TRANSFER PRICING REGULATIONS IN INDIA

– In Sync with the World

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Transfer Pricing Regulations in India
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Includes:

- ✓ Country-by-Country Reporting (CbCR) and Master File
- ✓ Secondary adjustment
- ✓ Time limit for transfer pricing assessments
- ✓ List of countries having comprehensive TP regulations
- ✓ Analysis of recent TP judgments

PREFACE

Multi-national enterprises (MNE) now represent a large proportion of global GDP. Also, intra-firm trade represents a growing proportion of overall trade. Globalisation has resulted in a shift from country-specific operating models to global models based on matrix management organisations and integrated supply chains that centralise several functions at a regional or global level. Moreover, the growing importance of the service component of the economy, and of digital products that often can be delivered over the Internet, has made it much easier for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers. To ensure that profits are taxed in the country where economic activities are undertaken, more than 100 countries have now adopted transfer pricing regulations based on the arm's length principle. The regulations provide countries to determine arm's length price for the transactions between related parties based on the most appropriate method as prescribed.

Due to increasing sophistication of business models, greater significance of intangibles and IPRs, the proliferation of digital economy, the country based transfer pricing approach and tax regulations have opened up opportunities for MNEs to greatly minimise their tax burden. In 2013, to address the issue of base erosion and profit shifting (BEPS), The Organisation for Economic Co-operation and Development (OECD's) and the Group of 20 major economies (G20) adopted a 15 Action Plans. The 15 Actions Plans are now finalised with more focus on cross-border transactions, transparency and strengthening existing international standards.

The Finance Act, 2001, introduced the transfer pricing rules in India. The transfer pricing rules have evolved over the years and now are moving towards being in coherence with global best practices. The Indian transfer pricing regulations and administration have been perceived earlier to be one of the most aggressive regimes in the world. The ambit of transfer pricing widened with the inclusion of domestic transfer pricing regulations although subsequently the applicability is restricted to units enjoying exemption or tax holiday. The Finance Ministry with a view to reduce cases under audit and to reduce litigation has introduced certain far reaching measures in the recent past to move away from a quantitative basis for selection of cases for transfer pricing audit to a risk based system. This is expected to reduce the cases under audit and thus reduce litigation. Further, the Central Board of Direct Taxes (CBDT) has introduced the range concept and use of multiple year data. These steps are expected to reduce litigation burden and bring

about a stable transfer pricing regime.

Indian Government has taken several measures to reduce the compliance and litigation burden to taxpayers. The safe harbor rules (SHR) were revised to reduce mark-up/margins for Information Technology (IT) and IT enabled Services (ITeS). The Advance Pricing Agreement (APA) provisions and has proved to be a step in the right direction, as on 31 December 2017, total 189 APA's have already been concluded (including 16 bilateral APAs). The scope of domestic transfer pricing has been reduced, clause (i) of Section 92BA was omitted by Finance Act, 2017 w.e.f. April 1, 2017, with respect to determination of arm's length price for any payments made to related parties as per Section 40A(2)(b).

Implementation of BEPS would mean amending the tax treaties with different countries and amending the local tax laws. India is slowly following recommendation as per BEPS regulations and accordingly, amending the local tax laws to get the same in coherence with the best global practices. India has started modifying the domestic tax laws by implementing certain Action Plans, originated from OECD under its Action Plan on BEPS.

In this publication we have endeavored to elucidate in a comprehensive manner the whole gamut of the transfer pricing regulation in India and the recent developments in this field. This publication should not be viewed as an exhaustive book but may be considered as a guide to understand the subject from a business perspective and identify areas of potential exposure and manner in which the exposure can be minimised.

Happy Reading!

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Part A

RECENT DEVELOPMENTS

Chapter 1 What Has Changed?

1.1 Scope of Domestic TP Provisions Restricted

The erstwhile provisions of section 92BA(i) of the Act, provided that any expenditure in respect of which payment has been made by the assessee to certain "specified persons" under section 40A(2)(b) are covered within the ambit of specified domestic transactions. The assessee had to ensure that any payments made to any person referred under Section 40A(2)(b) meets the arm's length test. This resulted in great hardship and double taxation since the expenditure was disallowed, the income continued to be taxable in the hands of the recipient.

As a matter of compliance and reporting, taxpayers need to obtain the chartered accountant's certificate in Form No.3CEB providing the details such as list of related parties, nature and value of specified domestic transactions (SDTs), method used to determine the arm's length price for SDTs, etc. This had considerably increased the compliance burden of the taxpayers.

In order to reduce the compliance burden, the Finance Act, 2017 amended section 92BA to provide that expenditure in respect of which payment has been made by the assessee to any person referred to in under section 40A(2)(b) shall be excluded from its scope. Accordingly, any payments made to the related parties referred to 40A(2)(b) will not be required to be reported in Form No 3CEB as SDTs, even if the amount of payment exceeds the prescribed limit of INR 20 crores.

1.2 TP Documentation and Country-By-Country Reporting

With a view to align the existing Indian Transfer Pricing regulations pertaining to maintenance of documentation, the Finance Act, 2016 adopted Action 13 of the Action Plan on BEPS ('BEPS Action Plan 13') for Transfer Pricing Documentation and Country-By-Country Reporting ('CbCR') by introducing an amendment to section 92D and inserting a new section 286 to the Act. These provisions will be effective from AY 2017-18 (financial year commencing from 1 April 2016) and subsequent assessment years.

Further, CBDT on 31 October 2017 issued a notification with respect to the new Rules 10DA, 10DB and new Forms namely Form No. 3CEAA to Form No. 3CEAE for laying down the guidelines for maintaining and furnishing of transfer pricing documentation in the Master File and Country-by-Country report.

Master File

The provisions with respect to applicability of Master File in India have been given in brief below:

Criteria	Evaluation period	Threshold exceeding*
(i) Consolidated group revenue of the international group	Accounting Year under consideration	INR 500 Crores (INR 5 billion) (i.e. approx. USD 78.74 million)
AND		
(ii) Aggregate value of international transactions of the constituent entity as per books of accounts	Accounting Year under consideration	INR 50 Crores (INR 500 million) (i.e. approx. USD 7.87 million)
OR		
(ii) Aggregate value of international transactions involving intangibles of the constituent entity as per books of accounts	Accounting Year under consideration	INR 10 Crores (INR 100 million) (approx. USD 1.57 million)

*USD 1 = INR 63.49

Country-by-Country Reporting

The provisions relating to filing of CbCR shall be applicable in case where the total consolidated group revenue of the international group in the previous accounting year is equal to or greater than INR 5,500 Crores (INR 55,000 million) (i.e. approx. USD 866.20 million).

The CbCR requires each multinational enterprise (MNE) to provide key financial information on an aggregate country basis with an activity code for each member of the MNE. The report would contain aggregate information in respect of revenue,

profit & loss before income-tax, amount of Income-tax paid and accrued, details of capital, accumulated earnings, number of employees, tangible assets other than cash or cash equivalent in respect of each country or territory along with details of each constituent's residential status, nature and detail of main business activity and any other prescribed information.

It is pertinent to note that one will be required to file the relevant forms as per the prescribed due dates to prevent the imposition of the stringent penalties. Also, the Budget 2018 has proposed some changes to rationalize the provisions of CbCR in order to improve effectiveness and reduce the compliance burden of such reporting like extension of time limits for filling of prescribed forms.

1.3 Secondary Adjustment

The Finance Act, 2017 introduced a new Section 92CE to provide for secondary transfer pricing adjustments in certain cases in order to align TP provisions to OECD TP Guidelines and international best practices. The provision and its applicability is summarized below:

Provisions	Applicability
Shall be made only in case of mentioned primary adjustment	▪ Suo Moto, acceptance of adjustment ▪ made by the Assessing Officer (AO), which has been accepted by the taxpayer ▪ Determination in an APA or SHR ▪ Resolution under MAP
No Adjustment	If the primary adjustment is less than INR 1 crore (INR 10 million)
Primary adjustment results in increase of total income or reduction in loss	Excess money with the AE should be repatriated to India within prescribed limit, if not then such amount will be treated as loan or advance
Timeline for repatriation of funds and interest rate pursuant to secondary adjustment	Excess money shall be repatriated to India within 90 days <u>Computation of Interest</u> – One year MCLR + 325 bps in case of INR denominated or – 6 months LIBOR + 300 bps in case of foreign currency

1.4 Penalty for furnishing incorrect reports and certificates

There are various provisions under the Act to penalize the defaulting assessee in case of furnishing incorrect information. However, there exists no penal provision for levy of penalty for furnishing incorrect information by the person who is responsible for certifying the same. Also, in order to encourage the habit of voluntary compliance, the Budget 2017 introduced section 271J wherein the AO or the Commissioner (Appeals) has been given the power to impose a penalty of an amount upto INR 10,000 in case the accountant (or a merchant banker or a registered valuer) has furnished incorrect information in any report or certificate.

Therefore, while furnishing any report or certificate like Form No. 3CEB it will not just be the responsibility of the assessee furnishing the said report but also of the accountant certifying it to ensure that information provided is true and correct.

Chapter 2 Important Issues Under Litigation

The important issues arising out of transfer pricing regulations have been discussed under the respective chapters and the discussion here is confined to certain latest judicial rulinghaving general and wider applicability. Chapter 16 contains detailed analysis of other transfer pricing issues that have been dealt in course of judicial rulings.

2.1 Domestic TP's deemed omission from inception

2.1.1 Issue

Disputed the ALP of managerial remuneration paid by taxpayer, by virtue of coverage under section 92BA(i) of ITA. The introduction of SDT caused considerable challenge to the taxpayer, in establishing the ALP of certain transactions such as managerial remuneration given that the roles/ responsibilities/ functioning of each of the directors in a particular company is unique/ different and thus may not always be comparable.

Taxpayers had undertaken compliances in relation to SDT, such as filing of Accountant's Report in Form No. 3CEB maintenance of Rule 10D transfer pricing documentation and in certain cases, such cases also went through the rigour of transfer pricing assessments. Some cases have faced adjustments during the transfer pricing assessments and are currently in the appellate forums.

2.1.2 Judicial Pronouncements

In the case of T**export Overseas Private Limited Vs. Dy. CIT (ITAT Bangalore) (Texport's case) for Assessment Year (AY) 2013–14** could serve as an important precedent for other similar cases. In Texport's case, the Transfer Pricing Officer (TPO) had disputed the ALP of managerial remuneration paid by taxpayer, by virtue of coverage under section 92BA(I) of ITA. The taxpayer argued that the aforesaid clause (i) of 92BA of ITA was omitted by Finance Act 2017, with effect from 1 April 2017 and therefore, this sub clause shall be deemed not to be on the statute since the beginning. The taxpayer relied upon the following decisions in support of its contention:

Honourable Supreme Court in the case of Kolhapur Canesugar Works Ltd. Vs Union of India

Honourable Supreme Court in the case of General Finance Co. Vs Assistant Commissioner of Income tax
Honourable Karnataka High Court in the case of GE Thermometrics India Pvt. Ltd.

The Bangalore ITAT held that as clause (i) of Section 92BA was omitted by Finance Act, 2017 w.e.f. April 1, 2017, it would be deemed that clause (i) was never been on the statue. It was further observed that while omitting the clause (i) of section 92BA, nothing was specified whether the proceedings initiated or action taken on this shall continue. Therefore, the proceedings initiated or action taken under that clause would not survive at all.

ITAT further opined that the cognizance taken by the Assessing Officer (AO) under section 92B(i) and reference made to the TPO under section 92CA is invalid and bad in law. Therefore, the consequential order passed by the TPO and Dispute Resolution Panel (DRP) is also not substantial in the eyes of law.

2.1.3 Precautionary Measure

Considering that any expenditure in respect of which payment has been made or is to be made to a person referred to in clause (b) of sub-section (2) of section 40A is omitted from transfer pricing regulations, it is therefore advisable that assessee is not required to compute ALP for the same. Based on the above ruling, a view can be taken that any reference made by the AO to the TPO for specified domestic transaction (expenditure in respect of payment made to related parties referred to in clause 40A(2)(b)) will be invalid and bad in law. However, the AO can do assessment in normal course after making necessary enquiry for claim of expenditure in accordance with other section of the Act i.e. Section 40A(2)(b) or Section 37(1).

2.2 Impact of delayed associated enterprise receivables subsumed in working capital adjustment made by the assessee company

2.2.1 Issue

Whether earning significantly higher margin than comparable companies compensates for credit period extended to AEs and no further TP adjustment was required.

2.2.2 Judicial Pronouncements

In the case of Healthcare (P.) Ltd. Vs. ACIT [2015] 62 taxmann.com 79 (Delhi – Trib.)

A working Capital adjustment appropriately takes into account the outstanding receivable. Therefore, the assessee has undertaken a working capital adjustment to reflect these differences by adjusting for differences in working capital and thereby, profitability of each comparable company. Accordingly, while calculating the working capital adjusted, operating margin on costs of the comparable companies, the impact of outstanding receivables on the profitability has been taken into account. If the pricing/profitability of the assessee are more than the working capital adjusted margin of the comparable, then additional imputation of interest on the outstanding receivables is not warranted.

2.2.3 Precautionary Measure

The assesse should have an approach of aggregating the international transactions pertaining to sale of goods to AE and receivables arising from such transactions which is inextricably connected is in accordance with established TP principles.

2.3 Levy of penalty under section 271G

2.3.1 Issue

The assessee company was mainly engaged in the business of importing and locally purchasing rough diamonds, getting them cut and polished, and exporting or locally selling the same. It also procured polished diamonds and exports the same without carrying out any material function.

The TPO was of the view that entity level benchmarking using Transactional Net Margin Method (TNMM) did not lead to correct results as the loss in transactions with AE segment could easily be set off with the profits of the non-AE segment.

Accordingly the TPO had called upon the assesse to submit the segmental profitability for AE transactions and non-AE transactions even though the assessee had expressed its inability to furnish details in the manner for the reason that it had not maintained separate books of accounts for AE and non-AE segments.

The TPO accordingly proposed to levy penalty under section 271G on the assesse for its failure to furnish the said requisite details.

2.3.2 Judicial Pronouncements

In the case of **Mumbai ITAT Ruling of ACIT V/s M/S D. Navinchandra Exports Pvt Ltd (ITA No. 6304/Mum/2016)**

ITAT took cognizance of the inherent difficulties of the gems and jewelry industry and the fact that it was extremely difficult to identify which rough diamond got converted into which polished diamond (unless the single piece rough diamond happened to be of exceptionally high carat value). Additionally, ITAT also upheld the CIT (A)'s rejection of using CUP method for the purpose of benchmarking. The ITAT remarked that the TPO should have exercised the viable option of determining the arm's length price of the international transactions of the assessee, either by making some comparison of realisation of prices in respect of export sales to AEs and non-AEs by comparing prices of diamonds of similar size, quality and weight to the best extent possible, or in the alternative could have asked for the copies of the Profit & loss accounts and the Balance sheets of the AEs in order to make an overall comparison with the gross profitability levels of the assessee with its AEs, which would had clearly revealed diversion of profits, if any, by the assessee to its AEs.

2.3.3 Precautionary Measure

The assesse should maintain robust documentation and also document the practical difficulties if any faced by the industry it operates in as no two businesses are identical which would be helpful to the TPO at the time of assessment and may avoid litigation.

2.4 Marketing Intangibles

2.4.1 Issues

In case of an international transaction between taxpayer and AE under which the taxpayer incurred Advertising Marketing Promotion ('AMP') expenses towards marketing intangibles legally-owned by the AE; the issue herein pertains to allowability of such AMP expenses in the hands of the taxpayer, considering the

commercial rational or the legal ownership. According to the tax Authorities, what is relevant under the transfer pricing regulations is ***legal ownership*** of intangibles.

2.4.2 Judicial Pronouncements

The said issue was examined by the Special Bench of Delhi Tribunal in the case of **L.G. Electronics India Private Limited** [2013] 29 taxmann.com 300, wherein, the Tribunal did not deny that there can be no economic ownership of a brand, however, it was opined that the same exists only in a commercial sense. Regarding AMP expenses, the Tribunal held that that it needs to be found out as to how much AMP expenses an independent enterprise behaving in a commercially rational manner would have incurred. On such comparison, if the result is that the taxpayer had incurred expenses proportionately more than that incurred by independent enterprises behaving in a commercially rational manner, then it becomes eminent to re-characterize the transaction of total AMP expenses with a view to separate the transaction of brand building for the foreign AE. The Tribunal further concluded that the transaction of brand building by the taxpayer for foreign AE is in the nature of the "provision of service" requiring a mark-up. Moreover, the Tribunal also endorsed the use of ***bright line test*** in order to determine the transaction value of such AMP expenses.

The Tribunal also provided broad guidance on various factors that need to be considered while ascertaining whether an intangible is created and determining the value of the international transaction of foreign brand building / logo promotion through such AMP expenses.

Recently, the Delhi High Court in case of **Sony Ericsson Mobile Communications India Pvt. Ltd.** [2015] 55 taxmann.com held that AMP expenses incurred by assesee subsidiary of MNE can be categorised as an international transaction subject to transfer pricing. It also held that marketing and distribution are inter connected and intertwined functions and bunching of inter-connected and continuous transactions is permissible, provided the said transactions can be evaluated and adequately compared on aggregate basis. It also concluded that it would be illogical and improper to treat AMP expenses as a separate transaction using bright line test. The court also recognised the concept of economic ownership of trade name or trade

mark is acceptable in international taxation as one of the components or aspects for, determining transfer pricing. The High Court has further stated that economic ownership would arise only in cases of long term contracts and where there is no negative stipulation of denying economic ownership.

A contrary view was held by the Delhi High Court in case of **Maruti Suzuki Ltd.** (ITA No. 110/2014), wherein it concluded that the AMP expenses incurred by assesse cannot be considered as an international transaction and therefore no transfer pricing adjustment can be made on account of AMP expenses. It also held that bright line test is not permitted by the law relying on the Sony Ericsson judgment.

The other judicial pronouncements in context of AMP expenses are as under

- **Reebok India Co. Vs. Adl. CIT** [2013] 35 taxmann.com 578 (Delhi Tribunal)
- **Panasonic Sales & Services Private Limited Vs. ACIT** [2013] 34 taxmann.com 276 (Chennai Tribunal)
- **Whirlpool India Ltd. Vs. DCIT** [2014] 30 ITR 29 (Delhi Tribunal)
- **Diageo India (P) Ltd. Vs. DCIT** [2013] 34 taxmann.com 284 (Mumbai Tribunal)

2.4.3 Precautionary Measure:

The necessity of transfer pricing adjustment for AMP expenses may arise where there is influence of an AE in advertising and marketing function of the Indian affiliate. It is advisable for the taxpayer to evaluate the TP policy in light of detailed analysis of roles / responsibilities undertaken, risks borne / reward reaped. Also, a robust documentation including legal contracts etc. has to be maintained by the taxpayer.

2.5 Issuance of Guarantee on behalf of the AE

2.5.1 Issues

The Indian tax authorities are of the view that the Indian entity must charge guarantee fees for the guarantee given in respect of the borrowings of AEs.

In the absence of any guarantee fees charged to AEs, the tax authorities may take stand that Indian entities provided an intra-group service to its AE by issuing the corporate guarantee to the loans taken by their AEs abroad, the latter are obliged to pay a service charge to the Indian entity. Accordingly, Indian entity should charge guarantee fee for provision of guarantee service.

2.5.2 Judicial Pronouncements

The Delhi Tribunal in the case of **Bharti Airtel Limited Vs. ACIT** [2014] 43 taxmann.com 150 noted that Explanation to section 92B states that it is merely clarificatory in nature as much as it is 'for the removal of doubts', and therefore, one has to proceed on the basis that it does not alter the basic character of definition of 'international transaction' under section 92B. Therefore, the Tribunal viewed that the said Explanation has to be read in conjunction with the main provisions, and in harmony with the scheme of the provisions, under section 92B. The Tribunal observed that under the scheme of the Act, any transaction including capital financing, guarantees, business restructuring / re-organization can be regarded as an 'international transaction' only if such a transaction has a bearing on the profits, income, losses or assets of an enterprise (either immediately or in future). The Tribunal further noted that such an impact in the future has to be certain (and not contingent) for covering a transaction in the definition of international transaction. Income Tax Appellate Tribunal (ITAT) noted that the corporate guarantees issued by the taxpayer to the bank on behalf of its AE did nothave any implication on the profits, income, losses or assets of the taxpayer. It also observed that the AE had not taken any borrowing from the bank based on the taxpayer's guarantee.

The Bombay High Court in case of **Everest Kanto Cylinders Ltd** [2015] 58 taxmann.com 254 held that no comparison can be made between guarantees issued by commercial banks as against a corporate guarantee issued by holding company for benefit of its AE, a subsidiary company, for computing ALP of guarantee commission. The Court further stated that the considerations which apply for issuance of a corporate guarantee are distinct and separate from that of bank guarantee and cannot be compared.

2.5.3 Precautionary Measure

Considering that the chargeability of fees on corporate guarantee provided by the taxpayer to its foreign AE is a subject matter of litigation and pursuant to the amendment in section 92B to include guarantees, it is therefore advisable to charge guarantee fees on such guarantees provided, at ALP. Reference can be drawn from the rates prescribed under the SHR.

2.6 Charging Notional Interest for Delay in Realization of Sales Proceeds from AEs

2.6.1 Issues

In case of excessive credit period allowed to AEs and delay in realization of sales proceeds from AEs as compared to non AEs, the tax authorities are of the view that by giving excess credit period to AEs and delay in realizing sales proceeds from AEs as compared to non AEs, the Indian entity is passing the benefits of prolonged credit to its AE. Accordingly, an adjustment should be made in respect of excess credit allowed to AE debtors by charging notional interest from AEs on excess amount outstanding or extended credit period.

2.6.2 Judicial Pronouncement

The Bombay High Court in the case of Indo **American Jewellery Ltd** [2014] 44 taxmann.com 310 affirmed the view of the Tribunal that if there is complete uniformity in the act of the taxpayer in not charging interest from both the AE and non AEs debtors for delay in realization of export proceeds, then no notional interest is to be charged on the exports proceeds received belatedly from the AEs.

The Delhi Tribunal in case of **Kusum Healthcare Pvt Ltd.** (ITA No. 6841/Del/2014) held that when the underlying transaction of sales to AE has been held to be at arm's length based on the working capital adjusted arm's length margin under TNMM, no further TP adjustment for interest on outstanding receivables is warranted.

2.6.3 Precautionary Measure

Finance Act, 2012 has widened the definition of international transaction under Section 92B with retrospective effect from AY 2002-03 to cover overdue

receivables within the definition of "international transaction". However, the High Court decision passed after the said amendment to the definition of international transaction under section 92B did not consider the implication of such amendment in the specific case.

Nevertheless, in order to avoid adjustment or litigation on this account, it is advisable that there is no excess credit allowed / prolonged credit period extended to AE debtors as compared to non AE debtors. It is advisable to maintain robust documentation to prove that the excess credit, if allowed to AE debtors is due to specific business reasons and not with the intention of passing any benefits to AEs.

2.7 Economic Adjustments

2.7.1 Issues

There may be certain circumstances wherein comparables identified may require adjustments for differences in working capital, risk profile of entities, capacity utilization, etc. for determining the ALP. Such adjustments are referred to as comparability adjustments or, economic adjustments in common parlance. Economic adjustments have been a subject matter of litigation in India.

2.7.2 Judicial Pronouncements

The Chennai Tribunal in case of **Mando India Steering Systems Pvt Ltd** [2014] 45 taxmann.com 160 was of the view that underutilization of production capacity in initial years is a vital factor and cannot be ignored when determining the ALP of a controlled transaction.

The Pune Tribunal in case of **Amdocs Business Services Private Ltd.** [2012] 26 taxmann.com 120 allowed economic adjustments on account of under utilization of capacity, startup cost and also for excess depreciation as taxpayer had charged excess depreciation at rates higher than the comparable companies.

The Pune Tribunal in case of **Demag Cranes & Components (India) (P.) Ltd.** [2012] 17 taxmann.com 190 held that working capital is a factor which influences price in open market and, therefore, requisite adjustment on account of working capital has to be made while determining arm's length operating margin of comparables. It also held

that TP adjustments should be made on proportionate basis (i.e. on proportionate sales relating to the impugned international transaction) and not the entire sales.

The Mumbai Tribunal in the case of **Petro Aradite** (ITA No. 3782/Mum/2011: [2013] 35 taxmann.com 590) discussed and explained a methodology for making capacity adjustment in detail. It held that if the fixed overheads allocation or absorption of comparables was brought to the level of taxpayer, it would nullify the effect of difference in capacity utilization on the profit margin. Thus the Tribunal held that the adjustment on account or difference in capacity utilization can be made by absorbing or allocating fixed overheads such as depreciation at the same level as that of the taxpayer. It also held that such absorption or allocation of fixed overheads would be more appropriate on operating cost instead of sales to eliminate the effect of differences in profit margin or difference in stock of finished goods, if any between the taxpayer and the comparables.

In a recent decision the Delhi Tribunal in the case of **Claas India Pvt. Ltd.** [TS-371-ITAT-2015], the Tribunal has not only accepted the need for a capacity utilization adjustment but has in fact treaded a step further and addressed two critical questions in relation to this adjustment, viz., whether the adjustment should be made to the tested party or to comparables? And how the adjustment be calculated?

2.7.3 Precautionary Measure

In view of the above, it is advisable that the claim on account of differences should be supported with evidence. For example, claim on account of quantity should be supported with evidence such as the commercial policy of the company, etc.

2.8 Tax authorities cannot question the commercial rationale of legitimate business expenses incurred

2.8.1 Issue

In certain cases, the taxpayer makes payment to its AE for the use of brand name, inspite of perpetual loss incurred by the taxpayer in its business. The Tax Authorities generally disallow such payments considering perpetual losses suffered by the Indian entity.

2.8.2 Judicial Pronouncement

The Delhi High Court in the case of **EKL Appliance Ltd. Vs. CIT** [2012] 24 taxmann.com 199 held that any legitimate expenditure for business purpose cannot be disallowed while computing ALP merely because assessee was continuously incurring losses. As long as the expenditure or payment is demonstrated to be incurred or laid out for business purpose, it is no concern of the TPO to disallow the same on any superfluous reasoning. The taxpayer need not show that any expenditure incurred by him for the purpose of business has actually resulted in profit. The High Court relying on OECD guidelines opined that TPO is expected to examine the international transaction as he actually finds the same and then make suitable adjustment but a wholesale disallowance of the expenditure, particularly on the grounds which have been given by the TPO is not contemplated or authorized. The relevant extract of the observations of the High Court is given below:

"Even rule 10B(1)(a) does not authorize disallowance of any expenditure on the ground that it was not necessary or prudent for the assessee to have incurred the same or that in the view of the revenue the expenditure was unremunerative or that in view of the continued losses suffered by the assessee in his business, he could have been far better, had he not incurred such expenditure. These are irrelevant considerations for the purpose of rule 10B. Whether or not to enter intothe transaction is for the taxpayer to decide. The quantum of expenditure can no doubt be examined by the TPO as per law but in judging the allowability thereof as business expenditure, tax administration has no authority to disallow the entire expenditure or a part thereof on the ground that the taxpayer has suffered continuous losses. The financial health of assessee can never be a criterion to judge allowability of an expense; there is certainly no authority for that. What the TPO has done in the present case is to hold that the assessee ought not to have entered into the agreement to pay royalty/brand fee, because it has been suffering losses continuously. So long as the expenditure or payment has been demonstrated to have been incurred or laid out for the purposes of business, it is no concern of the TPO to disallow the same on any extraneous reasoning. As provided in the OECD guidelines, he is expected to examine the international transaction as he actually finds the same and then make suitable adjustment but a wholesale disallowance of the expenditure, particularly on the grounds which have been given by the TPO is

not contemplated or authorised''

2.8.3 Precautionary Measure

The decision highlights the fact that the tax authorities per se cannot question the commercial rationale of legitimate business expenses incurred by the taxpayer. However, it also becomes imperative for taxpayer to demonstrate that the transaction is at arm's length by application of the prescribed methods with proper evidences/ documentation.

2.9 Compensation for Intra Group Services

2.9.1 Issue

Indian tax authorities take an aggressive approach while examining the TP policies in respect of intra-group services, especially when an Indian entity is the recipient of services and management fee has been charged to Indian entity.

The Indian tax authorities mainly seek and examine the following details in this respect:

- Need of such services to Indian entity i.e. whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself.
- Whether the amount charged by AE for services commensurate with the benefit derived by the Indian entity by availing such services, whether the allocation key used by AE make sense under the circumstances, etc.
- Whether such services have given any special advantage / commercial or economic benefit to the Indian entity or the services are just in the nature of shareholder's services i.e. services rendered to protect the interest of the AE, being the shareholder and thus, not recoverable.
- A copy of agreement between AEs and invoices/debit notes raised by AE to examine exact nature of services rendered by AE and the basis on which the payment is made to AE.

2.9.2 Judicial Pronouncements

The Bangalore Tribunal in the case of **Gemplus India Pvt. Ltd. vs. ACIT** (2010-TII-55-ITAT-BANG-TP) held that the onus was on the taxpayer to establish that the payments made to AE for service charges were commensurate to the volume and quality of services provided by the AE and that the costs were comparable to an uncontrolled transaction. Since, the assessee could not prove any commensurate benefits against the payment of service charges to AE; adjustment made by the TPO was justified.

2.9.3 Precautionary Measure

It is advisable to design a proper Group TP policy, considering the various factors such as the nature of the activity services rendered, significance of the activity to the group, functional profiling and the characterization of the intra-group transactions involved, relative efficiency of the service supplier, any advantage that the activity creates for the group, etc. Further, it is advisable to maintain robust documentation to demonstrate the actual receipt of intra-group services and fulfillment of the benefit test i.e., to demonstrate that the consideration received by the AE for services rendered to Indian entity is proper as compared to the benefit which Indian entity received from such intra group services.

2.10 Management Charges

2.10.1 Issues

The taxpayer receives certain services from its AE's for which it makes payment in nature of management charges. The tax authorities determine the management service charges as NIL using CUP Method. This has become a major issue of litigation.

2.10.2 Judicial Pronouncements

The Delhi Tribunal in the case of **AWB India P Ltd** (ITA No 4454/Del/2011) 2014 50 taxmann.com 323 observed that the TPO had not disputed the taxpayer's contention that it was not possible to document every record of receipt of the services, since they were received in the form of directions and recommendations

through phone calls/emails/reports etc. It was concluded that the taxpayer had successfully demonstrated that the information provided by its AE was critical to the taxpayer's business. Just because some of the data was available for free on the internet, it would not be of use to specialized businesses like those carried on by taxpayer unless it is structure, cross-referenced and made easy to use. The Tribunal concluded that Revenue authorities are not empowered to question the taxpayer's commercial wisdom and it is entirely for the taxpayer to take such decisions as favour to the advancement of its business.

Further, the Delhi Bench in case of **McCann Erikson India (P) Ltd** (ITA No. 5871/Del/2011), held that entity level TNMM for benchmarking would be the most appropriate method for computing ALP, due to assessee's distinct nature of business and services received from AE. There are no segments or activities which can be said to be as independent of each other in the assessee's business. The ITAT ruled that in the field in which the assessee's company was functioning, it would be difficult to envision a business entity that can successfully carry out its operations the global environment without receipt of services, which carry a huge intrinsic and creative value. No one except a business expert can evaluate the true value of such services. Also, the Mumbai Tribunal in case of **Dresser Rand India Pvt Ltd.** (ITA No.3509/Mum /2008), concluded it is entirely the assessee's prerogative to determine the manner in which it conducts its business, and it is not for the tax deparment to make the decision on its behalf. The Tribunal also observed that an assessee may have any number of qualified accountants and management experts on his rolls, but that goes not prevent the assesse from engaging the services of outside experts for auditing and management consultancy.

Further, it is not for the tax authorities to question the assessee's wisdom in doing so. Whether a particular expense on services received is beneficial for an assessee in monetary terms should not be a consideration for the tax authorities. The benefit of the service or the lack thereof to the organisation cannot influence the ALP of that service. The real question that is to be determined in such cases is whether the price of this service is equivalent to the price that an independent enterprise would have paid for the same.

2.10.3 Precautionary Measure

In view of the above it is advisable to enter into a detailed agreement with the AE specifying the service to be received and fees for the same. In addition the taxpayer needs to maintain evidences in respect of services like email communications etc. to justify receipt of services from its AE's.

2.11 Re-imbursement of expenses

2.11.1 Issues

The transactions involving pure cost reimbursements also require a TP analysis (including benchmarking) for determination of ALP.

2.11.2 Judicial Pronouncements

The Delhi High Court in the case of **Cushman and Wakefield India Pvt Ltd** (Delhi HC (2014) 89 CCH 0076) struck down the taxpayer's argument that mere cost recharge without mark-up requires no benchmarking analysis. Since uncontrolled transactions would involve a mark-up and lead to higher price. Cost incurred in an uncontrolled transaction cannot be speculated to be higher on account of mark-up. Whether the cost charged by the AE is inflated or not is required to be tested explicitly by undertaking a benchmarking analysis. The High Court emphasized maintenance of documentary evidence to demonstrate receipt of service, basis of cost incurred, activities for which they were incurred, benefits directly related to such act etc. for providing validity of claim and determination of ALP. The decision as to whether the services claimed to be provided to the taxpayer existed and the expenditure was wholly and exclusively for the purposes of business is a fact to be determined by the AO. This right of the AO is not prejudiced due to reference made to the TPO, whose role is limited to determination of ALP of the transactions. The High Court remanded the case back to the files of AO and TPO.

2.11.3 Precautionary Measure

In view of the above, it is advisable to carefully frame the policy for re-imbursement of expenses incurred on behalf of AEs. If the expenses are administrative/routine in nature, it is advisable to maintain documentation in support of expenses incurred,

the benefit, if any, derived by the AE, rationale for incurring the expenses by Indian entity, arrangement/agreement with the AE in respect of the same, etc.

Further, in cases where such activities are done on regular and frequent basis and continue over a period of time, it is important to look into the substance of the transaction to find whether the activities carried on by the Indian entity amounts to service rendered by the Indian entity for which it should charge appropriate amount of service fee to the AEs.

2.12 Determination of arm's length price for a non-resident in India

2.12.1 Issues

Whether the TPO was correct in manking an arm's length price adjustment to the income of the assesssee, non-resident in India with respect to the international transaction of interest free loan granted to its wholly owned subsidiary in India.

2.12.2 Judicial Pronouncements

The Kolkata Special Bench rules in favor of the revenue, in the case of Instrumentarium Corporation Limited by rejecting the argument of base erosion with respect to the interest free loan advanced by the assessee (non-resident) to its wholly owned subsidiary in India.

Special Bench rejected the argument of the assesssee that the case was covered by Section 92(3) i.e. Section 92(1) does not apply if the transfer pricing adjustment has effect of reducing income or increase the loss. The Special Bench further held that there is no scope at all for taking into account the impact of taxes in subsequent years.

As per the local laws in India, there is nothing in the Act which would allow Indian company to re-compute its income and claim the loss (on account of higher interest expense payable to assessee) to be set off against the profits of the future year. Special Bench opines that benefit of loss is not real and contingent on uncertain future event and that the revenue will not have the telepathy whether or not Indian AE will actually make sufficient profits in the coming 8 assessment years which will subsume the losses incurred by the assesse.

2.12.3 Precautionary Measure:

Based on the above ruling, such transactions are prone to double taxation in India. Until the matter gets settled by the higher authorities, the special bench ruling will provide more uncertainty.

In view of the above, it is advisable to carefully frame the transfer pricing policy with respect to the international transactions between associated enterprises. It is clear from the above verdict that the arm's length principle is to be seperatly applied on assesse as well as the non-resident associated enterprise. Further, going forward, taxpayers should resort to entering into bilateral APA's.

Chapter 3 Countries Having Comprehensive Transfer Pricing Regulations

3.1 Evolution of Transfer Pricing Regulations

Transfer Pricing has been in practice in United States (US) since the 1920s. US and the OECD played a phenomenal role in evolution of transfer pricing practices across the world. US were the first country to adopt a comprehensive transfer pricing legislation in 1968. OECD issued the first draft of the transfer pricing Guidelines in 1995 which is regarded as the most important document in drafting transfer pricing legislation and its interpretation.

In 1995, only 3 Countries (US, Australia & South Africa) were having transfer pricing regulations. However, since then there has been steep increase in number of countries adopting TP regulations with over 80 countries having TP regulations. Some of the countries in which the domestic transfer pricing regime exists, besides India, include Australia, South Africa, China, Brazil, France, Russia and United Kingdom. As a result, it is important to design an appropriate global transfer pricing policy and approach keeping in view not only the Indian regulations but other countries where the entity has associated enterprises and with whom the entity has international transactions.

3.2 Countries Having Comprehensive Transfer Pricing Regulations

In the below table, we have enlisted the countries having a comprehensive transfer pricing regime in place.

Albania	Belgium	Cost Rica
Algeria	Bolivia	Croatia
Angola	Brazil	Cyprus
Argentina	Bulgaria	Czech Republic
Armenia	Republic of Cameroon	Congo republic
Australia	Canada	Denmark
Austria	Cape Verde	Dominican Republic
Bahrain	Chile	Ecuador
Bangladesh	China	Egypt
Belarus	Colombia	El Salvador

Estonia	Latvia	Portugal
Fiji	Lebanon	Qatar
Finland	Libya	Romania
France	Lithuania	Russia
Gabon	Luxembourg	Saudi Arabia
Georgia	Macedonia	Senegal
Germany	Madagascar	Serbia
Ghana	Malawi	Singapore
Gibraltar	Malaysia	Slovak Republic
Greece	Maldives	Slovenia
Guam	Malta	South Africa
Guatemala	Mauritius	Spain
Honduras	Mexico	Sri Lanka
Hong Kong	Mongolia	Sweden
Hungry	Montenegro	Switzerland
Iceland	Morocco	Taiwan
India	Myanmar	Tanzania
Indonesia	Namibia	Thailand
Iraq	Netherland	Turkey
Ireland	New Zealand	Uganda
Israel	Nigeria	Ukraine
Italy	Norway	United Kingdom
Japan	Oman	United States
Jordon	Pakistan	Uruguay
Kazakhstan	Panama	Venezuela
Kenya	Papua New Guinea	Vietnam
Kosovo	Paraguay	Zambia
Korea	Peru	Zimbabwe
Kuwait	Philippines	
Laos	Poland	

PART B

BRIEF OVERVIEW

Chapter 4 Introduction

4.1 Background And Recent Developments

4.1.1 In the midst of an uncertain global economic outlook, India is emerging as the new 'global economic hotspot' according to International Monetary Fund. The Indian economy is estimated to have grown at 7.1% in FY 2016-17[1] and is expected to grow at 6.75% to 7.50% in FY 2017-18[2]. For this purpose, it is imperative that India's cross border and transfer pricing regime is investor friendly and reduces potential and frivolous litigation. The Indian transfer pricing regime had been considered to be one of the most aggressive in the world with spate of litigation. A slew of measures have been taken by the government in the recent past leading to introduction of range concept, use of multiple year data in benchmarking etc. Further at a global level as part of G20 India was involved in the BEPS project. In the Budget of 2016 the Honourable Finance Minister introduced BEPS Action Plan 13 which includes provision for requirement of Country-by-Country reporting for companies with consolidated group revenue of more than Euro 750 million which are applicable from Assessment Year 2017-18. In addition the Indian government signed about 196 (178 Unilateral and 18 Bilateral) Advance Pricing Agreement[3] (APA) with taxpayers.

4.1.2 The Finance Act, 2001 introduced for the first time detailed TP regulations in India and a separate mechanism for reporting and assessment of international transactions between associated enterprises. The relevant provisions are contained in Chapter X of the Income-tax Act, 1961 ('the Act') - Sections 92 to 92F and 94A of the Act and Rules 10A to 10THD of the Income-tax Rules, 1962 ('the Rules'). In addition to this, a major change was introduced in the Finance Act, 2017, accordingly TP documentation and certification compliance requirements with respect to domestic expenditures covered under section 40A(2)(b) of the Act have been removed with effect from the Fiscal Year 2016-17. However, the Government has correctly retained transfer pricing compliance requirements for computing profit linked incentives or tax holiday schemes, with a view to prevent the propensity to shift profits from non-tax holiday undertakings to undertakings enjoying tax holiday.[4]

1 https://www.ibef.org/economy/indian-economy-overview
2 https://www.ibef.org/economy/economic-survey-2015-16
3 Source: tp.taxsutra.com
4 Source: tp.taxsutra.com

4.1.3 India has also introduced secondary adjustment provisions in TP for the first time, in line with similar provisions prevalent in some of the major countries. Accordingly, a primary adjustment in TP in excess of INR 10 million in the hands of an Indian taxpayer, arising out of any of the following situations, namely –

- suo-moto stand taken by the taxpayer in the return of income;
- made by the Assessing Officer (AO), which has been accepted by the taxpayer;
- determined in an APA;
- made as per safe harbour rules; and
- settlement under MAP

if not repatriated to India in favour of the taxpayer, by the concerned foreign associated enterprise (AE) of the taxpayer, within a time limit to be duly prescribed, then it would be deemed to be an advance made by the taxpayer in favour of such foreign AE; and the interest thereon shall be computed in a manner to be prescribed; and taxed in the hands of the Indian taxpayer. Provisions of secondary adjustment are applicable from AY 2018–19 onwards.[5]

4.1.4 In continuation to India's commitment to the BEPS Project, the Honourable Finance Minister introduced provisions for thin capitalisation in the Finance Act 2017 by insertion of Section 94B under the Act. Thin capitalisation refers to a situation in which a company is financed through a relatively high level of debt compared to equity, which significantly affects the amount of profit it reports for tax purposes. Typically, tax legislations of countries including India allow a deduction for interest paid or payable in arriving at the profit for tax purposes, while the dividend paid on equity contribution is not deductible. Accordingly, non-resident investors and multinational groups structure their financing arrangements to maximise these benefits. For example, assume that an overseas parent company finances an Indian organisation with INR 100 crores comprising an equal mix of equity and debt. Considering that the Indian company makes a profit of INR 25 crore, with interest payment of INR 5 crore on debt, its taxable profit would be INR 20 crore vis-a-vis INR 25 crore where the entire investment is funded through equity.

5 Source: tp.taxsutra.com

In order to curb such loss of revenue and streamline the investment flow, section 94B was introduced in the Act to restrict deduction towards payment of interest on a debt sourced from outside the country.

Section 94B, which will be applicable from AY 2018–19 onwards, restricts deduction of payment of excess interest by Indian companies or permanent establishment of foreign companies on its borrowing from overseas AEs. This provision not only applies to direct lending from an AE, but is also applicable on payment of interest to unrelated lenders if the AE has provided an implicit or explicit guarantee or paid the equivalent deposit for the debt.

The section is triggered when interest or similar consideration paid to the AE exceeds INR 1 crore.

The interest amount that will be disallowed as deduction in computation of income is defined as lower of:

- The total interest amount in excess of 30% of earnings before interest, taxes, depreciation and amortization;
- Interest paid or payable to Associated Enterprise.[6]

4.1.5 The Central Board of Direct Taxes (CBDT), vide notification 46/2017 dated 7 June 2017, has come up with the revised Safe Harbour Rules ("new SHR"), which will be applicable from Financial Year ("FY") 2016-17 to FY 2018-19. The SHR were introduced about five years ago, and these rules were applicable from FY 2012-13 to FY 2016-17. While the FY 2016-17 is an overlapping year, the new rules clarify that for FY 2016-17, the tax payer can choose the best from the old and new rules.[7]

4.2 Transfer Pricing – Meaning and Purpose

Transfer pricing refers to the price charged by one member of multinational organization to another member of the same organization for the provision of goods or services or the use of a property, including intangible property. Transfer pricing is significant for both taxpayers and tax administrations, because it affects

6 Source: tp.taxsutra.com
7 Source: tp.taxsutra.com

the allocation of profits from intra-group transactions, which impacts the income and expenses reported, and therefore taxable profits of related companies that operate in different taxing jurisdictions.

The OECD Guidelines define "Transfer Prices as the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises".

Transfer Pricing is based on the principle of arm's length price which refers to the price that an independent party would be willing to pay to another independent party for a product, service or intangible. Thus, the term Transfer Pricing refers to determination of price of goods, services and intangible transactions between associated enterprises that belong to the same group.

The Chennai Tribunal in the case of **Iljin Automotive Private Ltd. v. Asstt. CIT [2011]** 16 taxmann.com 225 explained the concept of 'transfer pricing' as "Transfer pricing may mean manipulation of prices in relation to international transaction between the parties which are controlled by the same interest."

The expression "Transfer Pricing" is neither used nor defined in the Act except as part of the expression "Transfer Pricing Officer".

The object and purpose of transfer pricing provisions, according to OECD Guidelines, is as under:

- Conditions made or imposed between two enterprises in their commercial or financial relations;
- Such conditions differ from those which would be made between independent enterprises; and
- The purpose of transfer pricing provisions is to tax any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued.

The profits derived by enterprises carrying on business in India can be controlled by the multinational group, **by manipulating the prices charged and paid** in such

intra-group transactions, thereby, **leading to erosion of tax revenues.**

Domestic Transfer Pricing regulations are relevant under two situations:

- Transactions between loss-making and profit-making related entities; and
- Transactions between two related units (of the same taxpayer) having differential tax rates.

Transfer Pricing regulations, therefore, are intended to prevent:

- In case of International Transactions, revenue loss arising to a country from shifting of profits from high to low tax jurisdictions and protect the tax base of the country from erosion.
- In case of Specified Domestic Transactions, from shifting of expenses or income between related enterprises / inter-unit, resulting in erosion of tax base of India.

A statutory framework leading to computation of reasonable, fair and equitable profits and tax in India, in the case of international transactions and specified domestic transactions, is therefore needed.

4.3 Applicability of Transfer Pricing Regulations

An assessee / the taxpayer are required to comply with Indian TP provisions in following circumstances:

a. It has entered into an international transaction with its associated enterprise.

b. It enters into a SDT.

The working of Chapter X of the Act pertaining to international transactions is as under:

- Income arising from an international transaction between AEs shall be calculated having regard to ALP calculated according to the Most Appropriate Method ('MAM') of the 6 methods specified in section 92C of the Act.

- The actual prices charged / paid shall be disregarded and substituted by the ALP and difference will be added to the income of the assessee, except in the following two cases:
  - Where the application of ALP results in reduction of income chargeable to tax in India;
  - An arms' length range beginning from 35th percentile of the dataset and ending on the 65th per centile will be considered. If the transaction price falls within the range, then the same shall be deemed to be the ALP. If the transaction price falls outside the range, the ALP shall be taken to be the median of the data set.
- The arithmetic mean of prices along with the permitted variation of 1% (in case of wholesalers) /3% percent (in all other cases) would continue to apply in the case of PSM and Other method. In other cases, it would also apply in cases where the numbers of comparables are less than 6.

Chapter 5 International Transactions – Provisions And Definitions

5.1 Broad Structure of Indian TP Regulations

Particulars	Relevant Sections	Relevant Rules
Coverage	Section 92	–
Definitions	Section 92A, 92B, 92BA and 92F	Rule 10A
Methods	Section 92C(1) to 92C(2B)	Rules 10AB, 10B and 10C
Documentation (including Master File)	Section 92D	Rule 10D, Rule 10DA
Accountant's Report	Section 92E	Rule 10E
Penalties	Sections 270A, 271AA, 271BA, 271G, Section 271GB and Explanation 7 to Section 271(1)	–
Administrative	Sections 92C(3), 92C(4), 92CA and 144C	Income-tax (DRP) Rules, 2009
Secondary Adjustment	Section 92CE	Rule 10CB
Safe Harbour Rules ('SHR')	Section 92CB	Rules 10TA to 10TG
Advance Pricing Agreement ('APA')	Section 92CC, 92CD	Rules 10F to 10T
Transaction with person located in notified jurisdictional area	Section 94A	–
BEPS Action Plan 13 – CbCR	Section 286	Rule 10DB

5.2 Provisions of Section 92

5.2.1 As per section 92(1) of the Act, it is required that **any income** arising from an international transaction / SDT is to be computed having regard to the ALP.

It is also provided that allowance for expenses should also be determined having regard to the ALP (E.g.: Imports from AEs).

5.2.2 Further, it is provided that where two or more associated enterprises enter into an International Transaction / SDT for mutual agreement or arrangement for the

allocation or apportionment of, or any contribution to, any cost or expenses incurred between two or more AEs in connection with a benefit, service or facility provided or to be provided by one or more enterprises is to be determined having regard to the ALP.

(E.g.: If contribution is made by the Indian subsidiary towards the cost of centralized R & D activity conducted by the US parent company for the benefit of all subsidiaries, then the same needs to be determined having regard to the ALP).

5.2.3 It is to be noted that the provisions **are not intended to be applied** in case determination of ALP reduces the income chargeable to tax or increases the loss as the case may be – Section 92(3). If income as per books of accounts is higher than ALP, then no adjustment can be made to reduce taxable income.

This may be due to the fact that TP regulations aim to protect erosion of India's tax base. (CBDT's Circular No. 8/2002)

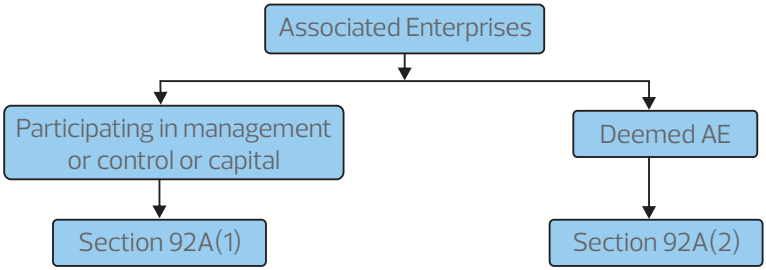
5.2.4 In case where the income is not subject to tax in India pursuant to the provisions of the tax treaty, the TP provisions may still be applicable. In case of **Castleton Investment Limited** [AAR No.999 of 2010, dated 14 August 2012], the AAR held that the transfer of shares in an Indian company by a Mauritius holding company to Singapore company as a part of internal re-structuring is not liable to capital gains tax under Article 13(4) of India-Mauritius tax treaty. However, it ruled that as per section 92 of the Act, TP provisions are applicable to any income arising from international transactions and that the word "income" has wide connotation. Thus AAR concluded on facts that the **TP provisions are mandatory and applicable for correct determination of gains accruing from international transactions, even though share transfers are not taxable under the tax treaty.**

5.2.5 The Mumbai High Court in the order case of **Vodafone India Services Pvt Ltd** (Writ petition no. 871 of 2014) held that the transaction of issue of shares was a capital account transaction, and consequently the share premium if any ought to be a capital receipt. The transfer pricing provisions permit a transaction to be re-quantified but not to be re-characterised. Hence there was no question of transaction resulting in income taxable in India, since no income arises from the said international transaction. Therefore, TP provisions do not apply to the issue of

shares transaction. The applicability of this verdict after introduction of section 56 whereby issue of shares can result in taxable income under certain circumstances needs to be examined.

5.3 Definitions

5.3.1 Associated Enterprise ('AE') – International Transactions



- The term 'Associated Enterprise' is defined in a broad manner. As per section 92A(1), 'AE' in relation to other 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) Where the same person, directly or indirectly or through intermediaries, participates in the management or control or capital of two or more enterprises.

- Further, section 92A(2) provides certain circumstances in which two enterprises shall be deemed to be AEs, if at any time during the year:

  a) One enterprise holds, directly or indirectly, at least **26% of voting power** in other enterprise

  b) Any person or enterprise holds, directly or indirectly, at least 26% voting power in each of such enterprises

  c) One enterprise **advancing of loan** of at least 51% of the book value of

the total assets of other enterprise.

d) One Enterprise providing **guarantees** not less than 10% of total borrowing of other enterprise.

e) More than 50% of **Board of Directors** or one or more **executive directors** of one enterprise are appointed by other enterprise;

f) Same person appoints more than 50% of BOD or one or more executive directors of two or more enterprises,

g) One Enterprise is wholly dependent on use of intangibles owned by other enterprise such as patents, copyright, trademark or any other business or commercial rights, etc,

h) 90% or more raw material and consumables required is supplied by the other enterprise or person specified by such enterprise and the prices & other conditions are influenced by the other enterprise

i) The goods manufactured or processed by one enterprise are sold to the other enterprise or person specified by it and the prices and other conditions are influenced by other enterprise;

j) Common control by individual or his relative or jointly in two or more enterprises;

k) Common control by Hindu Undivided Family ('HUF') or its member or its relative in two or more enterprises,

l) 10% or more interest in a firm, Association of Persons ('AOP') or Body of Individual ('BOI'),

m) There exists between the two enterprises, any relationship of mutual interest as may be prescribed. (However till date, nothing has been prescribed in this regard).

Certain issues in definition of AE:

- **Whether for International Transactions, the conditions as mentioned in section 92A(1) & 92A(2) above need to be satisfied simultaneously? Or satisfaction of any one condition is sufficient to determine the AE relationship?**

  E.g. if 90% or more raw materials are supplied by other enterprise, condition as per section 92A(2) is satisfied but not as per section 92A(1).

  It appears that both the conditions as specified in sub-section (1) & (2) need to be satisfied since:

  a) The words used in section 92A(2) are **'for the purposes of sub-section (1)'**, it means that sub-section (2) is not independent and it has to be read with sub-section (1).

  b) As per amendment made by the Finance Act, 2002 in section 92A(2) read with the Memorandum which explains that 'mere satisfaction of conditions specified in sub-section (1) shall not make them AEs **unless the criteria specified in sub section (2) are fulfilled.'**

  Based on the above, it appears that conditions of both sub-section (1) & (2) need to be satisfied to establish AE relationship. However, the possibility of the transfer pricing authorities taking a contrary view cannot be negated and therefore litigation cannot be ruled out.

5.3.2 Enterprise

The term 'Enterprise' has been exhaustively defined in section 92F(iii) and the definition is very wide. "Enterprise" means a person who is, or has been, or is proposed to be, engaged in any of the specified activities whether carried on directly or indirectly. However, the term "person" is not defined under Chapter X of the Act containing the TP provisions and hence, one has to rely on the meaning of "person" defined under section 2(31) of the Act.

The term 'Enterprise' also includes Permanent Establishment ('PE') of such person.

The term PE for this purpose is defined to include a fixed place of business through which the business of enterprise is wholly or partly carried on.

Thus, branch of a foreign bank in India will be treated as Enterprise. (Fixed place PE)

- **Whether Agency PE, Service PE and Construction PE will be treated as Enterprise?**

  It appears that even Agency PE, Service PE and Construction PE will be treated as Enterprise.

5.3.3 International Transaction

- Section 92F(v) defines "transaction" which includes an arrangement, understanding or action in concert whether or not such arrangement is formal or enforceable by legal proceeding.

- International transaction is defined in section 92B(1) as a transaction between **two or more associated enterprises**, either or both of whom are **non–residents**.

  The term 'International Transaction' has been exhaustively defined to mean a transaction, between **two or more AEs**, either or both of whom are **Non–Residents**, to include :

  a) purchase, sale or lease of tangible or intangible property; or
  b) provision of services; or
  c) lending or borrowing money; or
  d) any other transaction having a bearing on the profit, income, losses or assets of such enterprise; and
  e) Includes a mutual agreement or arrangement between two or more AEs.

- **Deemed International Transaction**

  In addition to the above, a transaction entered into by an enterprise with **an independent third party** can also be deemed to be an international

transaction entered into between two AEs if either of the following condition is satisfied:

a) There is a prior agreement in relation to the relevant transaction between such independent third party and the AE; or

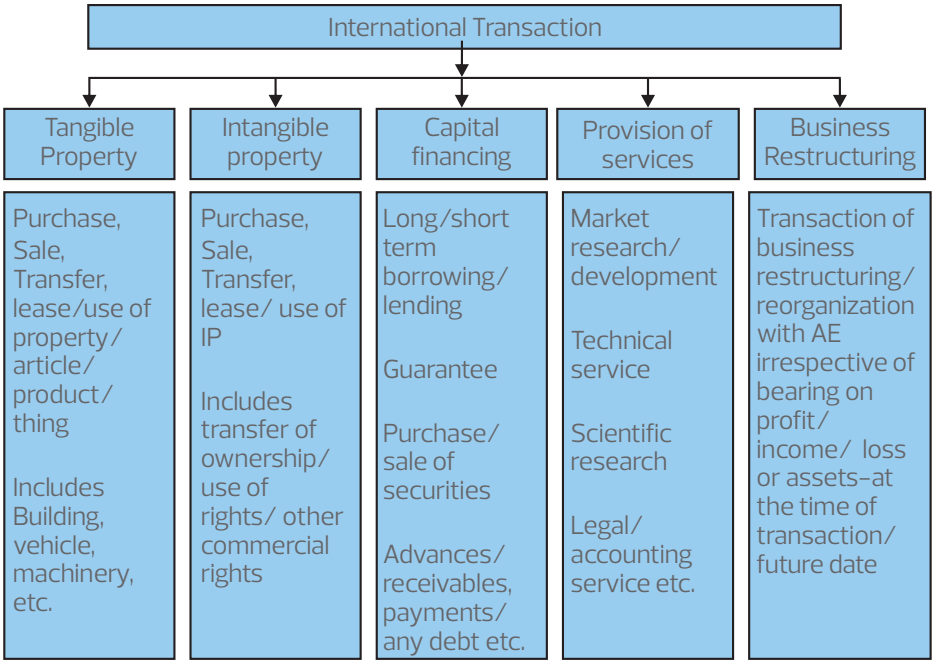
b) The terms of the relevant transaction are determined in substance between such independent third party and the AE.

- **Example of Deemed International Transaction**

Global Supply agreement entered by US Parent company with unrelated party for supply of raw material to all its global subsidiaries:

In such case, transaction by Indian subsidiary with unrelated party will be considered as international transaction since the price of such transaction is determined as per agreement between US AE and unrelated party.

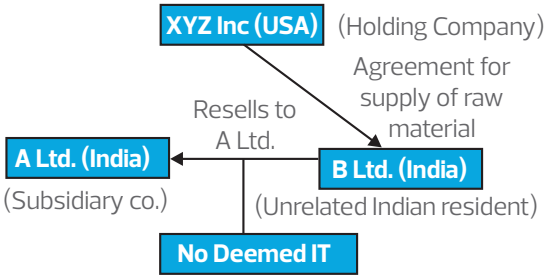
Explanation to section 92B



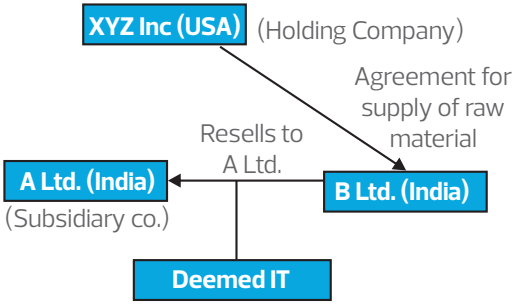
- **Extended Scope of Section 92B(2) according to Finance (No. 2) Act 2014**

Finance Act 2014 has amended Section 92B(2) on deemed international transaction to provide that the transaction between a tax payer and the other person, even if such person is a non-resident or not, is deemed to be an international transaction if either there is a prior agreement between the AE & such other person or the terms are determined in substance between such other person and the AE.

Prior to Finance (No.2) Act 2014



W.e.f. Finance (No. 2) Act 2014



The transaction between two domestic companies subject to fulfilling the condition of having agreement or terms thereof determined in substance by the AE could also be regarded as 'international transaction'. Thus, to this extent the impact of judicial precedents in cases of **Kodak India (P.) Ltd.** Vs. ACIT [(2013) 37 taxmann.com 233 (Mum)] and **Swarnandhra IJMII Township Development Co. (P.) Ltd.** Vs. Dy.CIT [2013] 32 taxmann.com 395 (Hyd.-Trib.)

seems to be diluted.

5.3.4 Arm's Length Price ('ALP')

Section 92F(ii) defines Arm's Length Price as "a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions"

The ALP denotes the price which is applied or proposed to be applied

- In a Comparable transaction between
- Unrelated independent entities in
- Uncontrolled conditions
- Usually corresponding to fair market price.

5.3.5 Transaction with person located in Notified Jurisdictional Area

Having regard to lack of effective exchange of information with such country or territory outside India, the Central Government by notification in Official Gazette specifies such country or territory as Notified Jurisdictional Area ('NJA'). If an assessee enters into a transaction with any person located in NJA then–

- All the parties to the transaction shall be deemed to be AE; and
- Any transaction with these parties shall be deemed to an international transaction.

All the such transaction will be subject to Transfer Pricing regulations in India and all compliance requirements, including maintenance of documents under TPR will be applicable and the person shall not be entitled to the benefit of second proviso of section 92C(2) of the Act i.e. application of variation of +/– 3% / 1%,as the case may be.

Cyprus was notified under section 94A by the Central Government as a NJA in November 2013. However, the said notification was rescinded in 2016 with retrospective effect from the date of notification[8]. As such, if an assessee enters into a transaction with a person in Cyprus, then all the parties to the transaction shall be treated as AEs and the transaction shall be treated as an international transaction resulting in application of transfer pricing regulations.

8 Central Board of Direct Taxes Notification No. 114/2016, 14th December, 2016

6.1 Evolution of Domestic TP Regulations

The scope of TP was widened from FY 2012-13 by extending the same to be Specified Domestic Transactions (SDT). The genesis of the above lies in the judgment of the Supreme Court in the case of **CIT vs. Glaxo SmithKline Asia (P) Ltd.** [(2010) 195 Taxman 35 (SC)].

In case of domestic Transactions between related parties, the under-invoicing of sales and over-invoicing of expenses ordinarily will be revenue neutral in nature, **except in two circumstances**, having tax arbitrage such as where one of the related entities is:

i. loss making; or
ii. liable to pay tax at a lower rate

and the profits are shifted to such entity.

Some of the countries where domestic transfer pricing regulations are already in force are Australia, Brazil, China, France, Russia, South Africa and United Kingdom.

TP documentation and certification compliance requirements with respect to domestic expenditures covered under Section 40A(2)(b) of the Act have been removed with effect from the Fiscal Year 2016-17. However, the Government has correctly retained transfer pricing compliance requirements for computing profit linked incentives or tax holiday schemes, with a view to prevent the propensity to shift profits from non-tax holiday undertakings to undertakings enjoying tax holiday.[9]

6.2 Meaning of Specified Domestic Transaction – Section 92BA[10]

The definition of section 92BA which defines Specified Domestic Transaction is amended vide Finance Act 2017 and has removed transactions in the nature of expenditure for which payment has been made or would be made to persons specified in Section 40A(2)(b). The said amendment is applicable for assessment

9 Source: tp.taxsutra.com
10 Source: ICAI Guidance Note on Report under section 92E of the Income Tax Act, 1961 (Transfer Pricing). [Based on the law as amended by the Finance Act, 2017] (Revised 2017)

year 2017-18 i.e. previous year 2016-17. Section 92BA defines SDT which is covered by TP regulations as under:

"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) [...] [11]

(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

6.3 Threshold Limit and Coverage

All the transactions covered under the above 5 limbs of section 92BA will be regarded as SDT only if the **aggregate value of all transactions** in the previous year **exceeds the threshold limit of INR 20 crores (INR 200 million)**.[12] If the threshold limit is crossed, TP compliances are required for all the SDTs covered under section 92BA.

11 Omitted vide Finance Act 2017. Prior to its omission Clause(I) read as under:
"(I) Any expenditure in respect of which payment has been made or is to be made to a person referred to in section 40A(2)(b)"

12 Prowess is a database of the financial performance of Indian companies from Centre for Monitoring Indian Economy Pvt Ltd. (CMIE)

6.4 Coverage of Domestic Transfer Pricing

Sections	Nature	Transaction with	Earlier methodology
80A, 80IA(8)	Income or expenditure	Between different business units of same tax payer	Fair Market Value
80IA(10) (Including SEZ)	Profits	Close connection	More than ordinary profits
10AA	Income	SEZ Unit	100% for the first 5 years; 50% for the next 5 years; 50% of the profits or amount credited to SEZ re-investment reserve, whichever is less for next 5 years

6.5 Examples of Transactions with the Tax Holiday Units

The provisions currently in force which grant profit linked tax holiday deductions and which are regulated by section 80A(6) and, consequently, subject to Domestic transfer pricing are as follows:-

- 80-IA – Infrastructure development, etc
- 80-IAB – SEZ development
- 80-IAC – Startup business
- 80-IB – Industrial undertakings
- 80-IBA – Development and building house projects
- 80-IC – Industrial undertakings or enterprises in special category states
- 80-ID – Hotels and convention centres in specified area
- 80-IE – Undertakings in North-Eastern states
- 80JJA – Collection and processing of bio-degradable waste
- 80JJAA – Employment of new workmen
- 80LA – Offshore Banking units and International Financial Services Centre
- 80P – Co-operative societies

6.6 Inter-unit transfer of goods / services as covered under section 80IA(8)

6.6.1 Section 80-IA(8) covers inter-unit transfer of goods and services. It covers transfer

of any goods or services to / from the eligible business of the Assessee. If the transfer is not at market value, then, for the purpose of deduction, the profits and gains for the eligible business shall be computed as if the transfer had been made at the market value of such goods as on that date.

6.6.2 The definition of market value has been substituted w.e.f. AY 2013-14 to include the ALP as defined in section 92F(ii), where the transfer of such goods or services is SDT as referred to in section 92BA.

6.6.3 The onus to prove that the transfer is at ALP lies with the taxpayer. In case of adjustment made by TPO, no corresponding benefit is available to the extent of that adjustment.

6.6.4 This section covers income as well as expenditure.

6.7 Business transaction with any other person generating more than ordinary profits – Section 80-IA(10)

6.7.1 Section 80-IA(10) applies to transactions between assessee and any other person which results in excessive profits in the hands of the assessee:

- Either owing to "Close Connection" with other person; or
- For any other reason.

6.7.2 Initial onus to prove that the transaction produces ordinary profit lies with the taxpayer. There is no guidance available on the meaning of 'close connection'.

6.7.3 This section covers income as well as expenditure.

6.7.4 Unlike section 80A(6) and section 80-IA(8), which apply to internal transfers, this provision is applicable in respect of transactions with close connection.

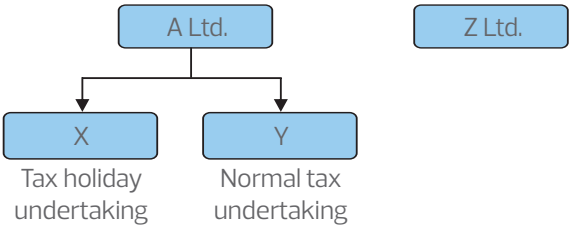
6.8 Whether transfers between eligible units are SDTs?

The other sections in Chapter VI-A which make references to eligible units under section 80-IA(8) and 80-IA(10) are 80IAB, 80IB, 80IC, 80ID and 80IE as tabulated below.

Section under the Act	Tax payers covered
10AA	▪ Persons with income from Special Economic Zone ('SEZ') units
80-IA	▪ Infrastructure developers ▪ Telecommunication service providers ▪ Developers of industrial park ▪ Producers or distributors of power
80-IAB	▪ Developers of SEZ
80-IB	▪ Small-scale industry engaged in operating a cold storage plant ▪ Industrial undertaking in an industrially backward state as mentioned in VIII Schedule ▪ Multiplex theaters and convention centers ▪ Company carrying on scientific research and development ▪ Eligible housing projects ▪ Eligible hospitals
80-IC and 80-IE	▪ Persons with units in North-eastern states claiming deduction
80-ID	▪ Hotels located in districts having World Heritage site

Transfers between any of the aforesaid eligible unit and another unit eligible for other profit-linked deduction will be covered within the purview of domestic TP.

- **Illustration: Tax Holiday undertaking**



Transactions between	Whether covered under SDT	Requirement
X and Y	Yes	▪ to justify that goods and services transactions are at ALP ▪ profits of tax holiday undertaking are 'ordinary profits' having regard to ALP
Y and Z	No	
X and Z	Yes, if Z is closely connected to A	

6.9 Distinction between applicability of Chapter X to International Transactions and Specified Domestic Transactions:

International transactions	Specified Domestic Transactions
Applicable to all international transactions irrespective of the amount involved	Applicable to SDTs where aggregate of SDTs exceeds INR 20 crores in a financial year
APA applicable	APA not applicable
Covers several types of transactions including transactions in the nature of capital financing	Restricted to limited transactions E.g. inter-units transfers of goods and services in case of tax-holiday units, etc.
Applicable to AEs as defined in section 92A	Applicable to related parties as defined in section 80A(6), 80IA(8), 80IA(10), etc.

Chapter 7 Methods And Computation Of Arm's Length Price

7.1 Computation of Arm's Length Price

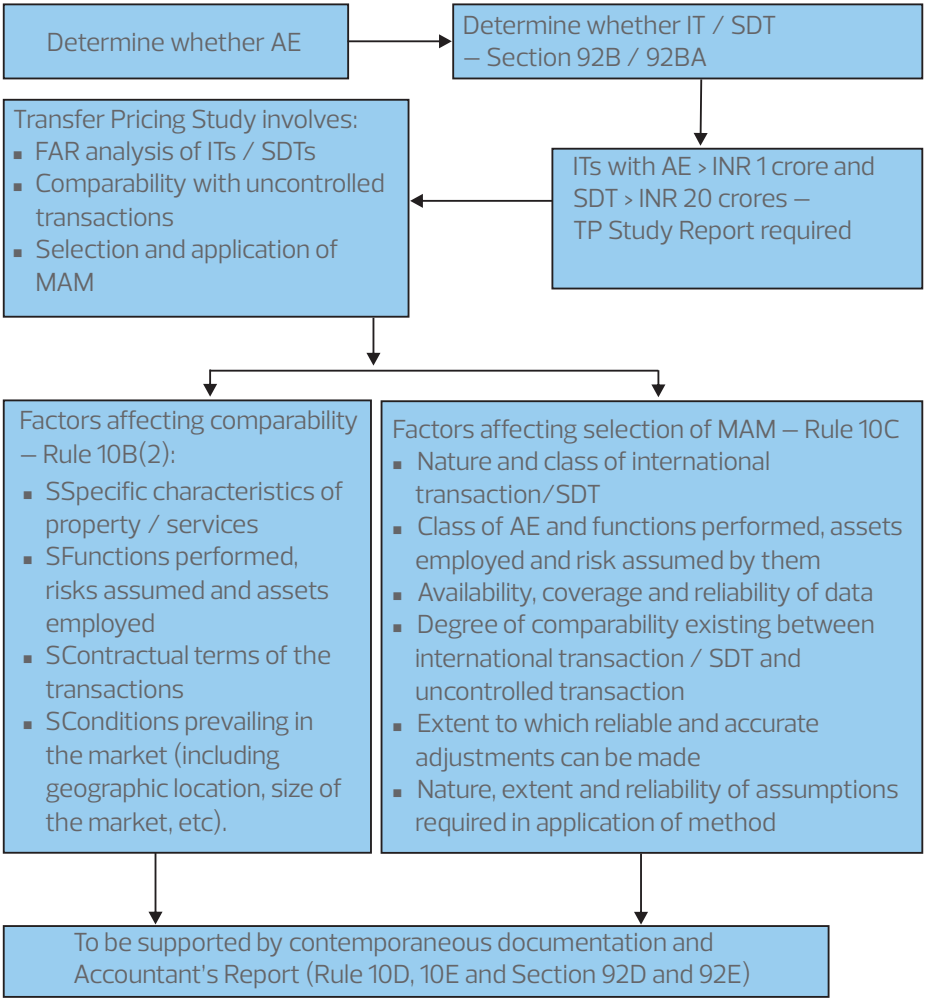
7.1.1 As per section 92(1) of the Act, any income arising from an international transaction shall be computed **having regard** to the Arm's Length Price.

7.1.2 It is to be noted that income arising from international transactions need to be computed **having regard to ALP** and **not at ALP**. This is because various adjustments for difference on account of Functional, Asset and Risk Analysis ('FAR analysis') of the entities need to be made. Further, Transfer Pricing is not an exact science and it is possible that an enterprise may incur losses due to genuine business reasons. Hence, while determining the ALP, such economic and commercial factors should be considered.

7.1.3 Arm's Length Price [Section 92F(ii)] is defined as:

- a price applied or proposed to be applied
- in a transaction between persons other than associated enterprises
- in uncontrolled conditions.

7.1.4 The following flowchart shows the process of transfer pricing regulations:



7.2 Transfer Pricing Methods

7.2.1 As per Indian TP Regulations, ALP is to be determined by applying one of the following methods being the MAM.

- Traditional Methods
  - Comparable Uncontrolled Price Method ('CUP' Method)
  - Resale Price Method ('RPM')

  - Cost Plus Method ('CPM')
- Profit Based Methods
  - Profit Split Method ('PSM')
  - Transactional Net Margin Method ('TNMM')
- Any Other Method as provided in Rule 10AB of the rules.

7.2.2 Comparable Uncontrolled Price (CUP) Method

a) The CUP method is the most direct way of analyzing whether the arm's length principle is complied with as it compares the price or value of the transactions.

b) The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in comparable uncontrolled transaction in comparable circumstances.

c) Hence, CUP method requires a relatively high level of comparability to produce reliable results. If reasonably accurate adjustments for differences in comparability cannot be made, it is necessary to select a less direct method.

d) Types of CUP:

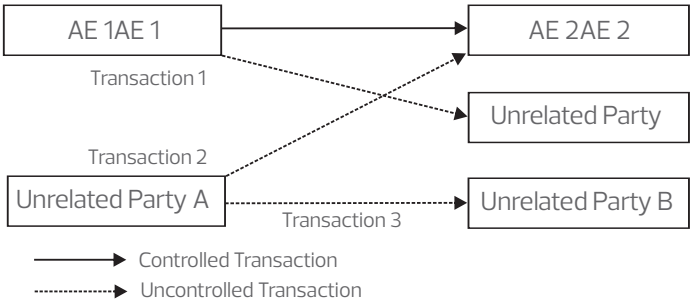
CUP method may be either Internal CUP or External CUP.

- **Internal CUP** – The price paid / charged in a controlled transaction vis-à-vis the price paid / charged in a comparable uncontrolled transaction with unrelated / third party. Internal CUP can be applied wherein the taxpayer or any other AE of the group buys or sells similar goods, in similar quantities and under similar terms from / to an independent enterprise in similar market conditions.

- **External CUP** – Where the price of the controlled transaction is compared to the price of a comparable transaction between third parties.

- Internal CUP is preferable to external CUP due to availability of more reliable and accurate data.

- Illustration of Internal and External CUP as per UN TP Manual



The above figure demonstrates that the transaction of transfer of goods between AE 1 (a goods producer in country 1) and AE 2 (a goods importer in country 2, which resells the goods to dealers in country 2) is a controlled transaction. AE1 is the parent company of AE 2.

In applying the CUP method to determine whether the price charged for goods transferred in this controlled transaction is at arm's length, reference can be made to:

- The price charged for goods transferred in a comparable uncontrolled transaction, if any, between AE1 and Unrelated Party (i.e. Transaction 1);
- The price charged for goods transferred in a comparable uncontrolled transaction, if any, between AE 2 and an unrelated party (i.e. Transaction 2); and
- The price paid for goods transferred in a comparable uncontrolled transaction, if any, between Unrelated Party A and Unrelated Party B (i.e. Transaction 3)

Uncontrolled transactions similar to Transaction 1 and Transaction 2 above can be referred to as Internal CUP. Uncontrolled transactions similar to Transaction 3 are referred to as External CUP.

e) Requirements for application of CUP method

CUP method requires a very high degree of comparability and similarity in circumstances in terms of:

- Quality of product or service
- Contractual terms (viz. warranties, credit terms, etc.)
- Level of market (retail, wholesale, etc.)
- Market condition
- Business strategies
- Geographical area (E.g. US and Kenya market cannot be compared)
- Date of transactions (particularly in case of commodities which are subject to price changes on periodic basis)
- Intangible property associated with sale (E.g. Price of branded products cannot be compared to the price of unbranded products)
- Volume discounts, interest free period and exchange rate fluctuations
- Bargaining power
- Associated risks (E.g. Market risk, credit risk, etc.)
- Functions carried out by parties

If the above requirements are fulfilled, then **the price** at which a controlled transaction is carried out can be compared to **the price** at which a comparable uncontrolled transaction is carried out.

Under above circumstances, CUP method is the most direct and reliable method for determination of ALP and is to be preferred to all other methods.

f) Adjustments to CUP

- If there are differences between the controlled and uncontrolled transaction **that affect price**, adjustments need to be made to the price of uncontrolled transaction.

- Indian Transfer Pricing regulations do not provide guidance on different types of adjustments that can be made. Hence, reference can be drawn from OECD Guidelines which provide an illustrative list of different types of adjustments that can be carried out.

- Where it is possible to make **reasonable accurate adjustments** to the uncontrolled price, (e.g. adjustments for freight and insurance, volume discounts as per standard price list, etc.), adjustments should be made to arrive at ALP.

  However, in certain circumstances, where it is not possible to make reasonable accurate adjustments to the uncontrolled price, (e.g. for difference in geographical locations and market conditions of controlled and uncontrolled transactions), CUP method should be rejected and the reasons for rejection of CUP method should be clearly documented in the Transfer Pricing Study Report.

g) Typical Transactions where CUP method can be used

Examples of situations when CUP method can be used are as follows:

- Transfer of goods
- Provision of services
- Interest on loans
- Royalty payment.
- Transaction dependent on publicly available market quotation (e.g. prices available on commodity exchange)

- Certain industries where CUPs are more prevalent, for instance software development where products are generally licensed to third parties.

h) Strengths of CUP method

- It is not a one sided analysis as the price is arrived at between two parties to the transaction;
- It involves detailed transactional comparison;
- Direct one-to-one comparison;
- Avoids tested party selection; and
- Less susceptible to difference in non-transfer pricing factors.

i) Difficulties in application of CUP Method

CUP method is the most direct and reliable method to determine the ALP and is to be preferred over all other methods. However, its practical application may pose various difficulties as given below:

- CUP method is highly sensitive to product characteristics and accompanying conditions which make its application difficult.
- Every difference that needs to be adjusted might not be supported by sufficient proof by way of documentation. (e.g. Difference in income levels in two countries for which reasonable accurate adjustment cannot be made)
- It is practically very difficult to meet with the high standards of comparability and make reasonable accurate adjustments.
- Comparable prices are not available in public database and hence are difficult to obtain.
- Internal comparables frequently don't exist and external comparable are difficult to find in practice.

- There is no strict comparability standard with respect to product comparability. Hence, CUP method is very difficult to apply in actual practice.

j) Certain issues in application of CUP method

The CUP method requires very high degree of comparability between controlled and uncontrolled transactions. In case it is possible to make reasonable accurate adjustments for the difference, such adjustments should be made. However, where it is not possible to make reasonable accurate adjustments for the differences, CUP method should be rejected. Certain important issues which generally arise in application of CUP method are explained below:

- **Difference in geographical location and market conditions of AE and Non AE**

  When there are differences in the geographical location and market conditions of AE and Non AE, question arises whether CUP method can be selected as most appropriate method. In this respect, it is to be noted the market conditions prevailing in the controlled transactions should be similar to the uncontrolled transaction. Hence, if there are differences then CUP method cannot be selected as most appropriate method unless reasonable accurate adjustments are made for such differences.

  In this respect, it is to be noted that the Delhi ITAT in the case of **Bharti Airtel Ltd. vs. ACIT** [2014](43 taxmann.com 50), held that geographical location of market is of no consequence in judging comparability of an uncontrolled transaction for purpose of applying CUP method, unless market conditions, in which uncontrolled transactions have taken place, are materially different vis-à-vis conditions in which international transaction has taken place.

  "Unless market conditions, in which uncontrolled transactions have taken place, are materially different vis-à-vis conditions in which

international transaction has taken place, and such a difference is on account of geographical location of the market, geographical location of the market is of no consequence in judging comparability of an uncontrolled transaction for the purpose of applying CUP method. The decisive factor, on the basis of which comparability is to be judged, is the state of 'conditions prevailing in the markets in which the respective transactions to the parties operate'. These market conditions could be affected by a number of factors, as the sub-rule itself suggests, including (a) geographical location and size of market; (b) overall economic development and level of competition in the market; and (c) whether the market are wholesale or retail. The true test, therefore, is whether the market in which uncontrolled transactions have taken place are materially different than the market in which controlled transactions have taken place. In a situation in which there are indeed material differences, including, of course, for the reason of geographical location and size of markets, those uncontrolled transactions cannot constitute valid comparables for benchmarking similar transactions between the AEs."

- **Whether Internal CUP should be preferred to external CUP?**

In case of internal CUP, the price that tested party has paid/ charged in a controlled transaction is compared to the price paid/charged in a comparable uncontrolled transaction **with a third party** whereas in case of external CUP, the price that assessee has paid/ charged in a controlled transaction is compared to the price paid/charged in a comparable uncontrolled transaction **between third parties.** Sometimes, question arises whether internal CUP should be preferred to the External CUP.

In case of internal CUP, the data for comparable uncontrolled transaction is entirely available with the assessee and hence, it is more reliable and accurate as compared to the external data. As a result, internal CUP should be preferred to external CUP. Even the OECD guidelines support the same view.

The Mumbai Tribunal in the case of **Gharda Chemicals Ltd. vs. DCIT** [(2010) 35 SOT 406 (Mum)], has held that the internal CUP should be preferred to the external CUP. The relevant extract of the observations is provided hereunder:

"Ordinarily the Internal CUP method should be preferred over the External CUP method as it neutralizes several distinguishing factors, such as the local factors and the economies available or unavailable to the assessee in particular, having bearing over the comparison of price charged from unrelated parties and AE."

- **Whether Independent Quotation can be used?**

One of the issues which often arises under CUP Method is whether for comparability purpose even tender / quotation price can be accepted. Tender or quotation price per se cannot be compared with actual transaction price as there may be difference between quoted price and actual price. Generally, the quotation price is an indicative approximation of the price which could be further fixed, subject to negotiations between parties and data in public domain may not exist of such negotiated prices. Nevertheless, if the actual transaction price is not available, then quoted or listed price can be used or relied upon as secondary evidence. However, in some cases, quoted price can be used for comparability subject to possibility of adjustments required, if any. The prices quoted at commodity exchanges or published in trade journals, particularly when the product is similar to the one traded between unrelated parties are generally considered reliable as per the trade practice and can be relied upon in the absence of data of actual transaction prices.

Independent quotation can be used as comparable as was held in the case of **CIT vs. Adani Wilmar Ltd.** (2014) 45 taxmann.com 365 (Gujarat). The High Court in its judgement dated 2 April 2014, held that:

"the price quotations of the MPOB would be entitled to its due and

full weightage and respect, would not necessarily mean that the other quotations would lose their significance, unless, of course, it is pointed out that such quotations lack basis. In this context, we may recall that the only objections with the TPO to take into consideration the rate quotations of the Oil World were, that were not based in Malaysia and that it was an independent organisation, which had nothing to do with the old price prevailing in Malaysia. When the CIT (Appeals) as well as the Tribunal have accepted the reliability and authenticity of the organisation and its publication of rate-list, such objection of the TPO must be overruled."

However, the Delhi Tribunal in the case of Sinosteel India Pvt Ltd Vs DCIT (2014) 147 ITD 313 (Delhi) has observed that a quotation price in isolation which is not preceded with or succeeded by any actual transaction cannot be considered as CUP.

- **Customs valuation as a comparable**

In case of transactions involving import of goods, the said goods also undergo customs valuation procedure. Taxpayers often contend that the valuation accepted for customs purposes should also be regarded as ALP for the purpose of transfer pricing. However, in practice, the same does not find favour with the department. The Mumbai Tribunal in the case of **Fabula Trading Co. P. Ltd. vs. ITO** 8 [2009] 122 TTJ 335 (Mum) has accepted the use of customs valuation as a CUP. However, the decisions of the Chennai Tribunal in the case of **Mobis India Ltd vs. DCIT** 9 [2014] 61 SOT 40 (Chennai) and of the Mumbai Tribunal in the case of **Fuchs Lubricants (India) Pvt. Ltd. vs. DCIT** [2014] 44 taxmann.com 284 (Mum) have both observed that valuation by the Customs authority was as per Customs Rules, and the same were not relevant for the purpose of transfer pricing under Income Tax Rules.

7.2.3 Resale Price Method ('RPM')

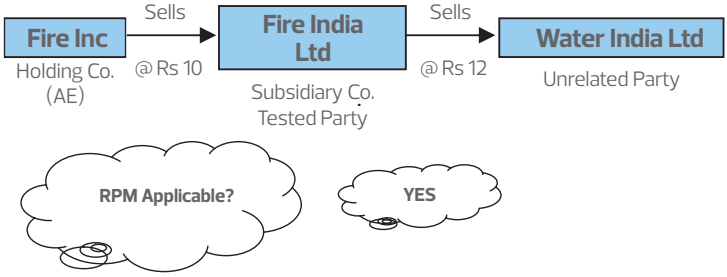
a) In RPM, gross profit margin earned in a controlled transaction is compared

with the gross profit margin earned in a comparable uncontrolled transaction to determine ALP. RPM is based on the price at which a product is purchased from a related party and resold to an unrelated enterprise.

b) Applicability

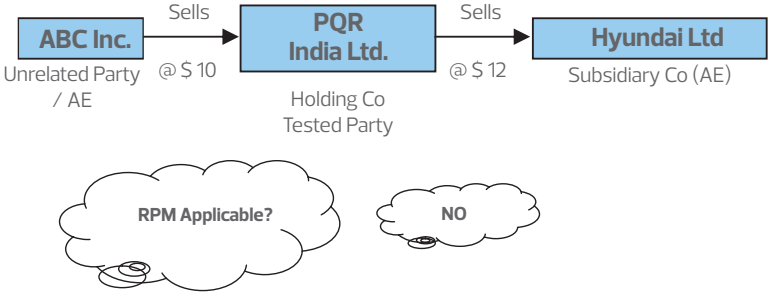
RPM is applicable when the property is purchased or service is obtained from an AE and resold to an unrelated party. In other words, RPM is suitable when the reseller adds relatively little value to the goods and does not alter the goods physically before the resale. Packaging, re-packaging, labeling or minor assembly does not ordinarily constitute physical alteration. In other words, RPM is applicable in case of distributors or service providers and not manufacturers. Refer illustration 1 below:

Illustration 1



It is to be noted that when the goods are purchased from unrelated party / AE and sold to AE, RPM cannot be applied since RPM can be applied only in situation where the goods are purchased from AE and sold to unrelated party. Refer illustration 2 below:

Illustration 2



The Bangalore Tribunal in the case of Sanyo India Pvt Ltd vs ACIT (ITA No. 1022 (B) 2012) rejected the department's stand of application of TNMM. The ITAT noted that Sanyo India has imported the goods from its AE and sold it in the domestic market without any value addition. Only work undertaken by Sanyo India on such goods was to repack according to local requirements. It was held that Sanyo India was a full-fledged distributor, who purchased goods from AEs & resold it in the domestic market without any value addition and hence RPM would be most appropriate method.

c) Types of RPM

Like CUP method, RPM can also be applied by way of Internal RPM or External RPM.

- **Internal RPM:** The gross profit margin of controlled transaction is compared with the gross profit margin of comparable uncontrolled transaction of the tested party.
- **External RPM:** The gross profit margin of tested party in controlled transaction is compared with the gross profit margin earned by the independent third party in a comparable uncontrolled transaction.
- **Internal RPM is preferable over external RPM** due to availability of more reliable and accurate data.

d) Requirements for applicability of RPM

- Property is purchased or service is obtained from an AE and resold to an unrelated party.
- Reseller adds relatively little or no value to the goods through physical modification or by using intangible property.

  Limited enhancements such as packaging, repacking, labeling or minor assembly which generally does not add significant value to the goods is acceptable. However, significant value addition through physical modification such as converting rough diamonds into cut and polished

diamonds adds significant value to the goods and hence, RPM cannot be applied for such value added activity.

Similarly, in case if mineral water is imported from AE and sold in the local market by adding the brand name of Indian Company, RPM cannot be applied since there is significant addition in value of goods due to the use of brand name of Indian Company.

- High degree of functional comparability rather than product comparability.

  Detailed comparison of functions performed, risks assumed and contractual terms of controlled and uncontrolled transactions needs to be done and adjustment should be made for the material differences which would affect the gross profit margin. (Example: Adjustment for exchange fluctuation risk, difference in warranty period, etc.)

- Minor difference in the products is acceptable if they are less likely to have effect on the gross **profit** margin.

  E.g. Gross profit margin earned from trading of microwave ovens in controlled transaction can be compared with the gross profit margin earned by unrelated parties from trading in toasters since both are consumer durables and fall within the same industry

  Shorter time gap between purchase and sale. When the time gap between the original purchase and resale is more, the other factors such as changes in market conditions, rate of exchange and change in costs will have to be appropriately considered. (E.g. if sugar is purchased at the time of low demand and sold after 6 months at the time of high demand, RPM would not be applicable).

e) When to use RPM method?

- Distributors / Wholesalers who purchase from AEs.

- Full-fledged manufacturer owning valuable patents or other intangible properties and affiliated sales companies which purchase and resell the products to unrelated customers.

f) Strengths of RPM

- Demand driven method because it is based on the resale price
- Reliable when demand is inelastic

g) Difficulties in application of RPM

The practical application of RPM may pose various difficulties as given below:

- Non availability of gross margin data of comparable companies from public database is the biggest challenge in applying RPM since Companies Act does not mandate disclosure of gross profit margin and Tax Audit Reports which contain gross profit margin data are not available in public database.
- Differential accounting policies followed across the globe makes application of RPM very difficult.

  E.g.1: Certain companies include exchange loss / gain in purchase / sale whereas some companies show it as part of administrative and other expenses.

  E.g.2: Certain companies include excise duty on purchase in 'Purchase A/c' whereas some companies show it under the head of rent, rates and taxes in the financials.
- RPM is unlikely to give accurate result if there is difference in level of market, functions performed or product sold.

  E.g. Gross profit margin of shoe distributor cannot be compared with the gross profit margin of detergent distributor even though both are Fast Moving Consumer Goods since there are huge differences in products which affect the gross profit margin.

- It is difficult to identify whether the comparable companies do or do not employ valuable marketing intangibles in their business. The presence of such intangible may allow the comparable entity to enjoy higher profitability in comparison to other marketing or selling companies who do not possess such intangible. Further the inability to undertake a functional analysis of the comparables hampers the comparability analysis.

h) Certain issues in application of RPM

Generally, RPM is useful in case of distributor who purchases goods from AE and sells to Non AE. However, certain issues which arise during practical application of RPM are as below:

- **Whether RPM can be used when the goods are purchased or services are obtained by an enterprise from non AE and resold or are provided to AE?**

  - Generally, RPM is used when the property is purchased or services are obtained by an enterprise from its AE which is thereafter resold or are provided to the unrelated enterprise. Sometimes, controversy arises as to whether RPM can be used in a reverse situation, viz. when the property is purchased or services are obtained by an enterprise from an unrelated enterprise which is thereafter resold or are provided to an AE.

  - In this respect, from the plain reading of Rule 10B(1)(b) of the Rules, it can be observed that RPM is applicable in case the property is purchased or services are obtained by an enterprise from its AE which is thereafter resold or are provided to the unrelated enterprise. Hence, as per the strict interpretation of Rule 10B(1)(b), it appears that RPM can be applied only when the property is purchased or services are obtained by an enterprise from its AE which is thereafter resold or are provided to the unrelated enterprise and not in the reverse situation.

- The Mumbai Tribunal in the case of **Gharda Chemicals Ltd. vs. DCIT** [(2010) 35 SOT 406 (Mum)], rejected RPM on the ground that RPM could be applied only in a case where Indian enterprise purchases goods or obtains services from its AE and not in a reverse case. The relevant extract of the observations of the Tribunal is given below:

  "A bare perusal of sub-rule (b) brings to fore that it is applicable with reference to the property purchased or services obtained by an enterprise from its AE which is thereafter resold or are provided to the unrelated enterprise. It shows that if the Indian enterprise purchases goods or obtains services from its AE in an international transaction, then the ALP shall be determined by adjusting the price at which the property is purchased or services are obtained by the Indian enterprise. In the instant case, we are dealing with a situation in which the property is sold and not purchased by an Indian enterprise from its AE abroad in an international transaction. Ex consequenti the Resale price method cannot be invoked in the hands of the assessee in India for the determination of ALP. If the situation had been otherwise that the assessee had purchased the goods from its AE situated in USA, then this method could have been invoked for determining the ALP. For these reasons we hold that Resale price method is not even appropriate, what to talk of the "most appropriate method" for determining of ALP in the present international transactions."

- The Mumbai Tribunal in the case of **L'Oreal India P. Ltd. vs. DCIT** (2013) 34 taxmann.com 78 held that since there is no order of priority in selection of methods and RPM is one of the standard method and the OECD guidelines also states that in case of distribution and marketing activities (where goods are purchased from AEs and sold to unrelated parties), RPM is the

most appropriate method. The Bombay High Court affirmed the above decision of the Tribunal accepting the taxpayers' use of the RPM for purpose of determination of arms length price of its international transactions with respect to distribution activities.

- **Whether close functional similarity between controlled transactions and uncontrolled transactions needs to be proved for the application of RPM as the most appropriate method?**

- In RPM, the comparability is at the gross margin level and hence, RPM requires a high degree of functional comparability rather than product comparability. Hence, a detailed analysis showing the close functional comparability and risk profile of the tested party and comparables should be clearly brought out in the TP Study to justify comparability at gross profit level under RPM.

- The Mumbai Tribunal in the case of **Mattel Toys (I) (P.) Ltd.** (2013) 34 taxmann.com held that the RPM method identifies the price at which the product purchased from the AE is resold to an unrelated party. RPM is mostly applied in a situation in which the reseller purchases tangible property or obtains services from an AE, and reseller does not physically alter the tangible goods and services or use any intangible assets to add substantial value to the property or services i.e. resale is made without any value addition having been made. Therefore, in such a situation, the nature of products has not much relevance, though their closer comparable may produce a better result. The focus is more on same or similar nature of properties or services rather than similarity of products. The main reason is that the product differentiation does not materially affect the gross profit margin as it represents gross compensation after the cost of sales for specific function performed. The functional attribute is more important while undertaking the comparability analysis under this method. In the instant case, the assessee is a distributor of toys and gets the finished goods from AE and resells the same to independent

parties without any value addition. In such a situation, RPM can be the best method to evaluate the transactions whether they are at ALP.

7.2.4 Cost Plus Method ('CPM')

a) CPM determines ALP of a controlled transaction by reference to the gross profit mark up on the direct and indirect costs of producing products or rendering services that is realized in comparable uncontrolled transactions. Thus, general and administrative expenses, finance cost, etc. should be excluded.

b) The UN TP manual defines CPM as "The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate gross profit in light of the function performed, risk assumed, asset used and market conditions."

c) 'Cost' in cost plus method means actual costs and not estimated costs. The Mumbai Tribunal in **Reliance Industries Ltd. Vs. Addl. CIT** [2012] 12 taxmann.com 189 held that –

- Actual costs have to be taken to arrive at the correct cost. Only then cost plus method can be applied.

- Cost plus method does not contemplate estimation of costs.

The Hyderabad Tribunal in the case of **Alumeco India Extrusion Ltd vs ACIT** (2010) ITA No. 1475/2010 rejected the application of TNMM by the department and held that there were significant domestic sales to non-AE of similar product. Therefore, held that internal domestic transaction could be used for benchmarking domestic transactions are similar to the export transactions. The ITAT held that the allegations of TPO that there was incorrect allocation of cost among various segments, was not sufficient to reject CPM. It therefore set aside the TPO's order and directed the TPO to compute ALP using

CPM and re-examine cost allocation between Alumeco's domestic, export and job work segment.

d) Applicability

CPM is most useful where:

- Semi-finished goods are sold between the related parties.

  E.g.: A foreign company gives components to Indian subsidiary in semi-finished form for manufacture of TV sets for which it pays the Indian subsidiary a mark-up on cost, plus a certain percentage.

- Where related parties have concluded joint facility agreements, contract manufacturer, a toll manufacturer or a low risk assembler

  E.g.: Where Indian Company manufactures software and supplies to US AE on cost plus basis and US AE sells entire computer system to global AEs on cost plus basis.

- Long-term-buy-and-supply arrangements

  E.g.: In practice, many pharma and software MNCs have their manufacturing base in India from where they supply to all AEs worldwide on cost plus basis as per long term contract.

- Rendering of services

  E.g. Indian Company rendering research services to foreign parent company whereby intangibles developed through R & D are owned by foreign company and also the risk of failure of research is borne by foreign company. Indian Company is only compensated on the basis of cost plus mark-up.

e) Types of CPM

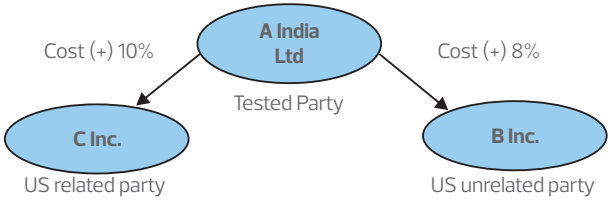
Like CUP and RPM, CPM can also be applied by way of Internal CPM or External CPM.

- **Internal CPM:** The gross profit mark-up on the direct and indirect costs of producing products or services of controlled transaction is compared with the gross profit mark-up of comparable uncontrolled transaction of the tested party.

- **External CPM:** The gross profit mark-up on the direct and indirect costs of producing products or services of tested party in controlled transaction is compared with the gross profit mark-up earned by the independent third parties in a comparable uncontrolled transaction.

- **Internal CPM is preferable over external CPM** due to availability of more reliable and accurate data.

Illustration:



Terms of Agreement (for sale of Refrigerators):

With C Inc.: Direct costs plus 50% (on account of overheads) plus 10% mark-up.

With B Inc.: Direct cost plus indirect costs @ 50% of direct costs plus 8% mark-up.

Since the methodology for computing the cost base is same in both the transactions, CPM is considered as appropriate method, ALP is determined @ cost plus 8%.

f) How does CPM differ from RPM?

- CPM starts by computing the cost of providing the goods or services and adds an appropriate mark-up.

- In contrast, RPM starts from the final selling price and subtracts an appropriate gross profit margin to arrive at purchase price.

g) Requirements for applicability of CPM

- CPM is normally employed in cases involving manufacture, assembly or production of tangible products or provision of services, which are sold / provided to related party.

- As per the Revised Guidance Note issued by ICAI, CPM can be adopted only in cases of supply of property or services to an AE and not when enterprise is in receipt of property or services from an AE.

- It requires a close degree of comparability of the functions performed, assets employed and risks assumed. Adjustment should be made for material differences which affect the gross profit mark-up on the direct and indirect cost of production.

- Broader product differences are allowed if it does not affect the gross profit mark-up on the direct and indirect cost of production.

  E.g.: Margin earned on manufacture and sale of toasters can be compared with margin earned on manufacture and sale of irons since both belong to consumer durables industry and thus, less likely to affect the gross profit mark-up on the direct and indirect cost of production.

h) Strengths of CPM

- According to UN TP manual, the strength of CPM is that it is based on internal costs, the information is usually readily available to the MNCs.

i) Difficulties in application of CPM

The practical application of CPM may pose various difficulties as under:

- Existence of material differences with respect to the following makes application of CPM less relevant:

- Intangibles (E.g. Branded T.V vs. Unbranded T.V.)
- Cost structure (E.g. labour oriented process vs. highly automated process)
- Business experience (E.g. 50 year old established player vs. new entrant in market)
- Management efficiency (E.g. Business / Functions managed by professionals, like MBA, Chartered Accountants, Cost Accountants vs. traditional management)
- Functions performed (E.g. manufacturer / owner vs. job worker)
- Products (E.g.: Shoe manufacturer vs. detergent manufacturer)
- Accounting methods (E.g.: Some companies include exchange loss / gain in purchase / sale whereas some companies show it as part of administrative and other expenses)

– The terms 'direct' and 'indirect' cost have not been defined. Hence, industry practice needs to be followed which is different for different companies.

  E.g.: Those companies which disclose service tax on income as part of income will reflect higher gross profit margin as compared to companies which book service tax through a separate liability account.

– Under Companies Act, there is no requirement to distinctly report gross profit margins of companies. Hence, non-availability of gross profit margins from database makes application of CPM difficult in actual practice.

  E.g.: Finding out wages cost for comparables is very difficult since in Profit and Loss account, combined figure of salary, wages and

allowance is given. Salary cannot be considered for gross profit margin since it does not relate to a production cost.

- Since the method is based on actual costs, there may be no incentive for the controlled manufacturer to control costs.

j) Following aspects are to be considered while applying CPM

- The cost of production of two transactions must be determined in a consistent manner.
- The tested party margin of gross profit should be calculated on the mark-up earned by comparables.
- Comparables should be similar in various respects to the tested party.
- Internal comparables are preferred for the purpose of analysis.

7.2.5 Profit Split Method ('PSM')

a) PSM evaluates whether the allocation of the combined operating profit or loss attributable to the controlled transaction is at arm's length as compared to the relative value of contribution of each AE to the combined operating profit or loss.

b) Applicability

- PSM may be applicable mainly in transactions involving
  - transfer of unique intangibles; or
  - in multiple inter-related international transactions which can not be evaluated separately.

Example: Where Indian subsidiary is manufacturing drugs using in-house developed technical knowhow and R & D (intangible) and selling it to US parent company which is selling the same in US using its brand name; PSM can be considered since the Indian Company makes use of

intangible in the form of technical knowhow and US Company makes use of intangible in the form of brand name.

c) Method of computing ALP under PSM

ALP under PSM may be computed in the following manner:

- Combined operating profit or loss should be determined for the entities engaged in the controlled transactions and which arises out of such controlled transactions.
- Allocation of the combined profit can be done by any one of the following ways:
  - Contribution Approach / Analysis
  - Residual Approach / Analysis
- **Contribution Approach**
  - The combined profit i.e. the total profit from the controlled transactions would be divided between the AEs based on:
    - the reasonable approximation of the division of the profits under the arm's length condition prevailing in similar transactions; and
    - based on the relative value of the functions performed after taking into account assets employed and risks assumed by each AE.
  - The different techniques used in applying Contribution Approach are as under:
    - Capital Investment Approach / Analysis
    - Compensation Approach
    - Bargaining Theory Approach

- Survey Approach

- The determination of contribution of each AE under Contribution Approach should be economically justified (else, it becomes Global Apportionment Formula which is not accepted by OECD countries.)

- It can be difficult to determine the relative value of the contribution that each of the AEs makes to the controlled transactions and the approach will often depend on the facts and circumstances of each case.

- **Residual Approach / Analysis:**

  - Under the residual approach, the combined profits of the controlled transactions are allocated in two stages:

    - Towards the basic return appropriate for the type of transactions (which would be without considering the contribution of intangibles or unique product)

    - The residual profit must be split between enterprises in their relative contribution (which is generally based on contribution of intangibles possessed by AEs).

  - The Delhi Tribunal has passed a landmark judgment in the case of **Global One India Pvt. Ltd. ACIT [(2014) 44 taxmann.com 100** for residual PSM wherein the application of PSM has been dealt with great maturity. The Tribunal not only accepted the purposive interpretation for a meaningful application of Residual Profit Split Method, but also accepted the appellant's alternative argument that if the PSM, as applied by the appellant, did not fall within the strict definition of PSM provided in Rule 10B(1)(d), then the same could be considered as the "Other Method" (sixth method), as provided in Rule 10AB of the Rules, and be applied retrospectively as the

insertion of the sixth method could be considered as curative in nature.

d) Factors to be borne in mind while determining ALP under PSM

The following factors should be kept in mind while determining ALP under PSM:

- The combined profit to be split (including losses) should be only that profit arising from controlled transactions under review;
- Allocation of combined profit between AEs should be consistent with the FAR Analysis of each AE and should be based on the factors agreeable between the third parties;
- Criteria or allocation keys used to split the profit should be reasonably independent of the transfer pricing policy formulation and should be supported reasonably by reliable comparable data;
- In practice, common allocation keys used are assets / capital (operating assets, fixed assets, intangible assets, capital employed) or costs (relative spending and / or investment in key areas such as research and development, engineering, marketing);
- Other allocation keys can be based on incremental sales, headcounts, time spent by certain group of employees, number of servers, data storage, floor space, etc.
- Asset based or capital based allocation keys can be used where there is a strong correlation between tangible or intangible assets or capital employed and creation of value in the context of the controlled transaction.
- Cost based allocation keys can be used where there is a strong correlation between relative expenses incurred and relative value added.

e) Strengths of PSM

PSM has certain strengths which are given below:

- PSM offers solution for highly integrated operations for which one-sided method would not be appropriate.
- PSM offers solutions where both the parties to the transaction contribute unique intangibles.
- PSM offers flexibility since it takes into account specific, possibly unique, facts and circumstances of the AEs which are absent in the case of independent third parties by adopting arm's length approach.
- The two-sided approach in PSM ensures that neither party to the controlled transaction is left with an extreme and improbable profit result.

f) Weaknesses of PSM

PSM has certain weaknesses which are given below:

- PSM is difficult to apply in practice.
- AEs and tax authorities face difficulties in accessing information from foreign affiliates.
- It may be difficult to measure combined costs and revenue for all AEs, as it may require stating of books and records on common basis as regards accounting practices, different currencies, etc.
- It may be difficult to identify the operating expenses associated with the international transactions and other activities of AEs.

Note: PSM is not widely used in practice in India.

7.2.6 Transactional Net Margin Method ('TNMM')

a) TNMM examines the net profit margin relative to an appropriate base (e.g.

costs, sales, assets) that a tested party realizes from a controlled transaction with the net profit margin earned from comparable uncontrolled transactions (Internal TNMM) or with that of an uncontrolled party engaged in a comparable uncontrolled transaction (External TNMM).

b) Applicability

TNMM is generally considered as a method of last resort and is applied when it is not possible to apply any other methods as mentioned earlier to determine ALP.

The UN TP manual offers the following guidance on the use of TNMM:

- TNMM is usually applied with respect to broad comparable functions rather than controlled transactions.
- TNMM is mostly applied to the party performing routine manufacturing, distribution or other functions that do not involve control over intangibles.
- TNMM may be more attractive if the data on gross margins are less reliable due to accounting differences between the tested party and the comparable companies.

c) Certain features of TNMM

- TNMM compares net margins by using certain ratios (PLIs) to express net profit as a % of a given base which commonly includes operating cost, operating income, total assets, operating expenses, etc.
- TNMM is similar to RPM and CPM to the extent that it involves a comparison of margins earned in a controlled situation with margins earned from comparable uncontrolled situations.
- However, TNMM differs from RPM and CPM to the extent that it involves comparison of margins at net profit level as against at gross profit level.

d) Strengths of TNMM

TNMM has certain strengths which are as follows:

- TNMM requires comparability at a broad functional level and product differences are acceptable provided it does not materially affect the net profit margin.
- Operating profit margins are less affected by transactional differences as is the case with price while applying CUP Method.
- It is necessary to examine the financial indicator of only one of the AEs (i.e. the tested party.)
- It is not necessary to restate the books and records for all participants on a common basis or to allocate costs as is the case with PSM.
- The differences in functions performed between enterprises are often reflected in variation in operating expenses. Consequently, enterprises may have wide range of gross profit margins but it may still earn broadly similar level of net profits.
- Because TNMM is applied to the least complex entity, it can be used even though one of the related parties hold intangible assets for which comparable return cannot be determined.
- TNMM is applicable to either side of the controlled transaction (i.e. related party manufacturer or the distributor).

e) Weaknesses of TNMM

TNMM has certain weaknesses which are as follows:

- Difficulty in ascertaining revenue and operating expenses (i.e. segmental results) related to the controlled transactions to establish the net profit indicator.
- Difficulty in making reasonable accurate adjustments in cases where

factors like difference in working capital, risks assumed, etc. have an influence on the net margins of the taxpayer vis-à-vis third parties.

- Difficulty in determining the corresponding adjustment, particularly where the controlled transactions are both on the purchase as well as sales side.

f) Certain issues in application of TNMM

TNMM is widely used in actual practice. However, certain issues arise in application of TNMM which are as below:

- **Whether TNMM requires comparison of profit earned from an international transaction or the entity level profits?**

  Rule 10B(1)(e) of the Rules mentions that net profit margin realized by an enterprise **from an international transaction** should be computed and compared with uncontrolled transactions. Hence, on plain reading of Rule 10B(1)(e), it appears that under TNMM, profit attributable to international transactions should be compared and not the profits at entity level.

  In this respect, it is to be noted that the Mumbai Tribunal in the case of **UCB India Pvt. Ltd. vs. ACIT** (2009-121-ITD-131-MUM) held that TNMM refers to only net profit margin realised by an enterprise from an **international transaction** or a class of such transaction, but not operational margins of enterprises as a whole. The relevant extract of the observations of the Mumbai Tribunal is given below:

  "Section 92C(1) refers to arm's length price in relation to an international transaction. Rule 10B(1)(e) read with section 92C deals with TNMM, and it refers to only net profit margin realized by an enterprise from an international transaction or a class of such transaction, but not operational margins of enterprises as a whole."

  Further, the Mumbai Tribunal has also taken similar view in the

following cases:

- ACIT vs. M/s Tej Diam (2010-TII-27-ITAT-MUM-TP)
- ACIT vs. M/s Twinkle Diamond (2010-TII-09-ITAT-MUM-TP)

Hence, if there are transactions with AEs and non AEs, it would be necessary to prepare segmental Profit and Loss account of AE and non AE segment and comparison should be made of the profit attributable to the AE segment.

- **Whether internal TNMM should be preferred to external TNMM?**

In case of internal TNMM, ALP is determined by comparing the net profit margin of the tested party from controlled transaction with net profit margin earned from comparable uncontrolled transactions whereas in case of external TNMM, ALP is determined by comparing the net profit margin of the tested party with the net profit margin of an uncontrolled party engaged in a comparable uncontrolled transaction. Sometimes, controversy arises as to whether Internal TNMM is preferable over External TNMM.

In case of Internal TNMM, all the information for the controlled and uncontrolled transactions is available with the assessee whereas in case of External TNMM, the assessee has to rely on the external data which may not be reliable. Hence, Internal TNMM should be preferred to External TNMM. Even the OECD guidelines support the similar view.

The Delhi Tribunal in the case of **Abhishek Auto Industries Ltd. vs. DCIT** (2010-TII-54-ITAT-DEL-TP), held that the internal comparables are more reliable than the external comparables and tends to reduce the scope of making any adjustment to the ALP. The relevant extract of the observations of the Delhi Tribunal is given below:

"The next proposition of using internal comparables also in our view helps the case of the assessee, to take it outside the scope of making any adjustment. Apart from relying on the judgments cited

by the appellant, in our opinion, the best comparability can be of the transactions of the tested party itself."

The Delhi Tribunal further, in the case of **Birlasoft (India) Ltd. vs. DCIT** (2011-TII-41-ITAT-DEL-TP), has reiterated the preference of internal comparables over external comparables. The relevant extract of the observations of the Delhi Tribunal is given below:

"...the assessee was justified in undertaking internal benchmarking analysis on standalone basis by placing on record working of operating profit margin from international transactions with AEs and transactions with unrelated parties undertaken in similar functional and economic scenario, and the same should be the basis for determination of arm's length price in respect of international transactions undertaken with the associated enterprise. In the light of the facts of the present case as discussed above, we therefore, hold that the Transfer Pricing Officer had no mandate to have recourse to external comparables when, in the present case, internal comparables were available, which could be applied for determining the arm's length price of international transactions with AEs."

7.2.7 Other Method as prescribed by CBDT — Rule 10AB

a) CBDT inserted Rule 10AB, vide notification No. 18/2012 dated 23 May 2012, notifying the "Other Method" apart from the 5 methods already prescribed. This rule is made effective from 1 April 2011, relevant to AY 2012-13.

b) The introduction of the Other Method as the sixth method allows the use of 'any method' which takes into account (i) the **price** which has been **charged or paid** or (ii) **would have been charged or paid** for the same or similar uncontrolled transaction, (iii) with or between non AEs, under similar circumstances, considering all the relevant facts.

c) As per Revised Guidance Note issued by ICAI the various data which may possibly be used for comparability could be:

- Third party quotations;
- Valuation reports;
- Tender / Bid documents;
- Documents relating to negotiations;
- Standard rate cards;
- Commercial and economic business models; etc.

d) According to Revised Guidance Note issued by ICAI, Rule 10AB does not describe any methodology but only provides an enabling provision to use any method that has been used or may be used to arrive at price of a transaction undertaken between non AEs. Hence, it provides flexibility to determine the price in complex transactions where third party comparable prices or transactions may not exist.

e) This particularly is useful in cases where the application of 5 specific methods is not possible due to reasons such as difficulties in obtaining comparable data due to uniqueness of transactions such as intangibles or business transfers, transfer of unlisted shares, sale of fixed assets, revenue allocation / splitting, guarantees provided and received, etc.

However, it would be necessary to justify and document reasons for rejection of all other 5 methods while selecting the 'Other Method' as the most appropriate method. The OECD Guidelines also permit the use of any Other Method and state that the taxpayer retains the freedom to apply methods not described in OECD Guidelines to establish prices, provided those prices satisfy the arm's length principle.

- **Illustrations as per Revised Guidance Note issued by ICAI**

A. AE1 Ltd. is an Indian Company. AE1 Ltd. owns certain registered patents which it has developed by undertaking research and development. It is a subsidiary of AE2 Ltd., a foreign company. AE1 Ltd. has sold its

egistered patents to AE2 Ltd. for INR 50 crores. The price has been determined based on a valuation report obtained from an independent valuer.

The sale of patents is a unique transaction and AE1 Ltd. or AE2 Ltd. has not entered into similar transactions with third parties and hence no internal or external CUP is available. AE1 Ltd. may select 'Other Method' as the most appropriate method and use the independent valuation report for comparability purposes.

B. An Indian Company ('I Co.') buys back its equity shares issued to its foreign AE ('AE Co'). I Co. obtains a valuation report from an external firm identifying the FMV of these shares. I Co. purchases the shares at the value determined in the valuation report. This value denotes a price that would have been charged if a third party would have bought the same shares. Hence, I Co. could use Rule 10AB and rely upon the valuation report to demonstrate this transaction to be at arm's length.

C. In case of cost allocation arrangements a taxpayer benefits from certain services provided by a central entity of the group and has to pay a portion of the total cost incurred by the service provider. These costs are generally allocated on the basis of allocation keys like headcount, time spent, revenues, etc. and a third party outside the group may not have the capability to provide identical services. Hence, in the absence of comparable prices or transactions, Rule 10AB may be applied and the cost allocation arrangement could be justified appropriately.

– The Bangalore Tribunal in the case of **Tally Solutions Pvt. Ltd. Vs. DCIT** [(2011) 14 taxmann.com 19] dealt with the complex subject of valuation of intellectual property rights. The Tribunal held that **Excess Earning Method** ('EEM') is an appropriate method to determine the arm's length price of transaction of sale of intangible property and this method can be considered equivalent to the CUP method. Valuation of a property based on recognized principles and international

practices has been given acceptance for determination of ALP by the Tribunal.

7.2.8 The Most Appropriate Method

Rule 10C(1) provides that the method to be selected should satisfy two conditions:

- It should be the one best suited to facts and circumstances of each international transaction / SDT; and
- It provides the most reliable measure of the arm's length price.

7.2.9 Concept of Most Appropriate Method

- As per Indian TP regulations, ALP in relation to an international transaction / SDT shall be determined by any of the prescribed methods, being the most appropriate method.
- Indian TP regulations do not provide any hierarchy or priority for selection of most appropriate method.
- Most appropriate method is that method which, under the facts and circumstances of the transaction under review, provides the **most reliable measure** of an arm's length result.
- Each method needs to be tested on its merits depending on the nature of international transaction, availability of reliable comparable data, extent to which reasonable adjustments can be made, etc.

7.2.10 Factors to be considered while selecting the Most Appropriate Method

Following factors should be considered while selecting the MAM:

- The nature and class of international transaction / SDT.
- The class of AEs and the FAR analysis of AEs.
- Availability of the reliable data necessary for the application of the method.

- Degree of comparability existing between IT / SDT and uncontrolled transaction and between the enterprises entering into such transactions.
- The extent to which reliable and accurate adjustments can be made for differences between international transaction and uncontrolled transaction.
- The nature, extent and reliability of the assumptions required to be made in application of the method.

7.2.11 Benefit of Proviso to section 92C(2) of the Act

The Indian Transfer Pricing regulation prescribes than no adjustment should be made if the value of international transaction is within the range as prescribed in Proviso to section 92C(2) of the Act. The Proviso reads as under:

"Provided further that if the variation between the arm's length price so determined and price at which the international transaction has actually been undertaken does not exceed five per cent of the latter, the price at which the international transaction has actually been undertaken shall be deemed to be the arm's length price".

The above proviso was applicable from AY 2009-10 (i.e. 1 October 2009).

It is important to note here that the range of +/-5% is to be applied to the value of the international transactions and not to the ALP [as stated in erstwhile Proviso 92C(2)].

The Finance Act 2012 amended the tolerance band and replaced the +/-5% range with the range of 1% to be applicable in case of wholesale trader and 3% range for others. The said range of ALP is applicable from AY 2013-14 onwards.

7.2.12 Use of multiple year data and adoption of range concept

On 19 October 2015, CBDT issued a notification releasing the rules for the use of range and multiple year data in line with the announcement made by Finance Minister to align the Indian Transfer Pricing regulations with international best practices.

The Rules are applicable with effect from 1 April 2014 and would apply for both international transactions as well as specified domestic transactions from FY 2014-15 prospectively.

a) Use of multiple-year data

In case where the Resale Price Method, Cost Plus Method or Transactional Net Margin Method is used as most appropriate method for determination of the ALP of IT/SDT entered into or after 1 April 2014, comparability will be conducted based on:

- data relating to current year; or
- data relating to the financial year immediately preceding the current year, if the data relating to the current year is not available at the time of furnishing the return of income

However, it has been provided that during the assessment proceedings, if the current year data becomes available, the same shall be considered irrespective of the fact that such current year data was not available at the time of furnishing the return of income.

b) Adoption of the range concept – Rule 10CA

The concept of range is applicable in case of all methods except the Profit Split Method and Other Method. The steps to be followed for constructing the range are as under:

- A minimum of 6 comparables would be required
- Where the comparable uncontrolled transaction of an enterprise has been identified based on current year data and the enterprise has undertaken the same or similar transactions in the 2 preceding financial years, three-year data of these comparables would be considered. In certain circumstances, data of two out of three years could also be used. Additionally, single year data can be used, provided that the data is for the current year in which the tested transaction is undertaken or a year prior to the current year in the case of non-availability of data for the current year.
- The data set using multiple year data is required to be computed based on the weighted average of the prices derived using the

following as weights depending upon the transfer pricing methodology used:

- The weighted average of the three-year data of each comparable would be used to construct the data set.
- The weighted average computation will involve aggregation of the numerator and denominator of the chosen profit level indicator for all the years for every comparable individually and the dataset will accordingly be constructed.
- An arms' length range beginning from 35th percentile of the dataset and ending on the 65th per centile will be considered
    - If the value arrived is not a whole number, the value shall be rounded off to the next higher value shall be considered so as to cover at least 35%/65% of the value below it.
    - If these values are whole numbers, then the value shall be the arithmetic mean of such value and the immediately succeeding value in the dataset
- If the transaction price falls within the range, then the same shall be deemed to be the ALP. If the transaction price falls outside the range, the ALP shall be taken to be the median of the data set.

The arithmetic mean of prices along with the permitted variation of 1% (in case of wholesalers) /3% percent (in all other cases) would continue to apply in the case of PSM and Other method. It would also apply in cases where the numbers of comparables are less than 6.

The above rules regarding allowability of multiple year data and range concept have been summarized below:

Method	Use of multiple year data	Range concept applicability		
		1 comparable	2–5 comparable	6 or more comparables
CUP	X	X	**X –Arithmetic mean of all values with benefit of variation from mean as notified by CBDT**	✓
RPM	✓	X		✓
CPM	✓	X		✓
TNMM	✓	X		✓
PSM	Not applicable			
OM	Not applicable			

The computation mechanism is explained by way of illustrations below:

Illustration 1: Where the data set comprises 7 data points (arranged in ascending order), and the percentiles computed are not whole numbers.

Percentile	Formula	Result	Value to be selected
35th	Total no. of data points in dataset *35% = [7 * 35%]	2.45	3rd value*
65th	Total no. of data points in dataset *65% = [7 * 65%]	4.55	5th value*
Median	Total	3.50	4th value*

* Value referred to here is the place value in the data set as arranged in ascending order.

Illustration 2: Where the data set comprises 20 data points (arranged in ascending order), and the percentiles computed are whole numbers.

Percentile	Formula	Result	Value to be selected
35th	Total no. of data points in dataset * 35% = [20 * 35%]	7.00	Mean of 7th & 8th value

Percentile	Formula	Result	Value to be selected
65th	Total no. of data points in dataset * 65% = [20 * 65%]	13.00	Mean of 13th & 14th value
Median	Total no. of data points in dataset * 50% = [20 * 50%]	10.00	Mean of 10th & 11th value

* Value referred to here is the place value in the data set as arranged in ascending order.

Illustration 3.– The data of the current year is available in respect of enterprises A , C, E, F and G at the time of furnishing the return of income by the assessee and the data of the financial year preceding the current year has been used to identify comparable uncontrolled transactions undertaken by enterprises B and D . Further, if the enterprises have also undertaken comparable uncontrolled transactions in earlier years as detailed in the table, the weighted average and dataset shall be computed as below:

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

From the above, the dataset will be constructed as follows:

Sr. No.	1	2	3	4	5	6	7
Values	(–)5%	7.31%	9%	10%	10.57%	11.9%	12%

If during the course of assessment proceedings, the data of the current year is available and the use of such data indicates that B has failed to pass any qualitative or quantitative filter or for any other reason the transaction undertaken is not a comparable uncontrolled transaction, then, B shall not be considered for inclusion in the dataset. Further, if the data available at this stage indicates a new comparable uncontrolled transaction undertaken by enterprise H, then, it shall be included. The weighted average and dataset shall be recomputed as under:

Sr. No.	Name	Year 1	Year 2	Year 3 [Current Year]	Aggregation of OC and OP	Weighted Average (OP/OC)
1.	A	OC = 100 OP = 12	OC = 150 OP = 10	OC = 225 OP = 35	Total OC = 475 Total OP = 57	12%
2.	C	OC = 250 OP = 22	OC = 230 OP = 26	OC = 250 OP = 18	Total OC = 730 Total OP = 66	9%
3.	D		OC = 220 OP = 22	OC = 150 OP = 20	Total OC = 370 Total OP = 42	11.35%
4.	E			OC = 100 OP = (–) 5	Total OC = 100 Total OP = (–)5	(–)5%
5.	F	OC = 160 OP = 21	OC = 120 OP = 14	OC = 140 OP = 15	Total OC = 420 Total OP = 50	11.9%
6.	G	OC = 150 OP = 21	OC = 130 OP = 12	OC = 155 OP = 13	Total OC = 435 Total OP = 46	10.57%
7.	H	OC = 150 OP = 12		OC = 80 OP = 10	Total OC = 230 Total OP = 22	9.56%

From the above, the dataset will be constructed as follows:

Sr. No.	1	2	3	4	5	6	7
Values	(–)5%	9%	9.56%	10.57%	11.35%	11.9%	12%

7.2.13 Tested Party

a) Tested Party means the party from whose perspective the ITs / SDTs is tested for the determination of arm's length price.

b) Indian TP Regulations do not prescribe any criteria for selecting the tested party. However, the following parameters can be used for selection of the tested party:

- Tested party should functionally be the least complex of the transacting parties.
- There should be availability of reliable comparable data that requires fewest and most reliable adjustments.
- The tested party should ideally not own any intangibles or own fewer intangibles.

c) Out of the above, availability of reliable comparable data that requires fewest and most reliable adjustments is the most important factor to be considered for selection of the tested party since an entity may be performing the least complex functions and may not be owning intangibles, but if the reliable comparable data is not available for such entity, such entity cannot be selected as the tested party.

d) In certain judicial pronouncements as under, it was held that even foreign entity can be selected as the tested party if the above conditions are fulfilled.

- **Onward Technologies Limited vs. DCIT** [(2013) 35 taxmann.com 584 – Mumbai Tribunal
- **General Motors India (P.) Ltd. vs. DCIT** [2013] 37 taxmann.com 403 – Ahmedabad Tribunal
- **Development Consultants Pvt. Ltd. vs. DCIT** [(2008) 23 SOT 455 – Kolkata Tribunal

e) The tested party should be selected based on the criterion as mentioned

above and the reasons for selection of tested party should be adequately documented in the TP Study. If foreign entity is selected as the tested party, then the assessee must ensure that the reliable comparable data is available for furnishing the same before the tax authorities and an in-depth FAR analysis of the tested party and the comparables is done.

7.2.14 Profit Level Indicator ('PLI')

a) PLIs are the ratios that measure the relationship between the profits and other attributes like costs or sales or resources like capital employed or assets employed to determine the arm's length price.

b) In assessing the financial performance of the comparable companies, it is important to use appropriate PLIs (i.e. measures that reflect the fact that these companies are predominantly engaged into). The choice of PLIs depends upon a number of factors, including the nature of the activities, the reliability of the available data with respect to the comparable companies and the extent to which the PLI is likely to produce an appropriate review of an arm's length result.

c) Overview of most commonly used PLIs are:

PLI	Computation	Uses
Return on Assets (ROA)	Operating profit divided by the operating assets (normally only tangible assets)	Generally in case of capital intensive manufacturers
Return on capital employed (ROCE)	Operating profit divided by capital employed which is usually computed as the total assets minus cash and investments	Generally in case of capital intensive manufacturers
Operating Profit Margin (OPM)	Operating profit divided by Operating Income	When amount payable to AE for purchase from AE or services received from AE
Operating Cost Margin (OCM)	Operating profit divided by Operating Cost	When amount receivable from AE for exports to AE or services rendered to AE

PLI	Computation	Uses
Return on total costs (ROTC)	Operating profit divided by total costs	When amount receivable from AE for exports to AE or services rendered to AE
Return on cost of goods sold	Gross profit divided by cost of goods sold	Distribution activities
Berry Ratio	Gross profit divided by operating expenses	Intermediary activities such as logistic industry / courier industry wherein taxpayer is performing intermediate activity.

d) The selection of PLI depends on the method which is selected as the most appropriate method. The following table summarizes the different PLIs used in different methods:

Method	PLI
CUP method	No PLI since price is compared
RPM	Gross Profit/Sales
CPM	Gross Profit/Direct and Indirect Cost of Production
PSM	Generally, Operating margin
TNMM	Generally, Operating margin
Other Method	"Would be price"

Chapter 8 Comparability Analysis

Comparability analysis is an important link between arm's length principle and operation of transfer pricing methods. The analysis is helpful to identify comparables and assess the degree of comparability of ITs/SDTs.

The OECD TP Guidelines defines 'comparability analysis' as "A comparison of a controlled transaction with an uncontrolled transaction or transactions."

According to Rule 10A(a), "uncontrolled transaction" means a transaction between enterprises other than associated enterprises, whether resident or non-resident. When an uncontrolled transaction has been entered into, it could be said that it has been contracted under "uncontrolled conditions". An uncontrolled transaction can be between:

- a resident and a non-resident; or
- a resident and a resident; or
- a non-resident and a non-resident.

8.1 Indian TP Regulations

8.1.1 As per Indian TP Regulations, an uncontrolled transaction shall be comparable to an international transaction / SDT if:

- 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
- reasonably accurate adjustments can be made to eliminate the material effects of such differences.

8.1.2 The following factors should be taken into account while conducting comparability analysis of an international transaction / SDT with an uncontrolled transaction:

- The specific characteristics of the property transferred or services provided in either transaction;
- The functions performed, taking into account assets employed or to be

employed and the risks assumed, by the respective parties to the transactions;

8.2 Database

Indian Database

To search comparable companies in India, generally three public databases are available:

The commonly used Indian database is 'Prowess'[13], 'Capitaline Plus'[14] and 'ACE TP'[15] which contain robust data of more than 50,000 companies. The Indian tax authorities also rely on these databases while doing comparability analysis.

Foreign Database

There are number of foreign database available for analysis. The commonly known databases are One Source[16], Lexis-Nexis[17], Royaltystat[18], Standard & Poor's Research – North American Database, ORBIS[19], OSIRIS[20], Amadeus[21], KTMINE, Bloomberg, Loan Connector etc. Mostly foreign databases are not generally used by taxpayer because it does not have information of Indian companies.

To ensure comparability of companies in public database with the tested party, various quantitative and qualitative filters are applied. These are explained below:

8.3 Certain filters applied in conducting the comparability analysis:

The following filters are generally applied while conducting comparability analysis:

13 Prowess is a database of the financial performance of Indian companies from Centre for Monitoring Indian Economy Pvt Ltd. (CMIE)
14 Capitaline is a digital corporate database of Indian listed, unlisted and subsidiary Companies providing fundamental and market data
15 ACETP Online is an Indian database application for comparing company financial information of Indian business entities for transfer Pricing.
16 https://tax.thomsonreuters.com/products/brands/onesource/onesource-transfer-pricing/
17 http://www.lexisnexis.com/
18 https://www.royaltystat.com/
19 https://orbis.bvdinfo.com/
20 https://osiris.bvdinfo.com/
21 http://amadeus.bvdinfo.com

8.3.1 Selection of the industry

The first step involves identifying the industry in which the tested party operates. E.g. a company engaged in manufacture of drugs shall primarily conduct its search in pharmaceutical industry.

8.3.2 Selection of the financial period

The Finance Minister in his budget speech 2014 had provided for the usage of multiple year data. The CBDT in October 2015 published a notification[22] releasing the final rules for the use of range concept and multiple year data.

- **Range concept**
  - The range concept is applicable for all the methods except for PSM & Other Method.
  - The range concept can be applied only if six or more comparables are available. If numbers of comparable are less than 6 then the arithmetic mean concept will be applicable.
  - The arm's length range shall constitute of the values falling between the 35th & the 65th percentile of the comparable entries that are arranged in ascending order. In case if the price at which the transaction has taken place falls outside the arm's length range, the median value of the comparables shall be considered to be ALP.
- **Multiple Year**

  The data to be used for a comparability analysis relates to the 'financial year' in which the international or the SDT was entered into or data relating to a period not more than two years prior to such financial year. The term 'financial year' has been replaced by the term 'current year'.

  Further, it has been mentioned that where RPM, CPM or TNMM is used as MAM for the determination of ALP of IT and SDT entered on or after 1 April

22 CBDT Notification No 83/2015 dated 19 October 2015

2014, comparability will be conducted based on

- Data relating to current year or
- Date relating to financial year immediately preceding the current year if data relating to current year is not available at time of furnishing return of income
- Multiple Year data will be considered for computation of ALP irrespective of the fact whether the range concept is applicable or not.

However it has also been provided that, during the assessment proceedings if the data relating to current year becomes available, the same shall be considered irrespective of the fact that such current year data was not available at the time of furnishing of return of income.

8.3.3 Turnover filter

The turnover filter is to be applied to ensure that only the companies which are operating at the similar level of activity as the tested party are selected as comparables. As such a suitable range of turnover has to be considered.

8.3.4 Manufacturing/trading filter

This filter is applied to ensure that the companies selected are engaged in the same function as the tested party. E.g. If the tested party is a manufacturing company, companies having income mainly from manufacturing activity to be considered.

8.3.5 Negative net worth filter

The companies having negative net worth in the year in which the international transaction is entered should be rejected since companies having negative net worth are considered to be abnormal in nature. E.g. If the international transaction has taken place in FY 2016-17, companies having negative net worth in FY 2016-17 should be rejected.

8.3.6 Companies incurring Consistent losses/High profit making

The companies which have incurred consistent losses say for more than 2 years

should be rejected since consistent loss making companies are not considered as having normal business operations. E.g. If the international transaction has taken place in FY 2016-17, companies incurring losses in FY 2014-15, 2015-16 and 2016-17 may be rejected. The Indian tax authorities tend to reject loss-making companies but do not follow the same approach for high profit making companies. With the introduction of the range concept, some of these issues automatically may be addressed

8.3.7 Related party transactions

As per the Indian TP Regulations, comparison is to be made with the companies having uncontrolled transactions. Therefore, companies having significant related party transactions should be rejected. E.g. Companies having related party transactions more than, say, 25% of total revenue may be rejected.

8.3.8 Functionally non-comparable

Finally, companies which are functionally not comparable to the tested party or companies for which sufficient information is not available regarding business activity should be rejected.

After applying the above filters, companies which are obtained would be the companies which are functionally comparable to the tested party.

8.4 Adjustments for Comparability Analysis

8.4.1 To ensure comparability of an international transaction / SDT with an uncontrolled comparable transaction, many adjustments may have to be made such as adjustments for difference in working capital, risk profile of entities, capacity utilization, etc.

8.4.2 The Indian TP regulations explicitly require that adjustments to prices/margins should be made to enhance the reliability of comparability analysis for the computation of arm's length price, yet they give limited guidance on the methodology to be adopted. Hence, guidance can be obtained from OECD guidelines, US TP regulations and Indian judicial Rulings.

8.4.3 Under Rule 10B(3) of the rules, an uncontrolled transaction shall be comparable to an international transaction if:

- None of the differences, if any ,between the transaction 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
- Reasonable accurate adjustments can be made to eliminate the material effects of such differences.

Indian courts have held the view that economic adjustments, wherever required, should be made to enhance comparability. The OECD has emphasized that one of the two conditions that should be met is that reasonably accurate adjustments can be made to eliminate the material effects of differences between the tested party on the one hand & comparables on the other. It has been emphasized that comparability adjustments should be considered if (and only if), they are expected to increase the reliability of the results.

8.4.4 Further, the Indian Courts have consistently taken a view that adjustments should be made for differences in working capital, risk profile of entities, capacity utilization, etc. In this respect, it is important to note that in Mumbai Tribunal in the case of **Maersk Global Centres (India) (P.) Ltd. Vs. ACIT** [2014] (43 taxmann.com 100) it was held that a relatively equal degree of comparability can be achieved by taking into consideration the functional profile of the tested party and comparing the same with the entities selected as potential comparables on broad functional analysis taken at ITES level. The principal functions performed by the tested party should be identified and the same can be compared with the principal functions performed by the entities already selected to find out the relatively equal degree of comparability. If it is possible by this exercise to determine that some uncontrolled transactions have a lesser degree of comparability than others, they should be eliminated. The examination of controlled transactions ordinarily should be based on the transaction actually undertaken by the AE and the actual transaction should not be disregarded or substituted by other transaction.

8.4.5 Further, the Delhi Tribunal, in the case of **Mentor Graphics (Noida) P. Ltd. v. DCIT**

[2007](109 ITD 101)(TDEL), has allowed adjustment on account of differences in working capital, risk profile, etc. The relevant extract of the observation of the Delhi Tribunal is given below:

"27. After the selection of the comparables..... Depending on facts of the case, final set of comparables may need to eliminate differences by making adjustments for the following:

(a) working capital.

(b) adjustment for risk and growth.

(c) adjustment of Research and Development ('R&D') expenses....."

8.4.6 Further, the Bangalore Tribunal in the case of **Philips Software Centre Private Ltd. v. ACIT** [2008](119 TTJ 721) (TBAN) has held as under:

"(ix) Adjustment needs to be made to the margins of the comparables to eliminate differences on account of different functions, assets and risks. More specifically, adjustment needs to be made for:

(a) Differences in risk profile

(b) Difference in working capital position

(c) Differences in accounting policies"

8.4.7 Further, Hon'ble Mumbai High Court in the case of J.P. Morgan India Private Limited for AY 2002-03 held that when there are differences between functions performed and risk with respect to transactions between related party and unrelated party then only after making appropriate adjustments to the rates charged by the assessee to the related and unrelated parties, the CUP method can be used

8.4.8 Working Capital Adjustment

Working capital adjustments should be utilized when a tested party exhibits different working capital intensities relative to a set of comparables. This is illustrated through two key areas of working capital adjustments:

i. Inventory and accounts receivable adjustments; and

ii. Accounts payable adjustments

If our tested party, a distributor for illustrative purposes, has a lower intensity of accounts receivable or inventories to sales relative to a set of comparables, then this would imply that the comparables in question were providing its' customers with a valuable function that should be compensated through higher prices. To correct for the fact that the given comparables are performing more value added functions than the tested party, the returns given by the comparables must be adjusted downward in order to assign the tested party with an accurate profit margins. If, on the other hand, the comparables in question have higher levels of accounts payable to sales relative to our tested party, then this would suggest that these comparables were receiving a valuable financing function from their suppliers and would likely be charged a higher price. In order to improve comparability, the returns given by the comparables must be adjusted upward in order to assign the tested party with a more reliable return. The OECD Guidelines on page 329 provides an illustration of working capital adjustment, the same maybe referred to in order to carry out an adjustment.

8.4.9 Risk Adjustment

The need for risk adjustment is based on the fundamental principle that the profits in the market place are a function of the risk assumed. This implies that two enterprises with different risk profiles would have different profitability levels. Adjustment for differences in the risk profile is one of the most complex and highly debatable issues.

The OECD guidelines recognize the need for adjustments on account of differences in risk profile. In this regard, the relevant extract of OECD Guidelines is given below:

"1.45 Controlled and uncontrolled transactions and entities are not comparable if there are significant differences in the risks assumed for which appropriate adjustments cannot be made. Functional analysis is incomplete unless the material risks assumed by each party have been considered since the assumption or allocation of risks would influence the conditions of transactions between the

associated enterprises. Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised.

1.46 The types of risks to consider include market risks, such as input cost and output price fluctuations; risks of loss associated with the investment in and use of property, plant, and equipment; risks of the success or failure of investment in research and development; financial risks such as those caused by currency exchange rate and interest rate variability; credit risks; and so forth.

1.47 The functions carried out (taking into account the assets used and the risks assumed) will determine to some extent the allocation of risks between the parties, and therefore the conditions each party would expect in arm's length transactions . For example, when a distributor takes on responsibility for marketing and advertising by risking its own resources in these activities, its expected return from the activity would usually be commensurately higher and the conditions of the transaction would be different from when the distributor acts merely as an agent, being reimbursed for its costs and receiving the income appropriate to that activity. Similarly, a contract manufacturer or a contract research provider that takes on no meaningful risk would usually expect only a limited return.

1.48 In line with the discussion below in relation to contractual terms, it may be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk. If, for example, a manufacturer sells property to an associated distributor in another country and the taxpayer's contract indicates that the distributor assumes all exchange rate risks, in relation to this controlled transaction, but the transfer price appears in fact to be adjusted so as to insulate the distributor from the effects of exchange rate movements, then the tax administrations may wish to challenge the purported allocation of exchange rate risk for this particular controlled transaction.''.

The Bangalore Tribunal in the case of **Philips Software Centre Pvt Ltd V. DCIT** ITA No. 218(BNG)/08, [TS-8-ITAT-2008] provided an adjustment for differences in risk profile by comparing the prime lending rate with the risk free bank rate and provided the difference as an adjustment factor to the taxpayer. Hence, though the need for carrying out necessary adjustment was recognized, the decision applied a "rule of thumb" calculation rather than a scientific analysis or model.

Based on current experience the most commonly used model to effect a holistic "market" risk adjustment is the Capital Asset Pricing Model ('CAPM') wherein beta coefficient has been used as a measure of the market risk.

In almost all cases, the Tribunal has accepted the requirement to make adjustment for differences in risks, there is no clarity on the underlying methology for computation of the adjustment. However, the Delhi Tribunal in the case of **Motorola Solutions India Private Limited v/s ACIT** (ITA No 5637) has accepted CAPM as a valid methodology for undertaking risk adjustment and has advised the Tax authority to use expert advice in order to arrive at an appropriate framework for application of CAPM

8.4.10 Capacity Utilisation Adjustment

The OECD Transfer Pricing Guidelines, prescribe the making of adjustments to eliminate differences in capacity utilization or idle capacity adjustments. Also, Rule 10B (1)(e)(iii) of the Rules stipulates that an adjustment to the net profit margin can be made for "capacity under-utilization".

Capacity under-utilization by enterprises is a factor affecting net profit margin because lower capacity utilization results in higher per unit costs, which, in turn, results in lower profits at a transactional or unit level.

Though the need for capacity adjustment has been appreciated there is at present no authoritative guidance in respect of the same. The Indian tax authorities generally do not allow these adjustments. The main argument of the tax authorities is that reliable information to show that capacity is underutilized viz-a-viz comparables is not available. In a recent decision the Delhi Tribunal in the case of **Claas India Pvt. Ltd.** [TS-371-ITAT-2015], the Tribunal has not only accepted the

need for a capacity utilization adjustment but has in fact treaded a step further and addressed two critical questions in relation to this adjustment, viz.,

(i) whether the adjustment should be made to the tested party or to comparables?;

Accordingly, the Tribunal based on a reading of Rule 10B(1)(e)(iii)in juxtaposition to sub-rules (2) & (3) of Rule10B, held that the net operating profit margin of comparable companies should be adjusted in such a manner so as to bring both the international transaction and comparable cases on the same pedestal, to ensure a meaningful and effective comparison.

(ii) how to compute the adjustment?

The Tribunal stated that the adjustment is called for only in respect of fixed operating costs as variable operating costs remain unaffected due to any under or over utilization of capacity; it stated that fixed operating costs have to be proportionately scaled up or down by considering the percentage of capacity utilization by the assessee and comparable. The judgment explains the adjustment in detail by way of an illustration.

The Mumbai Tribunal in the case of **Petro Aradite Pvt Ltd** (ITA No. 3782/Mum/2011: [2013] 35 taxmann.com 590) discussed and explained a methodology for making capacity adjustment in detail. It held that if the fixed overheads allocation or absorption of comparables was brought to the level of taxpayer, it would nullify the effect of difference in capacity utilization on the profit margin. Thus the Tribunal held that the adjustment on account or difference in capacity utilization can be made by absorbing or allocating fixed overheads such as depreciation at the same level as that of the taxpayer. It also held that such absorption or allocation of fixed overheads would be more appropriate on operating cost instead of sales to eliminate the effect of differences in profit margin or difference in stock of finished goods, if any between the taxpayer and the comparables.

In view of the above, it would be advisable to make adjustments for difference in working capital, risk profile of entities, capacity utilization and functions, etc. on a reasonable basis and furnish the calculation of the same before the tax authorities

(if required) rather than doing it on adhoc basis.

8.5 Certain Issues While Conducting Comparability Analysis

Certain important issues which have arisen while conducting comparability analysis are explained below:

8.5.1 Certain issues in applying turnover filter

Certain issues which generally arise while applying turnover filter are – whether the turnover filter is necessary, whether upper and lower limit is required to be given in turnover filter, what should be the upper and lower limits, etc.

Indian TP Regulations require that the comparable companies should be functionally comparable to the tested party. Accordingly, a view may be taken that very large companies can also be considered as comparable to the tested party having small business if the companies are functionally comparable to the tested party. Application of turnover filter while conducting benchmarking analysis has been a subject matter of controversy and litigation, particularly in case of service-oriented companies, especially in the ITES/software segment. There have been conflicting decisions by the Tribunal on appropriateness of use of turnover filter in the context of service-oriented companies. In some cases, it has been held that there is a direct nexus between the level of operations and the profitability because of economies of scale. There are also conflicting observations as provided by Mumbai Tribunal, in case of Capgemini India P Ltd., the Tribunal observed that the concept of "economy of scale" is relevant for manufacturing and not for service-oriented companies and that there is no linear relationship between margin and turnover of comparables. Similar observations have been made by Mumbai Tribunal in case of Wills Processing Services (I) Pvt. Limited.

The Bangalore Tribunal in the case of **LG Soft India (P.) Ltd. vs. DCIT** [2013] 35 taxmann.com 202 held that the size of the comparable is an important factor in comparability. The Revised Guidance Note issued by ICAI has observed that the transaction entered into by a Rs.1000 crores company cannot be compared with the transaction entered into by Rs.10 crores company and the two most obvious reasons are the size of the two companies and related economies of scale under

which they operate. The TPO's range had resulted in selection of companies as comparable such as Infosys Technologies Limited which was 150 times bigger than that of the assessee. The earlier Bench of the same Tribunal in the case of **Genisys Integrating Systems (India) (P.) Ltd. v. Dy. CIT [2012]**] 20 taxmann.com 715 relying on Dun and Bradstreet's analysis had held that turnover range of INR 1 crore to INR .200 crores is appropriate.

The Mumbai Tribunal in the case of **DCIT vs. M/s Indo American Jewellery Ltd** (2010-TII-24-ITAT-MUM-TP), accepted the contentions of the assessee that the companies having a very low or very high turnover as compared to the turnover of the assessee cannot be selected as comparables.

The Mumbai Tribunal in the case of **DHL Express (India) Private Limited vs. ACIT** [2011] taxmann.com 40 (Mum) held that it is a universal fact that there are lot of differences between the large businesses and small businesses operating in the same field. In case of small business economies of scale are not available and therefore generally less profitable.

Further the Bombay High Court in the case of **CIT vs Pentair Water India (P.) Ltd.** [Tax Appeal No. 18 of 2015, dated 16-9-2015] had affirmed an order of the Tribunal where large companies having huge turnover were to be excluded.

In view of the above judicial decisions and considering the fact that economies of scale do play an important role in determining the profitability of the company, a reasonable turnover range should be applied considering the turnover of the tested party and the availability of the comparable data.

8.5.2 Whether a company having nominal related party transactions should be rejected?

The Indian TP Regulations require comparison with companies engaged in comparable **uncontrolled** transactions. Accordingly, as per the strict interpretation of the law, companies having even a single rupee of related party transactions should be rejected. However, it is generally observed that most of the companies have atleast nominal related party transactions. Hence, question arises as to whether companies having even nominal related party transactions should be rejected.

The Bangalore Tribunal in the case of **LG Soft India (P.) Ltd. vs. DCIT** [2013] 35 taxmann.com 202 , **24/7 Customer.com (P) Ltd v/s Dy CIT** [2013] 140 ITD 344/ [2012] 28 taxmann.com 258 and **Misys Software (I) (P) Ltd v/s Deputy Commissioner of Income-tax, Circle 12 (1)** [2015]56 taxmann.com 332, allowed an entity having related party transactions not exceeding 15% of total revenue as uncontrolled.

While giving the pronouncement the Bangalore followed the decision of Tribunal in the case of Sony India (P.) Ltd. (supra) and the relevant extract of the observations of the Tribunal is given below:

"'We are further of the view that an entity can be taken as uncontrolled if its related party transactions do not exceed 10 to 15% of total revenue. Within the above limit, transactions cannot be held to be significant to influence the profitability of the comparables. For the purpose of comparison what is to be judged is the impact of the related party transactions vis-à-vis sales and not profit since profit of an enterprise is influenced by large number of other factors ...."

The Mumbai Tribunal in the case of **Willis Processing Services (India) (P.) Ltd.** 2013] 30 taxmann.com 350 ruled that 0% related party transaction is an impossible situation and therefore, it is practically not possible to find out a comparable having no related party transaction.

The Hon'ble Delhi High Court in the case of Oracle (OFSS) BPO Services Private Limited for AY 2007-08 held that "RPT filter is relevant and fits in with the overall scheme of a transfer pricing study". Further, the Hon'ble Delhi High Court held that related party transactions by a particular entity in excess of a certain threshold may result in a profit-making capacity that presents a distorted picture. Accordingly, Delhi High Court confirmed the RPT filter of 25% applied by the ITAT.

In practice, generally it is difficult to find comparable companies not having even a single rupee of related party transactions. Hence, depending on the extent of availability of the comparable data, the percentage for related party transactions may be determined. In the absence of sufficient comparable data, related party transactions upto 25% of total revenue may be considered as insignificant.

8.5.3 Whether very high profit making companies / loss making companies can be considered as comparable companies?

It is commonly observed that assessee generally rejects very high profit making companies and tax department rejects loss making companies from the list of comparables. However, question arises as to what is correct– Whether very high profit making companies / loss making companies can be considered as comparable companies?

Further, it is a well-accepted fact that "Higher the risk, higher the returns". Hence, question arises as to whether it is correct to compare a captive service provider which functions in a risk mitigated environment with companies that assume high amount of risk.

Indian TP Regulations require that the comparable companies should be functionally comparable. Accordingly, one may take a view that very high profit making companies and loss making companies should also be considered as comparable if the companies are functionally comparable to the tested party.

The Mumbai Tribunal in the case of **Maersk Global Centres (India) (P.) Ltd. Vs. ACIT** [2014] (43 taxmann.com 100) I ruled that after taking into consideration guidance provided in OECD Guidelines and on analyzing the decisions rendered in Division benches of Tribunals on this issue after taking into consideration inter alia the TP Regulations in India, it can be said that the potential comparables cannot be excluded merely on the ground that their profit is abnormally high as the matter in such case would require further investigation to ascertain the reasons for unusual high profit and in order to establish whether the entities with such high profit can be taken as comparables or not.

The Delhi Tribunal further, in the case of **Adobe Systems India Pvt. Ltd. vs. ACIT** (2011-TII-13-ITAT-DEL-TP), held that exclusion of companies showing super normal comparable profits as compared to other comparables is quite correct.

The Mumbai Tribunal in the case of **Capgemini India (P.) Ltd. vs. ACIT,** [2013] 33 taxmann.com 5 held that the comparable cases cannot be rejected only on the ground of extremely high profit or loss and in case if the companies satisfy the

comparability criteria, and do not involve any abnormal business conditions, the same cannot be rejected only on the ground of loss or high profit. The OECD guidelines also provide that loss making uncontrolled transactions should be further investigated and it should be rejected only when the loss does not reflect the normal business conditions, thus, the comparable could not be rejected on the sole basis of loss.

Further, in the case of **Brigade Global Services Pvt. Ltd. vs. ACIT** [2013] 33 taxmann.com 618 (Hyderabad – Trib.], the Bench of Hyderabad Tribunal held that only companies incurring 'abnormal / continuous' losses to be excluded from list of comparables, comparable incurring loss in ordinary course of business can be considered.

In view of the above, it would be sensible to look into the functional aspects of the companies. If the margin earned by the uncontrolled company is on the extreme low or extreme high side, it would be advisable to do an in depth analysis for the reasons of such extreme margins and if such extreme margins are due to abnormal reasons, such company may be rejected. In short, the decision has to be taken based on the FAR analysis of the company and the relevant economic and commercial factors responsible for the outcome rather than merely looking at the outcome or profitability.

Chapter 9 Documentation Requirements

9.1 Indian Transfer Pricing regulations prescribe robust documentation requirements. As per Section 92D of the Act, every person who has entered into an IT / SDT shall require to keep or maintain document in respect thereof. As per Rule 10D(2), if the aggregate value of IT exceeds INR. 1 crore, assessee is mandatorily required to keep and maintain the prescribed information and documents. In a case where the aggregate value as recorded in the books of accounts, of IT entered into by the assessee does not exceed INR 1 crore (INR 10 million), the information and documents as specified is not required to be maintained.

In case of SDTs, if the aggregate value of transactions is INR 20 crores (INR 200 million) or more, the assessee is mandatorily required to keep and maintain prescribed documentation. However, the assessee shall be required to substantiate, on the basis of material available with him, that the income arising from IT / SDT entered into by him has been computed in accordance with section 92 of the Act.

9.2 Mandatory Documentation – Local File

Rule 10D of the Income Tax Rules, 1962 prescribes detailed information and documentation that has to be maintained by the assessee relating to IT/SDTs undertaken with AEs or related parties. The Indian transfer pricing regulations provide for 13 items of mandatory documents and additional 7 items of supporting documentation which inter alia include:

Rule	Description
10D(1)(a)	A description of the **ownership structure** of the assessee enterprise with details of shares or other ownership interest held therein by other enterprises
10D(1)(b)	A **profile of the multinational group** of which the assessee enterprise is a part along with the name, address, legal status and country of tax residence of each of the enterprises comprised in the group with whom international transactions have been entered into by the assessee, and ownership linkages among them
10D(1)(c)	A broad **description of the business** of the assessee and the industry in which the assessee operates, and of the business of the associated enterprises with whom the assessee has transacted

Rule	Description
10D(1)(d)	The **nature and terms (including prices)** of IT/SDT entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction
10D(1)(e)	A description of the **functions performed, risks assumed and assets employed** or to be employed by the assessee and by the associated enterprises involved in the IT/SDT
10D(1)(f)	A record of the **economic and market analyses, forecasts, budgets or any other financial estimates** prepared by the assessee for the business as a whole and for each division or product separately, which may have a bearing on the IT/SDT entered into by the assessee
10D(1)(g)	A record of uncontrolled transactions taken into account for analysing their **comparability** with the international transactions entered into, including a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the IT/SDT
10D(1)(h)	A record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant IT/SDT
10D(1)(i)	A description of the methods considered for determining the arm's length price in relation to each IT/SDT or class of transaction, the method selected as **the most appropriate method** along with explanations as to why such method was so selected, and how such method was applied in each case
10D(1)(j)	A record of the actual working carried out for determining the arm's length price, including details of the **comparable data and financial information** used in applying the most appropriate method, and adjustments, if any, which were made to account for differences between the IT/SDT and the comparable uncontrolled transactions, or between the enterprises entering into such transactions
10D(1)(k)	The assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's length price
10D(1)(l)	Details of the **adjustments**, if any, made to transfer prices to align them with arm's length prices determined under these rules and consequent adjustment made to the total income for tax purposes
10D(1)(m)	Any other information, data or document, including information or data relating to the associated enterprise, which may be relevant for determination of the arm's length price

9.3 Documentation – Master File

Refer Chapter 12.

9.4 Time Limit for Maintenance of Documentation

The documentation should be retained for a period of 8 years from the end of the Assessment Year to which the transaction relates. During the assessment proceedings, the Transfer Pricing Officer (TPO) may require assessee to furnish any of the information and documents specified under the Transfer Pricing regulations within a period of 30 days from the date of receipt of notice issued to the assessee and such period may be further extended, but not exceeding 30 days.

9.5 Furnishing of Return of Income and Accountant's Report

Every person who has entered into an international transaction / SDT with AEs is required to obtain a report in Form No. 3CEB from a Chartered Accountant and furnish the same to the tax authorities on or before the due date i.e. 30 November each year. The due dates prescribed are the same due dates which are prescribed for submitting income tax returns. From AY 2013–14 and onwards, online filing of Form No. 3CEB has been made mandatory.

9.6 Certain Issues on Maintaining the Documentation

9.6.1 Documentation should be 'contemporaneous' and to be kept by 'due date'

Indian Transfer Pricing Regulations require that the information and documentation maintained by the taxpayer should be contemporaneous and should exist latest by the due date of filing of return of income.

Oxford dictionary defines the term "contemporaneous" as "Existing or occurring in the same period of time". Hence, one can take a view that while conducting the benchmarking process, the data of comparables should relate to the same period in which the international transactions / SDTs have taken place and that the benchmarking process should be completed latest by the due date of filing of return of income.

9.6.2 Whether all the documents stated in Rule 10D are required to be maintained by the assessee?

The Indian TP Regulations require the taxpayer to maintain a prescribed set of information and documentation to prove that the international transactions entered by the taxpayer are at ALP. However, the question arises as to whether the taxpayer is required to maintain each and every document prescribed in Rule 10D.

In this respect, it is to be noted that in the case of Cargill India Pvt. Ltd. vs. DCIT (2008-TIOL-94-ITAT-DEL), the Delhi Tribunal held that only documentation which has a bearing on the international transaction are required to be maintained and taxpayer cannot be penalized for not maintaining all the documents stated in Rule 10D if they are not relevant for determining the ALP of the international transactions undertaken by the taxpayer.

In view of the above, it is important that the assessee should maintain robust documentation to prove that the international transactions entered with the AEs are at arm's length price. The primary burden to prove that the international transactions are at arm's length price is on the assessee.

Chapter 10 Penalties

Indian Transfer Pricing regulations prescribe stringent penalties for various defaults which are summarized below:

Sections under IT Act	Particulars of Default	Quantum of Penalty
271AA	Failure to keep and maintain information and documents as required by section 92D(1) and (2). Fails to report such transaction which he is required to do so; or Maintains or furnishes an incorrect information or document	2% of value of each IT / SDT
Section 271AA	Fails to furnish the information and the documents as required under sub-section (4) of Section 92D i.e. Master File	INR 500,000
271G	Failure to furnish information or documents as required by section 92D(3)	2% of the value of IT / SDT for each such failure
271BA	Failure to furnish accountant's report as required by section 92E (i.e. Form No 3CEB)	INR 100,000
271J	Furnishing of incorrect information in any report or certificate by an accountant or merchant banker or a register valuer	INR 10,000
Section 271GB	**Non-furnishing of the CbCR Report**	
	(a) Default not more than one month	INR 5,000 per day
	(b) Default more than one month	INR 15,000 per day for period exceeding 1 month

Sections under IT Act	Particulars of Default	Quantum of Penalty
	(c) Default even after service of order levying penalty under either (a) or (b) above	INR 50,000 per day continuing default beyond the date of service of penalty order
Section 271GB	**Timely non-submission of information and documents before prescribed authority with respect to CbCR**	
	(a) timely non-submission of information before prescribed authority when called for	INR 5,000 per day
	(b) Default even after service of order levying penalty under (a) above	INR 50,000 per day continuing default beyond the date of service of penalty order
271(1)(c)	Deliberately concealment of particulars of income or furnishing inaccurate particulars thereof. (Applicable till AY 2016-17)	Minimum – Amount of tax sought to be evaded; Maximum – 3 times the minimum; in addition to tax, if any, payable
270A	Under-reporting or mis-reporting of Income (Applicable from AY 2017-18)	When the "under-reporting" is not because of misreporting, the penalty would be 50% of tax payable on the under-reported income. When the "under-reporting" is because of misreporting, the penalty would be 200% of the tax payable on the under-reported income.

Chapter 11 Transfer Pricing Assessment Procedure

Transfer pricing litigation has been a major concern for the taxpayers in India. Further, since transfer pricing audits have resulted in huge tax demands in India, the same as cause a dispute between the Indian Revenue Authorities and tax payers.

Government is trying its best to get the transfer pricing regulations in coherence with the best global practices. Government has come up with different various operational and procedural guidelines for transfer pricing assessment.

11.1 Reference to Transfer Pricing Officer

11.1.1 Section 92CA(1) provides that where any person being the assessee, has entered into an IT or SDTs in any previous year, and the assessing officer considers it necessary or expedient so to do, he may with the prior approval of the Principal Commissioner or Commissioner, refer the computation of ALP in relation to the said IT / SDTs to the TPO.

11.1.2 CBDT vide instruction 3/2016 dated 10th March, 2016 has issued guidelines for implementation of transfer pricing provisions by replacing instruction no 15/2015. The said guidelines are applicable for both IT as well as SDT. The key features of the guidelines are as under:

Selection Criteria	Action to be taken
All cases selected under Computer Assisted Scrutiny Selection (CASS) system or under the compulsory manual selection system	Mandatorily referred to the TPO by the AO after obtaining approval of the PCIT or CIT.
All cases selected under non-transfer pricing risk parameters Referred to the TPO only in the following circumstances:	Where the taxpayer has entered in to and IT or SDT, however the taxpayer has not filed Form No. 3CEB or has not disclosed all the IT's or SDT's in the report so filed.
	Where there has been a transfer pricing adjustment of INR 10 crores or more in any earlier assessment year which has been upheld by the judicial authorities or is pending in appeal.

Selection Criteria	Action to be taken
	Where, in the search and seizure or survey operations, findings have been recorded by the investigation wing or AO regarding transfer pricing issues.

11.1.3 In other situations, the AO shall provide an opportunity of being heard to the assessee before referring the case to the TPO. In case, the assessee objects to the reference, the AO shall pass a speaking order for either accepting or rejecting of objections and take the prior approval of PCIT or CIT before making reference to the TPO.

11.1.4 After receiving reference from AO, the TPO shall serve a notice on the taxpayer requiring him to produce or cause to be produced, any evidence on which taxpayer may rely in support of the computation made by him of the arm's length price in relation to the ITs /SDTs.

11.1.5 If any other IT/SDT not reported in Form No. 3CEB comes to the notice of the TPO during the course of assessment proceedings, the provision of section 92CA shall also apply to such transactions. This is pursuant to the insertion of sub-section (2B) in section 92CA by Finance Act, 2012 with retrospective effect from 1 June, 2012.

The Chennai Tribunal In the case of **Ford India (P.) Ltd. vs. DCIT** [2013] 34 taxmann.com 50 held that the TPO can consider international transactions not reported by the assessee but coming to his notice during proceedings before him.

11.1.6 The TPO shall pass a speaking order incorporating the relevant documents like data used, reasons for arriving at certain price and the applicability of method.

11.1.7 For administering the TP regime in an efficient manner. AO has no power to determine ALP in respect of cases which are not referred to the TPO and must record in the body of assessment order, due to board instruction on this matter, the transfer pricing issues has not been examined at all.

Order of the AO / TPO

11.1.8 The TPO shall determine the ALP and send a copy of his order in writing to the AO

and to the assessee. On receipt of the order of the TPO, the AO shall proceed to compute the total income of the assessee in **conformit**y with the ALP determined by the TPO. The AO shall, thereafter forward the draft assessment order ('draft order') to the assessee for his objections.

11.1.9 The assessee can opt to accept the draft order issued by the AO within 30 days of the receipt of the draft order and file appeal before CIT(Appeal) within 30 days of the receipt of final order from the AO. Alternatively, the assessee can file his objections against the draft order before the Dispute resolution Panel ('DRP') and AO within 30 days of the receipt of the draft order.

Note: The AO is required to pass the Final Assessment Order within 1 month from the end of the month in which,-

(i) the acceptance is received from the assessee; or

(ii) the period of filing of objections (i.e. 30 days from receipt of the draft order) expires.

Time-limit for completion of Assessment

11.1.10 The Finance Act, 2016 has substituted Section 153 of the Act w.e.f 1st June, 2016 with regard to time limit for completion of assessment. The said time limit is changed from three years to thirty-three months from the end of the relevant assessment year i.e. the time limit for completion of assessment is reduced by three months. Resultantly, transfer pricing assessment is now required to be completed by end of October instead of January.

11.1.11 The Finance Act 2017 further reduced the time limit for completion of assessment from thirty-three months to thirty months for AY 2018-19 and to 24 months for AY 2019-20 respectively.

11.1.12 The Finance Act, 2016 has also proposed to amend sub-section (3A) of section 92CA to extend time limit in cases where assessment proceedings are stayed by any court or where a reference for exchange of information has been made by the competent authority and time available to TPO for making an order after excluding the time for aforesaid is less than sixty days, then the remaining period for passing

an order shall be extended to sixty days.

11.2 Dispute Resolution Panel (DRP)

11.2.1 Finance (No.2) Act, 2009 inserted section 144C which provided for an alternate dispute resolution mechanism vide setting up of a DRP with the intent to facilitate expeditious resolution of disputes on a fast track basis. The DRP operates as a collegium constituted by the CBDT– comprising of 3 PCITs/CITs.

11.2.2 As per the Indian TP regulations, the DRP shall issue directions for the guidance of the AO to enable him to complete the assessment. Such directions need to be issued within 9 months from the end of the month in which the draft order is forwarded by the AO to the assessee.

11.2.3 DRP has the power to confirm, reduce or enhance the variations proposed in the draft order but cannot set aside any proposed variation or issue direction for further enquiry.

11.2.4 DRP cannot leave adjudication of issue with tax authority by directing them to pass order of assessment by conducting further inquiry.

The decision of DRP is to be based on opinion of the majority of members. The order passed by the AO, after considering the DRP directions, is appealable before the ITAT which is to be filed within 60 days of receipt of the AO order.

11.2.5 The Finance Act, 2012 inserted a new explanation to section 144C(8) with retrospective effect from 1 April 2008. The explanation provides that the power of the DRP to enhance the variation shall include and shall be deemed always to have included the power to consider any matter arising out of the assessment proceeding relating to the draft order, notwithstanding that such matter was raised or not by the eligible assessee.

11.2.6 Pursuant to the amendments made by Finance Act, 2012 by inserting sub-section (2A) and (3A) under section 253, with effect from 1 July 2012, the AO was empowered to file appeal before the Tribunal against an order passed in pursuance and directions of the DRP.

11.2.7 In order to minimize litigation, the Finance Act 2016 has omitted subsection (2A) and (3A) of section 253 retrospectively to do away with the filing of appeal by the AO against the order of DRP.

11.3 Whether order passed by the AO pursuant to GAAR provisions under section 144BA is appealable before DRP?

11.3.1 The Finance Act, 2013 as amended w.e.f. 1 April 2016 (FY 2015-16) has provided under section 144C(14A) that the assessment / reassessment order passed by AO with the prior approval of the PCIT/CIT pursuant to GAAR provisions (as per section 144BA) shall not be appealable before the DRP. The appeal in such case shall lie before the ITAT.

11.4 Whether DRP is required to pass a speaking order after considering the submissions of the assessee?

11.4.1 It has been observed that the directions issued by the DRP in many cases are not speaking one and are even without considering the submissions of the assessee. Hence, question arises as to whether DRP has to pass a speaking order after considering the submissions made by the assessee before DRP.

11.4.2 In this respect, it is to be noted that the Delhi High Court in the case of **Vodafone Essar Ltd. vs. DRP-II & Others** (2010-TII-HC-DEL-INTL), held that when a quasi-judicial authority deals with an issue, it is obligatory on its part to ascribe cogent and germane reasons as the same is the heart and soul of the matter and further, the same also facilitates appreciation when the order is called in question before the superior forum. The Delhi High Court remanded the matter to the DRP for fresh adjudication.

11.4.3 The Chennai Tribunal further in the case of **SCM Microsystems (India) (p.) ltd. Vs. ACIT** [(2012) 21 taxmann.com 264 held that DRP has to pass a speaking order stating that all the objections of the taxpayer and disposing them by giving cogent reasons for adjudication of the objections.

11.4.4 Further, the Delhi Tribunal in the case of Gap International **Sourcing India Pvt. Ltd. vs. DCIT** (2010-TII-59-ITAT-DEL-TP), held that the DRP needs to pass a speaking order

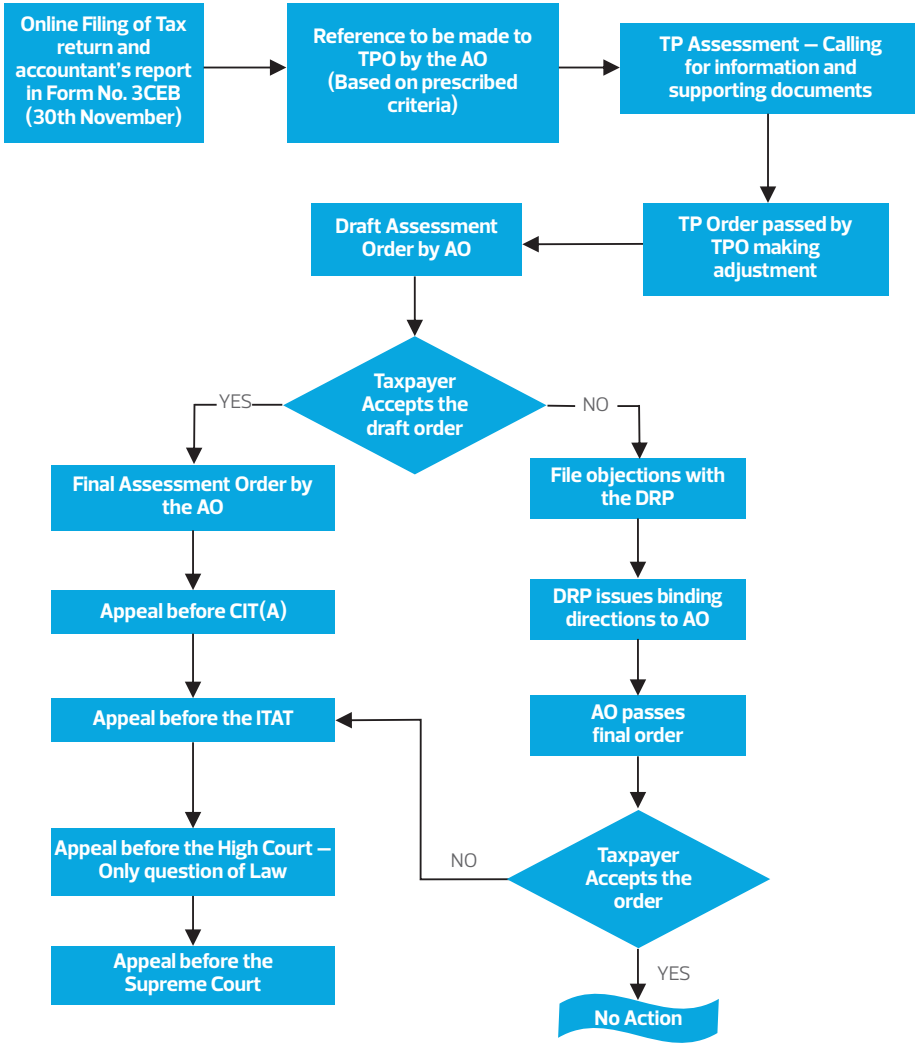
after taking into account the objections raised by the assessee. The relevant extract of the observations of the Tribunal is given below:

"As against the above provisions of the Act here the DRP has passed a very laconic order. Ld. counsel of the assessee contended that voluminous submissions have been made before the DRP against the draft assessment order. But the DRP has brushed aside everything without even a whisper of the assessee's objections and the submissions of the assessee. Under the circumstances, in our opinion, the directions of the DRP are too laconic to be left uncommented. The directions given by the DRP almost tantamount to supervising the Assessing Officer's draft order and in that sense it can be equated that appellate jurisdiction being exercised."

The matter was remitted to the file of DRP to consider the issue once again and pass a proper and speaking direction u/s 144C of the Act after giving assessee an adequate opportunity of being heard.

The above judicial pronouncements make it amply clear that the DRP is required to pass a speaking order after considering all the submissions made by the assessee before the DRP.

11.5 Litigation Process in India



PART C

SIGNIFICANT DEVELOPMENTS

Chapter 12 BASE EROSION AND PROFIT SHIFTING (ACTION PLAN 13)

12.1 Overview

12.1.1 The integration of national economies and market has increased substantially in recent years putting a strain on the international taxes, which were devised many years ago. Weaknesses in the current roles create opportunities for Base Erosion and Profit Shifting ('BEPS') requiring bold moves by policy makers to restore confidence in the system and ensure that the profits are taxed where economic activities take place and value is created. Accordingly, OECD and G20 countries adopted a 15-point action plan to address BEPS. The G20 along with OECD agreed to implement recommendations of BEPS project.

12.1.2 With a view to align the existing Indian Transfer Pricing regulations pertaining to maintenance of documentation, the Finance Act, 2016 has adopted BEPS Action Plan 13 for **Transfer Pricing Documentation and Country-By-Country ('CbC')** reporting by introducing an amendment to section 92D and inserting a new section 286 to the Income-tax Act, 1961 ('the Act'). These provisions will be effective from the Assessment year 2017-18 (financial year commencing 1 April 2016) and subsequent assessment years.

12.1.3 BEPS Action Plan 13 requires the development of *"rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNEs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template"*.

12.2 BEPS Action Plan 13 – Transfer pricing documentation and Country-by-Country Reporting

12.2.1 The G20 / OECD have agreed on very significant changes to the compliance and reporting of global information for risk assessment and transfer pricing purposes. The **OECD Report** on **BEPS Action Plan 13** provides for revised standards for transfer pricing documentation and a template for **CbC reporting** of income, earnings, taxes paid and certain measure of economic activity.

A three-tiered structure has been mandated consisting of:

- a Master File containing standardized information relevant for all MNE group members;
- a Local File referring specifically to material transactions of the local taxpayer; and
- a CbC report containing certain information relating to the global allocation of the MNE's income and taxes paid together with certain indicators of the location of economic activity within the MNE group.

12.2.2 There are three objectives of transfer pricing documentation are:

- to ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and other conditions for transactions between associated enterprises and in reporting the income derived from such transactions in their tax returns;
- to provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment; and
- to provide tax administrations with useful information to employ in conducting an appropriately thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction, although it may be necessary to supplement the documentation with additional information as the audit progresses.

12.2.3 As per BEPS Action Plan 13, following **contents recommended by the OECD** for maintenance of information/ documentation under three tier transfer pricing documentation approach:

A. Contents of Master File

The report requires businesses to prepare a transfer pricing Master File providing a high-level overview of the MNE's global operations along with an overview of the group's transfer pricing policies. The Master File requirements include:

- Legal ownership structure chart, including geographies;
- Description of the business, including drivers of profit, supply chain for 5 large products/service offerings plus other products or services amounting to more than 5% of a MNC's sales, important service arrangements including locations, capabilities, cost allocations and pricing;
- Description of overall strategy for development, ownership and exploitation of intangibles, including of principal R&D facilities and R&D management and details of intangibles related intra-group agreements (including related transfer pricing policies);
- Financing arrangements with third parties, group financing companies and their location and transfer pricing policies; and
- Financial and tax information including annual consolidated financial statements and details of unilateral APAs and other tax rulings relating to income allocation.

The Master File is to be filed locally with tax authorities and it is recommended that the Master File be finalised by the filing date for the tax return of the ultimate parent entity.

B. Contents of Local File

The Local File is required to provide information and support of the intercompany transactions that the local company engages in with related parties. It needs to contain most of the information traditionally included in transfer pricing documentation, though specific additional requirements have been introduced, that include:

- Local Management structure and an organization chart, and disclosure of local management reporting lines;
- Details of intercompany transactions and financial information;
- Copies of material intercompany agreements entered by local entity;

- Detailed functional and economic analysis for the intercompany transactions:
  - With preference for local comparables
  - With search for comparable companies once every three years for same functional profile and annual data
- Details of unilateral/ bilateral/ multilateral APAs, and other rulings 'related to' the transaction of the entity.

The Local File is to be filed locally and it is recommended that it be finalised by the filing date for the local tax return.

C. Country-by-Country ('CbC') report

- **Requirements**

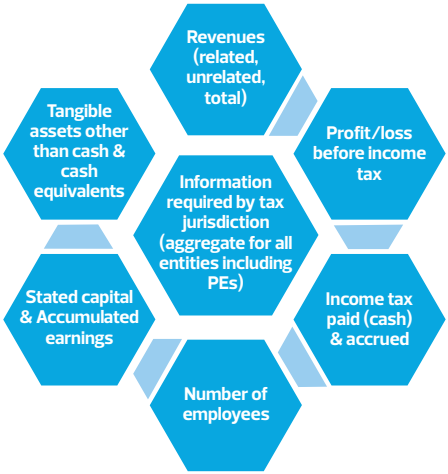
  The CbC report requires each MNE to provide key financial information on an aggregate country basis with an activity code for each member of the MNE. CbC report is a new concept for the international tax world and represents the biggest change to the existing Guidelines. The provision of the CbC report to the tax authorities is a 'minimum standard' requirement, and the report makes clear that countries participating in the BEPS project are expected to commit to and adopt this measure. It will provide tax authorities with global information for the purposes of risk assessment.

  The elements relating to CbC reporting requirement shall apply in respect of an international group having consolidated revenue, based on consolidated financial statements, exceeds the threshold. The current international consensus is for a threshold of €750 million equivalent in local currency.

  The CbC report requires MNEs to report annually and for each tax jurisdiction in which they do business; the amount of revenue, profit before income tax and income tax paid and accrued. It also requires MNEs to report their total employment, capital, accumulated earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs to

identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities of each entity.

The CbC report should set out the specified financial data (diagrammatically represented) as stated below of the Group by tax jurisdiction, in a prescribed template together with a list of constituent entities by country of residence and indication of their activities.



A model template for the CbC Report

Table 1. Overview of allocation of income, taxes and business activities by tax jurisdiction

Name of the MNE group: Fiscal year concerned: Currency Used:										
Tax Jurisdiction	Revenues			Profit (Loss) Before Income Tax	Income Tax Paid (on cash basis)	Income Tax Accrued – Current Year	Stated capital	Accumulated earnings	Number of Employees	Tangible Assets other than Cash and Cash Equivalents
	Unrelated Party	Related Party	Total							

Table 2. List of all the Constituent Entities of the MNE group included in each aggregation per tax jurisdiction

Name of the MNE group: Fiscal year concerned:															
Tax Jurisdiction	Constituent Entities resident in the Tax Jurisdiction	Tax Jurisdiction of organisation or incorporation if different from Tax Jurisdiction of Residence	Main business activity(ies)												
			Research and Development	Holding or Managing intellectual property	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing or Distribution	Administrative, Management or Support Services	Provision of Services to unrelated parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding shares or other equity instruments	Dormant	Other[2]
	1.														
	2.														
	3.														
	1.														
	2.														
	3.														

[2]Please specify the nature of the activity of the Constituent Entity in the "Additional Information" section.

Table 3. Additional Information

Name of the MNE group: Fiscal year concerned:
Please include any further brief information or explanation you consider necessary or that would facilitate the understanding of the compulsory information provided in the country-by-country report.

– **Submission, Exchange and Use**

The CbC is to be filed in the tax jurisdiction of the ultimate parent entity (or nominated surrogate parent entity) and will be exchanged widely by governments, including with many developing countries, via

various sharing mechanisms. If the CbC report is not filed with and shared by the tax jurisdiction of the ultimate parent company (or the nominated surrogate), then companies may be required to file the CbC report locally. The report includes three model competent authority agreements that can be used by tax authorities to facilitate implementation of the exchange of CbC reports. The agreements make it clear that information shared as a result of these agreements must be kept confidential and used appropriately. In particular, the agreements emphasize that the information should not be used as a substitute for detailed transfer pricing analysis of individual transactions based on full functional and comparability analysis, and that transfer pricing adjustments should not be made on the basis of the CbC reporting alone.

– **Timelines**

The CbC report has to be submitted by parent entity of an international group to the prescribed authority in its country of residence. This report is to be based on consolidated financial statement of the group. As per the guidance:

- The first CbC reports will be required to be filed for MNE fiscal years beginning on or after January 1, 2016;
- MNCs will be allowed 1 year from the close of the fiscal year to which the CbC report relates to prepare and file the CbC report, the first CbC report would be filed by 31 December 2017;
- It should be noted that the MNE fiscal year relates to consolidated reporting period for financial statement purposes, not to taxable years or the financial reporting periods of individual group entities;
- The G20/ OECD have provided an XML Schema and a related User Guide to allow for electronic tagging of data in the CbC report to facilitate their exchange electronically. Countries will

be monitored on their implementation of the CbC reporting requirements and associated exchange of information.

- **Signatories of the Multilateral Competent Authority Agreement on the exchange of CbC reports**

The following 68 countries have entered into Multilateral Competent Authority Agreement for exchange of CbCR report.

The list is updated till 19 December 2017[23].

Country Name	Country Name	Country Name	Country Name
Argentina	Denmark	Italy	Pakistan
Australia	Estonia	Japan	People's Republic of China
Austria	Finland	Jersey	Poland
Belgium	France	Korea	Portugal
Belize	Gabon	Latvia	Qatar
Bermuda	Georgia	Liechtenstein	Russian Federation
Brazil	Germany	Lithuania	Senegal
Bulgaria	Greece	Luxembourg	Singapore
Canada	Guernsey	Malaysia	Slovak Republic
Cayman Islands	Haiti	Malta	Slovenia
Chile	Hungary	Mauritius	South Africa
Costa Rica	Iceland	Mexico	Spain
Colombia	India	Monaco	Sweden
Croatia	Indonesia	Netherlands	Switzerland
Curaçao	Ireland	New Zealand	Turks and Caicos Islands
Cyprus	Isle of Man	Nigeria	United Kingdom
Czech Republic	Israel	Norway	Uruguay

23 Source: http://www.oecd.org/ctp/beps/CbC-MCAA-Signatories.pdf

12.3 Introduction of Action Plan 13 in India

12.3.1 Three tier transfer pricing documentation approach under BEPS project adopted by India (BEPS Action Plan 13)

- In keeping with India's commitment to implement the recommendations of Action Plan 13 of BEPS, the Finance Act 2016 has inserted section 286 in the Act to provide a specific reporting regime in respect of CbC reporting and also the Master File.

- The reporting provision shall apply in respect of an international group having consolidated group revenue, based on consolidated financial statements for the accounting year preceding such accounting year, exceeds the threshold. The current international consensus is for a threshold of €750 million equivalent in local currency.

- The parent entity of an international group, if it is resident in India shall be required to furnish the report in respect of the group to the prescribed authority on or before the due date of furnishing of return of income for the Assessment Year relevant to the Financial Year (previous year) for which the report is being furnished;

- The parent entity shall be an entity which is required to prepare consolidated financial statement under the applicable laws or would have been required to prepare such a statement, had equity share of any entity of the group been listed on a recognized stock exchange in India;

- Every constituent entity in India, of an international group having parent entity that is not resident in India, shall provide information regarding the country or territory of residence of the parent of the international group to which it belongs. This information shall be furnished to the prescribed authority on or before the prescribed date;

- The report shall be furnished in prescribed manner and in the prescribed form and would contain aggregate information in respect of revenue, profit & loss before Income-tax, amount of Income-tax paid and accrued, details of

capital, accumulated earnings, number of employees, tangible assets other than cash or cash equivalent in respect of each country or territory along with details of each constituent's residential status, nature and detail of main business activity and any other information as may be prescribed. This shall be based on the template provided in the OECD BEPS Action Plan 13, the prescribed date for filing the CbC report is the due date of filling of return of income for the relevant assessment year for which the report is being furnished;

- An entity in India belonging to an international group shall be required to furnish CbC report to the prescribed authority if the parent entity of the group is resident:
  - where the parent entity is not obligated to file the report ***(inserted in Finance Bill 2018)***
  - in a country with which India does not have an arrangement for exchange of the CbC report; or
  - there has been a systemic failure of that country and the said failure has been intimated by the prescribed authority to such constituent entity
- If there are more than one entities of the same group in India, then the group can nominate (under intimation in writing to the prescribed authority) the entity that shall furnish the report on behalf of the group. This entity would then furnish the report;
- If an international group, having parent entity which is not resident in India, had designated an alternate reporting entity for filing its report with the tax jurisdiction in which the alternate reporting entity is resident, then the entities of such group operating in India would not be obliged to furnish report if the report can be obtained under the agreement of exchange of such reports by Indian tax authorities;
- If any other alternate reporting entity of the international group has furnished the CbC report with the tax authority of their country, there will be no need

for the local constituent entity to furnish the same again locally if the following conditions are satisfied:

- the CbC report is required to be furnished under the local law of that country;
- that country has entered into an agreement with India providing for exchange of the CbC report in respect of the international group;
- that country's prescribed authority has not conveyed any systemic failure in respect of the said country to any constituent entity resident in India;
- the said country or territory has been informed in writing by the constituent entity that it is the alternate reporting entity on behalf of the international group.

- The prescribed authority may call for such document and information from the entity furnishing the report for the purpose of verifying the accuracy as it may specify in notice. The entity shall be required to make submission within 30 days of receipt of notice or further period if extended by the prescribed authority, but extension shall not be beyond 30 days.

12.3.2 Final rules on Master File and Country-by-Country reporting released by CBDT

- CBDT through Finance Act, 2016 amended the Indian Income-tax Act to introduce provisions for additional transfer pricing documentation and CbC reporting to implement the recommendations contained in the Organisation for Economic Co-operation and Development's (OECD's) Base Erosion and Profit Shifting report on Action 13. These provisions were expected to be followed by detailed rules for implementation. Accordingly on 6 October 2017, the Central Board of Direct Taxes ('CBDT') issued draft rules for CbC reporting and the furnishing of the Master File for public comments. Following the submission of public comments from various industry stakeholders, on 31 October 2017, the CBDT issued the final rules for CbC reporting and the furnishing of the Master File (Final Rules). The Final Rules contain a few administrative changes and clarifications. Key highlights of the Final Rules are:

- The contents of the Master File and the CbC report are largely in line with the recommendations specified in Action 13 barring a few additional requirements for the Master File;
- A monetary threshold, based on cumulative conditions of consolidated revenue and the value of international transactions, is prescribed for maintenance of the Master File, while the threshold for CbC reporting is in line with the OECD recommendation;
- Filing of the Master File and CbC report (including notification) would be made electronically in accordance with the specification prescribed by the designated authorities who are also responsible for evolving and implementing appropriate security, archival and retrieval policies;
- The due date for the first year, i.e. FY 2016-17, for Master File compliance, as well as for CbC reporting has been extended to 31 March 2018. For subsequent FYs, the Master File need to be filed on or before the due date for filing the income tax return and CbC report within a period of twelve months from the end of the reporting accounting year ***(inserted in Finance Bill 2018)***;
- A notification regarding the details of the parent entity or the alternate reporting entity (which files CbC report) needs to be filed for every constituent entity resident in India (if its parent entity is not resident in India) at least two months prior to the due date for filing an income tax return. For FY 2016-17, such due date would be on or before 31 January 2018.

- ***Information and documents to be kept and maintained under proviso to sub-section (1) and to be furnished in terms of sub-section (4) of Section 92D of the Act***

  Rule 10DA

  (1) Every person, being a constituent entity of an international group shall,-

(i) if the consolidated group revenue of the international group, of which such person is a constituent entity, as reflected in the consolidated financial statement of the international group for the accounting year, exceeds five hundred crore rupees; and

(ii) the aggregate value of international transactions,–

(A) during the accounting year, as per the books of accounts, exceeds fifty crore rupees, or

(B) in respect of purchase, sale, transfer, lease or use of intangible property during the accounting year, as per the books of accounts, exceeds ten crore rupees, keep and maintain the following information and documents of the international group, namely:–

(a) a list of all entities of the international group along with their addresses;

(b) a chart depicting the legal status of the constituent entity and ownership structure of the entire international group;

(c) a description of the business of international group during the accounting year including,–

(I) the nature of the business or businesses;

(II) the important drivers of profits of such business or businesses;

(III) a description of the supply chain for the five largest products or services of the international group in terms of revenue and any other products including services amounting to more than five per cent. of consolidated group revenue;

(IV) a list and brief description of important service arrangements

made among members of the international group, other than those for research and development services;

(V) a description of the capabilities of the main service providers within the international group;

(VI) details about the transfer pricing policies for allocating service costs and determining prices to be paid for intra-group services;

(VII) a list and description of the major geographical markets for the products and services offered by the international group;

(VIII) a description of the functions performed, assets employed and risks assumed by the constituent entities of the international group that contribute at least ten per cent of the revenues or assets or profits of such group; and

(IX) a description of the important business restructuring transactions, acquisitions and divestments;

(d) a description of the overall strategy of the international group for the development, ownership and exploitation of intangible property, including location of principal research and development facilities and their management;

(e) a list of all entities of the international group engaged in development and management of intangible property along with their addresses;

(f) a list of all the important intangible property or groups of intangible property owned by the international group along with the names and addresses of the group entities that legally own such intangible property;

(g) a list and brief description of important agreements among

members of the international group related to intangible property, including cost contribution arrangements, principal research service agreements and license agreements;

(h) a detailed description of the transfer pricing policies of the international group related to research and development and intangible property;

(i) a description of important transfers of interest in intangible property, if any, among entities of the international group, including the name and address of the selling and buying entities and the compensation paid for such transfers;

(j) a detailed description of the financing arrangements of the international group, including the names and addresses of the top ten unrelated lenders;

(k) a list of group entities that provide central financing functions, including their place of operation and of effective management;

(l) a detailed description of the transfer pricing policies of the international group related to financing arrangements among group entities;

(m) a copy of the annual consolidated financial statement of the international group; and

(n) a list and brief description of the existing unilateral advance pricing agreements and other tax rulings in respect of the international group for allocation of income among countries.

(2) The report of the information referred to in sub-rule (1) shall be in Form No. 3CEAA and it shall be furnished to the Director General of Income-tax (Risk Assessment) on or before the due date for

furnishing the return of income as specified in sub-section (1) of section 139:

*Provided that the information in **Form No. 3CEAA** for the accounting year 2016-17 may be furnished at any time **on or before 31 March, 2018.***

(3) Information in,-

*(i) **Part A of Form No. 3CEAA** shall be furnished by every person, being a constituent entity of an international group, whether or not the conditions as provided in sub-rule (1) are satisfied;*

*(ii) **Part B of Form No. 3CEAA** shall be furnished by a person, being a constituent entity of an international group, in those cases where the conditions as provided in sub-rule (1) are satisfied.*

(4) Where there are more than one constituent entities resident in India of an international group, then the report referred to in sub-rule (2) or information referred to in clause (i) of sub-rule (3),as the case may be, may be furnished by that constituent entity which has been designated by the international group to furnish the said report or information, as the case may be, and the same has been intimated by the designated constituent entity to the Director General of Income tax (Risk Assessment) in Form 3CEAB.

*(5) The intimation referred to in sub-rule (4) shall be made **at least thirty days before the due date of filing the report** as specified under sub-rule (2).*

(6) The Principal Director General of Income-tax (Systems) or Director General of Income-tax (Systems), as the case may be, shall specify the procedure for electronic filing of Form No. 3CEAA and Form No. 3CEAB and shall also be responsible for evolving and implementing

appropriate security, archival and retrieval policies in relation to the information furnished under this rule.

(7) The information and documents specified in sub-rule (1) shall be kept and maintained for a period of eight years from the end of the relevant assessment year.

(8) The rate of exchange for the calculation of the value in rupees of the consolidated group revenue in foreign currency shall be the telegraphic transfer buying rate of such currency on the last day of the accounting year.

Explanation. - For the purposes of this rule,-

(A) "telegraphic transfer buying rate" shall have the same meaning as assigned in the Explanation to rule 26;

(B) the terms 'accounting year', 'consolidated financial statement' and 'international group' shall have the same meaning as assigned in sub-section (9) of section 286.

- ***Furnishing of CbC Report in respect of an International Group***

Rule 10DB

*(1) For the purposes of sub-section (1) of section 286, every constituent entity resident in India, shall, if its parent entity is not resident in India, intimate the Director General of Income-tax (Risk Assessment) in **Form No. 3CEAC**, the following, namely:-*

(a) whether it is the alternate reporting entity of the international group; or

(b) the details of the parent entity or the alternate reporting entity, as the case may be, of the international group and the country or territory of which the said entities are residents.

*(2) Every intimation under sub-rule (1) shall be made **at least two months prior to the due date for furnishing of report** as specified under sub-section (2) of section 286.*

*(3) Every parent entity or the alternate reporting entity, as the case may be, resident in India, shall, for every reporting accounting year, furnish the report referred to in sub-section (2) of section 286 to the Director General of Income-tax (Risk Assessment) in **Form No. 3CEAD.***

(4) A constituent entity of an international group, resident in India, other than the entity referred to in sub-rule (3), shall furnish the report referred to in sub-rule (3) within the time specified therein if the provisions of sub-section (4) of section 286 are applicable in its case.

*(5) If there are more than one constituent entities resident in India of an international group, other than the entity referred to in sub-rule (3), then the report referred to in sub-rule (4) may be furnished by that entity which has been designated by the international group to furnish the said report and the same has been intimated to the Director General of Income-tax (Risk Assessment) in **Form No. 3CEAE.***

(6) For the purposes of sub-section (7) of section 286, the total consolidated group revenue of the international group shall be five thousand five hundred crore rupees.

(7) Where the total consolidated group revenue of the international group, as reflected in the consolidated financial statement, is in foreign currency, the rate of exchange for the calculation of the value in rupees of such total consolidated group revenue shall be the telegraphic transfer buying rate of such currency on the last day of the accounting year preceding the accounting year.

(8) The Principal Director General of Income-tax (Systems) or Director General of Income-tax (Systems), as the case may be, shall specify the procedure for electronic filing of Form No. 3CEAC, Form No. 3CEAD and Form No. 3CEAE and shall also be responsible for evolving and implementing appropriate security, archival and retrieval policies in relation to the information furnished under this rule.

12.3.3 Criteria for applicability of CbC report and Master File

Nature of Document	Criteria	Evaluation Period	Threshold exceeding*
Master File	(i) Consolidated revenue of the international group	Accounting Year	INR 500 Crores (INR 5 billion) (i.e. approx. USD 78.74 million)
	AND		
	ii) A. Value of international transactions of the constituent entity	Accounting Year under consideration	INR 50 Crores (INR 500 million) (i.e. approx. USD 7.87 million)
	OR		
	(ii) B. Value of international transactions involving intangibles of the constituent entity	Accounting Year under consideration	INR 10 Crores (INR 100 million) (i.e. approx. USD 1.57 million)
CbCR	Total consolidated group revenue of the international group	Immediately preceding previous year of the Reporting Accounting Year	INR 5,500 Crores (INR 55,000 million) (i.e. approx. USD 866.20 million)

*Exchange rate considered INR 1 = USD 63.49

12.3.4 Applicable Forms

Form	Description	In relation to	Who needs to file	For FY 2016–17	Subsequent years
Form No. 3CEAA PART A	Every person, being a constituent entity of an international group	Every constituent entity of an international group whether or not it satisfies the cumulative thresholds mentioned in above table		31 March 2018	30 November of the assessment year
Form No. 3CEAA PART B	Constituent entity of an international group, in those cases where the conditions as provided in Rule 10DA(1) are satisfied	Master File	Designated Constituent entity of an international group		
Form No. 3CEAB	Where there are more than one constituent entities resident in India of an international group, then the international group may designate any one constituent entity and the intimation to be filed only by that constituent entity	Master File	Designated Constituent entity irrespective of whether the parent entity is resident in India or not	1 March 2018	31 October of the assessment year

Form	Description	In relation to	Who needs to file	For FY 2016-17	Subsequent years
Form No. 3CEAC	Intimation by a constituent entity, resident in India, for the purposes of section 286 (2) of the Act	CbCR	Constituent entity resident in India but parent entity is non-resident in India	31 January 2018	31 January of the assessment year
Form No. 3CEAD	Report by a parent entity or an alternate reporting entity or any other constituent entity, resident in India, for the purposes of sub-section (2) or sub-section (4) of section 286 of the Act	CbCR	Parent or Alternative reporting entity resident in India	31 March 2018	31st March of the assessment year (i.e. within a period of twelve months from the end of the reporting accounting year)
Form No. 3CEAE	Intimation on behalf of the international group for the purposes of the proviso to sub-section (4) of section 286 of the Act	CbCR	Indian designated constituent entity of the foreign parented group	Due date for filing of intimation by the designated entity is not yet prescribed	Due date for filing of intimation by the designated entity is not yet prescribed

12.4 Certain Aspects

The Indian Master File and CbC reporting Final Rules released by CBDT are broadly in line with OECD guidance on BEPS Action Plan 13. While the Final Rules require the Indian constituent entities to furnish few additional details in the Master File which deviates from the BEPS Action Plan 13 recommendation, it appears that the CBDT

has considered such requirement to be relevant for risk assessment purposes from India perspective.

International groups should focus on the new reporting requirements and should assess readiness as to whether the necessary data is available, what must be done to ensure that data can be sourced and presented in an effective, efficient and clear manner and also analyze how tax authorities are likely to assess such information. Taxpayers will need to adopt a consistent and harmonized approach to preparing their Master File and Local File as well as CbC reporting and be prepared for a more detailed information or document requests during an audit.

12.5 Penalty for failure to furnish report or for furnishing inaccurate report under section 286

Finance Act 2016 has introduced penalty for non-furnishing of the report or furnishing inaccurate report, under which a graded penalty structure namely by inserting section 271GB of the Act and amending section 271AA of the Act. The details have been provided in Chapter 7.

Chapter 13 Secondary Adjustment

13.1 Overview

13.1.1 The Finance Act 2017 introduced some significant changes to the IT Act with the objective of strengthening the anti-abuse measures as well as to align the IT Act with international practices. One of the changes included the introduction of secondary adjustments in the TP regulations. The secondary adjustment rules are an internationally recognized approach and already part of the TP regulations in many leading economies.

13.1.2 Secondary Adjustment means an adjustment in the books of accounts of the assessee and its associated enterprise to reflect that the actual allocation of profits between the assessee 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 assessee. As per the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD transfer pricing guidelines), secondary adjustment may take the form of constructive dividends, constructive equity contributions, or constructive loans. While the approaches to secondary adjustments by individual countries vary, they represent an internationally recognized method to realign the economic benefit of the transaction with the arm's length position and seek to restore the financial situation of the relevant connected parties to an arm's length scenario. In order to align Indian TP regulations with OECD Guidelines and international practices, Finance Act 2017 introduced the "secondary adjustment" provision under section 92CE in the IT Act.

13.2 Meaning of Primary Adjustment and Secondary Adjustment

13.2.1 Primary adjustment is defined to mean determination of the transfer price in accordance with the arm's length principle resulting in an increase in the total income or reduction in the loss, as the case may be, of the taxpayer.

13.2.2 Secondary adjustment has been defined to mean an adjustment in the books of accounts of the taxpayer and its AE to reflect the actual allocation of profits between the taxpayer and its AE consistent with the transfer price determined as a result of primary adjustment.

13.3 Applicability of Secondary Adjustment

13.3.1 The provisions are applicable in cases where the primary TP adjustment to the transfer price:

- has been made suo moto by the assessee in his return of income; or
- has been made by AO and accepted by assessee; or
- is determined by APA entered into by assessee under section 92CC of the Act; or
- is made as per the SHR framed under section 92CB of the Act; or
- is arising as a result of resolution of an assessment by way of mutual agreement procedure (MAP) under agreement entered into under Section 90 / 90A of the Act.

13.3.2 The secondary adjustment provisions require that, where as a result of a primary adjustment to the transfer price, there is an increase in the total income or reduction in the loss of the taxpayer, the "excess money" (i.e. the difference between the arm's length price determined in the primary adjustment and the price at which the international transaction was actually undertaken) which is available with its AE, needs to be repatriated into India within the prescribed time.

13.3.3 In case the "excess money" is not repatriated within the prescribed time, such excess money shall be deemed to be an advance made by the taxpayer to such AE. Further, interest on such advance shall be computed as the income of the taxpayer in the prescribed manner as per Rule 10CB(2) of the Rules.

13.3.4 The above provisions shall not be applicable in the following situations:

- The primary adjustment made is less than INR 1 crore; or
- The primary adjustment relates to FY 2015–16 or prior years.

13.4 Time limit for repatriation of excess money and interest rate pursuant to secondary adjustment

13.4.1 Rule 10CB covers two aspects of computation of interest on secondary adjustment, namely, time limit for repatriation of excess money and imputed per annum interest on excess money. Tabulated below is the interest to be charged in case money is not repatriated within the prescribed time period:

Type of Primary adjustment	Time Limit for repatriation	Applicable Interest rate for imputation for delayed receipts	
		For rupee (INR) denominated transactions	For Foreign Currency denominated transactions
Adjustment made by the Indian Tax Authority and accepted by the taxpayer	On or before 90 days from the date of relevant order	1 year MCLR* + 325 basis points *MCLR of State Bank of India as of 1 April of the relevant FY	6 months LIBOR* + 300 basis points *LIBOR as of 30 September of the relevant FY
Suo-moto adjustment by the taxpayer	On or before 90 days from the due date of filing return of income under Section 139(1) of the Act or (in case of APA, the due date of filing of modified return of income)		
Adjustment pursuant to APA,Safe Harbour or MAP			

PART D

LITIGATION RESOLUTION MECHANISM

Chapter 14 Safe Harbour Rules

14.1 Background

To reduce increasing number of transfer pricing audits and prolonged disputes, the CBDT issued the Safe Harbour Rules ('SHR') on 18 September 2013 under Finance (No.2) Act, 2009 with retrospective effect from 1 April 2009. SHR is covered under section 92CB of the Act and the Rules are comprehended in Rules 10TA to 10TG.

A "safe harbour" is defined in the Act as circumstances in which the tax authority shall accept the transfer price declared by the assessee.

The CBDT, vide notification 46/2017 dated 7 June 2017, has amended the safe harbour rules by extending the applicability to an additional category of international transaction as well revising the applicable price/margins that would be accepted as arm's length. The SHR is effective from assessment year 2017-18, i.e. relevant to the fiscal year, ended 31st March, 2017.

14.2 Who is eligible to apply for SHR?

The SHR mechanism is available only for the following assessee ("**eligible assessee"**):

- Engaged in providing Software Development Services & Information Technology Enabled Services or Knowledge Process Outsourcing services with insignificant risk to foreign principal;
- Has provided corporate guarantee;
- Engaged in providing contract research and development services wholly or partly relating to software development and generic pharmaceutical drugs with insignificant risk to foreign principal;
- Engaged in manufacture and export of core or non-core auto components and where 90% or more of total turnover during the year is in the nature of original equipment manufacturer sales;
- Has issued loan to its AE(s), where the amount of loan is denominated in Indian Rupees (INR) or foreign currency
- Has received low value-adding intra-group services

- Has entered into SDT and is engaged in business of –
  - Supply of electricity, transmission of electricity, wheeling of electricity
  - Purchase of milk or milk products by a co-operative society from its members.

14.3 Revised Safe Harbour Rules for various sectors are prescribed which is tabulated as under:

The taxpayer has the option to opt for the safe harbour under the old rules or the amended rules, whichever is more beneficial.

No comparability adjustment and allowance under second proviso to 92C(2) shall be made to the transfer price declared by the eligible assessee and accepted under the revised SHR.

Where an eligible assessee has entered into an eligible international transaction and the option exercised by the said assessee is not held to be invalid under rule 10TE, the transfer price declared by the assessee in respect of such transaction shall be accepted by the income-tax authorities, if it is in accordance with the circumstances as specified in the table below in respect of the eligible international transaction's:

Sr. No.	Eligible International Transaction	Safe Harbour ratios
1.	Software development services (IT services) and Information Technology Enabled services (ITES), with insignificant risks –	Operating profit margin to operating expenses
	▪ where aggregate value of such transactions ≤ INR 100 crores (INR 1 billion)	▪ ≥ 17%
	▪ Where aggregate value of such transaction > INR 100 crores (INR 1 billion) and ≤ INR 200 crores (INR 2 billion)	▪ ≥ 18%

Sr. No.	Eligible International Transaction	Safe Harbour ratios
2.	Knowledge Process Outsourcing services (KPO Services), with insignificant risk where aggregate value of such transactions ≤ INR 200 crores (INR 2 billion)	Operating profit margin to operating expense ▪ ≥ 24% and the Employee Cost in relation to the Operating Expense is at least 60 % ▪ ≥ 21% and the Employee Cost in relation to the Operating Expense is at least 60 % ▪ ≥ 18% and the Employee Cost in relation to the Operating Expense does not exceed 40%
3.	Intra-group loan to Wholly Owned Subsidiary ('WOS') where the amount of loan is denominated in Indian Rupees (INR). ▪ where the AE has CRISIL[24] credit rating between AAA to A or its equivalent ▪ where the AE has CRISIL credit rating of BBB-, BBB or BBB+ or its equivalent; ▪ where the AE has CRISIL credit rating between BB to B or its equivalent; ▪ where the AE has CRISIL credit rating between C to D or its equivalent; or ▪ where credit rating of the AE is not available and the amount of loan advanced to the AE including loans to all AE in Indian Rupees does not exceed a sum of Rs 100 crore in the aggregate as on 31st March of the relevant previous year.	The interest rate declared in relation to the eligible international transaction is not less than the six-month London Inter-Bank Offer Rate of the relevant foreign currency as on 30th September of the relevant previous year plus, – ▪ 150 basis points ▪ 300 basis points ▪ 450 basis points ▪ 600 basis points ▪ 400 basis points

24 CRISIL (formerly Credit Rating Information Services of India Limited) is a global analytical company providing ratings, research, and risk and policy advisory services

Sr. No.	Eligible International Transaction	Safe Harbour ratios
4.	Intra-group loan to Wholly Owned Subsidiary ('WOS') where the amount of loan is denominated in foreign currency ▪ where the AE has CRISIL credit rating between AAA to A or its equivalent ▪ where the AE has CRISIL credit rating of BBB-, BBB or BBB+ or its equivalent; ▪ where the AE has CRISIL credit rating between BB to B or its equivalent; ▪ where the AE has CRISIL credit rating between C to D or its equivalent; or ▪ where credit rating of the associated enterprise is not available and the amount of loan advanced to the associated enterprise including loans to all associated enterprises does not exceed a sum equivalent to Rs 100 crore in the aggregate as on 31st March of the relevant previous year.	The interest rate declared in relation to the eligible international transaction is not less than the six-month London Inter-Bank Offer Rate of the relevant foreign currency as on 30th September of the relevant previous year plus, – ▪ 150 basis points ▪ 300 basis points ▪ 450 basis points ▪ 600 basis points ▪ 400 basis points
5.	Provision of corporate guarantee to WOS	The commission or fee declared is at the rate ≥ 1% p.a. on the amount guaranteed.
6.	Specified contract research and development services (Contract R&D services), with insignificant risks, wholly or partly relating to software development where the value of the international transaction is ≤ INR 200 crores (INR 2 billion)	Operating profit margin to operating expense ≥ 24%
7.	Contract R&D services, with insignificant risks, wholly or partly relating to generic pharmaceutical drugs where the value of the international transaction is ≤ INR 200 crores (INR 2 billion)	Operating profit margin to operating expense ≥ 24%

25 Government Company shall have the same meaning as assigned to it in sub-section (45) of section 2 of the Companies Act, 2013 (18 of 2013)

Sr. No.	Eligible International Transaction	Safe Harbour ratios
8.	Manufacture and export of: ▪ Core auto components ▪ Non-core auto components Where 90% or more of total turnover relates to original equipment manufacturer sales	Operating profit margin to operating expenses: ≥ 12% ≥ 8.5%
9.	Receipt of low value-adding intra-group services ▪ where entire value of the International transactions ≤ INR 10 crores (100 million) including mark-up	mark-up ≤ 5% Provided that the method of cost pooling, the exclusion of shareholder costs and duplicate costs from the cost pool and the reasonableness of the allocation keys used for allocation of costs to the assessee by the overseas AE, is certified by an accountant.

14.4 Safe Harbour Rules for Specified Domestic Transactions

14.4.1 The CBDT vide notification 11/2015 dated 4th February, 2015 announced the applicability of Safe Harbour Rules for SDT's undertaken by *Government companies*[25] engaged in business of generation, supply, transmission and distribution of electricity.

SDT's, in relation to above, includes:

- Supply of electricity; or
- Transmission of electricity; or
- Wheeling of electricity.

14.4.2 Further, the CBDT vide notification 90/2015 dated 8th December, 2015 also announced the applicability of Safe Harbour Rules for SDT's undertaken by co-operative society engaged in the business of procuring and marketing milk and milk

25 Government Company shall have the same meaning as assigned to it in sub-section (45) of section 2 of the Companies Act, 2013 (18 of 2013)

products. SDT's, in relation to above, includes purchase of milk or milk products by a co-operative society from its members.

14.4.3 Evaluation of Transactions

Sr. No.	Eligible Specified Domestic Transaction	Safe Harbour ratios
1.	Supply of electricity, transmission of electricity, wheeling of electricity referred to in clauses (i), (ii) or (iii) of rule 10 THB, as the case may be.	The tariff in respect of supply of electricity, transmission of electricity, wheeling of electricity, as the case may be, is determined or the methodology for determination of tariff is approved by the *Appropriate Commission*[26] in accordance with the provisions of the Electricity Act, 2003 (36 of 2003)
2.	Purchase of milk or milk products referred to in clause (iv) of rule 10THB.	The price of milk or milk products is determined at a rate which is fixed on the basis of the quality of milk, namely, fat content and Solid Not Fat (SNF) content of milk; and– (a) the said rate is irrespective of,– (i) the quantity of milk procured; (ii) the percentage of shares held by the members in the co-operative society; (iii) the voting power held by the members in the society; and (b) such prices are routinely declared by the cooperative society in a transparent manner and are available in public domain.''

26 Appropriate Commission shall have the same meaning as assigned to it in sub-section (4) of section 2 of Electricity Act, 2013 (36 of 2013)

14.5 Revision in definition of Certain Terms as per revised SHR

- The definition of contract R&D services relating to software development has amended to exclude services which involve making available source code to carry out routine functions.
- Definition of operating costs and operating income has been expanded to include costs relating to stock based compensation provided to employees and reimbursement of expenses.

14.6 Additional Definitions as per revised SHR

14.6.1 Definition of "employee cost" as per revised SHR includes the following:

- salaries and wages;
- gratuities;
- contribution to Provident Fund and other funds;
- the value of perquisites as specified in clause (2) of section 17 of the Act;
- employment related allowances, like medical allowance, dearness allowance, travel allowance and any other allowance;
- bonus or commission by whatever name called;
- lump sum payments received at the time of termination of service or superannuation or voluntary retirement, such as gratuity, severance pay, leave encashment, voluntary retrenchment benefits, commutation of pension and similar payments;
- expenses incurred on contractual employment of persons performing tasks similar to those performed by the regular employees;
- outsourcing expenses, to the extent of employee cost, wherever ascertainable, embedded in the total outsourcing expenses (Provided that where the extent of employee cost embedded in the total outsourcing

expenses is not ascertainable, eighty per cent. of the total outsourcing expenses shall be deemed to be the employee cost embedded in the total outsourcing expenses)

- recruitment expenses;
- relocation expenses;
- training expenses;
- staff welfare expenses; and
- any other expenses related to employees or the employment

14.6.2 Definition for "low value-adding intra-group services" inserted to mean services that are performed by one or more members of a multinational enterprise group on behalf of one or more other members of the same multinational enterprise group and which,

- are in the nature of support services;
- are not part of the core business of the multinational enterprise group, i.e., such services neither constitute the profit-earning activities nor contribute to the economically significant activities of the multinational enterprise group;
- are not in the nature of shareholder services or duplicate services;
- neither require the use of unique and valuable intangibles nor lead to the creation of unique and valuable intangibles;
- neither involve the assumption or control of significant risk by the service provider nor give rise to the creation of significant risk for the service provider; and
- do not have reliable external comparable services that can be used for determining their arm's length price, but does not include the following services, namely:

- research and development services;
- manufacturing and production services;
- information technology (software development) services;
- knowledge process outsourcing services;
- business process outsourcing services;
- purchasing activities of raw materials or other materials that are used in the manufacturing or production process;
- sales, marketing and distribution activities;
- financial transactions;
- extraction, exploration, or processing of natural resources; and
- insurance and reinsurance

14.7 Validity

SHRs are applicable for a maximum period of 5 years starting from AY 2013-14 for the prescribed sectors. The option of being governed by SHRs shall continue to remain in force for the period specified by the taxpayer in the prescribed form (Form No. 3CEFA) or a period of 5 years, whichever is less.

The revised SHRs are applicable for three FYs from FY 2016-17 through FY 2018-2019. For FY 2016-17, as the amended rules overlap with the prior rules, the taxpayer has the option to opt for the rule which is more beneficial.

14.8 MAP not to apply when SHR opted for

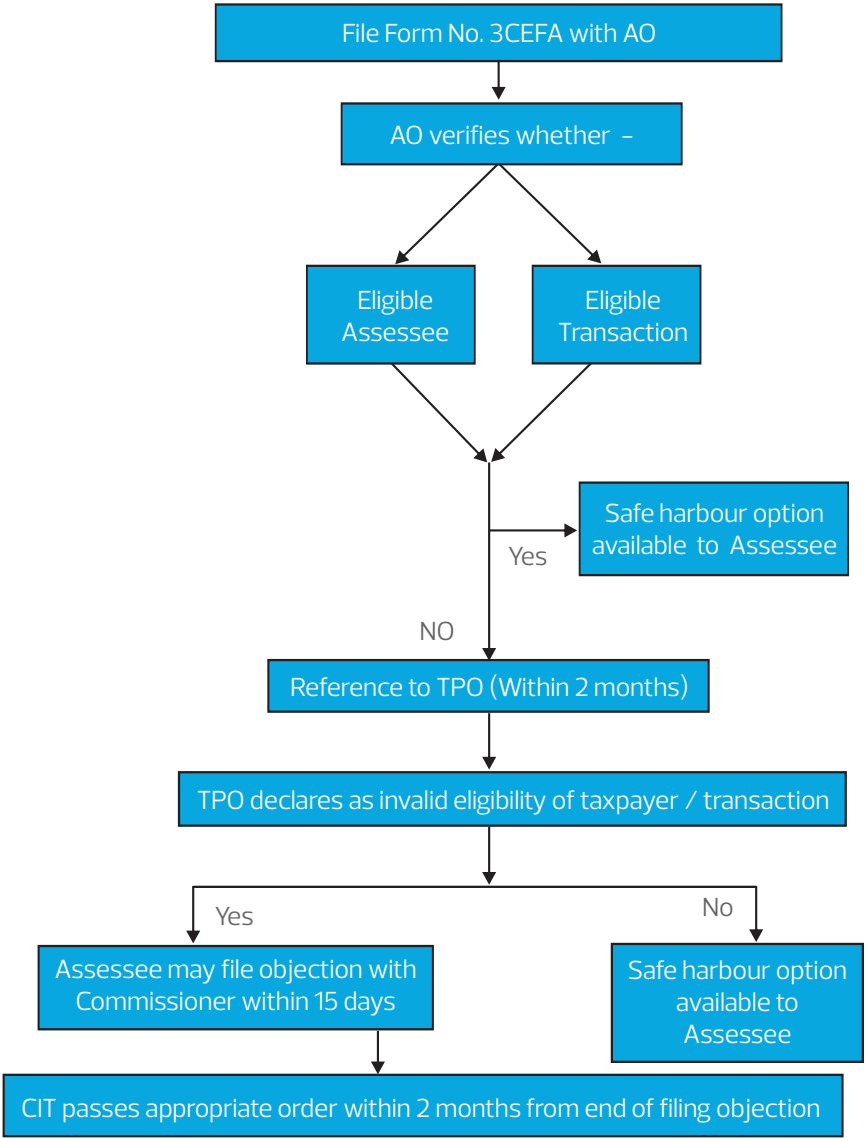
A taxpayer opting for SHR shall not be allowed to invoke Mutual Agreement Procedure ('MAP') provided under relevant DTAAs.

14.9 Safe Harbor Regulations as a Tool of Tax Exposure Management

SHR provide an enormous opportunity for reducing tax exposure on account of

transfer pricing adjustments. This is particularly relevant for enterprises engaged in Information Technology (IT), ITeS and auto component sector.

14.10 Procedure to file SHR



Chapter 15 Advance Pricing Agreements And Mutual Agreement Procedure

15.1 Background

To bring down Transfer Pricing disputes and provide tax certainty, the Finance Act, 2012 had introduced the provisions of Advance Pricing Agreement ('APA') w.e.f. 1 July, 2012. An APA is an agreement between the CBDT and a taxpayer, which determines in advance the ALP or specifies the manner of the determination of ALP, in relation to IT. Thus, once APA has been entered into with respect to an IT, the ALP with respect to that IT, for the period specified in the APA, shall be determined only as per the APA.

15.2 Definition and Applicability

An APA is an agreement between the taxpayer and the tax authority on the pricing of future intercompany transactions. The taxpayer and tax authority mutually agree on the transfer pricing methodology to be applied and its application for a certain future period of time for covered transactions (subject to fulfillment of critical assumptions).

APA scheme is applicable to international transactions only and not to SDT.

The ALP of any international transaction, in respect of which APA has been entered into, shall be determined in accordance with the APA so entered.

APA provisions are provided in section 92CC and 92CD of the Act and are contained in Rules 10F to 10T and Rule 44GA of the Rules. The APA scheme became effective from 30 August 2012.

15.3 Current Status of APA Scheme

Since the notification of APA scheme, approximately 815 applications for APA have been filed and about half of these contain a request for roll-back provisions. As on January, 2018, CBDT had signed a total of 196 (178 Unilateral and 18 Bilateral).

15.4 Who is Eligible to Apply for APA?

- Any person who has undertaken an international transaction; or

- Any person who is contemplating to undertake an international transaction is eligible to enter into an APA.

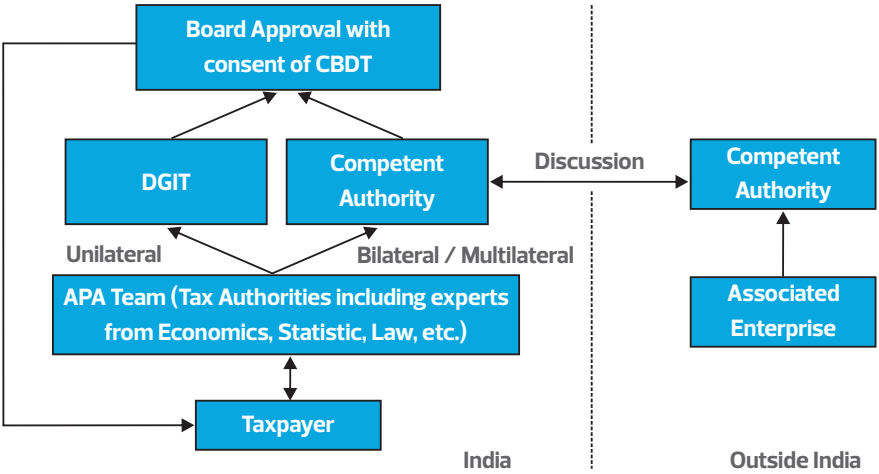
15.5 Time Involved

There is no binding or tentative timeframe prescribed within which the APA process needs to be completed.

15.6 Types of APA

Type of APA	APA entered into between –
Unilateral APA	a taxpayer and the tax administration of the country where it is subject to taxation
Bilateral APA	the taxpayers, the tax administration of the host country and the foreign tax administration
Multilateral APA	the taxpayers, the tax administration of the host country and more than one foreign tax administrations

15.7 Application for APA



15.8 APA Process

Phase 1	Feasibility Study – Determine suitability of an APA
Phase 2	Pre-filing Consultation – Understand the prespective of the department on basic issues
Phase 3	APA Application – File a written APA application and preliminary screening
Phase 4	Negotiation – Negotiations between the taxpayer and tax administrator
Phase 5	Execute APA – Formal agreement of APA executed which is binding on taxpayer and tax administrator
Phase 6	Annual APA Compliance Report – File an annual compliance report in relation to the implementation of the APA
Phase 7	Compliance Audit – TPO to carry out compliance audit for each covered year
Phase 8	APA Renewal – Extending the APA beyond the period originally provided (new APA)

- **Phase 1: Feasibility Study**

  An APA may not be suitable for everyone and in every situation. Thus, a feasibility study needs to be undertaken to analyze which transaction or group of transactions the taxpayer should cover while entering into an APA. In its simplest terms, the feasibility study should encapsulate the objective, type of transaction(s) to be covered, cost-benefit (economic) analysis and the risks assumed. This will enable a company to decide if an APA is feasible or not.

- **Phase 2: Pre-filing Consultation**

The process for APA would start with pre-filing consultation meeting. The taxpayer can request for a pre-filing consultation meeting which shall be held with the objective of determining the scope of the agreement, understanding the transfer pricing issues involved and examining the suitability of international transactions for an APA.

The taxpayer also has an option of applying for a pre-filing consultation on an anonymous basis. This process is non-binding on the taxpayers and the Revenue.

Going by the information required in Form (Form No. 3CEC) for a pre-filing consultation, it is clear that the Indian APA program puts lot of emphasis on pre-filing process. Pre-filing consultation will not only be vital to the APA process, but could possibly determine the course of APA.

Previously, pre-filing consultation was mandatory but the same has now been made optional and hence, an applicant can file the main APA application in the main Form No. 3CED without filing for pre-filing consultation.

After pre-filing consultation, the suitability of entering into an APA is determined. The applicant before filing formal APA application is required to pay fees which are as under:

Amount of international transaction entered into or proposed to be undertaken	Fees (in INR)
Amount not exceeding INR 100 crores	10 lacs
Amount not exceeding INR 200 crores	15 lacs
Amount exceeding INR 200 crores	20 lacs

Fees paid is not refundable except in case there is any defect in the proposed application, the DGIT or Competent Authority would require the taxpayer to remove such deficiency within stipulated time, barring which the application would be rejected and correspondingly the fee received would also be refunded.

- **Phase 3: APA Application**

  After the pre-filing meeting, if the taxpayer is desirous of applying for an APA, an application would be required to be made in prescribed Form (Form No. 3CED) containing specified information.

- **Phase 4: Negotiation**

  Once the application is accepted, the APA team shall hold meetings with the applicant and undertake necessary inquiries relating to the case. Post the discussion and inquiries, the APA team shall prepare a draft report which shall be provided to the Competent Authority (for bilateral /multilateral APA), or DGIT (International Taxation and TP) (for unilateral APA).

- **Phase 5: Execute APA**

  This phase involves exchange of comments on draft APA, finalization of APA and giving effect to the initial years covered under the APA term that have already elapsed.

- **Phase 6: Annual compliances**

  Filing of Annual Compliance Report to DGIT (International Taxation) for each year covered in APA, in Form No. 3CEF, in quadruplicate, within 30 days of due date for filing Income-tax return for that year or within 90 days of entering into APA, whichever is later.

- **Phase 7: Compliance Audit**

  The TPO having jurisdiction over the taxpayer will carry out the compliance audit of the agreement for each of the year covered in the agreement. The TPO will have to furnish the compliance audit report within 6 months from the end of the month in which the annual compliance report is referred to him.

  The TPO shall submit the compliance audit report, for each year covered in the agreement, to the DGIT (International Taxation) in case of unilateral

agreement and to the Competent Authority in India, in case of bilateral or multilateral agreement.

- **Phase 8: APA Renewal**

  When an existing APA is drawing to a close of its term, the parties agree to enter into further discussions or negotiations with a view to extend the APA beyond the period originally provided. Any such extended arrangement is concluded as a new APA.

15.9 Roll Back Provision in APA Scheme

The Finance (No.2) Act, 2014 introduced the "roll back" mechanism in the APA scheme with effect from 1 October 2014. The "roll back" provisions refer to the applicability of the methodology of determination of ALP, or the ALP, to be applied to the international transactions which had already been entered into in a period prior to the period covered under an APA.

The APA is subject to such prescribed conditions, procedure and manner for determining the ALP or for specifying the manner in which ALP is to be determined, in relation to an international transaction entered into by a person, during any period not exceeding 4 previous years preceding the first of the previous year for which the APA applies.

15.10 APA Tenure

The tenure of APA can be up to 5 years for onward determination of ALP. In case of roll back mechanism, the APA can be made applicable for a period not exceeding 4 years. Hence, the total tenure applicable for APA can be 9 years.

15.11 Modified Return of Income

The person entering into an APA shall have to furnish a Modified Return of Income (ROI) in respect of the ROI already filed for a previous year to which APA applies, within a period of 3 months from the end of the month in which the said APA was entered into. The modified ROI has to reflect only the changes in respect of the issues arising from APA which needs to be in accordance with the terms and

conditions of APA.

15.12 Terms of the Agreement

An agreement may, amongst other things, include:

- International transactions covered by the agreement;
- Agreed transfer pricing methodology, if any;
- Determination of ALP, if any;
- Critical assumptions.

In case of any change in critical assumptions or failure to meet such conditions, the APA shall not be binding on the Board or the taxpayer.

15.13 Advantages of APA

- Certainty on the transfer pricing issues;
- Avoidance of possible audit along-with penalty and ligation costs;
- Efficient management of transfer pricing issues;
- Potential elimination of double taxation;
- Fewer compliance costs for MNE groups;
- Favorable environment for FDI; and
- Ability to deal with contentious issues in open years

15.14 Disadvantages of APA

- Precision is required on the assumptions about future economic circumstances; any error can distort the whole process;
- Closure of APA requires substantial time;
- APA demands huge resources, both, in terms of costs and personnel;

- Unilateral APA does not eliminate the risk of double taxation;
- Cumbersome APA procedures can multiply the tax compliances;
- Potential misuse of the secret information shared by the taxpayer to the tax authorities, wastage of resources in case an APA cannot be finalized; and
- APA does not altogether eliminate the transfer pricing audit.

15.15 Statistics

As on 31 December 2017, the CBDT has entered into a total number of 189 APA's. This includes 173 Unilateral APA's and 16 Bilateral APA's. APA is not limited to specific industries. We have listed below 20 diffirent type of industries that have availed the APA program:

Sl. No.	Industry	No. of Agreements Signed
1	Information Technology	41
2	Banking & Finance	29
3	Industrial/Commercial Goods Manufacture	16
4	Pharmaceutical	10
5	Consumer Goods Manufacture	6
6	Oil & Gas	6
7	Engineering Services	5
8	Telecommunication	5
9	Foods & Beverages	3
10	Power & Energy	3
11	Shipping	3
12	Automobile	2
13	Healthcare	2
14	Infrastructure & Real Estate	2
15	Media & Communication	2
16	Textile	2

Sl. No.	Industry	No. of Agreements Signed
17	Chemical	1
18	Forestry	1
19	Tourism & Hospitality	1
20	Trading & Logistics	1
	Total	**141**

Source: Advance Pricing Agreement (APA) programmee of India – Annual Report 2016-17 (as on 31 March 2017)

15.16 Global Comparison

Sr. No.	Countries	Pre–filing	Type of APA	Filing Fee	Time frame to conclude	Tenure of APA
1.	**India**	**Optional**	**Unilateral/ Bilateral/ Multilateral**	**INR 10-20 lacs**	**Not specified**	**5 years (in case of roll back additional 4 preceding years)**
2.	Australia	Mandatory	Unilateral/ Bilateral/ Multilateral	No fees	Not specified	3-5 years
3.	Canada	Mandatory	Unilateral/ Bilateral/ Multilateral	▪ Flat fee of CAN$ 5,000 for limited transaction APA ▪ Out of pocket costs for other than limited transaction APA	Not specified	3-5 years

Sr. No.	Countries	Pre–filing	Type of APA	Filing Fee	Time frame to conclude	Tenure of APA
4.	China	Mandatory	Unilateral/ Bilateral/ Multilateral	No Fees	Not specified	3–5 years
5.	France	Optional	Unilateral, Bilateral (multilateral may be possible)	No Fees	Not specified	3–5 years
6.	Germany	Optional	Unilateral, Bilateral (multilateral may be possible)	No Fees	Not specified	3–5 years
7.	Israel	Optional	Unilateral/ Bilateral/ Multilateral	Not specified	Within 120 days of filing of application	Not specified
8.	Italy	Optional	Unilateral	Not specified	180 days	3 years
9.	Japan	Optional	Unilateral & Bilateral	No Fees	Not specified	3–5 years
10.	Korea	Optional	Unilateral, Bilateral & Multilateral	No Fees	Not specified	Not specified
11.	Lithuania	Optional	Unilateral	Not specified	60 – 120 days	Not specified
12.	Malaysia	Mandatory	Unilateral & Bilateral	Not specified	Not specified	3–5 years
13.	Mexico	Optional	Unilateral & Bilateral	Not specified	Not specified	Up to 3 years forward, 1 year back and issuing year
14.	Netherlands	Mandatory	Unilateral/ Bilateral/ Multilateral	Not specified	Not specified	3–5 years

Sr. No.	Countries	Pre–filing	Type of APA	Filing Fee	Time frame to conclude	Tenure of APA
15.	Russia	Mandatory	Unilateral & Bilateral	Not specified	Not specified	3–5 years
16.	Singapore	Mandatory	Unilateral/ Bilateral/ Multilateral	No Fees	Not specified	3–5 years
17.	USA	Mandatory	Unilateral/ Bilateral/ Multilateral	Indicatively between US$ 20,000–50,000	Not specified	3–5 years
18.	UK	Optional	Unilateral & Bilateral (no distinction between Bilateral & Multilateral)	No Fees	Not specified	3–5 years

15.17 Mutual Agreement Procedure ("MAP")

Under various DTAAs, the MAP option provides for the competent authorities of the respective jurisdictions to interact with the intention of resolving international tax disputes. This option is in addition to options available under domestic laws.

A Framework Agreement was recently signed with United States under the MAP provision of the India–US Double Taxation Avoidance Convention (DTAC). This is a major positive development. About 200 past transfer pricing disputes between the two countries in Information Technology (Software Development) Services [ITS] and Information Technology enabled Services [ITeS] segments have been resolved under this Agreement during the year 2015.

Chapter 16 Nexus With Other Statutory Laws

A business enterprise in India is required to comply with various statutory regulations resulting in the submission of data with such authorities. Considering the fact that data is readily available with various such authorities and the synchronized working approach recently adopted by them including data exchange, it is pertinent that abundant caution and diligence is observed by such enterprise to ensure uniformity in compliances to minimize litigations.

Due to readily available data, robustness of the IT systems, increased inter-connectivity and close working of various departments, it is pertinent that the business enterprise maintain uniformity, ensure consistency and have a reasoned approach which dealing with such authorities and compliances under the various regulations, as any contravention would lead to unavoidable legal hassles.

16.1 Nexus between Goods & Service Tax (GST) and Indian TP Regulations

16.1.1 Under GST regime, in Indian context, supply of goods and/or services between distinct person, as described in section 25(4) and (5) of the CGST Act, 2017, and related person, as defined in an explanation (a) attached with section 15 of the CGST Act, 2017, would be subject to levy of GST. Therefore, it is important to determine the correct value of supply of goods and services to distinct persons or related persons to avoid the litigation.

16.1.2 As business entities look into the appropriate transfer price of transactions, they should be mindful of the GST implications arising from the transfer pricing adjustments.

16.1.3 For instance, the retrospective increase in the transfer price of sales of goods is effectively an increase in the GST value of the supply of these goods. The increase in the value should be duly accounted for in GST returns. If the goods were exported and existing export documentation is not sufficient to support the adjusted price of goods, it is not clear how the GST authority would accept these documents for the purposes of allowance of benefit of zero-rated supply under section 16 of the IGST Act, 2017.

16.1.4 Meaning of 'Associates Enterprises', 'Related Persons' and 'Distinct Person' under GST

Associates Enterprises

- Transfer pricing provisions as defined under Income Tax Act, 1961, are applicable in context of transactions between assessee and its associated enterprises. Meaning of the term "associated enterprises" has been defined in section 92A of the Income Tax Act, 1961.
- Under GST Act, 2017, section 2(12) provides meaning of the term "associated enterprises". Accordingly, "associated enterprises" shall have the same meaning as assigned to it in section 92A of the Income Tax Act, 1961.
- Accordingly, the term 'Associated Enterprise' generally means any entity that participates directly or indirectly or through one or more intermediaries in the management or control or capital of another entity. Further, where two entities are commonly controlled by one or more controlling entities, such entities are also considered as 'Associated Enterprises'.

Related Persons

Under GST, as per explanation (a) attached with section 15 of the CGST Act, 2017, persons shall be deemed to be "related persons" if––

- such persons are officers or directors of one another's businesses;
- such persons are legally recognised partners in business;
- such persons are employer and employee;
- any person directly or indirectly owns, controls or holds twenty-five per cent. or more of the outstanding voting stock or shares of both of them;
- one of them directly or indirectly controls the other;
- both of them are directly or indirectly controlled by a third person;
- together they directly or indirectly control a third person; or
- they are members of the same family.

Distinct Person

- As per section 25(4) of the CGST Act, 2017, a person who has obtained or is required to obtain more than one registration, whether in one State or Union territory or more than one State or Union territory shall, in respect of each such registration, be treated as distinct persons for the purposes of GST Act.
- As per section 25(5) of the CGST Act, 2017, where a person who has obtained or is required to obtain registration in a State or Union territory in respect of an establishment, has an establishment in another State or Union territory, then such establishments shall be treated as establishments of distinct persons for the purposes of GST Act.

16.1.5 The overview of the difference between GST and TP regulation is as under:

Basis	TP Regulation	GST
Valuation aspects for transactions between distinct persons and related persons	Computation of ALP is based on the prescribed TP methods. ▪ Comparable Uncontrolled Price Method (CUP), ▪ Cost Plus Method (CPM), ▪ Resale Price Method (RPM), ▪ Profit Split Method (PSM), and ▪ Transactional Net Margin Method (TNMM).	The Rule 28* of the CGST Rules, 2017 provides 4 methods to determine the value of supply, which are as follows: ▪ Open Market Value (''OMV'') Method ▪ Like kind and Quality Method (Or comparable method) ▪ Cost Plus Method (Rule 30) ▪ Residual Method (Rule 31) ▪ Resale price Method
Tolerance Range	The tolerance range available for wholesale traders is 1%, while that for other taxpayers is 3% of the value of IT / DST	No tolerance range available under GST hence it will invite the accuracy related issues, correctness issues, hence, resultant in disputes between the Department and assesse.

*As per Rule 28 of the CGST Rules, 2017– "Value of supply of goods or services or both between distinct or related persons, other than through an agent" provides the valuation methods for the determination of value of supply. The text of Rule 28 is reproduced below:

"The value of the supply of goods or services or both between distinct persons as specified in subsection (4) and (5) of section 25 or where the supplier and recipient are related, other than where the supply is made through an agent, shall–

a. be the open market value of such supply;

b. if the open market value is not available, be the value of supply of goods or services of like kind and quality;

c. if the value is not determinable under clause (a) or (b), be the value as determined by the application of rule 30 or rule 31, in that order.

Provided that where the goods are intended for further supply as such by the recipient, the value shall, at the option of the supplier, be an amount equivalent to ninety percent of the price charged for the supply of goods of like kind and quality by the recipient to his customer not being a related person.

Provided further that where the recipient is eligible for full input tax credit, the value declared in the invoice shall be deemed to be the open market value of the goods or services"

16.1.6 Conclusion

Transfer pricing itself is not a means of tax avoidance if transaction value matches with what the supplier would charge to an unrelated recipient. As the objective of the arm's length principles and mechanism is basically to ensure that the affairs of distinct persons or related persons are not arranged in a manner that results in lower GST payment to the Government, therefore, the governing principles need to be harmonized. The governing principles can be obtained from the judicial precedence available on several transfer pricing issues in other taxation laws in India as well as taxation laws of other Countries where similar provisions are applicable.

From a taxpayer's perspective, the GST framework governing arms' length standard or method(s) to determine value of supply would need to be aligned with the Income Tax provisions on transfer pricing viz, the methodologies adopted, the nature of documentation to be maintained and any GST specific Compliances.

16.2 Nexus between Indian TP Regulations & The Companies Act 2013

16.2.1 Companies Act 2013 has introduced the arm's length concept for RPT. With the introduction of this concept, the Companies need to assess whether their related party transactions comply with the arm's length concept and evaluate their compliance and reporting obligations under the Companies Act. The Arm's Length concept was hitherto used only under Indian Transfer Pricing Regulations. As a consequence, related party transactions covered under the provisions of the Companies Act may now call for benchmarking and convergence with the India Transfer Pricing regulations.

16.2.2 Meaning of a 'related party' under Companies Act 2013

Related party with reference to company means

(i)	(ii)	(iii)	(iv)	(v)	(vi)	(vii)	(viii)	(ix)
Director or his relative	KMP or his relative	Firm in which a director, manager or his relative is a partner	Private company in which a director or manager or his relative is a member or director	Public company in which a director or manager is a director and holds along with his relatives, more than two per cent. of its paid-up share capital	anybody corporate whose Board, managing director or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager	Any person on whose advice, direction or instructi-ons a director or manager is accusto-med to act.	A) a holding, subsidiary or an associate company (B) a subsidiary of a holding company to which it is also a subsidiary; or (C) an investing company or the venturer of the company	a director [other than an indepen-dent director] or KMP of the holding company or his relative

Definition amended by the Companies (Amendment) Act 2017

Nothing in clause (vi) or (vii) shall apply to advice given in professional capacity.

The definition of the term 'relative' has been limited and now only includes members of a Hindu Undivided Family, husband and wife and father including step father, mother including step mother, son including step son, son's wife, daughter, daughter's husband, brother including step brother, and sister including step sister.

16.3 Nexus between Indian TP Regulations & IND AS

16.3.1 The Ministry of Corporate Affairs (MCA) recently notified Companies (Indian Accounting Standard) Rules, 2015 (the Rules). Based on International Financial Reporting Standards (IFRS), the Rules specify the Indian Accounting Standards (IND AS) applicable to certain class of companies. India plans to achieve a high standard of transparency in financial re[porting post implementation of IND AS.

16.3.2 IND AS needs to be adopted depending upon the size and listing status. Companies may voluntary adopt IND AS for the financial reporting, however, Companies shall continue following existing accounting standard if the thresholds are not met. The inconsistency followed by different companies may distort the profit level indicator (PLI) in applying the most appropriate method as prescribed by the TP regulations,

16.3.3 The APAs which are already signed or under negotiation have a critical assumption with respect to no change in the financial accounting methods. IND AS will significantly affect the APA's which are already signed. However, taxpayer negotiating the APA may consider discussing the effects of IND AS.

16.3.4 With introduction to multiple year data, there will be a situation where it is possible two different sets of accounting principles are followed in the multiple year comparable data.

Abbreviations

Terms	Definition
AAR	Authority for Advance Ruling
ACIT	Assistant Commissioner of Income- tax
AE	Associated Enterprise
ALP	Arm's Length Price
AMP	Advertising Marketing & Promotion
AO	Assessing Officer
AOP	Association of Persons
APA	Advance Pricing Agreement
AY	Assessment Year
BOD	Board of Directors
BOI	Body of Individuals
BEPS	Base Erosion & Profit shifting
CBDT	Central Board of Direct Taxes
CGST	Central Goods & Service Tax
CIT	Commissioner of Income-tax
CPM	Cost Plus Method
CRISIL	Credit Rating Information Services of India Limited
CUP	Comparable Uncontrolled Price
CbCR	Country by Country Reporting
CAPM	Capital Asset Pricing Model
CASS	Computer Assisted Scrutiny Selection
DCIT	Deputy Commissioner of Income- tax
DGIT	Director General of Income- tax
Draft Order	Draft Assessment Order
DRP	Dispute Resolution Panel
DTAA	Double Taxation Avoidance Agreement
DTAC	Double Taxation Avoidance Convention
FAR Analysis	Functions, Assets and Risk Analysis
FDI	Foreign Direct Investment
FMV	Fair market Value
FY	Financial Year
GAAR	General Anti Avoidance Rule
GST	Goods & Service Tax
G20	Group of 20
HUF	Hindu Undivided Family
ICAI	The Institute of Chartered Accountants of India
INR	Indian Rupee

Abbreviations

Terms	Definition
IT	International Transaction
ITES	Information Technology EnabledServices
ITAT	Income Tax Appellate Tribunal
ITS	Information Technology (Software Development) Services
IND AS	Indian Accounting Standard
KMP	Key Management Personnel
KPO	Knowledge Process Outsourcing
MAM	Most Appropriate Method
MAP	Mutual Agreement Procedure
MNC	Multi National Company
MNEs	Multinational Enterprises
NJA	Notified Jurisdictional Area
OECD	Organization for Economic Co-operation and Development
OCM	Operating Cost Margin
OC	Operating Cost
OPM	Operating Profit Margin
PCIT	Principal Commissioner of Income-tax
PE	Permanent Establishment
PLI	Profit Level Indicator
PSM	Profit Split Method
R&D	Research and Development
ROI	Return of Income
RPM	Resale Price Method
RPT	Related Party Transactions
ROA	Return on Assets
ROTC	Return on Total Cost
ROCE	Return on Capital Employed
SDT	Specified Domestic Transactions
SEZ	Special Economic Zone
SHR	Safe Harbour Rules
the Act	Income tax Act, 1961
the Rules	Income tax Rules, 1962
TNMM	Transactional Net Margin Method
TP	Transfer Pricing
TPO	Transfer Pricing Officer

Abbreviations

Terms	Definition
UK	United Kingdom
UN TP	United Nations practical Manual on Transfer Pricing
US	United States of America
USD	United States Dollar
WOS	Wholly Owned Subsidiary
W.E.F.	With Effect From

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