

Transfer Pricing



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PREFACE

In the era of globalization, when Multinational Enterprises (MNEs) have branches, divisions, subsidiaries and offices operating across the globe; it is common for them to transact goods and services from one jurisdiction to an associated enterprise in another tax jurisdiction.

Accordingly, section 92 to 92F (i.e. transfer pricing provisions) have been first introduced vide Finance Act, 2001 in the Income-tax Act, 1961. The law relating to transfer pricing is very dynamic. The Finance Act, 2012 has made significant changes in the transfer pricing regulation such as introducing the provisions related to Advance Pricing Agreement (APA), expansion of Transfer Pricing Officer's (TPO's) Power, amendments relating to penalties, etc. Also, a new section 92BA has been introduced that covers certain specified domestic transaction within the ambit of transfer pricing regulation.

The legal, Financial and accounting aspects relating to transfer pricing are highly complex and have global ramifications. The Company Secretaries are getting acquainted with the practical implications of the law and the rules relating to transfer pricing. The Company Secretaries, being the Principal Officer of the company, it is imperative for them to understand, appreciate and develop expertise on various dimensions of Transfer Pricing, so as to guide the industry.

I wish to place on record my thanks to CS A Sekar and CMA Nayana Savala for conceptualising this topic and presenting it in the form of a compact book. I also express my gratitude and appreciation to CS Hitesh Kothari, Chairman, WIRC for giving the concrete shape of this publication.

I believe the efforts in bringing out this publication will get amply rewarded if it proves to be useful to members of the Institute. It will be our endeavor to revise the edition more frequently.

CS Makarand Lele
President
ICSI

Place: New Delhi

Date: 15.05.2018

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CHAPTER 1

INTRODUCTION AND BACKGROUND

1.1 OVERVIEW

1.1.1 We are now firmly back to the classical economic theories of comparative advantage when it comes to international trade. Over the last two and a half decades, the rapid advances in technology, transportation and communication have converted our world into a global village and there is an increasing realization of the potential benefits of doing international trade based more and more on comparative advantage. This has contributed to a mammoth growth in global volumes of international trade. There are a large number of Multi National Enterprises (MNE's) and they are in a position to have presence in multiple locations and do business activities virtually anywhere in the world. Apart from global trade which the MNE's anyway do, a significant volume of transfers of goods and services, capital (equity, debt or other hybrid forms) and intangibles (intellectual property rights) take place within a MNE group. These transfers within a group are called intra-group transactions and it is estimated that these intra-group transactions may be in the region of about 60% of all international transactions. It is perceived that within these intra-group transactions, transactions involving intangibles and shared services shows an increasing trend contributing substantially to growing complexities in understanding and analysis of such transactions. This understanding becomes important in the context of determination of consideration for doing such transactions (pricing/ transfer price), which in the case of transactions between truly independent entities, is determined by market forces. When transactions takes place between two unknown entities it is entirely driven by demand and supply forces in the market but when such transactions are effected within the group entities ie. associates, subsidiaries, holding companies, JV's or otherwise related parties, they are supposed to be driven by market forces which in practice may or may not be there. Price mechanism is artificially decided by the parent company with a view to derive maximum economic benefits and comparative tax advantage. This depends on differential tax regulation and economies of scales of operations in different countries. So it becomes pertinent that the right price is fixed called as Transfer price for inter unit and intra unit transfers and cross border transactions in buying or selling goods and services including tangible assets and intangibles too. Transaction arising amongst related parties must comply with arms' length pricing principles so that profits are correctly reflected in countries where related parties to transaction exists. Scenarios of this type require that right pricing mechanism called as transfer pricing amongst inter / intra group cross border transactions is set.

1.1.2 With the liberalization and expansion of business territory beyond limits of countries' boundaries coupled with advances in information technology, transportation, communications etc., flexibility to place their enterprise in any part of the world has led to increase in number of cross border transactions, and enlarges scope to exploit differences between domestic tax systems resulting in ultimately reducing tax impact. The challenge to shift the profit from high tax regime country to low tax regime countries are relevant for the countries /companies to draw global capital in a conducive manner and in an environment offering ease of doing business.

1.1.3 The economic reason for charging transfer prices for intra-group transactions is to be able to measure the performance of the individual entities in a multinational group. The individual entities within a multinational company group are separate profit / cost centres and transfer prices are required to determine the profitability of the entities. Rationally, an entity having a view to its own interests as a distinct legal entity would only acquire products or services from a related party or an entity in the group if the purchase price was equal to, or cheaper than, prices being charged by unrelated suppliers. This principle applies, conversely, in relation to an entity providing a product or service; it would rationally only sell products or services to an associated entity if the sale price was equal to, or higher than, prices paid by unrelated purchasers. Prices should on this basis tend towards the so-called "arm's length price", the price which two unrelated parties would agree to a transaction.

1.1.4 The transfer pricing set by MNE's do not *per se* involve tax avoidance or evasion. But tax authorities are rightly concerned when transactions between related parties or entities in the same group are not carried out at an Arms' Length Price and such pricing methodologies lead to lower tax revenues. With pressure on increasing tax revenues ever mounting, tax authorities are on the lookout for an effective revenue mopping exercise. When it comes to transfer pricing, a key incentive is that it is a soft target to produce very large increases in tax revenues with little effort.

1.2 HISTORICAL BACKGROUND

1.2.1 History traces the first transfer pricing legislation to UK in 1915, with USA following suit in 1917. The main intention of the introduction of these provisions was to discourage companies to shift profit to overseas associate entities through underpricing or over-pricing of cross border transactions. They had limited impact.

1.2.2 In the period after 1960, countries started laying emphasis on detailed rules to counter the devices for shifting profits from one legal jurisdiction to another with the object of reducing tax impact.

1.2.3 The period of 1970's saw many developed countries trying to develop expertise in transfer pricing matters and applied prevailing law to deal with transactions routed through tax heavens when simpler or conventional provisions could not be made applicable.

1.2.4 The Organisation for Economic Co-operation and Development (OECD) which was established in 1961 and now 34 countries are its members. OECD undertook an in depth analysis of transfer pricing provisions and published a report on "Transfer Pricing and Multinational Enterprises" in 1979. It prescribed three standard methods of computing Arms' Length Price (ALP) namely Comparable Controlled Price, Resale Price and Cost Plus and mentioned the danger of using other bases for determining ALP. In 1984, OECD published its report which dealt with transfer pricing for intra group services and dealt with the treatment of intra-bank interest and other issues which could not be resolved under the tax treaties.

1.2.5 The United Kingdom in 1984 introduced a new anti-avoidance legislation called "The Controlled Foreign Corporation (CFC) rules". These rules provided that profits accumulated in off shore subsidiaries should be attributed back to the parent company. But the provisions did not include cases where off shore parent companies charged higher than ALP from their subsidiaries.

1.2.6 OECD reports published in 1987, 1988 and 1994 dealt with the problems relating to thin capitalization, the tax consequences of foreign exchange gains and losses and attribution of income to Permanent Establishment (PE).

1.2.7 The OECD Guidelines, published in 1995 represents a consensus among OECD Member countries, mostly developed countries, and have largely been followed in domestic transfer pricing regulations

1.2.8 The first Indian attempt at Transfer Pricing Regulations was in 2001, when the Finance Act amended the Income Tax Act, 1961 by the amendment of Section 92 and insertion of new sections 92A to 92F providing for determination of proper income arising from international transactions where either or both the parties involved happen to be non-resident(s).

1.2.9 These provisions read with relevant rules 10A to 10T of the Income Tax Rules also stipulated the maintenance and keeping of information and documents by persons entering into an international transaction and furnishing report by an Accountant if the volume of transactions touches or crosses a prescribed threshold limit.

1.2.10 With effect from 1st April, 2013, the transfer pricing regulations were also extended to cover certain specified domestic transactions.

1.3 RELEVANCE OF TAX TREATIES

1.3.1 The tax treaties have an important role in dealing with transfer pricing cases and examination of the transactions of MNE's and Associated Enterprises. The OECD's model treaty containing model articles are of relevance.

1.3.2 The double taxation avoidance agreements entered into by India with other countries incorporate provisions on the lines of the OECD model articles.

1.3.3 The ever increasing focus on transfer pricing has highlighted the importance of co-operation between tax authorities of different countries under the provisions of these treaties. The Article dealing with exchange of information is important. But there are limitations, particularly when it comes to furnishing information regarding any trade, business, industrial or professional secret or any trade process, as the tax authorities though have access to such confidential information, cannot part with such information.

1.4 ISSUES IN TRANSFER PRICING

1.4.1 There are many challenges with respect to tax administration as transfer pricing is not an exact science. With increasing globalization, national borders seem less relevant to how they conduct business transaction which results in increase in mobility of assets, funds, technology, thereby increase in national- international transactions. Multinational enterprises have cross border transaction which carry on transaction in different form leading to movement of resources in different countries with different tax jurisdictions. This leads to many issues like allocation of resources, profits, valuations, taxation on profits across such jurisdiction, domestic tax law, international tax laws, sovereign political rights, tax treaties and trade analysis. Each countries' fiscal authorities have taken several steps to protect their tax bases and thereby protecting their economy. There are many more challenges like laying standard procedures,

reducing the cost of compliance and developing database for fact finding relating to applicability of transfer pricing.

1.4.2 Indian Income tax Act introduced the provisions on transfer pricing in 2001. Transfer pricing owes its existence to the Finance Act 2001 which amended the sec 92 of the Income Tax Act and introduced new provision u/s 92A to F. The amended act brought out more clarity in terms like Multinational Enterprise (MNE) and Associated Enterprise (AE). It also provides for methods of Arms' length pricing. The provisions are exhaustive and in line with international practices. However, there are a number of disputes leading to a lot of litigation. Tax authorities have taken number of initiatives like Safe Harbor Provisions, selection of risk based cases for TP Audit etc.

1.4.3 Further India is committed to implement recommendations given in Base Erosion and Profits Sharing (BEPS) Action Plan concerning Transfer Pricing. From F Y 2016-2017. TP documentation and reporting is by and large aligned with OECD BEPS planned action. The documentation to be called for require a three level approach i.e. master file representing global business of entity along with transfer pricing policies , local file representing India entities in the group complying with ALP principles and country level representing country by country reporting business, transfer pricing policies etc.. All this leads to more dynamic and transparent dealings by the company having global presence. It is of utmost importance that business houses are diligent enough while adopting transfer pricing policies and maintains enough documentation supporting the cost, pricing and valuation of goods and services involved in the transfer pricing, both with arms' length and non- arms' length parties.

1.4.4 Transfer pricing per se is not in itself illegal or necessary evil or abusive, but mispricing or manipulative transfer pricing is illegal or abusive.

1.4.5 With respect to India, however the following basic issues in Transfer Pricing continue:-

1.4.5.1 Tax Mitigation:- MNE's adopt several ways and means to shift profits out of high to low tax regions. For Example, it includes the option to finance an affiliate with debt or equity, the organizational form (e.g., to own the affiliate or to engage in a joint-venture with a local firm), or the payment of management fees or royalties between the parent company and its affiliates. Thus transfer pricing involves recognizing and rewarding the

parties related to sale of goods and services, financing, or use of intangibles or intellectual property.

1.4.5.2 Jurisdictional Issues:- Which country should tax the transaction and which country should be given tax relief? Further this issue gets aggravated if MNE adopts manipulative tactics of shifting the profits through transfer pricing so as to reduce the tax burden and in similar way, profits may be shifted from some other country to obtain tax benefits. In either of these cases, this will impact the legitimate tax revenue of the countries where commercial and economic activity takes place. Every MNE aims to maximize PAT which they try to achieve by reducing taxation for which they resort to shifting profits to country with low tax regime either by over pricing or under pricing mechanism. Such unethical practices are sought to be addressed by the tax authorities of the respective countries through their multilateral and bilateral arrangements as also at the country level, by having in place General Anti Avoidance Rules (GAAR)

1.4.5.3 Comparable data /information:- Data once processed becomes information. But to become information that too comparable, such data should meet the standards of comparables. Contemporaneous data of comparable companies at domestic or international level gives more appropriate and accurate base for transfer price.

Data available with the- Ministry of Corporate Affairs (MCA) or various tax authorities are with respect to financial accounts, loans and advance or various approvals and licences, various policies adopted by the organisation, which is meant for relevant stakeholders. As more than 60 % of transactions of MNE and its related Associated Enterprises are within the integrated group, very rarely transparent data is available unless their products are traded in public as a commodity. Further tax authorities have access to data which is otherwise not available to tax payers. One of the issues in Transfer Pricing (TP) is limited availability of comparable information on commercial transactions in public domain. Further different countries have different requirement in different formats for reporting the information which makes it difficult for both tax payers as well as tax authorities to analyze and make use of such information as there is no commercial data bases available for the purpose of TP only.

In India data can be analysed from the data base available in public domain like Annual returns filed on MCA sites, like financial statements, Auditors and directors report, related party transaction. Entities which are required to maintain TP documentation draw upon information from databases like Prowess and Capitaline. With latest concept of filing all the financial data in xbrl format, makes it possible to have comparable data. However, this information is not readily available at an affordable price for small entities who are hit by the TP provisions, unless they are part of MNE's.

1.4.5.4 Availability of qualitative data:

1.4.5.4.1 For Transfer pricing study and documentation, there is a distinct need not only for quantitative data, but also qualitative data. With the advent of super computers, it is possible to process the huge voluminous data at a click of mouse. TP is similar to business process in the sense that it involves data collection, processing including transactional data, benchmarking data, operation data, product data and such other data / information that influence the transfer pricing. However, instead of processing such data on a continuous basis and having in place the necessary and meaningful information by adopting advanced data analytics and other techniques, which would serve as a backup for internal controls and reporting, Indian entities invariably neglect this part and resort to cover-up at the time the entities face TP audit or scrutiny.

1.4.5.4.2 Corporate India and the regulators have missed a wonderful opportunity presented under the erstwhile regime of maintenance of cost accounting records under Companies Act, 1956 (CA 1956). The Cost Accounting Records Rules for various industries notified under Section 209(1)(d) of the then prevailing CA 1956, required maintenance of records to determine reasonableness of transfer pricing policy adopted in case of related party transactions relating to supplies made or services rendered by a company to its holding or subsidiary company and vice versa, in respect of purchase and sale of raw materials, finished products, services etc. The above transactions were also covered under Companies (Cost Audit) Report Rules, 2001 issued under the provisions of Section 233B of CA 1956. Having defined the framework, the simplest thing to do was to extend the logic and the framework to all types of transactions not only with respect to Holding and Subsidiary companies, but also to all entities within a MNE group as also all types of transactions being covered under the TP regime. Even now, if these provisions are restored, the TP landscape would significantly become world class in line with BEPS Action Plan.

1.4.5.4.3 Application of Data Rules:- TP provision in India provided for use of data of the period under audit in analyzing comparable uncontrolled transaction. Further there was additional provision that data of previous 2 years can be used if it influences the determination of arm's length pricing. But on later date, the government amended the provisions applicable from FY 2014 allowing the use of multiple years' data of the comparables.

1.4.5.5 Risk Related issues :-There are a number of stake holders in the transfer pricing i.e. tax authorities, investors in MNE business, Management of MNE and its subsidiaries ,shareholders, operational management, suppliers of goods and services, customers and public in general. All these stake holders have different perception about RISK, OECD is also silent on RISK concept affecting the Transfer price. Risk can be categorized as strategic risk, operational risk, tactical risk, Regulatory risk, intellectual capital risk etc. There are quite a few risks which the corporates would like to convert into opportunity or secure themselves against such risk. Risk identification, risk analysis and risk allocation are the important factors and issues in transfer pricing to be addressed so that one can apply insight into the conditions contributing to pricing decisions and understand the circumstances leading to determination of such prices, before taking a view whether they are at arms' length or not. Further financial capabilities to bear the risk will also influence whether party is able to bear the implication of risk or able to control the risk to prevent the negative impact on transfer price.

1.4.5.6 Valuation Issues:- The company utilizes the resources drawn from the economy by performing functions and conducting activities and processes it to produce and supply goods and services for which it incurs expenses .These expenses needs to be recovered by adopting proper costing ,pricing and valuation methods for buying as well as supplying goods to intra unit . From MNE view point such resources should be put to efficient and effective use to minimize cost and maximize profit.

1.4.5.7 Diversion of Funds by misusing TP like Payments for services which were never rendered or at inflated prices.

Purchases of redundant assets at prices in excess of fair market value and then scrapping it by subsidiary company. For example Company 'A', a foreign company supplies plant and machinery and technology to Company 'B' located in India. Mostly

the plant and machinery is old but categorised as refurbished to avail of the benefits of depreciation and other allowances.

1.4.5.8 Borrowing or Lending : Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates prevailing at the time of the transaction, with the sole purpose of benefitting or accommodating one of the parties and / or ultimately the group as a whole.

1.5 INTRODUCTORY SUM UP

1.5.1 In such a scenario identifying, characterising, benchmarking, comparing and ultimately validating the Arms' Length Price in an international transaction makes Transfer Pricing a subjective proposition, where no two experts may always have the same view. Driven by conflicting considerations of the tax payer and the revenue authorities, this becomes a very complex scenario, perhaps explaining the reasons for significantly large volume of litigations on the subject.

1.5.2 The typical international transaction that takes place is purchase and sales of goods/materials/ plant and machinery, loans and advance given or taken, transfer of technology, Royalty, technical services fees, management consultancy fees, reimbursement of expenses, giving and taking premises on lease and various other services.

1.5.3 The relevant information should ideally be traced from the records in the company and its foreign counterpart, or Associated Enterprise profile, details of information on international transactions, Functions, Assets and Risk analysis, commercial and economic analysis, selecting correct bases of international transaction etc .

1.5.4 With advent of technology, more amendments in TP provisions, introduction of GST, and the provision to set up Information Utility under the Insolvency and Bankruptcy Code, it is expected that significant part of the TP challenges will be addressed arising out of reduction in asymmetry in information in the public domain, which is a typical challenge faced by entities in the SME sector.

1.5.5 In the subsequent chapters, attempt is made to structure the understanding of this complex subject in a manner that it would provide the necessary framework for an entity to deal with the subject of transfer pricing.

CHAPTER 2

IMPORTANT DEFINITIONS, TERMS AND ABBREVIATIONS USED IN TRANSFER PRICING

2.0 IMPORTANT TERMS

In the understanding of the conceptual framework of Transfer Pricing, certain terms have to be well understood. These terms namely Permanent Establishment (PE), Business Connection, Enterprise, Place of Effective Management (POEM) – a concept introduced by the Finance Act, 2017, Associated Enterprise (AE) and International Transactions are discussed.

2.1 RELEVANCE OF RESIDENCE UNDER INCOME TAX ACT (IT ACT) WITH RESPECT TO A COMPANY

The taxability of income of a company under the IT Act is different with respect to a company resident in India and company not resident in India. The relevant provisions are contained in Section 5 of the IT Act under the head "Scope of Total Income". The position is briefly summarized below :-

Nature of Income with respect to the relevant Previous Year (FY)	Taxability for a Resident Company	Taxability for a Non Resident company
Income received or deemed to be received in India	Taxable	Taxable
Income accrues or arises or deemed to accrue or arise in India	Taxable	Taxable
Income accrues or arises outside India	Taxable	NOT TAXABLE

From the above it can be readily seen that with respect to income accruing or arising outside India, the taxability of such income would clearly depend upon the residence of the company.

The Concept of Residence under the Act with respect to a company is governed by Section 6(3) of the IT Act. Accordingly,

A company is said to be a resident in India in any previous year, if—

(i) it is an Indian company; or

(ii) its place of effective management, in that year, is in India.

Explanation.—For the purposes of this clause "place of effective management" means a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made.]

It is very clear that an Indian company (meaning a company registered in India) is clearly a resident.

Until 2015, the only manner in which a foreign company could be deemed to be an Indian tax resident was if the control and management of its affairs were **“wholly”** situated in India during the concerned financial year. And such cases were very few.

Finance Act, 2015 replaced the test of “Control and management of affairs wholly” (which was objective) with a more subjective but substantive test of “Place of Effective Management” (POEM). However, in the absence of guidance in the form of rules until 2017, the applicability of this test was postponed to 1st April, 2017.

As regards applicability, Circular No. 08 of 2017 dated 23rd February, 2017 has made it clear that the POEM guidelines will apply only to a company whose turnover or gross receipts for a financial year is more than Rs. 50 Crores.

With this PROSE of residence in the background, let us now get into the CONCEPT of PE and POEM and how these two concepts are to be reconciled in practice.

2.2 PERMANENT ESTABLISHMENT IN CONNECTION WITH INTERNATIONAL TAXATION

2.2.1 The term Permanent Establishment (PE) has probably been the most important concept in the framework of international taxation both in India and worldwide due to its direct impact on the tax revenue generated by a Country. The PE concept provides the basis to determine the right of a country to tax the profits of an enterprise which is resident of another country and is generally used in parlance of cross border business and taxability of the income generated.

2.2.2 When it comes to International taxation, the basis of taxation has so far been either source based or residence based. A source-based approach entitles the “source” country to tax the income of non-residents that is earned within its borders. On the other hand, in a residence-based system, the home country has the jurisdiction to tax the worldwide income of its residents, regardless of its source

2.2.3 One of the fundamental principles of taxation is that no income should be taxed twice. It is on this basis that the countries have entered into Double Taxation Avoidance Agreements (DTAA) to assure that the same income will not be taxed twice.

2.2.4 The two most popular tax conventions are the OECD and the UN Convention which have acted as templates for a number of DTAAs. The OECD Model, it is believed, tends to favour the developed nations or the capital exporting nations as it recognizes residence based taxation and the source country does not have the right to tax that income. The underlying rationale for the existence of this principle is that it is the investors of the developed countries that invest in developing countries and not the other way round. On the other hand the UN Model is perceived to be more favourable to the developing or the capital importing countries as it recognizes both residence and source based taxation. But the net impact is only marginally favourable.

2.2.5 PE may be defined as a fixed place of business through which activities of an organization are wholly or partially carried on. This fixed place of business should be the place of business of foreign entity itself (at the disposal of such foreign entity) and not the local entity. Accordingly, maintenance of fixed place of business only for preparatory and auxiliary activities does not make that establishment a PE.

2.2.6 Even though the basic concept of PE revolves around the fixed place of business, it may also extend to include an agent who is legally separate from an enterprise and also rendering of services in India by a foreign entity. The Double Taxation Avoidance Agreements entered into by India recognizes the following main types of PE for a foreign enterprise in India:

- ° Fixed Place PE
- ° Agency PE
- ° Site PE
- ° Service PE

2.2.6.1 **Fixed Place PE :**

In order to constitute a fixed place permanent establishment (PE), three criteria have to be satisfied viz. (a) the physical criterion (existence of physical location) (b) subjective criterion (right to use that place) and (c) functional criterion (carrying on business through that place). It is only when the three conditions are satisfied that a PE under the basic rule can be said to have come into existence. The onus is on the Revenue to show that the assessee has a PE

Specifically included Places (OECD Model Paragraph 2 and commentary thereon)

The following are generally considered, *prima facie*, as constituting permanent establishments:

- A branch
- A warehouse (but see excluded places below)
- A factory
- A mine or place of extraction of natural resources
- A place of management

Specifically excluded Places (OECD Model Paragraph 4 and commentary thereon)

Many treaties explicitly exclude from the definition of PE places where certain activities are conducted. Generally, these exclusions do not apply if non-excluded activities are conducted at the fixed place of business. Among the excluded activities are:

- Ancillary or preparatory activities
- The use of a storage facility solely for delivery of goods to customers
- The maintenance of a stock of goods owned by the enterprise solely for purposes of processing by another enterprise (sometimes referred to as toll processing)
- Purchasing or information gathering activities

2.2.6.2. Agency PE

2.2.6.2.1 The activities of a dependent agent may give rise to a PE for the principal. Dependent agents may include employees or others under the control of the principal. A company is generally not considered an agent solely by reason of ownership of the agent company by the principal.

2.2.6.2.2 The primary test for an agency is the ability of the agent to bind the principal to a third party. If the agent is an independent Agent, then it is not construed as PE as he has legal and economic independence.

2.2.6.2.3 A Dependent Agent who;

- a) Acts on behalf of enterprise
- b) Has authority to conclude contracts
- c) Has no authority but habitually maintains stock of goods constitutes a PE.

2.2.6.2.4 As per Article 5, paragraph 7 of UN Model convention, an enterprise of a contracting state shall not be deemed to have a permanent establishment in the other contracting state only because it carries the business through a broker, Commission Agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. “However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph”

2.2.6.3 Site PE

Many treaties provide specific rules with respect to construction sites. Under those treaties, a building site or construction or installation project constitutes a PE only if it lasts more than a specified length of time. The amount of time varies by treaty.

As per Article 5, Paragraph 2 UN model convention, the following are the illustrative list of facilities constituting a PE

- a. Building Site
- b. Construction
- c. Assembly/Installation/Supervision

2.2.6.4 Service PE

Some treaties deem a PE to exist for an enterprise of one country performing services in the other country for more than a specified length of time or for a related enterprise.

The concept of Service PE exists in Article 5 of UN MC. UN MC, which favors source based taxation, though does not specifically use the expression “Service PE”, but its Article 5(3) (b), which deals with the concept of Service PE reads as under; “The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve –month period”

It is customary for developing and emerging economies, which are predominantly capital importing nations, to generally try and negotiate Service PE clause in bilateral treaties, so as to tax profits of foreign enterprises operating within their territories, even in circumstances where no Fixed or Agency PE exists.

2.2.7 Tax treaties help to resolve the claims of competing jurisdictions where an enterprise is resident in one country and carries out business activities in another. Domestic tax laws of countries prescribe the threshold for taxing business profits of a foreign enterprise carrying on business within their taxable territory. For instance in India, we have the concept of a 'business connection', which is analogous to the concept of a PE. In the UK, the threshold is described as the point when a foreign enterprise trades within the UK, as opposed to merely trading with the UK. The PE concept is therefore a major contribution to international tax law and is a significant feature of bilateral tax treaties in force throughout the world. Where a tax treaty is in operation, the crucial question is whether a foreign enterprise is carrying on business through a PE in the country where the profits are earned or not. If the enterprise does not have a PE then it can be taxed only in the country where it is a resident. However, where the enterprise operates through a PE, the profits attributable to it, may be taxed by the country where the PE is located. The enterprise will then have to apply to the tax authorities of its country of residence for obtaining relief from double taxation. Thus it may be possible for an enterprise with overseas trading operations to optimize foreign taxes by carefully structuring its operations. Where a PE is in existence, the country where it is located may also tax its capital gains, dividends, interest and royalties that are effectively connected to such PE.

2.2.8 CONCEPT OF PERMANENT ESTABLISHMENT (PE) IN INDIAN INCOME TAX

2.2.8.1 Both the OECD Model Convention and the UN Model Convention contain the definition of a PE. Both these model conventions have served as the basis for the various DTAA's entered into by India with a number of countries. Up until now, India's official policy has tended to follow the UN Model in a majority of cases, as it is considered beneficial for a capital importing country like India.

2.2.8.2 In India, the Income Tax Act, 1961 provides for levy of income-tax on the income of foreign companies and non-residents, but only to the extent of their income sourced from India. Under section 5 of the Act, a foreign company or any other non-resident person is liable to tax on the following:-

- a) income which is received or is deemed to be received in India by or on behalf of such person, or
- b) income which accrues or arises or is deemed to accrue or arise to it in India.

2.2.8.3 Income tax is payable by a taxpayer, regardless of whether he is a resident taxpayer, a non-resident taxpayer, or a non-resident Indian, on the total income computed by the Assessing Officer under the provisions of the Income Tax Act 1961.

2.2.8.4 Section 9 of the Income Tax Act specifies certain types of income that are deemed to accrue or arise in India in certain circumstances. These two sections namely Sections 5 and 9 read together embody the source rule of income taxation in the domestic law. To tax the income of a non-resident in India it has to fall within the corners of section 5 read with section 9 of the Income-tax Act. Section 9(1) of the I.T. Act specifies that for the income to be taxed in India, it should be deemed to accrue or arise in India.

And one of the types of incomes that arises is income from “business connection” in India .

2.2.8.5 According to Section 9, the business income of a foreign company or other non-resident person is chargeable to tax to the extent –

- a) it accrues or arises through a business connection in India or
- b) from any asset or source of income located in India, and

such income is attributable to the operations carried out in India.

Certain income is deemed to accrue or arise in India under section 9 of the said Act, even though it may actually accrue or arise outside India Section 9 applies to all assesses irrespective of their residential status and place of business. Thus, only Indian income is liable to income tax in India in the case of a non-resident person. This means that a non-resident person is not liable to pay any income tax in India on his foreign income. But though an income may not actually accrue or arise in India, yet it may be deemed to accrue or arise in India by virtue of the provisions of Section 9 of the Income Tax Act.

2.2.8.6.0 The term “Business Connection” has not been explicitly defined in the Income Tax Act.

2.2.8.6.1 Explanation 2 to Section 9(1) of the Income Tax Act dealing with Business Connection states "For the removal of doubts, it is hereby declared that "business connection" shall include any business activity carried out through a person who, acting on behalf of the non-resident,—

- (a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or
- (b) has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or
- (c) habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident:

Provided that such business connection shall not include any business activity carried out through a broker, general commission agent or any other agent having an independent status, if such broker, general commission agent or any other agent having an independent status is acting in the ordinary course of his business :

Provided further that where such broker, general commission agent or any other agent works mainly or wholly on behalf of a non-resident (hereafter in this proviso referred to as "the principal non-resident)" or on behalf of such non-resident and other non-residents which are controlled by the principal non-resident or have a controlling interest in the principal non-resident or are subject to the same common control as the principal non-resident, he shall not be deemed to be a broker, general commission agent or an agent of an independent status.

2.2.8.6.2 *Explanation 3 states* "Where a business is carried on in India through a person referred to in clause (a) or clause (b) or clause (c) of *Explanation 2*, only so much of income as is attributable to the operations carried out in India shall be deemed to accrue or arise in India."

2.2.8.6.3 *Explanation 4 states* "For the removal of doubts, it is hereby clarified that the expression "through" shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of".

2.2.8.6.4 *Explanation 5 states* “For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India”

2.2.8.6.5 The term business connection has evolved over a period of time. The Hon’ble Courts have time and again interpreted the term “business connection” with reference to facts, circumstances and prevailing conditions. A business connection involves a relation between a business carried on by a non-resident which yields profits or gains and some activity in India which contributes to the earning of these profits or gains. A business connection can arise between a non-resident and a resident if both of them carry on business and if the non-resident earns income through such a connection. A business connection involves a relation between business carried on by non-resident which yields profits or gains and some activity in India which contributes to the earning of these profits or gains

2.2.8.6.6 A business connection can arise between a non-resident and a resident if both of them carry on business and if the non-resident earns income through such connections. It basically predicates an element of continuity between the business of the non-resident and the activity in India: a stray or isolated transaction is not normally regarded as business connection

2.2.8.6.7 The taxation of income derived from a business connection in India can be avoided by the non-resident, if he is a non- resident in a country with which India has signed a DTAA. In such cases, income is treated as ‘business profits’ under the DTAA and consequently taxed only if the non resident has a PE in India and such profits are attributable to the PE. This overriding effect of the DTAA is due to the fact that the DTAA supersedes the Act and in case of a conflict between the Act and the DTAA, the assessee shall be entitled to the beneficial provisions among the two, i.e. the DTAA and the Act.

2.2.8.6.8 It should be noted that the concept of business connection is to be distinguished from the concept of a PE and the two do not stand on an equal footing. While, Business Connection is relevant for assessment of income under the Income Tax Act, the concept of PE will be applicable for assessment of income under the Act in respect of a Non-resident under the DTAA. It will have to be appreciated that the existence of a PE would not constitute sufficient business connection, and the PE would be the taxable entity. Hence, even if global income of a resident is subject to tax, the tax liability on global income of a non-resident is dependent upon the condition of the existence of a PE in the source country.

2.2.8.6.9 Article 7 of the various DTAA's that India has entered into, including the OECD and the UN Models deal with the concept of 'business profits'. Accordingly 'business profits' is subject to tax in the source country only if such business is carried on in the source country through a PE situated in such country. The generally advocated rationale for taxing the PE in a country is the assumption that it has a significant presence in the country and the non-resident enterprise is earning its income in the source country through the carrying on of activities by the PE.

2.3 IMPACT OF E-COMMERCE ON THE CONCEPT OF PE

2.3.1 The E-commerce transactions particularly in the international market has had a significant impact in the way the otherwise established concept has responded. Consequent to e-commerce transactions, the traditional market place has disappeared and instead we have virtual markets. What is happening is that markets are created with virtual ease and operations are also shifted virtually. This has significantly influenced the constitution of a PE and provided opportunities to avoid building a PE in a high tax jurisdiction. This causes revenue discomfort to that tax jurisdiction who may like to interpret such devices as avoidance devices and bring the transactions into the tax net.

2.3.2 E-commerce transactions are typically characterized by elements such as online sales through an enterprise' website, online payment gateway, download of products from website etc., products being downloaded from the web site onto the consumer's computer etc. It is imperative that international and domestic tax principles and practices take into view the above to prevent revenue loss, especially since tax principles have traditionally required some sort of geographical presence or a geographical connection to levy taxes. E-commerce has thrown up a number of issues that the traditional tax principles is finding difficult to arrive at a consensus for legislation specifically in the international context.

2.3.3 Apart from the generic issues listed above, another important issue is the concept of 'disintermediation'. E-commerce has removed the need for the presence of any physical intermediary of the non-resident enterprise in the source country. This disintermediation often results in significant losses to the source country as non-resident enterprises can shift their business operation from the physical intermediaries in the source country to their e-commerce base in the residence country as there is no physical presence in the source country. The above problem gets bigger for the policy makers as these transactions could be sometimes anonymous, as neither the buyer nor the seller can be conclusively identified. Another point for consideration could be the role of e-commerce as a dependent or an independent agent. Internet technology can be substituted for the functions performed by the dependent agents like concluding contracts etc. This again entails the loss of revenue to the source country.

2.3.4 OECD has tried to clarify the situation by referring to certain important variables such as location of the server or carrying on core activities as the basis for deciding the PE issue. However, given the fact that constitution of a PE can be totally avoided by carrying on only preparatory or auxiliary services in the source country, a great deal would have to depend upon the facts and circumstances of each case, and one would have to deal with uncertainty about determination.

2.3.5 As far as India is concerned, the lack of clarity vis a vis OECD prescription continues with respect to four basic points. These are :-

- a) Hosting of a website from a server in India would constitute a PE
- b) A PE can be constituted without having a fixed place of business in source country
- c) Mere presence of an agent of a foreign enterprise to conclude a contract would constitute an Agency PE and
- d) Mere provision of services constitute a PE and the entire consideration received outside the source state is taxable

Whether or not India's concerns are addressed appropriately in the future, the above points remain significant concerns.

2.4 PLACE OF EFFECTIVE MANAGEMENT (POEM)

2.4.1 Concept of POEM

The idea of introducing the POEM test has been to align the Indian Taxation law on residence of company with India's double taxation avoidance agreements and with the OECD's Model Tax Convention. The concept of POEM is the subject matter of a detailed circular No. 06 of 2017 issued by CBDT dated January 24, 2017.

As regards applicability, Circular No. 08 of 2017 dated 23rd February, 2017 has made it clear that the POEM guidelines will apply only to a company whose turnover or gross receipts for a financial year is more than Rs. 50 Crores.

In the following paragraphs, a brief summary is attempted :-

a) *Active and Passive Companies* :-

Distinction is made between active and passive foreign companies. An active foreign company is not treated as a resident if certain conditions are fulfilled. A passive foreign company is treated as a resident.

A foreign company qualifies as an active foreign company if all the following conditions are satisfied: -

- i) Passive income is less than 50% of its total income. Passive Income covers income from transactions where both the purchase and sale of goods is between related parties, as well as income from royalty, dividend, capital gains, interest, and rent. The guidelines provide a carve-out with respect to interest income of regulated banking companies and public financial institutions, which are not considered as passive income.
- ii) A company that fails any of the above conditions is considered a passive foreign company.
 - Less than 50% of the value of the company's total assets are situated in India.
 - Less than 50% of the company's employees are Indian residents. Employees include persons who perform tasks similar to those performed by employees, even though such persons are not directly employed by the company.
 - Payroll expenses incurred on Indian resident employees are less than 50% of the company's total payroll expenses.

b) Conditions to be fulfilled by an Active foreign company for not being treated as resident

If a majority of its board meetings are held outside India, unless it is established that its board is "standing aside" and not exercising its powers of management and such powers are being exercised by some other person resident in India.

If a company can objectively satisfy that it is an active foreign company, and a majority of its board meetings are held outside India, the burden of proof to establish that its Board is 'standing aside' falls shifts to the tax authorities.

The guidelines clarify that merely because a company's board follows general and objective principles of global policy of its group, laid down by the company's parent with respect to administrative functions, such as payroll, supply chains, etc., it does not by itself result in the board being considered as 'standing aside.'

c) Determination of POEM for Passive Foreign Companies

In cases of companies other than those that are engaged in active business outside India, the determination of POEM would be a two stage process, namely:-

(i) First stage would be identification or ascertaining the person or persons who actually make the key management and commercial decision for conduct of the company's business as a whole.

(ii) Second stage would be determination of place where these decisions are in fact being made.

The place where these management decisions are taken would be more important than the place where such decisions are implemented. For the purpose of determination of POEM, it is the substance which would be conclusive rather than the form.

The cited circular provides certain guiding principles for determining POEM :-

Location where Company's Board meets regularly :- The location where the board of the company regularly meets and makes decisions for the company may be construed as the POEM, provided that the board retains its authority to govern the company and itself takes key management and commercial decisions, i.e., such authority is not de facto delegated by the board to someone else. If the minutes of the Board Meeting are maintained at a location outside India, it appears to be sufficient to establish that the Place of Management is outside India.

Board Delegation to Committee : If the Board delegates some of its authority to a committee consisting of key members of senior management, the location where such members are based, and where the committee formulates and develops key strategies and policies for mere formal approval by the board will often be considered to be the company's POEM.

The guidelines define 'senior management' as persons who are generally responsible for formulating key strategies and policies of the company and overseeing their implementation on an ongoing basis. These persons may include managing director or CEO, financial director or CFO, chief operating officer, and heads of various divisions or departments.

Location of head office : The location of the head office is considered an important factor in determining POEM, and is to be determined considering certain factors including :

Location where the company's senior management and support staff are based and which is held out to the public as its headquarters.

In case of a more decentralised company, the place where the senior management is predominantly based, normally returns to after travel, or meets when formulating key strategies or policies would be considered the head office.

Where senior management permanently operate from different locations, and participate in meetings via telephone or video conferencing, the location of the highest level of management such as the MD or Finance Director will be considered as the head office.

In case of a highly decentralized company where it is not possible to determine location of Head office, the head office would not be of much relevance in determining POEM.

Physical Location of Meetings : The use of modern technology impacts the place of effective management in many ways. Therefore physical location of board meeting or executive committee meeting or meeting of senior management may not be where the key decisions are in substance being made. In such cases the place where the directors or the persons taking the decisions or majority of them usually reside may also be a relevant factor.

Decisions through circular resolutions :- In case of circular resolution the factors like, the frequency with which it is used, the type of decisions made in that manner and where the parties involved in those decisions are located etc. are to be considered. It cannot be said that proposer of decision alone would be relevant but based on past practices and general conduct; it would be required to determine the person who has the authority and who exercises the authority to take decisions. The place of location of such person would be more important

Shareholder Decisions :- The decisions made by shareholder on matters which are reserved for shareholder decision under the company laws are not relevant for determination of a company's place of effective management. Such decisions may include sale of all or substantially all of the company's assets, the dissolution, liquidation or deregistration of the company, the modification of the rights attaching to various classes of shares or the issue of a new class of shares etc. These decisions typically affect the existence of the company itself or the rights of the shareholders as such, rather than the conduct of the company's business from a management or commercial perspective and are therefore, generally not relevant for the determination of the POEM.

However, the shareholder's involvement can, in certain situations, turn into that of effective management. This may happen through a formal arrangement by way of shareholder agreement etc. or may also happen by way of actual conduct. As an example if the shareholders limit the authority of board and senior managers of a company and thereby remove the company's real authority to make decision then the shareholder guidance transforms into usurpation and such undue influence may result in effective management being exercised by the shareholder. Therefore, whether the shareholder involvement is crossing the line into that of effective management is one of fact and has to be determined on case-to-case basis only.

Routine Operational Decisions :- It may be clarified that day to day routine operational decisions undertaken by junior and middle management shall not be relevant for the purpose of determination of POEM. The operational decisions relate to the oversight of the day-to-day business operations and activities of a company whereas the key management and commercial decision are concerned with broader strategic and policy decision. In certain situations it may happen that person responsible for operational decision is the same person who is responsible for the key management and commercial decision. In such cases it will be necessary to distinguish the two type of decisions and thereafter assess the location where the key management and commercial decisions are taken.

Secondary factors :- If the above factors do not lead to clear identification of POEM then the following secondary factors can be considered :-

- (i) Place where main and substantial activity of the company is carried out; or
- (ii) Place where the accounting records of the company are kept.

All relevant factors to be considered and not in isolation :- The determination of POEM is to be based on all relevant facts related to the management and control of the company, and is not to be determined on the basis of isolated facts that by itself do not establish effective management, as illustrated by the following examples:

(i) The fact that a foreign company is completely owned by an Indian company will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.

(ii) The fact that there exists a Permanent Establishment of a foreign entity in India would itself not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.

(iii) The fact that one or some of the Directors of a foreign company reside in India will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.

(iv) The fact of, local management being situated in India in respect of activities carried out by a foreign company in India will not, by itself, be conclusive evidence that the conditions for establishing POEM have been satisfied.

(v) The existence in India of support functions that are preparatory and auxiliary in character will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.

No Single principle is decisive :- No single principle will be decisive in itself. The various principles covered above are not to be seen with reference to any particular moment in time rather activities performed over a period of time, during the previous year, need to be considered. In other words a “snapshot” approach is not to be adopted. Further, based on the facts and circumstances if it is determined that during the previous year the POEM is in India and also outside India then POEM shall be presumed to be in India if it has been mainly /predominantly in India

2.4.2 Two Step Approval process

The guidelines prescribe that the tax authorities should undertake a two-step approval process to initiate a POEM challenge.

The assessing officer is required to obtain a prior approval of the jurisdictional Principal Commissioner or Commissioner of Income Tax, as the case may be.

Further, if the assessing officer arrives at a finding that the company’s POEM is in India, such finding must be approved by a collegium of three members consisting of the Principal Commissioners or the Commissioners, as the case may be, to be constituted by the Principal Chief Commissioner of the region concerned Revenue officials, and the concerned company must be given an opportunity of being heard by the collegium.

2.4.3 Way forward with POEM

Determination of tax residence is the first step towards determining tax incidence and therefore should be free from any ambiguity or uncertainty.

The guidelines contain a significant shift to Corporate Residency test and emphasis on substance over form. This by itself can lead to lot of ambiguities from a tax payer point of view as multiple principles are prescribed and their application with different objectives could lead to different interpretations.

Certainty in taxation is a basic tenet of taxation which when ensured will go a long way in improving India's ranking in "Ease of Doing Business". To some extent strengthening of the Advance Ruling Mechanism can help, but how far the Authority for Advance Ruling, as existing in the present form will be able to cope up with the pace of POEM determination on a year to year basis.

Greater safeguards may be a solution in the form of having an approving panel to be chaired by a sitting or former High Court judge, accompanied by one tax official and an academician or scholar as in the case of invocation of GAAR, unlike the present provision for POEM which consists of all tax officials only who are generally not prone to take a position different from that of an Assessing Officer.

Circular No 25 of 2017 dated 23rd october, 2017 has clarified the position with respect to regional headquarters of Non Resident MNE's stating that they will not be treated as Non-Residents. However the circular has cautioned that GAAR Provisions will get triggered in the event of aversive /aggressive tax planning.

This is just the beginning with POEM and possibly with learnings, there will be improvements in the way the provisions are administered.

2.5 RECONCILING BETWEEN PERMANENT ESTABLISHMENT AND POEM

2.5.1 The concept of POEM being incorporated in the Indian tax structure arises out of India's role and commitment with the Base Erosion Profit Sharing (BEPS) action plan initiative of the G20 countries and some developed nations. Under POEM, the basis of taxation shifts from "source based" to "residence based".

2.5.2 Significantly, the taxation shift would impact Controlled Foreign Corporations (CFC's) set up by Indian MNE's, as these CFC's would be treated as resident in India and would have to pay Indian income tax on its foreign income. Of course, the POEM concept is applicable for companies with turnover or gross receipts for a financial year is more than Rs. 50 Crores.

2.5.2.1 Thus for companies having turnover or gross receipts for a financial year up to Rs. 50 Crores, their CFC's would not be regarded resident in India unless its PE is situated in India.

2.5.2.2 With respect to these companies to which POEM is applicable, they are entitled to claim tax credits in accordance with the Double Taxation Avoidance Agreements (DTAA) entered into by India with the foreign tax jurisdictions, where the company might be paying taxes.

2.6 ENTERPRISE

2.6.1 The term "Enterprise" has been defined in Section 92F(iii) of the Income Tax Act. Accordingly "enterprise" means a person (including a permanent establishment of such person) who is, or has been, or is proposed to be, engaged in any activity, relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights, or the provision of services of any kind, or in carrying out any work in pursuance of a contract, or in investment, or providing loan or in the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate, whether such activity or business is carried on, directly or through one or more of its units or divisions or subsidiaries, or whether such unit or division or subsidiary is located at the same place where the enterprise is located or at a different place or places;

2.6.2 The definition of Enterprise is very wide and covers almost every type of business or activity that an entity would normally engage in. The term "Enterprise" applies to all persons and hence any entity which is a "Person" within the meaning of Section 2(31) of the Income Tax Act would be an enterprise for the purpose of Transfer Pricing Regulations, if it were engaged in specified categories of activity / business directly or through a subsidiary.

2.6.3 The term “Enterprise” also includes a Permanent Establishment of such person. A question arises as to whether a branch PE of an Indian company set up outside India would be regarded as a separate entity. It is understood that the transfer pricing provisions apply if either or both parties to a transaction are non-resident. There are two views on this matter. One view is that when an Indian Company has a branch outside India, the Indian tax authorities would be treating the Indian Company and its branch PE as two separate entities. The PE may be liable to tax in the foreign country. Another view can be that such transactions would be covered by the TP regulations as PE is considered a separate entity in a foreign jurisdiction and a non-resident entity. These varying interpretations call for planning the legal structure properly in such a way that double taxation is avoided and full benefits of treaty provisions are realized.

2.7 ASSOCIATED ENTERPRISE :

Intra-group transactions of MNE, (apart from market considerations governing individual entities) is by and large influenced and overruled by MNE’s group considerations and perspective. In such a situation, it becomes important to establish the right price, called the “transfer price”, for intra-group, cross-border transfer of goods, intangibles and services. Transfer pricing is the commonly understood term for the pricing of cross-border, intra-firm transactions between related parties. The term “related parties” is a well understood term in the accounting fraternity all over the world. In the context of “Transfer Pricing”, these related parties are referred to “Associated Enterprises”.

The term “Associated Enterprise” is central to the concept of Transfer Pricing. It is defined in a broad manner based on the criteria of direct or indirect participation in the management, control or capital of the other enterprise or by the same persons in such enterprise. The tax authorities are concerned with the pricing methodologies followed by the Associated Enterprises in their international transactions amongst themselves. Hence it is necessary to clearly identify the “Associated Enterprises” in international transactions.

2.7.1 Definition of associated enterprise.

Section 92A of the Income Tax Act, 1961 defines the term “Associated Enterprise” in two parts.

The first part is covered by sub section 1, which states “For the purposes of this section and sections 92, 92B, 92C, 92D, 92E and 92F, “associated enterprise”, in relation to another enterprise, means an enterprise—

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

The second part of the definition lists out the enterprises which would for the purpose of sub section 1 be deemed to be “associated enterprises”

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

- (a) one enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise; or
- (b) any person or enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in each of such enterprises; or
- (c) a loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise; or
- (d) one enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise; or
- (e) more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise; or
- (f) more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons; or

- (g) the manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights; or
- (h) ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise; or
- (i) the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise; or
- (j) where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or
- (k) where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or jointly by such member and his relative; or
- (l) where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association of persons or body of individuals; or
- (m) there exists between the two enterprises, any relationship of mutual interest, as may be prescribed.

2.7.2 Analysis of the definition of Associated Enterprise (AE)

2.7.2.1 Associated Enterprise :- The first part of the definition of Associated Enterprise (AE) in sub section 1 of Section 92A clearly specifies which enterprise can be treated as Associated Enterprise

According to sub-section (1), an enterprise which participates directly or indirectly or through one or more intermediaries, in the management or control or capital of the other enterprise shall be regarded as an associated enterprise.

It can be seen that the participation in an enterprise can take three forms namely

- a) Management, meaning the act of planning, directing, handling, or performing any other functions in relation to the enterprise and taking important decisions
- b) Control, meaning the exercise of restraint or issue of direction or carry out checks or regulate or monitor through delegation and reporting
- c) Capital, meaning ownership or interest in a business through holding of shares or voting power

The following types of participation in the management or control or capital by one enterprise over the other are covered in Sub section 1 :-

- 1) Enterprise participating directly
- 2) Enterprise participating indirectly
- 3) Enterprise participating through one or more intermediaries.

2.7.2.2 Deemed Associate Enterprise : - The second part of the definition of Associated Enterprise (AE) covered by sub section 2 of Section 92A is basically supplementary nature and lists out the situations in which certain enterprises are deemed to be Associated Enterprises in clauses (a) to (m). It is further clarified that for the purposes of sub-section (1), two enterprises shall be deemed to be associated enterprises if, at any time during the previous year any of the conditions mentioned in clauses (a) to (m) are satisfied.

Analysis of the various situations in which an Enterprise is deemed to be an Associated Enterprise

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

Two enterprises shall be associated enterprises based on the shareholding of one enterprise in the other if the investing enterprise holds shares carrying not less than 26% of the voting power in the other enterprise. Holding for this purpose refers to beneficial shareholding and also includes indirect shareholding. Holding for this purpose includes indirect holding too.

As the terms used are “shares” and “voting power”, it is apparent that this clause applies only to those cases where the investee enterprise is a company.

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

This is based on not less than 26% of shareholding or voting power in both enterprises being held the same person or enterprise. Accordingly, it is possible that two enterprises are deemed associated enterprises, even though one enterprise may not hold any shares in the other enterprise. The deeming is based on common shareholding by any person or enterprise.

The term "Person" is defined in Section 2(31) of the Income Tax Act. Accordingly it includes the following :-

- (i) an individual*
- (ii) a Hindu undivided family*
- (iii) a company,*
- (iv) a firm*
- (v) an association of persons or a body of individuals, whether incorporated or not,*
- (vi) a local authority and*
- (vii) every artificial juridical person, not falling within any of the preceding sub-clauses.*

Further an explanation has been added to the effect that for the purpose of the clause defining the term "Person", an association of persons or a body of individuals or a local authority or an artificial juridical person shall be deemed to be a person, whether or not such person or body or authority or juridical person was formed or established or incorporated with the object of deriving income, profits or gains.

The purpose of using the term "Person" to define a deemed associated enterprise based on common shareholding in two enterprises is to make it clear that the common shareholder need not necessarily have the motive of profit.

Here too like clause (a) above, the terms used are "shares" and "voting power" and the same logic applies that this clause applies only to those cases where the investee enterprise is a company.

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

Where the loans of the lending enterprise to the borrower enterprise constitute more than 51% of the 'book value' of the total assets of the borrowing enterprise, then both the lender and the borrower enterprises would be treated as 'associated enterprises'.

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

If the guarantor enterprise guarantees 10% or more of the total borrowing of the enterprise seeking guarantee, then they would become 'associated enterprises'. Here it is to be noted that total borrowing should include guarantees as well, since the value of guarantees is included in the numerator, then value of all guarantees should also be included in the denominator. Another question for which no ready answer is available is whether letters of comfort or back to back letters of credit arranged or issued by the bankers of one of the enterprises who has shareholding interest in another enterprise less than 26% (but more than 25% as stipulated in the FEMA regulations for ECB) is includible in the definition of "guarantees" in this clause d. Here it should be further noted that the clause does not use the words "directly" or "indirectly" leaving the ground open for interpretation.

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

Where one enterprise has appointed

- (a) more than one-half of the board of directors or members of the governing board; or
- (b) one or more executive directors or executive members of that board in another enterprise the two enterprises shall be deemed to be associated enterprises.

This clause refers to two terms namely "Board of Directors" and "governing board". As per section 2(6) of the Companies Act, 1956, the term "board of directors" would refer to the board of directors of a company. The term "governing board" is not defined. This appears to refer to a body or council that has the executive authority to manage the affairs of the enterprise to which it relates. These enterprises could be artificial juridical non-corporate bodies.

For the purposes of this clause, the appointment of even one person to the post of executive director or executive member would make the enterprise an associated enterprise.

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

Clause (f) is an extension of the principle laid down in clause (e). This clause is applicable where the same person has

(a) appointed more than one-half of the board of directors or members of the governing board; or

(b) appointed one or more executive directors or executive members of the governing board of two or more enterprises

As explained in Clause (b), the term “Person” would carry the meaning assigned to it under the Income Tax Act.

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

Two enterprises are deemed to be associated, if one is wholly dependent on the other for the use of know-how, patents, copyrights, trade marks, licences or such other business or commercial rights for the manufacture or processing of goods or articles or business carried on by such enterprise.

It should be noted that such rights (business or commercial) must be either owned by the other enterprise or the exclusive rights thereto must vest with the other enterprise. Since the definition enumerates the various rights and then adds “any other business or commercial rights of similar nature”, it is necessary the rights that are conferred should be a business or commercial rights of a nature similar to know-how, patents, copyrights, trade-marks, licences or franchises. If the business or commercial rights are not of a nature similar to the enumerated, it appears that they will not be covered under this clause.

Further it should be noted that the clause also covers any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process which is owned by one enterprise and the other enterprise has exclusive right.

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

There are two situations dealt with in this clause and they are as follows:

(i) 90% or more of the raw materials and consumables required for manufacturing or processing of goods or articles are supplied by the other enterprise,

or

(ii) 90% or more of the raw materials and consumables required for manufacturing or processing of goods or articles are supplied by persons specified by the other enterprise,

and

the prices and other conditions relating to supply by the other enterprise or by a person specified by that other enterprise are influenced by that other enterprise.

Since this clause relates to manufacture or processing of goods, it is important to note that the 90% criteria should be applied exclusively to raw materials and consumables used for manufacturing and processing only.

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

This clause is applicable in the case of sale of goods / articles manufactured or processed by one enterprise to

- 1) the other enterprise or
- 2) persons specified by the other enterprise

And the prices and other conditions for such sale are influenced by such other enterprise.

It is to be noted that the 90% criteria specified in clause (h) is not prescribed for this clause. Also this clause refers to manufactured or processed goods / articles and not traded goods.

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

This clause deals with a situation where one enterprise is controlled by an individual and the other enterprise is also controlled by –

- (i) such individuals; or
- (ii) his relative; or
- (iii) jointly by such individual and his relative then both the enterprises shall be deemed as associated enterprises.

The word 'control' can be interpreted to mean that the individual along with his relatives has the power to make crucial decisions regarding the management and operations of the two enterprises.

Section 2(41) of the Income Tax Act defines relative. Accordingly, "relative", in relation to an individual, means the husband, wife, brother or sister or any lineal ascendant or descendant of that individual"

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

Under this clause control of the two enterprises by the same Hindu undivided family (HUF) is envisaged. It also includes control by -

- (i) a member of the HUF, or
- (ii) by a relative of a member of such HUF, or
- (iii) jointly by such member and his relatives.

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

This clause seeks to cover non-corporate bodies like partnership firms, Association of Persons (AOP) and body of individuals. Further it appears that the term "Firm" would include Limited Liability Partnership firms (LLP's), although no specific clarification has either been sought or given.

The definition of the term "Person" in Sub-clause (v) of clause (31) of section 2 of the Income Tax Act includes these entities.

In case of partnership firm or AOP or body of individuals, the other enterprise must hold not less than 10% interest in such firm, AOP or body of individuals to be regarded as an AE.

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

This is a residuary clause which empowers the CBDT to prescribe any relationship of mutual interest by virtue of which one enterprise may be treated as an Associated Enterprise (AE) of that other enterprise. As of now, CBDT has not prescribed any relationship of mutual interest.

2.8 TRANSACTION

The term “transaction” has been defined in Section 92 (v) of the Income Tax Act, 1961 and includes an arrangement, understanding or action in concert,—

- (A) whether or not such arrangement, understanding or action is formal or in writing; or
- (B) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceeding

It can be readily seen that the definition is inclusive in nature. Accordingly, a transaction includes any arrangement, understanding or action, whether formal or informal, whether oral or in writing, whether legally enforceable or not.

2.9 DEFINITION OF INTERNATIONAL TRANSACTION

Understanding the definition of “International Transaction” is very important, since the provisions of Chapter X of the Income Tax Act, 1961 dealing with Transfer Pricing mechanism are applicable to transactions between two or more Associated Enterprises, either or both of whom are non-residents. Characterization of a transaction as an international transaction is of great significance, since the transfer pricing provisions would be applicable only to an international transaction. If both the parties are residents, then the provisions of the Chapter X relating to Transfer Pricing are applicable, only if they enter into a Specified Domestic Transaction within the meaning of Section 92BA (discussed in greater detail in Chapter 4).

2.9.1 Section 92B of the Income Tax Act defines an “International Transaction”. It is in two parts. In the first part the term “International Transaction” has been defined through sub section 1 and in the second part, there is a deeming provision which stipulates the circumstances under which a transaction with an enterprise other than associated enterprise would be become an international transaction with Associated Enterprise (AE).

2.9.2 Sub section 1 of Section 92B defines “For the purposes of this section and sections 92, 92C, 92D and 92E, “international transaction” means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

To state very briefly, Section 92 refers to computation of income using Arms’ Length Pricing (ALP); Section 92C refers to computation of ALP; Section 92D refers to requirement relating to maintenance and keeping of information and documents by a person entering into international transaction and 92E refers to furnishing of report from an Accountant by a person entering into international transaction.

2.9.3 Sub Section 2 of Section 92B states “A transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purposes of sub-section (1), be deemed to be a transaction entered into between two associated enterprises, if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise.”

It is interesting to note that unlike Section 92B(1) which clearly states that at least one of the transacting entity should be non-resident, Section 92B(2) does not provide any such clarification as to whether unrelated third party with whom Indian taxpayer transacts has to be a non-resident or not.

2.9.4 The definition of international transaction under the transfer pricing regulations is very wide and in its scope and has been further clarified vide Finance Act 2012 with retrospective effect from 1 April 2002 to include:

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

2.9.5 Any transaction between an enterprise and a person other than an associated enterprise will be deemed to be a transaction with an associated enterprise as per sub-section (2) of section 92B under certain situations. This deeming provision is intended to cover cases where an independent third party can be interposed by two associated enterprises just for the purpose of staying away from the transfer pricing provisions of the Act.

2.9.6 According to sub-section (2) of section 92B, a transaction between an enterprise and an unrelated person shall be deemed to be a transaction between associated enterprises if in relation to that transaction -

- (i) there exists a prior agreement between such other person and the associated enterprise; or
- (ii) the terms of the relevant transaction are determined in substance between such unrelated person and the associated enterprise.

2.10 CATEGORIES / TYPES OF INTERNATIONAL TRANSACTIONS

2.10.1 Tangible Property

2.10.1.1 Tangible property refers to all the physical assets of a business. Sales of raw materials, work in progress and finished goods represent a major portion of the transfers that take place between related parties. Typically these transactions are referred to sales of inventory. These inventory items may be either manufactured by the seller or purchased from third parties.

2.10.1.2 An important consideration in the context of determining comparability in the context of transfer of inventory is the level of investment in working capital between the Associated Enterprises and the independent enterprises, which is driven by payment terms and inventory lead times. At arm's length, an uncontrolled entity expects to earn a market rate of return on that required capital. Accordingly, the effects on profits from investing in different levels of working capital warrant an adjustment to the transfer prices

2.10.1.3 The meaning of Tangible Property also includes all the machinery and equipment employed in the day to day activities as well as the goods they produce. In typically MNE environment, Machinery and equipment is frequently provided to manufacturing affiliates by the parent company. The equipment may have been purchased from an unrelated company or manufactured by the parent or its other manufacturing affiliates or might be older equipment that the parent (or another manufacturing affiliate) no longer needs. Tax rules generally require that the transferor of this equipment (whether new or used, manufactured or purchased) should receive an arm's-length consideration for the equipment. This is generally considered to be the fair market value of the equipment at the time of transfer.

2.10.2 Intangible Property

2.10.2.1 The expression "intangible property" for purposes of the Indian transfer pricing regulations has been clarified to include-

(i) marketing related intangibles assets, such as, trademarks, trade names, brand names, logos; or

(ii) technology related intangibles assets, such as, process patents, patent applications, technical documentation such as laboratory notebooks, technical know-how; or

(iii) artistic related intangible assets, such as, literary works and copyrights, musical compositions, copyrights, maps, engravings ; or

(iv) data processing related intangible assets, such as proprietary computer software, software copyrights, automated databases, and integrated circuit masks and masters; or

(v) engineering related intangible assets, such as industrial design, product patents, trade secrets, engineering drawing and schema-tics,blueprints, proprietary documentation; or

(vi) customer related intangible assets, such as, customer lists, customer contracts, customer relationship, open purchase orders; or

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

(viii) human capital related intangible assets, such as, trained and organised workforce, employment agreements, union contracts; or

(ix) location related intangible assets, such as leasehold interest, mineral exploration rights, easements, air rights, water rights; or

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

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

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

2.10.2.2 Intangibles can be transferred between Associated Enterprises in four ways:

1. Outright sale for consideration;
2. Outright transfer for no remuneration (i.e. by way of gift);
3. Licence in exchange for a royalty (lump sum or periodic payment based on a percentage of sales, sum per unit, etc.); and
4. Royalty-free licence.

2.10.2.3 As a general rule, transfers without remuneration are not accepted by the tax authorities of any country. Transfers of intangibles are generally treated in the same

way as sales of tangible property. In other words, the arm's length principle that requires that the transfer price be the fair market value of the property at the time of transfer. In some tax jurisdictions, for example, the USA, it is also required that the consideration paid be commensurate with the income generated or expected to be generated by the intangible asset.

2.10.3 Capital Financing

2.10.3.1 The associated enterprises often enter into transactions of capital financing including borrowing, lending, guarantee arrangements, etc. The pricing of these arrangements will have a bearing on the profits or losses of the associated enterprises and hence are included as part of the definition of 'international transaction'. These transactions of capital financing including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business are expressly covered as international transactions as per the amending provisions of Finance Act, 2012.

2.10.3.2 Before we go into the subject of Arms' Length nature of capital financing transactions, it is necessary to analyse the various forms of finance that are being provided by one Associated Enterprise (often the parent company) to another.

A number of factors are relevant in the context of financing of Associated Enterprises :

- The rate of interest on the loan (including whether it is fixed or floating);
- The capital amount of the loan;
- The currency; and
- The credit worthiness of this borrower (including whether any guarantees have been provided in connection with the loan).

Tax authorities may review whether a third party would charge the rate of interest set between the Associated Enterprises or whether that rate is too high or low.

2.10.3.3 A company's short-term capital needs are typically greatest when it is first formed or undergoing rapid expansion. A parent company that has established a new subsidiary needing to finance its short-term working capital may use:

- Inter-company payables and receivables;
- Advances of capital from a related party;
- Extended credit for inventory purchase or sales; and
- Loans guaranteed by Associated Enterprises.

2.10.3.4 As regards intra-group financing companies, the functions that are performed when an Associated Enterprise grant loans or guarantees to group entities are, in substance, comparable to the functions performed by independent financial institutions in accordance with applicable lending norms. Before granting a loan or advancing money, financial institutions perform an analysis of the risks incurred. As part of their analysis, they review the financial statements of the borrower in order to evaluate the financial risk related to the transaction. They verify the existence of guarantees and examine the purpose of the loan, as well as its term, in order to evaluate borrower risk. An analysis of the industry sector in which the borrower operates enables the lender to evaluate business risk. Finally, structural risk is calculated based on ratings provided by independent rating agencies.

2.10.3.5 Independent financial service providers determine the expenses relating to granting loans by applying additional charges to the financing cost base. Such additional costs take into account, among other things, additional expenses generated by solvency requirements, additional expenses related to credit risk, processing fees or additional expenses related to foreign exchange risk.

2.10.3.6 Credit risk is to be determined based on the terms and conditions of the loan agreement and based on the outcome of the risk analysis. The terms of the credit agreement may have an impact on the degree of foreign exchange risk. In general, independent financial service providers set their remuneration based either on the loan amount or on the actual market value of the assets under management.

2.10.3.7 An additional fee related to solvency requirements may be based on the lender's solvency or on the solvency of another group entity which acts as guarantor as, in the latter case, the guarantor's equity is exposed to risk. In the former case, the additional cost is the arm's length remuneration for the equity that the lender must retain to be able to carry out the transaction. In the latter case, the enterprise which acts as guarantor would, in principle, receive remuneration for putting its equity at risk. The additional fee charged by the lender should at least correspond to the costs of the guarantee.

2.10.3.8 Tax authorities expect the pricing of the intra-group financing transactions should be at the Arms' Length. And to establish the Arms' Length due consideration should be given to the above aspects when it comes to capital financing arrangements between Associated Enterprises.

2.10.4 Provision of Services and sharing of costs

2.10.4.1 "Provision of services" refers to trade related services like intellectual property rights and trade related investments. According to the OECD guidelines, there are two main issues while analysing intra-group services:

- (i) whether an intra-group service that should be charged for has been provided; and
- (ii) what the charge should be in accordance with the arm's length principle.

2.10.4.2 The basis to decide whether a service has been provided is set out in the guidelines as '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. If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's length principle'. Services benefiting a group of enterprises as a whole should be allocated amongst the group in a way that matches the benefit received.

2.10.4.3 The definition of International Transaction shall also include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any International Transaction, contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service, facility provided or to be provided to any one or more such enterprises.

2.10.4.4 Agreement or arrangement represents understanding, and not a transaction as ordinarily understood as being some business or dealing, which is carried on or transacted between two or more persons. It is reciprocal to contribute to the cost or incur expenditure for the mutual advantage or to share according to the agreement or the arrangement. Such agreement or arrangement is not in the nature of conveying any property or provision of services or lending or borrowing and is known as "cost contribution arrangement".

2.10.4.5 The cost contribution arrangements, as aforesaid, are arrangements between business enterprises to share the costs and risks of developing, producing, or obtaining assets, services or rights. Its conditions should be in conformity with arm's length principle and therefore, a participant's contributions must be consistent with what an independent enterprise would have agreed to contribute under comparable circumstances given the benefits it reasonably expects to derive from the arrangement.

2.10.5 Business restructuring or Reorganisation

2.10.5.1 It is relevant to note that a transaction of business restructuring or reorganization has been clarified to be an international transaction irrespective of whether it has a bearing on the profits, income, losses or assets of the enterprise. However, the Income Tax Act does not define business restructuring.

2.10.5.2 In this respect, guidance may be drawn from the OECD guidelines which defines business restructuring as cross border redeployment by a multinational enterprise of functions, assets or risks. A business restructuring may also involve cross border transfers of valuable intangibles or alternatively involve the termination or substantial renegotiation of existing arrangements. Restructuring could be in the form of operational change (in functional, asset and risk profile of the entity) or organizational change (in ownership structure/management of the entity). It could include a change in the nature or scope of transactions among controlled entities, a shift in the allocation of risks, a change in responsibility for specific functions or commencement or termination of a relationship, etc.

2.10.5.3 OECD has opined that it is not sufficient from a transfer pricing perspective that an arrangement makes commercial sense for the group as a whole. The transactions must be arm's length at the level of each individual taxpayer, taking into account its assets, expected benefits from the restructuring agreement, and realistically available options. Tax authorities will consider if the contractual arrangement is consistent with the actual allocation of risks. It has further opined that the arm's length principle does not of necessity require compensation for loss of profit/loss potential. The question is whether there are assets transferred that carry profit/loss potential and how they should be remunerated at arm's length.

2.10.5.4 Taxpayers will need proper documentation describing: comparability (including functional) analysis performed both for the pre and post restructuring arrangements and a description for the actual changes that took place upon the restructuring, what the business reasons for and the anticipated benefits from the restructuring were, and

what options would have been realistically available for the parties at arm's length. The functional analysis may have to cover also a transition period over which the transfer is being implemented.

2.11 CONSTITUENT ENTITY AND INTERNATIONAL GROUP

2.11.1 The definition of Constituent Entity under Section 286(9)(d) is as under :-

"constituent entity" means,—

- (i) any separate entity of an international group that is included in the consolidated financial statement of the said group for financial reporting purposes, or may be so included for the said purpose, if the equity share of any entity of the international group were to be listed on a stock exchange;
- (ii) any such entity that is excluded from the consolidated financial statement of the international group solely on the basis of size or materiality; or
- (iii) any permanent establishment of any separate business entity of the international group included in clause (i) or clause (ii), if such business unit prepares a separate financial statement for such permanent establishment for financial reporting, regulatory, tax reporting or internal management control purposes;

2.11.2 The definition of "International Group" under Section 286(9)(g) is as under :-

"international group" means any group that includes,—

- (i) two or more enterprises which are resident of different countries or territories; or
- (ii) an enterprise, being a resident of one country or territory, which carries on any business through a permanent establishment in other countries or territories;

The definitions of "Constituent Entity" and "International Group" are important from the point of view of Section 286 which stipulates requirement of documentation to be submitted by a Constituent Entity and the requirements of Country by Country Reporting (CbCR). The documentation and reporting requirements for "Constituent Entity" and "International Group" are covered in Chapter 13

2.12 TERMS AND ABBREVIATION USED

A number of terms and abbreviations are used in the context of Transfer Pricing. Since these terms will be referred to fairly frequently, in this paragraph a brief explanation of such terms and the expanded form of the abbreviations are given below.

Further unless any Act is specifically referred to, reference to any section is a reference to the Income Tax Act, 1961.

(a) Act

The Income-tax Act, 1961.

(b) Accountant

Accountant means a chartered accountant within the meaning of the Chartered Accountants Act, 1949 and as referred to in section 288 of the Act.

(It would be of interest to note that there are various representations before the Central Government that the definition of Accountant should also include "Cost Accountant" and "Company Secretary". Suitable provision to this effect was also made in the Draft Direct Tax code when introduced. But as of now, Accountant means only a Chartered Accountant).

(c) Arm's Length Price (ALP)

ALP as defined under section 92F(ii) of the Act.

(d) AS

The Accounting Standards issued, prescribed and made mandatory by the ICAI or as under section 2 (2) of Companies Act, 2013 and the Companies (Accounting Standards) Rules, 2006.

(e) AS (IT)

Income Computation and Disclosure Standards notified by the Central Government under section 145(2) of the Act.

(f) AAS

Auditing and Assurance Standards prescribed and made mandatory by the Institute of Chartered Accountants of India.

(g) Associated enterprises (AEs)

An AE as defined under section 92A of the Act.

(h) APA

Advance Pricing Agreement

(i). BEPS

Base Erosion and Profit Shifting

(j) CBDT

The Central Board of Direct Taxes constituted under the Central Boards of Revenue Act, 1963.

(k) Circular

A circular or instructions issued by the Board under section 119(1) of the Act.

(l) CUT

Comparable Uncontrolled transaction

(m) CUP Method

Comparable Uncontrolled Price Method

(n) RPM

Resale Price Method

(o) PSM

Profit Split Method

(p) CPM

Cost Plus Method

(q) TNMM

Transactional Net Margin Method

(r) MNE

Multi National Enterprises

(s) Enterprise

An enterprise as defined under section 92F (iii) of the Act.

(t) ICAI

The Institute of Chartered Accountants of India.

(u) ICAI – CMA

The Institute of Cost Accountants of India

(v) ICSI

The Institute of Company Secretaries of India

(w) Ind-As

The converged International Financial Reporting Standards (IFRS) by Indian entities who have adopted IFRS with adaptations as permitted by the Companies (Indian Accounting Standards) Rules, 2015

(x) International transaction

International transaction as defined under section 92B of the Act.

(y) OECD

Organisation for Economic Co-operation and Development.

(z) OECD Guidelines

Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations by OECD - provides guidance on the application of the "arm's length principle"

(aa) Report

The report of an accountant under section 92E of the Act.

(ab) Rules

The Income-tax Rules, 1962.

(ac) Specified date

Specified date as stipulated under clause (iv) of section 92F of the Act.

(ad) Specified domestic transaction

Specified domestic transaction as defined under section 92BA of the Act.

(ae) Transaction

A transaction as defined under section 92F(v) of the Act.

(af) Transfer Pricing Officer (TPO)

An officer as defined in explanation to section 92CA.

CHAPTER 3

PROVISIONS OF COMPANIES ACT AND ACCOUNTING STANDARDS **vs TP REGULATIONS**

3.0 FRAMEWORK UNDER COMPANIES ACT

Under the provisions of Sections 184, 188 and 189 of the Companies Act, 2013, there are requirements of disclosure, compliance and approval with respect to certain arrangements entered into by the company, transactions carried out by the company and receipts from / Payments to certain persons by the company, as also maintenance of certain registers in the format prescribed.

The entire scheme of governance and regulatory framework centers around “related parties” and “arrangements & transactions between them”. While section 184 deals with the disclosure of interest by a director based on certain defined criteria with respect to certain transactions and arrangements, Section 188 deals with the transactions & arrangements between related parties. It therefore becomes very much necessary to understand the meaning of related party under the Companies Act, 2013, before we proceed to the operative and governing sections – namely Section 184 and 188.

3.1 SECTION 2(76) – RELATED PARTY & SECTION 2(77) – RELATIVE

3.1.1 “*Related Party*”, with reference to a company, means—

- (i) a director or his relative;
- (ii) a key managerial personnel or his relative;
- (iii) a firm, in which a director, manager or his relative is a partner;
- (iv) a private company in which a director or manager is a member or director;
- (v) a public company in which a director or manager is a director or holds along with his relatives, more than two per cent. of its paid-up share capital;
- (vi) any body corporate whose Board of Directors, managing director or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager;
- (vii) any person on whose advice, directions or instructions a director or manager is accustomed to act:

Provided that nothing in sub-clauses (vi) and (vii) shall apply to the advice, directions or instructions given in a professional capacity;

- (viii) any company which is—

- (A) a holding, subsidiary or an associate company of such company; or
- (B) a subsidiary of a holding company to which it is also a subsidiary;
- (ix) such other person as may be prescribed.

3.1.2 “Relative”, with reference to any person, means anyone who is related to another, if—

- (i) they are members of a Hindu Undivided Family;
- (ii) they are husband and wife; or
- (iii) one person is related to the other in such manner as may be prescribed.

Rule 3 of the Companies (Specification of Definition) Rules, 2014 stipulates that for the purposes of sub-clause (ix) of clause (76) of section 2 of the Act, a director (other than an independent director) or key managerial personnel of the holding company or his relative with reference to a company, shall be deemed to be a related party.

Rule 4 of the Companies (Specification of Definition) Rules, 2014 stipulates that a person shall be deemed to be the relative of another, if he or she is related to another in the following manner, namely:-

(1) Father:

Provided that the term “Father” includes step-father.

(2) Mother:

Provided that the term “Mother” includes the step-mother.

(3) Son:

Provided that the term “Son” includes the step-son.

(4) Son’s wife.

(5) Daughter.

(6) Daughter’s husband.

(7) Brother:

Provided that the term “Brother” includes the step-brother;

(8) Sister:

Provided that the term “Sister” includes the step-sister.

3.1.3 Definition of Key Managerial Personnel (KMP) :- It may be noted that the term “Key Managerial Personnel” is defined in Section 2(51) of the Companies Act, 2013 as under :-

“Key Managerial Personnel”, in relation to a company, means—

- (i) the Chief Executive Officer or the managing director or the manager;
- (ii) the company secretary;
- (iii) the whole-time director;

- (iv) the Chief Financial Officer; and
- (v) such other officer as may be prescribed.

3.2 SECTION 184 – DISCLOSURE OF INTEREST BY DIRECTORS

3.2.1 Section 184 of the Companies Act, 2013, requires every director to disclose his interest or concern, whether directly or indirectly in any contract or arrangement (including proposed contract or arrangement) at a meeting of the Board of Directors.

3.2.2 The requirement to make disclosures of interest is also extended to cover contracts or arrangements with the following :-

- a) any body corporate, in which such director alone or with other directors hold more than 2% of its shareholding or is a promoter, manager or CEO of that body corporate
- b) any firm or other entity in which such director is a partner, owner or member, as the case may be.

3.2.3 The section contains detailed provisions as to when and how the disclosure should be made at a Board Meeting, which is not the scope of this discussion.

3.2.4 The provisions of Section 184 does not apply to any contract or arrangement entered into or to be entered into between two companies or between one or more companies and one or more bodies corporate where any of the directors of the one company or body corporate or two or more of them together holds or hold not more than two per cent of the paid-up share capital in the other company or the body corporate

3.2.5 When we compare the entities covered by applicability of Section 184 vis a vis the concept of AE, we notice that the coverage of entities on the other side of the contract or arrangement would be based more on the connection with the director on the basis of the director being interested. It is possible that an enterprise with whom the company would be dealing could be an AE, though it may not be an enterprise or an entity in which any director could be interested. This situation could arise because of the clauses in the definition of the AE which get triggered by virtue of provisions other than shareholding, control or management. The converse could also happen as explained in Para 3.2.6

3.2.6 Again, it may be noted that though the definition of relative under Companies Act, 2013 is now narrowed down as compared to the corresponding provisions in the Companies Act, 1956, the term “related party” offers a much broader definition, which converges to the concept of “related party” under AS 18, with some differences. The analysis of the differences can become more and more complex when compared with the definition in the Income Tax Act, 1961, because of which a director may not be interested pursuant to Section 184 in any arrangement or contract but it may be an AE within the meaning of sub section 1 or sub section 2 clauses (a) to (m).

3.3 SECTION 188 – RELATED PARTY TRANSACTIONS

3.3.1 The Provisions as they are :-

The bare text of the provisions of Section 188 of the Companies Act, 2013 as amended by Companies Amendment Act, 2017 reads as under :-

188. (1) *Except with the consent of the Board of Directors given by a resolution at a meeting of the Board and subject to such conditions as may be prescribed, no company shall enter into any contract or arrangement with a related party with respect to—*

- (a) sale, purchase or supply of any goods or materials;*
- (b) selling or otherwise disposing of, or buying, property of any kind;*
- (c) leasing of property of any kind;*
- (d) availing or rendering of any services;*
- (e) appointment of any agent for purchase or sale of goods, materials, services or property;*
- (f) such related party’s appointment to any office or place of profit in the company, its subsidiary company or associate company; and*
- (g) underwriting the subscription of any securities or derivatives thereof, of the company.*

Provided that no contract or arrangement, in the case of a company having a paid-up share capital of not less than such amount, or transactions not exceeding such sums, as may be prescribed, shall be entered into except with the prior approval of the company by a resolution:

Provided further that no member of the company shall vote on such resolution, to approve any contract or arrangement which may be entered into by the company, if such member is a related party:

Provided also that nothing contained in the second proviso shall apply to a company in which ninety per cent. or more members, in number, are relatives of promoters or are related parties

Provided also that nothing in this sub-section shall apply to any transactions entered into by the company in its ordinary course of business other than transactions which are not on an arm's length basis.

Provided also that the requirement of passing the resolution under first proviso shall not be applicable for transactions entered into between a holding company and its wholly owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval

Explanation. — In this sub-section—

(a) the expression "office or place of profit" means any office or place—

(i) where such office or place is held by a director, if the director holding it receives from the company anything by way of remuneration over and above the remuneration to which he is entitled as director, by way of salary, fee, commission, perquisites, any rent-free accommodation, or otherwise;

(ii) where such office or place is held by an individual other than a director or by any firm, private company or other body corporate, if the individual, firm, private company or body corporate holding it receives from the company anything by way of remuneration, salary, fee, commission, perquisites, any rent-free accommodation, or otherwise;

(b) the expression "arm's length transaction" means a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest.

(2) Every contract or arrangement entered into under sub-section (1) shall be referred to in the Board's report to the shareholders along with the justification for entering into such contract or arrangement

(3) Where any contract or arrangement is entered into by a director or any other employee, without obtaining the consent of the Board or approval by a resolution in the general meeting under sub-section (1) and if it is not ratified by the Board or, as the case may be, by the shareholders at a meeting within three months from the date on which such contract or arrangement was entered into, such contract or arrangement shall be voidable at the option of the Board or the as the case may be of the shareholders and if the contract or arrangement is with a related party to any director, or is authorised by any other director, the directors concerned shall indemnify the company against any loss incurred by it.

(4) Without prejudice to anything contained in sub-section (3), it shall be open to the company to proceed against a director or any other employee who had entered into such contract or arrangement in contravention of the provisions of this section for recovery of any loss sustained by it as a result of such contract or arrangement.

(5) Any director or any other employee of a company, who had entered into or authorized the contract or arrangement in violation of the provisions of this section shall,—

(i) in case of listed company, be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees, or with both; and

(ii) in case of any other company, be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees.

3.3.2 Analysis of the Provisions

3.3.2.1 Compared to the provisions in Section 297 and 314 of the erstwhile 1956 Act, the 2013 Act has enlarged the scope of coverage to the following transactions :-

- Selling or otherwise disposing of, or buying property of any kind (1956 Act did not cover immovable property)
- leasing of property of any kind
- availing or rendering of any services
- appointment of related party to any office or place of profit in associate company also (1956 Act covers only subsidiaries)
- appointment of any agent for purchase or sale of goods, materials, services or property
- underwriting the subscription of any securities or derivatives thereof, of the company (1956 Act covered shares and debentures only)

3.3.2.2 Instead of the requirement to obtain approval of the Central Government (powers delegated to Regional Director for transactions covered by Section 297 under the 1956 Act) for companies with paid up capital of Rs. 1 Crore or more, the new requirement refers to a resolution of the members. Section 314(1B) of the 1956 Act also stipulated approval of Central Government where the office or place of profit of a relative carries a monthly remuneration of Rs. 2,50,000/- or more, whereas the Section 188 while doing away with Central Government, requires prior approval of members by way of a resolution.

It may be noted that the word “special” has been deleted by the Companies Amendment Act, 2017

3.3.2.3 First Proviso of Section 188 provides for prior approval from the members by way of special resolution in cases of certain companies based on threshold criteria with respect to Net Worth and / or Turnover before entering into any contract or arrangement with a related party.

3.3.2.4 Second Proviso to Section 188 provides that *no member of the company shall vote on such resolution, to approve any contract or arrangement which may be entered into by the company, if such member is a related party.* Under the erstwhile Companies Act, 1956, there were no prohibitions for the member to vote on a related party contract. In fact it was interpreted that if all members of a company are related parties, then it is not possible even for the members to approve any arrangement or contract with related party. Since the provisions were so stringent to the extent of unintended consequences, certain relaxations were made in the Companies Amendment Act, 2017 to provide that in case of a company in which ninety per cent. or more members, in number, are relatives of promoters or are related parties, the provision stipulating prohibition on voting by a related party does not apply.

3.3.2.5 Fourth Proviso to Section 188 provides that “Provided also that nothing in this sub-section shall apply to any transactions entered into by the company in its ordinary course of business other than transactions which are not on an arm’s length basis.”

The meaning of this proviso is that the provisions shall not apply if the transactions are entered into by the company in its ordinary course of business on arms’ length basis.

Here it should be noted that both the conditions should be fulfilled :-

The transaction should be in the ordinary course of business And
It should be on an arms’ length basis

Only if the conditions of “ordinary course of business” and “Arms length basis” is fulfilled, the approval by way of a resolution from members is not required.

By the term “ordinary course of business” one understands transactions that a company “carries on” or “does in the normal or usual course of business regularly”.

The term “Arms Length Basis” is perhaps a very crucial aspect. Hitherto the question of Arms’ Length Pricing was being looked into only from the point of view of tax compliance and that too only much after the end of the financial year in the Indian context, when the assessee files the Form 3CEB Transfer Pricing Report with respect to “International Transactions” or “Specified domestic Transactions”.

Explanation (b) to sub section 1 has defined the expression “arm’s length transaction” as meaning a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest.

The explanation highlights two important variable conditions that has to be fulfilled in RPT’s. These are :-

- Conduct of transaction between two related parties that is conducted as if they were unrelated And
- So that there is no conflict of interest

Again here too it should be noted that both the conditions should be fulfilled. The RPT’s should be conducted as if they were unrelated. Also it should be done in such a manner that there is no conflict of interest.

The concept of an arm's length transaction is to ensure that both parties in the deal are acting in their own self-interest and are not subject to any pressure or duress from the other part

It would be interest to note that in the transfer pricing law applicable under the Income Tax Act for “International Transactions” and “Specified Domestic Transactions”, there are detailed provisions for determining the Arms Length Price (ALP). Prima facie, if a company maintains its documentation on a contemporaneous basis as required in the Income Tax Act and the rules and the ALP for RPT’s are determined accordingly, it appears that the requirement of Section 188 would be met.

3.4 SECTION 189 – REGISTER OF CONTRACTS

3.4.1 Section 189 requires maintenance of a Register of Contracts giving details of all contracts or arrangements to which Section 184 or Section 188 applies. The requirement of Section 189 is more procedural in nature and not impacting any substantive analysis vis a vis Transfer pricing regulations, although a useful part of record and documentation, which is covered in Chapter 7.

3.4.2 The importance of the Register of Contracts under the Companies Act, 2013 can be understood from the requirement to place the same before the next Board meeting after making entries in the said register. The register is also required to be produced before the commencement of every annual general meeting pursuant to Section 189(4)

3.5 ASSOCIATED ENTERPRISE V RELATED PARTY UNDER AS 18 (INDIAN GAAP) AND IND AS 24

3.5.1 The Institute of Chartered Accountants of India has issued Accounting Standard (AS) 18 which deals with related party disclosures for companies following Indian GAAP and IND AS 24 for companies following Ind AS (Converged IFRS).

3.5.2 The requirements apply basically to financial statements of the reporting enterprise (including consolidated financial statements presented by a holding company). For this purpose, parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and / or operating decisions.

3.5.3 Accordingly, the standard deals with related party relationships described below :-

- (a) enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries);
- (b) associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture;
- (c) individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual;
- (d) key management personnel and relatives of such personnel; and

(e) enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

3.5.4 In the context of this Standard, the following are deemed not to be related parties:

(a) two companies simply because they have a director in common, notwithstanding paragraph 3(d) or (e) above (unless the director is able to affect the policies of both companies in their mutual dealings);

(b) a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence; and

(c) the parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process):

(i) providers of finance;

(ii) trade unions;

(iii) public utilities;

(iv) government departments and government agencies including government sponsored bodies.

3.5.5 AS 18 as well as IND AS 24 is more concerned with the disclosure of the transactions with a view to ensure transparency, and it is not concerned whether such transaction take place at arm's length price, but only require that necessary information about such transactions to be disclosed. The intention is to enable the stakeholders and other users of financial statements to analyse its operating results, its true financial position and net worth. It may help a person to understand the credit standing of the enterprise, resources by way of raw material or market, and such other information which may be relevant in judging the standing of the enterprise as a member or group of associated enterprise, since the normal reporting is one as an independent entity.

3.5.6 It is to be noted that the essence of related party relationships is the ability to control the other party or exercise significant influence over the other party in making financial and / or operating decisions, arising out of the relationship. Further certain parties though having capacity to influence financial and / or operational decision making would not be called "Related Parties" as clearly outlined in the AS 18 as well as IND AS 24. (Refer Para 3.5.4 (b) and (c).) In the case of Associated Enterprise (AE) it is the right of fixation of price or some other important conditions relating to pricing,

which becomes critical in determining whether an Enterprise is AE where the case does not fit in the clearly demarcated definition clauses.

Though there are some overlaps between the two concepts, it is always possible that an entity may be a related party, but not an Associated Enterprise (AE) and conversely an enterprise may be AE, but not a related party. Thus the challenge is to apply the respective tests strictly for each of these concepts.

3.6 SUMMARY OF REQUIREMENTS RELATING TO IND AS (CONVERGED IFRS)

3.6.1 Applicability of IND AS

The following is the summary of the roadmap as prescribed by Ministry of Corporate Affairs vide Notification dated 2nd January, 2015

Voluntary adoption

Companies can voluntarily adopt Ind AS for accounting periods beginning on or after 1 April 2015 with comparatives for period ending 31 March 2015 or thereafter. However, once they have chosen this path, they cannot switch back.

Mandatory applicability

Phase I

Ind AS will be mandatorily applicable to the following companies for periods beginning on or after 1 April 2016, with comparatives for the period ending 31 March 2016 or thereafter:

Companies whose equity and/or debt securities are listed or are in the process of listing on any stock exchange in India or outside India and having net worth of 500 crore INR or more.

Companies having net worth of 500 crore INR or more other than those covered above.

Holding, subsidiary, joint venture or associate companies of companies covered above.

Phase II

Ind AS will be mandatorily applicable to the following companies for periods beginning on or after 1 April 2017, with comparatives for the period ending 31 March 2017 or thereafter:

Companies whose equity and/or debt securities are listed or are in the process of being listed on any stock exchange in India or outside India and having net worth of less than rupees 500 Crore.

Unlisted companies other than those covered in Phase I and Phase II whose net worth are more than 250 crore INR but less than 500 crore INR.

Holding, subsidiary, joint venture or associate companies of above companies.

3.6.2 Applicability of Indian GAAP

Companies other than the following companies will continue to follow Indian GAAP :-

- a) Companies that have voluntarily adopted IND AS
- b) Companies that are mandatorily required to adopt IND AS

3.7 IND AS 24 HOW DIFFERENT FROM AS 18

3.7.1 Entities covered by IND AS, have to comply with IND AS 24, the IFRS converged Indian Accounting Standards, in their financial reporting.

3.7.2 While by and large the reporting requirements are similar, there are differences in the coverage of the related parties. In the following paragraph, the significant differences between AS 18 (Indian GAAP) and IND AS 24 (IND AS) are summarised :-

- a) While AS 18 covers “Relatives” who may be expected to influence or be influenced by that individual in his / her dealings with the reporting enterprise, IND AS 24 includes in its umbrella the close members of the family and here the family of Key Managerial Personnel (KMP) is also included.
- b) IND AS 24 includes any director, whether executive or Non – Executive, if they are directly or indirectly involved in planning, directing or controlling activities of the company
- c) IND AS 24 covers the KMP of the reporting entity as well of its parent.

In short, the emphasis of IND AS 24 is on substance over legal form.

3.8 THE CONNECT BETWEEN SECTION 188 AND ACCOUNTING STANDARDS

3.8.1 When establishing related party arrangements or entering into related party transactions, an entity has to bear in mind that there are two aspects :-

- a) compliance aspect
- b) Reporting requirements

3.8.2 The compliance aspect with respect to related party contracts or arrangements is specified under Section 188 and Section 189 read with the Companies (Meetings of Board and its Powers) Rules 2014, which

- a) lists out the nature of transactions, contracts and arrangements to which these provisions apply
- b) provides for the manner and the time limit within which approval of the Board should be obtained
- c) stipulates the disclosures and reporting required in a Board Meeting or the Audit Committee with respect to Related Party Transactions, if the Board is required to constitute an audit committee
- d) prescribes the threshold levels beyond which approval of the shareholders is required
- e) requires certain disclosures to be made in the explanatory statement seeking approval of shareholders

3.8.3 The requirements relating to disclosures and reporting of the Related Party Transactions in the financial statements of a company are contained in AS 18 and IND AS 24. Companies that are governed by Indian GAAP shall follow AS 18 and entities that are governed by IND-AS (converged IFRS) shall follow IND AS 24

3.9 IMPERATIVES

3.9.1 The provisions of the Companies Act, 2013 highlight the very crucial role of both the CS and the Accounting Professionals.

3.9.2 There is a significant underlying emphasis on the approval process for related party transactions. Further, the mandatory code of conduct for independent directors stipulates that they should pay sufficient attention and ensure that adequate deliberations are held before approving Related Party Transactions (RPT's) and provide assurance that these transactions are in the interests of the company.

3.9.3 Non-executive and independent directors are entitled to immunity from prosecution only when they can demonstrate evidence of due diligence having been exercised through the Board process. Companies will have to gear up to face greater scrutiny and questioning by independent directors. The management would have to design the right procedures, formats and structures for recording discussions in Board meetings, which will help in asking the right questions and provide evidence of such due diligence having been exercised in the manner envisaged.

3.9.4 Further, the audit committee's responsibility has been enhanced to include approval of all related party transactions. The Board, in its report to shareholders, will now have to disclose all contracts with related parties along with justification thereof.

3.9.5 Apart from the identification of RPT's, its reporting and the requisite procedures, which is the active domain of CS, the requirement of determining Arms Length Price (ALP) is an area where the accounting professionals (CA/CMA) have a major role.

CHAPTER 4

SPECIFIED DOMESTIC TRANSACTIONS

4.0 INTRODUCTION OF TRANSFER PRICING (TP) REGULATIONS TO SPECIFIED DOMESTIC TRANSACTIONS (SDT)

4.1 HISTORICAL BACKGROUND - DTP APPLICABLE FROM AY 2013-14

4.1.1 Under the usual provisions of the Income Tax Act, 1961, prior to the coming into force of these new provisions of Transfer Pricing (TP) for Specified Domestic Transactions (SDT), the revenue authorities were anyway empowered to disallow unreasonable expenditure incurred between related parties. The authorities can also reduce the reported income based on fair market value in respect of the undertaking to which profit linked deduction is provided. Such determinations today are made on a discretionary basis.

4.1.2 Applicability of transfer pricing provisions was earlier limited to *International Transactions* only. With effect from 01.04.2013, the scope of Transfer Pricing provisions has been widened to cover "*Specified Domestic Transactions*" and was accordingly made applicable from A.Y. 2013-14.

4.1.3 With the introduction of provisions dealing with "Specified domestic transactions", transfer pricing regulations became applicable to all taxpayers including Individuals, Hindu Undivided Families (HUFs). Taxpayers were put to greater burden with the need to evaluate intra-group transactions with greater detail and in turn also increase the administrative and compliance burden for the taxpayer in respect of such transactions.

4.2 THE PRECURSOR TO THE INTRODUCTION OF TP REGULATIONS TO SDT

The transfer pricing regulations introduced in India in 2001 up until 2013 were in force for just over a decade and the tax authorities not only gained significant experience, but also achieved significant revenue mop up. Besides the issue of related party transactions and its use and abuse have been a cause of concern to the Central Government, apart from the tax revenue consideration.

The matter came up before Supreme Court.

4.2.1 Supreme Court prescription

In *CIT Vs. Glaxo SmithKline Asia (P) Ltd. (195 Taxman 35) (SC)*, it so happened that the assessee did not have any employee other than a company secretary and all administrative services relating to marketing, finance, HR etc were provided by Glaxo Smith Kline Consumer Healthcare Ltd (GSKCH) pursuant to an agreement under which the assessee agreed to reimburse the costs incurred by GSKCH for providing the various services plus 5%. The costs towards services provided to the assessee were allocated on the basis suggested by a firm of CAs.

The AO disallowed a part of the charges reimbursed on the ground that ***they were excessive and not for business purposes*** which was upheld by the CIT (A). However, the Tribunal deleted the disallowance on the ground that ***there was provision to disallow expenditure only on the ground that it was excessive or unreasonable and it fell within the scope of s. 40A (2)***. It was held that as it was not the case of the Department that s. 40A (2) was attracted, the disallowance could not be made. The department challenged the deletion before the Hon'ble Supreme Court by filing a Special Leave Petition (SLP).

The Hon'ble Supreme Court dismissed the SLP on the following grounds:-

- i. The Authorities below have recorded a concurrent finding that the said two Companies are not related Companies under s. 40A (2) and
- ii. The entire exercise was a revenue neutral exercise.

The Hon'ble Supreme Court went a step ahead and suggested introduction of transfer pricing provisions to domestic transactions to minimize litigation and it identified specific transactions where transfer pricing provisions should apply in respect of domestic transactions. In domestic transactions, 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

4.2.2 Grand Success through Huge Demands arising from TP orders on cross border transactions

As per estimates from press reports in May 2012, it was reported that the tax authorities were able to raise demands to the tune of Rs. 45,000 Crores from foreign MNC's in India which was further compounded by conflicting judicial rulings.

Perhaps the success achieved must have prompted the introduction of TP regulations to SDT with a similar expectation.

4.3 MEANING OF SPECIFIED DOMESTIC TRANSACTION & THRESHOLD LIMITS

5.3.1 Finance Act 2012, inserted section 92BA in the income tax act, which defines the Specified Domestic Transactions. Text of section 92BA, when introduced was as under:-

92BA. 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) 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 (Popularly called as “Payments to Sister Concerns”) (until the amendment introduced by Finance Act, 2017)*;
- (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
- (vi) any other transaction as may be prescribed,

And where the aggregate of such transactions entered into by the assessee in the previous year exceeds a sum of Rs. 5 Crores*

*Responding to representations from various quarters, the following amendments were made by Finance Act, 2017, with effect from 1st April, 2017

- i) Payments made to Sister Concerns is no longer under the SDT net.
- ii) The threshold limits was increased to Rs. 20 Crores from the earlier limit of Rs. 5 Crores.

4.3.2 All the transactions covered by (ii) to (vi) above will be regarded as SDT only if the aggregate value of all such transactions exceeds threshold of Rs. 20 crores in the previous year. If the threshold limit is crossed, the taxpayer will be required to comply with the TP requirements with reference to all the transactions regardless of the fact that the value of transactions under any one of the above categories may be very small or insignificant. Further it is to be noted that the scope of coverage may be extended to cover any other transaction as may be prescribed by the CBDT.

4.3.3 The Guidance Note issued by the Institute of Chartered Accountants of India has advised that the threshold limit for SDT can be computed either on net basis (i.e. without including indirect tax levies like service tax, VAT, etc.) if the assessee is availing credit of those indirect taxes or on gross basis if the assessee is not availing credit, depending upon the method of accounting regularly followed.

4.3.4 Read with GAAR which has come into effect from 1st April, 2018, the tax authorities will be well armed to deal with any transaction which is not guided by commercial consideration and not based on ALP.

4.4 A BRIEF ANALYSIS OF THE SCOPE OF SDT TO WHICH TP REGULATIONS ARE APPLICABLE

4.4.1 The definition of Specified Domestic Transaction is exhaustive in the sense that the word used “means” and “namely”. Further the following may be noted :-

a) International Transactions are specifically excluded : - The use of the words “not being an international transaction” in the definition makes it clear that once a transaction is an international transaction within the meaning of Section 92B, it cannot be a specified domestic transaction.

b) List of Specified Domestic Transactions enumerated :- The definition enumerates a list of six types of transactions, which only can be classified under “Specified Domestic Transactions”. Out of this list item no. 1, namely payments to sister concerns under Section 40A(2)(b) has been deleted with effect from 1st April, 2017. Thus something not enumerated in the list cannot fall under the net of “Specified Domestic Transactions”.

c) Residuary item :- However, the last item in the list of six is “Any other transaction as may be prescribed”. Thus the Central Government has retained the right to notify any other transaction through rules prescribed by the CBDT. However, so far, the CBDT has not prescribed any new transaction to be under the net of “Specified Domestic Transactions”

4.4.2 Any transaction referred to in Section 80 A

4.4.2.1 The transactions referred to here are the claiming of deductions with reference to Profits through Sections 10A, 10AA, 10B or 10BA

4.4.2.2 Section 80A (6) refers to internal transactions between various units / undertakings of the assessee in respect of goods or services. This clause covers any transactions of goods or services and hence this transaction will be applicable to income as well as expenditure.

4.4.2.3 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-IB – Industrial undertakings
- 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

4.4.2.4 Sub section 6 of Section 80A states that “ Notwithstanding anything to the contrary contained in section 10A or section 10AA or section 10B or section 10BA or in any provisions of this Chapter under the heading “*C—Deductions in respect of certain incomes*”, where any goods or services held for the purposes of the undertaking or unit or enterprise or eligible business are transferred to any other business carried on by the assessee or where any goods or services held for the purposes of any other business carried on by the assessee are transferred to the undertaking or unit or enterprise or eligible business and, the consideration, if any, for such transfer as recorded in the accounts of the undertaking or unit or enterprise or eligible business does not correspond to the market value of such goods or services as on the date of the transfer, then, for the purposes of any deduction under this Chapter, the profits and gains of such undertaking or unit or enterprise or eligible business shall be computed as if the transfer, in either case, had been made at the market value of such goods or services as on that date.

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

4.4.3 Any transfer of goods or services referred to in Section 80-IA (8)

4.4.3.1 Section 80IA-(8) deals with the internal transactions with more than one undertaking / units of the assessee, out of which one or more undertaking is enjoying the tax holiday. Normally units enjoying tax holiday, charge more than the market value for goods or services used by non-eligible units. Due to this conduct, there is no effect on the health of the tax holiday unit as there are no taxes at all and the non-eligible unit gets higher deduction from taxable income. As per Section 80IA-(8), if the internal transfer of goods or services is not at market value, then profits or gains of transacting units shall be computed as if transfer, in either case, had been made at market value of such goods or services. Onus is on the taxpayer to prove that the internal transfer is at ALP.

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

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

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

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

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

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

As per this clause, when due to close connection between assessee and 'any other person' or for any other reason, the eligible business of the assessee produces 'more than the ordinary profit', then for the purpose of deduction under this section, profit of the eligible business shall be determined by taking ALP of the transaction. Primary onus is on the taxpayer to prove that the internal transfer is at ALP. However, the department has to prove that the transaction is not at ALP

Sub section 10 of Section 80-IA provides "where it appears to the Assessing Officer that, owing to the close connection between the assessee carrying on the eligible business to which this section applies and any other person, or for any other reason, the course of business between them is so arranged that the business transacted between them produces to the assessee more than the ordinary profits which might be expected to arise in such eligible business, the Assessing Officer shall, in computing the profits and gains of such eligible business for the purposes of the deduction under this section, take the amount of profits as may be reasonably deemed to have been derived therefrom:

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

4.4.3.4 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

As per this section, profits of the units located in SEZ, engaged in the manufacturing of any article or thing or providing any services, is exempt subject to conditions.

The following profit linked incentive provisions under Chapter VI-A are also governed by provisions of section 80-IA(8) and section 80-IA(10) and hence will be subject to Domestic Transfer Pricing :-

- 80-IAB- Deductions in respect of profits and gains by an undertaking or enterprise engaged in development of Special Economic Zone.

- 80-IB- Deduction in respect of profits and gains from certain industrial undertakings other than infrastructure development undertakings
- 80-IC- Special provisions in respect of certain undertakings or enterprises in certain special category States
- 80-ID- Deduction in respect of profits and gains from business of hotels and convention centres in specified area
- 80-IE- Special provisions in respect of certain undertakings in North- Eastern States

4.5 PROBLEMS AND OPPORTUNITIES

4.5.1 CLARIFICATIONS REQUIRED

An analysis of the provisions relating to DTP and the existing provisions for International Transfer Pricing, the following points would require clarification, else it could lead to a plethora of litigations.

a) 'Close Connection' not defined

By applying arm's length principle, a new monster concept of 'more than ordinary profits' has suddenly appeared. Section 80- IA(10) talks about 'close connection' between the assessee and the other person. However, the term has not been defined, which can lead to litigation.

b) 'Corresponding Adjustments'

Normally DTAA provides that where any upward adjustment has been made in the hands of one entity, say an Indian Company, with respect to transaction with another company, say a company based in US, then the corresponding downward adjustments should be made in the hands of the US Company. This eliminates the double taxation. No corresponding provisions are incorporated in DTP law, which in the opinion of some experts violates the basic canon of taxation ie. Equity and is therefore unjust.

c) 'Indian Company having Domestic / International Transaction' :

What happens when an Indian company is having both international transactions as well as domestic transactions? Whether the specified domestic transactions are required to be reported in the following scenarios:

a) When the value of aggregate of international transactions and specified domestic transactions is less than INR 20 crore.

b) When the value of aggregate of international transactions and specified domestic transactions is more than INR 20 crore, but value of specified domestic transactions is less than INR 20 crore.

What if, when the value of International transactions as well as value of Specified Domestic Transaction will be for instance INR 3 crore each? Is the assessee required to report the same or to take an accountant's report for the same? A clarification is required from CBDT on this issue.

4.5.2 PLANNING A STRUCTURE FOR DEALING WITH DTP

4.5.2.1 There is no doubt that DTP is here to stay. There are many countries that mandate compliance requirements for domestic transactions within their transfer-pricing regimes. The UK, for instance, is a jurisdiction where TP provisions governing domestic transactions are fairly well developed. In India, the concepts, though are in a developing stage.

4.5.2.2 This is an opportunity for professionals practising in this area and under these circumstances the approach for dealing with DTP would be to acknowledge and recognize :

- * that there will be significant impact on business, cost structures and published profits of the companies in the future
- * that there is necessity to assess impact of these changes on business
- * that there is need to re-organise / restructure keeping in mind upcoming GAAR
- * that there is a need to balance the requirements of direct tax and indirect tax
- * that there is a need to review and revise contracts & documentation

4.5.2.3 It is necessary for entities to carry out a complete SWOT analysis relating to utilization of its resources between different segments of its operations at the unit level. Based on the said SWOT analysis the entities should review the long term sustainability of the manner in which it has been structuring its transactions, specifically transfer of its resources within different segments of its business and this exercise may be carried out as under :-

- a) Identification of transactions covered by Section 92A and the rules made thereunder pertaining to SDT. Transactions here would cover both items of income as well as expenditure as also revenue and capital in nature
- b) Carry out a Cost Benefit Analysis of the SDT at the unit level of the entity.
- c) Evaluate the method followed for determination of the Transfer Price having regard to the permitted methods of determination of ALP in the TP regulations.
- d) Quantify the impact of various indirect taxes arising out of the various permitted methods of determination of ALP
- e) Evaluate the effectiveness of the financing plan of the entity including the coverage of the operations and its impact on the unit level finance cost and determine its impact on the ALP.
- f) Narrow down on the most appropriate method of determination of ALP.

4.5.2.4 All the above calls for strengthening the Cost and Management Accounting Systems, which is an imperative in any case for a company to be sustainable in the long run, so that the company has in place its own reliable internal data to support information and documentation for Domestic Transfer Pricing. Above all it can also help in substantiating the basis of company's documentation and the appropriateness of the Transfer Pricing Method followed before the revenue authorities who will have to consider the reasonable submissions of the taxpayer.

CHAPTER 5

ARMS LENGTH PRICE – CONCEPT AND PRESCRIBED METHODS

5.1 CONCEPT OF ARMS LENGTH PRICE

5.1.1 The MNE's use the transfer price mechanism while valuing the goods and services to be transacted with their Associate companies or subsidiaries to reduce the burden of taxation, maximize their profits and rationalize the various risk factors. The MNE's also use this mechanism for the purpose of intra-unit transfers. The acceptance or rejection of such transfer price should be based on concept of Arm's length. The OECD Guidelines provide that transfer prices should be based on arm's length principle, that is, transfer prices should be same as the prices that would have been charged as if the two units were independent companies. The adoption of the arm's length price principle is based on the belief that it is "sound in theory since it provides the closest approximation of the working of the open market where goods and services are transferred between associated enterprises" (OECD, 2001, p. 16).

5.1.2 Further the framework on which the OECD bases its international guidelines is the arm's length principle. However, there is no express global definition of the arm's length principle, nor is it applied uniformly. The OECD does not recommend a specific methodology to be used, they recommend that taxpayers select a transfer pricing methodology that will best reflect an arm's length transaction in terms of the facts, circumstances, evidence and reliability of the methodology used. Most countries have developed their own transfer pricing rules and methodologies.

Para 1 of the commentary to Article 9 of the OECD model states that the guidelines represent "*internationally agreed principles and [provide] guidelines for the application of the arm's length principle of which [Article 9] is the authoritative statement*". However, this reference is made in the commentary to the model, the status itself of which can vary significantly between countries and is the subject of much debate.

The demand and supply forces prevailing in the market, conflicting various government regulations relating to customs valuation, anti-dumping duties, exchange control, prices control, licensing, sectoral regulations, tax holidays and many such other various factors influence the pricing of goods and services transacted between independent enterprises and also affect the transfer of risk, resources and profits within the MNE group.

5.1.3 Investopedia defines Arm's length Transaction as a transaction in which the buyers and sellers of a product act independently and have no relationship to each other. The concept of an arm's length transaction allows the market to ensure that both parties in the deal are acting in their own self-interest and are not subject to any pressure or duress from the other party. It also assures third parties that there is no collusion between the buyer and seller.

The meaning of above definition is that final transfer – purchase or sales of goods or services will be at fair market value. Therefore, the price is charged in accordance with the market mechanism ie. demand and supply position. It makes the price of the product comparable to the other price as if the parties are not related to each other. However, when pricing of intangibles or proprietary goods are to be done, it generally becomes difficult to arrive at arm's length transactions as there are no comparables available where the product or service is unique one.

5.2 ARM'S LENGTH PRINCIPLE UNDER VARIOUS STATUTES

5.2.1 Arm's Length Principle is a valuation principle that is commonly applied to commercial and financial transactions between related companies. It says that transactions should be valued as if they had been carried out between unrelated parties, each acting in his own best interest.

Simply stated, the arm's-length principle requires that compensation for any inter-company transaction conform to the level that would have applied had the transaction taken place between unrelated parties, all other factors remaining the same. The problem however is that all other factors never remain the same. Consequently, an apparently innocuously simple concept of "Arms' Length Price" has become a significant bone of contention. This is because although the principle can be easily stated on paper, in practice, the actual determination of arm's-length price is factually difficult and done with different perspective that leads to different often diametrically opposite results. Important factors influencing the determination of arm's-length compensation include the type of transaction under review as well as the economic circumstances surrounding the transaction. Further, these factors may also influence the form of the payment. For example, a certain agreed consideration payable might be structured as a lump-sum payment or a stream of royalty payments made over a predetermined period. These variable factors do have an influence in the determination of the price, which needs to be adjusted reasonably to satisfy the tests of Arms' Length.

5.2.2 The various areas wherein the concept of Transfer Pricing is seen to be reflected are briefly covered below :-

- a) Central Excise Act, 1944 which speaks of Levying of excise duty for transactions between 'related persons' determined by value at which it sells a good to an unrelated party (Section 4 (3)(b)). The Excise laws, provide for a deeming provision, whereby the value of the goods shall be the normal transaction value at which such goods are sold to the unrelated parties. In case such similar goods are sold to related parties, the excise laws provide that the valuation for such goods shall be the cost of production plus 10 per cent mark-up.
- b) Service Tax- Finance Act 1994 provides in the Valuation Rules, the gross amount charged by a person providing a similar service forms the taxable base provided that the transaction is at arm's length.
- c) The valuation rules under the Customs Act, 1962 recognizes the principle of ALP in dealing with Transfer Pricing. Under the Customs Rules, unless an exception applies, the 'Assessable Value' is the invoice value (i.e. 'Transaction Value' under Rule 4(2)). Transfer Pricing concept In Customs valuation is provided under S.14 of the Act read with S.2(2) Customs Valuation (Determination of Prices of Imported Goods), Rules, 1988.
- d) While Section 129 in the Companies Act, 2013 which deals with the form and content of Balance sheet and the profit and loss account requires the financial statements to provide the true and fair picture of the state of affairs of the company, there are quite a few provisions (chiefly in Section 134 read with the rules made thereunder) relating to directors' report that require disclosure of related party transactions. These disclosure requirements along with the financial statements have indirect implication on Transfer Pricing.
- e) The Accounting Standards (AS-18) framed by the Institute of Chartered Accountants in India (ICAI) deals with transactions between a reporting enterprise and its related parties. There are disclosures relating to these transactions
- f) The VAT legislation in India has recognised the fact that price of the goods may not be fair value and may be its manipulated by related parties in order to reduce or evade the VAT liability.

Certain States like Delhi and Arunanchal Pradesh contains a specific provision relating to sales of goods or services to related parties . it provides that where a registered dealer who sells or gives goods to a related person, and such relationship influence the terms or conditions of the transaction and then the sale price of the goods in such cases shall be deemed to be the 'fair market value' of such goods for the purpose of levying taxes.

g) Under GST regime, **Sec. 15 (1)** – Value of a supply of goods and/or services shall be:

“Transaction Value (TV), that is the price actually paid or payable for the said supply of goods and/or services”

Where:

- The supplier and the recipient of the supply are not related
- The price is the sole consideration for the supply

Under Rule 3 Rule 3 – Methods of determination of Value

“(1) Subject to rule 7, the value of goods and/or services shall be the transaction value

(2) The “transaction value” shall be the value determined in monetary terms

(3) Where the supply consists of both taxable and non-taxable supply, the taxable supply shall be deemed to be for such part of the monetary consideration as is attributable thereto.

(4) The transaction value shall be accepted even where the supplier and recipient of supply are related, provided that the relationship has not influenced the price.

Different Bases of valuation under GST :-

➤ Value of Supply

Every fiscal statute makes provision for the determination of value as tax which is normally payable on ad-valorem basis. In GST also, tax is payable on ad-valorem basis i.e percentage of value of the supply of goods or services. Section 15 of the CGST Act and Determination of Value of Supply, CGST Rules, 2017 contain - provisions related to valuation of supply of goods or services made in different circumstances and to different persons.

➤ Transaction Value

Under GST law, taxable value is the transaction value i.e. price actually paid or payable, provided the supplier & the recipient are not related and price is the sole consideration. In most of the cases of regular normal trade, the invoice value will be the taxable value. However, to determine value of certain specific transactions, Determination of Value of Supply rules have been prescribed in CGST Rules, 2017.

➤ Compulsory Inclusions

Any taxes, fees, charges levied under any law other than GST law, expenses incurred by the recipient on behalf of the supplier, incidental expenses like commission & packing incurred by the supplier, interest or late fees or penalty for delayed payment and direct subsidies (except government subsidies) are required to be added to the price (if not already added) to arrive at the taxable value.

➤ Exclusion of discounts

Discounts like trade discount, quantity discount etc. are part of the normal trade and commerce. Therefore, pre-supply discounts i.e. discounts recorded in the invoice have been allowed to be excluded while determining the taxable value.

Discounts provided after the supply can also be excluded while determining the taxable value, provided two conditions are met, namely:

(a) discount is established in terms of a pre supply agreement between the supplier & the recipient and such discount is linked to relevant invoices

(b) input tax credit attributable to the discounts is reversed by the recipient

➤ Taxable value when consideration is not solely in money

In some cases, where consideration for a supply is not solely in money, taxable value has to be determined as - prescribed in the rules. In such cases following values have to be taken sequentially to determine the taxable value:

- i. Open Market Value of such supply
- ii. Total money value of the supply i.e. monetary consideration plus money value of the non-monetary consideration
- iii. Value of supply of like kind and quality iv. Value of supply based on cost i.e. cost of supply plus 10% mark-up v. Value of supply determined by using

reasonable means consistent with principles & general provisions of GST law. (Best Judgement method)

- Open Market Value means the full value of money excluding taxes under GST laws, payable by a person to obtain such supply at the time when supply being valued is made, provided such supply is between unrelated persons and price is the sole consideration for such supply.
- Supply of like kind & quality means any other supply made under similar circumstances, is same or closely resembles in respect of characteristics, quality, quantity, functionality, reputation to the supply being valued.

Illustration: (1) Where a new phone is supplied for Rs. 20000/- along with the exchange of an old phone and if the price of the new phone without exchange is Rs.24000/-, the open market value of the new phone is Rs 24000/-.

(2) Where a laptop is supplied for Rs. 40000/- along with a barter of printer that is manufactured by the recipient and the value of the printer known at the time of supply is Rs. 4000/- but the open market value of the laptop is not known, the value of the supply of laptop is Rs. 44000/-

- Value of supply between distinct and related persons (excluding Agents)

A person who is under influence of another person is called a related person like members of the same family or subsidiaries of a group company etc. Under GST law various categories of related persons have been specified and as relation may influence the price between two related persons therefore special valuation rule has been framed to arrive at the taxable value of transactions between related persons. In such cases following values have to be taken sequentially to determine the taxable value: -

- a) Open Market Value
- b) Value of supply of like kind and quality.
- c) Value of supply based on cost i.e. cost of supply plus 10% mark-up.
- d) Value of supply determined by using reasonable means consistent with principles & general provisions of GST law. (Best Judgement method)

(Source :

i. <http://www.cbec.gov.in/>

ii. (<http://www.indialawjournal.org/archives> - article_by_madhu.html)

The requirement to justify the arm's length standard for the domestic transactions between related parties was introduced vide Finance Act 2012, which has now been proposed to be restricted to profit linked transactions only vide the recent Finance Bill 2017 in order to reduce the burden of compliance and reporting requirements for the taxpayers. This benefit granted to the taxpayers seems to be short lived if the GST framework (the way it appears as of date) is introducing the arm's length driven compliance burden for domestic related party flow of goods and services. For sake of simplicity, a comparative chart of different scenarios for arm's length compliances is produced below:

Current Indirect Tax (pre GST) & Transfer Pricing regime		
Transactions	Customs /Service Tax	Transfer pricing (Income-Tax)
	Valuation	
Imports		
Goods	Yes	Yes
Services	No	Yes
	Excise/Service Tax Valuation	Transfer pricing (Income-Tax)
Domestic		
Goods	Yes	Yes (restricted to profit linked transactions)
Services	No	Yes (restricted to profit linked transactions)

GST & Transfer pricing regime			
Transactions	Customs valuation (BCD)	GST valuation (IGST)	Transfer pricing (Income-Tax)
Imports			
Goods	Yes	Yes	Yes
Services	No	Yes	Yes
Domestic			
Goods	No	Yes	Yes (restricted to profit linked transactions)
Services	No	Yes	Yes (restricted to profit linked transactions)

(<http://www.cfo-india.in/article/2017/04/20/gst-and-transfer-pricing-%E2%80%93-need-harmonisation>)

As the spirit of the arm's length standard is basically to ensure that the affairs of related parties are not arranged in a manner that results in lower taxes being paid to the exchequer, the governing principles need to be harmonised. The said governing principles can be obtained from the judicial precedence available in India on several transfer pricing issues being dealt with under the income tax law for many years now under different business models. It would be only prudent to consider the same and cast

obligations on the taxpayers accordingly for the purposes of GST compliances. From a taxpayer's perspective, a transfer pricing policy determines the pricing for the goods and services between the related parties. The said policy, if implemented appropriately and being justified to be complied with the income-tax transfer pricing provisions, should serve a great piece of documentation that the GST authorities can rely upon. The GST framework governing arms' length standard would need to be aligned with the income-tax provisions on transfer pricing viz: the methodologies to be adopted, the nature of documentation to be maintained, the process to identify the comparable data and the reliance to be placed on the same, etc.

Whilst it is known that one cannot arrive at a price point that could be regarded as satisfying the arm's length standard under both the laws, but certainly with the governing principles getting converged, the arm's length range determined under the income tax law could certainly be the starting point for GST authorities to proceed further and arrive at a price point on which the GST could be levied.

To conclude, the transaction between related parties, whether for supply of goods or services, may or may not attract greater scrutiny from the revenue authorities and may have serious consequences on the taxability of the transaction, it becomes necessary for the companies to ensure that reasonable care of the legislative provisions is taken while planning business operations either domestic level or international level.

5.3 PRESCRIBED METHODS OF DETERMINING ARMS LENGTH PRICE (ALP)

Section 92C(1) of the Income Tax Act read with Rule 10B of the Income Tax Rules stipulate that the arm's length price is to be determined by adopting any one of the following methods, being the most appropriate method:

- Comparable Uncontrolled Price method (CUP method)
- Resale Price Method (RPM)
- Cost Plus Method (CPM)
- Profit Split Method (PSM)
- Transactional Net Margin Method (TNMM)
- Other Method (OM) as prescribed by the CBDT

The detailed provisions with respect to method of determining ALP are contained in Rule 10B read with Rule 10AB, which is reproduced below :-

“Rule 10B : (1) For the purposes of sub-section (2) of section 92C, the arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, in the following manner, namely :—

(a) Comparable uncontrolled price method, by which,—

- (i) the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified;
- (ii) such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market;
- (iii) the adjusted price arrived at under sub-clause (ii) is taken to be an arm's length price in respect of the property transferred or services provided in the international transaction;

b) Resale Price Method is a method by which,—

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

- (v) the adjusted price arrived at under sub-clause (iv) is taken to be an arm's length price in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise;
- (c) Cost plus method, by which,—
- (i) the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined;
 - (ii) the amount of a normal gross profit mark-up to such costs (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions, is determined;
 - (iii) the normal gross profit mark-up referred to in sub-clause (ii) is adjusted to take into account the functional and other differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market;
 - (iv) the costs referred to in sub-clause (i) are increased by the adjusted profit mark-up arrived at under sub-clause (iii);
 - (v) the sum so arrived at is taken to be an arm's length price in relation to the supply of the property or provision of services by the enterprise;
- (d) Profit split method, which may be applicable mainly in international transactions involving transfer of unique intangibles or in multiple international transactions which are so interrelated that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction, by which—
- (i) the combined net profit of the associated enterprises arising from the international transaction in which they are engaged, is determined;
 - (ii) the relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market

data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances;

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

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

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

(e) Transactional net margin method, by which,—

(i) the net profit margin realised by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;

(ii) the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;

(iii) the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;

(iv) the net profit margin realised by the enterprise and referred to in sub-clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii);

(v) the net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction.

(f) *Any other method as provided in rule 10AB.]*

(Rule 10AB provides that for the purposes of clause (f) of sub-section (1) of section 92C, the other method for determination of the arms' length price in relation to an international transaction shall be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts.”)

5.4 ANALYSIS OF VARIOUS TRANSFER PRICING METHODS

TRADITIONAL METHODS AND NON TRADITIONAL METOHDS

The comparable uncontrolled price method (CUP) is considered as one of the traditional methods of determining the arm's length price. Two other traditional methods are the Resale Price Method and the Cost Plus Method.

The other methods are called “Non Traditional Methods” or “Transactional Methods”.

5.5 COMPARABLE UNCONTROLLED METHOD (CUP)

5.5.1 CUP method may be either internal CUP or External CUP

(a) 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.

(b) External CUP: Where the price of the controlled transaction is compared to the price of a comparable transaction between third party External CUP requires independent transactions entered by independent parties (unrelated parties) in similar conditions

to the intercompany transaction that is under review. External CUP data is generally sourced using specialised databases.

5.5.2 Examples of Internal CUP and External CUP

Internal CUP requires comparable independent transactions entered by either party in the transaction under review with independent parties. For example, Company A purchases Mobiles from its parent company B. The Internal CUP method can be applied if the following data is available:

1. Company A purchases similar Mobiles from other independent suppliers under comparable circumstances (i.e. similar contractual terms and market condition), or
2. Company B supplies similar Mobiles to other independent customers under comparable circumstances (i.e. similar contractual terms and market condition)

5.5.3 Which CUP internal or External Is preferable?

Internal CUP should be preferred as reliable and accurate data of comparable uncontrollable transaction is available .OECD guideline prefers Internal CUP as against external CUP.

5.5.4. Whether Independent tender price or Quotation can be used? It is observed that such quotation or tender price may be subject to negotiation and may vary depending upon the terms and condition as parties to the transaction may decide. Further there is no comparable available in the public domain for such transactions. Such prices can be used if adjustment can be made without influencing the price margin. Further if there is no precedence or succeeded by actual transaction then it can be taken as basis in CUP methods.

5.5.5. Typical transactions in respect of which the comparable uncontrolled price (CUP) method may be adopted are:

- (a) Transfer of standard goods;
- (b) Provision of standardized services;
- (c) Certain types of Intangibles;
- (d) Interest on loans.
- (e) Royalty payment
- (f) Transaction dependent on publicly available market quotation ie commodity exchange.

5.5.6 The OECD in its Transfer Pricing Guidelines observes as under:

“The CUP method is a particularly reliable method where an independent enterprise sells the same product as is sold between two associated enterprises. It compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. If there is any difference between the two prices, this may indicate that the conditions of the commercial and financial relations of the associated enterprises are not arm's length, and that the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction.”

5.5.7. The CUP Method offers the finest evidence of ALP. ALP may arise where :-

- The tax payer or another member of the associate group sells the product in comparable sizes and in the comparable terms to a party (not an associated enterprise, referred to as “unrelated party”) in similar promoted markets. If this evidence is available it is called internal comparable.
- The taxpayer of the entities buys the similar quantities, in comparable quantities and in the similar terms from the associate parties in the comparable markets. (Internal Comparable)
- An unrelated party sells the similar product, in similar size or quantity and in the comparable conditions to other unrelated party in similar markets (External Comparable)
- An unrelated party buys the particular goods, in comparable quantities and in the similar terms from the other unrelated party in similar markets (External Comparable)

5.5.8. The following steps are involved in the application of this method :-

- i) Identification of priced charged or paid in Comparable Uncontrolled transactions
- ii) Carrying out adjustment to the prices for transaction level differences on the basis of functions performed, assets used and risks taken (FAR) analysis and including therein any enterprise level differences

5.5.9. Adjustments as per OECD guidelines

Indian provision for various adjustment is silent .Hence, reference can be drawn from OECD Guidelines which provide an illustrative list of different types of adjustments that

can be carried out. Few examples of difference could be quality of the product, intangible added to the sales ,foreign currency risk, geographical, market mechanism. Etc.

5.5.10 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.

5.5.11. Using the CUP method has its own benefits and risk as stated below

1) Benefits: Availability of comparable then it is more reliable, appropriate way of applying to the ALP .it becomes strong case to defend before the IT officers. Further internal CUP data is available then it more reliable and cost effective

2) Risk: Risk that comparable data available is comparable with tested transaction. Such transaction can affect cost price and value and risk of allocation of resources. Further it requires continuous monitoring and review on year to year basis. Each and every product should be analysed while applying CUP .

It will very often be hard to find closely comparable uncontrolled transactions as strict comparability standard is required particularly with respect to product comparability; and internal comparables frequently don't exist and external comparables are difficult to find in practice as some differences like business relations, future expectations, use of Trademark and other marketing intangibles, specific circumstance, etc. which cannot be accurately adjusted.

Product or services which are made to order, or where technology is fast changing, or unstable government can also affect the comparable.

5.5.12 Requirements for Application of CUP methods

CUP method requires a very high degree of comparability, Like

- a) Like characteristics
- b) Component material
- c) Commercially perfect substitute or interchangeable
- d) Design of the product
- e) Product engineering
- f) Product features
- g) Durability
- h) Brand value

- i) Goodwill
- j) Contractual terms
- k) Market condition
- l) Bargaining power
- m) Associated Risk

CUP may be applicable in a situation where there is minor difference for which adjustment is possible in the price determination or there is no difference between controlled and uncontrolled transactions. If there are differences between the controlled and uncontrolled transaction that affect transfer price, then adjustments need to be made to the price of uncontrolled transaction to arrive at ALP. And if adjustment is not possible at all then CUP should be rejected and proper document should be maintained giving justification for rejection.

5.5.13 Difficulties in Application of CUP :- CUP method is reliable method to determine the ALP. However, its practical application may pose various difficulties as given below:

- 1) CUP method is highly sensitive to comparable .so it is not so practically feasible.
- 2) Every difference needs to be adjusted and justified.
- 3) Comparable prices are not easily available
- 4) The market conditions prevailing in the controlled transactions should be similar to the uncontrolled transaction which may not exist if MNE belong to different country .As both the country has different economies of scales of operation
- 5) If there are material difference and cannot be adjusted then Comparable Uncontrolled Price Method is unlikely to provide a reliable measure of the arm's length result
- 6) Effect of geographical difference if any with all other comparable same and such difference is likely to influence the price or cannot be adjusted or reliably ascertained
- 7) Comparability of Domestic transaction and International transaction is fairly difficult as it may mean comparing apples with oranges.

5.5.14 Strength of CUP methods

There is a detailed transactional and line by line comparison. Tested parties can be avoided .Non transfer pricing factors may not be able to influence Transfer Pricing. Where it is possible to establish Arm's Length Price through CUP method in a manner acceptable to the tax payer and the tax authorities, it is not necessary to hunt for any other method.

5.6 RESALE PRICE METHOD

5.6.1 Typical transactions where the resale price method may be adopted are distribution of goods involving little or no value addition.

Here ALP is determined by reducing the relevant gross profit mark-up from the sale price charged to unrelated party.

5.6.2 The OECD in its Transfer Pricing Guidelines has observed as under:

“An appropriate resale price margin is easiest to determine where the reseller does not add substantially to the value of the product. In contrast, it may be more difficult to use the resale price method to arrive at an arm’s length price where, before resale, the goods are further processed or incorporated into a more complicated product so that their identity is lost or transformed (e.g. where components are joined together in finished or semi-finished goods). Another example where the resale price margin requires particular care is where the reseller contributes substantially to the creation or maintenance of intangible property associated with the product (e.g. trademarks or trade names) which are owned by an associated enterprise. In such cases, the contribution of the goods originally transferred to the value of the final product cannot be easily evaluated. A resale price margin is more accurate where it is realised within a short time of the reseller’s purchase of the goods. The more time that elapses between the original purchase and resale the more likely it is that other factors – changes in the market, in rates of exchange, in costs, etc. – will need to be taken into account in any comparison.

5.6.3 The following steps are involved in the application of this method :-

- (i) Identification of transaction involving purchase of property or services which constitutes an international transaction.
- (ii) Identification of the price at which such property or services are resold or provided to an unrelated party (resale price);
- (iii) Working out the normal gross profit margin in a comparable uncontrolled transaction. This is to be worked out both for internal comparable transaction as well as external comparable transaction. Here it should be noted that for working out the normal gross profit margin it is necessary to consider what an enterprise would earn from purchase of the similar property or service from an unrelated party and the resale of the same to another unrelated party.
- (iv) Deduction of the normal gross profit so derived from the resale price.
- (v) Deduction of expenses incurred in connection with the purchase of goods;

(vi) Carrying out adjustment to the resultant amount for the material functional and other differences between the uncontrolled transaction and the international transaction from the point of view of an open market;

The resultant price arrived at on the basis of (i) to (vi) explained above would be the arm's length price of the international transaction;

5.6.4 Applicability of Resale Price method:- It is applied when there is no further value addition to tangible property and no physical alteration in product is done. This method is often used when goods are transferred between related parties before sale to the independent party. If the distributor sells similar goods having virtually no difference, RPM method can be applied on aggregate basis.

It cannot be applied where there physical alteration is done or possible or there is enhancement in the value of product by adding intangible property.

5.6.5 The resale-price method is used to determine the price to be paid by a reseller for a product purchased from an associated enterprise and resold to an independent enterprise. The purchase price is set so that the margin earned by reseller is sufficient to allow it to cover its selling and operating expenses and make an appropriate profit.

Example

A Ltd buys from its parent company B in Germany @Rs 15000 per unit and sells it at Rs 20000 per unit . A Ltd also buys from C LTD an unrelated party at Rs 12000. A sells them at 15000 per unit . Selling and Distribution and other overhead expenses incurred by him Rs 1500.

Margin earned in case of uncontrolled transaction by Co A with Co C

Sales value	15000
Less cost of goods sold	12000

Gross profit 3000

Less Operating Expenses 1500

Gross margin 1500 ie 10% of sales value

Margin earned in case of controlled transaction by Co A with Co B

Sales value	15000
Add- Operating Expenses	1500

	16500
Add - Margin on Sale @10%	2000
Therefore transfer price is	18500
Gross margin	1500 ie 10% of sales value

5.6.6 RPM method can be applied only where goods are purchased from AE and same are sold to Unrelated party. The purchase price is so set that margin of safety available to him is sufficient to cover compensation for his efforts and make an appropriate profit. The resale price margin for a reseller should always be determined by taking into account the functions performed, assets used and risks assumed by the reseller

The resale price method would normally be adopted where the seller adds relatively little or no value to the product or where there is little or no value addition by the reseller prior to the resale of the finished products or other goods acquired from related parties. This method is often used when goods are transferred between related parties before sale to an independent party. 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

5.6.7 Gross profit is the basis for this method rather than directly determining arm's length prices as basis for CUP Method. The Resale Price Method requires less direct transactional (product) comparability than the CUP Method. It is easy to calculate GP if reseller does not add any value to the product.

5.6.8 Types of RPM: Like CUP it can be internal 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. So internal RPM comparable are between tested parties

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. In External there is involvement of third party.

Internal RPM is preferable over External RPM for obvious reason that more reliable and accurate data is available . Further External RPM may require various adjustment which may or may be easily possible.

5.6.9 Requirements of Resale price method :-

Goods or services are purchased from Related party and not unrelated party.

Goods and service are purchased only from related associate enterprise and sold to unrelated party. Party selected should be tested party that purchases the product in the controlled transaction which it then resells.

Reseller should not be capable of adding any value to goods or services by changing physical properties or characteristics or adding any intangible to be resold to unrelated party. Small packing labeling if not enhancing or adding value can be done

More emphasis is on 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. All those items of direct income and direct expenses affecting the gross margin should be considered and those items of indirect income or expenses which do not have impact on gross margin should be ignored.

Example :

If cellphone is imported from AE and sold in local market by adding brand name of the company ,and there is a addition in value of product ie carrying brand value of the company , then in such case RPM cannot be applied .

RPM is applicable in case of reseller or service provider not manufacturer.

5.6.10 Benefits and Risk of Resale Price method:-

Benefits:

This method is based on market driven factors influencing resale price, market price. It is useful when demand is less elastic and there is no relationship between cost incurred and sales price. RPM may be the best method where there is insufficient product comparability for the application of the CUP Method.

Risk :

Adjustments are difficult for market condition, operational efficiency, demand and supply position, elasticity of demand. Determining reliability of cost of goods sold and its components in case of uncontrolled transaction is difficult. RPM cannot be applied if the goods are purchased from unrelated party and sold to related party. Accounting Consistency is most important if RPM method is to be applied. RPM cannot be used if product comparison is inevitable. Contractual terms or geographical location or time gap can influence the margin then RPM cannot be applied.

5.6.11 Practical Difficulty in application of RPM methods is

- 1) Non-availability of Gross margin data in public domain as Indian companies are not required to disclose the gross margin earned in financial reports . 3cd report contain the details on gross margin but it is not available in public domain.
- 2) If distributor applies IPR ie. brand name that adds significant value to transaction
- 3) It is very difficult to locate similar FAR
- 4) Different Economies of scale of different countries
- 5) Different tax regime, different accounting policies will make difficult to use RPM
- 6) When company is dealing in FMCG market and gross margin is contribution from product segments
- 7) In case where functional analysis cannot be done
- 8) 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.

5.7 COST PLUS METHOD

5.7.1 Typical transactions where the cost plus method may be adopted are:

- (a) provision of services;
- (b) joint facility arrangements;
- (c) transfer of semi finished goods;
- (d) long term buying and selling arrangements.

5.7.2 The application of this method involves the following steps :-

- (i) Determination of the direct and indirect costs of production in respect of property transferred or service provided to an Associated Enterprise.
- (ii) Identification of one or more comparable uncontrolled transactions for same or comparable and similar property or service.
- (iii) Determination of normal gross profit mark-up on costs in the comparable uncontrolled transaction. Here it should be noted that the various components of costs of comparable uncontrolled transaction should be the same as those of the international transaction.
- (iv) Adjustment of gross profit mark-up so as to account for functional and other differences including enterprise level differences between the international transaction and the comparable uncontrolled transaction.
- (v) Adjustment of the cost of production in the international transaction which will give effect to the adjusted gross profit mark-up.
- (vi) Arrival of the arm's length price based on steps (i) to (v)

Under this method gross profit mark-up is added to the direct and indirect cost of producing product and or rendering services. The cost below the line ie administration, selling or finance cost is not added to derive at the cost. Those cost which added value to the product gets added. Thus under CPM, TP is arrived at by the mark up earned in comparable transaction(s) / by comparable companies to the cost incurred by Tested Party under controlled transaction .

The cost plus mark-up represents the margin that a supplier of the goods or services would seek to make in order to cover operating expenses, taking into account the functions performed, assets employed and risks assumed, market condition and geographical distance . It is one sided method that needs the selection of tested parties. These tested parties must be the one who supplies good and services in the controlled transaction. Further cost should be actual cost and not estimated cost.

5.7.3 Applicability of cost plus method

- 1) Where CUP or RPM method cannot be applied.
- 2) Inter group services
- 3) Contract manufacturers or joint facility agreements
- 4) Semi-finished goods sold
- 5) Long term buy and sell contracts
- 6) Rendering of research services

5.7.4 Types of CPM methods

Internal CPM Method:-

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 method-

The Gross mark up of tested party in controlled transactions is compared with gross profit mark-up earned by the independent third parties in a comparable uncontrolled transaction.

Obviously internal CPM method is preferable over External CPM methods due to its reliability and accuracy of data.

Example :-

Cost plus methods

Cost of Raw material	30000
Direct and indirect production cost	10000
Total cost	40000
Mark up cost 25%	10000
Transfer price	50000

5.7.5 Requirement for applicability of CPM :-

- 1) It is to be clearly understood that 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.
- 2) It requires a close degree of comparability of the functions performed, assets employed and risks assumed and market conditions
- 3) Adjustment must be made for any factors or comparable that affects mark up.
- 4) If there are no comparable ie. there are broader product difference yet CPM is to be applied, it can be allowed if it does not affect the mark up.
- 5) FAR should not be materially different.
- 6) In applying CPM, it is crucial that the compared profit mark-ups relate to a comparable cost base. If differences materially which influences the mark-up, then the ability to make reliable adjustments for these would affect the reliability of the results.
- 7) Most Important point to be noted is that in a country like India where Cost Records and Cost Audit rules are applicable then in such case it is preferable that cost data be taken as a basis. And if cost records and cost audit rules are not applicable then in such a case the cost of production of products or rendering of service should be arrived based on costing accounting standards. As in maintenance of cost records many abnormal factors not affecting the cost/margin of products are not considered or are treated as non-cost items

5.7.6. Benefits and Risk in applying CPM methods

5.7.6.1 CPM Benefits

The benefits of the CPM as the basis for a company's global transfer pricing system include:

Due to mark up above cost, there is less scope for variable unrelated to the transfer price in the controlled transaction to have an affect

Administrative ease: Because the methodology is applied at the entity level (rather than the transaction level), companies realize increased flexibility, simplicity, and administrative ease.

5.7.6.2 CPM Risks

Although the advantages of the CPM are great, there are issues and risks associated with adopting it as a global transfer pricing method.

- *Transfer pricing risk related to pre-adoption years:* Any change of transfer pricing method presents the risk that the newly adopted method may shed light on past deficiencies. Such exposure may be more readily understood and accepted by shareholders, tax authorities, and other constituents to the extent that a method change can be coordinated with a business changes
- *Foreign tax variations:* Different countries have different regulation w.r.t to taxation. An understanding of foreign tax law and practice, as well as flexibility, are required to avoid conflicts with foreign tax authorities.
- *Operational Risk :* with expansion of business horizontally and vertically , new methods of transfer pricing will affect product ,product mix, inter company transaction agreements etc which will affect the mark up
- *Management support:* It is important that both domestic and foreign management understand the benefits of the CPM to the global enterprise and support its adoption.
- *Customs duties:* Although importation tariffs on many products have been reduced or eliminated under the General Agreement on Tariffs and Trade (GATT), some products still bear significant duties, especially in many developing countries. The effect of any transfer pricing changes on importation duties should be considered.

5.7.7 Practical Difficulties in applying CPM method.

Existence of material difference w.r.t. following will affect the mark up:-

- 1) Intangibles – branded cosmetics versus unbranded products
- 2) Manufacturing process – labour oriented or automated process
- 3) Start-ups or well set age old business
- 4) Functions performed
- 5) Products and Product mix
- 6) Make or buy
- 7) Economies of scales of operation

- 8) Geographical distance
- 9) Regulated and unregulated prices

The cost records and cost audit, 3cd report are not in public domain. Further companies act do not require to disclose gross margin or mark- up cost.

5.8 PROFIT SPLIT METHOD

5.8.1 Typical transactions where the profit-split method may be used are transactions involving:-

(a) integrated services provided by more than one enterprise for e.g., in case of financial service sector, where the activities performed by Indian company and foreign AEs in relation of a merger and acquisition transaction are so interrelated that it may not possible to segregate them;

(b) transfer of unique intangibles, for e.g. two associated enterprises contribute their respective intangibles to develop a new product or process and earn income from such product or process.

5.8.2 The observations of the OECD, in its Transfer Pricing Guidelines, on this method are as follows:-

“This method aims to determine what division of total profits independent enterprise would expect in relation to the relevant transactions. The profits should be split on an economically valid basis that reflects the functions and risks of each of the parties. In order to apply this method, it is necessary to identify the total profit arising from the related party transactions and split that profit between the parties according to their respective contributions.”

5.8.3 There are 3 approaches to this method, namely,

- a) Over all PSM -Contribution Analysis
- b) Comparable profit split
- c) Residual Analysis

a) Over all PSM -Contribution Analysis- This method is used in Financial services and telecom industry. Combined profits (or losses) from the controlled transaction(s) allocated between the associated parties on the basis of their

relative contributions. In this contribution approach the total profit is from the controlled transaction is divided based on :-

The reasonable approximation of the division of the profits under the arm's length condition prevailing in similar transactions; and on the relative value of the functions performed after taking into account assets employed and risks assumed by each AE

The Technique applied in contribution analysis is Compensation approach, bargaining approach, capital investment approach.

This is suitable only when analysis of FAR for each entity is done in a detailed manner.

This method is well suited to groups with complex transactions where it is not possible to define the scope of functions and responsibilities clearly.

- b) Comparable profit split – This method is used in Pharmaceuticals. Combined profit (or loss) is split by reference to comparable splits between independent enterprises. The comparable transactions should meet the comparability requirements. There should be similarity with regards to the contractual terms

The combined operating profits from controlled and uncontrolled transactions should be similar and shall not vary significantly.

- c) Residual Analysis - This method is used in Automotive, Consumer Electronics, Financial services. A two-step approach that first allocates profits to non-unique (routine) activities of the associated parties and then splits the residual profit (if any) on an economically valid basis, e.g. by applying a contribution analysis.
- d) The residual profit, i.e., portion of the profit attributable to the entrepreneurial, non-routine or residual functions is split based on the profit split principles

There is characterization of functions, risks and assets to routine and non-routine, wherein the routine functions are considered to be relatively simple and for which the comparable market data is easily available.

–The profit is attributed to the routine functions and the arm's length character is first applied to this part of the profit.

–The residual profit, if attributable to the non-routine / entrepreneurial functions is split on the basis as considered appropriate depending on the character of the profit

5.8.4 Applicability of Profit split method

- 1) Transfer of unique intangibles
- 2) In multiple inter-related international transactions which cannot 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

5.8.5. Requirements in profit split method

The profit split method is the split of the combined profits, the profit split is not a one-sided method, the results of all parties to the controlled transaction(s) are considered. This method depends on other methods like CPM, TNMM as one of the methods for determining appropriate splits. This method is applicable when transactions are highly related and both the parties' buyer and seller make unique and valuable contribution

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 used to split the profit should be reasonably independent of the transfer pricing policy formulation and should be supported reasonably by reliable comparable data;

Asset based or capital based allocation criteria 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 criteria can be used where there is a strong correlation between relative expenses incurred and relative value added.

This method is well suited to groups with complex transactions where it is not possible to define the scope of functions and responsibilities clearly.

This may be relevant in SDT to price the inter-unit transfer of intermediate goods between Tax Holiday and other units

5.8.8 Benefits and Risk –

Benefits

- It is very important tool for pricing complex transaction. PSM offers solution for highly integrated operations for which one-sided method would not be appropriate and where both the parties to the transaction contribute unique intangibles
- The two-sided approach in PSM ensures that neither party to the controlled transaction is left with an extreme and improbable profit result.
- Specialisation factor of a group and the industry is taken into account.
- Method takes into account the economic integration and the returns associated with valuing intangibles

Risk

- It is difficult to apply in practice .
- Risk of assessing 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

This method is not so popular in India

5.9 TRANSACTIONAL NET MARGIN METHOD (TNM)

5.9.1 Typical transactions where the transactional net margin method may be adopted are:

- (a) provision of services;
- (b) distribution of finished products where resale price method cannot be applied;

- (c) transfer of semi-finished goods where cost plus method cannot be applied;
- (d) transactions involving intangibles where profit split method cannot be applied.

5.9.2 The determination of Arms' Length Price in this method is done with the following steps :-

(i) Identification of the net profit margin of the enterprise realised from an international transaction. It may be enquired whether the assessee also has transactions and /or segments or businesses such that the international transactions with associated enterprises are not relevant, only that net profit margin that is derived from transactions, businesses or segments that are related to the international transactions must be considered for the purposes of application of TNMM method. Further, the net profit margin may be computed in relation to any of the following bases :-

- costs incurred or
- sales effected or
- assets employed or
- any other relevant base.

For example,

- For import transactions, revenue may be used as base and
- For export transactions, costs may be taken as base.

(ii) Identification of the net profit margin from either a comparable uncontrolled transaction or a number of such transactions having regard to the same base. There could be two scenarios possible :-

- a) Where Segment data is available :- Net Profit margin is ascertained at segment level. It then follows that the unallocated expenses are allocated on a reasonable basis and the segmental net profit is determined.
- b) Where segment data is not available :- In such cases, net profit is normally determined at enterprise level. Where internal CUT is available, transaction level net profit may be determined. In case internal CUT is not available, external CUT has to be taken.

In such cases, net profit margin should be taken at enterprise level (segmental or enterprise as a whole) of comparable companies, to be identified on the basis of a search of such companies and then on the basis of information and data available with the taxpayer. Where such information and data are not available, search may be carried out with reference to database in public domain.

(iii) Adjustments are made to the identified net profit margin to take into account the transaction level and enterprise level differences that materially affect or has the potential to materially affect the net profit margin in the open market.

(iv) The adjusted net profit margin worked out from steps (i) to (iii) is used to arrive at the arm's length price in relation to the international transaction.

While using the TNMM method, it is necessary to pay attention to the following points :-

(a) Different bases of determining the net profit margin [i.e. profit level indicators (PLI)] are used in practice and also recognized. Consistency is advised in terms of following the same basis of arriving at the net profit margin to be adopted year after year, unless the circumstances justify or warrant an alternate base;

(b) When a base is selected in determining the net profit margin in an international transaction, the same base should be adopted for arriving at the net profit margin in the comparable uncontrolled transaction;

(c) Generally, there is preference to use operating profit margin as the base compared to net profit margin. This is because, Operating profit margin would eliminate the non-operating items (which includes various items of revenue and costs which do not result from routine business operations such as profit on sale of assets, dividend, foreign exchange fluctuations, income from non-core activities etc.).

The operating profit margins should be computed on the basis of financial statements of the taxpayer and the comparable company.

(d) The accounting treatment of expenses and depreciation is also a critical factor in computing the arm's length price. Unlike the preceding methods, the rule does not explicitly provide for adjustment on account of differing accounting practices. Nevertheless, such differing practices should also be factored in the determination of ALP.

(e) It is not uncommon to find purchase transaction being an international transaction where TNMM is used. TNMM requires the determination of the net profit margin from an international transaction and purchase transaction as such does not result in net profit. However, as purchase is linked to earning net profit, TNMM may be used for establishing arm's length purchase value. In such case, comparable operating margin should be appropriately used to work back the arm's length purchase cost.

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)

5.9.3 **Applicability**

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

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.

5.9.4 **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.

TNMM becomes inevitable where the assessee has interlinked transactions of purchase and sale from / to related parties where they cannot be benchmarked isolated

5.9.5 Benefits and Weakness

Benefits

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).

Weakness

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.

5.9.6 Procedure for Application of TNMM

A very important point to be noted is that with respect to TNMM without further benchmarking analysis, the method is not likely to stand out

The further steps are :-

- ✓ Selection of the tested party
- ✓ –Period of Comparison
- ✓ –Aggregation of Transactions
- ✓ –Identification of Comparable entities
- ✓ –Profit Level Indicators
- ✓ –Adjustment Calculations

Selection of the tested party - Basis of selection of tested party is net profitability of controlled transactions, reliable comparable data can be identified and has less complexity without its own intangibles or unique assets and which performs the routine functions.

Period of Comparison

As per income tax act provision multiple years data can be used to eliminate variations or difference in product life cycles, accounting years, economic conditions, market conditions etc.

Simple average or weighted average can be used for multiple years data.

–Aggregation of Transactions – Those transactions which cannot be evaluated on a standalone basis can be bundled with multiple transactions or those transactions which have closely linked products, similarity of functions, assets, investments, intangible rights .

–Identification of Comparable entities - This can be internal or external comparables . In case of external comparables, reliable databases of Prowess and Capitaline Plus can be used or those data which are available in the public domain.

–Profit Level Indicators

Gross profit less operating expenses

Or

PBT /PBIT/ PBDIT over Net sales, Return on capital assets or capital employed, operating profit over operating cost

–Adjustment Calculations

Adjustment to comparable margin should be made to improve comparability. It shall be based on commercial practices, economic principles or statistical analyses

5.10 Any Other Method

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 transactions, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts.

The various data which may possibly be used for comparability purposes could be:

- (a) Third party quotations;
- (b) Valuation reports;
- (c) Tender/Bid documents;
- (d) Documents relating to the negotiations;
- (e) Standard rate cards;
- (f) Commercial & economic business models; etc.

Prima facie, the intent of introducing “the other method” is to have in place an enabling provision which provides some flexibility to determine prices in complex transactions, where external comparables may not be available. It also recognizes that there could be 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, when “other method” is followed, the onus is on the taxpayer to have in place documentation explaining the reasoning for rejection of all the other five methods and selecting the ‘Other Method’ as the most appropriate method. The OECD Guidelines also permit the use of any other method and re-iterates the principle that the taxpayer retains the freedom to apply methods not described in OECD Guidelines to establish prices, with the proviso that the prices so established satisfy the arm’s length principle.”

5.11 IMPACT OF COST & MANAGEMENT ACCOUNTING, COST ACCOUNTING STANDARDS (CAS) AND REQUIREMENT OF COST RECORDS AND COST AUDIT REPORT RULES

5.11.1 COST AND MANAGEMENT ACCOUNTING AND ALP

5.11.1.1 If one analyses the various methods of transfer pricing prescribed for determination of ALP, three of the five methods are directly or indirectly based on costs of the enterprise. This is explained as follows:-

- a) Cost plus Method (CPM) is basically a mark- up over costs
- b) Transactional Net Margin Method (TNMM) requires working out the net margin of the international transactions. Now Net Margin is nothing but revenue minus costs, thus Net Margin is in reality a function of costs.
- c) Profit Split Method (PSM) requires working out either the combined profits of the associated enterprises or the residual profits of the associate enterprises. In either case, costs enter the calculation

5.11.1.2 As regards the Comparable Uncontrolled Price (CUP) method as well as the Resale Price Maintenance (RPM), the costs of the enterprise which is being assessed continues to be in question. It is only when comparison is made with external price, the non-cost factors require adjustment.

5.11.1.3 Most of the MNE's (about 60% of international trade) recognize the importance of Cost and Management Accounting (CMA) and it is a reality that the CMA reports, though generally used for internal management, form the basis for the strategic decisions taken by them both at the group level as well as at the entity level.

5.11.1.4 It is well known that in the first instance the onus of proof regarding the ALP is on the assessee enterprise. If the relevant portion of the Cost Records and Cost Audit reports form part of the structured documentation, it would constitute a strong evidence to support the enterprise and may actually help the enterprises in shifting the burden of proof on to the Assessing Officer / TPO.

5.11.2 COST ACCOUNTING RECORDS (CAR) AND COST ACCOUNTING STANDARDS (CAS)

The Institute of Cost Accountants of India (ICAI – CMA) is a premier body in India regulating the profession of Cost and Management Accounting.

ICAI –CMA has so far issued Cost Accounting Standards numbering 1 to 24 (CAS 1 to CAS 24) which is mandatorily required to be followed by the companies in the maintenance of cost accounting records. A listing of the currently applicable Cost Accounting Standards and the subject covered by it is summarized below :-

Cost Accounting Standard (CAS)	Dealing with
CAS 1	Classification of Costs
CAS 2	Capacity Determination
CAS 3	Production and Operation Overheads
CAS 4	Cost of Production for Captive Consumption
CAS 5	Determination of Average (Equalised) Cost of Transportation
CAS 6	Material Cost
CAS 7	Employee Cost
CAS 8	Cost of Utilities
CAS 9	Packing Material Cost
CAS 10	Direct Expenses
CAS 11	Administrative Overheads
CAS 12	Repairs and Maintenance Cost
CAS 13	Cost of Service Cost Centre

CAS 14	Pollution Control Cost
CAS 15	Selling and Distribution Overheads
CAS 16	Depreciation and Amortization
CAS 17	Interest and Finance Charges
CAS 18	Research and Development Costs
CAS 19	Joint Costs
CAS 20	Royalty and Technical Knowhow fee
CAS 21	Quality Control
CAS 22	Manufacturing Cost
CAS 23	Overburden Removal Cost
CAS 24	Treatment of Revenue in Cost Statements

5.11.3 REQUIREMENT IN COMPANIES (COST RECORDS AND AUDIT) RULES, 2014

5.11.3.1 MAINTENANCE OF COST RECORDS

The requirement to maintain cost records is governed by Rule 3 of the said rules prescribed under Section 148. Every company which is covered by the said rules and engaged in the production of the goods or providing services, specified in the Table appended in the rules, having an overall turnover from all its products and services of rupees thirty five crore or more during the immediately preceding financial year are required to maintain the prescribed records as stipulated in Form CRA 1

Para 24 of Form CRA 1 deals with related party transactions, the extract of which is given below:-

- a) Related Party means related party as defined under sub-section 76 of section 2 of the Companies Act, 2013.
- b) "Normal" Price means price charged for comparable and similar products in the ordinary course of trade and commerce where the price charged in the sole consideration of sale and such sale is not made to a related party. Normal price can be construed to be a price at which two unrelated and non-desperate parties would agree to a transaction and where such transaction is not clouded due to the proximity of the parties to the transaction and free from influence though the parties may have shared interest.

- c) The basis adopted to determine Normal price should be classified as under:
 - i. Comparable uncontrolled price method
 - ii. Resale price method;
 - iii. Cost plus method;
 - iv. Profit split method;
 - v. Transactional net margin method;
 - vi. Any other method, to be specified.

- d) In respect of related party transactions or supplies made or services rendered by a company to a company termed “related party relationship” and vice-a-versa, records shall be maintained showing contracts entered into, agreements or understanding reached in respect of –
 - I. purchase and sale of raw materials, finished good(s), rendering of service(s), process materials and rejected goods including scraps, etc.;
 - II. utilisation of plant facilities and technical know-how;
 - III. supply of utilities and any other services;
 - IV. administrative, technical, managerial or any other consultancy services;
 - V. purchase and sale of capital goods including plant and machinery; and
 - VI. any other payment related to the production of goods or rendering of services under reference.

- e) These records shall also indicate the basis followed for arriving at the rates charged or paid for such goods or services so as to enable determination of the reasonableness of such rates in so far as they are in any way related to goods or services under reference.

The following can be readily inferred from the above

- a) the basis to determine “Normal Price” is virtually the same as prescribed in the Transfer Pricing Regulations.
- b) The term used is “Normal Price” which more or less coincides with the concept of “Arm’s Length Price.
- c) However, applicability is restricted to related parties as defined under Companies Act, 2013 and for contracts, agreements or understanding relating to production of goods or rendering of services in relation to the product or service under reference for which the cost records are required to be maintained.

In Para 10 of the Cost Records and Cost Audit Report Rules, 2014, the cost auditor appointed under Section 148 required to report the details of Related Party Transactions for the company as a whole for the financial year covered in the cost audit.

5.11.3.2. COST AUDIT REPORT

All companies required to maintain cost records are not required to carry out cost audit. The threshold requirements for cost audit is governed by Rule 4 of the said rules prescribed under Section 148.

For the purpose of coverage of cost audit report, the requirement is divided into two categories :-

- a) Regulated Sectors, where the overall turnover threshold is Rs. 50 Crores in the immediately preceding previous year, with the turnover threshold for the individually covered products or services is Rs. 25 Crores
- b) Non Regulated Sectors, where the turnover threshold is Rs. 100 Crores in the immediately preceding previous year with the turnover threshold for the individually covered products or services is Rs. 25 Crores

The requirement of cost audit does not however apply to a company:-

- Whose turnover from exports in foreign exchange exceeds 75% of its total revenue
- Which is operating from a Special Economic Zone
- Which is engaged in generation of electricity for captive consumption through Captive Generating Plant.

Para 5 of Form CRA 3 requires the Cost Auditor to report the details of the related party transactions for the company as a whole :-

- a) The following details are required to be furnished with respect to each and every transaction with related party :-
 - i. Name and Address of the party
 - ii. Name of the Product / Service
 - iii. Nature of Transaction (Sale / Purchase etc.)
 - iv. Quantity
 - v. Transfer Price
 - vi. Amount
 - vii. Normal Price

b) Details to be furnished for each related party and Product / Service separately

c) Basis adopted to determine the Normal Price

In the notes under Para 5 of the said rules, it is mentioned as under :-

(1) Details should be furnished for each sale / purchase separately.

(2) Details of Related Party transactions without indicating the Normal Price and the basis thereof shall be considered as incomplete information.

It is obvious that it is the duty of the cost auditor to mention the basis adopted for determining the Normal Price. It may also be added that the rules notified in 2001 (which have now been superseded by the 2011 rules) required the cost auditors to mention in their report where price charged for related party transactions as defined in the respective Cost Accounting Records Rules is different from normal price, impact of such lower/higher price on margin of the product under reference.

Prima facie, it may appear that the concept of “Normal Price” as employed in the said rules is relevant mainly with reference to goods (either manufactured or traded) and availing / rendering of services, which forms part of the cost of production and for which the requirement to maintain cost records are applicable by virtue of these rules. But interpretation varies, since the term used is “Company as a whole”.

5.12 SEGMENT REPORTING AS – 17 V ALP

The Accounting Standard (AS 17) issued by the Institute of Chartered Accountants of India is mandatory for all enterprises whose equity or debt is listed or proposed to be listed or whose turnover exceeds Rs. 50 Crores or whose borrowings including public deposits exceed Rs. 10 Crores and the holding / subsidiary entities of such an enterprise.

Basically Segment reports give segment-wise results. These segments could be either Business Segment or Geographical Segment.

With respect to compliance of TP regulations, the segment results help in explaining the business of the tax payer and also in undertaking a transaction specific analysis. Read in conjunction disclosures in Accounting Standard (AS 18), it helps in analysis the transaction with related parties, most of whom would be Associated Enterprises.

Apart from identification and documentation, the real value of analysis of segmental results is in understanding the ALP for a transaction or a group of closely linked transactions and for determining the operating margin.

The matter of using segmental results came up before ITAT in M/s. Technimont ICB Pvt Ltd (ITA No. 7098/Mum/2010) in which the Mumbai bench held that segmental results should be considered for the calculation of the operating margin of the results of the transactions with related parties and not the profit at entity level, while accepting the audited segmental results filed by the taxpayer.

5.13 FAIR VALUE DETERMINATION IN IFRS V ALP

Prima facie, it may appear that “Fair Value” under IFRS and “ALP” are similar since both focus on independent parties. In this paragraph an attempt is made to analyse the similarities and differences in the concept

The similarities between the determination of “Fair Value” and “ALP” are :-

- a) Both methods focus on arms’ length relationship and determination by mutually independent parties.
- b) The main assumption is that the objective is Profit Maximisation and there is information symmetry meaning all relevant information is known to the parties concerned.
- c) With regard to the valuation itself, both IFRS and ALP are transactional and price-based.

However, when one applies the concept of “Fair Value” and “ALP”, there are differences. Fair Value is in reality an exit price ie. It is looked at from the point of view of seller and relies on the “highest / best use” principle. Thus it is a one dimensional value in the sense that the value for both parties would become identical. On the other hand, in the case of ALP, the view point of both the buyer and seller / service provider is considered and recognizes ranges in the arms’ length value, while rejecting the highest / best use principle.

5.14 TRANSACTION VALUE IN CUSTOMS ACT V ALP – UNDERSTANDING THE CONFLICT

The provisions relating to valuation under the Customs Act, 1962 are contained in Section 14 of the said Act read with the Customs Valuation (Determination of Price of Imported Goods) Rules, 2007.

Accordingly, transaction value shall be the basis for the determining ALP with respect to transactions between unrelated parties. However, for transactions with related parties, the transaction value will be accepted by the customs authorities only if it is proved to their satisfaction that the relationship did not influence the price for the transaction.

It is noticed that there are similarities in the method of valuation adopted in the Customs Valuation rules when compared to the ALP determination in the transfer pricing regulations (TPR) in the sense that

- a) Transaction Value under the Customs Valuation Rules is similar to the ALP determined using the Comparable Uncontrolled Price (CUP) method
- b) Computed Value Method under the Customs Valuation Rules is similar to the ALP determined using the Cost plus (CPM) method

Further both under customs regulations and the TPR, the object is to determine the pricing in a fair manner, ie. Without the influence of related parties in the pricing. Conceptually the methods are similar, but in application they are different, as the thrust of the Indian TPR is on the “most appropriate method” while in case of customs, the methods of pricing have to be applied based on a hierarchy ie. One after the other.

However, there is a fundamental conflict in the application of the valuation / pricing methods in the sense that the customs authorities would like to get the highest possible valuation for the imports keeping in mind the tax perspective, while in the case of Transfer Pricing Regulations (TPR), the best / most appropriate method is applied on the results of the whole year rather than a particular given transaction/(s) and though the given objective is to determine the ALP in accordance with the regulations, actually the application of the methods by the tax authorities is done with the intention to obtain a lower valuation when it comes to imports, so that the profits of the Indian AE are boosted or losses reduced.

CHAPTER 6
FUNCTIONS ASSETS AND RISK (FAR) ANALYSIS

6.0 INTRODUCTION AND CONCEPT

In transactions between two enterprises dealing at arms' length, the price decided normally reflect the functions that each enterprise performs. This in turn takes into account the assets (various resources) used and the risks assumed. From a revenue perspective, the ultimate purpose is to determine whether the price charged by an AE in an international transaction is at arms' length or not. This determination and subsequent validation will necessarily involve giving due consideration to the various functions performed by the contracting enterprises, the assets employed by each of them and the risks assumed by each of them.

FAR analysis is an exercise carried out with the objective of determining and documenting the significant activities performed by the Enterprise and its AE in an International Transaction or a Specified Domestic Transaction. This invariably forms part of the Transfer Pricing Documentation, which the assessee must have in place.

It can be readily seen that the FAR Analysis of the transactions has three components:-

- Functions Performed
- Assets Employed
- Risks Assumed

FAR analysis helps in having a quick overview of the enterprises and the operations of the group, thereby providing the basis for identifying the functions performed by each entity in the group. This in turn helps in assessing the importance of the functions so performed in relation to the overall operations of the group and its contribution to the overall profits.

From an economic perspective, profits are the rewards for risk and enterprise and it is the expectation of tax authorities that there would be greater rewards for risk taking, which should be transparently reflected in the documentation and the manner in which the Arms' Length price is determined.

6.1 COMPONENTS OF THE FAR

6.1.1 Functions Performed

Functions performed are the activities that are carried out by each of the parties to the transaction. In performing functional analysis, important and significant functions are considered. It is important to recognize that functions that add more value to the transactions are expected to fetch higher returns for the entity performing such functions. Thus, the focus should be not only on identifying the maximum number of functions but on identification of critical functions performed by the related parties.

Some of the important functions that are generally observed and examined in a transaction are:-

- Research and Development
- Process Engineering and Designing Work
- Purchasing and Materials Management
- Manufacturing, Production or assembly work
- Warehousing and Inventory
- Quality Control and Assurance
- Marketing and Distribution
- Development of software services
- Business Process Management
- Outsourcing nature of work etc.

Analysis of the various functions performed would involve ensuring an understanding of:-

- a) Activities carried out by each of the parties to the transaction
- b) Critical functions which add value to the transaction (international or specified domestic)
- c) Comparability of the principal functions performed by the entities in a controlled transaction as compared with the functions in uncontrolled transactions.

6.1.2 Assets employed

The following are some of the important considerations, in analysis of assets employed:-

- a) Here it is necessary to identify both the tangible and intangible assets used in the course of transactions with Associated Enterprise and the role of various departments in performing the desired functions and utilization of all kinds of assets.
- b) The study should involve identification of the type of capital assets used, as well as the capital assets left idle and the nature of assets used, such as the age, market value, location, property right protections available etc., and quantify the same, wherever possible.
- c) In case of capital intensive industries, the utilization of a capital asset such as property, plant and equipment etc. involve significant costs and has to be financed either internally or externally. However, there can also be cases where entities involved are doing pure assembly work for which the assets employed may not require huge capital investment. In any case, the point is the cost of funds become important
- d) It is also necessary to know which enterprise developed the intangibles, which has the legal ownership of the intangibles, and which receives the benefit of the intangibles.
- e) With respect to assets employed, the analysis has to assess their contribution to the business process and economic activities

This will ultimately help in:-

- a) Having a proper understanding of the respective roles played by the entities participating in and carrying out the transaction
- b) Having a good knowledge of assets owned and employed from the point of view of determining the returns earned by them.

6.1.3 Risks assumed

- a) Risk study involves identification of various risks that are assumed by each of the parties to the controlled transaction. Risks and Returns go hand in hand and in a truly global world and also in a typically arm's length business, more the risks assumed by an enterprise, higher the returns it should expect. Conversely stated, in case where the risks undertaken by the enterprise in a transaction are minimal, the returns expected to be generated from such transactions would be lower.
- b) The OECD Guidelines provide that "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 entities and therefore, the conditions each entity would expect in arm's length dealings. For example, when a distributor takes on responsibility for marketing and advertising by risking its own resources in these activities, it will be entitled to a commensurate higher anticipated return from the activity 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 research provider that takes no meaningful risk will be entitled to only a limited return."
- c) A comprehensive Risk Analysis is an important exercise as it facilitates adjustment based on differences in risks that are undertaken in a controlled transaction as compared to uncontrolled transaction and helps to arrive at the most reasonable comparative analysis of the international transactions.
- d) The risk analysis and its allocation should ultimately take into account the actual conduct of the entities in taking and absorbing the risk as this is the best evidence about the true allocation of risk between the associated enterprises. Then comes the question as to whether the actual allocation of risk is consistent with the economic substance of the transaction.
- e) In risk analysis the assessment of the following two factors are very important :-
 - i. Which of the two associated enterprises is actually bearing the risks? If both the entities are bearing the risks and the risk exposure varies the assessment has to consider the variations and the type of risks each entity is bearing.
 - ii. How does one quantify the effect of risks borne by the associated enterprises on the transfer price and consequently what adjustment is required to be made to the transfer price.

In the context of risks assumed, the following will have to be borne in mind :

- a) Probability and extent of possible variations of future outcomes and / or returns
- b) With increase in risks, the rewards should also proportionately increase and vice versa
- c) Clear distinction between company specific risks and industry specific and general risks
- d) Focus should be on important and significant risks
- e) Clear understanding of the assumption of the risks as per legal terms and its distinction with the assumption of the risks in terms of the conduct of the transaction.

It has to be remembered that the FAR analysis lays more emphasis on substance over form and will be more greatly influenced by the actual assumption of risks in the conduct of the transactions.

6.1.4 Contractual Terms

6.1.4.1 Contractual terms play a major role in defining explicitly or implicitly, how the responsibilities, risks and benefits are to be divided between the parties in a particular transaction.

6.1.4.2 Some of the important items included in the contractual terms which have to be identified, even if not specifically stated are:-

- Sales or Purchase Volume
- Working Capital
- Financing – Direct / Indirect
- Collaterals for transactions
- Contract duration
- Delivery terms
- Credit and payment terms
- Terms governing the provision of warranties
- Terms governing the right to updates or modifications
- Terms allocating the different risk, such as the exchange rate risk, inventory risk etc.

6.1.4.3 When parties dealing at arm's length enter into a contract, the mutual interest of making profits guarantees that each party will as far as possible expect that the other party adheres to the terms of the contract. However, the extent of flexibility between contracting parties is perceived to be greater in the case of transactions between associated enterprises, unless proved to the contrary. It is in this context, it is necessary to thoroughly examine whether how the parties act in actual practice in fact is a reflection of what is projected as the terms of their contract. Terms of contract may or may not be in writing.

6.1.4.4 Thus, the challenge is to actually derive the terms of the contract or the arrangement in actual practice based on an understanding of the conduct of the associated parties and then the same should be considered in the comparability analysis.

6.1.5 Economic circumstances

The following economic factors are recommended to be considered:-

- Market comparability
- Geographic Location
- Size of the markets
- Extent of the competition in the markets and the relative competitive positions of the buyers and sellers
- Credit terms
- Availability of substitute goods and services
- Levels of supply and demand in the market as a whole and in particular regions
- Government regulation of the market
- Costs of production, including the costs of land, labour and capital
- Transport costs
- Level of the market (eg. Retail or wholesale)
- Date and time of transactions
- Business, economic and product cycles etc.

6.2 PROVISIONS IN THE INCOME TAX ACT

6.2.1 Rule 10B (2) highlights the importance of the FAR analysis. It provides that comparability of an international transaction or a specified domestic transaction with an

uncontrolled transaction shall be judged (inter alia) with reference to the following, namely:—

- (a) the specific characteristics of the property transferred or services provided in either transaction;
- (b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;
- (c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;

6.2.2 Sub Rule (e) of Rule 10D requires every person, who has entered into an international transaction or a specified domestic transaction, 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 international transaction or a specified domestic transactions.

6.3 ANALYSIS OF THE PROVISIONS

The provisions of the Act (mentioned in Para 6.2) clearly highlight the importance of the FAR analysis in the comparison of the Controlled transaction with an uncontrolled transaction.

The comparability (including the extent of comparability) with respect to a transaction (international transaction or a specified domestic transaction) shall be judged with respect to the following :-

- a) Specific characteristics of the property transferred or services provided:- This is important from the point of view of determination of comparability of controlled transaction vis a vis uncontrolled transaction in the sense that those specific characteristics of the property transferred or services provided in the controlled transaction – whether they are also present in an identified uncontrolled transaction and if not, whether it is possible to meaningfully provide for adjustments so as to make them comparable.

- b) FAR Analysis:- Functions Performed, Assets employed and risks assumed by each of the parties to the transaction
- c) Contractual terms:- It is not necessary that the terms of the transaction are formal or it is in writing. The contractual terms can be inferred from the conduct of the parties to the transaction and in the manner in which the responsibilities, risks and benefits are divided among the parties.

6.4 RELEVANCE AND IMPORTANCE OF FAR ANALYSIS & CHARACTERIZATION

6.4.1 FAR Analysis in fact is the first step in the Transfer Pricing Study and Documentation, carried out with the following purposes:-

- a) Gathering and organizing facts needed to analyse intercompany prices
- b) Identifying an appropriate level of profit that related parties should earn with respect to international transactions under review
- c) Identifying the effects of functions, risks and assets on its profitability
- d) Determining the economic characterization of the entities in the transaction and to select a tested party
- e) Determining the most appropriate method for benchmarking the transaction
- f) Identifying any uncontrolled transaction involving one of the controlled parties

A robust FAR Analysis provides an in-depth understanding the various aspects, significantly the economic aspects of the business and provides valuable inputs to a proper characterization of the entity.

6.4.2 From an economic standpoint “Characterization” is very important as rewards will be directly correlated to the risks assumed and it is reasonable economic premise that “Profit” (which is an economic term connoting reward for “Risk taking and Enterprise”) should flow proportionately to the entities in terms of the risks assumed by the enterprise.

6.4.2.1 In terms of Characterization, it is important to understand whether the entity is:-

- a) Manufacturer

b) Dealer

c) Service Provider

6.4.2.2 Further Characterization could be broadly as follows :-

a) Manufacturer – Whether Full-fledged manufacturer, Licenced Manufacturer, Job Worker, Contract Manufacturer or Toll Manufacturer ?

b) Dealer – Whether full-fledged Market Distributor, Normal Distributor or Limited Risk Distributor (Exclusively for one or few principals) ?

c) Service Provider – Whether Entrepreneur or Low risk service provider or Captive Risk Service Provider

Taking the case of Manufacturer, for instance, in terms of risks assumed on one extreme, a full-fledged manufacturer absorbs all risks related to manufacturer, while a Toll Manufacturer assumes only risks related to the process of manufacture carried out for others. Naturally the rewards will vary with the risks assumed.

Similar considerations would be applicable to Dealer and Service Provider.

6.4.3 It should be noted that the economic characterization in turn depends upon a, b and c mentioned in Para 6.4.1, which are valuable inputs.

6.5 INPUTS TO THE FAR ANALYSIS

The following could be the inputs to the FAR analysis :-

a) Identification of the Entities

b) Identification and brief description of the transactions

c) Analysis of Markets / Competition

d) Organisation Structure

e) Business Processes and systems

f) Functions, Assets and Risks

g) Terms of Contract / Arrangement in the conduct of the transaction

6.6 OUTPUTS OF THE FAR ANALYSIS

- a) Characterisation of Entities
- b) Pricing Policies
- c) Detailed documentation
- d) Internal Comparables
- e) Basis for searching external comparables
- f) Determination of the most appropriate method of determining ALP

6.7 CERTAIN KEY FACTORS / POINTS TO BE REMEMBERED IN THE FAR ANALYSIS

The following are certain key factors / points to be remembered with respect to FAR Analysis:-

- a) Relevance / Importance of functions:- Sheer volume of functions is not decisive. But relevance of the functions and its relative importance with respect to the transaction in question is to be given weightage in FAR analysis. Thus functions performed may be few, but may be significant.
- b) Identification of contribution of each party:- It is necessary to identify the contribution of each party (taxpayer and the AE/AE's) to the transaction to the identified functions
- c) Identification and assignment of risks:- Identification and assigning of risks to each entity shall be on the basis of a proper understanding of the identified significant functions.
- d) Aggregation of transactions:- Aggregation of transactions shall be done only if the FAR analysis of these transactions are capable of being aligned meaningfully.
- e) Shift focus from legal form to economic reality of the transaction:- In this connection Section D of Chapter I of the OECD Guidelines,2017 states as under :-
 - Accurately delineate the actual transactions by analysing the contractual relations together with evidence of the actual conduct of the parties
 - Detailed guidance on analysing risks as integral part of a functional analysis, including six step analytical framework

- Party assuming risk should control the risk and have the financial capacity to assume the risk
- Capital-rich MNE group member without any other relevant economic activities (“cashboxes”) that provides funding, but cannot control financial risks in relation to the funding, will attain no more than a risk-free return ,or less if the transaction is commercially irrational

6.8 ANALYTICAL FRAMEWORK FOR RISK ANALYSIS

The Six step analytical framework prescribed by OECD (referred to in Para 6.7 e) consists of the following steps :-

1. Identification of economically significant risks
2. Determination of contractual assumption of the specific risks
3. Functional analysis in relation to the risk
4. Interpreting steps 1-3
5. Allocation of risk
6. Pricing the transaction taking into account the allocation of risk

Arising out of the OECD guidelines (specified in Para 6.7 e) If AE contractually assuming the risk does not exercise control over the risk or does not have the financial capacity to assume the risk, then risk should be allocated to enterprise exercising control and having financial capacity to assume risk.

6.9 COMMON RISKS

While performing FAR analysis, it is necessary to analyse the transaction keeping in mind the perspective of the overall risks involved and the share of the risks assumed by each of the parties to the transaction.

Some of the more common risks in a business are :-

- a) Market Risk : arising out of increased competition, pressure on maintaining price line, change in demand patterns, needs of customers etc.
- b) Risk of Technological obsolescence : Risk of process, product or technology or all of them becoming obsolete and consequently not being competitive in the market.
- c) Credit Risk : Risk of non-payment of debts by the customers

- d) Foreign exchange risk
- e) Risk of fluctuation of prices of raw materials
- f) Service Level risk : Ability to maintain service level and the risk of not being able to continuously deliver quality product or service at all times
- g) Working Capital risk : Non availability of sufficient working capital necessary to manage the operating cycle
- h) Human Resources (HR) risk : Risk of high turnover (particularly in case of IT companies), shortage / non-availability of personnel with appropriate skill level
- i) Regulatory risk : Risk of changes in existing regulations and / or new regulations and their impact on the transactions and business in general. For example, GST would have material impact for small businesses.

In the case of all the above risks, it would be necessary to document the key terms of the contract / understanding between the parties to the transaction.

6.10 SPECIAL ASPECTS WITH RESPECT TO FAR ANALYSIS OF INTANGIBLES

6.10.1 The DEMPE concept

6.10.1.1 The concept of DEMPE has been aptly explained by *Kestutis Rudzika, Director* in an article contributed by him in August 2017 for Royalty Range <https://www.royaltyrange.com/home/blog/dempe-explained>. In the following paragraphs 6.10.1.2 to 6.10.1.13, the points highlighted are covered.

6.10.1.2 (DEMPE) stands for Development, Enhancement, Maintenance, Protection and Exploitation. The introduction of the concept of development, enhancement, maintenance, protection and exploitation of intangibles (DEMPE) has resulted in significant changes in how MNEs implement the arm's length principle for transfer pricing. DEMPE is designed to ensure that allocation of the returns from the exploitation of intangibles, and also allocation of costs related to intangibles, is performed by compensating MNE group entities for functions performed, assets used, and risks assumed in the DEMPE of the intangibles.

6.10.1.3 DEMPE was first introduced in the final Actions 8–10 report of the Transfer Pricing Aspects of Intangibles ('Aligning Transfer Pricing Outcomes with Value Creation'),

released on October 5th 2015. The reports were published by OECD under its base erosion and profit shifting (BEPS) initiative.

6.10.1.4 Multiple entities within an MNE – not just the intangible’s legal owner – may have been involved in the creation of an intangible’s value. They may have “performed functions, used assets, or assumed risks that are expected to contribute to the value of the intangible” (6.32, Actions 8–10). As such, those various entities within an MNE should receive a portion of the profits that were gained from the exploitation of the intangible in question.

6.10.1.5 DEMPE is designed to help both taxpayers (including MNEs) and tax authorities achieve an accurate assessment of transactions to help with the determination of appropriate transfer pricing. By identifying the entities that perform DEMPE functions in a transaction, MNEs and taxpayers in general can ensure that they are complying with the OECD’s BEPS guidelines.

6.10.1.6 Implications of DEMPE for MNEs

6.10.1.6.1 Before the DEMPE concept was introduced, the legal owner of an intangible was entitled to essentially all the returns generated by that particular intangible (e.g. intellectual property (IP), such as a brand name or logo). This meant that, in practice, the owner of a brand could set up their company – for example, in the UK – but also register their trademark in a low-tax jurisdiction – such as Cyprus or similar low tax jurisdiction – so that they could charge royalties to the UK business for any income related to the IP registered in the low-tax environment. With the old model, the IP owner would be entitled to the income effectively generated by the UK entity.

6.10.1.6.2 With the new DEMPE concept in place, any income that is generated as a result of that IP is owned by all the parties that perform the DEMPE functions. So, rather than the legal IP owner receiving the full amount of the returns generated by the intangible, these instead have to be divided between the relevant parties, in line with each entity’s contribution to the value of the IP. To return to the Cyprus example: if there were entities in Cyprus that carried out DEMPE functions, then they would be entitled to a proportional share of the income generated by the intangible in question (and not the entire income as a legal owner in form).

6.10.1.6.3 As the reports say: “a determination that a particular group member is the legal owner of intangibles does not, in and of itself, necessarily imply that the legal owner is entitled to any income generated by the business after compensating other members of the MNE group for their contributions in the form of functions performed, assets used, and risks assumed.” (6.47, Actions 8–10)

It is worth noting that in the case of the UK–Cyprus example, if no DEMPE functions resulted from the Cyprus activities, then under the new approach the UK tax authorities would likely disallow the Cyprus IP royalty deductions from the taxable UK profits, especially if these functions were performed by the UK entity. For transfer pricing purposes, legal ownership of intangibles, by itself, does not confer the right to retain returns derived by the MNE group from exploiting the intangible.

As a result of the contractual arrangement between the MNE entities, these returns may initially accrue to the legal owner. However, if the legal owner performs no DEMPE functions, but acts only as a holding entity, the legal owner will not be entitled to any portion of the returns, other than compensation for the holding activities, if any.

6.10.1.6.4 DEMPE has significantly changed the way in which MNEs should determine arm’s length conditions for controlled IP transactions between related parties. Appropriate compensation of entities that have performed DEMPE functions that contribute towards the profit generating value of an intangible is now a key consideration in establishing arm’s length transfer pricing.

The DEMPE functions: an example scenario

It is important to look at each of the DEMPE functions individually, in order to understand the overall intention and significance of DEMPE. Below is an explanation of each of the functions, for clarification. The functions will be discussed in the context of an example scenario, to highlight what each function may entail and how profits may be split.

The example scenario is as follows. A super-premium Italian clothing brand has entities in Italy, the UK and Switzerland. The group develops a new product line for semi-professional sporting goods, which is owned and promoted by the Italian entity. The Italian entity acquires the manufacturing technology licenses that are needed to make the sporting goods from third parties. The sporting goods are manufactured to the highest standards in the UK, by the UK entity. The UK entity also distributes the sporting goods, and launches an online platform where customers can connect with the brand and receive exercise support to complement their purchase. Meanwhile, the Swiss entity enhances, revises and updates the product line.

Across the Italian, UK and Swiss entities, different DEMPE functions are carried out – each of which contributes to the overall value of the intangibles of the sporting goods product line. Based on the example scenario, the possible DEMPE functions and contributions of different entities are described below.

6.10.1.7 Development

The development of intangibles refers to everything that is associated with coming up with ideas for the brand and products, and putting plans and strategies in place for their creation.

A number of different processes and ideas went into creating the intangibles for the example Italian brand's sporting goods product line. Each of the brand's entities were responsible for various parts of the development process, with some functions overlapping, so that multiple entities carried them out. For example, while the Italian entity was solely responsible for the initial brand development and the acquisition of technology licenses, it had a limited input in comparison to the UK entity when it came to establishing quality standards for the manufacturing process. Likewise, the Swiss entity was instrumental in terms of establishing an enhancement strategy for the product line. Indeed, it was up to the UK entity to set up the sales process, refine the user experience and create the client platform.

6.10.1.8 Enhancement

The term 'enhancement', in the context of DEMPE, involves continuing to work on aspects of intangibles to make sure they can perform well at all times and be constantly improved.

Just like with the development stage, the enhancement functions were divided between the three entities in the example scenario. Italian entity was mainly responsible for promoting the brand and enhancing its awareness, though it also inputted (to a lesser degree) on searching for the latest technologies to enhance the semi-professional characteristics of the product. The UK entity made contributions to enhancing the manufacturing process and improving the client purchase experience, and had sole responsibility when it came to encouraging client interaction. It was up to the Swiss entity to enhance the existing technology that the sporting goods product line was using.

6.10.1.9 Maintenance

Maintaining intangibles involves doing everything that is possible to ensure they continue to perform well and generate revenue for a business.

In the case of the Italian clothing brand, maintenance was all about making sure clients were happy and that the quality of the products was consistently high. The majority of the responsibility for this fell with the UK entity, which was in charge of nurturing client connections, monitoring client feedback, and quality control. The UK entity also had input on making sure the purchase experience was consistent. The Italian entity was responsible for monitoring brand health and maintaining the brand's legal license agreements. The Swiss entity collected the client feedback and made sure that any performance issues were addressed through constant enhancements, revisions and updates.

6.10.1.10 Protection

Brand protection is important for ensuring that the value of a brand's assets remains strong. It involves securing IP legal rights, making sure nobody can copy the ideas and monitoring competitor's activities.

The processes for protecting the sporting goods brand were mainly divided between the Italian and UK entities, with the Swiss entity just handling the legal registration of the technology enhancement patents. The Italian entity took care of enforcing brand protection and legally registering the brands, and, to a lesser degree, monitoring the technology license agreements. The UK entity developed the brand's online support systems and kept track of competition, while also handling aspects of patenting the business's manufacturing know-how and ensuring client privacy protection.

6.10.1.11 Exploitation

In relation to intangibles, the term 'exploitation' refers to the way in which intangibles are used to generate profits.

For the Italian clothing brand example, the majority of responsibility for exploitation fell with the UK entity, which was in charge of the following: introducing the brand to market; implementing the licensed and developed technology during the manufacturing process; selling the products; connecting with customers online; and helping clients

benefit from the products. The Italian entity showcased the brand along with its other brands, while the Swiss entity built on current technology and feedback.

6.10.1.12 The outcome of DEMPE

As can be seen from the example above, the three entities contributed in varying degrees to the intangibles' value at different points of the revenue-generating process. Before DEMPE, all the residual income generated from the activities of the intangibles would have gone to the Italian entity, as it legally owns the brand IP and the contractual rights to the technology.

However, now that DEMPE has been introduced, each of the three entities outlined above is entitled to a proportional share of the income generated by the particular intangibles that they helped to develop, enhance, maintain, protect or exploit.

The share that the different entities within the supply chain receive is determined in accordance with the importance of their contributions to the value of the intangible. This can be measured by assessing the performance of the different functions. However, this is only the first step of the analysis (which can be a typical appraisal exercise to be carried out using Activity Based Costing (ABC) techniques with respect to the functions, activities and processes including the associated risks with it.

The DEMPE functions have different degrees of contribution to the value creation. Before any distribution of returns is estimated, one would need to assess the level of contribution (by adopting Contribution Analysis techniques) by the different functions to the value-creation process.

6.10.1.13 Finding third-party DEMPE data

Ultimately, the Actions 8–10 report clarifies that taxpayers should carry out a DEMPE analysis to ensure that they are complying with the OECD BEPS guidance with regards to determining appropriate arm's length compensation for functional contributions towards intangibles. DEMPE functions are integral to the value of intangibles, so they need to be analyzed in detail when assessing transactions between related entities.

6.10.2 Steps in FAR Analysis with respect to Intangibles

The following are the steps in the FAR Analysis with respect to Intangibles :-

1. Identify the intangibles used or transferred in the transaction in question
2. Identify the complete contractual arrangements including ascertaining legal ownership of the intangibles.
3. Detailed FAR Analysis using the DEMPE concept
4. Verify and confirm the consistency or otherwise between the terms of contractual arrangements and the conduct of the parties with a clear focus on DEMPE functions, associated risks and contribution of each of the parties in the DEMPE of the intangibles.
5. Determine the ALP for the contributions.

6.11 FAR ANALYSIS - LEADING TO ALP DETERMINATION

The completion of the FAR analysis leads us to the following steps towards the determination of ALP :-

- a) Characterisation of Entity (as explained in Para 6.4 of this Chapter)
- b) Deciding upon the Tested Party
- c) Economic Analysis consisting of Selection of Comparables and Benchmarking
- d) Evaluation and Financial Analysis on the basis of selected Profit Level Indicator (PLI)
- e) Determination of ALP

The steps in b to d ultimately leading to determination of ALP are covered in Chapter 7.

CHAPTER 7

BENCHMARKING, SELECTION OF COMPARABLES, COMPARABILITY ADJUSTMENTS AND DETERMINATION OF ARM'S LENGTH PRICE

7.0 WHAT IS BENCHMARKING

Benchmarking is generally understood to be a process of measuring the performance of a company's products, services, or processes against those of another business considered to be the best in the industry.

In the context of transfer pricing, Benchmarking is the process by which the arms' length price is validated on the basis of comparable financial information obtained from current and recognized databases with the use of filters objectively. Benchmarking studies are the critical part of any transfer pricing documentation file or policy and are mainly used to test the arm's length nature of the transactions with AE's in preparing a transfer pricing documentation file, set the mark-up attached to the transactions carried out between the AE's.

7.1 PURPOSE AND IMPORTANCE OF BENCHMARKING

7.1.1 PURPOSE

The purpose of a benchmarking study is to select comparable transactions for deriving arm's length price rationally based on the financial data of selected comparable. In other words, this requires identification of comparable transactions that are used to assess whether the international transactions under review comply with the arm's length principle.

7.1.2 IMPORTANCE

7.1.2.1 A well-conducted benchmarking analysis is the backbone of TP documentation. It can provide strong support for the company in justifying that its transfer price has been determined as per the arm's length principle and based on commercial drivers, and hence mitigate the risk of undesired TP adjustments by tax authorities.

7.1.2.2 In view of Rule 10D which requires maintenance of record with respect to analysis performed to evaluate comparability of uncontrolled transactions, Benchmarking Analysis as part of Transfer Pricing Documentation comes up in the form of first line of defence.

7.2 THE BENCHMARKING PROCESS – OVERVIEW

7.2.1 Benchmarking as a predominant tool is however relevant only if the method of determination of Arm's Length Price is one of the two following methods :-

1. Transactional Net Margin Method
2. Cost Plus Method

7.2.2 The following are the steps to be followed in carrying out the benchmarking process:-

- a) Determination of years to be covered
- b) Analysis of taxpayer circumstances
- c) Understanding of controlled transaction on the basis of FAR Analysis
- d) Review of Internal Comparables, if any
- e) Identifying sources for external comparables, wherever existing and possible
- f) Selection of the most appropriate method and Profit Level Indicators
- g) Identification of potential comparables after applying the filters
- h) Determining the comparability adjustments required to be made
- i) Interpretation of results and finally use of collected data and arrive at Arm's Length Price (ALP)

7.3 SALIENT POINTS IN BENCHMARKING ANALYSIS

7.3.1 SELECTION OF TESTED PARTY

There are at least two parties to an international transaction or specified domestic transaction. Comparability for determining the arm's length price can be either from taxpayer's perspective or associated enterprise's perspective. As per OECD guidelines; tested party should be the party who is least complex and whose comparable data can easily be found. In most of the cases; taxpayer is treated as a tested party since it becomes difficult to get all the detailed information of associated enterprise. Although the Indian Transfer pricing provisions have not specified any guidelines on choice of tested party, for the purpose of choice of tested party; OECD guidelines are referred.

OECD guidelines prescribe that the tested party should be the participant in the transaction. Paragraph 3.18 of the OECD guidelines provides that "the choice of the tested party should be consistent with the functional analysis of the transaction. As a general rule, the tested party is the one to which the transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found, ie. It will most often be the one that has the less complex functional analysis."

Consequently the enterprise that requires the least amount of adjustments as compared to other potentially comparable entities should be selected as the tested party. This principle is also highlighted in the Income Tax Rules

The step of selection of the tested party is of paramount importance, as the entire benchmarking exercise will be undertaken with reference to the tested party.

Here, it may be pointed out that the Indian tax authorities generally prefer Indian tested party.

7.3.2 SELECTION OF VALID COMPARABLES

7.3.2.1 Identification of Uncontrolled transactions

7.3.2.1.1 As per Rule 10A (a) of the Income Tax Rules, "uncontrolled transaction" means a transaction between enterprises other than associated enterprises, whether resident or non-resident

7.3.2.1.2 An uncontrolled transaction entered into between enterprises other than associated enterprises is deemed to be contracted under “uncontrolled conditions”.

7.3.2.1.3 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.

7.3.2.2 Factors to be considered while selecting comparables which will be ultimately valid

Rule 10B(2) provides that the comparability of an international transaction with an uncontrolled transaction shall be the comparability of an international transaction with an uncontrolled transaction shall be judged with reference to the following, namely:—

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

It can be seen that Rule 10B (2), lays down the criteria for comparability between international transactions and uncontrolled transactions. This process is not quantitative but qualitative and involves exercise of judgment. The criteria listed in Rule 10B(2) are:

- distinctive nature of the property transferred or services provided;
- functions performed taking into account the assets employed or to be employed;
- risks assumed by the respective parties;
- contractual terms of the transaction;
- market conditions.

Based on the OECD Transfer Pricing Guidelines, it could be mentioned that the following are the major factors determining comparability:-

- * Characteristics of Property or services
- * Functions performed, Assets employed and Risks assumed (FAR Analysis)
- * Contractual Terms
- * Economic circumstances
- * Business Strategies, Commercial Considerations and Economic principles

7.3.2.3 Period of Comparability

The position can be summarised as under :-

a) Rule 10B(4) not applicable for FY beginning on or after 1st April, 2014:-

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

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

Provided further that the first proviso shall not apply while analysing the comparability of an uncontrolled transaction with an international transaction or a specified domestic transaction, entered into on or after the 1st day of April, 2014.

b) Rule 10B(5) applicable on or after 1st April, 2014:-

In a case where the most appropriate method for determination of the arm's length price of an international transaction or a specified domestic transaction, entered into on or after the 1st day of April, 2014, is the method specified in clause (b), clause (c) or clause (e) of sub-section (1) of section 92C, then, notwithstanding anything contained in sub-rule (4), the data to be used for analysing the comparability of an uncontrolled transaction with an international transaction or a specified domestic transaction shall be,—

- (i) the data relating to the current year; or
- (ii) the data relating to the financial year immediately preceding the current, if the data relating to the current year is not available at the time of furnishing the return of income by the assessee, for the assessment year relevant to the current year:

Provided that where the data relating to the current year is subsequently available at the time of determination of arm's length price of an international transaction or a specified domestic transaction during the course of any assessment proceeding for the assessment year relevant to the current year, then, such data shall be used for such determination irrespective of the fact that the data was not available at the time of furnishing the return of income of the relevant assessment year.

Analysis of the provisions:-

- a) For FY commencing prior to 1.4.2014, the comparability could go backwards to two years before the current year.
- b) For FY commencing on or after 1.4.2014, the comparability could go back to only one previous year before the current year, if current year data is not available. If current year data is available later on during assessment proceedings, then the current year data would be used even if it was not available at the time of filing of the return.

7.3.3 INTERNAL COMPARABLES

Internal comparables are defined as transactions between one party to the controlled transaction and an independent party.

The advantages of the use of internal comparables are the following:-

- a) Closer relationships to taxpayer's transactions
- b) Easier access and the availability of more detailed information
- c) Less costly and SME's would generally prefer use of internal comparables
- d) In the case of intangibles, reliable external comparables may not be available in some cases.

However, the following are the usually noted shortcomings:-

- a) Comparable searches are done through short cuts and documentation is not up to the standard of acceptance
- b) Asymmetry of information between the taxpayer and the tax authorities as regards availability of internal comparables.
- c) Consequent to a) and b), difficulty in making proper adjustments for functional differences to arrive at the Arm's Length Price

The way to overcome the situation is to use internal comparables in combination along with external comparables to the extent possible depending upon facts and circumstances could be a way out.

7.3.4 SECRET COMPARABLES

7.3.4.1 It may be noted that the transfer pricing regulations do not provide any specific guidelines with respect to use of information relating to secret comparables.

7.3.4.2 An inference can be drawn from the OECD Transfer Pricing guidelines 2010 which in Para 3.30 suggests that Commercial databases in which the accounts filed by various Companies with the relevant administrative bodies are compiled and presented in an electronic format should be considered for search of comparables. Further, in Para 3.33 OECD guidelines suggest that in addition to the commercial databases any other publically available information can be used for the purpose of comparability analysis.

7.3.4.3 A question may arise whether the tax authorities can use the data not available in the public domain during the course of the assessment proceedings. In this regard the Bangalore bench of Income Tax Appellate Tribunal in the recent case of Genisys Integrating Systems (India) Pvt Ltd (ITA No.1231 (Bang.)/2010) has concluded that if any information is sought to be used against the Taxpayer, then such information has to be furnished to the Taxpayer and the Taxpayer's objections have to be considered by the TPO, before coming to a conclusion.

7.3.4.4 Further, if the Taxpayer seeks an opportunity to cross examine the party from whom information is sought under Section 133(6), the Taxpayer shall be provided with such an opportunity.

7.3.5 SELECTION OF SUITABLE METHOD

7.3.5.1 Rule 10C provides as under:-

(1) For the purposes of sub-section (1) of section 92C, the most appropriate method shall be the method which is best suited to the facts and circumstances of each particular international transaction, and which provides the most reliable measure of an arm's length price in relation to the international transaction.

(2) In selecting the most appropriate method as specified in sub-rule (1), the following factors shall be taken into account, namely:—

- (a) the nature and class of the international transaction;
- (b) the class or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;
- (c) the availability, coverage and reliability of data necessary for application of the method;
- (d) the degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;
- (e) the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;
- (f) the nature, extent and reliability of assumptions required to be made in application of a method.

7.3.5.2 The Choice of each method to use is to be made on the basis of an intelligent understanding of the facts and circumstances of each case and the applicable provisions of the Income Tax Act and the Rules discussed in detail in the preceding paragraphs.

7.3.5.3 The following comparative table gives as a general guideline a brief summary of the Comparability requirements, Benchmarking Approach and the Practical application with regard to the various methods of determination of Arm's Length Price:-

Method	Comparability Requirements	Benchmarking Approach	Practical Application
Comparable Uncontrolled Price (CUP)	Very High	Price Benchmarking	Very difficult but most preferred, since it offers direct comparison
Resale Price Maintenance (RPM)	High	Gross Profit based Benchmarking	Used mainly for Distributors and Service Providers
Cost Plus Method (CPM)	High	Gross Profit based Benchmarking	Used mainly for Manufacturers and Service Providers
Profit Split Method (PSM)	Medium	Net Profit / Operating Profit / Cash Profit based Benchmarking	Used for Manufacturers, Distributors and Service Providers
Transactional Net Margin Method (TNMM)	Medium	Net Profit / Operating Profit / cash Profit based Benchmarking	Used for Manufacturers, Distributors and Service Providers

7.3.6 COMPUTATION OF PROFIT LEVEL INDICATOR (PLI)

In benchmarking; a profit level indicator ("PLI") is computed. PLI for the purpose of **benchmarking through TNMM could be:-**

- Net margin ratio
- Operating margin ratio
- Return of capital employed and
- Return on operating assets

The choice of the appropriate ratio must be done keeping in mind the characterisation and the nature of business of the tested party, as well as, the nature of comparables selected and the quality of information available. For example, if the tested party is a distributor, operating profit / sales would be the ideal ratio as it measures the return

(profit) as a percentage of sales achieved, which is the main function and responsibility of a distributor. In another example, if the tested party is a manufacturer in an industry requiring significant capital assets, return on capital employed may be more appropriate.

Cash profit ratio is one such modified PLI, which is nothing but operating profit adjusted for depreciation and amortisation. This is used in cases involving significant differences in capitalised asset base where a separate adjustment may not be feasible to account for such differences.

Berry ratio (gross profit / operating expenses) is another such example which measures the return on the efforts employed by a commission agent.

Turning to the Indian transfer pricing regulations, while applying TNMM, for the PLI the numerator is prescribed to be "net profit margin", however, this term is not defined anywhere in the Indian Income-tax Act. This term was examined, in particular reference with the use of cash profit, for the first time in the case of Schefenacker Motherson Ltd. (Delhi ITAT) in 2009, and more recently in the case of Sumi Motherson Innovative Engineering Ltd. (Delhi ITAT). Upon initial read, these two judgements may seem to be contradictory, as the former categorically uphold use of cash profit / sales as a PLI, whereas the later explicitly rejects use of any numerator other than net operating margin while applying TNMM under the Indian transfer pricing regulations. That said, both the rulings dwell into further details on the arguments involved, and clearly converge on one transfer pricing fundamental - the need for making necessary adjustment while establishing comparability between the tested party and the comparables.

As mentioned before, cash profit ratio is derived by modifying the operating profit ratio through removal of depreciation and amortisation. Just as for any other PLI, it is important to establish the need for such an adjustment leading to the use of cash profit as the most appropriate PLI. Once the economic basis is established, one may proceed to use the cash profit / sales ratio to demonstrate the arm's length price of the intercompany transactions. It is important to understand that fulfilment of such criteria is also equally applicable to the use of more commonly applied PLIs such as the operating profit / sales, or operating profit / total cost, etc.

7.3.7 COMPARABILITY ADJUSTMENTS

Rule 10B(3) provides that an uncontrolled transaction shall be comparable to an international transaction or a specified domestic transaction, if –

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

7.3.7.1 Analysis of the provisions

It can be seen that Rule 10B(3) refers to broadly two situations and the conditions to be fulfilled in these situations to make an uncontrolled transaction to be comparable to the controlled transaction :-

- i) Situation 1 :- Differences exist, but they are not likely to materially affect the price or profits if such transactions in the open market
- ii) Situation 2:- Differences are material, but reasonably accurate adjustments can be made to remove the material effects of the differences.

7.3.7.2 The Comparability is influenced by the choice of the method of determining ALP. For instance, under the TNMM method, net margins are less effected by the transactional differences than in the case of price, as used in the CUP method.

7.3.7.3 The Resale Price Method, though apparently simple to apply, requires functional and other differences including accounting practices to be adjusted to the price.

7.3.7.4 The Cost Plus Method – CPM and TNMM require functional and other differences including those arising out of different accounting practices to be quantified and the differences are required to be adjusted to the margin.

7.3.7.5 OECD Guidelines gives emphasis on reliable adjustments based on objective and verifiable economic criteria for those differences which have a material influence on price / margin. In case too many types of adjustments are made, the test of comparability may fail.

7.3.7.6 Para 3.48 of OECD Guidelines state, “examples of comparability adjustments include adjustments for accounting consistency designed to eliminate difference that may arise from differing accounting practices between the controlled and uncontrolled transactions, segmentation of financial data to eliminate significant non-comparable

transactions, adjustments for differences in capital, functions, assets, risks.”. The list of adjustment factors are by no means exhaustive and in practice there may be more factors such as for example differences in capacity utilization, considerations in start-ups.

7.3.7.6 In general, it could be said that the various adjustments that would be required to be made based on comparability could be classified under the following heads :-

- i. Working Capital Adjustment
- ii. Business Risk adjustment
- iii. Foreign Exchange Risk adjustment
- iv. Accounting Adjustments
- v. Geographic Market differences
- vi. Capacity Utilisation Adjustment
- vii. Marketing Cost Adjustments
- viii. Onsite activity cost adjustments

7.4 DETERMINATION OF ARMS' LENGTH PRICE

7.4.1 Determination of Arm's Length where there will be one price

After applying the most appropriate method and after making the necessary comparable adjustments as discussed in Para 7.3.7, the Arm's Length price will be determined.

7.4.2 Determination when there is more than one price (Rule 10CA)

(1) Where in respect of an international transaction or a specified domestic transaction, the application of the most appropriate method referred to in sub-section (1) of section 92C results in determination of more than one price, then the arm's length price in respect of such international transaction or specified domestic transaction shall be computed in accordance with the provisions of this rule.

(2) A dataset shall be constructed by placing the prices referred to in sub-rule (1) in an ascending order and the arm's length price shall be determined on the basis of the dataset so constructed:

Provided that in a case referred to in clause (i) of sub-rule (5) of rule 10B, where the comparable uncontrolled transaction has been identified on the basis of data relating to the current year and the enterprise undertaking the said uncontrolled transaction, [not being the enterprise undertaking the international transaction or the specified domestic transaction referred to in sub-rule (1)], has in either or both of the two

financial years immediately preceding the current year undertaken the same or similar comparable uncontrolled transaction then,—

- (i) the most appropriate method used to determine the price of the comparable uncontrolled transaction or transactions undertaken in the aforesaid period and the price in respect of such uncontrolled transactions shall be determined; and*
- (ii) the weighted average of the prices, computed in accordance with the manner provided in sub-rule (3), of the comparable uncontrolled transactions undertaken in the current year and in the aforesaid period preceding it shall be included in the dataset instead of the price referred to in sub-rule (1):*

Provided further that in a case referred to in clause (ii) of sub-rule (5) of rule 10B, where the comparable uncontrolled transaction has been identified on the basis of the data relating to the financial year immediately preceding the current year and the enterprise undertaking the said uncontrolled transaction, [not being the enterprise undertaking the international transaction or the specified domestic transaction referred to in sub-rule (1)], has in the financial year immediately preceding the said financial year undertaken the same or similar comparable uncontrolled transaction then,—

- (i) the price in respect of such uncontrolled transaction shall be determined by applying the most appropriate method in a similar manner as it was applied to determine the price of the comparable uncontrolled transaction undertaken in the financial year immediately preceding the current year; and*
- (ii) the weighted average of the prices, computed in accordance with the manner provided in sub-rule (3), of the comparable uncontrolled transactions undertaken in the aforesaid period of two years shall be included in the dataset instead of the price referred to in sub-rule (1) :*

Provided also that where the use of data relating to the current year in terms of the proviso to sub-rule (5) of rule 10B establishes that,—

- (i) the enterprise has not undertaken same or similar uncontrolled transaction during the current year; or*
- (ii) the uncontrolled transaction undertaken by an enterprise in the current year is not a comparable uncontrolled transaction,*

then, irrespective of the fact that such an enterprise had undertaken comparable uncontrolled transaction in the financial year immediately preceding the current year or the financial year immediately preceding such financial year, the price of comparable uncontrolled transaction or the weighted average of the prices of the uncontrolled transactions, as the case may be,

undertaken by such enterprise shall not be included in the dataset.

(3) Where an enterprise has undertaken comparable uncontrolled transactions in more than one financial year, then for the purposes of sub-rule (2) the weighted average of the prices of such transactions shall be computed in the following manner, namely:—

- (i) where the prices have been determined using the method referred to in clause (b) of sub-rule (1) of rule 10B, the weighted average of the prices shall be computed with weights being assigned to the quantum of sales which has been considered for arriving at the respective prices;*
- (ii) where the prices have been determined using the method referred to in clause (c) of sub-rule (1) of rule 10B, the weighted average of the prices shall be computed with weights being assigned to the quantum of costs which has been considered for arriving at the respective prices;*
- (iii) where the prices have been determined using the method referred to in clause (e) of sub-rule (1) of rule 10B, the weighted average of the prices shall be computed with weights being assigned to the quantum of costs incurred or sales effected or assets employed or to be employed, or as the case may be, any other base which has been considered for arriving at the respective prices.*

(4) Where the most appropriate method applied is a method other than the method referred to in clause (d) or clause (f) of sub-section (1) of section 92C and the dataset constructed in accordance with sub-rule (2) consists of six or more entries, an arm's length range beginning from the thirty-fifth percentile of the dataset and ending on the sixty-fifth percentile of the dataset shall be constructed and the arm's length price shall be computed in accordance with sub-rule (5) and sub-rule (6).

(5) If the price at which the international transaction or the specified domestic transaction has actually been undertaken is within the range referred to in sub-rule (4), then, the price at which such international transaction or the specified domestic transaction has actually been undertaken shall be deemed to be the arm's length price.

(6) If the price at which the international transaction or the specified domestic transaction has actually been undertaken is outside the arm's length range referred to in sub-rule (4), the arm's length price shall be taken to be the median of the dataset.

(7) In a case where the provisions of sub-rule (4) are not applicable, the arm's length price shall be the arithmetical mean of all the values included in the dataset:

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

behalf, the price at which the international transaction or specified domestic transaction has actually been undertaken shall be deemed to be the arm's length price.

(8) For the purposes of this rule,—

(a) "the thirty-fifth percentile" of a dataset, having values arranged in an ascending order, shall be the lowest value in the dataset such that at least thirty five per cent of the values included in the dataset are equal to or less than such value:

Provided that, if the number of values that are equal to or less than the aforesaid value is a whole number, then the thirty-fifth percentile shall be the arithmetic mean of such value and the value immediately succeeding it in the dataset;

(b) "the sixty-fifth percentile" of a dataset, having values arranged in an ascending order, shall be the lowest value in the dataset such that at least sixty five per cent of the values included in the dataset are equal to or less than such value:

Provided that, if the number of values that are equal to or less than the aforesaid value is a whole number, then the sixty-fifth percentile shall be the arithmetic mean of such value and the value immediately succeeding it in the dataset;

(c) "the median" of the dataset, having values arranged in an ascending order, shall be the lowest value in the dataset such that at least fifty per cent of the values included in the dataset are equal to or less than such value:

Provided that, if the number of values that are equal to or less than the aforesaid value is a whole number, then the median shall be the arithmetic mean of such value and the value immediately succeeding it in the dataset.

Illustration 1.—The data for the current year of the comparable uncontrolled transactions or the entities undertaking such transactions is available at the time of furnishing return of income by the assessee and based on the same, seven enterprises have been identified to have undertaken the comparable uncontrolled transaction in the current year. All the identified comparable enterprises have also undertaken comparable uncontrolled transactions in a period of two years preceding the current year. The Profit level Indicator (PLI) used in applying the most appropriate method is operating profit as compared to operating cost (OP/OC). The weighted average shall be based upon the weight of OC as computed below :

Sl. No.	Name	Year 1	Year 2	Year 3 [Current Year]	Aggregation of OC and OP	Weighted Average
1	2	3	4	5	6	7

1	A	OC = 100 OP = 12	OC = 150 OP = 10	OC = 225 OP = 35	Total OC = 475 Total OP = 57	OP/OC = 12%
2	B	OC = 80 OP = 10	OC = 125 OP = 5	OC = 100 OP = 10	Total OC = 305 Total OP = 25	OP/OC = 8.2%
3	C	OC = 250 OP = 22	OC = 230 OP = 26	OC = 250 OP = 18	Total OC = 730 Total OP = 66	OP/OC = 9%
4	D	OC = 180 OP = (-)9	OC = 220 OP = 22	OC = 150 OP = 20	Total OC = 550 Total OP = 33	OP/OC = 6%
5	E	OC = 140 OP = 21	OC = 100 OP = (-)8	OC = 125 OP = (-)5	Total OC = 365 Total OP = 8	OP/OC = 2.2%
6	F	OC = 160 OP = 21	OC = 120 OP = 14	OC = 140 OP = 15	Total OC = 420 Total OP = 50	OP/OC = 11.9%
7	G	OC = 150 OP = 21	OC = 130 OP = 12	OC = 155 OP = 13	Total OC = 435 Total OP = 46	OP/OC = 10.57%

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

SI. No.	1	2	3	4	5	6	7
Values	2.2%	6%	8.2%	9%	10.57%	11.9%	12%

For construction of the arm's length range the data place of thirty-fifth and sixty-fifth percentile shall be computed in the following manner, namely:

*Total no. of data points in dataset *(35/100)*

*Total no. of data points in dataset *(65/100)*

*Thus, the data place of the thirty-fifth percentile = 7*0.35=2.45.*

Since this is not a whole number, the next higher data place, i.e. the value at the third place would have at least thirty five per cent of the values below it. The thirty-fifth percentile is therefore value at the third place, i.e. 8.2%.

*The data place of the sixty-fifth percentile is = 7*0.65=4.55.*

Since this is not a whole number, the next higher data place, i.e. the value at the fifth place would have at least sixty five per cent of the values below it. The sixty-fifth percentile is therefore value at fifth place, i.e. 10.57%.

The arm's length range will be beginning at 8.2% and ending at 10.57%.

Therefore, if the transaction price of the international transaction or the specified domestic transaction has OP/OC percentage which is equal to or more than 8.2% and

less than or equal to 10.57%, it is within the range. The transaction price in such cases will be deemed to be the arm's length price and no adjustment shall be required. However, if the transaction price is outside the arm's length range, say 6.2%, then for the purpose of determining the arm's length price the median of the dataset shall be first determined in the following manner:

The data place of median is calculated by first computing the total number of data point in the dataset * (50/100). In this case it is $7*0.5=3.5$.

Since this is not a whole number, the next higher data place, i.e. the value at the fourth place would have at least fifty per cent of the values below it (median).

The median is the value at fourth place, i.e., 9%. Therefore, the arm's length price shall be considered as 9% and adjustment shall accordingly be made.

Illustration 2.—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:

Sl. No.	Name	Year 1	Year 2	Year 3 [Current Year]	Aggregation of OC and OP	Weighted Average
1	2	3	4	5	6	7
1	A	OC = 100 OP = 12	OC = 150 OP = 10	OC = 225 OP = 35	Total OC = 475 Total OP = 57	OP/OC = 12%
2	B	OC = 80 OP = 10	OC = 125 OP = 5		Total OC = 205 Total OP = 15	OP/OC = 7.31%
3	C	OC = 250 OP = 22	OC = 230 OP = 26	OC = 250 OP = 18	Total OC = 730 Total OP = 66	OP/OC = 9%
4	D		OC = 220 OP = 22		Total OC = 220 Total OP = 22	OP/OC = 10%

5	E			OC = 100 OP = (-)5	Total OC = 100 Total OP = (-)5	OP/OC = (-)5%
6	F	OC = 160 OP = 21	OC = 120 OP = 14	OC = 140 OP = 15	Total OC = 420 Total OP = 50	OP/OC = 11.9%
7	G	OC = 150 OP = 21	OC = 130 OP = 12	OC = 155 OP = 13	Total OC = 435 Total OP = 46	OP/OC = 10.57%

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

Sl. 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 :

Sl. No.	Name	Year 1	Year 2	Year 3 [Current Year]	Aggregation of OC and OP	Weighted Average
1	2	3	4	5	6	7
1	A	OC = 100 OP = 12	OC = 150 OP = 10	OC = 225 OP = 35	Total OC = 475 Total OP = 57	OP/OC = 12%
2	C	OC = 250 OP = 22	OC = 230 OP = 26	OC = 250 OP = 18	Total OC = 730 Total OP = 66	OP/OC = 9%
3	D		OC = 220	OC = 150	Total OC = 370	OP/OC = 11.35%

			OP = 22	OP = 20	Total OP = 42	
4	E			OC = 100 OP = (-)5	Total OC = 100 Total OP = (-)5	OP/OC = (-)5%
5	F	OC = 160 OP = 21	OC = 120 OP = 14	OC = 140 OP = 15	Total OC = 420 Total OP = 50	OP/OC = 11.9%
6	G	OC = 150 OP = 21	OC = 130 OP = 12	OC = 155 OP = 13	Total OC = 435 Total OP = 46	OP/OC = 10.57%
7	H	OC = 150 OP = 12		OC = 80 OP = 10	Total OC = 230 Total OP = 22	OP/OC = 9.56%

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

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

Illustration 3.— In a given case the dataset of 20 prices arranged in ascending order is as under :

Sl. No.	Profits (in Rs. Thousand)
1	2
1	42.00
2	43.00
3	44.00
4	44.50
5	45.00
6	45.25

7	47.00
8	48.00
9	48.15
10	48.35
11	48.45
12	48.48
13	48.50
14	49.00
15	49.10
16	49.35
17	49.50
18	49.75
19	50.00
20	50.15

Applying the formula given in the Illustration 1, the data place of the thirty-fifth and sixty-fifth percentile is determined as follows:

Thirty-fifth percentile place = $20 * (35/100) = 7$.

Sixty-fifth percentile place = $20 * (65/100) = 13$.

Since the thirty-fifth percentile place is a whole number, it shall be the average of the prices at the seventh and next higher, i.e.; eighth place. This is $(47+48)/2 = \text{Rs.}47,500$.

Similarly, the sixty-fifth percentile will be average of thirteenth and fourteenth place prices. This is $(48.5+49)/2 = \text{Rs.}48,750$

The median of the range (the fiftieth percentile place) = $20 * (50/100) = 10$

Since the fiftieth percentile place is a whole number, it shall be the average of the prices at the tenth and next higher, i.e.; eleventh place. This is $(48.35+48.45)/2 = \text{Rs.}48,400$.

Thus, the arm's length range in this case shall be from Rs.47,500 to Rs.48,750.

Consequently, any transaction price which is equal to or more than Rs.47,500 but less than or equal to Rs.48,750 shall be considered to be within the arm's length range.]

7.4.3 COMPARISON OF THE ALP WITH THE ACTUAL TRANSFER PRICE

The ALP so determined (either as per Para 7.4.1 or Para 7.4.2) is compared with the actual transfer price to determine whether any transfer pricing adjustment is required.

The determination of the ALP and its comparison with the actual transfer price could lead to re-determination of addition to income or reduction of Loss and consequent tax liability of the tax payer. Such re-determination of Income or loss can lead to Primary Adjustment which could also in certain cases lead to Secondary Adjustment.

This resulting scenario is discussed in Para 10.3 of Chapter 10.

CHAPTER 8

INFORMATION AND DOCUMENTATION REQUIREMENTS

8.0 RECORD KEEPING AND MAINTENANCE

The matter of record keeping is of great importance and significance in the context of transfer pricing, since the enforceability of the transfer pricing regulations is fundamentally related to it. Further, the various records or documents that are required to be maintained by an enterprise constitute evidence for the purposes of law as to whether or not the enterprise has been keeping reasonable records relating to transfer pricing or indulging in transfer pricing manipulation in connection with the transactions covered by Transfer Pricing (TP) regulations. Also failure to comply with the requirements of maintenance of information and documents is a potential ground for initiation of penalty proceedings.

TP regulations prevalent across tax jurisdictions fully recognize that tax administrations face an inherent challenge, which stems from an understanding of the need to balance the ultimate objective of achieving a high degree of compliance with the statutory and regulatory framework in the various countries in which an MNC is operating on the one hand and the management of the level of taxes being paid on a global basis in a competitive environment. From the point of view of Multinational Corporations (MNC's) the ability of its effective tax planning depend upon the effectiveness of the record maintenance, information availability and documentation.

From the perspective of tax administrations, it is expected that enterprises are in a position to support their tax returns and demonstrate that their transactions have been carried out at ALP and not been subject to transfer pricing manipulation. Almost all the countries that have TP regulations have evolved detailed requirements for the documentation of transfer pricing matters.

OECD in their guidelines pertaining to transfer pricing documentation has stated as under:-

“Taxpayers should make reasonable efforts at the time the transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the arms’ length principle. Tax administrations should have the right to obtain the

documentation prepared or referred to in this process as means of verifying compliance with the arms' length principle.

However, the extensiveness of this process should be determined in accordance with the same prudent business management principles that would govern the process of evaluating the business decision of a similar level of complexity and importance.

Moreover, the need for the documents should be balanced by the costs and administrative burdens, particularly where this process suggests the creation of documents that would not otherwise be prepared or referred to in the absence of tax considerations.

Documentation requirements should not impose on tax payers, costs and burdens disproportionate to the circumstances. Taxpayers should nonetheless recognize that adequate record-keeping practices and production of documents facilitates examination and resolution transfer pricing issues that arise.”

In most tax jurisdictions the onus of proof is concurrently both with the assessee as well as the income tax department. The assessee has to establish that the transfer pricing adopted conforms to the market trend and is in accordance with the Arms' Length principle, while concurrently, the tax authorities would have to substantiate and demonstrate the adjustments that they would like to make to the transfer price determined by the assessee. In this context, maintenance of appropriately proper documentation would provide assurance to the tax authorities regarding the reasonableness of the transfer pricing adopted by the tax payer.

8.1 MAINTENANCE OF PRESCRIBED INFORMATION AND DOCUMENTATION - FRAMEWORK

8.1.1 Section 92D of the Income Tax Act read with Rule 10D of the Income Tax Rules prescribe the legal framework for maintenance of information and documentation by a taxpayer with respect to an international transaction. With the applicability of the Transfer Pricing (TP) regulations to Specified Domestic Transactions (SDT) as well, the requirements relating to availability of information and documentation with respect to International Transactions will mutatis mutandis apply to SDT.

8.1.2 The effect of the provisions of Section 92D is that “every person who has entered into an international transaction or a specified domestic transaction, during a previous year, shall keep and maintain such information and documents, prescribed by the Board,

which shall assist the Assessing Officer / Transfer Pricing Officer to compute the income arising from that transaction, having regard to the arms' length price"

8.1.3 The requirement to maintain and keep information and documents has been extended to a constituent entity of an international group by the Finance Act 2016 which is effective from 1.4.2017 by insertion of a proviso to sub section 1 of Section 92D. The meaning of both the terms "Constituent Entity" and "International Group" have been covered in Chapter 2.

8.1.4 Section 286(1) prescribes the various documents that are required to be furnished by the constituent entity. Section 92D(4) stipulates that "without prejudice to the provisions of Section 92D(3) (referring to a person being a constituent entity) the person shall furnish the information and document referred in Section 286(1) in such manner on or before the date, as may be prescribed.

8.2 INFORMATION REQUIRED TO BE MAINTAINED

The requirements of the information to be kept and maintained by an Enterprise are stipulated in Rule 10D of the Income Tax Rules, 1962. The gist of the requirements can be classified under three broad categories as under:-

a) *Enterprise centric documents:-*

- i. Ownership details: A description of the ownership structure of the enterprise and details of shares or other ownership interest held therein by other enterprises;
- ii. Profile of the multinational group : A profile of the multinational group of which the taxpayer is a part and 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 made by the taxpayer and the ownership linkages among them;
- iii. Business profile of taxpayer and Associated Enterprise: A broad description of the business of the taxpayer and the industry in which it operates and the business of the associated enterprises;

b) *Transaction specific documents:-*

iv. Terms of International Transaction : The nature, terms and prices of international transaction 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;

v. FAR Analysis (Functions, Assets and Risks) Analysis: A description of the functions performed, risks assumed and assets employed or to be employed by the taxpayer and by the associated enterprise involved in the international transaction (discussed in detail in Chapter 6);

vi. Economic and Market Analysis :A record of the economic and market analyses, forecasts, budgets or any other financial estimates prepared by the taxpayer for its business as a whole or separately for each division or product which may have a bearing on the international transaction entered into by the taxpayer;

vii. Record of Uncontrolled Transactions: A record of uncontrolled transactions taken into account for analyzing their comparability with the international transaction entered into, including a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevant to the pricing of the international transactions;

viii. Evaluation of comparability: A record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction;

c) *Computation and connected documents:-*

ix. Analysis of methods used for determining ALP : A description of the methods considered for determining the arm's length price in relation to each international transaction 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;

x. Workings for determining ALP: 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 international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transaction;

xi. Assumptions, policies and Price Negotiations: The assumptions, policies and price negotiations if any which have critically affected the determination of the arm's length price ;

xii. Adjustment details: Details of the adjustments, if any made to the transfer price to align it with arm's length price determined under these rules and consequent adjustment made to the total income for tax purposes;

xiii. Any Other information: 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.

8.3 AUTHENTIC DOCUMENTS TO SUPPORT

Rule 10D prescribes that the above information (covered in 7.2) is to be supported by authentic documents which may include the following:

i. Official publications, reports, studies and data bases of the government of the country of residence of the associated enterprise or of any other country;

ii. Reports of market research studies carried out and technical publications of institutions of national or international repute;

iii. Publications relating to prices including stock exchange and commodity market quotations;

iv. Published accounts and financial statements relating to the business of the associated enterprises;

v. Agreements and contracts entered into with associated enterprises or with unrelated enterprises in respect of transaction similar to the international transactions;

vi. Letters and other correspondence documenting terms negotiated between the taxpayer and associated enterprise;

vii. Documents normally issued in connection with various transaction under the accounting practices followed.

8.4 ANALYSIS OF THE REQUIREMENTS

8.4.1 It is noteworthy that the information and documentation requirements referred to above are linked to the burden of proof laid on the taxpayer to prove that the transfer price adopted is in accordance with the arm's length principle. One of the conditions to be fulfilled for discharging this burden by the taxpayer is maintenance of prescribed information and documents in respect of an international transaction entered into with an associated enterprise. A default in maintaining information and documents in accordance with the rules is one of the conditions which may trigger a transfer pricing audit under Section 92C(3). Any default in respect of the documentation requirement may also attract penalty of a sum equal to 2% of the value of the international transaction (Sec 271AA).

8.4.2 Neither the Income tax Act nor the Income tax Rules stipulate any requirement to submit the prescribed information and documents at the stage of filing of the report of the Accountant under Section 92E, which requires the concerned taxpayer to obtain a report from an Accountant in the prescribed form (Form 3CEB) and submit the report by the specified date. Form 3CEB contains a certificate from the Accountant that in his opinion proper information and documents as prescribed have been maintained by the taxpayer. It does not require their submission along with the report. But Rule 10D requires that the information and document maintained should be contemporaneous as far as possible and should exist latest by the specified date for filing the report under section 92E. Further, Section 92D also provides that information and documentation may be requisitioned by the Assessing Officer or the Appellate Commissioner on a notice of 30 days which period may be extended by another period of 30 days.

8.4.3 Para 2 of Rule 10D provides an exemption in respect of the information and document requirement in respect of transactions not exceeding INR 10 million, providing that the above requirement will not apply to such transactions. However, the concerned taxpayer may be required to substantiate on the basis of available material that the income arising from the international transaction is computed in accordance with the arm's length rule.

8.4.4 The prescribed information and documents are required to be maintained for a period of 8 years. Rule 10D absolves a taxpayer entering into an international transaction which continues to have effect over more than one year from maintaining separate set of documents for each year. However separate documents are required for each year if there is any significant change in the terms and conditions of the international transaction which have a bearing on the transfer price.

8.4.5 Since information and documents are required to be maintained for a period of 8 years, the taxpayer has to ensure that in case these are maintained in electronic form or in servers / cloud, it is possible to retrieve the records, information and documents for the said period, so that the compliance of this provision is ensured.

8.5 APPROACH TO DOCUMENTATION

8.5.1 If the commercial reasoning behind the arm's length nature of intra-group transactions is adequately documented as well as explained to the tax/transfer pricing authorities, the taxpayer has a very good chance of sailing through the transfer pricing audit/scrutiny without any major adverse adjustments.

8.5.2 A good transfer pricing documentation is one which is maintained on an "as and when" basis. In other words, the documentation must be maintained at the very moment when the transaction takes place. This is the typical failure in most TP cases when it comes to documentation.

8.5.3 It is also imperative that the quality and adequacy of documentation must be subjected to an internal review by an "in-house" team or preferably, external consultants at regular quarterly/half yearly intervals; in addition to the final review and sign-off at the year end.

8.5.4 This would enable taxpayers to capture the thought process and the business realities when the same is still fresh in the memory; rather than digging for such information at a later date. This is where a strong, robust and real time use of Cost and Management Accounting tools comes in handy. This however depends upon having in place an integrated accounting framework (meaning the cost and financial accounting systems are integrated). This is where top management involvement in the real sense is crucial to achieve desired outcomes.

8.5.5 Also important is the Board approach and attitude coupled with having in place appropriate process, particularly with respect to Related Party Transactions, where it is of paramount importance to demonstrate that the transactions are in fact carried out at arms' length and this is possible only if proper documentation is maintained.

8.5.6 Further many taxpayers have the practice of maintaining documentation only if the case is selected for a transfer pricing scrutiny. This approach is fraught with huge risks. Even the regulations require the documentation to be contemporaneous. As the good old saying goes, "A stitch in time saves nine!"

8.5.7 The identification and reporting procedures as also the formulation of an active strategy with respect to International Transactions and Specified Domestic Transactions call for a multi-disciplinary professional approach comprising of a team of Accounting and Compliance Professionals.

CHAPTER 9

REPORT OF ACCOUNTANT

9.1 According to section 92E every person who has entered into an international transaction or specified domestic transaction during a previous year shall obtain a report from an accountant and furnish such report on or before the specified date in the prescribed form duly signed and verified in the prescribed manner by such accountant and setting forth such particulars as may be prescribed. The report is to be given by an accountant in Form No.3CEB as prescribed under Rule 10E. Recently, the Income Tax rules have been amended to require the filing of the said report electronically. The scope of examination envisaged by section 92E is restricted to such examination of accounts and records of the assessee relating to the international transaction or specified domestic transaction entered into by the assessee during the previous year under examination.

9.2 Explanation to Section 288 (2), defines the term Accountant. Accordingly the term “Accountant” means a chartered accountant within the meaning of the Chartered Accountants Act, 1949 (38 of 1949), and includes, in relation to any State, any person who by virtue of the provisions of sub-section (2) of section 226 of the Companies Act, 1956 (1 of 1956), is entitled to be appointed to act as an auditor of companies registered in that State. It may be noted that the explanation has not been updated to refer to the corresponding provision in the Companies Act, 2013 namely Section 139.

9.3 Further, the accountant has to give his opinion whether “proper information and documents as are prescribed” have been kept by the assessee in respect of the international transactions or specified domestic transaction entered into by him.

9.4 The report consists of three paragraphs dealing with distinct aspects as mentioned below :-

- a) The first paragraph contains the declaration about examination of the accounts and records of the assessee in order to review the international transaction(s) and the specified domestic transaction(s).
- b) The second paragraph involves rendering of an opinion whether proper information and documents as are prescribed under Rule 10D are maintained by the assessee in respect of the identified international transactions and the specified domestic transaction(s), on the basis of the details furnished in Annexure to Form No.3CEB.

c) The third and the last paragraph requires expression of the opinion whether the particulars given in the Annexure to Form No.3CEB are true and correct.

9.5 The Annexure to Form No. 3CEB has three parts namely Part A, Part B and Part C.

9.5.1 Part A, which is basic information about the assessee such as

Name

Address

PAN No.

Nature of Business

Previous Year

Assessment Year

Residential Status

Aggregate Value of International Transactions in the relevant Previous Year and

Aggregate Value of Specified Domestic Transactions (SDT) in the relevant Previous Year.

9.5.2 Part B forms the detailed information to be furnished by the Accountant about the various International Transactions entered into by the assessee.

9.5.3 Part C forms the detailed information to be furnished by the Accountant about the various Specified Domestic Transactions entered into by the assessee.

9.5.4 Clause 10 requires a detailed listing of all the Associated Enterprises (AE) with whom the assessee has entered into international transactions, giving their name, the nature of business carried on by them and the relationship of the assessee with the AE's listed.

9.5.5 Clauses 11 to 20 of Annexure to Form No.3CEB lists the various typical transactions with AE that are required to be reported under specific heads namely

Clause No.	Transaction Covered
11	International Transaction in tangible property
12	International Transaction in intangible property
13	International Transaction in respect of services
14	International Transaction in lending or borrowing money
15	International Transactions in the nature of guarantee
16	international transaction(s) in respect of purchase or sale of marketable securities or issue of equity shares
17	International Transactions in respect of mutual agreement or arrangement
18	International transactions arising out/ being part of business restructuring or reorganizations
19	Any other international transaction including the transaction having a bearing on the profits, incomes, losses, or assets of the assessee
20	Particulars of deemed international transaction

9.5.6 Clause 21 requires a detailed listing of all the Associated Enterprises (AE) with whom the assessee has entered into Specified Domestic Transactions, giving their name, their PAN Number, the nature of business carried on by them and the relationship of the assessee with the AE's listed.

9.5.7 Clauses 22 to 24 of Annexure to Form No. 3CEB lists the various Specified Domestic Transactions with AE that are required to be reported under specific heads namely

22	Details of SDT being in respect of which payment has been made or is to be made to any person referred to in section 40A(2)(b)
23	Details with respect to any undertaking or unit or enterprise or eligible business of the assessee [as referred to in section 80A(6), 80IA(8) or section 10AA]] with respect to transfer of any goods or services to any other business carried on by the assessee?
24	Details of any undertaking or unit or enterprise or eligible business of the assessee [as referred to in section 80A(6), 80IA(8) or section 10AA]]with respect to acquiring any goods or services to any other business carried on by the assessee

9.5.8 Clause 25 requires the assessee to report any transactions that are not specifically covered by clauses 22 to 24.

CHAPTER 10

ASSESSMENT, APPEAL AND PENAL PROVISIONS

10.1 Assessment provisions for Transactions covered by Transfer pricing regulations

The relevant provisions are contained in Section 92CA. The provisions are as under:-

92CA (1) Where any person, being the assessee, has entered into an international transaction *or specified domestic transaction* in any previous year, and the Assessing Officer considers it necessary or expedient so to do, he may, with the previous approval of the Commissioner, refer the computation of the arm's length price in relation to the said international transaction *or specified domestic transaction* under section 92C to the Transfer Pricing Officer.

(2) Where a reference is made under sub-section (1), the Transfer Pricing Officer shall serve a notice on the assessee requiring him to produce or cause to be produced on a date to be specified therein, any evidence on which the assessee may rely in support of the computation made by him of the arm's length price in relation to the international transaction *or specified domestic transaction* referred to in sub-section (1).

(2A) Where any other international transaction [other than an international transaction referred under sub-section (1)], comes to the notice of the Transfer Pricing Officer during the course of the proceedings before him, the provisions of this Chapter shall apply as if such other international transaction is an international transaction referred to him under sub-section (1).

(2B) Where in respect of an international transaction, the assessee has not furnished the report under section 92E and such transaction comes to the notice of the Transfer Pricing Officer during the course of the proceeding before him, the provisions of this Chapter shall apply as if such transaction is an international transaction referred to him under sub-section (1).

(It is interesting to note that sub section 2A and 2B does not mention about “Specified Domestic Transaction)

(2C) Nothing contained in sub-section (2B) shall empower the Assessing Officer either to assess or reassess under section 147 or pass an order enhancing the assessment or reducing a refund already made or otherwise increasing the liability of the assessee under section 154, for any assessment year, proceedings for which have been completed before the 1st day of July, 2012.

(3) On the date specified in the notice under sub-section (2), or as soon thereafter as may be, after hearing such evidence as the assessee may produce, including any information or documents referred to in sub-section (3) of section 92D and after considering such evidence as the Transfer Pricing Officer may require on any specified points and after taking into account all relevant materials which he has gathered, the Transfer Pricing Officer shall, by order in writing, determine the arm's length price in relation to the international transaction *or specified domestic transaction* in accordance with sub-section (3) of section 92C and send a copy of his order to the Assessing Officer and to the assessee.

(3A) Where a reference was made under sub-section (1) before the 1st day of June, 2007 but the order under sub-section (3) has not been made by the Transfer Pricing Officer before the said date, or a reference under sub-section (1) is made on or after the 1st day of June, 2007, an order under sub-section (3) may be made at any time before sixty days prior to the date on which the period of limitation referred to in section 153, or as the case may be, in section 153B for making the order of assessment or reassessment or re-computation or fresh assessment, as the case may be, expires.]

Provided that in the circumstances referred to in Clause (ii) or clause (x) of Explanation (1) to Section 153, if the period of limitation available to the Transfer Pricing Officer for making an order is less than sixty days, such remaining period shall be extended to sixty days and the aforesaid period of limitation shall be deemed to have been extended accordingly.

(4) On receipt of the order under sub-section (3), the Assessing Officer shall proceed to compute the total income of the assessee under sub-section (4) of section 92C in conformity with the arm's length price as so determined by the Transfer Pricing Officer.

(5) With a view to rectifying any mistake apparent from the record, the Transfer Pricing Officer may amend any order passed by him under sub-section (3), and the provisions of section 154 shall, so far as may be, apply accordingly.

(6) Where any amendment is made by the Transfer Pricing Officer under sub-section (5), he shall send a copy of his order to the Assessing Officer who shall thereafter proceed to amend the order of assessment in conformity with such order of the Transfer Pricing Officer.

(7) The Transfer Pricing Officer may, for the purposes of determining the arm's length price under this section, exercise all or any of the powers specified in clauses (a) to (d) of sub-section (1) of section 131 or sub-section (6) of section 133 or section 133A.

Explanation.—For the purposes of this section, "Transfer Pricing Officer" means a Joint Commissioner or Deputy Commissioner or Assistant Commissioner authorised by the Board to perform all or any of the functions of an Assessing Officer specified in sections 92C and 92D in respect of any person or class of persons.

10.2 Assessment Procedures for Transfer Pricing

10.2.1 In the first instance the income tax return along with the Form 3CEB (Report of Accountant) is processed by the Assessing officer having jurisdiction over the assessee.

10.2.2 The minimum threshold level for reference of international transactions to the Transfer Pricing Officer (TPO) is Rs. 15 Crores. For transactions of the volume of Rs. 15 Crores or more in a financial year, the reference to a TPO is compulsory for scrutiny. For transactions below Rs. 15 Crores, the assessment procedures will be performed by the concerned Assessing Officer. In other words, for transactions below Rs. 15 Crores, the usual assessment procedures under the existing applicable provisions of Income Tax Act.

10.2.3 Further, it is to be noted that the requirement for maintaining documentation and information by the assessee pursuant to the Transfer Pricing Regulations is Rs. 1 Crore.

10.2.4 For the purpose of Transfer Pricing Audit / Scrutiny, 5 audit teams have been constituted at Delhi, Mumbai, Bengaluru, Chennai and Kolkata. Each team consists of a Director of International Tax and Joint / Additional Commissioners as TPO.

10.2.5 On receiving a reference from the Assessing officer having jurisdiction over the assessee (with the approval of the Commissioner), the Transfer Pricing Officer would notify taxpayer to produce evidence supporting the transfer price as Arms' Length.

10.2.6 On the completion of the Transfer Pricing Audit / scrutiny proceedings, the TPO would determine the ALP by passing an order based on information gathered from the assessee and other sources and intimate the assessing officer and the assessee accordingly.

10.2.7 Assessing Officer would then proceed to compute the income of the assessee after considering the ALP as determined by the TPO.

10.3 TRANSFER PRICING ASSESSMENT ADJUSTMENTS

10.3.1 Introduction of Secondary Adjustment Mechanism by Finance Act 2017

The Finance Act 2017 (with effect from AY 2018-19) stipulated new provisions (Section 92CE) stipulating secondary adjustments seeking to reflect the adjustments in the books of the Associated Enterprises (AE) the allocation of profits consistent with the transfer price determined by Primary Adjustment

10.3.2 Primary Adjustment and Secondary Adjustment - Definition

Section 92CE(3)(iv) defines “Primary Adjustment” to mean the determination of transfer price in accordance with the arms’ length principle resulting in an increase in the total income or reduction in the loss, as the case may be, of the assessee

Section 92CE(3)(v) defines “Secondary Adjustment” to mean 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 associated enterprise 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

10.3.3 When is secondary adjustment required to be made?

Secondary Adjustments will be required in case of the following Primary Adjustments:-

- Suo-moto adjustment offered by the taxpayer.
- Adjustment made by the Assessing Officer and accepted by the taxpayer.
- Adjustment determined by an Advance Pricing Agreement (APA) pursuant to Section 92CC (Refer Chapter 12, Para 12.2).
- Adjustment made as per Indian safe harbour rules framed under Section 92CB. (Refer Chapter Para 12.4)

- Adjustment arising as a result of a Mutual Agreement Procedure (MAP) resolution under Section 90 (Refer Chapter 12, Para 12.3).
- Adjustment arising as a result of resolution of an assessment pursuant to Section 90A for avoidance of double taxation

10.3.4 Non applicability of requirement of Secondary Adjustment

The requirement to carry out secondary adjustment is not applicable if –

- i) The amount of primary adjustment made in any previous year does not exceed Rs. 1 Crore and
- ii) The primary adjustment is made in respect of an assessment year commencing on or before 1st April, 2016 (Corresponding to FY 2015-16 or before)

10.3.5 Repatriation of excess money

The term “excess money” has been defined in Section 92CE(3)(iii) to mean “the difference between the arms’ length price determined in primary adjustment and the price at which international transaction has actually been undertaken”

Section 92CE(2) stipulates that if such ‘excess money’ is not repatriated to India, it will be considered as an advance and interest will be computed thereon. The time limit for repatriation and manner of computation of interest on such advance shall be as may be prescribed.

10.3.6 Time Limit and Interest

- a) The notified time limit is 90 days from the date of filing of return (in case of suo motu adjustment by assessee (modified return in case of Safe Harbour or APA) or 90 days from the date of acceptance of ITO Order or Appellate order. In the case of Appellate Order, the period of 90 days should start from date of receipt of Appellate Order by the assessee. The notification however merely refers to “date of order”. There is a lack of clarity in case of MAP procedures, since in the MAP scenario, the Primary Adjustment arises only on the acceptance of a MAP resolution by the assessee, so the 90 days should be reckoned from that date. But the notification stipulates merely 90 days from the date of order
- b) For INR denominated international transaction, the rate of interest shall be one year MCLR of SBI plus 325 basis points

- c) For international transaction denominated in foreign currency, the rate of interest shall be six month LIBOR as on 30th September of the previous year plus 300 basis points.
- d) It is stipulated that the interest will be applicable for delays beyond 90 days till the amount is ultimately repatriated into India.

10.4 APPEAL TO COMMISSIONER OF INCOME TAX (APPEALS)

10.4.1 An assessee aggrieved by the order of the Assessing Officer (AO) passed on the basis of order passed by Transfer Pricing Officer (TPO) may submit his appeal pursuant to Section 246A of the Income Tax Act before the Commissioner of Income Tax (Appeals) within the time limit stipulated in Section 250 being 30 days from the date of the order passed by AO.

10.4.2 The said section 250 provides the procedure to be followed in the case of CIT (Appeals). The CIT (Appeals) is given a time frame of 1 year from the end of the financial year in which such appeal is filed before him.

10.4.3 Orders passed by CIT (Appeals) shall be communicated to the assessee and the Commissioner / Chief Commissioner.

10.5 REFERENCE TO DISPUTE RESOLUTION PANEL

The relevant provisions are contained in Section 144C. The same is reproduced below:-

(1) The Assessing Officer shall, notwithstanding anything to the contrary contained in this Act, in the first instance, forward a draft of the proposed order of assessment (hereafter in this section referred to as the draft order) to the eligible assessee if he proposes to make, on or after the 1st day of October, 2009, any variation in the income or loss returned which is prejudicial to the interest of such assessee.

(2) On receipt of the draft order, the eligible assessee shall, within thirty days of the receipt by him of the draft order,—

(a) file his acceptance of the variations to the Assessing Officer; or

(b) file his objections, if any, to such variation with,—

(i) the Dispute Resolution Panel; and

(ii) the Assessing Officer.

(3) The Assessing Officer shall complete the assessment on the basis of the draft order, if—

- (a) the assessee intimates to the Assessing Officer the acceptance of the variation; or
- (b) no objections are received within the period specified in sub-section (2).

(4) The Assessing Officer shall, notwithstanding anything contained in section 153 or section 153B, pass the assessment order under sub-section (3) within one month from the end of the month in which,—

- (a) the acceptance is received; or
- (b) the period of filing of objections under sub-section (2) expires.

(5) The Dispute Resolution Panel shall, in a case where any objection is received under sub-section (2), issue such directions, as it thinks fit, for the guidance of the Assessing Officer to enable him to complete the assessment.

(6) The Dispute Resolution Panel shall issue the directions referred to in sub-section (5), after considering the following, namely:—

- (a) draft order;
- (b) objections filed by the assessee;
- (c) evidence furnished by the assessee;
- (d) report, if any, of the Assessing Officer, Valuation Officer or Transfer Pricing Officer or any other authority;
- (e) records relating to the draft order;
- (f) evidence collected by, or caused to be collected by, it; and
- (g) result of any enquiry made by, or caused to be made by, it.

(7) The Dispute Resolution Panel may, before issuing any directions referred to in sub-section (5),—

- (a) make such further enquiry, as it thinks fit; or
- (b) cause any further enquiry to be made by any income-tax authority and report the result of the same to it.

(8) The Dispute Resolution Panel may confirm, reduce or enhance the variations proposed in the draft order so, however, that it shall not set aside any proposed variation or issue any direction under sub-section (5) for further enquiry and passing of the assessment order.

[*Explanation.*—For the removal of doubts, it is hereby declared that the power of the Dispute Resolution Panel 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 proceedings relating to the draft order, notwithstanding that such matter was raised or not by the eligible assessee.]

(9) If the members of the Dispute Resolution Panel differ in opinion on any point, the point shall be decided according to the opinion of the majority of the members.

(10) Every direction issued by the Dispute Resolution Panel shall be binding on the Assessing Officer.

(11) No direction under sub-section (5) shall be issued unless an opportunity of being heard is given to the assessee and the Assessing Officer on such directions which are prejudicial to the interest of the assessee or the interest of the revenue, respectively.

(12) No direction under sub-section (5) shall be issued after nine months from the end of the month in which the draft order is forwarded to the eligible assessee.

(13) Upon receipt of the directions issued under sub-section (5), the Assessing Officer shall, in conformity with the directions, complete, notwithstanding anything to the contrary contained in section 153 or section 153B, the assessment without providing any further opportunity of being heard to the assessee, within one month from the end of the month in which such direction is received.

(14) The Board may make rules for the purposes of the efficient functioning of the Dispute Resolution Panel and expeditious disposal of the objections filed under sub-section (2) by the eligible assessee.

The following sub-section (14A) shall be inserted after sub-section (14) of section 144C by the Finance Act, 2013, w.e.f. 1-4-2016 :

(14A) The provisions of this section shall not apply to any assessment or reassessment order passed by the Assessing Officer with the prior approval of the Commissioner as provided in sub-section (12) of section 144BA.

(15) For the purposes of this section,—

(a) "Dispute Resolution Panel" means a collegium comprising of three Commissioners of Income-tax constituted by the Board for this purpose;

(b) "eligible assessee" means,—

(i) any person in whose case the variation referred to in sub-section (1) arises as a consequence of the order of the Transfer Pricing Officer passed under sub-section (3) of section 92CA; and

(ii) any foreign company.

10.6 APPEAL TO INCOME TAX APPELLATE TRIBUNAL (ITAT)

10.6.1 An aggrieved tax payer can file an appeal before Income Tax Appellate Tribunal (ITAT) against Orders passed by Assessing Officer pursuant to directions issued by the Dispute Resolution Panel (DRP) or by the Assessing Officer pursuant to determination of ALP by the Transfer Pricing Officer (TPO) or orders passed by the Commissioner pursuant to an Impermissible Arrangement covered in Chapter XA of the Income Tax Act, 1961 within a period of 60 days of the order sought to be appealed against in accordance with the provisions of Section 253 of the Income Tax Act, 1961

10.6.2 The provisions relating to the passing of the orders by ITAT are contained in Section 254 of the Income Tax Act.

10.6.3 It is to be noted that Section 255 of the Income Tax Act provides that the proceedings before ITAT shall be deemed to be judicial proceedings within the meaning of Indian Penal Code and the ITAT shall be deemed to be a Civil Court under the Code of Criminal Procedure 1898.

10.6.4 Section 256 of the Income Tax Act provides that ITAT on an application made against an order passed under Section 254 and the Appellate Tribunal is of the opinion that, on account of a conflict in the decisions of High Courts in respect of any particular question of law, it is expedient that a reference should be made direct to the Supreme Court, the Appellate Tribunal may draw up a statement of the case and refer it through its President direct to the Supreme Court.

10.7 APPEAL TO HIGH COURT

10.7.1 Under Section 260A of the Income Tax Act, appeals can be filed against orders passed by ITAT, if the High Court is satisfied if it involves a substantial question of law.

10.7.2 The time period fixed for filing the appeal in such a case is 120 days. Any aggrieved party namely the assessee or the Commissioner or the Chief Commissioner may file an appeal against the orders passed by ITAT in the form of a memorandum of appeal precisely stating the substantial question of law involved.

The High Court may admit an appeal after the expiry of the period of one hundred and twenty days, if it is satisfied that there was sufficient cause for not filing the same within that period.

10.7.3 Where the High Court is satisfied that a substantial question of law is involved in any case, it shall formulate that question.

10.7.4 The appeal shall be heard only on the question so formulated, and the respondents shall, at the hearing of the appeal, be allowed to argue that the case does not involve such question

However it is provided that nothing shall be deemed to take away or abridge the power of the court to hear, for reasons to be recorded, the appeal on any other substantial question of law not formulated by it, if it is satisfied that the case involves such question.

10.7.5 The High Court shall decide the question of law so formulated and deliver such judgment thereon containing the grounds on which such decision is founded and may award such cost as it deems fit.

10.7.6 The High Court may determine any issue which—

(a) has not been determined by the Appellate Tribunal; or

b) has been wrongly determined by the Appellate Tribunal, by reason of a decision on such question of law as is referred to it.

10.7.7 Except as otherwise provided in the Income Tax Act, the provisions of the Code of Civil Procedure, 1908 (5 of 1908), relating to appeals to the High Court shall, as far as may be, apply in the case of appeals under this section.

10.8 APPEALS TO SUPREME COURT

10.8.1 An appeal against a judgement passed by the High Court can be filed before the Supreme Court if the High Court certifies it to be a fit one for appeal to the Supreme Court in accordance with the provisions of Section 261 of the Income Tax Act.

10.8.2 Section 262 of the Income Tax Act provides that the provisions of the Code of Civil Procedure, 1908 (5 of 1908), relating to appeals to the Supreme Court shall, so far as may be, apply in the case of appeals under section 261 as they apply in the case of appeals from decrees of a High Court

The costs of the appeal shall be in the discretion of the Supreme Court.

10.8.3 Where the judgment of the High Court is varied or reversed in the appeal, effect shall be given to the order of the Supreme Court in the manner provided in section 260 which provides for giving effect to the decisions of the High Court or Supreme Court.

10.9 PENAL PROVISIONS

10.9.1 The Income Tax Act contains various penal provisions with respect to Transfer Pricing. The relevant provisions are those contained in Sections 271(1)(b), 271(1)(c), 271AA, 271BA, 271G and 273B of the Act.

10.9.2 The following table summarises the penalties:-

Section No.	Particulars	Penalty
271(1)(b)	Failure to comply with notice under Section 142 or 143(2) or directions under Section 142(2A)	Rs. 10,000/- for each failure
271(1)(c) (withdrawn with effect from 1.4.2017)	Concealment of income or furnishing inaccurate particulars of income	Three times the amount sought to be evaded by such concealment but not less than the tax sought to be evaded
270A (with effect from 1.4.2017)	Direction from the Assessing Officer or the Principal Commissioner or Commissioner during the	Penalty equal to 50% of tax payable on the under-reported income and in case of misreporting thereof by

	proceedings under the Act in the case of under-reporting of income by any person	any person, the penalty shall be equal to 200% of amount of tax payable on under-reported income
271AA	Failure to maintain documentation	2% of the value of each international transaction (and w.e.f 1.4.2012, SDT also)
271BA	Failure to furnish report of accountant	Rs. 1,00,000/-
271G	Failure to furnish / submit any information / document to the transfer pricing officer	2% of the value of each international transaction (and w.e.f 1.4.2012, SDT also)
Section No.	Particulars	Penalty
271GA	Failure to furnish information or documentation under Section 285A (<i>Deriving direct or indirect benefits from assets in India or through or in an Indian concern</i>)	2% of value of transaction undertaken, if such transaction has the effect of directly or indirectly transferring the right of management or control in relation to the Indian concern and in any other case Rs. 5,00,000/-
271GB	(1) Failure to furnish report under Section 286 (<i>in respect of constituent entity or international group</i>)	Rs. 5,000/- per day till one month and for default beyond one month Rs. 15,000/- per day

	(2) Failure to furnish report after expiry of extended period	Rs. 5,000/- per day from the date of expiry of extended period.
	(3) Failure under 1 or 2 above continues after penalty order	Rs. 50,000/- per day from the date of order under this sub section
	(4) Furnishes inaccurate information with knowledge of inaccuracy but fails to inform the authority	Rs. 5,00,000/-
271J	Furnishing inaccurate information in report or certificates by a Merchant Banker or Accountant or Registered Valuer	Rs. 10,000/- for each such report or certificate

10.9.3 Section 273B provides that no penalty shall be imposed on the person or the assessee, as the case may be, for any failure referred to in the said provisions if he proves that there was reasonable cause for the failure.

CHAPTER 11

SYNOPSIS OF SOME OF THE LEADING DECIDED CASES

11.1 The Management Accountant edition of May 2012 which featured Theme Articles on the subject of “Arms’ Length Pricing : Role of CMA” carried out an Editorial comment “International Pricing is one such area, which upholds arm’s length principle, but ends up in a maze of disputes while practically applying it.” This aptly sums up the situation arising out of a plethora of litigations. The Editorial substantiates this situation as it states “Although the logic of arms’ length pricing appears to be straightforward, but in reality it requires robust economic analysis and a clear understanding of not only the functioning of the market, but also of the subtle factors like the economic drivers and the mechanism in the market. Behind the theory of arms’ length pricing there is clearly an assumption that there is a free flow of information in the market and the parties involved – the multinational entities and the revenue authorities of the respective tax jurisdiction – are able to gather it whenever needed. Such an assumption is not only naïve, but it faces challenge from the theory of efficient market hypothesis, which comes in a strong, semi-strong and weak form. Indeed the world we live in is better explained, not by such phenomena as perfect market or perfect information, but by the existence of imperfect market where information asymmetry prevails.

11.1.1 Parties involved in such a situation can come up with differing interpretations for the same event and get muddled up in disputes. International transfer pricing is one such area, which upholds arms’ length principle, but ends up in a maze of disputes while practically applying it.” Perhaps, this explains why India is locked in tax disputes with several multinational entities involving thousands of crores in tax revenues. The following statistics for a period of ten years covering FY 2005-06 to FY 2014-15 would highlight the extent of the sums involved :- (Source : Statistics appearing in Annual

Reports 2013-14 and 2014-15 published by MOF)

Financial Year	No. of TP Audits Completed	Adjustment in Rs. Crores	Average Rs. Crore per TP Audit
			(Derived)
2005-06	1061	1220	1.15
2006-07	1501	2287	1.52
2007-08	1768	3432	1.94
2008-09	1945	7754	3.99
2009-10	1830	10908	5.96
2010-11	2368	24111	10.18

Financial Year	No. of TP Audits Completed	Adjustment in Rs. Crores	Average Rs. Crore per TP Audit
2011-12	2638	44532	16.88
2012-13	3171	70016	22.08
2013-14	3617	59602	16.48
2014-15	4290	46466	10.83
Total	24189	270328	11.18

The above table shows an interesting trend in the sense that the maximum impact was in the financial year 2012-13, where the TP Audits were most effective in bringing tax revenue.

11.1.2 One of the primary reasons for the huge surge in TP adjustments in FY 2012-13 is the TP dispute relating to valuation of shares. However, FY 2014-15 has seen a reverse trend. In fact, there has been a reduction of 22% in the quantum of adjustments when compared with FY 2013-14. (Source : Transfer Pricing Reports Trends Report 2015 by taxsutra – Deloitte)

11.1.3 As per an estimate in the report of TARC (Tax Administrative Reforms Commission) dated May 30, 2014, the average time taken for disposal of 75% of direct tax cases (which includes Transfer Pricing cases) is less than two years.

11.1.4 In terms of success rate, on an overall basis, 69% of the cases across Supreme Court, High Court and Tribunals have been adjudicated in favour of tax payers. (In case of High Court alone, an overwhelming 86% has been in favour of tax payers).(Source : Transfer Pricing Reports Trends Report 2015 by taxsutra – Deloitte)

Though, this should be interesting to investors, lack of uniformity across various Tribunals come out as a matter of concern leaving investors unsure.

11.2 It must be stated here that the Government through its tax authorities is committed to providing a tax friendly atmosphere and have piloted a number of tax reforms with the ultimate objective of promoting Ease of Doing Business such as Strengthening Advance Ruling framework, introducing Advance Pricing Arrangements(APA), Mutual Agreement Procedures (MAP) and Safe Harbour Provisions. However, as always there are areas offering scope for further reforms

11.2 Bulk of the decided cases so far are Tribunal decisions but there are a few from the High Courts and the Supreme Court as well. There were significant amendments through the Finance Act, 2012, which have been highlighted at the appropriate places in the respective chapters, which have amended the position decided earlier. In the following paragraphs, an attempt is made to give a brief synopsis of the leading decided cases at ITAT, High Court and Supreme Court with the object of providing an idea of the issues involved and how the judicial authorities have applied the principles and the decisions given.

11.2.1 For the sake of convenience of the reader, the cases have been arranged / grouped under distinct topic of transfer price, with the main purpose of giving an introductory idea of the nature of issues involved and the applicable ruling on the subject matter.

11.2.2 References have been made to the on line portal of Income Tax tribunal www.itatonline.org

11.2.3 For a detailed discussion on the merits of the case, readers are advised to refer to the detailed case document.

11.3.1 Concept of Associated Enterprises

11.3.1.1 Kodak India Pvt. Ltd vs. ACIT (ITAT Mumbai) - ITA 7349/M/2012

Though s. 92B(2) provides for a situation where even a transaction between two non-associated enterprises can be subject to the transfer pricing provisions, it is essential that there should first be an "AE" with whom there exists an "international transaction" before it can be examined whether the international transaction with the "the non-AE" exists or not. On facts, the agreement between the two foreign companies was independent of the agreement between the two Indian domestic companies. The assessee had full authorization to perform and take its own decision with regard to the sale of the imaging segment to the buyer. Even if one accepts that the sale agreement by the assessee was as the result of prior agreement or was consequential upon the agreement between the two non resident companies, yet, as the holding company had not dictated the terms and conditions of the sale and the entire exercise of transfer of imaging segment was independently done on its own terms by the assessee and the buyer, the deeming provision of s. 92B(2) does not apply. The Department's argument that the legal character of the assessee and the other enterprise be disregarded due to the influence of the agreement between the foreign holding companies is not acceptable (**Vodafone vs. UOI** 341 ITR 1 (SC) followed).

11.3.1.2 Orchid Pharma Limited vs. DCIT (ITAT Chennai) – February 2017

The definition of 'associated enterprise', as the above academic analysis shows, has two approaches- wider approach and narrow approach. A narrow approach to the concept of associated enterprises takes into account only "de jure" association i.e. through formal participation in the capital or participation in the management. A wider approach to the concept of 'associated enterprises' takes into account not only the de jure relationships but also de facto control, in the absence of participation in capital or participation in management, through other modes of control such as commercial relationships in which one has dominant influence over the other. This wider concept is clearly discernible from the principles underlying approach to the definition of 'associated enterprises' in the tax treaties and has also been adopted by the transfer pricing legislation in India in an unambiguous manner. There is no other justification in the Indian transfer pricing legislation, except the participation in capital of an enterprise, management of an enterprise or control of an enterprise, which can lead to the relationship between enterprise being treated as 'associated enterprises'. What essentially follows is that clause (i) of Section 92A(2) has, at its conceptual foundation, de facto control by one of the enterprise over the other enterprise, on account of commercial relationship of its buying the products, either on his own or through any nominated entities, from such other enterprise and in a situation in which it can influence the prices and other related conditions. The wordings of clause (i), however, do not reflect this position in an unambiguous manner inasmuch as it does not set out a threshold of activity, giving de facto control to the other enterprise engaged in such commercial activity, in percentage terms or otherwise- as is set out in clause (g) and (h) or, for that purpose, in all other operative clauses of Section 92A(2)

11.3.1.3 Pr CIT v M/s. Veer Gems – Gujarat High Court – July 2017

A plain reading of Section 92A makes the legal position quite clear. The basic rule for treating the enterprises as associated enterprises is set out in Section 92A(1). The illustrations in which basic rule finds application are set out in Section 92A(2). Section 92A(1) lays down the basic rule that in order to be treated as associated enterprise one enterprise, in relation to another enterprise, participate, directly or indirectly, or through one or more intermediaries, “in the management or control or capital of the other enterprise” or when “one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise” . Section 92(A)(2) only provides illustrations of the cases in which such an enterprise participates in management, capital or control of another enterprise. In other words, what Section 92A (1) decides is the principle on the basis of which one has to examine whether or not two or more enterprise are associated enterprise or not.

11.3.2 Maintenance of documentation

11.3.2.1 Airtech Private Limited (ITA No. 3591)

In this case, the Delhi bench of ITAT held that in absence of change in intra-group arrangement will not by itself justify not maintaining contemporaneous annual documentation, unless it can be shown that the market dynamics have also remained constant.

11.3.2.2 ADIT vs. M/s I. M. Technologies (ITAT Delhi) – December 2014

In the light of the facts on record, on a consideration of the same we are of the view that the reliance placed on the data available in the public domain at the time of the assessment proceedings which was not allowed by the AO and ultimately allowed at the Appellate stage cannot be faulted with. It is not the case of the Revenue that the three comparables taken by the assessee in the TP study as comparable were not comparable companies. This aspect not having been disputed, we see no reason why the Revenue should insist upon ignoring the updated relevant data for the period under consideration. Having accepted the fact that these companies taken in the TP study

were comparable there can be no right vested in the Revenue to insist upon the incomplete data available at the time of TP study and refuse to look at the updated data available for the relevant period at the assessment stage. The CIT(A) in appeal has correctly taken the updated data which stand is approved by us.

11.3.2.2 GE Money Financial Services Pvt Limited vs. ACIT (ITAT Delhi) – May 2016

Intra group services

Rendering of services must be seen from the view point of the assessee and further assessee cannot be asked to keep and maintain evidences of services rendered by AE higher than which is expected from a businessman receiving services from an unrelated provider. Therefore, we reject the view point of Ld. TPO and Ld. DRP that assessee has not shown the receipt of the services. In view of above we are of the view that assessee has justified the receipt of services and satisfied the rendition test

S. 92(2): Important principles of law laid down with regard to the “Need Test”, “Evidence Test” or “Rendition Test” to evaluate the ALP of intra-group services rendered by an Associated Enterprise and whether the TPO has the right to determine the ALP at ‘Nil’

11.3.3 Binding nature of ALP determination by the Transfer Pricing Officer (TPO) on the Assessing Officer (AO)

11.3.3.1 Oracle India Private Limited (ITA No. 18)

In this case it was held that in case of international transactions, the findings of the TPO would be binding on AO and the AO is not entitled to make any further adjustments to the ALP as determined by the TPO.

11.3.4 TPR applicable between resident to non resident AE’s

11.3.4.1 Tianjin Tianshi India Private Limited (ITA No. 3991)

The Delhi Tribunal in this case ruled that TP regulations would apply when one of the parties to the transaction is non-resident, even if the transactions take place within India. The tribunal further observed that there is no need to look into the legislative intent when the provisions are unambiguous.

11.3.5 Selection of Methods

11.3.5.1 MSS India Private Limited (ITA No. 393/PN/07)

The decision of the Pune bench in this case ruled that revenue authorities cannot discard the benchmarking method proposed by the taxpayer in preference over transactional profit method without any cogent reason. Further, the tribunal also upheld the Special bench decision of “Aztec Software Technology” and ruled that determination of ALP is essential irrespective of the fact whether or not the income the assessee is exempt from income tax.

This has been a landmark ruling since it acknowledged the preference of traditional benchmarking methods (CUP, CPM and RPM) over Profit based methods (TNMM and PSM) thereby acknowledging the importance of OECD guidelines.

11.3.5.2 Star Diamond Group (ITA No. 3923)

Mumbai bench of the ITAT in this case held that the determination of ALP of an international transaction has to be done at the transaction level or at the level of a class of transactions. The tax payer had used the RPM method being in the business of import of rough diamonds and selling in the local market. The TPO has applied the TNMM and calculated the adjustment on gross purchase value of international transactions. The tribunal ruled that RPM is the most appropriate method for determining ALP and if comparables are not found appropriate, then fresh comparables can be searched, but the method adopted cannot be rejected. Also the tribunal ruled that the law permits determination of ALP of international transaction only, and so the arms’ length value should be calculated on net purchase value and not on gross purchase value.

11.3.5.3 Tally Solutions Pvt Ltd vs. DCIT (ITAT Bangalore) - ITA No.1235/Bang/2010

The argument that the “Excess Earning Method” adopted by the TPO is not a prescribed method is not acceptable. A sale of IPR is not a routine transaction involving regular purchase and sale. There are no comparables available. The “Excess Earning Method” is an established method of valuation which is upheld by the U.S Courts in the context of software products. The “Excess Earning Method” method supplements the CUP method and is used to arrive at the CUP price i.e. the price at which the assessee would have sold in an uncontrolled condition.

11.3.5.4 ACIT vs. Tara Ultimo Private Limited (ITAT Mumbai)

Transfer Pricing: Important Principles of Cost Plus, CUP & TNMM Explained

The assessee, engaged in the business of manufacture and export of studded diamond and gold jewellery, imported & exported diamonds and exported jewellery to associated enterprises. For transfer pricing purposes, the ALP of the imported & exported diamonds was evaluated using the “*Comparable Uncontrolled Price*” (CUP) method while the exports of jewelry was evaluated using the “*Cost Plus Method*” (CPM). The TPO & AO rejected both methods on the ground that adequate material to support it was not available and instead adopted the *TNMM* and made an adjustment. On appeal, the CIT(A) upheld the adoption of CPM on the imports & exports of diamonds on the ground that total cost details were maintained and the average margin earned from AE transactions was higher than that earned from non AE transactions. However, he did not deal with the ALV on export of jewellery. On appeal by the department, HELD reversing the CIT(A):

(i) As regards the **CPM**, it had not been correctly applied. The application of CPM provides for (a) ascertaining the direct and indirect costs of property transferred, or services rendered, to the AE; (b) ascertaining the normal mark up of profit over aggregate of costs in respect of similar property or services to unrelated enterprises and (c) adjusting the normal mark up for differences, if any, in the material factors such as risk profile, credit period etc. **While the benchmark gross profit can be set by taking into account several transactions with unrelated enterprise on a ‘global basis’, the benchmark cannot be applied on a global basis but has to be on a transaction basis.** Eg. if the benchmark GP is 20% and the assessee charges a mark-up of 2% in one transaction with AE and 38% in another transaction with the AE, both transactions, will meet the ALP test resulting in an incongruity. On facts, while the normal mark up has been computed at 16.31%, and the average of mark up on sales to AEs has been taken at 17.08% and all AE transactions taken to be at ALP, there are individual instances which are less than the benchmark. **This is not the correct way to apply the CPM.** Also, the costs of inputs have not been verified and it is not shown that the terms of sale to the AEs and all other relevant factors are materially similar to the transactions with independent enterprises. Also, **the CPM has been applied by comparing gross profit on sales, whereas the method requires comparison of mark up on costs on transactions with AEs vis-à-vis mark up on costs on transactions with non AEs** (matter remanded to CIT (A) for de novo consideration);

(ii) As regards the **CUP** for import & export of diamonds (which was not decided by the CIT (A)), the assessee ought to have produced evidence to show that the transactions are at prevailing market prices;

(iii) As regards the **TNMM, International transactions with AEs have three significant areas of impact on the overall profitability** i.e. sales of finished goods to AEs, sales of raw materials to AEs and purchase of raw materials of AEs), and if the ALP cannot be reasonably determined by CUP or any other direct method (i.e. CPM and RPM) in respect of even one of these areas, **the application of TNMM or other indirect method (i.e. profit split method) is inevitable**. On a conceptual note, **when ALP of the transactions with AEs cannot be reasonably ascertained, the profit earned by the assessee entering into these transactions is to be estimated, and that is precisely what TNMM does**. When TNMM is applied in the context of sales of finished goods to AEs, it is this figure which is taken as variable figure and it bears the impact of higher margins, and when TNMM is applied in the context of purchases of raw materials from AEs, it is the figure of purchases of raw material from AEs which is taken as variable figure and it bears the impact of higher margins. Beyond that, the cause of invoking TNMM does not make much material difference (*point whether TNMM has to be applied to the transactions and not on overall profits left open*);

(iv) The argument, relying on **Indo American Jewellery** Ltd 41 SOT 1, that no ALP adjustment can be made as the assessee enjoys s. 10A tax benefits and has no “*motive*” to *avoid tax* is not acceptable because those observations are “*obiter dicta*” without binding force and in view of **Aztech Software** 107 ITD SB 141 where it was held that **tax avoidance motives need not be shown before invoking transfer pricing provisions**.

11.3.5.5 Denso India Limited vs. CIT (Delhi High Court) – March 2016

The High Court had to consider the question “Whether the Transactional Net Margin Method adopted by the assessee is the most appropriate method envisaged under Section 92C(2) of the Income Tax Act, 1961 read with Rule 10C of the Income Tax Rules, 1962 and whether the Income Tax Appellate Tribunal had erred in directing the Assessing Officer to apply Comparable Uncontrolled Price Method?” HELD by the High Court:

(i) The narrow controversy which this Court is called upon to decide is as to whether the adoption of the CUP method by the revenue authorities was justified. What the assessee urges essentially is that whereas the TP report furnished by it applied the TNMM method which was found acceptable as regards all other transactions/business

activities, it was not open to the revenue to segregate a portion and subject it to an entirely different method, i.e. CUP. The assessee relies upon paras 3.6, 3.9 and 3.10 of the OECD guidelines in support of its contentions. It also relies upon certain rulings of different Benches of the ITAT to urge that such sequential segregation and setting portion of the TP exercise – so to say, to break with the integrity is unjustified and unsupported by the text of the law, i.e. Section 92C of the Income Tax Act. The assessee also relies upon Rule 10E of the Income Tax Rules, which guide the proper approach of the TPO in such matters.

(ii) The cumulative effect of various provisions of the Income Tax Act, notably Sections 92, 92C, 92D and 92E read together with Rule 10B and 10D is the obligation to discern, if in a given set of circumstances, the assessee has disclosed international transactions, as well as an ALP. The ultimate purpose of this exercise- the primary onus of which is upon the assessee, is to ensure that no amount which is otherwise to be designated or treated as income, under law, escapes assessment. The assessee's TP report is to be accurate and based on materials; its explanations for the queries raised by the TPO, convincing and reasonable. The underlying emphasis of the law (Section 92-C) is that the method appropriate to the transaction, amongst the four specified ones, is to be applied.

(iii) The factual discussion in this case clearly reveals that the assessee chose to import components not from the manufacturer (which was an AE) but an intermediary. Normally, this would have been a commercial decision, which revenue authorities would not question. However, interestingly, the vendor of the components (which constituted over 85% of the raw materials imported and about 38% of the total raw materials sourced) was also connected with both the assessee and the manufacturer. If these realities emerged during the TP exercise, compelling the TPO to closely scrutinize the value of such imports and seek further details from the assessee, to justify its decision, the onus was clearly on the latter to afford a convincing and reasonable explanation. Such of the explanations that were forthcoming, were apparently unconvincing. What the assessee banks upon in its appeal to this Court is the unbending and inflexible acceptance of its TP exercise; according to its logic, a "bundled" or aggregated series or chain of transactions used in the TP report should remain undisturbed. Now, there can be no dispute that the AO would normally accept the figures given, if they do not show features that call for his interference. However, his job also extends to critically

evaluating materials and in cases which do require scrutiny, go ahead and do so. In the process, at least in this case, the unusual features which remained unexplained by the assessee, influenced the TPO and the AO to resort to transfer pricing adjustment and determine ALP by adopting the CUP method for the procurements from Sumitomo Japan. The “second test” spoken of in Sony Ericsson (supra) i.e “the form and substance of the transaction were the same but the arrangements made in relation to a transaction, when viewed in their totality, differ from those which would have been adopted by an independent enterprise behaving in a commercially rational manner..” was in effect adopted. This Court finds no infirmity in this approach. As a result, the question framed is answered against the assessee and in favour of the revenue (Commissioner of Income Tax v. EKL Appliances Ltd. (2012) 345 ITR 241 (Del) and Sony Ericsson Mobile Communications India (P) Ltd v Commissioner of Income Tax (2015) 374 ITR 118 (Del) followed).

11.3.5.6 Fresenius Kabi India Private Limited vs. DCIT (ITAT Pune) – September 2017

It is settled legal position at the various Benches of the Tribunal that, in case of distribution activity, even when there are selling and marketing expenses are borne by the assessee, there cannot be any value addition to the product in question. In such cases, Resale Price Method is the most appropriate one and accordingly we reverse the decision given by the AO/TPO/DRP in thrusting on the assessee the TNM method to the transaction under consideration

11.3.6 Application of CUP Method

11.3.6.1 Clear Plus India Private Limited (ITA No. 3944)

The Delhi bench of the Tribunal held that the CUP method being a direct method provides the most reliable measure of arm’s length price and should be preferred to any other method when the CUP can be reliably applied. Also it is not necessary that there should be 100% comparability. Minor adjustments do not justify its rejection.

11.3.6.2 Dufon Laboratories Private Limited (ITA No. 1172)

In this case, the tax payer used the CUP method, whereas the TPO used the CUP method. The CIT(A) ruled in favour of the TPO and in the appeal before the Mumbai

Tribunal, it ruled that use of TNMM should be the method of last resort and when CUP gives the appropriate results, CUP method should be used for computing ALP.

11.3.6.3 Global Services Private Limited (ITA No. 1812)

In this case, the application of CUP by adopting the hourly rates of “Customer Care” segment as published by NASSCOM. The TPO rejected CUP Method in favour of TNMM and selected five companies as comparables to make his upward adjustment. The CIT(A) upheld the taxpayer’s contention and when the department went in appeal before ITAT, the Mumbai bench of the Tribunal upheld the order of CIT(A) upholding the CUP method. Interestingly, in earlier ruling by Bangalore ITAT in Aztec Software & Technology Service Ltd., the average per hour rate given by NASSCOM was not taken on the basis that OECD’s transfer pricing guidelines also establishes that unadjusted industry average rate should not be considered as CUP.

11.3.6.4 Pr. CIT vs. Toll Global Forwarding India Pvt Ltd (Delhi High Court) – January 2016

Rule 10B(1)(f) inserted vide notification dated 23rd May 2012 is not a residual method in the sense that it is not a condition precedent for the application of this method that all other methods set out in s. 92C (1)(a) to 92C(1)(e) and as elaborated under rule 10B(1)(a) to (e), must fail and only then this method can be applied. This method is at par with all other methods of determining the arm’s length price as set out in sections 92C(1)(a) to (f), and, in terms of Section 92C(2), the most appropriate method, referred to in Section 92C(1), “shall be applied, for determination of arm’s length price, in the manner prescribed”. Therefore, as long as the method covered by rule 10AB, which is duly covered by Section 92C(1) satisfies the test of being the ‘most appropriate method’, it can be applied to a fact situation. The expression ‘ price which....would have been charged on paid” is used in rule 10BA, dealing with this method, in this method the place of “price charged or paid”, as is used in rule 10B(1)(a), dealing with CUP method, such an expression not only covers the actual price but also the price as would have been, hypothetically speaking, paid if the same transaction was entered into with an independent enterprise. This hypothetical price may not only cover bonafide quotations, but it also takes it beyond any doubt or controversy that where pricing mechanism for associated enterprise and independent enterprise is the same, the price charged to the associated enterprises will be treated as an arm’s length price. In this view of the

matter, the business model said to have been adopted by the assessee, in principle, meets the test of arm's length price determination under rule 10BA as well

11.3.7 Application of Transactional Net Margin Method (TNMM)

11.3.7.1 Birlasoft (India) Ltd (ITA No. 3839)

The Delhi bench of the Tribunal upheld the taxpayer's determination of the ALP by comparing the net cost plus margin earned from rendering software services to AE's with that of unrelated enterprises. The tribunal noted that the taxpayer had computed the net cost plus margin on a scientific basis considering different allocation keys and on the basis of segmental accounts for the transactions with related and unrelated parties, duly verified and certified by a Chartered Accountant. The TPO rejected the internal benchmarking on the ground that the taxpayer had not maintained audited segmental accounts and resorted to computation of ALP on the basis of external benchmarking. The matter was referred to DRP who upheld the TPO's order and aggrieved by the DRP's directions, the taxpayer filed an appeal before the Tribunal which upheld the TNMM basis for determination of ALP based on internal comparables.

11.3.7.2 Marubeni India Private Limited (ITA Nos. 809,919,935 and 1420)

The Delhi bench of the Tribunal upheld the contention of the AO for excluding interest from the computation of operating profit margin to justify the ALP using the TNMM. The Tribunal observed that items of income and expenditure that are not connected with the international transaction sought to be tested using TNMM cannot be taken into account while computing the operating margin. The essence of the TNMM is the operating margin and non-operating income and expenses will not enter the calculation.

11.3.8 Application of Cost Plus Method & Cost Contribution Agreement

11.3.8.1 Wrigley India Pvt Ltd vs. ACIT (ITAT Delhi) (Transfer Pricing) – January 2015

Application of Cost Plus Method

The fundamental input for application of CPM method, next only to ascertainment of historical costs, is ascertainment of the normal mark-up of profit over aggregate of such direct costs and indirect costs in respect of same or similar property or services in a "comparable uncontrolled transaction" or, of course, a number of such "comparable

uncontrolled transactions". When compared with CUP method, as against the "price" of a comparable uncontrolled transaction, one has to find out "normal mark up of profit" in a comparable uncontrolled transaction. Whether it is "price" or "normal mark up of profit", the starting point of both these exercises in the CUP and the CPM is finding a "comparable uncontrolled transaction". In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable. It is only elementary, as is also noted in the OECD Transfer Pricing Guidelines, that "to be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences"

11.3.8.2 Dresser-Rand India Pvt Ltd vs. ACIT (ITAT Mumbai)

Transfer Pricing & "Cost Contribution Agreements": Law Explained



The assessee entered into a '*cost contribution agreement*' with its parent company pursuant to which it paid a sum of Rs. 10.55 crores as its share of the costs. The TPO, AO & DRP disallowed the expenditure on the ground that (i) the ALP was 'Nil' as *no real services* had been availed by the assessee and the arrangement was not genuine, (ii) the cost sharing could not be on the basis of *head count but on the basis of actual services* availed by the assessee, (iii) the expenditure was "*excessive & unreasonable*" u/s 40A(2) and (iv) as there was *no TDS*, the disallowance u/s 40(a)(i) had to be made. The assessee also rendered field services to its associated enterprises where it granted a *discount of 10%* over the price charged to third parties on the basis that such discount was a part of reciprocal global policy. It was held that the ALP had to be computed by ignoring the discount. On appeal by the assessee, HELD:

(i) The TPO was not entitled to determine the ALP under the cost contribution agreement at "Nil" on the basis that the assessee did not need the services at all. How an assessee conducts his business is entirely his prerogative and it is not for the revenue authorities to decide what is necessary for an assessee and what is not. **The TPO went beyond his powers in questioning the commercial wisdom of the assessee's decision to take benefit of its parent company's expertise.** Further, the TPO's argument that the **assessee did not benefit from the services is irrelevant** because whether there is benefit or not has no bearing on the ALP of the services. The fact that similar services may have been granted in the past on gratuitous basis is also irrelevant in determining the ALP. The argument that no evidence of services having been rendered was produced

is not acceptable because the assessee did produce voluminous evidence before the DRP which was not dealt with. The DRP ought to have dealt with the material and given reasons. *Matter remanded to the AO to determine actual rendering of services (Vodafone Essar Ltd vs. DRP 240 CTR 263 (Del) followed);*

(ii) A cost contribution arrangement has to be consistent with the arm's length principle. **The assessee's share of overall contribution to costs must be consistent with the benefits expected to be received, as an independent enterprise would have assigned to the contribution in hypothetically similar situation.** The TPO's objection that the cost should be shared in the ratio of actual use of services and should be charged as per Indian employee costs is not acceptable. There is no objective way in which the use of services can be measured and as is the commercial practice even in market factors driven situation, the costs are shared in accordance with some objective criterion, including sales revenues and number of employees. **The question of charging as per domestic employee costs cannot be a basis of allocating the costs because such an allocation will deal with some hypothetical pricing whereas the allocations are to be done for the actual costs incurred;**

(iii) The disallowance of payment under the 'cost contribution agreement' **u/s 37(1) & 40A(2)** is not justified because the **payment did not involve mark-up and was at arms length price.** The services were for furtherance of the assessee's business interests;

(iv) The disallowance of payment **u/s 40(a)(i)** for want of TDS is not justified because the **payment was not taxable in the AE's hands under Article 5 & 12 of the India-USA DTAA** as the AE did not have a PE and the services did not constitute "fees for included services". (**GE India Technology Centre 327 ITR 456 (SC)** followed);

(v) The TPO's argument that in charging for the services rendered to the AE, a 10% discount could not be given is not acceptable because (i) the assessee had followed the **TNMM** for determination of ALP which had not been disputed as the appropriate method, (ii) **Even under CUP, all sales need not be at the same price** and there can be variations of prices for the same product or services on grounds such as quantum of business, risk factors, etc. Discount is a normal occurrence even in independent business situations. **The material factor is whether the 10% discount is an arm's length discount** and there is nothing on record to suggest that it is not so.

11.3.9 Application of Profit Split Method

11.3.9.1 Infogain India Pvt. Ltd vs. DCIT (ITAT Delhi) – August 2015

The Tribunal had to consider whether the most appropriate method is the Profit Split Method (PSM) as claimed by the assessee or the TNMM as claimed by the AO, while working out the Arm's length value in respect of international transactions between Infogain India i.e. assessee and Infogain US i.e. parent company. HELD by the Tribunal:

(i) Rule 10B(1)(d) of the Income Tax Rules, 1962, defines the Profit Split Method. From the provisions contained in the said Rule 10B(1)(d), it is clear that "PSM" may be applicable in case where transaction involved transfer of unique, intangibles or any multiple transactions interrelated international transactions which cannot be evaluated separately for determining the Arm's Length Price of any one transaction. The Profit Split Method (PSM) first identifies the profit to be split for the associated enterprise from the controlled transactions in which the AEs are engaged. It then splits these profits between the AEs on an economically valid basis that approximates the division of the profit that would have been anticipated and reflected in an agreement, transaction or a residual profit intended to represent the profit that cannot readily be assigned to one of the parties. The contribution of each enterprise is based upon a functional analysis and valued to the extent possible by any available reliable standard market data. The functional analysis is an analysis of the functions performed (taking into account assets used and risk assumed) by each enterprise (Aztech Software and Technology Ltd. Vs ACIT 107 ITD 147 (SB) and Global One India Pvt. Ltd. Vs ACIT in ITA No. 5571/Del/2011 referred);

(ii) A perusal of the function of the assessee company reveals that the international transactions are highly integrated and interrelated and both the entities are contributing significantly to the value chain of provision of software services to the end customers. The Global Delivery Organization Group (GDO) in India is responsible for delivery of services to the customers globally. The primary objective of the group is to bring synergies amongst geographic groups and project, to make efficient use of the available resources, to broaden areas of service offerings, to improve opportunity fulfillment ration, and to maximize customer satisfaction with each project execution. However, the TPO had not considered the role of the GDO. The assessee assigned weights to each activity keeping in view the relative importance in the entire value chain, based on

interviews with the key management personnel and the functions in the value chain of software services provided by the Infogain Group to the customers based in the US were identified and weights were assigned to the functions having regard to their relative importance in the value chain. Both the parties i.e. Infogain India (assessee) and Infogain US are making contribution. Therefore, the Profit Split Method is the most appropriate method for determination of ALP. The decision as to what is the most appropriate method does not depend on the fact as to whether an assessee is having loss or has a profit.

(iii) On the question as to how the allocation is to be done for residuary profits under the Profit Split Method, it is well settled that as per the Rule 10D, the benchmarking should be done with the external uncontrolled transactions, however, in the present case, it is not possible to get a comparable. Therefore, such allocation can be done on the basis that how much each independent enterprise might have contributed. Therefore, relative contribution has to be determined, based on key value drivers because benchmarking is not practicable. In the present case, as the comparables having similar transactions would be difficult to find out, therefore, in such a situation, a harmonious interpretation of the provisions is required to make the rule workable, so as to achieve the desired result of the determination of the ALP.

(iv) Both the OECD Transfer Pricing Guidelines as well as the UN draft method of transfer pricing for developing countries, suggest that an allocation of residual profits under PSM should be done, based on contributions by each entity. In the present case, since the department has accepted in the preceding year and the succeeding year 40:60 ratio between the Infogain India and Infogain US and if the facts are similar for the year under consideration then no deviation is to be done.

11.3.10 Application of Resale Price Method

11.3.10.1 Nokia India (P) Ltd vs. DCIT (ITAT Delhi) – November 2014

(i) The assessee simply purchased mobile phones and accessories from Nokia group companies situated outside India and resold the same as such without any further value addition, mainly, to HCL Infosystems in India. Since the goods imported from the foreign AEs representing the international transaction under this segment were neither processed further nor used as raw material for manufacturing any other product, in our

considered opinion, RPM is the first choice as the most appropriate method for determination of ALP of the international transaction under this segment.

(ii) The incurring of high advertisement and marketing expenses by the assessee vis-a-vis the other comparable companies does not in any manner affect the determination of ALP under the RPM. When we consider gross profit in numerator and net sales in denominator, all the expenses debited to the Profit & loss account automatically stand excluded. It is but natural that only those expenses can have bearing on the gross profit that are debited to the Trading account. As the amount of advertisement and marketing expenses falls 'below the line' and finds its place in the Profit and loss account, the higher or lower spend on it cannot affect the amount of gross profit and the resultant ALP under the RPM. If the assessee has incurred more expenses on advertisement and promotion, which, in the opinion of the Id. DR went on to brand building for an AE, then, the transfer pricing adjustment on account of such AMP expenses was separately called for.

(iii) In principle if any company though functionally comparable, but, has more than a specific percentage of the RPTs, then, the same should be ignored by treating it as a controlled transaction. However, the percentage of RPTs to make a company as ineligible for comparison, in our considered opinion, should be taken as more than 25% and not 15% as suggested on behalf of the assessee. The view adopting more than 25% RPTs making a company incomparable has been taken by various benches of tribunal including Aglient Technologies International P. Ltd. VS. ACIT (2013) 36 CCH 187 Del Trib ; Stream International Services Pvt. Ltd. VS. ADIT (IT) (2013) 152 TTJ (Mumbai) 553 ; and Actis Advisers Pvt. Ltd. VS. DCIT (2012) 20 ITR (Trib) 138 (Delhi). We, therefore, hold that a company can be considered as incomparable if its RPTs exceed 25%.

(iii) Ratio of the RPTs represents the proportion of transactions with the associated enterprises (numerator) vis-a-vis the total of transactions (denominator). In order to decide that what should constitute the contents of numerator and denominator for the purposes of finding out the percentage of RPTs, it is relevant to note the logic behind applying this filter. It is manifest that the aim of the transfer pricing regime is to ensure that the international transactions are recorded at arm's length price. This is done under the TNMM by comparing the profit earned from the international transaction with that earned by the comparable independent parties in an uncontrolled situation. Thus, while

choosing comparables, it must be ensured that the profit earned by them correctly reflects true profit as is earned by an enterprise from an independent third party. If such a chosen company, though functionally comparable, has also entered into international transactions beyond a particular percentage with the related parties, it is quite possible that its overall profit may have been distorted due to such transactions rendering it as incomparable. That is why, this filter is applied to make certain that a company sought to be considered as comparable should have its profit uninfluenced by the impact of the related party transactions.

(iv) Transactions which do not impact the profitability, such as loan given or taken or other items finding place in the balance sheet, can have no place either in the numerator or the denominator of this formula. However, any income or expenditure resulting/relating from/to or likely to result/relate from/to such items of assets or liabilities, should not be confused with the per se international transactions finding place in the balance sheet of the company calling for exclusion.

(v) In CIT VS. Agnity India Technologies (P.) Ltd. (2013) 219 Taxman 26 (Del), the assessee was a captive unit providing software services to its associated enterprises. The Hon'ble High Court directed the exclusion of Infosys Ltd. from the list of comparables, which list otherwise included several companies with huge turnover. The exclusion was ordered on account of the giantness of this company, which was, in turn, determined by seeing the cumulative effect of several factors, including risk profile, nature of services, turnover, ownership of branded/proprietary products, onsite vs. offshore services, expenditure on advertisement and R&D etc. The higher turnover was only one of the criterion and not the sole criteria for the exclusion of this company. In view of the above discussion, we hold in principle that no potentially comparable company can be expelled from the list of comparables simply for the reason of high or low turnover.

11.3.10.2 Yamaha Motor India Pvt. Ltd vs. ACIT (ITAT Delhi) – October 2014

The argument of the department that under Rule 10B(1)(b) the Resale Price Method can be applied only when the assessee buys from an associated enterprise and sells to a non-associated enterprise and not when the sale is to an AE is not correct. As per the Rule 10B(1)(b), under the Resale Price Method the price at which property purchased or services obtained is sold to an unrelated enterprise, the price at which this property is sold less margin of the associated enterprise is to be reduced for determination of the

resale arm's length price. There is no condition that this method cannot be used when the tested party is an associated enterprise. The contention of the learned DR that the basic condition of resale price method is that "the property has to be obtained by the enterprise i.e. the assessee from an associated enterprise is incorrect." In the Act as well as Rules the words 'enterprise' and 'associated enterprise' have been used interchangeably. Thus the argument that enterprise will mean 'the assessee' and associated enterprise will mean 'the other party' to whom the assessee has sold or purchased the goods is incorrect. The above definition of 'enterprise' and 'associated enterprise' in the Act nowhere indicates that the 'enterprise' shall mean the assessee and the 'associated enterprise' will mean other than the assessee. Thus the contention of the learned DR that resale price method cannot be used in the case of the assessee company is devoid of any merit. This view gets further supported by the fact that there is no such condition or prohibition provided in Section 92C as well as Rule 10B. In the absence of any such condition or prohibition it cannot be read into the Rule to mean that resale price method shall not be applicable in case the assessee company is selling its product to an associated enterprise. The OECD guidelines in respect of resale price method support this interpretation.

11.3.11 Selection of Comparables, inclusion / exclusion of certain items and tested party

11.3.11.1 Sony India (P) Ltd (114 ITD 448)

This is a landmark ruling in which the ITAT Delhi has extensively dealt with various key issues like selection of comparables, inclusion / exclusion of certain income / expenditure and application of +/- 5% range in the determination of ALP

a) Selection of comparables

- If related party transactions of an entity do not exceed 10-15% of total revenue, then such entity can be taken as uncontrolled comparable. The requirement is to assess and judge the impact of the related party transaction vis a vis sales and not profit as profit is influenced by various other factors.
- Exclusion of loss making comparables is not justified, as a business may make either profit or loss

- Functions, assets and risk profile (FAR) analysis should be done and references should be made to the OECD guidelines and US TP regulations in addition to other commentaries
- Possible adjustments should be made for the differences between the comparable and the taxpayer. However, if the difference is material and it is not possible to make adjustments, then the comparable should be rejected.

b) Inclusion / exclusion of certain income / expenditure and other income

- Items of other income such as provision written back, balance written back, insurance claim received, interest received from customers for delayed payment, should be treated as part of operating income

c) Other Adjustments

- Under-utilisation of capacity cannot justify export of finished goods at a price less than the price charged to any unrelated party. It should be shown that a similar price was charged for a similar item in similar circumstances.
- Considering differences between the taxpayer and the comparables, a deduction of 20% out of mean margin of comparables having regard to fact of no ownership of intangibles, various risks assumed etc.

d) +/- 5 % *

- The application of +/- 5% range is applicable to all cases irrespective of the fact that price of international transaction disclosed by the taxpayer is beyond the +/- 5% range as ALP itself is more of an approximation and may not be scientific evaluation.

* The matter regarding +/-5% is not applicable consequent to amendment to the second proviso to Section 92C(2) which now refers to variation between the international transaction and the ALP as determined not to such percentage to be notified not exceeding 3%. (No notification is issued by CBDT so far)

11.3.11.2 Avenues Asia Advisors Pvt Ltd vs. DCIT (Delhi High Court) – October 2017

Identification of comparables - Transactions selected should be similar

In so far as identifying comparable transactions/entities is concerned, the same would not differ irrespective of the transfer pricing method adopted. In other words, the comparable transactions/entities must be selected on the basis of similarity with the controlled transaction entity. Comparability of controlled and uncontrolled transactions has to be judged, inter alia, with reference to comparability factors as indicated under rule 10B(2) of the Income Tax Rules, 1962. Comparability analysis by the transactional net margin method may be less sensitive to certain dissimilarities between the tested party and the comparables. However, that cannot be the consideration for diluting the standards of selecting comparable transactions/entities. A higher product and functional similarity would strengthen the efficacy of the method in ascertaining a reliable arm's length price. Therefore, as far as possible, the comparables must be selected keeping in view the comparability factors as specified. Wide deviations in profit level indicator must trigger further investigations/analysis

11.3.11.3 Selection of companies with disproportionate size for comparables

11.3.11.3.1 CIT vs. Ut Starcom Inc. (India Branch) (Delhi High Court) – October 2017

When we examine the profile of the assessee company vis-à-vis Infosys Technologies Limited in the light of the judgment in CIT vs. Agnity India Technologies Pvt. Ltd. (supra), there is no comparability for benchmarking the international transactions for the reasons inter alia that Infosys Technologies Limited is a giant risk taking company whereas, on the other hand, the assessee is a captive unit of its parent company and prone to minimum/ limited risk; that the Infosys Technologies Limited is having huge significant intangibles and having huge assets leading to the exorbitant turnover; that it is not in dispute that functional profile of assessee company and CIT vs. Agnity India Technologies Pvt. Ltd. is similar

11.3.11.3.2 CIT vs. Pentair Water India Pvt. Ltd (Bombay High Court) – February 2016

Companies with large turnover like Infosys & Wipro are not comparable to companies with smaller turnover and should be excluded from the list of comparables

The said Companies are no doubt large and distinct companies where the area of development of subject services are different and as such the profit earned therefrom cannot be a bench-marked or equated with the assessee. The Tribunal whilst passing the impugned Order has considered the said principles whilst coming to the conclusion that the said three Companies cannot be treated to be comparable to the Assessee Company. The turnover is obviously a relevant factor to consider the comparability

11.3.11.4 E Gain Communication Private Limited (118 TTJ 354)

Most of the issues in this case were similar to Sony India P Ltd (114 ITD 448), except that there was no issue of loss making comparables and there were some additional issues decided :-

- Turnover alone is not the relevant factor for comparability purposes. FAR analysis is to be done
- Parameters such as nature or line of business, product or service market, the assets employed, size and scope of operations, stage of business, product cycle should be duly factored for ensuring proper comparability
- Prima facie adjustments should be considered by the tax authorities while calculating the margins of the tested party. In this case, the depreciation of the tested party was as per US GAAP for the parent company should have been replaced by depreciation as per Indian companies Act

11.3.11.5 Philips Software vs. ACIT (ITAT Bangalore)

In view of the definition of “uncontrolled transaction” in Rule 10A (a), for purposes of comparability analysis, the comparables should not have any transactions with its associated enterprises. A company having even a single rupee of related party transaction cannot be considered as a comparable transaction.

11.3.11.6 Adobe Systems India Private Limited (ITA No. 5043)

In this case, the Delhi bench underlined a significant principle that if high loss making comparable companies are not accepted, then high profit making companies should also not be accepted as comparables. This is also in line with the principle by the same tribunal on Sapient Corporation Private Limited (ITA No. 5263) covered in 10.3.6.5

11.3.11.7 Sapient Corporation Private Limited (ITA No. 5263)

In this case, the Delhi bench of ITAT upheld the taxpayer's contention that when loss making companies have been removed from the list of comparables, then a company which earns super normal profits should also be excluded. Transfer pricing adjustment was consequently deleted since the taxpayer's OP/ TC fell within the safe harbour range +/- 5% of the balance three comparables.

11.3.11.8 Mentor Graphics (Noida) Private Limited (109 ITD 101)

In this case, ITAT made several observations on comparability. The important ones are :-

- a) Selection of comparables should be made based on FAR (including intangibles) rather than a broad based comparison of activities.
- b) A Sound analysis of the risk profile of the taxpayer and that of the comparables is necessary since greater the risk, the greater the expected return is an accepted economic principle
- c) Adjustments to be made based on FAR analysis for the differences between that of the taxpayer and the comparables
- d) Certain significant risks like market risks, contract risks, credit and collection risks, infringement of intellectual property right etc. are material and can lead to major differences in the value of a transaction
- e) so Comparables should be rejected, if the differences between the companies are material that adjustment is not possible
- f) Diagnostic ratios like inventory/ sales, operating assets / total assets, etc. should be applied depending upon on the specific aspects of the comparables in the course of transfer pricing analysis
- g) ALP does not mean maximum price or maximum profit in the range. It is not necessary for the taxpayer to satisfy all points (margins) in the range. The taxpayer needs to establish just one point (margin)

11.3.11.9 DHL Express India Pvt. Ltd. (ITA No. 7360)

In this case, the Mumbai bench upheld the view of the revenue regarding rejection of comparable companies having lower turnover as compared to that of tax payer. The tribunal ruled that companies with turnover less than 20% of that of taxpayer cannot be accepted since the economies of scale are not available to small business operating in the same industry. The Tribunal ruled that when direct comparables are available, it is not necessary to consider segmental results of comparable company engaged in multiple activities.

11.3.11.10 NGC Network (India) Pvt. Ltd. (ITA No. 5307)

The Tribunal in this case while observing that since the same method and set of comparables had already been accepted by the TPO for the subsequent Assessment Year (AY) , it has to be adopted for the relevant AY. Accordingly taxpayers' transactions with the AE during the previous AY can serve as the basis for application of CUP, especially where such prior year's transactions have already been accepted at arms' length. On this basis, the Tribunal set aside the order of CIT (A) and restored the case to the file of AO re-working of the Transfer Pricing adjustment using the TNMM on the basis of facts and figures available for the subsequent AY.

11.3.11.11 CIT vs. Agnity India Technologies (Delhi High Court)

Companies with extreme turnover like Infosys are not comparable The assessee, a wholly owned subsidiary of Bay Packets Inc., USA, was engaged in the business of development of software for the parent company in the field of telecommunications. To determine the arms' length price, the TPO & DRP took Infosys Technologies as a comparable. On appeal by the assessee, the Tribunal held that the assessee was not comparable with Infosys as Infosys was a large and bigger company in the area of development of software and the profits earned by it cannot be benchmarked or equated with the assessee's results. One of the aspects pointed out by the Tribunal was that Infosys' turnover was Rs. 9,028 crores while that of the assessee was only Rs. 16.09 crores. On appeal by the department to the High Court, HELD dismissing the appeal: The Tribunal's findings that Infosys should be excluded from the list of comparables for the reason that (i) Infosys was a giant company and it assumed all risks leading to higher profits, whereas the assessee was a captive unit of the parent company and assumed only a limited risk and (ii) that the financial data (turnover) was not comparable has not been controverted by the Revenue. The Tribunal has given valid and good reasons for excluding Infosys as a comparable.

11.3.11.12 General Motors India Pvt. Ltd vs. DCIT (ITAT Ahmedabad)

Transfer Pricing: Foreign associated enterprise can be taken as ‘Tested Party’

While there is nothing in the transfer pricing law as to the selection of the tested party, the tested party normally should be the party in respect of which reliable data for comparison is easily and readily available and fewest adjustments in computations are needed. It may be local or foreign entity, i.e., one party to the transaction. The object of transfer pricing exercise is to gather reliable data, which can be considered without difficulty by both the parties, i.e., taxpayer and the revenue. It is also true that generally least of the complex controlled taxpayer should be taken as a tested party. But where comparable or almost comparable, controlled and uncontrolled transactions or entities are available, it may not be right to eliminate them from consideration because they look to be complex. If the taxpayer wishes to take foreign AE as a tested party, then it must ensure that it is such an entity for which the relevant data for comparison is available in public domain or is furnished to the tax administration. The taxpayer is not then entitled to take a stand that such data cannot be called for or insisted upon from the taxpayer. This is supported by the United Nation’s Practical Manual on Transfer Pricing for Developing Countries which stated that a foreign entity (a foreign AE) could also be taken as a tested party for comparison. The revenue’s argument that GMDAT should not be selected as a ‘tested party’ as it does not fall within the ambit of TPO’s jurisdiction and he can neither call for any additional information nor scrutinize their books of accounts is not acceptable because the Revenue can get all the relevant particulars around the globe by using the latest technology under its thumb or direct the assessee to furnish the same (**Ranbaxy Laboratories** 110 ITD 428 (Del), **Mastek Limited, Development Consultants** 136 TTJ 129 & **Sony India** 114 ITD 448 (Del) followed; **Onward Technologies** (Mum) & **Aurionpro Solutions** (Mum) not followed/distinguished)

11.3.11.13 Vodafone India Services Pvt. Ltd vs. DCIT (ITAT Mumbai)

Transfer Pricing: “High End” Cos in ITES/BPO sector comparable to “Low End” ones

The assessee raised three contentions in support of the contention that its charges were at ALP: (i) that the assessee was engaged in the “low end” activity of “voice based call centre” and that the comparables chosen by the TPO were not functionally comparable as they were engaged in the “high end” activity of “knowledge process outsourcing (KPO)”, “software development” etc, (ii) that the margin has to be computed on the basis of return on asset employed (ROA) or on capital employed (ROCE) and not on the

basis of operating cost & (iii) that as its income was exempt u/s 10A, there was no 'tax avoidance' and the transfer pricing provisions could not apply. HELD by the Tribunal:

(i) The argument that the ITES/BPO industry has several segments starting from low end segment such 'call centre', 'customer care' to high end segments such as 'KPO', 'content development' etc. in which there is wide variation in the billing rates and that high end services are not comparable to the low end services is not acceptable because under Rule 10B(2) the comparability of an international transaction with an uncontrolled transaction has to be judged with the reference to the services provided, functions performed, asset employed and risk assumed. All companies which are in the ITES segment are providing similar services and difference is in the internal working which is reflected through difference in qualifications and skills of the employees. The difference in skill/ qualification of the employees and their payment structure and the difference in billing rate does not affect the comparability in any significant manner under TNMM;

(ii) Though Rule 10B(1)(e) gives the option of computing the margin in relation to asset employed (ROA or ROCE), the OECD and the United Nations TP manual provide that ROCA/ROA are suitable only for manufacturing and other capital or asset intensive industries and not for the service sector. In the case of service companies, the main asset is employees which is not reflected in the balance sheet and, therefore, ROCA/ROA will not be an appropriate method for the purpose of computation of margin;

(iii) The argument that as the assessee's income is exempt u/s 10A, there was no tax avoidance in transferring profit to a low tax jurisdiction is not acceptable because the law has to be applied as enacted. There is no provision in the transfer pricing regulations that for applying the said provisions the revenue has to prove tax avoidance. Once there is a international transaction, the ALP has to be computed as per the prescribed methods.

11.3.11.14 Patni Telecom Solutions Pvt. Ltd vs. ACIT (ITAT Hyderabad)

Transfer Pricing: Turnover filter must be applied to exclude giant companies from comparison

The assessee, a provider of software development services, claimed that in determining the ALP under TNMM, Infosys Technologies & Wipro were not comparable entities given their extreme large turnover in comparison to that of the assessee. To oppose this, the Department relied on **Capgemini India** (ITAT Mum) where it was held that the concept of economy of scale was not applicable to service oriented companies and that the turnover filter could not be applied to exclude companies with an extremely large turnover. HELD by the Tribunal:

Though in **Capgemini** it was held that the concept of economy of scale is relevant only for manufacturing concerns, which have high fixed assets, and not for service concerns and that the turnover filter cannot be applied to exclude companies with an extremely large turnover from comparison, a contrary view has been taken in **CCH India Consulting** 145 TTJ 589 (Hyd) that “giant” companies like Wipro are not at all comparable with smaller “pygmy” companies. Consequently, giant companies like Wipro and Infosys cannot be taken as comparables as their turnover is multiple number of times higher compared to that of the assessee and the TPO erred in considering their PLI to arrive at the arithmetic mean.

11.3.11.15 Marubeni India Pvt. Ltd vs. DIT (Delhi High Court)

The question whether a particular activity of the assessee such as the interest generating activity should be taken into consideration in the determination of the ALP is a question which needs to be decided considering the nature of the business of the assessee and its’ “business model”. The Tribunal rightly held that as the earning of interest income was only the result of investment of surplus funds and was not a primary income-generating activity, the interest income had to be excluded from the “operating profit” for purposes of determination of ALP

11.3.11.16 Trilogy E-Business Software India vs. DCIT (ITAT Bangalore)

U/s 92C & Rule 10B(2), there is no bar to considering companies with either abnormal profits or abnormal losses as comparable to the tested party, as long as they are functionally comparable. This issue does not arise in the OECD guidelines and the US TP regulations because they advocate the quartile method for determining ALP under which companies that fall in the extreme quartiles get excluded and only those that fall in the middle quartiles are reckoned for comparability. Cases of either abnormal profits or losses (referred to as outliers) get automatically excluded. However, Indian regulations specifically deviate from OECD guidelines and provide Arithmetic Mean method for determining ALP. In the arithmetic mean method, all companies that are in the sample are considered, without exception and the average of all the companies is considered as the ALP. Hence, while the general rule that companies with abnormal profits should be excluded may be in tune with the OECD guidelines, it is not in tune with Indian TP regulations. However, if there are specific reasons for abnormal profits or losses or other general reasons as to why they should not be regarded as comparables, then they can be excluded for comparability. It is for the Assessee to demonstrate existence of abnormal factors. On facts, as the assessee has not shown any factors for abnormal profits, no comparable can be excluded for that reason (contra view in **Quark Systems & Sap Labs** noted)

11.3.11.17 Demag Cranes & Components (India) vs. DCIT (ITAT Pune)

Rule 10B(e)(iii) provides that *“the profit margin arising in comparable uncontrolled transactions has to be adjusted to take into account the differences, if any between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market”*. While the “differences” are not specified, it covers **“any differences” which could materially affect the amount of net profit margin. The litmus test to be applied is if the ‘difference, if any, is capable of affecting the NPM in open market? If yes, then the TPO is under statutory obligation to eliminate such differences.** The revenue cannot say that difference is likely to exist in all accounts and so the demands of the assessee should be ignored. The revenue’s stand that the assessee is ineligible for any adjustments if he provides the set of comparable is not correct because under Rule 10(3) **it is the duty of the AO/TPO/DRP to minimize/eliminate the difference which is likely to materially affect the price.** It is the settled proposition that ‘working capital’ adjustment is an adjustment that is required to be made in TNMM. The revenue’s contention that the ‘differences’ specified should refer to only (i) the factor of demand and supply; (ii) existence of marketable intangibles

i.e. brand name etc; (iii) geographical location and the like is not acceptable. Further, as the difference in the Arm's length Operating Margin of the Comparables before and after making the adjustment for working capital was up to 3.77%, it was "material" and had to be eliminated (**Mentor Graphics** 109 ITD 101 (Del), **E-gain Communication** 118 ITD 243 (Pune) **Sony India** 114 ITD 448 (Del) & **TNT India** followed)

11.3.11.18 DCIT vs. BP India Services Pvt Ltd (ITAT Mumbai)

Under Rule 10B(1)(e)(ii), "the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transaction is computed having regard to the same base;" The term "uncontrolled transaction" is defined in Rule 10A(a) to mean "a transaction between enterprises other than associate enterprises, whether resident or non-resident". The result is that in applying the TNMM, the net profit margin realized from a comparable uncontrolled transaction is to be taken into consideration. **The conditions require that a case should not only be comparable but also have uncontrolled transactions. These twin conditions need to be cumulatively satisfied. If a case is only comparable but has controlled transactions or vice-versa, it falls outside the ambit of the list of comparable cases**

11.3.11.19 Rampgreen Solutions Pvt. Ltd vs. CIT (Delhi High Court) – August 2015

ALP in BPO, KPO and ITES

We have reservations as to the Tribunal's aforesaid view in Maersk Global Centers (India) Pvt. Ltd. (supra). As indicated above, the expression 'BPO' and 'KPO' are, plainly, understood in the sense that whereas, BPO does not necessarily involve advanced skills and knowledge; KPO, on the other hand, would involve employment of advanced skills and knowledge for providing services. Thus, the expression 'KPO' in common parlance is used to indicate an ITeS provider providing a completely different nature of service than any other BPO service provider. A KPO service provider would also be functionally different from other BPO service providers, inasmuch as the responsibilities undertaken, the activities performed, the quality of resources employed would be materially different. In the circumstances, we are unable to agree that broadly ITeS sector can be used for selecting comparables without making a conscious selection as to the quality and nature of the content of services

11.3.12 Validity of Segmental accounts

11.3.12.1 Technimount ICB Pvt Ltd. (ITA No. 7098)

In this case, the Mumbai bench of ITAT ruled in favour of the taxpayer to the effect that segmental accounts should be considered for the calculation of the Profit Level Indicator (PLI). Other issue involved was the acceptance of loss making comparables and use of single year data, where the bench ruled in favour of tax payer.

11.3.13 Adjustment of economic and market conditions

11.3.13.1 Intervet India Private Limited (ITA No. 3185)

The Mumbai bench of ITAT ruled that appropriate adjustments for differences in economic and market conditions in different locations must be made in applying the CUP method. The taxpayer sought a 50% adjustment to the ALP on account of differences in volume, credit, economy and market conditions between Vietnam and Thailand. The TPO allowed only 10% adjustment for volume and credit risk, allowing no benefit on account of economy and market conditions. The CIT (A) enhanced it to 20% and the Tribunal ruled that the adjustments needed to be widened and set it aside to the file CIT (A)

11.3.14 Financial Transactions

11.3.14.1 Perot Systems TSI (India) Pvt Ltd (ITA Nos. 2320, 2321, 2322)

The taxpayer sought to rely on Para 1.37 of the OECD guidelines dealing with characterization of debt as equity in the hands of the borrower and also contended that no real income has been earned. The ITAT did not accept the argument of interest free loans as being exempt from interest free loans and also did not accept the contention of the taxpayer that there is no real income earned.

11.3.14.2 VVF Limited (ITA No. 673 – MUM - 08)

It was held by the ITAT that the transaction of lending money by the assessee by way of interest-free foreign currency loan to its foreign subsidiaries, should be compared with a company lending in foreign currency to unrelated party. It was observed that the ICICI Bank had advanced foreign currency loan to the assessee at LIBOR plus 3%. This can be taken as an "internal CUP" as the credit rating of subsidiary merges with the credit rating

of the Parent. The comparison of interest should not be benchmarked with the Cash Credit @ 14% given to the Assessee.

11.3.14.3 TNT India Limited (ITA No. 1442)

The Bangalore bench of ITAT held that prior data is relevant for determination of ALP of the international transaction only if the assessee proves that pricing pattern has been influenced by market conditions / business cycle / product cycle of earlier years. The bench also held that benefit of working capital adjustment has to be provided to the tax payer and remanded the issue of “mark up” on reimbursements to the AO/TPO since the CIT(A) did not record any findings against the contention of the taxpayer.

11.3.14.4 Micro Inks Ltd vs. ACIT (ITAT Ahmedabad)

In this case, the matter regarding the law on adjustment for notional interest on interest-free loan & excess credit period to AE has been explained by the Tribunal

The question which really needs to be adjudicated is whether, in the context of s. 92A, but for the management, capital or control being in the same hands, the AE would have entered into the transaction on the same terms. In other words, whether there is such a commercial justification for the values at which transactions have been entered or not, so as not to attract the adjustment in the arm’s length price, has to essentially depend on factors other than the factors regarding management, capital or control. In still other words, merely because the entity receiving interest free funds is a subsidiary wholly owned by the assessee cannot be reason enough to justify such loans or advances being interest free and not warranting an arm’s length price adjustment, so far as transfer pricing provisions are concerned.

However, on facts, the assessee’s claim that the loans were in the nature of “*quasi capital*” deserves to be accepted. Under the RBI’s guidelines, while a loan from the EEFC account could be given without permission, the subscription to the equity capital required permission. The assessee applied for the permission and on receipt of it converted the loan into equity capital

Further, in applying the CUP method, an adjustment has to be made under Rule 10B(1) “*to account for differences which could materially affect the price in the open market*”. There are significant differences between a typical transaction of loan of money and this transaction. LIBOR cannot be adopted in this situation because (a) the transaction is not a simplicitor financing transaction but is a transaction of investing in a

subsidiary as quasi capital pending formal approval of the RBI and (b) it is not a case of granting advance to a business concern without significant and decisive commercial considerations. The monies were given for strengthening the assessee's marketing apparatus in the USA and to keep alive its biggest exports customer. The comparable uncontrolled price for interest on such a transaction in which advances are made pending capital subscription in a company which plays strategically significant commercial role in assessee's business would be nil

11.3.14.5 Working Capital Adjustment

11.3.14.5.1 Aurionpro Solutions Ltd vs. ACIT (ITAT Mumbai)

Working capital adjustment – Interest should be charged on the basis of LIBOR + 2%

The assessee's argument that the non-charging of interest on the working capital advances to AEs from whom the assessee was getting good business was justified by commercial considerations and that no transfer pricing adjustment is warranted is not acceptable because the existence or non existence of commercial consideration between the assessee and the AEs is not a required condition for applicability of the TP regulations. Further, the advance was not the credit period extended to the AEs in respect of business transactions but was a transaction of advancing loans to the AEs which falls under the ambit of "international transaction" u/s 92B. In principle, the DRP is justified in its view that the ALP should be determined on the basis of the interest rate that would have been earned by the assessee by advancing loans to an unrelated third party (in India) such as a Fixed Deposit with the Bank. However, since LIBOR has been accepted by the Tribunal in other cases, the ALP should be determined on the basis of LIBOR + 2% (**Siva Industries** 59 DTR 182 (Che), **Tech Mahindra** 46 SOT 141 (Mum) & **Tata Autocomp Systems** 73 DTR 220 (Mum) referred)

11.3.14.5.2 Kusum Healthcare Pvt. Ltd vs. ACIT (ITAT Delhi) – April 2015

The Tribunal had to consider whether the AO/DRP is justified in enhancing the income of the assessee on account of notional interest charged on receivables outstanding beyond 180 days. HELD by the Tribunal:

(i) An uncontrolled entity will expect to earn a market rate of return on its working capital investment independent of the functions it performs or products it provides. However, the amount of capital required to support these functions varies greatly, because the level of inventories, debtors and creditors varies. High levels of working

capital create costs either in the form of incurred interest or in the form of opportunity costs. Working capital yields a return resulting from a) higher sales price or b) lower cost of goods sold which would have a positive impact on the operational result. Higher sales prices acts as a return for the longer credit period granted to customers. Similarly in return for longer credit period granted, a firm should be willing to pay higher purchase price which adds to the cost of goods sold. Therefore, high levels accounts receivable and inventory tend to overstate the operating results while high levels of accounts payable tend to understate them thereby necessitating appropriate adjustment. The appropriate adjustments need to be considered to bring parity in the working capital investment of the assessee and the comparables rather than looking at the receivable independently. Such working capital adjustment takes into account the impact of outstanding receivables on the profitability.

(ii) The principle of aggregation is a well-established rule in the transfer pricing analysis. This principle seeks to combine all functionally similar transactions wherein arm's length price can be determined for a number of transactions taken together. The said principle is enshrined in the transfer pricing regulation itself and has also been advocated by the OECD Guidelines. As the assessee had earned significantly higher margin than the comparable companies (which have been accepted by the TPO) which more than compensates for the credit period extended to the AEs. Thus, the approach by the assessee of aggregating the international transactions pertaining to sale of goods to AE and receivables arising from such transactions which is undoubtedly inextricable connected is in accordance with established TP principles as well as ratio laid down by the Hon'ble jurisdictional High Court in the case of Sony Ericson Mobile Communication India Pvt. Ltd.

(iii) Any separate adjustment on the pretext of outstanding receivables while accepting the comparables and transfer price of underlying transaction i.e. sale of goods by application of TNMM is unjustified. The differential impact of working capital of the assessee vis-a-vis its comparables has already been factored in the pricing/ profitability of the assessee and therefore, any further adjustment to the margins of the assessee on the pretext of outstanding receivables is unwarranted and wholly unjustified.

11.3.14.6 Evonik Degussa India P. Ltd vs. ACIT (ITAT Mumbai)

No interest cost if no borrowing and payments are received as per billing cycle

The assessee has no borrowings and so there is no interest liability. Even if the payments have been made by the AE beyond the normal credit period, there is no interest cost to the assessee. Moreover, there is no such agreement whereby interest is to be charged on such a delayed payment. The assessee does the billing on a quarterly basis and accordingly, the payment is being received. Therefore, the delay is not wholly on account of late payment by the AEs only. Moreover, the T.P. adjustment cannot be made on hypothetical and notional basis until and unless there is some material on record that there has been under charging of real income. Consequently, an addition on account of notional interest relating to alleged delayed payment in collection of receivables from the A.Es is uncalled for

11.3.14.7 Aithent Technologies Pvt Ltd vs. ITO (ITAT Delhi)

CUP Method is most appropriate for international lending transaction

The assessee was required to comply with the transfer pricing provisions of s. 92 to 92F with respect to the transaction of interest-free loan to its subsidiary. **The CUP method is the most appropriate method in order to ascertain the ALP of such international transaction by taking into account prices at which similar transactions with other unrelated parties have been entered into.** For that purpose, an assessment of the credit quality of the borrower and estimation of a credit rating, evaluation of the terms of the loan e.g period of loan, amount, currency, interest rate basis, and additional inputs such as convertibility and finally estimation of arm's length terms for the loan based upon the key comparability factors and internal and/or external comparable transactions are relevant. None of these inputs have anything to do with the costs; they only refer to prevailing prices in similar unrelated transactions instead of adopting the prices at which the transactions have been actually entered in such cases, the hypothetical arms length prices, at which these associated enterprises, but for their relationship, would have entered into the same transaction, are taken into account. **Whether the funds are advanced out of interest bearing funds or interest free advances or are commercially expedient for the assessee or not, is wholly irrelevant in this context.** As the transaction is of lending money, in foreign currency, to its foreign subsidiary, the comparable transaction should also be of foreign currency lending by unrelated parties (**Perot Systems** 130 TTJ 685 (Del) followed).

11.3.14.8 Zee Entertainment Enterprises Ltd vs. ACIT (ITAT Mumbai) May 2017

Corporate Guarantee – One of the points

Notably, as the orders of the lower authorities reveal, the principal plea of the assessee was that furnishing of a corporate guarantee on behalf of the associated enterprise is not to be construed as an 'international transaction' within the meaning of section 92B of the Act. Before us, the Ld. Representative for the assessee has not laid any emphasis on the aforesaid primary plea, but has assailed the rate of 3% adopted by the income tax authorities to determine arm's length rate of the impugned international transaction of providing corporate guarantee to the bank on behalf of the associated enterprise. Therefore, we are confining our discussion to the efficacy of the rate of 3%, which has been considered to be arm's length rate for corporate guarantee fee/commission. In this context, the Ld. Representative for the assessee referred to the judgement of the Hon'ble Bombay High Court in the case of CIT vs. Everest Kanto Cylinders Ltd., 378 ITR 57 (Bom), wherein the arm's length rate of 0.50% has been approved in respect of corporate guarantee fee/commission. According to him, the rate of 0.50% was approved in the case of Everest Kanto Cylinders Ltd. (supra) because the same was suo-moto applied by the assessee, whereas in the present case, the facts and circumstances are such that the arm's length rate of corporate guarantee fee/commission ought to be determined at a lower rate. In order to justify the lower rate, the Ld. Representative for the assessee pointed out that the loan raised by the associated enterprise was fully secured by the assets owned by the associated enterprise and it was pointed out that net worth of the associated enterprise as on 31/03/2008 was around Rs.800 crores and profit after tax for the year ending 31/03/2008 is to the tune of Rs.48 crores. It was sought to be pointed out that the associated enterprise was in a good financial health to borrow monies from bank on its own account; that the loan was only to the extent of 30 million US dollars, which was quite insignificant considering the net worth of the associated enterprise. Secondly, it was also explained that assessee was in possession of about Rs.183.30 crores of interest-free funds belonging to the associated enterprise as on 31/3/2008 and considering all these aspects, there was no risk of the guarantee devolving on the assessee for payment. For all the said reasons, it is sought to be pointed out that the adjustment, if any, be restricted to a rate even lower than 0.50%.

11.3.14.9 Thomas Cook (India) Limited vs. ACIT (ITAT Mumbai) – May 2016

The only dispute that the assessee has contested before us relates to the application of the rate of 3% take by the Transfer Pricing Officer to determine the arm's length rate of the international transaction of provision of corporate guarantee on behalf of the associated enterprise. Therefore, we confine ourselves to examine the veracity of the arm's length rate adopted by the income-tax authorities. In the present case, assessee company issued corporate guarantee on behalf of the its associated enterprise which enabled its associated enterprise to avail banking facilities from HSBC Bank in Mauritius. The Hon'ble Bombay High Court in the case of Everest Kento Cylinders Ltd 232 Taxman 307/[2015] 378 ITR 57 /[2015] 277 CTR 511 was considering a somewhat similar situation, where in the matter of guarantee commission fee the adjustment made by the income-tax authorities was based on instances of commercial banks providing guarantees. The Hon'ble Bombay High Court has explained that instances of commercial banks providing guarantees could not be compared to instances of issuance of corporate guarantee. As per Hon'ble Bombay High Court, when commercial banks issue bank guarantees, the same is quite distinct in character, than the situation where a corporate issues guarantee to the effect that, if a subsidiary associated enterprise does not repay a loan, the same would be made good by such corporate. Keeping the said ratio of the Hon'ble Bombay High Court in mind, it is quite clear that the manner in which the Transfer Pricing Officer has proceeded to determine the arm's length rate based on the probable rate being charged by the commercial banks is not justified. In this view of the matter, we are unable to approve 3% rate of guarantee commission fee determined as arm's length rate by the income-tax authorities. In the alternative, the addition that is required to be sustained is the position canvassed by the assessee before the Transfer Pricing Officer i.e. adoption of 0.50% as arm's length rate for the purpose of determining the arm's length income on account of guarantee commission fee in the present case. The Departmental Representative had referred to certain decisions of the Mumbai Tribunal, wherein a rate higher than 0.50% has also been approved in order to determine the guarantee commission fee. All those decisions are based on the probable rates at which the guarantees are issued by the commercial banks, and in view of the judgment of Hon'ble Bombay High Court in the case of Everest Kento Cylinders Ltd.(supra), such an approach cannot be upheld since the instant is a case, where a corporate guarantee has been issued by holding company for the benefits of its step-down subsidiary associated enterprise. Considering the entirety of facts and

circumstances of the case and on the basis of the material available on record, we, therefore proceed to uphold the rate of 0.50% for the purpose of determining the arm's length rate of the guarantee commission fee.

11.3.14.10 Loans to Associated Enterprises

11.3.14.10.1 CIT vs. Aurionpro Solutions Ltd (Bombay High Court) – June 2017

Advances were made to the company situated abroad. The LIBOR rate naturally will be considered to determine the Arms Length interest, the same would be reasonable and proper in applying the commercial principle. The Tribunal has directed the appropriate rate would be LIBOR plus 2% instead of LIBOR plus 3% applied by the TPO

11.3.14.10.2 Varroc Engineering Pvt. Ltd vs. ACIT (ITAT Pune) – January 2015

While benchmarking the international transactions what has to be seen is the comparison between related transactions i.e. where the assessee has advanced money to its associated enterprises and charged interest then the said transaction is to be compared with a transaction as to what rate the assessee would have charged, if it had extended the loan to the third party in foreign country. Once there is a transaction between the assessee and its associated enterprises in foreign currency, then the transaction would have to be looked upon by applying the commercial principles with regard to the international transactions. In that case, the international rates fixed being LIBOR+ rates would have an application and the domestic prime lending rates would not be applicable

11.3.15 Intangibles

11.3.15.1 Maruti Suzuki India Limited (W.P. (C) 6876/2008)

This is a landmark decision made by Delhi High Court. Though the decision has been set aside by the Supreme Court, but the principles laid down by it are followed in the later TP orders at their audit stage.

The High Court (HC) while passing the orders observed that it was necessary to have the royalty agreement and the need for using brand name of Suzuki to stand up to competition in the market and that the department has failed to establish that Maruti had become a super brand and therefore did not need Suzuki's brand name and logo on

its products. Besides the HC noted that it was not obligatory for Maruti to use the logo of Suzuki on the products manufactured by it and sold by it in India was discretionary. But the benefit of using the joint brand name “Maruti Suzuki” does flow to Suzuki which should be factored in the determination of ALP by the TPO by finding out what payment, if any, a comparable independent domestic entity would have made in respect of an agreement of the same nature. As regards advertisement expenses, the taxpayer argued that it does not give rise to building Suzuki brand in India and in fact Maruti had benefited by marketing expenses as its own average growth of 18% p.a. in the last 13 shows the results. The HC observed that it cannot be presumed that the additional expenses contented to have been incurred by domestic entity were aimed at benefitting non-resident AE unless it is shown that they are more than what a comparable independent entity would have incurred. HC further observed that TPO should have found / selected appropriate companies which could have been good comparable considering its nature of products, number of products launched by it in the market, the territories served by it, and the turnover and profit achieved by it.

11.3.15.2 L.G.Electronics India Pvt. Ltd vs. ACIT (ITAT Delhi Special Bench)

Transfer Pricing: The ‘Bright Line test’ can be applied to disallow the excessive advertisement, marketing and sales promotion (AMP) expenses incurred by the assessee for the benefit of the brand owner

Transfer pricing adjustment in relation to advertisement, marketing and sales promotion expenses incurred by the assessee for creating or improving the marketing intangible for and on behalf of the foreign Associated Enterprises is permissible.

Earning a mark-up from the Associated Enterprises in respect of AMP expenses incurred for and on behalf of the AE is allowable. However, the matter is restored to the file of TPO for de novo adjudication in the light of certain guidelines outlined by Tribunal in its order.

11.3.15.3 Reebok India Co vs. ACIT (ITAT Delhi)

Transfer Pricing: Scope in the context of expenditure (royalty payment) explained – Weightage to be given to Government approval, though not conclusive for determining ALP The assessee paid royalty at the rate of 5% to its associated enterprise and claimed that the same was at arm’s length basis by applying the CUP method. The TPO and DRP determined the ALP of the royalty at Nil on the basis that (a) the approval given by the Government for payment of royalty did not automatically mean that the

transaction was at arm's length; (b) the assessee had not furnished a cost benefit analysis, (c) the technology had in fact not helped the assessee in earning better margins. It was held that as the technology had not contributed to the assessee's profitability and there was no commercial benefit received, no independent enterprise would have made payment for royalty for the technology and so its ALP had to be determined at Nil. On appeal by the assessee to the Tribunal, HELD reversing the TPO & DRP:

(a) The TPO's argument that the assessee need not have paid for the technology as it did not derive any benefit therefrom is not acceptable. The assessee is free to conduct business in the manner it deems fit and the commercial and business expediency of incurring any expenditure has to be seen from the assessee's point of view. The Revenue cannot step into the shoe of the assessee and decide what is prudent for the business. On facts, the very survival of the assessee in the industry depended upon the licence and technology & know how provided by the AE. There has been a considerable increase in the sales figures and the growth in revenue clearly demonstrates the benefits derived by the assessee from the use of technology;

(b) the payment of royalty was approved by the Government of India. Though it is not conclusive proof, the said approval of the Government has to be given consideration while considering the arms length price of the transaction;

(c) Under Rule 10B(1)/ s. 92C(2), the arm's length price has to be determined by one of the five methods which is found to be most appropriate method. While the assessee rightly considered the CUP method for determining the ALP, the TPO's conclusion that the arms length price of the royalty payment should be NIL without specifying any cogent basis is not sustainable (**EKL Appliances** 345 ITR 241 (Del), **Ericsson** 146 TTJ 708 (Del), **ThyssenKrupp Industries** 154 TTJ 689(Mum), **Dresser Rand** 55 SOT 167 (Mum), **SC Enviro Agro** 143 ITD 195 (Mum) etc followed)

11.3.16 Management Charges

11.3.16.1 Gemplus India Private Limited (ITA No. 352)

In this matter the ITAT upheld certain important principles with respect to management charges. The taxpayer contended that it received services in respect of marketing and

sales, customer service, finance, accounting, administration and legal support from its AE. Charges for such services were booked on the basis of time spent by the AE's personnel. The TPO disallowed the entire payment on the ground that the taxpayer failed to provide credible evidence to substantiate the actual rendering of service by the AE and had failed to satisfy the benefits test. The CIT (A) upheld the TPO's order and the ITAT upheld the disallowance of management fee payout observing that payment terms are independent of actual services and apportionment of cost has been done on a mutually agreed basis and not on the basis of actual services rendered. Further the taxpayer was unable to furnish any details / evidence regarding rendering of services by the AE and so failed to satisfy the benefits test.

11.3.17 Penalty

11.3.17.1 Cargill India Pvt Ltd. (110 ITD 616)

This was a case where the AO on the recommendation of the TPO levied the penalty for not furnishing information within the stipulated time. The CIT (A) upheld the order of the AO. The actual delay involved was about a month. The Tribunal held that all clauses and sub rules of the TPR may not be applicable in every instance and would be dependent on specific facts surrounding circumstances. The TPO should not "casually" ask for information under all clauses in a mechanical manner, without drawing references to specific clauses under the rules, where any information / document is required from the tax payer. The ITAT ruled that no penalty can be imposed for failure to furnish documents in time if such failure is proved to be due to a "reasonable cause" by the taxpayer.

11.3.17.2 RBS Equity India Ltd (ITA No. 156, ITA No. 157)

In this case, the taxpayer followed the TNMM to determine the ALP, but the TPO adopted the CUP method and made an adjustment to the ALP, which was accepted by the taxpayer. The AO then levied penalty under explanation 1 to section 271(1)(c) on the ground that the assessee had filed inaccurate particulars of income. The CIT (A) deleted the penalty upon which the department went in appeal with the Tribunal. The Tribunal held that penalty cannot be levied for transfer pricing adjustments as per explanation 1 to Section 271(1)(c). Explanation 7 governs the levy of penalty in respect of transfer pricing adjustment and here it is sufficient if the assessee shows that the ALP was computed by the assessee in accordance with the scheme of Section 92C in "good faith" and with "due diligence".

11.3.18 Profits attribution to a PE

11.3.18.1 DDIT vs. B4U International Holdings Ltd (ITAT Mumbai)

Under Article 5(5), an agent is deemed not to be of independent status when his activities are devoted exclusively or almost exclusively to the non-resident enterprises. Though in **DHL Operations B.V.** 142 TM 1 (Mum) it was held that the question whether the agent is “dependent” has to be seen from the perspective of the non-resident principal, **this view cannot be followed** because it is contrary to the language of Article 5(5). **The wordings refer to the activities of an agent** and its devotion to the non-resident and not the other way round. **The perspective should be from the angle of the agent and not of the non-resident.** As the income from the assessee was only 4.69% of the agent’s income, the agent was not a “dependent agent” (**Morgan Stanley** 272 ITR 416 (AAR) & **Rolls Royce** (Del) followed)

11.3.18.2 ADIT vs E-funds IT Solutions Inc. (Supreme Court) Date of Pronouncement – 24th October, 2017

The Income Tax Act, in particular Section 90 thereof, does not speak of the concept of a PE. This is a creation only of the DTAA. By virtue of Article 7(1) of the DTAA, the business income of companies which are incorporated in the US will be taxable only in the US, unless it is found that they were PEs in India, in which event their business income, to the extent to which it is attributable to such PEs, would be taxable in India. Article 5 of the DTAA set out hereinabove provides for three distinct types of PEs with which we are concerned in the present case: fixed place of business PE under Articles 5(1) and 5(2)(a) to 5(2)(k); service PE under Article 5(2)(l) and agency PE under Article 5(4). Specific and detailed criteria are set out in the aforesaid provisions in order to fulfill the conditions of these PEs existing in India. The burden of proving the fact that a foreign assessee has a PE in India and must, therefore, suffer tax from the business generated from such PE is initially on the Revenue. Under Article 5(1), a PE means a fixed place of business through which the business of an enterprise is wholly or partly carried on. What is a “fixed place of business” is no longer res integra. The principle laid down by this Court in *Formula One World Championship Ltd. v Commission of Income Tax*, International Taxation, Delhi – 3 and Others was followed.

11.3.18.3 Formula One World Championship Ltd. v Commission of Income Tax , International Taxation, Delhi – 3 and Others (Supreme Court Pronounced on 24th April, 2017)

The principal test, in order to ascertain as to whether an establishment has a fixed place of business or not, is that such physically located premises have to be 'at the disposal' of the enterprise. For this purpose, it is not necessary that the premises are owned or even rented by the enterprise. It will be sufficient if the premises are put at the disposal of the enterprise. However, merely giving access to such a place to the enterprise for the purposes of the project would not suffice. The place would be treated as 'at the disposal' of the enterprise when the enterprise has right to use the said place and has control thereupon. Some of the examples where premises are treated at the disposal of the enterprise and, therefore, constitute PE are: a place of business may thus be constituted by a pitch in a market place, or by a certain permanently used area in a customs depot (e.g. for the storage of dutiable goods). Again the place of business may be situated in the business facilities of another enterprise. This may be the case for instance where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise. At the same time, it is also clarified that the mere presence of an enterprise at a particular location does not necessarily mean that the location is at the disposal of that enterprise

11.3.18.4 Director of Income Tax (International Taxation) v Morgan Stanley and Co. Ltd. (292 ITR 416)

This is a landmark decision on various aspects of international taxation. It lays down rules regarding several fundamental issues such as fixed and service Permanent Establishment (PE), transfer pricing and attribution of profits to PE. In this case, Morgan Stanley & Co. Inc. USA (MSCO) utilized the services of Morgan Stanley Advantage Services Private Limited (MSAS) for carrying out certain outsourced back office services. MSCO also deputed its employees to India from time to time to ensure the quality of the outsourced services.

In this case, the Supreme Court (SC) held that an arrangement for provision of back office and other outsourced services did not constitute a PE in India. However, it held that deputation of personnel by MSCO to MSAS would constitute a service PE. On the attribution of income, the Supreme Court has held that as a principle, there cannot be attribution, if the AE namely MSAS that constituted a PE is remunerated at the arms'

length basis determined after a proper transfer pricing analysis. The ruling further mentions that the appropriate method for determination of the ALP in such cases would be the TNMM.

11.3.18.5 Rolls Royce Plc. (122 TTJ : 125 ITD 136, TIUL – 103)

In this case, the ITAT had held that Rolls Royce PLC, UK had a Permanent Establishment (PE) in India for marketing activities and that 35% of the company's profits are attributable to such PE. The tribunal after considering the facts ruled that the taxpayer carried on marketing activities in India through the utilization of its own employees and the employees of the PE and that the assessment in India would be on the sum total of profit attributed to the PE (dependent agent) and the amount of profit attributable to the taxpayer's own activity in India. The profit to be attributed should be based on a proper Function, Assets and Risk (FAR) analysis.

11.3.18.6 Set Satellite Singapore Pte Ltd (AIT- 2008 – 297)

The Mumbai High Court (HC) in this historic ruling set aside the ruling by ITAT ruling that "in matters of tax and more so, in case of international transactions, the provisions of the tax treaty have to be considered. If the provisions of the treaty are more advantageous to a taxpayer, most beneficial construction shall have to be given. In this particular case, HC ruled that circular 23 of 1969 was binding and relevant for the purpose of deciding the question in issue and read with Article 7(1) of the tax treaty between India and Singapore, advertisement revenues received by the taxpayer is not taxable in India. Further the HC held that remuneration received by SET India (at 15% of gross receipts from advertisement) was at arms' length. Further, the revenue had never in any case disputed the fact that SET India was remunerated on the basis of ALP. The HC also held that in view of circular 742 of 1996, it would be fair and reasonable to compute the taxable income of SET Singapore at 10% of gross receipts from advertisements and in this case, since the percentage is 15%, it extinguished the tax liability of SET Singapore.

11.3.18.7 Convergys Customer Management Group Inc vs. ADIT (ITAT Delhi)

Law on what constitutes a PE and how to attribute profits to a PE explained

The Tribunal had to consider the following legal issues: (i) whether the assessee could be said to have a PE in terms of Article 5(1) and 5(2) of the DTAA? (ii) what is the correct

method to allocate profits to the PE?, (iii) whether fees for software is assessable as royalty after the retrospective amendment to s. 9(1)(vi) and (iv) whether the payment for link charges is taxable as 'equipment royalty'? HELD by the Tribunal:

(i) The assessee's argument that it does not have a PE under Article 5(1) cannot be accepted because its employees frequently visited the premises of CIS to provide supervision, direction and control over the operations of CIS and such employees had a fixed place of business at their disposal. CIS was practically the projection of assessee's business in India and carried out its business under the control and guidance of the assessee and without assuming any significant risk in relation to such functions. Besides the assessee has also provided certain hardware and software assets on free of cost basis to CIS. However, it does not constitute a dependent agent PE in terms of Article 5(4) and 5(5) of the DTAA;

(ii) The correct approach to arrive at the profits attributable to the PE should be as under: (i) compute the Global operating Income percentage of the customer care business as per annual report/10K of the company, (ii) this percentage should be applied to the end-customer revenue with regard to contracts/projects where services were procured from CIS. The amount arrived at is the Operating Income from Indian operations, (iii) the operating income from India operations is to be reduced by the profit before tax of CIS. This residual is now attributable between US and India, (iv) the profit attributable to the PE should be estimated on residual profits as determined under Step 3 above;

(iii) As regards the taxability of software license fees, the retrospective amendment to s. 9(1)(vi) by the Finance Act, 2012 widens the scope of the term "royalty" but does not impact the provisions of the DTAA in any manner. Consequently, the purchase of software falls within the category of copyrighted article and not towards acquisition of any copyright in the software and hence the consideration is not assessable as Royalty. Even otherwise, as the payment is in the nature of reimbursement of expenses, it is not taxable in the hands of the assessee (**B4U International Holding & Nokia Networks OY** followed);

(iv) As regards the payment of link charges as equipment royalty, there is no transfer of the right to use, either to the assessee or to CIS. The assessee has merely procured a service and provided the same to CIS, no part of equipment was leased out to CIS. Even otherwise, the payment is in the nature of reimbursement of expenses and accordingly not taxable in the hands of the assessee.

11.3.18.8 Delmas, France vs. ADIT (ITAT Mumbai)

Onus on AO to show foreign co has a PE in India. Under India-France DTAA, even dependent agent is not PE in absence of finding that transactions are not at ALP

The assessee, a French company, engaged in the operation of ships in international traffic, claimed that it did not have a PE in India and that no part of its income was chargeable to tax in India. The AO & DRP held that *as the assessee had an agent in India which concluded contracts, obtained clearances and did the other work, there was a PE in India under Articles 5(5) & 5(6) of the DTAA*. On appeal by the assessee, HELD allowing the appeal:

(i) **In order to constitute a PE under Article 5(1) & 5(2), three criteria are required to be satisfied viz; physical criterion (existence), functionality criterion (carrying out of business through that place of physical location) & subjective criterion (right to use that place).** There must exist a physical "location", the enterprise must have the "right" to use that place and the enterprise must "carry on" business through that place. An "agency" PE will not satisfy this condition because the enterprise will not have the "right" to use the place of the agent. **Under Article 5(6) of the India-French DTAA (which is at variance with the UN & OECD Model Conventions), even a wholly dependent agent is to be treated as an independent agent unless if it is shown that the transactions between him and the enterprise are not at arms' length.** The Department's argument that as the AO had not examined whether the transactions were done in arm's length conditions, the matter should be restored to him is not acceptable because the **onus was on the Revenue to demonstrate that the assessee had a PE.** The onus is greater where the very foundation of DAPE rested on the negative finding that the transactions between the agent and the enterprise were not made under at arms length conditions. **A negative finding about transactions with the dependent agent not being at ALP is sine qua non for existence of a DAPE under the India-France DTAA.** The AO could not be granted a fresh inning for making roving and fishing enquiries whether the transactions were at arm's length conditions or not (Airlines Rotables 44 SOT 368 followed);

(ii) *(Observed, on a conceptual note, taking note of revenue's plea but without deciding)*
If as a result of a DAPE, no additional profits, other than the agent's remuneration in the source country – which is taxable in the source state anyway de hors the existence of PE, become taxable in the source state, the very approach to the DAPE profit attribution seems incongruous. Further, before accepting the DAPE profit neutrality theory, as per **Morgan Stanley 292 ITR 416 (SC)**, the arm's length remuneration paid to the PE must take into account 'all the risks of the foreign enterprise as assumed by the PE'. **In an agency PE situation, a DAPE assumes the entrepreneurship risk in respect of which the agent can never be compensated because even as DAPE inherently assumes the entrepreneurship risk, an agent cannot assume that entrepreneurship risk.** To this extent, there may be a **subtle line of demarcation between a dependent agent and a dependent agency PE**. The tax neutrality theory, on account of existence of DAPE, may not be wholly unqualified at least on a conceptual note.

11.3.19 Aggregation of International Transactions

11.3.19.1 Cummins India Limited vs. ACIT (ITAT Pune) – January 2015

(i) On a combined reading of Rule 10A(d) and 10B of the Rules, a number of transactions can be aggregated and construed as a single 'transaction' for the purposes of determining the ALP, provided of course that such transactions are 'closely linked'. Ostensibly the rationale of aggregating 'closely linked' transactions to facilitate determination of ALP envisaged a situation where it would be inappropriate to analyse the transactions individually. The proposition that a number of individual transactions can be aggregated and construed as a composite transaction in order to compute ALP also finds an echo in the OECD guidelines. It may be noted that two or more transactions can be said to be 'closely linked', if they originate from a common source, being an order or contract or an agreement, and the nature, characteristic and terms of such transactions substantially flow from the said common source;

(ii) On facts, the international transactions of import of spare parts, export of spare parts, IT support services, access to customized parts catalogue and amount received for warranty consideration are inter-related transactions, which were the sourcing activities of the assessee company and have to be aggregated in order to benchmark the international transactions. The assessee had benchmarked the arm's length price of all the transactions by comparing results of the comparable companies which were found

to be at arm's length price (Demag Cranes & Components (India) Pvt. Ltd. Vs. DCIT followed).

11.3.20 Location Savings

Watson Pharma (P.) Ltd. v DCIT [2015] Mumbai – October 2015

The facts of the case were that taxpayer was engaged in provision of contract manufacturing and contract Research and Development (R&D) services to its Associated Enterprises (AEs). The taxpayer adopted Transactional Net Margin Method (TNMM) and selected Indian comparable companies for benchmarking its international transactions with its AEs to substantiate the arm's length nature of these transactions.

The TPO while making addition on account of choice of comparables also contended that the taxpayer's AEs enjoyed locational advantage on account of lower costs in India by shifting contract manufacturing and contract R&D activities to the taxpayer in India vis-à-vis undertaking the same in the US. Further, relying on research paper / articles, the TPO held that there is approximately 40% and 50% cost reduction in India to the AEs on contract manufacturing and contract R&D activities respectively. Based on this analysis, the TPO computed the overall cost savings to AEs from these activities in India and attributed 50% of such savings to the taxpayer on the ground that such arrangement was mutually beneficial for the AEs and the taxpayer. The TPO accordingly proposed an adjustment for location savings which adjustment was confirmed by the DRP.

The Tribunal ruled in favour of the assessee. Amongst other reasons, the ITAT relied heavily on the ruling of the Delhi Tribunal in the case of *GAP International Sourcing India Pvt. Ltd. vs. ACIT (2012) 149 TTJ 437* and held that when local Indian comparables which are operating in similar economic circumstances as that of the taxpayer are considered for benchmarking, any benefit (if at all) on account of location savings would have already got embedded in the operating margins of the comparable companies. Since the taxpayer's operating margin is higher than the arm's length margin based on such local comparables, specific adjustment for location savings is not required. While holding this position, the Tribunal also observed that G20 countries have given their consensus to the above view in OECD Guidance in Intangibles and India is part of G20 countries.

The Tribunal disregarded the contention of the TPO that in the absence of the various details regarding AEs (such as cost of manufacturing in the US and ultimate selling price by them to the distributors), it could be assumed that location savings arise to the AEs.

The Tribunal held that the financial results of the AEs are not relevant for determining the arm's length margin of the taxpayer. The Tribunal also observed that the reliance placed by the TPO on research papers for computation of location savings is *ad hoc*, based on assumptions and cannot be accepted. The Tribunal observed that the research papers were only web based articles and were not accepted by any forum.

11.3.21 Principles of Natural Justice

11.3.21.1 MOSER BAER INDIA LTD vs. ACIT (Delhi High Court)

The provisions of sub-section (3) of section 92 CA casts an obligation on the TPO to afford a personal hearing to the assessee before he proceeds to pass a order of determining of the ALP in terms of sub-section (3) of Section 92CA. ii. Since such a requirement flows from a plain reading of the provisions of sub-section (3) of section 92CA, the determination of ALP by the TPO cannot be sustained by taking recourse to the fact that the assessee did not demand an oral hearing.

11.3.21.2 Genisys Integrating Systems vs. DCIT (ITAT Bangalore)

While Rule 10D(4) requires that the information should be “contemporaneous” and exist latest by the “specified date”, there is no “cut-off date” upto which only the information available in public domain can be considered by the TPO. Even data that becomes available in the public domain after the specified date can be considered. If the TPO collects information u/s 133(6), he is not required to inform the assessee about the process used by him nor is he required to furnish the entire information to the assessee. However, the assessee must be given proper hearing if any information is proposed to be used against it.

CHAPTER 12

MITIGATING UNCERTAINTY IN TRANSFER PRICING

12.0 UNCERTAINTY IN TRANSFER PRICING

Whether or not determination of ALP in international transaction (and extending to Specified Domestic Transactions with effect from FY 2012-13) will be accepted by the Income Tax authority is a question that only time will tell for those entities which are covered by the Transfer Pricing (TP) regulations. Uncertainty impacts businesses, particularly entities in the SME sector where the tax adjustments resulting from the TP audits could have significant impact impinging on their post-tax net profits. Advance Ruling, Safe Harbour Provisions, Advance Pricing Arrangements (APA) and Mutual Agreement Procedures (MAP) are available for international transactions. Safe harbour regulations have been recently extended to certain types of Specified Domestic Transactions.

12.1 ADVANCE RULING

The provisions relating to Advance Ruling are covered in Sections 245N to Section 245T.

12.1.1 Accordingly,

(a) "Advance Ruling" is defined in Section 245N(a) to mean

- (i) a determination by the Authority in relation to a transaction which has been undertaken or is proposed to be undertaken by a non-resident applicant;
or
- (ii) a determination by the Authority in relation to the tax liability of a non-resident arising out of a transaction which has been undertaken or is proposed to be undertaken by a resident applicant with such non-resident, and such determination shall include the determination of any question of law or of fact specified in the application;
- (iii) a determination or decision by the Authority in respect of an issue relating to computation of total income which is pending before any income-tax authority or the Appellate Tribunal and such determination or decision shall include the determination or decision of any question of law or of

fact relating to such computation of total income specified in the application;

(iv) a determination or decision by the Authority whether an arrangement, which is proposed to be undertaken by any person being a resident or a non-resident, is an impermissible avoidance arrangement as referred to in Chapter X-A or not (with effect from 1.4.2015)

(b) As per Section 245N(b) "applicant" means any person who—

(i) is a non-resident referred to in sub-clause (i) of clause (a); or

(ii) is a resident referred to in sub-clause (ii) of clause (a); or

(iii) is a resident falling within any such class or category of persons as the Central Government may, by notification in the Official Gazette, specify in this behalf; *and*

(iiia) (with effect from 1.4.2015) is referred to in sub-clause (iv) of clause (a); and

(iv) makes an application under sub-section (1) of section 245Q;

12.1.2 The authority constituted under Section 245-O is referred to as “Authority for Advance Rulings” (AAR), the office of which is located in Delhi.

To summarise, advance ruling option is available as under:

For matters	Non-resident	Non-resident with resident
Transactions undertaken or proposed to be undertaken	Yes	No
Tax liability	No	Yes
Computation of total income in dispute	No	Yes
To determine impermissible avoidance arrangement	Yes	Yes

- 12.1.3 Section 245Q deals with the submission of application for advance ruling. Rule 44E prescribes Form Nos. 34C to 34E for application for obtaining advance ruling in quadruplicate
- 12.1.4 Section 245R deals with the procedure to be followed by the AAR on receipt of the application for advance ruling. The AAR may call for relevant records, which shall be furnished by the applicant. The AAR after examining the application either allow or reject the application. However, opportunity of being heard should be given to the applicant, who may appear himself or through his authorised representative. The time period given to the AAR to pass its orders is six months from the date of receipt of application.
- 12.1.5 Advance ruling could be sought from AAR with regard to the interpretation of the transfer pricing law, or in respect of factual matters, such as whether a transaction will be covered by transfer pricing regulations.
- 12.1.6 An application was made to AAR by Instrumetarium Corporation of Finland with respect to an arrangement involving grant of interest free loan by it to its Wholly Owned Subsidiary (WOS) seeking whether transfer pricing regulations are applicable to it and whether this arrangement adhered to the principles of Arms' Length Pricing. The issue was made abundantly clear by AAR in its first ever ruling after transfer pricing regulations came into force in India, when it held that the question of determining "arm's length price was beyond its scope as it involves the determination of fair market value of any property", while ruling that the foreign company will have to comply with transfer pricing provisions.

12.1.7 Binding nature of AAR

As per Section 245S of the Income Tax Act, the advance ruling is binding on the applicant in respect of the transaction and on the Commissioner and the income tax authorities subordinate to him.

The binding nature of the ruling under Section 245S(1) of the Act, would not affect the jurisdiction of either the Supreme Court under Article 136 or of the High Courts under Articles 226 and 227 of the Constitution of India, as held in *Columbia Sportswear Company v. DIT* (SLP no.31543 of 2011).

12.2 ADVANCE PRICING ARRANGEMENT

12.2.1 CONCEPT OF APA

12.2.1.1 An APA is an agreement between the Central Board of Direct Taxes (CBDT) and the person (taxpayer), which determines, in advance, the ALP or specifies the manner of the determination of ALP (or both), in relation to an international transaction. Hence, once an APA has been entered into with respect to an international transaction, the ALP with respect to that international transaction, for the period specified in the APA, will be determined only in accordance with the APA.

12.2.1.2 The APA once entered into shall be binding on the person as well as the Commissioner of Income tax (and his subordinate income tax authorities) having jurisdiction over such person and such transaction. The term of APA can be a maximum of 5 years. There is no minimum period. However, looking into the time, money and efforts that are expected to be spent before entering into APA, it is likely that the application for APA would normally be for a term which is not less than at least three years.

12.2.1.3 Sections 92CC (6) and 92CC (7) of the Income Tax Act contain circumstances under which the APA will not be binding or can be declared void ab-initio. Rules 10F to 10T of the Income Tax Rules read with Rule 44GA contain the detailed provisions relating to APA.

12.2.2 TYPES OF APA

12.2.2.1 The APA scheme envisages three types of APAs: unilateral, bilateral and multilateral. The choice is on the applicant to choose a particular type of APA at the time of making the application.

12.2.2.2 Unilateral APA is an agreement between the CBDT and the applicant and does not involve any agreement with the treaty partner. It, therefore, does not guarantee the ALP or Transfer Pricing Method (TPM), determined under an APA, being accepted by the other country.

12.2.2.3 In bilateral APA, the applicant is required to make an application with the competent authority of India and simultaneously the applicant or its AE should apply to the competent authority of the other country. The two competent authorities are required to reach an arrangement through Mutual Agreement Procedure (MAP)

negotiation. This arrangement is required to be accepted by the applicant before a bilateral APA can be entered into.

12.2.2.4 In multilateral APA, the applicant is required to make an application with the competent authority of India and simultaneously the applicant or its AE should apply to the competent authority of the other countries which are relevant for such a Agreement. Indian competent authority has to reach an arrangement through MAP with competent authorities of more than one country, before that agreement could be offered to the applicant. The arrangement is required to be accepted by the applicant before a multilateral APA can be entered into.

12.2.2.5 Request for bilateral or multilateral APA can be accepted by Indian competent authority where:

(i) a tax treaty exists between India and other country(ies) containing an article on “Mutual Agreement Procedure”;

(ii) in case of international transactions leading to economic double taxation arising out of TP adjustments, the said tax treaty contains provisions similar to paragraph 2 in the article 9 as provided in OECD model convention on “Associated Enterprises”, and

the corresponding APA program exists in the other country.

12.2.2.6 In unilateral APA, the applicant does not wish to involve competent authority of any other country, and the agreement is only between him and the CBDT. Since, there is no prior agreement with the competent authority of any other country; there may be a possibility of double taxation in unilateral APA.

12.2.3 OBJECTIVE OF APA

The APA is designed to:

(a) provide tax certainty with regard to determination of ALP of the international transaction with respect to which the APA has been entered into (also called “covered transaction”);

(b) reduce the risk of potential double taxation through bilateral or multilateral APA (A taxpayer is thus encouraged to apply for bilateral or multilateral APAs);

(c) reduce compliance cost by eliminating the risk of transfer pricing audit and resolving long drawn and time consuming litigation;

- (d) reduce the burden of record keeping, as the taxpayer knows in advance the required documentation to be maintained to substantiate the agreed terms and conditions of the agreement

12.2.4 THE APA TEAM

There are two different set-ups for processing of APA and to help the CBDT to enter into an APA. First set-up comprises of the competent authority of India [which is Joint Secretary (FT&TR-I) in the Ministry of Finance], and his representative (i.e; one Director and two Under Secretaries).

The second set-up is the APA team which is defined in Rule 10F. At present the APA team, constituted by the CBDT, consists of one Commissioner, 4 Additional Commissioners and 4 Deputy Commissioners. The CBDT may include more officers in future in this team. The APA team reports to DGIT (International Taxation). DGIT may include experts in economics, statistics, law or any other field in the team who would be drawn from the Government Departments. CBDT may constitute more APA teams in future depending on the work load.

12.2.5 PROCESS INVOLVED

The APA scheme involves the following process:

1. Pre-filing consultation
2. Furnishing of an APA application;
3. Acceptance/rejection of an APA application;
4. Action by the taxpayer, the assessing officer and the transfer pricing officer while the APA is processed or negotiated;
5. Amendment to an APA application;
6. Assignment of an APA application to APA team; Examination and analysis of an APA application; Conversion of a unilateral APA into bilateral APA Entering into a unilateral APA;
7. Negotiation by the competent authority in bilateral/ multilateral APA and entering into an APA
8. Action by the taxpayer and the assessing officer on entering into an APA;
9. Annual compliance report;
10. Compliance audit of the agreement; Cancellation and revision of APA.

Serial Number 1 to 8 above are by and large procedural in nature. The details are available on the FAQ posted on the website www.incometaxindia.gov.in

In the following paragraphs, the provisions relating to the terms of the APA Agreement, Roll Back Provisions, Annual Compliance Report (Serial Number 9) and Compliance Audit, Cancellation and Revision of APA (Serial Numbers 9 and 10) above are covered briefly

12.2.5.1 APA AGREEMENT

Rule 10M contains the provisions relating to terms of the agreement as under:-

- (1) An agreement may among other things, include –
 - (i) The international transactions covered by the agreement;
 - (ii) The agreed transfer pricing methodology, if any;
 - (iii) Determination of arm's length price, if any;
 - (iv) Definition of any relevant term to be used in item (ii) or (iii);
 - (v) Critical assumptions;
 - (vi) Roll back provision referred in Rule 10MA
 - (vii) The conditions if any other than provided in the Act or these rules.
- (2) The agreement shall not be binding on the Board or the assessee, if there is change in any of critical assumptions or failure to meet conditions subject to which agreement has been entered into
- (3) The binding effect of agreement shall cease only if any party has given due notice of the concerned other party or parties
- (4) In case there is a change in any of the critical assumptions or failure to meet the conditions subject to which the agreement has been entered into, the agreement can be revised or cancelled, as the case may be.
- (5) The assessee who has entered into an agreement shall give a notice in writing of such change in any of the critical assumptions or failure to meet conditions to the DGIT (International Taxation) as soon as it is practicable to do so
- (6) The Board shall give a notice in writing of such change in critical assumptions or failure to meet conditions to the assessee, as soon as it comes to the knowledge of the Board.
- (7) The revision or cancellation of the agreement shall be in accordance with Rules 10Q and 10R respectively.

12.2.5.2 ROLL BACK PROVISIONS

The APA when first introduced did not contain roll back provisions to previous years. Rule 10MA was amended with effect from 14.3.2015. Also a new Rule 10RA was introduced prescribing the procedure for giving effect to rollback provision.

12.2.5.2.1 Rule 10MA Roll Back of the APA

- (1) Subject to the provisions of this rule, the agreement may provide for determining the arm's length price or specify the manner in which arm's length price shall be determined in relation to the international transaction entered into by the person during the rollback year (hereinafter referred to as "rollback provision").
- (2) The agreement shall contain rollback provision in respect of an international transaction subject to the following, namely:—
 - (i) the international transaction is same as the international transaction to which the agreement (other than the rollback provision) applies;
 - (ii) the return of income for the relevant rollback year has been or is furnished by the applicant before the due date specified in Explanation 2 to sub-section (1) of section 139;
 - (iii) the report in respect of the international transaction had been furnished in accordance with section 92E;
 - (iv) the applicability of rollback provision, in respect of an international transaction, has been requested by the applicant for all the rollback years in which the said international transaction has been undertaken by the applicant; and
 - (v) the applicant has made an application seeking rollback in Form 3CEDA in accordance with sub-rule (5);
- (3) Notwithstanding anything contained in sub-rule (2), rollback provision shall not be provided in respect of an international transaction for a rollback year, if,—
 - (i) the determination of arm's length price of the said international transaction for the said year has been subject matter of an appeal before the Appellate Tribunal and the Appellate Tribunal has passed an order disposing of such appeal at any time before signing of the agreement; or

(ii) the application of rollback provision has the effect of reducing the total income or increasing the loss, as the case may be, of the applicant as declared in the return of income of the said year.

(4) Where the rollback provision specifies the manner in which arm's length price shall be determined in relation to an international transaction undertaken in any rollback year then such manner shall be the same as the manner which has been agreed to be provided for determination of arm's length price of the same international transaction to be undertaken in any previous year to which the agreement applies, not being a rollback year.

(5) The applicant may, if he desires to enter into an agreement with rollback provision, furnish along with the application, the request for the same in Form No. 3 CEDA with proof of payment of an additional fee of five lakh rupees:

[Provided that in a case where an application has been filed on or before the 31st day of March, 2015, Form No.3CEDA along with proof of payment of additional fee may be filed at any time on or before the 30th day of June, 2015 or the date of entering into the agreement whichever is earlier:]

[Provided further that in a case where an agreement has been entered into on or before the 31st day of March, 2015, Form No.3CEDA along with proof of payment of additional fee may be filed at any time on or before the 30th day of June, 2015 and, notwithstanding anything contained in rule 10Q, the agreement may be revised to provide for rollback provision in the said agreement in accordance with this rule.]

12.2.5.2.2 Rule 10RA Procedure for giving effect to rollback provision of APA

(1) The effect to the rollback provisions of an agreement shall be given in accordance with this rule.

(2) The applicant shall furnish modified return of income referred to in section 92CD in respect of a rollback year to which the agreement applies along with the proof of payment of any additional tax arising as a consequence of and computed in accordance with the rollback provision.

(3) The modified return referred to in sub-rule(2) shall be furnished along with the modified return to be furnished in respect of first of the previous years for which the agreement has been requested for in the application.

(4) If any appeal filed by the applicant is pending before the Commissioner (Appeals), Appellate Tribunal or the High Court for a rollback year, on the issue which is the subject matter of the rollback provision for that year, the said appeal to the extent of the subject covered under the agreement shall be withdrawn by the applicant before furnishing the modified return for the said year.

(5) If any appeal filed by the Assessing Officer or the Principal Commissioner or Commissioner is pending before the Appellate Tribunal or the High Court for a rollback year, on the issue which is subject matter of the rollback provision for that year, the said appeal to the extent of the subject covered under the agreement shall be withdrawn by the Assessing Officer or the Principal Commissioner or the Commissioner, as the case may be, within three months of filing of modified return by the applicant.

(6) The applicant, the Assessing Officer or the Principal Commissioner or the Commissioner, shall inform the Dispute Resolution Panel or the Commissioner (Appeals) or the Appellate Tribunal or the High Court, as the case may be, the fact of an agreement containing rollback provision having been entered into along with a copy of the same as soon as it is practicable to do so.

(7) In case effect cannot be given to the rollback provision of an agreement in accordance with this rule, for any rollback year to which it applies, on account of failure on the part of applicant, the agreement shall be cancelled.

12.2.5.3 ANNUAL COMPLIANCE REPORT:

The assessee is required to file annual compliance report in quadruplicate in Form 3CEF to DGIT(International Taxation) for each year covered in the agreement. Rule 10-O governs the filing of annual compliance report by the assessee. It is required to be filed within 30 days of the due date of filing the income tax return for the assessment relevant to the previous year or within 90 days of entering into an agreement, whichever is later. The filing of Annual Compliance report is in addition to the modified return that is required to be filed.

The following information is required to be furnished in the annual compliance report :-

- a) Details of the Taxpayer
- b) Type of APA entered into

- c) Name of the Associated Enterprise(s) with which international transactions have been undertaken during the year
- d) Details of covered transactions including nature, amount, agreed TPM, agreed Profit Level Indicator (PLI), actual result achieved, adjustment required
- e) Details of any changes in the business model
- f) Details of any changes in the Functional and Risk profile of the taxpayer and the Associated Enterprises
- g) Transfer Pricing Methodology agreed upon in the APA
- h) Details of Critical assumptions agreed upon in the APA and changes thereof, if any
- i) Details of any changes in the organizational structure of the taxpayer / group
- j) Details of other terms and conditions agreed upon by the APA

12.2.5.4 COMPLIANCE AUDIT OF THE AGREEMENT:

12.2.5.4.1 The compliance audit shall be carried out by the jurisdictional TPO in accordance with Rule 10P. The TPO has to submit the report to the DGIT in case of unilateral APA and to the competent authority in India in case of bilateral or multilateral APA. 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.

12.2.5.4.2 The purpose of the compliance audit is to ensure compliance with the terms of the APA. While undertaking the compliance audit, the TPO may require the assessee to substantiate compliance with the terms of agreement, including satisfaction of the critical assumptions, correctness of the supporting data or information and consistency of the application of the transfer pricing method.

12.2.6 REVISION AND CANCELLATION OF APA:

12.2.6.1 Revision of APA

The provisions for cancellation of APA are dealt with in Rule 10Q. The gist of the provisions are as follows :-

- (1) An agreement, subsequent to it having been entered into, may be revised by the Board, if.-
 - (a) there is a change in critical assumptions or failure to meet a condition subject to which the agreement has been entered into;

(b) there is a change in law that modifies any matter covered by the agreement but is not of the nature which renders the agreement to be non-binding ; or
(c) there is a request from competent authority in the other country requesting revision of agreement, in case of bilateral or multilateral agreement.

(2) An agreement may be revised by the Board either *suo moto* or on request of the assessee or the competent authority in India or the Director General of Income-tax (International Taxation).

(3) Except when the agreement is proposed to be revised on the request of the assessee, the agreement shall not be revised unless an opportunity of being heard has been provided to the assessee and the assessee is in agreement with the proposed revision.

(4) In case the assessee is not in agreement with the proposed revision the agreement may be cancelled in accordance with rule-10R.

(5) In case the Board is not in agreement with the request of the assessee for revision of the agreement, the Board shall reject the request in writing giving reason for such rejection.

(6) For the purpose of arriving at the agreement for the proposed revision, the procedure provided in rule 10 L may be followed so far as they apply.

(7) The revised agreement shall include the date till which the original agreement is to apply and the date from which the revised agreement is to apply.

In case of revised agreement, the procedure as regard to original agreement shall be repeated. That is the taxpayer will be required to file the modified return for the period after the revision of the APA within three months and the assessing officer will reassess or recompute the total income of the relevant assessment year having regard to and in accordance with the revised agreement.

12.2.6.2 Cancellation of APA

The provisions for cancellation of APA are dealt with in Rule 10R. The gist of the provisions are as follows :-

(1) Accordingly, an agreement shall be cancelled by the Board for any of the following reasons:

(i) the compliance audit referred to in rule 10P has resulted in the finding of failure on the part of the assessee to comply with the terms of the agreement;

- (ii) the assessee has failed to file the annual compliance report in time;
 - (iii) the annual compliance report furnished by the assessee contains material errors; or
 - (iv) the agreement is to be cancelled under sub-rule (4) of rule 10Q.
- (2) The Board shall give an opportunity of being heard to the assessee, before proceeding to cancel an application.
- (3) The competent authority in India shall communicate with the competent authority in the other country or countries and provide reason for the proposed cancellation of the agreement in case of bilateral or multilateral agreement.
- (4) The order of cancellation of the agreement shall be in writing and shall provide reasons for cancellation and for non-acceptance of assessee's submission, if any.
- (5) The order of cancellation shall also specify the effective date of cancellation of the agreement, where applicable.
- (6) The order under the Act, declaring the agreement as *void ab initio*, on account of fraud or misrepresentation of facts, shall be in writing and shall provide reason for such declaration and for non-acceptance of assessee's submission, if any.
- (7) The order of cancellation shall be intimated to the Assessing Officer and the Transfer Pricing Officer, having jurisdiction over the assessee.

12.2.7 WITHDRAWAL OF APA

The applicant can withdraw APA application by filing a request in form 3CEE at any time before the finalization of the term of the agreement. The fee paid shall not be refunded on withdrawal of application. (i.e before sending of the draft agreement by the DGIT to the Board in case of unilateral APA request and before sending of the MAP arrangement by the competent authority to the Board in case of bilateral or multilateral APA request)

12.2.8 OBLIGATION OF DISCLOSURE

Any facts, information and statement submitted by an applicant in connection with APA request along with application or during processing of application must be true, correct and accurate. If APA team or competent authority requires additional information for processing and negotiation of agreement, the applicant is required to provide such information within the time requested.

- While the APA request is pending, the applicant has an obligation to update all the material facts and information filed along with application on a timely basis.

- Failure to provide all the requisite information for process involved in the APA, or on requests by APA team or the competent authority, can cause significant delay and may result in non-finalization of APA.

12.2.9 LEGAL EFFECT OF APA

11.2.9.1 An APA is binding on the assessee who entered into an APA in relation to the covered transactions and on the Commissioner of Income-tax and other income-tax authorities subordinate to him in respect of that assessee and that transaction. If the assessee complies with the terms and conditions of the APA, the tax administration will not contest the ALP or the application of the TPM to the covered transactions in the APA in the case of the assessee for the years to which the APA specifically relates.

12.2.9.2 The APA shall not be binding on the assessee or the Commissioner, if-

- There is a change in law or facts having bearing on the agreement so entered [section 92CC(6) of the Act];
- The agreement has been obtained by the assessee by fraud or misrepresentation of facts-the agreement void ab-initio [section 92CC(7) of the Act];
- There is any change in any of the critical assumptions or there is failure on the part of the assessee to meet conditions subject to which the agreement has been entered into-the agreement can be revised or cancelled[Rule 10M(4)];
- The agreement is cancelled under Rule 10R.

12.2.10 AMENDMENT OF APA

The provisions for amendment of APA are dealt with in Rule 10N. The gist of the provisions are as follows :-

(1) An applicant may request in writing for an amendment to an application at any stage, before the finalisation of the terms of the agreement.

(2) The Director General of Income-tax (International Taxation) (for unilateral agreement) or the competent authority in India (for bilateral or multilateral agreement) may, allow the amendment to the application, if such an amendment does not have effect of altering the nature of the application as originally filed.

(3) The amendment shall be given effect only if it is accompanied by the additional fee, if any, necessitated by such amendment in accordance with fee as provided in rule 10-I.

12.2.11 RENEWAL OF APA

12.2.11.1 A new application has to be filed by the taxpayer after the expiry of the APA term with the DGIT (Intl. Taxation) and the competent authority in India as the case may be.

12.2.11.2 The renewal request will follow the same forms and procedures as in initial APA request except that pre-filing consultation is not required.

12.2.11.3 The renewal application would be treated as a fresh application and procedure and fee would apply accordingly, with the only difference being that the process of pre filing consultancy referred to in Rule 10 H would not be applicable

12.2.11.4 The renewal request may be filed well in advance before the expiration of the terms of the existing APA.

12.2.12 POTENTIAL ADVANTAGES AND DISADVANTAGES OF APA

12.2.12.1 ADVANTAGES

The following are the potential advantages of APA :-

- a) Certainty on the transfer pricing issues
- b) Avoidance of possible audit along with penalty and litigation costs
- c) Efficient management of transfer pricing issues
- d) Elimination of potential double taxation effects
- e) Fewer compliance costs for the MNE group as a whole
- f) Free flow of information between taxpayer and revenue authorities
- g) Encouraging and favourable environment for FDI
- h) Enhances ability to deal with contentious issues with respect to open assessment years, though not binding

12.2.12.2 DISADVANTAGES

The following are the potential disadvantages of APA :-

- a) Error in assumptions about future economic circumstances can disrupt the whole process and can lead to undesired results

- b) Establishing APA entails significant time and effort. There will be significant demand for resources in terms of cost and HR. All this would be a waste if APA is not concluded.
- c) Unilateral APA does not eliminate the risk of double taxation impact
- d) Cumbersome APA procedures can multiply the tax compliances
- e) Potential misuse of secret information shared by the tax authorities. (But it could be countered that the information asked for in APA application and compliance are those that are any way asked for by tax authorities in TP assessments and audit)
- f) APA does not altogether eliminate the TP audit

12.2.13 CONCLUSION

APA is definitely here to stay. The Indian TP regulations on APA has imported the best features of the practices worldwide and now with the roll back introduced in 2015 for 4 prior years, an validly concluded gives certainty for 9 years ie. 4 prior years + 5 future years including the current. The general perception is that the benefits far outweigh the costs, if the volume of international transactions with Associated Enterprises is of a reasonably large volume. The greatest advantage is certainty and if documentation is done properly and there is good intent on the part of the taxpayer, it is really worthwhile.

In the words of David Bowen (Principal & National Transfer Pricing Practice Leader, Grant Thornton LLP, Washington, D.C.), “APA programs, when properly designed and administered, allow both taxpayers and tax administrators to achieve certainty for current and future tax years, often on a bilateral basis. Whereas the up-front investment in time and resources can be significant (particularly for first-time users) that up-front investment pays continuing long-term dividends by reducing (and often eliminating) the financial and economic opportunity costs of compliance and continued uncertainty over the appropriate TP for intercompany transactions”.

In the words of Arun Chhabra, Partner, TP Services, Walker Chandiook & Co., “ The single most attribute of a good investment and business climate is certainty. The APA scheme has the potential to bring certainty in tax impact of transactions for potential investors and taxpayers in India. For the litigious Indian transfer pricing regime, this is a welcome step which can create an environment of trust between tax authorities and taxpayer. What is required now is that both sides adopt a positive approach and make this a success.

“As of September 2015, more than 575 APA applications have been filed with the APA authorities. 14 of these APAs have been concluded, of which 12 are unilateral and 2

bilateral (with Japan and United Kingdom). This includes one roll back APA, which was signed in August 2015, within four months of introduction of APA rollback rules. APAs concluded are in diverse sectors like telecom, oil exploration, pharma, finance / banking, software development and BPOs, covering international transactions, such as interest payments, corporate guarantees, non-binding investment advisory services, contract manufacturing, trading and IT / ITeS services. It is interesting to note that roughly over 40% of APA applications are from the IT & ITeS sector, consistent with the litigation trends that have been observed.” (Source : Transfer Pricing Disputes Trends – Report 2015 by taxsutra, Deloitte)

12.3 MUTUAL AGREEMENT PROCEDURES (MAP)

12.3.1 Need for MAP

Certainty on tax issues has today become one of the key drivers for business decisions, especially where the transactions encompass various jurisdictions. Although there is a robust procedure under the Indian domestic tax law for resolution of tax disputes, the lack of speed and effectiveness of such procedures has increased demand for mutual agreement procedures (MAP), when it comes to International Transactions.

12.3.2 Alternative Dispute Resolution Mechanism

MAP is an alternative dispute resolution mechanism provided under the tax treaties, and is a special procedure, which is outside the scope and purview of the domestic tax regulations. Almost all Indian tax treaties now include an article on MAP.

12.3.3 Scope of MAP under the tax treaties

12.3.3.1 Typically, the Indian tax treaties cover the following scenarios where MAP could be possible:

- a) Where the action by one or both the tax jurisdictions has resulted or will result in taxation not in accordance with the relevant tax treaty;
- b) Resolving difficulties arising as to interpretation and application of the tax treaty; and
- c) Elimination of double taxation in cases not provided for in the tax treaty.

12.3.3.2 However, certain Indian treaties (for example, treaties with countries like Australia, Belgium, UK) do not specifically cover cases of elimination of double taxation in cases not provided for in the tax treaty under the MAP.

12.3.4 Common issues for MAP

12.3.4.1 Some of the common issues under MAP include:-

- Issues relating to existence of a permanent establishment (PE) in one of the tax jurisdictions;
- Issues relating to attribution of profits to a PE in the other tax jurisdiction;
- Issues on determination of residence status under the tax treaty; and
- Characterisation of income.

12.3.4.2 Of late, considering the aggressive transfer pricing adjustments made by the Indian tax authorities, there have instances where some multinational companies have taken recourse to MAP as an alternate dispute resolution mechanism.

12.3.5 MAP – Procedural guidelines

12.3.5.1 MAP needs to be initiated by the taxpayer before the competent authority (CA) in the country of his residence.

12.3.5.2 The procedure to be followed has the following two-fold requirement:

- a) The application should first be presented to the CA of the resident country which shall endeavour to resolve the dispute on its own.
- b) If the CA of the country of residence is not itself able to arrive at an appropriate solution, it may endeavour to resolve the same by mutual agreement with the CA of the other tax jurisdiction.

12.3.5.3 Most of the Indian tax treaties (for example, treaties with countries like Australia, Belgium, Finland, US, Sweden, Switzerland) specify a time limit within which the application can be presented to the CA. Typically, the time limit is two to three years, from the date of receipt of the first notification of an action (a notice) which gives rise to taxation not in accordance with the tax treaty.

12.3.5.4 Rule 44G and 44H of the Income-tax Rules 1962, contains the procedure to be followed with respect to MAP

- Under Rule 44G the prescribed form is Form No 34, in which the taxpayer resident in India can make an application to the CA in India. The form requires the taxpayer to give relevant details relating to the case, along with documentary support.

- Rule 44H provides that the CA in India shall endeavour to arrive at a resolution based on the provisions of the relevant tax treaty.

12.3.5.5 Further under Rule 44H it is prescribed that any resolution arrived at under MAP is to be given effect by the tax officer within ninety days from the receipt of the same by the Chief Commissioner or Director General of Income-tax, if the taxpayer:

- i) gives acceptance to the resolution taken under MAP; and
- ii) withdraws an appeal, if any, pending on the issue which was the subject matter for adjudication under MAP.

12.3.5.6 MAP is not a substitute to domestic provisions

12.3.5.6.1 Generally, the Indian tax treaties provide that the MAP provisions can be initiated irrespective of the remedies provided by the domestic law. Further, it is popularly viewed that the MAP provisions are in addition and not in substitution of the remedies before the domestic tax authorities and Courts [Andhra Pradesh High Court in *CIT v Visakhapatnam Port Trust (1983) 144 ITR 146*].

12.3.5.6.2 Further, the Central Board of Direct Taxes (CBDT), *vide its instruction no. 12/2002, dated November 1 2002*, has also clarified that the outcome of a MAP process would be binding on a taxpayer only if he gives his acceptance to the results of the MAP process.

12.3.5.7 Practical issues in initiating MAP in India

12.3.5.7.1 Though a MAP process may appear to be a complete resolution mechanism, one also needs to be aware of some practical issues which one may encounter. Some of the issues have been highlighted below:

- The tax treaty provisions typically provide that it shall be the endeavour of the Competent Authority (CA) of both the taxing jurisdictions to seek a resolution but there is no guarantee that a resolution would be reached. There have been cases where the CAs of the states have failed to reach an agreement on the issues. In such a case, the matter would get resolved through the dispute resolution mechanism as provided under the domestic law (the regular appellate procedure).
- The CA of both the taxing jurisdictions may not meet quite often to discuss the issues before them. Further, with no time limit fixed for the resolution, the process could be slow.

- A resolution under MAP is valid only for the issues raised for that particular year. There is no guidance on whether a MAP resolution for one year would apply equally for other years, with similar facts and issues.
- Depending upon the matter involved, the resolution under MAP could be only on the principle issues, whereas the actual computation may be left to be done by the tax officer. This may lead to another round of debate with the tax authorities. It would also be have to be kept in mind that the tax officer is required to give effect to the MAP order within ninety days of receipt of the order by the tax authorities.

12.3.5.7.2 There are no clear guidelines on the payment of the tax demands when the MAP process has been initiated. Perhaps the way forward is to enter into Memorandum However, the Indian and the US competent authorities have entered into a memorandum of understanding (MoU) which provides that tax demand would be kept in suspension during the pendency of MAP. The suspension would be dependent upon various conditions, which include furnishing of a bank guarantee of an amount equal to the amount of tax under dispute and interest accruing thereon as per the provisions of the Act. A similar MoU has also been entered by the Indian authorities with UK.

12.4 SAFE HARBOUR PROVISIONS

12.4.1 Concept of Safe Harbour

12.4.1.1 Safe harbour (referred to as a comfort mechanism in the OECD guidelines) has been defined to mean circumstances in which tax authorities shall accept the transfer prices declared by the taxpayers, which consist of provision for circumstances in which a certain category of taxpayers can follow a simple laid down set of rules under which transfer prices are automatically accepted by the revenue authorities.

12.4.1.2 Safe harbour provisions offer essentially benefits to taxpayers and tax administrators with benefits of compliance relief, administrative simplicity and certainty.

12.4.1.3 For the tax authorities, the safe harbour provisions substantially reduce the administrative burden involved in terms of minimal examination (or limited number of companies being picked up for detailed scrutiny) of the transfer pricing compliance by the taxpayers. They can choose to concentrate their time and resources on larger taxpayers, transactions or issues.

12.4.1.4 From the tax payers' point of view, it significantly eases their compliance efforts in terms of not calling for collection and analysis of data that may be often difficult to obtain in connection with application and establishment of arms' length principle.

12.4.1.5 The adoption of safe harbour rules provides many perceived benefits both for taxpayers and the revenue authorities in terms of predictability as well as continuity for all the participating organizations, elimination of the possibility of litigation between the taxpayers and the revenue authorities through the process of automatic approvals and self assessment procedures all of which will lead to simplification of the whole process.

12.4.1.6 In the context of developing countries which are dependent upon FDI, introduction of the safe harbour rules can boost the foreign investment climate in the sectors where it is introduced on the basis of the certainty and continuity it affords.

12.4.1.7 The availability of safe harbours for a given category of taxpayers would have a number of adverse consequences which must carefully be weighed by tax administrations against the expected benefits. These concerns stem from the facts that the implementation of a safe harbour in a given country would not only affect tax calculations within that jurisdiction, but would also impinge on the tax calculations of associated enterprises in other jurisdictions and the harbour provisions can potentially produce prices or results that may not be consistent with the arm's length principle. One of the ways to partially address this problem is to give the option to the taxpayers to decide whether they want to use the safe harbour provisions or follow the detailed Transfer pricing procedures, guidelines and comply accordingly.

12.4.1.8 Globally, Australia, New Zealand, Brazil, Singapore, Japan, Switzerland, USA and Taiwan have detailed Safe Harbour provisions. Russia had safe harbour provisions, which was abolished. Cyprus is on course to evolve Safe Harbour provisions and China does not have safe harbour provisions.

12.4.1.9 Indian safe harbour provisions are just about five years old, having been introduced in 2013. Significant amendments to address certain issues were made in this year. The provisions are discussed in Paragraph 12.4.2

12.4.2 Safe Harbour provisions in the Indian context

12.4.2.1 In a country like India, where there are a multitude of organizations which are involved in the execution of routine, repetitive tasks such as transaction processing, or claims processing and so on, the provision of a safe harbour rule would definitely be

perceived as a breather to such industries and save them a substantial proportion of compliance costs. The software development and back office sectors that have witnessed numerous transfer pricing adjustments in the past years, whereby revenue authorities have determined the arm's length margin to be earned by such companies anywhere between 15-30%, were amongst the top aspirants who called for relief. The IT and IT enabled services as this domain is called has seen the maximum litigation in the transfer pricing audits ever since a decade and two years of introduction of Transfer pricing regulations in India. There were also representations with respect to contract R&D in IT and Pharma Sectors, Financial Transactions of outbound loans and corporate guarantees and OEM of Auto Ancillaries.

12.4.2.2 It must be stated that the Government has been alive to the voices of the various sections. In order to reduce the increasing number of transfer pricing audits and prolonged disputes, the Finance (No.2) Act, 2009 w.e.f 1.4.2009 inserted a new section 92CB to provide that determination of arm's length price under section 92C or Section 92CA shall be subject to safe harbour rules. Vide this amendment, the Government of India empowered the CBDT to make Safe Harbour rules. "Safe harbour" was defined to mean circumstances in which the income-tax authorities shall accept the transfer price declared by the assessee.

12.4.2.3 Thereafter, the issuance of the Safe Harbour Rules was examined and discussed at various points of time, but no finality could be reached. After various rounds of representations and consultations, and on the basis of recommendations of the Rangachary Committee, which consulted various stakeholders including sector related government departments, NASSCOM, CII, FICCI, ASSOCHAM, ICAI etc., the government

finally decided to frame Safe Harbour Rules in the following sectors in the first instance in September 2013 :-

- (i) IT Sector
- (ii) ITES Sector
- (iii) Contract R&D in the IT and Pharmaceutical Sector
- (iv) Financial transactions-Outbound loans
- (v) Financial Transactions-Corporate Guarantees
- (vi) Auto Ancillaries-Original Equipment Manufacturers

12.4.2.4 However, the general perception was that the safe harbour rules as prescribed provided for high margins and there were ambiguities in the classification of services. Based on some stakeholder responses and consultations, the CBDT has made some

amendments to the rules vide notification dated 7th June, 2017, which have definitely made significant improvements. In the following paragraphs, the provisions are briefly covered upon :-

12.4.3 India's Safe Harbour Rules

Rules 10TA to 10HD contain the detailed Safe Harbour Rules.

12.4.3.1 Rule 10 TA Definitions

For the purposes of this rule and rule 10TB to rule 10TG,—

(a) "accountant" means an accountant referred to in the Explanation below sub-section (2) of section 288 of the Act and includes any person recognised for undertaking cost certification by the Government of the country where the associated enterprise is registered or incorporated or any of its agencies, who fulfils the following conditions, namely:—

(I) if he is a member or partner in any entity engaged in rendering accountancy or valuation services then,—

(i) the entity or its affiliates have presence in more than two countries; and

(ii) the annual receipt of the entity in the year preceding the year in which cost certification is undertaken exceeds ten crore rupees;

(II) if he is pursuing the profession of accountancy individually or is a valuer then,—

(i) his annual receipt in the year preceding the year in which cost certification is undertaken, from the exercise of profession, exceeds one crore rupees; and

(ii) he has professional experience of not less than ten years.]

²*[(aa)] "contract research and development services wholly or partly relating to software development" means the following, namely:—*

(i) research and development producing new theorems and algorithms in the field of theoretical computer science;

(ii) development of information technology at the level of operating systems, programming languages, data management, communications software and software development tools;

- (iii) *development of Internet technology;*
 - (iv) *research into methods of designing, developing, deploying or maintaining software;*
 - (v) *software development that produces advances in generic approaches for capturing, transmitting, storing, retrieving, manipulating or displaying information;*
 - (vi) *experimental development aimed at filling technology knowledge gaps as necessary to develop a software programme or system;*
 - (vii) *research and development on software tools or technologies in specialised areas of computing (image processing, geographic data presentation, character recognition, artificial intelligence and such other areas);or*
 - (viii) *upgradation of existing products where source code has been made available by the principal³[except where the source code has been made available to carry out routine functions like debugging of the software];*
- (b) *"core auto components" means,—*
- (i) *engine and engine parts, including piston and piston rings, engine valves and parts cooling systems and parts and power train components;*
 - (ii) *transmission and steering parts, including gears, wheels, steering systems, axles and clutches;*
 - (iii) *suspension and braking parts, including brake and brake assemblies, brake linings, shock absorbers and leaf springs;*
- (c) *"corporate guarantee" means explicit corporate guarantee extended by a company to its wholly owned subsidiary being a non-resident in respect of any short-term or long-term borrowing.*

Explanation.—For the purposes of this clause, explicit corporate guarantee does not include letter of comfort, implicit corporate guarantee, performance guarantee or any other guarantee of similar nature;

⁴*[(ca) "employee cost" includes,—*

- (i) *salaries and wages;*
- (ii) *gratuities;*
- (iii) *contribution to Provident Fund and other funds;*
- (iv) *the value of perquisites as specified in clause (2) of section 17 of the Act;*
- (v) *employment related allowances, like medical allowance, dearness allowance, travel allowance and any other allowance;*

- (vi) *bonus or commission by whatever name called;*
 - (vii) *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;*
 - (viii) *expenses incurred on contractual employment of persons performing tasks similar to those performed by the regular employees;*
 - (ix) *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;*
- (x) *recruitment expenses;*
 - (xi) *relocation expenses;*
 - (xii) *training expenses;*
 - (xiii) *staff welfare expenses; and*
 - (xiv) *any other expenses related to employees or the employment;]*
- (d) *"generic pharmaceutical drug" means a drug that is comparable to a drug already approved by the regulatory authority in dosage form, strength, route of administration, quality and performance characteristics, and intended use;*
- (e) *"information technology enabled services" means the following business process outsourcing services provided mainly with the assistance or use of information technology, namely:—*
- (i) *back office operations;*
 - (ii) *call centres or contact centre services;*
 - (iii) *data processing and data mining;*
 - (iv) *insurance claim processing;*
 - (v) *legal databases;*
 - (vi) *creation and maintenance of medical transcription excluding medical advice;*
 - (vii) *translation services;*
 - (viii) *payroll;*
 - (ix) *remote maintenance;*
 - (x) *revenue accounting;*

- (xi) *support centres;*
 - (xii) *website services;*
 - (xiii) *data search integration and analysis;*
 - (xiv) *remote education excluding education content development; or*
 - (xv) *clinical database management services excluding clinical trials,*
- but does not include any research and development services whether or not in the nature of contract research and development services;*
- (f) *"intra-group loan" means loan advanced to wholly owned subsidiary being a non-resident, where the loan—*
- (i) *is sourced in Indian rupees;*
 - (ii) *is not advanced by an enterprise, being a financial company including a bank or a financial institution or an enterprise engaged in lending or borrowing in the normal course of business; and*
 - (iii) *does not include credit line or any other loan facility which has no fixed term for repayment;*
- (g) *"knowledge process outsourcing services" means the following business process outsourcing services provided mainly with the assistance or use of information technology requiring application of knowledge and advanced analytical and technical skills, namely:—*
- (i) *geographic information system;*
 - (ii) *human resources services;*
 - (iii) *engineering and design services;*
 - (iv) *animation or content development and management;*
 - (v) *business analytics;*
 - (vi) *financial analytics; or*
 - (vii) *market research,*
- but does not include any research and development services whether or not in the nature of contract research and development services;*
- [(ga) *"low value-adding intra-group services" means 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,—*
- (i) *are in the nature of support services;*

- (ii) *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;*
- (iii) *are not in the nature of shareholder services or duplicate services;*
- (iv) *neither require the use of unique and valuable intangibles nor lead to the creation of unique and valuable intangibles;*
- (v) *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*
- (vi) *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:—*
 - (i) research and development services;*
 - (ii) manufacturing and production services;*
 - (iii) information technology (software development) services;*
 - (iv) knowledge process outsourcing services;*
 - (v) business process outsourcing services;*
 - (vi) purchasing activities of raw materials or other materials that are used in the manufacturing or production process;*
 - (vii) sales, marketing and distribution activities;*
 - (viii) financial transactions;*
 - (ix) extraction, exploration, or processing of natural resources; and*
 - (x) insurance and reinsurance;]*
- (h) *"non-core auto components" mean auto components other than core auto components;*
- (i) *"no tax or low tax country or territory" means a country or territory in which the maximum rate of income-tax is less than fifteen per cent;*
- (j) *"operating expense" means the costs incurred in the previous year by the assessee in relation to the international transaction during the course of its normal operations including [costs relating to Employee Stock Option Plan or similar stock-based compensation provided for by the associated enterprises of the assessee to the employees of the assessee, reimbursement to associated enterprises of expenses incurred by the associated enterprises on behalf of the assessee, amounts recovered from associated enterprises on account of expenses incurred by the*

assessee on behalf of those associated enterprises and which relate to normal operations of the assessee and] depreciation and amortisation expenses relating to the assets used by the assessee, but not including the following, namely:—

- (i) interest expense;*
- (ii) provision for unascertained liabilities;*
- (iii) pre-operating expenses;*
- (iv) loss arising on account of foreign currency fluctuations;*
- (v) extraordinary expenses;*
- (vi) loss on transfer of assets or investments;*
- (vii) expense on account of income-tax; and*
- (viii) other expenses not relating to normal operations of the assessee:*

[Provided that reimbursement to associated enterprises of expenses incurred by the associated enterprises on behalf of the assessee shall be at cost:

Provided further that amounts recovered from associated enterprises on account of expenses incurred by the assessee on behalf of the associated enterprises and which relate to normal operations of the assessee shall be at cost;]

(k) "operating revenue" means the revenue earned by the assessee in the previous year in relation to the international transaction during the course of its normal operations [including costs relating to Employee Stock Option Plan or similar stock-based compensation provided for by the associated enterprises of the assessee to the employees of the assessee] but not including the following, namely:—

- (i) interest income;*
- (ii) income arising on account of foreign currency fluctuations;*
- (iii) income on transfer of assets or investments;*
- (iv) refunds relating to income-tax;*
- (v) provisions written back;*
- (vi) extraordinary incomes; and*
- (vii) other incomes not relating to normal operations of the assessee.*

(l) "operating profit margin" in relation to operating expense means the ratio of operating profit, being the operating revenue in excess of operating expense, to the operating expense expressed in terms of percentage;

(la) "relevant previous year" means the previous year relevant to the assessment year in which the option for safe harbour is validly exercised;]

(m) "software development services" means,—

- (i) business application software and information system development using known methods and existing software tools;
- (ii) support for existing systems;
- (iii) converting or translating computer languages;
- (iv) adding user functionality to application programmes;
- (v) debugging of systems;
- (vi) adaptation of existing software; or
- (vii) preparation of user documentation,

but does not include any research and development services whether or not in the nature of contract research and development services.]

12.4.3.2 Rule 10 TB - Eligible Assessee

(1) Subject to the provisions of sub-rules (2) and (3), the 'eligible assessee' means a person who has exercised a valid option for application of safe harbour rules in accordance with rule 10TE, and—

- (i) is engaged in providing software development services or information technology enabled services or knowledge process outsourcing services, with insignificant risk, to a non-resident associated enterprise (hereinafter referred as foreign principal);
- (ii) has made any intra-group loan;
- (iii) has provided a corporate guarantee;
- (iv) is engaged in providing contract research and development services wholly or partly relating to software development, with insignificant risk, to a foreign principal;
- (v) is engaged in providing contract research and development services wholly or partly relating to generic pharmaceutical drugs, with insignificant risk, to a foreign principal;
- (vi) is engaged in the manufacture and export of core or non-core auto components and where ninety per cent or more of total turnover during the relevant previous year is in the nature of original equipment manufacturer sales [; or]
- [(vii) is in receipt of low value-adding intra-group services from one or more members of its group.]

(2) For the purposes of identifying an eligible assessee, with insignificant risk, referred to in item (i) of sub-rule (1), the Assessing Officer or the Transfer Pricing Officer, as the case may be, shall have regard to the following factors, namely:—

- (a) *the foreign principal performs most of the economically significant functions involved, including the critical functions such as conceptualisation and design of the product and providing the strategic direction and framework, either through its own employees or through its other associated enterprises, while the eligible assessee carries out the work assigned to it by the foreign principal;*
 - (b) *the capital and funds and other economically significant assets including the intangibles required, are provided by the foreign principal or its other associated enterprises, and the eligible assessee is only provided a remuneration for the work carried out by it;*
 - (c) *the eligible assessee works under the direct supervision of the foreign principal or its associated enterprise which not only has the capability to control or supervise but also actually controls or supervises the activities carried out through its strategic decisions to perform core functions as well as by monitoring activities on a regular basis;*
 - (d) *the eligible assessee does not assume or has no economically significant realised risks, and if a contract shows that the foreign principal is obligated to control the risk but the conduct shows that the eligible assessee is doing so, the contractual terms shall not be the final determinant;*
 - (e) *the eligible assessee has no ownership right, legal or economic, on any intangible generated or on the outcome of any intangible generated or arising during the course of rendering of services, which vests with the foreign principal as evident from the contract and the conduct of the parties.*
- (3) *For the purposes of identifying an eligible assessee, with insignificant risk, referred to in items (iv) and (v) of sub-rule (1), the Assessing Officer or the Transfer Pricing Officer, as the case may be, shall have regard to the following factors, namely:—*
- (a) *the foreign principal performs most of the economically significant functions involved in research or product development cycle, including the critical functions such as conceptualisation and design of the product and providing the strategic direction and framework, either through its own employees or through its other associated enterprises while the eligible assessee carries out the work assigned to it by the foreign principal;*
 - (b) *the foreign principal or its other associated enterprises provides the funds or capital and other economically significant assets including intangibles required for research or product development and also provides a remuneration to the eligible assessee for the work carried out by it;*
 - (c) *the eligible assessee works under the direct supervision of the foreign principal or its other associated enterprise which has not only the capability to control or*

supervise but also actually controls or supervises research or product development, through its strategic decisions to perform core functions as well as by monitoring activities on a regular basis;

- (d) the eligible assessee does not assume or has no economically significant realised risks, and if a contract shows that the foreign principal is obligated to control the risk but the conduct shows that the eligible assessee is doing so, the contractual terms shall not be the final determinant;*
- (e) the eligible assessee has no ownership right, legal or economic, on the outcome of the research which vests with the foreign principal and is evident from the contract as well as the conduct of the parties.]*

12.4.3.3 Rule 10 TC Eligible International Transaction

Eligible international transaction' means an international transaction between the eligible assessee and its associated enterprise, either or both of whom are non-resident, and which comprises of:

- (i) provision of software development services;*
- (ii) provision of information technology enabled services;*
- (iii) provision of knowledge process outsourcing services;*
- (iv) advance of intra-group loan;*
- (v) provision of corporate guarantee, where the amount guaranteed,—*
 - (a) does not exceed one hundred crore rupees; or*
 - (b) exceeds one hundred crore rupees, and the credit rating of the associated enterprise, done by an agency registered with the Securities and Exchange Board of India, is of the adequate to highest safety;*
- (vi) provision of contract research and development services wholly or partly relating to software development;*
- (vii) provision of contract research and development services wholly or partly relating to generic pharmaceutical drugs;*
- (viii) manufacture and export of core auto components;*
 - (ix) manufacture and export of non-core auto components [; or]*
- [(x) receipt of low value-adding intra-group services from one or more members of its group,]*
by the eligible assessee.

12.4.3.4 Rule 10 TD Safe Harbour Provisions

As per Rule 10TD (1), (2) and (2A) read together, where an eligible assessee has entered into an eligible international transaction, the transfer price declared by the assessee in respect of each transaction shall be acceptable to income tax authorities as per the table below :-

Serial No.	Eligible International Transaction	Safe Harbour Threshold (Sub rule 2) AY 13-14 to AY 17-18*	Safe Harbour Threshold (Sub Rule 2A) AY 17-18* to AY 19-20
1	Software Development [Rule 10C(i)]	Operating Profit Margin % to Operating Expenses $\geq 20\%$ up to Turnover of Rs. 500 Crores and $\geq 22\%$ for Turnover of above Rs. 500 Crores	Operating Profit Margin % to Operating Expenses $\geq 17\%$ up to Turnover of Rs. 100 Crores and $\geq 18\%$ for Turnover of above Rs. 100 Crores up to Rs. 200 Crores
2	IT enabled Services [Rule 10C(ii)]	Operating Profit Margin % to Operating Expenses $\geq 20\%$ up to Turnover of Rs. 500 Crores and $\geq 22\%$ for Turnover of above Rs. 500 Crores	Operating Profit Margin % to Operating Expenses $\geq 17\%$ up to Turnover of Rs. 100 Crores and $\geq 18\%$ for Turnover of above Rs. 100 Crores up to Rs. 200 Crores
3	Knowledge Process Outsourcing Services [Rule 10C(iii)]	Operating Profit Margin % to Operating Expenses $\geq 25\%$	Value of international transaction \leq Rs. 200 Crores and Operating Profit Margin in the eligible international transaction in relation to operating expense is - (i) $\geq 24\%$. and the Employee Cost in relation to the Operating Expense is $\geq 60\%$.

			(ii) $\geq 21\%$ and the Employee Cost in relation to the Operating Expense is $\geq 40\%$ and $\leq 60\%$ or (iii) $\geq 18\%$ per cent and the Employee Cost in relation to the Operating Expense $\leq 40\%$.
Serial No.	Eligible International Transaction	Safe Harbour Threshold (Sub rule 2) AY 13-14 to AY 17-18*	Safe Harbour Threshold (Sub Rule 2A) AY 17-18* to AY 19-20
4	Intra-Group Loans to Associate Enterprises [Rule 10C(iv)]	Interest Rate as on 30th June of the relevant PY= SBI Base Rate plus 150 points up to loan of Rs. 50 Crores and plus 300 points for loan exceeds Rs. 50 Crores	Interest rate linked to CRISIL rating, if available and If CRISIL rating is not available, then for loans up to Rs. 100 Crores Interest Rate as on 30 th June of the relevant PY = SBI Base Rate plus 425 points. If total loans to AE exceeds Rs. 100 Crores and there is no credit rating, assessee is not eligible for safe harbour provisions
5	Intra-group loans (denominated in foreign currency) [Rule 10C(iv)]	No specific provision	Interest rate linked to CRISIL rating, if available and If CRISIL rating is not available, then for loans up to Rs. 100 Crores Interest Rate as on 30 th June of the relevant PY LIBOR plus 400 points If total loans to AE exceeds Rs. 100 Crores and there is no credit rating, assessee is not eligible for safe harbour provisions
6	Inter Corporate Guarantee not exceeding Rs. 100 Crores [Rule 10C(va)]	Commission or Fee @ 2% or more per annum on the amount guaranteed	Not less than 1% per annum

7	Inter Corporate Guarantee exceeds Rs. 100 Crores and credit rating equivalent to highest safety by an agency accredited to SEBI [Rule 10C{va}]	Commission or Fee @ 1.75% or more per annum on the amount guaranteed	Not less than 1% per annum
Serial No.	Eligible International Transaction	Safe Harbour Threshold (Sub rule 2) AY 13-14 to AY 17-18*	Safe Harbour Threshold (Sub Rule 2A) AY 17-18* to AY 19-20
7	Contract R&D relating wholly or partly to Software Development [Rule 10C{vi}]	Operating Profit Margin % to Operating Expenses $\geq 30\%$	Operating Profit Margin % to Operating Expenses $\geq 24\%$, for international transactions \leq Rs. 200 Crores.
8	Contract R&D relating wholly or partly to generic pharmaceutical drugs [Rule 10C{vii}]	Operating Profit Margin % to Operating Expenses $\geq 29\%$	Operating Profit Margin % to Operating Expenses $\geq 24\%$, for international transactions \leq Rs. 200 Crores.
9	Manufacture and export of core auto components [Rule 10C{viii}]	Operating Profit Margin % to Operating Expenses $\geq 12\%$	Operating Profit Margin % to Operating Expenses $\geq 12\%$
10	Manufacture and export of Non Core Auto Components [Rule 10C{ixi}]	Operating Profit Margin % to Operating Expenses $\geq 8.5\%$	Operating Profit Margin % to Operating Expenses $\geq 8.5\%$
11	Receipt of low value adding intra-group services (Value not exceeding Rs. 10 Crores) [Rule 10C{x}]	No specific provision	Entire Value of International Transaction with mark-up not $> 5\%$ subject to certificate from accountant about method of cost pooling

* Where an assessee is eligible for AY 2017-18 under both the options, the assessee shall have the right to choose the option which is most beneficial to him. (Rule 3A)

12.3.4.5 Rule 10 TE Procedure for availing the option of Safe Harbour Provisions

An eligible assessee choosing the option to be governed by the safe harbour provisions will be required to file a prescribed return in Form 3CEG. An eligible assessee has an option not to be governed by the safe harbour provisions. In such a case, the regular TP provisions contained in Section 92C and 92CA read with the applicable rules shall apply for the determination of ALP.

The text of Rule 10 TE is reproduced below :-

(1) For the purposes of exercise of the option for safe harbour, the assessee shall furnish a Form 3CEFA, complete in all respects, to the Assessing Officer on or before the due date specified in Explanation 2 below sub-section (1) of section 139 for furnishing the return of income for—

- (i) the relevant assessment year, in case the option is exercised only for that assessment year; or*
- (ii) the first of the assessment years, in case the option is exercised for more than one assessment year:*

Provided that the return of income for the relevant assessment year or the first of the relevant assessment years, as the case may be, is furnished by the assessee on or before the date of furnishing of Form 3CEFA.

(2) The option for safe harbour validly exercised shall continue to remain in force for the period specified in Form 3CEFA or a period of five years whichever is less:

Provided that the assessee shall, in respect of the assessment year or years following the initial assessment year, furnish a statement to the Assessing Officer before furnishing return of income of that year, providing details of eligible transactions, their quantum and the profit margins or the rate of interest or commission shown:

Provided further that an option for safe harbour shall not remain in force in respect of any assessment year following the initial assessment year, if—

- (i) the option is held to be invalid for the relevant assessment year by the Transfer Pricing Officer under sub-rule (11) or by the Commissioner under sub-rule (8) in respect of an objection filed by the assessee against the order of the Transfer Pricing Officer under sub-rule (11), as the case may be; or*
- (ii) the eligible assessee opts out of the safe harbour, for the relevant assessment year, by furnishing a declaration to that effect, to the Assessing Officer:*

[Provided also that in case of the option for safe harbour validly exercised under sub-rule (2A) of rule 10TD, the word "three" shall be substituted for "five".]

(3) On receipt of Form 3CEFA, the Assessing Officer shall verify whether—

- (i) the assessee exercising the option is an eligible assessee; and
- (ii) the transaction in respect of which the option is exercised is an eligible international transaction,

before the option for safe harbour by the assessee is treated to be validly exercised.

(4) Where the Assessing officer doubts the valid exercise of the option for the safe harbour by an assessee, he shall make a reference to the Transfer Pricing Officer for determination of the eligibility of the assessee or the international transaction or both for the purposes of the safe harbour.

(5) For the purposes of sub-rule (4) and sub-rule (10), the Transfer Pricing Officer may require the assessee, by notice in writing, to furnish such information or documents or other evidence as he may consider necessary, and the assessee shall furnish the same within the time specified in such notice.

(6) Where—

- (a) the assessee does not furnish the information or documents or other evidence required by the Transfer Pricing Officer; or
- (b) the Transfer Pricing Officer finds that the assessee is not an eligible assessee; or
- (c) the Transfer Pricing Officer finds that the international transaction in respect of which the option referred to in sub-rule (1) has been exercised is not an eligible international transaction,

the Transfer Pricing Officer shall, by order in writing, declare the option exercised by the assessee under sub-rule (1) to be invalid and cause a copy of the said order to be served on the assessee and the Assessing Officer:

Provided that no order declaring the option exercised by the assessee to be invalid shall be passed without giving an opportunity of being heard to the assessee.

(7) If the assessee objects to the order of the Transfer Pricing Officer under sub-rule (6) or sub-rule (11) declaring the option to be invalid, he may file his objections with the Commissioner, to whom the Transfer Pricing Officer is subordinate, within fifteen days of receipt of the order of the Transfer Pricing Officer.

(8) On receipt of the objection referred to in sub-rule (7), the Commissioner shall after providing an opportunity of being heard to the assessee pass appropriate orders in respect of the validity or otherwise of the option exercised by the assessee and cause a copy of the said order to be served on the assessee and the Assessing Officer.

(9) In a case where option exercised by the assessee has been held to be valid, the Assessing officer shall proceed to verify whether the transfer price declared by the

assessee in respect of the relevant eligible international transactions is in accordance with the circumstances specified in sub-rule (2) [or, as the case may be, sub-rule (2A)] of rule 10 TD and, if it is not in accordance with the said circumstances, the Assessing Officer shall adopt the operating profit margin or rate of interest or commission specified in sub-rule (2) [or, as the case may be, sub-rule (2A)] of rule 10TD.

(10) Where the facts and circumstances on the basis of which the option exercised by the assessee was held to be valid have changed and the Assessing Officer has reason to doubt the eligibility of an assessee or the international transaction for any assessment year other than the initial Assessment Year falling within the period for which the option was exercised by the assessee, he shall make a reference to the Transfer Pricing Officer for determination of eligibility of the assessee or the international transaction or both for the purpose of safe harbour.

Explanation.—For purposes of this sub-rule the facts and circumstances include:—

- (a) functional profile of the assessee in respect of the international transaction;*
- (b) the risks being undertaken by the assessee;*
- (c) the substantive contractual conditions governing the role of the assessee in respect of the international transaction;*
- (d) the conduct of the assessee as referred to in sub-rule (2) or sub-rule (3) of rule 10TB; or*
- (e) the substantive nature of the international transaction.*

(11) The Transfer Pricing Officer on receipt of a reference under sub-rule (10) shall, by an order in writing, determine the validity or otherwise of the option exercised by the assessee for the relevant year after providing an opportunity of being heard to the assessee and cause a copy of the said order to be served on the assessee and the Assessing Officer.

(12) Nothing contained in this rule shall affect the power of the Assessing Officer to make a reference under section 92CA in respect of international transaction other than the eligible international transaction.

(13) Where no option for safe harbour has been exercised under sub-rule (1) by an eligible assessee in respect of an eligible international transaction entered into by the assessee or the option exercised by the assessee is held to be invalid, the arm's length price in relation to such international transaction shall be determined in accordance with the provisions of sections 92C and 92CA without having regard to the profit margin or the rate of interest or commission as specified in sub-rule (2) [or, as the case may be, sub-rule (2A)] of rule 10TD.

(14) For the purposes of this rule,—

- (i) no reference under sub-rule(4) shall be made by an Assessing Officer after expiry of a period of two months from the end of the month in which Form 3CEFA is received by him;*
 - (ii) no order under sub-rule (6) or sub-rule (11) shall be passed by the Transfer Pricing Officer after expiry of a period of two months from the end of the month in which the reference from the Assessing officer under sub-rule(4) or sub-rule (10), as the case may be, is received by him;*
 - (iii) the order under sub-rule (8) shall be passed by the Commissioner within a period of two months from the end of the month in which the objection filed by the assessee under sub-rule (7) is received by him.*
- (15) If the Assessing Officer or the Transfer Pricing Officer or the Commissioner, as the case may be, does not make a reference or pass an order, as the case may be, within the time specified in sub-rule (14), then the option for safe harbour exercised by the assessee shall be treated as valid.]*

12.3.4.6 Rule 10 TF Safe Harbour rules not applicable in certain cases

The safe harbour provisions shall not apply in respect of eligible international transactions entered into with an associated enterprise located in any country or territory notified under section 94A or in a no tax or low tax country or territory. The term “No tax or low tax country or territory” means a country or territory in which maximum marginal rate of income-tax is zero or less than 15 per cent in respect of the Associated Enterprise.

12.3.4.7 Rule 10TG MAP Procedure not to apply

Where transfer price in relation to an eligible international transaction declared by an eligible assessee is accepted by the income-tax authorities under section 92CB under the Safe Harbour provisions, the assessee shall not be entitled to invoke mutual agreement procedure under an agreement for avoidance of double taxation entered into with a country or territory outside India as referred to in sections 90 or 90A.

12.3.4.8 Safe Harbour Rules for Specified Domestic Transactions

The Safe Harbour Provisions for certain Specified Domestic Transactions are contained in Rules 10TH to 10THD. These are effective as under

10TH. Definitions.— *For the purposes of this rule and rules 10THA to 10THD,—*

- (a) *"Appropriate Commission" shall have the same meaning as assigned to it in sub-section (4) of section 2 of the Electricity Act, 2003 (36 of 2003);*
- (b) *"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);*

10THA. *The 'eligible assessee' means a person who has exercised a valid option for application of safe harbour rules in accordance with the provisions of rule 10THC, [and—*

- (i) *is a Government company engaged in the business of generation, [supply,] transmission or distribution of electricity; or*
- (ii) *is a co-operative society engaged in the business of procuring and marketing milk and milk products.*

10THB. *The "Eligible specified domestic transaction" means a specified domestic transaction undertaken by an eligible assessee and which comprises of:—*

- (i) *supply of electricity or*
- (ii) *transmission of electricity; or*
- (iii) *wheeling of electricity; or*
- (iv) *purchase of milk or milk products by a co-operative society from its members.]*

10THC. (1) *Where an eligible assessee has entered into an eligible specified domestic transaction in any previous year relevant to an assessment year and the option exercised by the said assessee is treated to be validly exercised under rule 10THD, the transfer price declared by the assessee in respect of such transaction for that assessment year shall be accepted by the income-tax authorities, if it is in accordance with the circumstances as specified in sub-rule (2).*

(2) *The circumstances referred to in sub-rule (1) in respect of the eligible specified domestic transaction specified in column (2) of the Table below shall be as specified in the corresponding entry in column (3) of the said Table:—*

Sr No.	Eligible Specified Domestic Transaction	Circumstances
1	2	3
1	Supply of electricity, transmission of electricity, wheeling of electricity referred to [in clause (i), (ii) or (iii) of rule 10THB, 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 the tariff is approved] by the Appropriate Commission in accordance with the provisions of the Electricity Act, 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— (i) the said rate is irrespective of,— a) Qty of Milk Produced b) % shares held by members of co-operative society c) Voting power held by the members (ii) such prices are routinely declared by the co-operative society in a transparent manner and are available in public domain

(3) No comparability adjustment and allowance under the second proviso to sub-section (2) of section 92C shall be made to the transfer price declared by the eligible assessee and accepted under sub-rule (1).

(4) The provisions of sections 92D and 92E in respect of a specified domestic transaction shall apply irrespective of the fact that the assessee exercises his option for safe harbour in respect of such transaction.

12.3.4.9 Way forward for Safe Harbour

- a) Advantage SME :- The revised safe harbor rules provide a definitive advantage to small and medium enterprises (SME) since there is now a cap on the value of transactions, keeping out larger companies. While these margins may not yet reflect arm's length mark-ups, paying taxes at a rate that's higher by a few percentage points would still be a better option to avoidable litigation, unless the impact of the differences are grossly unfavourable to the tax payer. This judgement would depend upon the facts and circumstances of the individual case.

- b) Financial transactions:- Indian MNCs expanding overseas faced uncertainty and controversy with respect to transfer pricing considerations in their funding arrangements for overseas expansion. Equity was not and is not always a preferred route and with respect to loans and guarantees, the tax authorities were benchmarking loans given by Indian MNCs to their overseas subsidiaries, even in foreign currencies, with the State Bank of India's base rate or prime lending rate. The guarantees were subject to a high guarantee commission of 3-7 percent. The earlier safe harbour rules were not very useful.

In that sense, the revised safe harbour rules are a great step forward. The safe harbour guarantee commission has been reduced from 2% to 1%. Considering the fact that safe harbour cannot be equated with arm's length price, a 1% guarantee commission seems reasonable and good for SMEs again to avoid litigation.

For outbound loans, the safe harbour rates now do take into consideration the currency of loans and credit rating of the AE. However, the hitch here is that of procuring a credit rating for an overseas associated AE, should the taxpayer opt for safe harbour. The taxpayer would have to do a proper cost benefit analysis of obtaining the credit rating vis-à-vis the safe harbour provisions.

- c) Low Value-Adding Intra-group services : The extension of Safe Harbour Rules to Low Value Adding Intra-group services has been welcomed. This is in line with BEPS Action Plan 8-10 guidelines. But the scope of the benefits is limited, as it does not extend to BPO and KPO services.

Properly designed safe harbour provisions will significantly reduce compliance complexities by eliminating data collection and associated documentation requirements in exchange for the taxpayer pricing qualifying transactions within the parameters set by the safe harbour. Taxpayers should evaluate the impact of these rules on their inter-company pricing arrangements and consider options to steer clear of and avoid TP controversy

Overall, the revision of Safe Harbour rates recently and the proactive measures initiated by the tax authorities coupled with a more open and transparent consultative approach definitely point to a safer ground leading through these harbours.

CHAPTER 13

EMERGING SCENARIO, CHALLENGES & WAY FORWARD

13.1 THIN CAPITALISATION

13.1.1 Concept of Thin Capitalisation

13.1.1.1 A company is said to be thinly capitalized when its capital is made up of a much greater proportion of debt than equity, ie. its gearing or leverage, is too high. This is perceived to create problems for two classes of people :-

- consumers and creditors bear the solvency risk of the company, which has to repay the bulk of its capital with interest; and
- revenue authorities, who are concerned about abuse by excessive interest deductions.

12.1.1.2 An entity (which may be part of a group) may be said to be thinly capitalized when it has excessive debt in relation to its arm's length borrowing capacity, leading to the possibility of excessive interest deductions. An important parallel consideration is whether the rate of interest is one which would have been obtained at arm's length rate while comparing from independent lender as a standalone entity.

13.1.2 Thin Capitalisation in International Transactions

13.1.2.1 In international transactions, the typical method of tax avoidance employed is the use of a thinly capitalized subsidiary that borrows from the parent or an off-shore vehicle, with the lender being in a low tax jurisdiction.

13.1.2.2 The main purpose of such an exercise is to shift profits from the country where profits are made to a tax haven. Many countries have introduced withholding taxes on interest payments made by the thinly capitalized company to counter this shifting of profits. Thin capitalization rules usually goes beyond just the levels of debt and equity.

13.1.2.3 Thin Capitalization rules can apply in situations where:

- A security is issued, which would not have been issued without a special relationship between the parties (tax deductions for interest on loans from group entities are stopped where the borrower would not have been able to sustain the debit on its own);

- A loan is made because of a guarantee given to the lender by a party related to the borrower.

12.1.2.4 The expression 'thin capitalisation' is commonly used to describe a situation where the proportion of debt to equity exceeds certain limits. Thin capitalisation legislation is a tool used by tax authorities to prevent the apparent leakage of tax revenues as a consequence of the way in which a company is financed. Financing a resident company with debt is considerably more tax efficient than financing with equity. The difference in tax treatment is an incentive to provide capital to the company in the form of debt instead of equity. If there are no thin capitalisation rules, it is relatively easy for a non-resident to advance funds to a resident company in a way that is christened as debt, so that the "interest payments" are straightaway tax deductible. If controlling shareholders in particular are indifferent to the form in which their investment is structured, they are more likely to be guided by tax considerations when structuring the legal form of their investment.

13.1.3 Response of tax authorities to thin capitalisation

13.1.3.1 The object of Thin Capitalisation Regulations is to prevent the use of excessive 'captive' or 'in-house' or 'friendly' loans which would be detrimental to the revenue of home country (where the borrower is resident), as the profits to this extent would effectively be shifted to the foreign lender, as the interest payments would be tax deductible in the home country.

13.1.3.2 Therefore many countries through Thin Capitalisation Regulations ensure that the deductions for interest on debt owed to connected parties, is allowable in the home country as a deduction in the hands of the borrower, only if within the permissible limits. While financial leverage has, on its own standing, its own value, this is definitely impaired when interest is not deductible either wholly or partially through these Thin Capitalisation Regulations.

13.1.4 Brief Comparative analysis of Thin Capitalisation Rules by different jurisdictions

13.1.4.1 A wide variety of methods are used to deal with thin capitalisation in various countries. These approaches range from complex legislation to no specific thin capitalisation legislation at all.

Within this range four general approaches may be distinguished :-

- (1) the fixed ratio approach
- (2) the subjective approach
- (3) application of rules concerning hidden profit distributions; and
- (4) the 'no rules' approach.

The emphasis on the above factors or combinations of factors often varies from country to country. Measures taken by countries to limit excessive debt financing by shareholders are either based on specific legislation or administrative rules or based on evolving practice.

13.1.4.2 Under the 'fixed ratio' approach, if the debtor company's total debt exceeds a certain proportion of its equity capital, the interest on the loan or the interest on the excess of the loan over the approved proportion is automatically disallowed and/or treated as a dividend. The ratio may be used as a safe-haven rule. It can be seen that these countries which use the fixed ratio approach usually have specific thin capitalisation legislation.

13.1.4.3 The basis of the 'subjective' approach is to look at the terms and nature of the contribution and the circumstances in which the financing has been made and to decide, in the light of all facts and circumstances, whether the real nature of the contribution is debt or equity. Some countries using the subjective approach have specific legislation. Other countries use more general rules if these are available, such as general anti-avoidance legislation, provisions on 'abuse of law', provisions on substance over form.

13.1.4.4 There are also countries that apply 'hidden profit distribution' rules to reclassify interest as dividends. In some of these countries the hidden profit distribution rules are applied along with specific rules which limit the deduction of interest on loans from shareholders. The general principles of transfer pricing rules may also play a role in this respect. The underlying idea is that if the loan exceeds what would have been lent in an arm's-length situation, the lender must be considered to have an interest in the profitability of the enterprise and the loan, or any amount in excess of the arm's-length amount, must be seen as being designed to procure share in the profits.

13.1.4.5 While some countries, like France, have detailed regulations, others like the UK, do not specify a debt to equity ratio, but merely give the right to the Inland Revenue to challenge the interest deductions keeping in view the arm's-length principle.

13.1.5 India and Thin Capitalisation

13.1.5.1 As of now India does not have any specific Thin Capitalisation Rules, other than provisions in GAAR.

13.1.5.2 In one of the leading case on the subject, it was held that **in absence of “thin capitalization rules”, interest paid to shareholders for loans cannot be disallowed despite capital-structure tax-planning resorted by the tax payer.**

13.1.5.3 This was the decision by the Income Tax Appellate Tribunal (ITAT) in the case of Besix Kier Dabhol SA v DDIT (131 ITD 299)

The assessee, a Belgium company, was set up to execute a project in India and had a PE in India. The assessee's share capital of Rs. 38 lakhs was owned by two foreign companies (shareholders) in the ratio of 60:40. The said two shareholders also advanced loans to the assessee aggregating Rs. 94.10 crores in the same ratio in which they held shares in the assessee i.e. 60:40. **The assessee's debt-equity ratio was 248:1.** The assessee paid interest of Rs. 5.73 crores on the loans obtained from its shareholders and claimed that as a deduction. The AO disallowed the claim on the ground that **though the moneys were borrowed from the shareholders, in view of the abnormal debt-equity ratio, they were to be treated as capital / loan taken from the Head Office** and (ii) that as the RBI approval did not permit the PE to borrow, the loan was in contravention of law. This was upheld by the CIT (A). On appeal by the assessee, HELD allowing the appeal:

- (i) Under Article 7 (1) & 7(3)(b) of the India-Belgium DTAA, the profits of the assessee as are attributable to the PE are chargeable to tax in India. **In determining such profits, all expenses are allowable subject to limitations specified in the DTAA and the Indian laws.** The only limitation is that notional interest paid by a branch to its HO is not allowable.
- (ii) **This limitation does not apply as the assessee borrowed from an outside party, i.e. its shareholders;**
- (iii) **The argument of the revenue that the abnormal debt-equity ratio attracts the “Thin Capitalization Rule” and that the “debt” should be characterized as “equity” for purposes of considering whether interest is deductible is not acceptable.** Several countries have detailed “thin capitalization rules” (e.g. Belgium). However, there are no such rules in India though the DTC 2010 has proposed this vide s. 123(1)(f). In the absence of specific “thin capitalization” rules, it is not open to the revenue to characterize debt as equity and disallow the interest (principles in **Azadi Bachao Andolan** 263 ITR 706 (SC))

followed). The domestic law limitation of Art 7(3) refers to the Source Country & not the Residence Country;

(iv Imposing the “thin capitalization rules” on the assessee when domestic companies are not subject to such rules will violate the “**non-discrimination**” provision in Art. 24(5);

(v) The argument that the finance structure should be treated as a “colourable device” and disregarded is not acceptable because **there is no anti-abuse provision in the DTAA and in the absence of specific language (such as the proposed s. 129(9) of DTC 2010), the DTAA cannot be overridden by the Act;**

13.1.5.4 With respect to thin capitalization, an entirely new concept of re-characterization of debt into equity or vice versa as introduced in General Anti Avoidance Rules (GAAR) which is effective from AY 2014-15. The emphasis is on the term “vice versa” which means that equity can also be classified into debt. Such reclassification including the circumstances in which this could result will be a completely new concept to which this complex financial world may not have a ready answer. Our accounting bodies will soon need to look at the impact of such a re-characterization which is distinctly provided in the wordings of the GAAR, that can be invoked by the tax authorities in the event of an impermissible avoidance arrangement within the meaning of GAAR.

13.1.6 Challenges before Domestic Entities

13.1.6.1 Domestic entities having international transactions are exposed to international financing pattern and the global taxation trends. For these companies, the concept of thin capitalization is going to add a new variable to the financial and tax structuring.

13.1.6.2 The greater challenge is however going to be faced by pure domestic companies in the SME sector, where there is a reasonable amount of related party transactions much beyond the stipulated the threshold levels of Rs. 20 Crores.

13.1.6.3.1 When there are many SME companies / organizations in a group, a great deal of planning would have to be done to plan and implement the capital structure in such a way that the group goals are achieved without falling into the erring side of the tax net.

13.1.6.3.2 Quite a few companies in the SME sector are known to be facing finance problems and are struggling to obtain debt financing at competitive rates. In such cases, it is usual for the companies to arrange finance from related parties (including group

companies) in the form of unsecured loans carrying structured interest rates rather than equity to meet the promoter's contribution requirements for obtaining maximum possible bank finance. The lending banks treat this "structured debt" as "Quasi Equity" and fit it as "Equity" in their assessment for "Debt Equity Ratio". If this structure is viewed by the tax authorities under the lens of GAAR and read with the domestic transfer pricing regulations and the interest charged is below the bank rate, the tax authorities can under this situation impose tax on the differential interest or even treat this "structured debt" as equity and disallow the interest deduction claimed by the borrowing company. All these could lead to uncertainties and unpredictable litigations.

13.1.6.4 There can be widespread ambiguity on what is the ideal or safe debt equity ratio which would be acceptable to the tax authorities. When we have multiple regulators giving different interpretations and meanings to otherwise established accounting definitions, the problem becomes more complex. Further complicating this would be the GAAR driven as it would be by revenue collecting considerations, the emerging confusion is going to be more and more difficult to comprehend particularly to the domestic SME sector which is in dire need of greater flexibility and openness.

13.1.6.5 The safe harbour provisions covering certain category of international transactions are already in place, including the threshold levels. A Small beginning has also been made with respect to Specified Domestic Transactions. Perhaps the solution lies in extending the safe harbour provisions with respect to this emerging subject on a proactive basis at the appropriate time before it becomes a contentious matter.

13.2 ETHICS IN TRANSFER PRICING

13.2.1 Transfer pricing set by multinational enterprise (MNE) for Management Accounting and decision making purposes without any impact on taxation is purely for internal reasons. But there are often strong external motivations to engage in transfer price manipulation (over/under invoicing)

13.2.2 MNEs represent a very large share of world trade is particularly important because these firms have the ability to set their own prices for transactions within the MNE group. In 2009, MNE value-added activities reached a "historic high of 11 per cent of world gross domestic product" (UNCTAD, 2010, p. 16). In 2010, 42 of the 100 largest economies in the world were MNEs, not countries. Total revenues of the five largest MNEs were larger than the combined GDP of the world's poorest 110 countries.

13.2.3 The primary reason why governments have developed the arm's length standard is that they do not believe that MNEs set their transfer prices at arm's length, but rather

engage in widespread *transfer price manipulation (TPM)*, that is, the over or under-invoicing of prices for intra-firm transactions.

13.2.4 While national tax authorities and non-governmental organizations view transfer pricing as suspicious at best and illegal and immoral at worst, transfer pricing is viewed by MNE executives and the tax planning industry as both legal and morally acceptable. (Hand, 1934, 1947; Friedman, 1970; Duhaime.org, 2011; Money Blue Book, 2011). Since the goal of the firm is to maximize the returns of its shareholders and transfer pricing can raise the MNE's after-tax profits on a worldwide basis, TPM is a valued activity for the MNE because it creates shareholder wealth.

13.2.5 Sikka and Willmott (2010) have opined that *"The use of transfer pricing to avoid taxes poses challenges to professional and corporate claims of acting as socially responsible corporations. It is difficult to reconcile claims of social responsibility with everyday corporate routines and processes that divert tax payments away from society to shareholders.Such practices may enrich a few people but also deprive millions of people of clean water, sanitation, education, healthcare, pensions, security, transport and public goods."*

13.2.6 According to Kramer (2001) there are two types of tax evasion: substance over form and abusive or sham transactions. In substance over form, the MNE may arrange its activities specifically so as to save tax, for example, by creating facts so as to take advantage of a favourable tax provision or to create facts so as to avoid the clear wording of an unfavorable tax position, thus, there is no economic substance behind the activity. In such cases, the tax authority may look through the transaction to the economic substance behind it, or look through the literal interpretation of the legal provision to assess the intention of the tax provision. Many tax authorities now explicitly keep the right to re-characterize transactions when the form and substance of the transaction differ significantly.

13.2.7 With abusive or sham transactions, the creation of facts are usually purely motivated for reducing tax liability and lacking any commercial substance. In such a situation, the tax authority is likely to disregard the transaction. More generally, governments may have anti-abuse rules where, if the MNE attempted to circumvent the tax code by setting up fictitious arrangements so as to save tax, these are treated as an abuse of the tax law provisions and penalties are levied in addition to the transactions being re-characterized

13.2.8 To sum up the situation, ethical issues arise when transfer pricing is done in a manner which prima facie lacks any commercial sense except for tax avoidance. Complex Anti-Avoidance Regulations have been framed by many tax jurisdictions, including India to counter this.

13.3 GENERAL ANTI AVOIDANCE REGULATIONS (GAAR)

13.3.1 General Anti Avoidance Regulations (GAAR) first found its place in the Direct Taxes Code (DTC) Bill 2009. After its introduction, a revised discussion paper on DTC was released in June 2010 proposing some safeguards based on the feedback of various stakeholders, based on which the Direct Taxes Code Bill (DTC 2010) incorporating these safeguards were released. DTC 2010 was then referred to the Standing Committee on Finance (SCF), which gave its report on 9th March, 2012.

13.3.2 The Finance Bill, 2012 announced on 16th March, 2012 incorporated the GAAR provisions. But the implementation of the same was deferred, following concerns raised by various stakeholders and the SCF. However, GAAR has now become effective from with effect from Assessment Year 2018-19.

13.3.3 The gist of the provisions relating to GAAR as contained in Chapter X-A consisting of Sections 95 to 102A and 144BA of the Income Tax Act, which are covered below :-

13.3.4 Applicability of General Anti-Avoidance Rule.

Section 95 provides that *Notwithstanding anything contained in the Act, an arrangement entered into by an assessee may be declared to be an impermissible avoidance arrangement and the consequence in relation to tax arising therefrom may be determined subject to the provisions of this Chapter. Further it has been explained that the provisions of this Chapter may be applied to any step in, or a part of, the arrangement as they are applicable to the arrangement.*

13.3.4.1 Impermissible avoidance arrangement.

Section 96 defines the term “impermissible avoidance arrangement” Accordingly, (1) *An impermissible avoidance arrangement means an arrangement, the main purpose of which is to obtain a tax benefit, and it—*

- (a) creates rights, or obligations, which are not ordinarily created between persons dealing at arm's length;*

- (b) results, directly or indirectly, in the misuse, or abuse, of the provisions of this Act;
- (c) lacks commercial substance or is deemed to lack commercial substance under section 97, in whole or in part; or
- (d) is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for bona fide purposes.

(2) An arrangement shall be presumed, unless it is proved to the contrary by the assessee, to have been entered into, or carried out, for the main purpose of obtaining a tax benefit, if the main purpose of a step in, or a part of, the arrangement is to obtain a tax benefit, notwithstanding the fact that the main purpose of the whole arrangement is not to obtain a tax benefit.

13.3.4.2 Arrangement to lack commercial substance.

According to Section 97, an arrangement shall be deemed to lack commercial substance if

- (a) the substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part; or
- (b) it involves or includes—
 - (i) round trip financing;
 - (ii) an accommodating party;
 - (iii) elements that have effect of offsetting or cancelling each other; or
 - (iv) a transaction which is conducted through one or more persons and disguises the value, location, source, ownership or control of funds which is the subject matter of such transaction; or
- (c) it involves the location of an asset or of a transaction or of the place of residence of any party which is without any substantial commercial purpose other than obtaining a tax benefit (but for the provisions of this Chapter) for a party; or
- (d) it does not have a significant effect upon the business risks or net cash flows of any party to the arrangement apart from any effect attributable to the tax benefit that would be obtained (but for the provisions of this Chapter).

The terms “round trip financing” and “an accommodating party” have been defined in subsections 2 and 3 of Section 97.

13.3.4.3 Consequences of impermissible avoidance arrangement.

Section 98 provides that *If an arrangement is declared to be an impermissible avoidance arrangement, then, the consequences, in relation to tax, of the arrangement, including denial of tax benefit or a benefit under a tax treaty, shall be determined, in such manner*

as is deemed appropriate, in the circumstances of the case, including by way of but not limited to the following, namely:—

- (a) disregarding, combining or recharacterising any step in, or a part or whole of, the impermissible avoidance arrangement;*
 - (b) treating the impermissible avoidance arrangement as if it had not been entered into or carried out;*
 - (c) disregarding any accommodating party or treating any accommodating party and any other party as one and the same person;*
 - (d) deeming persons who are connected persons in relation to each other to be one and the same person for the purposes of determining tax treatment of any amount;*
 - (e) reallocating amongst the parties to the arrangement—
 - (i) any accrual, or receipt, of a capital nature or revenue nature; or*
 - (ii) any expenditure, deduction, relief or rebate;**
 - (f) treating—
 - (i) the place of residence of any party to the arrangement; or*
 - (ii) the situs of an asset or of a transaction,
at a place other than the place of residence, location of the asset or location of the transaction as provided under the arrangement; or**
 - (g) considering or looking through any arrangement by disregarding any corporate structure.*
- (2) For the purposes of sub-section (1),—*
- (i) any equity may be treated as debt or vice versa;*
 - (ii) any accrual, or receipt, of a capital nature may be treated as of revenue nature or vice versa; or*
 - (iii) any expenditure, deduction, relief or rebate may be recharacterised.*

13.3.4.4 Treatment of connected person and accommodating party.

Section 99 provides how a connected person and accommodating party will be treated. *In determining whether a tax benefit exists,—*

- (i) the parties who are connected persons in relation to each other may be treated as one and the same person;*
- (ii) any accommodating party may be disregarded;*
- (iii) the accommodating party and any other party may be treated as one and the same person;*
- (iv) the arrangement may be considered or looked through by disregarding any corporate structure.*

13.3.4.5 Application of GAAR provisions and framing of guidelines.

Section 100 provides that *the GAAR provisions shall apply in addition to, or in lieu of, any other basis for determination of tax liability.*

Section 101 provides for framing of guidelines relating to GAAR provisions. *The provisions of this Chapter shall be applied in accordance with such guidelines and subject to such conditions, as may be prescribed.*

The following rules (Rule 10U, 10UA, 10UB and 10UC) are prescribed under the Income Tax Rules, 1962 and shall be applicable from AY 2017-18

13.3.4.5.1 Rules Prescribed

Rule 10U – Application of GAAR

Chapter X-A not to apply in certain cases.—(1) The provisions of Chapter X-A shall not apply to—

(a) an arrangement where the tax benefit in the relevant assessment year arising, in aggregate, to all the parties to the arrangement does not exceed a sum of rupees three crore;

(b) a Foreign Institutional Investor,—

(i) who is an assessee under the Act;

(ii) who has not taken benefit of an agreement referred to in section 90 or section 90A as the case may be; and

(iii) who has invested in listed securities, or unlisted securities, with the prior permission of the competent authority, in accordance with the Securities and Exchange Board of India (Foreign Institutional Investor) Regulations, 1995 and such other regulations as may be applicable, in relation to such investments;

(c) a person, being a non-resident, in relation to investment made by him by way of offshore derivative instruments or otherwise, directly or indirectly, in a Foreign Institutional Investor;

(d) any income accruing or arising to, or deemed to accrue or arise to, or received or deemed to be received by, any person from transfer of investments made before the 1st day of April, 2017 by such person.

(2) Without prejudice to the provisions of clause (d) of sub-rule (1), the provisions of Chapter X-A shall apply to any arrangement, irrespective of the date on which it has been entered into, in respect of the tax benefit obtained from the arrangement on or after the 1st day of April, 2017.

(3) For the purposes of this rule,—

(i) "Foreign Institutional Investor" shall have the same meaning as assigned to it in the Explanation to section 115AD;

(ii) "off shore derivative instrument" shall have the same meaning as assigned to it in the Securities and Exchange Board of India (Foreign Institutional Investor) Regulations, 1995 issued under Securities and Exchange Board of India Act, 1992 (15 of 1992) ;

(iii) "Securities and Exchange Board of India" shall have the same meaning as assigned to it in clause (a) of sub-section (1) of section 2 of the Securities and Exchange Board of India Act, 1992 (15 of 1992);

(iv) "tax benefit" as defined in clause (10) of section 102 and computed in accordance with Chapter X-A shall be with reference to—

(a) sub-clauses (a) to (e) of the said clause, the amount of tax; and

(b) sub-clause (f) of the said clause, the tax that would have been chargeable had the increase in loss referred to therein been the total income.

Rule 10 UA – Determination of consequences of impermissible avoidance arrangement

For the purposes of sub-section (1) of section 98, where a part of an arrangement is declared to be an impermissible avoidance arrangement, the consequences in relation to tax shall be determined with reference to such part only

Rule 10 UB – Notice and Forms for reference under Section 144BA

(1) For the purposes of sub-section (1) of section 144BA, the Assessing Officer shall, before making a reference to the Commissioner, issue a notice in writing to the assessee seeking objections, if any, to the applicability of provisions of Chapter X-A in his case.

(2) The notice referred to in sub-rule (1) shall contain the following:—

(i) details of the arrangement to which the provisions of Chapter X-A are proposed to be applied;

(ii) the tax benefit arising under the arrangement;

(iii) the basis and reason for considering that the main purpose of the identified arrangement is to obtain tax benefit;

(iv) the basis and the reasons why the arrangement satisfies the condition provided in clause (a), (b), (c) or (d) of sub-section (1) of section 96; and

(v) the list of documents and evidence relied upon in respect of (iii) and (iv) above.

(3) The reference by the Assessing Officer to the Commissioner under sub-section (1) of section 144BA shall be in Form No. 3CEG.

(4) Where the Commissioner is satisfied that the provisions of Chapter X-A are not required to be invoked with reference to an arrangement after considering—

(i) the reference received from the Assessing Officer under sub-section (1) of section 144BA; or

(ii) the reply of the assessee in response to the notice issued under sub-section (2) of section 144BA,

he shall issue directions to the Assessing Officer in Form No. 3CEH.

(5) Before a reference is made by the Commissioner to the Approving Panel under sub-section (4) of section 144BA, he shall record his satisfaction regarding the applicability of the provisions of Chapter X-A in Form No. 3CEI and enclose the same with the reference

13.3.4.6 Definitions.

For the purposes of GAAR provisions, the terms “arrangement”, “asset”, “benefit”, “connected person”, “fund”, “party”, “relative”, “substantial interest”, “tax benefit” and “tax treaty” have been defined in Section 102.

13.3.4.7 Reference to Principal Commissioner or commissioner in certain cases

(1) If, the Assessing Officer, at any stage of the assessment or reassessment proceedings before him having regard to the material and evidence available, considers that it is necessary to declare an arrangement as an impermissible avoidance arrangement and to determine the consequence of such an arrangement within the meaning of Chapter X-A, then, he may make a reference to the Principal Commissioner or Commissioner in this regard.

(2) The Principal Commissioner or Commissioner shall, on receipt of a reference under sub-section (1), if he is of the opinion that the provisions of Chapter X-A are required to be invoked, issue a notice to the assessee, setting out the reasons and basis of such opinion, for submitting objections, if any, and providing an opportunity of being heard to the assessee within such period, not exceeding sixty days, as may be specified in the notice.

(3) If the assessee does not furnish any objection to the notice within the time specified in the notice issued under sub-section (2), the Principal Commissioner or Commissioner shall issue such directions as he deems fit in respect of declaration of the arrangement to be an impermissible avoidance arrangement.

(4) In case the assessee objects to the proposed action, and the Principal Commissioner or Commissioner after hearing the assessee in the matter is not satisfied by the explanation of the assessee, then, he shall make a reference in the matter to the Approving Panel for the purpose of declaration of the arrangement as an impermissible avoidance arrangement.

(5) If the Principal Commissioner or Commissioner is satisfied, after having heard the assessee that the provisions of Chapter X-A are not to be invoked, he shall by an order in writing, communicate the same to the Assessing Officer with a copy to the assessee.

(6) The Approving Panel, on receipt of a reference from the Principal Commissioner or Commissioner under sub-section (4), shall issue such directions, as it deems fit, in respect of the declaration of the arrangement as an impermissible avoidance arrangement in accordance with the provisions of Chapter X-A including specifying of the previous year or years to which such declaration of an arrangement as an impermissible avoidance arrangement shall apply.

(7) No direction under sub-section (6) shall be issued unless an opportunity of being heard is given to the assessee and the Assessing Officer on such directions which are prejudicial to the interest of the assessee or the interests of the revenue, as the case may be.

(8) The Approving Panel may, before issuing any direction under sub-section (6),—

(i) if it is of the opinion that any further inquiry in the matter is necessary, direct the Principal Commissioner or Commissioner to make such inquiry or cause the inquiry to be made by any other income-tax authority and furnish a report containing the result of such inquiry to it; or

(ii) call for and examine such records relating to the matter as it deems fit; or

(iii) require the assessee to furnish such documents and evidence as it may direct.

(9) If the members of the Approving Panel differ in opinion on any point, such point shall be decided according to the opinion of the majority of the members.

(10) The Assessing Officer, on receipt of directions of the Principal Commissioner or Commissioner under sub-section (3) or of the Approving Panel under sub-section (6), shall proceed to complete the proceedings referred to in sub-section (1) in accordance with such directions and the provisions of Chapter X-A.

(11) If any direction issued under sub-section (6) specifies that declaration of the arrangement as impermissible avoidance arrangement is applicable for any previous year other than the previous year to which the proceedings referred to in sub-section (1) pertains, then, the Assessing Officer while completing any assessment or reassessment proceedings of the assessment year relevant to such other previous year shall do so in accordance with such directions and the provisions of Chapter X-A and it shall not be necessary for him to seek fresh direction on the issue for the relevant assessment year.

(12) No order of assessment or reassessment shall be passed by the Assessing Officer without the prior approval of the Principal Commissioner or Commissioner, if any tax consequences have been determined in the order under the provisions of Chapter X-A.

(13) The Approving Panel shall issue directions under sub-section (6) within a period of six months from the end of the month in which the reference under sub-section (4) was received.

(14) The directions issued by the Approving Panel under sub-section (6) shall be binding on—

(i) the assessee; and

(ii) the Principal Commissioner or Commissioner and the income-tax authorities subordinate to him,

and notwithstanding anything contained in any other provision of the Act, no appeal under the Act shall lie against such directions.

(15) The Central Government shall, for the purposes of this section, constitute one or more Approving Panels as may be necessary and each panel shall consist of three members including a Chairperson.

(16) The Chairperson of the Approving Panel shall be a person who is or has been a judge of a High Court, and—

(i) one member shall be a member of Indian Revenue Service not below the rank of Principal Chief Commissioner or Chief Commissioner of Income-tax; and

(ii) one member shall be an academic or scholar having special knowledge of matters, such as direct taxes, business accounts and international trade practices.

(17) The term of the Approving Panel shall ordinarily be for one year and may be extended from time to time up to a period of three years.

(18) The Chairperson and members of the Approving Panel shall meet, as and when required, to consider the references made to the panel and shall be paid such remuneration as may be prescribed.

(19) In addition to the powers conferred on the Approving Panel under this section, it shall have the powers which are vested in the Authority for Advance Rulings under section 245U.

(20) The Board shall provide to the Approving Panel such officials as may be necessary for the efficient exercise of powers and discharge of functions of the Approving Panel under the Act.

(21) The Board may make rules for the purposes of the constitution and efficient functioning of the Approving Panel and expeditious disposal of the references received under sub-section (4).

Explanation.—In computing the period referred to in sub-section (13), the following shall be excluded—

(i) the period commencing from the date on which the first direction is issued by the Approving Panel to the Principal Commissioner or Commissioner for getting the inquiries conducted through the authority competent under an agreement referred to in section 90 or section 90A and ending with the date on which the information so requested is last received by the Approving Panel or one year, whichever is less;

(ii) the period during which the proceeding of the Approving Panel is stayed by an order or injunction of any court:

Provided that where immediately after the exclusion of the aforesaid time or period, the period available to the Approving Panel for issue of directions is less than sixty days, such remaining period shall be extended to sixty days and the aforesaid period of six months shall be deemed to have been extended accordingly.

Rule 10 UC – Time Limits

(1) For the purposes of section 144BA, —

(i) no directions under sub-section (3) of section 144BA shall be issued by the Commissioner after the expiry of one month from the end of the month in which the date of compliance of the notice issued under sub-section (2) of section 144BA falls;

(ii) no reference shall be made by the Commissioner to the Approving Panel under sub-section (4) of section 144BA after the expiry of two months from the end of the month in which the final submission of the assessee in response to the notice issued under sub-section (2) of section 144BA is received;

(iii) the Commissioner shall issue directions to the Assessing Officer in Form No.3CEH, —

(a) in the case referred to in clause (i) of sub-rule (4) of rule 10UB, within a period of one month from the end of month in which the reference is received by him; and

(b) in the case referred to in clause (ii) of sub-rule (4) of rule 10UB, within a period of two months from the end of month in which the final submission of the assessee in response to the notice issued under sub-section (2) of section 144BA is received by him.]

13.4 CONTROLLED FOREIGN CORPORATIONS

13.4.1 1 A corporate entity that is registered and conducts business in a different jurisdiction or country than the residency of the controlling owners.

13.4.2 In the Indian context, Controlled Foreign Corporations are understood as Companies which have been incorporated abroad, in countries with low tax jurisdictions, controlled directly or indirectly by Residents in an attempt to accumulate income without having to pay tax in India. It can therefore be concluded that such a structure is an added method for legally avoiding the payment of taxes in India.

13.4.3 The present proposal can be seen as yet another attempt by the Revenue to overcome the recognition given to the principle of Tax Avoidance in *Azadi Aandolan*. It has sought to tax the Resident controlling such a Foreign Corporation on the passive income earned by the same. Furthermore in order to check the deferral of taxes from dividend earned by the CFC's which are not distributed in India to the shareholders. The recently notified POEM rules seek to tax such dividends as deemed dividend from the Foreign Corporation. The effective test laid down under the POEM rules is an internationally recognised principle for determining the residence of the Corporation. This has been discussed in detail in Chapter 2. In substance it widens the ambit of residence of a Foreign Company if it is managed *wholly or partially* in India unlike the earlier law which limits a Foreign Corporation liable to tax only if the management and control are wholly in India as in present Section 9 of the Income Tax Act, 1961.

13.4.4 Over the years the developed countries have extensively advanced several principles relating to the taxation of CFC's as a result of which there has come to exist a set of uniform global principles which have been adopted. A glance at some of the provisions under foreign jurisdictions and the POEM rules make it evident that India's POEM rules are quite comprehensive. Illustrating further, most jurisdictions have adopted the principle of determining 'control' under the control/ ownership test where a definite percentage is specified which determines if such a corporation could be subject as a Controlled Foreign Corporation. Secondly most of these jurisdictions follow the 50% Shareholder test according to which a Corporation is taxed as a CFC only if 50% of its shareholders are residents of their country or have voting power comprising 50%. Such a threshold ensures that there are no two ways in interpreting the provision. Most countries which have adopted this regime do not impose these provisions on Corporations which have their residence in countries with a high tax rate. Therefore it can be inferred that as long as there is *bona fide* intention for not evading tax, the Corporation will not be taxed. Further, certain exemptions are also granted in favour of these corporations such as the application of the *De minimis* rule which is prevalent in the UK and the U.S. whereby an exemption is granted only when no part of the gross income of the corporation exceeds a specific limit under the governing laws. In India too, the POEM rules provide a minimum threshold level of Rs. 50 Crores for the trigger of these principles.

13.4.5 India today largely depends on inward flow of funds; therefore it remains to be seen as to whether introduction of such legislation at this stage, though with reasonably high threshold levels, would be counter-productive in the economic sense. A consequent effect of such law prevent Corporations having Holding Companies in India which would largely affect Mergers and Acquisitions made by Indian Residents. It may be pointed out here that the Companies Act, 2013 now enables cross border acquisitions and mergers of foreign companies into Indian companies and vice versa. It will remain to be seen what is the response of the Indian Corporates to the new POEM rules.

13.5 BASE EROSION PROFIT SHARING (BEPS)

BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place. No or low taxation is not *per se* a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it. In other words, what creates tax policy concerns is that, due to gaps in the interaction of different tax systems, and in some cases because of the application of bilateral tax treaties, income from cross-border activities may go untaxed anywhere, or be only unduly lowly taxed.

13.5.1 BEPS – CONCEPT, CONCERNS AND IMPLEMENTATION

13.5.1.1 Following the strengthening the Arms' Length Pricing regime virtually across most tax jurisdictions, innovative tax planning structures are being used to create tax efficient supply chain models which can result in profits being shifted to a low tax jurisdiction and a significantly reduced effective tax impact. The realization particularly in the tax jurisdictions in the developed countries that such international tax planning exercises have resulted in the reduction / erosion of their tax base has resulted in many famous brands being targeted across a number of countries (to name a few Starbucks, Google, Amazon and facebook). This erosion of base and shift of profits is referred to as "Base Erosion Profit Sharing".

13.5.1.2 The BEPS has different impacts on developed and developing countries. This was evident from discussions around the UN Model Tax Treaty and views of emerging non-OECD powerhouse economies like India and China. The OECD announced its BEPS review after the G20 Leaders Summit in June 2012. After a detailed review, the OECD's BEPS report concluded that based on a number of indicators, BEPS activity is taking place, and that it "poses a threat in terms of tax sovereignty and of tax revenue" :-

- collaborative, multinational effort to address BEPS concerns is necessary.
- Unilateral actions could lead to further mismatches, additional disputes, and increased uncertainty; and
- there is an urgent need to deal with the BEPS issue and proposes that a plan of action be developed and approved by the OECD's Committee on Fiscal Affairs at its next meeting in June 2013.

13.5.1.3 The G20 finance ministers called on the OECD to develop an action plan to address BEPS issues in a co-ordinated and comprehensive manner. Specifically, it was mandated that this Action Plan should provide countries with domestic and international instruments that will better align rights to tax with economic activity. As called for in the OECD report on BEPS, *Addressing Base Erosion and Profit Shifting* (OECD, 2013a), this Action Plan required (i) identification of actions needed to address BEPS, (ii) setting of deadlines to implement these actions and (iii) identification of the resources needed and the methodology to implement these actions.

13.5.1.4 In the background note of its report, among other factors identified, the OECD had highlighted **“The spread of the digital economy also poses challenges for international taxation”**. It went on to say “The digital economy is characterized by an unparalleled reliance on intangible assets, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs. This raises fundamental questions as to how enterprises in the digital economy add value and make their profits, and how the digital economy relates to the concepts of source and residence or the characterization of income for tax purposes. At the same time, the fact that new ways of doing business may result in a relocation of core business functions and, consequently, a different distribution of taxing rights which may lead to low taxation is not *per se* an indicator of defects in the existing system. It is important to examine closely how enterprises of the digital economy add value and make their profits in order to determine whether and to what extent it may be necessary to adapt the current rules in order to take into account the specific features of that industry and to prevent BEPS.”

13.5.2 ACTION PLAN & METHODOLOGY OUTLINED BY OECD

13.5.2.1 The OECD came out with a 15-point action plan and a 3 point methodology which have been outlined in its report released in June 2013 after a joint meeting of the representatives of the OECD member nations and G20 nations.

13.5.2.2 The G20 Leaders endorsed the BEPS Action Plan at the 2013 G-20 St. Petersburg summit. The BEPS Package consisting of reports on 15 actions designed to be implemented domestically in the respective countries and through tax treaty provisions was agreed at the 2015 G20 Antalya summit:

- Action 1: Addressing the Tax Challenges of the Digital Economy
- Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements
- Action 3: Designing Effective Controlled Foreign Company Rules
- Action 4: 2 Limiting Base Erosion Involving Interest Deductions and Other Financial Payments
- Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance
- Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances
- Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status
- Actions 8–10: Aligning Transfer Pricing Outcomes with Value Creation
- Action 11: Measuring and Monitoring BEPS
- Action 12: Mandatory Disclosure Rules
- Action 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting
- Action 14: Making Dispute Resolution Mechanisms More Effective
- Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

13.5.2.3 There are 4 minimum standards on BEPS relating to :

- Countering Harmful Tax Practices (Action 5)
- Treaty Shopping (Action 6),
- Transfer Pricing Documentation and Country-by-Country Reporting (Action 13) and
- Dispute Resolution (Action 14).

Each of the four BEPS minimum standards is subject to peer review.

13.5.2.4 In November 2016, the main text on the Multi-Lateral Instrument (MLI) was agreed. This is a single instrument by which countries will be able to amend up to 3,000 bilateral treaties. It includes clauses which relate to the BEPS minimum standards on treaty abuse and dispute resolution, as well as other opt-in/opt-out provisions and options where there are multiple ways to address BEPS.

13.5.3 APPROACH FOR DEALING WITH BEPS REGIME

13.5.3.1 Principles to be followed by MNE's.

It is clear that there is certainty about uncertainty and unilateral responses by countries to perceived "tax avoidance" practices. Under these circumstances the MNE's have to follow certain principles when dealing with this situation:-

- Assume that what is done will have to be fully transparent to the tax authorities.
- Understand that ultimately it is the substance that will prevail over form, when it comes to transfer pricing.
- Avoid commercially artificial structures and treaty shopping
- Ensure that tax and transfer pricing structures mirror their substance
- Expect local country audits subject to local country laws and interpretations of the arm's length principle and treaty clauses (especially in non-OECD countries) and increased enforcement from all countries
- Consider the use of APAs as a risk-management tool, especially in high-risk countries
- Investigate efficient documentation processes
- Think about international tax and transfer pricing from a governance and corporate reputational perspective

13.5.3.2 Indian Perspective

13.5.3.2.1 The BEPS project is extremely relevant for India, especially the action plans dealing with treaty abuse, permanent establishment, intangibles, digital economy, and transfer pricing documentation and country-by-country reporting. The relevance of BEPS is from an India outbound as well as India inbound perspective

13.5.3.2.2 The Finance Act, 2016 and Finance Act, 2017 has given effect to almost of all the action plans affecting India, by the following measures:-

- a) Having in place the GAAR provisions, which is effective from 1st April, 2017 (Section 95 to 102, and 144AB) : These have been discussed in detail in Para 13.3 of this Chapter.
- b) Providing for detailed POEM rules with a threshold of Rs. 50 Crores (POEM rules) effective from 1.4.2017 :- These have been discussed in detail in Para 2.4 of Chapter 2.
- c) Commencing the process of re-negotiating its tax treaties: - This is an ongoing exercise.
- d) Introducing the equalisation levy (Section 164 to 168 and 174 & 175 of Finance Act, 2016 read with Equalisation Levy Rules, 2016 effective 1.6.2016) :- This seeks to levy a tax of 6% on the amounts paid by
 - i) Residents and
 - ii) Non Residents having a PE in Indiato Non Residents (not having a PE in India) with respect to services specified in Section 164(i) of the said Finance Act, 2016, covering the following services :-

* On Line Advertisement services

* Any Provision for digital advertising space

* Any other facility or service for the purpose of online advertisement

* Any other service as may be notified by the Central Government (No other service has been notified so far)

Payments by a Resident or a Non Resident having a PE in India up to Rs.1 lakh in a financial year per payee Non Resident is exempt from this levy.

As of now, no credit of taxes paid is available to the Non Resident receiving these payments through any of the DTAA entered into by India.

e) Country-by-country reporting (CbCR)(Section 286):- Section 92D of the Act was amended vide Finance Act, 2016 to provide for keeping and maintaining of Master File by every constituent entity of an international group, which is required to be furnished as per rules prescribed in this regard.

Accordingly, subsequent to the aforesaid amendments to the Act, new rules 10DA and 10DB and form nos. 3CEBA to 3CEBE in the Income-tax Rules, 1962 ('the Rules') were introduced. These rules lay down the guidelines for maintaining and furnishing of transfer pricing documentation in the Master File and Country-by-Country report. The first reporting year for furnishing CbCR was 2016-17 and vide circular no. 26/2017 dated 25th October, 2017 the 'due date' prescribed therein for furnishing of report in respect of international group for reporting accounting year 2016-17 was stipulated as 31st March, 2018.

The text of the Rules 10DA and 10DB are reproduced hereinbelow :-

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 account, 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 the 31st day of 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.]

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.

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

13.5.3.2.3 The impact of these measures will have to be seen in the years to come.

CHAPTER 14

COMPANY SECRETARY AND TRANSFER PRICING

14.0 Strategy and Governance

Strategy and Governance are really two sides of the same coin. Without good governance no strategy is sustainable in the long run. And governance without proper strategy will only add to cost without delivering value. Companies that manage Strategy and Governance well are the ones that will be able to deliver value to all stake holders in the long run and achieve sustainable success over a long period of time.

14.1 Role of CS

14.1.1 The profession of Company Secretary has been growing in leaps and bounds over the last decade and the expectation from a company secretary (whether in employment or practice) has been rising high and the trend is only expected to continue. Because of his direct interaction with the Board of Directors of all companies and the shareholders in the listed companies, the company secretary is increasingly becoming a significant point of reference for well governed companies, who have realized the potential of the profession to contribute towards better governance that goes a long way in strengthening the strategic decisions of the Board.

14.1.2 Increasingly there is a realization amongst many companies that Company Secretary (CS) can play a major role in the implementation of the various policies relating to governance across the organization that calls for understanding the business, strategy and risk appetite of the company / its promoters. It is indeed noteworthy quite a few in the profession are already doing that in their areas of functioning and this is true for CS both in employment and practice, as they have extended their scope beyond their traditionally perceived roles in Company Law to emerging areas like Intellectual Property Law, Foreign Exchange Management, Labour Laws, Environmental Laws, Banking & Insurance, Direct & Indirect Taxes and of late some of them have even entered into the areas of Transfer Pricing, International Taxation, Real Estate Regulation, Goods & Service Tax, Insolvency Resolution, Liquidations and Valuation. This list of new areas may not be exhaustive.

14.1.3 The Companies Act, 2013 which recognized the emerging role of CS and the fact that they are doing much more than just company law related functions, through Section 205 put in focus the functions of company secretary and this includes -

- (a) to report to the Board about compliance with the provisions of this Act, the rules made thereunder and other laws applicable to the company;
- (b) to ensure that the company complies with the applicable secretarial standards;
- (c) to discharge such other duties as may be prescribed.

(Further it has been explained that for the purpose of this section, the expression “secretarial standards” means secretarial standards issued by the Institute of Company Secretaries of India constituted under section 3 of the Company Secretaries Act, 1980 and approved by the Central Government.

It has also been clarified that these provisions shall not affect the duties and functions of the Board of Directors, chairperson of the company, managing director or whole-time director under this Act, or any other law for the time being in force.)

14.1.4 From the above definition, the emphasis is on **“reporting to the Board on the compliance of this Act (meaning Companies Act), the rules made thereunder and other laws applicable to the company”**. It is obvious that role and responsibility of CS (in employment) is no longer restricted only to Companies Act and his functions extend to compliance of all laws applicable to the company and the CS has to report to the Board about the compliances of the Companies Act and all other laws applicable to the company. This places substantial responsibilities which require that the organization of the companies should provide proper structures of delegation, control and reporting so that the CS is able to discharge his duties as required in the spirit of these provisions.

14.2 CS and Transfer Pricing

14.2.1 CS in employment

14.2.1.1 In the preceding chapters an attempt has been made to highlight the important provisions governing the international transfer pricing (which is now almost two decades old in India) and the five year old domestic transfer pricing, where the scenario is just emerging.

14.2.1.2 The various important aspects of the Transfer Pricing (TP) regulations which will require attention of the company with respect to TP documentation and study are:-

- a) Identification of Associated Enterprises (AE)
- b) Identification of International Transactions
- c) Identification of Specified Domestic Transactions
- d) Analysis of functions, assets employed and risks (FAR)
- e) Identification of Comparable Uncontrolled Transactions
- f) Choice of Appropriate Method of determination of ALP
- g) Determination of ALP
- h) Country by Country Reporting (CbCR), wherever applicable

14.2.1.3 CS by virtue of his background, experience and knowledge is capable to bring to the table valuable inputs to this process of documentation and study. Of specific mention is the requirement relating to Identification of AE, transactions (international and domestic), FAR analysis and Identification of Comparable Uncontrolled Transactions where the CS in fact is best equipped to lead and co-ordinate the working of the TP team.

14.2.1.4 Under the Income Tax Act, CS (in employment) is the principal officer of the company. Accordingly, CS can represent the company in its assessment and appellate proceedings before the AO, TPO, Commissioner, DRP and up to the level of ITAT.

14.2.1.5 The recent developments in the TP law has added further new dimensions to the subject such as the emerging field of Advance Pricing Arrangement (APA), Mutual Agreement Procedures (MAP) and Safe Harbour provisions. Specifically with respect to APA and MAP procedures, the CS can play a major role in leading and coordinating the efforts of the company's TP team.

14.2.2 CS in Practice

14.2.2.1 CS in practice is recognized under the Income Tax Act to act as an Authorised Representative under Section 288 of the said Act read with Rule 50 of the Income Tax Rules. Accordingly, he can appear on behalf of the company or any other organization

- a) in connection with assessment proceedings before the AO, TPO and CIT
- b) in connection with proceedings before AAR and DRP
- c) in connection with appellate proceedings before CIT (A)
- d) in connection with appellate proceedings before ITAT

and render advisory services in connection with such representation.

14.2.2.2 Where companies have not employed a full time CS or in cases of other types of organizations (Partnership Firm, LLP, HUF or other) which have attracted the TP regulations having crossed the threshold limits for the size of the International Transactions or SDT or both, there is tremendous opportunity for Practicing CS to provide advisory / consultancy / support services to these companies / organizations in the areas of

- a) TP documentation / study
- b) APA Documentation
- c) MAP procedures
- d) Whether or not to utilize the safe harbour provisions

14.2.2.3 An added dimension to international transactions involving Business restructuring where CS in practice can also offer transactional advisory services relating to this area. It may be pointed out here that the enabling provisions in the Companies Act, 2013 for cross border mergers including amalgamation of Indian Company with a foreign company has been recently notified. This is expected to bring forth a new dimension to the business restructuring exercise. The expertise of CS is well recognized in these areas and the impact of TP regulations will have to be considered in such exercises.

14.3 CONCLUSION

14.3.1 Legal compliance, ongoing financial scrutiny and control, and fulfilling accountability requirements are fundamental features of good corporate governance. However, it is the strategic management and leadership that the Board provides that will drive performance of a company. A performance-oriented Board recognizes the importance of strategic management and corporate governance as it plans for the future, keeps pace with dynamic changes in the market place and the external environment, nurture and build key external relationships and be alert to opportunities for growth in the business. The focus is on performance as well as conformance. The board is not there to simply monitor and protect but also to enable and enhance.

14.3.2 The role of CS in interpretation of substantive law in harmony with the provisions of other applicable laws, support in documentation and compliance is well known. The Companies Act, 2013 has recognized the position of CS in governance process. There is thus a statutory requirement for CS for performing their role in governance and supporting the Board of Directors in their efforts to ensure governance, but with the added responsibility and accountability, an urgent need is felt for bridging the triangular gaps in performance, expectations and rewards.

14.3.3 Coming to Transfer Pricing, companies that have global presence will have to pay attention to Transfer Pricing concepts, documentation, management of the relations between Associated Enterprises and managing tax compliance in all jurisdictions. This is very much crucial for achieving success in ensuring bottom lines. Domestic Transfer Pricing requires entities to manage its structure and transactions keeping in mind the emerging regime. The new requirement of CbCR adds a new dimension in the transfer pricing regime and CS will have a major role to play in streamlining the MNE reporting.

14.3.4 It is now up to the CS fraternity both in employment and in practice to recognize the tremendous opportunities presented in the field of Transfer Pricing to quickly learn the concepts, acquire the necessary experience by networking, make their mark and create a name for themselves and for the profession.

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