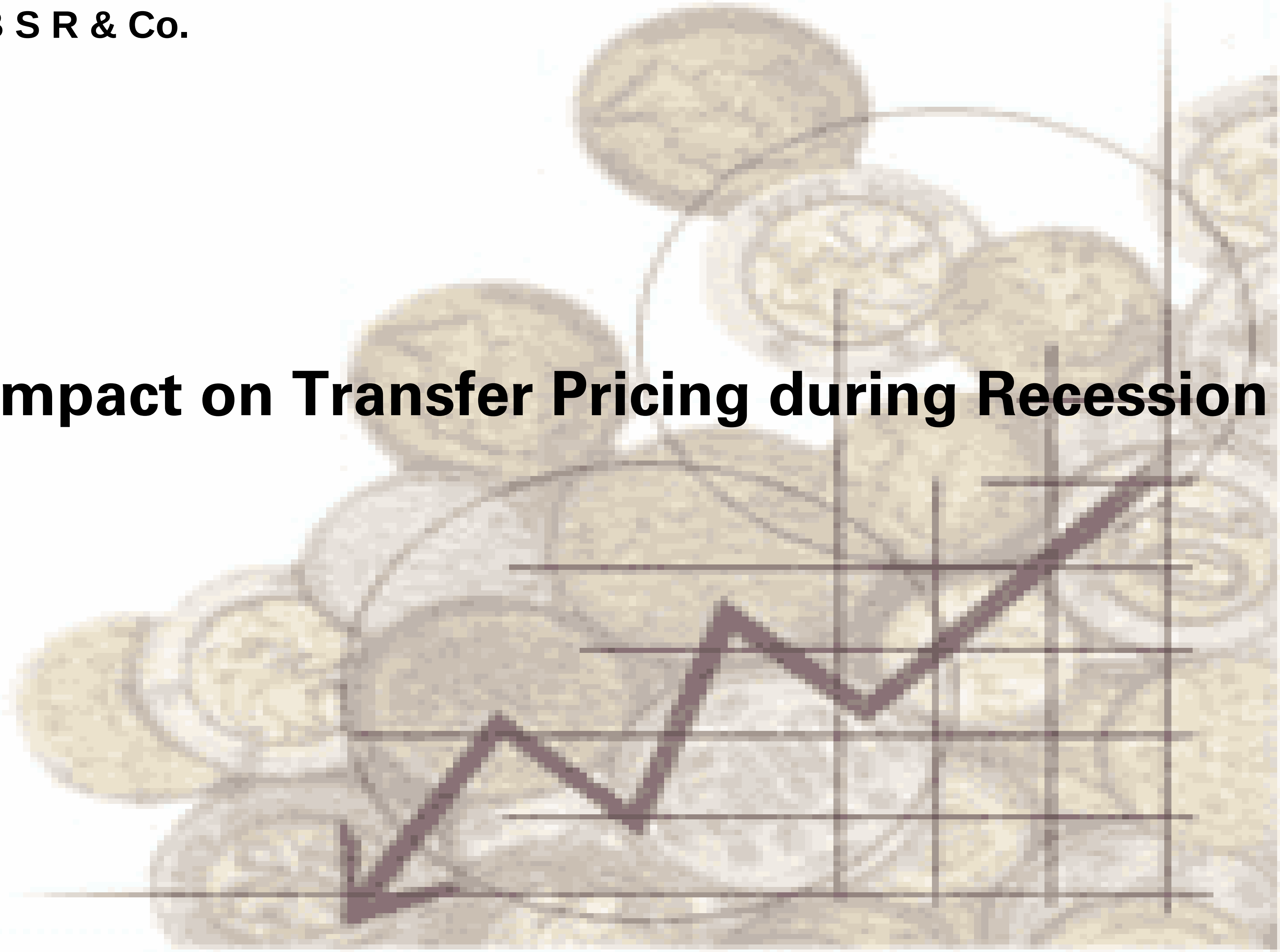
- Transfer Pricing is not an exact science and involves a fair amount of objective reasoning / approximations.
- No need to establish diversion of profits outside India to determine applicability of the TP provisions
- Detailed FAR analysis crucial
- Aggregation of International transactions permissible only if they are inextricably linked
- Least complex entity to be tested party
- Multiple adjustments accepted if it enhances comparability and irons out material differences
- Option to avail safe harbor provisions rests purely with the taxpayer
- Usage of reasonable approximation if inevitable is permissible
- Documentation to be filed by the assessee only if available

Unanswered issues

- Whether one should take cognizance of the group's global profitability scenario?
- Whether high margin and loss making companies can be removed from a set of comparables?
- Whether to use standalone financial / consolidated financial statement of comparable companies?
- Whether companies having related party transactions can be completely eliminated from the set of comparables? Does use of consolidated results help?
- What is the definition of contemporaneous data?
- How would a risk adjustment be made?
- How would an adjustment for presence of intangibles be made?
- Acceptance of secret comparables

End of Part III

B S R & Co.



Impact on Transfer Pricing during Recession

Transfer Pricing in a Recessionary Economy

Carefully Document the "Functional & Risk Profile"

- Specify up-front the functions performed and risks assumed by each related party to the transaction: Source of losses and which entity should bear the losses:
- Without contemporaneous evidence of taxpayer intent, it may be difficult to convince tax authorities after the fact

Avoid Sudden Changes in Transfer Prices

- The fact that risks were realized and losses were incurred is not necessarily a reason to adjust previously negotiated transfer prices or to make compensating payments
- Changes to the transfer pricing policy today, in response to an economic downturn, could raise questions concerning past transfer pricing positions
- Averaging results over the business cycle may mitigate temporary downturns in performance

Transfer Pricing in a Recessionary Economy

Draw Attention to Impact of Realized Risks

- State the original intent of the parties with respect to functions and risks
- Show that past transfer pricing results were commensurate with the functions and risks set forth at the initiation of the transaction
- Describe the specific risks that were realized by each party during the test period, and quantify the economic impacts
- Adjust the tested party results as if the risks had not materialized

Closely Scrutinize Benchmark Companies

- Closely screen comparable companies for signs of serious financial distress, and consider rejecting all companies in specific sectors that experience unique disruption unrelated to tested party situation
- In the final analysis, make sure your basis of presentation for tested party performance (i.e., adjusted vs. unadjusted) is consistent with your treatment of similar issues for companies in the benchmark set

Transfer Pricing in a Recessionary Economy

Don't Try to Force Fit an Approach

- Describe overall company performance and the factors driving the results (internal-operational, external-market, and competitive dynamics)
- Describe the effects that similar economic shocks have had on companies in analogous situations in the past
- Articulate why decline in results are not driven by inappropriate transfer prices
- Describe why the relative performance of both sides of the transaction is appropriate in light of the relative profiles of functions and risks

Maintain Current Transfer Pricing Documentation

- During business downturns, be especially vigilant in monitoring transfer pricing results periodically throughout the year
- Keep track of market and operational factors driving overall company performance, and relate it back to transfer pricing results in "real time"
- Develop comprehensive documentation prior to filing each year's tax return to protect the company from penalties

Emerging Trends

- Detailed guidance on specific transfer pricing issues
- Synchronization of transaction value with Customs Act
- Guidance on Intangibles, services, cost sharing, treatment of losses, income attribution to PE
- Improving dispute resolution process & Introduction of APAs
- MAP - Aim to relieve taxpayers from economic double taxation
- Guidance on collateral consequences of upward adjustments
- Guidance on Compensating adjustments
- Introduction of correlative relief, secondary adjustment, set-offs