

# Transfer Pricing

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**At** Navi Mumbai Chapter of  
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<http://www.incometaxindia.gov.in/Pages/international-taxation/transfer-pricing.aspx>

# Agenda

- ☀ Introduction to Indian Transfer Pricing Regulations
- ☀ Recent Judicial Pronouncements
- ☀ Takeaways
- ☀ Open House

# Background

- Measure to curb tax avoidance
- Overall based on the Organisation for Economic Co-operation and Development (OECD) TP Guidelines

# Important Sections

- Any income arising from an *international transaction* shall be computed having regard to the arm's length price – Section 92(1)
- The “*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 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 such enterprise – Sec 92B(1)

# International Transaction Definition Expanded

## International Transaction – Definition expanded by Finance Act 2012

With retrospective effect from 1<sup>st</sup> April 2002.

**The inserted 'explanation' clarifies that the term, international transaction, shall include:**

- Non-reported Transactions (Guarantee / Excess Credit Period / Advance for Services)
- Capital Financing
- Business Restructuring (future profit/loss, wide coverage, exit charge)
- Intangibles relating to:
  - Marketing
  - Human Resource
  - Others (property deriving value from intellectual content)

# Important Sections

| <b>Definitions of Associated Enterprise<br/>(AE) Section 92A (1) &amp; (2)</b>                                  | <b>Criterion</b>  |
|---|---|
| <b>Capital</b>  | <b>26% or more share holding carrying voting rights</b>   |
| <b>Management</b>   | <b>Appointment of more than half of the board of directors OR one or more executive directors</b>                                   |
| <b>Control</b>  | <b>As mentioned below (indicative items)</b>  |
| <ul style="list-style-type: none"> <li>• Loan provided by one enterprise to another enterprise</li> </ul>       | <ul style="list-style-type: none"> <li>• If loan constitutes &gt;51% of total assets of the customer</li> </ul>                     |
| <ul style="list-style-type: none"> <li>• Guarantee provided by one enterprise to another enterprise</li> </ul>  | <ul style="list-style-type: none"> <li>• If guarantee constitutes &gt; 10% of total borrowings of the customer</li> </ul>           |
| <ul style="list-style-type: none"> <li>• One enterprise supplying raw material to another enterprise</li> </ul> | <ul style="list-style-type: none"> <li>• If raw material supplied is &gt;90% of total raw materials used for manufacture</li> </ul> |

# Arm's Length Price & Methods

- “*Arm's length price*” means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled condition - **Sec 92F (ii)**
  - 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, having regard to the nature of the transaction or class of the transactions or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely –
    - a) *Comparable uncontrolled price method (CUP)*
    - b) *Resale price method (RPM)*
    - c) *Cost plus method (CPM)*
    - d) *Profit split method (PSM)*
    - e) *Transactional net margin method (TNMM)*
    - f) *Such other methods as may be prescribed by the Board*
- Section 92C(1)**

# Arm's Length Price – Rule 10 B

Reference to Rule 10B is important as it **covers the scope to adjust the arm's length price on account of functional and other differences**, if any, between the international transaction and uncontrolled transactions or between the enterprises entering into such transactions which could materially affect the price in the open market.

Section 92C lists out the methods to compute the Arm's Length Price (ALP) whereas Rule 10B describes the manner in which each of these methods is to be practically applied (steps to arrive at transaction price, arm's length price, adjustment for functional/other differences, establishment of whether transaction is at arm's length).



# Other Important Sections

- The provision of section 92 shall not apply in a case where the computation of income under sub-section (1) or the determination of the allowance for any expense or interest under that sub-section, or the determination of any cost or expense allocated or apportioned, or, as the case may be, contributed under sub-section (2), **has the effect of reducing the income chargeable to tax or increasing the loss**, as the case may be, computed on the basis of the entries made in the books of account in respect of the previous year in which the international transaction was entered into – Section 92(3)

## Example

Assessee has earned 6% OPM (on sales) during FY 2013-14. The arm's length OPM is arrived at 5%. Sec 92(3) restricts, assessee to refund the additional 1% OPM back to its AE through retrospective increase in the import price.

# Other Important Sections

- A transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purpose 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 where the enterprise or the associated enterprise or both of them are non-residents ***irrespective of whether such other person is a non-resident or not*** – Section 92B(2)

## Example

I Ltd (Indian Co) purchases raw materials from G Ltd. F Ltd (**French Co and AE of I Ltd**) has entered into an agreement with G Ltd to supply raw material to all its affiliates companies, globally.

By virtue of this section, the transaction between I Ltd and G Ltd shall be deemed to be a transaction entered into between two associated enterprises *irrespective of whether G Ltd is a resident or non-resident.*

# Other Important Sections

## Specified Domestic Transaction – Section 92BA (FA-2012 wef AY 2013-14)

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**;
  - (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 five crore rupees.**]

# Other Important Sections

The proviso to Section 92C(2) states 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 has actually been undertaken shall deemed to be the arm's length price – 92C(2). *Refer example in following slide.*

\*Notifications for FY 2012-13 and FY 2013-14 mention:

1% for '**wholesale traders**'# and 3% in all other cases.

#'**wholesale trading**' explained vide notification dated 23<sup>rd</sup> September 2014:

For the purposes of this notification, “wholesale trading” means an international transaction or specified domestic transaction of trading in goods, which fulfils the following conditions, namely:-

- i. Purchase cost of finished goods is 80% or more of the total cost pertaining to such trading activities; and
- ii. Average monthly closing inventory of such goods is 10% or less of sales pertaining to such trading activities.

# Other Important Sections

Example: (non-wholesale trading viz. others => tolerance band = 3%)

| I Ltd (Imports from AE) |            | I Ltd (Imports from Non AE) |             |
|-------------------------|------------|-----------------------------|-------------|
| Particulars             | Rs. In Mio | Particulars                 | Rs. In Mio  |
| SALES                   | 200        | SALES                       | 200         |
| COGS (AE)               | -100       | COGS (Non AE)               | -95         |
| GM                      | 100        | GM                          | 105         |
| OPEX                    | -86        | OPEX                        | -86         |
| OPM                     | 14         | OPM                         | 19          |
| OPM % on Sales          | <b>7%</b>  | OPM % on Sales              | <b>9.5%</b> |

Prima facie, looking at the OPM, it seems the transaction falls within the 3% range. But the range of 3% needs to be applied on international transaction.

Hence 3% variation of Rs. 100 (imports by I Ltd) = 3 . Variation allowed up to 97 (100 - 3).

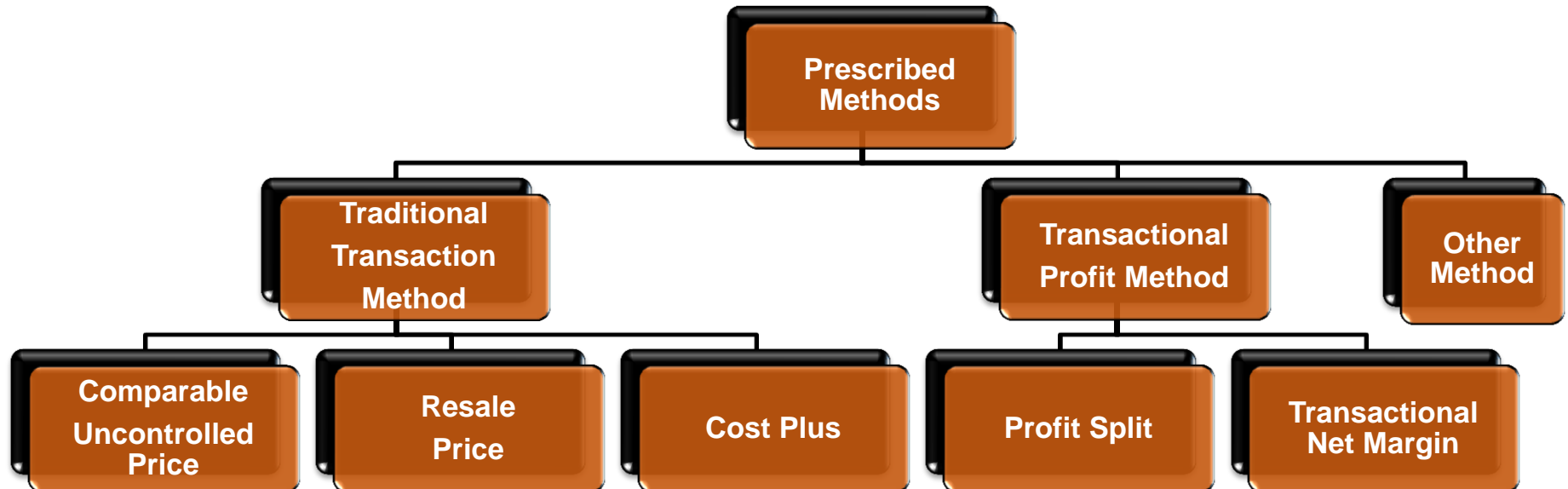
Since the import price with Non AE amounts to Rs. 95, the international transaction does not fall within the 3% variation. Hence, TPO is justified in adjusting the import price by Rs. 5.

# Other Important Sections

Every person who has entered into an international 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 (Form 3CEB) duly signed and verified in the prescribed manner by such accountant and setting forth such particulars as may be prescribed – Section 92E

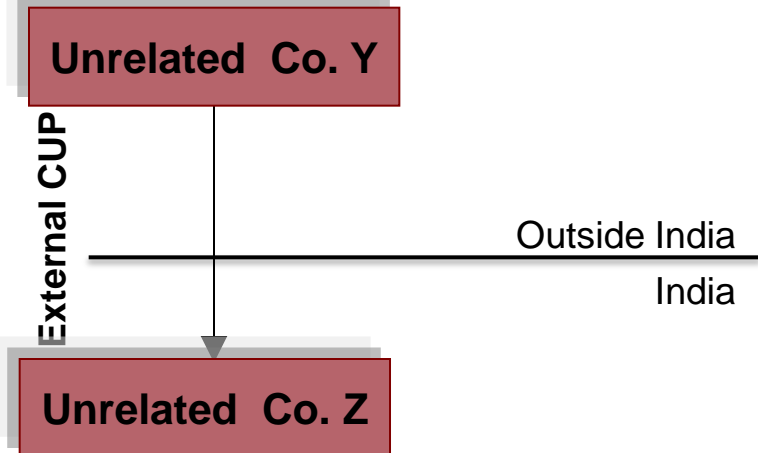
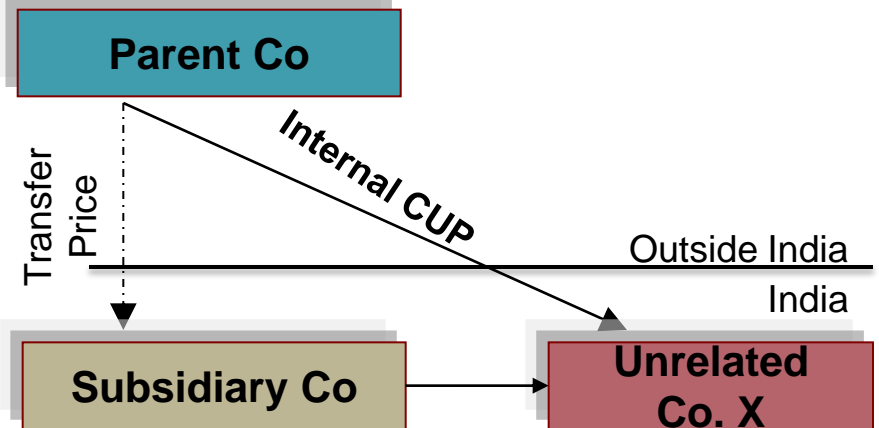
# Computation of Arm's Length Price (ALP)

- Determination of ALP using one of the Prescribed methods -
  - Best suited to the facts and circumstances of each particular international transaction and
  - Provides the most reliable measure of an arm's length price in relation to the international transaction ~ termed as the "**Most Appropriate Method**"
- Where more than one ALP is determined, the arithmetic mean of such prices is taken to be the ALP
- No hierarchy or preference of methods prescribed under the Act



# Comparable Uncontrolled Price (CUP) Method

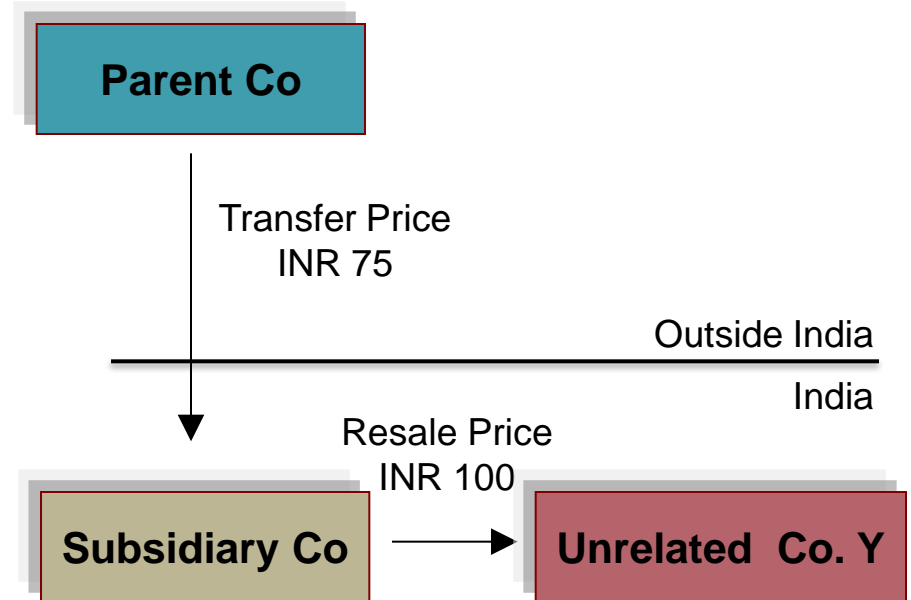
- Most Direct Method for testing ALP and the Prices are Benchmarked
- Requires strict comparability in products, contractual terms, economic terms, etc.
- Two types of CUPs available - Internal CUP & External CUP
- Calls for adjustments to be made for differences which could materially affect the price in the open market e.g.:
  - Difference in volume/quality of product
  - Difference in credit terms
  - Risks assumed
  - Geographic market
- OECD - Priority to Internal CUP over External CUP due to higher degree of comparability





# Resale Price Method (RPM)

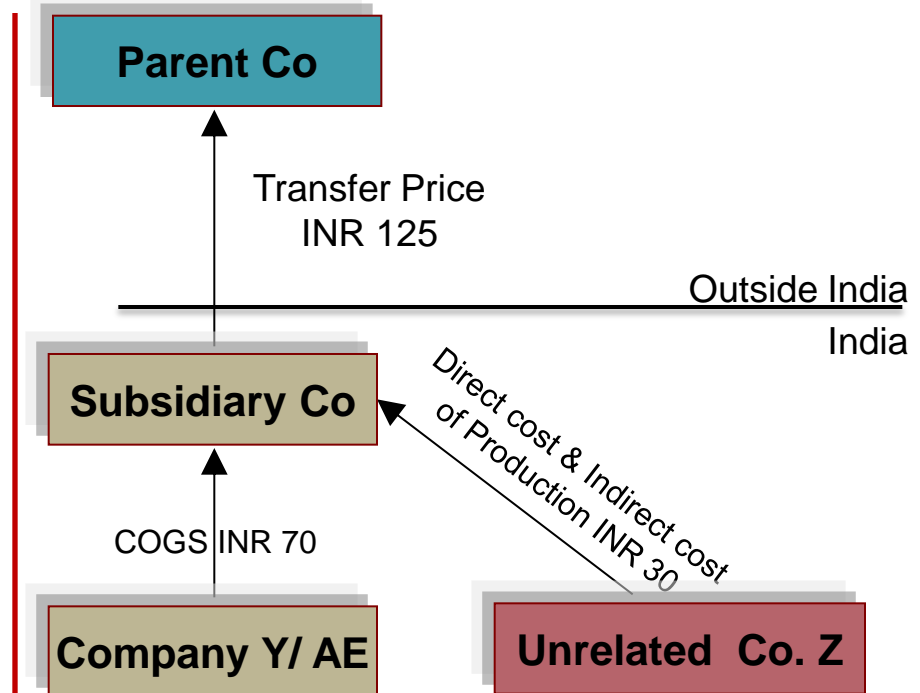
- Compares the resale gross margin earned by associated enterprise with the resale gross margin earned by comparable independent distributors
- Preferred method for a distributor buying purely finished goods from a group company (if no CUP available)
- To be applied when a goods purchased or service obtained from an AE is resold to an unrelated enterprise.
- Under this method comparability is less dependent on strict product comparability and additional emphasis is on similarity of functions performed & risks assumed



**Price paid by Sub Co. to AE is at arm's length if the 25% resale margin earned by Sub Co. is more than margins earned by similar Indian distributors`**

# Cost Plus Method (CPM)

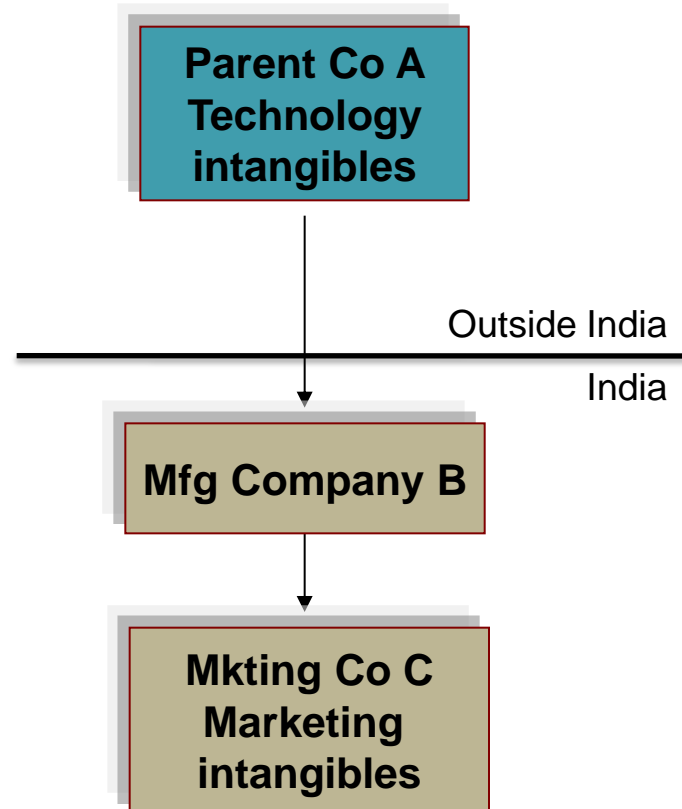
- Compares and identifies the mark up earned on direct and indirect costs incurred with that of comparable independent companies
- Preferred method in case
  - Semi finished goods sold between related parties
  - Contract/toll manufacturing agreement
  - Long term buy/supply arrangements
- To be applied in cases involving manufacture, assembly or production of tangible products or services that are sold/provided to AEs
- Comparability under this method is not as much dependent on close physical similarity between the products.
- Larger emphasis on functional comparability



**Price charged by Sub co to AE is at arm's length if the 25% mark up on cost is more than that of similar Indian assemblers**

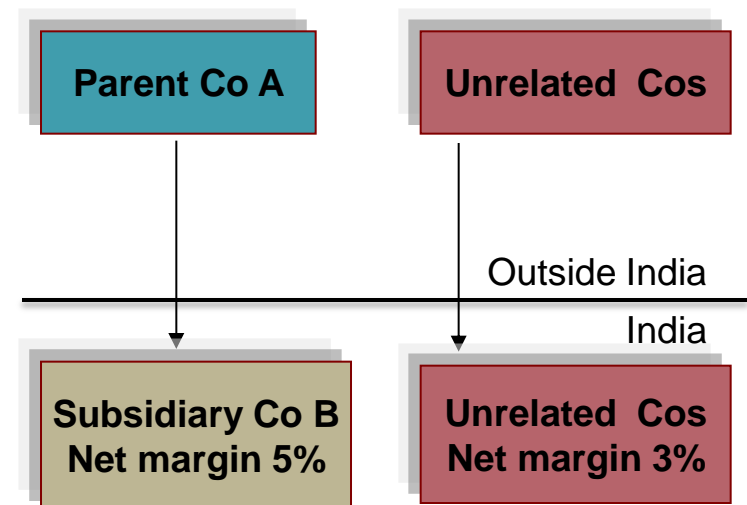
# Profit Split Method (PSM)

- To be applied in cases involving transfer of unique intangibles or in multiple international transactions that cannot be evaluated separately
- Calculates the combined operating profit resulting from an inter-company transaction based on the relative value of each AEs contribution to the operating profit
- Evaluates allocation of combined profit/loss in controlled integrated transactions
- The contribution made by each party is based upon a functional analysis and valued, if possible, using external comparable data
- The two methods discussed by OECD Guidelines:
  - Contribution PSM Analysis
  - Residual PSM Analysis



# Transactional Net Margin Method (TNMM)

- Examines net operating profit from transactions as a percentage of a certain base (can use different bases i.e. costs, turnover, etc) in respect of similar parties
- Ideally, operating margin should be compared to operating margin earned by same enterprise on uncontrolled transaction – Internal TNMM
- Most frequently used method in India, due to lack of availability of comparable uncontrolled prices and gross margin data required for application of the comparable uncontrolled price method / cost plus method / resale price method
- Broad level of product comparability and high level of functional comparability
- Applicable for any type of transaction and often used to supplement analysis under other methods
- The application of the TNMM to a specific tested party breaks down when factors other than transfer prices have a material impact upon profits



# Transactional Net Margin Method (TNMM)

## (contd.)

- Grouping of transaction - Relevant controlled transactions require to be aggregated to test whether the controlled transaction earn a reasonable margin as compared to uncontrolled transaction
- **Selection of tested party - Least complex entity**
- Selection of Profit Level Indicator such as Operating Margin, Return on Value added expenses, Return on assets – Unaffected by transfer price
- Benchmarking exercise (**on Databases**)
  - Entity with similar industry classification to the tested party – through search in Prowess and Capitaline plus databases
  - Screen entities by applying appropriate quantitative filters, such as mfg sales <75%, R&D exp >5%, Advertisement exp >5%.
  - Review financial and textual information available in the public database of the selected entities – for qualitative filters
  - Computation of ALP

**Usually regarded as an indirect and one-sided method, but is most widely adopted**

# “Other Method” (Sixth method notified by CBDT)

- CBDT has notified the “other method” vide a Notification and Rule 10AB has now been inserted in the Income-tax Rules, 1962 (the Rules). Applicable from FY 2011-12.
- Rule 10AB describes the other method as “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.”
- “other method” refers to “price which has been charged or paid, or would have been charged or paid”. Effectively, this implies that under this “other method” “quotations” rather than prices “actually” charged or paid can also be used by the taxpayers.
- Could also cover new instances of ALP computation which would now arise due to the various amendments introduced in the Finance Act 2012 like expansion/clarification of the definition of “international transaction” and introduction of domestic transfer pricing. (e.g. intangibles, exit charge)

# CUP Case Study

- I Ltd (Indian Co.) exports 1000 red apples to B Ltd (AE) in Brazil at Eur 1.3/unit
- C Ltd exports 1000 red apples to D Ltd (Non AE) in Brazil at Eur 2/unit
- Assume there are no functional and other differences what shall be the arm's length price ?
- CUP method can be applied as the all the commercial terms i.e. Qty, Product, Market are identical in both the transactions
- Hence, the arm's length price in the case shall be Eur 2 per piece
- TPO is justified in adjusting the price of I Ltd by Eur 0.7/unit

# CUP Case Study (contd.)

| I Ltd (Exports to AE)   |                |  | Z Ltd (Exports to Non AE) |                |
|---|----------------|--|---------------------------|----------------|
| Particulars   |                |  | Particulars               |                |
|   |                |  |                           |                |
| Qty   | 1000           |  | Qty                       | 1000           |
| Basis   | Cash           |  | Basis                     | 30 days Credit |
| Export Price  | Eur 1.5 / unit |  | Export Price              | Eur 2 / unit   |
| <b>Cash Payment fetches discount of Eur 0.5 / unit in the open market</b> |                |  |                           |                |

Assuming there are no other functional differences, what shall be the arm's length price ?

Except for payments terms, there are no functional differences in the two transactions.  
Hence CUP method can be applied after adjusting the arm's length price for difference in payment terms.

Hence arm's length price of Eur 2/unit shall be adjusted to accommodate the discount of Eur 0.5/unit.  
Hence the adjusted arm's length price is derived at Eur 1.5/unit which is equal to the price of international transaction.

Prima facie, it may appear that I Ltd has under invoiced its AE, the international transaction is at arm's length



# TNMM Case Study

| Particulars                          | I LTD            | I LTD                                 |
|--------------------------------------|------------------|---------------------------------------|
| <b>Product</b>                       | CD writers       | CD writers                            |
| <b>Imports</b>                       | Y LTD - AE       | K LTD - Non AE                        |
| <b>Price</b>                         | Rs. 2900/unit    | Rs. 2550/unit                         |
|                                      | Terms of Imports |                                       |
| <b>Incoterms</b>                     | CIF              | Exworks                               |
| <b>Costs</b>                         | -                | Rs. 100 / unit (Freight & insurance)  |
|                                      |                  |                                       |
| <b>Exports</b>                       | A LTD - Non AE   | M LTD - Non AE                        |
| <b>MRP</b>                           | Rs. 3000/u       | Rs. 3000/u                            |
|                                      | Terms of Exports |                                       |
| <b>Incoterms</b>                     | Ex works         | CIF                                   |
| <b>Cost of freight and Insurance</b> | -                | Rs. 60 / unit                         |
|                                      |                  |                                       |
| <b>Qty</b>                           | 10000 units      | 1000 units                            |
| <b>Discount</b>                      | 1%               | -                                     |
|                                      |                  |                                       |
| <b>Marketing strategy</b>            | -                | 3 CD packs /unit (Potential customer) |
| <b>Cost</b>                          | -                | Rs. 30/CD pack                        |
|                                      |                  |                                       |
| <b>Warranty</b>                      | 6 months         | 12 months                             |
| <b>Additional cost</b>               | -                | Rs. 150/unit                          |

# TNMM Case Study (contd.)

Amount in INR

| Particulars                    | I LTD (imports from AE)    | I LTD (Imports from Non AE)                  |
|--------------------------------|----------------------------|--|
| <b>Sales</b>                   | 2970 ( 3000 - 1% Discount) | 3000   |
| <b>COGS</b>                    | 2900                       | 2650 ( 2550 + 100 for freight and insurance) |
| <b>Gross Margin</b>            | 70                         | 350  |
| <b>GM %</b>                    | 2%                         | 12%  |
|                                |                            |  |
| <b>Freight &amp; Insurance</b> | 0                          | 60   |
| <b>Marketing</b>               | 0                          | 90   |
| <b>Additional Warranty</b>     | 0                          | 150  |
|                                |                            |  |
| <b>Total Opex</b>              | 0                          | 300  |
|                                |                            |  |
| <b>Operating Margin</b>        | 70                         | 50   |
| <b>OP % on sales</b>           | 2.4%                       | 1.7%   |

# TNMM Case Study (contd.)

- Though the product is same, but the commercial terms and functions performed by I LTD are different in both the transactions
- The transaction not only impacts the GM but the OPEX also. Hence TNMM method shall be used which compares the transactions at margin level
- Looking at GM %, we may have an impression that I LTD has imported at a higher value, but the imports with AE is at arm's length

# TP Documentation

- Mandatory under Section 92D (1) read with Rule 10D(1)
- Burden of proof on taxpayer to demonstrate compliance with regulations
- To eliminate/ minimize penalties
- To demonstrate how pricing decisions were made
- To show that you did adopt arm's length principle
- Adequately structure the cross border transactions between group companies

# Prescribed documents

## Sec 92D (1) & Rule 10D (1)

1. Ownership Details
2. Relationship, addresses, legal status and country details of AE
3. Business description of taxpayer and AE
4. Nature, terms & value of International / 'specified domestic' transaction
5. Description of International / 'specified domestic' transaction
6. Details of functions, risks & assets employed by taxpayer & AE
7. Market analysis, forecasts, budgets & financial estimates with divisional and product split having a bearing on the international / 'specified domestic' transaction
8. Relevant data collected and analyzed for uncontrolled transactions for comparability
9. Method considered and applied with reasoning for individual or class of transactions & justification

# Prescribed documents

## Sec 92D (1) & Rule 10D (1) (contd.)

10. Comparable data used and comparison with other enterprises and adjustments made for difference
11. Assumptions, policies, price negotiations which have critical effect
12. Other supporting data or document for price determination

Exemption to maintain prescribed documentation

*Aggregate value thresholds:*

*International Transactions not exceeding Rupees 1 Crore*

*Specified Domestic Transactions not exceeding Rupees 5 Crores*

# Supporting Documents

## Rule 10D (3)

- Official/ Government publications & reports, studies or database
- Market research studies or technical publications by reputed institutions
- Published market prices (Exchanges)
- Published accounts & financial statements
- Agreements & contracts with AE & others for similar transactions
- Letters & other correspondence on negotiations
- Transaction documents as per accounting practice

# Other Documents

- Internet downloads of -
  - third party comparable data
  - press clippings
  - industry information
- Brochures and catalogues
- Price lists
- Marketing material
- Management accounts and management reports
- Internal presentations
- Business Plans



# Steps towards documentation

## Step 1: Functions

- Map economically relevant facts and characteristics of international / 'specified domestic' transactions w.r.t functions/ risks/ assets to assess impact on pricing thereof
- Meet key personnel to understand:
  - **F**unctions performed
  - **A**ssets/ intangibles utilized
  - **R**isks (economic) undertaken by each group entity and their effect on international / 'specified domestic' transactions
- Contractual terms of international / 'specified domestic' transactions
- Contribution by each group entity to overall economic value

# Steps towards documentation

## Step 2: Industry

- Determine market/ industry driven factors that impact pricing of international / 'specified domestic' transactions of the Company
- Obtain understanding of industry/ market in which Company operates to identify market characteristics, risks and conditions specific to the industry and its key players
- Analyze key growth/ value drivers and critical success factors of the industry and its key players
- Reconfirm inferences with the Company's personnel

# Steps towards documentation

## Step 3: Economic analysis

- This forms the 'core' of the TP study as it establishes the defensible arm's length price ('ALP')
- Characterize the nature of operations of the Company
- Identify the tested party
- Determine the method which is best suited to the facts and circumstances of international / 'specified domestic' transactions and provides the most reliable measure of arm's length price
- Document reasons for selection of the method / rejection of methods

# Steps towards documentation

## Step 4: Methodology

- Perform search on universe of comparables and collate comparables data
- Perform detailed financial & economic analysis for evaluation of comparability based on quantitative and qualitative factors (i.e., search filters)
- Benchmark relevant company data against the final set of comparables for the identified parameters (e.g., performance/ profit level indicators)

# Steps towards documentation

## Step 5: Benchmarking

### Documenting assessment of comparables

- Selection criteria
- Data sources
- Search process
- Search results
- Reasons for exclusions
- Description of selected comparables
- Compute the arm's length price

# Penalties

|   |  |
|---|--|
| Transfer Pricing Adjustment – Sec 271(1)(c)       | 100% – 300% of tax on adjustment         |
| Non-maintenance of documentation – Sec 271AA      | 2% of value of international transaction |
| Non-furnishing of Accountant's Report – Sec 271BA | INR 100,000                              |
| Non-furnishing of documentation – Sec 271G        | 2% of value of international transaction |

# Audit Experience

| Method Applied                  | % of Cases  |
|---------------------------------|-------------|
| Transactional Net Margin Method | 72%         |
| Comparable Uncontrolled Price   | 19%         |
| Cost Plus Method                | 6%          |
| Resale Price Method             | 3%          |
| Profit Split Method             | 0.1%        |
| <b>Total</b>                    | <b>100%</b> |

- ◆ Scrutiny levels  
 < 15 Crores by AO  
 > 15 Crores by TPO
- ◆ TPOs thoroughly review and at times revise benchmarking Strategy of the taxpayer
- ◆ Adjustments over 9 rounds from AY 2002-03 (Rs 1,403 Crs) to AY 2010-11 (Rs 60,000 Crs) exceed Rs 220,000 Crs (USD 36 bn). Over Rs. 200,000 Crs of TP adjustments in the last 5 assessment cycles.
- ◆ More than 3,600 cases were taken up for TP audit during FY14 with adjustments made in over half of these

# Evolving Dispute Resolution Mechanisms

## Dispute Resolution Panel (DRP)

- Alternate dispute resolution mechanism to 1st level appellate proceeding before the CIT (A)
- Specialist 3 member collegium for settling disputes on a fast track basis
- No demand till Assessing Officer issues final order after directions of DRP

## Advance Pricing Agreement (APA) – Introduced in Finance Act 2012

- Would be limited to a maximum term of five consecutive financial years
- The ALP shall be determined on the basis of prescribed methods or any other method
- Rules governing the APA regime notified by CBDT

## Safe Harbour - to reduce transfer pricing disputes

- Safe Harbor rules notified
- Seeks to reduce the impact of judgmental errors in transfer pricing
- Stipulation of margins-specified industries (Priority -IT/ITeS) / Class of transactions / threshold limits
- Safe Harbour regime would be optional and could be exercised on a year to year basis

## Mutual Agreement Procedure (MAP) – To avoid double taxation and provide relief

- MAP is an alternate mechanism incorporated into tax treaties for the resolution of international tax disputes
- Resolution of disputes through the intervention of competent authorities of each State who evolve a mutually acceptable solution



# Dispute Resolution Panel (DRP)

## Background

- Collegium of 3 Commissioners to comprise of DRP
- 2 DRP's in Mumbai
- DRP to have same powers as vested in a Court
- DRP – Optional else normal appellate channel i.e. CIT(A)
- Applicable to: Taxpayer's with transfer pricing adjustments, any foreign company.
- DRP to issue directions to AO within 9 months

# Advance Pricing Agreements (APAs)

1. Agreement between taxpayer and tax authorities for specifying the manner in which the arm's length price is to be decided
2. The arm's length price shall be decided by any method whether prescribed or not
3. Valid for 5 years – unless there is change in provisions
4. Can also be extended to 4 preceding years
5. Binding on taxpayer, CIT and tax authorities below CIT
6. In the case an APA covering a particular year is obtained after filing the return of income, a modified return to be filed based on the APA and assessment or reassessment to be completed based on such modified return

# Safe Harbour Rules (SHR)

- “Safe harbour” - Circumstances in which the income-tax authorities shall accept the transfer price declared by the assessee.
- Introduced in India by Finance (No.2) Act, 2009 w.r.e.f. 1.4.2009 and new Section 92CB inserted in the Act.
- Safe Harbour Rules have been framed based on the recommendations of the Rangachary Committee – Committee to Review taxation of development centres and the IT sector chaired by N. Rangachary.
- Rangachary Committee has submitted six reports including specific sector-wise/transaction-wise reports for
  - IT Sector,
  - ITES Sector
  - Contract R&D in the IT and Pharmaceutical Sector
  - Financial Transactions-Outbound loans
  - Financial Transactions-Corporate Guarantees
  - Auto Ancillaries-Original Equipment Manufacturers

# Safe Harbour Rules (SHR)

## Key Highlights

| International Transaction  | Value of International Transaction (INR)   | Safe Harbour Margin   |
|--|--|---|
| IT / ITES Services   | -  | 20% or more up to transaction value of INR 500 cr. And at least 22% beyond 500 cr.  |
| ITES being knowledge processes outsourcing services  |  | 25% or more   |
| Intra-group loan to wholly owned subsidiary  | <ul style="list-style-type: none"> <li>•does not exceed INR 50 crore</li> <li>•exceeds INR 50 crore</li> </ul>                                     | <ul style="list-style-type: none"> <li>•SBI base rate plus 150 bps</li> <li>• SBI base rate plus 300 bps</li> </ul>           |
| Corporate guarantee  | <ul style="list-style-type: none"> <li>•does not exceed INR 100 crore</li> <li>•exceeds INR 100 crore +credit rating related conditions</li> </ul> | <ul style="list-style-type: none"> <li>•Commission /fee of 2 % or more</li> <li>•Commission /fee of 1.75 % or more</li> </ul> |
| Specified contract research and development services wholly or partly relating to software development | -  | 30% or more   |

# Triggers / Contributors for TP Litigation

## Key Triggers for Aggressive Audits

- Consistent losses / low margins of the assessee attributable to inter-company transactions
- Significant changes in profitability of the assessee and its AEs
- High Royalty / Technical fee payouts, Cost recharges, Management Fees, Cost allocations
- Net losses incurred by routine distributors
- Low mark-ups for services
- Application of Ratio's such as ROCE / Berry ratio / cash profit instead of net margins
- Significant Advertisement and marketing spends by manufacturing / distribution companies
- Use of foreign comparables

## Contributors to Aggressive Audits:

- Mounting fiscal demand on Government
- Need to Preserve tax base
- Constant competitive pressure to restructure business operations efficiently
- Unprecedented sharing of information between revenue authorities

***Substantial increase in transfer pricing audits and disputes across the Globe , India is no exception....***

# Relevant Judicial Pronouncements

## Aggregation of Transaction

### *Panasonic India Pvt. Ltd v. ITO [2010-TII-47-ITAT-DEL-TP]*

The Delhi Tribunal affirmed the aggregation of transactions where the Functions, Assets & Risks underlying those transactions are similar in nature.

#### **Facts:**

- The taxpayer is an Indian company engaged in the business of trading of household appliances, consumer electronics, office automation and telecommunication products and provision of agency services. During Financial year (FY) 2001-02, the taxpayer operated in three segments:
  - Consumer Product Division (CPD);
  - System Products Division (SPD); and
  - Industrial Sales Division (ISD).

In respect of CPD and SPD Division, the taxpayer was characterised as a typical distributor while in relation to the ISD segment, it acted as an agency service provider. In the Transfer Pricing documentation, the taxpayer aggregated the CPD and SPD segments and benchmarked them under the TNMM with Net Profit Margin (NPM) as the profit level indicator (PLI). The ISD segment was also benchmarked under TNMM, though with Net Cost Plus mark-up (NCP) as the PLI.

# Relevant Judicial Pronouncements

## Aggregation of Transaction (contd.)

During the course of Transfer Pricing assessment proceedings, the Transfer Pricing Officer (TPO) proposed Transfer Pricing adjustment based on the following observations:

The TPO rejected the aggregation of CPD and SPD divisions owing to differences in products and target customer group of the two divisions. He further segregated the CPD division into CPD (Local) and CPD (Imported Goods);

The TPO characterised the reimbursement of advertisement expenditure received by the taxpayer from its AE as non-operating income; and

In respect of the ISD segment, the TPO disregarded the rationale provided by the taxpayer that the losses in this segment were attributable to low volumes owing to specific industry dynamics.

Aggrieved by the order of the Assessing Officer (AO), the taxpayer filed an appeal with the Commissioner of Income Tax (Appeals) [CIT(A)] which affirmed the adjustment proposed by the AO.

The Tribunal, after considering rival submissions and perusing the material on record, rejected the order of the CIT(A) and ruled in favour of the taxpayer. The key aspects of Tribunal's order are:

# Relevant Judicial Pronouncements

## Aggregation of Transaction (contd.)

The Tribunal affirmed the aggregation of the CPD (Imported Goods) and the SPD divisions primarily based on the following assertions:

- The Functions, Assets & Risks analysis underlying the two divisions were similar; and
- The TPO had relied on the same set of comparables for benchmarking the disaggregated segments

Secondly, it was held that as the taxpayer has been receiving reimbursement of advertisement expenditure for the past few years, the taxpayer was in reasonable expectation of receiving such reimbursement even in FY2001-02, even though there were no written contractual terms in this regard. Therefore, such reimbursement was directly linked to the business of the taxpayer and could not be disregarded while calculating taxpayer's income under the TNMM method.

In respect of the ISD division (agency business), the Tribunal accepted the use of multiple year data for both the taxpayer and the comparable companies. The Tribunal observed that the losses incurred by the taxpayer in the current year on account of low volumes satisfy the proviso to Rule 10B(4) which provides for use of two years data prior to the relevant financial year where a taxpayer can demonstrate that such data reveals facts which have an influence on the determination of transfer prices for the year in question.



# Relevant Judicial Pronouncements

## Aggregation of Transaction (contd.)

The Tribunal rejected the taxpayer's contention for relying upon the valuation done by the Special Valuation Bench (SVB) of the Custom Department to justify arm's length character under the Income Tax Act observing that where specific rules of law exist in the statute on a particular subject, they would hold the field.

# Relevant Judicial Pronouncements

## Generic vs Originally Researched Product – Usage of CUP method

### *UCB India Pvt. Ltd. vs. ACIT Mumbai [2009-TIOL-184-ITAT-MUM]*

The Mumbai Tribunal rejected CUP method applied by the TPO for comparing Generic drug with Originally researched drug considering functional and risk aspects.

#### **Facts:**

Assessee is a 100 per cent subsidiary of a Belgian pharma company - imports bulk drugs from its AE - files return with Form 3CEB u/s 92 - AO refers it to TPO for determination of ALP - TPO rejects the application of TNMM used for arriving at operational profits - takes the view that CUP method be used first and if it fails other methods may be resorted to - recommends adjustments of profits on various ground - AO agrees with the TPO.

CIT(A) grants partial relief to the assessee – held:

- the assessee was in error in comparing the operational margin at entity level and terming it as 'Transaction Net Margin Method Adoption of such method is rejected;
- the adoption of CUP method by the revenue, cannot be considered as the most appropriate method as the same suffers from many deficiencies and infirmities and specifically lack of information and data on comparables;

# Relevant Judicial Pronouncements

## Generic vs Originally Researched Product – Usage of CUP method

- issue remanded to the file of the assessing officer for fresh adjudication in accordance with law after giving adequate opportunity to the assessee, with the following directions:
  - The assessee to file a fresh transfer pricing study report and any other document or evidence, which he may seek to furnish, for the first time, in support of his report and the AO shall take the same on record and examine the same.
  - The assessee is free to adopt any method as prescribed by law, if it considers that method as the most appropriate method.
  - TNMM may also be considered, if the transaction or a class of transaction are properly evaluated in accordance with law. In case external comparables are not available due to lack of data in public domain, the AO may accept internal comparables including segmental data or internal TNMM.

# Relevant Judicial Pronouncements

## Adjustment to OP based on robust FAR Analysis

### *ITO vs Zydus Atlanta Healthcare Pvt. Ltd. [2010-TII-29-ITAT-MUM-TP]*

The Mumbai Tribunal emphasized that the determination of the arm's length price should be based on the functional and asset profile of the company and operating margins of the comparables should be adjusted for the functional and other differences between the taxpayer and the comparables.

#### **Facts:**

1. Assessee company is a JV between Cadila Healthcare Ltd and Byk Gulden Lomberg GmbH Germany (BGL) a 100% (EOU) engaged in the manufacture of pharmaceutical products and intermediates exclusively for the Byk Gulden. The assessee also provided clinical research services on new molecules emerging from the research pipeline of the Byk Gulden.
2. With regards to clinical trial services performed by the assessee company for Byk Gulden, the TPO after examining the various aspects concluded that the mark up of 5% over cost was not as per arm's length price and same should have been 17.14% on the basis of comparables.
3. CIT (A) upheld the contentions made by the assessee.

# Relevant Judicial Pronouncements

## Adjustment to OP based on robust FAR Analysis

(contd.)

After appeal preferred by the Revenue, ITAT held that:

- the main function of the assessee was to collate the data and transmit the same to Byk Gulden for which it was suitably reimbursed by Byk by mark up of 5% over the cost.
- The assessee's functions were more like coordinator/facilitator rather than performing the function itself.

# Relevant Judicial Pronouncements

## Pass Through Cost – Whether mark up required

### *DCIT vs. Chell Communications India Pvt. Ltd [ITA No. 712/DEL2010]*

The Delhi Tribunal endorsed the views of the OECD that while applying TNMM, the costs to be considered should be the costs incurred in relation to the value addition activity.

#### **Facts:**

1. The assessee, a wholly owned subsidiary of Chell Communications Inc, Korea, is primarily engaged in the business of rendering advertising services to its AEs against payment of commission.
2. The assessee applied the TNMM to confirm the ALP and selected OP/VA expenses as PLI
3. The assessee also facilitates the placement of advertisements in the print/electronic media. For this purpose, the assessee makes payment to 3<sup>rd</sup> parties like advt. agencies, printing presses etc. for booking of advt. space / time slots. on behalf of customers. The assessee recognized these payments as pass through costs and did not charge any mark up on the same.

# Relevant Judicial Pronouncements

## Pass Through Cost – Whether mark up required (contd.)

- However the TPO considered the payments to 3<sup>rd</sup> parties as part of the cost and made adjustments to the income of the assessee.
- CIT(A) upheld the contentions of the assessee.
- After appeal preferred by the Revenue, ITAT held that assessee facilitates the placement of advertisements for its AEs for which it makes payment to 3<sup>rd</sup> parties for renting advt. space on behalf of AEs and is not in the business of selling advt. slots to its AEs.

# Recent Judicial Pronouncements

## Law for applying PSM as per Rule 10B(1)(d) explained

### *ITO vs. Net Freight (India) P. Ltd. (ITAT Delhi) [2014]*

The Profit Split Method as provided under Rule 10 B(1)(d) is applicable mainly in international transactions:

- (a) involving transfer of unique intangibles;
- (b) in multiple international transactions which are so interrelated that they cannot be valued separately.

The method specified in clause (ii) of Rule 10B(1)(d) that the relative contribution made by each of associated enterprise should be evaluated on the basis of FAR analysis and on the basis of reliable external data. Thus, bench marking by selection of comparables is mandatory under this Method.

The profits need to be split among the AEs on the basis of reliable external market data, which indicate how unrelated parties have split the profits in similar circumstances. For practical application, bench marking with reliable external market data is to be done, in case of residual profit split method, at the first stage, where the combined net profits are partially allocated to each enterprise so as to provide it with an appropriate base returns keeping in view the nature of the transaction.

The residual profits may be split as per relative contribution of the Associated Enterprise. At this stage of splitting of residual profits, no bench marking is necessary, as it is not practicable. Nevertheless, for splitting the residuary profits a scientific basis for allocation may be applied.



# Recent Judicial Pronouncements

## Law for applying PSM as per Rule 10B(1)(d) explained (contd.)

### **Facts:**

- The Taxpayer, a logistics service provider, and its associated enterprises (AEs) have an arrangement of profit sharing on a 50% basis of all transactions of inbound and outbound shipments.
- The Taxpayer's transfer pricing documentation supported that the international transactions were arm's length using the Residual Profit Split Method (RPSM) as the most appropriate method (MAM).
- The Transfer Pricing Officer (TPO) rejected the RPSM adopted by the Taxpayer stating that sufficient information was not available to determine whether the arrangement of the profit sharing rate of 50% was appropriate or not.
- The TPO, instead, adopted Transactional Net Margin Method (TNMM) and tested the net operating margin of the Taxpayer at the entity level with third party comparable companies and made a transfer pricing adjustment.
- The Tribunal rejected the application of TNMM at the entity level as adopted by the TPO.

# Recent Judicial Pronouncements

## Law for applying PSM as per Rule 10B(1)(d) explained (contd.)

- The Tribunal held that RPSM was the MAM in the case of the Taxpayer. Further, the Tribunal held that a two-step approach should be followed to allocate the profit between the AEs. At the first stage, the combined net profits are partially allocated to each enterprise so as to provide each with an appropriate routine return based on reliable external market data and the residual profits thereafter may be split on a scientific basis in accordance with the relative contribution of the AEs, which need not be benchmarked.

# Recent Judicial Pronouncements

## Issue of Shares – Not subject to TP / adjustments

### *Vodafone India Services Pvt. Ltd. vs. UoI [2014] 368 ITR 1 (Bom)*

The Bombay High Court held that neither the capital receipts received by the Petitioner on issue of equity shares to its holding company, a non-resident entity, nor the alleged short-fall between the so called fair market price of its equity shares and the issue price of the equity shares can be considered as income within the meaning of the expression as defined under the Act.

#### **Facts:**

- The assessee, an Indian company, issued equity shares at the premium of Rs.8591 per share aggregating Rs.246.38 crores to its holding company. Though the transaction was reported as an “international transaction” in Form 3 CEB, the assessee claimed that the transfer pricing provisions did not apply as there was no income arising to it.
- The AO referred the issue to the TPO without dealing with the preliminary objection.
- The TPO held that he could not go into the issue whether income had arisen or not because his jurisdiction was limited to determine the ALP. He held that the assessee ought to have charged the NAV of the share (Rs. 53,775) and that the difference between the NAV and the issue price was a deemed loan from the assessee to the holding company for which the assessee ought to have received 13.5% interest.

# Recent Judicial Pronouncements

## Issue of Shares – Not subject to TP / adjustments

(contd.)

- He accordingly computed the adjustment for the shares premium at Rs. 1308 crore and the interest thereon at Rs. 88 crore.
- The AO passed a draft assessment order u/s 144C(1) in which he held that he was bound u/s 92-CA(4) with the TPO's determination and could not consider the contention whether the transfer pricing provisions applied.
- The assessee filed a Writ Petition challenging the jurisdiction of the TPO/AO to make the adjustment.
- The High Court directed the DRP to decide the assessee's objection regarding chargeability of alleged shortfall in share premium as a preliminary issue.
- Upon the DRP's decision, the assessee filed another Writ Petition.
  
- HELD by the High Court allowing the Petition:
  - A plain reading of Section 92(1) of the Act very clearly brings out that income arising from a International Transaction is a condition precedent for application of Chapter X of the Act.

# Recent Judicial Pronouncements

## Issue of Shares – Not subject to TP / adjustments

(contd.)

- The word income for the purpose of the Act has a well understood meaning as defined in s. 2(24) of the Act. The amounts received on issue of share capital including the premium is undoubtedly on capital account. Share premium have been made taxable by a legal fiction u/s 56(2)(viib) of the Act and the same is enumerated as Income in s. 2(24)(xvi) of the Act. However, what is brought into the ambit of income is the premium received from a resident in excess of the fair market value of the shares. In this case what is being sought to be taxed is capital not received from a non-resident i.e. premium allegedly not received on application of ALP. Therefore, absent express legislation, no amount received, accrued or arising on capital account transaction can be subjected to tax as Income (Cadell Weaving Mill Co. vs. CIT 249 ITR 265 approved in CIT vs. D.P. Sandu Bros 273 ITR 1 followed);
- In case of taxing statutes, in the absence of the provision by itself being susceptible to two or more meanings, it is not permissible to forgo the strict rules of interpretation while construing it. It was not open to the DRP to seek aid of the supposed intent of the Legislature to give a wider meaning to the word 'Income';

# Recent Judicial Pronouncements

## Issue of Shares – Not subject to TP / adjustments

(contd.)

- The other basis in the impugned order, namely that as a consequence of under valuation of shares, there is an impact on potential income and that if the ALP were received, the Petitioner would be able to invest the same and earn income, proceeds on a mere surmise/assumption. This cannot be the basis of taxation. In any case, the entire exercise of charging to tax the amounts allegedly not received as share premium fails, as no tax is being charged on the amount received as share premium.
- Chapter X is invoked to ensure that the transaction is charged to tax only on working out the income after arriving at the ALP of the transaction. This is only to ensure that there is no manipulation of prices/consideration between AEs. The entire consideration received would not be a subject-matter of taxation;
- The department's method of interpretation indeed is a unique way of reading a provision i.e. to omit words in the Section. This manner of reading a provision by ignoring/rejecting certain words without any finding that in the absence of so rejecting, the provision would become unworkable, is certainly not a permitted mode of interpretation. It would lead to burial of the settled legal position that a provision should be read as a whole, without rejecting and/or adding words thereto. This rejecting of words in a statute to achieve a predetermined objective is not permissible. This would amount to redrafting the legislation which is beyond/outside the jurisdiction of Courts.

# Recent Judicial Pronouncements

## Issue of Shares – Not subject to TP / adjustments

(contd.)

- In tax jurisprudence, it is well settled that following four factors are essential ingredients to a taxing statute:- (a) subject of tax; (b) person liable to pay the tax; (c) rate at which tax is to be paid, and (d) measure or value on which the rate is to be applied. Thus, there is difference between a charge to tax and the measure of tax (a) & (d) above;
- The contention that in view of Chapter X of the Act, the notional income is to be brought to tax and real income will have no place is not acceptable because the entire exercise of determining the ALP is only to arrive at the real income earned i.e. the correct price of the transaction, shorn of the price arrived at between the parties on account of their relationship viz. AEs. In this case, the revenue seems to be confusing the measure to a charge and calling the measure a notional income. We find that there is absence of any charge in the Act to subject issue of shares at a premium to tax.
- W.e.f. 1 April 2013, the definition of income u/s 2(24)(xvi) includes within its scope the provisions of s. 56(2) (vii-b) of the Act. This indicates the intent of the Parliament to tax issue of shares to a resident, when the issue price is above its fair market value. In the instant case, the Revenue's case is that the issue price of equity share is below the fair market value of the shares issued to a non-resident. Thus Parliament has consciously not brought to tax amounts received from a non-resident for issue of shares, as it would discourage capital inflow from abroad.

# Recent Judicial Pronouncements

## Issue of Shares – Not subject to TP / adjustments

(contd.)

- Consequently, the issue of shares at a premium by the Petitioner to its non resident holding company does not give rise to any income from an admitted International Transaction. Thus, no occasion to apply Chapter X of the Act can arise in such a case.



# Takeaways

- Functional and Risk Analysis very crucial
- Transaction by transaction analysis will be the trend for future
- Appropriate selection of the tested party
- Appropriate justification for use of the method (especially if CUP is rejected)
- Possible adjustment for Risk differential
- Removal of outliers - extremes inconsistent with 'captive' profile
- Need for specific recognition of "business strategy" as a factor for judging comparability in Indian TP rules
- Strong TP documentation very crucial to defend profit attribution to Permanent Establishments (PEs)



The Revenue will never  
understand your business  
as well as you do—

if you fail to **explain your business**  
and pricing in “easy” language,  
you will encounter ongoing  
expensive difficulties.

Most importantly, **use TP for planning** than a post mortem  
exercise...

# Open House

