

TRANSFER PRICING DOCUMENTATION UNDER INDIAN LEGISLATION - BEST PRACTICES

Transfer pricing documentation is central to the process of justifying the arm's length pricing of cross-border transactions. For any transfer pricing analysis, documentation is the key to comply with the law.

The Indian transfer pricing regulations mandates specified taxpayers ("Indian multinationals") entering into international transactions with its overseas "associate enterprises" ("AE"), to maintain specified transfer pricing documentation and information, on a contemporaneous basis.

This newsletter seeks to share a few practical pointers to enable an Indian company to comply with the law and withstand the might of Transfer Pricing scrutiny assessments conducted by the Transfer Pricing Officers ("TPO").

1: TRANSFER PRICING PROCESS

Here is a step-by-step process to conduct a transfer pricing study and comply with the documentation requirements:

1. Identification of intra group transactions
2. Functions, Assets and Risks ("**FAR**") Analysis
3. Identification of comparable transactions
4. Economic model characterization
5. Selection of tested party and selection of "most appropriate method"
6. Benchmarking with comparables using databases
7. Determination of Arm's Length Price
8. Documenting each step into a woven transfer pricing study report
9. Preparing and filing Form 3CEB, and retaining a complete documentation file, backing up each and every number and disclosure shown in the 3CEB Annexures.
10. Transfer Pricing assessments - a robust representation defending the transfer pricing study that was conducted, the documentation that was prepared and the arm's length pricing that was arrived at.

Practice Pointer: *This process is fundamental to arriving at and documenting the arm's length analysis of each transaction entered into by the Indian multinational entity with its AE.*

2: FAR ANALYSIS DOCUMENTATION

The starting step in any transfer pricing study is to conduct a Functional Analysis.

Functional Analysis: This requires a thorough understanding of the business model of the company, deep knowledge of the industry and the economy. Each function of the tested party needs to be analyzed in detail.

Once can start with the analysis of the technical services being rendered, manufacturing activities being undertaken, and go on to analyzing research and development activities, quality control, marketing, sales / business development, ordering and distribution, invoicing and collection, warehousing and inventory management, service warranty, human resources, administrative, financial and legal matters - each as a separate function.

Asset Analysis: A detailed analysis of the Intangibles being employed, include manufacturing and marketing intangibles, (IPs, Patents, Trademarks, Manufacturing Processes, Customer Lists, Brand etc.) should be conducted. This should be followed with a detailed analysis of tangible assets, including land and building, plant and equipments, other operating assets, non-operating assets, loans and advances granted and guarantees issued.

Risk Analysis: This includes a detailed analysis of entrepreneurial risk, product risk, market risk, collection risk, financial risk and all other risks facing an organization.

Practice Pointer: *There is an increased level of scrutiny of FAR in each transfer pricing assessment and we have observed transfer pricing adjustments in cases where the FAR analysis was not conducted appropriately by the Indian multinational. Thus, a robust FAR analysis, followed by the steps below, is the only sustainable solution to a strong transfer pricing defence.*

3: ECONOMIC CHARACTERIZATION

For manufacturing entities, one has to ascribe the economic characterization of limited scope manufacturer, to a toll manufacturer, to a contract manufacturer, to a full fledged manufacturer - varying with the degree of risks being assumed and assets being employed.

Distributors of products can be commission agents, commissionaire, limited risk distributors and full scope distributors, again the precise classification being a function of the risk being assumed and the exact role being performed.

For a service provider, the following value accretion scale needs to be ascribed to: Administration services, Support services, Co-ordination services, Back office services - Captive services and Customer satisfaction services, Marketing services, Business development / sales services and going up to Technical services: Low end, Medium end and High end.

Practice Pointer: *An analysis of the characterization would help us to classify the Entrepreneur in a given transaction and correspondingly, the Service Provider/Low Risk Manufacturer in the transaction.*

4: SELECTION OF TESTED PARTY, BENCHMARKING WITH COMPARABLES AND EXECUTING THE SEARCH PROCESS

An interesting aspect of Indian transfer pricing litigation has been the choice of tested party, followed by the benchmarking process.

As to the choice of tested party, OECD rules recommend that the "least complex" entity in the value chain be taken as the tested party and tested for arm's length analysis. But, Indian TPOs invariably prefer Indian multinational or Indian entity as the tested party, citing that the data is "verifiable" and therefore more reliable. This can be contested with strong documentation.

The benchmarking process starts with executing the search process meticulously and also needs that detailed documentation is generated and maintained with respect to the following:

1. Search methodology
2. Details of database
3. Source documents

4. Reasons for acceptance or rejection of comparables
5. Detailed accept/reject sheet- REJECTION MATRIX
6. Short business descriptions of accepted comparables
7. Financial data of all companies forming part of the search
8. Calculation of the margins/ mark-up using database and detailed review of annual reports for all accepted companies, bringing out the following:
 - Details of adjustments made to account for differences
 - Working the arithmetic mean of the chosen Profit Level Indicator (PLI) - comparables margin/mark-up.

Practice Pointer: *Even if the overseas entity was chosen as the tested party, a back-up arm's length analysis should be created with comparable position, wherever feasible, as if Indian entity was chosen as the tested party. This will help in a strong transfer pricing defence.*

5: FORM 3CEB

Another area of concern of transfer pricing documentation is the discrepancies found in Form 3CEB. These generally include disclosures as mentioned hereunder:

- Incomplete disclosure of information and Incorrect application of method
- Non-reporting of AEs and transactions with them. **Example:** Interest free loans, Corporate guarantees issued, intra-company services being rendered - for which no corresponding charge was recovered etc.
- Mismatches between Form 3CEB and the audited accounts
- Misclassification of information in the Form.

Practice Pointer: *Just like disclosures in the Tax Audit Report, Form 3CEB should be completed with adequate and abundant caution.*

The Income tax department will never understand your business as well as you do BUT if you fail to explain your business and pricing in easy language through documentation, the Transfer Pricing Officer will have a field day in proposing transfer pricing adjustments in favour of the revenue.

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