

# Lectures on Transfer Pricing

## A 360 degree view

By  
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# Why do we need Transfer Pricing?

- The structure of transactions within an MNE group (whose component parts, such as companies, are called “associated enterprises” in the language of transfer pricing) is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities.
- A large and growing number of international transactions are therefore NOT governed entirely by market forces, but driven by the common interests of the entities of a group.

# Why do we need Transfer Pricing?

- In such a situation, it becomes important to establish the appropriate price, called the “**transfer price**”, for intra-group, cross-border transfers of goods, intangibles and services. “Transfer pricing” is the general term for the pricing of cross-border, intra-firm transactions between related parties.
- Transfer pricing therefore refers to the setting of prices for transactions between associated enterprises involving the transfer of property or services.
- These transactions are also referred to as “controlled” transactions, as distinct from “uncontrolled” transactions between companies that are not associated and can be assumed to operate independently (“on an arm’s length basis”) in setting terms for such transactions.

# Why do we need Transfer Pricing?

## Some examples

MASTERS INC  
UAE

A pays \$100 for widget W

A Pvt. Ltd., India  
(subsidiary of Masters Inc, UAE)

- A and B both import from Masters Inc. UAE same widget.
- Transaction between A & Masters Inc is “controlled” transaction (A is WOS of Masters)
- A could move profits to Masters Inc by paying higher price than market price (i.e., not an “arm’s length” price) so that more money flows out of India to a less taxed jurisdiction
- B is a third party to Masters Inc. It has no incentive to pay higher than market price!

MASTERS INC  
UAE

B pays \$10 for widget W

B Pvt. Ltd., India  
(unrelated to Masters Inc &  
A Pvt. Ltd.)

# What is Transfer Pricing?

- Layman's definition: Transfer pricing refers to the rules and methods for pricing transactions within and between enterprises under common ownership or control.
- OECD: The pricing at which an Enterprise transfers physical goods and intangible goods and provides services to Associated Enterprises.

# How is Transfer Pricing applied?

- TP is applied or implemented on the basis of the **arm's length principle** allows national tax authorities to make an adjustment to the profits of one enterprise where the terms of transactions between associated enterprises differ from terms that would be agreed between unrelated enterprises in similar circumstances.
  - “arm's length price”, i.e. the transaction price to which two unrelated parties would agree.
- Article 9 of the OECD Model Convention provides for the concept of the ALP wherein the profits of Enterprises of MNE is based on transactions between the independent Enterprise under similar conditions and circumstances.
- **How to arrive the arm's length price for international transactions between associated enterprises? There in lies the rub!**

# A brief history of Transfer Pricing

- OECD TP Guidelines, 1995
- UN Practical Manual on Transfer Pricing, 2013
- IRC Section 482 Guidelines, 1994
- OECD BEPS (Base Erosion & Profit Shifting) Action Plans 8-10: Transfer Pricing – Guidance for applying the arm's length principle

# Indian genesis

- Standing Committee in March 1991 – the existing provisions of the Act were inadequate to deal with tax minimisation through transfer pricing
- Expert Group of CBDT – recommended complete overhaul of section 92 of the Act. Section 92, as it then stood, read:

***Income from transactions with non-residents, how computed in certain cases.***

*92. Where a business is carried on between a resident and a non-resident and it appears to the Assessing Officer that, owing to the close connection between them, the course of business is so arranged that the business transacted between them produces to the resident either no profits or less than the ordinary profits which might be expected to arise in that business, the Assessing Officer shall determine the amount of profits which may reasonably be deemed to have been derived therefrom and include such amount in the total income of the resident.*

- The Finance Act, 2001 introduced transfer pricing regulations in India by substituting existing Section 92 of the Act and introducing new sections 92A to 92F w.e.f. 01.04.2002 (AY 2002-03)



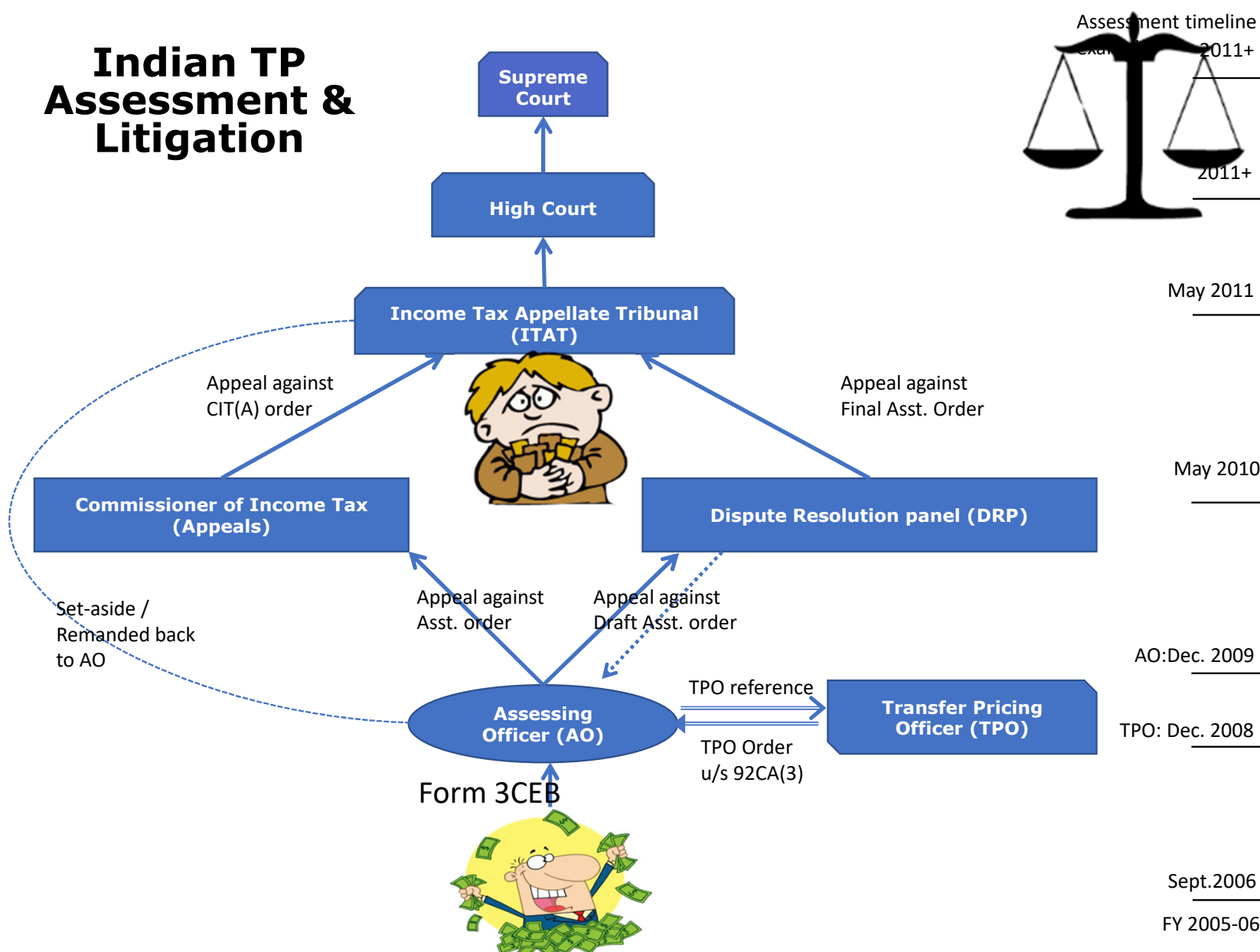
# TP in the Indian Income Tax Act & Rules

- **Chapter X : Special Provisions Relating to Avoidance of Tax”**
  - **Chapter X, Section 92** of the Income Tax Act (1961) and **Rule 10A-10THD** of the Income Tax Rules (1962)
- **Birds-eye, one-line overview of Indian TP:**
  - Run-of-the-mill TP provisions, OECD-lite and delightfully vague (like most TP provisions)!

# Indian TP Provisions – Section 92

Sections/Rules	Provisions relate to
<b>s 92</b>	Computation of Income, expenses, CCA
<b>s 92A</b>	Associated Enterprises (“AE”)
<b>s 92B</b>	International Transactions
<b>s 92C(1) (Rule 10B, 10C, 10CA, 10CB)</b>	Computation of Arm’s Length Price (“ALP”)
<b>s 92C/92CA</b>	Powers of Assessing Officer (“AO”) and Transfer Pricing Officer(“TPO”)
<b>s.92CB (Rule 10TA-10THD)</b>	Safe Harbor Rules
<b>s.92CC/92CD (Rule 10F-10T)</b>	APA
<b>s.92CE</b>	Secondary Adjustment
<b>s.92D (Rule 10D, 10DA, 10DB)</b>	Documentation requirements
<b>s 92E (Rule 10E, Form 3CEB)</b>	Accountant’s report
<b>s.92F (Rule 10A)</b>	Definitions
<b>s 271(1)(c), 271AA, 271BA, 271G</b>	Penalties

# Indian TP Assessment & Litigation



# Indian TP Glossary

Associated Enterprise / Related Party	CUP, CPM, RPM, TNMM, PSM, 6 <sup>th</sup> Method
International Transaction	Profit Level Indicator (PLI)
Controlled & Uncontrolled Transactions	Advertising, Marketing & Promotion (AMP)
Tested Party	Bright Line Test (BLT)
TP Methods	Advance Pricing Arrangement (APA)
Most Appropriate Method	Mutual Agreement Procedure (MAP)
Comparables	Safe Harbor
Filters	Secondary Adjustment
Adjustments	Contemporaneous Data

# Quick segue into S.92F - Definitions

In sections 92, 92A, 92B, 92C, 92D and 92E, unless the context otherwise requires,—

(i) "accountant" shall have the same meaning as in the *Explanation* below sub-section (2) of section 288;

(ii) **"arm's length price" means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions;**

(iii) "enterprise" means a **person** (including a permanent establishment of such person) who is, or has been, or is proposed to be, engaged in any activity, relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights, or the provision of services of any kind, or in carrying out any work in pursuance of a contract, or in investment, or providing loan or in the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate, whether such activity or business is carried on, directly or through one or more of its units or divisions or subsidiaries, or whether such unit or division or subsidiary is located at the same place where the enterprise is located or at a different place or places;

## Quick segue into S.92F - Definitions

(*iiia*) "permanent establishment", referred to in clause (*iii*), includes a fixed place of business through which the business of the enterprise is wholly or partly carried on;

(*iv*) "specified date" shall have the same meaning as assigned to "due date" in *Explanation 2* below sub-section (1) of section 139;

(*v*) "transaction" includes an arrangement, understanding or **action in concert**,—

(A) whether or not such arrangement, understanding or action is formal or in writing; or

(B) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceeding.

## Quick segue into Rule 10A - Meanings

- (a) "uncontrolled transaction" means a transaction between enterprises other than associated enterprises, whether resident or non-resident;
- (b) "property" includes goods, articles or things, and intangible property;
- (c) "services" include financial services;
- (d) "transaction" includes a number of closely linked transactions.

## S.92 Computation of income from international transaction having regard to arm's length price.

**92. (1) Any income arising from an international transaction shall be computed having regard to the arm's length price.**

*Explanation.*—For the removal of doubts, it is hereby clarified that the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arm's length price.

**(2) Where in an international transaction or specified domestic transaction, two or more associated enterprises enter into** a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises, the cost or expense allocated or apportioned to, or, as the case may be, contributed by, any such enterprise shall be determined having regard to the arm's length price of such benefit, service or facility, as the case may be.

**(2A)** Any allowance for an expenditure or interest or allocation of any cost or expense or any income in relation to the specified domestic transaction shall be computed having regard to the arm's length price.

**(3)** The provisions of this section shall not apply in a case where the computation of income under sub-section (1) or sub-section (2A) or the determination of the allowance for any expense or interest under sub-section (1) or sub-section (2A), or the determination of any cost or expense allocated or apportioned, or, as the case may be, contributed under sub-section (2) or sub-section (2A), has the effect of reducing the income chargeable to tax or increasing the loss, as the case may be, computed on the basis of entries made in the books of account in respect of the previous year in which the international transaction or specified domestic transaction was entered into.



## S.92A Meaning of associated enterprise

92A. (1) For the purposes of this section and sections 92, 92B, 92C, 92D, 92E and 92F, "associated enterprise", in relation to another enterprise, means an enterprise—

(a) which participates, directly or indirectly, or through one or more intermediaries, in the **management or control or capital** of the other enterprise; or

(b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

# S.92A Meaning of associated enterprise

(2) **For the purposes of sub-section (1)\***, two enterprises shall be deemed to be associated enterprises if, at any time during the previous year,—

(a) one enterprise holds, directly or indirectly, shares carrying **not less than twenty-six per cent of the voting power** in the other enterprise; or

(b) any **person** or enterprise holds, **directly or indirectly**, shares carrying not less than twenty-six per cent of the voting power in each of such enterprises; or

(c) a loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise; or

(d) one enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise; or

(e) more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise; or

(f) more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons; or

\* Finance Act 2002, w.e.f 1-4-2002, substituted for “Two enterprises shall be deemed to be associated enterprises, if, at any time during the previous year”

## S.92A Meaning of associated enterprise

(g) the manufacture or processing of **goods or articles or business** carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights; or

(h) ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise; or

(i) **the goods or articles** manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise; or

(j) where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or

(k) where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or jointly by such member and his relative; or

(l) where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association of persons or body of individuals; or

(m) there exists between the two enterprises, any relationship of mutual interest, as may be prescribed.

## S.92A(1) vs. S.92A(2)

Kaybee Pvt. Ltd . Vs ITO (ITA No.2165/Mum/15) dated Feb. 28, 2020

- The assessee before us is an Indian company and 99.9% of its shareholding is held by a person by the name of Govind Karunakaram (GK).
- The assessee had certain business transactions, which admittedly fall in the definition of 'international transactions', with a Singapore based entity by the name of Kaybee Exim Pte Ltd (KE- S, in short). GK is also one of the three directors in KE-S.
- It was also noted by the Assessing Officer that KE-S website shows the assessee company as a "representative company". It was in this backdrop that the Assessing Officer observed that under section 92A(1)(b) *"an associated enterprise, in relation to another associated enterprise, means an enterprise in respect of which one or more persons who participate, directly or indirectly or through one or more intermediaries, in its management or control or capital of the other enterprise"*.
- As regards plea of the assessee that relationship between the assessee company and KE-S does not satisfy the conditions laid out in section 92A(2), and, therefore, the assessee and KE-S cannot be treated as AEs, the Assessing Officer observed that "sub section (2) [of section 92A] does not negate the provisions of section (1) [of section 92A]".

# S.92A(1) vs. S.92A(2)

Kaybee Pvt. Ltd . Vs ITO (ITA No.2165/Mum/15) dated Feb. 28, 2020

- According to the learned Assessing Officer, the provisions of Section 92A(1) are required to be read on standalone basis rather than in conjunction with Section 92A(2). The assessee and KE-S were thus held to be AEs.
  - Issue at the time of ITAT hearing was covered against assessee by *Diageo India Pvt Ltd Vs DCIT [(2011) 47 SOT 252]* and two coordinate benches of assessee's own case
- **Tribunal held in favour of assessee because:**
  - Amendment w.e.f 1<sup>st</sup> April 2002 “for the purpose of sub-section (1)”. It is thus pointed out that by way of this amendment, the scope of Section 92A(1) was specifically restricted.
  - Also CBDT circular No. 8 dated 27th August 2008 which states “*the existing provisions contained in section 92A of the Income Tax Act, provide as to when the two enterprise will be deemed to be associated enterprises*” and then adds that “*the Finance Act, 2002, has amended sub section (2) of section 92A to clarify that where any of the criterion specified in sub section (2) is fulfilled, two enterprises shall be deemed to be associated enterprises*”
  - **ACIT Vs Veer Gems [(2017) 77 taxmann.com 127]**, approved by Hon'ble Gujarat High Court **PCIT Vs Veer Gems [(2017) 83 taxmann.com 271]** and SLP against it dismissed **PCIT Vs Veer Gems [(2018) 95 taxmann.16]**.

## S.92A(1) vs. S.92A(2)

PCIT Vs Veer Gems [(2017) 83 taxmann.com 271] Guj. HC

*"However, the expression 'participation in management or capital or control' is not a defined expression. To find the meaning of this expression, one has take recourse to Section 92(2) which gives practical illustrations, which are exhaustive and not simply illustrative- as clarified in the Memorandum explaining the provisions of the Finance Bill 2002 which, while inserting the words 'For the purpose of sub section (1) of section 92A' in Section 92A(2), observed that 'It is proposed to amend subsection (2) of the said section to clarify that the mere fact of participation by one enterprise in the management or control or capital of the other enterprise, or the participation of one or more persons in the management or control or capital of both the enterprises shall not make them associated enterprises, unless the criteria specified in sub-section (2) are fulfilled'. **In this sense, Section 92A(2) governs the operation of Section 92A(1) by controlling the definition of participation in management or capital or control by one of the enterprise in the other enterprise. If a form of participation in management, capital or control is not recognized by Section 92A(2), even if it ends up in de facto or even de jure participation in management, capital or control by one of the enterprise in the other enterprise, it does not result in the related enterprises being treated as 'associated enterprises'. Section 92A(1) and (2), in that sense, are required to be read together, even though Section 92A(2) does provide several deeming fictions which prima facie stretch the basic rule in Section 92A(1) quite considerably on the basis of, what appears to be, manner of participation in "control" of the other enterprise.***

***What is thus clear that as long as the provisions of one of the clauses in Section 92A(2) are not satisfied, even if an enterprise has a de facto participation capital, management or control over the other enterprises, the two enterprises cannot be said to be associated enterprises***

## S.92A(1) vs. S.92A(2)

Orchid Pharma Ltd Vs DCIT [76 taxmann.com 63] Chennai

- Orchid pharma and its distributor Irish company Northstar were they AE's? There was a profit sharing arrangement between the parties
- TPO relied on earlier year order of Settlement Commission in assessee's case where Commission was of view that assessee & Northstar were AE's.
- Chennai Bench of ITAT held Settlement Commission decision is not binding legal precedent for it.
- ITAT limited the scope and context of 'associated enterprises' under the Income Tax Act, 1961.
- Merely influencing price would not make an entity an Associated Enterprise of the other under Section 92A(2)(i), unless it also results in participation in 'control' of the other entity under Section 92A(1).
- Northstar related sales of assessee are only 5% . 'Influence' over price should be '*dominant influence*' and not merely '*influence simplicitor*'.

## S.92A: AE in substance not form

- Two or more enterprises cannot be regarded as associated enterprises unless the provisions of section 92A are satisfied. This will be the case even if the assessee files Form No. 3CEB (CA report) mentioning the names of certain enterprises as its AEs as a matter of abundant caution - Sanchez Capital Services (P.) Ltd. v. ITO [2012] 26 taxmann.com 61 (Mum.).



## S.92A: Foreign AE as Tested Party

- Tested party is a basic step of TP analysis. We apply the TP methods on the tested party. Especially important for transactional methods.
  - Not defined in the Act!
- OECD Guidelines Para 3.18 - *“the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparable can be found, i.e. it will most often be the one that has the less complex functional analysis.”*
- UN Model Para B.2.3.3 – *“The tested party normally should be the less complex party to the controlled transaction and should be the party in respect of which the most reliable data for comparability is available. It may be the local or the foreign party...”*

## S.92A: Foreign AE as Tested Party:

Those in favour, say aye!

- General Motors India Pvt. Ltd (37 taxmann.com 403) (Ahm Trib)
- Ranbaxy Laboratories Ltd. v. ACIT (68 taxmann.com 322) (Delhi Trib.)
- IDS Infotech Ltd v. DCIT [2017] (80 taxmann.com 88) (Chd Trib.)
- Almatis Alumina Pvt Ltd v. DCIT (ITA. No. 283 of 2016)
- Global Vantage Pvt Ltd v. ACIT 97 taxmann.com 172 (Delhi Trib)
- If the foreign AE meets criteria of:
  - Least complex entity among parties in transaction
  - Availability of comparable data
  - Minimal adjustments required to use data
- Concur with the UN and OECD view. (Perfect world much?)

## S.92A: Foreign AE as Tested Party:

Those against, say nay!

- M/s. Onward Technologies Limited [2013] 155 TTJ 439 (Mum.)
- AT & S India (P.) Ltd. v. DCIT [2016] 72 taxmann.com 324 (Kol Trib.)
- GE Money Financial Services (P.) Ltd. v. DCIT (ITA 440 of 2014) (Delhi Trib.)
- Jaso India Private Limited v DCIT [2018] (98 Taxmann.com 469)
- Bekaert Industries Private Limited v DCIT (Pune Tribunal) [2019] (ITA No. 146 and 171 pf 2014)
- Reasoning:
  - Lacks legal sanction under Indian law
  - “enterprise” under Rule 10B restricted to Indian entities

## S.92A: Foreign AE as Tested Party

- S.92F(iii) defines “enterprise” which states “.... *A person (including a permanent establishment of the person) ...*” .
- S.2(31) definition of person includes “company” r.w. S.2(17) includes foreign company ie incorporated by or under laws of a country outside India
- Theoretically everything is justifiable, practically what is possible?
  - Foreign AE is the Rube Goldberg answer to Transfer Pricing?
- Interesting interplay with CbCR and MasterFile ie using global transfer pricing policy to satisfy Indian TP?

## S.92B Meaning of international transaction

(1) For the purposes of this section and sections 92, 92C, 92D and 92E, "inter- national transaction" means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of 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 such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

## S.92B Meaning of international transaction

(2) A transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purposes of sub-section (1), be deemed to be an international transaction entered into between two associated enterprises, if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise where the enterprise or the associated enterprise or both of them are non-residents irrespective of whether such other person is a non-resident or not.

# S.92B Meaning of international transaction

*Explanation (by Finance Act 2012 w.r.e.f 1<sup>st</sup> April 2002)* .—For the removal of doubts, it is hereby clarified that—

(i) the expression "international transaction" shall include—

- (a) the purchase, sale, transfer, lease or use of tangible property including building, transportation vehicle, machinery, equipment, tools, plant, furniture, commodity or any other article, product or thing;
- (b) the purchase, sale, transfer, lease or use of intangible property, including the transfer of ownership or the provision of use of rights regarding land use, copyrights, patents, trademarks, licences, franchises, customer list, marketing channel, brand, commercial secret, know-how, industrial property right, exterior design or practical and new design or any other business or commercial rights of similar nature;
- (c) capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business;
- (d) provision of services, including provision of market research, market development, marketing management, administration, technical service, repairs, design, consultation, agency, scientific research, legal or accounting service;
- (e) a transaction of business restructuring or reorganisation, entered into by an enterprise with an associated enterprise, irrespective of the fact that it has bearing on the profit, income, losses or assets of such enterprises at the time of the transaction or at any future date;

## S.92B Meaning of international transaction

(ii) the expression "intangible property" shall include—

- (a) marketing related intangible assets, such as, trademarks, trade names, brand names, logos;
- (b) technology related intangible assets, such as, process patents, patent applications, technical documentation such as laboratory notebooks, technical know-how;
- (c) artistic related intangible assets, such as, literary works and copyrights, musical compositions, copyrights, maps, engravings;
- (d) data processing related intangible assets, such as, proprietary computer software, software copyrights, automated databases, and integrated circuit masks and masters;
- (e) engineering related intangible assets, such as, industrial design, product patents, trade secrets, engineering drawing and schema-tics, blueprints, proprietary documentation;
- (f) customer related intangible assets, such as, customer lists, customer contracts, customer relationship, open purchase orders;



## S.92B Meaning of international transaction

....(g) contract related intangible assets, such as, favourable supplier, contracts, licence agreements, franchise agreements, non-compete agreements;

(h) human capital related intangible assets, such as, trained and organised work force, employment agreements, union contracts;

(i) location related intangible assets, such as, leasehold interest, mineral exploitation rights, easements, air rights, water rights;

(j) goodwill related intangible assets, such as, institutional goodwill, professional practice goodwill, personal goodwill of professional, celebrity goodwill, general business going concern value;

(k) methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data;

(l) any other similar item that derives its value from its intellectual content rather than its physical attributes.

## S.92B – Corporate Guarantee

- Is act of giving a corporate guarantee for an AE an “international transaction”?
  - Doesn’t retrospective Explanation (i)(c) directly say so?
- **Assessee contention:** The guarantees do not have any **impact on income, profits, losses or assets** when an assessee extends an assistance to the associated enterprise, which does not cost anything to the assessee and particularly for which the assessee could not have realized money by giving it to someone else during the course of its normal business, such an assistance or accommodation does not have any bearing on its profits, income, losses or assets, and, therefore, it is outside the ambit of international transaction under section 92B(1).
- **Assessee’s further contend** it is a quasi-equity transaction. Father helps child, child takes care of father 😊 [dividends etc]

# S.92B – Corporate Guarantee

Bharti Airtel Ltd. Vs. ACIT (ITA No.5816/Del/2012 AY 08-9 dated March 11, 2014)

- Bharti Airtel beautifully sets this up by examining clauses (c) to (e):

*“This pre-condition about impact on profits, income, losses or assets of such enterprises is a pre-condition embedded in Section 92B(1) and the only relaxation from this condition precedent is set out in clause (e) of the Explanation which provides that the bearing on profits, income, losses or assets could be immediate or on a future date. The contents of the Explanation fortifies, rather than mitigates, the significance of expression ‘having a bearing on profits, income, losses or assets’ appearing in Section 92 B(1).”*

....

*However, as we have decided the issue in favour of the assessee on merits and **even after taking into account the amendments brought about by Finance Act 2012**, we need not deal with this aspect of the matter in greater detail” !!*

# S.92B – Corporate Guarantee

Favourable judgments to the Assessee

- Adani Ports and Special Economic Zone Ltd [2019] (104 taxmann.com 368)
- BS Ltd v ACIT [2018] 94 taxmann.com 346 [2018](Hyd Tribunal)
- Suzlon Energy Ltd. vs. ACIT [2017] 81 taxmann.com 190 (Ahm Trib.)
- Cadila Healthcare Ltd. ACIT [2017] 186 TTJ 421 (Ahm Trib.)
- Dr. Reddy's Laboratories Ltd. vs. ACIT [2017] 81 taxmann.com 398 (Hyd Trib.)
- Redington India Ltd. v/s. JCIT [2014] 49 Taxmann.com 146 (Chennai Trib.)
- M/s. Aban Offshore Ltd. v/s. DCIT [TS-877-ITAT-2016 (CHNY)-TP]

## S.92B – Corporate Guarantee

Everest Kanto Cylinder Ltd. Vs. DCIT (ITA 542/Mum/2012) dated 23<sup>rd</sup> Nov. 2012

*“So far as the learned Senior Counsel's contention that guarantee commission is not an international transaction and there could not be any method for evaluating the ALP for the guarantee commission, **we do not find any merit in the said contention in view of the amendment brought by the Finance Act, 2012 with retrospective effect from 1-4- 2002 by way of Explanation added in Section 92B. Payment of guarantee fee is included in the expression 'international transaction' in view of the Explanation i(c) of Section 92B.** Once the guarantee fee falls within the meaning of 'international transaction', then the methodology provided in the rules also becomes applicable. Here in this case, it is undisputed that the assessee in its T.P.Study Report and also the TPO, have accepted that it is an international transaction and CUP is the most appropriate method for benchmarking the charging of guarantee fee*

*We also do not agree with the contention of the learned counsel that there could not be any cost or charge of guarantee fee by providing corporate guarantee to its subsidiary because there is an always element of benefit or cost while providing such kind of guarantee to AE. However, in this case, **the assessee has itself charged 0.5% guarantee commission** from its AE, therefore, it is not a case of not charging of any kind of commission from its AE. The only point which has to be seen in this case is whether the same is at ALP or not”*

- High Court confirmed this ruling in **Tax Appeal No.1165 of 2013 dated 8<sup>th</sup> May, 2015** saying there was no substantial question of law and also pointing out Bank Guarantees as taken by TPO for comparison are different from Corporate Guarantees

# S.92B Corporate Guarantee

If you paid guarantee fees, the ALP is....

## **0.5%**

- Videocon Industries Ltd. vs. DCIT [2017] 186 TTJ 353 (Mum.)
- Xchanging Solutions Ltd. vs. DCIT [2017] 185 TTJ 385 (Bang Trib.)
- Laqshya Media (P.) Ltd. vs. DCIT [2017] 80 taxmann.com 309 (Mum.)
- Zee Entertainment Enterprises Ltd. vs. ACIT [2017] 81 taxmann.com 379 (Mum.)
- Endurance (India) (P.) Ltd. vs. ACIT [2017] 79 taxmann.com 181 (Pune Trib.)
- Piramal Glass Ltd. vs. DCIT [2017] 80 taxmann.com 68 (Mum.)

## **0.25% – 0.27%**

CIT vs. Glenmark Pharmaceuticals Ltd [TS-61-HC-2017(BOM)-TP]

DCIT vs. Lanco Infratech Ltd [2017] 81 taxmann.com 381 (Hyd Trib.)

## S.92C Computation of arm's length price

*92C. (1) The arm's length price in relation to an international transaction or specified domestic transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely :—*

- (a) comparable uncontrolled price method;*
- (b) resale price method;*
- (c) cost plus method;*
- (d) profit split method;*
- (e) transactional net margin method;*
- (f) such other method as may be prescribed by the Board.*

## S.92C Computation of arm's length price

*Provided that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the **arithmetical mean** of such prices:*

*Provided further that if the variation between the arm's length price so determined and price at which the international transaction or specified domestic transaction has actually been undertaken **does not exceed such percentage not exceeding three per cent** of the latter, as may be notified by the Central Government in the Official Gazette in this behalf, the price at which the international transaction or specified domestic transaction has actually been undertaken **shall be deemed to be the arm's length price** :*

***Provided also that where more than one price is determined by the most appropriate method, the arm's length price in relation to an international transaction or specified domestic transaction undertaken on or after the 1st day of April, 2014, shall be computed in such manner as may be prescribed and accordingly the first and second proviso shall not apply.***

*Explanation.—For the removal of doubts, it is hereby clarified that the provisions of the second proviso shall also be applicable to all assessment or reassessment proceedings pending before an Assessing Officer as on the 1st day of October, 2009*

- Arm's length band +/- 5% (then made +/- 3%)
  - **Is it a standard deduction?** Up to Finance Act 2009 amendment clarifying it is NOT, decisions favourable & against by various ITAT's
  - Finance Act 2012 retrospective amendment put a stop to issue?
  - **Read IHG IT Services India P Ltd vs. ITO (5890/Del/2010 SB dated 30.4.2013)**



# Applying the new Arm's length Range Concept

- CBDT Notification No 83/2015 dated 19<sup>th</sup> October 2015
- Amended rules allow for use of a “range concept” for determination of ALP and “use of multiple year” data for undertaking TP comparability analysis
- Applicable for international txns & SDT undertaken w.e.f 1 April 2014
- Minimum of 6 comparable entities are required to be selected
- 3-year data of comparable entities considered in constructing the data set and the weighted average of data of each company will be used
- **Data points lying within 35-65<sup>th</sup> percentile of data set series would constitute the “range”**
- If number of comparables less than 6, then arithmetic mean of PLIs shall be used as ALP. Not applicable for PSM & 6<sup>th</sup> Method
- **Income Tax Rules - Rule 10CA(4) to (8) define range concept in detail**

# Applying the new Range Concept – Part 2

- Step 1: Arrange margins/prices data in ascending order
- Step 2: Compute
  - $A = .35 * \text{number of data points}$
  - $B = .65 * \text{number of data points}$
- Step 3: If A & B are whole numbers:
  - Lower = Average of data point at A and (A+1)st position
  - Upper = Average of data point at B and (B+1)st position
- Step 4: If A & B are not whole numbers:
  - Lower = Round up A and use data point at such position
  - Upper = Round up B and use data point at such position

# Math refresher!

- **Percentile**

- Indicates the value below which a given % of observations in a group of observations fall
- In simpler words: “A percentile is a number where a certain percentage of scores fall below that percentile”
- In even simpler words: Say, if you scored 67 out of 90 it has no meaning unless you know your score is in the 90<sup>th</sup> percentile which means you scored better than 90% of the people who took the test!

- **Arithmetic Mean** is average of the dataset

- **Median** is the middle value of the organized dataset

- Most statisticians will tell you that: “Averages can be misleading! Try a percentile” – Why?

- Outliers will affect the mean a lot; not percentile. Remember Bodhtree Consulting?!

- **Quiz question: What percentile is the Median?**

# Applying Range Concept - Illustrations

Percentile	Formula	Result	Value to be Selected
35 <sup>th</sup>	Total no of data points * 35% [ <b>7</b> * 35%]	2.45	3 <sup>rd</sup> Value
65 <sup>th</sup>	Total no of data points * 65% [ <b>7</b> * 65%]	4.55	5 <sup>th</sup> Value
Median	Total no of data points * ____% [ <b>7</b> * ____]	_____	____ Value

Percentile	Formula	Result	Value to be Selected
35 <sup>th</sup>	Total no of data points * 35% [ <b>20</b> * 35%]	7.00	Mean of 7 <sup>th</sup> & 8 <sup>th</sup> Value
65 <sup>th</sup>	Total no of data points * 65% [ <b>20</b> * 65%]	13.00	Mean of 13 <sup>th</sup> & 14 <sup>th</sup> Value
Median	Total no of data points * ____% [ <b>20</b> * 0.5]	_____	Mean of ____ & ____ Value

# RANGE- AN ILLUSTRATION

## Scenario 1 – Benchmarking sale of goods

Three-year old weighted average margin of comparable companies (OP/OC %)	1	2	3	4	5	6	7	8	9
	10	15	16	-4	5	25	30	6	30
Step 1. Sorted in Ascending order	-4	5	6	10	13	15	16	25	30
Arithmetic mean	.....???								
Step 2. Range 35th to 65th percentile	DON'T SLEEP! CALCULATE!								

## Scenario 2 – Benchmarking sale of goods

Three-year old weighted average margin of comparable companies	1	2	3	4	5	6	7	8	9
	10	15	16	-4	5	40	30	6	13
Step 1. Ascending order	-4	5	6	10	13	15	16	30	40
Arithmetic Mean	.....???								
Step 2. Range 35 <sup>th</sup> to 65 <sup>th</sup> Percentile	CALCULATE!								







## Scenario 4 – Benchmarking sale of goods

Three-year old weighted average margin of comparable companies (OP/OC %'s)	1	2	3	4	5	6	7
	20	22	-1	-2	-4	-5	25
Step 1. Ascending order	-1	-2	-4	-5	20	22	25
Arithmetic Mean	.....???						
Step 2. Range 35 <sup>th</sup> to 65 <sup>th</sup> Percentile	CALCULATE!						



# Points to remember

- Arithmetic mean allows a +/- 3% range around it.
- Arms length range concept via percentiles gives you the range for the ALP price. **If not in range, adjustment made using median of dataset as ALP.**
- Percentiles are not a panacea. Comparable cherrypicking will stick exists on both sides
- **Margin** means profit margin
  - OP/OC: Operating Profit / Operating Cost
  - OP/OR : Operating Profit / Operating Revenue
- **Operating** is the key word here!
- “Weighted average” in the CBDT circular context is just adding OP’s and OC’s over 3 years and dividing OP/OC.

# Weighted average

Sl. No.	Name	Year 1	Year 2	Year 3 [Current Year]	Aggregation of OC and OP	Weighted Average
1	2	3	4	5	6	7
1	A	OC = 100 OP = 12	OC = 150 OP = 10	OC = 225 OP = 35	Total OC = 475 Total OP = 57	OP/OC = 12%
2	B	OC = 80 OP = 10	OC = 125 OP = 5		Total OC = 205 Total OP = 15	OP/OC = 7.31%
3	C	OC = 250 OP = 22	OC = 230 OP = 26	OC = 250 OP = 18	Total OC = 730 Total OP = 66	OP/OC = 9%
4	D		OC = 220 OP = 22		Total OC = 220 Total OP = 22	OP/OC = 10%
5	E			OC = 100 OP = (-) 5	Total OC = 100 Total OP = (-)5	OP/OC = (-)5%
6	F	OC = 160 OP = 21	OC = 120 OP = 14	OC = 140 OP = 15	Total OC = 420 Total OP = 50	OP/OC = 11.9 %
7	G	OC = 150 OP = 21	OC = 130 OP = 12	OC = 155 OP = 13	Total OC = 435 Total OP = 46	OP/OC = 10.57%

# What do other countries follow?

- OECD advocates the usage of Inter-Quartile Range (IQR)
  - This is the range from the 25<sup>th</sup> to the 75<sup>th</sup> percentile of results derived from the uncontrolled comparables
- TP Adjustments usually done to the Median
- Concept of IQR has been adopted by majority of the countries in their TP regulations
  - UK, USA, Austria, Australia, France, Singapore, South Africa, Mexico, Indonesia, Denmark, China etc.

# Multiple year data

Rule 10B(4) – History lesson

*Rule 10B(4) The data to be used in analysing the comparability of an uncontrolled transaction with an international transaction [or a specified domestic transaction] shall be the data relating to the financial year [(hereafter in this rule and in rule 10CA referred to as the 'current year')] in which the international transaction [or the specified domestic transaction] has been entered into :*

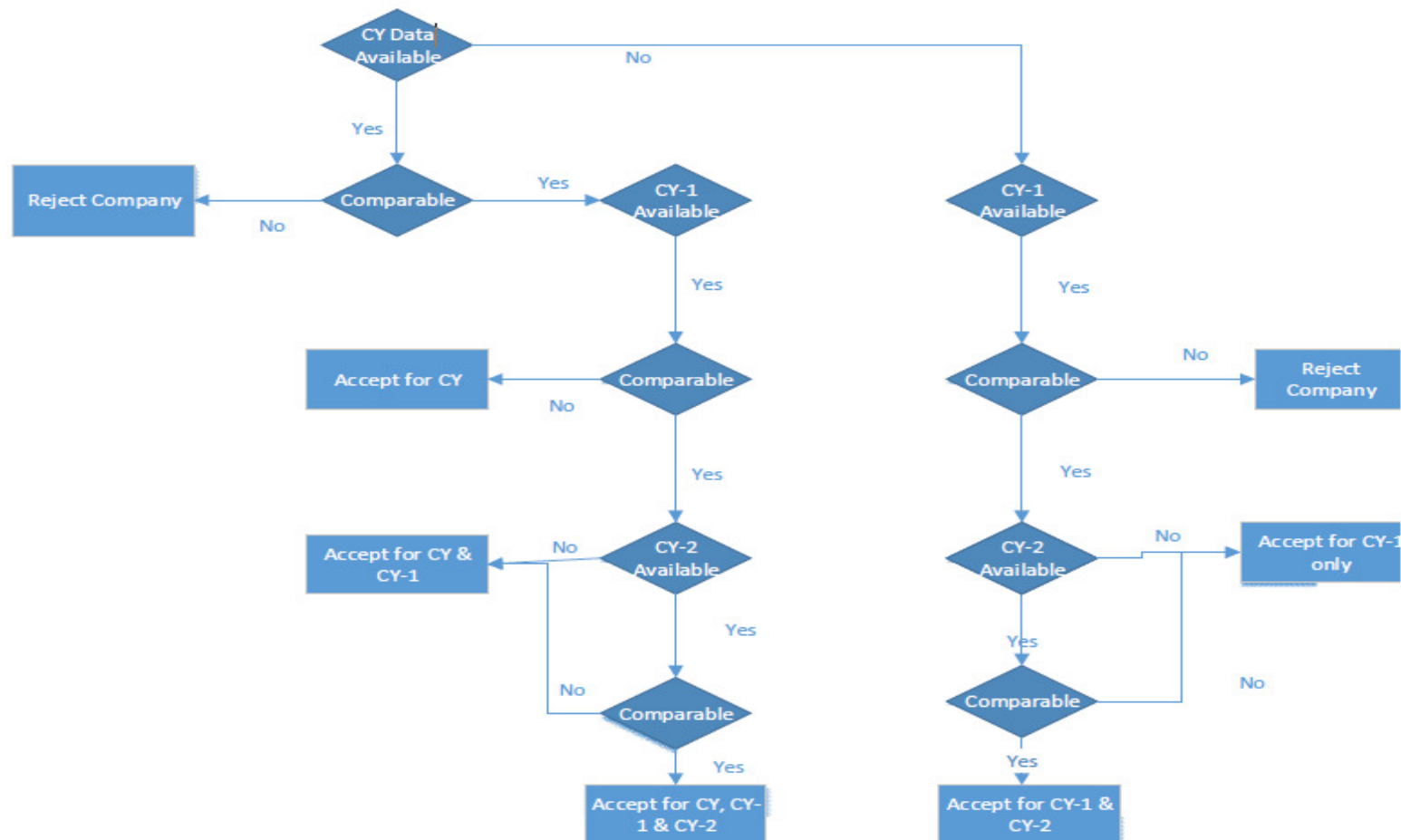
*Provided that data relating to a period not being more than two years prior to [the current year] may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared:*

- Practically never accepted or easily demonstrated
- CBDT Circular 19.10.2015 sunsets Proviso to 10B(4) by inserting second Proviso and adds S.10B(5) & S.10CA detailing the new “Multiple year” data regime. Let’s look at it!!

# Multiple year data – Dataset construction

- **STEP 1:** In case current year ('CY') data is available, assess comparability for CY.
  - If found not comparable for CY, comparable is rejected.
  - If comparable for CY, use available data for CY.
    - Proceed to check comparability for CY-1.
      - If CY-1 data is available and comparable, then accept for CY-1.
      - If CY-1 is comparable, proceed to check comparability for CY-2 and accept if comparable for CY-2.
- **Step 2:** If data for CY not available, check for CY-1 data.
  - If CY-1 data not available/not comparable, reject company.
  - If CY-1 data available and comparable, check for comparability for CY-2. Accept CY-2 data if CY-2 data available and comparable; if not, use only CY-1 data

# Multiple year Data Flowchart





## Operating margins – Multiple year Data Rule 10CA (2) and (3)

Comparable	Availability of Data		
	2015	2014	2013
<b>A Ltd</b>	Available and Comparable	Available and Comparable	Available and Comparable
<b>B Ltd</b>	Not Available	Available and Comparable	Available and Comparable
C Ltd	Not Available	Not available	Available and Comparable
D Ltd	Available but not Comparable	Available and comparable	Available and Comparable
<b>E Ltd</b>	Available and Comparable	Available but not Comparable	Available and Comparable

# Applicability of Range & Multiple year data

Methods	Multiple year Data	Range Concept
CUP	No	Yes
Cost-Plus	Yes	Yes
RPM	Yes	Yes
TNMM	Yes	Yes
PSM	No	No
Other Method	No	No

## S.92C : TP Methods

Comparable Uncontrolled Price (CUP)	Price of transaction	Where there is very close similarity or identical transaction undertaken with non-AE or by third parties
Re-sale price (RPM)	Gross Profit Margin	When purchases from related party and sales to unrelated party with little value addition
Cost Plus (CPM)	Gross Profit Margin on direct/indirect cost	When purchase or sale is semi-finished goods/services
Profit Split Method (PSM)	Relative contribution per entity to total value addition	Unique intangibles involved, multiple inter-related transactions exist
Transactional Net Margin Method (TNMM)	Net Profit Margin with reference to costs incurred, sales affected or assets employed	Broad comparability criteria
Other Method	Price charged	Info is available by way of quotations, valuation reports etc. to the establish price that would be charged

# FAR-reaching consequences

Rule10B(2) & (3) - TP's bedrock

(2) *For the purposes of sub-rule (1), the **comparability of an international transaction** [or a specified domestic transaction] with an uncontrolled transaction shall be judged with reference to the following, namely:—*

- (a) the specific characteristics of the property transferred or services provided in either transaction;*
- (b) the **functions performed, taking into account assets employed or to be employed and the risks assumed**, by the respective parties to the transactions;*
- (c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;*
- (d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.*

(3) *An **uncontrolled transaction shall be comparable to an international transaction** [or a specified domestic transaction] if—*

- (i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market; or*
- (ii) **reasonably accurate adjustments can be made to eliminate the material effects of such differences.***

# TP Methods: Conceptual Understanding

- **Traditional Transaction methods** (CUP, RPM, CPM)
  - Measure terms and conditions of actual transactions between independent enterprises and compares these with those of a controlled transaction i.e **rely on actual transactions**.
  - This comparison can be made on the basis of direct measures such as the price of a transaction but also on the basis of indirect measures such as gross margins realized on a particular transactions.
- **Transactional Profit Methods** (TNMM, PSM for example)
  - The transactional profit methods don't measure the terms and conditions of actual transactions. In fact, these methods measure the net operating profits realized from controlled transactions and compare that profit level to the profit level realized by independent enterprises that are engaged in comparable transactions **i.e rely on profit levels**
  - The transactional profit methods are less precise than the traditional transaction methods, but much more often applied. The reason is that application of the traditional transaction methods, which is preferred, requires detailed information and in practice this information is not easy to find.

# Indian TP : Most Appropriate Method

- Indian TP never had hierarchy of methods. It was always the “Most Appropriate Method”
- OECD originally had preference for the “traditional” methods being but has long dropped any preference or hierarchy.
- *Rule 10C(1) For the purposes of sub-section (1) of section 92C, **the most appropriate method shall be the method which is best suited to the facts and circumstances of each particular international transaction** [or specified domestic transaction], and which provides the most reliable measure of an arm's length price in relation to the international transaction [or the specified domestic transaction, as the case may be].*
- Rule 10C(2) lists all the factors that need to be taken into account to select MAM
- Bottomline: TNMM is by far simplest to apply and is a de-facto choice in many cases by the (Assessee &) Department.

# CUP Method

Rule 10B(1)(a) comparable uncontrolled price method

*(i) the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified;*

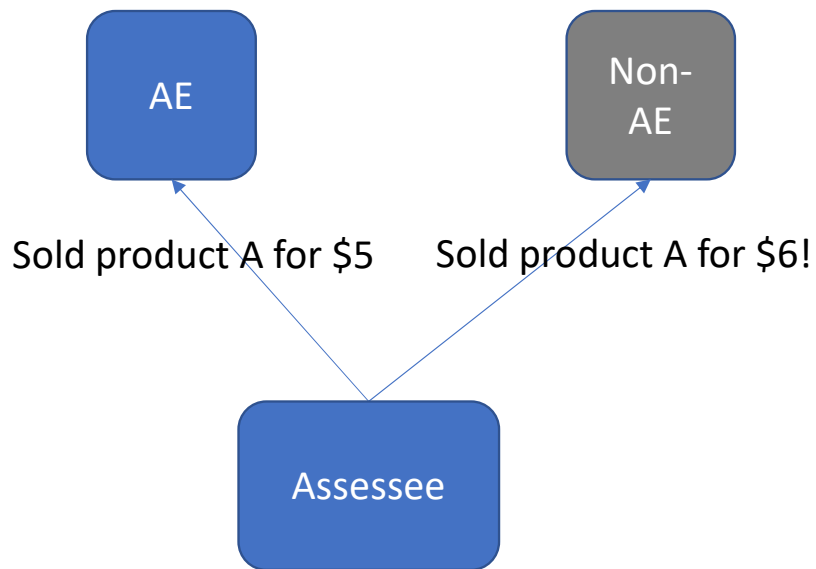
*(ii) such price is adjusted to account for differences, if any, between the international transaction [or the specified domestic transaction] and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market;*

*(iii) the adjusted price arrived at under sub-clause (ii) is taken to be an arm's length price in respect of the property transferred or services provided in the international transaction [or the specified domestic transaction] ;*

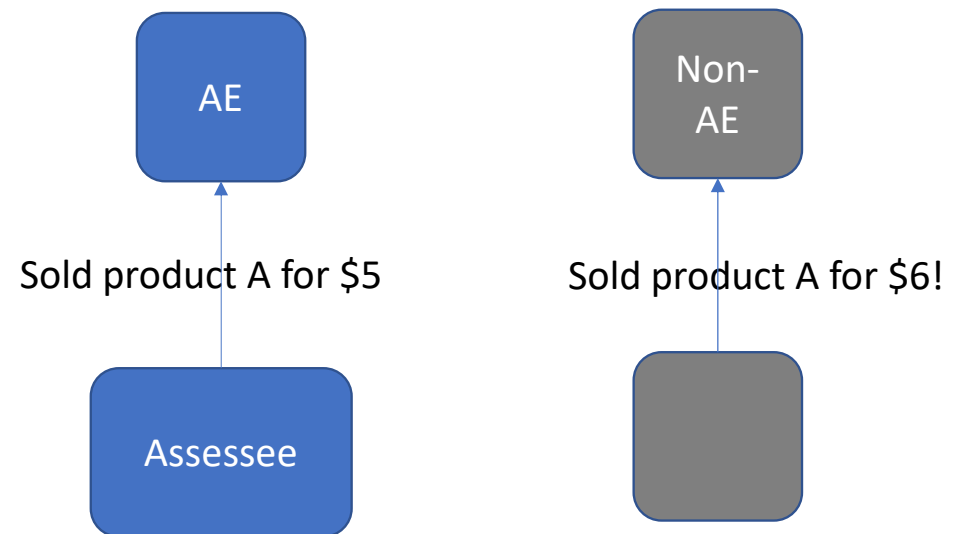
# CUP Method

- CUP = Comparable Uncontrolled Price
- The CUP Method compares the terms and conditions (including the price) of a controlled transaction to those of a third party transaction.

## Internal CUP



## External CUP





# CUPle of examples! (A simple Quiz?)

## **Example 1:**

Say a well-known car rental company is trying to determine how much to charge its Indian subsidiary for the use of its brand name and logo.

To apply the internal CUP method, their transfer pricing team must find examples of licensing agreements between the car rental company and an independent third-party that use their branding.

Assuming that the third party arrangement is sufficiently comparable, to be accepted by tax authorities, the car rental company should charge its Canadian subsidiary the same licensing fee that it charges the third party they do business with.

## **Example 2:**

A diamond company is trying to determine an appropriate amount to charge its subsidiary for diamonds. The diamond company has no relationships with third parties and thus has no similar internal transactions to use.

Its transfer pricing team identifies comparable transactions between two unrelated companies.

Assuming that identifies sufficiently comparable transactions, to be accepted by tax authorities, the diamond company should charge its subsidiary a price comparable to the market price of diamonds.

**What CUP is Example 1 ? What about Example 2?**

# Internal CUP

- Similarity of transaction
  - Exact/Identical transaction is what the Department is looking for!
- Geography
  - AE in developed country, non-AE in completely different market?
- Volume of sales to non-AE
  - AE 95%, non-AE 5% - does that work? (This is TP – nobody knows what will work!)
- While bench marking a controlled transaction, mere selling of an identical product to unrelated party is not sufficient for applying Comparable Uncontrolled Price (CUP) as the most appropriate method unless reasonable and accurate adjustments on account of economic and market differences can be arrived to determine the arm's length price. [**M/s Intervet India Private Limited – 2010-TIOL-240- ITAT-MUM**].
  - Emami Limited [TS-468-ITAT-2018(Kol)-TP]
  - ACIT Vs Genesys International Corpn. Ltd. (ITAT Mumbai) (IT Appeal NoS. 3333 & 3334 (Mum.) of 2010, 31/08/2012)

# External CUP

Using external data

- No bar on reliance of private database u/R 10D(3) , it only compiled public data in easily available form (Daily Export Port data, TIPS software)
  - **Tilda Riceland vs ACIT (dated 22.2.2014)**
- Prices on London Metal Exchange found to be valid CUP data
  - **ACIT Vs. MSS India (P) Ltd reported in 123 TTJ 657 (Pune)**
- Quotations?
  - Average of two sets of prices from quotations of Malaysia Palm Oil Board (statutory nodal agency in Malaysia) and OilWorld (independent org.) . TPO took only MPOB, rejected OilWorld. CIT, Tribunal and HC accepted assessee's view! (**CIT vs Adani Wilmar 363 ITR 338 Guj HC**)
  - Price quotes Approved in *Cargill Foods India Ltd.* ([TS-151-ITAT-2015\(PUN\)-TP](#)).
  - Quotations which haven't fructified into transactions not approved in **DCIT v Noble Resources & Trading India Pvt Ltd - TS-269-ITAT-2016 (Del) – TP**
  - **BEPS Action Plans 8-10** in respect to use of Quoted Prices and their authenticity for comparability analysis under the CUP Method.

# CUP Aggregation

- Can we aggregate in CUP? “closely linked” **depends on facts & circumstances.**

*“82. There is considerable tax literature and text that CUP Method, i.e. Comparable Uncontrolled Price Method, RP Method, i.e. Resale Price Method and CP Method, i.e. Cost Plus Method can be applied to a transaction or closely linked, or continuous transactions. Profits Split Method and TNM Method grouped as transactional profit methods, can be equally effective and reliable when applied to closely linked or continuous transactions. **Thus, it would be inappropriate to proceed with the arm's length computation methods, with a pre-conceived suppositions on singularity as a statutory mandate.** Clubbing of closely linked, which would include continuous transactions, may be permissible and not ostracized. Aggregation of closely linked transactions or segregation by the assessed should be tested by the Assessing Officer/TPO on the benchmark and the exemplar; whether such aggregation/segregation by the assessed should be interfered in terms of the four clauses stipulated in [Section 92C\(3\)](#) of the Act, read with the Rules”*

- Comparing average of export prices to AE with average uncontrolled price INCORRECT
  - *Tilda Riceland (supra) , ACIT vs Tara Ultimo Pvt Ltd (143 TTJ 91) in context of Cost-Plus*
- Lease of dredgers/equipments from different AE's: ITAT permitted aggregation of transactions with respect to each AE! (*Boskalis Intl. Dredging 47 taxmann.com 150 (Mum.)*)

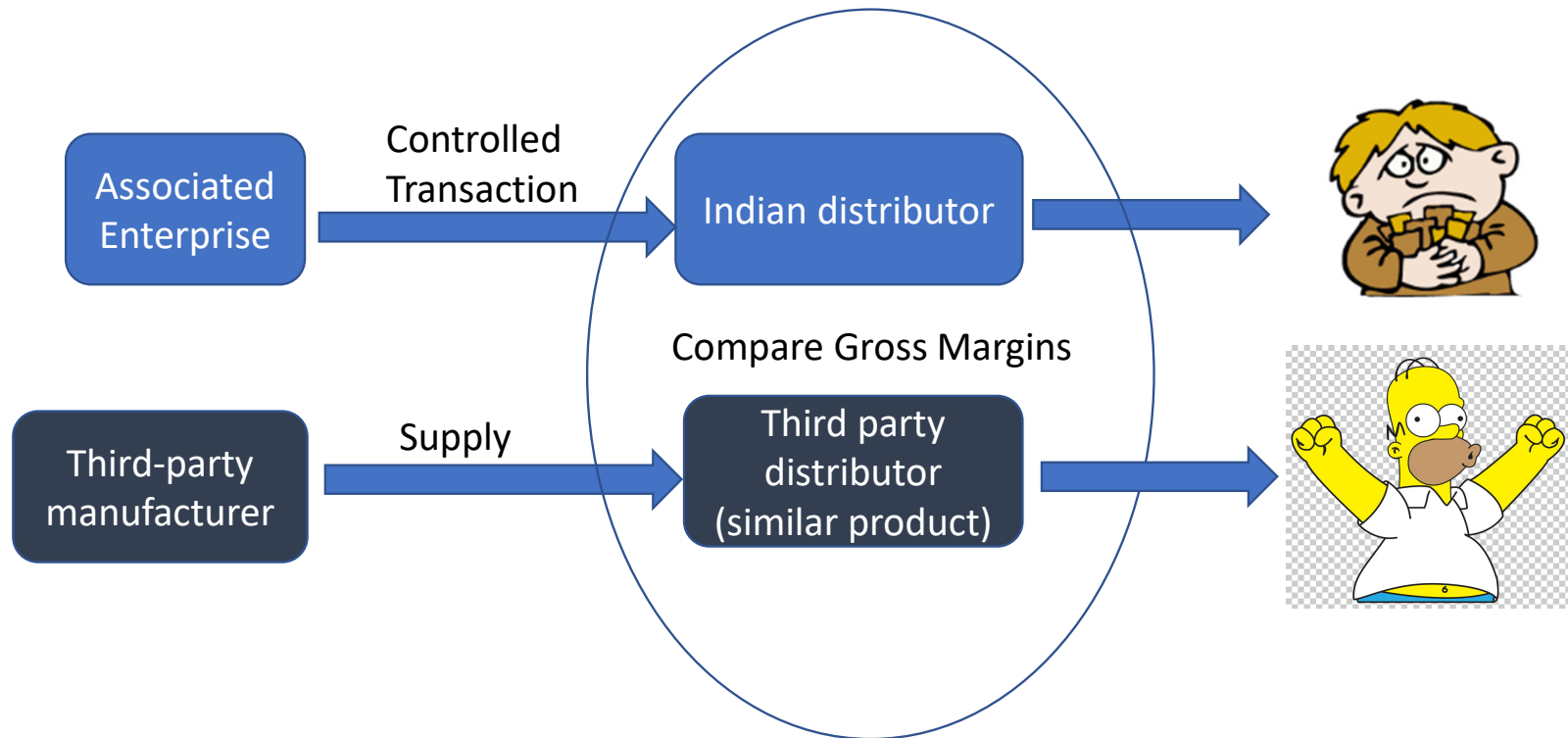
# RPM

## Rule 10B(1)(b) Resale Price Method

- (i) the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise, is identified;*
- (ii) such resale price is reduced by the amount of a normal **gross profit margin** accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction, or a number of such transactions;*
- (iii) the price so arrived at is further reduced by the expenses incurred by the enterprise in connection with the purchase of property or obtaining of services;*
- (iv) the price so arrived at is adjusted to take into account the functional and other differences, including differences in accounting practices, if any, between the international transaction [or the specified domestic transaction] and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market;*
- (v) the adjusted price arrived at under sub-clause (iv) is taken to be an arm's length price in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise;*

# Resale Price Method (RPM)

- Ideal for Resellers/Distributors where key metric is gross margin.



# Resale Price Method Example



	Vulcan India
Sale price in India of "Vulcan Shoes" to third party customers	USD 30million
Less: Resale margin @ <b>13.85%</b> (the <b>Gross Profit Margin</b> from distribution of Markiv Shoes in India)	USD 4.155million
<b>ALP i.e., price at which Vulcan India should have purchased</b>	USD 25.845million
Actual purchase price (GPM = ____ ?)s	USD 28 million

# Resale Price Method

- **$TP = RP * (1 - GPM)$**

Where TP = Transfer Price of a product sold between related parties

Where RP = Resale price of product by distributor/reseller to unrelated customers

Where GPM = Gross Profit Margin that the distributor/reseller/sales company should earn, defined as **Gross Profit / Net sales**.

(Remember: Gross Profit is Net Sales – Cost of Goods Sold)

\$100 per pair



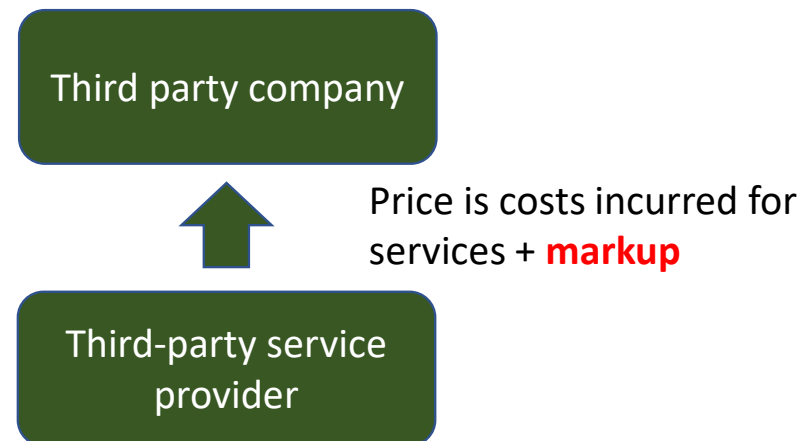
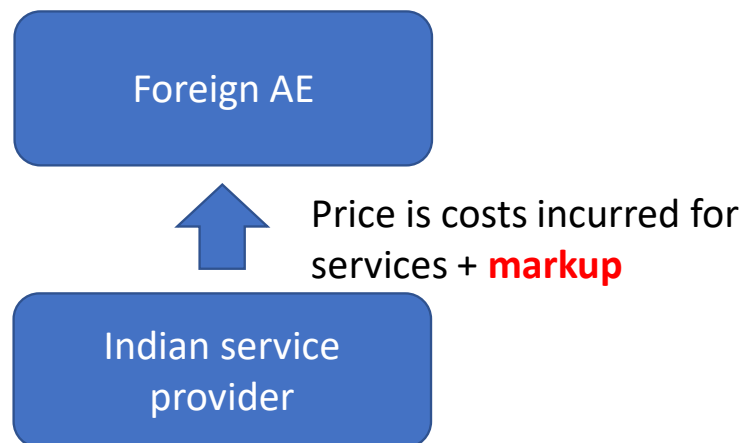
# Cost-Plus Method

## Rule 10B(1)(c) Cost-Plus Method

- (i) the **direct and indirect costs of production** incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined;
- (ii) the amount of a **normal gross profit mark-up to such costs** (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions, is determined;
- (iii) the normal gross profit mark-up referred to in sub-clause (ii) is adjusted to take into account the functional and other differences, if any, between the international transaction [or the specified domestic transaction] and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market;
- (iv) the costs referred to in sub-clause (i) are increased by the adjusted profit mark-up arrived at under sub-clause (iii);
- (v) the sum so arrived at is taken to be an arm's length price in relation to the supply of the property or provision of services by the enterprise;

# Cost Plus Method

- Cost Plus Method requires identification of a mark-up on costs applied for comparable transactions between independent enterprises. An arm's length mark-up can be got based on mark-up applied on comparable transactions among independent enterprises.



# TNMM

## Rule 10B(1)(e) Transactional Net Margin Method

- (i) the net profit margin realised by the enterprise from an international transaction [or a specified domestic transaction] entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;*
- (ii) the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;*
- (iii) the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction [or the specified domestic transaction] and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;*
- (iv) the net profit margin realised by the enterprise and referred to in sub-clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii);*
- (v) the net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction [or the specified domestic transaction];*

# Transactional Net Margin Method (TNMM)

- With TNMM, you determine the **net profit** of a controlled transaction of an associated enterprise (tested party). This net profit is then compared to the net profit realized by comparable uncontrolled transactions of independent enterprises.
- Under TNMM comparables can be “broadly similar” (a whole career in this phrase!)
  - May literally end up comparing apples & oranges!

# TNMM Example (with Arm's length range)

Vulcan India				Value			Remarks	
Total Operating Costs				INR 4.5 crore				
Profit Margin				5.5%				
Sale Price to AE				INR 4.7475 crore			4.5cr+ 5% of 4.5cr	
S.I. No.	1	2	3	4	5	6	7	
Values	2.2%	6%	8.2%	9%	10.57%	11.9%	12%	
Arms Length Range			8.2 to 10.57%					
Is Vulcan India profit margin falling within the acceptable arms length range of profit margins of comparable			No (5.5% vs [8.2 to 10.57%])					
ALP to be assumed (Median value, 4 <sup>th</sup> item)			9%					
Sale Price to AE should be			INR 4.905 crores			4.5cr + 9% of 4.5cr		
TP adjustment			INR 0.1575 crores			4.905-4.7475cr		

# TNMM Example (with Arithmetic Mean)

Vulcan India			Value				Remarks
Total Operating Costs			INR 4.5 crore				
Profit Margin			5.5%				
Sale Price to AE			INR 4.7475 crore				4.5cr+ 5.5% of 4.5cr
S.I. No.	1	2	3	4	5	6	7
Values	2.2%	6%	8.2%	9%	10.57%	11.9%	12%
Arithmetic Mean			8.55%				
Is Vulcan India profit margin falling within the acceptable arms length range of profit margins of comparable			Yes. ALP is 4.88475cr. But Actual price + 3% range > ALP!				4.5+8.55% of 4.5 = 4.88475cr (ALP) 4.7475+3%*4.7475 = 4.889925cr
ALP to be assumed			8.55%				
Sale Price to AE should be			INR 4.5 crores				4.5cr + 8.55% of 4.5cr
TP adjustment			NIL				

# TNMM in practice

- PLI = Profit Level Indicator
  - $OP/OC$  = Operating Profit / Operating Cost
  - $OP/OR$  = Operating Profit / Operating Revenue
- Do a comparable study using databases such as Prowess, Capitaline
- *Apply filters to weed out comparable companies*
- *Apply adjustments to comparable PLI*
- *Apply changes to your PLI (such as removal of non-operating expenditure)*
- Arithmetic mean (OR) arms length range of comparable PLI's computed
- Are you in 3% range (OR) within range interval given by percentile method?
- If so, enjoy! If not, TP adjustment ☹️

# Filters

- Filters are, simply put, criteria which make sure comparables selected for TP analysis are representative of the assessee while filtering out the rest.
    - No definitive guidance in the Act.
  - Turnover Filter
  - Related Party Transactions (RPT) Filter
  - Super-profit (& loss-making) filters
  - Diminishing revenue filter (Loss making companies)
  - Different year ending filter
  - Minimum employee cost filter
  - On-site revenue filter
- (etc etc etc....!)



# Life is an Adjustment!

- Working Capital Adjustment
- Depreciation adjustment
- Capacity utilization adjustment
- Customs Duty Adjustment
- Risk Adjustment
  - Hellosoft India Pvt. Ltd. [2013 (10) TMI 747 - ITAT HYDERABAD]
- Start-up years
  - Skoda Auto India Pvt. Ltd. v. ACIT (2009-TIOL-214-ITAT-PUNE)];
- Forex adjustment (operating or non-operating)
- Extraordinary expenditure (operating or non-operating)

Bottomline: These are common adjustments.....but sky is the limit. Get creative!

# Barter of comparables

- Typical day in the life of TP:
  - Assessee has a low % profit margin, chooses favourable comparables having low % and asks for a number of “adjustments”
  - Dept chooses high margin comparables and denies adjustments
- Comparable barter makes no sense!
  - Is TP art, science....magic?
  - More discussion in Critique of TP section
- *CIT Vs. M/s Quark Systems Pvt. Ltd. (38 SOT 307 Chandigarh)*
  - Comparables barter up to Tribunal possible.
- Number of ground-laying decisions in the early days of TP such as ***e-Gain*** (23 SOT 385), ***Mentor Graphics*** 109 ITD 101 (Delhi), ***Philips Software*** (TS-8-ITAT-2008(Bang))
  - Indian TP has matured & moved well beyond those innocent days ☺

# Comparables: High Turnover fiasco

Should high turnover comparables be rejected?

- 0-200cr range: **Genesis Integrating Systems (India) Pvt. Ltd. v. DCIT, ITA No.1231/Bang/2010** and a million other decisions!
- 10x : **Mcafee Software vs. ACIT (IT(TP) 4/Bang/2012, 18.3.2016)**
- What Turnover filter? **Shipnet Systems vs. DCIT (ITA No.3404/Mds/2016)**
- High Courts have upheld turnover filter based rejection
  - **Commissioner of Income-tax vs. Agnity India Technologies (P.) Ltd.** (2013) 36 taxmann.com 289 (Delhi HC)
  - **CIT vs. Pentair Water India Pvt. Ltd. (Tax Appel 18 of 2015 dated 16/10/15 Mum. HC)** : Companies with large turnover like Infosys & Wipro are not comparable to companies with smaller turnover and should be excluded from the list of comparables

# Comparables: KPO vs BPO

- **Rampgreen Solutions vs CIT – Del HC (60 taxmann.com 355)**

*“Rule 10B(2)(a) of the Income Tax Rules, 1962 mandates that the comparability of controlled and uncontrolled transactions be judged with reference to service/product characteristics. This factor cannot be undermined by using a broad classification of ITeS which takes within its fold various types of services with completely different content and value. **Thus, where the tested party is not a KPO service provider, an entity rendering KPO services cannot be considered as a comparable for the purposes of Transfer Pricing analysis.** The perception that a BPO service provider may have the ability to move up the value chain by offering KPO services cannot be a ground for assessing the transactions relating to services rendered by the BPO service provider by benchmarking it with the transactions of KPO services providers.”*

- Disagrees with Maersk Global Centre vs. ACIT (ITA 7466/Mum/2012 Special Bench dated 7-3-14)
- SC status: Revenue appeal is admitted, final hearing is pending and has been tagging similar appeals of Revenue and admitting appeals

# Comparables- Related Party Transaction (RPT) Filter

- Comparables ideally shouldn't have related party transactions ie you want to compare uncontrolled transactions
  - **Is this practical?** 0% RPT filter applied by many Appellate authorities!
- *Ariba Technologies India (P.) Ltd. v. ITO* [2016] 67 taxmann.com 265 (Bang-Trib.) held 0% is impractical, *and therefore a reasonable tolerance range has to be considered for selecting uncontrolled comparables using RPT* (depending on number comparables. **Usually 15% or 25%**)
- 15% RPT filter is common
  - ACIT vs AT & T Global Business Services India Pvt Ltd [TS-1092-ITAT-2018(Bang)-TP] IT(TP)A No.171/Bang/2016 dated 31.08.2018
  - DCIT v. Synopsis India (P.) Ltd. [2015] 64 taxmann.com 110 (Bang-Trib.)
  - 24/7 Customer.com v. Dy. CIT [2013] 140 ITD 344/[2012] 28 taxmann.com 258 (Bang.)
- 25% RPT filter is also used
  - Faurecia Interior Systems India Private Limited vs. ACIT [TS-396-ITAT-2018(PUN)-TP] ITA No.781/Pun/2015 dated 23.05.2018
  - Cordys R & D (India) (P.) Ltd. [2014] 43 taxmann.com 64/149 ITD 587 (Hyd. – Trib.)
- **PCIT vs. Softek India (ITA 108/2018, 29.8.18 Kar HC)** – no question of law relying on Softbrands!

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# Comparables – Different year ending filter

- Comparables commonly used such as R Systems have different financial year ending (Jan-Dec following USA fiscal). Can they be used for Indian TP comparisons?
- Sure, if the results could be reasonably extrapolated
  - Pr. CIT vs. Baxter India Pvt Ltd – TS-135-HC-2018(DEL)-TP – ITA 260/2018 dated 27.02.2018.
  - Navisite India Pvt Ltd vs ITO [TS-1367-ITAT-2018-(Del)-TP] ITA No.1054 /Del/2016 dated 17.12.2018
  - VAILDOR CAPITAL INDIA PVT LTD vs ITO [TS-1329-ITAT-2018(DEL)-TP] (ITA No.1961/Del/2015) dated 22.11.2018
  - CIT vs McKinsey Knowledge Center India Pvt Ltd. (ITA 217/2014) (Del HC) for AY 2006-07 dated 27.03.2015
  - RR Donnelley India Outsource (P) Ltd vs DCIT (ITA No. 678/Mds/2015) for the ay 2010-11 dated 18.08.2016
- Companies could NOT be taken as comparable as they followed a different financial year ending.
  - XLHealth Corporation India Pvt. Ltd vs. ACIT – TS-162-ITAT-2018(Bang)-TP – IT{TP}A No. 2311/Bang/2016 dated 09.02.2018

# Comparables - Super-profit filter

- Comparables with high profit margins to be excluded?
  - What about the very low ones ? ☺
- Many rulings held that super-profit companies (remember Bodhtree Consulting?) can be rejected. Such as M/s Kodiak Networks (India) Private Limited Vs. ACIT (ITA No.1413/Bang/2010)
- But some like **Trilogy E-Business vs DCIT (1054/Bang/2011 dated 23.11.2012)** said that *“Hence, a general rule that companies with abnormal profits should be excluded may be in tune with the principles enunciated in OECD guidelines but cannot be said to be in tune with Indian TP regulations. However, if there are specific reasons for abnormal profits or losses or other general reasons as to why they should not be regarded as comparables, then they can be excluded for comparability. It is for the Assessee to demonstrate existence of abnormal factors.”*
- In **ChrysCapital Investment Advisors vs. DCIT (ITA 471/2014 dated 27.4.2015)**, Delhi HC decision held that ipso facto you cannot remove a comparable just because it makes a super-profit.
- Decision has been interpreted by Department to accept all super profit comparables as well (as even high turnover comparables, based on some observations in the decision)

# Adjustments

- A comparability adjustment is an adjustment made to the conditions of uncontrolled transactions in order to eliminate the effects of material differences which exist between them and the controlled transaction being examined.
- Examples of comparability adjustments include adjustments for accounting consistency designed to eliminate differences that may arise from differing accounting practices between the controlled and uncontrolled transactions; segmentation of financial data to eliminate significant noncomparable transactions; adjustments for differences in capital, functions, assets, risks.
- TNMM: Rule says adjustment to be done to comparables



# Working Capital Adjustment

- In a competitive environment, money has a time value. If a company provided, say, 60 days trade terms for payment of accounts, the price of the goods should equate to the price for immediate payment plus 60 days of interest on the immediate payment price.
- By carrying high **accounts receivable** a company is allowing its customers a relatively long period to pay their accounts. It would need to borrow money to fund the credit terms and/or suffer a reduction in the amount of cash surplus which it would otherwise have available to invest. **In a competitive environment, the price should therefore include an element to reflect these payment terms and compensate for the timing effect.**
- The opposite applies to higher levels of **accounts payable**. By carrying high accounts payable, a company is benefitting from a relatively long period to pay its suppliers. It would need to borrow less money to fund its purchases and/or benefit from an increase in the amount of cash surplus available to invest. **In a competitive environment, the cost of goods sold should include an element to reflect these payment terms and compensate for the timing effect.**
- A company with **high levels of inventory** would similarly need to either borrow to fund the purchase, or reduce the amount of cash surplus which it is able to invest.

# Working Capital Adjustment

- Making a working capital adjustment is an attempt to adjust for the differences in time value of money between the tested party and potential comparables, with an assumption that the difference should be reflected in profits.
- The underlying reasoning is that:
  - A company will need funding to cover the time gap between the time it invests money (*i.e.* pays money to supplier) and the time it collects the investment (*i.e.* collects money from customers)
  - This time gap is calculated as: the period needed to sell inventories to customers (plus) the period needed to collect money from customers – (less) the period granted to pay debts to suppliers.

# Working Capital Adjustment

TESTCo	Year 1	Year 2	Year 3	Year 4	Year 5
Sales	\$179.5m	\$182.5m	\$187m	\$195m	\$198m
Earnings Before Interest & Tax (EBIT)	\$1.5m	\$1.83m	\$2.43m	\$2.54m	\$1.78m
EBIT/Sales (%)	0.8%	1%	1.3%	1.3%	0.9%

TESTCo	Year 1	Year 2	Year 3	Year 4	Year 5
<b>Working Capital (at end of year)</b>					
Trade Receivables (R)	\$30m	\$32m	\$33m	\$35m	\$37m
Inventories (I)	\$36m	\$36m	\$38m	\$40m	\$45m
Trade Payables (P)	\$20m	\$21m	\$26m	\$23m	\$24m
Receivables (R) + Inventory (I) – Payables (P)	\$46m	\$47m	\$45m	\$52m	\$58m
(R + I – P) / Sales	25.6%	25.8%	24.1%	26.7%	29.3%

# Working Capital Adjustment

Working Capital Adjustment	Year 1	Year 2	Year 3	Year 4	Year 5
TestCo's $(R + I - P) / \text{Sales}$	25.6%	25.8%	24.1%	26.7%	29.3%
CompCo's $(R + I - P) / \text{Sales}$	19.9%	20.6%	28.7%	24.5%	24.6%
Difference (D)	5.7%	5.1%	-4.7%	2.1%	4.7%
Interest Rate (i)	4.8%	5.4%	5.0%	5.5%	4.5%
<b>Adjustment <math>(D \cdot i)</math></b>	<b>0.27%</b>	<b>0.28%</b>	<b>-0.23%</b>	<b>0.12%</b>	<b>0.21%</b>
CompCo's EBIT/Sales (%)	1.32%	2.96%	2.59%	3.31%	4.95%
<b>Working Capital Adjusted EBIT / Sales for CompCo</b>	<b>1.59%</b>	<b>3.24%</b>	<b>2.35%</b>	<b>3.43%</b>	<b>5.16%</b>

# Depreciation adjustment

- Delhi Bench of the Tribunal in the case of **Schefenacker Motherson Ltd. Vs. ITO (2009) 123 TTJ 509 (Del)** wherein the Tribunal held that depreciation could be excluded while computing the margin of the comparable companies and tested party, if depreciation is resulting in a large differences in margin of tested party and comparable company.

# Softbrands (Karnataka HC)

PCIT vs. Softbrands India (ITA No.536/2015 dated 25.6.2018 Kar.HC)

- Assessee was an Indian company (subsidiary of a foreign parent) providing software services at cost + margin
- CUP method was applied by assessee; however rejected by TPO and TNMM applied
- TPO margin – 20.68% on cost; Assessee margin – 8.33% on cost
- CIT(A) ruling
  - RPT and turnover filter was applied; list of comparable companies was reduced to three
  - Both Revenue and Assessee filed appeals with ITAT
- ITAT ruling
  - RPT filter kept at 15%
  - Turnover filter decision of CIT(A) not disturbed as Revenue had not challenged it.
  - Based on functional comparability of comparable companies, the list was changed
- Revenue appeal to HC – substantial questions of law
  - Whether ITAT was right in applying 15% RPT filter?
  - Whether ITAT's act of rejecting comparable companies (four comparable companies named in the appeal memo) was right?

# Softbrands (Karnataka HC)

PCIT vs. Softbrands India (ITA No.536/2015 dated 25.6.2018 Kar.HC)

- HC summarises that the dispute relates to – (para 14)
  - Whether ITAT has rightly included/excluded comparables after analyzing each of them
  - Whether correct filters have been applied
  - Whether right method has been selected
  - Other connected factors in deciding the appropriate TP adjustment
- Formulates scope of appeal before HC – (para 15-17)
  - Appeal can only pertain to “substantial question of law”
  - Unless perversity in findings of ITAT can be demonstrated based on evidence on record, there cannot be “substantial question of law”
  - ITAT has analysed each of the comparables in detail and these findings, prima facie, are not perverse, so as to admit the appeal

# Softbrands (Karnataka HC)

PCIT vs. Softbrands India (ITA No.536/2015 dated 25.6.2018 Kar.HC)

- Can any question of law be decided by HC? (para 18-27)
  - Argument cannot be accepted that HC can decide any question not decided by ITAT
  - Sec 260A(6) is *pari materia* with Sec 103 of CPC; only such issue not decided (or wrongly decided) by ITAT can be dealt with, based on the answer given by HC to the main substantial question of law (framed by and answered by HC)
  - Facts confirmed by ITAT cannot be disturbed, unless perversity is established
- What is “substantial question of law”? (para 28-31)
  - Scope of “substantial question of law” has been clarified by a host of SC judgments
  - HC has to determine whether the question that arises before it in all cases, including TP cases falls within that scope
  - In ***Chunilal V Mehta Vs Century Spinning AIR 1962 SC 1314***: A question of law would be substantial if
    - (a) it is of general public importance OR
    - (b) if it directly and substantially affects the rights of parties; and in either cases, it is either an open question that is not finally settled by the OR is not free from difficulty OR calls for discussion of alternate views
    - (c) If the question is settled by the highest Court or the general principles to be applied in determining the question are well settled and there is a mere question of applying those principles, then no substantial question of law arises
  - ***Hero Vinoth Vs Seshammal (2006) 5 SCC 545 and Vijay Talwar VS CIT (2011) 1 SCC 673*** referred



# Softbrands (Karnataka HC)

PCIT vs. Softbrands India (ITA No.536/2015 dated 25.6.2018 Kar.HC)

- Para 41-48 : Wrong filters or wrongly applied filters, particularly turnover filter with differing views by ITATS. Such parameters do not satisfy requirement of “substantial question of law”.
- Perversity in ITAT order has not been pointed out by parties. HC cannot undertake factual analysis of comparables; **HC does not have sufficient data or technical expertise to undertake fact finding exercise**
- Facts established by ITAT cannot be disturbed by HC unless they are ex-facie perverse and unsustainable and exhibit a total non-application of mind by the ITAT to the relevant facts of the case and evidence before the ITAT
- **Even inconsistent view taken by ITAT, depending on the facts of the case before it, cannot lead to a ‘substantial question of law’ in a particular cases**
- Point to ponder: What happens to all the HC decisions on comparables?

# TP & Royalty payments

- Royalty payments from Indian companies to AE's were separately carved out and their ALP set to NIL by TPO's
  - Effectively holding these Royalty transactions weren't needed
- Let us understand the Dept's view:
  - Companies maybe paying Royalty for decade old products at the same rate. Dept's view was this was an easy way to shift money out of India.
  - In other words,
- Counter points from the assessee:
  - TPO cannot sit in the businessman's shoes and decide on the benefit of such Royalty to the business.
  - TNMM is an overall application at entity level and in it Royalty transactions are part and parcel of and once TNMM is done, why carve out Royalty separately?
  - Without prejudice, Royalty transactions have to be benchmarked and understood separately and with the context of what it was being paid for.

# TP & Royalty payments

- **CIT v. EKL Appliances Ltd. [2012] 345 ITR 241/209 Taxman 200/24 taxmann.com 199 (Delhi)** (and many other ITAT decisions)
- It is not necessary for the assessee to show that any legitimate expenditure incurred by him was also incurred out of *necessity*.
- It is also not necessary for the assessee to show that any expenditure incurred by him for the purpose of business carried on by him has actually resulted in profit or income either in the same year or in any of the subsequent years.
- The only condition is that the expenditure should have been incurred “wholly and exclusively” for the purpose of business and nothing more.
- Based on the above mentioned rulings, there seems to be a clear position that the tax authorities cannot determine the commercial expediency of royalty payment by merely applying the benefit test or through quantification of benefits. In spite of this, it is recommended that the taxpayers maintain the relevant evidences for demonstrating the business necessity/rationale associated with the use of such intangible assets!

# TP & Royalty payments

- **TNMM is enough. No (slip between the lip and the) CUP!**
  - **Cadbury India Ltd. vs. Addl. CIT [2013] 40 taxmann.com 529** Mumbai ITAT decision in wherein the Hon'ble ITAT upheld the use of TNMM for Royalty.
  - **DCIT vs. Air Liquide Engineering India (P.) Ltd. ([2014] 43 taxmann.com 299)** The Hyderabad tribunal in Air Liquid held that once TNMM has been applied to the assessee company's transaction, it covers under its ambit the Royalty transactions in question too and hence separate analysis and consequent deletion of the Royalty payments by the TPO in the instant case seems erroneous.
- **RBI approval of Royalty rates sufficient?**
  - **Abhishek Auto Industries Ltd. v. CIT [2011] 9 taxmann.com 27** (Delhi) held that Agreement under which royalty was paid to taxpayer for technical know-how, not to be disregarded without cogent reasons, especially when it was approved by RBI and other regulatory agencies.
  - **SKOL Braveries V/s SEIT 2013 29 Taxmann.com 111** held that the automatic approval permitting certain percentage of payment of royalty cannot substitute as ALP to be determined under the provisions of the Indian IncomeTax Act,1961.

# AMPing up TP!

- In MNC's brand is owned by one entity but is exploited across the group.
- Group entities will spend on advertising, marketing & promotion (AMP) to increase their sales in their territories
  - Example Hyundai India takes out ads in local newspaper to sell their cars locally
- Contention is that such AMP has two benefits:
  - Direct : Increase in local sales
  - Indirect: Increase in brand value
- Bottomline: Indian Dept felt that the Indian companies belonging to branded MNC's spending on AMP expenses here to promote these branded products should be compensated by their foreign AE's for brand-building ALONG with a markup!

# AMPing up TP: OECD vs UN

- OECD TP Guidelines:
  - Recognize indirect brand building
  - Calls for compensation of entities performing functions of DEMPE (development, enhancement, maintenance, protection & exploitation) of Intangibles.
  - Provides a framework for identify DEMPE (Para 6.34 of OECD Guidelines)
- UN TP Guidelines:
  - Recognizes marketing intangibles
  - These local marketing activities could result in “unique and valuable intangible” distinct from foreign owned brand
  - Provides for the use of DAEMPE and is FAR analysis where the A stands for acquisition of intangibles

# AMPing up TP: Case law cesspool

- LG Electronics India vs. ACIT (140 ITD 141 SB Delhi.)
  - Bright Line Test appropriate for ascertaining value of international transaction of brand building
    - BLT is a line drawn with overall amount of AMP expenses; whatever is above bright line is considered expenses on behalf of AE
  - Bottomline : Poor decision (in my opinion)
- Sony Ericsson Mobile Communications India (P.) Ltd. vs. CIT [2015] 374 ITR 118 (Delhi) – Distributor
  - Existence of international transaction not disputed by assessee
  - In absence of statutory provisions, BLT is not permissible
  - It would be erroneous and fallacious to treat brand building as counterpart of advertisement expenses;
  - Department has filed SLP against the Court's order which has been granted

# AMPing up TP: Case law cesspool

- Maruti Suzuki India Ltd. v. CIT (ITA 110 of 2014, 11.12.2014)
  - Existence of international transaction has to be established de hors BLT
  - Price of international transaction has to be adjusted.
  - The very existence of an international transaction cannot be presumed by assigning some price to it and then deducing that since it is not an ALP, an 'adjustment' has to be made.
  - Substantive and machinery provisions fail – TP Regulations not applicable;
- Whirlpool of India vs. DCIT (ITA 228/2015 dated 22.12.2015)
  - The onus is on the Revenue to demonstrate by tangible material that there is an international transaction involving AMP expenses between the Indian Co and the AE.
  - In the absence of that first step, the question of determining the ALP of such a transaction does not arise.
  - In the absence of a machinery provision it is hazardous for any TPO to proceed to determine the ALP of such a transaction since Bright Line Test has been negated as a valid method of determining the existence of an international transaction and thereafter its ALP.
- Many other such decisions in Delhi for popular Brands.
- Before the SC but hope this is the end of this saga.....



## Other method of determination of arm's length price – Rule 10AB

*For the purposes of clause (f) of sub-section (1) of section 92C, the other method for determination of the arm's length price in relation to an international transaction [or a specified domestic 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.*

# S.92C - The Other Method

Toll Global Forwarding India Vs.DCIT (ITA No.5025/Del/10, 18<sup>th</sup> Nov. 2014)

- 50:50 business model (i.e. the business model of sharing residual profits in equal ratio with the service provider at the other end of the transaction i.e. at the consignee's end in the case of export transaction and at consigner's end in the case of import transaction), is a standard practice.
- In other words, even with respect to the transaction with unrelated parties in this line of activity, it is admitted practice to share the residual profit in equal ratio and that is precisely the assessee claimed to have been adopted with the associated enterprise as well.
- The trouble however is that while there is a standard formulae for computing the consideration, the data regarding precise amount charged or received for precisely the same services may not be available for comparison.
- While the assessee is pleading for acceptance of former as a valid comparable under the CUP, the authorities below are of the considered view that availability of precise amount having been charged for precisely the same service is a sine qua non for application of CUP method.

# S.92C - The Other Method

Toll Global Forwarding India Vs.DCIT (ITA No.5025/Del/10, 18<sup>th</sup> Nov. 2014)

- “Transfer pricing should not be viewed as a source of revenue” 😊
- Rule 10B(1)(f) inserted vide notification dated 23rd May 2012 is not a residual method in the sense that it is not a condition precedent for the application of this method that all other methods set out in s. 92C(1)(a) to 92C(1)(e) and as elaborated under rule 10B(1)(a) to (e), must fail and only then this method can be applied.
- This method is at par with all other methods of determining the arm's length price as set out in sections 92C(1)(a) to (f), and, in terms of Section 92C(2), the most appropriate method, referred to in Section 92C(1), “shall be applied, for determination of arm's length price, in the manner prescribed”.

## S.92C - The Other Method

Toll Global Forwarding India Vs.DCIT (ITA No.5025/Del/10, 18<sup>th</sup> Nov. 2014)

- ITAT held that not only CUP would be applicable in this case but in fact Rule 10AB is the 6<sup>th</sup> method covered this case.
- Furthermore, ITAT held Rule 10AB inserted w.e.f 1<sup>st</sup> April 2012 ie AY 2012-13 could be applied retrospectively as it is a beneficial measure following CIT vs. Vatika Townships Pvt. Ltd. (2014 TIOL 78 SC)
- Confirmed by the Delhi HC with respect to correctness of application of CUP in PCIT vs. Toll Global Forwarding (ITA 374/2015 dated 10.12.2015)

## S.92C – The Other Method – Quotation

Gulf Energy Maritime Services (P.) Ltd. vs. ITO [2016] 178 TTJ 683 (Mumbai Trib.)

- “A” rendered ship management services to its AE
- Benchmarked it using CUP using quotations from third-party
- TPO doubted credibility of quotations and made additions, CIT(A) confirmed
- ITAT held:
  - CUP method emphasis on actual transaction ie “price charged”. Quotation cannot be considered
  - Rule 10AB allows hypothetical price – “price which would have been charged”
  - Bonafide quotations are valid input for ascertaining ALP

# Profit Split Method

## Rule 10B(1)(d)

*profit split method, which may be applicable mainly in international transactions [or specified domestic transactions] involving transfer of unique intangibles or in multiple international transactions [or specified domestic transactions] which are so interrelated that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction, by which—*

*(i) the combined net profit of the associated enterprises arising from the international transaction [or the specified domestic transaction] in which they are engaged, is determined;*

*(ii) the relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances;*

*(iii) the combined net profit is then split amongst the enterprises in proportion to their relative contributions, as evaluated under sub-clause (ii);*

*(iv) the profit thus apportioned to the assessee is taken into account to arrive at an arm's length price in relation to the international transaction [or the specified domestic transaction] :*

# Profit Split Method

Rule 10B(1)(d)

*...Provided that the combined net profit referred to in sub-clause (i) may, in the first instance, be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of international transaction [or specified domestic transaction] in which it is engaged, with reference to market returns achieved for similar types of transactions by independent enterprises, and thereafter, the residual net profit remaining after such allocation may be split amongst the enterprises in proportion to their relative contribution in the manner specified under sub-clauses (ii) and (iii), and in such a case the aggregate of the net profit allocated to the enterprise in the first instance together with the residual net profit apportioned to that enterprise on the basis of its relative contribution shall be taken to be the net profit arising to that enterprise from the international transaction;*

# Profit Split Method

- There are two kinds of Profit Split Methods:
  - **Contribution profit split method;**
  - **Residual profit split method. (Proviso refers to this!)**
- The contribution profit split method splits profit among associated enterprises according to the functions performed and risks assumed. In addition, the assets are analyzed which are contributed by each entity. In particular, intangible assets.
  - The application of the contribution profit split method requires careful analysis. First of all of the functions performed, risks borne and assets used by each associated enterprise. In addition, the allocation of cost, expense, earnings, and capital of the associated enterprises involved in the transaction needs to be measured.
- The residual profit split method requires the identification of the routine profit for an entity as a first step. Any remaining profit is then split based on each party's contribution to the earning of the non-routine profit, for example the ownership of intangibles.



## Adjustment to be restricted in proportion to international transactions

- DRP decided to suo moto make these additions.
  - Entire adjustment of ALP obtained from entity level comparables loaded on as a TP adjustment! TP adjustment applies to only international transactions.
  - Adjustment has to be applied in proportion to the international transactions to overall transactions. Mathematically only this is possible! Anything else could result in an absurdity!
- M/s.Mobis India Ltd., vs. DCIT (I.T.A.No.2112/Mds/2011, dated 14.08.2013)
- CIT vs. ALSTOM Projects India Ltd. (ITA No.362 of 2014, dated 14.09.2016)
- CIT vs. M/s.Hindustan Unilever Ltd., in ITA No.1873 of 2013, dated 26.07.2016;
- CIT vs. M/s.Tara Jewels Exports Pvt., Ltd., in ITA No.1814 of 2013, dated 05.10.2015;
- CIT vs. Petro Araldite Pvt., Ltd., in ITA No.1804 of 2013, dated 24.11.2015;
- CIT vs. M/s.Thyssen Krupp Industries., ITA No.2201 of 2013, dated 02.12.2015;
- CIT vs. M/s.Firestone International (P) Ltd., in ITA No.1354 of 2013, dated 15.06.2015;
- CIT vs. Keihin Panalfa Ltd in ITA No.11 of 2015, dated 09.09.2015;
- Il Jin Electronics (I) (P) Ltd., vs. ACIT (ITA No.438/Del/2008, dated 06.11.2009)

# Adjustment to be restricted in proportion to international transactions

Non-restriction of adjustment to value of international transactions					
Part	Description	Scenario 1 - When AE purchases are INR 10 and ALP is considered to be 30%		Scenario 2 - as given by DRP and ALP is considered to be 20%	
		Particulars	Details	Particulars	Details
1	Margin details of tested party	Selling price (a)	100	Selling price (a)	100
		C1 - Non AE (b)	60	C1 - Non AE (b)	50
		C2 - AE (c)	10	C2 - AE (c)	30
		Total purchases (b+c)	70	Total purchases (b+c)	80
		Other cost (d)	20	Other cost (d)	10
		Total cost (e) = (b+c+d)	90	Total cost (e) = (b+c+d)	90
		Profit (f) = (a-e)	10	Profit (f) = (a-e)	10
		Margin (OP/OR) (g) = (f/a)	10%	Margin (OP/OR) (g) = (f/a)	10%
		AE purchases (h) = (c/(b+c))	14.29%	AE purchases (h) = (c/(b+c))	37.50%
2	Computation of TP adjustment	Operating revenue (a)	100	Operating revenue (a)	100
		ALM (Assumption) (i)	30%	ALM (Assumption) (i)	20%
		AL profit (j) = (a*i)	30	AL profit (j) = (a*i)	20
		AL cost (k) = (a-j)	70	AL cost (k) = (a-j)	80
		Actual operating cost (e)	90	Actual operating cost (e)	90
		Adjustment (l) = (e-k)	20	Adjustment (l) = (e-k)	10
		C2 - AE (revised ALP) (m) = (c-l)	-10	C2 - AE (revised ALP) (m) = (c-l)	20
		Parity (AE transaction) (n) = (h*m)	2.86	Parity (AE transaction) (n) = (h*m)	

# Adjustment cannot exceed the amount received by AE

DCIT vs Global Vantage P. Ltd., (ITA No. 1432 & 2321/Del/2009 and 116/Del/2011)

- ITAT held that adjustment on account of ALP of international transactions cannot exceed the amount received by the AE from the customer and the actual value of international transactions, i.e., the amount received by the assessee in respect of international transactions.
- Global Vantage got jobs from its AE who in turn outsourced from RCS USA. Total revenue share for AY 02-03 from RCS Rs. 8,32,66,596/- which comprised 90.6% of RCS revenue. TPO after rejecting foreign AE tested party, did TNMM study arriving at Rs.14,70,10,071/- adjustment!
- Hon'ble Jurisdictional High Court in Order dated 14-03-2013 (in ITA Nos. 1828/2010, 1829/2010 & 1254/2011) dismissed the Revenue's appeal. SLP of Revenue also been dismissed by SC vide 02-01-2014 (CC No. 22166 of 2013).

# S.92BA : Domestic Transfer Pricing Genesis

- Decision of the H'ble Supreme Court in the case of **Glaxo Smithkline Asia (P) Ltd [236 CTR 113]**
- The SC while deciding on the issue of section 40A(2) made some of the important observations as under: In domestic transactions, under-invoicing and over-invoicing will be revenue neutral except in two circumstances:
  - where one of the related entities is loss making or
  - where one of the related entities is liable to pay tax at a lower rate and the profits are shifted to such entity
- The question of extending Transfer Pricing regulations to domestic transactions require expeditious consideration by the tax authorities
- Finance Act, 2012 – introduced domestic transfer pricing for 'specified domestic transactions' from AY 2013-14

# S.92BA: Specified Domestic Transaction

*For the purposes of this section and sections 92, 92C, 92D and 92E, "specified domestic transaction" in case of an assessee means any of the following transactions, not being an international transaction, namely:—*

*(i) [\*\*\*]*

*(ii) any transaction referred to in section 80A;*

*(iii) any transfer of goods or services referred to in sub-section (8) of section 80-IA;*

*(iv) any business transacted between the assessee and other person as referred to in sub-section (10) of section 80-IA;*

*(v) any transaction, referred to in any other section under Chapter VI-A or section 10AA, to which provisions of sub-section (8) or sub-section (10) of section 80-IA are applicable; or*

***Following clause (va) shall be inserted after clause (v) of section 92BA by the Taxation Laws (Amendment) Act, 2019, w.e.f. 1-4-2020:***

*(va) any business transacted between the persons referred to in sub-section (4) of section 115BAB;*

*(vi) any other transaction as may be prescribed,*

*and where the aggregate of such transactions entered into by the assessee in the previous year exceeds a sum of twenty crore rupees.*

# Domestic Transfer Pricing

## S.80A(6)

(6) Notwithstanding anything to the contrary contained in section 10A or section 10AA or section 10B or section 10BA or in any provisions of this Chapter under the heading "C.—Deductions in respect of certain incomes", **where any goods or services held for the purposes of the undertaking or unit or enterprise or eligible business are transferred to any other business carried on by the assessee or where any goods or services held for the purposes of any other business carried on by the assessee are transferred to the undertaking or unit or enterprise or eligible business and, the consideration, if any, for such transfer as recorded in the accounts of the undertaking or unit or enterprise or eligible business **does not correspond to the market value of such goods or services as on the date of the transfer****, then, for the purposes of any deduction under this Chapter, the profits and gains of such undertaking or unit or enterprise or eligible business shall be computed as if the transfer, in either case, had been made at the market value of such goods or services as on that date.

*Explanation.*—For the purposes of this sub-section, the expression "**market value**",—

(i) in relation to any goods or services sold or supplied, means the price that such goods or services would fetch if these were sold by the undertaking or unit or enterprise or eligible business in the open market, subject to statutory or regulatory restrictions, if any;

(ii) in relation to any goods or services acquired, means the price that such goods or services would cost if these were acquired by the undertaking or unit or enterprise or eligible business from the open market, subject to statutory or regulatory restrictions, if any;

(iii) in relation to any goods or services sold, supplied or acquired means the **arm's length price as defined in clause (ii) of section 92F** of such goods or services, if it is a specified domestic transaction referred to in section 92BA.

## Domestic Transfer pricing: S.80-IA(8) & (10)

*(8) Where any **goods or services held for the purposes of the eligible business are transferred to any other business carried on** by the assessee, or where any goods or services held for the purposes of any other business carried on by the assessee are transferred to the eligible business and, in either case, the consideration, if any, for such **transfer as recorded in the accounts of the eligible business does not correspond to the market value of such goods or services** as on the date of the transfer, then, for the purposes of the deduction under this section, the profits and gains of such eligible business shall be computed as if the transfer, in either case, had been made at the **market value of such goods or services** as on that date :*

*Provided that where, in the opinion of the Assessing Officer, the computation of the profits and gains of the eligible business in the manner hereinbefore specified presents exceptional difficulties, the Assessing Officer may compute such profits and gains on such reasonable basis as he may deem fit.*

*Explanation.—For the purposes of this sub-section, "**market value**", in relation to any goods or services, means—*

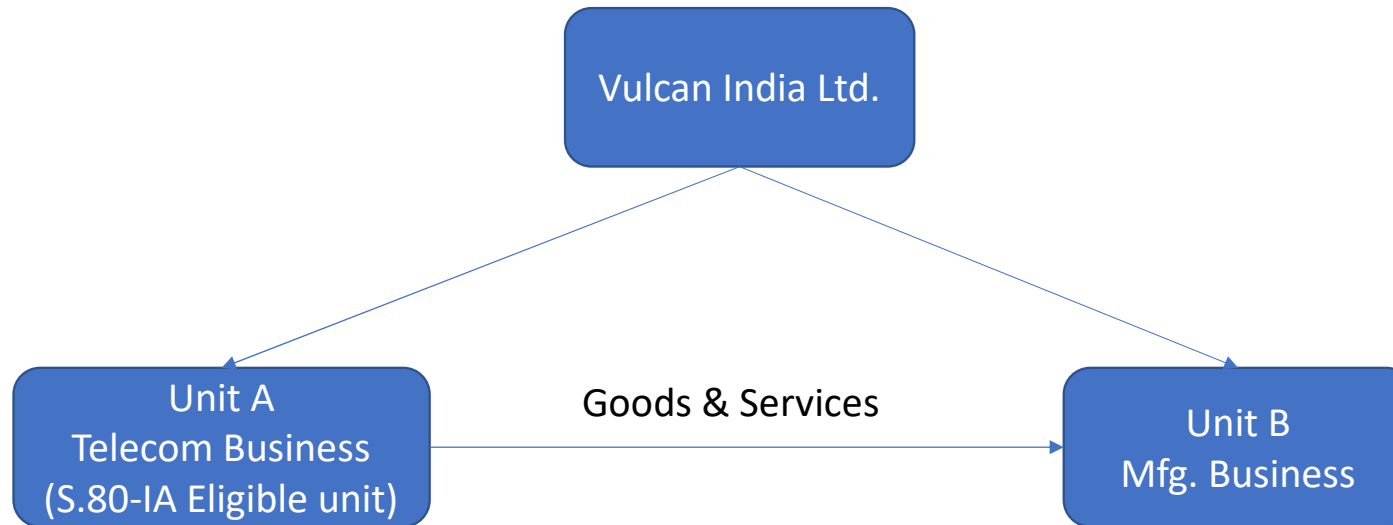
*(i) the price that such goods or services would ordinarily fetch in the open market; or*

*(ii) **the arm's length price** as defined in clause (ii) of section 92F, where the transfer of such goods or services is a specified domestic transaction referred to in section 92BA.*

***(10) Where it appears to the Assessing Officer that, owing to the close connection between the assessee carrying on the eligible business to which this section applies and any other person, or for any other reason, the course of business between them is so arranged that the business transacted between them produces to the assessee more than the ordinary profits** which might be expected to arise in such eligible business, the Assessing Officer shall, in computing the profits and gains of such eligible business for the purposes of the deduction under this section, take the amount of profits as may be reasonably deemed to have been derived therefrom:*

*Provided that in case the aforesaid arrangement involves a specified domestic transaction referred to in section 92BA, the amount of profits from such transaction shall be determined having regard to arm's length price as defined in clause (ii) of section 92F.*

## S.80IA(8)



Goods & Services transferred at Rs.120/- per unit

Market value should be Rs.100/- per unit

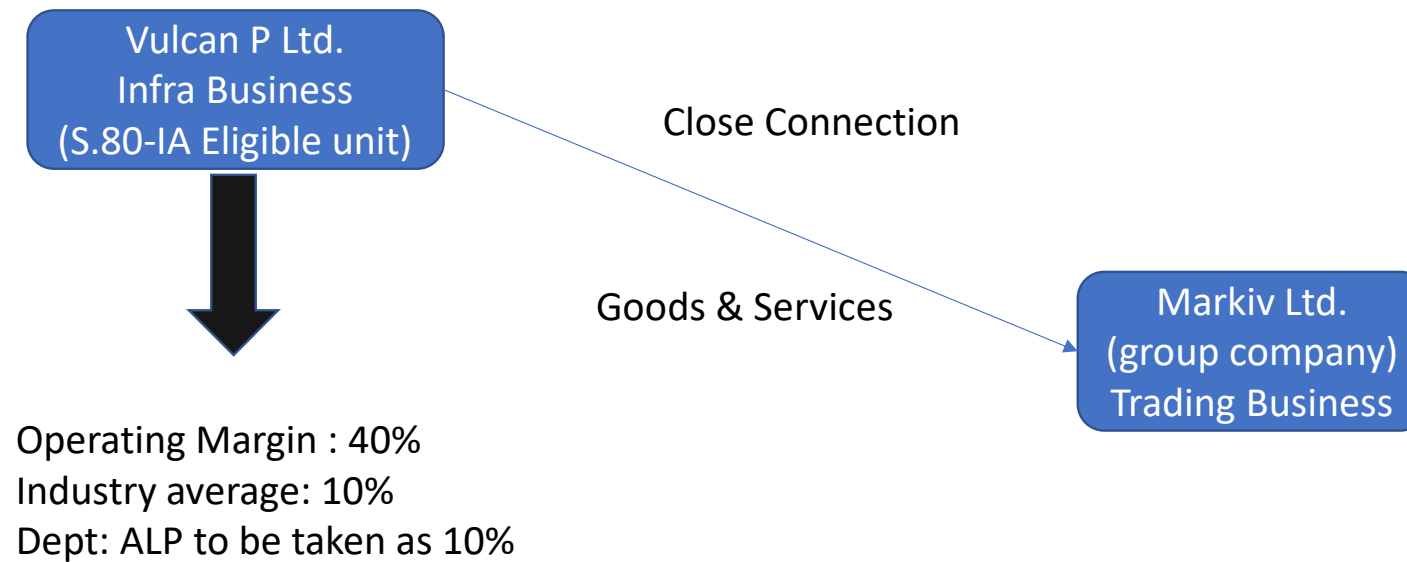
More profit being booked in eligible unit which enjoys tax breaks!

ALP of transaction fixed at Rs.100/- per unit



# S.80IA(10) : Domestic TP

“close connection”



# Section 92CA – Reference to TPO

- Board Instruction 3 of 2003 explains the procedure in detail. This Instruction has been upheld by the Delhi HC.
- Reference to be made if necessary and expedient.
- Reference with the approval of CIT. The Delhi HC in Sony and Gujarat HC in
- Veer Gems held that there was no need to give opportunity to assessee at this stage. Bombay HC in the case of Vodafone has held that where assessee contends that TP provisions do not apply in its case, Assessee should be given an opportunity before making reference.
- New provisions relating to transactions not disclosed by the assessee which come to the notice of the TPO, deemed to have been referred

# Safe Harbor

- Safe harbour refers to a legal provision to reduce or eliminate liability in certain situations as long as certain conditions are met.
- Safe harbours provide for circumstances in which a certain category of taxpayers can follow a simple set of rules under which transfer prices are automatically accepted by the revenue authorities.
- Safe harbour provisions offer essentially benefits to taxpayers and tax administrators with benefits of compliance relief, administrative simplicity and certainty.
- CBDT issued Safe Harbor Rules in September 2013 – tepid response as the rates were very high.
- Revised rates via Notification 46/2017 dated 7<sup>th</sup> June 2017 more conducive!

# APA

- Finance Act, 2012 introduced **Advance Pricing Agreement (APA)**. While introducing the provisions, the then Finance Minister explained: *“(I)n a globalised economy with expanding cross-border production chains and growing trade within entities of the same group, Advance Pricing Agreement (APA) can significantly bring down tax litigation and provide tax certainty to foreign investors. Though, the provision for APA has been included in the DTC Bill, 2010, I propose to bring forward its implementation by introducing it in the Finance Bill, 2012.”*
- **Read the Annual Report’s on APA published by CBDT!** **“In 2018-19, the average time taken by the CBDT to conclude the 41 unilateral agreements was 45.22 months.** This is more than the average time taken in any of the previous 5 years. As a result, the average time taken to conclude unilateral APAs in India has increased from 31.75 months (as on 31st March, 2018) to 32.50 months (as on 31st March, 2019). This is better than what most countries have achieved.”

# APA

- The APA programme has gained considerable traction as evidenced by the conclusion of 271 APAs, including 31 bilateral APAs till 31.3.19
- The concluded APAs span across diverse industries such as IT, telecommunication, pharma, oil, gas and minerals, automobile, banking & finance, etc. Furthermore, they cover varied intra-group transactions such as the provision of IT/ITeS/ KPO, investment advisory services, import and export of goods, financial transactions, intangible related transactions such as royalty payments, the incurrence of advertising, marketing & promotion expenses, etc.

# MAP

- MAP is an alternative available to taxpayers for resolving disputes giving rise to double taxation whether juridical or economic in nature. The agreement for avoidance of double taxation between the countries would give authorization for assistance of Competent Authorities in the respective jurisdiction under MAP. In the context of OECD Model Convention for the Avoidance of Double Taxation, Article 25 provide for assistance of Competent Authorities under MAP.
- The main benefit of pursuing MAP is elimination of double taxation (either juridical or economic). It is very rare that a case under MAP is not resolved. • Also, cases involving certain jurisdictions (US, UK and Denmark), the Indian authorities have entered into an agreement under which the taxpayer can choose to provide a bank guarantee for the outstanding tax demand. In such cases, the tax demand would not be pursued by the tax authorities until disposal of the MAP application. • The MAP resolution, once accepted, eliminates the need for protracted litigation.

# MAP

- The taxpayer of the country having to bear the incidence of double taxation can apply for assistance of Competent Authorities under MAP to resolve the issue of such double taxation.
- The time limitation for filing an application for MAP is governed by the respective Treaty for Avoidance of Double Taxation entered into between the countries.
- Generally, the time limit ranges between 2-3 years from the date of the notice giving rise to double taxation. Based on experience, the date of order of the original Assessment would be reckoned for computation of time limitation for filing an application for assistance of Competent Authorities under MAP.
- Certain Conventions for Avoidance of Double Taxation between the countries provide for three years from the date of receipt of first notice giving rise to double taxation.
- India-UK does not provide timelimits, use UK domestic law of 6 years

# MAP – CBDT Notification 6<sup>th</sup> May 2020

## Possible practical alternate

- The negotiation process between the Competent Authorities of countries under MAP, are generally a 'closed door' event. The taxpayer would not have access to and cannot participate in the negotiation process between the Competent Authorities.
- Taxpayers can work with the Competent Authorities to explain their own case and positions prior to the negotiation meetings between the Competent Authorities.
- See CBDT 6<sup>th</sup> May Notification on Amended MAP Rules!
  - The amended rules states that Indian Competent Authority shall endeavour to arrive at resolution within an average period of 24 months.
  - Best endeavour is to accommodate the difficulties normally experienced in any treaty negotiations and is in line with the OECD MAP peer review recommendation



# MAP in the APAC region

Reporting jurisdictions	2018 start inventory (A)	Cases started in 2018 (B)	Cases closed in 2018 (C)	End inventory (A) + (B) – (C)	No of TP cases in end inventory (D)	% of TP cases in end inventory (E = D/C)
<b>Australia</b>	<b>41</b>	<b>18</b>	<b>28</b>	<b>31</b>	<b>19</b>	<b>61.29%</b>
China	132	24	45	111	59	53.15%
<b>Hong Kong</b>	<b>15</b>	<b>5</b>	<b>4</b>	<b>16</b>	<b>10</b>	<b>62.50%</b>
<b>India</b>	<b>778</b>	<b>148</b>	<b>85</b>	<b>841</b>	<b>710</b>	<b>84.42%</b>
<b>Indonesia</b>	<b>52</b>	<b>26</b>	<b>19</b>	<b>59</b>	<b>37</b>	<b>62.71%</b>
<b>Japan</b>	<b>117</b>	<b>33</b>	<b>57</b>	<b>93</b>	<b>84</b>	<b>90.32%</b>
New Zealand	10	13	10	13	6	46.15%
Singapore	27	25	19	33	18	54.55%
South Korea	130	41	38	133	70	52.63%

Source: OECD, Mutual Agreement Procedure Statistics per country for 2018

No differentiation is made in the above statistics on cases started prior and/ or after to 01 January 2016. Such further breakdown is available in OECD website

<https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics-2018-per-jurisdiction-all.htm>

## APA, MAP have persuasive value?

- ***Ranbaxy Laboratories Ltd. v. ACIT (ITA 196/Del/2013)*** held that advance pricing agreement (APA) can apply to periods that are not covered even if the taxpayer does not apply for a rollback of the APA provisions.
- Because the function, asset, and risk profile for international transactions is the same for the year under consideration and for the APA period in the case at issue, and because the tax authorities under the APA agree with the taxpayer's approach for determining an arm's-length price, due consideration should be given to the APA while determining that price.

# APA, MAP have persuasive value?

- **Principal Commissioner of Income Tax versus J.P. Morgan Services India Pvt. Ltd. (ITA No. 4 of 2017 with ITA No. 170 of 2017)**
  - *Ranbaxy (supra)* started this and was followed by several ITAT decisions such as *3i India Pvt. Ltd. Vs. DCIT (ITA No. 581/Mum/2015, dated 16.09.2016)*, *Celltick Technologies Ltd. Vs. DCIT (ITA No.4167/Mum/2017 AY 14-15 dated 11.6.2019)*
  - Subsequently, the government started putting certain clause in APAs restricting the APA only to covered period and covered transactions.
  - JP Morgan Mumbai HC judgement has brought out clearly that if there is similarity between the circumstances and the nature of transactions, MAPs and APA can provide persuasive value before the judicial forums. But it is not to be considered mechanically and needs to be appropriately substantiated before the appellate authorities.

# Indian TP Documentation

- Taxpayers are required to annually maintain extensive supporting information and documents relating to international transactions undertaken with their associated enterprises.
- Rule 10D of the Income Tax Rules 1962, which has been widely interpreted by the courts, prescribes that the documentation requirements may be broadly divided into two parts.
- The first part lists the following mandatory information that a taxpayer must maintain:
  - information on the ownership structure (e.g., group profile and business overview);
  - whether in writing, implied in action or acting in concert: the associated enterprises' contractual nature, terms, quantity, value, etc., of an international transaction; and
  - relevant financial forecasts or estimates that form part of a comprehensive transfer pricing study.
  - The documentation includes functions performed; risks assumed; assets employed; details of relevant uncontrolled transactions; comparability analyses; benchmarking studies; assumptions; policies; details of economic adjustments; and explanations as to the selection of the most appropriate transfer pricing method.
- The second part stipulates documentation authenticating the information and analyses provided in the first part.

# Indian TP Documentation

- This documentation must be **contemporaneous**, maintained for a period of eight years from the end of the relevant assessment year (i.e., nine years from the end of the relevant financial year) and presented to the tax authorities on request, at the audit, assessment or dispute resolution stage.
- The annual documentation has to be updated to reflect the latest financial data for comparability analysis and changes, if any, in transactions, as regards functions, assets, risks or terms of arrangements between associated enterprises.
- A mandatory accountant's report furnished as Form 3CEB for all international transactions between AE's is to be obtained from an independent accountant, who would certify the value of international transactions and state the ALP based on the documentation and supporting information maintained by the taxpayer.
- The report requires the accountant to give an opinion on the proper maintenance of prescribed documents and information according to the rules, and to certify the correctness of an extensive list of transactions, including the methodology of the transactions.
- Failure to supply this report leads to a penalty of 100,000 rupees. A penalty of 2 per cent of the value of the international transaction may be levied for failure to maintain the prescribed documentary report of a transaction or for providing incorrect documentation.

# Indian TP Documentation

## OECD BEPS Action Plan 13: Transfer Pricing Documentation & Country-by-Country Reporting

- Suggests that taxpayers should maintain documents in three parts:
  - Country-by-Country Reports (CbCR),
  - Master File and
  - Local File
- This is a Minimum Standard agreed by countries to implement in their laws

# Indian TP Documentation

## Action 13: India's take

- India introduced 3-layered TP documentation in Finance Act, 2016!
  - Includes the Master File and Country-by-Country Reporting (CbCR)
  - Will apply for FY 2016-17 and first filing will be due Nov. 30, 2017
  - CbCr applies to international groups having consolidated annual revenue greater than EUR750 million (~Rs.5395 crores)
  - Detailed rules will be prescribed for Master File (and CbCr)
  - Penalties prescribed for not maintaining/filing these documents

# Indian TP Documentation

## Action 13: India's take

- **Master File** as per OECD BEPS Action Plan 13
  - Introduced by Finance Act, 2016; effective from FY16-17
  - High-level blue print of MNE group's global operations:
    - Group org structure
    - Overview of MNE group business
    - MNE's main intangibles
    - Important intercompany financial activities
    - Financial & tax positions
    - Overall TP policies
  - Ideally prepared by ultimate parent for consolidation; submitted by Indian entity to local tax authorities
  - No monetary threshold prescribed (as of now)
- ***“The master file shall contain information which may not be restricted to transaction undertaken by a particular entity situated in particular country. In that aspect, information in master file would be more comprehensive than the existing regular transfer pricing documentation.” - Budget Memorandum 2016***



# Indian TP Documentation

## Action 13: India's take

- Local file
  - Local country TP documentation
  - To be prepared by each local entity; and submitted to local tax authority
  - In place in India since 2001
  - Local file shall comprise functional and economic analysis of international transactions undertaken by the local entity.

# Indian TP Documentation

## CbCR – Section 286

- S. 286. ....**(3) For the purposes of sub-section (2), the report in respect of an international group shall include,—**
- (a) **the aggregate information** in respect of the amount of revenue, profit or loss before income-tax, amount of income-tax paid, amount of income-tax accrued, stated capital, accumulated earnings, number of employees and tangible assets not being cash or cash equivalents, **with regard to each country or territory in which the group operates;**
  - (b) **the details of each constituent entity of the group** including the country or territory in which such constituent entity is incorporated or organised or established and the country or territory where it is resident;
  - (c) the nature and details of the main business activity or activities of each constituent entity; and
  - (d) any other information as may be prescribed

# Indian TP Documentation

## Action 13: India's take

- CbC Report:
  - Requires aggregate tax jurisdiction-wise information relating to the global allocation of the income, the taxes paid, and certain indicators of the location of economic activity among tax jurisdictions in which the MNE group operates.
  - Introduced by Finance Act, 2016; effective from FY16-17
  - **MNEs having consolidated annual revenue greater than EUR750 million**
  - Prepared by ultimate parent entity for consolidation purposes
  - Submitted to the tax authority of the ultimate parent entity
  - Shared with other tax authorities through official channels (if such official channels don't exist or there is 'systemic failure' to obtain the report, the local entity has to provide the CbC report to tax authorities)
  - **Summary data and economic activity in each country**
  - Though Revenue assures CbCR confidentiality, it is a matter of additional worry for the Indian taxpayers/MNE's

## S.92CE - Secondary Adjustment

- Secondary adjustment means an adjustment in the books of accounts of the taxpayer and its associated enterprise ('AE') to reflect that the actual allocation of profits between the taxpayer and its AE are consistent with the transfer price determined as a result of primary adjustment, thereby **removing the imbalance between cash account and actual profit of the taxpayer.**
- **Vulcan (India) purchases goods from Vulcan (USA) for Rs. 100**
  - ALP = Rs. 60
  - Excess payment = Rs. 40
  - This could be treated as: (i) Loan, or (ii) Dividend payment

# Secondary Adjustment

- The taxpayer shall be required to carry out secondary adjustment where the primary adjustment to transfer price:
  - has been made suo-moto by the taxpayer in his return of income;
  - made by the AO or appellate authority and accepted by the taxpayer;
  - is determined by an **APA**
  - is made as per the safe harbour rules framed;
  - is arising as a result of resolution of an assessment by way of the **mutual agreement procedure (“MAP”)** under an agreement entered into under Section 90 or 90A of the Act for avoidance of double taxation.
- Where as a result of primary adjustment to the transfer price, there is an increase in the total income or reduction in the loss, as the case may be, of the taxpayer, the **excess money** which is available with its AE, if not repatriated to India within the time as prescribed, shall be deemed to be an advance made by the taxpayer to such AE and the interest on such advance, shall be computed as the income of the taxpayer.
- Excess money means the difference between the arm's length price determined in primary adjustment and the price at which the international transaction has actually been undertaken.

# Secondary Adjustment

## Constructive loan vs dividend approach

- There are two most adopted models for making secondary adjustments prevalent globally, which consider secondary adjustment as
  - (i) constructive loan or
  - (ii) constructive dividend.
- In constructive loan approach, the taxpayer is required to offer the imputed interest on the amount of primary adjustment to tax till the time such amount is not brought back to India the amount of secondary adjustment is treated as a dividend paid by the taxpayer and taxed accordingly.
- While till date the amount of transfer pricing adjustment, if not brought to India was treated as a loan to AE, the Finance Bill 2019 provided an option of paying one-time tax of 18% plus 12% surcharge i.e. 20.16%, on the amount of transfer pricing adjustment and get rid of interest imputing with effect from 1st September 2019.

## Transfer Pricing Penal provisions (*a.k.a* ‘rubbing salt into the wound’)

Reference under the Income-tax Act	Particulars	Penalty
271AA	Failure to maintain documentation	2% of the value of each international transaction
271G	Failure to furnish/submit any information / document to the transfer pricing officer	2% of the value of the international transaction for each such failure
271BA	Failure to furnish accountant’s report	INR 100,000
271(1)(c)(iii) read with Explanation 7	Transfer pricing adjustment considered as concealed income	100-300% of amount of tax on adjustments

# Critique of TP

- **TP: Economic transactions codified by open-ended law**
- **Inequitable results : result of process to find ALP**
  - Arm's length price good in theory, does it make practical sense in practice.
  - No two transactions are really comparable let alone identical.
  - Separate-entity not the answer to all problems
  - In practice, we see **inequitable results** in trying to arrive at ALP
  - Artificial distinction between legal entities - branch, liaison office, dependent agent, subsidiaries etc.
  - The entire process and outcome seems to defeat the very purpose of the TP regime
- **TOO MANY VARIABLES** to factor in (*similar to weather modeling!*)
  - Engineering shout-out : this seems like a *NP-hard* problem.
  - Research theories may be complex. **Laws should be precise**



# TP in the time of Corona

- Suspend all TP assessments? Or fix a low % across the board?
  - Where are the comparables?
  - What are the adjustments to be made – covid adjustment?
  - Each person, entity, sector has a different problem
  - Each location has a different issue
  - Each nation has its own schedule and system in place
  - What about APA's negotiated?
  - **Extraordinary times call for extraordinary actions**

Yet to cover.....

- **Reference to TPO** (see Board's Instruction no 3 of 2003)
- **Intra-group transactions**
- Share transactions & TP
- Head Office & Branch Transactions
- Cushman & Wakefield decision
- OP/VAE : Berry Ratio

# References

- UN TP Manual
- OECD TP Guidelines
- ICAI Pune, TP Seminar, 2019
- <https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/in-tax-khc-ruling-noexp.pdf>

# Let's stop here!

Thanks!

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