

Transfer Pricing

Internal Restructuring



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Evaluation of TRANSFER PRICING?

- Transfer pricing as a concept traditionally began with the **amount charged by one segment of an enterprise for a product or service that it supplied to another segment of the same enterprise.**
- With the evolution of **MNC concept**, segments of the enterprise started spreading as independent entities operating in various parts of the globe.
- Accordingly, the term has evolved to mean ***price which is charged between two or more entities of a MNC [associated enterprises (AEs)] operating in different countries.***

Example:

- *X Limited, a trader of goods, purchases and sells goods as below:*

Particulars	Related parties in other countries	Unrelated parties
Purchases	8,00,000	5,00,000
Sales	10,00,000	10,00,000
Profits	2,00,000	5,00,000

- *By increasing the costs of purchases from related parties, X Ltd. has reduced its taxable profits in its jurisdiction.*
- This, the tax administrators believe is unjust. Thus, to protect each country's fair share in an MNC's total profit, the tax authorities have established principles under which it can be assumed that related parties deal with each other as if they were independent and this principle is called the arm's length principle.

MEANING OF THE TERM “ARM’S LENGTH PRINCIPLE”

- The Arm’s Length Price (ALP) of a transaction between two associated enterprises is the **price that would be paid** **if** the transaction had taken place between two comparable independent and unrelated parties, where the consideration is only commercial.
- The OECD transfer pricing guidelines provides guidance on the application of the arm’s length principle in order to arrive at the proper transfer pricing range between associated enterprises.

The members are countries describing themselves as committed to democracy and the market economy, providing a platform to compare policy experiences, **seek answers to common problems, identify good practices** and coordinate domestic and international policies of its members.

SIGNIFICANCE OF ARM'S LENGTH PRINCIPLE

- Parity between MNCs and independent enterprises –

A major reason is that the ALP provides broad parity of tax treatment for MNCs and independent enterprises. Since the ALP puts associated and independent enterprises on a **more equal footing for tax purposes**, **it avoids the creation of tax advantages and disadvantages** that would otherwise distort the relative competitive positions of these entities. The ALP, thus promotes the growth of international trade and investment by removing these tax considerations from economic decisions.

SIGNIFICANCE OF ARM'S LENGTH PRINCIPLE

- **Determines real taxable profits –**

The transfer price adopted by a multinational has a direct bearing on the proportional profit it derives in each country in which it operates. If inadequate or excessive consideration is paid for the transfer of goods, services or intangible property between the members of an MNC group, the income calculated for each of those members will be inconsistent with their relative economic contributions. An 'arm's length' price – a price two independent firms operating at arm's length would agree on – is needed to determine taxable profits earned in each country.

The arm's length doctrine permits the taxing authorities to rectify the accounts of the enterprise so as to reflect correctly the income that the establishment would have earned if it were an independent enterprise.

SIGNIFICANCE OF ARM'S LENGTH PRINCIPLE

- Reduction of artificial price distortion –

If the ALP is not followed, an MNC will sell goods/ provide services to a controlled entity in a high tax regime at a high price (which exceeds the market price)

and

to an entity in a low-tax regime or a tax haven at a low price (which is lower than the market price).

This would result in extreme price distortion of goods and services in the international market.

SIGNIFICANCE OF ARM'S LENGTH PRINCIPLE

- **Minimization of double taxation –**

The ALP is an international concept and it represents the international norm. The potential for double taxation is minimized, since in international transfer pricing, adjustment to the transfer price in one tax jurisdiction requires a corresponding adjustment in the other tax jurisdiction.

- **Accurate measurement of economic contribution –**

The ALP provides accurate measurement of the fair market value of the economic contribution units of an MNC. The focus of the ALP is to ensure that the proper amount of income is attributed to where it is earned. This results in each unit of the MNC earning a return commensurate with its economic contribution and risk assumed.

COMPUTATION OF INCOME FROM TRANSACTION WITH NON-RESIDENT [SECTION 92] -

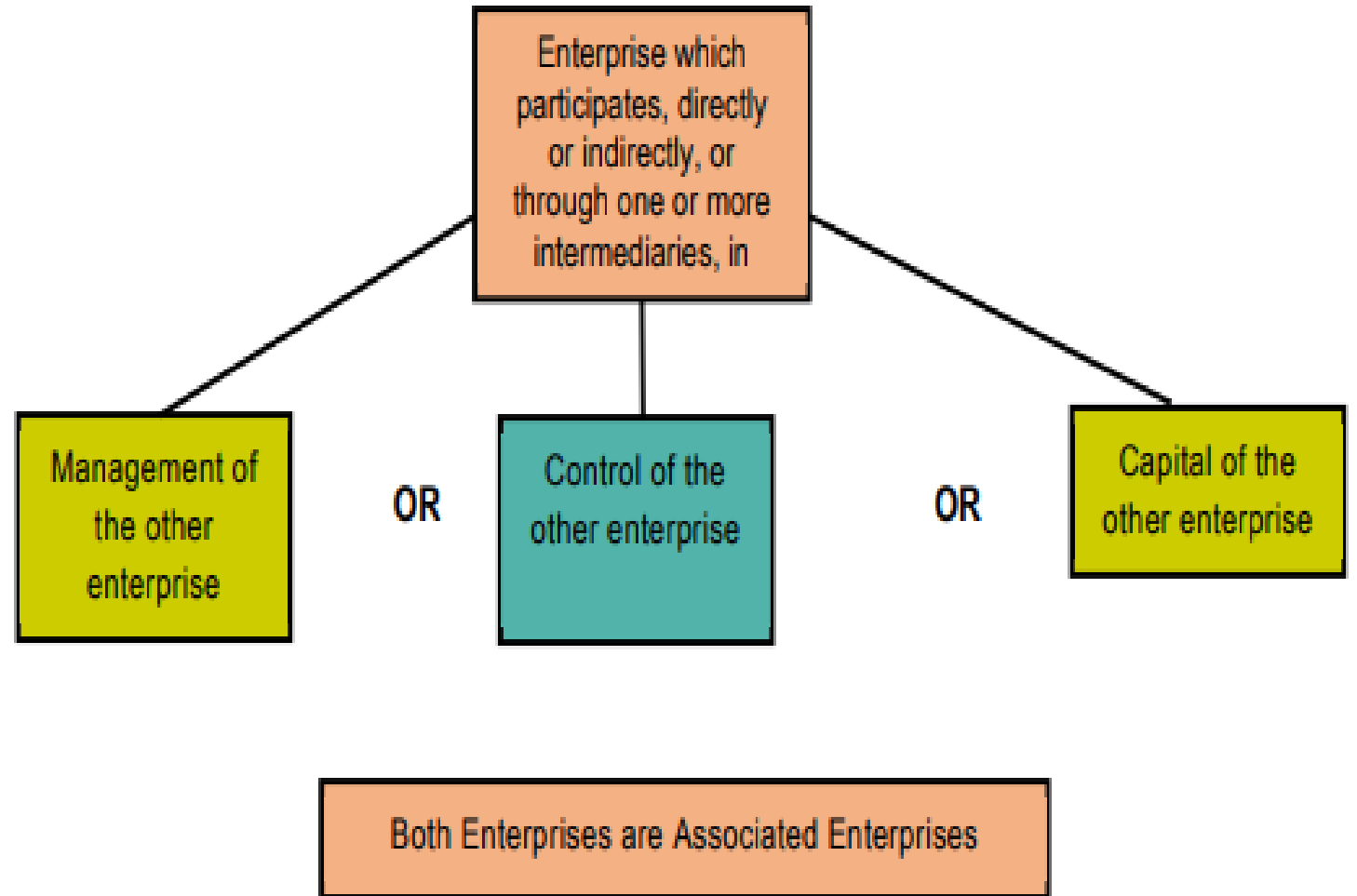
- Section 92 provides that any income arising from an “international transaction” shall be computed having regard to “the arm’s length price”.
- The objective of transfer pricing provisions is to protect the tax base of India and to ensure that due to inter-company transactions, there is no reduction in the taxable profits or the taxes paid by the Indian taxpayer. ***The reverse, however, does not hold true (Section 92(3)) .
- Section 92(3) provides that the transfer pricing provisions contained in section 92 shall not apply if the same has the effect of reducing the income chargeable to tax or increasing the loss of the assessee for the year under consideration.

COMPUTATION OF INCOME FROM TRANSACTION WITH NON-RESIDENT [SECTION 92] - Example:

Case	Income as determined by assessee	Income as per ALP	Expenses claimed by assessee	Expenses as per ALP	Profit/Loss as per assessee	Profit/Loss after applying TP provisions	Has TP resulted in reduction of taxable income/increase of losses?	Will TP provisions apply?
1	100	150	70	70	30	80	No	Yes
2	100	90	70	70	30	20	Yes	No
3	100	90	110	110	(10)	(20)	Yes	No
4	100	100	70	110	30	(10)	Yes	No

ASSOCIATED ENTERPRISES

- As per section 92A(1), associated enterprise refers to:
- an enterprise which participates, directly or indirectly, or through one or more intermediaries, in:
 - management of the other enterprise, or
 - control of the other enterprise, or
 - capital of the other enterprise.



ASSOCIATED ENTERPRISES - Example

- *A Ltd. directly participates in management of B Ltd.*

Therefore, both A Ltd. & B Ltd. are associated enterprises.

- *Now, consider a situation where A Ltd. directly participates in management of B Ltd. and B Ltd. directly participates in management of C Ltd. In such situation, A Ltd. has direct participation in management of B Ltd. but has an indirect participation in management of C Ltd.*

Therefore, in such scenario, C Ltd. is also an associated enterprise of A Ltd.

ASSOCIATED ENTERPRISES - Example

- If one or more persons participates, directly or indirectly, or through one or more intermediaries in:
 - management of the two different enterprises
 - control of two different enterprises
 - capital of two different enterprises
- Then, those two enterprises are associated enterprises.
- **Example:** *Mr. A directly has control in A Ltd. and B Ltd. In such a scenario, both A Ltd. & B Ltd. are associated enterprises since they have a common person i.e. Mr. A, who controls both entities A Ltd. & B Ltd.*

Deemed Associated Enterprises

- Two enterprises are deemed to be associated enterprises if they fall under any one or more of the situations contained in section 92A(2).
- This section provides **13 such situations** during which associated enterprise relationship is deemed to be established.

Two enterprises are deemed to be associated enterprise if:

- **Enterprise ownership** - One enterprise holds 26% or more of the voting power, directly or indirectly, in the other enterprise.

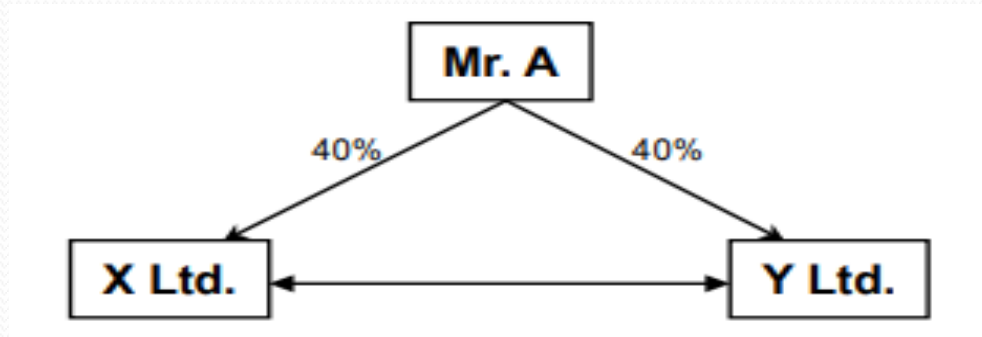
***Example:** A Ltd. holds 33% of voting power in B Ltd. and B Ltd. holds 80% voting power in C Ltd.*



In above situation, A Ltd. holds 26% or more voting power in B Ltd., directly and in C Ltd. indirectly (i.e. through B Ltd.). Therefore, both B Ltd. & C Ltd. are deemed associated enterprises of A Ltd.

Deemed Associated Enterprises - 2

- **Substantial voting power in two entities by common person** - Any person or enterprise holds 26% or more of the voting power, directly or indirectly, in each of two different enterprises.
- ***Example:** Mr. A holds 40% of voting power in both X Ltd. and Y Ltd. where neither X Ltd. has any holding in Y Ltd. nor Y Ltd. has any holding in X Ltd.*



- In this situation, since Mr. A directly holds 40% of voting power in both X Ltd. and Y Ltd., *X Ltd. & Y Ltd. will be deemed associated enterprises.*

Deemed Associated Enterprises - 3

- **Advancing of substantial sum of money** - One enterprise advances loan to the other enterprise of an amount of **51% or more of the book value of the total assets** of such other enterprise.
- ***Example:** Book value of total assets of Y Ltd. is Rs. 100 crores. X Ltd. advances loan of Rs. 60 crores to Y Ltd.*
- *Since, in this case, X Ltd. advances loan of Rs. 60 crores to Y Ltd, which is 60% of the book value of total assets of Y Ltd. Hence, X Ltd. & Y Ltd. are deemed associated enterprises*

Deemed Associated Enterprises – 4 & 5

- **Guaranteeing borrowings** - One enterprise guarantees 10% or more of the total borrowings of the other enterprise.
- *Example: P Inc. has total loan of 1 million dollars from XYZ Bank of America. Out of that, A Ltd., an Indian company, guarantees 20% of total borrowings in case of any default made by P Inc.*

In such scenario, since A Ltd. guarantees 20% of total borrowings of P Inc., P Inc. and A Ltd. are deemed associated enterprises.

- **Appointment of majority directors of other enterprise** - One Enterprise appoints 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 another enterprise.
- *Example: X Ltd. has 15 directors on its Board. Out of that, Y Ltd. has appointed 8 directors. In such case, X Ltd. and Y Ltd. are deemed associated enterprises.*

Deemed Associated Enterprises – 6&7

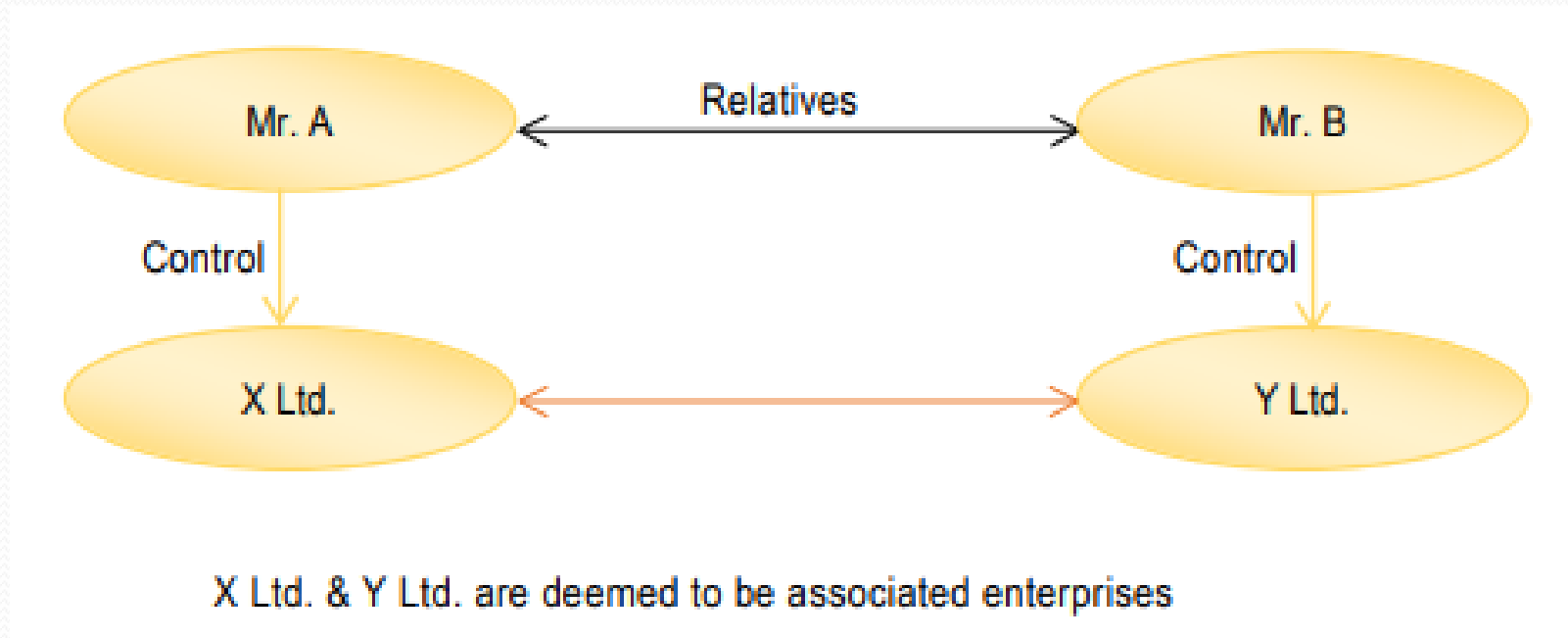
- Appointment of **majority directors of two different enterprises by same person(s)** - More than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons.
- *Example: Mr. A appointed 9 directors out of 15 directors of X Ltd. and appointed 2 executive directors on the board of Y Ltd. In such case, since a common person i.e. Mr. A appointed more than half of the directors in X Ltd. and appointed 2 executive directors in Y Ltd., both X Ltd. and Y Ltd. are deemed associated enterprises.*
- **Dependence on intangibles** - The manufacture or processing of goods or articles or business carried out by one enterprise is **wholly dependent (i.e. 100%) on the know-how, patents, copyrights, trade-marks, licenses, 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 entity is the owner or in respect of which the other enterprise has exclusive rights.

Deemed Associated Enterprises – 8&9

- **Dependence on Purchase** (raw material supplied by other enterprise) - 90% or more of raw materials and consumables required for the manufacture or processing of goods or articles or business carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, where the prices and other conditions relating to the supply are influenced by such other enterprise.
- **Dependence on sale** - 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.

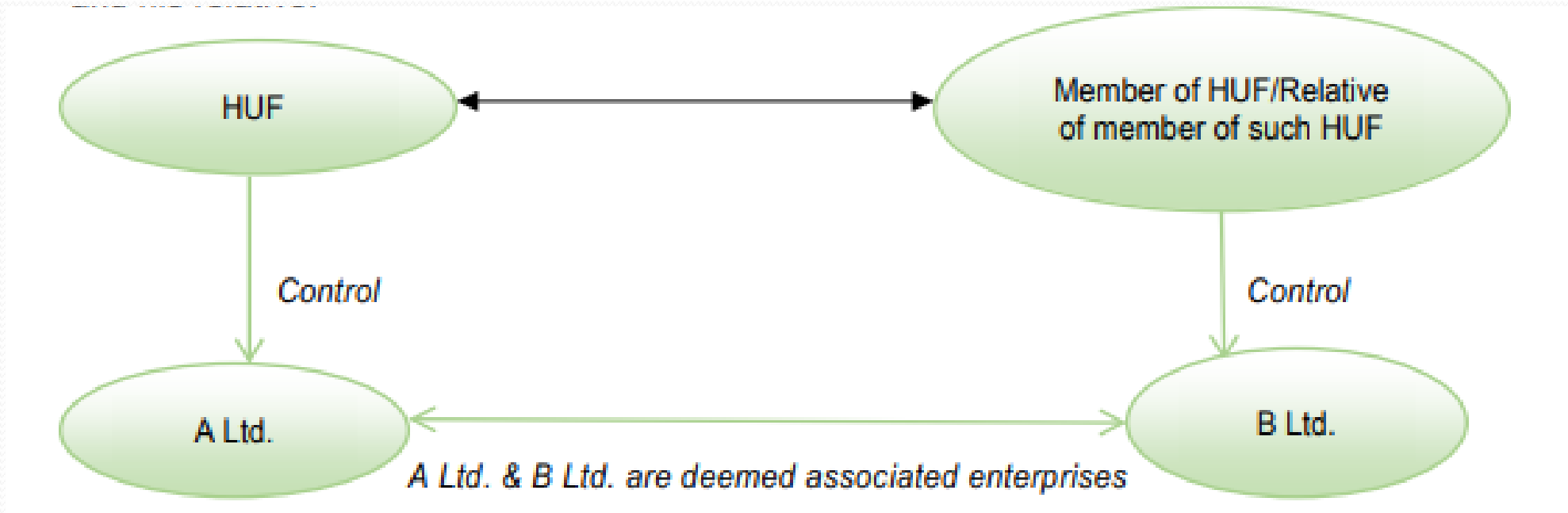
Deemed Associated Enterprises – 10

- **Control by common individual** - 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 his relatives.
- **Example:** *Mr. A and Mr. B are relatives. Mr. A has control over X Ltd. and Mr. B has control over Y Ltd. Therefore, both X Ltd. and Y Ltd. will be deemed associated enterprises.*



Deemed Associated Enterprises – 11

- **Control by Hindu Undivided Family or member thereof-** Where one enterprise is controlled by a Hindu undivided family (HUF) and the other enterprise is controlled by a member of such HUF or by relative of a member of such HUF or jointly by such member and his relative.

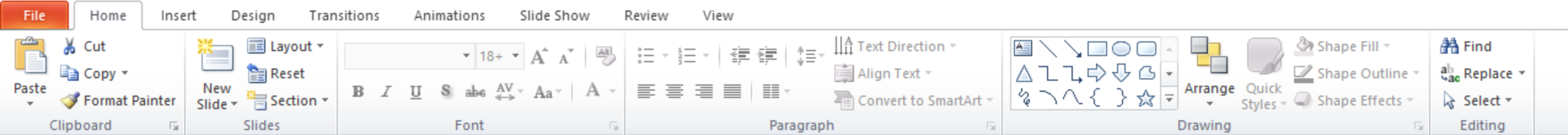


Deemed Associated Enterprises – 12 & 13

- **Interest in a firm, association of persons or body of individuals** – Where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds 10% or more interest in firm/AOPs/BOIs.
- **Mutual interest relationship** - There exists between the two enterprises, any relationship of mutual interest, as may be prescribed.

International transaction [Section 92B(1)]

- As per section 92B, an international transaction means: a transaction between two or more associated enterprises, either or both of whom are non- residents; and
- transaction in the nature of:
 - sale/ purchase/ lease of tangible property; or
 - sale/ purchase/ lease of intangible property; or
 - provision of services; or
 - lending/ borrowing money; or
 - any other transaction having a bearing on profits, income, losses or assets of such enterprises; or
 - mutual agreement or arrangement between two or more associated enterprise 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.



Slides Outline

24 International transaction [Section 92B(2)]

- As per section 92B, an international transaction means: a transaction between two or more associated enterprises, either or both of whom are non-residents, and transactions that are covered:
 - sale/purchase/lease of tangible property; or
 - sale/purchase/lease of intangible property; or
 - provision of services; or
 - lending/borrowing money; or
 - any other transaction having a bearing on profits, losses, losses, or assets of such enterprises; or
 - contractual 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.

25 Deemed international transaction [Section 92B(2)]

- Where, in respect of a transaction entered into by an enterprise with a person other than an associated enterprise (hereinafter referred to as "other person"),
 - there exists a prior agreement in relation to the relevant transaction between the other person and the associated enterprise; and
 - where the terms of the relevant transaction are determined in substance between such other person and the associated enterprise; and
 - either the enterprise or the associated enterprise or both of them are non-residents,
 then such transaction entered into between the enterprise and the other person shall be deemed to be an international transaction entered into between two associated enterprises, whether or not such other person is a non-resident.

(Example in Next Slide)

26

Example:

A Ltd., an Indian company, has entered into an agreement for sale of product X to B Co., an associated enterprise, on 15/03/2015 and B Co. has entered into an agreement for sale of product X to C Ltd., a non-resident entity, which is a specified foreign company in relation to A Ltd., on 30/03/2015. Thus, the transaction between A Ltd. and B Co. shall be deemed to be an international transaction entered into between two associated enterprises, irrespective of whether or not B Co. is a non-resident.

Transaction for sale of Product X entered into on 15/03/2015

Transaction for sale of Product X entered into on 30/03/2015

Note - C Ltd. is deemed to be an associated enterprise of A Ltd. since it is a specified foreign company in relation to A Ltd., which means that A Ltd. holds 25% or more in the nominal value of the equity share capital of C Ltd.

27 The scope of "international transaction" shall include:

S. No.	Transactions	Usable scope of scope of common code
1.	Purchase, sale, transfer, lease, use of tangible property	Tangible property includes: <ul style="list-style-type: none"> building; transportation vehicle; machinery, equipment, tools, plant; fixtures; movable, or any other article, product or thing.
2.	Purchase, sale, transfer, lease, use of intangible property, including transfer of knowledge or the provision of use of service right	The intangible rights/property include: <ul style="list-style-type: none"> land use; copyrights, patents, trademarks, licenses, know-how; customer list, marketing channel, brand, commercial secrets; leasehold; intellectual property right; computer software and data; and any other business or commercial rights of similar nature.

Deemed international transaction [Section 92B(2)]

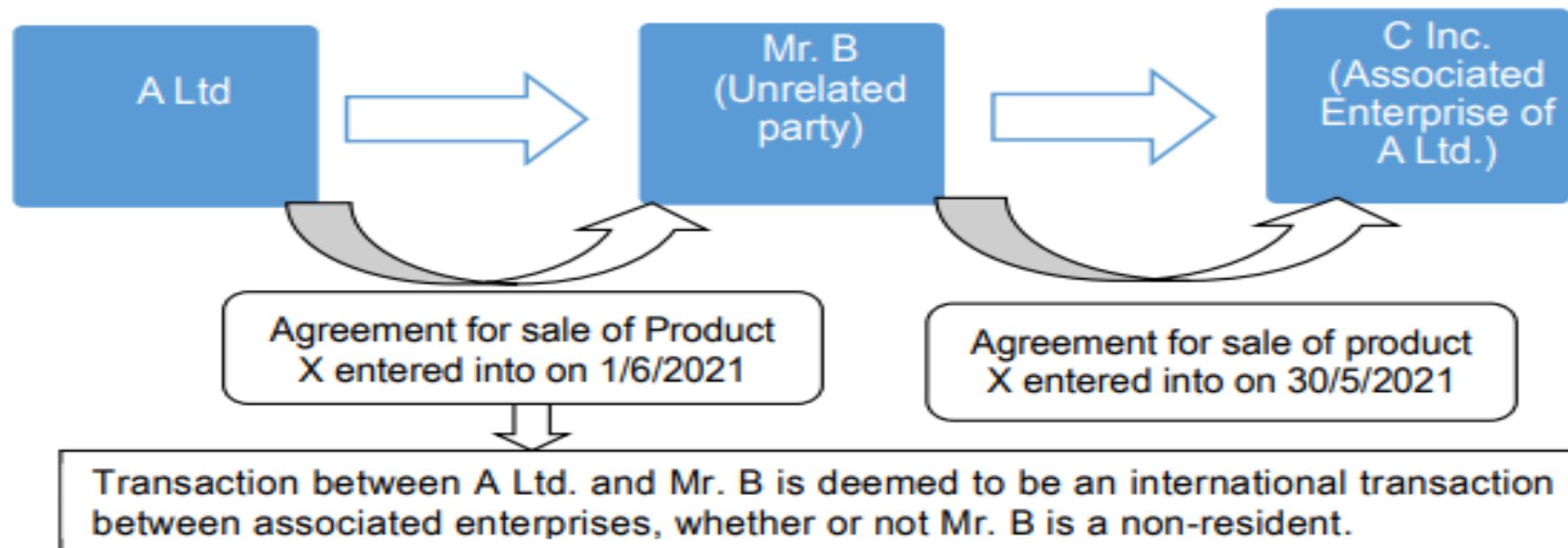
- Where, in respect of a transaction entered into by an enterprise with a person other than an associated enterprise (hereinafter referred to as "other person"),
- there **exists a prior agreement in relation to the relevant transaction** between the other person and the associated enterprise **or**,
- where the terms of the relevant transaction are determined in substance between such other person and the associated enterprise; **and**
- either the enterprise or the associated enterprise or both of them are non-residents,

then such transaction entered into between the enterprise and the other person shall be **deemed to be an international transaction** entered into between two associated enterprises, **whether or not such other person is a non-resident.**

[Example in Next Slide]

Example:

If A Ltd., an Indian company, has entered into an agreement for sale of product X to Mr. B, an unrelated party, on 1/6/2021 and Mr. B has entered into an agreement for sale of product X with C Inc., a non-resident entity, which is a specified foreign company in relation to A Ltd., on 30/5/2021, then, the transaction between A Ltd. and Mr. B shall be deemed to be an international transaction entered into between two associated enterprises, irrespective of whether or not Mr. B is a non-resident.



Note – C Inc. is deemed to be an associated enterprise of A Ltd. since it is a specified foreign company in relation to A Ltd., which means that A Ltd. holds 26% or more in the nominal value of the equity share capital of C Inc.

The scope of “international transaction” shall include:

Sl. No.	Transactions	Amplification of scope of terms used
1	Purchase, sale, transfer, lease or use of tangible property	Tangible property includes - <ul style="list-style-type: none">• building,• transportation vehicle,• machinery, equipment, tools, plant,• furniture,• commodity or• any other article, product or thing;
2	Purchase, sale, transfer, lease or use of intangible property , including transfer of ownership or the provision of use of certain rights	“Use of certain rights” refer to – <ul style="list-style-type: none">• 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.

The scope of “international transaction” shall include:

Sl. No.	Transactions	Amplification of scope of terms used
3	Capital financing	<ul style="list-style-type: none">• 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.
4	Provision of services	<ul style="list-style-type: none">• provision of market research,• market development,• marketing management,• administration,• technical service,• repairs,• design,• consultation,• agency,• scientific research,• legal or accounting service.

The scope of “international transaction” shall include:

Sl. No.	Transactions	Amplification of scope of terms used
5	Business restructuring or reorganization entered into by an enterprise with an associated enterprise [Merger, demerger, amalgamation]	<ul style="list-style-type: none">• All such transactions are included in the definition of “international transaction”, whether or not it has bearing on the profit, income, losses or assets of such enterprises at the time of the transaction or at any future date.

Example 1: Profit shifting from a domestic tariff area (DTA) unit to a tax holiday unit

Actual situation

Particulars	Tax Holiday Unit	DTA Unit
Tax Rate	-	30%
Income from related party transaction ('RPT')	100	-
Other income	300	300
Expenses in relation to RPT	-	100
Other expenses	200	50
Profit / (loss)	200	150
Tax	0	45 (i.e. $150 * 30\%$)

Shifting of profits

Particulars	Tax Holiday Unit	DTA Unit
Tax Rate	-	30%
Income from related party transaction ('RPT')	250	-
Other income	300	300
Expenses in relation to RPT	-	250
Other expenses	200	50
Profit / (loss)	350	0
Tax	0	0

SPECIFIED DOMESTIC TRANSACTIONS

It is common knowledge that the under invoicing of sales and over invoicing of expenses is ordinarily revenue neutral in case of a domestic transaction.

However, shifting of profits from a profit making entity to related entity which is into losses or from one group entity to another to take undue advantage of tax incentive (tax holiday or any other), can create unwarranted situation of significant revenue loss to the Government.

Example 2: Profit shifting from a profit making entity to a related loss making concern.

Actual situation

Particulars	ABC Ltd.	XYZ Ltd.
Tax Rate	30%	30%
Income from related party transaction ('RPT')	100	-
Other income	300	300
Expenses in relation to RPT	-	100
Other expenses	700	50
Profit / (loss)	(300)	150
Tax	0	45 (i.e. $150 \times 30\%$)

Tax planning to shift profits

Particulars	ABC Ltd.	XYZ Ltd.
Tax Rate	30%	30%
Income from related party transaction ('RPT')	250	-
Other income	300	300
Expenses in relation to RPT	-	250
Other expenses	700	50
Profit / (loss)	(150)	0
Tax	0	0

SPECIFIED DOMESTIC TRANSACTIONS

In order to provide objectivity in determination of income from domestic related party transactions and determination of reasonableness of expenditure between related domestic parties, the provisions of section 92 have been extended to include within its ambit the specified domestic transactions

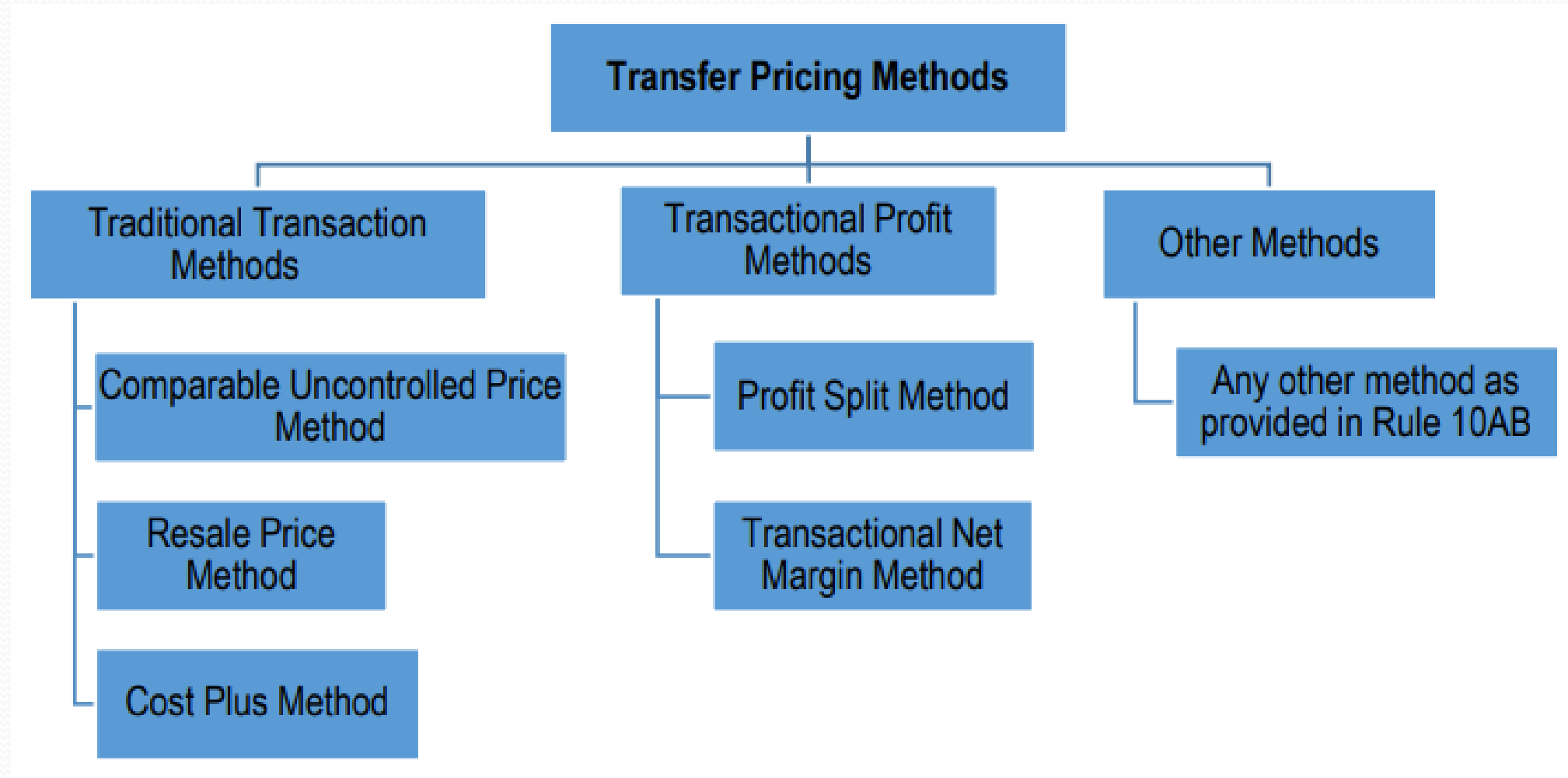
COMPUTATION OF **ARM'S LENGTH PRICE** (SECTION 92C)

- “Arm’s length price” is defined in section 92F(ii) to mean
 - price which is applied or proposed to be applied in a transaction
 - between persons other than associated enterprises
 - in uncontrolled conditions.
- Section 92C deals with the method for determining arm’s length price and the factors which are to be considered for applicability or non-applicability of a particular method to a given situation. The factors as well as methods incorporated in this section are not exhaustive and the CBDT may prescribe further factors and methods.

COMPUTATION OF ARM'S LENGTH PRICE (SECTION 92C)

- It provides that the **arm's length price** in relation to an international transaction **would be determined by any of the following methods**, being the **most appropriate method**, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely –
 - ❑ comparable uncontrolled price method;
 - ❑ resale price method;
 - ❑ cost plus method;
 - ❑ profit split method;
 - ❑ transactional net margin method;
 - ❑ such other method as may be prescribed by the Board.

COMPUTATION OF **ARM'S LENGTH PRICE** (SECTION 92C)



1. Comparable uncontrolled price method

- A comparable uncontrolled price is the price agreed between unconnected parties for the transaction of goods or services under similar circumstances.
- Mechanism to determine CUP is as follows:
 - i. Identification of price charged or paid for property transferred or services provided under any comparable uncontrolled transaction(s).
 - ii. Such price is adjusted to account for differences, if any, between the international transaction and comparable uncontrolled transactions or between the enterprises entering into such transactions which could materially affect the price in the open market can be made. [Quality of the product or service, contractual terms, credit terms, transport terms, level of the market (i.e. wholesale, retail, etc.), geographic market.]
 - iii. Adjusted price arrived above taken to be as arm's length price in respect of the property transferred or services provided in the international transaction.

Meaning of “Uncontrolled transaction”:

- Uncontrolled transaction means a transaction between enterprises other than associated enterprises, whether resident or non-resident.
- The comparable uncontrolled price method requires a high degree of comparability of products, services and functions and such comparability can be improved by carrying out **necessary reasonable adjustments**, in respect of differences arising on account of various factors such as **quality** of the product or service, **contractual terms**, **credit terms**, **transport terms**, **level of the market** (i.e. wholesale, retail, etc.), geographic market in which the transaction takes place, etc

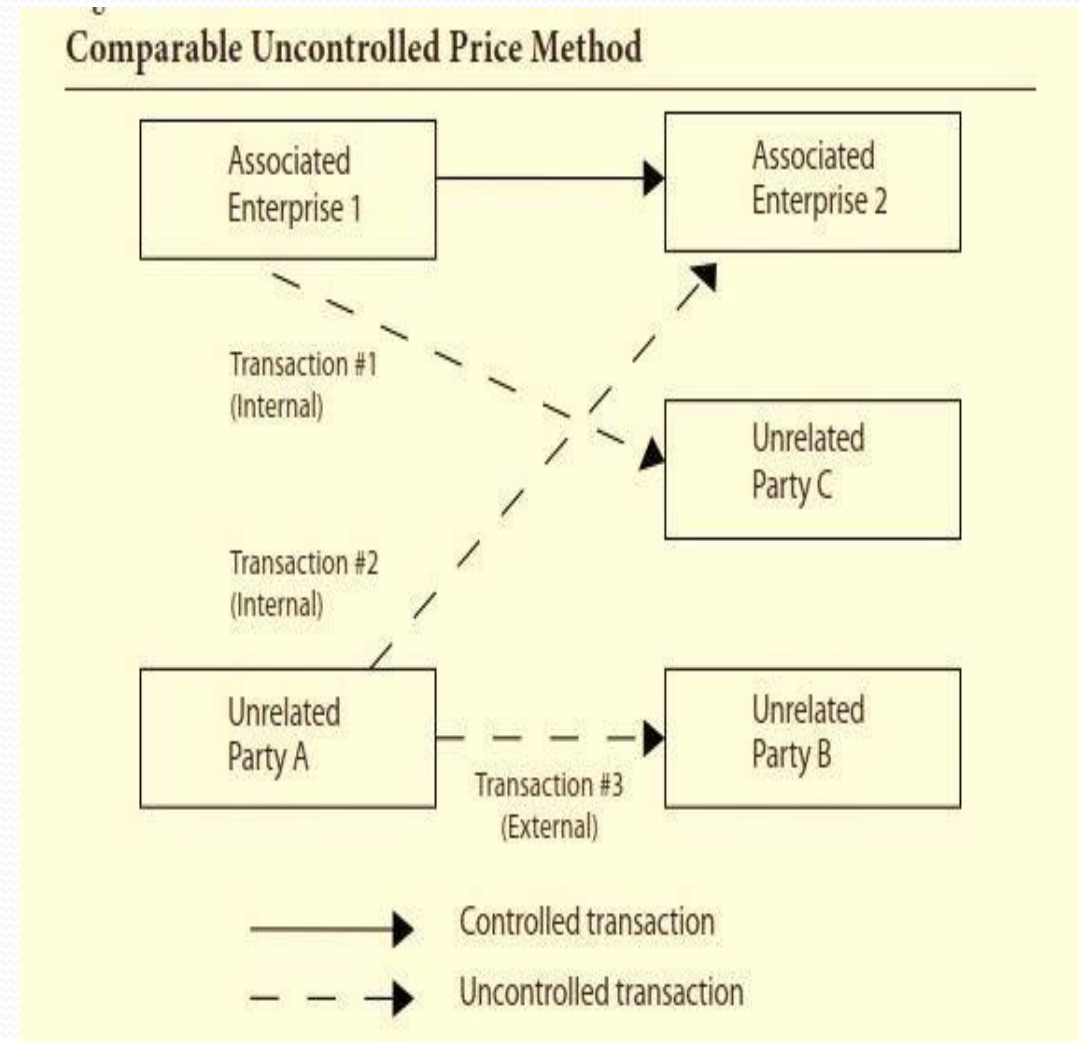


ILLUSTRATION 1

- US Ltd., a US company has a subsidiary, IND Ltd. in India.
- US Ltd. sells computer monitors to IND Ltd. for resale in India.
- US Ltd. also sells computer monitors to CMI Ltd., another computer reseller.

- It sells 50,000 computer monitors to IND. Ltd. at Rs. 11,000 per unit.
- The price fixed for CMI Ltd. is Rs. 10,000 per unit.
- The warranty in case of sale of monitors by IND Ltd. is handled by IND Ltd. However, for sale of monitors by CMI Ltd., US Ltd. is responsible for the warranty for 3 months.

- Both US Ltd. and IND Ltd. offer extended warranty at a standard rate of Rs. 1,000 per annum.
- On these facts, how is the assessment of IND Ltd. going to be affected?

ILLUSTRATION 1 - Solution

Hence arm's length price for computer monitors being sold by US Ltd. to IND Ltd. would be:

Particulars	No.	Rs.
Sale price charged by US Ltd. to CMI Ltd.	50,000	10,000
Less: Cost of warranty included in the price charged to CMI Ltd. (1,000 x 3 /12)		250
Arm's length price		9,750
Actual price paid by IND Ltd. to US Ltd.		11,000
Difference per unit		1,250
No. of units supplied by US Ltd. to IND Ltd.		
Addition required to be made in the computation of total income of IND Ltd. (1,250 × 50,000)		6,25,00,000

Resale Price Method (RPM)

- The resale price method (RPM) is a method which compares the gross margins (i.e. gross profit over sales) earned in transactions between related and unrelated parties for the determination of the ALP. The RPM **requires high level of functional comparability** and is mainly applicable where the controlled party is a distributor.
- The RPM evaluates whether the amount charged in a controlled transaction is at arm's length by reference to the gross margin realised in comparable uncontrolled transactions. RPM can be computed as follows:
 - i. **Identification of resale price** by tested party i.e., the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or provided to an unrelated enterprise.
 - ii. **Resale price is reduced by normal gross profit margin** with reference to uncontrolled transaction(s).
 - iii. Such price **reduced by expenses incurred (customs duty etc.)** in connection with purchase of the product/ services.
 - iv. This **price may be adjusted** to account for functional and other differences, if any, including differences in accounting practices which could materially affect the gross profit margin in the open market.
 - v. Adjusted price arrived above taken to be as **arm's length price** in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise.

Resale Price Method (RPM)

Using RPM as the most appropriate method, ALP can be computed as follows :

- AE2 has purchased goods from AE1 and re-sold to independent enterprise at USD 100.
- A similar transaction is entered into by unrelated parties with resale price margin of USD 25.
- Thus, the arm's length price arrived at is USD 75 (i.e. market value of goods at which AE2 should have purchased from AE1 (assuming no other costs for AE2 for simplicity purposes)).

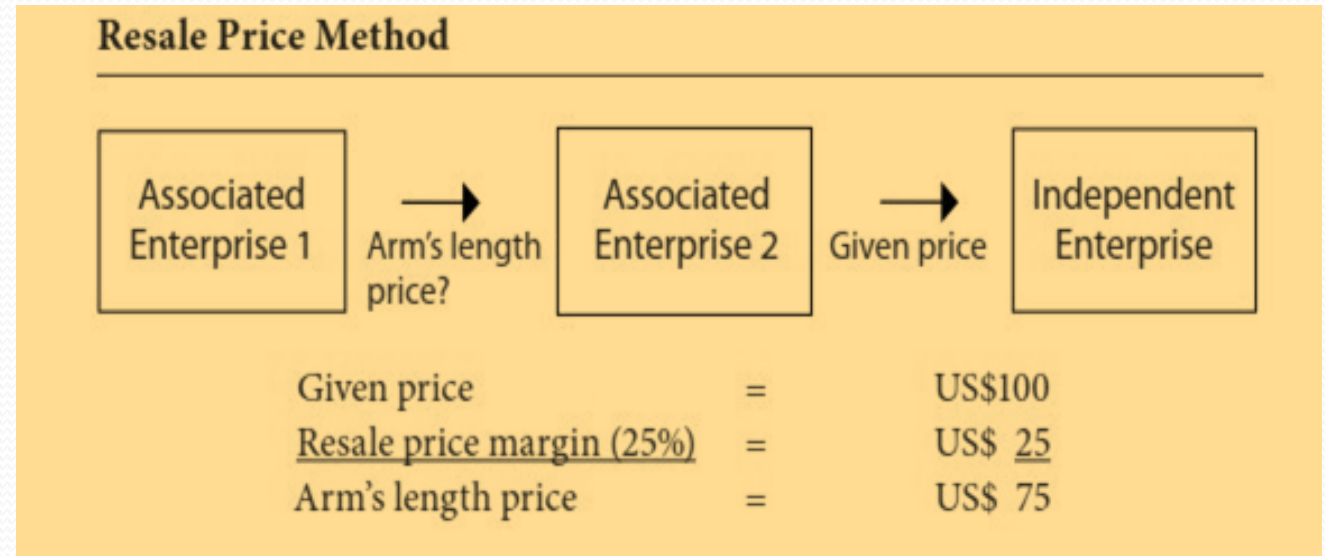


ILLUSTRATION 2

- Earth (P) Ltd., Calcutta is engaged in trading of electronic goods. It purchased goods from its associated enterprise Sun Pte. Ltd., Singapore, and also from unrelated party, Oceania Ltd., UK.
- For the F.Y.2021-22, the **gross profit margin** was **15%** on the sale of goods of Sun Pte Ltd., whereas it was **20%** in the case of Oceania Ltd.
- After-sales warranty of **6 months was provided by Sun Pte Ltd.** whereas **Oceania Ltd. gave after-sales warranty of 1 year.** The cost of warranty of Oceania may be taken as **2% of the sale price.**
- The Sun Pte. Ltd.'s brand value is internationally known and the benefit of the **brand value can be taken as 1% of sale price.**
- During the F.Y.2021-22, it sold goods of Sun Pte Ltd. for **Rs. 20 crores** and of Oceania Ltd. for Rs. **15 crores.**
- As regards transport cost of the goods purchased, there was no difference between related and unrelated party. **Compute the ALP** of the transaction between Earth (P) Ltd. and Sun Pte Ltd., Singapore **by applying the Resale Price Method**, considering the facts of the case.

ILLUSTRATION 2 - Solution

Particulars	Amount (In `)
Resale price of goods purchased from Sun Pte. Ltd.	20,00,00,000
Less: Profit margin with reference to uncontrolled transaction between Earth (P) Ltd. and Oceania Ltd. (20% on sale)	4,00,00,000
	16,00,00,000
Add: Adjustment for benefit of brand value of Sun Pte. Ltd. [Sun Pte. Ltd has its brand value internationally. Therefore, adjustment of benefit of brand value has to be carried out to arrive at ALP (1% of sale price)]	20,00,000
Less: Adjustment of cost of warranty [Sun Pte. Ltd. provides warranty for 6 months whereas unrelated party has provided warranty of 12 months. Therefore, adjustment for the cost of such warranty has to be carried out to arrive at arm's length price (2% of sale price x 6/12)]	(20,00,000)
Arm's length price	16,00,00,000

Cost plus method

- The Cost Plus Method ('CPM') determines an arm's-length price by adding an appropriate gross profit margin to an associated entity's costs of producing goods or services. The gross profit margin should reflect the functions performed by an entity and should include a return for capital used and risks assumed by the entity.

Mechanism to compute ALP based on CPM is as follows:

1. Determination of **direct and indirect costs of production** incurred by the enterprise in respect of property transferred or services provided to an associated enterprise.
2. Determination of amount of **normal gross profit mark-up** to such costs arising from the transfer or provision of the same or similar property or services by the enterprise or by an unrelated enterprise in comparable uncontrolled transaction or transactions.
3. The normal gross profit mark-up determined above is **adjusted to account for functional and other differences**, if any, which could materially affect such profit mark-up in the open market.
4. **Adjusted gross profit mark-up** added to total costs determined in (i) above.
5. Sum arrived above is taken to be **arm's length price** in relation to the supply of property or provision of services by the enterprise.

Cost plus method

- This method probably is most useful where semi-finished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.
- Using CPM as the most appropriate method, ALP can be computed as follows:

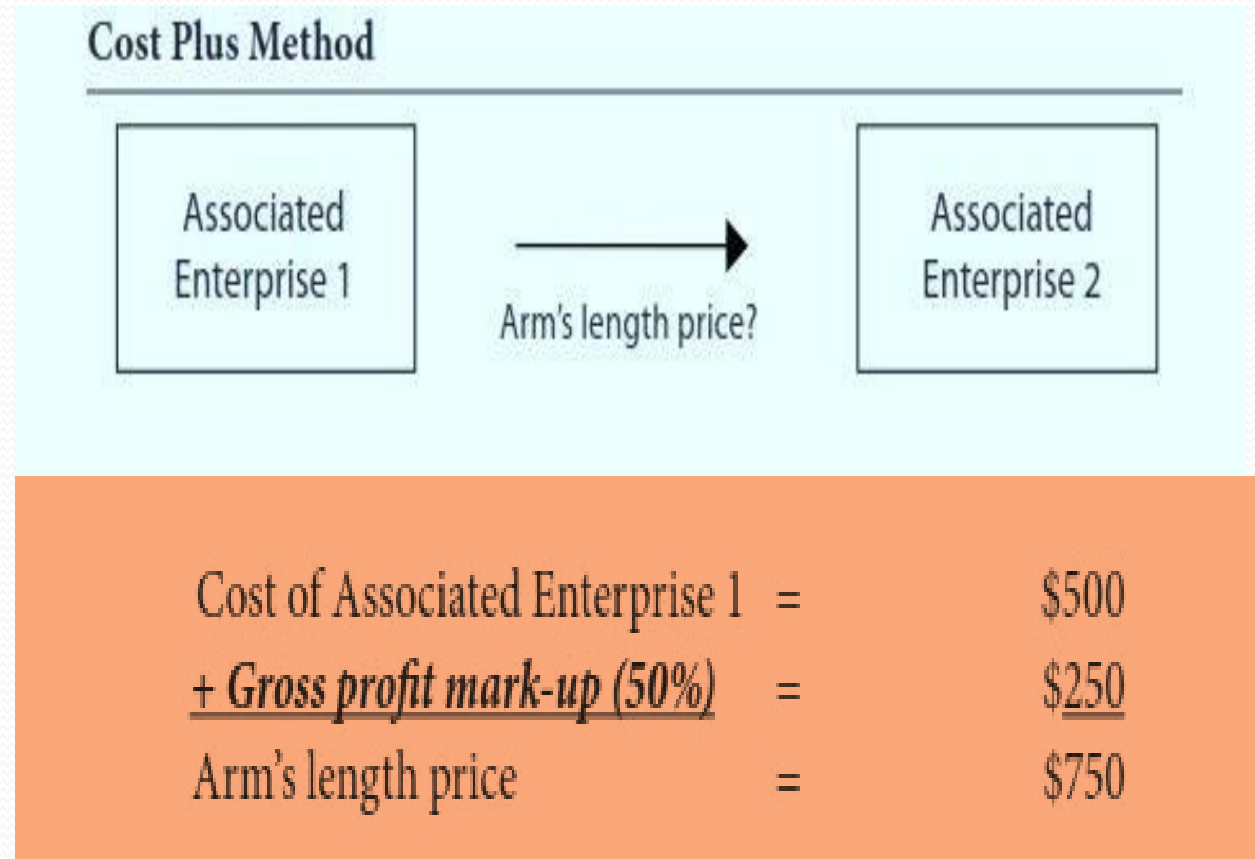


ILLUSTRATION 3

- ABC Ltd., Canada holds 35% shares in LMN Ltd., India. LMN Ltd. develops software and does both onsite and offsite consultancy services for the customers. LMN Ltd. during the year billed ABC Ltd. Canada for 120 man-hours at the rate of Rs. 1,800 per man hour.
- The total cost (direct and indirect) for executing this work amounted to ` 2,25,000.
- However, LMN Ltd. billed XYZ Ltd., India at the rate of ` 2,800 per man hour for the similar level of manpower and earned **a Gross Profit of 50% on its cost.**
- The transactions of LMN Ltd. with ABC Ltd. and XYZ Ltd. are comparable, subject to the following differences:
- While LMN Ltd. derives technology support from the ABC Ltd., there is no such support from XYZ Ltd. The **value of technology support received from ABC Ltd. may be put at 18% of normal gross profits.**
- As ABC Ltd. gives business in large volumes, LMN Ltd. offered to ABC Ltd., a **quantity discount** which may be valued at **10% of normal gross profits.**
- In the case of rendering services to ABC Ltd., LMN Ltd. neither runs any risk nor incurs any marketing costs. On the other hand, **in the case of services to XYZ Ltd.,** LMN Ltd. has to assume all the risk and costs associated with the marketing function which may be estimated at **12% of the normal gross profits.**
- **LMN Ltd. offered one month credit to ABC Ltd.** The cost of providing such credit may be valued at **2%** of the gross profits. No such credit was given to XYZ Ltd.
- Compute the Arm's Length Price along with income to be increased under the Cost Plus Method.

Computation of Arm's Length Price as per Cost Plus Method		
Gross Profit mark-up on cost in case of XYZ Ltd. [an unrelated party]		50%
Less: Adjustments for functional and other differences		
- Value of technology support [ABC Ltd. provides technology support, but XYZ Ltd. does not provide such support. Therefore, value of technology support shall be adjusted] [18% of 50%, being gross profit]	9%	
- Quantity discount to ABC Ltd. [Quantity discount is allowed to ABC Ltd. as it gives business in large volumes, but the same is not provided to XYZ Ltd. Therefore, it shall be adjusted] [10% of 50%, being gross profit]	5%	
- Risk and cost associated with marketing [LMN Ltd. has to bear all the risk and costs associated with the marketing function in case of XYZ Ltd., while there is no such risk in case of services to ABC Ltd. Therefore, market risk and cost shall be adjusted] [12% of 50%, being gross profit]	6%	
		20%
		30%
Add: Cost of credit to ABC Ltd. [LMN Ltd has provided credit of 1 month to ABC Ltd. but not to the unrelated party. Therefore, adjustment for the cost of such credit has to be carried out to arrive at the ALP] [(2% of 50%, being gross profit]		1%
Arm's length gross profit mark up to cost		31%
Cost incurred by LMN Ltd. for executing ABC Ltd.'s work		2,25,000
Add: Adjusted gross profit (` 2,25,000 x 31%)		69,750
Arm's length billed value		2,94,750
Less: Actual Billed Income from ABC Ltd. (` 1800 x 120 man hours)		2,16,000
Total Income of LMNLtd to be increased by		78,750

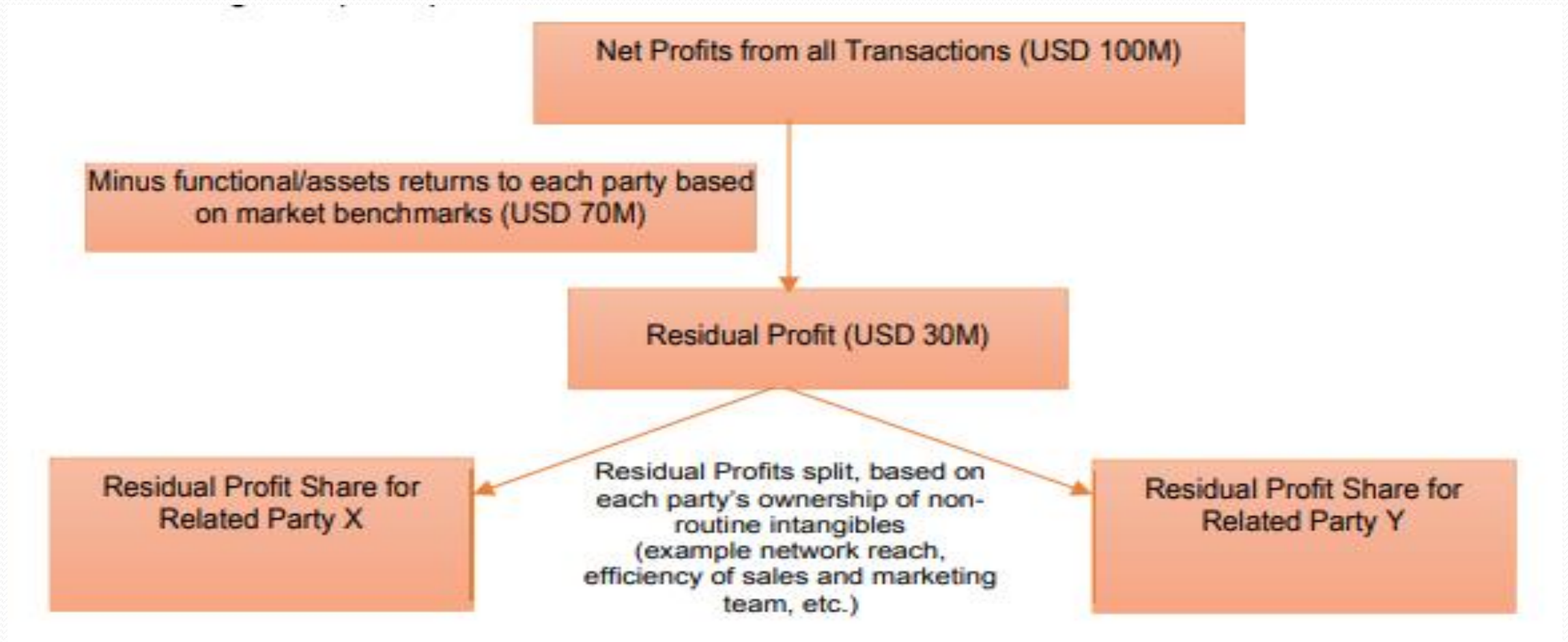
4. Profit split method

- This is a method which may be applicable mainly in international transactions involving transfer of unique intangibles or in multiple international transactions which are so inter-related that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction.
- The Profit Split Method (PSM) evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is at arm's length with reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most prominently identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions (relevant business activity).
- Profit split method, generally, is applied as per following steps:
 1. Determination of **combined net profit of the associated enterprises** arising out of international transaction in which they are engaged.
 2. Evaluation of **relative contributions by each enterprise** to the earning of such combined net profit on the basis of functions performed, risks assumed and assets employed by each enterprise. This evaluation is to be made on the basis of reliable external market data which can indicate how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances.
 3. **Splitting of combined net profit amongst the enterprises in proportion to their relative contributions**, as evaluated above.
 4. Profit thus apportioned to the assessee is taken into account to arrive at the **arm's length price** in relation to the international transaction.

Allocation of profits must be made in accordance with one of the following allocation methods:

- Comparable profit split - Under this method, uncontrolled taxpayer's percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity.
- Residual profit split - Following the two-step process:
 - Allocate income to routine contributions
 - Allocate residual profit

The following example explains the PSM:



Continuous illustration.....

- Suppose in the above example, Net profit margins from all transactions were USD 100M. Depending on the contribution of each AE, the net profit of USD 70M will be distributed to all AEs (i.e. Allocate income to routine contributions). Further, after the respective contribution is allocated specifically, the residual profit of USD 30M will be distributed among AEs based on various factors.
- Total profit for Related Party X:
- **Income for specific contribution** (suppose 40% by X and 60% by Y) made by X: USD 28M (i.e. USD 70M x 40%)
- **Income as residual profit** (i.e. 50:50) (allocated considering various factors): USD 15M (i.e. USD 30M x 50%)
- Total Arm's length profit of related party X: USD 43M (USD 28M + USD 15M)

5. Transactional net margin method

- Under the Transactional net margin method (TNMM), an arm's-length price is determined by **comparing the net profit margin in relation to an appropriate base** (example costs, sales, assets) of the tested party with the net profit margin in relation to the same base, of an uncontrolled party engaged in comparable transactions.

The following steps are required to determine ALP using TNMM:

- i. **Computation of net profit margin** realized by the enterprise from the international transaction with an AE having regard to costs incurred OR sales effected OR assets employed or having regard to any other relevant base.
- ii. Computation of **net profit margin** realized by the enterprise or an **unrelated enterprise** in a comparable uncontrolled transaction by applying the same base as above.
- iii. **Net profit margin** realized from uncontrolled transaction is **adjusted to account for differences**, if any, which could materially affect the net profit margin in the open market.
- iv. The net profit margin realized by the enterprise referred in (i) above is established to be the same as net profit margin referred in (iii) above.
- v. The **net profit margin thus established is taken into account** to arrive at an **arm's length price** for the international transaction.

The following example explains the TNMM:

- AE1 has purchased raw materials from its AE2 and manufactures goods for sale to third parties. The **similar transaction** is entered into by unrelated parties with net margin of 5% of sale price.
- Thus, if AE1 earns net margin of 5% of sale price, then its transaction of purchase of raw materials from AE2 will be at arm's length.

Given price	=	\$10 000
<u>Cost of goods sold</u>	=	\$ ____?
Gross profit	=	?
<u>Operating expenses</u>	=	\$ <u>2 000</u>
Net profit (5% of price)	=	\$ 500 <i>Comparable</i>

Illustration - 5

- **Andes Inc.** having its business in Malaysia has advanced a loan of **MD 1,60,000** to Andes **Ltd**, India. Book value of total assets of Andes Ltd was **Rs. 125 lakhs**. **Andes Ltd provides software backup support to Andes Inc.** Andes Ltd has spent **50,000 man hours** during the financial year 2021-22 for the services rendered to Andes Inc. The cost for Andes Ltd is MD **75/manhour**. Andes Ltd has billed Andes Inc. at **MD 90.75/manhour**.
- **Gama Ltd.** in India which has a similar business model, provides software backup support to Olive Inc. in Penang, Malaysia. Gama Ltd.'s cost and operating profits are as hereunder:

Particulars	in lakhs
Direct costs	600
Indirect costs	200
Operating profits	200

1. Calculate Arm's Length Price for the transaction between Andes Ltd. and Andes Inc. based on the above data of Gama Ltd. using the Transactional Net Margin Method. Assume 1 MD = ` 45.
 2. Explain, if there is any adjustment to be made to the total income of Andes Ltd.
- **Note:** MD = Malaysia Dollars

Illustration - Solution

- Two enterprises are deemed to be associated enterprises where one enterprise advances loan constituting not less than 51% of the book value of the total assets of the other enterprise.
- In this case, since Andes Inc., a foreign company, has advanced loan to Andes Ltd., an Indian company, and such loan constitutes 57.6% [$(` 45 \times 1,60,000 \times 100 / 1,25,00,000)$] of the book value of total assets of Andes Ltd., Andes Inc and Andes Ltd. are deemed to be associated enterprises. Since the transaction of provision of software backup support by Andes Ltd. to Andes Inc. is an international transaction between associated enterprises the provisions of transfer pricing would be attracted in this case.
- Determination of Operating Margin of transaction of provision of software backup support by Andes Ltd. to Andes Inc

	Rs.
Billing per manhour [MD 90.75/hour x ` 45]	4,083.75
Cost per man hour [MD 75/hour x ` 45]	3,375.00
Operating profit per manhour	708.75
Operating profits to cost (%) [$708.75 \times 100 / 3375$] = 21%	

Determination of Operating Margin of Comparable Uncontrolled transaction i.e., provision of software backup support. by Gama Ltd. to Olive Inc.

Particulars	₹ in lakhs
Direct Cost	600
Indirect Cost	200
Total cost	800
Operating profits	200
Operating profits to cost (%) $[200 \times 100 / 800] = 25\%$	

1. Computation of Arm's Length Price of provision of software backup support provided by Andes Ltd. to Andes Inc. by applying TNMM

	₹
Cost for Andes Ltd. (per man hour) [MD 75 x ₹ 45/MD]	3,375.00
Add: Arm's length operating profit margin as % of cost (25% of ₹ 3,375)	843.75
Arm's length price (per manhour) in ₹	4,218.75
Arm's length price of total manhours spent by Andes Ltd. for providing software backup support to Andes Inc. [₹ 4,218.75 x 50,000 man hours] = ₹ 21,09,37,500	

2. Adjustment to be made to the total income of Andes Ltd.

Particulars	₹
Arm's length price of total manhours spent by Andes Ltd. for providing software backup support to Andes Inc.	21,09,37,500
Less: Amount actually billed [90.75 MD x ₹ 45/MD x 50,000 manhours]	20,41,87,500
Arm's length adjustment to be made to the total income of Andes Ltd.	67,50,000

Exercise 1

- Mr. Hari holds **30%** of voting power in **ABC Inc**, a company incorporated under the laws of Country A. For the purpose of expansion of business, the said company enters into an agreement with XYZ Ltd., a company incorporated under the Indian laws.
- As per one of the clauses of the agreement, **ABC Inc has the power to appoint 6 directors of XYZ Ltd., which has 12 directors on the board.**
- Further, total **purchases** by XYZ Ltd. for the F.Y. 2021-22 is estimated to be ` **500 crores**, out of which, purchases of ` **48 crores has been sourced locally** and the balance shall be supplied by ABC Inc. The price for entire purchase has been fixed in the agreement and the conditions for supply are determined by ABC Inc.
- **Advise Mr. Hari** as to **whether ABC Inc and XYZ Ltd are Associated Enterprises**, on the basis of the provisions of the Income-tax Act, 1961.

Exercise 1 - Solution

- Two enterprises shall be deemed to be associated enterprises if, at any time during the previous year, **more than half** of the board of directors or members of the governing board, or one or more of the executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise.
- In the present case, the power to appoint is only for half the number and not more than half. Hence, ABC Inc. and XYZ Ltd. are **not associated** enterprises under this criteria.
- Two enterprises shall be deemed to be associated enterprises, if **90%** or more of the raw materials and consumables required for the manufacture or processing of goods or article 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.
- In this case, ABC Inc. supplies more than 90% of the requirements of purchases of XYZ Ltd. Further, the price is controlled by the former by way of written agreement. Also, the conditions for supply are determined by ABC Inc. Hence, the two entities would be deemed to be **associated** enterprises under this criterion.

Exercise 2, 3 & 4

- Examine with reasons whether the two enterprises referred to in the independent situations given below can be deemed to be associated enterprises under the Indian transfer pricing regulations:
1. **Kingston Inc**, a US company having its place of effective management also in the USA, has advanced a loan equivalent to ` **130 crores to Ganga Ltd.**, an Indian company on 10-4-2021. The total book value of assets of Ganga Ltd. is ` **250 crores**. The market value of the assets, however, is ` **300 crores**. Ganga Ltd. **repaid ` 22 crores** before 31-3-2022.
 2. Charles plc., a UK company having its place of effective management also in the UK, has the power to appoint 4 of the directors of Andes Ltd, an Indian company, whose total number of directors in the Board is 9.
 3. Total value of raw materials and consumables of Kaveri Ltd., an Indian company, is ` 720 crores. Out of this, supplies to the tune of ` 650 crores are by Aurubis GmbH, a German company having its place of effective management in Germany, at prices and terms decided by the German company.

Exercise 2,3 &4 - Solution

1. Kingston Inc, a foreign company, has advanced loan of ₹ 130 crores to Ganga Ltd., an Indian company, which amounts to 52% of book value of assets of Ganga Ltd. Since the loan advanced by Kingston Inc. is 51% or more of the book value of assets of Ganga Ltd., Kingston Inc. and Ganga Ltd. are deemed to be associated enterprises under the Indian transfer pricing regulations.

The deeming provisions would be attracted even if there is a repayment of loan during the same previous year which brings down the said percentage below 51%.

2. Charles plc, a foreign company has the power to appoint 44.44% (4 out of 9) of the directors of an Indian company, Andes Ltd. Two enterprises would be deemed to be associated enterprises **if more than half of the board of directors of one enterprise are appointed by the other enterprise.** In this case, since Charles plc has the power to appoint only 44.44% (which is less than half) of the directors of an Indian company, Andes Ltd., Charles plc and Andes Ltd. are **not deemed to be associated enterprises.**

3. Since Aurubis GmbH, a German company, supplies 90.27% of the raw materials and consumables required by Kaveri Ltd., an Indian company, which is more than the specified threshold of 90%; and the prices and terms of supply are decided by the German company, the two companies are deemed to be **associated enterprises.**

Exercise 5 : Examine whether transfer pricing provisions under the Income-tax Act, 1961 would be attracted in respect of the following cases -

- Transfer of *process patents* by Rho Ltd., an Indian company, to ABC Inc., a US company, *which guarantees 12% of the total borrowings* of Rho Ltd.

Ans: The scope of the term “intangible property” includes, *inter alia*, process patents, which is a technology related intangible asset. Transfer of intangible property falls within the scope of the term “**international transaction**”.

Since ABC Inc., a **US company, guarantees not less than 10% of the total borrowings of Rho Ltd., an Indian company, ABC Inc. and Rho Ltd. are deemed to be associated enterprises under section 92A(2).** Therefore, since transfer of process patents by Rho Ltd., an Indian company, to ABC Inc., a US company, is an international transaction between associated enterprises, the provisions of transfer pricing are attracted in this case.

Other Method as may be prescribed by the CBDT

- Note: First we need to give **justification why** each method is not suitable for us. Then only CBDT will prescribe suitable methods to calculate ALP.
- The Other method allows the use of ‘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 transactions with or between non-associated enterprises, under similar circumstances.
- The **various data** which may possibly be used for comparability purposes under this method could be **valuation reports , third party quotations, tender/Bid documents, documents relating to the negotiations, standard rate cards**, commercial & economic business models; etc.

For applying the all above methods, the comparability of the international transaction with an uncontrolled transaction is to be judged with reference to the **Following Factors**:

- The specific characteristics of the property transferred or services provided in either transaction;
Same type of Goods & Services
- The functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;
- **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;
- 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.

Data to be used for analyzing the comparability of an uncontrolled transaction with an international transaction

- The data relating to the **current year**; or
- The data relating to the **financial year immediately preceding the current year**, **if the data relating to the current year is not available** at the time of furnishing the return of income by the assessee, for the assessment year relevant to the current year.
- [Note: Last year data we can use only in resale price method or cost plus method or the transactional net margin method if current year data not available. For other method we have to use current year data only.]
- However, 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 **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.

Selection of “**Tested Party**” – Concept 1

- Concept of tested party does not find any specific mention in Indian transfer pricing regulations. The concept of tested party has been explained in detail in the transfer pricing guidelines issued by **OECD** and Practice Manual issued by United Nations from time to time.
- The tested party will be the participant in the controlled transaction whose **profitability/ pricing attributable to the controlled transactions can be verified based on the most appropriate data** and **requiring the fewest & most reasonable adjustments**, and for which reliable data regarding uncontrolled comparable can be located.
- Consequently, in most cases the tested party will be the “**least complex**” of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparable.

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From Beginning From Current Slide Broadcast Slide Show Custom Slide Show Start Slide Show

Set Up Slide Show Hide Slide Rehearse Timings Record Slide Show Set Up

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Resolution: Use Current Resolution Show On: Use Presenter View Monitors

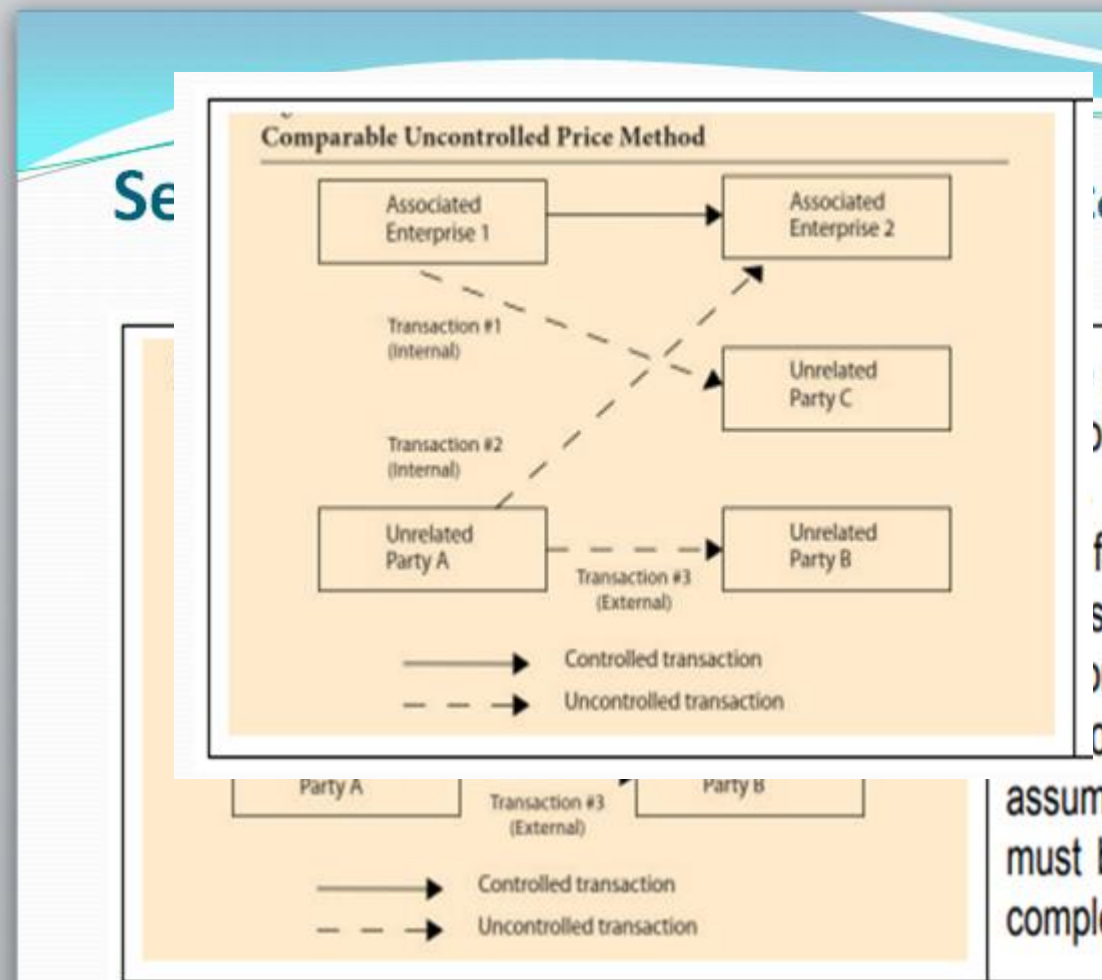
Slides Outline

63 Data to be used for analyzing the comparability of an uncontrolled transaction with an international transaction

64 Selection of "Tested Party" - Concept 1

65 Selection of "Tested Party" - Concept 1 - Example

66 Selection of "Profit Level Indicator" - Concept 2



Concept 1 - Example

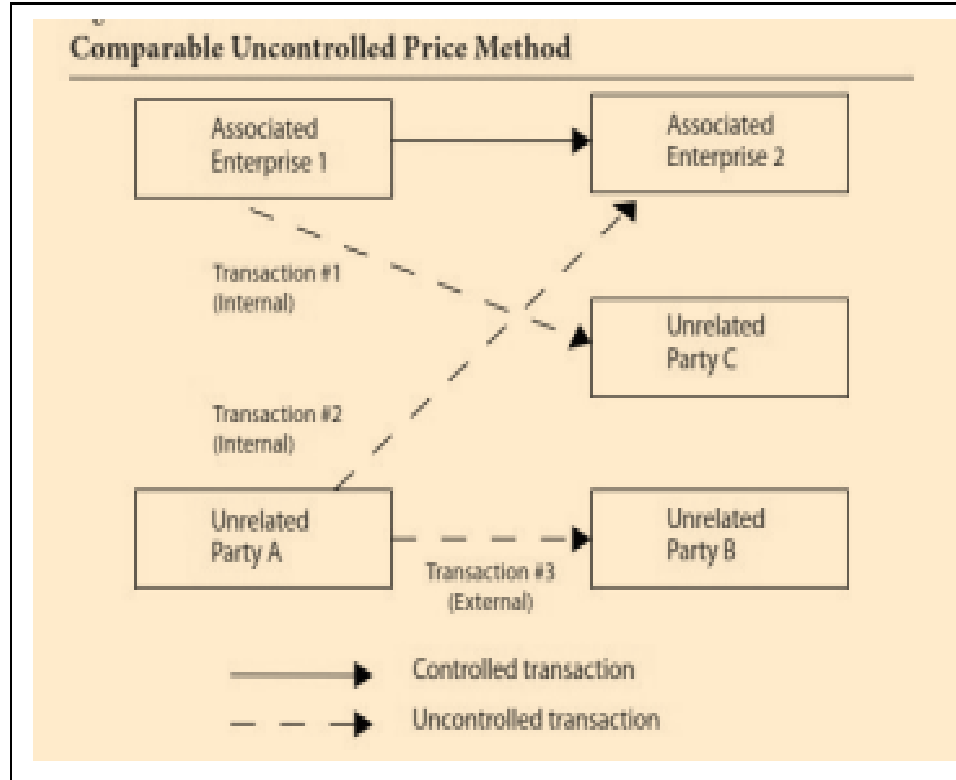
given example, AE1 and AE2 are parties to a controlled transaction. Assume, AE1 provides back office support services to AE 2 (i.e. engaged in manufacturing of goods). The functions performed, assets deployed and risk assumed for back office support services is less complex vis-à-vis the functions performed, assets deployed and risk assumed in manufacturing activities. Hence, AE1 must be selected as tested party which has least complex functional profile

Selection of “Profit Level Indicator” – Concept 2

- A profit level indicator (PLI) is selected to test the profitability of tested party. PLIs are ratios that measure relationships between profits and costs incurred or resources employed. A variety of PLI's can be calculated in any given case.
- PLI should always have an untainted base (denominator) like adopting
 - ❑ Cost as base for Export transactions
 - and
 - ❑ Revenue as base for Import transactions
- It is a practice to adopt the denominator of the PLI as being un-tainted or less-tainted.
- A tainted income or expense would mean one that is received from an AE or paid to an AE and therefore cannot be considered to be independent or at arm's length.
- Untainted on the other hand would mean revenue or costs which relate to transactions with independent third parties and are therefore more reliable.

Selection of “Profit Level Indicator” — Concept 2 - Example

In previous example, the revenue from back support services will be tainted because it is received from related party. So, the PLI, in the above case, should be costs.



In the given example, AE1 and AE2 are parties to a controlled transaction. Assume, AE1 provides back office support services to AE 2 (i.e. engaged in manufacturing of goods). The functions performed, assets deployed and risk assumed for back office support services is less complex *vis-à-vis* the functions performed, assets deployed and risk assumed in manufacturing activities. Hence, AE1 must be selected as tested party which has least complex functional profile

The following table briefly summarizes the **various PLIs** used:

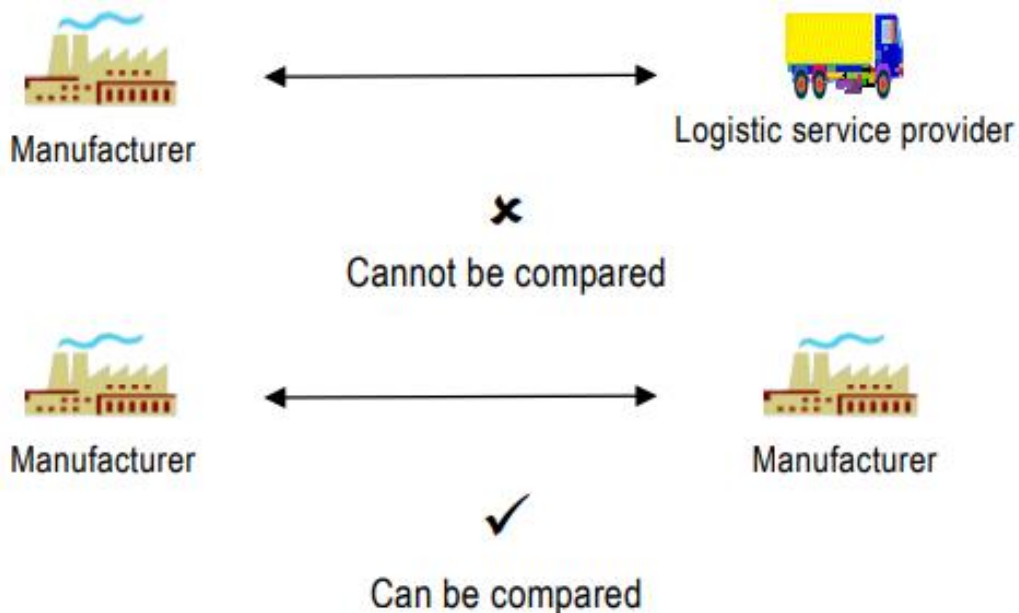
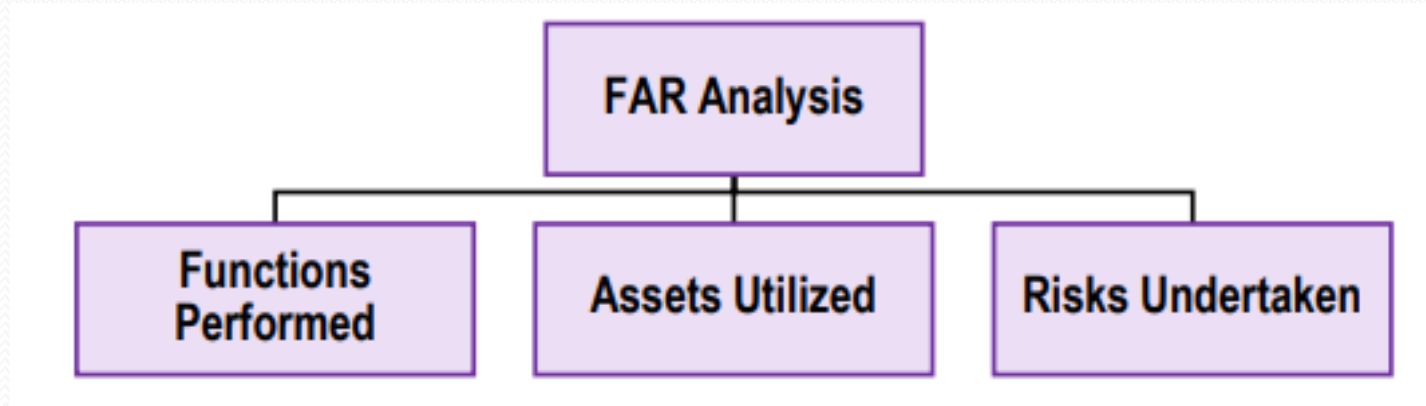
Overview of Various Profit Level Indicators	
Return on Assets (ROA)	Operating profit divided by the operating assets (normally only tangible assets)
Return on Capital Employed (ROCE)	Operating profit divided by capital employed which is usually computed as the total assets minus cash and investments Johnson Matthey India (P.) Ltd. Vs Deputy Commissioner of Income- tax ([2016] 380 ITR 43 (Delhi)) – It was held that reliability of ROCE as a PLI depends upon extent to which composition of assets/capital deployed by tested party and their valuation is similar to that of comparable and if balance sheet does not accurately reflect average use of capital throughout year, ROCE would be less reliable.
Operating Margin	Operating profit divided by sales
Return on Total Costs (ROTC)	Operating profit divided by total costs
Return on Cost of Goods Sold	Gross profit divided by cost of goods sold
Berry Ratio	Gross profit divided by operating expenses

Most Appropriate Method - Concept 3

For the purpose of selecting the most appropriate method, the following factors should be taken into account.

- The **nature and class** of the **international transaction**;
- 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;
- The availability, coverage and **reliability of data** necessary for application of the method;
- The **degree of comparability** existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;
- The extent to which **reliable and accurate adjustments** can be made to account for difference, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;
- The nature, extent and **reliability of assumptions** required to be made in application of a method.

FUNCTIONS, ASSETS AND RISK (FAR) ANALYSIS - Concept 4



Functions performed:

- In performing functional analysis, **important and significant functions** are considered.
- Such functions add more value to the transactions and therefore, are expected to fetch higher returns for the entity performing such functions.
- Thus, the focus should not only be 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
 - Budgeting
 - Purchasing and materials management
 - Manufacturing, production or assembly work
 - Warehousing and inventory
 - Marketing and distribution
 - Business process management/ administrative functions
 - Scheduling
 - Supervision

Assets employed:

- As regards assets employed, one needs to **identify the assets** (tangible as well as intangible) used by the entities being compared in relation to the transaction under consideration. The analysis of assets employed into tangible assets and intangible assets is of vital importance.
- **Intangible** : The existence of **intangible assets** in the form of technical knowhow, trademarks, patents, etc. **contribute to the super normal growth in profits** of an enterprise.
- **Tangible** : However, an entity which owns only tangible assets which are used in normal course of operations such as computers, furniture & fixture, plant and machinery, etc. is expected to earn routine/normal profits as earned by other companies engaged in similar business.

Risks assumed:

- Risk study involves **identification of various risks** that are assumed by each of the parties to the transaction.
- It is commonly understood that risk and return go hand in hand.
- In the open market, **more the risks** assumed by an enterprise, **higher the returns that it expects**.
- Conversely, in case where the **risks** undertaken by the enterprise in a transaction are **minimal**, the **returns expected** to be generated from such transactions should also normally be **lower**.

Type of risks	Description
Market risk	Risk relating to increased competition and relative pricing pressures , change in demand patterns and needs of customers , inability to develop/penetrate in a market , etc.
Inventory risk	Risk associated with management of inventory in case of overstocking or slow/moving inventory . As a result, the enterprise may be forced to bear a loss of margin on the inventory, or incur additional costs to dispose-of the same.
Credit risk	Risk relating to default in receivables by customers .
Product liability risk	Risk associated with product failures including non-performance to generally accepted or regulatory standards . This could result in product recalls and possible injuries to end-users.
Foreign exchange risk	Risk relating to the potential impact on profits that may arise because of changes in foreign exchange rates .
Research and Development risk	Risk associated with loss incurred due to unsuccessful R&D expenditure
Capacity Utilization risk	Risk associated with loss of profits due to unutilized capacity

An illustrative list of functions, assets and risks for a different entities is provided below:

Type of entity	Functions	Assets	Risks
Manufacturer	<ul style="list-style-type: none"> Budgeting Administration Product strategy and design R&D Purchasing Product manufacturing Quality control Inventory management Logistics Marketing Sales Customer support 	<ul style="list-style-type: none"> Intangibles – Patents, technical knowhow, trademarks, etc. Plant & Machinery Storage/warehouse Office equipment Land & Building Vehicles 	<ul style="list-style-type: none"> Business risk Inventory risk Scheduling risk Product liability risk Credit and collection risk Foreign exchange fluctuation risk

An illustrative list of functions, assets and risks for a different entities is provided below:

Type of entity	Functions	Assets	Risks
Trader	<ul style="list-style-type: none">- Budgeting- Administration- Purchasing- Inventory management- Logistics- Marketing- Sales- Customer support	<ul style="list-style-type: none">- Storage/ warehouse- Office equipment- Land & Building- Vehicles	<ul style="list-style-type: none">- Business risk- Inventory risk- Credit and collection risk- Foreign exchange fluctuation risk
Service provider	<ul style="list-style-type: none">- Budgeting- Quality control- Conceptualization and design of services- Project management- Training- Invoicing	<ul style="list-style-type: none">- Intangibles –, trademarks, brand name, etc.- Office equipment- Land & Building- Vehicles	<ul style="list-style-type: none">- Business risk- Service liability risk- Utilization and idle time risk- Credit and collection risk- Foreign exchange fluctuation risk

CONCEPT OF COMPARABILITY ADJUSTMENTS - Concept 4

- An uncontrolled transaction **should be considered comparable** to the controlled transaction only **if there are no material differences** (in terms of functions, assets and risks) between the transactions being compared or the enterprises entering into such transactions which would materially affect the prices or costs charged or margins arising in such transactions in the open market.
- Comparability adjustments can take various forms. Some **examples** of prevalent comparability adjustments are provided below:

Nature of comparable adjustment	Description
Working capital adjustment	<p>The levels of inventories, cash on hand, debtors, creditors, other current assets and liabilities impact the level of free reserves that the company has to fulfill its day-to-day working capital requirements and the consequent levels of borrowings it needs to make to fund its working capital requirements.</p> <p>The extent to which companies extend and receive credit in the form of accounts payable and receivable affects their sales and cost of sales. The selling price incorporates two elements: the price of the product and the time value of money lent.</p> <p>(Cash Sale vs. Credit Sale)</p>

Nature of comparable adjustment

Description

Capacity Utilization adjustment

This adjustment is to bring entities with different level of capacity utilization at par with each other for comparison purpose. Capacity utilization by enterprises is an essential factor affecting net profit margin in open market because lower capacity utilization results in higher per unit cost, which, in turn results in lower profits.

For example, if an entity A Ltd. is utilizing **50% of its capacity** while entity B Ltd. is operating at **full capacity**, it may not be appropriate to compare A Ltd. and B Ltd. without undertaking this adjustment.

The level of capacity utilization of the resources (plant and machinery, fixed assets, etc.) **impacts the direct and fixed costs** of the company.

For example, if a company has high installed capacity but less utilized capacity, it shall be incurring **heavy fixed costs** and **not earning proportionate revenue** for the same. This in effect, impacts the profitability of the company. A capacity utilization adjustment is undertaken to eliminate such differences in the profitability of the tested party and the comparable companies.

Nature of comparable adjustment	Description
Risk adjustments	<p>Risk adjustment is mainly relevant in case of captive entities (entities providing services or selling goods only to its associated enterprises) or low risk bearing entities.</p> <p>For comparison of tested party with comparable companies, risk profiles of each of them should ideally be similar.</p> <p>The comparables that would be identified might have different risk profiles as compared to tested party and in case the difference is material, adjustment would be required. Accordingly, risk adjustment is made to adjust for the difference in the level of risks assumed by the tested party and comparables.</p>
Accounting adjustments	<p>This adjustment is carried out to bring the entity being compared at par with the taxpayer in terms of differences in accounting policies being followed.</p>

DOCUMENTATION AND COMPLIANCES

Persons responsible for keeping and maintaining Document -

Section 92D imposes responsibility on every person –

1. who **enters into an international transaction** to keep and maintain such information and documents in respect thereof as may be prescribed;
2. being a **constituent entity of an international group** to keep and maintain the prescribed information and document **in respect of an international group**

Note to point 2 : The constituent entity is required to keep and maintain the information and document irrespective of the fact **whether or not any international transaction is undertaken** by such constituent entity.

Information and documents to be kept and maintained for prescribed **Period**

- The CBDT is empowered to prescribe the period for which the information and documents shall be kept and maintained. – **8 years.**

Assessing Officer & Commissioner (Appeals) empowered to require persons entering into international transaction to **furnish prescribed information and documents**

- The Assessing Officer or the Commissioner (Appeals) may, in the course of any proceedings under the Income-tax Act, require any person who has entered into an international transaction to furnish any such prescribed information or documents within a period of **30 days** from the date of receipt of a notice issued in this regard.
- The requisition period may, on request, be **extended further** for a period not exceeding **thirty days** by the Assessing Officer or the Commissioner (Appeals).

Information and documents to be kept and maintained under section 92D [Rule 10D]

- Rule 10D(2) provides that in a case where the aggregate value of international transactions does not exceed **Rs. 1 crore**, it will not be obligatory for the assessee to maintain the below information and documents.
- However, it is provided that in the above cases also the assessee will have to substantiate that the income arising from the international transactions with associated enterprises, as disclosed by the accounts, is in accordance with section 92. This will mean that, even if the aggregate value of the international transactions is **less than ` 1 crore**, the assessee **will have to maintain adequate records and evidence** to show that the international transactions with associated enterprises are on the basis of arm's length principle.

- (a) Ownership structure of the assessee with details of shares or other ownership interest held therein by other enterprise;
- (b) Profile of the multinational group and basic details of associated enterprises with whom assessee has entered into international transaction;
- (c) Business description of the business of the assessee and associated enterprises and the industry in which the assessee operates;
- (d) Nature and terms (including price) of the international transactions, details of property transferred or services provided and quantum and value of each such transaction;
- (e) Description of functions performed, risks assumed and assets employed by the assessee and associated enterprises;
- (f) Records of economic and market analysis, budgets, forecasts, financial estimates for the business as a whole and for each division or product separately which may have a bearing on such transaction;



**Entity
Related**

- (g) Record of uncontrolled transaction (if any) for analysing comparability of international transaction with such uncontrolled transaction(s);
- (h) Record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction.
- (i) Description of method considered for determining ALP, most appropriate method along with the explanations as to why such method was selected and applied;
- (j) Analysis performed to determine the arm's length price of the transactions between related parties, etc.
- (k) Assumptions, policies and price negotiations, if any, which critically affected the determination of the arm's length price;
- (l) Details of transfer pricing adjustment(s) made (if any) and consequent adjustment made to the total income for tax purposes.
- (m) Any other information, data or document including information or data relating to associated enterprise which may be relevant for determining ALP.

**Price
Related**

**Transaction
Related**

Information to be **supported** by authentic documents

[Rule 10D(3)]

The information to be maintained by the assessee, is to be supported by authentic documents. These documents may include the following:

- **Official publications, reports, studies and data bases from the Government** of the country of residence of the associated enterprise, or of any other country;
- **Reports of market research studies** carried out and technical publications brought out by institutions of **national or international reputation**;
- **Price publications including stock exchange and commodity market quotations**;
- **Published accounts and financial statements** relating to the business affairs of the associated enterprises;
- **Agreements and contracts** entered into with associated enterprises or with unrelated enterprises in respect of transactions similar to the international transactions;
- Letters and other correspondence documenting any terms negotiated between the assessee and the associated enterprise;
- Documents normally issued in connection with various transactions under the accounting practices followed.

Audit Report [Section 92E]:

- Under section 92E, every person who enters into an international transaction during a previous year is required to obtain a **Report** from a **Chartered Accountant** and furnish such report on or before the specified date in the prescribed form.
- Rule 10E provides that the auditor's report shall be in **Form No.3CEB**. It requires the auditor to state that he has examined the accounts and records of the assessee relating to the international transactions entered into by the assessee during the relevant year. He has also to give his opinion whether the prescribed information and documents relating to the above transactions have been kept by the assessee. Further, he has to state that the particulars stated in the Annexure to his report are true and correct. The Annexure is in **Two parts**.
- In the **First part** of the Annexure, **general information** of the assessee is required to be reported. In the **Second part** of the Annexure, the particulars about the international transactions are required to be stated. Broadly stated, these particulars include **list of associated enterprises, particulars and description of transactions relating to purchase, sales, provisions of service, loans, advances**, etc.
- “**Specified date**” means the date **one month prior to the due date for furnishing the return of income** under section 139(1) for the relevant assessment year. The due date for filing of transfer pricing report under section 92E in **Form 3CEB is 31st October** of the assessment year.

Penalty for failure to comply with TP provisions : A Summary

Section	Nature of default	Penalty
270A(9)	<p>Failure to report any International transaction or deemed International transaction to which the provision of Chapter X applies would constitute 'misreporting of income' – 200%</p> <p>“Under Reporting of Income' – 50% - if Reported everything correctly but due to change in assumption/method income increased by TPO.</p> <p>Note: Transfer pricing officer (TPO) found, intentionally misrepresented.</p>	<p>200% of the tax payable on mis-reported income or 50% on Under-reported income</p>
271BA	Failure to furnish a report from an accountant as required under section 92E (Audit Report)	Rs. 1 lakh
271G	Failure to furnish info or doc as required by Assessing Officer or CIT(A) u/s 92D(3) within 30 days from the date of receipt of notice or extended period not exceeding 30 days, as the case may be.	2% of the value of the international transaction for each failure
271AA	<p>(1) Failure to keep and maintain any such document and information as required by section 92D(1)/(2); - 8 Years</p> <p>(2) Failure to report such international transaction which is required to be reported; or</p> <p>(3) Maintaining or furnishing any incorrect information or document.</p>	2% of the value of each such international transaction

Notes:

- ⌚ The penalty u/s **271AA** shall be **in addition** and not in substitution of penalty u/s **271BA**.
- ⌚ If the assessee **proves that there was reasonable cause** for the failure, no penalty would be leviable under section 271BA, 271G and 271AA.

COUNTRY BY COUNTRY REPORTING (CBCR)

- SPECIFIC REPORTING REQUIREMENTS

Three-tier structure mandated by BEPS

Document		Information
(1)	Master File	Standardised information relevant for all multinational enterprises (MNE) group members (Company related basic structural information)
(2)	Local file	Specific reference to material transactions of the local taxpayer. (Other Document as discussed before)
(3)	Country-by-country report	Information relating to the Global allocation of the MNE's income and taxes paid; and Indicators of the location of economic activity within the MNE group.

Advantages of the three tier structure [as per BEPS Report]:

- Taxpayers will be required to articulate **consistent transfer pricing positions across the globe**;
- **Tax administrations** would get **useful information** to assess transfer pricing risks;
- Tax administrations would be able to make determinations about **where their resources can most effectively be deployed**, and, in the event audits are called for, provide information to commence and target audit enquiries.

Threshold limit for applicability of CbCr [Sub-section (7)]:

- The reporting provision shall apply in respect of an international group for an accounting year, if the total consolidated **group revenue** as reflected in the **consolidated financial statement** (CFS) for the accounting year **preceding** such accounting year is above a threshold to be prescribed i.e. **Rs. 6400 Crores**.
- 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 (TTBR)** of such currency on the **last day of the accounting year** preceding the accounting year [Rule 10DB(7)].

Who is responsible to submit CBCR

- The **parent entity** of an international group
or
- The **alternate reporting entity, if it is resident in India** shall be required to furnish the report in respect of the group.
- **Time Limit** for filling CBCR: within a period of **Twelve months** from the end of the said reporting accounting year for which the report is being furnished, in
- **Manner** of filling CBCR - in **Form No. 3CEAD**.

Details/ information to be included in CBCR

- It should contain aggregate information in respect of:
 - the amount of **revenue**,
 - **profit and loss before income-tax**,
 - amount of **income-tax paid** and accrued,
 - details of stated **capital**, accumulated earnings, **number of employees**, **tangible assets** other than cash or cash equivalent **in respect of each country** or territory along with details of each constituent's incorporation country and **residential status**, nature and **details of main business activity** or activities of each constituent entity and any **other information** as may be prescribed.

Note: This shall be based on the template provided in the OECD BEPS report on Action Plan 13.

Penalty for non-furnishing of the report by any reporting entity which is obligated to furnish such report

	Period of delay/default	Penalty
(a)	Not more than a month	Rs. 5,000 per day
(b)	beyond one month	Rs. 15,000 per day for the period exceeding one month
(c)	Continuing default even after service of order levying penalty either under (a) or under (b)	Rs. 50,000 per day of continuing failure beginning from the date of service of order



Thank You!

By **CMA** Amit Dey
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