Documentation for Arriving at Transfer Price – A Practical Insight

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Documentation

An overview
Rationale for TP documentation in India?

- Tax Exposure
- Burden of proof
- Legal Requirement
- Penalty Protection
- Strengthen the Appeal
Who bears the burden of proof in the Indian Transfer Pricing context?

In Indian Transfer Pricing the primary burden of proof lies with the Taxpayer.

As per Section 92D of the Income Tax Act, 1961 (‘the Act’)

(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.

Taxpayer to keep and maintain documentation and maintain the reports to support the pricing of inter-company transactions
Legal Requirement

Shifting of burden of proof

As per Section 92C(3) of the Act, the Assessing Officer may proceed to determine the arm's length price (‘ALP’) during the course of any proceeding for the assessment of income, if on the basis of material or information or document he / she is of the opinion that-

a) The price charged or paid for the international transaction [or specified domestic transaction] has not been determined in accordance with the Income Tax Act.

b) Any information and document relating to an international transaction [or specified domestic transaction] have not been kept and maintained by the assessee in accordance with the Act.

c) The information or data used in computation of the arm’s length price is not reliable or correct.

d) The assessee has failed to furnish, within the specified time, any information or document which he was required to furnish by a notice issued under sub-section (3) of section 92D of the Act.

TP Documentation is the key to demonstration of ALP
Rule 10D of Income Tax Rules 1962 (‘the Rules’)

Every person who has entered into an international transaction shall keep and maintain-

− description of the ownership structure

− profile of the multinational group

− broad description of the business of the assessee and the industry in which the assessee operates

− nature and terms (including prices) of international transactions [or specified domestic transactions]

− description of the functions performed, risks assumed and assets employed [FAR Analysis]

− record of economic and market analyses, forecasts, budgets as prepared by the assessee

− record of uncontrolled transactions

− description of the methods considered for determining the arm’s length price

− details of adjustments and a record of actual working carried out for determining the arm’s length prices

− the assumptions, policies and price negotiations, if any, which have critically affected the determination of ALP
Rule 10D of Income Tax Rules 1962 (‘the Rules’)

Supporting documentation –

a) official publications/ reports/ data bases/ studies

b) market research studies/ technical publications

c) published accounts/ financial statements relating to business affairs of associated enterprises (‘AEs’)

d) agreements/ contracts with AEs or non AEs.

e) letters and other correspondence documenting any terms between the assessee and the AE
Rule 10D of Income Tax Rules 1962 (‘the Rules’)

**Rule 10D(2) - Threshold Limit:**
- If the aggregate book value of international transactions < INR 10 million – NO need to maintain above prescribed documentation, HOWEVER should have documents to establish ALP

**Period of maintenance of documentation:**
- The prescribed information & documentation should be contemporaneous and must be in existence by the specified date – November 30th following the end of the financial year
- Documentation to be retained for period of eight years from the end of relevant assessment year - Rule 10D(5) of the Rules
## Penalties

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<tr>
<td>271AA(i)</td>
<td>Failure to maintain transfer pricing documentation</td>
<td>2% of the value of each international transaction or specified domestic transaction</td>
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<tr>
<td>271AA(ii)</td>
<td>Failure to report such transaction which is required to be reported</td>
<td>2% of the value of each international transaction or specified domestic transaction</td>
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<td>271AA(iii)</td>
<td>Maintaining or furnishing incorrect information or documentation</td>
<td>2% of the value of each international transaction or specified domestic transaction</td>
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<td>271BA</td>
<td>Failure to file Form 3CEB</td>
<td>INR 1,00,000</td>
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<td>271G</td>
<td>Failure to furnish transfer pricing documentation</td>
<td>2% of the value of each international transaction or specified domestic transaction</td>
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<td>271(1)(c)</td>
<td>In case of concealment of particulars of income or furnishing of inaccurate particulars</td>
<td>Penalty of 100% to 300% of tax on the adjusted amount</td>
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Maintenance of contemporaneous and robust documentation is the key to **avoid penalties**
Documentation Process
Transfer Pricing Process

Stage 1: Pre-project planning
- Preparation of project plan

Stage 2: Functional analysis - Information gathering
- Interviews
- Questionnaires
- Discussions with Management
- Characterisation of each entity
- Agreement reviews

Stage 3: Comparable data / Industry Analysis
- Search strategy
- Access to local & global database
- Analysis of internal comparables
- Judicious identification of arm’s length range

Stage 4: Economic Analysis
- Understand existing costing mechanism
- Determination of billing methodology
- Benchmarking exercise

Stage 5: Issuance of Transfer Pricing Documentation
- Consultation with management
- Finalization of Transfer pricing documentation
Information Gathering
Information Gathering

### Entity Related
- Taxpayer’s profile
- AE’s profile
- Industry profile

### Price Related
- Transaction terms, forecasts and budget estimates
- Market Profile
- Functional analysis – functions performed, assets used & risk assumed
- Economic Analysis - method selection & benchmarking

### Transaction Related
- Agreements
- Invoices
- Pricing related correspondence – letters, e-mails, etc.

Sequential progression
Functions, Assets and Risks (‘FAR’) Analysis
Rule 10B (2) & (3) – Functional Comparability

The comparability of an international transaction with an **uncontrolled transaction** shall be judged with reference to:—

a) the specific characteristics of the property transferred or services provided
b) the **Functions** performed, taking into account **Assets** employed or to be employed and the **Risks** assumed - ‘**FAR Analysis**’

c) the contractual terms – defining responsibilities, risks and benefits
d) conditions prevailing in the markets in which the respective parties to the transactions operate

Comparison is appropriate if:

a) Differences, if any, are not likely to affect the price or cost charged or paid /profit arising from the transaction
b) Reasonably accurate adjustments can be made to eliminate the effect of material differences.
Why is FAR Analysis important?

- To have a proper understanding of the business and related commercial considerations
- Appropriate characterization (e.g. Entrepreneur / Limited Role / Captive, etc)
- Mapping of the economically relevant facts and characteristics of international transactions
- First step in evaluating the relative contribution to profit of various related entities – Understanding of price-setting mechanisms
- Key to mitigate transfer pricing risks, passes the onus on Revenue Authorities

A comprehensive FAR Analysis should enable 2-sided review for both AE and the taxpayer with:
- Clear distinction of the functions and risks of the taxpayer and the AE
- Commensurate compensation
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
- Industry Specific Risk - to be identified
- Contractual Relationship, Key Entrepreneurial Risk
- Business risks such as Currency Risk, Capacity Risk & Market Risk
- Consistency of risks assumed with the functions performed
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**
Functional Analysis - Snapshot

Activities performed

An assessment of:
- Operations of group companies
- Their management and ownership characteristics
- Economic factors impacting business

Markets trend in the industry

Pricing Strategy

Risks assumed
(Debtors, Currency, Market)

Assets employed
(Infrastructure, Intangibles)

Quality process
Industry Analysis, Benchmarking / Economic Analysis
Industry Analysis

Some important factors to be considered:

- Names of competitors
- Generic / Speciality products – Margins are often influenced by these factors
- Market Dynamics – e.g. Matured, growing, nascent etc. (impacts pricing strategies of companies)
- Market positioning – Explains differences in key expense items like advertising
- Existence of regulations governing the industry
- Suggested trends expected in the market
Benchmarking / Economic Analysis

- Search Strategy to be clearly documented
  - Selection of Most Appropriate Method, Tested Party, Profit Level Indicator
  - Analysis of internal comparables
  - Databases used and applicability of filters used to select comparables
  - Search methodology and basis for acceptance / rejection of companies
  - Process of determining arm’s length price, margin of tested party, etc.

- Broad similarity in functions performed by the comparables to be documented

- Appropriate documentation for reasonably accurate adjustment made for differences in functions / risks borne by the comparables vis-a-vis taxpayer/AEs

- Documentation to capture commercial realities e.g. sufficient back-up documentation / justification
**Benchamarking Analysis**

**Selection of Most Appropriate Method**

**Search for uncontrolled comparables – Internal or External**

**Use of Databases for identifying External Comparables**

Prowess –

- A database of large and medium sized companies in India
- Approximately 27,000 companies
- Developed by Centre for Monitoring Indian Economy (CMIE)
- A highly reliable database built by researchers at CMIE under a rigorous system of normalisation and validation.

CapitalinePlus –

- A database of public, private, co-operative & joint sector companies in India
- Approximately 23,000 companies
- Developed by Capital Markets Publishers India Pvt. Ltd.
- Compilers have standardized / normalized the data through reclassification of certain heads of income and expenses
Importance of Search Process

• Mandatory requirement as per Rule 10D

✓ Necessitates maintenance of record of analysis performed to evaluate comparability of uncontrolled transactions

• Forms part of the transfer pricing documentation which is the first line of defense for the taxpayer

Robust and scientific search process goes a long way in defending the taxpayer’s International Transactions
TP Documentation Methodology

1. Information Gathering
2. Functional Analysis
3. Economic Analysis/Benchmarking
4. Documentation
5. Accountant’s Report

This exercise will assist in meeting the taxpayer’s requirements from a TP perspective.
Suggested Documentation for Specific Transactions
Trading Transactions – Purchase/Sale of goods

- Copies of the Pricing Policy for inter-company transactions
- Annual Rate Cards
- Comparable Data (CUP) – Internal/External
- Inter-company invoices
- Tenure of credit
- Documents providing the details of discount
- Product Return Policy
- Abnormal situations – damage/ poor quality
Service Transactions

- Inter Company Service Agreements
- Documents documenting the exact nature of services provided/received by the tax payer
- Roles and Responsibilities of the tax payer vis-à-vis the AEs
- Inter-company pricing policy
- Billing arrangements
- Tenure of Credit
- Comparable Data – Internal/External
Management Fees

Suggested documentation:

- Copies of inter-company agreement
- Copies of debit notes and third party invoices
- Details of allocation keys proposed to be used
- Back-up of third party costs to be allocated
- Working of internal costs that are allocated
- Benefit Test
- Documentary evidences supporting the use of services availed/ benefits availed
- Detailed breakup of services availed locally/ in-house vis-a-vis group company
- Global working sheets including workings relating to costs allocated to Indian company
- Details of global team – qualification/ organisation structure
Management Fees

- **Strategic Planning**
  - Business Reports/Plans
  - Emails
  - Telecon-Notes
  - Corporate Governance initiatives

- **Accounting and Finance**
  - Accounting System/Manual
  - Policies
  - Business Reporting System
  - Trainings

- **Sales and Marketing**
  - Details of any marketing strategic inputs
  - Details of Sales Promotion material
  - Details of sales converted due to marketing assistance
  - Brand and Sales Promotion material
  - Training

- **Information Technology Support**
  - IT Security Policy and Manual
  - Details of trainings received
  - E-mail system
  - Intranet
  - IT support

- **Human Resources**
  - HR Manual
  - Appraisal and evaluation
  - Trainings

- **Supply chain management (‘SCM’)**
  - Manual and policies
  - Write-up on inventory management
  - Daily Distribution plan
  - Demand forecasting and production rescheduling
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<thead>
<tr>
<th>Particulars</th>
<th>Ruling</th>
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| EKL Appliances Limited (Delhi High Court) | • It is not for the revenue authorities to dictate to the taxpayer how he or she should conduct his business and what expenditure should be incurred  
  • It is not necessary for the taxpayer to show that any legitimate expenditure incurred by him or her  
    ○ was also incurred out of necessity or  
    ○ that the expenditure incurred by him or her for the purpose of business has actually resulted in profit or income  
  • The taxpayer only needs to show that the expenditure should have been incurred “wholly and exclusively” for the purpose of business.  
  • The amount of expenditure can be examined by the TPO but he or she has no authority to disallow the expenditure on the basis that the taxpayer has suffered continuous losses.  
  • The High Court also relied on the OECD Guidelines: Tax administrators should not disregard and restructure the transactions as actually undertaken by the taxpayer in normal circumstances |
Suggested documentation:

- Copies of License agreement clearly defining the purpose of payment of royalty viz. payment towards use of a patent, trademark or towards technical/commercial or scientific knowledge, experience or skill
- Documentation substantiating the benefits received/receivable by the assessee and quantification of the benefits derived
- Details of the patents/intangibles registered/owned by the taxpayer in India
- Quote from a comparable independent technology recipient for the intangible
- Benchmarking of royalty transaction
- Rates at which royalty is paid for use of similar intangibles by any other concern/subsidiary of the AE/Group.
- Market Dynamics and Market positioning
- Statement of comparative profits before and after the use of intangible
## Interest on Loans/ Debentures

**Suggested documentation:**

- Copy of agreements and correspondences evidencing the negotiations, basis on which the interest is charged or paid between the AEs viz. LIBOR.

- Quotation from bank or interest rate published in the reputed databases (e.g. Bloomberg/NSDL)

- Details of interest, if any, paid/ received in a comparable transaction

- External Benchmarking analysis conducted to determine the interest rate

- A detailed note to demonstrate the need for funds on the part of the borrowing entity

- Working of interest amount
Few Landmark Rulings are as follows:

- Siva Industries (Chennai ITAT)
- Tech Mahindra Limited (Mumbai ITAT)

The courts have largely upheld the use of LIBOR in case of overseas Lending by Indian Companies.
Sustained Losses

- Analysis of Reason of Loss
- External evidences to support loss – cyclical industry, external market dynamics
- Projections of future profitability statement and cash flows
- Comparative studies showing the period in which comparable independent entities have incurred losses
- Comparative studies showing the prices at which independent enterprises dealing at arm’s length would have been prepared to sell in the same or similar conditions
- Details of Subvention Receipts
Profit & Loss account - practical guidelines

Review of Segmental Profit and Loss Account

- Justification of allocation keys
- Workings of allocation keys
- Fixed and semi-fixed costs – for capacity utilisation adjustments
- Abnormal items
- Risk adjustments
- Working capital adjustments
Judicial Precedents on documentation
## Judicial Precedents on documentation

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| **Cargill India Private Limited** *(Delhi ITAT)* | • If the ALP has been properly and correctly determined by the taxpayer, there is no question of issuing further notice to the taxpayer.  
• Documents and information prescribed under Rule 10 D and its various sub-rules are voluminous and the TPO should not ‘casually’ ask for information under all clauses in a mechanical manner  
• Specific clauses of Rule 10D(1) with reference to which there was failure to furnish information should be mentioned in the show notice issued under Section 271G  
• Further, the decision gives direction to TPOs that notices, the non compliance of which entail penal consequences cannot be vague and should be issued after examination of documents on record and proper application of mind. |
| **Leroy Somer & Controls (India) Private Limited** *(Delhi ITAT)* | • The Revenue is required to specifically mention the documentation or information which was not maintained. A mere record in the order that there was a failure to file Rule 10D documentation without specifying which document or statement cannot be sustained  
• A general and substantive compliance of the provisions of Rule 10D are sufficient. |
| **Pentasoft Technologies Limited** *(Chennai ITAT)* | • If the revenue alleges that there has been a failure of the assessee with regard to production of any of these records, it is required to point out specifically where such failure occurs.  
• It cannot go by a general statement that the assessee had not maintained information as envisaged under rule 10D. |
OECD BEPS Action Plan

**ACTION 13**

**Re-examine transfer pricing documentation**

*Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNE’s provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.*

- Initial draft on AP 13 was released on 30 January 2014
- Finalised guidelines were released on 16 September 2014
- The Guidance on Transfer Pricing documentation has prescribed a ‘three-tier’ documentation structure consisting of Master file, Local file and CbC report:
- The OECD has indicated that it will provide further guidance on the implementation mechanism by February 2015.
Provides high level information of the multi-national group as a whole, which inter alia include::

- Group’s legal and ownership structure
- TP practices followed globally
- Drivers of business profit
- Description of supply chain
- Description of important service agreements
- Description of key geographical markets
- Description of FAR
- Details of intangibles
- Description of financial arrangements of the group
- Annual consolidated financial statement
- Details of unilateral APAs and other tax rulings
**Sample Table of Contents: Master File**

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<td>II. Executive Summary</td>
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<td>III. Overview of MNE</td>
<td>A. Business description and background</td>
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<td>B. Products and services</td>
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<td>C. Business strategy</td>
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<td>D. Operating business segments</td>
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<td>E. Historical financial performance</td>
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<td>IV. Industry Analysis</td>
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<td>V. Global Supply Chain</td>
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<td>VI. Value Chain Analysis</td>
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<tr>
<td>VII. Intangibles</td>
<td>A. Identification and description of intangible-creating activities</td>
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<td></td>
<td>B. Summary of transfer pricing policies governing the use/exchange of intangibles</td>
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<tr>
<td>VIII. Conclusion</td>
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Local File

- Information about local entity which inter-alia include:
  - Management structure and Organisation chart
  - Details of transactions undertaken during the year
    - Description of controlled transactions
  - Copy of inter-company agreements
  - Functional analysis of the taxpayer
  - Selection of most appropriate method and tested party
  - Search process
    - Search methodology, comparable data
    - Description of comparability adjustments
    - Reason for concluding a transaction is at arm’s length
    - Reason for use of multiple year data.
  - Financial statement for the fiscal year as well as financial data of comparable companies
Sample Table of Contents: Local File

I. Introduction
   A. Review of local requirements

II. Executive Summary

III. Legal Entity Overview
   A. Key points from Master File
   B. Business Overview
   C. Legal ownership structure
   D. Key products and services

IV. Local Industry Analysis

V. Intercompany Transactions

VI. Functional Analysis

VII. Selection of Transfer Pricing Methodology

VIII. Economic Analysis

IX. Conclusion
CbCR is intended to provide information to tax administration to gain transparency regarding a multinational group’s operations as a whole for conducting a high level risk assessment.

CbCR template requires disclosure of following information:

- Revenues from related and unrelated parties
- Profit and loss computation before tax
- Income tax paid
- Stated capital and accumulated earnings
- Number of employees
- Tangible assets other than cash or cash equivalent
Thank You

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