

Diploma in International Taxation

Paper – I

International Tax -Transfer Pricing



The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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Foreword to the Seventh Edition

The Committee on International Taxation is one of the important non-standing Committees of the Institute of Chartered Accountants of India (ICAI). As a partner in nation building, ICAI through this Committee submits Pre and Post-budget Memoranda pertaining to International Taxation. Apart from the same, the Committee at regular intervals examines the tax laws, rules, circulars, notifications etc. relating to international taxation issued by the CBDT and sends suitable suggestions for improvements. The Committee also submits inputs/submissions to OECD from time to time. Besides conducting various activities ICAI through this Committee regularly organises Workshops/Seminars/ Conferences/ Refresher Courses/ Residential course, prepares e-learning modules, revises its existing publication, releases new publication and many more.

One of the core activities of the Committee is to organise *Post Qualification Diploma in International Taxation*. I am happy to mention that the Committee has prepared the seventh edition of Background Material for Diploma in International Taxation in which all the amendments made upto Finance Act, 2022, have been incorporated. It has been written and reviewed by eminent experts in the area of taxation. This course, if completed, would provide an aspiring practitioner the desired confidence to practice in this complex and upcoming field.

For this course, an open book, case study-based assessment pattern for international taxation Assessment Test (INTT-AT) has been adopted recently to initiate practical understanding of the subject. As there are only few chartered accountants who are practicing in this area, there are plentiful of professional opportunities available for the person who masters in this area.

I appreciate the efforts of CA. Sanjay Kumar Agarwal, Chairman, CA. Cotha S. Srinivas, Vice-Chairman and other members of the Committee on International Taxation for updating this publication and for conducting the course in a professional manner.

I am sure that this seventh revised edition of the Background Material for Diploma in International Taxation will be very useful to the members.

Date: 25.01.2023

Place: New Delhi

CA. (Dr.) Debashis Mitra

President, ICAI

Preface to the Seventh Edition

Long distance trade has been taking place since pre-historic times. Evidences suggest that sea-route trade was prevalent during Indus Valley Civilisation, apart from those other civilisations. However, during those days the concept of “nation/country” did not exist. The concept of “nation-state” came into existence after the French Revolution (1789-99). However, there is another view that this concept was established in 1649 through English Commonwealth. Whatever, the genesis of this concept may be, it gave rise to competition among nations to increase cross-country trade on the one hand, and to protect their revenue by building fiscal and non-fiscal structures on the other. These gave rise to the concept of “international taxation” which is a subset of domestic income tax law which covers the transactions between persons of two countries. Since the law of one country cannot be extended to apply on the person or jurisdiction of another country; the same is governed by the agreement entered by the two countries. The agreement entered by both the country is called Double Tax Avoidance Agreement (DTAA) which defines the methods of sharing jurisdiction to tax, reducing evasion of taxes as well as ways to reducing/eliminating double taxation and avoiding litigation and supporting one another on administrative measures. Although the DTAA may help in deciding the taxing rights of the jurisdictions, the computational aspect is governed by domestic tax laws of the respective country. Unlike Indian income tax which characterise income under five heads of income, DTAA specifies separate article for the nature of transactions. In the changing business environment, many recent issues have evolved which made difficult for the identification of permanent establishment and attribution of business profit. Such transactions become even more complex when passive incomes are connected to such permanent establishment. In those conditions interplay of transfer pricing provisions may arise.

To protect the revenue base, India has developed Transfer pricing regulations more than two decades ago. The international transactions may be examined as per the TP regulation in accordance with the arm’s length principles. Finding the appropriate comparable, benchmarking of those transactions and reporting thereof involve a lot of intricacies. It has many issues like cases of restructuring, cost sharing arrangements, expenditure on marketing and promotions and expenditure on research & developments of intangibles etc., the transfer pricing adjustments of which may not be an easy exercise. In the present situation almost all the major countries have developed their own transfer pricing regulations.

In the changing business environment, the members are expected to have robust understanding of international taxation and transfer pricing. Since the members are expected to have practical understanding of the subjects, the Committee has adopted a case study-based assessment pattern for international taxation Assessment Test (INTT-AT).

I am grateful to CA. (Dr.) Debashis Mitra, President, ICAI and CA. Aniket Sunil Talati, Vice-President, ICAI for being the guiding force behind initiatives being taken by the Committee.

I whole heartedly acknowledge the contribution of CA. Ganesh Rajgopalan, Sree Lakshmi Valli, CA. Sachin Kumar in revision of the background material pertaining to “*International*

Taxation” which further reviewed by Past CCM. CA. Dhinal Ashwin Shah with the assistance of CA. Karan Sukhramani.

We also thank CA. Arun Saripalli and his team members CA. Anand Kankani, CA Aman Agrawal, CA. Disha Kevin Vora, CA. Keyur Shah, CA. Mayur Chudasama, CA. Sumit Rathod, Tarun Mirchandani, CA. Vashishth Dave, CA. Nilesh Bangera and CA. Vipra Shetty who contributed towards the revision of the background material for the subject ‘*Transfer Pricing*’.

I, admire the guidance of Mr. S.P. Singh, Ex-IRS in reviewing the background material. Being an Ex-Deputy Secretary, Foreign Tax and Tax Research Division, CBDT his long experience can be perceived in this revised edition. As Director of International Taxation, Mumbai he was involved in implementation of the tax laws and his knowledge and experience in the area has added value to the publication.

I would also like to thank CA. Cotha S Srinivas, Vice-Chairman, Committee on International Taxation of ICAI for his support in all activities of the Committee. I gratefully acknowledge the support provided by the members of the Committee (including co-opted members) and special invitees; *Committee members*: CA. Chandrashekhar Vasant Chitale, CA. Vishal Doshi, CA. Purushottamlal Khandelwal, CA. Mangesh Pandurang Kinare, CA. Priti Savla, CA. Umesh Sharma, CA. Sridhar Muppala, CA. Rajendra Kumar P, CA. Sushil Kumar Goyal, CA. Rohit Ruwatia, CA. Anuj Goyal, CA. Gyan Chandra Misra, CA.(Dr.) Raj Chawla, CA. Pramod Jain, CA. Charanjot Singh Nanda, CA.(Dr.) Sanjeev Kumar Singhal, CA. Chhajed Piyush Sohanraji, Shri Ritvik Ranjanam Pandey, *Co-opted members*: CA. Avinash Gupta, CA. Rajat Sharma, CA. Mithilesh Sai Sannareddy, CA. Anup Kumar Sanghai, CA. Kaushik Mukerjee, CA. Nandkishore Chidambar Hegde, CA. Sanjay Bhattacharya, *Special invitees*: CA. Aseem Chawla , CA. Kriti Chawla Khanna, CA. Gaurav Singhal, CA. Sachin Sinha, CA. Manoj Kumar Mittal, CA. Smita Patni, CA. Ajay Rotti, CA. Akshay Kenkre, CA. Akshat Maheshwari, CA. Dilip Gupta, CA. Naman Shrimal, CA. Hari Om Jindal, CA. Deepender Kumar Agarwal, CA. Raju Kumar, CA. Parthasarathi Dasgupta, CA. Tejveer Singh, CA. Raj Kumar Nahata, CA. Parul Jolly, CA. Gaurav Geol, CA. Harpreet Singh, CA. Vikas Gupta, CA. Neha Gupta, CA. Surinder Kumar Kalra and CA. Geetika Gupta.

I also acknowledge the efforts made by CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation, and her team members CA. Dhiraj Shrivastav, Project Associate and CA. Harshita Sagar Jaiswal, Project Associate for co-ordinating the project and for rendering technical and secretarial assistance.

I am sure that this revised edition will help participants of the course to gain practical understanding of the subject.

Place: New Delhi

Date: 25.01.2023

CA. Sanjay K. Agarwal

Chairman,

Committee on International Taxation, ICAI

Foreword to the Sixth Edition

The world has been gradually moving towards digitalisation of business activities. COVID-19 has brought human tragedy and economic devastation which has been never seen before in our lifetime. Humanity is fighting tenaciously to defeat the pandemic resulting into paradigm shift in almost all walks of lives. Teleconferencing, which used to be novelty has become the regular way of doing business and communication. Technological advancements are being adopted at a speed not experienced in the recent times. All these changes are also the root cause for new challenges for tax advisors and tax administrations across the globe. Digitalisation of economies is altering the fundamental concepts of taxation. In order to make taxation more effective and efficient, India is taking several steps to simplify source based taxation which in turn makes the domestic law more transparent and certain. Recently, the law relating to taxation of payments for computer software, which had been a subject matter of litigation, has been settled by the Supreme Court of India; Similarly, the provision of dividend distribution tax was not free from litigation. The Finance Act, 2020 has abolished the dividend distribution tax as a result of which the incidence of taxation now lies in the hands of shareholder. Of late, sending positive message to foreign investors, the Taxation Laws Amendment Bill 2021, proposes to retract the retrospective amendment pertaining to Indirect transfers.

The transfer pricing law is becoming increasingly challenging due to unprecedented impact of COVID-19. Finding the comparable data, the most appropriate method and the arm's length price are significant challenges for all stakeholders. In these exceptional circumstances, OECD Guidance on the transfer pricing implications of the COVID-19 pandemic might be helpful. However, this guidance has not been yet adopted by many countries including India.

Since a lot has happened in the field of international taxation and transfer pricing during the recent years, members should have a comprehensive understanding of the concepts and changes in these areas. Understanding of domestic law appears to be incomplete without appreciating its interplay between treaties and Transfer Pricing Guidelines. This Background material on International Taxation and Transfer pricing is a comprehensive material which has been written and reviewed by eminent experts of the profession. For many years, Committee on International Taxation of ICAI has been effectively disseminated practical knowledge to members through this publication, which is revised annually.

I would like to appreciate Chairman, Vice-Chairman and all other members of Committee on International Taxation of ICAI under whose guidance the Committee on International Taxation has been taking various initiatives including series of refresher course, various panel discussions on important topics, revising publications and coming out with new ones so on and so forth. My best wishes for the members of ICAI!

Place: New Delhi

Date: 31.08.2021

CA. Nihar N. Jambusaria

President, ICAI

Preface to the Sixth Edition

Amid the pandemic, the cross border digital payments in India have accelerated. The pandemic has further reinforced the businesses to go digital which is the need of business and economy. Now, the traditional brick-and-mortar businesses have also adopted the internet based digitalised business models to increase revenue through the customers located across the globe without paying any or negligible taxes in those countries. This had raised concerns for revenue authorities of various countries. Each country is trying to establish consensus to tax the Digital Economy. The OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting has agreed a two-pillar solution to address the tax challenges arising from the digitalisation of the economy. Where pillar-one focuses on tax certainty while pillar-two allows source jurisdictions to impose limited source taxation on certain related party payments subject to tax below a minimum rate. The latest development is conceptual adoption of Minimum Global Tax by many countries. The final picture will emerge after the details of this concept are drawn.

Considering the recommendation, the Government of India has taken measures to tax the digital transactions by way of introduction of equalization levy on sale of goods & AMP; services by e-commerce operator, redefining the scope of business connection to curb the issue of digital PE. Along with these, like in many jurisdictions, measures are being adopted through amendments in domestic law as well as in tax treaties with the help of Multilateral Instruments to avoid manipulation of clauses on permanent establishment and other clauses. Concepts like Principal Purpose Test, Limitation of Benefits, and measures against unjustified splitting of activities etc. are being adopted. Apart from this, the Government has also taken various other measures to provide tax certainty to the taxpayers. Earlier the Government had introduced the faceless assessment scheme, Vivad se Vishwas (VSVD) scheme to end up the long pending litigations. In addition to this, in order to provide pace in the decisions of AAR, the Authority for Advance Rulings has also been reconstituted. Recently, the Taxation Laws (Amendment) Bill 2021 has been introduced to provide exemption from indirect transfer of Indian assets made before certain period. The Government has also come out with the new e-filing portal with the features of less documentation leading to fast processing time.

Considering the rapidly evolving subject; understanding the impact of domestic law and treaties has become a necessity for the members of ICAI. In order to update the knowledge of its members and to provide learning knowledge the Committee on International Taxation, ICAI has come out with various publications on many important subject of international taxation. However, to have a comprehensive understanding of the subject; this Background Material of Diploma in International Taxation has proved to be a one stop shop, written and reviewed by veterans in the profession.

I am sincerely thankful to President, ICAI and Vice-President, ICAI for being guiding force behind all initiatives being taken by the Committee.

I also whole heartedly acknowledge the efforts of CA. Dhinal Ashwin Shah who actively assisted by CA. Karan Sukhramani, for revising the Background material pertaining to International Taxation. We are also thankful to CA. Arun Saripalli who was actively assisted by CA. Abhishek Gupta and Ronak Jain in the revision of the background material pertaining to the subject of Transfer Pricing.

I, highly, appreciate the efforts put in by Mr. S.P. Singh, Ex-IRS in reviewing the background material. While working as Deputy Secretary, Foreign Tax and Tax Research Division in the CBDT Mr. Singh, participated in framing laws for non-residents and participated in negotiation of approximately 30 tax treaties. He was also, the first Director of Income Tax (International Taxation), Mumbai. He was one of the members of the Expert Group set up by the government for drafting Transfer Pricing regulations. His long experience in the areas of International Taxation and Transfer Pricing has rewarding impact on the material. We also thank CA Sharad Goyal and CA. Ankit Arora who actively supported Mr. S.P. Singh in this task.

With the efforts of all of them, the Committee was able to come out with the revised edition in a timely manner.

I am also grateful for the unstinted support provided by Vice-Chairman CA. N.C. Hegde and other members (including co-opted members) and special invitees of the Committee on International Taxation;

Last, but not the least, I appreciate the efforts made by the Secretariat, Committee on International Taxation for co-ordinating the project and for rendering secretarial assistance.

I am hopeful that this revised edition will be of immense use to the members.

Place: New Delhi
Date: 31.08.2021

Chairman,
Committee on International Taxation, ICAI

Foreword to the Fifth Edition

The globalized economy has fostered the growth of multinational and transnational enterprises, leading to a massive increase in the volume and nature of cross border trade and transactions. While international trade and commerce has grown manifold, the international tax framework, designed more than a century ago is proving to be inadequate in dealing with such transactions, thereby creating opportunities for Base Erosion and Profit Shifting (BEPS) between Countries. The introduction of Multilateral Instrument (MLI) has enabled countries to revise tax treaties bypassing the regular time taking process of revising tax treaties. It will go a long way in preventing Base Erosion and Profit Shifting. International organisations like United Nations and Organisation for Economic Cooperation and Development are endeavouring to develop internationally acceptable approach to tax Digital Economy.

Appreciating that a good tax system not only discourages revenue leakages, but is effective, efficient, equitable and economical, India has proactively taken measures like developing smoother tax filing mechanism, establishing computer generated documents identification system, introducing e-Assessment system, and granting relaxation from filing of returns in certain specific cases etc. These steps and initiatives will help build an atmosphere of trust between taxpayers and tax authorities.

As the importance of international taxation is growing it is need of the hour for the members of ICAI to develop expertise to take up the professional opportunities in this area. The ICAI through its dedicated Committee on International Taxation has been imparting knowledge to the members of ICAI to enhance their knowledge to enable them to provide high quality professional services.

I would like to express my gratitude to CA. Nandkishore Chidamber Hegde, Chairman and CA. G. Sekar, Vice-Chairman and all other members of Committee on International Taxation of ICAI for taking various initiatives in the field of International Taxation for the benefit of members and other stakeholders. Timely annual up-dation of the Background material of the Diploma course is one of the commendable accomplishments of the Committee.

I am sure that this Background Material would be of immense use for the participants of the Diploma in International Taxation.

Best Wishes,

Place: New Delhi

Date:31.08.2020

CA. Atul Kr. Gupta

President,ICAI

Preface to the Fifth Edition

With recent rise in the digital transactions, the old brick-and-mortar business is now outdated. The business models are evolving rapidly along with the technology and it becomes important to understand the impact of technology on business model from taxation perspective. In digital transactions, the global economy is swiftly intertwined with the traditional economy by digital means, thus making it harder to create a clear delineation of the true meaning of a digital economy. Both developed and developing countries are struggling to develop an effective and efficient system of taxation of Digital Economy, which would be internationally acceptable and would address the possibilities of double taxation and double non-taxation. As international consensus is awaited, many countries have, unilaterally, imposed taxes on such economic transactions. In line with this approach, India has introduced Equalisation Levy for the taxation of digital economy.

An important consequence of the growth of Digital Economy is that it is now possible for an enterprise resident in one State to be substantially involved in another State's economy without a permanent establishment or fixed base in that State and without any substantial physical presence in that State. This makes the present taxation system in almost all countries inadequate in bringing such transactions within tax net.

Considering the rapidly changing laws pertaining to international Taxation and the complexities involved, ICAI through its Committee on International Taxation organises Diploma in International Taxation so as to ensure that the members of ICAI are able to enhance their knowledge in this area. Considering the present situation due to pandemic, the course is now being organised online. The course takes care of International Taxation as well as Transfer Pricing.

Every year changes which are announced by the Finance Act as also changes in International tax laws are incorporated in the Background material of the course. This year also, the Committee has revised and updated the material to include all the recent amendments made by the Finance Act, 2020 like: deemed residency, equalisation levy, dividend distribution tax etc. The objective of this course is to provide our members update information about all the happening in the world of international taxation and to enable them to provide best professional services in the industry.

I also whole heartedly acknowledge the efforts of CA. Dhinal Ashwin Shah who actively assisted by CA. Karan Sukhramani, for revising the Background material pertaining to International Taxation. We are also thankful to CA. Arun Saripalli who was actively assisted by CA. Tarun Bindlish and CA. Anurag Agrawal in the revision of the background material pertaining to the subject of Transfer Pricing. I, highly, appreciate the efforts put in by Mr. S.P. Singh, Ex-IRS in reviewing the background material. His long experience in the area of

International Taxation and Transfer Pricing has rewarding impact on the material. We also thank Mr. Ankit Arora who actively supported Mr. S.P. Singh in this task.

With the efforts of all of them, the Committee was able to come out with the revised edition in a timely manner.

I am also grateful for the unstinted support provided by Vice-Chairman CA. G. Sekar and other members (including co-opted members) and special invitees of the Committee on International Taxation; CA. Tarun Jamnadas Ghia, CA. Chandrashekhar Vasant Chitale, CA. Dayaniwas Sharma, CA. Rajendra Kumar P, CA. Sushil Kumar Goyal, CA. Anuj Goyal, CA. Kemisha Soni, CA. Satish Kumar Gupta, CA. Hans Raj Chugh, CA. Pramod Jain, CA. (Dr.) Sanjeev Kumar Singhal, CA. Charanjot Singh Nanda, Shri Manoj Pandey, Shri Chandra Wadhwa, Dr. Ravi Gupta, CA. Sachin Sastakar, CA. T.P. Ostwal, CA. Ujwal Nagnath Landge, CA. B. M. Agrawal, CA. Nidhi Goyal, CA. Kirti Chawla and CA. Amar Deep Singhal.

Last, but not the least, I appreciate the efforts made by CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation and CA. Dhiraj Shrivastav, Project Associate for co-ordinating the project and for rendering secretarial assistance.

I am hopeful that this revised edition will be of immense use to the members.

Place: New Delhi

Date: 31.08.2020

CA. Nandkishore Chidamber Hegde

Chairman,

Committee on International Taxation, ICAI

Foreword to the Fourth Edition

Developments in the area of International taxation have considerably impacted the multinationals as well as the tax authorities. The multinationals are gearing up for a tax regime driven by an agenda to curb the Base Erosion and Profit Shifting (BEPS) while the tax authorities in India are taking the lead in implementing tax measures that are now being looked at by more developed countries.

Since the developments in International taxation have opened up a plethora of opportunities for professionals, our members need to update the requisite skill sets professionally to help the stakeholders in investing both domestically and internationally. The Institute of Chartered Accountants of India (ICAI) through its Committee on International Taxation has been taking various steps so as to enable our members to keep a tab with the emerging developments in the area of international taxation for effective discharge of their responsibilities towards the stakeholders.

I congratulate CA. Nihar N. Jambusaria, Chairman and CA. Pramod Jain, Vice-Chairman, Committee on International Taxation of ICAI for taking various initiatives in the field of International Taxation for the benefit of members and other stakeholders at large. I appreciate timely and regular updation of this background material which is an integral part of Diploma in International Taxation being organised by the Committee.

I am sure that this revised publication would be of immense use to the participants of Diploma Course. I wish the participants of the course a very delightful learning experience.

Best Wishes,

Place : New Delhi

Date : November 15, 2019

(CA. Prafulla P. Chhajed)

President

Preface to the Fourth Edition

In this dynamic world where there is constant free flow of cross border investments, knowledge and human capital, international tax assumes an important role. Significant changes in the law keep the regulators as well the assesseees on their toes. Our members, being tax professionals, too are required to keep themselves updated in the area. Thus, training is imparted to them, on regular basis, through the Diploma in International taxation organised by the Committee on International Taxation of ICAI.

In tandem with the updated knowledge being imparted through this Diploma course, the Committee every year updates its background material. Once again efforts have been made this year to revise the background material in a timely manner. Apart from the same the Committee is also working on various new publications which will be released over the period of time.

I am sincerely thankful to CA. Prafulla Premeukh Chhajed, President and CA. Atul Kumar Gupta, Vice-President of the Institute of Chartered Accountants of India for being a guiding force behind the activities being undertaken by the Committee.

I am appreciative of the efforts put in by CA. Pramod Jain, Vice-Chairman of the Committee and also other Committee Council members, CA. Tarun Jamnadas Ghia, CA. Nandkishore Chidamber Hegde, CA. Chandrashekhar Vasant Chitale, CA. Aniket Sunil Talati, CA. Dayaniwas Sharma, CA. G Sekar, CA. Pramod Kumar Boob, CA. Satish Kumar Gupta, CA. Hans Raj Chugh, Shri Sunil Kanoria, Shri Chandra Wadhwa, Dr. Ravi Gupta, co-opted members CA. T.P. Ostwal, CA. Padam Khincha, CA. Ameya Kunte and CA. Yogesh Thar who have contributed towards revision of this Background material.

I also appreciate the efforts of CA. Dhinal Shah supported by CA. Twinkle Shah and CA. Karan Sukhramani who undertook the task of revising the background material pertaining to International taxation. I am also thankful to CA. Arun Saripalli supported by CA. Sunny Kishore Bilaney and CA. Leena Chhabria for their contribution towards the revision of background material pertaining to Transfer Pricing. This joint effort has enabled the Committee to come out with the revised version of the background material in a timely manner.

Last, but not the least, I appreciate the efforts made by CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation and her team for co-ordinating the project and for rendering secretarial assistance.

I believe that this background material would be helpful to the members not only for their examination but also in discharging their professional responsibilities.

Place: New Delhi

Date: November 14, 2019

CA. Nihar N. Jambusaria

Chairman,

Committee on International Taxation, ICAI

Foreword to the Second Edition

Globalisation has greatly impacted the economies of various Countries and their tax policies. There is a huge flow of funds across the nations, which needs to be monitored from various perspectives. Tax evasion is one of the important perspectives which required OECD on request of G20 countries to work on implementation of Base Erosion and Profit Shifting (BEPS) action plans.

Since there is difference in the tax rates across the countries BEPS was adopted by many multinationals. India too witnessed huge inflow and outflow of funds through tax haven countries like Mauritius. Sincere efforts are being made by the Government to plug all the loopholes which lead to loss of revenue to the Indian exchequer. Negotiations to amend DTAA's, implementation of GAAR and POEM, Cbc reporting are examples of some of the steps being taken in this direction. Further, in order to tackle treaty abuse, India has recently signed the multilateral Instrument (MLI). The MLI will be applicable alongside the existing tax treaty with the required changes, without any further bilateral negotiation between the countries concerned.

The ocean namely "International taxation" is much deeper than "domestic taxation". Sailing safely through it requires, will, knowledge, experience, and the ability to learn and keep oneself updated. The Committee on International Taxation of ICAI under the able chairmanship of CA. Sanjiv Kumar Chaudhary has been taking all efforts to educate the members in the area of International taxation. Infact considering the need and importance of International taxation in today's time, the subject has also been included in the new curriculum of Chartered Accountancy course.

I would like to express my whole hearted gratitude to CA. Sanjiv Kumar Chaudhary, Chairman and CA. Nand Kishore Hegde, Vice-Chairman, Committee on International Taxation of ICAI for taking various initiatives through the Committee to keep the members updated in the field of International taxation. Revision of this publication is one of the important tasks accomplished by the Committee.

I am sure that this revised publication would be of immense use to the registrants of Diploma Course. I wish the registrants of the course all the very best for their future.

Best Wishes,

Place: New Delhi

Date : 20.07.2017

CA. Nilesh Shivji Vikamsey

President, ICAI

Preface to the Second Edition

Opening up of vast consumer base, economic potential and financial reforms has led to increase in investment in almost every sector of the Indian economy. Today, India is preferred over other developing countries for cross border investments. Increase in cross border trade and rendering of services, has further lead to various taxation issues which are interesting and also complex. Enormous increase in the digital transactions has further added to the complexities involved in taxation thereof. For the Government to have its fair share of taxes has become a challenge in itself. Successful implementation of BEPS Action plan is the only probable solution to the issue.

For broad and consistent implementation of BEPS the Inclusive Framework was established in June 2016. Nearly 100 countries and jurisdictions have become members since then. To cater to issues of tax avoidance, various countries including India have commenced implementation of some of the BEPS action plans. Further, to strengthen tax treaties the concept of multilateral Instrument has been brought in. India too is committed to address the issues of tax evasion and thus has signed this multilateral Instrument recently in June, 2017.

Since International Taxation has been assuming importance rapidly, gaining knowledge in this area has become a necessity. This area of practice has great prospects in the today's time and also in the years to come. It has always been the endeavour of ICAI to provide necessary support to its members to update themselves in such upcoming areas. Efforts are made through various means like sending updates to members on regular basis, organising of webcasts on recent issues in International Taxation, bringing out e-newsletter on quarterly basis, bringing out new publications and revising the existing ones and so on.

One such effort in this direction is organisation of Post Qualification Diploma in International Taxation on regular basis in all parts of the country by the Committee on International Taxation. The Committee launched this course in the year 2016 and has received overwhelming response from the members. With this course the Committee endeavours to strengthen the knowledge base of the members who practice in the area of International taxation as well as members who aspire to do so.

I am thankful to CA. Nilesh Shivji Vikamsey, President and CA. Naveen N D Gupta, Vice-President for being the motivational force behind the efforts being taken by the Committee.

The Study material for the course, developed by over 40 experts, has also been appreciated. Since taxation is a dynamic area, every year up-dation of the study material becomes a necessity. Thus, the Committee has come out with the revised second edition of the study material. The recent developments in the area have been taken care of.

I place on record my sincere thanks to the Vice Chairman, CA. N.C.Hegde who not only undertook revision of the publication but has actively supported all endeavors of the

Committee. I am also thankful to all the Committee members for sharing their experience and knowledge for creating awareness about the subject of International Taxation.

It is indeed a pleasure to convey my gratitude to CA. N. C. Hegde supported by CA. Mallika Apte, CA. Paras Modi, CA. Richa Gandhi, CA. Jhankana Thakkar and CA. Miloni Mehta; CA. Nihar N. Jambusaria supported by CA. Kushal Shah and CA. Shyam Ambani; CA. Dhinal Shah supported by CA. Ashwin Vishwanathan and CA. Ankit Bansal; CA. Rahul Garg supported by CA. Saurav Bhattacharya; who took untiring efforts to revise this study material in a timely manner. I also appreciate the efforts of CA. Parul Mehta; CA. Mrugen Trivedi; CA. Madhavi Mandovra ; CA. Hetal Mehta; CA. Nidhi Khanna; CA. Vinaya Phanse; CA. Shruti Agarwal; CA. Radhika Mangla; CA. Surbhi Mahendru; CA. Alpesh Shete; CA. Shailendra Dhole; CA. Anuradha Rathod; CA. Karnik Kansara and Bhavesh Hodar who supported me in revising the portion assigned to me by the Committee.

Special thanks to CA.P.V.SS Prasad; CA. T.S.Ajai and CA. Arun Saripalli who took the enormous task of reviewing the revised material in a short span of time.

I would also like to extend my appreciation to CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation of ICAI and her team for providing technical and administrative support in revising this study material. I am sure that this study material would be able to bring conceptual clarity to the members, which, is indeed the need of the hour.

Place: New Delhi

Date: 20.07.2017

Chairman

***Committee on International Taxation of
ICAI***

Foreword to the First Edition

The globalization of Indian economy and the progressive development that has taken place in recent years have offered strong incentive to multinational corporations to enter into Indian business space on their own or by engaging through domestic partners. This has led to various developments in the field of taxation and has generated interest in the Indian tax system by multinational corporations and their professional consultants. In fact, globalization, capital mobility and the increased trade and services has made international taxation a key concern area both for business enterprises engaged in the cross-border transactions and the tax administrations of the concerned states.

These developments have paved way for an additional area of expertise in practice for our Chartered Accountants. The Institute has always supported its members by updating their knowledge and professional skills so as to enable them to face such new challenges. ICAI introduced the Certificate Course on International Taxation in the year 2008 to provide focus attention in the evolving area of International Taxation. I am sure that the members who have pursued that course would vouch for the splendid work done by the Committee on International Taxation in all these years.

In order to give more value to the members, committed efforts have been made all these years to convert the Certificate course into Diploma. I am glad to mention that due to its unstinted efforts to provide the best to its members, ICAI had in the year 2015 received approval from the Ministry of Corporate Affairs for conducting Diploma in International Taxation. The Committee on International Taxation has been taking all possible efforts to launch this course in the most efficient manner. This study material is one such effort in this direction. I congratulate CA. Nihar N. Jambusaria, Chairman and CA. Sanjiv Chaudhary, Vice-Chairman and all other members of Committee on International Taxation for bringing out this Study material for the participants of the course. In fact an important milestone shall be successfully achieved with its release.

I am sure that this comprehensive background material, which is specifically designed for the Diploma Course, will certainly provide an insight into the complex aspects of International Taxation in a very lucid manner.

Date: 1st May, 2016

Place: New Delhi

CA. M. Devaraja Reddy

President, ICAI

Preface to the First Edition

Since the opening up of the Indian economy in 1991, India has seen a huge inflow of capital in the form of foreign investments. With each passing year, the Government has taken further steps to ensure that India integrates with the global economy. The advent of economic reforms in the form of globalization and liberalization in our country has resulted in the rapid growth of the Indian economy in general and cross border transactions in particular. The process of globalization is set to gain further impetus with the good performance of the economy in recent past. There has been manifold increase in the cross border activities of multinational corporations and other non-residents in the manufacturing and service sectors of the economy.

All the above developments have a great impact on taxation of the transactions arising out of such activities. Thus, international taxation has steadily become a major area of professional interest. However, the concepts and issues concerning international taxation are of a complex nature. Realizing the importance of the subject, the Committee on International Taxation of ICAI had taken an initiative earlier in the year 2009 by introducing Certificate Course on International Taxation. Till date 44 batches have been conducted all over India.

Since ICAI has received approval from Ministry of Corporate affairs for conducting Diploma in International Taxation, the Committee on International Taxation is now making its unstinted efforts to launch the same. In this effort, CA. Manoj Fadnis, President, ICAI and CA. M. Devaraja Reddy, Vice- President, ICAI were the guiding force for the Committee. I place on record my sincere thanks to them on behalf of all the members of the Committee. I am also thankful to Vice Chairman, CA. Sanjiv Chaudhary and all Committee members for supporting me in such an important initiative of the Committee. The Committee also took the inspiration, encouragement and guidance of CA. T.P.Ostwal ji for which I am grateful to him.

The first and the most important step in the launch of this Diploma was preparation of the study material. The Committee had various meetings to finalise the syllabus, structure and the contributors to the Background material. It is heartening to mention that about forty senior International tax professionals have generously contributed to this material. Thereafter, the material was vetted by the stalwarts in the profession. From the bottom of my heart, I thank all authors; CA. Vijay Iyer, CA. Pallavi Dinodia, Mr. S P Singh, Mr. Gaurav Bhutani, CA. Muke sh Buttani, Mr. Sunchit Majumdar, CA. Sandeep Puri, CA. Rajan Sachdev, CA. Hardev Singh, CA. Nidhi Khanna, CA. Madhavi Mandovra, CA. Dhishat B. Mehta, CA. Yashodhan Pradhan, CA. Mayur Nayak, CA. Tarun Chaturvedi, CA. Tarun Singhal, CA. Anil Doshi, CA. K.R. Girish, CA. Rajesh Simhan, CA. Nilesh Kapadia, CA. Prashant Maheshwari, CA. Neetu Vinayek, CA. Kedar Karve, CA. Paresh P. Shah, CA. Amrish Shah, CA. Sonu Iyer, CA. Preeti Sharma,

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I also appreciate the efforts of CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation of ICAI and Mr. Ashish Bhansali, Assistant Secretary for providing technical and administrative support in giving final shape to this study material. I am confident that this comprehensive study would be of immense use to the members and would provide conceptual clarity regarding the basics of International taxation.

Date: 1st May, 2016

Place: New Delhi

CA. Nihar N. Jambusaria

Chairman,

Committee on International Taxation of ICAI

SYLLABUS

Provisions of Income-tax Act, 1961 and Income tax Rules, 1962 relating to Transfer pricing, OECD Transfer Pricing Guidelines and multinational Enterprises & tax Administration, UN Transfer Pricing guidance for developing Countries.

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Module A

An Overview of Transfer Pricing

The taxation of Multinational Enterprises (MNEs) is determined on the basis of domestic taxation law of the country where income arises, accrues or is deemed to arise or accrues or is received or is deemed to be received. This jurisdiction of taxation is subjected to tax treaty which the country of source may be having with the country of residence of the enterprise of the MNE involved. The tax treaties are, normally, negotiated on the basis of models developed by the Organisation for Economic Cooperation and Development (OECD) and the United Nations (UN). While applying the principles of taxation to the MNCs, one of the most difficult issues that arises is the establishment for tax purposes of appropriate transfer prices. To assist the taxpayers as well as tax administration the OECD has come out with Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (referred to as the "OECD TP Guidelines" or the "TP Guidelines" or the "Guidelines"). The United Nations (UN) has also come out with Guidelines, which with some significant differences, are in line with the OECD Guidelines. According to these guidelines, "Transfer prices" are *the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises*. Transfer Pricing is the process of fixing the transfer price. Two enterprises are "associated enterprises" if one of the enterprises participates directly or indirectly in the management, control or capital of the other or if both enterprises are under common control. Since international transfer pricing involves more than one tax jurisdiction, any adjustment to the transfer price in one jurisdiction requires a corresponding adjustment in the other jurisdiction. If a corresponding adjustment is not made, economic double taxation will result.

The increase in global trade and foreign direct investment has seen a sharp rise in companies operating across national borders. In the present age of commercial globalisation, it is a universal phenomenon that MNEs have branches/subsidiaries/ operating in more than one country. In such a situation, it is a common event for MNEs to transfer goods produced by a subsidiary / branch in one tax jurisdiction to a subsidiary / branch operating in another tax jurisdiction. While doing so, the MNEs concerned have in mind the goal of minimizing tax burden and maximizing profits but the two tax jurisdictions/countries have also the consideration of maximizing their revenue while making laws that govern such transactions. It is an internationally accepted practice that such 'transfer pricing' should be governed by the Arm's Length Principle and the transfer price should be the price applicable in case of a transaction at arm's length. In other words, the transaction between associated enterprises should be priced in the same way as a transaction between independent enterprises. Today, transfer pricing is one of the most important issues faced by MNEs as one of the guiding principles to maximise the group profits is to have the most efficient tax structure, whereby maximum profits are in the country with lowest tax regime, unless there are other group considerations. On the other hand, the tax authorities implement transfer pricing regulations and strengthen the enforcement in order to prevent loss of revenue for each regime where these companies are incorporated and/or operating. The net result of this dichotomy is that

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transfer pricing has become a major tax issue for the companies.

Arguably, significant volume of global trade nowadays consists of cross-border transfer of goods and services, capital and intangibles (such as intellectual property) within an MNE group; such transfers are called 'intra-group transactions'. Of these, transactions involving intangibles and multi-tier services constitute a rapidly growing proportion of an MNE's commercial transactions and have greatly increased the complexities involved in analysing and understanding such transactions. Transfer pricing relates to the pricing arrangements between the business entities of a MNE for such inter-company transaction.

The structure of transactions within an MNE group is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities. A large and growing number of international transactions are therefore no longer governed entirely by market forces, but driven by the common interests of the entities of a group. The common interests are both fiscal and non-fiscal in nature. Fiscal interest consists of minimising taxes – both direct and indirect taxes. Since, transfer prices serve to determine the income of both parties involved in cross-border transactions, MNE try to use tax benefits, such as a tax loss in a jurisdiction of operation. This may be either a current year loss or a loss that has been carried forward from a prior year by an associated enterprise. In some cases, an MNE may wish to take advantage of an associated enterprise's tax losses before they expire, in situations where losses can only be carried forward for a certain number of years. Even if there are no restrictions on carrying forward tax losses by an associated company, the MNE has an incentive to use the losses as quickly as possible. In other words, profits may sometimes be shifted to certain countries in order to obtain specific tax benefits.

1. What is 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 MNE 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 an MNE [associated enterprises (AEs)] operating in different countries.

For example, common business transactions between the AEs are in the nature of purchase and sale of assets, raw materials, finished goods and provision of services. Due to the lack of a natural conflict between the parties involved in commercial transactions in a group scenario, most MNEs, given their wide geographical presence, have a possibility to use their position to arrange business transaction to favourably exploit tax positions. By structuring transactions in a way which is most beneficial to the MNE from a tax perspective, a MNE is able to actively influence the tax burden.

This, the tax administrators believe is unjust. Thus, to protect each country's fair share in an MNE'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. So, it is essential to understand that the only external party which is interested in the intra group allocation of income of MNE are the tax authorities. So, everything which is done in transfer pricing is eventually very likely assessed by a tax authority in one of the countries involved and, therefore, requires careful work and careful scrutiny before it is implemented.

2. Historical background

2.1 Global scenario

The transfer pricing was initiated in the United States with introduction of Section 262 of the Revenue Act, 1921 wherein consolidated return reflecting the true tax liability were permitted to be prepared by the Commissioner on behalf of controlled entities. These powers were further enhanced by Section 45 of the Revenue Act, 1928 which empowered the Commissioner to see that there would be no tax evasion in a related party scenario. In 1968, the US Treasury Department issued transfer pricing regulations under Section 482 of the Revenue Act, 1921 which replaced all earlier regulations.

With the increase in number of MNEs across the globe, coupled with the multi-fold increase in the cross-border transactions (among MNEs), the Working Party No. 6 formed under the Committee on Fiscal Affairs of the OECD came out with a report titled "Transfer Pricing and Multinational Enterprises" in 1979. Addendum to the 1979 report was introduced in 1984 wherein the OECD included mutual agreement procedure, transfer pricing in the banking sector and central cost allocation.

For about one decade, the OECD reports resulted in a common approach to transfer pricing principles and methods. With the amendment in US Treasury transfer pricing regulations, the OECD felt the need to update the reports to reflect the developments in international trade. Hence, the Working Party No. 6 came out with revised guidelines in July 1995. These guidelines were further revised in 2010 known as OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (OECD TP Guidelines).

Being concerned with the abilities of MNEs to manipulate taxes in their jurisdictions of incorporation or operation, thereby eroding the tax bases of those jurisdictions, the G20 countries mandated OECD to come out with recommendations to prevent base erosion and profit shifting ('BEPS'). The OECD released the final BEPS package giving its recommendation in the form of 15 Action Points. Subsequently, on 10 July, 2017 the OECD released the 2017 edition of the TP Guidelines, which essentially integrates the guidance set out in Action 8 to 10, and Action 13 of the OECD's BEPS initiative. Further, revised TP Guidelines were released on January 20, 2022 that includes the revised guidance on the application of the transactional profit method and the guidance for tax administrations on the application of the approach to hard-to-value intangibles agreed in 2018, as well as the new transfer pricing guidance on financial transactions approved in 2020.

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The OECD is working on reaching a globally acceptable approach to tax income from digital transactions. The result of the deliberations is Two Pillar approach, which is being finalised. Pillar One would provide taxing rights to market jurisdiction on part of the residual profits earned by MNE groups with an annual turnover exceeding Euro20 billion and 10 percent profitability. Pillar Two requires MNE groups with an annual global turnover exceeding Euro 750 million to pay at least 15 percent tax. To what extent and in what form the arm's length principle would be incorporated in the scheme of the Two Pillar approach would have to be watched.¹

2.2 Indian scenario

Post globalization, in 1991, the enhanced presence of MNEs in India and their ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions, made the issue of transfer pricing a matter of serious concern for the Indian policy makers. Just like their global counterparts, the Indian tax authorities presumed the ability / intention of the MNEs to resort to transfer pricing as a tool to shift profits and thereby erode the Indian tax base. This presumption ultimately led to the evolution of the transfer pricing regulations in India.

2.2.1 Pre 2001 scenario

Prior to the introduction of comprehensive transfer pricing regulations by the Finance Act, 2001, certain basic provisions existed under the income-tax and the customs and excise legislation. While provisions like erstwhile Section 92 of the Income Tax Act, 1961 ("the Act") and Rule 10 of the Income Tax Rules, 1962 ("the Rules") did exist in law (which empowered Assessing Officers to examine inter-company transactions of MNE groups), however, given their restricted scope / methodology, it was felt over a period of time that the same were not sufficient enough to prevent the erosion of the Indian tax base on account of inter-company transactions undertaken by MNE members. There was no detailed statute on transfer pricing.

In *Mazagaon Dock Ltd v. CIT*², transaction between group companies was considered by the Supreme Court with reference to Section 42 of the Indian Income-tax Act, 1922. The question before the Supreme Court was whether the transaction was covered within the scope set out under section 42(2) of the Indian Income-tax Act, 1922³. It was observed that section 42 (2) of the Indian Income-tax Act,1922 states that it is not the question of the non-residents carrying

¹ This position is as on September 13, 2022

² [1958] 34 ITR 368 (SC)

³ section 42 (2): "Where a person not resident or not ordinarily resident in the taxable territories carries on business with a person resident in the taxable territories, and it appears to the Income-tax Officer that owing to the close connection between such persons the course of business is so arranged that the business done by the resident person with the person not resident or not ordinarily resident produces to the resident either no profits or less than the ordinary profits which might be expected to arise in that business, the profits derived therefrom, or which may reasonably be deemed to have been derived therefrom, shall be chargeable to income- tax in the name of the resident person who shall be deemed to be, for all the purposes of this Act, the assessee in respect of such income- tax."

on business in the abstract but of their carrying on business with the resident. The arrangement has to be looked into and decided on the taxability.

The Apex court rejected the contentions of the Indian company and held that profits, if any foregone, must be taxed. The court expressed the view that the fact, that the dealings were such as to yield no profit, was immaterial.

Section 42(2) in the Indian Income-tax Act, 1922 dealt, inter alia, with transactions between a resident and non-resident. On the enactment of the Income-tax Act, 1961 (the Act), the provisions of section 42(2) of the Indian Income-tax Act, 1922 were incorporated in this Act in the form of section 92 of the Act with minor changes to bring out the purport of the section more clearly. Section 92 of the Act was backed by Rule 10 and 11 of the Rules.

For invoking Section 92 of the Act⁴, certain requisite conditions had to exist. These were:

- (i) The business was transacted between a resident and a non-resident.
- (ii) There was a close connection between the two.
- (iii) On that account, the course of business was so arranged that the business produces either no profit or less than normal profit to the resident.

If the conditions at (i) to (iii) were found to exist, the Assessing Officer under the Act was empowered:

- to determine the amount of profits, which may reasonably be deemed to have been derived from such business; and
- to include such amount in the total income of the resident.

Rules 10 and 11 of the Rules, provided the methodology for working out the normal profit to be included in the income of the resident assessee in the circumstances mentioned above. The normal profit could be calculated:

- (i) at such percentage of the turnover so accruing or arising as the Assessing Officer may consider to be reasonable, or
- (ii) on any amount which bears the same proportion to the total profits and gains of the business of such person, as the receipts so accruing or arising bear to the total receipts of the business, or
- (iii) in such other manner as the Assessing Officer may deem suitable.

Section 92 of the Act as it existed prior to its amendment, was not sufficient to deal with complex cases of transfer pricing. Its primary shortcomings were:

- The section applied only to 'businesses' between a resident and a non-resident. Since business demands a continuity of relationship, isolated transactions were outside its

⁴ section 92: "where a business is carried on between a resident and a non-resident and it appears to the Assessing Officer that, owing to the closed connection between them, the course of business is so arranged that the business transacted between them produces to the resident either no profits or less than the ordinary profits which might be expected to arise in that business, the Assessing Officer shall determine the amount of profits which may reasonably be deemed to have been derived therefrom and include such amount in the total income of the resident."

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purview.

- The section was not wide enough in its scope to cover cases of transfer of services or intangibles.
- The section was not applicable in the case where a non-resident enters into a transaction with another non-resident. Therefore, business transactions between a permanent establishment of a non-resident company and a non-resident were not covered.
- The section provided for adjustment of profits instead of adjustment of prices and the rules prescribed for estimating profits were not scientific.
- The concept of 'close connection' was not defined, leading to arbitrariness in applying the said provisions.
- No detailed rules for necessary documentation were prescribed to defend actions by the Revenue authorities.

The government decided to look into the possibility of a separate legislation for transfer pricing policy framework not effectively dealt with by then existing provisions. In view of the above, the Central Board of Direct Taxes (CBDT) set up an Expert Group on Transfer Pricing in November, 1999 to determine whether any amendments were necessary in the Act and if so, to suggest a regulatory framework for the same.

The Group submitted its report in January, 2001 to the CBDT. The Ministry of Finance after considering the report introduced exhaustive legislative framework to deal with transfer pricing issues vide the Finance Act, 2001.

2.2.2 Post 2001 scenario

Finance Act, 2001 introduced Transfer Pricing Regulations for curbing tax avoidance and manipulation of intra-group transactions by abusing transfer pricing. Specifically, the memorandum to the Finance Act, 2001 stated that:

*“The increasing participation of multinational groups in economic activities in the country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in such intra-group transactions, thereby, leading to erosion of tax revenues. **With a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises, new provisions are proposed to be introduced in the Income Tax Act.**” (Emphasis provided)*

Section 92 in the Act was substituted by eight sections in the Act numbered 92, 92A, 92B, 92C, 92CA, 92D, 92E and 92F dealing with various aspects concerning transfer pricing. The contents of these provisions concerning transfer pricing were explained in the Explanatory Memorandum to the Finance Act, 2001. Essentially, these are intended to 'curb tax avoidance by abuse of transfer pricing'. The provisions were later explained in a greater detail in Circular

No. 14 dated 20 November, 2001 which provides a clear and detailed idea about the objective of the Revenue underlying the new provisions and their implementation, the relevant portion from this circular are discussed in this chapter wherever required. These regulations have been amended from time-to-time. Summary of such amendments is provided in **Appendix**.

The Indian Legislation is not entirely aligned to the OECD transfer pricing guidelines. Since India is not a member of the OECD, it is not mandatory to follow OECD model tax code. However, OECD guidelines have been relied upon by the Indian Tax Tribunals / Courts while dealing with the TP cases. In a recent decision in the case of Engineering Analysis Centre of Excellence Private Limited⁵ the Supreme Court of India reiterated the importance of Commentary to the OECD Model Tax Convention.

3. International Transaction

Section 92 of the Act deals with any income or expense arising from an “International Transaction”. In order to understand the definition of “International Transaction”, it is essential to understand the definition of “Transaction”.

Clause (v) of Sections 92F of the Act defines a transaction as:

“Transaction” includes an arrangement, understanding or action in concert,—

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

Section 92F of the Act provides an inclusive definition of the term “transaction”. Based on the reading of the section, it is evident that it is not necessary that for a transaction undertaken between two enterprises there needs to be a formal written agreement between them. It is only relevant whether a transaction has been entered into in substance. The section also negates the requirement as to the legal enforceability of agreement or understanding.

As per section 92B of the Act, the term international transaction refers to a transaction between two or more AEs, either or both of whom are non-residents, which is in nature of:

- Purchase, sale, transfer, use or lease of tangible or intangible property, or
- Provision of services, or
- Lending, borrowing or guarantee money, or
- Business restructuring or reorganisation irrespective of the fact that it has bearing on the profit, income, losses or assets, or
- Any other transactions having a bearing on the profits, income, losses or assets of such enterprises.

⁵ *Engineering Analysis Centre of Excellence Private Limited Vs CIT, Civil Appeal Nos. [TS-106-SC-2021]*

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It also includes a mutual agreement or arrangement between two or more AEs for:

- Allocation or appointment 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 one or more of such enterprises.

Further, a transaction entered into by an enterprise with a person other than an associated enterprise shall be deemed to be a transaction entered into between two AEs, if:

- there exists a prior agreement in relation to the relevant transaction between such other person and the AE; or
- the terms of the relevant transaction are determined in substance between such other person and the AE.

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.

The definition of the term 'international transaction' also includes several other items including tangible / intangible property.

4. Specified domestic transactions

As per section 92BA of the Act "Specified domestic transaction" in case of an assessee means any of the following transactions, not being an international transaction, namely⁶:

- any transaction referred to in section 80A of the Act, or
- any transfer of goods or services referred to in sub-section (8) of section 80-IA of the Act,
- any business transacted between the assessee and other person as referred to in sub-section (10) of section 80-IA of the Act,
- any transaction, referred to in any other section under Chapter VI-A or section 10AA of the Act, to which provisions of sub-section (8) or sub-section (10) of section 80-IA of the Act are applicable,
- any business transacted between the persons referred to in sub-section (6) of section 115BAB⁷, or
- any other transaction as may be prescribed,

and where the aggregate of such transactions entered into by the assessee in the previous year exceeds a sum of **twenty crore**⁸ rupees.

⁶ Finance Act 2017, omitted "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" with effect from 1 April, 2017

⁷ Ins. by the Act No. 46 of 2019, w.e.f. 1-4-2020.

⁸ Substituted for '**Five crores**' by the Finance Act, 2015 with effect from 1 April 2016

5. Associated Enterprise

As per Section 92A(1) of the Act, associated enterprise refers to an enterprise which participates directly or indirectly or through one or more intermediaries in :

- Management of the other enterprise
- Control of the other enterprise
- Capital of the other enterprise

Section 92A(1) of the Act lays down a broad guidance as to when two or more entities can be associated. Section 92A(2) of the Act provides a list of situation during which AE relationship is deemed to be established:

- *Enterprise ownership* - one enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise.
- *Voting power* - any person or enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in each of such enterprises.
- *Lender* - a loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise.
- *Guarantor* - one enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise.
- *Appointment of Board* - more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise.
- *Appointment of Board* - 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.
- *Dependence on intangibles* - the manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights
- *Dependence on supply in manufacturing process* - ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise.
- *Dependence on sale in manufacturing process* - the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by

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the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise.

- *Individual control* - where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual.
- *Control by Hindu Undivided Family* - where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or jointly by such member and his relative
- *Holding 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 not less than ten per cent interest in such firm, association of persons or body of individuals.
- *Mutual interest relationship* - there exists between the two enterprises, any relationship of mutual interest, as may be prescribed.

Example:

ABC Inc USA ("ABC US") holds shares carrying more than 26 percent of the voting power in ABC Singapore (ABC SG). XYZ USA, another AE of ABC US, holds 80 percent interest in – PQR & Co. a private company which is based out of India. Remaining 20 percent interest in PQR & Co. is held by another AE of ABC US, XYZ Singapore.

While PQR & Co. may be regarded as AE of its parent XYZ USA, ABC US may be regarded as AE of its subsidiary ABC SG by virtue of section 92A(2)(a) of the Act.

In this case, ABC US holds directly or indirectly more than 26% of voting power in both PQR & Co. Ltd. and ABC SG hence both these companies will be considered as AE by virtue of section 92A(2)(b) of the Act.

Relevant judgements:

- **Veer Gems (TS-2-SC-2018-TP)**

The Supreme Court (SC) dismissed Revenue's Special Leave Petition ('SLP') challenging Gujarat High court ('HC') order holding that assessee and its supplier of rough diamonds viz. Blue Gems BVBA (Belgian entity) were not associated enterprises for AY 2008-09. TPO had treated assessee and Blue Gems as AE on the ground that both the entities were controlled by same family of four brothers and their close relatives. HC had held that clause (i) of Sec 92A(2) was not applicable as Blue Gems neither manufactures nor processes any articles. HC had also ruled out application of clause (j) which triggers when enterprise is controlled by an individual, noting that both assessee and Blue Gems were partnership firms. Further HC had also rejected applicability of clause (l) as the condition for the other enterprise to hold not less than 10% interest in partnership firm was not fulfilled in assessee's case. Thus, HC had concluded that "The Tribunal in our opinion therefore committed no error in holding that the

assessee and M/s. Blue Gems not being associate enterprises, the question of applying transfer pricing formula would not arise". Dismissing the SLP, SC also stated that "Pending application(s), if any, shall stand disposed of".

6. Arm's length Principle – Article 9 of OECD/UN TP Model

The arm's length principle is the fundamental principle for determining transfer prices. Article 9 of the OECD Model Convention provides that –

1. *Where*

(a) *an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or*

(b) *the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,*

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

The above clarifies the arm's length principle. It basically, stipulates that related parties have to deal with each other in commercial transactions as if they were unrelated. Commercial transactions in this context can be any commercial transaction that can be conducted between related parties - so the supply of goods, supply of services, treasury transactions i.e. loans, guarantee fees, intra group transfer of shares can be subject to the arm's length principle; cost contribution arrangements, business restructurings, royalty transactions, sale of assets etc. can be subject to the arm's length principle and basically in all these cases related parties have to deal with each other as if they were unrelated.

The Arm's Length Principle applies also to the attribution of profits to permanent establishments that is now explicitly stipulated in Article 7 of OECD Model Convention. So the recent change of the model tax treaty includes the application of Arm's Length Principle explicitly, in the old language of the Article 7 which is included in most of the double tax avoidance treaties concluded between countries this explicit reference is not included, but in the revised commentary to the old Article 7 from 2008, the principles of the application of the Arm's Length Principle to the attribution of profit to Permanent Establishment (PE), is also included.

Hence, for transactions between related parties i.e. operations and for the attribution of profits to PE, the same principles apply. The Arm's Length Principle is also included in many tax laws around the world. Basically, the definitions included in these provisions are in line with Article 9 of OECD Model Convention.

Arm's Length Principle is about simulating third party behaviour and hence what third parties

would have done or an appropriate allocation key of income between countries is a more practical view which many tax authorities also take. Hence, in the transfer pricing regime, all questions around substantiating arm's length behaviour between the related parties of an MNE group are dealt with and to substantiate this arm's length behaviour, the tax authorities in many countries have included provisions in their tax laws that require taxpayers to prepare comprehensive transfer pricing documentation either contemporaneously or on request. Contemporaneously, basically, means that transfer pricing documentation has to be prepared by a specified date, which is one month prior to the due date of filing tax return. In some countries, it has to be submitted to the tax authorities at a certain date. In other countries, the documentation has to be presented to the tax authorities within specified timeframe.

7. Methods of Transfer pricing

As per Section 92C(1) of the Act, the arm's length price in relation to an international transaction (or specified domestic transaction) shall be determined by any of the following methods, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely:

- a) Comparable uncontrolled price method ('CUP')
- b) Resale price method ('RPM')
- c) Cost plus method ('CPM')
- d) Profit split method ('PSM')
- e) Transactional net margin method ('TNMM')
- f) Any other method as provided in Rule 10AB.

As per the provisions of the Act, the ALP in relation to an international transaction shall be determined by any one of the abovementioned methods (being the most appropriate method). The Indian transfer pricing regulations follow the principle of most appropriate method and does not recommend any hierarchy of method to be used.

8. Documentation

8.1. Transfer Pricing Documentation for international / specified domestic transactions undertaken during the year

As per Section 92D(1) of the Act, every person who has entered into an international transaction or SDT is required to keep and maintain the prescribed information and documentation. Such information and documentation need not be maintained in cases where the aggregate book value of international transactions entered into by the taxpayer does not exceed INR one crore. However, in such cases, the taxpayer would need to substantiate, on the basis of material available with him, that income arising from international transactions entered into by him has been computed in accordance with the arm's length principle.

Transfer pricing documentation is especially important in justifying the arm's length nature of the international / specified domestic transactions. The documentation is required to be robust and should typically include nature of business, activities performed and Functions, Assets and Risk (FAR) analysis for performing such activities. Further, it should also contain an economic analysis of similar or same type of companies operating in the market for which the documentation is being prepared.

In addition to the accounts/documents to be maintained in normal course of business, Rule 10D of the Rules specifies the following documents to be maintained by every person who has entered into an international transaction / SDT to establish arm's length nature of transactions.

- a) A description of the ownership structure of the taxpayer with details of shares or other ownership interest held therein by other enterprises.
- b) A profile of multinational group of which the taxpayer is a part along with the name, address, legal status and country of tax residence of each of the enterprises comprised in the group with whom international transactions / SDT are carried out and the ownership links.
- c) A brief description of the business and the industry in which the taxpayer operates, and of the business of the AEs with whom international transactions / SDT have taken place.
- d) The nature and terms (including prices) of all the international transactions / SDT with the AEs, as to the property transferred or services performed and the quantum and value of each such transaction or class of such transaction.
- e) A description of the functions performed, risks assumed and assets employed or to be employed by the taxpayer and by the AEs involved in the international transaction / SDT.
- f) Economic and market analysis, forecasts, budget or any other financial estimates for the business as a whole and for each of the division or product separately which may have a bearing on the international transactions / SDT entered into by the taxpayer.
- g) A record of uncontrolled transactions to analyse the comparability with the international transactions / SDT entered into, by the taxpayer, as to the nature of transaction, terms and conditions, value and other relevant factors for comparison.
- h) A record of analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction / SDT.
- i) Description of the methods considered to determine the arm's length principle in relation to each of the international transactions/ SDT or class of transactions, the method selected as most appropriate method ('MAM'), why it is most appropriate and how such method was applied in each case.
- j) A record of actual working carried out for the comparability analysis, its financial information and its applicability to the international transaction by the taxpayer for

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controlled transactions, any adjustments made to the comparable data and the like, should be available.

- k) Assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's length price.
- l) Details of the adjustments, if any, made to transfer prices to align them with arm's length prices determined under these rules and consequent adjustment made to the total income for tax purposes;
- m) Invoices, debit notes and other related documents in defence of the arm's length price.
- n) Contracts/Agreements with AEs.
- o) Any other information, data or document, including information or data relating to the AE, which may be relevant for determination of the arm's length price.

Section 92D of the Act mandates a taxpayer to maintain specified transfer pricing documentation and information, on a contemporaneous basis. It includes economic analysis which is a critical part of the documentation that forms the basis to conclude that the international transactions with its overseas affiliates are at arm's length.

Also, proviso to Rule 10D(4) of the Rules states:

“Provided that where an international transaction or a specified domestic transaction continues to have effect over more than one previous year, fresh documentation need not be maintained separately in respect of each previous year, unless there is any significant change in the nature or terms of the international transaction or the specified domestic transaction, as the case may be, in the assumptions made, or in any other factor which could influence the transfer price, and in the case of such significant change, fresh documentation as may be necessary under sub-rules (1), (2) and (2A) shall be maintained bringing out the impact of the change on the pricing of the international transaction or the specified domestic transaction”.

The above rule clearly stipulates that so long as there is no significant change in the nature/terms of international transactions, there is no requirement for creating fresh set of documentation for the subsequent year. However, it becomes imperative for the taxpayer to update the documentation and information so that true and accurate business reality of the taxpayer is reflected in the documentation, including the future business plans, strategies and market positioning.

In cases wherein an international transaction continues to have effect over more than one financial year, fresh documentation need not be maintained separately in respect of each financial year (unless there is any significant change in the nature or terms of the international transaction, in the assumptions made, or in any other factor which could influence the transfer price).

However, there have been cases under Indian transfer pricing regulations that although transfer price for an international transaction have been accepted in one tax year, the same has been rejected in the next year without there being any change in the commercials of the

transaction. Accordingly, a taxpayer is forced to test its transfer price on a year-on-year basis. Though the regulations recommend contemporaneous maintenance of documentation, it is also . The specified information and documents are required to be maintained for a period of eight years from the end of the relevant assessment year.

8.2 Master File

As mentioned earlier, the OECD released the final BEPS package giving its recommendation on 15 Action Plans (AP) one of which being Action 13. Pursuant to these two changes were made with respect to maintenance of master file and CbCR in certain cases.

The Finance Act 2016, in line with recommendations of the BEPS Action 13 amended section 92D and inserted section 286 of the Act to provide for a three-tiered documentation structure.

The MF provisions are (provided under Section 92D of the Act read with Rule 10DA of the Rules) which is in accordance with AP13 of the BEPS Action Plan issued by the OECD, the MF shall provide an overview of the MNE group business, its overall TP policies, and its global allocation of income and economic activity in order to place the MNE group's TP practices in their global economic, legal, financial and tax context. The MF shall contain information which need not be restricted to the transaction undertaken by a particular constituent entity situated in a particular country. In that aspect, information in the MF would be more comprehensive than typical current documentation standards.

As per the provisions of the Act and Rules, entities that are constituents of an international group, shall also be required to maintain such information and documents as prescribed in Rule 10DA (i.e. Master File) in addition to the information prescribed in Rule 10D of the Rules.

The Rules prescribe a separate statutory form i.e. Form 3CEAA to provide the information prescribed in Rule 10DA of the Rules. The form has been divided into two parts:

- Part A – to be filed by every person, being a constituent entity of an international group - consists of name, address, the tax identification number (i.e., referred to as permanent account number or PAN) of the constituent entity resident in India, name and address of the international group, accounting year for which the report is being submitted, number of constituent entities of the international group operating in India along with its name, address and PAN.
- Part B – to be filed if the following two conditions are satisfied - consists of the contents as prescribed under the AP13 report and a few additional information:
 1. The consolidated revenue of the international group, of which such taxpayer is a constituent entity, as reflected in the consolidated financial statement of the international group for the relevant accounting year, exceeds INR 500 crores
 2. Either of the below transactional thresholds is achieved for the relevant accounting year:
 - The aggregate value of international transactions as per the books of accounts maintained by the taxpayer exceeds INR 50 crores; or

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- The aggregate value of international transaction in respect of purchase, sale, transfer, lease or use of intangible property as per the books of accounts maintained by the taxpayer exceeds INR 10 crores.

The list of information and documents to be maintained are as under:

- a. a list of all entities of the international group along with their addresses;
- b. a chart depicting the legal status of the constituent entity and ownership structure of the entire international group;
- c. a description of the business of international group during the accounting year including,—
 - I. the nature of the business or businesses;
 - II. the important drivers of profits of such business or businesses;
 - III. a description of the supply chain for the five largest products or services of the international group in terms of revenue and any other products including services amounting to more than five per cent of consolidated group revenue;
 - IV. a list and brief description of important service arrangements made among members of the international group, other than those for research and development services;
 - V. a description of the capabilities of the main service providers within the international group;
 - VI. details about the transfer pricing policies for allocating service costs and determining prices to be paid for intra-group services;
 - VII. a list and description of the major geographical markets for the products and services offered by the international group;
 - VIII. a description of the functions performed, assets employed and risks assumed by the constituent entities of the international group that contribute at least ten per cent of the revenues or assets or profits of such group; and
 - IX. a description of the important business restructuring transactions, acquisitions and divestments;
- d. a description of the overall strategy of the international group for the development, ownership and exploitation of intangible property, including location of principal research and development facilities and their management;
- e. a list of all entities of the international group engaged in development and management of intangible property along with their addresses
- f. a list of all the important intangible property or groups of intangible property owned by the international group along with the names and addresses of the group entities that legally own such intangible property;

- g. a list and brief description of important agreements among members of the international group related to intangible property, including cost contribution arrangements, principal research service agreements and license agreements;
- h. a detailed description of the transfer pricing policies of the international group related to research and development and intangible property;
- i. a description of important transfers of interest in intangible property, if any, among entities of the international group, including the name and address of the selling and buying entities and the compensation paid for such transfers;
- j. a detailed description of the financing arrangements of the international group, including the names and addresses of the top ten unrelated lenders;
- k. a list of group entities that provide central financing functions, including their place of operation and of effective management;
- l. a detailed description of the transfer pricing policies of the international group related to financing arrangements among group entities; a copy of the annual consolidated financial statement of the international group; and
- m. a list and brief description of the existing unilateral advance pricing agreements and other tax rulings in respect of the international group for allocation of income among countries.

The report of the information in Form No. 3CEAA shall be furnished to the Joint Director⁹ of Income-tax as may be designated by the Director General of Income-tax (Risk Assessment) on or before the due date for furnishing the return of income as specified in sub-section (1) of section 139 of the Act.

9. Report from an accountant

Every person who has entered into an international transaction shall obtain a report from an independent practicing Chartered Accountant. This Report (Form No. 3CEB) is required to be furnished to the Income Tax department on or before the specified due date in the prescribed form duly signed and verified. As per clause (iv) of Section 92F of the Act, specified date means the date one month prior to the due date for furnishing the return of income under sub-section (1) of Section 139 of the Act for the relevant assessment year. The Accountant's Report gives particulars of AEs, international transactions, ALP and the method used for determining ALP.

⁹ Substituted the word 'Commissioner' with 'Director' vide CBDT Notification No. 31/2021 dated 5th April 2021 in the Income-tax (Ninth Amendment) Rules, 2021 w.e.f. 1-4-2021

10. Special measures in respect of transactions with persons located in notified jurisdictional area

Section 94A, introduced by the Finance Act, 2011, w.e.f. 1-6-2011, extends the provisions of sections 92, 92A, 92B, 92C [except the second proviso to sub-section (2)], 92CA, 92CB, 92D, 92E and 92F to the transactions with a person located in a notified jurisdictional area. The notified jurisdictional areas are those countries or territories with which there is lack of effective exchange of information and are specified by notification in the Official Gazette by the Government of India.

11. Country by Country Reporting (CbCR)

As discussed, the Action Plan 13 recommends three tier documentation i.e. CbCR, Main File (MF) and Local File (LF). The CbC report will be helpful for high-level TP risk assessment purposes.

According to the Rule 10 DB of the Rules, CbC reporting requirements would apply to an international group for an accounting year, if the total consolidated group revenue, as reflected in the consolidated financial statement for the preceding accounting year exceeds INR 6,400 crores¹⁰.

As per section 286 of the Act, the CbC report filing requirements would arise in the case of the following entities:

- If the parent entity of an international group (which has been defined to include two or more enterprises including a permanent establishment which are resident of different countries or territories) is resident in India¹¹.
- If there is a constituent entity in India belonging to an international group and the parent entity of the group is resident in a country if any of the following conditions is fulfilled:
 - Where the parent entity is not obligated to file the report referred to in Section 286(2) of the Act,
 - A country with which India does not have an arrangement for exchange of the CbC reporting, or
 - there has been a systematic failure of the country or territory and the said failure has been intimated by the prescribed authority to such constituent entity.

The Indian Transfer Pricing Regulations have prescribed the format of CbC report which is in line with the OECD recommended format. The CbC reporting template i.e. Form 3CEAD requires MNEs to report the amount of revenue, profits, income tax paid and accrued, employees, stated capital, retained earnings and tangible assets annually for each tax jurisdiction where they do business. In addition, MNEs are required to identify each entity

¹⁰Substituted for words "five thousand five hundred" by the Income-tax (Ninth Amendment) Rules, 2021, w.e.f. 1-4-2021.

¹¹The deadline for filing of CbCR in this case is 30 November (for FY 2016-17 the deadline was 31 March 2018)

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

The CbC reporting template is divided into three tables:

- Table I - Overview of allocation of income, taxes and business activities by tax jurisdiction
- Table II - List of all constituent entities of the MNE group included in each aggregation per tax jurisdiction, including designation of Main Business Activity
- Table III - Additional information

The report of the information in Form No. 3CEAD shall be furnished to the Joint Director of Income-tax as may be designated by the Principal Director General of Income-tax (Systems) or the Director General of Income Tax (Systems)¹² within a period of twelve months from the end of the said reporting accounting year.

Further, every constituent entity resident in India, if its parent entity is not a resident in India, would need to notify as to whether:

- The constituent entity in India is the alternate reporting entity of the international group
Or
- Provide the details of the parent entity or the alternate reporting entity, which will be the reporting entity of the international group and the country or territory of which the said entities are resident

Such notification needs to be made in Form 3CEAC to the Joint Director of Income Tax at least two months prior to the due date for furnishing of report as specified under sub-section (2) of section 286 of the Act.

12. Penalties

The penalties for non-compliance with the Indian transfer pricing regulations are described below:

Section	Default	Penalty
270A(7)	Underreporting of income.	50% of tax payable on amount of underreported income
270A(8)	Misreporting of income.	200% of tax payable on amount of underreported income
271(1)(c) ¹³	In case of a transfer pricing adjustment, in absence of good faith and due diligence	100-300% of tax on the adjusted amount

¹² Substituted the word 'Commissioner' with 'Director' and "Principal Director General of Income Tax (Systems)" or 'the Director General of Income Tax (Systems)', instead of earlier Director General of Income Tax (Risk Assessment) vide CBDT Notification No. 31/2021 dated 5th April 2021 in the Income-tax (Ninth Amendment) Rules, 2021 w.e.f. 1-4-2021

¹³ Explanation 7 of Section 271(1)(c) of the Act. Not applicable from AY 2017-18

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Section	Default	Penalty
	by the taxpayer in applying the provisions and maintaining adequate documentation.	
271AA(1)	Failure to maintain TP documentation, failure to report the transaction, maintenance or furnishing of incorrect information/document.	2% of the value of each international transaction/ SDT
271AA(2)	Failure to furnish master file by prescribed date.	INR 500,000
271G	Failure to furnish documents/report transaction.	2% of the value of the international transaction/ SDT for each such failure
271BA	Failure to furnish accountant's report.	INR 100,000
271J	Penalty on accountants for furnishing incorrect information in reports or certificates furnished under any provisions of the Act or the rules made thereunder.	INR 10,000 per report/ certificate

Section 271GB of the Act provides for penalty for failure to furnish the documents prescribed under Section 286 of the Act i.e. CbC report. The penalty prescribed under Section 271GB of the Act are as follows:

Nature of penalty	Penalty (INR)
Failure to furnish the prescribed documents required to be maintained by the India parent entity of the international group:	
a. Where period of failure is equal to or less than 1 month	INR 5,000 per day
b. Where period of failure is greater than 1 month	INR 15,000 per day
c. Continuing default after service of penalty order	INR 50,000 per day
Furnishing of inaccurate particulars (subject to certain conditions)	INR 5,00,000
Failure to produce the information and documents within 30 days (extendable by maximum 30 days)	INR 5,000 per day up to service of penalty order INR 50,000 per day for default beyond date of service of penalty order

Appendix

- Introduction of Transfer Pricing regulations by the Finance Act, 2001, applicable from AY 2002-03
- The Finance Act, 2002 made certain changes to the provisions contained in Sections 92A, 92C, 92F and 271F of the Act;
- The Finance Act, 2006 further amended Section 92C of the Act;
- The Finance Act, 2007 inserted sub-sections (3A) and (4) in Section 92CA of the Act;
- The Finance Act, 2009 amended the proviso to Section 92C of the Act, provided for constitution of Dispute Resolution Panel and empowered the Board to formulate Safe Harbour rules;
- The Finance Act, 2011 amended the allowable variation as per second proviso to section 92C (2) of the Act to be notified by the Central Government and made changes to Section 92CA of the Act. Also introduced section 94A of the Act.
- The Finance Act, 2012 has introduced significant amendments including inter alia clarifying the coverage of the term 'international transactions', expanding the scope of transfer pricing provisions to SDTs (Section 92BA) of the Act, and providing an Advance Pricing Agreement framework (Section 92CC and Section 92CD) of the Act.
- The Finance Act, 2014 made further changes, specifically in respect of arm's length price by introducing the use of multiple-year data and range concept for determination of arm's length price and roll-back mechanism for APA, and expansion of ambit of deemed international transactions.
- The Finance Act, 2015 increased the threshold limit for applicability of SDTs from INR 5 crores to INR 20 crores w.e.f. FY 2015-16
- The Finance Act 2016, in line with recommendations of the BEPS Action 13, inserted Section 286 of the Act for furnishing of CbCR and inserted proviso to section 92D(1) of the Act for maintenance of Master File, with effect from FY 2016-17. It also paved way for rationalisation of time-barring limitations for assessments, and insertion of Section 270A of the Act for revised penalty provisions for concealment.
- The Finance Act, 2017 introduced Secondary Adjustment and Thin Capitalization provisions in the Indian legislation, along with exclusion of Section 40A(2) of the Act payments from the ambit of SDT provisions
- The CBDT on 7th June 2017 notified a new safe harbour regime to come into effect from 1st of April, 2017, i.e. A.Y. 2017-18 and shall continue to remain in force for two immediately succeeding years thereafter, i.e. up to A.Y. 2019-2020.
- The CBDT on 31st October 2017 introduced Rule 10DA and Rule 10DB prescribing the applicability, procedures and forms in relation to MF and CbCR
- The Finance Act, 2018 introduced certain amendments to section 286 of the Act to

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broadly bring it in line with model legislation of Action 13 of BEPS and reduce the compliance burden of CbCR in India

- The Finance (no. 2) Act, 2019 introduced certain amendments to section 92CE of the Act relating to secondary adjustments and section 92D of the Act relating to Master File, clarifying certain aspects. Further, there was an amendment in section 92D of the Act clarifying the intent of the Government relating to post APA compliance audits.
- The Finance Act 2019 introduced subsection 2A to the secondary adjustment provisions allowing option to the assessee to pay additional tax @ 18% on the amount not repatriated within time limits as specified.
- The Finance Act, 2020 introduced amendment to Section 92CB of the Act (safe harbour provisions) and Section 92CC of the Act (advance pricing agreement provisions) of the Act to cover attribution of profits to a Permanent Establishment, amended Section 94B of the Act in relation to interest limitation.
- The Finance Act, 2021 introduced a new section 115JB(2D) to provide that if there is an increase in book profit of a previous year due to income of past year or years included in the book profit on account of an advance pricing agreement or on account of secondary adjustment, the taxpayer being a company can make an application to the AO to recompute book profit of past years. The said provision is applicable for AY 21-22 and all AYs beginning on or before April 1, 2020, only if the taxpayer has not utilized the credit of tax paid u/s 115JB in any subsequent AY u/s 115JAA. Furthermore, no interest shall be payable on refund arising out of this provision.
- Also, the Finance Act, 2021 has amended section 153(1) of the Act, there by further rationalizing the time limit for making an assessment order which has been reduced to 9 months from the end of the relevant AY (over the years this timeline has reduced from 21 to 18 to 12 months, and now 9 months).

Pursuant to the existing provisions of section 153(4) of the Act, this timeline would stand further extended by 12 months in cases involving transfer pricing assessments.

Module B

Comparability Analysis and Functional Analysis

1. Comparability analysis (including functional analysis)

1.1 Introduction

The application of the arm's length principle for benchmarking any controlled transaction essentially comes down to establishing its 'comparability' with an uncontrolled transaction undertaken between unrelated enterprises under similar circumstances. Only when this comparability between the controlled and uncontrolled transactions or between the tested party and unrelated enterprises is established, the process of comparison of the prices or the margins, as the case may be, be initiated. Therefore, the United Nations Practical Manual on Transfer Pricing for Developing Countries 2021 (UN TP Manual 2021) has befittingly noted that "Transfer pricing theory meets practice in comparability analysis"¹.²

The OECD defines comparability analysis³ as a comparison of a controlled transaction with an uncontrolled transaction or transactions. Controlled and uncontrolled transactions are *comparable* if none of the differences between the transactions could materially affect the factor being examined in the methodology (e.g., price or margin), or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences.

Thus, the determination of the arm's length price (ALP) of a controlled transaction involves an aggregated analysis at two levels viz. at transactional level by analysing controlled and uncontrolled transaction and at entity level by analysing tested party and uncontrolled enterprise. Consequently, comparability analysis is a critical pre-requisite of a transfer pricing regulation.

1.2 Legislative framework

The Indian transfer pricing regulations have given a formal recognition to the comparability analysis by laying down several factors which are to be considered for judging the comparability of the controlled against the uncontrolled transactions. For the purpose of comparability analysis, sub-rule (2) of Rule 10B states:

"10B(2) For the purposes of sub-rule(1), the comparability of an international transaction or a specified domestic transaction with an uncontrolled transaction shall be judged with reference to the following, namely-

¹Para B.3.7.1 of the UN TP Manual, 2021

² UN TP Manual draws significantly from the OECD guidelines.

³Page 20 of Glossary of OECD Guidelines, 2022

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

Therefore, Rule 10B(2) has laid down four specific factors which would determine whether and to what extent are the controlled and uncontrolled transactions comparable to each other, which will in turn be critical for the selection of the ‘most appropriate method’ for determining the ALP of the controlled transactions.

The examination of the aforesaid comparability factors is to be done for both, controlled and uncontrolled transactions or entities or both for judging the comparability. The extent to which such factors influence the comparability depends upon the nature of the controlled transaction and method adopted for determination of its ALP. While all the methods prescribed u/s. 92C are sensitive to the differences between a controlled and an uncontrolled transaction, however, the degree of tolerance and acceptability varies from method to method. Thus, the factors affecting comparability are to be carefully analysed before accepting or rejecting an uncontrolled comparable under the MAM for computing the ALP of the controlled transaction.

In light of the above, each of the above four factors are discussed in the ensuing paragraphs:

1.2.1 Characteristics of the property transferred or services provided:

Arguably, one of the most important factors which determines the comparability between a controlled and an uncontrolled transaction is that of the nature or the characteristics of the property (tangible or intangible) or services transferred. In practice, this factor gains even more significance, especially in methods such as CUP method, where similarity of the characteristics is of paramount importance.

For instance, a product, which is superior in quality and offers more features, would command a better price in the market, as compared to a product which is inferior in quality and offers fewer features. This differentiation would render the prices of the two products to be not comparable to each other, unless suitable adjustments can be made to account for the said differences so as to bring them at par with each other.

As per the OECD guidelines, the following characteristics may be considered with respect to the property or service while carrying out the comparability analysis:

- In case of transfer of tangible property, the physical features of the property, its quality and reliability, the end use etc. of the tangible property may be considered.

- In case of provision of services, the nature and extent of services may be considered.
- In case of intangible property, the form of transaction (e.g. Licensing or sale), type of property (e.g. Patent, trademark, know how etc.), the duration and degree of protection and the anticipated benefits from the use of the property may be considered.

Therefore, both, the OECD guidelines and the Indian legislature recognize the relevance of these factors in carrying out comparability analysis.

Effect of the characteristics of the property transferred or services provided on the selection of the Most Appropriate Method (MAM)

To appreciate the effects of these factors on the choice of the MAM, a broad classification may be assigned to the methods prescribed u/s. 92C:

- (a) *Price based method: CUP method* requires a comparison between the prices charged or paid for property transferred or services provided in the controlled transaction and a comparable uncontrolled transaction. Since there is a one-to-one comparison between the prices charged in the two transactions, the characteristics of the property transferred becomes more important and therefore material variations between the properties transferred in the two transactions would certainly require an adjustment when the controlled transaction is benchmarked using this method. Therefore, the CUP method generally requires the strictest level of comparability in the characteristics of the properties transferred or the services rendered. The OECD guidelines⁴ also support this view and states:

“Among the methods described at Chapter II of these guidelines, the requirement for comparability of property or services is the strictest for the comparable uncontrolled price method. Under the comparable uncontrolled price method, any material difference in the characteristics of property or services can have an effect on the price and would require an appropriate adjustment to be considered.”

- (b) *Gross profit based methods:* With respect to methods such as the cost plus method or the resale price method, the gross profit margins of the entities are compared for the purpose of benchmarking the controlled transactions. The gross profit margin of an entity represents the profits earned by the entity by performing core business functions and is not specifically related to the product in which a company deals in to the extent it is an application of CUP method. Hence, some differences, (if any) in the characteristics of the property transferred or services rendered are less likely to affect the gross profit margin of the transactions in the case of cost plus method/ resale price method as compared to the CUP method. In this respect, the OECD guidelines⁵ state as under:

“Under the resale price method and cost plus method, some differences in the characteristics of property or services are less likely to have a material effect on the

⁴Para 1.128 of revised Chapter 1 of OECD Guidelines, 2022 [Earlier Para 1.108 of OECD Guidelines, 2017]

⁵ Para 1.128 of revised Chapter 1 of OECD Guidelines, 2022 [Earlier Para 1.108 of OECD Guidelines, 2017]

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gross profit margin or mark up on costs.”

- (c) *Net (operating) profit based methods:* In case of transactional net margin method, the condition of arm's length is established by comparing the net profit margins of controlled and uncontrolled transactions. Therefore, the comparability based purely on characteristics of property transferred or services provided becomes more liberal under TNMM as difference in the characteristic of products/services and functions performed are often reflected in variation in operating expenses. Therefore, subject to exceptions, the profit margins prevailing in a particular industry are generally within a particular range and hence under this method, the comparable uncontrolled transactions need to belong to the same genus of products or services but they need not be identical.⁶ The OECD Guidelines⁷ in this regard states that:

“Differences in the characteristics of property or services are also less sensitive in the case of the transactional profit methods than in the case of traditional transaction methods. This, however does not mean that the question of comparability in characteristics of property or services can be ignored when applying these methods, because it may be that the product differences entail or reflect different functions performed, assets used and/or risks assumed by the tested party.”

- (d) *Others:* There might also be a controlled transaction which involves the transfer of unique intangibles or a transaction which involves multiple transactions which are so inter-related that their independent evaluation may not be possible. In such circumstances, it may be difficult to effectively apply the aforesaid price based or profit based methods to check whether or not, they are at arms' length. These peculiar circumstances warrant the use of Profit Split Method (PSM) which essentially involves allocating the combined profits arising from the transaction to the participants on the basis of their relative contribution to the performance of such transaction. This relative contribution is measured in terms of the functions performed, assets employed and risks undertaken by the transacting parties in the course of the performance of such transaction.

Many regulations recognise that in certain circumstances none of the above-mentioned methods can be applied. In such situations, they prescribe other methods for determining the arm's length price/margin.

Therefore, it can be concluded that in price based methods, the requirement for similarity of property or services is the strictest. However, margin based methods are less sensitive to the product differences but even under such methods, the requirement for similarity cannot be ignored altogether.

⁶L.G. Electronics India Pvt. Ltd. v. ACIT (TS-11-ITAT-2013(Del)TP), Lionbridge Technologies Pvt Ltd (TS-984-ITAT-2017(Mum)-TP), Saipem India Projects Limited (TS-974-ITAT-2016(CHNY)-TP)

⁷ Para 1.128 of revised Chapter 1 of OECD Guidelines, 2022 [Earlier Para 1.108 of OECD Guidelines, 2017]

1.2.2 Functions performed, assets used, and risks assumed by the respective parties to the transaction (Functional analysis)

The OECD Guidelines define function, asset and risk (FAR) analysis or Functional analysis as *“the analysis aimed at identifying the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions.”*

In any independent business transaction, the compensation, or the price involved is a result of the functions performed, assets employed and risks assumed by the transacting parties. Functional analysis is therefore essential to the identification of potential comparables, as the search for such comparables will generally focus on uncontrolled transactions that present a similar allocation of functions, assets and risks between the parties.

This analysis helps to select the tested party/ parties where needed, the most appropriate transfer pricing method, the comparables and ultimately to determine whether the profits (or losses) earned by the entities are appropriate to the functions performed, assets employed and risks assumed.⁸

The OECD Guidelines⁹ take a similar view when it states that in the transactions between two independent enterprises, compensation will usually reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in delineating the controlled transaction and determining comparability between controlled and uncontrolled transactions or entities, a functional analysis is necessary.

Components of FAR analysis

A detailed discussion of the three elements of the FAR analysis, namely, functions performed, assets employed and risks assumed is as under:

- **Functions performed**

Functions performed are those activities that are carried out by each of the parties to the transaction. In performing the functional analysis, economically significant functions are considered. Such functions determine characterization of an entity, which in turn determine attributable return for the entity performing such functions. Thus, the focus should not be on identifying the maximum number of functions but rather on the identification of critical functions performed by the related parties.

Some of the important functions that are generally observed and examined in the transaction include the following:

- Research and development (R&D)
- Process engineering and designing work
- Purchasing and materials management

⁸ Para B. 3.4.4.4 of UN TP Manual, 2021

⁹Para 1.51 of revised Chapter 1 of OECD Guidelines, 2022 [Earlier Para 1.51 of OECD Guidelines, 2017]

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- Manufacturing, production or assembly work
- Warehousing and inventory
- Marketing and distribution
- Development of software services
- Financial transactions
- Intragroup services, for example managerial, legal, accounting and finance, credit and collection, training and personnel management services

Having identified the principle functions performed by the parties in the controlled transaction, the next step is to compare the same with the functions performed in the uncontrolled transactions to determine the extent of comparability for the purpose of carrying out the benchmarking process.

The functions performed in a controlled transaction require a detailed analysis and form a critical input in determining comparable uncontrolled transactions.

For Instance, Hon'ble tribunal in several cases have held that entity performing high end functions such as analytics or knowledge processing outsourcing services ("KPO") cannot be compared with an entity performing low end functions such as customer care or call centre services. Similarly, an entity carrying out a full-fledged manufacturing function cannot be compared with an entity merely doing assembly of goods.

Assets employed

As regards assets employed, one needs to identify the assets (tangible as well as intangible) used in the course of the controlled transaction. One also needs to study the role of various departments in performing the desired functions and utilisation of assets.

The study should involve identification of the type and nature of capital assets used, such as the age, market value, location, rights etc. and quantify the same, wherever possible.

It is also essential to know which entity developed the intangibles, which has the legal/economic ownership of the intangibles and which receives the benefit of the intangibles.

Risks assumed¹⁰

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 a 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

¹⁰The OECD Final Report on aligning transfer pricing outcomes with value creation (Action Plan 8–10) Detailed guidance on analyzing risks as an integral part of a functional analysis, including a new six-step analytical framework. For transfer pricing purposes, the party assuming a risk should control the risk and have the financial capacity to assume the risk.

lower. Some of the significant risks present in transactions are tabulated below:

Sr. no.	Nature of risks	Particulars
1.	Market risk	<ul style="list-style-type: none"> • Increased competition and relative pricing pressures, • Change in demand patterns and needs of customers. • Inability to develop / penetrate in a market, etc.
2.	Technology risk	<ul style="list-style-type: none"> • Introduction of new products and change in technologies. • Inefficiencies arising from obsolete infrastructure and tools as well as obsolescence of processes.
3.	Product / service liability risk	<ul style="list-style-type: none"> • Risks associated with product/service failures
4.	Credit risk	<ul style="list-style-type: none"> • Risk arising from non-payment of dues by customers.
5.	Foreign exchange risk	<ul style="list-style-type: none"> • Potential impact on profits that may arise because of changes in foreign exchange rates.
6.	Manpower risk	<ul style="list-style-type: none"> • Risk of losing its trained personnel
7.	Capacity utilisation risk	<ul style="list-style-type: none"> • Under-utilisation of manufacturing /service facility/ personnel.

Analysis of risks assumed is an important exercise as it facilitates adjustments based on differences in risks that are undertaken in a controlled transaction as compared to uncontrolled transactions. The OECD Final Report on aligning Transfer Pricing outcomes with Value Creation, BEPS Actions 8-10 suggests the six-step process for analysing risks in a controlled transaction:

Step 1: Identify economically significant risks with specificity.

Step 2: Contractual assumption of risk

Step 3: Functional analysis in relation to risk

Step 4: Interpreting Steps 1-3

(i) Whether the associated enterprise follows the contractual terms?

(ii) Whether the party contractually assuming the risk, as analysed in (i) above, exercises control over the risk and has financial capacity to assume risk?

Step 5: Allocation of Risk

Step 6: Pricing of the transaction, taking account of the consequences of risk allocation.

In practice, one cannot compare all the functions, risks and assets employed. Hence, it must be emphasized that only those functions, assets and risks that are economically significant and are likely to have an impact on cost/expenses, prices, profits arising in a transaction

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should be identified and compared.

Hence, a crucial step in the comparability analysis is the comparison of the economically significant functions performed, risks assumed, and assets employed by the associated enterprises with those by the independent parties which have been selected as potentially comparable for benchmarking the ALP of the controlled transactions.

In this context, the Swedish Tax Agency (STA) delivered a ruling in case of Puma Nordic AB, thoroughly analysing the six-step analytical framework:

Facts of the case:

- Puma Nordic AB (Puma Sweden) was a wholly owned subsidiary of Puma SE (German parent). It was engaged in marketing and selling of sports products under the brand 'Puma' in Sweden.
- It purchased products from the group sourcing company (AE). It also paid royalty to Puma SE for use of the brand name and related marketing materials.
- Puma Sweden characterised itself as a full-fledged distributor assuming significant risks related to distribution operations. While it incurred continuous losses, it justified the related party transaction as arm's length by using the comparable uncontrolled price/transaction method.

Analysis/decision of the STA

- The STA conducted an analysis using the six-step framework prescribed by the OECD TP guidelines to identify the economically significant risks. It also relied on the Puma Group's annual report and TP documentation and argued that the key value drivers and the corresponding economically significant risks were:
 - strong international brand – brand risk; and
 - new product developments and design – product risk.
- The STA concluded that Puma Sweden did not have actual control of key risks pertaining to brand building and product design and development. The STA, therefore, re-allocated the economically significant risks to Puma SE as in the STA's view, Puma SE had actual control over such significant risks and also the capacity to bear such risks.
- The STA re-characterised Puma Sweden as a limited risk distributor and selected Puma Sweden as the tested party. It adjusted Puma Sweden's results by selecting the TNMM as the most appropriate method. It aggregated the transactions for sourcing of products and payment of royalty for the purpose of the analysis.

- The STA also relied on the concept of 'options realistically available' from the OECD TP guidelines and commented that an independent distributor incurring continuous losses would have looked for realistic alternatives, including negotiating lower purchase prices, switching suppliers, or discontinuing operations, as a last step.

Effect of FAR analysis on the selection of the MAM

In price-based methods such as CUP method, the similarity in characteristics of the property transferred or service provided is of utmost importance, while under the gross margin based methods such as RPM and CPM, similarity in functions, assets and risks is more important as gross profit is driven more by the functions performed and less by the nature of products being transferred. Furthermore, in net profit-based methods, such as TNNM, broad similarity in the FAR would be desirable. This is because in profit-based methods, net profit margins are compared to determine the ALP and net profit margins are derived after considering all the operating business functions of the entity. The FAR analysis of the controlled transaction becomes all the more important in applying methods such as PSM, wherein the combined profits arising from the controlled transaction are allocated between the transacting entities on the basis of their relative contribution to such transaction and this relative contribution is in turn measured in terms of the functions performed, assets employed and risks assumed by each of such entities in the performance of such transaction.

1.2.3 Contractual terms of the transactions which lay down how the responsibilities, risks and benefits are to be divided between the respective parties to the transaction.

The similarity of the contractual terms of the controlled and the uncontrolled transactions plays a vital role in determining the extent of comparability between the said transactions.

The conduct of the contracting parties is generally a result of the terms of the contract between them. The contractual relationship thus warrants a careful analysis when computing the transfer price. Other than a written contract, the terms of the transactions may be found in the correspondences and communications between the parties involved. In cases where the terms of the arrangement between the two parties are not explicitly defined, the contractual terms have to be deduced from their economic relationship and conduct. Also, explicit contractual terms of a transaction involving members of an MNE may provide evidence as to the form in which the responsibilities, risks and benefits have been assigned among those members. In addition to an examination of those contractual terms, it will be important to check that the actual conduct of the parties conforms to them. Where there are material differences in economically significant contractual terms between the taxpayer's-controlled transactions and the potential comparables, such differences should be evaluated, in order to judge whether comparability between the controlled and the uncontrolled transactions is nevertheless satisfied and whether comparability adjustments need to be made to eliminate

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the effects of such differences.¹¹

Effect of contractual terms on the selection of the MAM

In price-based methods such as CUP method, the contractual terms of the transactions have a bigger impact as compared to profit based methods.

For instance, in case of benchmarking of the controlled transaction in the nature of sale of goods (by applying CUP method), the similarity in the credit terms offered, volume discounts, or other terms such as shipment on FOB or CIF basis in the controlled and the uncontrolled transaction would have to be seen to determine whether and to what extent are the two transactions comparable.

On the other hand, when profit based methods like TNMM are applied, consideration with regard to the contractual terms may not be as important as the effect of differences in contractual terms between the controlled and the uncontrolled transactions may be evened out when the net profitability of the entities and not of the transactions are compared.

Having established that the similarity of the contractual terms is important while applying price-based methods, it is natural to conclude that in cases where the contractual terms of the potential comparable uncontrolled transactions are not available or where they have significant effect on price, profit based methods should be given a priority over price based methods. However, if the contractual terms have significant impact on the functions and risks the comparability would be impacted. In such cases, economic analysis of the impact has to be carried out and adjustments have to be made.

1.2.4 Conditions prevailing in the market in which the respective parties to the transactions operate

In the present economy, no business can operate in isolation. It, therefore, follows that the price involved in every transaction is somewhat effected by the conditions surrounding it, both internal and external. The internal environment includes those conditions which are under the control of the enterprise itself. These factors may include business policies, plans, production methods etc., whereas external environment encompasses all the conditions over which the enterprise has little control.

Sub-clause (d) of Rule 10B(2) requires the respective parties to the transaction to consider the conditions prevailing in the market in which they operate, including:

- (a) Geographical location
- (b) Size of the markets and level of competition
- (c) The laws and government orders in force
- (d) Costs of labour and capital in the markets

¹¹Para B.3.4.3.4 of the UNTP manual, 2021

- (e) Overall economic development
- (f) Level of competition-Whether markets are retail or wholesale.

Each of the aforesaid conditions are discussed hereunder:

(a) *Geographical location*

For carrying out an effective benchmarking exercise, it is desirable that the geographical location of the comparable should be the same as that of the tested party to the controlled transaction. This is for a simple reason that even an identical product may command different prices in different markets. If however, information from the same market is not available, an uncontrolled comparable derived from a different geographic market may be considered, if it can be determined that (i) there are no differences between the market relevant to the transaction or (ii) adjustments can be made to account for the relevant differences between the two markets.

Another aspect which comes into play as a result of having different geographical markets is that of 'location savings'. Location savings are the net cost savings that an MNE realises as a result of relocation of operations from a high-cost jurisdiction to a low-cost jurisdiction. This concept is relevant from transfer pricing point of view as it gives rise to a question as to how the location savings are to be shared among the parties.

In this regard, the OECD Guidelines 2022, in Paras 9.127 to 9.129 state the following:

"...the question arises of whether and if so how the location savings should be shared among the parties. The response should obviously depend on what independent parties would have agreed in similar circumstances. The conditions that would be agreed between independent parties would normally depend on the functions, assets and risks of each party and on their respective bargaining powers.

Take the example of an enterprise that designs, manufactures and sells brand name clothes. Assume that the manufacturing process is basic and that the brand name is famous and represents a highly valuable intangible. Assume that the enterprise is established in Country A where the labour costs are high and that it decides to close down its manufacturing activities in Country A and to relocate them in an affiliate company in Country B where labour costs are significantly lower. The enterprise in Country A retains the rights on the brand name and continues designing the clothes. Further, to this restructuring, the clothes will be manufactured by the affiliate in Country B under a contract manufacturing arrangement. The arrangement does not involve the assumption of any significant risks by the affiliate in Country B. Once manufactured by the affiliate in Country B, the clothes will be sold to the enterprise in Country A which will on-sell them to third party customers. Assume that this restructuring makes it possible for the group formed by the enterprise in Country A and its affiliate in Country B to derive significant location savings, the question arises whether the location savings should be attributed to the enterprise in Country A, or its affiliate in Country B, or both (and if so in what proportions).

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In such an example, given that the relocated activity is a highly competitive one, it is likely that the enterprise in Country A has the option realistically available to it to use either the affiliate in Country B or a third party manufacturer. As a consequence, it should be possible to find a comparable data to determine the conditions in which a third party would be willing at arm's length to manufacture the clothes for the enterprise. In such a situation, a contract manufacturer at arm's length would generally be attributed very little, if any, part of the location savings. Doing otherwise, would put the associated manufacturer in such a situation different from the situation of an independent manufacturer, and would be contrary to the arm's length principle."

While the concept of location savings has been recognized by the OECD, its complete acceptability in Indian context is yet to be seen. In this respect, the Delhi ITAT in the case of *Li & Fung*¹² observed that the taxpayer created location savings for its AE. It held that benefit of such advantage should be shared by the taxpayer. The Hon'ble Delhi High Court, however, reversed the order of ITAT and held that it had not been demonstrated how the AE benefitted from such location advantages.

In the case of *GAP International*¹³, the Delhi ITAT held that no additional allocation is called for on account of location savings. ITAT rejected the TPO's reliance on a newspaper report in respect of cost of procurement services in various countries and held that location savings to the developing economy arise to the industry as a whole and that there is nothing on record to show that the assessee on standalone basis was the sole beneficiary. ITAT observed that:

"Generally, the advantages of location savings are passed onto the end-customer via a competitive sales strategy. The arm's length principle requires benchmarking to be done with comparables in the jurisdiction of tested party and the location savings, if any, would be reflected in the profitability earned by comparables which are used for benchmarking the international transactions. Thus, in our view, no separate/additional allocation is called for on account of location savings."

Further, in the case of *GAP International*, the Delhi HC¹⁴ dismissed the Revenue's appeal challenging ITAT's deletion of TP-adjustment following co-ordinate bench ruling in 'Li and Fung India Pvt. Ltd. case. The HC rejected revenue's submission that there were significant differences in assessee's international transactions as opposed to those carried out by Li and Fung India. The HC observed that ITAT's findings with respect to the functional similarity and identity between Li and Fung India and assessee was clear and observed that like Li and Fung India, the assessee did not assume any risk and was dependent entirely for reimbursement of its expenses by the AEs and was entitled to the annual and identical mark-up of 5% over the annual expenditure; The HC, thus, opined that *"the application of the rule in Li and Fung India Pvt. Ltd. (supra) was appropriate and therefore this question of law does not arise"*.

¹²TS-583-ITAT-2011(Del)-TP

¹³TS-667-ITAT-2012(Del)-TP

¹⁴TS-259-HC-2018(Del)-TP

In case of Watson Pharma Pvt. Ltd.¹⁵, the Bombay HC dismissed the Revenue's appeal in case of assessee providing contract manufacture, contract research and development of drugs services to its AE, upholds ITAT conclusion on comparable selection, risk adjustment and deletion of adjustment towards location advantage. HC notes Tribunal's finding that since assessee and comparables were situated in India, no adjustment on account of locational advantage was necessary, thus holds that no substantial question of law arises for its consideration.

It may also be noted here that in the revised country chapter submitted by the Indian revenue for United Nation Manual for Transfer Pricing, a stand is taken that effect of location saving should be factored in the results of local comparable companies. Thus, if proper comparables are identified and the margin/price charged by tested party is in line with those comparables, no separate adjustment for location savings is required.

(b) Size of the market and level of competition

The pricing strategies of an enterprise are generally driven by the size of the market in which it operates. For instance, if the enterprise has a fairly big share in the market, it would be able to sell higher volumes and thus may not be apprehensive of selling its products at reduced prices. If prices in such controlled transactions are compared with the prices prevailing in another market, say, the one in which an entity is following skimming policy and for the identical product in another market where it has priced its goods at higher margins, the comparability exercise would not yield any fruitful results.

Similarly, the level of competition in the market also affects the pricing of a product. Some markets may be highly competitive which would force the participating entities to reduce its margins and cut down on prices whereas the lesser competitive markets would try to fetch higher margins and price their products accordingly. Therefore, the level of competition also has to be considered while searching for comparable uncontrolled transactions.

(c) The laws and government orders in force

Much like the other market forces, the government policies and regulations also have a considerable impact on the prices and margins of the entities. The manner in which the government rules and regulations affect the controlled and the uncontrolled transactions would also be an indicator of the comparability of such transactions. Such rules could include government interventions in the form of price controls, interest rate controls, exchange controls, subsidies for certain sources, anti-dumping duties etc.

An example of where government rules affect the market is that of certain pharmaceutical formulations, which may be subject to pricing regulations in a particular country.

(d) The cost of labour and capital in the markets

Generally, the price of any product is computed by adding the desired profit margin of the

¹⁵TS-480-HC-2018(Bom)-TP

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entity to its cost of production. Therefore, the price in any particular transaction is a function of its cost and since the cost of labour and capital vary from market to market, so does the consequential price earned by the enterprises. For instance, the cost of labour is cheaper in some of the Asian countries and the same must be taken into account while carrying out the comparability analysis.

(e) Overall economic development

The overall state of the economy in terms of its level of development also needs to be considered in the comparability analysis. For instance, in the more developed economies such as USA, there is generally larger disposable income and accordingly the participants in the market will be in a position to charge higher prices for its products/services.

(f) Nature of market- Whether wholesale or retail

The prices charged in the transactions carried out in the wholesale market are generally lower than the prices charged in the retail market. Therefore, the nature of market in which an enterprise operates also affects the prices/margins involved in the transaction.

1.3 Reasonably accurate adjustments (Comparable)

As per Rule 10B(3) of the Rules an uncontrolled transaction should be considered comparable to the controlled transaction only if there are no material differences 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.

It, further, provides that in a case there are any such material differences, reasonably accurate adjustments should be made to eliminate such material differences in order to compare the controlled and the uncontrolled transactions.

However, it needs to be kept in mind that while adjustments can be made while evaluating these factors so as to enhance comparability, the number, magnitude and the reliability of such adjustments do affect the reliability of the overall comparability analysis and the same should be kept in mind while carrying out such adjustments.

In this context, the OECD Guidelines have similar provisions¹⁶:

“Controlled and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor being examined in the methodology (e.g., price or margin), or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences.”

1.4 Contemporaneous data

The conditions surrounding a particular transaction at a given point in time are likely to differ from the conditions surrounding a similar transaction at any other time. This could be on

¹⁶ Page 20 of Glossary to OECD Guidelines, 2022

account of change in the economic environment, government regulations etc. With the passage of time, the time value of money changes which in turn impacts the costs incurred and prices charged for the products.

In this background, the Indian transfer pricing regulations in Rule 10B(4) require that the data to be used in analysing the comparability of an uncontrolled transaction with a controlled transaction should be the data relating to the same financial year in which the controlled transaction was entered into.

However, the proviso to Rule 10B(4) allows the use of data relating to a period of two years prior to the financial year in which the controlled transaction was entered into, **provided** that such data reveals facts, which *could* have an influence on the determination of transfer prices in relation to the transactions being compared.

The following judgements are relevant in this context:

In the case of *Exxon Mobil Company India P. Ltd.*¹⁷, the Mumbai Tribunal held that if an assessee wants to take previous year's data, then burden is on the assessee to demonstrate that previous year's data contained certain facts which would influence the determination of transfer price.

The Delhi Tribunal in the case of *Geodis Overseas Pvt. Ltd.*¹⁸ held that sub-rule (4) of Rule 10B states that the data to be used in analyzing the comparability of uncontrolled transaction with a controlled transaction shall be the data relating to the financial year in which the international transaction has been entered into. The proviso carves out an exception that the data relating to a period not being more than two years prior to such financial year may also be considered if such data reveals facts which could have an influence on the determination of transfer price in relation to transactions being compared. Thus, according to the law, the data relating to the relevant financial year is the only contemporaneous data and the proviso is applicable only in some specified conditions.

On the other hand, the OECD Guidelines¹⁹ encourage use of multiple year data if the same adds value to the transfer pricing analysis. The OECD supports the use of contemporaneous data so as to bring about a certain level of consistency in the comparability analysis. For instance, the tested party and the potential comparable entity could be at different stages of their business cycles and therefore have varying levels of profitability. A comparison of their profit margins without making suitable adjustments would therefore not be appropriate.

In the budget speech of 2014, the then Hon'ble Finance Minister had proposed to amend the regulations to allow the use of multiple year data. In furtherance to the above, the Central

¹⁷46 SOT 294 (Mum)

¹⁸45 SOT 375 (Del)

¹⁹Para 3.75 of OECD Guidelines, 2022

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Board of Direct Taxes (CBDT) on October 20, 2015 issued the final rules vide Notification no. 83/2015 for computation of ALP of controlled transactions entered during financial year 2014-15 and onward. As per the notification issued by CBDT, use of multiple year data (of the comparable companies for the purpose of comparability analysis) is applicable only in cases where Resale Price Method (RPM), Cost Plus Method (CPM) or Transactional Net Margin Method (TNMM) has been selected as the MAM.

Thus, in cases where CUP, PSM or Other Method are selected as the MAM, multiple year data of comparable companies cannot be used.

For each comparable selected (under RPM, CPM or TNMM), the data of the current year is required to be considered. In case such data is not available at the time of furnishing the return of income, data pertaining to up to two preceding financial years may be used.

If a comparable is selected on the basis of preceding year data (say Year 1 and Year 2), but is not found to be comparable for the current year (Year 0) for qualitative or quantitative reasons, then such comparable would need to be rejected from the data set.

When using multiple year data, data for each comparable shall be the weighted average of the selected years.

Further, the notification provides that in the event current year data becomes available during the course of the assessment proceedings, then the same shall be used by the TPO for the purpose of the analysis.

1.5 Types of comparables

Comparable uncontrolled transactions could be of two types-Internal or external.

- (a) *Internal comparables:* These are the comparable transactions between one of the parties to the controlled transaction, (taxpayer or the AE) and an independent third party. When available, these are considered a good measure of comparability as it is likely that the FAR analysis of the comparable transaction would be similar to that of the controlled transaction due to the involvement of a common entity to the said two transactions. Even though these comparables may offer a higher degree of comparability, there is a need to subject the internal comparables to a rigorous scrutiny as external ones and suitable adjustments should be made, wherever necessary.
- (b) *External comparables:* These are the comparable transactions between two independent parties, neither of which is a party to the controlled transaction. Generally, the level of comparability offered in the external comparables is not as precise as internal comparables; however this rule is not absolute. For instance, it may so happen that an entity offers a certain variation of its product exclusively to its AE and a slightly different variation to unrelated parties. In such a situation, preference should be given to search for external comparables involving the identical product than accepting the internal comparable involving a somewhat similar product (and identical contractual

terms).

Nevertheless, on a general basis, wherever internal comparables are available, a preference should be given to use such comparables rather than taking recourse to external comparables. Various judicial pronouncements have also taken a similar view:

In this regard, the Delhi bench of the Tribunal in the case of *Destination of the World (Subcontinent) P. Ltd.*²⁰ held that “preference should be given first to the internal comparables and reference has to be made to the results of independent enterprises only when the former course of action is not possible.”

Similarly, in other cases too, preference has been given to internal comparable over external comparables. In case of *Genisys Integrating System (I) P. Ltd.*²¹, the Mumbai Tribunal held that the internal TNMM is more appropriate over external TNMM where similar services were provided to AE and non AE and reliable internal data was available. Similar rulings were pronounced in the cases of *Cable & Wireless (India) Ltd.*²² by Mumbai ITAT, *BirlaSoft (India) Ltd.*²³ by the Delhi ITAT, and *Sami-Sabinsa Group Ltd.*²⁴ by the Bangalore ITAT. Further, in the case of *BirlaSoft (India) Ltd.*²⁵, the Delhi High Court dismissed the Revenue’s appeal against the Tribunal order directing benchmarking of international transactions with AE by making internal comparison on the net margin earned by the assessee from its AEs with profit earned by it from unrelated parties. Since the assessee was a service provider to its AE as well as other foreign customers or non-AEs, the lower margins earned from the non-AE transactions could be used for benchmarking the AE transactions.

Another issue which merits consideration is that whether the net margins realized from a transaction with an AE, found and accepted at arm’s length, could be taken as an internal comparable for computation of ALP of a controlled transaction with another AE?

This issue was considered by the Mumbai ITAT in the case of *Technimont ICB Pvt. Ltd.*²⁶ wherein it was held that:

“the entire scheme of the Act & Rules for determining the ALP of a controlled transaction is based on making comparison with certain comparable uncontrolled transactions. The various methods prescribed for determining ALP clearly divulge that the comparison is always sought to be made of the assessee’s international transactions with comparable ‘uncontrolled transactions’.

An ‘uncontrolled transaction’ is defined under Rule 10A(ab) to mean ‘a transaction between

²⁰12 taxmann.com 310 (Del)

²¹ITA no. 908/Bang/2011

²²TS-33-ITAT-2014(Mum)-TP

²³ITA no. 1572/Del/2014 (Del)

²⁴TS-97-ITAT-2022(Bang)-TP

²⁵TS-672-HC-2019(DEL)-TP

²⁶TS-557-ITAT-2012(Mum)

enterprises other than associated enterprises whether resident or non-resident'. A transaction between two associated enterprises goes out of the ambit of 'uncontrolled transaction' under Rule 10A. That is why the legislature has ignored controlled transactions, even though at ALP, and restricted the ambit only to uncontrolled transactions for computing ALP in respect of international transactions between two AEs".

1.5.1 Process for identification and selection of external comparables:

As already discussed, where available, preference should be given to internal comparables in the process of determination of ALP. However, in the absence of the same, recourse has to be taken to searching for external comparables. The transfer pricing legislation in India does not prescribe a particular process for selection of such comparables. However, various decisions of the judicial authorities have provided guidance on how to carry out such process based on the data available in public domain. The process of selection of external comparables are discussed in Chapter 4. (It is, therefore, suggested that this section should be read with Chapter 4 to have a complete understanding of comparability analysis.)

The major steps involved in the search process are discussed hereunder:

Step 1: Selection of database

A database is a domain where information (financial and non-financial) about companies is maintained in an organised manner so as to facilitate easy search for data and also for the application of the relevant filters. Some of the commonly used databases in India are as under:

(a) *Capitaline Plus/ Capitaline TP*

It contains digital database of over 58,000 companies. It includes information of public, private, co-operative and joint sector companies, listed or otherwise.

(b) *Prowess*

Prowess is a database of the financial performance of Indian companies. An annual report of individual companies is the principle source of the database. The database covers both listed and unlisted companies.

(c) *ACE TP Database*

ACE TP database contains information, both financial and non-financial of companies and sectors. It also contains information regarding equity and commodity and derivative markets.

There are other available Indian and foreign databases also like Prowess Pro, Amadeus, Royalty Stat, Compustat Global, Osiris, ktmine, Oriana, Bloomberg etc. which can be referred.

A question may arise that whether the tax authorities can use the data not available in public domain in the course of the assessment proceedings. In this regard, the Bangalore bench of the ITAT in the case of *Genisys Integrating Systems (India) Pvt. Ltd.*²⁷ held that if any

²⁷ITA no. 1231/Bang/2010

information is sought to be used against the taxpayer, then such information has to be furnished to the taxpayer and the taxpayer's objections have to be considered by the TPO, before coming to a conclusion. Further, if the taxpayer seeks an opportunity to cross examine the party from whom information is sought under section 133(6), the taxpayer shall be provided with such an opportunity.

Step 2: Application of quantitative filters

The application of the quantitative filters help in reducing the companies available in the database based on the similarity of the quantitative information between the tested party and the potential comparables. Some of the commonly used quantitative filters are:

(a) Availability of financial data

The companies whose financial information for the relevant period (financial year of the controlled transaction or the preceding two years as the case may be) are not available in the public domain should not be considered in the comparability analysis.

(b) Industry of the tested party

The appropriate industry head should be selected. For instance, if the tested party operates in the seed segment, it should be ensured that various industry heads which could likely include comparable companies should be chosen, i.e. seeds, agriculture etc. Therefore, while applying this filter, the parameters should be fairly broad.

(c) Turnover filter

This is perhaps the most commonly used quantitative filter in the search process. This is for the reason that companies which are operating in the same range of turnover would have similar share in the market and thus are more likely to have somewhat similar margins. On the other hand, companies with extremely high or low turnover would not provide an effective base for comparison since their margins would not only reflect the efficiency of their business but also the scale of the operations. Various judicial decisions²⁸ have from time to time supported the application of this filter. The range of the filter is very subjective and varies with the facts of each case.

(d) Net worth filter

Net worth of a company can be used to determine the creditworthiness of the company. Negative net worth would indicate that the debts of the company have surpassed its assets. Therefore, a company with consistent negative net worth should be rejected in the comparability analysis since its margins would be adversely affected and it would ordinarily be difficult to quantify and adjust the effect of its negative worth on the margins. Companies with net worth of less than zero are usually rejected in this filter.

²⁸Genisys Information Systems India P. Ltd. (TS-307-ITAT-2014(Bang)-TP), Trilogy E-business Software P. Ltd. (29 taxmann.com 310 (2013)), Berkadia Services India P. Ltd. (TS-294-ITAT-2014(Hyd)-TP), Same Deutz-Fahr India (Tax Case (Appeal) No.567 of 2017), Pentair Water India Pvt Ltd (TS-566-HC-2015(BOM)-TP), McAfee Software (India) Pvt Ltd (TS-136-ITAT-2016(Bang)-TP), Ametek Instruments India Pvt Ltd (TS-364-ITAT-2022(Bang)-TP), Robert Bosch Engineering and Business Solutions Ltd (TS-151-ITAT-2022(Bang)-TP)

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(e) *Export filter*

The parameter of 'geographic location of market' has led to adoption of 'export turnover filter' whereby Transfer Pricing Officers ('TPOs') insist that if the taxpayer is an exporter then the comparables should also have export earnings of a certain degree. The export activity levels, by itself, cannot be a valid filter unless it is established that the market to which the exports are made are materially different from the domestic market.

(f) *Employee expense filter*

The employee expense ratio helps to analyse the level of activities and intensity of employee dependence.

(g) *Related party transactions*

As already discussed, a transaction between two related parties cannot be taken as a comparable uncontrolled transaction for the purpose of benchmarking a controlled transaction. This filter finds its application on the same principle, i.e., if a potential comparable has substantial related party transactions, it can be inferred that its margins are contaminated with transactions which are not entirely governed by the market forces and thus such a company should be rejected in the search process.

Various judicial decisions²⁹ generally accept comparables with up to 25% related party transactions.

(h) *Consistently loss making companies*

The companies which are incurring losses on a consistent basis cannot be considered as good comparables as their profitability is adversely impacted by factors which are not specific to the industry but to the entity. However, loss in just one year would not be indicative of any extra ordinary factors surrounding the company and therefore such a company should not be rejected on that count alone. The Pune Tribunal in the case of *Bobst India Pvt. Ltd.*³⁰ held that for excluding a company being a continuously loss making company, it should have persistent losses in 3 or more years. If there's profit in even one year, the company cannot be rejected on this ground.

Step 3: Application of qualitative filters

The entities remaining after the application of the quantitative filters are further streamlined by analyzing each of the said entities qualitatively. Some of the commonly used qualitative filters are as under:

(a) *Product filter*

Although the industry filter excludes the companies not operating in the same industry but at

²⁹Pr. CIT vs. Oracle (OFSS) BPO Services Pvt. Ltd. (TS-67-HC-2018(DEL)-TP), United Online Software Development P. Ltd. (TS-22-ITAT-2014(Hyd)-TP), DSM Anti Infectives India Ltd. (ITA no. 1395/Chd/2010), Zee Entertainment Enterprises Ltd. (TS-244-ITAT-2014(Mum)-TP), Acuity Knowledge Center (India) Pvt. Ltd (TS-304-ITAT-2022(Bang)-TP)

³⁰ TS-343-ITAT-2014

the same time there are entities producing a variety of products in the same industry and therefore in order to reach a precise measure of comparability, the list of companies should be further shortlisted to exclude the companies not dealing in the same/similar products as that of the tested party. For instance, for a tested party trading in seeds, the industry filter to be applied could be agri-trading. However, this filter might result in companies engaged in various types of agricultural products such as fertilizers, pesticides etc. In order to remedy this, product criteria would be applied to only select the companies engaged in trading of seeds in the agriculture industry.

(b) Functional filter

The chosen companies must be further analyzed to select only those companies which are functionally similar to the tested party. The functions could be in the form of manufacturing of goods, rendering of services, trading in goods etc. Thus, the filter to be applied depends on the functions performed by the tested party to find transactions which are functionally similar.

(c) Ownership (Government or private)

Generally, entities in the private sector exist for generating profits. Government owned entities on the other hand, function to serve the society and are not necessarily driven by the profit motive. Accordingly, although there are HC and Tribunal decisions both in favour and against the inclusion of government companies, such companies should be included / excluded based on their comparability analysis like the other private companies.

In the case of *Same Deutz-Fahr India*³¹ Madras HC dismissed Revenue's appeal seeking exclusion of HMT Limited as comparable for assessee (engaged in the manufacture and export of tractors) for AY 2006-07. HC rejected Revenue's contention that Tribunal failed to appreciate that HMT Ltd should have been excluded as it was a government owned company. It held that "*There is...no provision of law which makes any distinction between a government owned company and a company under private management for the purpose of transfer pricing audit and/or fixation of ALP... There is no reason why a government owned company cannot be treated as a comparable*"; further, stating that comparability of HMT Ltd was a factual issue and Tribunal had factually assessed the similarities between this company and assessee, HC declined to interfere with ITAT order on exclusion of HMT Ltd.

1.6 Work done by International Organisations

The Platform for Collaboration on Tax (PCT)—a joint initiative of IMF, OECD, UN and the World Bank—has released the final version of its toolkit on Transfer Pricing Documentation, which is designed to support countries in implementing effective transfer pricing documentation requirements.

These organisations acting through PCT have from time to time come out with various toolkits to provide guidance on various aspects of comparability including functional analysis and

³¹ Tax Case (Appeal) No.567 of 2017

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preparation of transfer pricing document. Some of these toolkits/publications are as below:

A. Toolkit for Addressing Difficulties in Accessing Comparables' Data for Transfer Pricing Analyses

This toolkit aimed at providing guidance to developing countries in the implementation of transfer pricing regimes relates to difficulties in accessing information on “comparables”: data on transactions between independent parties used in the application of the arm's length principle. In response to this challenge and under a mandate from the Development Working Group of the G20, the Platform for Collaboration on Tax (PCT) – a joint initiative of the IMF, OECD, UN, and World Bank Group – has developed a toolkit to assist tax administrations of developing countries.

B. Guidance on the transfer pricing implications of the COVID-19 pandemic

This Guidance clarifies and illustrates the practical application of the arm's length principle as articulated in the OECD Transfer Pricing Guidelines to the unique fact patterns and specific challenges implied by the COVID-19 pandemic. It was developed and approved by the 137 members of the OECD/G20 Inclusive Framework on BEPS.

C. Practical Toolkit to Support the Successful Implementation by Developing Countries of Effective Transfer Pricing Documentation Requirements

The toolkit compiles essential information on transfer pricing documentation and analyses policy choices and legislative options. Readers can also find sample legislation, real-life examples and practices from over 30 countries in the toolkit.

D. Transfer Pricing Country Profiles

These country profiles focus on countries' domestic legislation regarding key transfer pricing principles, including the arm's length principle, transfer pricing methods, comparability analysis, intangible property, intra-group services, cost contribution agreements, transfer pricing documentation, administrative approaches to avoiding and resolving disputes, safe harbours and other implementation measures.

1.7 Need for Comparability Analysis

It may be safe to say that comparability analysis is the foundation on which the entire process of transfer pricing analysis rests. A carefully conducted comparability analysis not only translates into the selection of appropriate comparables but also aids in the selection of the MAM for the purpose of determining arm's length price of the controlled transactions.

In doing the comparability analysis, it may be necessary to undertake a detailed functional analysis and wherever warranted, necessary adjustments should be made. The choices made in the course of this analysis have to be substantiated and the overall process should be documented.

2. Economic Analysis

After the functional analysis of the controlled transactions has been carried out, the next step in the process of benchmarking is to conduct the economic analysis of the controlled transactions. The process of economic analysis consists of steps, viz selection of the tested party and selection and application of the MAM to determine the arm's length price of the said transactions.

2.1 Selection of tested party

Before commencing a search for comparable data, it is necessary to identify the party that has to be the point of reference, known as the 'tested party'. In any controlled transaction, there is an involvement of at least two parties (known as AEs). Each of these parties could be different from each other in terms of their functional profile, area of operation, complexity of operations etc. In case of such a differentiation, it becomes essential to select one of the said parties as the tested party for each transaction. The tested party is one, with respect to whom, comparable data is sought and the MAM is applied. The choice of the tested party should be consistent with the functional analysis undertaken.

The selection of the tested party has been a matter of dispute since the introduction of the transfer pricing legislation in India, the reason being that the Act does not recognize the concept of tested party. On the other hand, the 2022 OECD Guidelines and the United Nations Practical Transfer Pricing Manual for Developing Countries (UN TP Manual, 2021) have recognized this concept and emphasized on the selection of the appropriate tested party. The OECD Guidelines in para 3.18 have laid down that '*it is necessary to choose the party to the transaction for which a financial indicator (mark up on costs, gross margin or net profit indicator) is tested. The choice of the tested party should be consistent with the functional analysis of the transaction. As a general rule, the tested party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found, i.e. it will most often be the one that has the less complex functional analysis.*'

The US Treasury Regulations under section 1.482-5 also state, '*that the tested party is that participant in the controlled transaction whose profits attributable to the controlled transaction can be verified using the most reliable data and requiring the fewest and most reliable adjustments. In most cases, the tested party is the least complex one amongst the controlled taxpayers, that is, the taxpayer with the least amount of risk associated with its operations and without valuable intangibles or unique assets that may distinguish it from potential uncontrolled comparable companies.*'

The UN TP Manual 2021 in Para B.3.5.1.1 provides that '*the choice of the tested party should be consistent with the functional analysis of the controlled transactions. Attributes of the controlled transaction(s) will influence the selection of tested party (where needed). The tested party normally should be the less complex party to the controlled transaction and should be*

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the party in respect of which the most reliable data for comparing the results of similar independent transactions is available. Either the local or the foreign party may be the tested party. If a taxpayer wishes to select the foreign associated enterprise as the tested party, it must ensure that the necessary relevant information about it and sufficient data on comparables is furnished to the tax administration in order for the latter to be able to verify the selection of the tested party and the accurate application of the transfer pricing method.'

Therefore, all these definitions have some of the following common attributes:

- (i) The tested party should be the one for which reliable and accurate data is available.
- (ii) The tested party should be the least complex among the parties to the transaction.
- (iii) The tested party should be the one, whose data requires least adjustments in order to make it comparable.

2.1.1 Indian context

While it is true that the Indian transfer pricing regulations do not recognize the concept of the tested party but that cannot be taken in any way to imply that a tested party need not be chosen to benchmark the controlled transactions. Even under the Indian regulations, it is necessary to choose a tested party even though there may not be a direct recognition for the same.

Example:

ABC Group is manufacturer of skin care products and is headquartered in USA. ABC Inc, USA is parent company owning brand name/ trademark and manufacturing related intangibles (such as technical know-how, secrete formulae, etc.). ABC Ltd, India is wholly owned subsidiary of ABC Inc., USA. ABC Ltd, India manufactures skin care products for ABC Inc. as well as for other ABC Group companies. ABC Ltd, India manufactures products based on annual production plan received from ABC Inc. and other ABC Group companies which assures that idle capacity (if any) would be absorbed by one of the ABC Group companies. Further, ABC Ltd, India it uses technical know-how and secret formulae owned by ABC Inc. USA to manufacture products.

Based on the brief profile of ABC Ltd, India can be characterized as low risk manufacturer akin to contract manufacturer. Thus, ABC Ltd, is less complex vis-à-vis ABC Inc. and other ABC Group companies and also does not hold unique or valuable intangible assets. Accordingly, ABC Ltd, India can be considered as tested party.

2.1.2 Judicial decisions involving selection of the tested party

- (a) *Can a foreign AE be chosen as the tested party?*

With respect to the selection of the tested party, one of the most common issues is that whether the foreign AE to the controlled transaction can be selected as the tested party or not?

In the case of *Ranbaxy Laboratories Ltd.*³², it was held that the assessee was wrong in selecting the overseas AE as the tested party for the purpose of comparison to apply TP regulations. The Tribunal held that the tested party normally should be the party in respect of which reliable data for comparison is easily and readily available and fewest adjustments in computations are needed. It *may be local or foreign entity*, i.e. any of the parties to the transaction. The object of transfer pricing exercise is to gather reliable data, which can be considered without difficulty by both the parties, i.e. taxpayer and the revenue. It is also true that generally the least of the complex controlled taxpayer should be taken as the tested party. But where comparable or almost comparable, controlled and uncontrolled transactions or entities are available, it may not be right to eliminate them from consideration because they look too complex. If the taxpayer wishes to take foreign AE as a tested party, then it must ensure that it is such an entity for which the relevant data for comparison is available in public domain or is furnished to the tax administration. The taxpayer is then not entitled to take a stand that such data cannot be called for or insisted upon from the taxpayer.

Similarly, the Ahmedabad Tribunal in the case of *General Motors India Pvt. Ltd.*³³ held that a foreign entity could also be taken as a tested party for comparison. This, according to the Tribunal would also be in line with the UN Transfer Pricing Manual. The Tribunal observed that there were divergent views in respect of the selection of tested party and after examining both views, came to the conclusion that the tested party could be the taxpayer or the foreign AE. The Tribunal also rejected the argument of the tax authorities that since they did not have jurisdiction over such entities and could neither call for additional information nor scrutinize its books of accounts, therefore such entities should not be chosen as the tested parties. In this regard, the Tribunal held that the tax authorities had enough technology to get all the relevant information around the globe or could direct the assessee to furnish the same. Similarly, the Delhi Tribunal in the case of *Yamaha Motor India Pvt. Ltd.*³⁴ held that the tested party should be the one for which reliable data is easily and readily available and fewest adjustments are required. Thus, in case, reliable data with respect to foreign party was available, there was no restriction on selecting the foreign party as the tested party.

Contrary to the aforesaid decisions, the Mumbai Tribunal in the case of *Onward Technologies*³⁵ completely brushed aside this proposition and held that the argument that the foreign AE should be selected as the tested party and the profit earned by the foreign AE from outside comparables should be compared with the price charged by the assessee from the AE to determine whether they are at ALP is not acceptable because under the scheme of Section 92C of the Act, the profit actually realized by the Indian assessee from the transaction with its foreign AE has to be compared with that of the comparables. There is no question of substituting the profit realized by the Indian enterprise from its foreign AE with the profit

³²110 ITD 428

³³TS-215-ITAT-2013(Ahd.)-TP

³⁴TS-348-ITAT-2014(Del)-TP

³⁵ITA no. 7985/Mum/2010

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realized by the foreign AE from the ultimate customers for the purposes of determining the ALP of the international transaction of the Indian enterprise with its foreign AE. The scope of TP adjustment under the Indian taxation law is limited to transaction between the assessee and its foreign AE. The contention that the profit earned by the foreign AE should be substituted for the profit of the comparables is patently unacceptable. The fact that this may be permissible under the US and UK regulations is irrelevant.

Further, the Delhi Tribunal in the case of *GlobalVantage*³⁶, held that though the least complex party is to be selected as the tested party, a foreign entity could not be chosen since it would be difficult to compare entities in different jurisdictions owing to difference in the geographical locations. It would also be difficult to obtain relevant facts that would lead to a proper analysis of the functions performed, assets employed and the risks faced by the associated enterprises. Further, on an appeal made by the revenue against the ITAT order, the Hon'ble Delhi High Court³⁷ has affirmed the same.

Similarly, in the cases of *Aurionpro Solutions Pvt. Ltd.*³⁸ and *Mission Pharma Logistics (India) Pvt. Ltd.*³⁹, it was held that the assessee, and not the foreign associated enterprise should be selected as the tested party for the purpose of benchmarking.

Further, recently the Pune Tribunal in the case of *Bekaert Industries Private Limited*⁴⁰ and *Carraro India Private Limited* has held that considering foreign AE as tested party renders the substantive Sec. 92 otiose and definition of 'international transaction' u/s 92B and Rule 10B redundant which is patently an unacceptable proposition having no sanction under the Indian transfer pricing law.

In the case of *Moser Baer India Ltd.*⁴¹, the Delhi High Court has admitted the Revenue appeal questioning whether ITAT erred in holding that the AE's transactions could be taken into account for ALP determination as tested party. ITAT had directed TPO to accept assessee's contention of foreign AE as tested party in the event assessee was able to provide complete financials of AE along with complete financials of relevant comparables required to benchmark the international transaction. ITAT had also directed TPO to verify if AE is the least complex entity requiring minimum adjustment and for which comparables are available in public domain.

In the case of *IDS Infotech*⁴², Chandigarh ITAT upheld assessee's selection of foreign AE as tested party for benchmarking international transaction of provision of IT/IT enabled services for AY 2010-11. The ITAT rejected Revenue's contention that reliable data was not available in respect of foreign comparables; Relying on ITAT decisions in *Ranbaxy Laboratories*,

³⁶2010-TII-01-ITAT-DEL-TP

³⁷ITA no. 1828/ & 1829/2010 and ITA no. 1254/2011

³⁸ITA no. 7872/Mum/2011

³⁹ITA no. 945/Ahd/2010

⁴⁰TS-347-ITAT-2019(PUN)-TP

⁴¹TS-434-HC-2019(DEL)-TP

⁴²ITA No.130/Chd/2016

General Motors and Development Consultants, the ITAT held that there is no bar in treating foreign AE as tested party merely because data of comparable companies was not available; Further the ITAT laid down two conditions to be fulfilled for a foreign entity to be considered as tested party, i) data should be available in public domain and ii) assessee has furnished all relevant data to tax administration; Notes that in the present case both these conditions were fulfilled because relevant data from Global Symposium database used by assessee was available in public domain and had also been furnished to TPO including entire detail of search process, business description and P&L accounts. Accordingly, the ITAT remarked, “*The Revenue with all resources available at hand could have accessed the said sources and conducted comparability analysis*”. The ITAT also observed inconsistencies in TPO’s approach noting that foreign AE had been accepted as tested party in preceding year as well as for benchmarking marketing support services in present year, and thereby allowed assessee’s appeal.

Other decisions on similar rationale have been delivered in the case of Royal Canin India Private Limited⁴³ (accepted foreign AE as a tested party) and GE Money Financial Services Pvt Ltd⁴⁴ (rejected foreign AE as tested party).

Recently, in the case of Almatix Alumina Pvt. Ltd.⁴⁵, the Calcutta High Court has upheld Hon’ble ITAT’s order which discussed at length the FAR profiles of the assessee as well as that of the AE and held that foreign AE can be considered as the tested party. The Hon’ble Calcutta High Court espoused the principle that – tested party normally should be the least complex party to the controlled transaction and there is no bar for selection of tested party either local or foreign party and neither the Act nor the guidelines on transfer pricing provides so and the selection of the tested party is to further the object of the comparability analysis by making it less complex and requiring fewer adjustment.

Therefore, in this respect, there exist contrary decisions, both in favour of and against the selection of the foreign AE as the tested party and a consistent view does not prevail.

(b) Least complex party to be chosen as the tested party

Ahmedabad Tribunal in the case of *Missionpharma Logistics Pvt. Ltd.*⁴⁶ held that once it was established that no intangible assets were developed by the assessee company, it had to be accepted that the assessee company is less complex as compared to its AEs, since the AEs were having intangibles in the form of supplier list and were developing the market by participating in tenders and were bearing all types of risks. The data of the assessee company was easily available and was reliable whereas the data of the AE was complex and less reliable and considering all these facts, it was held that as compared to its AEs, the assessee should be chosen as the tested party.

⁴³TS-294-ITAT-2016(Mum)-TP

⁴⁴TS-457- ITAT- 2016 (DEL)-TP

⁴⁵ TS-109-HC-2022(CAL)-TP

⁴⁶33 taxmann.com 479

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Similarly, the Kolkata Tribunal in the case of *Development Consultants P. Ltd.*⁴⁷ referring to the relevant portion of the US Transfer Pricing regulations held that in order to determine the MAM for determining the ALP, it is first necessary to select the tested party and the tested party should be the one which does not own valuable intangible property or unique assets that would distinguish it from potential uncontrolled comparables.

In the case of *GKN Driveline (India)*⁴⁸ Delhi ITAT rejected assessee's consideration of foreign AE as tested party for AY 2012-13; ITAT referred to Para 3.18 of OECD TP Guidelines as per which the tested party should be the least complex entity for which reliable data is available with minimum adjustments. ITAT further noted that the assessee failed to provide FAR of AE to ascertain its least complex nature, further, assessee was unable to provide financials of the AE.

2.2 Selection of the MAM

One of the most crucial steps in the process of benchmarking a controlled transaction is that of selection of the MAM. In this regard, six methods have been prescribed u/s. 92C of the Act read with Rule 10B of the Rules, which are as under:

- (a) CUP method
- (b) RPM
- (c) CPM
- (d) PSM
- (e) TNMM
- (f) Any other method

It must be noted that the Indian transfer pricing regulations do not provide for any order or priority in which the prescribed methods are to be applied. Instead, it stresses on the concept of the 'Most Appropriate Method', i.e., a set of factors have been prescribed in the legislation, in the light of which, one of the prescribed methods, which is best suited to the facts and circumstances of each controlled transaction is to be chosen as the *most appropriate* method for benchmarking that particular transaction.

In this regard, the following factors have been laid down in Rule 10C of the Rules, which should be taken into account to select the MAM:

- (a) *the nature and class of international transactions [or the specified domestic transaction];*
- (b) *the class or classes of associated enterprises entering into the transaction and the functions performed by them, taking into account assets employed or to be employed and risks assumed by such enterprises;*

⁴⁷23 SOT 455

⁴⁸ ITA No. 278/Del/2017

- (c) *the availability, coverage and reliability of data necessary for application of the method;*
- (d) *the degree of comparability existing between the international transaction [or the specified domestic transaction] and the uncontrolled transaction and between the enterprises entering into such transactions;*
- (e) *the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction [or the specified domestic transaction] and the comparable uncontrolled transaction or between the enterprises entering into such transactions;*
- (f) *the nature, extent and reliability of assumptions required to be made in application of a method.*

OECD too in its 2022 Guidelines in para 2.2 has prescribed certain factors, which are to be taken into account while selecting the MAM. The same areas under:

- (a) *appropriateness of method considered in view of the nature of controlled transactions, determined in particular through a functional analysis;*
- (b) *availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods;*
- (c) *the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them.*

Another aspect which needs to be highlighted is that the method chosen to benchmark the controlled transactions must be from among the six methods prescribed u/s. 92C of the Act. In this regard, the Mumbai Tribunal (and later on accepted by the Bombay HC) in the case of *CA Computer Associates Pvt. Ltd*⁴⁹. held that where the ALP was not determined by applying one of the methods prescribed in Rule 10B, this action of the TPO was to be set aside.

Similarly, Special bench of the Delhi Tribunal in the case of *L.G. Electronics India Pvt. Ltd.*⁵⁰ held that '*as regards the contention that the methods are tools for determining the ALP, we find that there is no dispute that the main purpose of Chapter X is to determine the ALP of an international transaction, but such determination can be done only by way of the methods specified by the statute. When the legislature has specifically enshrined a provision u/s. 92C requiring the computation of ALP by any of the prescribed methods, it does not fall in the realm of the TPO or for that matter any other authority to breach such mandate and apply or direct to apply any other method. Going by the dictate of the provision as subsists under subsection(1), of section 92C, there can be absolutely no doubt on adoption of any single method out of those set out in section.*'

⁴⁹37 SOT 306

⁵⁰TS-11-ITAT-2013(Del)-TP

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Furthermore, in the case of Castrol India Limited⁵¹, the Hon'ble Tribunal observed as under:

“In our opinion, it is incumbent upon the TPO to work out the ALP of the relevant transactions by following some authorized method and the entire cost borne by the Assessee cannot be disallowed by taking the ALP at NIL keeping in view the facts and circumstances of the case and the relevant details furnished by the Assessee... In our opinion, the exercise of ascertaining ALPs has to be done by the TPO keeping in view the well laid down scheme in the relevant provisions of the Act and addition, if any, on account of TP adjustment, has to be made only after doing such exercise. We, therefore, restore this issue to the file of the AO/TPO with a direction to do such exercise and make addition, if any, on this issue after completing such exercise in accordance with law.”

Also, in the case of Quintiles Research (India) Private Ltd. vs DCIT⁵², the Bangalore Tribunal referred to the Tribunal ruling in Festo Controls India Pvt. Ltd. v. DCIT, wherein the Tribunal had held that, it was not open to the TPO and he has no jurisdiction to hold that no services were rendered for which payments were made by the assessee and on that ground, the TPO cannot hold that the arm's length price is NIL. In arriving at such conclusion in the aforesaid ruling, Bangalore ITAT had relied on Mumbai ITAT ruling in Castrol India Ltd. and Delhi HC ruling in EKL Appliance.

While it is difficult to explicitly lay down the circumstances in which each of the six methods should be chosen as the most appropriate, some specific illustrations in which one method may be considered more suitable than the others are as under:

- (a) In *Aithent Technology*⁵³, Delhi Tribunal held that CUP method is the most appropriate to ascertain the arm's length price of the international transaction of interest free loans to AEs by taking into account the prices at which similar transactions with other unrelated parties was undertaken.
- (b) In *Star Diamond Group*⁵⁴, it was held that where the assessee is a trader and not doing any value addition to goods, resale price method is the MAM for determining the ALP of the controlled transaction.
- (c) In *Bayer Material Sciences*⁵⁵, it was held that the MAM for indenting activity (i.e. finding the customers and getting commission in return) is CUP and not TNMM. It was held that since the transaction was of commission income, which is normally allowed as a percentage of turnover effected, the ratio of net profit to sales cannot be held as appropriate. On the other hand, CUP is useful where the AEs buy or sell similar good or provide similar services. In that context, CUP was considered appropriate under the

⁵¹TS-664-ITAT-2012(Mum)-TP

⁵²ITA 1605/Bang/2012

⁵³17 taxmann.com 59

⁵⁴44 SOT 532

⁵⁵18 taxmann.com 60

circumstances.

- (d) In *L'oreal India Pvt. Ltd.*⁵⁶, the Mumbai Tribunal held that the Resale Price Method would be the MAM for determining the arm's length price of the international transaction of the assessee where the assessee was engaged in the distribution and marketing activities of the goods purchased from the associated enterprise. Further, the same has been confirmed by Bombay High Court thus, accepting RPM over TNMM for determining ALP of L'Oreal India's international transaction in respect of imports of finished goods.
- (e) In *GE BE P. Ltd.*⁵⁷, it was held that for contract manufacturing, CPM was the MAM and the contention of the assessee for using TNMM was rejected.
- (f) In *Yamaha Motor India Pvt. Ltd.*⁵⁸, it was held that in the transaction of sale of goods by the Indian taxpayer and re-sale by the foreign AE without substantial value addition, RPM and not TNMM was the MAM.
- (g) In case of *Amphenol Interconnect India*⁵⁹, Bombay HC dismissed Revenue's appeal, and held that ITAT was justified in holding TNMM as MAM for benchmarking exports to AEs for AYs 2006-07, 2007-08 & 2008-09; Notes that TPO made adjustment on approx. 5% of total exports by applying CUP-method on the basis that there were similarities between goods sold to AE and third parties; However, considering the customization of finished goods and the geographical, volume, timing, risk and functional differences, conclusion that CUP method could not be MAM and upheld the assessee's stand that TNMM was MAM.

In the case of *AWB India Private Limited*⁶⁰, the jurisdictional Delhi bench of the Hon'ble ITAT held that the TPO remained oblivious to the fact that rule 10B(1)(a) stipulates comparable and uncontrolled transactions while applying the CUP method and in the absence of comparables, the arm's length price cannot be determined as NIL.

2.3 Where more than one ALP is determined by the MAM

The first proviso to section 92C(2) of the Act provides that where more than one arm's length price is determined by the application of the MAM, the arithmetical mean of all such prices should be deemed to be the arm's length price for the purpose of the controlled transaction.

For instance, if the taxpayer sells goods worth `100 to its AE and sells similar goods to two of its unrelated parties at `100 and `110, then instead of further narrowing down the comparable

⁵⁶TS-293-ITAT-2012(Mum)-TP

⁵⁷TS-364-ITAT-2013(Bang)-TP

⁵⁸TS-348-ITAT-2014(Del)-TP

⁵⁹TS-205-HC-2018(BOM)-TP

⁶⁰TS-67-ITAT-2013(DEL)-TP

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data to one particular independent transaction, the legislature provides for taking arithmetical mean of the prices of all the uncontrolled transactions which were considered comparable in light of the functional analysis carried out. Therefore, in the instant example, instead of carrying out a further analysis and choosing one of the two transactions as comparable, the law provides for taking the arithmetical mean of the said two prices, i.e. INR 105 as the ALP of the controlled transaction. This is done in view of the fact that when more than one transaction is considered in the final economic analysis, it evens out the effect of the peculiar circumstances under which each of the similar transactions was carried out.

2.3.1 Range of tolerance: In the case of *Sony India P. Ltd.*⁶¹, the Delhi Tribunal recognized that the ALP determined by the MAM is only an approximation and not a scientific evaluation. Therefore, even though the price charged in a comparable uncontrolled transaction (selected after carrying out a detailed comparability analysis) should theoretically confirm to the price charged in the controlled transaction, it is only natural for there to be a slight deviation between the said two prices given the constantly changing business scenarios and the economic environments surrounding the two transactions. Recognizing the possibility of such a difference, a second proviso was added to section 92C(2) of the Act, which provides that if the variation between the arm's length price determined by the MAM and the price of the controlled transaction does not exceed such percentage as may be prescribed, the price of the controlled transaction may be taken as the arm's length price.

Prior to Finance Act, 2011, the second proviso to section 92C(2) of the Act provided for a tolerance band of 5% with respect to the arithmetic mean for the purpose of computing the arm's length price.

Thereafter, Finance Act 2012 further amended the tolerance band for FY 2012-13 and onwards. The upper limit of the tolerance band was not to exceed 3%, i.e., the transaction was to be considered at arm's length if the difference between the transfer price and arithmetic mean did not exceed the number as notified by the Government, subject to an upper limit of 3%. In this regard, the Government has issued a notification for FY 2012-13 (AY 2013-14), which specifies the tolerance band to be 1% for wholesale traders and 3% in all other cases. The Government notifies tolerance band for each assessment year by way of a notification. The Government has retained the tolerance range under section 92C for AY 2019-20 at 1% for wholesale traders and 3% for all other taxpayers.

For illustrative purposes, if a taxpayer sells one unit of an article for Rs. 100 to its AE and the average selling price of same article is Rs.102 for an unrelated party under similar circumstances. Considering CUP as the most appropriate method, ALP is determined at Rs.102. In light of the second proviso, the ALP determined by the most appropriate method (i.e., Rs.102) falls between +/-3% of the transaction price (Rs.100) i.e. Rs. 97 and Rs.

⁶¹114 ITD 448

103. Hence, the price of the controlled transaction, i.e. Rs.100 would be considered to be at arm's length and no transfer pricing addition would be called for with respect to this transaction.

In this context, it also needs to be highlighted that in view of the clear wordings of the second proviso, the range of +/- 1% / 3% is to be applied on the controlled transaction and not the comparable uncontrolled transaction to determine the acceptable ALP.

2.3.2 Range Concept

In addition to the above, the Government of India further agreed that Transfer Pricing is not an exact science and there will be many occasions when the application of the most appropriate method will produce a range of prices or margins.

In this regard, CBDT vide notification dated 19th October 2015, published rules relating to the use of range concept. As per these rules, the price of the transaction shall be considered to be at arm's length if it falls within the range of 35th-65th percentile of the dataset; thus, warranting no transfer pricing adjustments.⁶²

These rules are applicable to international transactions and specified domestic transactions that are entered into by taxpayers on or after 1st April 2014. By way of notification, the CBDT inserted Rule 10CA - Computation of arm's length price in certain cases.

As per Rule 10CA, the 'range concept' shall be applicable when:

- (a) the MAM is either CUP, RPM, CPM, or TNMM; and
- (b) there are at least 6 comparables.

Where these conditions are not fulfilled, 'arithmetic mean' shall continue to apply, as before, along with the tolerance range benefit (3% or 1% as the case maybe)

However, where both the above conditions are satisfied, for the determination of the percentiles, the margins in the data set (i.e., set of comparable companies) are required to be arranged in ascending order and the arm's length range would be data points lying between the 35th and 65th percentile of the data set.

If the transaction price falls within the range, then the same shall be deemed to be the ALP. If the transaction price falls outside the range, the ALP shall be taken to be the Median of the data set.

2.4 Conclusion

It is abundantly clear that economic analysis is the stage where the theory of transfer pricing is given effect to. It, therefore, follows that each step in this process should be carried out with utmost care as economic analysis is the stage in which most of the disputes arise in the ensuing assessments. Thus, facts and circumstances of each case should be taken into

⁶² This has been discussed in detail in Module C.

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account while carrying out the economic analysis and guidance should be taken from the prescription of Rule 10C/10CA along with the OECD guidelines⁶³ and relevant judicial precedents. Further, it is suggested that the analysis performed should be documented as required under Section 92D of the Act.

⁶³In order to boost transparency in international tax matters, the OECD wide Action Plan 13 released a package of measures for the implementation of a new Country-by-Country reporting plan, developed under the OECD/G20 BEPS project. Country-by-country reporting requirements requires MNEs to provide aggregate information annually, in each jurisdiction where they do business, relating to the global allocation of income and taxes paid, together with other indicators of the location of the economic activity within the MNE group, as well as, information about which entities do business in a particular jurisdiction and the business activities each entity engages in. These were subsequently incorporated in Chapter 5 of the OECD Guidelines, 2017 and the OECD Guidelines, 2022.

Module C

Selection of Transfer Pricing Methods

1. What is an arm's length price?

The OECD Guidelines 2022 reiterates that arm's length principle is *“the international standard that OECD member countries have agreed should be used for determining transfer prices for tax purposes. It is set forth in Article 9 of the OECD Model Tax Convention as follows: where “conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly”.*¹ The UN defines the arm's length principle as follows: *“The arm's length principle is an international standard that compares the transfer pricing charged between related entities with the price of similar transactions carried out between independent entities at arm's length. An adjustment may be made to the extent that profits of a related party differ from those that would be agreed between independent entities in similar circumstances.”*²

The Income-tax Act, 1961 (the Act) defines the term arm's length price (“ALP”) in Section 92F(ii) of the Act to mean ‘a price which is applied or proposed to be applied in a transaction between person ‘other than AEs in ‘uncontrolled conditions’. Accordingly, ALP means a price which is applied to a transaction between two unrelated persons undertaken in uncontrolled conditions. In effect, the ALP is also akin to ‘market price’. Consequently, it provides a benchmark against which the controlled transactions can be compared. As ALP is the pivot on which the whole transfer pricing regulations revolve, identification of method for determining the ALP assumes great importance. ALP benchmarks the price existing between AEs under controlled conditions for determining appropriate transfer prices and in turn tax liability of a taxpayer. As neither controlled and uncontrolled transactions nor entities involved in the two sets of transactions are identical, the process for determining the ALP involves subjectivity and requires appropriate adjustments to reach the best solution.

2. Selection of transfer pricing method

2.1 Introduction

The selection of method goes hand-in-hand with comparability (which is a subject matter of

¹ Glossary, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022.

² Glossary, United Nations Practical Manual on Transfer Pricing for Developing Countries, 2017

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another chapter) and is arguably the most critical step in the determination of the arm's-length price. The various available transfer pricing methods and the determination of the most appropriate method are discussed in greater detail in the paragraphs below. Section 92C of the Act provides the following methods for the computation of ALP:-

- Comparable Uncontrolled Price (“CUP”) Method
- Resale Price Method (“RPM”)
- Cost Plus Method (“CPM”)
- Profit Split Method (“PSM”)
- Transactional Net Margin Method (“TNMM”)
- such other method as provided in Rule 10AB.

The said section, further, provides that the ALP in relation to an international transaction or specified domestic transaction should be determined by the most appropriate method out of the above-mentioned methods. Rule 10C identifies following factors which need to be kept in mind while determining the most appropriate method:

- the nature and class of the international transaction or specified domestic transaction;
- the class or classes of AEs 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 or specified domestic transaction; 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 differences, if any, between the international transaction or specified domestic 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.

The various methods identified by the Act are classified by the OECD³ under two classes – traditional transaction methods and transactional profit methods.

³Organisation for Economic Cooperation and Development

Name of the method in Section 92C of the Act	Classified by OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax administrations, 2022 (OECD Guidelines)
CUP Method	Traditional Transaction Methods
RPM	
CPM	
PSM	Transactional Profit Methods
TNMM	

The UN Manual, 2017, also, recognises the methods mentioned above.

Further, the Indian transfer pricing regulation also provides use of a sixth method referred to as “*other method*”.

The above-mentioned methods are discussed in this chapter with specific examples.

Traditional Transaction Methods

2.2 CUP Method

An uncontrolled price is the price agreed between unrelated parties for the transaction of goods or services under similar circumstances. If this transaction is in all material respects comparable to the transaction between associates, then that price is called a “comparable uncontrolled price”. The CUP method is the most direct method for the determination of the ALP. The OECD puts CUP as one of the “traditional transaction methods” and defines it as “*transfer pricing method that compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.*”

2.2.1. Indian Regulations

According to Rule 10B(1)(a) CUP method is described as follows:

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

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2.2.2. International Regulations

According to the OECD Guidelines⁴, the CUP method is the most direct way to compare the price in a related party transaction to the price charged in a comparable uncontrolled transaction. It observes as under:

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

An uncontrolled transaction is comparable to a controlled transaction (i.e. it is a comparable uncontrolled transaction) for the purposes of the CUP method if one of two conditions is met: a) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or, b) reasonably accurate adjustments can be made to eliminate the material effects of such differences. Where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases the CUP method is preferable over all other methods”.

According to UN TP Manual CUP method is explained as under:

“4.2.1.1 “The Comparable Uncontrolled Price (CUP) Method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. The CUP Method may also sometimes be used to determine the arm's length royalty for the use of an intangible, or to determine an arm's length rate of interest on a loan. CUPs may be based on either “internal” comparable transactions or on “external” comparable transactions.”

In the Australian Transfer Pricing Regulations, the CUP method is described as under:-

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

From the approaches mentioned above it can be appreciated that the CUP method requires a high degree of comparability of products, services and functions. Product/service similarity is the most important influencing factor in determining comparability under this method. The factors to be considered while evaluating the comparability between the controlled transaction and the uncontrolled transaction include functions, contractual terms, risks, economic conditions, geographic markets, property or services, etc.

Comparability can be improved by carrying out necessary adjustments, in respect of

⁴OECD Guidelines, 2022 para 2.14 and 2.15

differences in product/service quality, contractual terms, geographic market, embedded intangibles, and foreign exchange fluctuation risks. Such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market. However, the adjustment must not seek to change the product profile of transaction or entities involved in a significant manner.

Depending upon the entities being compared, there are two types of comparable uncontrolled transactions. The first, known as 'Internal Comparable', is a transaction between the tested party and an unrelated party. The second, called 'External Comparable', is a transaction between two unrelated parties (other than those involved in the international transaction). These can be appreciated from the examples below:

- the taxpayer sells similar goods in similar quantities and under similar terms to an independent enterprise in a similar market (an internal comparable);
- an independent enterprise sells the particular product in similar quantities and under similar terms to another independent enterprise in a similar market (an external comparable);
- the taxpayer buys similar goods in similar quantities and under similar terms from an independent enterprise in a similar market (an internal comparable); or
- an independent enterprise buys similar goods in similar quantities and under similar terms from another independent enterprise in a similar market (an external comparable).

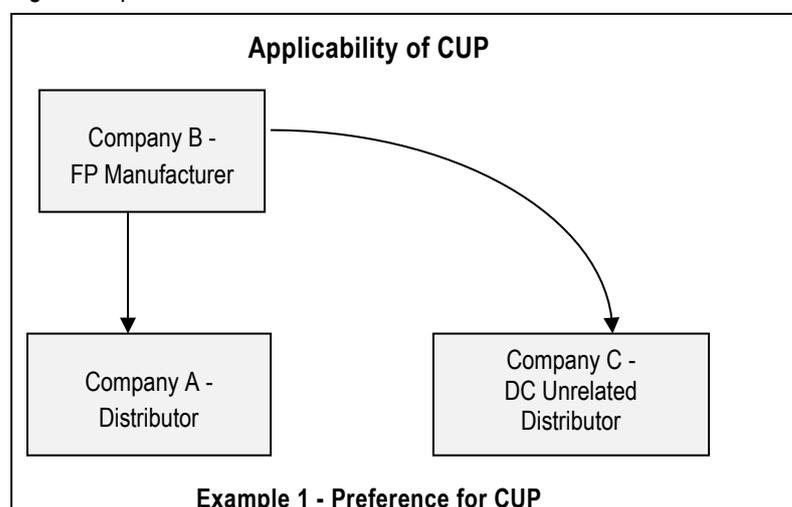
The Indian transfer pricing regulation ("TPR")⁵ provides only a general and basic framework on the application of the CUP method and no detailed guidelines has been provided. Hence, further guidance on application of CUP can be taken from following:

- The case laws in India;
- The OECD Guidelines;
- Canada Revenue provides its interpretation of the legislation in the information Circular IC 87-2R. This circular refers to OECD Guidelines;
- The Australian Transfer Pricing Regulations;
- US Regulations' §1.482-3 provides methods to determine taxable income in connection with a transfer of tangible property; it also provides the detail guidelines with the examples on the application of CUP method; and
- Case laws in other countries.

⁵ This term is used to include the Act and the Income-tax Rules, 1962

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The following diagram explains the CUP⁶:



Company B sells toaster ovens to its subsidiary A and to unrelated distributor C. Toaster ovens sold to A and C are identical and there are no material differences between the B to A and B to C transactions. CUP is most reliable (best) method in such a situation.

As discussed, *supra*, under the CUP method, the price of the goods or services is directly compared with the price in uncontrolled transactions under similar conditions. Hence, it is the most direct method for determining the ALP. Its sensitivity on the properties of the product and the accompanying circumstances and conditions make its application difficult. Differences in the properties of the products, circumstances of trade (billing period, amount of trade, branding, trade terms etc.) may have a significant effect on the price. Product comparability is the most important factor, in particular, physical features such as size, weight, appearance along with volume, reliability, storage requirements, regulatory requirements and the like. Other important factors include the market, delivery and payment terms, etc. Where an independent enterprise buys or sells the same product as is supplied in the controlled transaction and sufficient data on the uncontrolled transaction is readily available, the CUP method will always be the most suitable method. Examples of transactions in which the CUP method may be used include:

- the interest rate charged on a loan;
- royalty payment; and
- the price charged for the transfer of a homogeneous item, such as traded commodity.

CUP method is suitable for analysing transfer of goods and services where similar

⁶Source: This, as well as other diagrams of the best method rule, referred to in this chapter, have been taken from IRC 482 of the US Regulation.

transactions are undertaken with/between unrelated parties in similar conditions.

2.2.3. Adjustments

Given the dynamic nature of business, it is often possible to have differences in two transactions and therefore the applicability of CUP method could be a challenge. It is possible to make adjustments to a potential comparable to take account of factors such as differences in volumes sold, markets traded, terms of trade, etc.

A comparable transaction with significant differences usually referred to as an 'inexact comparable'. Obviously, for such a transaction to be of any use it has to be possible to quantify with some accuracy the effect of any differences between the comparable transaction and the controlled transaction under review.

Hence, the CUP method requires a high degree of comparability along the following dimensions:

- Quality of the product or service
- Contractual terms (example- scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms)
- Level of the market (i.e. wholesale, retail, etc.)
- Geographic market in which the transaction takes place
- Date of the transaction
- Intangible property associated with the sale
- Foreign currency risks

Sometimes it is extremely difficult to meet these standards of comparability and adjustments are needed to make the controlled and uncontrolled transactions more comparable to each other. This can reduce the reliability of the conclusion regarding the ALP.

For every difference between the controlled and the uncontrolled transactions that affect the price, the taxpayer must make an adjustment to account for this difference. The taxpayer must provide sufficient proof by way of concrete documentation that the adjustments made were accurate and reliable.

It needs to be remembered that the term "comparable" means that either of the following conditions should be satisfied:

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

differences.⁷

2.2.4. Important rulings

(a) *Eli Lilly & Company v Commissioner*⁸

Eli Lilly & Company (Lily), a pharmaceuticals manufacturer, developed two forms of painkillers which it marketed under the names Darvon and Darvon-N. It transferred Darvon products and intangibles to Lilly PR, its subsidiary operating in Puerto Rico, which in turn resold the Darvon products throughout the United States in 1971 and 1973.

Although Lilly supported its pricing under the RPM, the Tax Court disagreed and applied the profit split methodology.

In late 1972, the patent on the principal Darvon compound expired and in 1973, numerous pharmaceutical companies entered the market with similar Darvon-like products. Thus, for the year 1973, unlike the two previous years, there appeared to be comparable uncontrolled sales.

In the tax Court, both Lilly and the Commissioner agreed that the CUP method be applied but the issue that arose before the Court was the comparability between controlled and uncontrolled sales as adjustments could not be made on account of differences arising on account of credit terms, supply of raw material, packaging, product quality and patent. Accordingly, at the end, the tax court rejected the CUP method because the differences between controlled and uncontrolled transaction could not be accounted for by a reasonable number of adjustments.

(b) *Bausch & Lomb Incorporated v Commissioner*⁹

Bausch & Lomb (B&L) Incorporated was the controller of most of the US market for soft contact lenses in 1978. In 1980, it organised an Irish subsidiary to manufacture and market lenses throughout the world, principally in Europe and also licensed to use the B&L trademarks. In 1981, B&L Incorporated also entitled it to advances in the manufacturing process from B&L's research and development in exchange for a 5% royalty on B&L Ireland's net sales. Although B&L was under no contractual obligation to purchase lenses from B&L Ireland, it purchased 61% of B&L Ireland's 1981 sales and 56% of B&L Ireland's 1982 sales. The sales price at which B&L purchased lenses from B&L Ireland was \$7.5 per lens. Bausch & Lomb could produce the same facility at a cost of \$1.5 per lens. The tax Court rejected 5% royalty on the licence of intangibles being too low, but upheld the \$7.5 transfer price for the lenses as the price paid by B&L was actually lower than the uncontrolled price. On appeal the Commissioner argued that the controlled sales were not identical to the uncontrolled sales

⁷Refer to Rule 10B(3) of the *Income-tax Rules, 1962*.

⁸84 TC 996 (1985).

⁹933 F2d 1084 (2d Cir. 1991).

because the relationship between Bausch & Lomb and B&L Ireland was different from the relationship between uncontrolled manufactures and their distributors. The Commissioner's argument was rejected on the grounds of demanding too strict a comparability. The decision was held in favour of Bausch & Lomb Incorporated on reliance of its prior decision in *United States Steel Corporation v Commissioner*.

(c) Kailash Jewels Private Limited v ITO¹⁰

Kailash Jewels Private Limited was engaged in the business of manufacturing and trading of Gold and Silver Jewellery. Kailash Jewels Private Limited was only entitled for the job charges / conversions charges @ \$0.65/gram of gold, which was higher than what the related party paid to other companies for making of plain gold Jewellery.

Kailash Jewels Private Limited applied CUP method for benchmarking of international transactions. The Tax Department contended that CUP method is not applicable in the case, as the taxpayer himself stated that making charges were different from design to design and also differed from region to region, so on and thus relied upon the TNMM for calculation of ALP.

The Tax Court referred to the comparables submitted by Kailash Jewels Private Limited, and observed that the nature of business of the comparables was similar to that of the Kailash Jewels Private Limited. The Tax Court observed that first it needs to agree on the applicability of the CUP method. Kailash Jewels Private Limited placed on record the invoices of the comparable companies. Attention was particularly drawn to the invoice of Meenakshi International, a company based in Delhi which was engaged in doing job work in similar business conditions with Ramadan Jewellery LLC, a company based in Dubai. It was seen from the invoices referred above that the labour charges charged by Meenakshi International was in the range of \$ 0.05-0.63 per gram of gold. Further, it was also seen from the invoices placed on record of Mizan & Co., Delhi to New Kailash Jewellery House, Delhi that the labour charges were in the range of \$ 0.21-0.52 per gram of gold. The Tax Court found that the nature of business of the comparables was similar to that of Kailash Jewels Private Limited and concluded that the price charged by Kailash Jewels Private Limited is at arm's length.

(d) CIT vs J P Morgan India Pvt Ltd ¹¹

The assessee provided two types of broking services to related as well as unrelated parties viz., Delivery Verses payment (DVP) and direct custodian settlement (DCS) and benchmarked these international transactions using TNMM as MAM. Since an internal CUP was available, the TPO rejected TNMM and applied CUP. However, it rejected assessee's contention that it had incurred lower cost in providing broking services to related parties than to unrelated parties and accordingly adjustment for additional cost incurred in transaction with unrelated

¹⁰ I.T.A.No.-101/Del/2015

¹¹TS-568-HC-2017(BOM)-TP

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parties was to be allowed to the assessee. The CIT(A) observed that there were substantial differences between the functions undertaken and risks assumed by assessee while providing broking to related and unrelated parties, the TPO ought to have granted adjustment sought by the assessee for additional cost incurred for unrelated parties and accordingly deleted the adjustment. Tribunal upheld the order of CIT(A). The Court observed that CIT(A) and Tribunal had rightly accepted the accepted the differences in functions performed and the risk undertaken by the assessee w.r.t the transaction between related and unrelated parties and accordingly it held that where the rates charged by the assessee to related parties and unrelated parties were not the same, CUP method could be used after making adjustments to the rate charged by the assessee to related and unrelated parties.

(e) DCIT vs. BobstIndia Pvt. Ltd¹²

The Tribunal held that the TPO was unjustified in benchmarking the commission earned by the assessee from its AE on sale of machinery (5 percent) with the commission rate earned by it from its AEs from the sale of spares (18 percent). Following the order of the co-ordinate bench for the earlier year, it held that the benchmark adopted by the TPO was invalid being a controlled transaction in itself. Accordingly, it dismissed Revenue's appeal and deleted the adjustment.

(f) Merck Ltd¹³

The assessee was in the business of manufacturing, trading and marketing of drugs and pharmaceuticals. The assessee imported a component used to manufacture pharmaceutical formulations, from its Switzerland-AE. Assessee applied TNMM to benchmark the same. However, TPO adopted CUP and made a TP-adjustment.

In appeal, the Tribunal opined that CUP method was the most appropriate method to determine the ALP. However, assessee contended that even if CUP method was applied to determine the ALP, there had to be an adjustment on account of the quality of the component imported from its AE, which would affect in determination of ALP. Accordingly, as per Rule 10B(1)(a)(ii), the Tribunal allowed 10% quality adjustment as the quality of assessee's products (being manufactured in a German plant where quality control requirements are much more stringent than in India) were demonstrably superior to locally manufactured products in India. The HC in this case held that even when two products are identical the possibility of price difference in the open market on account of perception of quality has to be factored in while determining the ALP. HC found that TPO himself had accepted this price adjustment on account of perception of quality by allowing the adjustment at 10% in the AY 2011-12. Thus, the HC has upheld the order of the Tribunal.

¹² TS-79-ITAT-2018(PUN)-TP

¹³ TS-973-HC-2019(BOM)-TP

(g) UBS Securities India Pvt. Ltd vs. DCIT¹⁴

The main international transactions entered into by the assessee was on account of brokerage charged by it on its group entities for the transactions undertaken by it on their behalf in India. For the purpose of benchmarking this transaction, assessee applied TNMM. TPO observed that while applying TNMM, assessee compared profits earned by it with the profits earned by other entities operating in India, providing similar broking services. Thereafter, TPO rejected the TNMM applied by the assessee. The TPO preferred internal comparable uncontrolled transactions to the external comparables selected by the assessee.

The Tribunal opined that TNMM applied by the assessee had been rightly rejected by the TPO/AO for the reasons that (i) assessee clearly had not applied the most appropriate method as there was a clear market rate prevailing for broking services which was expressed in terms of a percentage of the trade undertaken, (ii) in the presence of a reliable comparable uncontrolled price, CUP method should have been chosen by the assessee as the most appropriate method, as it was most direct method and was preferable to all other methods which determine the arm's length price in an indirect manner, (iii) the comparable cases considered by the assessee under the TNMM were not engaged in functions that were similar to the assessee.

Illustration on Application of CUP method

A Ltd an Indian Company is a subsidiary of B Inc. US. During previous year 2016-17, A Ltd has borrowed funds for working capital from B Inc. US amounting to USD 500,000 at the rate of LIBOR + 200 basis point. The tenor of loan is 3 years and it is unsecured loan. The credit rating of A Ltd is Baa3 (as per Moody's credit rating model).The details of third party loan agreement available in public domain are as follows:

Lender	Borrower	Credit Rating of Borrower	Tenor	Currency of loan	Secure/ Unsecure	Basis point on LIBOR
X Inc., US	Y Inc., US	Aa1	3 years	USD	Unsecure	50
X Plc, UK	Z Inc. US	Baa3	3 years	USD	Unsecure	150
M Ltd, India	N Inc. US	Baa3	10 years	USD	Secure	200
H GmbH	I Plc, UK	Aa3	3 years	GBP	Unsecure	200
D Inc. US	F Plc, UK	Baa3	3 year	USD	Unsecure	250
P Pte	Q Inc. US	A2	3 year	USD	Unsecure	125

Determine arm's length rate of interest for loan borrowed by A Ltd from B Inc. US. Assume A Ltd has not taken any other loan.

¹⁴ TS-126-ITAT-2021(Mum)-TP

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Answer

During previous year 2016-17, A Ltd has borrowed funds for working capital from B Inc. US amounting to USD 500,000 at the rate of LIBOR + 200 basis point. The relevant details of inter-company loan arrangement is as follows:

Lender	Borrower	Credit Rating of Borrower	Tenor	Currency of loan	Secure/ Unsecure	Basis point on LIBOR
B Inc.	A Ltd	Baa3	3 years	USD	Unsecure	200

In the above questions, details of third-party loan arrangement between independent third parties are provided. Thus, such third-party loan arrangement are analysed to identify comparable uncontrolled transaction. Accordingly, CUP method as per Rule 10B(1)(a) is used to determined ALP of interest rate on loan taken by A Ltd from B Inc. US.

Analysis of third party loan arrangement

Lender	Borrower	Credit Rating of Borrower	Tenor	Currency of loan	Secure/ Unsecure	Basis point on LIBOR	Whether comparable
X Inc., US	Y Inc., US	Aa1	3 years	USD	Unsecure	50	No, as credit rating is different
X Plc, UK	Z Inc. US	Baa3	3 years	USD	Unsecure	150	Yes
M Ltd, India	N Inc. US	Baa3	10 years	USD	Secure	200	No, as tenor is different and also it is secured
H Gmbh	I Plc, UK	Aa3	3 years	GBP	Unsecure	200	No, as credit rating and currency of loan is different
D Inc. US	F Plc, UK	Baa3	3 year	USD	Unsecure	250	Yes
P Pte	Q Inc. US	A2	3 year	USD	Unsecure	125	No, as credit rating is different

Thus, following two arrangements are comparable uncontrolled transactions:

Lender	Borrower	Credit Rating of Borrower	Tenor	Currency of loan	Secure/ Unsecure	Basis point on LIBOR
X Plc, UK	Z Inc. US	Baa3	3 years	USD	Unsecure	150
D Inc. US	F Plc, UK	Baa3	3 year	USD	Unsecure	250
Average						200

Application of CUP Method

Steps	Particulars	Amount in Euro
1	Average rate in comparable uncontrolled transaction	200
2	Adjustment: no adjustment is required	-
3	Arm's Length Price	200

Thus, ALP rate of interest is LIBOR + 200 basis point. Since the rate at which interest is paid by A Ltd to B Inc. is same i.e. LIBOR + 200%. The transaction is at ALP.

2.3 Resale price method (“RPM”)

The RPM is a traditional transaction 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.

2.3.1 Indian Regulations

Rule 10B(1)(b) describes RPM as follows:

- (i) *The price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise, is identified;*
- (ii) *such resale price is reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction, or a number of such transactions;*

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

2.3.2. International Regulations

The OECD Guidelines, 2022 describes the RPM as under:

“2.27 The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin on this price (the “resale price margin”) representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm's length price for the original transfer of property between the associated enterprises. This method is probably most useful where it is applied to trading operations.”

According to UN TP Manual, RPM:

4.3.1.1 “The Resale Price Method (RPM) is one of the traditional transaction methods that can be used to determine whether a transaction reflects the arm's length principle. The Resale Price Method focuses on the related sales company which performs marketing and selling functions as the tested party in the transfer pricing analysis.

4.3.1.2 The Resale Price Method analyses the price of a product that a related sales company (i.e. Associated Enterprise) charges to an unrelated customer (i.e. the resale price) to determine an arm's length gross margin, which the sales company retains to cover its sales, general and administrative (SG&A) expenses, and still make an appropriate profit. The appropriate profit level is based on the functions it performs, the assets it uses and the risks it assumes. The remainder of the product's price is regarded as the arm's length price for the inter-company transactions between the sales company (i.e. Associated Enterprise) and a related company. As the method is based on arm's length gross profits rather than directly determining arm's length prices (as with the CUP Method) the Resale Price Method requires less direct transactional (product) comparability than the CUP Method”.

In the Australian Transfer Pricing Regulations, the RPM is described as under:-

3.20. *The RP method is:*

'A transfer pricing method based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the resale price margin. What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g., customs duties), as an arm's length price of the original transfer of property between the associated enterprises'.

3.21. *The resale price margin is:*

'A margin representing the amount out of which a reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit'.

From all the approaches mentioned above, it can be said that under RPM the yardstick of similarity of products/ services is more related than that in CUP method. The process can be summarised as under:

- (a) Identify the price at which property or services are resold or provided to an unrelated party;
- (b) Deduct the normal gross profit margin derived by the enterprise from the resale price of such property or services in comparable uncontrolled transactions. Also, the gross profit margin earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide;
- (c) Also deduct expenses incurred in connection with the purchase of goods like customs duty from the price so arrived;
- (d) Adjust the prices so computed for the differences between the uncontrolled transaction and the international transaction. These differences could be functional and other differences including differences in accounting practices. Further, these differences should be such as would materially affect the amount of gross profit margin in the open market;
- (e) The adjusted price arrived at is the ALP for the property purchased or services obtained from related parties;

The resale normal gross profit margin is that margin which the enterprise would earn from purchase of the similar product from an unrelated party and the resale of the same to another unrelated party. This comparable gross margin is determined by reference to either:

- the resale price margin earned by a member of the group in comparable uncontrolled transactions (internal comparable); or
- the resale price margin earned by an arm's-length enterprise in comparable uncontrolled transactions (external comparable).

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This resale margin should allow the seller to:

- recover its operating costs; and
- earn an arm's-length profit based on the functions performed, assets used, and the risks assumed.

2.3.3. Applicability of RPM

RPM is generally used to test transactions involving distribution function, i.e. when the tested party purchases products/ acquires services from related party and resells the same to independent parties. The use of RPM is appropriate where the reseller does not add substantially to the value of the product/ services.

The salient features of RPM are as follows:

- (a) The RPM begins with the price at which a product that has been purchased from an AE is resold to an independent enterprise. Therefore, the use of RPM is ideal for distribution activity, whereby the tested party purchases the products or obtains the service from its AEs and resells the products/services to independent enterprises;
- (b) RPM measures the value of the functions performed;
- (c) RPM is the most appropriate in a situation where the sellers add relatively little value to the goods and not alter the goods physically before the resale. Packaging, repacking, labelling or minor assembly does not ordinarily constitute physical alteration;
- (d) RPM is used in cases where reseller does not apply intangible assets to add value. The greater the value-added to the goods by the functions performed by the seller, the more difficult it will be to determine an appropriate resale margin. This is especially true in a situation where the seller contributes to the creation or maintenance of an intangible property, such as a marketing intangible, in its activities;

2.3.4. Difficulty in application of RPM

Due to the limitation of the Indian databases and lack of uniformity in classification of items of expenses/revenue by companies it's often difficult to compute reliably the gross margin data and thus, application of RPM becomes difficult.

2.3.5. Comparability in RPM

A reseller's gross profit provides compensation to the reseller for the performance of resale functions. Compensation includes an operating profit in return for the initial capital investment and the assumption of risks.

In making comparisons for purposes of the RPM, fewer adjustments are normally needed to account for product differences than under the CUP method, because minor product differences are less likely to have as material an effect on profit margins as they do on price. Because gross profit margins represent gross compensation, after the cost of sales for specific functions performed (taking into account assets used and risks assumed), product

differences are less significant.

This method requires detailed comparisons of functions performed, risks borne, and contractual terms of controlled and uncontrolled transactions. As a result, a higher degree of comparability is more likely to exist between controlled and uncontrolled resale of property by the same reseller (i.e. internal RPM). In the absence of comparable uncontrolled transactions involving the same reseller, an appropriate comparison may be derived from comparable uncontrolled transactions of other resellers (i.e. external RPM).

The resale margin will be influenced by the level of activities performed by the reseller. The level of activities can vary over a wide range from the case where the reseller performs only minimal services such as import and resale to the cases where the reseller takes on the full risk of ownership together with the full responsibility for and the risks involved in advertising, marketing, distributing and guaranteeing the goods, financing stocks, warranty risk, inventory risk attached to products and other connected services. In these events the application of RPM needs to be carefully evaluated.

If the reseller in the controlled transaction does not carry on a substantial commercial activity but only transfers the goods to a third party, the RPM could be considered as an appropriate method.

Application of RPM as MAM for reseller of goods is upheld in various rulings by Indian courts including Bombay High court in case of Lóreal India Private Limited.

2.3.6. Adjustment to RPM

Where the transactions are not comparable in all ways and the differences have a material effect on price, one has to make adjustments to eliminate the effect of those differences. For this purpose, consideration of operating expenses associated with functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses. Specific examples of the factors that may be particularly relevant to this method include:

- Inventory (example inventory levels and turnover rate may have to be adjusted including any price protection programs offered by the manufacturer)
- Contractual terms (example scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms)
- Sales, marketing, advertising programs and services (including promotional programs, rebates, and co-op advertising)
- The level of the market (example wholesale, retail, etc.)
- Foreign currency risks

The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables will materially affect the gross profit margin which in turn will affect the reliability of the result. Thus, for example, if differences in inventory and other cost

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accounting practices would materially affect the gross profit margin, the ability to make reliable adjustments for such differences can mislead the reliability of the results. Further, the controlled transaction and the uncontrolled comparable should be consistent in the reporting of items (such as discounts, returns and allowances, rebates, transportation costs, insurance, and packaging) between the cost of goods sold and operating expenses.

Example

There are two distributors selling the same product in the same market under the same brand name. Distributor A offers a warranty; Distributor B offers none. Distributor A is including the warranty as part of a pricing strategy and so sells its product at a higher price resulting in a higher gross profit margin (if the costs of servicing the warranty are not taken into account) than that of Distributor B, who sells at a lower price. The two margins are not comparable until an adjustment is made to account for that difference (i.e. impact of warranty).

Further, assume that a warranty is offered with respect to all products so that the downstream price is uniform. Distributor C performs the warranty function but is, in fact, compensated by the supplier through a lower price. Distributor D does not perform the warranty function which is performed by the supplier (products are sent back to the factory). However, Distributor D's supplier charges D a higher price than what is charged to Distributor C. If Distributor C accounts for the cost of performing the warranty function as a cost of goods sold, then the adjustment in the gross profit margins for the differences is automatic. However, if the warranty expenses are accounted for as operating expenses, there is a distortion in the margins which must be corrected. The reasoning in this case would be that, if D performed the warranty itself, its supplier would reduce the transfer price, and therefore, D's gross profit margin would be greater.

2.3.7. Important rulings

(a) Sundstrand¹⁵

Sundstrand, manufacturer of numerous products including constant speed drive (CSD), decided to expand operations at SunPac, its wholly owned foreign subsidiary located in Singapore, to include the production of CSD. Pursuant to a license agreement entered into in July 1975, Sundstrand gave SunPac:

- (1) The exclusive right to use its industrial property rights for the manufacture of CSD spare parts in Singapore;
- (2) The non-exclusive right to sell spare parts anywhere in the world;
- (3) The non-exclusive subcontract in Singapore to third parties to partial manufacture of spare parts; and
- (4) The authorisation for SunPac's use of Sundstrand's trademarks, which Sundstrand

¹⁵96 TC 226 (19 Feb 1991).

normally used in the sale of similar products.

SunPac agreed to pay Sundstrand a royalty of 2% of the net selling price of each spare part manufactured and sold by SunPac for these rights and for assistance rendered to SunPac. Sundstrand purchased all of SunPac's output at Sundstrand's catalog price less 15% discount, pursuant to a distributor agreement.

The court believed that Sundstrand's catalogue prices for spare parts revealed an appropriate starting point for establishing an ALP for SunPac's parts. Sundstrand's history of granting discounts for its distribution agreements was varied ranging from 5% to 20%.

The tax court applied the RPM to address Sundstrand's price of catalogue price less a 15% discount. In holding that the 15% discount was not at arm's length, the court determined a 20% discount under RPM by relying on certain sales and/or distribution agreements between Sundstrand and unrelated parties, and on certain representations made by Sundstrand to US customs service.

(b) Sanyo India Private Limited v ACIT¹⁶

Sanyo India Private Limited was engaged in the business of distribution and marketing of consumer durables in the nature of electronic and electrical products under the brand name 'Sanyo'. These goods which were sold by Sanyo India Private Limited were imported from its related party abroad namely Sanyo Electric Company Limited, Japan. In its transfer pricing documentation, Sanyo India Private Limited adopted RPM as the most appropriate method, using gross profit margin on sales as profit level indicator ('PLI').

The Tax Officer rejected the use of RPM and substituted it with TNMM.

The Tax Court observed that Sanyo India Private Limited was importing the goods from its related parties and selling it in the local market without any value addition. The only work done by Sanyo India Private Limited on such goods were to re-pack it according to the local requirements. The Tax Court noted that the only reason provided by Tax Officer to reject RPM was that Sanyo India Private Limited had considered multiple year data to compute average gross profit margin. Quashing Tax Officer's reasons the Tax Court held that the reason for rejecting the RPM adopted by the Tax Officer was not correct. The Tax Court held that the Tax Officer has to do a fresh analysis of international transaction involving trading of imported goods, considering RPM as the most appropriate method.

(c) CIT v L'Oreal India Private Limited¹⁷

L'Oreal India Private Limited was engaged in the business of manufacturing and distribution of cosmetics and beauty products and has exclusive rights to import, manufacture, market,

¹⁶IT (TP) No.. 1022(B)/2012

¹⁷Bombay High Court Appeal No..1046 of 2012

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distribute and sell branded products, consumer products and professional products relating to L'Oreal Group.

In respect of the distribution segment, L'Oreal India Private Limited adopted RPM for computing arm's length price of purchase of finished goods. The Tax Officer rejected RPM and applied TNMM as most appropriate method by taking the view that the degree of similarity in the FAR analysis of L'Oreal India Private Limited and the comparables was not sufficient for application of RPM but was sufficient for TNMM. The Tax Officer further held that gross margins of the comparables could not be relied upon owing to product differences. The Tax Officer also held that goods were purchased from related parties at a higher price than the arm's length price and the related party earned higher profit.

While adjudicating the matter, the Court placed reliance on OECD Guidelines. L'Oreal India Private Limited bought products from its AEs and sold them to unrelated parties without any further processing. It was observed that comparing gross margins extinguishes the need for making adjustments in relation to differences in operating expenses. The Court also noted that though L'Oreal India Private Limited had incurred losses, the same were on account of its business strategy and could be attributed to the initial years of the distribution segment. Further, it also noted that L'Oreal India Private Limited's related parties too were earning low profits. Thus, there was no motive on part of L'Oreal India Private Limited to transfer profits to its related parties and accordingly deleted the addition made by the Tax Officer.

The Tax Court agreed that there was no order of priority of methods to determine arm's length price. It also noted that OECD Guidelines state in case of distribution or marketing activities when the goods are purchased from associated entities and there are sales effected to unrelated parties without any further processing, then, RPM can be adopted.

(d) ACIT vs Akzo Nobel Car Refinishes India Pvt. Ltd¹⁸

In the case of Akzo Nobel Car Refinishes India Pvt. Ltd., the Tribunal held that where the assessee was engaged in purchase of finished goods from its AE without any value additions, the most appropriate method for benchmarking the international transactions was the Resale price method. It held that the TPOs reasoning to adopt TNMM i.e that comparability could be compromised under TNMM which provides for broad comparability as opposed to higher degree of similarity under the other methods was invalid.

(e) Fresenius Kabi India Private Limited vs DCIT¹⁹

In the aforesaid case, where assessee bought products from AE and resold them without further processing, the Tribunal, relying on the decision in the case of Tektronix India P Ltd [ITA No. 1334/bang/2010 dated 31st October 2012], held that RPM was the most appropriate method. It also relied on the case of Frigoglass India Pvt. Ltd. [TS-112-ITAT-2014(DEL)-TP]

¹⁸TS-661-ITAT-2017(DEL)-TP

¹⁹TS-625-ITAT-2017(PUN)-TP

and Bose Corporation India Pvt. Ltd which upheld Resale Price Method as the most appropriate method in case of a distributor. This view was further fortified by OSI Systems Pvt. Ltd ruling wherein all the aforementioned rulings were considered before deciding in favour of RPM in case of distribution activity. The Tribunal opined that it was a settled position in law that in case of distribution activity, there could not be any value addition to the product in question, even when selling and marketing expenses were borne by assessee. Noting that Revenue did not dispute that assessee was into distribution activity, it held that in such cases, RPM was the most appropriate method and accordingly reversed the decision given by the TPO/DRP of using TNMM as the most appropriate method for the transaction under consideration.

(f) Bristol Myers Squibb India Private Limited vs DCIT²⁰

The assessee was engaged in the business of trading in pharmaceutical products and healthcare products like lifesaving drugs and nutritional products. Assessee purchased / imported formulations from its AEs for distribution in India. Assessee stated that it was a distributor who bought goods from its AEs and sold them in the domestic market without adding any significant value to the products, i.e., there was no value addition done by taxpayer. For the concerned year, assessee had benchmarked the concerned international transaction by adopting RPM as the most appropriate method with gross profit margin as the profit level indicator. Assessee compared its gross profit margin with the mean gross profit margin of third party comparables and as its margin was higher than that of comparables, the transaction was claimed to be at arm's length.

During TP audit proceedings, the TPO rejected RPM as the most appropriate method and instead considered TNMM as the most appropriate method.

The Tribunal observed that the Rule 10B(1)(b) of the Rules contemplates the determination of the ALP as per RPM under section 92C of the Act. From perusal of the said Rule, it can be safely gathered that RPM is the best suited method for determining the ALP of an international transaction where goods purchased by a taxpayer from its AE are resold to unrelated parties without any value addition. Reliance in this regard was placed on the following precedent decisions: Videojet Technologies (I) Pvt Ltd (ITA No. 6956/Mum/2012, TS-497-ITAT-2019(Mum)-TP, AY 2008-09, ITAT Mumbai, May 2019), Burberry India Pvt Ltd (ITA No. 758 & 7684/Del/2017, TS-615-ITAT-2018(DEL)-TP, AY 2012-13 & 2013-14, ITAT Delhi, June 2018) etc. Therefore, in view of the aforesaid, RPM is the MAM for benchmarking the international transactions in case of a pure distributor.

In TNMM, the net margin or operating profit achieved in a controlled transaction is compared with the net margin or operating profit from an uncontrolled transaction. Accordingly, under TNMM the major thrust is to derive the operating profit at the transactional level and to identify the operating expenses of both, the tested party as well as the independent parties, which

²⁰ITA No.1969/Mum/2014 (Assessment Year: 2009-10)

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requires a lot of adjustments to arrive at the actual operating profit. Therefore, if the ALP of a transaction can be determined by applying any of the direct methods like CUP method, RPM, CPM, then they should be given a preference and it is only where the said traditional methods cannot be applied that TNMM should be resorted to. Hence, in view of the aforesaid, it was held that RPM was rightly selected by the assessee in the instant case as the most appropriate method to benchmark its transaction of importing of formulations from its AEs.

(g) Mattel Toys (I) Pvt. Ltd. vs. DCIT²¹

The assessee is wholly owned subsidiary of Mattel Inc., USA, which is worldwide leader in manufacturing and marketing variety of toys and games. During AY 2002-03, the assessee imported finished goods and sold them in India as well as exported to AEs. The assessee had also imported raw material from AE for manufacturing of toys in India. Regarding distribution activity, the assessee had adopted TNMM and selected 6 comparables. The assessee had specifically rejected Resale Price Method (RPM) in its TP study.

During assessment, the Tax Officer segregated the assessee's activities into 3 segments - (i) import of goods from the AE and sale in domestic market; (ii) import of goods from AE and sold to AE; and (iii) import of goods from AE and export to third parties outside India. He worked out operating margin for all three segments separately. Since margin on first 2 activities was considerably low in comparison with margin for comparables determined at 0.91%, the Tax Officer proposed an adjustment. He made an adjustment for advertisement cost while computing TP adjustment. The assessee had contended before Tax Officer for adoption of RPM, which was rejected by the TPO. The CIT(A) confirmed the addition and the assessee was in appeal before ITAT.

Before ITAT, the assessee argued that RPM was the most appropriate method for determination of ALP for distribution activity. Even though the assessee had adopted TNMM, it failed to take into account peculiar circumstances of the assessee. AY 2002-03 being the first year of application of transfer price mechanism, it was not clear even to the professionals as to what should have been the best methodology and comparability analysis for arriving at ALP for particular type of business transactions. The assessee pointed out that it had incurred huge administrative cost as it started its distribution activities on its own and all the earlier arrangements under the joint venture with Blowplast were discontinued. The comparables administrative cost were much lower than the assessee. The assessee also contended that its gross profit margin was higher than that of comparables.

ITAT noted that RPM is prescribed as one of the methods for determination of ALP under Rule 10B(1)(b). ITAT observed, 'The RPM is mostly applied in a situation in which the reseller purchases tangible property or obtain services from an A.E. and reseller does not physically alter the tangible goods and services or use any intangible assets to add substantial value to the property or services i.e., resale is made without any value addition having been made.'

²¹ TS-159-ITAT-2013(Mum)-TP

ITAT noted that since margins were to be compared in respect of item purchased and resold by an independent enterprise, the nature of product was not much relevant, even when closer comparable could produce better results. The main reason is that the product differentiation does not materially affect the gross profit margin as it represents gross compensation after the cost of sales for specific function performed. The functional attribute is more important while undertaking the comparability analysis under this method. Thus, ITAT noted that, under the RPM products similarity is not a vital aspect for carrying out comparability analysis but operational comparability is to be seen. It was further held that gross profit margin earned by an independent enterprise was a guiding factor in RPM. ITAT drew support from OECD TP Guidelines and ICAI guidelines. ITAT observed that TNMM requires a lot of adjustments to derive at the actual profit margin. If ALP can be determined by applying any of direct methods like CUP, RPM or CPM, then they should be given preference over TNMM.

Illustration on Application of RPM method

A taxpayer in India imports pure cotton shirts from an associated enterprise in USA. Further, the taxpayer also imports synthetic material shirt from unrelated party in USA for resale in India. For previous year 2016-17 the details of imports made by the taxpayer are as follows:

Import from AE		Import from unrelated party	
Number of units	200	Number of units	100
Price per unit (in Rs)	210	Price per unit (in Rs)	180
Total Price (200x210)	42,000	Total Price (100x180)	18,000

Sale price to third party customers in India is Rs. 250 per shirt for shirts purchased from AE and Rs. 225 per shirt for shirts purchased from unrelated party.

Analysis

If RPM is considered the most appropriate method than arm's length price is determined as follows:

S. No,	Import from AE		Import from unrelated party	
Step 1	Resale Price per unit (a)	250	Resale Price per unit (a)	225
	Number of units sold (b)	200	Number of units sold (b)	100
	Resale Price (in Rs)	50,000	Resale price (in Rs)	22,500

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S. No,	Import from AE		Import from unrelated party
Step 2	Less: Normal Gross Profit Margin	20% ←	Less: Purchase price (100*180) 18,000
	Gross Margin	10,000	Gross Margin 4,500
	Step1-Step2 (Arm's Length Price of imports)	40,000	Gross Profit Margin [(4,500/ 22,500)*100] 20%
Step 3	Less: Expense incurred (if any) in purchase	Nil	
Step 4	Adjustment for difference in controlled and uncontrolled transaction	Nil	
<p>Arm's Length Price of imports from AE is Rs 40,000 i.e. per unit price of Rs. 200. The taxpayer has imported the shirts from AEs for Rs. 42,000 (i.e. 200*Rs.210). Thus an adjustment of Rs. 2,000 will arise.</p>			

Note: CUP method cannot be applied as shirts imported from AE are pure cotton short whereas those imported from non-AEs are synthetic shirts.

2.4 Cost plus method (“CPM”)

The CPM determines an ALP 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. The gross profit margin for a controlled transaction is calculated by reference to the gross profit margins made in comparative uncontrolled transactions.

2.4.1. Indian Regulations

Rule 10B(1)(c) describes steps in the CPM as follows:

- i. *the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined;*
- ii. *the amount of a normal gross profit mark-up to such costs (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions, is determined;*

- iii. *the normal gross profit mark-up referred to in sub-clause (ii) is adjusted to take into account the functional and other differences, if any, between the international transaction [or specified domestic transaction] and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market;*
- iv. *the costs referred to in sub-clause (i) are increased by the adjusted profit mark-up arrived at under sub-clause (iii);*
- v. *the sum so arrived at is taken to be an arm's length price in relation to the supply of the property or provision of services by the enterprise.*

2.4.2. International Regulations

The OECD Guidelines, 2022 describes CPM as under:

2.45 The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to an associated purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction. This method probably is most useful where semi-finished goods are sold between associated parties, where associated parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.

2.46 The cost plus mark-up of the supplier in the controlled transaction should ideally be established by reference to the cost plus mark-up that the same supplier earns in comparable uncontrolled transactions ("internal comparable"). In addition, the cost plus mark-up that would have been earned in comparable transactions by an independent enterprise may serve as a guide ("external comparable").

2.49 The cost plus method presents some difficulties in proper application, particularly in the determination of costs. Although it is true that an enterprise must cover its costs over a period of time to remain in business, those costs may not be the determinant of the appropriate profit in a specific case for any one year. While in many cases companies are driven by competition to scale down prices by reference to the cost of creating the relevant goods or providing the relevant service, there are other circumstances where there is no discernible link between the level of costs incurred and a market price (e.g. where a valuable discovery has been made and the owner has incurred only small research costs in making it).

According to UN TP Manual, CPM is defined as under:

4.4.1.2 The Cost Plus Method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost-plus mark-up is then added to this cost, to calculate an

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appropriate gross profit in light of the functions performed, risks assumed, assets used and market conditions.

4.4.1.3 The Cost Plus Method is most often used to analyse transfer pricing issues involving tangible property or services. It is typically applied to manufacturing or assembling activities and relatively simple service providers. The method evaluates the arm's-length nature of an intragroup charge by reference to the gross profit mark-up on costs earned by independent suppliers of tangible property or services in comparable uncontrolled transactions. That is, it compares the gross profit mark-up earned by the tested party for manufacturing the product or for providing the service to the gross profit mark-ups earned by comparable companies engaged in comparable transactions.

Ideally, the comparative transactions should be the same or similar to the controlled transactions. If an associated entity engages in both controlled and uncontrolled transactions for the supply of the same products or services, the uncontrolled transactions may provide a comparative gross profit margin. The following example explains how cost plus methodology will work:

- Company A has two units, one eligible and another non-eligible unit.
- Non-eligible unit (NEU) is engaged in the manufacture of auto ancillary goods of varied range. One of such goods is steering part which it sells to the eligible unit (EU).
- EU is engaged in the manufacture of suspension parts where it uses the steering parts purchased from the NEU as a raw material.
- NEU is not selling the steering parts to any of its other customers
- Few comparable companies are available which are engaged into selling similar products (steering parts).
- In the current scenario, CPM could be considered as the most appropriate method wherein, the NEU charges EU a price which is calculated by adding a reasonable mark up the cost of production of such goods.

The comparison under the CPM should reflect the functions performed, risks involved, and contractual terms. While the products, being compared under the CPM, need not be similar, there are limitations to the product differences. If there is a significant difference between the products being produced under controlled and uncontrolled conditions, the product differences may reflect different functions being performed by the suppliers and would make these transactions unreliable for comparison.

When applying the CPM, comparable accounting methods should be used. If there are differences between the accounting methods used for the controlled and uncontrolled transactions, the data will need to be adjusted to ensure that the same costs and the same methods of measuring the costs are being used.

The gross profit margins for controlled and uncontrolled transactions have to be measured consistently to ensure that the uncontrolled comparable(s) being used is a reliable indicator of ALPs.

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. It is, also, useful where low end services are provided by an AE. **Example** – Application of cost plus method

As explained above, the cost plus method tends to evaluate the mark up charged on direct and indirect cost of production for the manufactured goods transferred between associated enterprises.

Under Cost Plus Method, components to be considered for determining cost of production are not defined under Income Tax Act and it shall be determined as per transaction entered. However, following category of costs are generally considered:

Direct costs- Cost of Raw Material, Freight Charges, Labour Expenses etc.

Indirect costs- Cost of repair and maintenance, rent, administration charges, Finance Charges etc

Application of cost plus method can be further explained with the help of following example:

X Limited has transferred goods to its wholly owned subsidiary Y Limited for INR 150,000. X Limited has incurred following cost of production for such goods:

- Cost of Raw Material: INR 75,000
- Labour Cost: INR 25,000
- Apportioned Indirect Cost: INR 20,000

Hence the total cost of production for X limited comes to be at 120,000. This gives X limited a profit of 30,000 i.e. a markup of 20% on its cost of production.

Now let's say independent comparable companies engage in similar business are available and a comparable study shows that mark up on direct and indirect cost of production charged by those companies is in similar range as charged by X limited, the transaction between X limited and its wholly owned subsidiary could be considered to be at arm's length.

UN Manual has explained the CPM with the help of following examples:

B .3 .2 .21.1. Example 1

LCO, a domestic manufacturer of computer components, sells its products to FS, its foreign distributor. UT1, UT2, and UT3 are domestic computer component manufacturers that sell to uncontrolled foreign purchasers.

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Relatively complete data is available regarding the functions performed and risks borne by UT1, UT2, and UT3, and the contractual terms in the uncontrolled transactions. In addition, data is available to ensure accounting consistency between all the uncontrolled manufacturers and LCO. As the available data is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified, the effect of the differences is definite and reasonably ascertainable, and reliable adjustments are made to account for the differences, an arm's length range can be established.

Example 2

The facts are the same as in Example 1 except that LCO accounts for supervisory, general, and administrative costs as operating expenses, which are not allocated to its sales to FS. The gross profit mark-ups of UT1, UT2, and UT3, however, reflect supervisory, general, and administrative expenses because they are accounted for as costs of goods sold. Accordingly, the gross profit mark-ups of UT1, UT2, and UT3 must be adjusted to provide accounting consistency. If data is not sufficient to determine whether such accounting differences exist between the controlled and uncontrolled transactions the reliability of the results will decrease.

Example 3

The facts are the same as in Example 1 above, except that under its contract with FS, LCO uses materials consigned by FS. UT1, UT2, and UT3, on the other hand, purchase their own materials, and their gross profit mark-ups are determined by including the costs of the materials. The fact that LCO does not carry an inventory risk by purchasing its own materials, while the uncontrolled producers carry inventory, is a significant difference that may require an adjustment if the difference has a material effect on the gross profit mark-ups of the uncontrolled producers. Inability to reasonably ascertain the effect of the difference on the gross profit mark-ups will affect the reliability of the results of UT1, UT2, and UT3.

2.4.3. Issues in application of CPM

(a) Comparability

Whether results derived from the application of this method are the most reliable measure of the arm's-length result must be determined using the factors described under comparability analysis. The CPM may be the best method if the producer provides complete data. This method is ordinarily used for the manufacture, assembly or other production of goods that are sold to related parties. The procedure for CPM like the RPM requires comparability between the controlled party and uncontrolled party. The procedure necessitates an analysis of functional comparability and other comparability factors. The result so obtained can be adjusted to account for the difference between the controlled and the uncontrolled transactions.

(b) Trademark

In cases where there is a well-recognised trademark, the gross profit margins may be significantly higher because the gross profit margins will vary for each good produced. Also, in practice, it is usually difficult to find comparable product lines for principal manufacturers where significant trademarks exist, thereby preventing the CPM from being applied.

(c) Cost allocations

The CPM presents some difficulties in proper application, particularly in the determination of costs. Although it is true that an enterprise must cover its costs over a period of time to remain in business, those costs may not be the determinant of the appropriate profit in a specific case for any one year. While in many cases companies are driven by competition to scale down prices by reference to the cost of creating the relevant goods or providing the relevant service, there are other circumstances where no discernible link exists between the level of costs incurred and a market price (example where a valuable discovery has been made and the owner has incurred only small research costs in making it).

(d) Comparable mark-up

In addition, when applying the CPM, one should pay attention to apply a comparable mark-up to a comparable cost basis. For instance, if the supplier to which reference is made is applying the CPM in carrying out its activities and employs leased business assets, the cost basis might not be comparable without adjustment if the supplier in the controlled transaction owns its business assets. As with the RPM, the CPM relies upon a comparison of the gross profit margin on costs achieved by the controlled supplier of goods or services and the achieved by one or more uncontrolled entities on their costs with respect to comparable transactions. Therefore, differences between the controlled and uncontrolled transactions that have an effect on the size of the mark-up must be analysed to determine what adjustments should be made to the uncontrolled transactions' respective mark-up.

For this purpose, it is particularly important to consider differences in the level and types of expenses—operating expenses and non-operating expenses including financing expenditures—associated with functions performed and risks assumed by the parties or transactions being compared.

Consideration of these differences may indicate the following:

- If expenses reflect a functional difference (taking into account assets used and risks assumed) which has not been taken into account in applying the method, an adjustment to the cost plus gross margin may be required.
- If the expenses reflect additional functions that are distinct from the activities tested by the method, separate compensation for those functions need to be determined. Such functions may, for example, amount to the provision of services for which an appropriate reward may be determined. Similarly, expenses that are the result of capital structures reflecting non-arm's-length arrangements may require separate adjustment.

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- If differences in the expenses of the parties being compared merely reflect efficiencies or inefficiencies of the enterprises, as would normally be the case for supervisory, general, and administrative expenses, then no adjustment to the gross margin may be appropriate.

In any of the above circumstances, it may be appropriate to supplement the CPMs by considering the results obtained by applying other methods.

2.4.4. Functional comparability

The degree of comparability between controlled and uncontrolled transactions is determined by applying the general comparability factors as discussed above. A producer's gross profit provides compensation for the performance of the production functions related to the product or products under review, including an operating profit for the producer's investment of capital and assumption of risks. Therefore, although all of the factors mentioned above must be considered, comparability under this method is particularly dependent on similarity of functions performed, risks borne, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross profit mark-up should be derived from comparable uncontrolled transactions of the taxpayer involved in the controlled sale, because similar characteristics are more likely to be found among sales of property by the same producer than among sales by other producers. In the absence of such sales, an appropriate gross profit mark-up may be derived from comparable uncontrolled sales of other producers whether or not such producers are members of the same controlled group.

The factors for determining functional comparability include the following:

- Research and development (R&D)
- Product design and engineering
- Manufacturing, production and process engineering
- Product fabrication, extraction and assembly
- Purchasing and materials management
- Marketing and distribution functions, including inventory management, warranty administration and advertising activities
- Transportation and warehousing
- Managerial, legal, accounting and finance, credit and collection, training and personnel management services

Comparability under the CPM is particularly dependent on the similarity of functions performed, risk borne and contractual terms as well as on the adjustments made to account for the effects of any such differences, effectively by relying more on functional comparability and somewhat less on physical similarity of products produced by the controlled and uncontrolled parties.

Other comparability factors

Comparability under this method is less dependent on close physical similarity between the products transferred than under the CUP method. Substantial differences in the products may, however, indicate significant functional differences between the controlled and uncontrolled taxpayers. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions involve the production of goods within the same product categories. Furthermore, significant differences in the value of the products due, for example, to the value of a trademark, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross profit may be adversely affected by factors that have less effect on prices. For example, gross profit may be affected by a variety of other factors, including cost structures (as reflected, for example, in the age of plant and equipment), business experience (such as whether the business is in a start-up phase or is mature), or management efficiency (as indicated, for example, by expanding or contracting sales or executive compensation over time). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected. Close consideration must be paid to those material differences that may potentially affect the gross profits. Examples of these differences include:

- Significant differences in value of the products. These could be due to value of a trademark or other proprietary information;
- Differences in cost structures, for example, the age of plant and equipment;
- Difference in business experience, such as the phase of development that an entity is in (example start-up, maturing or developing phase);
- Differences in management efficiency, exemplified by the expansion or contraction of sales trends in executive compensation over time.

2.4.5. Adjustments for CPM

If there are differences between the controlled and uncontrolled transactions that would affect the gross profit mark-up, adjustments should be made to the gross profit mark-up earned in the comparable uncontrolled transaction. For this purpose, consideration of the operating expenses associated with the functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses. If there are differences in functions performed, the effect on the gross profit of such differences, however, is not necessarily equal to the differences in the amount of related operating expenses. Specific examples of the factors that may be particularly relevance to this method include:

- the complexity of manufacturing or assembly
- manufacturing, production, and process engineering
- Procurement, purchasing, and inventory control activities

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- testing functions
- Selling, general, and administrative expenses
- foreign currency risks
- Contractual terms (example scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms)

2.4.6. Consistency in accounting

The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross profit mark-up affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect the gross profit mark-up, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, controlled transaction and the comparable uncontrolled transaction should be consistent in the reporting of costs between the cost of goods sold and operating expenses. The term “cost of producing” may include the cost of acquiring property that is held for resale and this could therefore distort the reliability of the gross margin being compared.

2.4.7. Important rulings

(a) *Edwards K. Edwards v Commissioner*²²

In *Edwards K. Edwards v Commissioner*, the IRS reallocated income to a partnership that sold cranes and heavy construction equipment to a corporation that was commonly controlled by the partners. IRS argued that the sales price was too low, alleging that the manufacturer’s list price for the property established an ALP under the CUP method.

The taxpayer argued that the CUP method could not apply because no one sold equipment at list price. The tax court agreed with the taxpayer that the RPM did not apply because the corporate purchaser was an end user and not a reseller of the equipment. Utilising the CPM, the Court determined an appropriate gross profit percentage based upon single sale of equipment by partnership to an unrelated party.

The decision is unusual in the way that the CPM was applied to a non-manufacturer that added no substantial value to the product on its resale.

(b) *Lilly*²³

During the early 1950s, Eli Lilly developed and patented Darvon, a pharmaceutical product, and in 1966, transferred the patent and know-how to a Puerto-Rican subsidiary. During the period from 1971 to 1973, the subsidiary manufactured Darvon for sale to Lilly, which then

²² 67 TC 224 (1976) acq. 1977-2 CB 1.

²³ 84 TC 996 (1985) aff’d rev’d rem’d, 856 7th Cir. 1988).

marketed the product in the US. Lilly had adopted an inter-company transfer pricing formula that divided combined profits from sale of Darvon between Lilly and its Puerto Rican subsidiary. Although Lilly did not have a binding agreement with the IRS for later years, Lilly used the profit split formula for years in issue.

The IRS argued for the application of the CPM for the taxable years 1971 and 1972. The service proposed that a cost plus formula be applied that would allow the subsidiary to recover manufacturing costs and location savings, plus a manufacturing profit.

The tax court rejected the use of the CPM on the grounds that the evidence submitted by the IRS experts had failed to provide Lilly's Puerto Rican subsidiary with a return on its patents and manufacturing know-how. The failure to provide evidence in attempting to value relevant manufacturing intangibles convinced the court that the CPM was extremely difficult to apply in the said case. Accordingly, the CPM was not considered as an appropriate method under the facts of the case.

(c) *Westreco Inc. v Commissioner*²⁴

Westreco, a US corporation, performed basic research and development services for Nestec, its Swiss parent. Westreco's contract with its parent provided that Westreco should be paid an amount equal to reimbursable costs incurred, plus a designated mark-up. Reimbursable costs included salaries and wages, fees paid to consultants and advisors, rents, raw materials used in research, supplies, cables and postage expenses, stationery and costs for office equipment and maintenance. Mark-up was based on sliding scale of 7.5% on the first \$3,50,000 of the costs, 5% on the next \$1,50,000 and 3.5% thereafter. The IRS argued that the appropriate plus should have been significantly higher based upon analysis of five companies asserted to be comparable to Westreco.

The court completely rejected the analysis prepared by the IRS expert witness. The court noted the functional and risk analyses relied upon by the IRS was faulty in that no adjustments were made to account for significant reduction in risks faced by Westreco as compared to 5 comparable chosen by the IRS.

(d) *Seagate Technology Inc. v Commissioner*²⁵

Seagate Technology Inc. was a leading manufacturer of hard disk drives for personal computers. During 1982, Seagate formed Seagate Singapore to manufacture e-blocks and printed circuit boards (PCBs) for Seagate's use in manufacture of disk drives.

Initially, Seagate used standard cost of manufacturing of either the component parts or completed disk drives in the US as the transfer price of the products sold by Seagate Singapore to Seagate. Thereafter Seagate began calculating the transfer price of the component parts or standard cost of manufacturing the product in Singapore plus a 25% mark-

²⁴TC Memo 1992-561 (1992).

²⁵*Seagate Technology, Inc. and Consolidated Subsidiaries v Commissioner of Internal Revenue* (1994) 102 TC no. 9.

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up on cost. The prices charged by Seagate Singapore to Seagate included an estimate for scrap and obsolescence costs, but were not adjusted for variations between actual and standard costs.

Some of the materials used by Seagate Singapore were purchased by it from third parties and sometimes Seagate Singapore subcontracted local subcontractors to perform simpler assembly than Seagate Singapore was performing.

Seagate and IRS disagreed on two issues:

- whether Seagate Singapore was a consignment manufacturer; and
- whether material costs should be included in Seagate Singapore's cost base.

The tax court found that the IRS did not apply CPM as set forth in TP regulations. IRS treated Seagate as a consignment manufacturer and excluded cost of raw materials from its calculations. The court believed that the costs of raw materials should have been included in the cost for several reasons:

- Seagate Singapore took title of materials purchased from Seagate;
- Seagate Singapore purchased more materials from unrelated parties;
- Seagate Singapore incurred material costs risk; and
- Seagate Singapore was established in part to access low-cost far-east sources of material.

Since the tax court found that neither the petitioner's nor the respondent's methodology was adequate, it used the best available evidence by both the parties and concluded reasonable transfer price was composed of cost of subsidiary materials such as labour, overheads plus a mark-up of 20% over those costs.

(e) *Altama Delta Corp. v Commissioner*²⁶

Altama Delta Corporation (ADC) was a manufacturer of combat boots. Its subsidiary, Altama Delta Puerto Rico (ADPR) was responsible for manufacturing the uppers for the boots and for their transfer to ADC at a price determined by ADC. ADPR selected the CPM. In this instance, the tax court in agreement with both parties concluded that neither CUP nor RPM was applicable.

The tax court examined the application of the CPM of both the parties and found fault with both. ADPR avoided inventory risks in that ADC virtually guaranteed the purchase of all uppers produced by ADPR. Also ADPR avoided much of the risk associated with maintaining government contracts and agreements with Ro-search, a company that provides boot moulds for which ADC was responsible. The court found that IRS cost plus application was faulty in

²⁶ 104 TC No. 22 (1995)

that they had used operating margins instead of gross mark-ups. The court pointed out whereas the combat boot industry was a static industry, comparables selected were a part of a dynamic industry.

Consequently, the court determined the gross profit mark-up to be the same as 1986 and 1987 average mark-up of ADC to account for lower risks of ADPR and the fact that ADC procured Government contracts.

(f) *Frigoglass India Private Limited v DCIT*²⁷

Frigoglass India Private Limited was in the business of glass door merchandising with a manufacturing plant in Gurgaon. It was engaged in manufacturing as well as trading of Glass door merchandising, which is relevant in alcoholic and non-alcoholic beverages, water, dairy products, bakery & confectionery, pharmaceuticals, etc. Frigoglass India Private Limited applied CPM for benchmarking its international transactions relating to manufacturing activities with its related parties.

The Tax Officer in respect of manufacturing segment rejected CPM citing reasons that Frigoglass India Private Limited functions were interlinked and costs were uncertain and extensive information about cost base of Frigoglass India Private Limited and comparables were not available. The Tax Officer thus held that, when reliable method viz. TNMM was available then there was no need to go to CPM.

Before the Tax Court, Frigoglass India Private Limited argued that internal data for the cost base and the gross margin information in respect sale to related parties as well as sale to non-related parties was available, which was totally ignored by the Tax Officer. Frigoglass India Private Limited also pointed out that if internal CPM were available then it should be accepted over external TNMM.

The Tax Court held that once taxpayer has given a methodology for working of arm's length price on selection of a particular method supported by appropriate comparables, the working can be dislodged by Tax Officer only on the basis of cogent reasons and objective findings. In this case except theoretical assertions and generalized observations by the Tax offices, no objective findings have been given to come to a reasoned conclusion that Frigoglass India Private Limited's adoption of CPM for manufacturing segment was factually and objectively not correct.

(g) *DCIT Vs. Deepak Industries Ltd*²⁸

Deepak Industries Ltd (engaged in manufacturing gearboxes and gears) has three manufacturing units at Kolkata, Faridabad, and Rudrapur. The unit at Rudrapur was set up in FY 2007-08 relevant to AY 2008-09 and is eligible for deduction under section 80IC of the Act and the Faridabad unit was not eligible for such deductions.

²⁷ ITA No. 463/Del/2013

²⁸ [TS-382-ITAT-2022(Kol)-TP]

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The Deepak Industries Ltd had specified domestic transactions (SDTs) between two units (Rudrapur and Faridabad) during the years under consideration (i.e. AY 2014-15 and AY 2015-16). The Faridabad unit manufactures gears for tractors and bigger trucks, whereas the Rudrapur unit (a contract manufacturer) produces 3rd & 4th gear for small trucks manufactured by Tata Motors Ltd, for which it procures semi-finished goods in the form of shaft/blank from Faridabad unit. For the AYs under consideration, Deepak Industries Ltd adopted CPM as MAM for determining the ALP of the SDTs.

Whereas the Tax Officer by rejecting CPM followed by Deepak Industries Ltd adopted TNMM as MAM and proposed adjustment on the ground that there is a huge difference in the profit margin of both units.

The Tribunal notes that Deepak Industries Ltd.'s claim for Sec 80-IC deduction, as also ALP of inter-unit transactions (between Faridabad and Rudrapur units) determined by it, was accepted by the Revenue from AYs 2008-09 to 2013-14. Accordingly, the Tribunal followed the principle of consistency, observing that Revenue had accepted similar transactions between Rudrapur and Faridabad units for earlier AYs even in scrutiny proceedings; Also affirms Deepak Industries Ltd's plea that mere extraordinary profit cannot be criteria for adjustment.

The Tribunal upholds the adoption of CPM as MAM, as the eligible unit is a contract manufacturer and procuring semi-finished goods from the Faridabad unit, besides doing the contractual job for the Faridabad unit; States that such approach is in consonance with section 92B of the Act read with Rules 10B(1), 10C(1) & (2) of the Rules as well as OECD guidelines, UNTP manual & ICAI Guidance Note, which lay down that CPM is to be applied where the semi-finished goods are transferred & job work is done.

Further, notes that Deepak Industries Ltd has maintained cost records CAS-4 which were duly certified by the CA in respect of direct and indirect cost, and the gross profit margin is also available; Further, Deepak Industries Ltd.'s net profit as a whole of 19.99% is much higher than the comparables companies and the Tribunal thus holds that price determined by the Deepak Industries Ltd is at arm's length.

2.5 Transactional Profits Method

Profit split method (“PSM”)

The Profit Split Method is typically applied when both sides of the controlled transaction contribute significant intangible property. The profit is to be divided such as is expected in a joint venture relationship.²⁹

The 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

²⁹ Page 206 UN Manual 2017

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).

The relative value of each controlled taxpayer's contribution to the success of the relevant business activity must be determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant in the relevant business activity, consistent with the comparability provisions. Such an allocation is intended to correspond to the division of profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing functions similar to those of the various controlled taxpayers engaged in the relevant business activity.

2.5.1. Indian Regulations

Rule 10B(1)(d) describes PSM as follows:

Rule 10B(1)(d) profit split method, which may be applicable mainly in international transactions [or specified domestic transactions] involving transfer of unique intangibles or in multiple international transactions [or specified domestic transactions] which are so interrelated that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction, by which

- (i) the combined net profit of the associated enterprises arising from the international transaction [or specified domestic transactions] in which they are engaged, is determined;*
- (ii) the relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated on the basis of the function performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances;*
- (iii) the combined net profit is then split amongst the enterprises in proportion to their relative contributions, as evaluated under sub-clause (ii);*
- (iv) the profit thus apportioned to the assessee is taken into account to arrive at an arm's length price in relation to the international transaction [or specified domestic transactions]:*

Provided that the combined net profit referred to in sub-clause (i) may, in the first instance, be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of international transaction [or specified domestic transactions] in which it is engaged, with reference to market returns achieved for similar types of transactions by independent enterprises, and thereafter, the residual net profit remaining after such allocation may be split

amongst the enterprises in proportion to their relative contribution in the manner specified under sub-clauses (ii) and (iii), and in such a case the aggregate of the net profit allocated to the enterprise in the first instance together with the residual net profit apportioned to that enterprise on the basis of its relative contribution shall be taken to be the net profit arising to that enterprise from the international transaction [or specified domestic transactions].

2.5.2. International Regulations

The OECD Guidelines, 2020 describes the PSM as under:

2.114 The transactional profit split method seeks to establish arm's length outcomes or test reported outcomes for controlled transactions in order to approximate the results that would have been achieved between independent enterprises engaging in a comparable transaction or transaction. The method first identifies the profits to be split from the controlled transactions – the relevant profits – and then splits them between the associated enterprises on an economically valid basis that approximates the division of profits that would have been agreed at arm's length. As is the case with all transfer pricing methods, the aim is to ensure that profits of the associated enterprises are aligned with the value of their contributions and the compensation which would have been agreed in comparable transactions between independent enterprises for those contributions. The transactional profit split method is particularly useful when the compensation to the associated enterprises can be more reliably valued by reference to the relative shares of their contributions to the profits arising in relation to the transaction(s) than by a more direct estimation of the value of those contributions.

Also, on 21 June, 2018, OECD released Guidance on application of PSM as part of OECD's Base Erosion and Profit Shifting ('BEPS') Action Plan 10.

According to UN TP Manual, PSM:-

The profit split method is a useful, but often complex method of determining transfer prices based on an allocation of the relevant, combined profits made by the related parties in relation to the transaction(s).

The Profit Split Method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that it is appropriate to aggregate) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions.

The Profit Split Method starts by identifying the relevant profits, or indeed losses in relation to the controlled transactions. It then seeks to split those profits or losses between the associated enterprises based involved on an economically valid basis in order to achieve an arm's length outcome for each party. Typically, the split should reflect the relative value of each enterprise's contribution, including its functions performed, risks assumed and assets used or contributed.

In the Australian Transfer Pricing Regulations, the PSM is described as under:-

Profit split methods

Profit split methods are transfer pricing methods that identify the combined profit to be split for the associated enterprises from a controlled transaction or controlled transactions, and then split those profits between the associated enterprises according to an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length between independent parties

The profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the parties, such as the profit arising from high value, sometimes unique, intangibles.

The allocation of profit or loss under the PSM must be made in accordance with one of the following allocation methods:

- comparable profit split; or
- residual profit split.³⁰

(a) Comparable profit split

A comparable profit split is derived from the combined operating profit of uncontrolled taxpayers whose transactions and activities are similar to those of the controlled taxpayers in the relevant business activity. 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.

(b) Residual profit split

Under this method, the combined operating profit or loss from the relevant business activity is allocated between the controlled taxpayers following the two-step process set.

- ***Allocate income to routine contributions***

The first step is to allocate operating income to each party relevant the controlled transactions to provide a market return for its routine contributions to the relevant business activity. Routine contributions are contributions of the same or a similar kind to those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns. Routine contributions ordinarily include contributions of tangible property, services and intangibles that are generally owned by uncontrolled taxpayers engaged in similar activities. A functional analysis is required to identify these contributions according to the functions performed, risks assumed, and resources employed by each of the controlled taxpayers. Market returns for the routine contributions should be determined by reference to the returns achieved by uncontrolled taxpayers engaged in similar activities.

³⁰ Referred to as contribution analysis and residual analysis under OECD guidelines

- ***Allocate residual profit***

The allocation of income to the controlled taxpayers' routine contributions will not reflect profits attributable to the controlled group's valuable intangible property where similar property is not owned by the uncontrolled taxpayers from which the market returns are derived. Thus, in cases where such intangibles are present there normally will be an unallocated residual profit after the allocation of income, described above. Under this second step, the residual profit generally should be divided among the controlled taxpayer based upon the relative value of their contributions of intangible property to the relevant business activity that was not accounted for as a routine contribution. The relative value of the intangible property contributed by each taxpayer may be measured by external market benchmarks that reflect the fair market value of such intangible property. Alternatively, the relative value of intangible contributions may be estimated by the capitalised cost of developing the intangibles and all related improvements and updates less an appropriate amount of amortisation based on the useful life of each intangible. Finally, if the intangible development expenditures of the parties are relatively constant over time and the useful life of the intangible property of all parties is approximately the same, the amount of actual expenditures in recent years may be used to estimate the relative value of intangible contributions. If the intangible property contributed by one of the controlled taxpayers is also used in other business activities (such as transactions with other controlled taxpayers), an appropriate allocation of the value of the intangibles must be made among all the business activities in which it is used.

The Indian TP regulations provide that PSM is mainly applicable to 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 ALP. For determining the ALP under the PSM, the following steps are required:

- (i) Combine the net profit of the AEs arising from the international transaction in which they are engaged.
- (ii) The relative contribution made by each of the AEs to the earning of such combined net profit is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances.
- (iii) The combined net profit is then split amongst the enterprises in proportion to their relative contributions, as evaluated in point (ii) above.
- (iv) The profit thus apportioned to the taxpayer is taken into account to arrive at an ALP in relation to the international transaction.

The Indian TP regulations also provide that the combined net profit referred in point (i) above may, in the first instance, be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of international transaction in which it is engaged, with reference to market returns achieved for similar types of transactions by independent

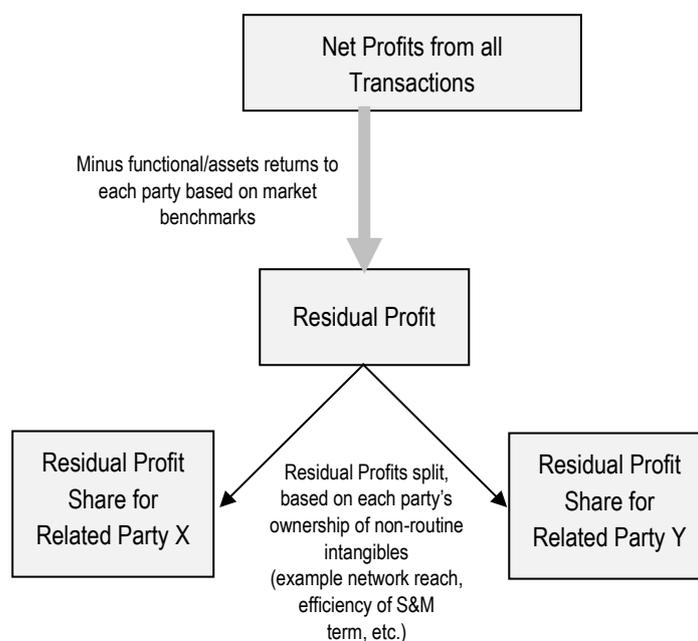
enterprises and, thereafter, the residual net profit remaining after such allocation may be split amongst the enterprises in proportion to their relative contribution in the manner specified under points (ii) and (iii) and in such a case the aggregate of the net profits allocated to the enterprise in the first instance together with the residual net profit apportioned to that enterprise on the basis of its relative contribution shall be taken to be the net profit arising to that enterprise from the international transaction.

OECD Guidelines, Para 3.9, refer that where transactions are very inter-related it might be possible that they cannot be evaluated on a separate basis.

Under similar circumstances, independent enterprises might decide to set up a form of partnership and agree to a form of profit split. Accordingly, the PSM seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that are appropriate to aggregate) by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions. The PSM first identifies the profit to be split for the AEs from the controlled transactions in which the AEs are engaged. It then splits those profits between the AEs on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length. The combined profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the parties, such as the profit arising from high value, sometimes unique, intangibles. The contribution of each enterprise is based upon a functional analysis, and valued to the extent possible by any available reliable external market data. The external market criteria may include, for example, profit split percentages or returns observed among independent enterprises with comparable functions.

2.5.3. Applicability of PSM

The following chart explains the PSM³¹:



PSM generally does not rely directly on comparable transactions, and it can therefore be used in cases when no such transactions between independent enterprises can be identified. The allocation of profit is based on the division of functions between the AEs themselves. External data from independent enterprises is relevant in the profit split analysis primarily to assess the value of the contributions that each associated enterprise makes to the transactions, and not to directly determine the division of profit. As a consequence, the PSM offers flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises, while still constituting an arm's length approach to the extent that it reflects what independent enterprises reasonably would have done if faced with the similar circumstances.

In PSM, it is less likely that either party to the controlled transaction will be left with an extreme and improbable profit result, since both parties to the transaction are evaluated. This aspect can be particularly important when analysing the contributions by the parties in respect of the intangible property employed in the controlled transactions. This two-sided approach may also be used to achieve a division of the profits from economies of scale or other joint efficiencies.

PSM generally applies to transactions related to intangible and is more relevant in the

³¹This is an example of residual profit split method. Under comparable profit split method entire net profit will be allocated to X & Y.

telecommunication industry, pharmaceuticals, courier or similar industry where intangible plays a vital role and are employed by both the transacting parties.

The following example helps in understanding the application of PSM:

- (i) XYZ is a US entity that develops, manufactures and markets a line of products for police use in the US. XYZ's research unit developed a bulletproof material for use in protective clothing and headgear (Nulon). XYZ obtains patent protection for the chemical formula for Nulon. Since its introduction in the US, Nulon has captured a substantial share of the US market for bulletproof material.
- (ii) XYZ licensed its European subsidiary, XYZ-Europe, to manufacture and market Nulon in Europe. XYZ-Europe is a well-established entity that manufactures and markets XYZ products in Europe. XYZ-Europe has a research unit that adapts XYZ products for the defence market, as well as a well-developed marketing network that employs brand names that it developed.
- (iii) XYZ-Europe's research unit alters Nulon to adapt it to military specifications and develops a high-intensity marketing campaign directed at the defence industry in several European countries. Beginning with the 2006 taxable year, XYZ-Europe manufactures and sells Nulon in Europe through its marketing network under one of its brand names.
- (iv) For the 2006 taxable year, XYZ has no direct expenses associated with the license of Nulon to XYZ-Europe and incurs no expenses related to the marketing of Nulon in Europe. For the 2006 taxable year, XYZ-Europe's Nulon sales and pre-royalty expenses are \$500 million and \$300 million, respectively, resulting in net pre-royalty profit of \$200 million related to the Nulon business. The operating assets employed in XYZ-Europe's Nulon business are \$200 million. Given the facts and circumstances, the district director determines under the best method rule that a residual profit split will provide the most reliable measure of an arm's-length result. Based on an examination of a sample of European companies performing functions similar to those of XYZ-Europe, the district director determines that an average market return on XYZ-Europe's operating assets in the Nulon business is 10 percent, resulting in a market return of \$20 million ($10\% \times \200 million) for XYZ-Europe's Nulon business, and a residual profit of \$180 million.
- (v) Since the first stage of the residual profit split allocated profits to XYZ-Europe's contributions other than those attributable to highly valuable intangible property, it is assumed that the residual profit of \$180 million is attributable to the valuable intangibles related to Nulon ,i.e. the European brand name for Nulon and the Nulon formula (including XYZ-Europe's modifications). To estimate the relative values of these intangibles, the District Director compares the ratios of the capitalized value of expenditures as of 2006 on Nulon-related research and development and marketing over the 2006 sales related to such expenditures.
- (vi) Because XYZ's protective product research and development expenses support the

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worldwide protective product sales of the XYZ group, it is necessary to allocate such expenses among the worldwide business activities to which they relate. The district director determines that it is reasonable to allocate the value of these expenses based on worldwide protective product sales. Using information on the average useful life of its investments in protective product research and development, the district director capitalises and amortises XYZ's protective product research and development expenses. This analysis indicates that the capitalised research and development expenditures have a value of \$0.20 per dollar of global protective product sales in 2006.

- (vii) XYZ-Europe's expenditures on Nulon research and development and marketing support only its sales in Europe. Using information on the average useful life of XYZ-Europe's investments in marketing and research and development, the district director capitalises and amortises XYZ-Europe's expenditures and determines that they have a value in 2006 of \$0.40 per dollar of XYZ-Europe's Nulon sales.
- (viii) Thus, XYZ and XYZ-Europe together contributed \$0.60 in capitalised intangible development expenses for each dollar of XYZ-Europe's protective product sales for 2006, of which XYZ contributed one-third (or \$0.20 per dollar of sales). Accordingly, the district director determines that an arm's-length royalty for the Nulon license for the 2006 taxable year is \$60 million, i.e. one-third of XYZ-Europe's \$180 million in residual Nulon profit.

2.5.4. Issues in application of PSM

(a) External data

The external market data considered in valuing the contribution each associated enterprise makes to the controlled transactions will be less closely connected to those transactions than is the case with the other available methods. The more tenuous the nature of the external market data used when applying the PSM, the more subjective will be the resulting allocation of profits.

(b) Internal data

On first review, the PSM may appear readily accessible to both taxpayers and tax authorities; however, associated enterprises and tax authorities alike may have difficulty in accessing information from foreign affiliates. Moreover, independent enterprises do not ordinarily use the PSM to determine their transfer pricing (except perhaps in joint ventures). In addition, it may be difficult to measure combined revenue and costs for all the associated enterprises participating in the controlled transactions, which would require stating books and records on a common basis and making adjustments in accounting practices and currencies. Further, when the PSM is applied to operating profit, it may be difficult to identify the appropriate operating expenses associated with the transactions and to allocate costs between the transactions and the associated enterprises' other activities. Also, identifying and valuing the intangibles contributed by the transacting parties would pose a significant challenge involving inherent

subjectivity.

The foregoing considerations should be taken into account in determining whether any particular application of the PSM is appropriate given the facts and circumstances. More importantly, because of the foregoing considerations, the application of the PSM is subject to the conclusions and limitations on transactional profit methods.

(c) Comparability

1. Comparable PSM

The degree of comparability between the controlled and uncontrolled taxpayers is determined by applying the comparability standard. The comparable profit split compares the division of operating profits among the controlled taxpayers to the division of operating profits among uncontrolled taxpayers engaged in similar activities under similar circumstances. Comparability under this method is particularly dependent on the considerations described under the TNMM, referred in the following paragraphs, because this method is based on a comparison of the operating profit of the controlled and uncontrolled taxpayers. In addition, because the contractual terms of the relationship among the participants in the relevant business activity will be a principal determinant of the allocation of functions and risks among them, comparability under this method also depends particularly on the degree of similarity of the contractual terms of the controlled and uncontrolled taxpayers. Finally, the comparable profit split may not be used if the combined operating profit (as a percentage of the combined assets) of the uncontrolled comparables varies significantly from that earned by the controlled taxpayers.

- **Data and assumptions**

The reliability of the results derived from the comparable profit split is affected by the quality of the data and assumptions used to apply this method. In particular, the following factors must be considered:

- (i) The reliability of the allocation of costs, income, and assets between the relevant business activity and the participants' other activities will affect the accuracy of the determination of combined operating profit and its allocation among the participants. If it is not possible to allocate costs, income, and assets directly based on factual relationships, a reasonable allocation formula may be used. To the extent direct allocations are not made, the reliability of the results derived from the application of this method is reduced relative to the results of a method that requires fewer allocations of costs, income, and assets. Similarly, the reliability of the results derived from the application of this method is affected by the extent to which it is possible to apply the method to the parties' financial data that is related solely to the controlled transactions. For example, if the relevant business activity is the assembly of components purchased from both controlled and uncontrolled suppliers, it may not be possible to apply the method solely to financial data related to the controlled transactions. In such a case, the

reliability of the results derived from the application of this method will be reduced;

- (ii) The degree of consistency between the controlled and uncontrolled taxpayers in accounting practices that materially affect the items that determine the amount and allocation of operating profit affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect operating profit, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, accounting consistency among the participants in the controlled transaction is required to ensure that the items determining the amount and allocation of operating profit are measured on a consistent basis.

- **Other factors affecting reliability**

The comparable profit split relies exclusively on external market benchmarks. As the degree of comparability between the controlled and uncontrolled transactions increases, the relative weight accorded to the analysis under this method will increase. In addition, the reliability of the analysis under this method may be enhanced by the fact that all parties to the controlled transaction are evaluated under the comparable profit split. However, the reliability of the results of an analysis based on information from all parties to a transaction is affected by the reliability of the data and the assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

2. Residual PSM

The first step of the residual profit split relies on market benchmarks of profitability. Thus, the comparability considerations that are relevant for the first step of the residual profit split are those that are relevant for the methods that are used to determine market returns for the routine contributions. The second step of the residual profit split, however, may not rely so directly on market benchmarks. Thus, the reliability of the results under this method is reduced to the extent that the allocation of profits in the second step does not rely on market benchmarks.

- **Data and assumptions**

The reliability of the results derived from the residual profit split is affected by the quality of the data and assumptions used to apply this method.

In particular, the following factors must be considered:

- (i) reliability of the allocation of costs, income and assets;
- (ii) accounting consistency; and
- (iii) reliability of the data used and the assumptions made in valuing the intangible property contributed by the participants.

In particular, if capitalised costs of development are used to estimate the value of intangible property, the reliability of the results is reduced relative to the reliability of other methods that do not require such an estimate, for the following reasons. First, in any given case, the costs of developing the intangible may not be related to its market value. Secondly, the calculation of the capitalised costs of development may require the allocation of indirect costs between the relevant business activity and the controlled taxpayer's other activities, which may affect the reliability of the analysis. Finally, the calculation of costs may require assumptions regarding the useful life of the intangible property.

- **Other factors affecting reliability**

The first step of the residual profit split relies exclusively on external market benchmarks. As the degree of comparability between the controlled and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase. In addition, to the extent the allocation of profits in the second step is not based on external market benchmarks, the reliability of the analysis will be decreased in relation to an analysis under a method that relies on market benchmarks. Finally, the reliability of the analysis under this method may be enhanced by the fact that all parties to the controlled transaction are evaluated under the residual profit split. However, the reliability of the results of an analysis based on information from all parties to a transaction is affected by the reliability of the data and the assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

As part of the Report, a mandate is included for follow-up work to be done on the transactional PSM. A discussion draft was published in July 2016 setting out proposed revisions to the guidance on PSM as set out in the aforesaid Action Plan, together with a number of questions eliciting public response. Subsequent to considering the public response on the draft, the OECD has recently released the final paper in 2017. This has resulted in further detailed guidance on the ways in which this method can usefully and appropriately be applied to align transfer pricing outcomes with value creation, including in the circumstances of integrated global value chains.

2.5.5. Important rulings

(a) 25/75 Split

The IRS frequently takes the position that as a "rule of thumb" an arm's length royalty requires the apportionment of net profits before royalties 25/75 between licensor and licensee. The IRS first raised this point in the case of *Ciba-Geigy*.³² The tax court noted in response that the licensee-taxpayer retained more than 80 percent of the combined net profits. Like PPG, the case was decided on the basis of method sanctioned by the regulations, i.e. a similar bid by a

³²85 TC 172, 229 (1985).

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competing transferee.

The tax court made a 25/75 profit split in *Hospital Corporation of America*.³³ The court did not say why, but the IRS had not asked for 25/75 split. The taxpayer had established a Cayman Islands subsidiary to manage a hospital in Saudi Arabia. The IRS allocated 100% of the subsidiary's income to the taxpayer on the theory that it, in substance, had performed the services. The tax court found that each had contributed to the management project. It made a finding of fact based on its "best judgement" that 75% of the income should be allocated to the taxpayer.

(b) *Perkin-Elmer Corp. v Commissioner*³⁴

Perkin-Elmer (P-E) is a US corporation with a Puerto Rican subsidiary (PECC). P-E sold PECC most of the parts PECC used to manufacture certain analytical instruments, lamps, and accessories. PECC sold the finished products to P-E.

All the parties including the Tax Court agreed to the resale minus method applied to the transfer price. However, it rejected both the taxpayer's and the IRS's adjusted comparables which each used to set its transfer price. The Tax Court stated that the adjustments were not subject to the quantification made by each party. It then made its own determination of an appropriate transfer price. Although, sustaining the taxpayer in most instances, the taxpayer relied on its own analysis rather than that of either litigant.

With respect to the royalty paid by PECC to P-E, the Tax Court sustained the taxpayer. Both parties agreed that there was a comparable license although they disagreed to the adjustments that should be made to it. Again, the Tax Court made its own determination, ultimately sustaining the taxpayer's overall position.

(c) *Infogain India (P.) Ltd. v DCIT*³⁵

The assessee company provided software services to its AE, Infogain US which in turn provided those services to the end customers. It adopted PSM to determine the ALP. The TPO however rejected PSM and applied TNMM.

The Delhi Tribunal held that the different activities performed by the Infogain India, i.e., the assessee and Infogain US are inextricably linked and both the entities are contributing significantly to the value chain of provision of software services to the end customers. Therefore, the PSM is the most appropriate method for determination of ALP. What is the most appropriate method does not depend on the fact as to whether an assessee is having loss or has a profit. Moreover, the TPO has not demonstrated or substantiated how the change in method was dependent upon the loss incurred. Therefore, the conclusion of the TPO that the PSM is adopted by the assessee only to camouflage loss at the net level is merely an

³³81 TC 520, 601 (1983).

³⁴1993-414, 8 Sept. 1993.

³⁵IT APPEAL NO. 6134 (DELHI) OF 2012

allegation and hence, devoid of merit. Therefore, PSM was rightly applied by the assessee for determining the ALP.

The Tribunal further held that the assessee is responsible for the significant delivery functions while Infogain US is responsible for the marketing, client identification and customers relation management functions. However, the activities performed by the Infogain India and Infogain US are inextricably linked with both entities contributing significantly to the value chain of provision of software services to the end customers. Therefore, PSM was rightly applied by the assessee for determining the ALP. It is well-settled that as per the rule 10D, the benchmarking should be done with the external uncontrolled transactions, however, in the present case, it is not possible to get a comparable. Therefore, such allocation can be done on the basis that how much each independent enterprise might have contributed. Therefore, relative contribution has to be determined, based on key value drivers because benchmarking is not practicable. In the present case, as the comparables having similar transactions would be difficult to find out, therefore, in such a situation, a harmonious interpretation of the provisions is required to make the rule workable, so as to achieve the desired result of the determination of the ALP. Both the OECD Transfer Pricing Guidelines as well as the UN draft method of transfer pricing for developing countries, suggest that an allocation of residual profits under PSM should be done, based on contributions by each entity. In the present case, since the Department has accepted in the preceding year and the succeeding year 40:60 ratio between the Infogain India and Infogain US and if the facts are similar for the year under consideration then no deviation is to be done. Therefore, the issue was to be set aside to file of the Assessing Officer/TPO to decide the issue accordingly.

(d) *Orange Business Services India Networks Private Limited v DCIT*³⁶

Orange Business Services India Networks Private Limited (Orange, India), formerly known as Equant Network Services India Private Limited (Equant India) was a joint venture company between EGN B.V, Equant Pte Ltd. and Emery Technologies Private Limited (Emery India) wherein EGN B.V. and Equant Pte Ltd. are the foreign investors and are part of the FT Group. Orange Business Services India Networks Private Limited was incorporated in the year 2007 and during the FY 2008-09 obtained licenses from Department of Telecommunications to provide services under the NLD and ILD service categories in India. The Company became operational from August 2008 and was engaged in providing data services including IP voice services and related network services to the Group's customers in India. Orange Business Services India Networks Private Limited had taken over the business operation of Global One India Private Limited.

Orange Business Services India Networks Private Limited adopted PSM as the most appropriate method for benchmarking its international transaction, for the reason that it satisfied the conditions, namely that a) international transactions involved the transfer of

³⁶I.T.A .No.-1201/Del/2015 and SA-169/Del/2015

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unique intangibles, and b) there were multiple international transactions which were so interrelated or integrated that they could not be evaluated separately. However, the Tax Officer rejected the PSM selected and adopted TNMM as most appropriate method, and made TP adjustment.

The Tax Court observed that in order to support its claim that the services rendered by the group entities were interrelated, Orange Business Services India Networks Private Limited submitted that it was engaged in providing data services and related network services to customers in India, whereas the Equant Group was a recognized leader in telecom services providing global, integrated and customized communication infrastructure solutions. Orange Business Services India Networks Private Limited further submitted that it followed the same business model, undertook the same operations, serviced the same Equant group clients and employed the same management personnel and employees, as was done by Global One India Private Limited.

The Tax Court referred to Orange Business Services India Networks Private Limited's submissions and observed that there was no doubt that Orange Business Services India Networks Private Limited had taken over the business operations of Global One India Private Limited after its Board's decision. The Tax Court observed Orange Business Services India Networks Private Limited's claim that it followed the same business model of Global One India Private Limited and also that the employees of Global One India Private Limited were transferred and the network equipment of Global One India Private Limited were sold to Orange Business Services India Networks Private Limited, which was not addressed by the Tax Officer.

The Tax Court mentioned that it disagreed with Tax Officer's stand rejecting Orange Business Services India Networks Private Limited's argument that PSM as method had been accepted in other tax jurisdictions, and held that even though ALP was to be determined with reference to Indian TP Regulations only, guidance can be taken from OECD commentaries, UN guidelines and other such literature.

The Tax Court dismissed Tax Officer's contentions that Orange Business Services India Networks Private Limited was operating in India as a standalone entity and thus TNMM was the most appropriate method, observing that Orange Business Services India Networks Private Limited's revenue was generated in a transaction where there was contribution from multiple entities. It was true Orange Business Services India Networks Private Limited ran its business independently from India, which might lead to the conclusion that Orange Business Services India Networks Private Limited was an independent entrepreneur. However, the Tax Court ruled that when a transaction was integrated and interrelated and when costs were incurred by multiple entities and the revenues were to be apportioned to multiple entities, then the factual conclusions of the Tax Officer had to be vacated.

The Tax Court agreed with Orange Business Services India Networks Private Limited's contention and placed reliance on OECD TP Guidelines wherein it is stated that TNMM is unlikely to be reliable if each party to a transaction makes valuable, unique contributions (para

2.4). In such a case, PSM will generally be the most appropriate method (para 2.109).

Accordingly, the Tax Court held PSM as most appropriate method observing that Orange Business services India Networks Private Limited generated revenue out of operations that were highly integrated. The Tax Court held “When one transaction, (example transmitting data from a destination in one country, to a destination in a different country in a secured manner) requires deployment of assets and functions of different entities, located in different Geographical locations, to ultimately deliver services and when such combined efforts generate revenues, the most appropriate method for determining arm’s length price is PSM.

(e) Global One India Private Limited v ACIT³⁷

Global One India Private Limited (Global India) was incorporated in India and is a subsidiary of EGN BV, Netherlands. It was engaged in providing internet and related network services to the group’s customers in India. The services offered by Global One India Private Limited include internet direct connections, installation/configuration of routers, etc., and fully managed support solutions developed around the basic network services. Global One India Private Limited adopted PSM based on residual profit analysis as the most appropriate method for benchmarking its international transaction. However, the Tax Officer rejected the PSM selected and adopted TNMM as most appropriate method and made upward TP adjustments.

The Tax Court observed that the PSM is the most appropriate method for the reason that the Global One India Private Limited generates revenue out of operations that are highly integrated. When one transaction, (example transmitting data from a destination in one country, to a destination in a different country in a secured manner) requires deployment of assets and functions of different entities, located in different Geographical locations, to ultimately deliver services and when such combined efforts generate revenues, in such a case the most appropriate method for determining arm’s length price is PSM.

The Tax Officer was wrong in rejecting PSM on the ground that it is not possible to determine the cost incurred by the Indian entity separately. The cost incurred by the Global One India Private Limited is available on record. The entity maintains books and the same are subject to audit. What is to be seen is the contribution of the entities’ resources to a transaction, or to a series of similar transactions.

(f) Google India (P.) Ltd. vs. Jt. DIT³⁸

Since business of AdWords programme of Google required deployment of assets and functions of different entities located in different geographical locations in order to ultimately deliver services and revenues was generated through combined efforts in respect of transactions aggregated with Adwords business transaction, the Tax Officer should benchmark the transaction by adopting PSM as the most appropriate method. The Tribunal

³⁷ITA Nos.. 5571/Del/2011 and ITA No.5896/Del/2012

³⁸ [2018] 93 taxmann.com 183 (Bang. – Trib.)

held that it was a settled proposition of law that PSM can be adopted as the MAM in cases involving multiple inter-related international transactions which cannot be evaluated separately.

2.6 Transactional net margin method (“TNMM”)

Under the TNMM, the ALP is determined by comparing the operating profit relative to an appropriate base (example costs, sales, assets) of the “tested” party with the operating profit of an uncontrolled party engaged in comparable transactions. The OECD Guidelines state that the TNMM may be particularly sensitive to differences in capacity utilisation, because differences in the levels of absorption of indirect fixed costs (example fixed manufacturing costs or fixed distribution costs) would affect the net profit indicator.

In comparing the profits or margins using the TNMM, typically some form of ratio analysis is used, measuring profits as a percentage of a given base. The ratios most commonly used express net profits as a percentage of costs (full cost or operating costs), a particular balance sheet category (example assets, capital employed, etc.) or sales/service receipts.

In other words, TNMM evaluates whether the amount charged in a controlled transaction is at arm’s length, based on objective measures of profitability (PLIs) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.

2.6.1. Indian Regulations

According to Rule 10B(1)(e) describes TNMM as follows:

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

2.6.2. International Regulations

The OECD Guidelines, 2022 describes the TNMM as under:

2.64 *The transactional net margin method examines the net profit relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction (or transactions that are appropriate to aggregate under the principles of paragraphs 3.9-3.12). Thus, a transactional net margin method operates in a manner similar to the cost plus and resale price methods. This similarity means that in order to be applied reliably, the transactional net margin method must be applied in a manner consistent with the manner in which the resale price or cost plus method is applied. This means in particular that the net profit indicator of the taxpayer from the controlled transaction (or transactions that are appropriate to aggregate under the principles of paragraphs 3.9-3.12) should ideally be established by reference to the net profit indicator that the same taxpayer earns in comparable uncontrolled transactions, i.e. by reference to “internal comparables” (see paragraphs 3.27-3.28). Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise (“external comparables”) may serve as a guide (see paragraphs 3.29-3.35). A functional analysis of the controlled and uncontrolled transactions is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results. Further, the other requirements for comparability, and in particular those of paragraphs 2.75 – 2.81, must be applied.*

2.65 *A transactional net margin method is unlikely to be reliable if each party to a transaction makes valuable, unique contributions, see paragraph 2.4. In such a case, a transactional profit split method will generally be the most appropriate method, see paragraph 2.119. However, a one-sided method (traditional transaction method or transactional net margin method) may be applicable in cases where one of the parties makes all the unique contributions involved in the controlled transaction, while the other party does not make any unique contribution. In such a case, the tested party should be the less complex one. See paragraphs 3.18-3.19 for a discussion of the notion of tested party.*

2.66 *There are also many cases where a party to a transaction makes contributions that are not unique – e.g. uses non-unique intangibles such as non-unique business processes or non-unique market knowledge. In such cases, it may be possible to meet the comparability requirements to apply a traditional transaction method or a transactional net margin method because the comparables would also be expected to use a comparable mix of non-unique contributions.*

2.67 *Finally, the lack of valuable and unique contributions involved in a particular transaction does not automatically imply that the transactional net margin method is the most appropriate method.*

According to UN TP Manual, TNMM:

4.5.2.1 *The TNMM examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction (or transactions that are*

appropriate to be aggregated). The profit margin indicators are discussed below. The TNMM looks at the profits of one of the related parties involved in a transaction, as do the Cost Plus Method and Resale Price Method. The party examined is referred to as the tested party.

4.5.2.2 The TNMM compares the net profit margin (relative to an appropriate base) that the tested party earns in the controlled transactions to the same net profit margins earned by the tested party in comparable uncontrolled transactions or alternatively by independent comparable companies. As it uses net margins to determine arm's length prices the TNMM is a less direct method than the Cost Plus Method and Resale Price Method that compares gross margins. It is also an even more indirect method than the CUP Method that directly compares prices. Many factors may affect net profit margins but may have nothing to do with transfer pricing.

4.5.2.3 The TNMM is used to analyse transfer pricing issues involving tangible property, intangible property or services. It may be applied when one of the associated enterprises employs intangible assets, the appropriate return to which cannot be determined directly. In such a case the arm's length compensation of the associated enterprise(s) not employing the intangible asset is determined by determining the margin realized by enterprises engaged in a similar function with unrelated parties. The remaining return is consequently left to the associated enterprise controlling the intangible asset. The return to the intangible asset is, in practice, a "residual category" being the return left over after other functions have been appropriately compensated at arm's length. This implies that the TNMM is applied to the least complex of the related parties involved in the controlled transaction. This approach has the added benefit that generally more comparable data are available and fewer adjustments are required to account for differences in functions and risks between the controlled and uncontrolled transactions. In addition, the tested party typically does not own valuable intangible property.

Regarding application of TNMM the UN Manual 2017 states as follows"

"B.3.3.12.1. TNMM is usually applied with respect to broad comparable functions rather than particular controlled transactions. Returns to these functions are typically measured by a PLI in the form of a net margin that arguably will be affected by factors unrelated to arm's length pricing. Consequently, one might expect the TNMM to be a relatively disfavoured method. Nevertheless, TNMM is typically applied when two related parties engage in a continuing series of transactions and one of the parties controls intangible assets for which an arm's length return is not easily determined. Since TNMM is applied to the party performing routine manufacturing, distribution or other functions that do not involve control over such intangible assets, it allows the appropriate return to the party controlling unique or difficult-to-value intangible assets to be determined indirectly.

B.3.3.12.2. TNMM may also be appropriate for use in certain situations in which data limitations on uncontrolled transactions make it more reliable than traditional methods. TNMM may be more attractive if the data on gross margins are less reliable due to accounting differences (i.e. differences in the treatment of certain costs as cost of goods sold or operating expenses) between the tested party and the comparable companies for which no adjustments

can be made as it is impossible to identify the specific costs for which adjustments are needed. In such a case, it may be more appropriate to use TNMM to analyze net margins, a more consistent measured profit level indicator than gross margins in case of accounting differences.”

In the Australian Transfer Pricing Regulations, the TNMM is described as under:-

TNMM is a transfer pricing methodology based on comparisons at the net profit level between the taxpayer and independent parties dealing wholly independently in relation to a comparable transaction or dealings. Comparisons at the net profit level can be made on a single transaction or in relation to some aggregation of dealings between associated enterprises. The concept of TNMM is identical to that of 'transactional net margin method' used by the OECD

A profit comparison usually begins with an examination of the net margin relative to an appropriate base (e.g., costs, sales, assets). Sometimes it may be necessary to make the appropriate comparison above the net profit line prior to interest or royalty payments, for example. In many respects, TNMM is an extension of the RP and CP methods.

Comparable operating profit is calculated by determining a PLI for an uncontrolled comparables, and applying the PLI to the financial data related to the tested party's most narrowly identifiable business activity for which data incorporating the controlled transaction is available (relevant business activity).

To the extent possible, PLIs should be applied solely to the tested party's financial data that is related to controlled transactions. The tested party's reported operating profit is compared to the comparable operating profits derived from the PLIs of uncontrolled comparables to determine whether the reported operating profit represents an arm's length result. The TNMM works in similar line with the comparable profit method as provided in the US regulations.

The Indian TPR provides the following steps to determine the TNMM:

Step 1: The net profit margin realised by the enterprise from an international transaction entered into with an AE is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base.

Step 2: The net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base.

Step 3: The net profit margin referred to in Step 1 arising in comparable uncontrolled transactions is adjusted taking into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market.

Step 4: The net profit margin realised by the enterprise and referred to in Step 1 is established to be the same as the net profit margin referred to in Step 3.

Step 5: The net profit margin thus established is then taken into account to arrive at an arm's-

length price in relation to the international transaction.

OECD Guidelines' Para 2.64 provides that the TNMM examines the net profit margin relative to an appropriate base (example costs, sales, assets) that a taxpayer realises from a controlled transaction (or transactions that are appropriate to aggregate). Thus, a TNMM operates in a manner similar to the CPM and RPM. This similarity means that in order to be applied reliably, the TNMM must be applied in a manner consistent with the manner in which the RPM or CPM is applied. This means in particular that the net margin of the taxpayer from the controlled transaction (or transactions that are appropriate to aggregate) should ideally be established by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions. Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise (external comparables) may serve as a guide. A functional analysis of the AE and, in the latter case, the independent enterprise is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results.

The net margins (example return on assets, operating income to sales, and possibly other measures of net profit) under TNMM are less affected by transactional differences than is the case with price, as used in the CUP method. The net margins also may be more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins. Differences in the functions performed between enterprises are often reflected in variations in operating expenses. Consequently, enterprises may have a wide range of gross profit margins but still earn broadly similar levels of net profits.

Further, it may not be necessary to determine the functions performed and responsibilities assumed by more than one of the AEs. Similarly, it is often not necessary to state the books and records of all participants in the business activity on a common basis or to allocate costs for all participants. This can be practically advantageous when one of the parties to the transaction is complex and has many inter-related activities or when it is difficult to obtain reliable information about one of the parties.

Para 2.65 of the OECD Guidelines provides that a TNMM is unlikely to be reliable if each party to a transaction makes valuable, unique contributions. In such a case, a transactional PSM will generally be the most appropriate method. However, a one-sided method (traditional transaction method or transactional net margin method) may be applicable in cases where one of the parties makes all the unique contributions involved in the controlled transaction, while the other party does not make any unique contribution. In such a case, the tested party should be the less complex one.

2.6.3. Approaches under OECD and US regulations

The Indian TPR does not provide any guidance on how to compute the operating profit margin either on cost, sales and assets. One can consider the standard parlance and related components for calculating the various ratios. However, OECD section B 3.3. and B 3.4 and

US Regulations provide detailed guidance on these and one can take gainful reference.

As per OECD, only those items that (a) directly or indirectly relate to the controlled transaction at hand and (b) are of an operating nature should be taken into account in the determination of the net profit indicator for the application of the TNMM. Further Para 2.86 provides that non-operating items such as interest income and expenses and income taxes should be excluded from the determination of the net profit indicator. Exceptional and extraordinary items of a non-recurring nature should generally also be excluded. This, however, is not always the case as there may be situations where it would be appropriate to include them, depending on the circumstances of the case and on the functions being undertaken and risks being borne by the tested party.

(a) Sales revenue

Sales revenue means the amount of the total receipts from sale of goods and provision of services, less returns and allowances. Accounting principles and conventions that are generally accepted in the trade or industry of the controlled taxpayer under review must be used.

(b) Gross profit

Gross profit means sales revenue *less* cost of goods sold.

(c) Operating expenses

Operating expenses include all expenses not included in cost of goods sold except for interest expense, foreign income taxes, domestic income taxes, and any other expenses not related to the operation of the relevant business activity. Operating expenses ordinarily include expenses associated with advertising, promotion, sales, marketing, legal and professional, warehousing and distribution, administration and a reasonable allowance for depreciation and amortisation.

(d) Operating profit

Operating profit means gross profit *less* operating expenses. Operating profit includes all income derived from the business activity being evaluated by the comparable profits method, but does not include interest and dividends, income derived from activities not being tested by this method, or extraordinary gains and losses that do not relate to the continuing operations of the tested party.

(e) Operating assets

The term operating assets means the value of all assets used in the relevant business activity of the tested party, including fixed assets and current assets (such as cash, cash equivalents, accounts receivable, and inventories). The term does not include investments in subsidiaries, excess cash, and portfolio investments. Operating assets may be measured by their net book value or by their fair market value, provided that the same method is consistently applied to

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the tested party and the comparable parties, and consistently applied from year-to-year. In addition, it may be necessary to take into account recent acquisitions, leased assets, intangibles, currency fluctuations, and other items that may not be explicitly recorded in the financial statements of the tested party or uncontrolled comparable. Finally, operating assets must be measured by the average of the values for the beginning of the year and the end of the year, unless substantial fluctuations in the value of operating assets during the year make this an inaccurate measure of the average value over the year. In such a case, a more accurate measure of the average value of operating assets must be applied.

Illustration on Application of TNMM method

AE1 Ltd., is an Indian company

AE1 Ltd., manufactures compact disc (CD) writers and sells the same to AE2 Ltd., which is an AE of AE1 Ltd.

As AE1 Ltd., does not have similar transaction with a non AE, no internal CUP is available. As AE1 Ltd., does not have information and data to identify a comparable company, it has used the databases in public domain for carrying out the search. The result of the search may be summarised as follows:

Particulars	No. of companies
Search on the basis of following keywords:	
(a) Computer	800
(b) Computer hardware	250
(c) Computer peripherals	66
Sub total	1116
Elimination process :	
Companies with different activities	800
Companies with duplication when multiple database are used	75
Companies with no financials	90
Companies having significant operations like sales or purchases with related party	100
Companies reporting no operations	50
Sub total	1115
Company/companies selected – Z Ltd.	1

Note: The search criteria and filters adopted above should be taken as illustrative only. The comparison between AE1 Ltd., and Z Ltd., is carried out as follows:

Financials	AE1 Ltd INR (in crores)	Z Ltd. INR (in crores)
Sales	130	200
Other income	5	10
Total Income	135	210
Operating expenses	85	120
Interest	5	7
Depreciation	10	12
Loss on sale of undertaking	5	0
Expenses relating to non-operating income	1	3
Total expenditure	106	142
Net profits	24	58

Operating margin	AE1 Ltd. INR(in crores)	Z Ltd. INR(in crores)
Sales	130	200
Gross revenue	130	200
Operating expenses	85	120
Interest	5	7
Depreciation	10	12
Total operating cost	100	139
Operating profit	30.00	61.00
Operating margin (before interest and depreciation)	52.94	66.67

2.6.4. Applicability of TNMM

The steps required to apply the TNMM include the following:

- Performing a functional analysis
- Identifying the tested party

- Identifying comparables
- Choosing a profit measure
- Determining the appropriate time period for analysis
- Testing the reasonableness of result

(a) Performing a functional analysis

The first step in applying TNMM is to analyse the functions performed, risk borne and assets utilised by the entity as well as AEs.

(b) Identifying the tested party

Next, in the TNMM process, one has to select the tested party. The tested party will be the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables 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 comparables.

(c) Identifying comparables

The important step is to identify potentially comparable transactions or companies. The OECD Guidelines recommend using internal comparables, which are uncontrolled transactions in which the tested party or AEs, if possible. Transactions in which the taxpayer is not involved should be used only if there are no internal comparable transactions. A function and risk assessment should be performed once the comparables have been identified, whether the comparables are internally generated or the company is relying on external comparables. This functions and risk analysis necessarily less thorough for external comparables than for analysis of the tested party. A great care must be taken to ensure that all differences that can affect profitability are identified and accounted for through adjustments to the comparables. The OECD Guidelines emphasise the need to carefully choose comparables that are as similar in function and product as is possible.

After deciding what comparables are to be used and whether to make adjustments for differences in functions and risk, it is necessary to choose a particular measure of profitability PLI in applying TNMM. The Indian regulations do not provide any specific guidance regarding the profit measures that can be employed.

(d) Choosing a profit measure

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. Whether use of a particular PLI is appropriate depends upon a number of factors, including the nature of the activities of the tested party, the reliability of the available data with respect to uncontrolled comparables, and the extent to which the PLI is likely to produce a reliable measure of the price that the

tested party would have earned had it dealt with controlled taxpayers at arm's length, taking into account all of the facts and circumstances. The PLIs should be derived from a sufficient number of years of data to reasonably measure returns that accrue to uncontrolled comparables. Generally, such a period should encompass at least the taxable year under review and the preceding two taxable years.

PLIs that may provide a reliable basis for comparing operating profits of the tested party and uncontrolled comparables include the following:

Rate of return on capital employed

The rate of return on capital employed is the ratio of operating profit to operating assets. The reliability of this PLI increases as operating assets play a greater role in generating operating profits for both the tested party and the uncontrolled comparable. In addition, reliability under this PLI depends on the extent to which the composition of the tested party's assets is similar to that of the uncontrolled comparable. Finally, difficulties in properly valuing operating assets will diminish the reliability of this PLI.

Financial ratios

Financial ratios measure relationships between profit and costs or sales revenue. Since functional differences generally have a greater effect on the relationship between profit and costs or sales revenue than the relationship between profit and operating assets, financial ratios are more sensitive to functional differences than the rate of return on capital employed. Therefore, closer functional comparability normally is required under a financial ratio than under the rate of return on capital employed to achieve a similarly reliable measure of an arm's-length result. Financial ratios that may be appropriate include the following:

- ratio of operating profit to sales; and
- ratio of operating profit to operating expenses. Reliability under this PLI also depends on the extent to which the composition of the tested party's operating expenses is similar to that of the uncontrolled comparables.

(e) Determining the appropriate time period for analysis

Once the profit measure or measures have been chosen, they must be computed for each of the comparables and for the controlled transaction. The number of years of financial data that should be considered is open to question. Para 3.77 of the OECD Guidelines states that multiple-year data will be useful to take the effects on profits of product life cycles and short-term economic conditions into account. The Indian regulations provide that the data to be used in analysing the comparability should be the data relating to the financial year in which the transaction has been entered into. Further, it provides that data relating to a period not being more than two years prior to such financial year may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared. The number of years that need to be examined will depend on the facts and circumstances of each case.

(f) Determining the “average” or the “range”

An average can be computed in several ways using multiple-year data. Margins can be computed for each company, across time, with a simple average being calculated. Alternatively, margins can be computed using a weighted average, so that years with higher sales will have more weight. By contrast, a yearly average of all comparables (either simple or weighted) could be computed, with these averages then averaged across time. The method of averaging depends to some degree on the reasons for using multiple-year data. If the overall business cycle is considered, averaging the individual results for each year may be the preferred method. In this case, the company to company differences within a year are suppressed, so that the overall pattern of profitability across time becomes clearer. Averaging results within a year is not as meaningful if the profitability of companies within an industry is highly affected by the product life cycle and different companies are in different portions of the product life cycle in any given year. The two techniques will give the same answer if simple averages are employed.

Hon'ble Finance Minister in his budget speech on 10th July 2014, paved way for adoption of “range” concept and “multiple year data” in the Indian TPR. It looked a step in the right direction and would have put the Indian TP regime in sync with the international practices, bringing a glimmer of hope to the Indian taxpayers. The key points under the “*Draft scheme of the proposed rules for computation of Arm’s Length Price (ALP) of an International Transaction or Specified Domestic Transaction undertaken on or after 01.04.2014*”³⁹ are as under:-

2.6.5 Use of multiple year data and the range concept:

The Central Board of Direct Taxes (CBDT) on October 20, 2015 issued the final rules to give effect to the use of ‘multiple year data’ and ‘range concept’ which were introduced by Finance Act, 2014. These rules are applicable to international transactions and specified domestic transactions that are entered into by taxpayers on or after 1 April 2014.

(a) Multiple year data

- As per the notification issued by CBDT, use of multiple year data (of the comparable companies for the purpose of comparability analysis) is applicable only in cases where RPM, CPM or TNMM has been selected as the Most Appropriate Method.

Thus, in cases where CUP, PSM or Other Method are selected as the Most Appropriate Method, multiple year data of comparable companies cannot be used.

- For each comparable selected (under RPM, CPM or TNMM), the data of the current year is required to be considered. In case such data is not available at the time of

³⁹Announced by Central Board of Direct Taxes dated 21 May 2015 (F. No. 134/11/2015-TPL). Once finalized, these rules would be applicable on international and specified domestic transactions undertaken on or after 01st April 2014

furnishing the return of income, data pertaining to up to two preceding financial years may be used.

To illustrate, say if the current year is Year zero and the financial year preceding that is Year 1 and the year prior to such year is Year 2, then it is worth noting that the rules do not envisage a situation wherein a comparable is selected only if it has data relating to Year 2.

- If a comparable is selected on the basis of preceding year data (say Year 1 and Year 2), but is not found to be comparable for the current year (Year 0) for qualitative or quantitative reasons, then such comparable would need to be rejected from the data set.
- When using multiple year data, data for each comparable shall be the weighted average of the selected years. An illustration explaining the computation is provided below:

	Year 0	Year 1	Year 2	Total	
Operating Profit	250	300	350	900	OP/TC for the comparable would be $900/5400 = 16.7\%$
Total Cost	1700	1800	1900	5400	

- Further, the notification provides that in the event current year data becomes available during the course of the assessment proceedings, then the same shall be used by the Transfer Pricing Officer (TPO) for the purpose of the analysis.

(b) Application of range

As per the notification, the ‘range concept’ shall be applicable when: (a) the MAM is either CUP Method, RPM, CPM, or TNMM; and (b) there are at least 6 comparables. Where these conditions are not fulfilled, ‘arithmetic mean’ shall continue to apply, as before, along with the tolerance range benefit (3% or 1%)

For the determination of the quartiles, the margins in the data set (i.e., set of comparable companies) are required to be arranged in ascending order and the arm’s length range would be data points lying between the 35th and 65th percentile of the data set. The methodology for computation of range, is explained by way of illustrations below:

Illustration 1.—The data for the current year of the comparable uncontrolled transactions or the entities undertaking such transactions is available at the time of furnishing return of income by the assessee and based on the same, seven enterprises have been identified to have undertaken the comparable uncontrolled transaction in the current year. All the identified comparable enterprises have also undertaken comparable uncontrolled transactions in a period of two years preceding the current year. The PLI used in applying the most appropriate method is operating profit as compared to operating cost (OP/OC). The weighted average shall be based upon the weight of OC as computed below :

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S. No.	Name	Y1	Y2	Y3 (CY)	Aggregation of OC and OP	Weighted Average
1	2	3	4	5	6	7
1	A	OC= 100 OP= 12	OC = 150 OP = 10	OC = 225 OP = 35	Total OC = 475 Total OP = 57	OP/OC = 12%
2	B	OC = 80 OP = 10	OC = 125 OP = 5	OC = 100 OP = 10	Total OC = 305 Total OP = 25	OP/OC = 8.2%
3	C	OC = 250 OP = 22	OC = 230 OP = 26	OC = 250 OP = 18	Total OC = 730 Total OP = 66	OP/OC = 9%
4	D	OC = 180 OP = (-)9	OC = 220 OP = 22	OC = 150 OP = 20	Total OC = 550 Total OP = 33	OP/OC = 6%
5	E	OC = 140 OP = 21	OC = 100 OP = (-)8	OC = 125 OP = (-)5	Total OC = 365 Total OP = 8	OP/OC = 2.2%
6	F	OC = 160 OP = 21	OC = 120 OP = 14	OC = 140 OP = 15	Total OC = 420 Total OP = 50	OP/OC = 11.9%
7	G	OC = 150 OP = 21	OC = 130 OP = 12	OC = 155 OP = 13	Total OC = 435 Total OP = 46	OP/OC = 10.57%

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

S. No.	1	2	3	4	5	6	7
Values	2.2%	6%	8.2%	9%	10.57%	11.9%	12%

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

The data set comprises 7 data points (arranged in ascending order), and the percentiles computed are not whole numbers

Percentile	Formula	Result	Value to be selected
35 th	Total no. of data points in dataset*35% = [7 * 35%]	2.45	3 rd value* (i.e. 8.2%)
65 th	Total no. of data points in dataset*65% = [7 * 65%]	4.55	5 th value* (i.e. 10.57%)
Median	Total no. of data points in datasets*50% = [7 * 0.5]	3.50	4 th value*(i.e. 9%)

The arm's length range will be beginning at 8.2% and ending at 10.57%. Therefore, if the transaction price of the international transaction or the SDT has OP/OC percentage which is equal to or more than 8.2% and less than or equal to 10.57%, it is within the

range. The transaction price in such cases will be deemed to be the ALP and no adjustment shall be required.

However, if the transaction price is outside the arm's length range, say 6.2%, then for the purpose of determining the arm's length price the median of the dataset shall be first determined in the following manner:

Percentile	Formula	Result	Value to be selected
Median	Total no. of data points in datasets*50% = [7 * 0.5]	3.50	4th value* (i.e. 9%)

Therefore, the arm's length price shall be considered as 9% and adjustment shall accordingly be made.

Illustration 2.—The data of the current year is available in respect of enterprises A, C, E, F and G at the time of furnishing the return of income by the assessee and the data of the financial year preceding the current year has been used to identify comparable uncontrolled transactions undertaken by enterprises B and D. Further, if the enterprises have also undertaken comparable uncontrolled transactions in earlier years as detailed in the table, the weighted average and dataset shall be computed as below :

S. No.	Name	Y1	Y2	Y3 (CY)	Aggregation of OC and OP	Weighted Average
1	2	3	4	5	6	7
1	A	OC = 100 OP = 12	OC = 150 OP = 10	OC = 225 OP = 35	Total OC = 475 Total OP = 57	OP/OC = 12%
2	B	OC = 80 OP = 10	OC = 125 OP = 5		Total OC = 205 Total OP = 15	OP/OC = 7.31%
3	C	OC = 250 OP = 22	OC = 230 OP = 26	OC = 250 OP = 18	Total OC = 730 Total OP = 66	OP/OC = 9%
4	D	-	OC = 220 OP = 22		Total OC = 220 Total OP = 22	OP/OC = 10%
5	E	-	-	OC = 100 OP = (-)5	Total OC = 100 Total OP = (-)5	OP/OC = (-)5%
6	F	OC = 160 OP = 21	OC = 120 OP = 14	OC = 140 OP = 15	Total OC = 420 Total OP = 50	OP/OC = 11.9%
7	G	OC = 150 OP = 21	OC = 130 OP = 12	OC = 155 OP = 13	Total OC = 435 Total OP = 46	OP/OC = 10.57%

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

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

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

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

S. No.	Name	Y1	Y2	Y3 (CY)	Aggregation of OC and OP	Weighted Average
1	2	3	4	5	6	7
1	A	OC= 100 OP= 12	OC = 150 OP = 10	OC = 225 OP = 35	Total OC = 475 Total OP = 57	OP/OC = 12%
2	C	OC = 250 OP = 22	OC = 230 OP = 26	OC = 250 OP = 18	Total OC = 730 Total OP = 66	OP/OC = 9%
3	D	-	OC = 220 OP = 22	OC = 150 OP = 20	Total OC = 370 Total OP = 42	OP/OC = 11.35%
4	E	-	-	OC = 100 OP = (-)5	Total OC = 100 Total OP = (-)5	OP/OC = (-)5%
5	F	OC = 160 OP = 21	OC = 120 OP = 14	OC = 140 OP = 15	Total OC = 420 Total OP = 50	OP/OC = 11.9%
6	G	OC = 150 OP = 21	OC = 130 OP = 12	OC = 155 OP = 13	Total OC = 435 Total OP = 46	OP/OC = 10.57%
7	H	OC = 150 OP = 12	-	OC = 80 OP = 10	Total OC = 230 Total OP = 22	OP/OC = 9.56%

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

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

Illustration 3.— In a given case the dataset of 20 prices arranged in ascending order is as under :

Sl. No.	Profits (in Rs. Thousand)
1	2
1	42.00
2	43.00
3	44.00
4	44.50
5	45.00
6	45.25
7	47.00
8	48.00
9	48.15
10	48.35
11	48.45
12	48.48
13	48.50
14	49.00
15	49.10
16	49.35
17	49.50
18	49.75
19	50.00
20	50.15

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

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Percentile	Formula	Result	Value to be selected
35 th	Total no. of data points in dataset*35% = [20 * 35%]	7	Mean of 7th & 8th value i.e. (47+48)/2 = 47,500/-
65 th	Total no. of data points in dataset*65% = [20* 65%]	13	Mean of 13th & 14th value i.e. (48.5+49)/2= 48,750/-
Thus, the arm's length range in this case shall be from Rs.47,500 to Rs.48,750.			
Median	Total no. of data points in datasets*50% = [20 * 0.5]	10	Mean of 10th & 11th value i.e. (48.35+48.45)/2 = 48,400/-

If the transaction price falls within the range, then the same shall be deemed to be the ALP. If the transaction price falls outside the range, the ALP shall be taken to be the median of the data set.

2.6.6. Use of Arithmetic Mean

- Where 'range' concept does not apply, the arithmetic mean concept shall continue to apply in the same manner as it applied before the amendment to Section 92C (2) of the Act by the Finance (No. 2) Act 2014 along with benefit of tolerance range.
- Where multiple year data is to be used, the same would apply whether "range" concept is used or arithmetic mean is used for determining the ALP.

Testing of reasonableness of the result

The final step in determining transfer price using TNMM is to check the reasonableness of the results using arm's-length range or arithmetic mean.

The following examples help in understanding the application of TNMM:

PLI-Return on assets

Funky Doll Limited (FDL) is a US-based company and has two subsidiaries one in the UK and other in Canada. Both subsidiaries manufacture designer dolls, using technology developed by FDL. Both perform no other functions. The plants in both the countries built in the same year and the UK factory is larger. The output of the UK factory is sold to FDI while output of the Canadian factory sold to a third party distributor.

FDL uses return on assets (ROA) to evaluate the performance of all its manufacturing plants and companies. FDL operates in a capital intensive industry where efficient utilisation of capital assets is essential to its survival. Because ROA is used by operating management to

evaluate and manage the business, it is appropriate to use ROA to determine transfer price in the absence of data to apply transactions based methods. The Canadian subsidiary is earning a 10% return on assets employed, based on original cost of the assets. The two factories are the only producer of these type of designer dolls in the world. The designer dolls are produced by using a very unusual manufacturing process, so no outside comparables are available. The following process is used to determine the appropriate price to pay the UK subsidiary for designer dolls.

The UK factory employs assets with an original cost of US\$30 million. Based on this cost and a 10% ROA, the UK subsidiary should earn net profit of US\$3 million on its total designer doll sales. The subsidiary sells 5,00,000 designer dolls per year, so the per-doll net profit should be US\$6 per doll per year. The subsidiary incurs total cost (costs of goods sold plus general and administrative expenses) of US\$10 per doll. The price charged to FDL therefore should be US\$16 per doll.

PLI-return of sales

Healthy Food is an Indian distributor of food products, which it purchases from its UK parent and sells to independent retailers. Healthy Food has identified three independent health food distributors that all buy from European manufacturers and sell to independent retailers. Healthy Food believes the three distributors perform exactly the same functions it does. Unfortunately, the distributors are privately owned and only information on sales and net profits is available. Healthy Food therefore decides to use return on sales (ROS) as its PLI. Furthermore, Healthy Food believes that ROS is the appropriate measure of net profit because it uses the measure to evaluate its sales operations.

The ROS for the three distributors are 3%, 3.5% and 4%, respectively. Healthy Food decides to use the mean of the range, i.e. 3.5%. Healthy Food's general and administrative costs have averaged 3% of sales for the last three years, and it anticipates that selling costs will be 6% of sales next year. Healthy Food must therefore earn a gross profit of 12.5% of sales to have a net margin of 3.5% of sales. Healthy Food's net selling price per case is US\$8; it must earn US\$1 per case to gain its desired net margin. Healthy Food would then pay US\$7 per case to its parent.

2.6.7. Issues in application of TNMM

There are also a number of issues to the TNMM. Perhaps the greatest issue is that the net margin of a taxpayer can be influenced by some factors that either do not have an effect, or have a less substantial or direct effect, on price or gross margins. These aspects make accurate and reliable determinations of arm's length net margins difficult.

(a) Availability of data

Application of any arm's length method requires information on uncontrolled transactions that may not be available at the time of the controlled transactions. This may make it particularly difficult for taxpayers that attempt to apply the TNMM at the time of the controlled

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transactions. In addition, taxpayers may not have access to enough specific information on the profits attributable to uncontrolled transactions to make a valid application of the method. It also may be difficult to ascertain revenue and operating expenses related to the controlled transactions to establish the financial return used as the profit measure for the transactions. Tax authorities may have more information available to them from examinations of other taxpayers. However, as with any other method, it would be unfair to apply the TNMM on the basis of such data use of secret data is generally not allowed by the Indian TP regulations.

(b) Other factors may influence the prices

One other issue that arises for the TNMM is that the method is typically applied to only one of the AEs. This one-sided aspect does not distinguish the method from most other methods, given that the resale price and CPMs also have this feature. However, the fact that many factors unrelated to transfer prices can affect net margins and can render the TNMM less reliable heightens the concerns over a one-sided analysis. A one-sided analysis may not take into account the overall profitability of the MNE group from the controlled transactions for purposes of comparability. A one-sided analysis potentially can attribute to one member of an MNE group a level of profit that implicitly leaves other members of the group with implausibly low or high profit levels. While the impact on the profits of the other parties to a transaction is not always a conclusive factor in determining the pricing of a transaction, it may act as a counter-check of the conclusions reached.

2.6.8. CPM versus TNMM

The cost-plus method is described in Rule 10B(c). According to the Rule, the gross margin (mark-up) is supposed to be based upon a cost base consisting of the direct and indirect costs of producing a product or service. The closest approximation to this cost base found in practice in statutory financial reports may be the COGS. Generally, operating expenses such as supervisory, general and administrative (SG&A) expenses will not be included in the cost base for a gross margin. Operating expenses represent the difference between gross margin and net margin analyses. Non-operating expenses, including financing expenditures and taxes, are not supposed to be part of the cost base. Thus, the cost-plus mark-up should cover the operating expenses, plus provide an appropriate profit, taking into consideration the functions performed, assets employed and risks assumed.

The question would arise whether cost base as well as mark-up should be comparable. In this regard, the Indian TPR provides that the gross profit mark-up to such cost (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise or by an unrelated enterprise, in a comparable controlled transaction. In view of this, one would say that no strict comparability would require for cost element; however, these costs should be computed according to the same accounting norms.

The OECD presupposes that both the cost base and the mark-up are comparable. For comparison, the test entity should preferably apply an internal comparable uncontrolled transaction (CUT). If not making comparable supplies to unrelated parties, an external CUT

may serve as a guide, i.e. the cost-plus mark-up earned in comparable transactions by independent suppliers. For comparability, the OECD Guidelines accept that differences in mark-up rates between the transfer price and CUT are considered to the extent that differences may be explained by additions in functions or risks. However, differences in efficiency should not entail adjustments to the mark-up. The difference in efficiency when it comes to operating expenses is one of the main reasons for not including operating expenses in the cost base.

The OECD Guidelines also accept that the gross margin analysis takes into account some type of operating expense in the cost basis, in particular in order to adjust for accounting differences. But at the same time, and for the same reasons as given for the less preferred net margin methods, the OECD Guidelines make note of the adverse effects of including operating expenses in the cost base. The distinction between gross margin methods (exclusive of operating expenses) and net margin methods is further underlined by the OECD Guidelines. Even though admitting that it may be difficult to “delineate with mathematical precision” the boundary between operating expenses and other expenses, the OECD Guidelines state that this does not alter the “basic practical distinction between the gross and net margin approaches”, i.e. between the preferred methods (cost-plus and resale minus) and the less preferred methods (TNMM and PSM).

In particular, while it is difficult to find comparable data on a gross margin level, it is similarly difficult with regard to the net margin methods. Problems faced by tax practitioners when trying to identify comparable data include the following:

- An increasing number of cross-border transactions take place within multinational enterprises (over 60% of world trade) and usually cannot be relied upon for comparability. A large portion of remaining independent transactions are undertaken by privately owned companies the financial information of which, in many countries, is protected by secrecy rules.
- Despite an increased access to entity databases, the categorisation of costs according to GAAP differs from what is needed for a comparison under the cost-plus and resale-minus methods.
- As the activities of multinationals tend to become more integrated across borders, it is also more difficult to separate the functions, risks and (intangible) assets of the tested entity for comparison. When it may be difficult for the tested party to separate the tested transaction, it may be even harder to find comparable transactions with independent companies.
- The contributions made by intangible assets explain more profit-generating activities, while contributions made from tangible assets explain less. This trend makes transactions more complex and comparisons more complicated.

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The following table summarises the application of method and its preferences on a very general basis:

Transactions	Method				
	CUP Method	Resale Price Method	Cost-plus Method	Transactional Net Margin Method	Profit Split Method
Commodities/Oil	√				
Payment of Interest	√				
Distribution of goods		√			
Provision of Services			√	√	
Contract manufacturing			√	√	
Manufacturing			√	√	
Payment of Royalty	√				
Multiple transactions involving intangibles					√
Management Charges	No Specified Method Benefit test and acceptable allocation				
Sales of shares, Intangible Assets (trademark, brand name etc.)	No Specified Method Can rely on valuation report under the other method				

2.6.9 Important Rulings

(a) *Schutz Dishman Biotech Private Limited v DCIT*⁴⁰

Schutz Dishman Biotech Private Limited was manufacturing medicines which were being exported. The quality control for these drugs was of high standards and the composition of the drugs had to be maintained as per the prescribed norms and of internationally quality. For a particular medicine which was to be exported the Government of India had prescribed the input ratio of various raw material which have been printed on the various sale invoices which were mentioned by the Schutz Dishman Biotech Private Limited.

Schutz Dishman Biotech Private Limited applied TNMM for benchmarking its transactions. However, the Tax Officer rejected TNMM and applied CUP.

Schutz Dishman Biotech Private Limited mentioned the facts of the case stating that PBIT of 16.67% was definitely comparable and better than industry average of 13.33%. Even margins with related party at 18% were better than overall PBIT. Further, Schutz Dishman Biotech

⁴⁰ ITA No.3590 & 3751/Ahd/2007

Private Limited argued that sales to non-AE and AE are not at all comparable inasmuch as the non-AE entities do not undertake any marketing exercises, no after sales support is provided and even technical support is also not provided. It was contested that in contrast, Schutz Dishman Biotech Private Limited provided all these services and therefore, the prices were not comparable. Schutz Dishman Biotech Private Limited also submitted that Tax Officer had ignored the fact that in open market, prices are determined based on demand and supply and therefore the comparisons without accounting such factors are no comparison at all.

The Tax Court dismissed Tax Officer's appeal and accepted TNMM followed by Schutz Dishman Biotech Private Limited and rejected the CUP method adopted by the Tax Officer. The Tax Court observed that margin earned by Schutz Dishman Biotech Private Limited PBIT was exactly similar or nearby with that earned by other uncontrolled transactions of unconnected enterprises. Further, Tax Court had stated that Schutz Dishman Biotech Private Limited had even compared PBIT of other independent entities with itself and demonstrated the application of TNMM correctly.

(b) Sun Pharmaceuticals Industries Ltd vs ACIT⁴¹

The Tribunal deleted TP adjustment of Rs. 612.03 crores in respect of sale of Pantoprazole tablets by assessee (Indian Pharma company engaged in manufacturing of bulk drugs as well as formulation products) to AE (SPG BVI). The TPO/CIT(A) had rejected TNMM adopted by assessee on the ground that the assessee was not merely a contract manufacturer but performed substantial functions and accordingly applied PSM on the basis that respective functions between assessee and AE could not be distinctly ascertained. Noting that the assessee performed only one simple function of manufacturing the tablets without providing any other significant unique contribution, the Tribunal held that as per OECD guidelines the profit split method was not appropriate for benchmarking. Further, it held that the conditions for applicability of PSM i.e. transfer of unique intangibles & interrelated multiple transactions were both missing in present case. Accordingly, it deleted the TP-adjustment.

(c) Rampgreen Solutions Pvt Ltd vs CIT⁴²

It has been argued that while applying TNMM, broad functionality is sufficient and it is not necessary that further effort be taken to find a comparable which renders services of similar characteristics as the tested entity. Further, it has also been argued that TNMM allows flexibility and tolerance in selection of comparables, as functional dissimilarities are subsumed at net margin levels.

However, this approach would not be apposite. Insofar as identifying comparable transactions/entities is concerned, the same would not differ irrespective of the transfer pricing method adopted. In other words, the comparable transactions / entities must be selected on the basis of similarity with the controlled transaction/entity. Comparability of controlled and uncontrolled transactions has to be judged, inter alia, with reference to comparability factors

⁴¹ TS-596-ITAT-2017(Ahd)-TP

⁴² ITA No. 102/2015, [TS-387-HC-2015(DEL)-TP], [2015] 60 taxmann.com 355 (Delhi), 2015-TII-33-HC-DEL-TP, AY 2008-09, High Court of Delhi, August 2015

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as indicated under Rule 10B(2) of the Rules. Comparability analysis by TNMM may be less sensitive to certain dissimilarities between the tested party and the comparables. However, that cannot be the consideration for diluting the standards of selecting comparable transactions/entities. A higher product and functional similarity would strengthen the efficacy of the method in ascertaining a reliable ALP. Therefore, as far as possible, the comparables must be selected keeping in view the comparability factors as specified. Wide deviations in PLI must trigger further investigations/analysis.

Accordingly, it was held that while using TNMM, the search for comparables may be broadened by including comparables offering services/products which are not entirely similar to the controlled transaction/entity. However, this can be done only if (a) the functions performed by the tested party and the selected comparable entity are similar including the assets used and the risks assumed; and (b) the difference in services/products offered has no material bearing on the profitability.

2.7. Other Methods as provided by Rule 10AB

The CBDT has inserted Rule 10AB in the Rules by notifying the “Other Method” apart from the five methods already prescribed.

2.7.1. Indian Regulation

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

The introduction of the Other Method as the sixth method allows the use of ‘any method’ which takes into account (i) the price which has been charged or paid or (ii) would have been charged or paid for the same or similar uncontrolled transactions, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts.

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

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

It is relevant to note that the text of Rule 10AB does not describe any methodology but only provides an enabling provision to use any method that has been used or may be used to

arrive at price of a transaction undertaken between non AEs. Hence, it provides flexibility to determine the price in complex transactions where third party comparable prices or transactions may not exist. The wide coverage of the Other Method would provide flexibility in establishing arm's length prices, particularly in cases where the application of the five specific methods is not possible due to reasons such as difficulties in obtaining comparable data due to uniqueness of transactions such as intangibles or business transfers, transfer of unlisted shares, sale of fixed assets, revenue allocation/splitting, guarantees provided and received, etc. However, it would be necessary to justify and document reasons for rejection of all other five methods while selecting the 'Other Method' as the most appropriate method. The OECD Guidelines also permits the use of any other method and state that the taxpayer retain the freedom to apply methods not described in OECD Guidelines to establish prices, provided those prices satisfy the arm's length principle.

Module D

Comparables

1. Selection or Rejection of Comparables

1.1 Introduction

The foundation of comparability analysis for transfer pricing rests on the arm's length principle to determine whether a transaction with associated enterprise ("AE") has been carried out at arm's length or not. Section 92C(1) of the Income-tax Act, 1961 requires that the ALP in relation to an international transaction be determined using the most appropriate method having regard to the nature or class of international transaction, the functional profile of the persons/entities involved in the transactions and any other relevant factors. Rule 10B of the Income-tax Rules, 1962 (Rules) in setting out the alternative transfer pricing methods that may be considered for the purpose of determination of ALP, refers to the fact that arm's length price be determined either from (a) price in comparable uncontrolled transactions or (b) based on profits derived from similar activities undertaken by comparable independent enterprise(s). In the case of (a), determination of ALP is either based on price agreed in transactions entered into by a taxpayer with an unrelated enterprise or a transaction between two or more unrelated enterprises. In the case of (b) the ALP is determined on the basis of profitability derived by an enterprise from its transactions with an unrelated enterprise or based on profitability of a comparable uncontrolled enterprise, engaged in similar business activities as the taxpayer, with another independent enterprise. Where the ALP is determined based on profitability of unrelated independent enterprises, such unrelated enterprises are referred to as "comparables" or "comparable companies" for the purpose of this section.

A transaction can, therefore, be said to be carried out at arm's length when it replicates or is in consonance with the terms which would have been agreed to by or between unrelated parties in uncontrolled conditions. Thus, selection of comparables to an international transaction is at the core of the arm's length principle.

For instance, let us assume that Associated Advisors India Ltd. is a company incorporated in India providing investment advisory services to its AE, Associated Investors Inc. in USA. Whether this international transaction between Associated Advisors India Ltd. and Associated Investors Inc. is at arm's length will be determined by comparing the international transaction with *either* (a) a similar transaction or transactions conducted by one of these entities with an unrelated enterprise *or* (b) with a similar transaction or transactions entered into between two unrelated enterprises under similar conditions. If the terms of the said international transaction vis-à-vis the comparable transactions with/between the unrelated parties are found to be similar, then broadly the international transaction between Associated India Ltd. and Associated Inc. can be said to be conducted as if between unrelated parties in uncontrolled

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conditions i.e., at arm's length. However, to reach this conclusion, it is important to demonstrate that the prices or outcome of such transactions are based on data of comparable transactions or comparable entities entering into such transactions.

This brings us to a set of questions on selection of comparables to be answered - What are the factors relevant for the purpose of selection and rejection of comparables? Has a procedure for selection or rejection of comparables been prescribed? What is the degree of comparability required for selection of a comparables? What information may be relied upon in selection of comparables? These questions are discussed in the first part of this section. The second part of this section provides a step-by-step guidance on selection of appropriate comparables and rejection of non-comparable companies.

1.2 Factors relevant for selection/rejection of companies as comparables

Transfer pricing is transaction centric, i.e., it seeks to determine whether the transactions between related parties or AEs have been conducted at an arm's length price (ALP) or not. However, practically comparison at the transaction level may not always be feasible due to non-availability of reliable transaction level data for companies such as prices charged, the timing differences of the transactions, differences in the other critical terms of each transaction etc. Where data on comparable uncontrolled transaction(s) and outcome of such transactions (i.e., prices or profit results) are not available, the next step is to search for independent enterprises carrying out similar transactions or activities. The results of these identified enterprises engaged in similar transactions or activities can then be used to determine whether the price/profit for the transaction between the AEs is at arm's length.

For selecting appropriate comparables, Rule 10B of the Rules and Section D of Chapter I and Chapter III in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Organisation for Economic Co-operation and Development "OECD TP Guidelines") prescribe a set of relevant factors on which the comparability of an international transaction with an uncontrolled transaction may be judged. These are summarized below –

- (a) The specific characteristics of the property transferred, or services provided
 - Differences in the specific characteristics of property or services transacted often account for differences in their values in the open market.
 - Characteristics that may be important in case of comparison of property or services transacted include – physical features of product, its reliability, quality and availability, use and anticipated benefits; in case of services, the nature and extent of the services.
 - The importance of the characteristics of the property or services transacted is greater for traditional transaction methods such as the CUP method, the RPM or the CPM, where stress is on product similarity, whereas for transactional profit methods such as TNMM, that compare net profits of entities, greater stress is laid on functional

similarities than on product similarities. The functions performed, the risks assumed, and the assets employed by the respective parties to the transaction.

- Compensation for a transaction reflects the functions performed, the risks assumed and the assets employed. Thus, where on an analysis of FAR, two companies are found to be performing comparable functions including the risks assumed and assets employed, then they can be said to be comparable.
 - FAR analysis is the most important element of comparability in transactional profit method that compare profitability of entities or segments, such as the TNMM.
- (b) The contractual terms which lay down how the risks, responsibilities and benefits of the transactions are divided between the respective parties to the transaction
- The contractual terms provide an idea of the functions and conduct of the potential comparables. Accordingly, analysis of contractual terms should be carried in order to ascertain that conduct and functioning of the potential comparables and the tested party¹ are comparable.
- (c) Economic circumstances, or the conditions prevailing in the markets in which the respective parties to the transaction operate
- Even for transactions involving the same property or service, the ALP may differ from one market to another.
 - Economic circumstances that may be relevant in ascertaining comparability in market conditions are geographic location, size of the markets, extent of competition in the markets, the level of supply and demand in the market, purchasing power of the consumer, government regulations in the market, costs of the factors of production etc.
- (d) Business strategies²
- Business strategies may have an impact on a taxpayer's current or future profits, such as business strategies involving market penetration or expansion of market share.
 - Business strategies would take into account aspects of an enterprise such as innovation and product development, degree of diversification, risk aversion, assessment of political changes and other factors having a bearing on the conduct of business.

These being the broad factors are to be kept in mind during the process of selection and rejection of comparables, the questions that crop up now is how to identify potential

¹The tested party is that party to the transaction for which a financial indicator (mark-up on costs, gross margin or net profit indicator) is tested at the time of applying the Most Appropriate Method. As a general rule, the tested party is one to which the Most Appropriate Method can be applied in the most reliable manner and for which the most reliable comparables can be found, i.e. it will most often be the one that has the less complex functional analysis. (OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations [OECD 2010] revised in 2022, Para 3.18)

²Business strategies as a factor of comparability finds mention in Section D.1.36 of revised Chapter 1 of OECD Guidelines, 2022. However, business strategies is not enlisted in the factors laid down in Rule 10B of the Rules.

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comparables and how is it to be ascertained if the factors described above are met by the potential comparables.

1.3 Approaches to selection and rejection of Comparables

Though there is no specific approach prescribed under the Indian transfer pricing regulations for carrying out the comparability analysis, the OECD TP Guidelines sets out certain approaches that may be considered by taxpayers for identification of potential comparables.³

(a) Additive Approach

- A list of companies that are believed to be potentially comparable is drawn up.
- This list can be collated from multiple sources (e.g., databases, industry publications etc.) thereby forming a broader list
- Information is then collected on the potential comparables to confirm whether they are acceptable comparables in terms of the factors of comparability listed above.

(b) Deductive Approach

- A wide set of companies operating in the same sector or line of business is taken typically through a search on database(s) of companies (e.g. Prowess⁴ or CapitalinePlus/ Capitaline TP⁵ or ACE TP⁶)
- The list is then refined in accordance with the factors of comparability through a quantitative and qualitative analysis in order to obtain a set of comparable companies.

The Indian TP Regulations does not prescribe any specific approach for identification of comparables but in practice, the deductive approach is followed by taxpayers as well as tax administration in India. The deductive approach ensures a sufficient degree of objectivity and transparency as it systematically narrows down from a broader set of potentially comparable companies to a narrower set of closely comparable companies. Further, in some of the cases, the Taxpayers also opt for a combination of additive and deductive approach to arrive at the appropriate set of comparable companies.

1.4 Quantitative and Qualitative Analysis in the Selection and Rejection of Comparables

Whether or not the set of potential comparables meet the factors of comparability and are

³OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD 2022), Paras 3.38 and 3.39.

⁴Prowess is a corporate database provided by Centre for Monitoring of Indian Economy that contains financial data and reports of about 38,000 companies.

⁵Capitaline Plus/Capitaline TP is a corporate database of more than 35,000 Indian Companies provided and monitored by Capital Market Publishers India Private Limited.

⁶ACE TP is a database compiled and managed by Accord Fintech Private Limited, having data of more than 38,000 Indian Companies and contain business profiles, annual reports, shareholding patterns and names of subsidiaries/ joint ventures, if any, of listed and major unlisted public companies

actually comparable to the tested party is determined by carrying out quantitative and qualitative analysis of the potential comparables.

For instance, where a search amongst a wide set of companies is to be made for comparables to Associated Advisors India Ltd. a company providing investment advisory services to its AE, Associated Investors Inc., then a quantitative filter to exclude companies with income from manufacturing activities greater than a small percentage point (as the tested party is 100% in advisory activities, this may be as small as possible) may be applied to exclude all those companies from the selection process which are engaged in manufacturing activities. This is an example of a quantitative filter. Similarly, other relevant quantitative filters may be applied in succession to narrow down to a small set of potentially comparable companies. These shortlisted companies are then to be qualitatively analysed in terms of comparability in their FAR, contractual terms, market conditions and other factors explained in Para II above with Associated Advisors India Ltd. to arrive at a final set of appropriately comparable companies.

The choice and application of criteria for quantitative and qualitative analysis depends on the particular facts and circumstances of each case. Nonetheless some of the commonly observed quantitative criteria are:

- Size criteria, in terms of sales, assets, number of employees. For instance, service sector has a larger salary to sales ratio than manufacturing sectors but may have a smaller ratio of fixed assets to sales than the manufacturing sector. This fact can be used as a quantitative filter.
- Intangible-related criteria; for instance, higher ratio of value of intangible to total value of assets may show greater involvement in R&D activities or product development.
- Criteria to exclude special situations such as a start-up or company under liquidation by placing a turnover filter.
- Criteria related to export sales may be applied to exclude companies which may be operating in different market conditions etc.
- Inventory criteria i.e., a company which sells against confirm orders will have lower inventory to sales ratio as compared to a company which stocks inventory.
- Expenses related criteria i.e., a company spending huge sum on marketing expenses may have built significant brand related intangible over the years.

1.5 Degree of Comparability required in Selection and Rejection of Comparables

It is widely acknowledged that transfer pricing is not an exact science. Accordingly, comparability analysis does not require shortlisting of transactions or enterprises that are perfectly identical to the tested party and there may be differences between comparables and the tested party.

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An enterprise or transaction will be comparable to the tested party so long as the differences do not materially affect the cost charged or price paid, or the profit arising from such transactions in the open market. (Rule 10B(3) of the Rules).

Even where the differences between comparables and the tested party materially affect the cost charged or price paid, or the profit arising from such transactions in the open market the transaction or the enterprise can be comparable to the tested party if reasonably accurate adjustment can be made to eliminate the material effects of such differences. (Rule 10B(3)(ii) of the Rules).

Examples of adjustments that can be made to eliminate material effects of differences would be adjustments made for differences in working capital, risk, assets etc. Comparability adjustments are explained in detail in Para 6.

1.6 Information and Documentation in Selection and Rejection of Comparables

Use and documentation of authentic, reliable and verifiable data is essential for an accurate analysis of comparability between the potential comparables and the tested party and for avoiding transfer pricing disputes.

For instance, comparability between a potential comparable XYZ Advisors Ltd. and the tested party Associated Advisors India Ltd is determined on the basis of facts and figures contained in the audited financials which would be more accurate and reliable than comparability determined on the basis of statements on company's website or unaudited financials.

- *Reliance on Authentic Documents* – Information relating to the international transactions, the comparables and the comparability analysis must be supported by authentic documents such as published accounts and financial statements; reports or publications relied upon must be those published by Government institutions or by institutions of national or international repute. (Rule 10D(3) of the Rules)
- *Data relating to the Financial Year of the International Transaction* – The data to be used in analysing the comparability of a potential comparable with the tested party must be the data relating to the financial year in which the international transaction has been entered into. However, data pertaining to two years previous to the international transaction may also be taken if such data reveals facts which could have an influence on the determination of the transfer prices. (Rule 10B(4) of the Rules)
- *Contemporaneous Data* – Data used in comparability analysis must be contemporaneous and available by on or before the specified date defined in Section 92F⁷ i.e. one month prior to the due date for furnishing the return of income under sub-section (1) of section 139 for the relevant assessment year) for the international

⁷ Amended by Finance Act, 2020.

transaction. (Rule 10D(4) of the Rules)

- *Documentation of Information* – Data and information used in respect of the international transaction, analysis of comparability and relating to the comparables is required be preserved in the form of documentation. (Rule 10D(1) of the Rules)
- *Source of Reliable Information* – Reliable information can be obtained from commercial databases. Commercial databases compile accounts filed by companies with the relevant administrative bodies and present them in an electronic format suitable for searches and statistical analysis.⁸ For example, in India, some of the commonly used corporate databases for comparability analysis are Prowess⁹ and Capitaline Plus¹⁰.
- *Importance of Documentation* – Section 92C of the Act states that where on the basis of documents and material in possession of the Assessing Officer, the Assessing Officer is of the opinion that either unreliable data has been used, transfer price has been incorrectly computed or documentation has not been maintained or furnished then the Assessing Officer can disregard the ALP determined by the assessee company and can proceed to determine the ALP himself.

Thus, while selection and rejection of comparables form the pillars of transfer pricing, use and documentation of reliable information in comparability analysis forms the foundation on which the entire edifice stands.

1.7 Step by Step Guide on Selection and Rejection of Comparables

Step 1: A detailed functional analysis of the international transaction is carried out. On the basis of functions performed, risks assumed, and assets employed, the international transaction is characterized.

- Associated Advisors India Ltd. provides investment advisory services to its AE, Associated Investors Inc. on the basis of which Associated Investors Inc. makes investments in India. Associated Advisors India Ltd. provides advisory services only to Associated Inc. The international transaction can be characterized as an investment advisory transaction with limited risk.

Step 2: From the various methods prescribed in Section 92C of the Act, the MAM for computation of ALP is chosen having regard to nature or class of transaction, or class of AEs, or functions performed and other relevant factors. (Discussed in detail in Module 3)

- Associated Advisors India Ltd. earns an operating profit of 25 percent on its investment advisory services. TNMM is chosen as the MAM to compare the operating profit margin

⁸OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD 2022), Section A.4.3.1 (Para 3.30)

⁹Prowess, *supra* n. 3.

¹⁰Capitaline Plus, *supra* n. 4.

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of Associated Advisors India Ltd. with other comparables and determine whether the operating profit margin of Associated Advisors India Ltd. is at arm's length or not.

Step 3: A broad-based search by business segment etc. is conducted on corporate databases to identify a set of companies in the same sector or line of business as the tested party.

- Associated Advisors India Ltd. being involved in providing investment advisory services, the corporate databases such as Prowess, Capitaline Plus etc. may be searched for companies whose transactions are similarly characterized as investment advisory, portfolio management, consultancy in financial services, allied services, etc.

Step 4: Quantitative analysis of the broad set of companies selected after Step 3 is carried out by application of quantitative filters.

- Associated Advisors India Ltd. is engaged in provision of investment advisory services. Accordingly, quantitative filters to eliminate companies with more than 50 percent income from trading or manufacturing activities may be applied. In addition, all companies with zero sales or income and negative net worth during the financial year may also be eliminated as they may not be going concerns.

Step 5: Qualitative analysis of the companies shortlisted after Step 4 is carried to determine the comparability of these companies with the tested party in terms of functions, operations, products and services provided, market conditions etc. to arrive at a final set of appropriately comparable companies.

- Pot Investments Ltd. was one of the comparables shortlisted after quantitative analysis but on a qualitative analysis it was found that Pot Investments Ltd. was also engaged in stock broking activities not similar to Associated Advisors India Ltd. Accordingly, Pot Investments Ltd. was eliminated owing to differences in functions.

Step 6: The set of companies that remain after Step 5 represent the final set of comparables.

Step 7: ALP is then determined for the international transaction by the application of the Most Appropriate Method. Adjustments to the ALP are made if there are differences between a comparable and the tested party that would materially affect the price, cost or profit margin in the open market.

- Since TNMM was chosen as the MAM, profit margins at the net level are to be compared. Accordingly, the operating profit margin for Associated Advisors India Ltd. and for each of the comparables is computed. Associated Advisors India Ltd. being a captive company assuming minimal risk, risk adjustment may be made in the net profit margin calculated for the comparables.

Step 8: Where there is more than one final comparable and accordingly more than one ALP is determined by the application of the Most Appropriate Method, which is often the case, then

the ALP for the international transaction shall be the arithmetical mean^{11/} range^{12/} of all the prices determined.

- Assuming that there are less than 6 comparables, the arithmetic mean of the operating margins (along with a +/- 3% or 1% range, depending on the facts of the case) of the final set of comparable companies will be the basis for the ALP for the international transaction of investment advisory services carried out by Associated Advisors India Ltd.

2. Timing issues in comparability

2.1 Introduction

Timing issues can pose problems for tax administrations when evaluating whether a taxpayer is following a business strategy that distinguishes it from potential comparables. Some business strategies, such as those involving market penetration or expansion of market share, involve reductions in the taxpayer's current profits in anticipation of increased future profits. If in the future those increased profits fail to materialize because the purported business strategy was not actually followed by the taxpayer, legal constraints may prevent re-examination of earlier tax years by the tax administrations.

The OECD recognizes that timing issues exist under which multinational enterprises or tax administrations might seek to obtain comparability between the controlled transactions and the uncontrolled transactions. Such timing issues can conceivably impact three comparability facets:

2.1.1 Timing of origin

In principle, information relating to the conditions of comparable uncontrolled transactions undertaken or carried out during the same period of time as the controlled transactions is expected to be the most reliable information to use in a comparability analysis, because it reflects how independent parties have behaved in an economic environment that is the same as the economic environment of the taxpayer's controlled transaction.

2.1.2 Timing of collection

In some cases, taxpayers establish transfer pricing documentation to demonstrate that they have made reasonable efforts to comply with the arm's length principle at the time their intra-group transactions were undertaken i.e. on an *ex ante* basis, based on information that was reasonably available to them at that point.

In other instances, the taxpayers might test the actual outcome of their controlled transactions to demonstrate that the conditions of these transactions were consistent with the arm's length principle i.e. on an *ex post* basis. Such test typically takes place as part of the process for

¹¹ Where there are less than 6 comparables

¹² Where there are 6 or more comparables

4.10 International Tax — Transfer Pricing

establishing the tax return at year-end.

2.1.3 Timing of production of information

Taxpayers should recognize that the tax administration will make a determination of ALPs even if the information available is incomplete. As a result, the taxpayer must take into consideration that adequate record-keeping practices and the voluntary production of documents can improve the persuasiveness of its approach to transfer pricing.

2.2 Statutory rules and regulations

As per Rule 10B(4) of the Rules, the data to be used in analyzing the comparability of an uncontrolled transaction with a controlled transaction shall be the data relating to the financial year in which the transaction has been entered into. However, the data relating to two years prior to the relevant financial year could also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared.

The Indian revenue authorities are of the view that use of contemporaneous comparable provides a more accurate ALP in a particular year in the way that contemporaneous transactions reflect similar economic conditions. In practice when the Indian revenue authorities carry out their audits which is typically three years post the financial year, due to the timing difference, they may have access to more information on comparable companies which may not have been available to the taxpayer at the time of preparation of transfer pricing study.

In the case of *Diageo India Private Limited v ACIT*¹³⁴⁷ it was held that only current year data of an uncontrolled transaction is to be used for the purpose of comparability while examining the international transactions with AEs, unless the case is covered by the proviso i.e. if the data of preceding two years reveals facts which could have an influence on the determination of transfer price.

However, the Finance Act (2), 2014 has sought to introduce rules to allow the use of multiple year data for comparability analysis as against the practice of allowing the use of multiple year data only if certain conditions, which are difficult to evidence, are met. The use of multiple year data generally helps look at prices/results over a period of time rather than be skewed with data points of only one year. The use of such multiple year data is also expected to factor in the cyclic effect of business, and accordingly would help in keeping the ALP more appropriately aligned to the economic circumstances prevailing in business.

Data from years following the year of transaction may also be relevant to the analysis of transfer prices, but care must be taken to avoid the use of hindsight. For example, data from later years may be useful in comparing life cycles of controlled and uncontrolled transaction for the purpose of determining whether the uncontrolled transaction is an appropriate

¹³⁴⁷ SOT 252

comparable to use in applying a particular method. The provisions of sub-Rule (4) of Rule 10B are quite explicit and provide for analyzing the comparability of an uncontrolled transaction with the international transaction in question on the basis of the data relating to financial year in which the international transaction sought to be tested has been entered into.

However, there are companies in India which follow different accounting period as compared to the April to March period. These companies are rejected during TP audits carried out by the tax administration in India, even though having different financial year ending, they were facing business cycles, market and economic conditions similar to the tested party. In order to avoid such issues the reliable comparability adjustment can be made to bring the comparison at par.

Further, there are companies in India which commenced their business operations in the financial year in which the controlled transaction has been entered into. These companies are rejected during TP audits, since their less than a year's business operations could not be compared with the tested party due to start-up factors, even though they were facing business cycles, market and economic conditions similar to the tested party.

One of the major substantive challenges faced by taxpayers is the availability of data in public domain of independent enterprises selected as comparables. Typically, there is a time lag of the data being available in the databases; in practice it is seen that for a limited number of comparable companies, data is available for the year for which the transactions are being tested. However, when the tax administration in India performs transfer pricing audits subsequently say after 3 years, they have the advantage of more information being available to them on such companies for the year for which they are conducting the audit. For example, when X Ltd prepared the transfer pricing analysis in relation to financial year ended 31 March 2020 (FY 2019-20), it did so based on the information available to it of comparable companies at that point of time. Typically, the case of X Ltd would be scrutinized during FY 2022-23 at that time the tax administration would have access to updated information on comparable companies with data for FY 2019-20.

2.3 Uncertain valuation and unpredictable future events

In the case of intangibles, when the valuation of an intangible is highly uncertain at the time of the transaction, then tax authorities might reasonably impute price adjustment clauses in the agreement, shorten the term of the contract, assume re-negotiation, or adopt any other approach they think third parties would adopt. If the taxpayer sets prices at an arm's-length levels for the intangible, then the tax authority should not be permitted to test prices and impute adjustments simply because the *ex post* realization of results is different from the *ex-ante* expected results.

The *ex-ante* and the *ex-post* approaches should target different circumstances and should result in different consequences. If the taxpayer is using an *ex-ante* approach, it is arguably attempting to prove the arm's length nature of the process it followed in establishing its transfer prices. If such an approach is followed and appropriately documented by the taxpayer,

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then the tax authority should not be entitled to use an *ex-post* approach to suggest that price adjustment clauses or prospective renegotiations should have been included in the arrangement provided the transfer prices fell within a reasonable range of results. If the taxpayer uses an *ex-post* approach to justify their pricing, then tax authorities might be entitled to argue that price adjustment clauses or prospective renegotiations should have been considered.

The transfer pricing adjustments are often performed before the end of the financial year, as a result of the transfer pricing analysis of the company's preliminary results. In these cases, the transfer pricing adjustment is typically reflected in its accounting books for that financial year and its tax return. In these cases, the commercial arrangements (invoices etc.) and custom duties, if applicable, should be corrected before the year-end.

If the results of the inter-company transactions were not adjusted and the corresponding credit/debit notes were not issued before the end of the financial year, it is still possible to perform adjustments at the time of filing the tax return (subject to applicability of Section 92CE of the Act).

Separately, the UN TP Manual recognizes that there can be problems in obtaining reliable comparables data, because there is commonly either a lack of reliable local comparables or an inability to access public data on uncontrolled comparables. Accordingly, while the use of comparables from the same geographic market is generally preferred, the UN TP Manual supports a flexible approach in searching for comparables, including the use of foreign comparables. It also recognizes the potential for geographic market differences affecting the reliability of foreign comparables, and the need to make reliable comparability adjustments to take into account any such differences.

Similarly, the OECD TP Guidelines recognize that geographic markets are an important comparability factor, and that while foreign comparables can be used, reasonably accurate adjustments are needed to account for any geographic market differences.

2.4 Guidance under OECD and UN TP manual on timing issues

The UN Manual seeks consistency with the OECD TP Guidelines in applying the arm's length principle found in Article 9 of both the UN Model Convention and the OECD Model Convention. As a result, there is a fundamental consistency between the UN TP Manual and the OECD TP Guidelines. While there are some differences between the two, those tend to reflect differences in perspective and emphasis, rather than differences in the principles to be applied.

On this issue, the UN TP manual, as a general rule, suggests that contemporaneous data most likely reflects similar economic conditions and ensures a higher degree of comparability. However, the manual recognizes that as an *exception*, multiple year data may also be used when it reveals facts which could have an influence on the determination of transfer prices. This appears to be a departure from the OECD TP guidelines, which do not seem to suggest the use of multiple year data only on *exception* basis. On the other hand, similar to OECD TP

Guidelines, the UN TP manual also states that the circumstances that may warrant consideration of data from multiple years include the effect of business cycles in the taxpayers industry or the effects of life cycles for a particular product or intangible.

It may be noted that the OECD TP guidelines say that multiple year data 'should' be used where it 'adds value' to the TP analysis. The UN TP Manual varies a bit on this aspect, as it states that multiple year data 'may' be used where it 'adds value' and 'makes the TP analysis more reliable'.

Needless to say, the onus to establish whether the TP analysis has become more reliable by using multiple year data or whether its use has added value would lie with the taxpayer. In the Indian context, the taxpayers have historically not been able to convince Indian tax authorities in this regard. However, the Finance Act (2), 2014 has amended the Indian transfer pricing regulations to allow the use of multiple year data for comparability analysis as against the practice of allowing the use of multiple year data only if certain conditions, which are difficult to evidence, are met.

2.5 Conclusion

Timing of a comparability analysis is an important criterion for validating the arm's length nature of a transaction that an enterprise enters into with its AEs. It is always advisable to have an arm's length analysis undertaken prior to the commencement of such transactions and to ensure that the same is monitored on a regular basis through a comparability analysis. However, the practical problems faced by taxpayers on account of lack of reliable data continue to exist and therefore it is important to adopt a broader and a more flexible approach while carrying out a comparability analysis.

3. Case study for use of available data base

Rule 10D of the Rules require that every person who has entered into an international transaction should maintain certain information and documentation. The list of information and documentation are also listed in Rule 10D of the Rules.

One of the information /documentation required is record of actual working carried out by the taxpayer for determining ALP including details of the comparable data. The rule further states that the information and documentation specified under sub rules (1) and (2) should as far as possible be contemporaneous and should exist latest by the specified date referred to in clause (iv) of section 92 F of the Act. However, the Rules do not specifically mention how information with respect to the comparables is to be gathered.

Chapter 3 of "The UN Practical Manual on Transfer Pricing for Developing Countries" provides detailed guidance on comparability issues.

The Manual states that comparable search criteria should be developed based upon the results of the five comparability factors in relation to the controlled transaction. These criteria must facilitate the identification of those external uncontrolled transactions that meet the

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requirements of comparability vis-à-vis the controlled transaction and tested party.

It further states that the search criteria should be set in a manner so as to select the most reliable comparables. However, the initial search criteria should not be overly restrictive, in order not to set unrealistic expectations in terms of comparability. Reasonably accurate comparability adjustments can be performed on selection of the potential comparables and where necessary, to enhance the reliability of the comparisons. Availability of reliable comparables will influence the choice of the MAM for transfer pricing.

The following broadly defined criteria are illustrative of those typically employed in an initial search process to identify and screen potential external comparables. The selection criteria must be tailored to the characteristics of the controlled transaction under examination. The criteria below must be matched with the specific transfer pricing method chosen:

- Comparables will generally be selected among companies performing the same or similar mix of functions as the tested party and operating at the same level of market; and
- Scale of operations

The OECD TP Guidelines state that the process followed to identify potential comparables is critical and should be transparent, systematic and verifiable. Choice of selection criteria should reflect the most meaningful economic characteristics of the transactions compared and will therefore have a significant influence on the outcome of the analysis.

A general source of information is commercial databases which have been developed by various organizations. These databases compile accounts filed by the companies with the relevant administrative bodies and present them in an electronic format suitable for searches and statistical analysis. These products typically provide detailed financial information as well as some textual information such as short business descriptions.

In India, databases commonly used by consultants and the tax administration include Prowess and Capitaline. These databases are used to search for companies engaged in activities that are similar to those that are sought to be benchmarked. In the recent past, the tax administration have also been open to accepting foreign databases where the entity being tested is a foreign entity, though the same is a litigative area.

Commercial databases are a practical and cost-effective way of identifying external comparables and may provide the most reliable source of information, depending on the facts and circumstances of the case.

The databases contain organized information about companies and provide the ability to sort quickly and retrieve selectively the desired results that meet certain screening criteria.

Companies under specific industries can be selected by way of application of certain search criteria on the databases. For example, companies under predefined industries, and certain keywords.

A case study is considered below to help understand how comparables can be determined under the Prowess database.

Case study: XYZ Group Limited is a company engaged in manufacturing smart cards. The production of smart cards is divided into 4 different steps:

- Module manufacturing
- Manufacturing of plastics
- Embedding of the module on the card
- Personalization

As part of XYZ Group's inter-company transactions, with the AEs, it outsources the function of embedding of the module on the card to XYZ (India) Pvt Ltd ("XYZ India").

Based on an analysis of functions, risks and assets, as well as availability of reliable data, XYZ India is selected as the tested party. A search on the database therefore has to focus on comparable companies engaged in activities similar to those carried out by XYZ India.

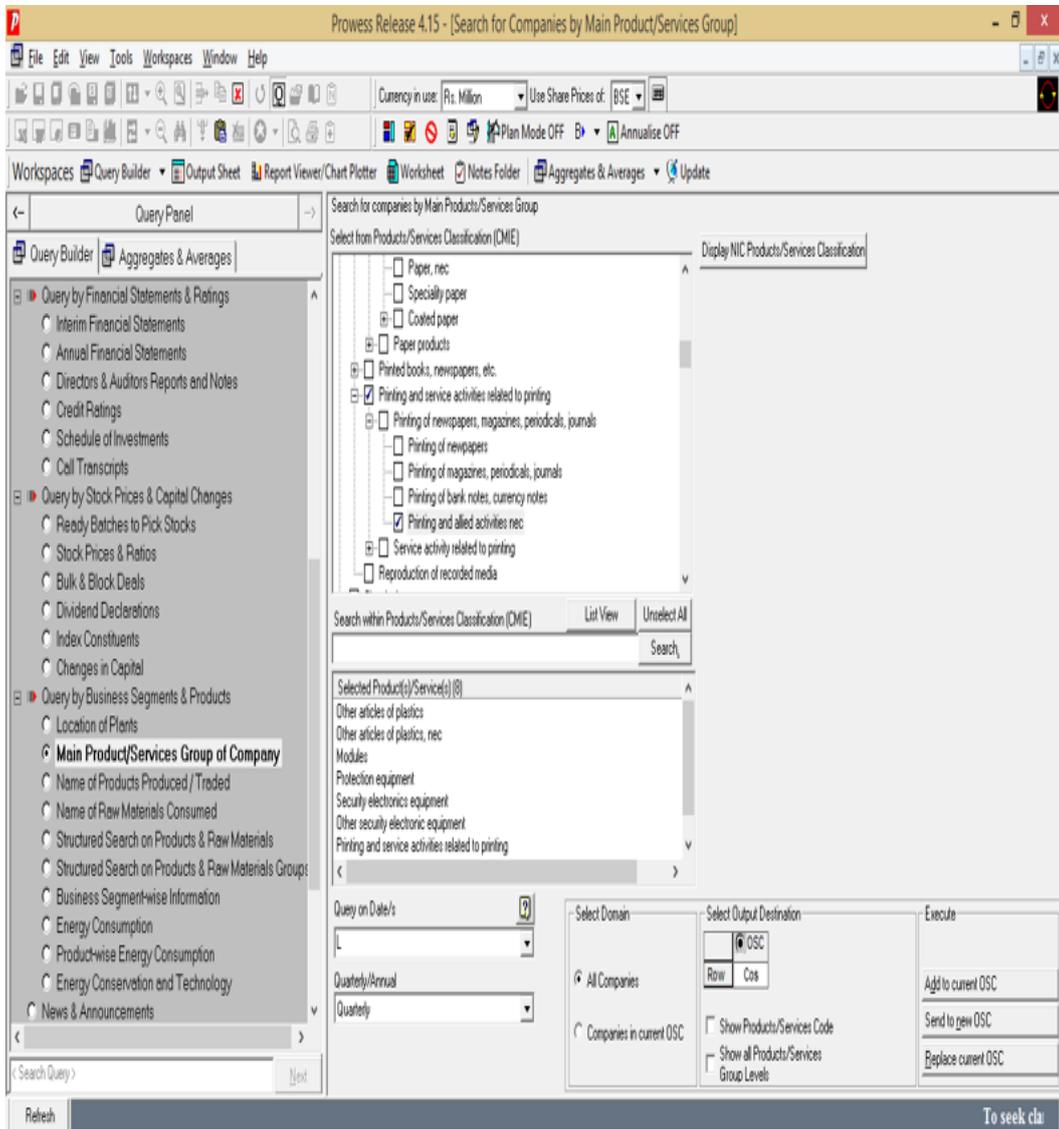
The search steps that may be carried out in Prowess database are as listed below.

Step 1: Based on an analysis of the international transactions, certain keywords closest to the activities under the covered international transaction are selected. The keywords are already provided by the vendor in the database and we need only make a selection. Accordingly, a search for broadly comparable companies can be conducted using the Query by Products section of Prowess, and under the following heads:

Main products services/group of companies:

- Other articles of plastic
- Other articles of plastic n.e.c
- Modules
- Protection equipment
- Security Electronics Equipment
- Other Security Electronic Equipment
- Printing and service activities related to printing
- Printing and allied activities n.e.c
- Engraving, etching and block making etc

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Note: Checking the main product for e.g. Printing and service activities related to printing does not automatically select the sub keywords under the said category. Each of the keywords have to be specifically selected after considering their relevancy to the transaction under review.

Once the keywords are selected, the companies selected under the search criteria should be saved so that they can be retrieved at a later time as required. In order to do this, companies selected under the keywords must first be transferred to an output sheet as shown below:

Prowess Release 4.15 - [Search for Companies by Main Product/Services Group]

File Edit View Tools Workspaces Window Help

Currency in use: Rs. Million Use Share Prices of: BSE

Plan Mode OFF Annualise OFF

Workspaces Query Builder Output Sheet Report Viewer/Chart Plotter Worksheet Notes Folder Aggregates & Averages Update

Query Panel

Search for companies by Main Product/Services Group

Select from Products/Services Classification (CME)

- Specially paper
- Coated paper
- Paper products
- Printed books, newspapers, etc.
- Printing and service activities related to printing

Display NIC Products/Services Classification

Executing Main Product/Services Group of Company Query

Scanning arguments

Stop

Abort

Search within Products/Services Classification (CME) List View Unselect All

engraving Search

Selected Product(s)/Service(s) (9)

- Other articles of plastics
- Other articles of plastics, nec
- Modules
- Protection equipment
- Security electronics equipment
- Other security electronic equipment
- Printing and service activities related to printing

Query on Date/s

Quarterly/Annual

Quarterly

Select Domain

All Companies

Companies in current OSC

Select Output Destination

OSC

Row Cos

Show Products/Services Code

Show all Products/Services Group Levels

Execute

Add to current OSC

Send to new OSC

Replace current OSC

Refresh

To seek clarifications on data and its operations, visit prowess.cmie.com

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Prowess Release 4.15 - [Output Sheet of Companies]

File Edit View Chart Tools Workspaces Window Help

Currency in use: Rs. Core Use Share Prices of: BSE Plan Mode OFF Annualise OFF

Output Sheet Report Viewer/Chart Plotter Worksheet Notes Folder Aggregates & Averages Update

Indices = 44

	1	2	3	4
	L	L	L	L
	Date	Main Products/Services Group	NIC Code	NIC Name
15	3/31/2014	Other security electronic equipment	27900	Manufacture of other electrical equipment
16	3/31/2006	Other articles of plastics, nec	22209	Manufacture of other plastics products n.e.c.
17	3/31/2011	Printing and service activities related to printing	18119	Other printing activities like screen printing other than textile n.e.c.
18	3/31/2013	Printing and service activities related to printing	18119	Other printing activities like screen printing other than textile n.e.c.
19	3/31/2014	Printing and allied activities nec	18119	Other printing activities like screen printing other than textile n.e.c.
20	3/31/2010	Other articles of plastics, nec	22209	Manufacture of other plastics products n.e.c.
21	3/31/2000	Other articles of plastics	22209	Manufacture of other plastics products n.e.c.
22	3/31/2012	Printing and service activities related to printing	18119	Other printing activities like screen printing other than textile n.e.c.
23	3/31/2004	Security electronics equipment	27900	Manufacture of other electrical equipment
24	3/31/2014	Other articles of plastics, nec	22209	Manufacture of other plastics products n.e.c.
25	3/31/2015	Other articles of plastics, nec	22209	Manufacture of other plastics products n.e.c.
26	3/31/2006	Printing and allied activities nec	18119	Other printing activities like screen printing other than textile n.e.c.
27	3/31/2013	Printing and service activities related to printing	18119	Other printing activities like screen printing other than textile n.e.c.
28	3/31/2011	Printing and service activities related to printing	18119	Other printing activities like screen printing other than textile n.e.c.
29	3/31/2012	Printing and service activities related to printing	18119	Other printing activities like screen printing other than textile n.e.c.
30	12/31/2014	Other articles of plastics	22209	Manufacture of other plastics products n.e.c.
31	3/31/2015	Printing and service activities related to printing	18119	Other printing activities like screen printing other than textile n.e.c.
32	12/31/2014	Other articles of plastics, nec	22209	Manufacture of other plastics products n.e.c.
33	3/31/2014	Other articles of plastics	22209	Manufacture of other plastics products n.e.c.
34	3/31/2015	Other articles of plastics, nec	22209	Manufacture of other plastics products n.e.c.
35	3/31/2012	Printing and allied activities nec	18119	Other printing activities like screen printing other than textile n.e.c.
36	9/30/2014	Other articles of plastics, nec	22209	Manufacture of other plastics products n.e.c.
37	3/31/2014	Printing and service activities related to printing	18119	Other printing activities like screen printing other than textile n.e.c.
38	3/31/2011	Other articles of plastics	22209	Manufacture of other plastics products n.e.c.
39	3/31/2012	Printing and service activities related to printing	18119	Other printing activities like screen printing other than textile n.e.c.
40	3/31/2012	Printing and service activities related to printing	18119	Other printing activities like screen printing other than textile n.e.c.

Refresh [click clarifications on data and its operations, visit prowess.cmie.com](#)

Prowess Release 4.15 - [Output Sheet of Companies]

File Edit View Chart Tools Workspaces Window Help

Currency in use: Rs. Million Use Share Prices of: BSE Plan Mode OFF Annualise OFF

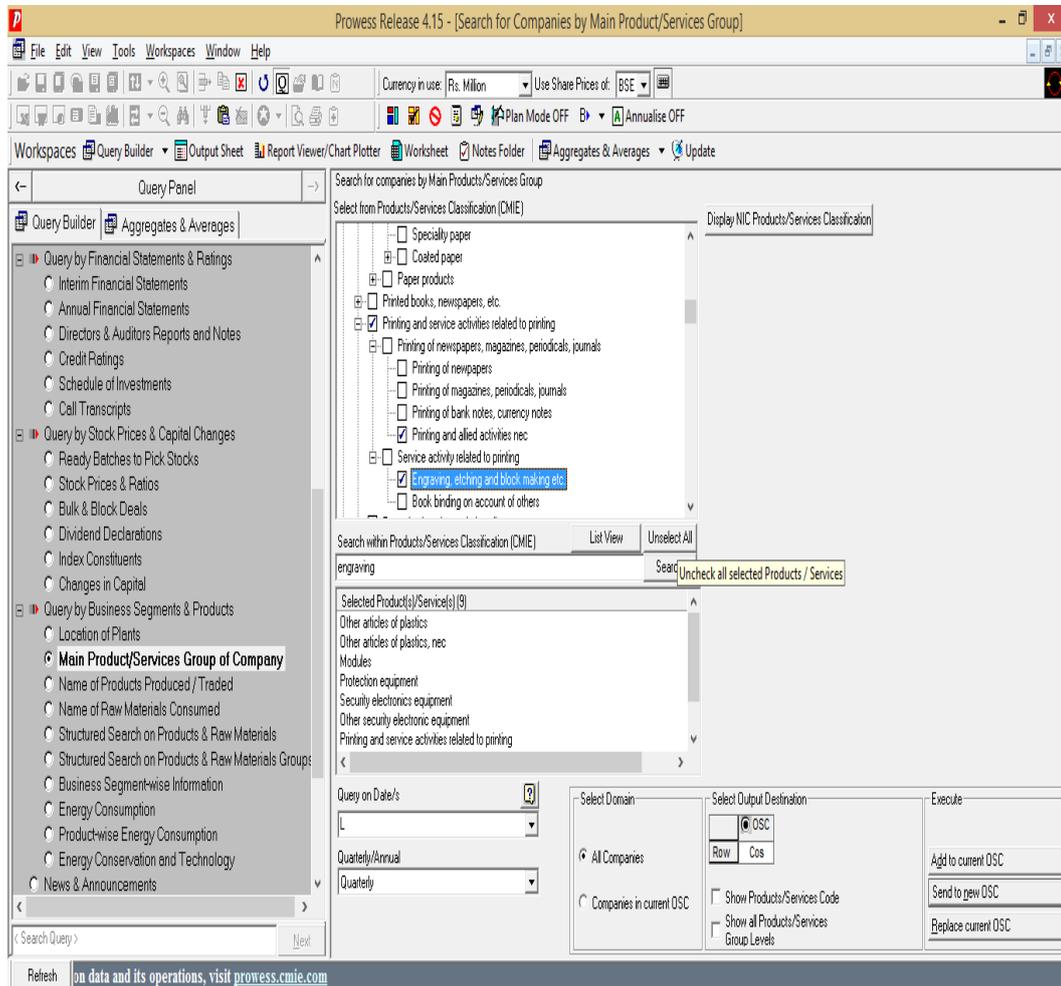
Workspaces Query Builder Output Sheet Report Viewer/Chart Plotter Worksheet Notes Folder Aggregates & Averages Update

Sheet0 Sheet1

No. of Companies/ Indices = 44	1	2	3	4
	L	L	L	L
Company Name	Date	Main Products/Services Group	NIC Code	NIC Name
1	3/31/2014	Other electrical equipment	27900	Manufacture of other electrical equipment
2	3/31/2006	Other plastics products n.e.c.	22209	Manufacture of other plastics products n.e.c.
3	3/31/2011	activities like screen printing other than textile n.e.c.	18119	Other printing activities like screen printing other than textile n.e.c.
4	3/31/2013	activities like screen printing other than textile n.e.c.	18119	Other printing activities like screen printing other than textile n.e.c.
5	3/31/2014	activities like screen printing other than textile n.e.c.	18119	Other printing activities like screen printing other than textile n.e.c.
6	3/31/2010	Other plastics products n.e.c.	22209	Manufacture of other plastics products n.e.c.
7	3/31/2000	Other plastics products n.e.c.	22209	Manufacture of other plastics products n.e.c.
8	3/31/2012	activities like screen printing other than textile n.e.c.	18119	Other printing activities like screen printing other than textile n.e.c.
9	3/31/2004	Other electrical equipment	27900	Manufacture of other electrical equipment
10	3/31/2014	Other plastics products n.e.c.	22209	Manufacture of other plastics products n.e.c.
11	3/31/2015	activities like screen printing other than textile n.e.c.	18119	Other printing activities like screen printing other than textile n.e.c.
12	3/31/2006	activities like screen printing other than textile n.e.c.	18119	Other printing activities like screen printing other than textile n.e.c.
13	3/31/2013	activities like screen printing other than textile n.e.c.	18119	Other printing activities like screen printing other than textile n.e.c.
14	3/31/2011	activities like screen printing other than textile n.e.c.	18119	Other printing activities like screen printing other than textile n.e.c.
15	3/31/2012	activities like screen printing other than textile n.e.c.	18119	Other printing activities like screen printing other than textile n.e.c.
16	12/31/2014	Other plastics products n.e.c.	22209	Manufacture of other plastics products n.e.c.
17	3/31/2015	activities like screen printing other than textile n.e.c.	18119	Other printing activities like screen printing other than textile n.e.c.
18	12/31/2014	Other articles of plastics, nec	22209	Manufacture of other plastics products n.e.c.
19	3/31/2014	Other articles of plastics	22209	Manufacture of other plastics products n.e.c.
20	3/31/2015	Other articles of plastics, nec	22209	Manufacture of other plastics products n.e.c.
21	3/31/2012	Printing and allied activities nec	18119	Other printing activities like screen printing other than textile n.e.c.
22	9/30/2014	Other articles of plastics, nec	22209	Manufacture of other plastics products n.e.c.
23	3/31/2014	Printing and service activities related to printing	18119	Other printing activities like screen printing other than textile n.e.c.
24	3/31/2011	Other articles of plastics	22209	Manufacture of other plastics products n.e.c.
25	3/31/2012	Printing and service activities related to printing	18119	Other printing activities like screen printing other than textile n.e.c.
26	3/31/2012	Printing and service activities related to printing	18119	Other printing activities like screen printing other than textile n.e.c.

Save As dialog box: Save in: XYZ India, Name: No items match your search, File name: Main products services set - 44 companies, Save as type: User Sets Files (*.psu)

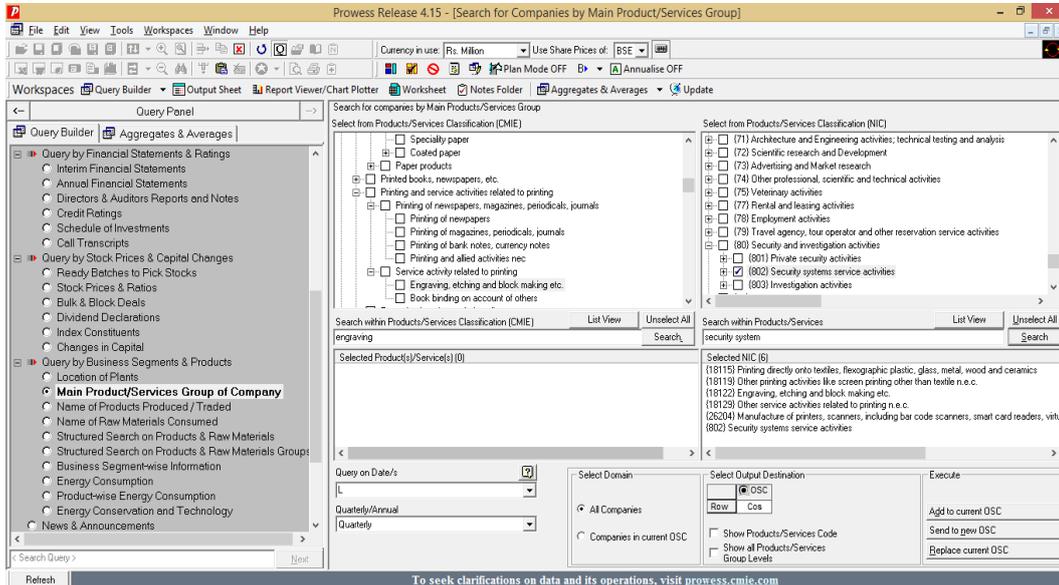
This screen needs to be cleared before moving onto the next search criteria by going back to the query builder and checking “Unselect all”.



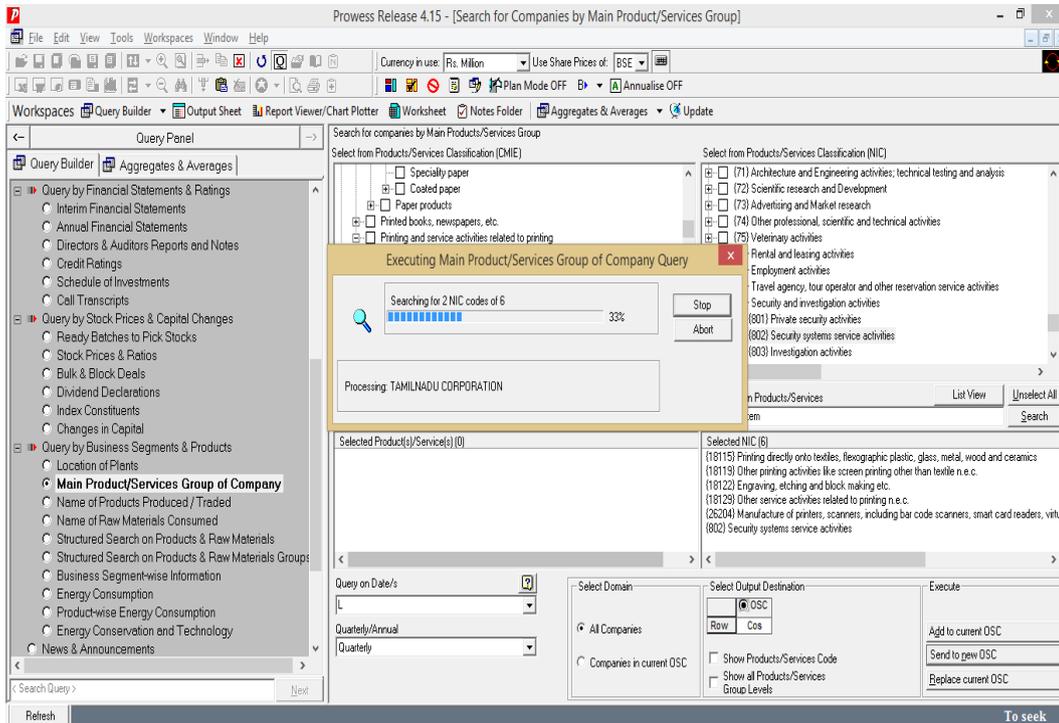
Step 2: Further, additional companies may be identified by using certain NIC codes as follows :

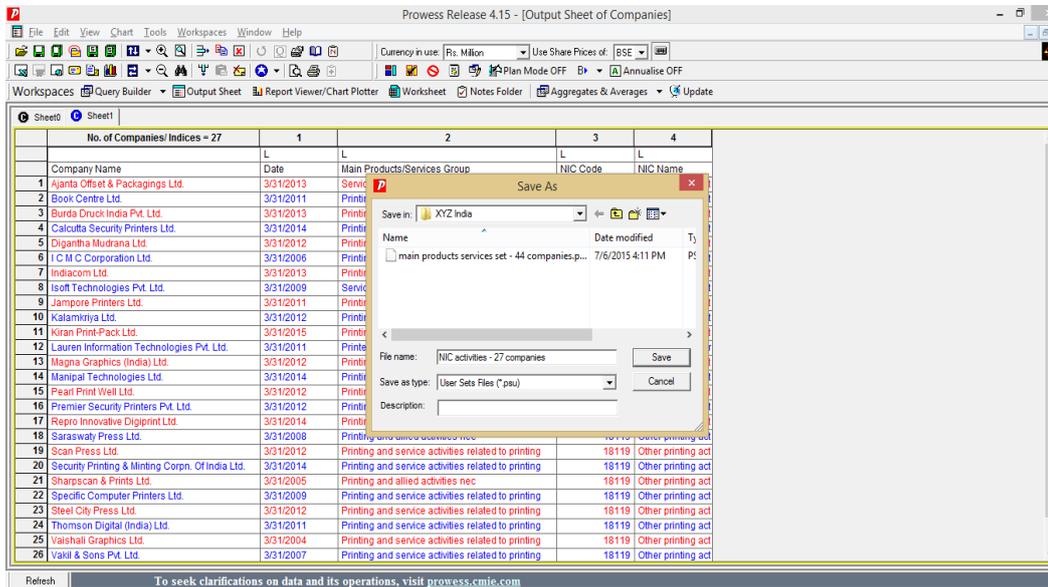
- Printing directly onto textiles, flexographic plastic, glass, metal, wood and ceramics
- Other printing activities like screen printing other than textile nec
- Engraving, etching and block making etc
- Other service activities related to printing nec
- Manufacture of printers, scanners, including bar code scanners, smart card readers, virtual reality helmets, computer projectors (video beamers)
- Security systems service activities

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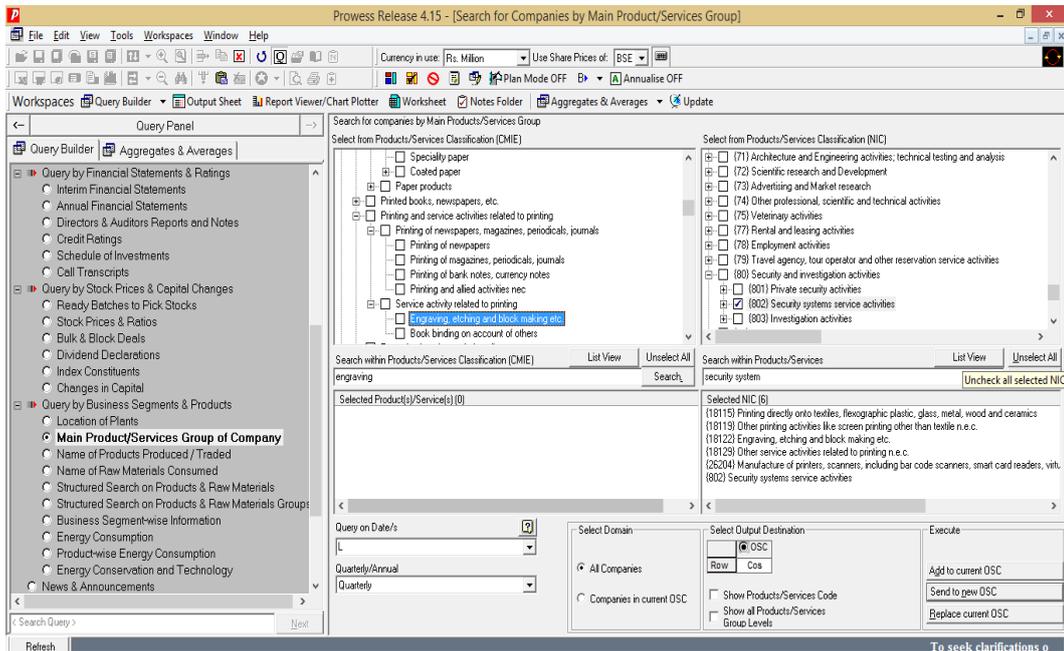


Again, the companies selected under this step should be saved as a peer set by transferring the companies to an output screen as shown below:





This screen needs to be cleared before moving onto the next screen by going back to the query builder and checking “Unselect all”.



Step 3: The *Query by Product Name* option can be used to identify all companies having the following variables in their product name / company name:

- 32K/36K Mobile Cards
- 64 KB Data Card

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- 64K Cards
- Card
- Card/ Gill/ Metapin
- Card Frames
- Card Personalization Income
- Card
- Data Card
- Debit Card Operations
- HID/ Card Print
- High Production Card
- I D Cards
- ID/ Membership, Scratch Cards
- ITZ Cash Cards
- ID Card
- International Roaming Cards
- Magnetic Stripe Cards
- Memory card
- Mobiles & Pre Paid Card
- Patch Card
- Pen Drives & Cards
- Plastic Cards
- Plastics Cards
- Prepaid Card
- Sale of Small Optical Cards
- Sim Cards
- Sim Cards & Accessories
- Smart Card Sales
- Smart Cards
- Telecard Service
- VC Cards
- Visacard Income

Prowess Release 4.15 - [Search for Companies by Name of Products Produced / Traded]

File Edit View Tools Workspaces Window Help

Currency in use: Rs. Million Use Share Prices of: BSE

Workspaces Query Builder Output Sheet Report Viewer/Chart Plotter Worksheet Notes Folder Aggregates & Averages Update

Query Panel

Query Builder Aggregates & Averages

- Query by Financial Statements & Ratings
 - Interim Financial Statements
 - Annual Financial Statements
 - Directors & Auditors Reports and Notes
 - Credit Ratings
 - Schedule of Investments
 - Call Transcripts
- Query by Stock Prices & Capital Changes
 - Ready Batches to Pick Stocks
 - Stock Prices & Ratios
 - Bulk & Block Deals
 - Dividend Declarations
 - Index Constituents
 - Changes in Capital
- Query by Business Segments & Products
 - Location of Plants
 - Main Product/Services Group of Company
 - Name of Products Produced / Traded**
 - Name of Raw Materials Consumed
 - Structured Search on Products & Raw Materials
 - Structured Search on Products & Raw Materials Groups
 - Business Segment-wise Information
 - Energy Consumption
 - Product-wise Energy Consumption
 - Energy Conservation and Technology
 - News & Announcements

Start Typing Product Name for Auto Search

Enter Pattern for Search within Product Name

Product Names: 83

PLASTIC CARD EMBOSSING MACHINES
 PLASTIC CARDS
 PLASTICS CARDS
 PREGNANCY TEST CARD
 PREPAID CARD
 PRINTED CARDBOARD CARTONS
 PRINTER LOGIC CARD
 PRINTER PCI CARD
 PRINTING PAPERS & CARD BOARDS
 RADIO, H.P.AMPLIFIERS, ANTENNA R.F. UNIT CARDS ETC
 SALE OF DISCARDED ASSETS
 SALE OF SMALL OPTICAL CARDS
 SIM CARDS
 SIM CARDS & ACCESSORIES
 SMART CARD DATA MANAGEMENT
 SMART CARD SALES
 SMART CARDS
 TELECARD SERVICE
 V C CARDS
WISACARD INCOME
 WOOLLEN, WORSTED, COTTON WASTE & ASBESTOS CARD CLD

Selected Product Names: 32

32K/38K MOBILE CARDS
 64 KB DATA CARD
 64K CARDS
 CARD
 CARD / GILL / METAPIN
 CARD FRAMES
 CARD PERSONALISATION INCOME
 DATA CARD
 DEBIT CARD OPERATIONS
 HID/ CARD PRINT
 HIGH PRODUCTION CARD
 I D CARDS
 I D/MEMBERSHIP,SCRATCH CARDS
 I T Z CASH CARDS
 ID CARD
 INTERNATIONAL ROAMING CARDS
 MAGNETIC STRIPE CARDS
 MEMORY CARD
 MOBILES & PRE PAID CARD
 PATCH CARD
 PEN DRIVES & CARDS
 PLASTIC CARDS
 PLASTICS CARDS
 PREPAID CARD
 SALE OF SMALL OPTICAL CARDS
 SIM CARDS
 SIM CARDS & ACCESSORIES
 SMART CARD SALES
 SMART CARDS

List of selected products

Select Domain: All Companies Companies in current OSC

Select Output Destination: OSC Row Cos

Execute: Add to current OSC Send to new OSC Replace current OSC

Refresh [to seek clarifications on data and its operations, visit prowess.cmie.com](http://www.prowess.cmie.com)

4.24 International Tax — Transfer Pricing

The screenshot displays the Prowess Release 4.15 software interface. The main window title is "Prowess Release 4.15 - [Search for Companies by Name of Products Produced / Traded]". The menu bar includes File, Edit, View, Tools, Workspaces, Window, and Help. The toolbar contains various icons for file operations and data management. The main workspace is divided into several panels:

- Query Panel:** Contains a search input field with the text "CARD" and a "Search" button. Below it, a "Full Load" button is visible.
- Query Builder:** A tree view on the left side of the main workspace, showing various search criteria categories such as "Query by Financial Statements & Ratings", "Query by Stock Prices & Capital Changes", and "Query by Business Segments & Products". The "Name of Products Produced / Traded" option is currently selected.
- Product List:** A large list of product names is displayed on the right side of the main workspace, including items like "32K/38K MOBILE CARDS", "64 KB DATA CARD", "84K CARDS", "CARD", "CARD / GILL / METAPIN", "CARD FRAMES", "CARD PERSONALISATION INCOME", "CARD OPERATIONS", "CARD PRINT", "PRODUCTION CARD", "DS", "MEMBERSHIP, SCRATCH CARDS", "SH CARDS", "INTERNATIONAL ROAMING CARDS", "MICRO STRIPE CARDS", "Y CARD", "S & PRE PAID CARD", "SIM CARDS", "SIM CARDS & ACCESSORIES", "SMART CARD DATA MANAGEMENT", "SMART CARD SALES", "SMART CARDS", "TELECARD SERVICE", "V C CARDS", "VISACARD INCOME", and "WOOLLEN, WORSTED, COTTON WASTE & ASBESTOS CARD CLO".
- Progress Dialog Box:** A modal dialog box titled "Executing Name of Products Produced / Traded Query" is overlaid on the main workspace. It features a progress bar showing "Searching for 13 products of 32" at 40% completion. Below the progress bar, it displays "Processing: M-TECH INNOVATIONS LTD." and "Found: 1". The dialog includes "Stop" and "Abort" buttons.
- Output Destination:** At the bottom right, there is a section for "Select Output Destination" with radio buttons for "OSC" (selected) and "Row / Cos". Below this are buttons for "Add to current OSC", "Send to new OSC", and "Replace current OSC".

The bottom status bar contains a "Refresh" button on the left and the text "To seek clarifications on data and its op" on the right.

Comparables 4.25

Prowess Release 4.15 - [Output Sheet of Companies]

No. of Companies/ Indices = 36		1	2	3
Company Name	Product (1)	Product (2)	Product (3)	
1 Aditya Birla Telecom Ltd.	Data Card			
2 Asian Sky Shop Ltd.	IT Z Cash Cards			
3 Bharti Cellular Ltd. (Merged)	Sim Cards			
4 Bharti Hexacom Ltd.	Sim Cards			
5 Bobcards Ltd.	Visacard Income	Debit Card Operations		
6 Bradma Of India Ltd. (Merged)	Plastic Cards			
7 Cardcom (India) Pvt. Ltd.	Plastics Cards			
8 Dhanus Technologies Ltd.	Telecard Service			
9 Digilife Distribution & Mktg. Services Ltd.	Memory Card			
10 E Cube India Solutions Ltd.	Card			
11 Gemalto Digital Security Pvt. Ltd.	32K/36K Mobile Cards	64K Cards		
12 Goa Electronics Ltd.	Smart Card Sales			
13 Idea Mobile Communications Ltd. (Merged)	Sim Cards			
14 Idea Telesystems Ltd.	Data Card			
15 Inis Smart Cards Ltd.	Plastic Cards	Smart Cards	Magnetic Stripe Cards	
16 Kerala State Electronics Devp. Corpn. Ltd.	ID Cards			
17 Krypton Industries Ltd.	Id Card			
18 Loop Mobile (India) Ltd.	Sim Cards & Accessories			
19 Loop Telecom Ltd.	Sim Cards			
20 M-Tech Innovations Ltd.	ID/Membership, Scratch Cards	Smart Cards		
21 Madhya Pradesh State Electronics Devp. Corpn. Ltd.	Hidi/ Card Print			
22 Moser Baer India Ltd.	Pen Drives & Cards			
23 Net Access (India) Pvt. Ltd.	Patch Card			
24 Precision Electronics Ltd.	64 Kb Data Card			
25 Ratan Glitter Inds. Ltd.	Prepaid Card	Mobiles & Pre Paid Card		
26 Rosmerita Technologies Ltd.	Smart Cards	Sale Of Small Optical Cards		
27 Schneider Electric President Systems Ltd.	Card Frames			

Refresh To seek clarifications on data and its operations, visit prowess.cmie.com

Prowess Release 4.15 - [Output Sheet of Companies]

No. of Companies/ Indices = 36		1	2	3
Company Name	Product (1)	Product (2)	Product (3)	
1 Aditya Birla Telecom Ltd.	Data Card			
2 Asian Sky Shop Ltd.	IT Z Cash Cards			
3 Bharti Cellular Ltd. (Merged)	Sim Cards			
4 Bharti Hexacom Ltd.	Sim Cards			
5 Bobcards Ltd.	Visacard Income	Debit Card Operations		
6 Bradma Of India Ltd. (Merged)	Plastic Cards			
7 Cardcom (India) Pvt. Ltd.	Plastics Cards			
8 Dhanus Technologies Ltd.	Telecard Service			
9 Digilife Distribution & Mktg. Services Ltd.	Memory Card			
10 E Cube India Solutions Ltd.	Card			
11 Gemalto Digital Security Pvt. Ltd.	32K/36K Mobile Cards	64K Cards		
12 Goa Electronics Ltd.	Smart Card Sales			
13 Idea Mobile Communications Ltd. (Merged)	Sim Cards			
14 Idea Telesystems Ltd.	Data Card			
15 Inis Smart Cards Ltd.	Plastic Cards	Smart Cards	Magnetic Stripe Cards	
16 Kerala State Electronics Devp. Corpn. Ltd.	ID Cards			
17 Krypton Industries Ltd.	Id Card			
18 Loop Mobile (India) Ltd.	Sim Cards & Accessories			
19 Loop Telecom Ltd.	Sim Cards			
20 M-Tech Innovations Ltd.	ID/Membership, Scratch Cards	Smart Cards		
21 Madhya Pradesh State Electronics Devp. Corpn. Ltd.	Hidi/ Card Print			
22 Moser Baer India Ltd.	Pen Drives & Cards			
23 Net Access (India) Pvt. Ltd.	Patch Card			
24 Precision Electronics Ltd.	64 Kb Data Card			
25 Ratan Glitter Inds. Ltd.	Prepaid Card	Mobiles & Pre Paid Card		
26 Rosmerita Technologies Ltd.	Smart Cards	Sale Of Small Optical Cards		
27 Schneider Electric President Systems Ltd.	Card Frames			

Save As

Save in: XYZ India

Name	Date modified	Type
main products services set - 44 companies.p...	7/6/2015 4:11 PM	PS
mic activities - 27 companies.psu	7/6/2015 4:13 PM	PS

File name: Product name -36 companies

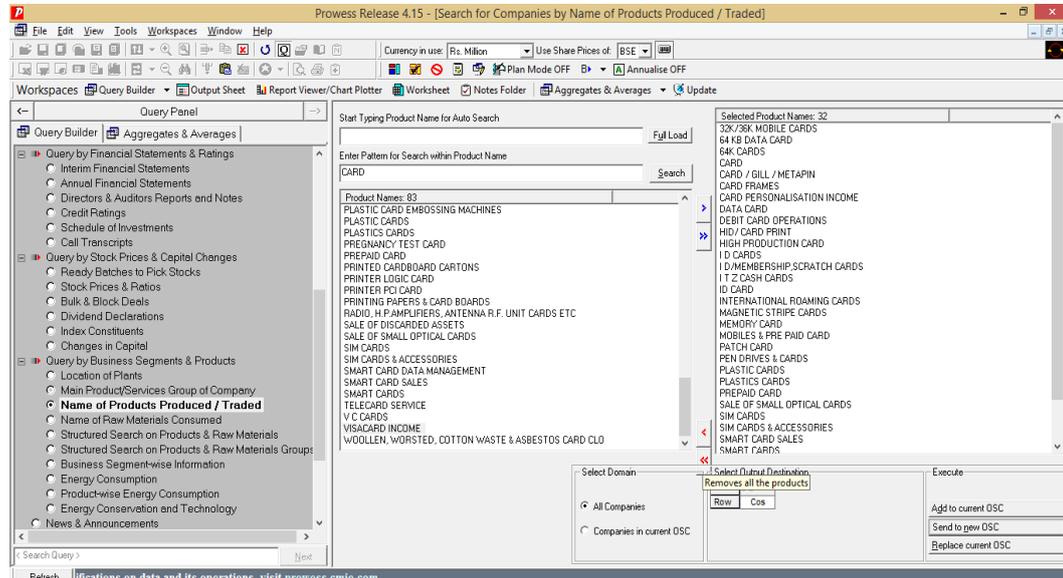
Save as type: User Sets Files (*.psu)

Description:

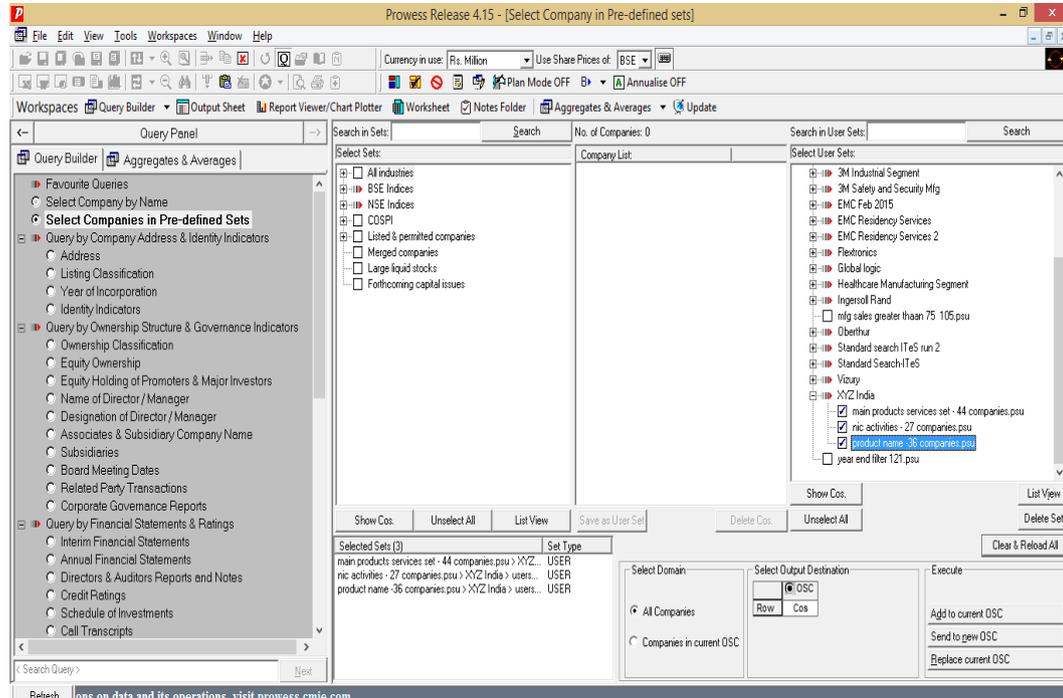
Refresh To seek clarifications on data and its operations, visit prowess.cmie.com

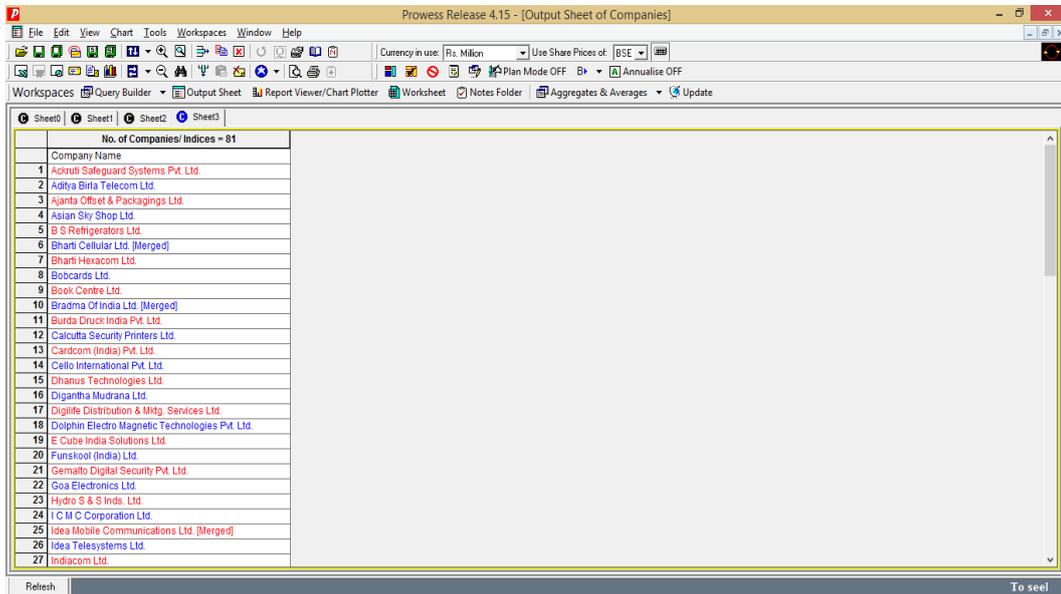
4.26 International Tax — Transfer Pricing

Unselecting the companies before moving onto combining the set;



Step 4: The peer sets should be combined as shown below so as to produce a “unique” set of companies identified under each search category.

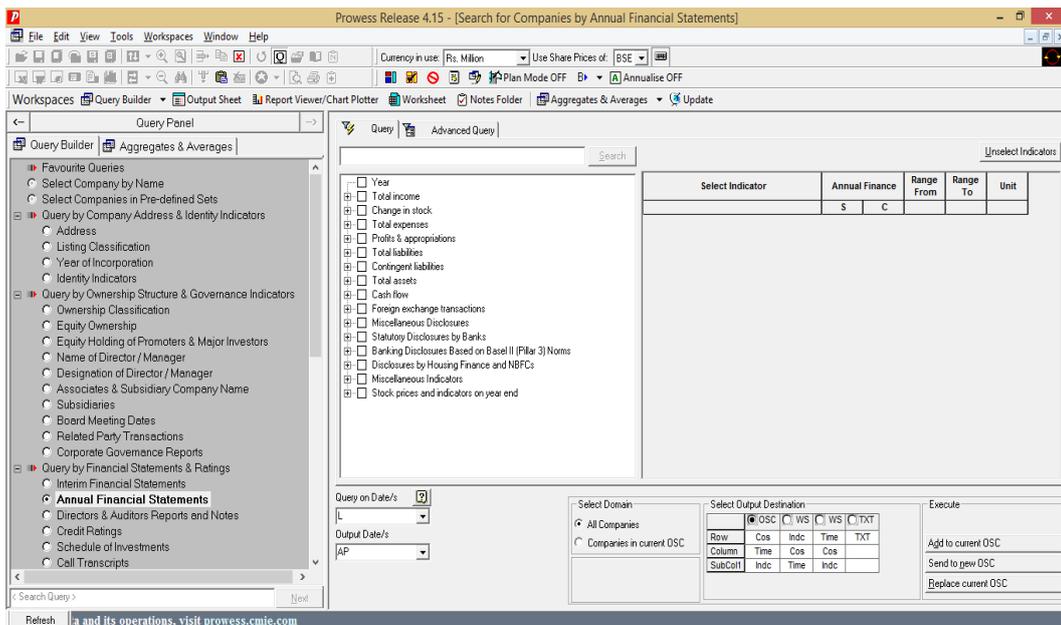




The search as can be seen in the above screenshot, has resulted in 81 unique companies.

These can be further refined to include companies that pass certain financial criteria. An example is provided below:

Step 5: The companies selected after the keyword criteria should have at least one year of financial information. This step is applied to the 81 companies output by going to the “advanced query” screen. At this point, we can also ensure that all values represented by the database is in INR “Crore” as shown below.



4.28 International Tax — Transfer Pricing

ProWess Release 4.15 - [Search for Companies by Annual Financial Statements]

Currency in use: Rs. Million Use Share Prices of: BSE

Mode OFF Annualise OFF

Workspaces Query Builder Output Sheet Report Viewer/Chart Plotter Worksheet Notes Folder Aggregates & Averages Update

Query Panel

Query Builder Aggregates & Averages

Favourite Queries

- Select Company by Name
- Select Companies in Pre-defined Sets
- Query by Company Address & Identity Indicators
 - Address
 - Listing Classification
 - Year of Incorporation
 - Identity Indicators
- Query by Ownership Structure & Governance Indicators
 - Ownership Classification
 - Equity Ownership
 - Equity Holding of Promoters & Major Investors
 - Name of Director / Manager
 - Designation of Director / Manager
 - Associates & Subsidiary Company Name
 - Subsidiaries
 - Board Meeting Dates
 - Related Party Transactions
 - Corporate Governance Reports
- Query by Financial Statements & Ratings
 - Interim Financial Statements
 - Annual Financial Statements
 - Directors & Auditors Reports and Notes
 - Credit Ratings
 - Schedule of Investments
 - Call Transcripts

Select Expressions :

- Year[finance_year]
- Total income[total_income]
- Change in stock[chng_in_stk]
- Total expense[total_expense]
- Profits & appropriations
- Total liabilities[total_liabilities]
- Contingent liabilities[contingent_liab]
- Total asset[total_assets]
- Cash flow
- Foreign exchange transactions
- Miscellaneous Disclosures
- Statutory Disclosures by Banks
- Banking Disclosures Based on Basel II (Pillar 3) Norms
- Disclosures by Housing Finance and NBFCs
- Miscellaneous Indicators
- Stock prices and indicators on year end
- User-defined Expressions

Enter Indicator / Expression for Search : finance_year

Enter Indicator / Expression for Display in Output :

Order	Expression	Header	Unit
-------	------------	--------	------

Query on Date/s: Standalone/Consolidated
Annual Finance Standalone

Output Date/s: Standalone/Consolidated
Annual Finance Standalone

Select Domain: All Companies, Companies in current OSC

Select Output Destination: OSC, WS, TXT

Row	Col	Indc	Time	TXT
Column	Time	Col	Col	
SubCol1	Indc	Time	Indc	

Execute: Add to current OSC, Send to new OSC, Replace current OSC

Refresh To seek clarifications

ProWess Release 4.15 - [Search for Companies by Annual Financial Statements]

Currency in use: Rs. Crore Use Share Prices of: BSE

Plan Mode OFF Annualise OFF

Workspaces Query Builder Output Sheet Report Viewer/Chart Plotter Worksheet Notes Folder Aggregates & Averages Update

Query Panel

Query Builder Aggregates & Averages

Favourite Queries

- Select Company by Name
- Select Companies in Pre-defined Sets
- Query by Company Address & Identity Indicators
 - Address
 - Listing Classification
 - Year of Incorporation
 - Identity Indicators
- Query by Ownership Structure & Governance Indicators
 - Ownership Classification
 - Equity Ownership
 - Equity Holding of Promoters & Major Investors
 - Name of Director / Manager
 - Designation of Director / Manager
 - Associates & Subsidiary Company Name
 - Subsidiaries
 - Board Meeting Dates
 - Related Party Transactions
 - Corporate Governance Reports
- Query by Financial Statements & Ratings
 - Interim Financial Statements
 - Annual Financial Statements
 - Directors & Auditors Reports and Notes
 - Credit Ratings
 - Schedule of Investments
 - Call Transcripts

Select Expressions :

- Year[finance_year]
- Total income[total_income]
- Change in stock[chng_in_stk]
- Total expense[total_expense]
- Profits & appropriations
- Total liabilities[total_liabilities]
- Contingent liabilities[contingent_liab]
- Total asset[total_assets]
- Cash flow
- Foreign exchange transactions
- Miscellaneous Disclosures
- Statutory Disclosures by Banks
- Banking Disclosures Based on Basel II (Pillar 3) Norms
- Disclosures by Housing Finance and NBFCs
- Miscellaneous Indicators
- Stock prices and indicators on year end
- User-defined Expressions

Enter Indicator / Expression for Search : finance_year

Enter Indicator / Expression for Display in Output :

Order	Expression	Header	Unit
-------	------------	--------	------

Query on Date/s: Standalone/Consolidated
[201303-2014] Annual Finance Standalone

Output Date/s: Standalone/Consolidated
Annual Finance Standalone

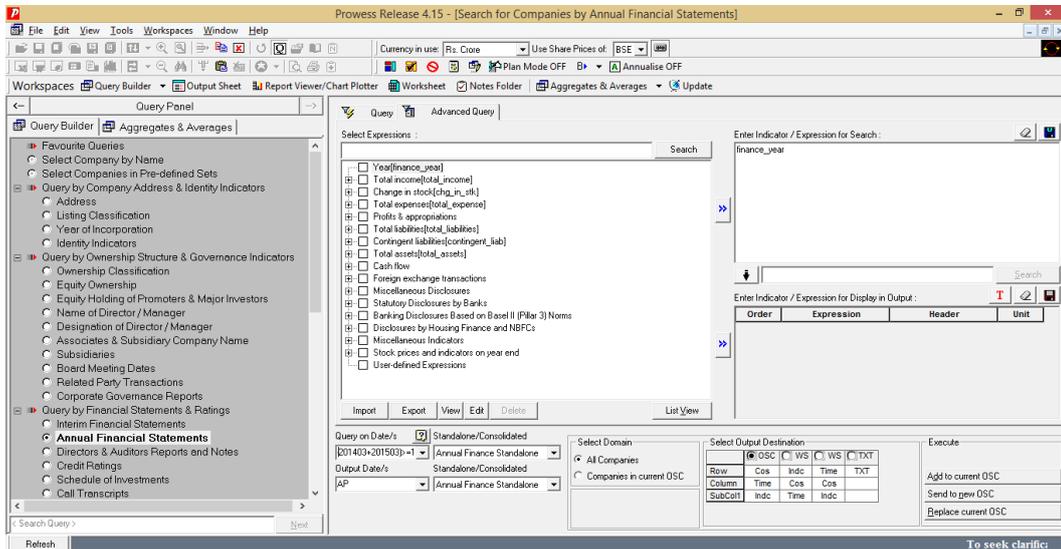
Select Domain: All Companies, Companies in current OSC

Select Output Destination: OSC, WS, TXT

Row	Col	Indc	Time	TXT
Column	Time	Col	Col	
SubCol1	Indc	Time	Indc	

Execute: Add to current OSC, Send to new OSC, Replace current OSC

Refresh [k clarifications on data and its operations, visit prowess.com](http://www.prowess.com)



Note: One needs to make sure that “Companies in current OSC” is selected to ensure that the screen is applied on the 81 companies only and not on all the companies in Prowess.

No. of Companies/ Indices = 37		1	2	3
		Annual Finance Standalone	Annual Finance Standalone	Annual Finance Standalone
Company Name		finance_year	finance_year	finance_year
1	Akruti Safeguard Systems Pvt. Ltd.	3/31/2013	3/31/2014	
2	Aditya Birla Telecom Ltd.	3/31/2013	3/31/2014	
3	Ajantra Offset & Packagings Ltd.	3/31/2013		
4	Bharti Hexacom Ltd.	3/31/2013		
5	Burda Druck India Pvt. Ltd.	3/31/2013		
6	Calcutta Security Printers Ltd.	3/31/2013	3/31/2014	
7	Digitlife Distribution & Mktg. Services Ltd.	6/30/2013	6/30/2014	6/30/2014
8	Funskool (India) Ltd.	3/31/2013	3/31/2014	
9	Hydro S & S Inds. Ltd.	3/31/2013	3/31/2014	
10	Idea Telesystems Ltd.	3/31/2013	3/31/2014	
11	Indiacom Ltd.	3/31/2013		
12	Kemrock Industries & Exports Ltd.	9/30/2013	9/30/2013	
13	Kiran Print-Pack Ltd.	3/31/2013	3/31/2014	
14	Khalpana Industries (India) Ltd.	3/31/2013	3/31/2014	
15	Krypton Industries Ltd.	3/31/2013	3/31/2014	
16	Loop Telecom Ltd.	3/31/2013		
17	M-Tech Innovations Ltd.	3/31/2013	3/31/2014	
18	Machino Plastics Ltd.	3/31/2013	3/31/2014	
19	Mahindra Composites Ltd. [Merged]	3/31/2013	3/31/2014	
20	Manipal Technologies Ltd.	3/31/2013	3/31/2014	
21	Moser Baer India Ltd.	3/31/2013	12/31/2013	12/31/2014
22	Net Access (India) Pvt. Ltd.	3/31/2013	3/31/2014	
23	Precision Electronics Ltd.	3/31/2013	3/31/2014	
24	Ratan Giffler Inds. Ltd.	3/31/2013		

4.30 International Tax — Transfer Pricing

Step 6: Further financial screens can be applied for e.g. we can select only those companies that have sales greater than 1 crore in any one of the 3 years of study (viz 2013, 2014 and 2015) as follows.

The screenshot shows the Proccess Release 4.15 interface for searching companies by annual financial statements. The 'Query Builder' window is active, displaying a list of 'Select Expressions' including 'Year[finance_year]', 'Total income[total_income]', 'Sales[sales]', and various income and expense categories. The 'Query on Date/s' is set to '201303-201403-20' and 'Annual Finance Standalone'. The 'Output Date/s' is 'AP'. The 'Select Domain' is 'Companies in current OSC'. The 'Select Output Destination' is 'OSC'. The 'Execute' button is visible at the bottom right.

The screenshot shows the 'Output Sheet of Companies' window in Proccess Release 4.15. The table displays sales data for 34 companies across three years: Mar 2013, Mar 2014, and Mar 2015. The 'Company Name' column lists various companies, and the sales values are displayed in the corresponding columns. The 'No. of Companies/Indices = 34' is displayed at the top of the table.

No. of Companies/Indices = 34				
	1	2	3	
	Annual Finance Standalone	Annual Finance Standalone	Annual Finance Standalone	
	Mar 2013	Mar 2014	Mar 2015	
Company Name	sales	sales	sales	
1 Acnuli Safeguard Systems Pvt. Ltd.		2.07		
2 Aditya Birla Telecom Ltd.	6.46			
3 Ajanta Offset & Packagings Ltd.	58.80			
4 Bharti Hexacom Ltd.	3666.10			
5 Burda Druck India Pvt. Ltd.	93.23			
6 Calcutta Security Printers Ltd.	13.25	20.90		
7 Digitlife Distribution & Mktg. Services Ltd.	645.33	609.35	609.35	
8 Funschool (India) Ltd.	100.64	122.19		
9 Hydro S & S Inds. Ltd.	176.34	199.33		
10 Idea Telesystems Ltd.	272.19	232.16		
11 Indiacom Ltd.	5.97			
12 Kemrock Industries & Exports Ltd.	464.12	464.12		
13 Kkaipana Industries (India) Ltd.	1274.33	1376.49		
14 Krypton Industries Ltd.	42.85	42.98		
15 M-Tech Innovations Ltd.	35.94	51.60		
16 Machino Plastics Ltd.	196.52	192.83		
17 Mahindra Composites Ltd. (Merged)	56.75	73.43		
18 Manipal Technologies Ltd.	432.78	487.62		
19 Moser Baer India Ltd.	1519.44	979.96	1023.28	
20 Net Access (India) Pvt. Ltd.	19.66	21.79		
21 Precision Electronics Ltd.	8.35	12.65		
22 Ratan Gifter Inds. Ltd.	4.47			
23 Repro Innovative Digiprint Ltd.	5.20	4.59		
24 Schneider Electric President Systems Ltd.	115.98	172.81		

Indices = 34			
	1	2	3
	Annual Finance Standalone	Annual Finance Standalone	Annual Finance Standalone
	Mar 2013	Mar 2014	Mar 2015
Company Name	sales	sales	sales
13 Kkaipana Industries (India) Ltd.	1274.33	1376.49	
14 Krypton Industries Ltd.	42.85	42.98	
15 M-Tech Innovations Ltd.	35.94	51.60	
16 Machino Plastics Ltd.	196.52	192.83	
17 Mahindra Composites Ltd. [Merged]	56.75	73.43	
18 Manipal Technologies Ltd.	432.78	487.82	
19 Moser Baer India Ltd.	1519.44	979.96	1023.28
20 Net Access (India) Pvt. Ltd.	19.66	21.79	
21 Precision Electronics Ltd.	8.35	12.65	
22 Ratan Giffler Inds. Ltd.	4.47		
23 Repro Innovative Digiprint Ltd.	5.20	4.59	
24 Schneider Electric President Systems Ltd.	115.98	172.81	

No. of Companies/ Indices = 34			
	1	2	3
	Annual Finance Standalone	Annual Finance Standalone	Annual Finance Standalone
	Mar 2013	Mar 2014	Mar 2015
Company Name	sales	sales	sales
1 Akrubi Safeguard Systems Pvt. Ltd.			
2 Aditya Birla Telecom Ltd.			
3 Ajanta Offset & Packagings Ltd.	5		
4 Bharati Hexacom Ltd.	39.6		
5 Burda Druck India Pvt. Ltd.	9		
6 Calcutta Security Printers Ltd.	1		
7 Digitlife Distribution & Mktg. Services Ltd.	6.4		
8 Funkskol (India) Ltd.	10		
9 Hydro S & S Inds. Ltd.	17		
10 Idea Telesystems Ltd.	27		
11 Indiacom Ltd.	1		
12 Kemrock Industries & Exports Ltd.	48		
13 Kkaipana Industries (India) Ltd.	127		
14 Krypton Industries Ltd.	4		
15 M-Tech Innovations Ltd.	3		
16 Machino Plastics Ltd.	196.52	192.83	
17 Mahindra Composites Ltd. [Merged]	56.75	73.43	
18 Manipal Technologies Ltd.	432.78	487.82	
19 Moser Baer India Ltd.	1519.44	979.96	1023.28
20 Net Access (India) Pvt. Ltd.	19.66	21.79	
21 Precision Electronics Ltd.	8.35	12.65	
22 Ratan Giffler Inds. Ltd.	4.47		
23 Repro Innovative Digiprint Ltd.	5.20	4.59	
24 Schneider Electric President Systems Ltd.	115.98	172.81	

A total of 34 companies are selected for further qualitative analysis.¹⁴ The set of unique companies identified are then considered for further qualitative analysis for FAR.

Once the companies are identified from the database they have to be further analysed for their functional comparability with the tested party and for this purpose, an illustrative set of steps for analysis outside the database is provided below.

¹⁴ Please note that the example above is for illustrative purposes only and should not be used to advise clients.

4.32 International Tax — Transfer Pricing

The business description of the 34 companies are analysed to assess if they are broadly performing the same functions as the tested party. On performing such a qualitative analysis, a few of the companies may be rejected for various reasons. Some of the reasons include rejecting companies if found to be engaged in unrelated functions for example, providers of unrelated manufacturing functions or providers of distribution functions. Companies may further be rejected if sufficient description cannot be found to corroborate the business of the company or if annual reports of the company cannot be found. The business descriptions of companies may be obtained from reliable sources such as annual reports of the companies, industry publications, internet websites etc.

The potential aspects may be further analysed to ensure that they are independent and do not have significant related party transactions (“RPT’s”) with their AEs. This step involves downloading the information on RPTs and computing the amounts in relation to the RPTs reported in the annual reports.

The RPTs in the nature of operating income/ expenses¹⁵ may be summed up and computed as a percentage of the total revenue of the company. However, there is more than one view prevailing on this, there are Income Tax Appellate Tribunals (Tribunal) rulings which say that while calculating RPT percentage income and expenses should be evaluated separately as a percentage of revenue and cost respectively.

If the RPT of a company exceeds a certain percentage, for example 15 percent, then the company may be rejected for having significant RPTs. Excess RPT may indicate that the company’s business activities including pricing of goods/ services are influenced by its association with AEs and therefore such a company may not be considered to be independent for it to be selected as a comparable company.

It is worth noting that the Tribunals in India vide various judicial rulings on transfer pricing arrangements have upheld the threshold of RPT filter at 15 percent in many cases and 25 percent in some cases for the purpose of selecting independent companies as comparables.

The above example is summarized in the table below for ease of reference with respect to the steps used in the illustration:

Particulars	Companies remaining
Total number of companies in Prowess	26,816
Companies selected on application of key words (industry, nice activities and product name)	81
Companies remaining after application of financial screens (at least 1 year of data and sales greater than INR 1 crore)	34
Companies selected after application of other qualitative filters	5

¹⁵ Operating income/ expense refers to income/ expense that arise in the ordinary course of a company’s normal business operations. For example, sales to AE’s, rent expense, purchase of goods from AE etc. However items that are capital in nature for example, interest, dividend, purchase of capital assets, etc. are not considered in RPT calculations.

Particulars	Companies remaining
including functional filters, RPT, etc.	
Final set of comparable companies	5

In this particular illustration, as can be seen from the table above, five companies pass all the qualitative filters. As the final step in comparability analysis, the PLIs of the 5 selected companies are computed. The PLI enables comparison of the tested party's ratios with those of the comparables. The PLI to be computed depends on various factors including choice of method, choice of tested party and an analysis of the functions, risks and assets of the tested party.

The Indian TP provisions (The Act as well as the Rules) do not provide any guidance on selection of the PLI. However, the OECD TP Guidelines¹⁶ provide the following;

“The denominator should be focused on the relevant indicator(s) of the value of the functions performed by the tested party in the transaction under review, taking account of its assets used and risks assumed. Typically, and subject to a review of the facts and circumstances of the case, sales or distribution operating expenses may be an appropriate base for distribution activities, full costs or operating expenses may be an appropriate base for a service or manufacturing activity, and operating assets may be an appropriate base for capital-intensive activities such as certain manufacturing activities or utilities. Other bases can also be appropriate depending on the circumstances of the case.

The denominator should be reasonably independent from controlled transactions; otherwise there would be no objective starting point. For instance, when analysing a transaction consisting in the purchase of goods by a distributor from an AE for resale to independent customers, one could not weight the net profit indicator against the cost of goods sold because these costs are the controlled costs for which consistency with the arm's length principle is being tested. Similarly, for a controlled transaction consisting in the provision of services to an AE, one could not weigh the net profit indicator against the revenue from the sale of services because these are the controlled sales for which consistency with the arm's length principle is being tested. Where the denominator is materially affected by controlled transaction costs that are not the object of the testing (such as head office charges, rental fees or royalties paid to an AE), caution should be exercised to ensure that said controlled transaction costs do not materially distort the analysis and in particular that they are in accordance with the arm's length principle.”

Accordingly, the appropriate PLI may be used to arrive at the ALP based on the margins of comparable companies and the same is then compared with that of the tested party to ascertain the arm's length nature of the transactions of the tested party with its AEs/related parties.

¹⁶ Para 2.93 and 2.94 in Chapter II

4. A comparison of Indian TP Rules with OECD and UN TP regulations

4.1 Introduction

The Indian Government introduced Transfer Pricing Regulations (“TPR”) in the Act vide Finance Act, 2001. The Indian TPR comprises of Sections 92 to 92F of the Act and Rule 10A to 10TG of the Rules which provides the code for compliance with the arm’s length principle in India.

On the global front, following are the extensively referred materials for guidance on implementation of the transfer pricing rules:

4.2 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

The said guidelines are agreed to be used by OECD member countries (comprising mainly of developed countries) for implementing their respective TPRs. The OECD TP Guidelines are referred to extensively worldwide, including India, which is not a member of OECD, however, has an observer status in the OECD forum.

It is relevant to note that OECD in light of concerns on Base Erosion and profit shifting (BEPS) expressed worldwide, had initiated Action Plans addressing the perceived flaws in the international tax rules, and the final reports on all 15 BEPS Action plans were released on 5 October 2015. Post October 2015, the focus has now shifted to the implementation of BEPS measures as described in the OECD reports. Further, OECD continues its efforts towards follow-up work on specific aspects of the BEPS actions as identified at the time of release of final reports. The final reports on all 15 BEPS Action plans are also meant to amend the existing guidelines on transfer pricing issued by OECD which were finally approved by the OECD Council by incorporating of BEPS amendments into the Transfer Pricing Guidelines in June 2016¹⁷ and the OECD released the 2017 edition of TP Guidelines on 10 July 2017, incorporating the said guidance. Further, the OECD published an updated TP Guidelines in 2022 to provide guidance on transactional profit method, HTVI and financial transactions.

4.3 The UN Practical Manual on Transfer Pricing for Developing Countries

Among other reasons, the UN Manual was issued in 2013, and revised in 2017 and recently in 2021 to address the difficulties faced by developing countries in applying the OECD TP Guidelines. While the said manual is broadly consistent with the OECD TP Guidelines, the differentiator is that the said Manual seeks to offer a practical guidance on how the TP Guidelines could be applied by developing countries by taking cognizance of their realities and priorities. One way the UN Manuals achieves this objective is by providing a chapter

¹⁷<http://www.oecd.org/tax/oecd-council-approves-incorporation-of-beps-amendments-into-the-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations.htm>

compiling four papers on country practices from China, India, Brazil, and South Africa (with a paper on Mexico added in 2017). The said papers were prepared by officials of the respective countries and each case seeks to inform the readers / users of the particular country experiences in dealing with transfer pricing issues in its specific country conditions.

Apart from the above, the guidelines issued by the European Union Joint Transfer Pricing Forum (EUTPJF), the transfer pricing rules contained in the US Internal Revenue Code 482, and the Australian and UK TPR are also useful reference points for the guidance on Transfer Pricing.

Considering that India is a member of the UN forum and has an observer status in the OECD forum, it is important to understand the confluence and diversities between the Indian TPR on the one hand and the guidelines on transfer pricing issued by the OECD and the UN, on the other.

4.4 Similarities between the Indian TPR, OECD TP Guidelines and the UN Manual

The Indian TPR, broadly and conceptually confirm to the guidelines on transfer pricing issued by the OECD and the UN. The said aspect could be understood by taking note of the following similarities between the OECD TP guidelines, UN Manual and the Indian TPR as listed in the below table.

Characteristics	OECD, UN and Indian TPR overview
Arm's Length Principle	All of them propagate on determination of transfer prices in accordance with the ALP / principle
Transfer Pricing Methods	They prescribe the same set of methodologies to test or validate the arm's length nature of transactions
Approach	They recommend a detailed functional analysis before undertaking the benchmarking analysis prescribing standards for comparability
Documentation	Detailed guidance provided on documentation required to be maintained is provided

4.5 Differences in the scope of the transfer pricing provision

The differences between the Indian TPR, and the OECD and UN transfer pricing guidelines could be noted from the finer analysis of the same. Some of the difference between the Indian TPR, and OECD and UN Guidelines are provided in the table below:

Table showing a comparison of the provisions contained in the Indian TPR vis-à-vis the UN TP manual and OECD TP Guidelines:

Characteristics	OECD TP Guidelines / UN Manual	Indian TPR	Point of difference
Authoritative statement imposing arm's length pricing requirement	<p>The authoritative statement of the arm's length principle is found in paragraph 1 of Article 9 of the OECD and UN Model Double Taxation Convention, which forms the basis of bilateral tax treaties involving OECD and UN member countries. Article 9 provides that: Where conditions are made or imposed between the two AEs in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.</p>	<p>Section 92 of the Act provides that any income arising from an international transaction shall be computed having regard to the ALP. It is further clarified in the explanation to the said provision that the allowance for any expenses or interest arising from an international transaction shall also be determined having regards to the ALP. The Indian TPR is also applicable to certain specified domestic transactions.</p>	<p>The Indian TPR applies to all the transactions between AEs which gives rise to income or expenses. On the other hand, Article 9 (1) of the OECD and UN model convention will apply only where conditions are made or imposed between the two AEs in their commercial or financial relations which differ from those which would be made between independent enterprises. The Indian TPR provides that any income from an international transaction shall be computed having regards to the ALP. It could be noted that the Indian TPR focuses only on determining ALP for a transaction and does not allow authorities to re-characterize a transaction. Conversely, Article 9 of the OECD and UN model convention</p>

Characteristics	OECD TP Guidelines / UN Manual	Indian TPR	Point of difference
			<p>focuses on arm's length conditions, therefore for example Article 9 of the model convention allows the authorities not only to determine whether the rate of interest in a loan contract is at arm's length, but also whether prima facie a loan can be regarded as a loan or it should be regarded as some other kind of payment such as contribution to equity capital.</p> <p>Further, OECD and UN guidelines being a guidance on implementing Article 9 of the bilateral agreement between two countries does not deal with any special consideration that should apply to transfer pricing of domestic transactions between related parties.</p>
Definition of AEs	<p>The OECD and the UN transfer pricing Guidelines refers to Article 9 of the model convention for the definition of AEs. Article 9 of the OECD and UN model double taxation avoidance</p>	<p>According to Section 92A of the Act, an AE is an enterprise which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital</p>	<p>The definition of the AEs is very extensive in the Indian TPR. Another difference between the definition of 'Associated Enterprises' in section 92A(1) of the Act and that in the OECD/UN</p>

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Characteristics	OECD TP Guidelines / UN Manual	Indian TPR	Point of difference
	<p>convention defines AEs as the following:</p> <p>(a) Where an enterprise of a Contracting State participates directly or indirectly, in the management, control or capital of an enterprise of the other Contracting State, or</p> <p>(b) The same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State.</p>	<p>of another enterprise. And it also covers situation where same persons participate directly or indirectly in the management, control or capital of an enterprise. Furthermore, the Act provides thirteen specific instances wherein two enterprises will be deemed to be AEs. These instances include voting power, loan value, total borrowings, and appointment of the Board or governing council, dependence on intellectual property of an enterprise, supply of raw materials and consumables, selling rights on products, controlling authority or mutual interest.</p>	<p>model conventions is that unlike the OECD/UN model conventions, section 92A(1) uses the words 'through one or more intermediaries' in section 92A(1). In other words, for the purpose of section 92A(1), it is made very clear that even if the participation is through an intermediary, the investing and the investee enterprises could be considered as an AE.</p>
<p>Definition of the International transaction</p>	<p>While the OECD Model Convention on Tax does not specifically address the concept of what kind of transactions will need to comply with ALP. However, from the reading of Article 9 (relating to AEs), it may be deduced that</p>	<p>Section 92B of the Act defines, transaction between two AEs, both or either of whom are non-residents. The international transactions has been specifically defined to include purchase, sale or</p>	<p>The provisions of section 92 read with section 92B apply to transactions even between two non-residents. Article 9 of the OECD or the UN Model apply to a transaction, only if one of the enterprises is a resident of one</p>

Characteristics	OECD TP Guidelines / UN Manual	Indian TPR	Point of difference
	<p>transactions resulting in profits to business enterprises would need to be comply with arm's length pricing.</p>	<p>lease of intellectual property, provision of services, lending or borrowing of money, or any transaction that has a bearing on the profits, incomes, assets and losses of the enterprise. Further, an international transaction shall include any mutual agreement between AE with regards to the allocation or apportionment of, or contribution to, any cost or expense incurred in relation to any benefit, service or facility to be provided by either of the enterprises. Further, as part of the statutory framework governing income tax, the transfer pricing law deems certain transactions with third parties to be international transactions. Where the transaction is entered into between parties who are not AEs within the meaning of the law, it will be deemed to be</p>	<p>Contracting State and the other enterprise is a resident of the other Contracting State (non-resident). In other words, Article 9 would not apply when there is a transaction between two non-residents. Further, concept of deeming a transaction with a third party as an international transaction is not provided for in Article 9 of the model convention.</p>

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Characteristics	OECD TP Guidelines / UN Manual	Indian TPR	Point of difference
		<p>an international transaction if there exists a prior agreement in relation to the relevant transaction or the terms of the relevant transaction are determined in substance by the two AEs.</p>	
<p>Issue of corresponding adjustment</p>	<p>Article 9 of the OECD and UN Model convention provides that where one contracting state taxes profits which would have accrued to the enterprise if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then the other state shall provide a corresponding adjustment to the amount of tax charged therein on those profits.</p>	<p>Section 92 of the Act on the other hand provides that the application of transfer pricing provisions cannot have the effect of reducing the income chargeable to tax or increasing the loss.</p>	<p>Unlike Article 9, the Indian TPR does not provide for the concept of corresponding adjustment specifically when it would reduce the income chargeable to tax in India.</p>

4.6 Differences in Application/determination of arm's Length Price

Characteristics	OECD TP Guidelines / UN Manual	Indian TPR
Methods prescribed	<p>The OECD and UN transfer pricing guidelines prescribe 5 methods viz. CUP, CPM, RPM, PSM and TNMM.</p> <p>Further, the OECD TP guidelines prescribes that any other method can also be used however the same should not be used in case any of the said five method are more appropriate to the facts and circumstances of the case. UN transfer pricing guidelines also acknowledges that several jurisdictions also apply the use of any other method apart from the said five.</p>	<p>The Indian TPR prescribe six methods viz. CUP, CPM, RPM, PSM and TNMM. Further, the Board has prescribed an additional method in Rule 10AB of the Rules. Such sixth method is any other method in addition to the above five prescribed methods for determination of the arm's length price in relation to an international transaction, provided the method 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.</p> <p>Use of any other method apart from the above six is not permissible unless it is prescribed by the Board.</p>
Computation of ALP in case of more than one comparable price being determined	<p>The OECD / UN guidelines approve the concept of arm's length range in principle. Where the price applied in a transaction is outside the range, then the OECD TP guidelines additionally prescribes the following:</p> <ul style="list-style-type: none"> In case the range comprises of results which are equal and highly reliable then any point in the range could be 	<p>The Indian TPR states that where more than one price is determined by the most appropriate method, then the ALP shall be taken to be the arithmetic mean of such prices. The Finance Act (No 2) 2014 has allowed the range concept for the purpose of determination of ALP. In this regard, the CBDT has also released a scheme providing the mechanism and conditions for</p>

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Characteristics	OECD TP Guidelines / UN Manual	Indian TPR
	<p>considered as the ALP; and</p> <ul style="list-style-type: none"> In case of comparability defects in the result of the range, it may be appropriate to use measures of central tendency to determine the ALP. 	<p>the usage of the Range concept while determining the ALP.</p>
Data for determination of the ALP	<p>Allows the use of multiple year data without any restriction on the number of years that can be considered.</p>	<p>Use of current year data along with two prior years is allowed for the purpose of comparability analysis. The use of data for two prior years is allowed subject to the taxpayer being able to evidence that the data for prior years reveals facts which could have an influence on the determination of the transfer price in relation to the transaction being compared. However, the Finance Act (No 2) 2014 has now allowed a liberal use of multiple year data. The CBDT has released a scheme providing the mechanism and the conditions for the use of multiple year data</p>
Penalties	<p>OECD TP guidelines suggest that penalties should be fair and not unreasonably, not unduly onerous for taxpayers. UN Guidelines provides that it would be unfair to impose sizeable penalties in cases that exerted reasonable efforts in good faith to undertake a sound transfer pricing analysis to ascertain arm's length pricing even if they did not fully satisfy documentation requirements.</p>	<p>Stringent penalties for non-compliance; Penalties imposed for transfer pricing adjustment, as well as for non-reporting of transactions, and non-maintenance of documentation.</p>

Characteristics	OECD TP Guidelines / UN Manual	Indian TPR
Use of foreign comparables	OECD TP guidelines, in principle, recognize the use of foreign comparable by making suitable adjustments if there is material effect on price due to geographical differences.	Indian TPR does not specifically prohibit use of foreign comparables. However, the revenue authorities have been reluctant to use overseas comparable laying strong preference for Indian comparables.

While in the recent time it could be said that the Indian TPR are broadly in line with the international transfer pricing guidelines issued by the OECD and the UN. The OECD as part of the BEPS initiative has issued several guidelines concerning transfer pricing which includes the following:

- Guidelines on transfer pricing documentation and country-by-country reporting;
- Guidance on transfer pricing aspects of intangibles;
- Transfer pricing guidelines relating to low-value adding intra-group services; and
- Transfer pricing aspects of cross border commodity transactions.

In light of these events, it will be interesting to see how India modifies its existing TPR to catch up with the recommendations contained in the said guidelines.

5. Selection of most appropriate method

The OECD TP Guidelines issued by the OECD in July 2010 (updated in 2017) and UN TP Manual by the United Nations in 2013 (and updated in 2017), broadly discuss on the selection of the most appropriate transfer pricing method. The transfer pricing methods are broadly categorized into Traditional transaction method and Transactional profit method.

- *Traditional transaction method*
 - CUP Method
 - RPM; and
 - CPM.
- *Transactional profit method*
 - TNMM; and
 - PSM.
- *Other method*

The traditional transaction method seeks to compute the price charged by the taxpayer in a controlled and uncontrolled transaction while the transactional profit method seeks to compute

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the operating profits earned by the taxpayer from such transactions. The price determined under traditional transaction method provides a reliable measure of “ALP” as compared to the profits determined under transactional profit method, because the profit and loss account based on which the margins are determined, is made up of several items of income and expense, that may not constitute international transactions or have a bearing on the determination of the transfer price.

With a view to providing flexibility to taxpayers to aid them to use any unspecified methods for the purpose of determination of ALP, the CBDT vide notification¹⁸ introduced the sixth transfer pricing method by making an amendment to the Rules as part of the Indian TPR. The Other method for the determination of ALP in relation to an international transaction shall be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between third parties, under similar conditions, considering all the relevant facts.

The use of the sixth method can be treated as the most appropriate method if none of the other methods specifically prescribed under the Act are considered appropriate.

5.1 Selection of most appropriate method

The onus of selecting the most appropriate method to determine the ALP is on the taxpayer. The taxpayer should demonstrate the correctness of its choice with supporting records and data, irrespective of the fact as to whether, the statute specifically requires him to do or not. However, the Revenue Authorities are at their discretion to accept a particular method based on the nature of transaction.

Rule 10C(1) of the Rules prescribes the use of the most appropriate method in determining the ALP of an international transaction or specified domestic transaction.

The Rules provide that the following factors should be taken into consideration in determining the most appropriate method.

- Nature and class of the transaction;
- Class of AEs entering into the transaction;
- Functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;
- Availability, coverage and reliability of data necessary for application of the method;
- Degree of comparability existing between the transaction and the uncontrolled transaction and between the enterprises entering into such transactions;
- Extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction and the comparable uncontrolled transaction; and

¹⁸ Notification No. 18 dated 23 May 2012

- Nature, extent and reliability of assumptions required to be made in application of a method.

5.2 Nature and class of the transaction

Each transfer pricing method is suitable in respect of certain transaction. The selection of the most appropriate method should be based on the suitability vis-à-vis the nature of transaction. The nature of the goods or services transferred and difference in their characteristics is important for the purpose of determining the degree or level of comparability of controlled and uncontrolled transactions.

For instance, where the international transaction pertains to transfer of goods it would be relevant to consider the physical characteristics of the property such as quality, quantity, etc. Similarly, where the transaction pertains to services or intangibles, it would be relevant to analyse the extent of services or the anticipated benefits from the use of intangible.

ALP in relation to the products produced by an enterprise can be determined under the CUP method if such products are subject matter of frequent trade in the open market and the open market may provide a ready reference to the ALP. In cases where the transactions involve trading of semi-finished goods which are not subject matter of frequent trade, cost-plus method can be used in determining the arm's length.

Illustrative Example

A Ltd. sells similar cars to its AEs and Non-AEs. All relevant information on the controlled and uncontrolled transactions is available and the circumstances relating to the controlled and uncontrolled transaction are similar. Considering the nature of transaction CUP can be selected as the most appropriate method as the information pertaining to controlled and uncontrolled transaction is readily available with A Ltd.

X Ltd. purchases goods from its AEs for resale to unrelated parties without any significant modifications. The goods are sold with a margin to cover the selling, general and administrative expenses and to account for the functions performed and risks incurred by X Ltd. No comparable transactions exist for the transaction undertaken by X Ltd. In such a case RPM is selected as the most appropriate method as the transaction deals with tangible property in which the reseller does not add substantial value to the tangible goods by physically modifying the goods before resale.

5.3 Functions performed and risk assumed by the enterprises

In selecting the most appropriate methodology, it is necessary to identify a comparable transaction undertaken by an unrelated third party. The functions performed, the responsibilities undertaken by an independent enterprise and AEs should be identified and compared in order to determine whether uncontrolled and controlled transactions and entities are comparable.

A functional analysis is carried out in order to analyse the functions carried out by each AEs

taking into account the assets used and risks assumed in determining the comparability between controlled and uncontrolled transactions. Also, it is important to analyse the contractual terms and conditions of the contract between the independent enterprises and the AEs. ALP can also vary for the transactions involving same goods or services due to the economic circumstances which includes the market in which the AEs and independent third parties operate. Due regard should also be given to the business strategies adopted by the taxpayer such as market penetration pricing, price skimming, etc. It is also important to analyse the relative importance of the functions performed by the unrelated third parties in a particular transaction for allocating profit.

To illustrate, Company X engaged in the distribution of mobile phones also undertakes marketing and advertising by risking its own resources in the distribution activity. Company Y carries out distribution function as an agent and does not perform any marketing activity. Company X would be entitled to a commensurately a higher rate of return considering the intensity of the functions performed.

5.4 Availability, coverage and reliability of data necessary for application of the method

The reliability of an arm's length measure depends on the completeness and accuracy of data available for benchmarking the transactions, the reliability of the assumptions, the sensitivity of the results, possible deficiencies in the data etc. Deficiencies in the data used or assumptions made will have an impact on the method applied. The analysis to determine the ALP is more reliable as the completeness and the accuracy of the data increases.

For instance, the reliability of CUP method is heavily dependent on similarity of product or services involved in a controlled and uncontrolled transactions. Similarly, RPM and CPM also requires a high degree of comparability between the controlled and uncontrolled transactions.

Illustrative Example

X Ltd. imported sunflower oil from its overseas AEs. Neither X Ltd. nor its overseas AEs undertook similar uncontrolled transactions. In the absence of internal comparable, X Ltd. can explore external sources like quotations from any reputed broker firm, price publications of oil world etc. to determine the price at which the products imported are traded in the market place. However, one should ensure that the price quotes are obtained for products which are of similar nature and are from an authentic and reliable source.

A Ltd. is engaged in the manufacture of hydraulic components. The manufactured components are sold to its AEs and Non-AEs alike. A Ltd. has the segmental break-up of the income and expenses as regards the transactions entered with its AEs and Non-AEs. Given the availability of segmental information, A Ltd. should determine the segmental profit margins earned from the transactions entered with its AE and Non-AE in determining the ALP provided the functional profile and contractual terms of such internally comparable arrangements are similar, in which case there will be no requirement to carry out an independent search to identify external comparable companies. This is referred to as an internal TNMM.

5.5 Degree of comparability existing between the transaction and the uncontrolled transaction and between the enterprises entering into such transactions

The arm's length character of the transactions is normally determined by comparing the controlled and uncontrolled transactions. Comparability of a transaction involves comparability of an enterprise, comparability of product, comparability of the terms and conditions, comparability of economic circumstances and comparability of business strategies. It is difficult to identify an uncontrolled transaction similar to the controlled transaction so as to constitute as comparables. For the differences between the controlled and the uncontrolled transaction which would materially affect the price in the open market, reasonably accurate adjustments should be made to eliminate the material effects of such differences. However, if the adjustments are carried out to increase the degree of comparability, the adjustments will affect the reliability of the results of the analysis.

Comparability adjustments should be made for the difference in the quantity of the product, contractual terms, date of transactions, level of market and other reasonable factors which may influence the market price.

To illustrate, X Ltd exports minerals to its AE in Dubai in bulk and also makes occasional sales of the same product in smaller quantity to non-AE. In this scenario, the occasional sales to non-AE in small volume cannot be compared with large sales made to AE on regular basis as in every trade, the volume of the consignment is a critical factor and the price of the goods widely vary based on the volume transacted.

5.6 Extent to which reliable and accurate adjustments can be made

The extent to which reliable and accurate adjustments can be made to account for differences between the controlled and uncontrolled transactions plays an important role in determining the most appropriate method.

Some methods provide a more appropriate and indicative arm's length result for certain functions than others. Where an entity sells the same product by way of a controlled and an uncontrolled transaction, CUP method would generally be considered as the most appropriate method. However, where such sales are carried out in different jurisdictions, adjustments may be required in respect of such differences in jurisdictions. In determining the ALP for services and manufacturing, a cost-based method is usually deemed more useful and for distribution functions, a resale price-based method is considered more appropriate.

However, reliable adjustments cannot be made for the transactions involving the use of intangibles or where there are geographical or product differences between the controlled and uncontrolled transactions.

Illustrative Example

TML exports SUVs to its AE located in South Africa and exports similar models to unrelated third parties in Egypt. The only material difference that could be identified between the

controlled and uncontrolled transactions concerns the geographical difference. In order to perform adjustments to account for geographical difference, factors such as differences in inflation rates between South Africa and Egypt, the competition in the two countries, governmental regulations etc. should be considered. Adjustment could not be carried out for such differences given the complex nature of issue involved and the limited availability of such information to the taxpayer.

A Ltd., sold Industrial chemicals to its AE and Non-AE on CIF basis. Since A Ltd. undertakes similar transaction with an AE and a Non-AE, CUP can be chosen as the most appropriate method for determining ALP on account of availability of internal comparable. However, freight and insurance charges should be excluded while comparing the value of transaction to ensure uniformity in prices charged from AE and Non-AE, as freight and insurance charges varies according to the destination.

5.7 Nature, extent and reliability of assumptions required to be made in application of a method

The reliability of the results derived from a method depends on the soundness of the assumptions made and on the economic analysis on which such assumptions are based on. Few assumptions may be relatively reliable, and a few assumptions may be less reliable depending on the nature and characteristics of the transactions.

For instance, it may be agreed between the AEs that the price for the international transaction would factor for the credit period extended, which is a critical assumption in determining the ALP. Similarly, while applying a residual PSM, it is assumed that the ALP reflects the capitalized intangible development expenses incurred by each of the party towards developing the intangible.

5.8 Circumstances under which traditional transaction methods are considered appropriate

Traditional transaction methods are the most direct means of establishing the arm's length nature of the transactions entered by the taxpayer with its AEs. The traditional transaction methods could be considered as the most appropriate method where the details of controlled and uncontrolled transactions are readily available with the taxpayer and the taxpayer's activities are best reflected only by factoring "above the line" expenses in the profit and loss account. For instance, where the taxpayer is engaged in the sale of traded goods or semi-finished goods, it would be relevant to consider only the direct costs involved in performing these activities and determine the operating margins at the gross level, since the gross margins provide more accurate and reliable comparison. The use of net margins in the above circumstances would make the comparison less precise due to the existence of indirect costs that are not related to the functions performed and risks assumed by the taxpayer in relation to the international transactions undertaken with its AEs.

In practice, the application of traditional transaction methods is often constrained by the lack

of reliable information on uncontrolled transactions in public domain. However, if the taxpayer or AE (in other words, the tested party) has entered into comparable uncontrolled transactions and such particulars are readily available (referred to as internal comparables), traditional transaction methods would typically be the most appropriate method.

CUP method

CUP method can be considered as the most appropriate method in the following scenarios:

- One of the AEs involved has entered into the same transaction with an independent enterprise and all relevant information on the uncontrolled transactions is available with the taxpayer; and
- The commodity or services transferred between the taxpayer and the independent entities are identical.

RPM

RPM can be considered as the most appropriate method in the following scenarios:

- Transactions involving purchase and resale of tangible property in which the reseller does not add substantial value to the tangible goods;
- In a commission agent structure involving a principal and related commission agents;
- Selling companies do not own valuable intangible properties; and
- Reliable comparisons can be made on COGS.

CPM

CPM can be considered as the most appropriate method in the following scenarios:

- For transfer of semi-finished goods between entities;
- Transactions involving a contract manufacturer, a toll manufacturer or a low risk assembler which does not own product intangibles and incurs little risk; and
- For intra-group provision of services (e.g., legal, accounting, information technology, marketing, tax, and management services) if the services can be considered to provide a benefit to the service recipient.

5.9 Circumstances in which transactional profit methods are considered appropriate

Transactional profit methods examine the net profit margins earned by taxpayer from a controlled and uncontrolled transactions. Transactional profit methods can be applied where the net profit margin analysis provides a more reliable result than a gross margin analysis, on account of the highly integrated transactions undertaken by the taxpayer. Transactional profit methods are appropriate for transactions involving intangibles, unique contributions, cost contributions etc. Practically speaking, due to readily available data of operating profit margins

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of comparable companies as compared to reliable gross margin data, one sees the use of transactional profit methods much more than traditional transaction methods; despite such transactions not necessarily being integrated or involving intangibles. Also, the results from transactional profit methods could be vitiated by a number of factors that are not relevant to the determination of prices at which international transactions are entered into by the AE.

TNMM

TNMM can be considered as the most appropriate method in the following scenarios:

- Transactions involving broad comparable functions rather than a particular controlled transactions;
- In cases where the data on uncontrolled transactions is limited;
- If the available comparables differ significantly with respect to products and functions, making it difficult to reliably apply the traditional methods; and
- In cases gross margins are less reliable due to accounting differences between the tested party and the comparable companies. For instance, the taxpayer would treat the warranty costs as cost of goods sold while the comparable distributor treats such costs as operating expenses which requires an adjustment on the gross profit level.

PSM

PSM can be considered as the most appropriate method generally in cases where the transactions are complex involving the use of intangible and that the transactions are so interrelated that they cannot be evaluated separately for determining the ALP of any one transaction.

Some of the cases where the PSM will apply include:

1. Transactions where both the controlled entities contribute/ own significant intangible property;
2. Highly inter-related transactions that cannot be analysed separately. In other words, the transactions are highly integrated and they cannot be evaluated separately.

6. Comparability Adjustments

6.1 Rationale for comparability adjustments

A comparability adjustment is an adjustment made to the conditions of uncontrolled transactions in order to eliminate the effects of the material differences which exist between them and the controlled transaction being examined. Controlled transaction may be defined as a transaction entered into between two related entities or AEs.

By Reading Rule 10B(3) of the Rules, one could infer that for comparability purposes, an uncontrolled transaction shall be comparable to an international transaction if none of the

differences (if any), between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from such transactions in the open market, or *reasonably accurate adjustments can be made* to eliminate the material effects of such differences. On the global front, guidance on comparability adjustments are found in paragraphs 3.47-3.54 and in the Annex to Chapter III of the OECD TP Guidelines. Similarly, the UN in its practical manual on Transfer Pricing, reiterates the need for comparability adjustments.

6.2 Comparability adjustments - Appropriateness

Comparability adjustments should be considered if (and only if) they are expected to increase the reliability of the results derived from a comparability analysis. Relevant considerations in this regard include the materiality of the difference for which an adjustment is being considered, the quality of the data subject to adjustment, the purpose of the adjustment and the reliability of the approach used to make the adjustment.¹⁹

The need to perform working capital adjustments increases when the tested party exhibits differing levels of working capital intensities relative to the comparables.

The issue at stake when deciding on a comparability adjustment is not whether it is new or has been used before, but whether it reliably improves the comparability of the adjusted data. In the context of the Indian TPR and the experiences during the transfer pricing audit process, the following kinds of adjustments have been seen and applied in various circumstances of taxpayers:

1. Capacity Utilization adjustments
2. Working Capital adjustments
3. Risk Adjustments
4. Other Adjustments

6.2.1 Capacity utilization adjustment

Under Rule 10B (1)(e)(ii), an adjustment to the net profit margin may be made for “capacity underutilization”. Capacity underutilization by enterprises is an essential factor affecting net profit margin in the open market because lower capacity utilization results in higher per unit costs, which, in turn, results in lower profits.

There is a need to calculate an economic/comparability adjustment for the differences in the

¹⁹Pr. CIT vs. Schneider Electric India Pvt. Ltd- TS-696-HC-2017(DEL)-TP - The High Court, noting that Tribunal had discussed in detail the factual position regarding the sharp depreciation of Indian Rupee (INR) against the Euro (EUR) by about 16% in a short span of 6 months, i.e., February to July 2008, held that a forex fluctuation adjustment had to be carried out in accordance with the Transfer Pricing regulations so as to eliminate differences between international transactions involving comparable companies and that entered into by the assessee. Accordingly, it held that the Tribunal was correct in making the said adjustment.

The revenue has filed special leave petition (“SLP”) against the matter before the Hon’ble Supreme Court of India (“SC”). The SC has admitted the revenue’s appeal. The matter is pending for hearing.

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level of capacity utilization by the comparables vis-à-vis the tested party. The need for a capacity utilization adjustment is mostly necessary in cases where the tested party is in a start-up phase or is going through a phase of slow business growth/demand for its products and such situation is not faced by the competitors in the market, or where an eventuality such as a strike or lock-out at a factory results in a significant decline in production.

The rationale for carrying out adjustments to eliminate differences in capacity utilization or idle capacity adjustments is explained in para 2.76 of the OECD TP guidelines. Depending on the facts and circumstances of case and in particular on the proportion of fixed and variable costs, the TNMM may be more sensitive than the cost plus or resale price methods because differences in the levels of absorption of indirect fixed costs (Example: fixed manufacturing costs or fixed distribution costs) would affect the net profit indicator but may not affect the gross margin or gross mark-up on costs if not reflected in price differences.

Example 1: Difference in capacity utilization

	Tested party - Manufacturer operates in full capacity 1000 units per year	Comparable Co. - Manufacturer does not operate in full capacity (80%) 800 units per year	Risk of Error
Sales	1000	800	
Purchase price from manufacturer taking account of the significance of the marketing function and obsolescence risk in accordance to the functional analysis	Variable – 750 Fixed – 50 Total - 800	Variable – 600 Fixed – 50 Total - 650	
Gross mark-up on cost of goods sold	200 (25%)	150 (23%)	16 (2%*800)
Indirect costs	150	150	
Net profit margin	50 (5%)	Breakeven	40 (5%*800)

Example 2:

A Limited is a company that is in its initial years of operation that has a few international transactions. While judging comparability of an international transaction with an uncontrolled transaction, A Limited has to access the conditions prevailing in the market in which it operates vis-à-vis its comparables. It is only reasonable for A Limited to make suitable adjustments for non-utilization of capacity considering the fact that it was in its initial years of operations. Low profit margin earned or loss incurred due to incurrence of high start-up cost and low utilization of capacity is a common phenomenon in case of start-up business. This difference in cost levels of the start-up company vis-à-vis the comparables who might be established players would require an adjustment. The revenues of start-ups during its inceptive years are generally low due to high overheads. It is essential to identify comparables that operate at identical cost levels. If we lack reliable data for independent companies operating in the same cost levels, we may choose to select a functionally similar comparable operating at a different business cycle but however make an adjustment to the extent of the economic differences in the comparable vis-à-vis the tested party.

In the case of Global Vantage (P) Ltd. Vs. DCIT and E-Gain Communications Pvt. Ltd., the Hon'ble Tribunal upheld the claim of the Company for capacity utilisation adjustment by considering the difference in the utilization of the tested party and the comparables.

6.2.2 Working capital adjustment

There might be a substantial difference in the working capital of the tested party vis-à-vis the comparables. Such differences are generally caused by differences in the financing terms of purchase and sales that the company receives from its suppliers and extends to its customers, and also by differences in the levels of inventories held by the companies. Such differences may generate substantial differences in the capital structure and operating profits of the companies.

In order to reduce the effect of differences in terms of purchase, sales and levels of inventories on the profitability measures, adjustments can be made to normalize the receivables, payables, and inventory levels of the comparables and the tested party. Operating profit is adjusted, in parallel, to reflect the return required in order to hold the increased level of payables, receivables, or inventories. This, however, should be done only if such adjustment can be reasonably made and it improves comparability.

Adjustments for inventory, accounts receivable, and accounts payable follow the same basic mechanics. First, a value is established for the difference between the function performed by the comparable and the tested party. The value can be established by calculating the difference between the ratio of the balance sheet item in question to net sales for the comparable and the same ratio for the tested party.

The denominator of these fractions will be an arm's length amount for the tested party example, denominator of PLI can be used. An alternative approach would be to calculate these ratios with respect to operating expenses like where Gross Profit / Operating Expense are the PLI used. The resulting difference in ratios is then multiplied by an interest rate and by the net sales of the comparables to generate an amount to adjust the income statement of the comparable. Then, the PLI of that comparable is recomputed.

When non-domestic comparables are used, it is likely that the working capital intensity of the tested party located in emerging/developing economies will be significantly different from that of the comparables located elsewhere (e.g., in developed countries) due to differences in business environments. Such differences may include disparities in interest rates for the short term debt, differences in credit terms, and credit risks of typical business borrowers.

It is not appropriate to view some comparability adjustments, such as for differences in levels of working capital, as "routine" and uncontroversial, and to view certain other adjustments, such as for country risk, as more subjective and therefore subject to additional requirements of proof and reliability. The only adjustments that should be made are those that are expected to improve comparability.

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The process of calculating working capital adjustment is explained below:

- Identify differences in the levels of working capital. Generally, trade receivables, inventory and trade payables are the three accounts considered. The transactional net margin method is applied relative to an appropriate base, for example, costs, sales or assets. So, if the appropriate base is sales, then any differences in working capital levels should be measured relative to sales.
- Calculate a value for differences in levels of working capital between the tested party and the comparable relative to the appropriate base and reflecting the time value of money by use of an appropriate interest rate.
- Adjust the result to reflect differences in levels of working capital. Alternative calculations are to adjust the tested party's results to reflect the comparables levels of working capital or to adjust both the tested party and the comparable's results to reflect "zero" working capital.
- $\text{Net Working Capital} = \text{Debtors} + \text{Inventory} - \text{Creditors}$

Working capital is computed as per the definition by adding up all the current assets but in transfer pricing we take only the debtors and inventories as they are considered to be items on working capital relating to the operating business that have a cost which must be recovered from the customers. In transfer pricing, we reduce creditors from the total sum of debtors and inventory to find out the net working capital and cost thereof.

Net working capital of the tested party = (debtors + Inventory) – (Payables/advances received to the extent of debtors plus inventory)

It is important to note that in case of Mentor Graphics (Noida) Private Limited, the Tribunal has allowed adjustment on account of differences in working capital and risk profile. Notably, this decision, being amongst the first in transfer pricing jurisprudence in India, was upheld by the Delhi High Court. Thereafter, the Tribunals have in many cases accepted the need for working capital adjustment. In the case of Kusum healthcare Private Limited the Tribunal granted the benefit of working capital adjustment to the Assessee which was also confirmed by Delhi High Court.

A major issue in making working capital adjustments involves the selection of the appropriate interest rate (or rates) to use. The rate (or rates) should generally be determined by reference to the rate(s) of interest applicable to a commercial enterprise operating in the same market as the tested party. In most cases a commercial loan rate will be appropriate. In cases where the tested party's working capital balance is negative (that is Payables > Receivables + Inventory), a different rate may be appropriate.

In the case where "payables < receivables + inventories", a borrowing rate is generally used because the company has to invest in the receivables (extent credit) and inventories (finance the inventory). In other words, the sums invested in receivables and inventory are greater than the "return" on the payment deferral the company received (the company has to "borrow"

money for financing its investment in receivables and inventory). In the case where “payables > receivables + inventories”, a lending rate is generally used because in a way the company receives an additional advantage through the payment deferral.

Example of an accounts receivable adjustment:

An enterprise that reports accounts receivable on its balance sheet is providing a service or goods to its customers by effectively providing financing to its debtors. Under the assumption that companies are profit maximizing, an enterprise would want to be compensated for providing this financing service. Its returns would therefore include an amount for the implicit interest earned through this financing activity. Therefore, if only difference between two enterprises with the higher level of accounts receivable, it would be expected that the enterprise with the higher level of accounts receivable would be earning higher returns because these returns would include an implicit finance charge. Therefore, adjusting the comparable enterprise’s financial results to account for differences in relative levels of accounts receivable is necessary to more accurately evaluate transfer prices.

In the case of *M/S. Ef Information Systems v Deputy Commissioner of Income-tax*, the Hon’ble Tribunal upheld the claim for working adjustment considering the fact that the difference in working capital (between the tested party and the comparable) would materially affect the price charged for the services rendered.

6.2.3 Risk adjustment

Rule 10C (2) of the Rules provides that in selecting the most appropriate method, the following factor shall be taken into account:

“The class or classes of AEs 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.....”

Identification of risk and the entity that bears such risks are important aspects in the comparability analysis. The risk-return trade-off refers to an expectation of a positive relationship between increasing risk and increasing reward.

The risk adjustment is undertaken when the comparables chosen for establishing the arm’s length price have different business complexities and bear a different level of entrepreneurial risks or other business risks to that of the taxpayer. It is not obvious what type of risk adjustments should be made to convert a set of full risk-bearing comparables into a set reflecting a highly customized and often much reduced set of risks.

In case of *E-gain Communication (P.) Ltd. vs. ITO*, the Tribunal upheld the need to provide for risk adjustment in case the taxpayer is not undertaking any risk in its transactions with the parent company. However, the issue of quantification of risk adjustments was first dealt in the case of *Philips Software Centre Private Limited vs. ACIT* wherein ITAT approved comparability adjustments being made to eliminate differences on account of differences in risk profile, working capital and accounting policies. Similarly, in case of *Motorola India solutions private*

limited, the Tribunal agreed that adjustment on account of risk be made for difference in risk profile of tested party vis-à-vis comparable companies. The Tribunal further directed for appointment of experts by both sides in order to reach an acceptable conclusion.

In the case of Visual Graphics Computing Services (India) Pvt Ltd, the Tribunal held that there's a need to provide for risk adjustment given that the taxpayer functions under limited risk as it is a captive service provider, as against the comparable companies that operate as independent entities; the Tribunal directed the Assessing Officer to grant 2% towards risk adjustment on an ad-hoc basis. The High Court did not call for any interference with the findings of the Tribunal, absent substantial question of law.

6.2.4 Accounting adjustments

Despite the ever-broadening adoption of uniform accounting standards such as IFRS by different countries, differences in accounting practices among countries still remain. Hence, it is important to investigate whether the differences in the accounting standards between the country where the tested party is located and the countries of the comparables will materially affect the reliability of the benchmarking analysis. Material differences in accounting standards and practices between the tested party and third-party comparables may lead to inconsistencies, unless appropriate adjustments are made.

It bears emphasis that comparability adjustments are only appropriate for differences that will have a material effect. Some differences will invariably exist between the taxpayer's controlled transactions and the third party comparables.

Module E

Documentation and Drafting

1. Introduction

Globalisation and economic growth have led to opening up of economy for multinational organisations which has resulted in increase in number and quantum of transactions between related parties i.e. transactions between different entities of the same business group. This has necessitated the creation of statute to ensure that the prices at which the aforesaid transactions are taking place, allocate a fair or reasonable portion of profits to each transacting entity so as to avoid leakage of revenue. Transfer Pricing regulations aim to meet the aforesaid objective by stipulating that the taxpayer need to maintain adequate documentation which clearly justifies the prices paid/charged in an intra group transaction.

As per Rule 10D of the Rules, the documentation should contain the details relating to shareholding structure of the taxpayer, description of the nature of operations carried on by the Group and the taxpayer, overview of the industry in which the taxpayer operates in, description of functions performed, risks assumed and assets employed by the taxpayer and related parties, analysis performed to determine the arm's length nature of the transactions between related parties, etc.

Further, the Finance Act 2016, in line with recommendations of the BEPS Action 13, amended Section 92D of the Act and inserted section 286 of the Act to provide for a three-tiered documentation structure.

The three-tiered documentation structure (applicable with effect from FY 2016-17) would consist of a "Country-by-Country Report" (CbC Report), "Master File" and "Local file". The CbC Report would be applicable for large multinational enterprises¹ (MNEs) and would capture key metrics of all entities in the group such as revenue, taxes paid, capital employed, headcount, etc (as defined in section 286 of the Act). The Master File seeks to capture information regarding the taxpayer's global operations and their transfer pricing policies (as required by Section 92D of the Act read with Rule 10DA of the Rules). The Local File would capture entity-specific information with reference to the related party transactions. In the Indian context, the existing transfer pricing documentation requirements as per Rule 10D of the Rules already encompasses the Local File requirements. Further, Rule 10DA and Rule 10DB in connection with Master File and CbCR respectively, have been introduced by CBDT on 31 October 2017 providing the detailed provisions on compliances of Master File and CbCR.

¹ Having annual consolidated group turnover of over INR 6,400 crores (applicable from April 01, 2021) [erstwhile threshold being INR 5,500 crores] in the immediately preceding financial year.

5.2 International Tax — Transfer Pricing

Transfer Pricing ('TP') Report/Study is the documentation maintained to highlight facts associated with transactions taking place between different entities of the same group (also known as intra-group transactions), and relevant facts of the entities involved in the transactions. The primary objective of the TP report is to demonstrate the arm's length nature of the transactions taking place between the entities of an MNE.

The OECD TP Guidelines has defined ALP as:

“When independent enterprises transact with each other, the conditions of their commercial and financial relations (e.g. the price of goods transferred or services provided and the conditions of the transfer or provision) ordinarily are determined by market forces. When associated enterprises transact with each other, their commercial and financial relations may not be directly affected by external market forces in the same way, although associated enterprises often seek to replicate the dynamics of market forces in their transactions with each other”².

Further, the ALP is also defined in Companies Act, 2013 as “a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest”.

As per section 92D of the Act read with Rule 10D of the Rules, every person entering into international/ Specified Domestic Transaction ('SDT') is required to maintain TP report for establishing the arm's length nature of the international transactions/ SDT.

The Indian Transfer Pricing Regulations defines 'International transaction' as a “*transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises*”³. Further, the term 'International transaction' also includes deemed international transactions as defined under Section 92B(2) of the Act.

Section 92BA of the Act⁴ defines SDT as transactions involving transfer of goods or services between tax holiday units (or entities claiming the benefit of 15% tax rate⁵) and other units of a taxpayer, or different taxpayers. The threshold for applicability of domestic Transfer Pricing regulations was raised from INR 5 crore to INR 20 crore w.e.f. AY 2015-16. Section 92BA of the Act has been amended vide Finance Act 2017 to exclude transactions in the nature of payments to specified persons defined u/s 40 (A)(2)(b) of the Act. Accordingly, the same is out

² Source: Para 1.2 of Chapter I of OECD Guidelines, 2022 (Page 29)

³ Section 92B(1) of the Act

⁴ As updated by the Finance Act, 2020

⁵ As per sub-section (4) of section 115BAB of the Act

of the purview of domestic transfer pricing. However, the same could still be under review by the Assessing Officer and who can make adjustments, if any, under different provisions of the Act. The key objectives of requiring the taxpayer to maintain TP Study are as follows:

- To ensure fair allocation of revenue between different jurisdictions;
- To provide tax administrations with the information necessary to conduct an informed transfer pricing assessment/audit;
- To ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and other conditions for transacting between associated enterprises.

It is pertinent to note that every taxpayer undertaking international transactions/SDT has to file an Accountant's Report in Form 3CEB latest by the specified date⁶ (i.e., 31st October 2022 for AY 2022-23), capturing details like nature of international transactions, brief description of AEs with whom the taxpayer has entered into international transactions/SDT, method adopted for benchmarking international transactions/SDT and the results thereon.

TP Study essentially contains all these details in an elaborate manner which forms the basis of obtaining Accountant's Certificate. It is worthwhile to note that the regulations only stipulate the preparation of TP Study on contemporaneous basis (i.e. latest) although the same is not required to be filed before tax authorities at the time of filing tax returns. However, for filing Form 3CEB, the taxpayer must maintain adequate documentation in the form of a TP study (in case of international transactions, or where aggregate value of all SDT in a year exceeds INR 20 crore) which justifies the arm's length nature of the international transactions/SDT undertaken during the year. Hence, TP Study must be prepared and maintained by the taxpayer before the due date of filing Accountant's Certificate. In case taxpayer fails to maintain TP documentation, the taxpayer is liable to pay penalty of 2 percent of the total value of international transaction/SDT. Penalty for not filing of form 3CEB by due date is Rs. 1,00,000.

2. Transfer Pricing Report

Typically, the structure of a TP Report is as follows:

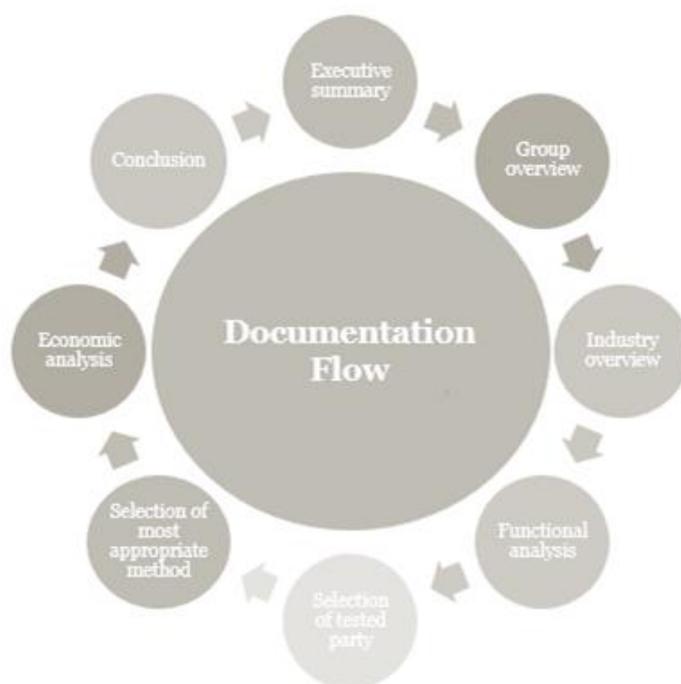
- Executive Summary
- Group Overview
- Industry Overview
- Functional Analysis
- Selection of tested party

⁶ Section 92F (iv) after amendment by the Finance Act, 2020 reads: "'specified date' means the date one month prior to the due date for furnishing the return of income under sub-section (1) of section 139 for the relevant assessment year;"

5.4 International Tax — Transfer Pricing

- Selection of the most appropriate method
- Economic analysis
- Conclusion
- Appendices

The structure of TP Study is diagrammatically presented below:



2.1 Executive Summary

The Executive summary section of the TP report captures high level analysis of the entire TP Study and summarises the results of benchmarking analysis (discussed later in the module) performed to determine arm's length price of the international transaction(s) undertaken during the relevant period.

Key elements of Executive summary:

While drafting executive summary, following pointers should be kept in mind for enhancing its effectiveness and ensuring completeness:

- *Objective*
The objective of executive summary is to provide broad overview of the key contents of the TP Study.

- *Scope*

Executive summary provides a brief description/overview of the business profile of the overall group as well as the taxpayer including the AEs with which the company has undertaken international transactions or SDTs. Further, this section includes the nature of the international transactions/SDT along with the results of the benchmarking analysis.

- *Key Takeaway*

The executive summary should be concise and at the same time capture the crux/brief summary of the entire TP Study including nature of the international transactions, transacting parties involved, value of transactions, selection of the tested party, selection of the most appropriate method and the results of the benchmarking analysis.

2.2 Group Overview

This section includes a brief description of the Group's as well as the taxpayer's business operations. The key points to be included in this section are:

- Brief description of the Group's business activities/operations/division;
- Brief overview/description of the nature of business operations of the taxpayer;
- Brief details of AEs with whom the international transactions have been entered into;
- Factual information such as turnover of the Group during relevant period, number of employees engaged by the Group and the shareholding structure of the Group;
- Information pertaining to various products and services offered by the Group;
- Data pertaining to jurisdictions where the Group has business operations i.e. geographical presence of the Group;
- Significant development(s) during the year;

How to source the aforesaid information?

- The annual report of the Group is considered to be the most reliable and authentic source for information pertaining to the nature of business operations, shareholding structure, products and services offered, etc.
- Inquiries made to client regarding, business operations, shareholding and group structure and international transactions undertaken
- In case of unavailability of annual report, reliance could be placed upon other sources

5.6 International Tax — Transfer Pricing

such as website of the Group, reference websites⁷, publicly available databases like Prowess, Capitaline, AceTP etc.

The Group overview could be illustrated by way of the following example:

Associated Enterprise 1, a bicycle manufacturer in Country 1, sells bicycles to Associated Enterprise 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2.

In the instant case, the Group overview would include the following broad headings:

Shareholding structure

Brief description of the business operations of the Group– including range of products/services offered, geographical presence, sales trend during past years, etc.

Brief description of business operations of Associated Enterprise 1 and Associated Enterprise 2 – including details of products/services offered, date of incorporation, regional presence, shareholding pattern/structure, etc.

2.3 Industry Overview

This section provides an understanding of the taxpayer/company's relative positioning in the industry vis-à-vis other players and overall justification of the taxpayer's financial results. The key objectives of industry overview are to:

- General overview of the industry in which client is operating
- Determine taxpayer's position within the industry;
- Provide information about the market share of the client;
- Establish linkage of industry overview with functional and economic analysis;
- Highlight the key growth drivers of the industry;
- Determining threats/challenges and opportunities pertaining to the industry; and
- Provide information about past trends and future projections of the industry.

Some of the points to be kept in mind while preparing industry overview are:

- It is advisable to provide a brief overview of the global scenario and then follow it up with conditions prevailing in Indian industry;

⁷Website information is dynamic and appropriate backup should be maintained by the tax payer in the form of web-links, date on which data has been extracted, file notes, etc.

- Always mention the source⁸ from where the data is obtained. Example of sources could be industry reports published by The Associated Chambers of Commerce and Industry of India ('ASSOCHAM'), reference websites such as Money control, Wikipedia, etc.;
- The industry overview should be kept as crisp/short as possible and at the same time include the complete overview of the industry;
- Contradictory statements should not be included, especially if there is a disconnect with functional analysis the same should be addressed; and
- Use of too many technical jargons and figures should be avoided.

The industry overview could be illustrated by way of following example:

Continuing the same example as above, where Associated Enterprise 1, a bicycle manufacturer in Country 1, sells bicycles to Associated Enterprise 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2, the following broad heads could be included while drafting the industry overview:

Industry structure – Types of bicycles produced and sold in the market, market size, demand-supply gap analysis, etc.

Characteristics of bicycle industry – Distribution channels, brief overview of legal regulations affecting the industry, factors affecting demand, sales trend of each category of bicycles relating to past 5-6 years, factors affecting demand, etc.

Key growth drivers of the industry and the potential regulatory as well as competitive threats affecting the industry, complete SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis of the industry

Way forward – Future projections pertaining to industry growth and potential challenges anticipated

2.4 Functional Analysis

2.4.1 What is Functional Analysis?

Functional Analysis refers to mapping of the economically relevant facts and characteristics of intercompany transactions with regard to their FAR (Functions, assets and risks). It seeks to identify the economically significant functions undertaken, assets used and risk assumed by the parties to the transactions.

The profits that a company earns are dependent on:

- the business environment it operates in;
- the strategy it pursues in that environment;

⁸ Appropriate backup of the source information must be maintained

5.8 International Tax — Transfer Pricing

- the functions performed;
- the assets employed; and
- the risks undertaken.

Functional analysis facilitates understanding of the economic value added by each entity which helps in characterization of the parties to the transaction. The primary objective of undertaking FAR analysis is to ensure that each entity is rewarded appropriately, commensurate to the functions undertaken, assets deployed and risks assumed – *which is the essence of the arm's length principle*. Functional analysis is the most critical exercise which determines the correct characterisation of the entity on which the selection of tested party (discussed in detail in subsequent sections) is dependant, and for the selection of most appropriate benchmarking method and for carrying out the benchmarking analysis to determine the ALP.

To understand the FAR of a transaction, interviews of the key persons of the entity and of the AE should be carried out. The questions asked should be in respect of the transaction, the tested party as well as of the AE involved.

The OECD TP Guidelines further states as below:

“In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in delineating the controlled transaction and determining comparability between controlled and uncontrolled transactions or entities, a functional analysis is necessary. This functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions. The analysis focuses on what the parties actually do and the capabilities they provide. Such activities and capabilities will include decision-making, including decisions about business strategy and risks. For this purpose, it may be helpful to understand the structure and organisation of the MNE group and how they influence the context in which the MNE operates. In particular, it is important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the associated enterprises with the rest of the group, and the contribution that the associated enterprises make to that value creation. It will also be relevant to determine the legal rights and obligations of each of the parties in performing their functions. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important.”⁹

Adjustments should be made for any material differences from the functions undertaken by any independent enterprises with which that party is being compared. While one party may

⁹Source: Para 1.51 of revised Chapter 1 of OECD Guidelines, 2022

provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important.

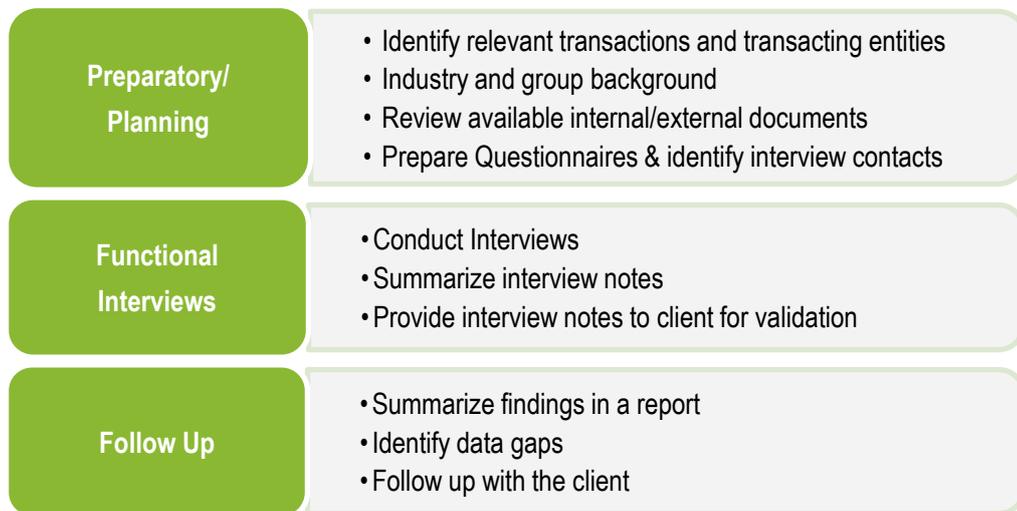
The functional analysis should consider the type of assets employed, such as plant and equipment, the use of valuable intangibles, financial assets, etc., and the nature of the assets used, such as the age, market value, location, property right protections, etc.

Controlled and uncontrolled transactions and entities are not comparable if there are significant differences in the risks assumed for which appropriate adjustments cannot be made. Functional analysis is incomplete unless the material risks assumed by each party have been considered; as the assumption or allocation of risks would influence the conditions of transactions between the AEs. Usually, in the open market, the assumption of increased risk also is expected to be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually assumed.

In view of above discussion, the key steps involved in carrying out functional analysis are discussed hereunder.

2.4.2 Key steps involved in Functional Analysis

The key steps involved in functional analysis have been shown in the diagram below:



2.4.3 Documentation for Functional Analysis involves:

- Complete record of the interviews
- Functional analysis documentation should contain
 - A detailed description of the functional analysis;
 - Interview notes kept as back-up;

5.10 International Tax — Transfer Pricing

- Review of other documentation as back-up, such as agreements, invoices, process charts, statement of work, etc.
- The functional analysis should direct the reader unambiguously to the correct conclusion about who performs the key functions and bears the related risks.

2.4.4 Guidelines for drafting Functional Analysis

- Focus on functional analysis from international transactions as well as a business segment perspective;
- Create platform for aggregation, if applicable;
- Facts and background of such transaction(s) including the pricing policy;
- Group Transfer Pricing Policy; and
- Unique business strategy, like launch of new product, termination of contract; etc.;

The various aspects covering functional analysis i.e. functions performed, assets employed and risk assumed are discussed in detail below:

(a) Functions Performed

- Description of functions performed by each transacting party;
- Study the entire value chain of the business:
 - Flow charts depicting the value chain, identifying the key value drivers;
 - Identifying unique intangible assets owned including contribution made by each party towards enhancement and maintenance of intangibles;
 - Identifying the non-routine value addition; and
 - Reference to agreements and pricing mechanism, wherever available.

While conducting functional analysis it is also important to ensure that contracts between related entities are followed in practice having regard to the substance and capability of each entity.

(b) Assets Employed

The analysis of assets employed into tangible assets and intangible assets is of vital importance to determine intensity of functions and selection of most appropriate method.

The existence of intangible assets in the form of technical knowhow, trademarks, patents, etc. contribute to the supernormal growth in profits of an enterprise.

While evaluating intangibles, it is important to understand and differentiate between economic and legal owner as well as contribution made by each entity towards subsequent enhancement and maintenance of those intangibles.

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.

For example, a routine manufacturer of bicycles is expected to own the following assets:

Type of Fixed Assets	Gross Block as on March 31, 2022(Rs.)
Land	XX
Building	XX
Plant & Equipment	XX
Data processing equipment	XX
Furniture and Fixtures	XX
Office Equipment	XX
Leasehold Improvement	XX
Vehicle	XX
Total	XXXX

(c) Risks Assumed

The risks assumed by an entity has a direct correlation with the returns or the profit margins which an entity is expected to earn. A risk-insulated entity is generally assured of a fixed return in the form of cost plus pricing model while an entity bearing significant risks is expected to earn higher profits. Typically, the various kinds of risks which an entity is exposed to are as follows¹⁰:

- 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/ non-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 / Service liability risk - risk associated with product failures including product / service non-performance to generally accepted or regulatory standards. This could result in product recalls and possible injuries to end-users.
- Technology risk – risk relating to inefficiencies arising from obsolete infrastructure and tools as well as obsolescence of processes.
- Foreign exchange risk – risk relating to the potential impact on profits that may arise because of changes in foreign exchange rates.

¹⁰This is an inclusive list and may vary from depending upon the facts and circumstances of the business

5.12 International Tax — Transfer Pricing

- Environmental risk – risk relating to potential harmful impact of the business operations on the environment.
- Political/Regulatory risk – risk associated with operating in geographical jurisdictions with unstable political regimes/ unfavourable government policies.
- R&D risk – risk associated with loss incurred due to unsuccessful R&D expenditure.
- Manpower risk – risk associated with losing trained personnel which contribute to the success of the enterprise.
- Capacity Utilisation risk – risk associated with loss of profits due to unutilised capacity.

A careful analysis of the risks assumed by the transacting entities would determine the true characteristics of each of the parties to the transaction. For instance, a distributor solely engaged in purchasing goods for the purpose of resale without performing any value addition would be characterised as a low risk distributor whereas a distributor who performs significant value addition in terms of packing goods, holding inventory, incurring advertisement and promotional expenditure, undertaking market risk, etc. would be characterised as a ‘full-fledged distributor’.

To summarize, FAR analysis is central/ core to the benchmarking analysis required to be performed for determining arm’s length price. FAR helps in:

- Determining the nature of functions performed by the taxpayer and AE(s);
- On the basis of the above, determining true and correct characterization of the entities;
- Determining tested party
- Providing guidance on selection of most appropriate benchmarking method; and
- Determining parameters for establishing comparability.

FAR analysis could be better understood with the help of following example:

Continuing the same example as above, where Associated Enterprise 1, a bicycle manufacturer in Country 1, sells bicycles to Associated Enterprise 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2.

Assuming that the international transaction pertains to import of bicycles by Associated Enterprise 2 from Associated Enterprise 1 for the purpose of resale, the following key points should be considered while undertaking FAR analysis:

Functions performed by Associated Enterprise 1 and Associated Enterprise 2 – whether Associated Enterprise 2 holds inventory or imports bicycles based on confirmed orders from end customers, whether Associated Enterprise 2 incurs marketing expenditure for creating its own market in India or the customers are provided by Associated Enterprise 1, which of the key functions are performed by Associated Enterprise 1.

This section should include an analysis of entire value chain involved in the international

transaction pertaining to import of bicycles by Associated Enterprise 2 from Associated Enterprise 1. Some of the key considerations or factors to be considered in the aforesaid exercise are as follows:

- Which entity is taking key decisions pertaining to purchase of finished goods, inventory management, etc.
- Entity responsible for packaging of goods, quality control, sales & marketing etc.

Assets employed by Associated Enterprise 1 and Associated Enterprise 2 – whether Associated Enterprise 2 employs routine assets in the nature of computers, furniture & fixtures, software, etc. or does it own intangibles in the form of trademarks, know-how, patents, etc., and the nature of assets employed by Associated Enterprise 1.

Risks assumed by Associated Enterprise 1 and Associated Enterprise 2 – which of the two entities bears significant risks such as market risk, price risk, credit risk, inventory risk, etc.

The results of the above analysis would determine the characterisation of Associated Enterprise 2 into ‘low risk distributor’ or ‘normal distributor’ depending upon the intensity of functions performed, the type of assets employed and the level of risks assumed.

2.5 Selection of the Tested Party

Selection of the tested party is the first step while undertaking ‘economic analysis’ i.e. analysis of commercial and economic factors affecting international transactions to determine arm’s length price. Economic analysis involves detailed analysis of the transaction to be benchmarked and includes the following three steps:

- Selection of the tested party;
- Selection of the MAM; and
- Application of the MAM to determine the ALP.

Each of the three steps involved in performing economic analysis are discussed in subsequent section.

“As a general rule, the tested party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found, i.e. it will most often be the one that has the less complex functional analysis.”¹¹

“When applying a cost plus, resale price or transactional net margin method it is necessary to choose the party to the transaction for which a financial indicator (mark-up on costs, gross margin, or net profit indicator) is tested. The choice of the tested party should be consistent with the functional analysis of the transaction. As a general rule, the tested party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found, i.e. it will most often be the one that has the less

¹¹Para 3.18, of Chapter III of the OECD Guidelines, 2022

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complex functional analysis.

This can be illustrated as follows. Assume that company A manufactures two types of products, P1 and P2, that it sells to company B, an associated enterprise in another country. Assume that A is found to manufacture P1 products using valuable, unique intangibles that belong to B and following technical specifications set by B. Assume that in this P1 transaction, A only performs simple functions and does not make any valuable, unique contribution in relation to the transaction. The tested party for this P1 transaction would most often be A. Assume now that A is also manufacturing P2 products for which it owns and uses valuable unique intangibles such as valuable patents and trademarks, and for which B acts as a distributor. Assume that in this P2 transaction, B only performs simple functions and does not make any valuable, unique contribution in relation to the transaction. The tested party for the P2 transaction would most often be B."¹²

2.6 Selection of Most Appropriate Method

In order to benchmark the international/intra group transactions, a taxpayer has to choose/select the most appropriate method out of the six methods prescribed by the Indian TP regulations which are as follows:

- CUP Method;
- RPM;
- CPM;
- PSM;
- TNMM; and
- Other Method

The selection of the most appropriate method depends upon the facts and circumstances of each case. Each method is described in detail as follows:

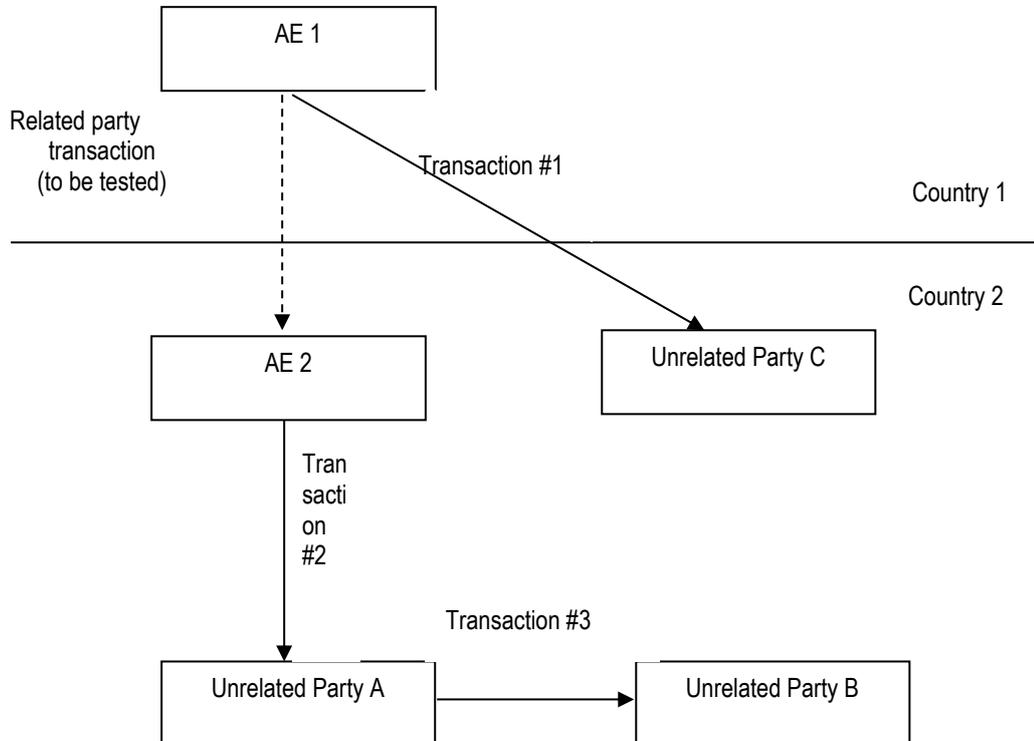
2.6.1 Comparable Uncontrolled Price Method

CUP method is the benchmarking approach which compares the prices charged/paid in a transaction between AEs with that of the transaction involving unrelated entities. The transactions that take place in an uncontrolled environment are known as 'comparable uncontrolled transactions'. In practice, there are two types of comparable uncontrolled transactions. The first, known as an "Internal Comparable", is a transaction between one of the parties to the controlled transaction and an unrelated third party. The second, known as an "External Comparable", is a transaction between two unrelated third parties.

The application of CUP method could be better understood with the help of following

¹²Source: Para 3.18 & Para 3.19 of Chapter III of the OECD Guidelines, 2022

diagram¹³:



Facts of the case: The controlled transaction i.e. the transaction between Associated Enterprises in the above diagram involves the transfer of bicycles between Associated Enterprise 1, a bicycle manufacturer in Country 1, and AE 2, a bicycle importer in Country 2, which purchases, imports and resells the bicycles to unrelated bicycle dealers in Country 2. AE 1 is the parent company of AE 2.

In applying the CUP method to determine whether the price charged for bicycles transferred in controlled is at arm's length, the following information is assumed to be available for consideration:

- The price charged for bicycles transferred in a comparable uncontrolled transaction between AE 1 and Unrelated Party C (i.e. transaction #1);
- The price charged for bicycles transferred in a comparable uncontrolled transaction between AE 2 and Unrelated Party A (i.e. transaction #2); and
- The price paid for bicycles transferred in a comparable uncontrolled transaction between Unrelated Party A and Unrelated Party B (i.e. transaction #3).

¹³Source: UN TP Manual 2021 (Para4.2.1.1), Figure 4.D.1

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Comparable uncontrolled transactions, such as transaction 1 or #2, which involve a transaction between the tested party and an uncontrolled party, are referred to as internal comparables. Comparable uncontrolled transactions such as transaction #3, which involves a transaction between two parties neither of which is an AE, are called external comparables.

2.6.2 Resale Price Method

RPM is the benchmarking approach which compares the gross profits earned by the tested party with that of comparable companies engaged in similar business. RPM is generally applied in case of resellers/distributors that purchase the finished goods from group companies for the purpose of resale.

“The RPM analyses the price of a product that a related sales company (i.e. Associated Enterprise 2 in diagram below) charges to an unrelated customer (i.e. the resale price) to determine an arm’s length gross margin, which the sales company retains to cover its sales, general and administrative (SG&A) expenses, and still make an appropriate profit. The appropriate profit level is based on the functions it performs and the risks it undertakes. The remainder of the products price is regarded as the arm’s length price for the inter-company transactions between the sales company (i.e. AE 2) and a related company (i.e. AE 1). As the method is based on arm’s length gross profits rather than directly determining arm’s length prices (as with the CUP Method), the Resale Price Method requires less direct transactional (product) comparability than the CUP Method.

The concept could be better understood with the help of the following example:¹⁴



Given price = US\$100

Re-sale price margin (25%) = US\$ 25

Arm’s length price = US\$ 75

“Consequently, under the RPM the starting point of the analysis for using the method is the sales company. Under this method the transfer price for the sale of products between the sales company (i.e. AE 2) and a related company (i.e. AE 1) can be described in the following formula:

¹⁴Source: UN TP Manual 2021 (Para 4.3.1.2)

TP = RSP x (1-GPM), where:

TP = the Transfer Price of a product sold between a sales company and a related company;

RSP = the Resale Price at which a product is sold by a sales company to unrelated customers; and

GPM = the Gross Profit Margin that a specific sales company should earn, defined as the ratio of gross profit to net sales. Gross profit is defined as Net Sales minus Cost of Goods Sold.”¹⁵

The financial ratio analysed under the RPM is the gross profit margin. Gross profit is defined as net sales minus cost of goods sold. It is easiest to determine where the reseller does not add substantially to the value of the product.

2.6.3 Cost Plus Method

“The CPM is typically applied in cases involving the inter-company sale of tangible property where the related party manufacturer performs limited manufacturing functions or in the case of intra-group provision of services. The method usually assumes the incurrence of low risks, because the level of the costs will then better reflect the value being added and hence the market price.

The CPM is also generally used in transactions involving a contract manufacturer, a toll manufacturer or a low risk assembler which does not own product intangibles and incurs little risk. The related customer involved in the controlled transaction will generally be much more complex than the contract manufacturer in terms of functions performed (e.g. conducting marketing and selling functions, coordination of production and sales, giving instructions to the contract manufacturer about the quantity and quality of production, and purchasing raw materials in some cases), risks incurred (e.g. market risk, credit risk and inventory risk) and assets owned (product intangibles). The contract manufacturer is thus the less complex and as such should be the tested party in the TP analysis.

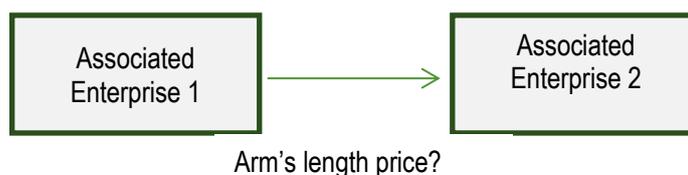
The CPM is usually not a suitable method to use in transactions involving a fully-fledged manufacturer which owns valuable product intangibles as it will be very difficult to locate independent manufacturers owning comparable product intangibles. That is, it will be hard to establish a profit mark-up that is required to remunerate the fully-fledged manufacturer for owning the product intangibles. In a typical transaction structure involving a fully-fledged manufacturer and related sales companies (e.g. commissionaires), the sales companies will normally be the least complex entities involved in the controlled transactions and will therefore be the tested party in the analysis. The RPM is typically more easily applied in such cases.”

“The CPM is most often used to analyse transfer pricing issues involving tangible property or services. It is typically applied to manufacturing or assembling activities and relatively simple service providers. The method evaluates the arm’s-length nature of an intragroup charge by reference to the gross profit mark-up on costs earned by independent suppliers of tangible

¹⁵Source: UN TP Manual 2021 (Para 4.3.1.3)

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property or services in comparable uncontrolled transactions. That is, it compares the gross profit mark-up earned by the tested party for manufacturing the product or for providing the service to the gross profit mark-ups earned by comparable companies engaged in comparable transactions¹⁶. The aforesaid method is explained with the help of following diagram:



Cost of Associated Enterprise 1	= US\$ 500
+Gross Profit Mark Up (50%)	= US\$ 250
Arm's length price	= US\$ 750

Like the RPM, the CPM is a gross margin method; that is, it attempts to derive an arm's length amount of gross profit, in this case through an arm's length mark-up on Cost of Goods Sold ('COGS').

"In the above example, Associated Enterprise 1, an electrical goods manufacturer in Country 1, manufactures under contract for AE 2. AE 2 instructs AE 1 on the quantity and quality of the goods to be produced. AE 1 will be guaranteed sales to AE 2 and will face little risk. As AE 1 is less complex in terms of functions, assets and risks than AE 2, the analysis under the CPM would focus on Associated Enterprise 1 as the tested party. Since Associated Enterprise 1 is a simple manufacturer, the Cost-Plus Method may be the best method of analysis in this case. The CPM analyses whether the gross profit mark-up earned by AE 1 is at arm's length by reference to the gross profit margins earned by companies manufacturing comparable goods for (or providing comparable services to) unrelated parties. The CPM thus does not directly test whether the transfer price is at arm's length by comparing prices. As such, it is a less direct (transactional) method as compared to the CUP Method."¹⁷

2.6.4 Profit Split Method

"As with any transfer pricing method, the profit split should be used where it is found to be the most appropriate method to the circumstances of the case. Primarily, this determination is based on the nature of the accurately delineated transaction in the context of its circumstances. The analysis to determine the accurately delineated transaction should consider the commercial and financial relations between the related parties, their functions performed, assets used or contributed, and risks assumed, and how the activities of the

¹⁶Source: UN TP Manual 2021 (Para 4.4.1.3 and figure 4.D.3)

¹⁷Source: UN TP Manual 2021 (Para 4.4.1.4.)

parties impact the transaction given the market context in which the transaction occurs.

While as noted above, the PSM can be a complex method to apply reliably, the determination of when it is the most appropriate method should be done as objectively as possible. That is, the profit split method should not simply be regarded as a method of last resort. Moreover, while the method may require relatively more, or more detailed information from the taxpayer and its associated enterprise(s) than other methods, where it is indeed found to be the most appropriate method, reasonable efforts should be made to gather such necessary information which, after all, will typically be in the hands of the MNE.”¹⁸

“The PSM seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that it is appropriate to aggregate) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions.

The PSM may be appropriate where:

- each related party to the transaction makes unique and valuable contributions; and/or
- the business operations of the related parties are so highly integrated that they cannot be reliably evaluated in isolation from each other; and/or
- the parties share the assumption of economically significant risk or separately assume closely related risks.

The PSM starts by identifying the relevant profits, or indeed losses in relation to the controlled transactions. It then seeks to split those profits or losses between the associated enterprises involved on an economically valid basis in order to achieve an arm’s length outcome for each party. Typically, the split should reflect the relative value of each enterprise’s contribution, including its functions performed, risks assumed and assets used or contributed.

The PSM is also referred to as the transactional profit split method. It can be distinguished from global formulary apportionment approaches in the following ways. The PSM typically does not start with the global or total combined profits of the entire MNE group. Rather, it begins from the relevant profits in relation to particular transactions between two or more associated enterprises. Moreover, in order to comply with the arm’s length principle, the way in which the method is applied should not be arbitrary, but rather should approximate the results achieved had the parties been independent of each other. In particular, the factors by which the relevant profits are split between the associated enterprises to the transaction are typically based on measures of their relative contributions to value creation rather than an arbitrary formula.”¹⁹

¹⁸Source: UN TP Manual 2021 (Para 4.6.3.1)

¹⁹Source: UN TP Manual 2021 (Para 4.6.1.3 – Para 4.6.1.6)

2.6.5 Transactional Net Margin Method

“The TNMM compares the net profit margin (relative to an appropriate base) that the tested party earns in the controlled transactions to the same net profit margins earned by the tested party in comparable uncontrolled transactions or alternatively by independent comparable companies. As it uses net margins to determine arm’s length prices the TNMM is a less direct method than the CPM and Resale Price Method that compares gross margins. It is also an even more indirect method than the CUP Method that directly compares prices. Many factors may affect net profit margins but may have nothing to do with transfer pricing.”²⁰

TNMM is usually applied with respect to broad comparable functions rather than particular controlled transactions. Returns to these functions are typically measured by a PLI in the form of a net margin that arguably will be affected by factors unrelated to arm’s length pricing. Consequently, one might expect the TNMM to be a relatively disfavoured method. Nevertheless, TNMM is typically applied when two related parties engage in a continuing series of transactions and one of the parties controls intangible assets for which an arm’s length return is not easily determined. Since TNMM is applied to the party performing routine manufacturing, distribution or other functions that do not involve control over such intangible assets, it allows the appropriate return to the party controlling unique or difficult-to value intangible assets to be determined indirectly.

The application of the transactional net margin method may be understood with the following example:

AE1 Ltd., is an Indian company

AE1 Ltd., manufactures compact disc (CD) writers and sells the same to AE2 Ltd., which is an AE of AE1 Ltd. AE 1 acts as a distributor of CD writers in India.

Bases on detailed Functional analysis AE2 is selected as the tested party as it has simpler operations.

As AE1 Ltd., does not have similar transaction with a non AE, no internal CUT is available

RPM cannot be taken as most appropriate method as AE 2 also performs certain value added function and accordingly TNMM is selected as the MAM.

As AE1 Ltd., does not have information and data to identify a comparable company, it has used the databases in public domain for carrying out the search. Comparable search would aim to identify companies similar to AE2. Accordingly, if operating margin of comparable selected is in line with margins earned by AE2, the transaction between AE1 and AE2 can be said to have been undertaken at arm’s length.

2.6.6 Other Method

The Other Method is applied in cases where all the five methods could not be adopted as the most appropriate method. It is pertinent to note that CUP requires comparable pricing data

²⁰Source: UN TP Manual 2021 (Para 4.5.2.2)

emanating from actual transaction that has taken place in uncontrolled environment; however, other method allows the use of comparable pricing data based upon price quotations, market rates, etc. Possible approaches under this method could be use of valuation methodologies for determining arm's length price for transfer of business/ intangibles and technical valuation reports for determining arm's length price for purchase/ sale of fixed assets, etc.

Comparability criteria under various methods:

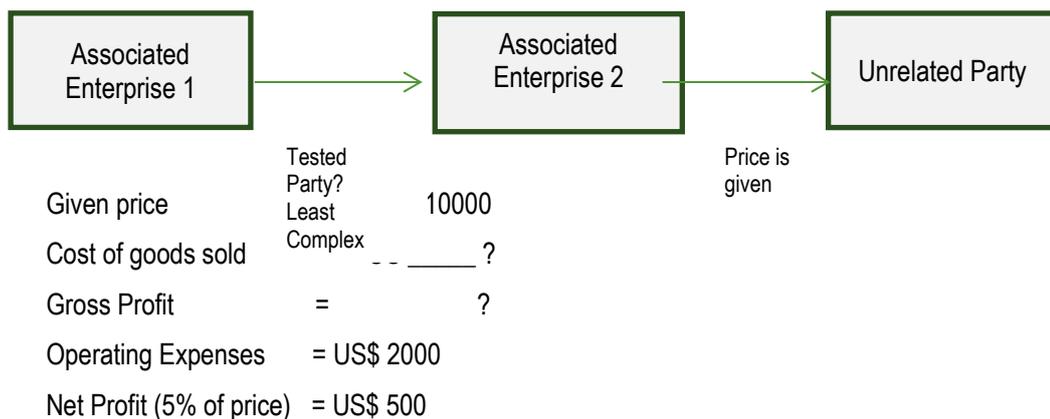
As discussed above, the comparability criteria would depend upon the most appropriate method selected for benchmarking the international transaction/SDT.

Product comparability is most important in applying the CUP Method, as differences in products will result in different prices. The Cost Plus Method and the Resale Price Method are less dependent on product comparability and focus on functional comparability because differences in functions that are reflected in differences in operating expenses may lead to a broad range of gross margins. However, the TNMM is even less dependent on product comparability and functional comparability than the traditional transaction methods, because net margins are less influenced by differences in products and functions. The TNMM focuses on broad product and functional comparability.

However, the comparability standard to be applied to the TNMM requires a high degree of similarity in several factors between the tested party and the independent enterprises that may adversely affect net margins. Net margins may be affected by factors that have no effect, or a less significant effect, on gross margins or prices due to the variation of operating expenses between companies. These factors may be unrelated to transfer pricing.

Application of most appropriate method – Case Study

“The process of selection of tested party and the most appropriate method is illustrated with the help of following example:



AE 1, a bicycle manufacturer in Country 1, sells bicycles to AE 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2. Assume that Associated

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Enterprise 1 is the more complex party, controlling a variety of technology and operating intangibles. The CUP Method would compare the price charged in the controlled transaction between AE 1 and AE 2 with the price charged in comparable uncontrolled transactions. If the CUP Method cannot be applied, the CPM and RPM may be considered.

The CPM is likely to be relatively unreliable in this case because it would treat the more complex entity, AE 1, as the tested party. Given that AE 1 owns valuable intangible property, the resale price could be considered. Under the RPM the sales company, the least complex of the two entities involved in the controlled transaction, will be the tested party. The analysis would entail a search for distributors which sell broadly similar products, which perform functions and incur risks comparable to those of AE 2, and for which appropriate data relating to gross profits can be obtained.

Sometimes it may be more reliable to choose the TNMM and compare net profits. If, for example, there is different reporting of the cost of goods sold and operating expenses for the tested party and the comparable distributors, so that the gross profit margins reported are not comparable and reliable adjustments cannot be made, the Resale Price Method may be relatively unreliable. However, this type of accounting inconsistency will not affect the reliability of the TNMM, as this method examines net profit margins instead of gross profit margins. Also, as further discussed below, the fact that the TNMM requires less product comparability than the traditional transaction methods (and as such has a greater tolerance to product differences and cost accounting differences compared to traditional transaction methods) can be a significant practical benefit of using TNMM.

The application of the TNMM would entail an analysis of the least complex party — in this case the distributor. Such an analysis would entail a search for comparable distributors taking into account the comparability standard of this method. An application of the TNMM focusing on the related party manufacturer as the tested party could be, for example, the situation in which AE 1 is a contract manufacturer. In such a case, the contract manufacturer will typically be the least complex entity as MNEs often separate the ownership of valuable technology intangibles from the manufacturing function. The CPM would normally be considered if the CUP Method cannot be applied. However, due to the accounting inconsistency mentioned above, it may be appropriate to apply the TNMM using a financial ratio based on net profit margin that is appropriate for a manufacturer (e.g. return on total costs).”

Selection of Most Appropriate Profit Level Indicator

Under profit based methods, the gross/net profits relative to an appropriate base earned by the tested party and comparables is compared to determine the arm’s length nature of the international transaction/SDT.

Several PLIs are allowed under the TNMM, typically based on operating profit. A PLI is a measure of a company’s profitability that is used to compare comparables with the tested party. A PLI may express profitability in relation to (i) sales, (ii) costs or expenses, or (iii)

assets. More specifically, the PLI can be the operating profit relative to an appropriate base (e.g. costs, sales or assets). With the help of “profit level indicators” the net profitability of the controlled transaction is compared to the net profitability of the uncontrolled transactions.

“The denominator should be reasonably independent from controlled transactions, otherwise there would be no objective starting point. For instance, when analysing a transaction consisting in the purchase of goods by a distributor from an AE for resale to independent customers, one could not weight the net profit indicator against the cost of goods sold because these costs are the controlled costs for which consistency with the arm’s length principle is being tested. Similarly, for a controlled transaction pertaining to the provision of services to an associated enterprise, one could not weight the net profit indicator against the revenue from the sale of services because these are the controlled sales for which consistency with the arm’s length principle is being tested. Where the denominator is materially affected by controlled transaction costs that are not the object of the testing (such as head office charges, rental fees or royalties paid to an AE), caution should be exercised to ensure that said controlled transaction costs do not materially distort the analysis and in particular that they are in accordance with the arm’s length principle.”²¹

The following table briefly summarises the various PLIs used while undertaking benchmarking of international transactions/SDT:

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
Operating Margin (OM)	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

The selection of most appropriate PLI could be illustrated with the help of following case study:

Continuing the same case study as discussed under the heading ‘Application of most appropriate method – Case Study’, the international transaction pertains to import of bicycles by Associated Enterprise 2 from Associated Enterprise 1.

²¹Source: Para 2.94 of Chapter II of OECD Guidelines, 2022

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As discussed earlier, while selecting PLI, the denominator should be the one which is uncontrolled or is least tainted. In the present case, the international transaction pertains to purchase of bicycles, hence, the most appropriate PLI would be Net Operating Profit as a percentage of Sales.

For determination of arm's length price, the PLI of tested party is compared with that of comparables. If the net operating profit relative to sales earned by tested party is equal to or greater than that of comparables, then the international transaction is at arm's length.

2.7 Economic Analysis

Economic (or Benchmarking) analysis means analysing or comparing the transfer price i.e. prices set in controlled environment with that of uncontrolled environment. This would involve the following:

- Application of the MAM
After reviewing all the transfer pricing methods, based on facts and circumstances, the most appropriate method should be selected which provides the most reliable measure of an arm's length result for the transaction.
- Search for uncontrolled comparable transactions and determination of ALP
Based on the most appropriate method selected for determining the arm's length price, the next step is search for uncontrolled comparable prices/profit margins and arriving at the arm's length price which is the primary objective of preparing TP study.

Typical process followed while performing comparability analysis

“Generally, benchmarking process involves following steps:

Step 1: Determination of years to be covered.

Step 2: Broad-based analysis of the taxpayer's circumstances.

Step 3: Understanding the controlled transaction(s) under examination, based in particular on a functional analysis, in order to choose the tested party (where needed), the most appropriate transfer pricing method to the circumstances of the case, the financial indicator that will be tested (in the case of a transactional profit method), and to identify the significant comparability factors that should be taken into account.

Step 4: Review of existing internal comparables, if any.

Step 5: Determination of available sources of information on external comparables where such external comparables are needed taking into account their relative reliability.

Step 6: Selection of the most appropriate transfer pricing method and, depending on the method, determination of the relevant financial indicator (e.g. determination of the relevant net profit indicator in case of a transactional net margin method).

Step 7: Identification of potential comparables: determining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on

the relevant factors identified in Step 3 and in accordance with the comparability factors discussed earlier in this module.

Step 8: Determination of and making comparability adjustments where appropriate.

Step 9: Interpretation and use of data collected, determination of the arm's length remuneration."²²

How to find comparable uncontrolled transactions?

"A comparable uncontrolled transaction is a transaction between two independent parties that is comparable to the controlled transaction under examination. It can be either a comparable transaction between one party to the controlled transaction and an independent party ("internal comparable") or between two independent enterprises, neither of which is a party to the controlled transaction ("external comparable")."²³

There are various sources of information that can be used to identify potential external comparables which are described below:

Databases

A common source of information is commercial databases, which have been developed by editors who compile accounts filed by companies with the relevant administrative bodies and present them in an electronic format suitable for searches and statistical analysis.

Some of the common databases used for finding comparable companies in India are Prowess [developed by Centre for Monitoring Indian Economy Pvt. Ltd.], Capitaline, etc. whereas 'Amadeus' is commonly used in European, and African region while Oriana and Osiris are generally used in Asian and Australian region. All companies on Prowess are mapped with a National Industrial Classification ('NIC') code. The NIC code for distribution of bicycles is 4649 ('wholesale of bicycles and related parts and accessories'), and 4763 ('retail sale of bicycles and related parts and accessories'). Other sources of information include the use of non-transactional third party databases such as Royalty Stat, S&P Loan Connector, etc. for benchmarking royalty and loan transactions.

If required, the following adjustments could be carried out in the comparability data to account for differences in:

- The type and quality of products;
- Delivery terms;
- Volume of sales and related discounts;
- Product characteristics;

²²Source: Para 3.4 of Chapter III of OECD Guidelines, 2022 [Page 150]

²³Source: Para 3.24 of Chapter III of OECD Guidelines, 2022 [Page 156]

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- Contractual terms;
- Risk incurred; and
- Geographical factors

The entire benchmarking process is illustrated with the help of following example:



Facts of the case: AE 1, a bicycle manufacturer in Country 1, sells bicycles to AE 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2.

As discussed earlier, AE 2 is selected as the tested party and TNMM is selected as the most appropriate method. The most appropriate PLI is 'Operating Profit/Sales'.

For benchmarking the international transaction pertaining to import of bicycle by AE 2, the following steps need to be undertaken:

- **Selection of time period:**

The Indian Regulations prescribe the use of current year data in which the transaction has been undertaken. However, if the data for current year is not available for comparable companies, the taxpayer may consider data for up to previous two years. For instance, the international transaction pertaining to import of bicycles was undertaken in financial year 2021-22, however, data for comparable companies is not available in public domain for the relevant year, then the taxpayer may consider data for financial years 2019-20 and 2020-21 and compute the arithmetic mean to determine the arm's length price.

- **Undertaking search for comparables:**

Assuming that in the above case study, Associated Enterprise 2 i.e. the tested party is situated in India, the search for comparable companies engaged in the business of distribution of bicycles could be undertaken by using databases such as Prowess, Capitaline, etc. The selection of comparables would involve application of common filters such as:

1. Selection of comparables having sales greater than INR 1 crore;
2. Selection of comparables having net worth greater than 0 (zero);
3. Selection of comparables having trading sales/total sales greater than 50%;
4. Rejection of comparables having RPT/Sales>25%; and/ or
5. Qualitative criteria: Selection of comparables engaged in distribution of bicycles.

If required, the appropriate adjustments could be carried out to account for differences in the type and quality of products, risk incurred etc.

2.8 Conclusion

The conclusion section of TP report captures high level summary of the TP study, primarily including the transactions involved, most appropriate method and PLI used and the results of the benchmarking analysis. The margins of the tested party must fall within the range²⁴ of the third party comparables or higher than the arithmetic mean²⁵ of comparable companies.

In case the tested party is incurring losses, the justification for the same is included in this section. Also, in case where the margins earned by tested party are lower than arithmetic mean of comparables (i.e. cases where 35th to 65th percentile range is not applicable), then the revised margin computation after allowing the benefit of (+/-) 3% as allowed under proviso to section 92C(2) of the Act is shown, based on which the final conclusion is drawn stating whether the results of tested party are at arm's length.

2.9 Appendices

At the end of the TP report, following could be annexed as Appendices

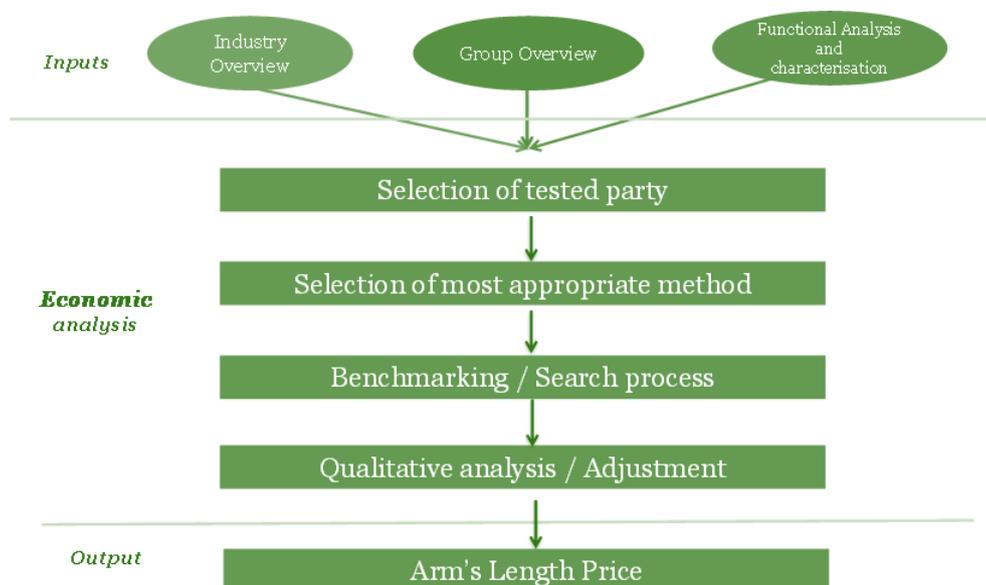
- Abbreviations
- Indian TP regulations
- Details of international transactions
- Details of Databases used, if any
- Business Description of comparable companies
- Segmented Financial Information, if applicable
- Application of the provisions to Section 92C(2) of the Act, if applicable

²⁴If the number of comparables is 6 or more

²⁵If number of comparables is less than 6

2.10 Summary of Entire TP Study

The entire TP Study could be summarised with the help of following diagram:



2.11 Things to Remember

Basic checks to be performed while/after preparing TP study:

- Perform a spell check after preparing the first draft of the TP Study;
- Check header and footers;
- Ensure that full forms of all the abbreviations used are defined;
- Update the 'Table of Contents' after editing the document so that the index is always updated
- Reconfirm executive summary results with economic analysis and financial results;
- Financial results should tally with signed financials/segment provided by client;
- Cross check value of transactions with 3CEB;
- If the report is draft ensure there is 'draft' written on cover page and reflected on each page; and
- Share pdf version of the report with the client.

3. Master File

Section 92D of the Act provides that the entities that are constituents of an international group, shall be required to maintain such information and documents as prescribed (i.e. master file) in addition to the information prescribed in Rule 10D. Further, Rule 10DA of the Rules

prescribe the requirements that apply to every taxpayer, being a constituent entity of an international group. The same needs to be furnished in Form 3CEAA to provide the information prescribed in Rule 10DA. The Form 3CEAA comprises of two parts namely Part A and Part B.

Part A of Master File – Part A comprises of basic information relating to the International Group (“IG”) and the constituent entities of the IG operating in India (such as name, permanent account number and address). The final rules have clarified that Part A of the Master File will be required to be filed by every constituent entity of an IG, without applicability of any threshold;

Part B of Master File:

Master File Requirement	Summary of documents to be maintained in India
Organization structure	<ul style="list-style-type: none"> • Chart illustrating international group’s legal and ownership structure and geographical location of operating entities and addresses of all entities of the international group
Description of international business of group’s	<ul style="list-style-type: none"> • Description of important drivers of business profit • Description of supply chain for five largest products/ services in terms of revenue and/or which contributes to more than 5% of IG’s revenues • Functional analysis of the principal contributors to value creation • Important business restructuring transactions • Functions, assets and risk (“FAR”) analysis of entities contributing at least 10% of the IG’s revenue OR assets OR profits
International group’s intangibles	<ul style="list-style-type: none"> • International group’s strategy for ownership, development and exploitation of intangibles • List of important intangibles with ownership • Important agreements and corresponding transfer pricing policies in relation to Research & Development (“R&D”) and intangibles • Names and addresses of all entities of the international group engaged in development and management of intangible property • Addresses of entities legally owning important intangible property and entities involved in important transfers of interest in intangible property
International Group’s intercompany financial	<ul style="list-style-type: none"> • Description of how the international group is financed, including identification of important financing arrangements

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Master File Requirement	Summary of documents to be maintained in India
activities	<p>with unrelated lenders</p> <ul style="list-style-type: none">• Identification of entities performing central financing function including their place of operation and effective management and corresponding transfer pricing policies• Names and addresses of top ten unrelated lenders• Names and addresses of entities providing central financing functions including their place of operation and effective management

As per Rule 10DA, every constituent entity of the international group, shall furnish the information as contained under Part A of Form 3CEAA to Joint Director of Income Tax. This requirement is mandatory even if such constituent entity does not meet the monetary thresholds prescribed by Rule 10DA. Further, the Finance (No.2) Act 2019 clarified that Master File (i.e. Part A) needs to be filed even if there is no international transaction.

Further, a constituent entity, which fulfils the consolidated revenue and transactional threshold as given below, would be required to furnish the information as contained under Part B of Form 3CEAA to meet the master file compliance obligation criteria:

- (i) The consolidated revenue of the international group, of which such taxpayer is a constituent entity, as reflected in the consolidated financial statement of the international group for the accounting year, exceeds INR 500 crores; and
- (ii) Either of the below transactional thresholds is achieved for the accounting year:
 - The aggregate value of international transactions as per the books of accounts maintained by the taxpayer exceeds INR 50 crores; or
 - The aggregate value of international transaction in respect of the purchase, sale, transfer, lease or use of intangible property (IP) as per the books of accounts maintained by the taxpayer exceeds INR 10 crores

Further, the Final Rules clarify that for the purpose of computation of the INR value of the consolidated group revenue (if it is reported in a foreign currency), telegraphic transfer buying rate of such foreign currency (as quoted by State Bank of India) on the last day of the accounting year would be adopted.

The accounting year for the purpose of these provisions where the ultimate parent entity/alternate reporting entity ('ARE') resident in India would be the FY starting from 1 April and ending on 31 March of the following year. In all other cases, the reporting accounting year would be an annual accounting period, with respect to which the parent entity of the international group prepares its financial statements under any law for the time being in force or the applicable accounting standards of the country or territory of which such entity is resident.

3.1 Structure of Master File (Form 3CEAA)

As mentioned above the Master File in Form 3CEAA is divided in 2 parts: Part A and Part B

3.1.1. Part A consists of the following:

- Name, address, the tax identification number (i.e., referred to as permanent account number or PAN) of the constituent entity resident in India,
- Name and address of the international group,
- Accounting year for which the report is being submitted,
- Number of constituent entities of the international group operating in India along with their names, addresses and PAN.

3.1.2. Part B consists of a high level description regarding the group business including the nature of its global business operations, its overall transfer pricing policies, its global allocation of income and economic activity in order to assist tax administrations in evaluating the presence of significant transfer pricing risk.

An indicative overview and description of the details to be covered in Part B is as follows:

- ***a list of all entities of the international group along with their addresses;***
The data contained to provide an overview of the types of entities by tax jurisdiction
- ***a chart depicting the legal status of the constituent entity and ownership structure of the entire international group;***
The Organizational structure of the group consists of manufacturing and processing facilities / sales, distribution / service entities. The data contained to provide an overview of the types of entities by tax jurisdiction in addition to the ownership of the entities by the overall parent entity.
Inactive entities, entities that no longer are operational or may have been already disposed of during the accounting year may not be included here.
- ***a description of the business of international group during the accounting year including:***
 - ***nature of the business or businesses;***
This section provides an overview of group's businesses.
 - ***important drivers of profits of such business or businesses;***
This section to provide the long term growth strategy of the group and drivers of such growth

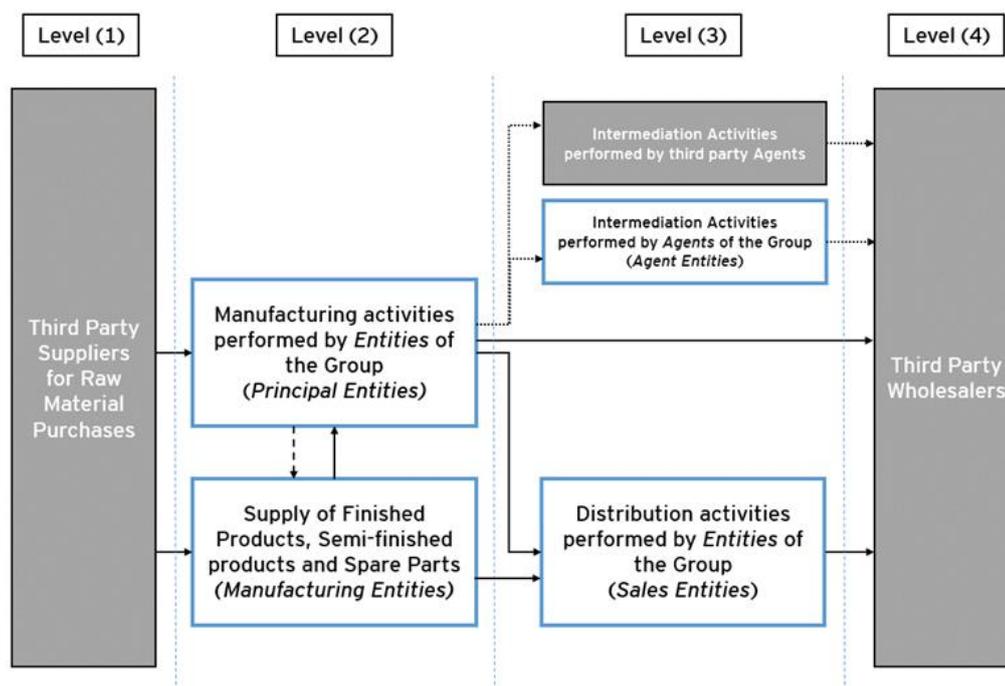
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- **supply chain for the five largest products or services in terms of revenue and any other products including services amounting to more than five per cent of consolidated group revenue;**

This section provides the description of the supply chain for the group's five largest products and/or service offerings by turnover plus any other products and/or services amounting to more than 5 percent of group turnover. [If services contribute to more than 5% of revenues, it needs to get captured under this section].

Example: A German headquartered printing machine manufacturer has twelve models of machine. Each machine model is to be understood as a product offering. The top five selling machine models are to be presented. If the revenue of another machine model exceeds 5%, it should be presented as well.

Further, a supply chain of the products can also be substantiated by way of a graphical representation. Illustrative example as given below:



- **important intra group service arrangements other than those for research and development services;**

This section provides the details of important intra group service arrangements being provided by the group companies within the group; other than those for research and development services. This section should cover all important arrangements whether or not they are documented in a written agreement;

Example: Intra Group services by a headquarter may include back-off/support services such as accounting, finance, tax, legal, human resources, information technology, and other support operations, but exclude shareholder or stewardship costs. In addition, headquarters services may include more value added services such as strategic operative guidance.

— **capabilities of the main service providers;**

This section to provide a description of the capabilities of the principal locations providing important services

Example: The capability of the Shared Service Center can be indicated by the headcount.

— **transfer pricing policies for allocating service costs and determining prices to be paid for intra-group services;**

This section provides transfer pricing policies for allocating services costs and determining prices to be paid for intra-group services

Example: Headquarter charges out all of its costs, including indirect and overhead costs, plus a mark-up, and allocates these costs across the beneficiaries using allocation keys that reflect proportional benefits, e.g., finance by proportion of revenue, IT by proportion of software licenses, human resources by proportion of headcount, etc.

— **major geographical markets for the products and services offered;**

This section provides a description of the main geographic markets for the group's products and services

— **the functions performed, assets employed and risks assumed by the constituent entities that contribute at least ten per cent of the revenues or assets or profits of such group;**

This section includes a brief functional analysis describing the principal contributions to value creation by individual entities within the group, i.e. key functions performed, important risks assumed, and important assets used. It is important to ensure consistency with Table 2 of country-by-country report (if applicable).

— **important business restructuring transactions, acquisitions and divestments;**

This section provides a description of important business restructuring transactions, acquisitions and divestitures occurred during the accounting year.

Example: If all commissionaires were converted to buy/sell distributors that could be included within this section.

- **Details and description of intangibles including:**
 - **overall strategy of the international group for the development, ownership and exploitation of intangible property, including location of principal research and development facilities and their management**

This section provides a general description of the MNE's overall strategy for the development, ownership and exploitation of intangibles, including location of principal R&D facilities and location of R&D management.

Example: The ABC group, an Indian-headquartered multinational life sciences group, develops, manufactures and sells patented pharmaceutical products world-wide. ABC India, the Indian parent company, owns and controls all of the group's patents and related IP. ABC operates R&D facilities in Switzerland, Germany, France, the US and China. ABC AG (Switzerland) provides funding and overall management and control of these facilities pursuant to contract R&D agreements. ABC's products are all manufactured in Switzerland and are sold to ABC group sales and marketing companies. ABC's transfer pricing policy is to sell all manufactured product on a cost plus basis that is designed to leave the group sales and marketing companies with an arm's length return on sales.

- **Details of all entities engaged in development and management of intangible property;**

This section provides generic details of all entities engaged in development and management of intangible property

- **important intangible property or groups of intangible property owned by the international group along with details of the group entities that legally own such intangible property;**

This section provides a list of the intangibles or groups of intangibles of the MNE group that are important for transfer pricing purposes for the current fiscal year and which entities legally own them

- **important agreements among members related to intangible property, including cost contribution arrangements, principal research service agreements and license agreements;**

This section provides a list of important agreements among identified associated enterprises related to intangibles, including cost contribution arrangements, principal research service agreements and license agreements.

- **transfer pricing policies related to research and development and intangible property;**

This section provides a description of the group's transfer pricing policies related to R&D and intangibles.

— **important transfers of interest in intangible property,**

This section provides a general description of any important transfers of interests in intangibles among associated enterprises during the accounting year concerned, including the entities, countries, and compensation involved.

Example: X Group acquired Y Group in 2018 year. X Group decided to centralize the intangibles of the Y Group. Prior to the transfer, intangibles were owned by entities A, B and C in countries A, B and C. Intangibles of Y Group were transferred to Z Company, based in Z Country. The ALP, determined by reference to discounted future cash flows for A, B and C, respectively, was \$100, \$120, \$130 USD.

• **Details and description of financial and tax arrangements**

— **Financing arrangements of the international group, including the names and addresses of the top ten unrelated lenders;**

This section provides a general description of how the group is financed, including important financing arrangements with unrelated lenders.

Example: The Group's Treasury Department centralizes all the subsidiaries' financing needs and negotiations with financial institutions in order to have better command over financing terms. Any transactions that may be carried out directly by subsidiaries are closely supervised.

— **Details of group entities that provide central financing functions, including their place of operation and of effective management;**

This section provides a general description of the members within the international group that provide a central financing function for the group, including the country under whose laws the entity is organised and the place of effective management of such entities.

— **transfer pricing policies of the international group related to financing arrangements among group entities;**

This section provides a general description of the group's general transfer pricing policies related to financing arrangements between associated enterprises.

For Example:

<i>Type of financing</i>	<i>Legal entity</i>	<i>Country of legal registration</i>	<i>Location of management</i>	<i>TP Policy</i>
<i>Cash pooling</i>	<i>ABC UK Ltd</i>	<i>United Kingdom</i>	<i>United Kingdom</i>	<i>Extend on same policy as third party lenders.</i>

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<i>Type of financing</i>	<i>Legal entity</i>	<i>Country of legal registration</i>	<i>Location of management</i>	<i>TP Policy</i>
<i>Guarantees</i>	<i>ABC UK Ltd</i>	<i>United Kingdom</i>	<i>United Kingdom</i>	<i>Percentage of underlying loan</i>
<i>Intercompany loans</i>	<i>Bahamas Ltd</i>	<i>Bahamas</i>	<i>United Kingdom</i>	<i>Fixed interest rate or LIBOR plus</i>

- **a copy of the annual consolidated financial statement of the international group;**

This section relates to group's annual consolidated financial statement for the fiscal year concerned if otherwise prepared for financial reporting, regulatory, internal management, tax or other purposes.

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

This section lists and offers a brief description of the international group's existing unilateral APAs, and other advance tax rulings relating to the allocation of income among countries enforceable in the current fiscal year.

3.2 Filing procedures and filing due dates

Form 3CEAA is to be filed with the Joint Director as may be designated by the Principal Director General of Income Tax (Systems) or the Director General of Income-Tax (Systems) on or before the due date for furnishing the income tax return.

Further, in cases where there are more than one constituent entity of an international group²⁶, Rule 10DA of the Rules allow for a single filing of both Part A and B of Form 3CEAA by a designated constituent entity. Notification of the same needs to be filed in Form 3CEAB to the Joint Director as may be designated by the Principal Director General of Income Tax (Systems) or the Director General of Income-Tax (Systems) on or before 30 days prior to the due date for furnishing the master file in Form 3CEAA.

Filing of the master file in Form 3CEAA as well as the notification by a designated constituent entity of an international group in Form 3CEAB would be done electronically on the income tax e-filing website in the specified procedure for such online filings.

²⁶ Rule 10DA(4) is amended effective from April 1, 2021 under the Income-tax (9th Amendment) Rules, 2021 introduced by CBDT; the words "constituent entities resident in India of an international group" are substituted by "constituent entities of an international group required to file the information and document under sub-rule (2)" i.e. to file Form 3CEAA.

Form 3CEAA / 3CEAB, as applicable, should be verified and signed by the person who is competent to verify the income tax return of the constituent entity under the Income Tax Act.

4. Country by Country ('CbC') Reporting

According to section 286 of the Act read with Rule 10DB, CbC reporting requirements would apply to an international group for an accounting year, if the total consolidated group revenue, as reflected in the consolidated financial statement for the preceding accounting year exceeds INR 6,400 crores (applicable from April 01, 2021) [erstwhile threshold being INR 5,500crores]. Similar to the Rule on master file maintenance, the Rules on CbC reporting provide that for the purpose of computation of the INR value of the consolidated group revenue (if it is reported in a foreign currency), telegraphic transfer buying rate of such foreign currency (as quoted by State Bank of India) on the last day of the accounting year would be adopted. The amount prescribed is consistent with the OECD recommendation of €750 million.

4.1 Details of information and documentation prescribed to be furnished as part of CbC reporting

AP 13 provides that the CbC reporting template requires MNEs to report the amount of revenue, profits, income tax paid and accrued, employees, stated capital, retained earnings and tangible assets annually for each tax jurisdiction where they do business. In addition, MNEs are required to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activity each entity conducts. The CbC reporting template is divided into three tables:

Table I. Part A - Overview of allocation of income, taxes and business activities by tax jurisdiction:

- Name of the Multinational Enterprise group:
- Reportable accounting year:
- Currency used:

Tax Jurisdiction	Revenues			Profit / (Loss) before Income Tax	Income tax paid on cash basis	Income tax Accrued – reportable accounting year	Stated Capital	Accumulated Earnings	Number of Employees	Tangible assets other than cash and cash equivalents
	Unrelated Party	Related Party	Total							

Specific instructions for Part A

a. In the column titled "Tax Jurisdiction", the Reporting multi-national enterprise (MNE) should list all of the tax jurisdictions in which Constituent Entities of the MNE group are resident for tax purposes. A tax jurisdiction is defined as a State as well as a non-State jurisdiction which

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has fiscal autonomy. A separate line should be included for all Constituent Entities in the MNE group deemed by the Reporting MNE not to be resident in any tax jurisdiction for tax purposes. Where a Constituent Entity is resident in more than one tax jurisdiction, the applicable tax treaty tie breaker should be applied to determine the tax jurisdiction of residence. Where no applicable tax treaty exists, the Constituent Entity should be reported in the tax jurisdiction of the Constituent Entity's place of effective management.

b. In the three columns of the template under the heading "Revenues", the Reporting MNE should report the following information: (i) the sum of revenues of all the Constituent Entities of the MNE group in the relevant tax jurisdiction generated from transactions with AEs; (ii) the sum of revenues of all the Constituent Entities of the MNE group in the relevant tax jurisdiction generated from transactions with independent parties; and (iii) the total of (i) and (ii). Revenues should include revenues from sales of inventory and properties, services, royalties, interest, premiums and any other amounts. Revenues should exclude payments received from other Constituent Entities that are treated as dividends in the payer's tax jurisdiction.

c. Under the column titled "Profit (Loss) before Income Tax", the Reporting MNE should report the sum of the profit (loss) before income tax for all Constituent Entities resident for tax purposes in the relevant tax jurisdiction. The profit (loss) before income tax should include all extraordinary income and expense items.

d. Under the column titled "Income Tax Paid (on Cash Basis)", the Reporting MNE should report the total amount of income tax actually paid during the relevant fiscal year by all Constituent Entities resident for tax purposes in the relevant tax jurisdiction. Taxes paid should include cash taxes paid by the Constituent Entity to the residence tax jurisdiction and to all other tax jurisdictions. Taxes paid should include withholding taxes paid by other entities (AEs and independent enterprises) with respect to payments to the Constituent Entity. Thus, if company A resident in tax jurisdiction A earns interest in tax jurisdiction B, the tax withheld in tax jurisdiction B should be reported by company A.

e. Under the column titled "Income Tax Accrued – Reportable Accounting Year", the Reporting MNE should report the sum of the accrued tax expense recorded on taxable profits or losses of the year of reporting of all Constituent Entities resident for tax purposes in the relevant tax jurisdiction. The tax expense should reflect only operations in the reportable accounting year and should not include deferred taxes or provisions for uncertain tax liabilities.

f. Under the column titled "Stated Capital", the Reporting MNE should report the sum of the stated capital of all Constituent Entities resident for tax purposes in the relevant tax jurisdiction. With regard to permanent establishments, the stated capital should be reported by the legal entity of which it is a permanent establishment unless there is a defined capital requirement in the permanent establishment tax jurisdiction for regulatory purposes.

g. Under the column titled "Accumulated Earnings", the Reporting MNE should report the sum of the total accumulated earnings of all Constituent Entities resident for tax purposes in the

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Specific instructions for Part B

a. Under the column titled “Constituent Entities Resident in the Tax Jurisdiction”, the Reporting MNE should list, on a tax jurisdiction-by-tax jurisdiction basis and by legal entity name, all the Constituent Entities of the MNE group which are resident for tax purposes in the relevant tax jurisdiction. As stated above with regard to permanent establishments, however, the permanent establishment should be listed by reference to the tax jurisdiction in which it is situated. The legal entity of which it is a permanent establishment should be noted (e.g. XYZ Corp – Tax Jurisdiction A PE).

b. Under the column titled “Tax Jurisdiction of Organization or Incorporation if different from Tax Jurisdiction of Residence”, the Reporting MNE should report the name of the tax jurisdiction under whose laws the Constituent Entity of the MNE is organised or incorporated if it is different from the tax jurisdiction of residence.

c. Under the column titled “Main Business Activity(ies)”, the Reporting MNE should determine the nature of the main business activity(ies) carried out by the Constituent Entity in the relevant tax jurisdiction, by ticking one or more of the appropriate boxes. In this column, if the Reporting MNE chooses the option ‘Other’, then it shall be required to specify the nature of the activity of the Constituent Entity in the “Part C: Additional Information” section.

Table III. Part C: Additional information

Name of the Multinational Enterprises group:
Reportable accounting year:
<i>Please include any further brief information or explanation that is considered necessary or that would facilitate the understanding of the compulsory information provided in Part A and Part B. (e.g. Source of Data)</i>

Rule 10DB of the Rules in India are largely in line with the above guidance and prescribe filing of the economic information of the international group as per above.

Rule 10DB also incorporates “administrative, management or support services” as one of the Main Business Activities in Table II. The definitions given under Rules for CbC Reporting in India are in line with the Action 13 report.

4.2 Taxpayers who are subject to CbC reporting requirements in India

The CbC report filing requirements in India would arise in the case of the following entities:

- The parent entity of an international group (which has been defined to include two or more enterprises including a permanent establishment which are resident of different countries or territories), if it is resident in India
- An entity in India belonging to an international group, if the parent entity of the group is

resident:

- In a country where the parent entity is not obligated to file the report of the nature referred to in Section 286(2) of the Act;
Or
- In a country with which India does not have an arrangement for exchange of the CbC reporting;
Or
- Such country is not exchanging information with India even though there is an agreement; and this fact has been intimated to the constituent entity by the Indian Tax Administration

Provisions in connection with CbCR also provide that if an international group, with a parent entity which is not resident in India, has designated an alternate entity for filing its report with the tax jurisdiction in which the alternate entity is resident, then the entities of such group operating in India would not be required to furnish a CbC report if the same can be obtained under the agreement of exchange of CbC reports by the Indian Tax Administration.

4.3 CbC report filing / notification requirements and filing due dates

CbC reports should be filed in the jurisdiction of tax residence of the ultimate parent entity and shared between jurisdictions through the automatic exchange of CbC reporting information, pursuant to government-to-government mechanisms under the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, bilateral tax treaties or Tax Information Exchange Agreements.

4.3.1 CbC report filing

According to Rule 10DB, every parent entity or the alternate reporting entity resident in India, should furnish the CbC report to the Joint Director as may be designated by the Principal Director General of Income-Tax (Systems) or the Director General of Income-Tax (Systems), as the case may be, for every reporting accounting year.

Such filing needs to be done in Form 3CEAD within a period of 12 months from the end of the reporting accounting year.

Further, where the parent entity is a resident of a country where there is a failure to exchange the CbC report/information, then Form 3CEAD may be furnished by the constituent entity in India within six months from the end of the month in which said systemic failure has been intimated.

Further, in cases where there are more than one constituent entity resident in India, the constituent entity designated to furnish the Form 3CEAD, can file a separate notification in Form 3CEAE in relation to such designation by the international group to furnish the said

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report with Joint Director as may be designated by the Principal Director General of Income-Tax (Systems) or the Director General of Income-Tax (Systems).

4.3.2 CbC reporting notification

According to the Rule 10DB of the Rules, every constituent entity resident in India, if its parent entity is not a resident in India, would need to notify as to whether:

- It is the alternate reporting entity of the international group; or
- Provide the details of the parent entity or the alternate reporting entity, as the case may be, of the international group and the country or territory of which the said entities are residents.

Such notification needs to be done in Form 3CEAC to the Principal Director General of Income-Tax (Systems) or the Director General of Income-Tax (Systems), as the case may be at least two month prior to the due date for furnishing of report as specified²⁷.

Filing of the CbC report in Form 3CEAD and notifications in Form 3CEAC, Form 3CEAE would be done electronically and following the prescribed procedures for such online filing and notification. These Forms should be verified and signed by the person who is competent to verify the income tax return of the constituent entity under the Income Tax Laws.

5. Global Scenario - BEPS Action 13 and impact in India

Around 90 countries around the globe have introduced provisions in their domestic laws to adopt and implement the OECD's recommendations in BEPS Action 13. The status of CbCR implementation by the major regions around the world is as below²⁸:

Country	Master File	Local File	CbCR
	Status of MF adoption	Status of LF adoption	Status of CbCR adoption
Argentina	Implemented	Implemented	Implemented
Australia	Implemented	Implemented	Implemented
Austria	Implemented	Implemented	Implemented
Belgium	Implemented	Implemented	Implemented
Bermuda	No announcements made to date / not required	No announcements made to date / not required	Implemented

²⁷ For every reporting accounting year, the due date is specified to be twelve months from the end of the said reporting accounting year.

²⁸ Updated as on April 2021.

Country	Master File	Local File	CbCR
	Status of MF adoption	Status of LF adoption	Status of CbCR adoption
Bosnia and Herzegovina	Implemented	Implemented	Implemented
Brazil	No announcements made to date / not required	No announcements made to date / not required	Implemented
Bulgaria	Implemented	Implemented	Implemented
Canada	No announcements made to date / not required	No announcements made to date / not required	Implemented
Cayman Islands	No announcements made to date / not required	No announcements made to date / not required	Implemented
Chile	Implemented	Implemented	Implemented
China	Implemented	Implemented	Implemented
Colombia	Implemented	Implemented	Implemented
Costa Rica	Implemented	Implemented	Implemented
Croatia	No announcements made to date / not required	In line with OECD TP Guidelines	Implemented
Cyprus	Implemented	Implemented	Implemented
Czech Republic	Implemented	Implemented	Implemented
Denmark	Implemented	Implemented	Implemented
Estonia	Implemented	Implemented	Implemented
Finland	Implemented	Implemented	Implemented
France	Implemented	Implemented	Implemented
Gabon	Implemented	Implemented	Implemented
Georgia	Intention to implement	Intention to implement	Implemented
Germany	Implemented	Implemented	Implemented

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Country	Master File	Local File	CbCR
	Status of MF adoption	Status of LF adoption	Status of CbCR adoption
Gibraltar	No announcements made to date / not required	No announcements made to date / not required	Implemented
Greece	Implemented	Implemented	Implemented
Guernsey	No announcements made to date / not required	No announcements made to date / not required	Implemented
Hong Kong	Implemented	Implemented	Implemented
Hungary	Implemented	Implemented	Implemented
Iceland	No announcements made to date / not required	No announcements made to date / not required	Implemented
India	Implemented	Existing rules will remain in effect unchanged	Implemented
Indonesia	Implemented	Implemented	Implemented
Ireland	Implemented	Implemented	Implemented
Isle of Man	No announcements made to date / not required	No announcements made to date / not required	Implemented
Israel	Draft bills / public discussion	Draft bills / public discussion	Draft bills / public discussion
Italy	Implemented	Implemented	Implemented
Japan	Implemented	Implemented	Implemented
Jersey	No announcements made to date / not required	No announcements made to date / not required	Implemented
Kazakhstan	Implemented	Implemented	Implemented
Kenya	Intention to implement	Draft bills / public discussion	Draft bills / public discussion

Country	Master File	Local File	CbCR
	Status of MF adoption	Status of LF adoption	Status of CbCR adoption
South Korea	Implemented	Implemented	Implemented
Latvia	Implemented	Implemented	Implemented
Liechtenstein	Implemented	Implemented	Implemented
Lithuania	Implemented	Implemented	Implemented
Luxembourg	No announcements made to date / not required	No announcements made to date / not required	Implemented
Malaysia	Implemented	Implemented	Implemented
Malta	No announcements made to date / not required	No announcements made to date / not required	Implemented
Mauritius	No announcements made to date / not required	No announcements made to date / not required	Implemented
Mexico	Implemented	Implemented	Implemented
Monaco	No announcements made to date / not required	No announcements made to date / not required	Implemented
Netherlands	Implemented	Implemented	Implemented
New Zealand	Master File and Local File documentation format is expected by Inland Revenue where it's practical	Master File and Local File documentation format is expected by Inland Revenue where it's practical	Implemented
Nigeria	Implemented	Implemented	Implemented
Norway	Implemented	Implemented	Implemented
Pakistan	Implemented	Implemented	Implemented
Panama	Implemented	Implemented	Implemented
Papua New Guinea	No announcements made to date / not	No announcements made to date / not	Implemented

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Country	Master File	Local File	CbCR
	Status of MF adoption	Status of LF adoption	Status of CbCR adoption
	required	required	
Peru	Implemented	Implemented	Implemented
Poland	Implemented	Implemented	Implemented
Portugal	Implemented	Implemented	Implemented
Qatar	Implemented	Implemented	Implemented
Romania	No announcements made to date / not required	No announcements made to date / not required	Implemented
Russia	Implemented	Implemented	Implemented
Singapore	No announcements made to date / not required	No announcements made to date / not required	Implemented
Slovakia	Implemented	Implemented	Implemented
Slovenia	Implemented	No announcements made to date / not required	Implemented
South Africa	Implemented	Implemented	Implemented
Spain	Implemented	Implemented	Implemented
Sweden	Implemented	Implemented	Implemented
Switzerland	Intention to implement	Intention to implement	Implemented
Taiwan	Implemented	Implemented	Implemented
Turkey	Implemented	Existing rules will remain in effect unchanged	Implemented
Uganda	Intention to implement	Intention to implement	Intention to implement
Ukraine	Implemented	Implemented	Implemented
United Kingdom	No formal announcements made to date	Existing rules will remain in effect unchanged	Implemented

Country	Master File	Local File	CbCR
	Status of MF adoption	Status of LF adoption	Status of CbCR adoption
United States	Formally announced, will not adopt	Existing rules will remain in effect unchanged	Implemented
Uruguay	Implemented	Implemented	Implemented
Vietnam	Implemented	Implemented	Implemented
Curaçao	Implemented	Implemented	Implemented

Multilateral Competent Authority Agreement and Bilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports

With the aim of reducing the incidence of filings, India and various other jurisdictions namely Australia, several EU countries, Brazil, Japan, Jersey, Korea, Malaysia, Mexico, Singapore, South Africa, the United Kingdom, USA etc.; have signed the multilateral Convention on Mutual Administrative Assistance in Tax Matters for automatic exchange of CbC reports amongst the tax administrators. Further, tax administrators of few other nations have also entered into bilateral agreements for automatic exchange of CbC reports amongst the tax administrators.

In the absence of such agreements and failure to obtain the CbC report from the country where the non-resident parent company is located, the India tax authorities have shifted the obligation of filing of CbC report to the Indian constituent entities.

Module F

Miscellaneous

UNIT-I	Advance Pricing Agreement
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1.1 Legislative Background

The Finance Act, 2012 had inserted Section 92CC of the Act and Section 92CD of the Act in the Income-tax Act, 1961 introducing the provisions of Advance Pricing Agreement ('APA'). The corresponding Rules 10F to 10T of the Income-tax Rules, 1962 were notified vide notification No. 36/2012, dated 30th August 2012. Further, the Finance Act, 2014 introduced the roll-back provisions in the APA scheme along with insertion of Rule 10MA and Rule 10RA in the Rules. Subsequently, the CBDT has also issued clarifications in the form of Frequently Asked Questions (FAQs) on APA (TPI-Series 43) and roll-back (Circular 10 of 2015) dated 10 June 2015. The Finance Act, 2020 introduced amendment to Section 92CB of the Act (safe harbour provisions) and Section 92CC of the Act (advance pricing agreement provisions) of the Act to cover attribution of profits to a Permanent Establishment.

1.2 Definition and Scope of APA

An APA is an agreement between a taxpayer / applicant and the Central Board of Direct Taxes (CBDT), which determines the ALP of future inter-company transactions which is valid for a maximum period of five years (and also extends to previous 4 years under roll-back provisions). The taxpayer / applicant agrees on the transfer pricing methodology to be applied and its application, in relation to the taxpayer's international transactions for certain future 5 years, maximum.

Hence, once an APA has been entered into with respect to an international transaction, the ALP with respect to that international transaction, for the period specified in the APA, will be determined only in accordance with the APA.

The APA shall be binding on the person as well as the Principal Commissioner or Commissioner of Income-tax (and his subordinate income-tax authorities) having jurisdiction over such person and such transaction.

The APA process is voluntary and will supplement appeal and other disputes resolution measures provided under the Double Tax Avoidance Agreement for resolving transfer pricing disputes.

6.2 International Tax — Transfer Pricing

1.2.1 Types of APA

The APA scheme envisages three types of APA's, viz.

- Unilateral APA;
- Bilateral APA; and
- Multi-lateral APA

The taxpayer / applicant at the time of making an APA application, has a choice to opt for any of the above-mentioned types of APA's. The respective types of APA are briefly described as under:

1.2.2 Unilateral APA

Unilateral APA is an agreement between the CBDT and the taxpayer / applicant and does not involve any corresponding agreement with the AEs. In an unilateral APA, the taxpayer / applicant does not wish to involve competent authority of any other country, thereby the risk of double taxation is not mitigated in an unilateral APA.

1.2.3 Bilateral APA

According to Rule 10F(c) of the rules, a bilateral agreement means an agreement between the Board and the taxpayer / applicant, subsequent to, and based on, any agreement referred to in rule 44GA between the competent authority in India with the competent authority in the other country regarding the most appropriate transfer pricing method or the arms' length price.

In a bilateral APA, the taxpayer / applicant is required to make an application with the competent authority of India and simultaneously the taxpayer / applicant or its AE should apply to the competent authority of the other country. The two competent authorities are required to reach a consensus through negotiation process. This arrangement is required to be accepted by the taxpayer / applicant before a bilateral APA can be entered into.

1.2.4 Multi-lateral APA

According to Rule 10F(h) of the rules, a multilateral agreement means an agreement between the Board and the taxpayer / applicant, subsequent to, and based on, any agreement referred to in rule 44GA between the competent authority in India with the competent authorities in the other countries regarding the most appropriate transfer pricing method or the arms' length price.

In a multi-lateral APA more than two tax jurisdictions are involved, the taxpayer / applicant is required to make an application with the competent authority of India and simultaneously the taxpayer / applicant or its AE should apply to the competent authority of the other countries which are relevant for such agreement. Indian competent authority must reach an agreement through negotiations with competent authorities of other countries, before the agreement could be offered to the taxpayer / applicant. The agreement reached in the negotiations is required to be accepted by the taxpayer / applicant before a multi-lateral APA can be entered into.

Request for bilateral or multilateral APA can be accepted by the Indian competent authority

where:

- A tax treaty exists between India and other contracting state containing an article on 'Mutual Agreement Procedure'; and
- The corresponding APA program exists in the other country.

CBDT vide its press release dated 27 November 2017 issued clarification of India's position on the acceptance of MAP and bilateral APA in cases of countries where provisions similar to Article 9(2) of OECD Model Tax Commentary is absent. The CBDT has decided to accept Transfer Pricing MAP and bilateral APA applications regardless of the presence or otherwise of Paragraph 2 of Article 9 (or its relevant equivalent Article) in the treaty. Prior to this CBDT press release, no bilateral application would be accepted in the absence of provisions similar to article 9(2) of the OECD model convention on 'Associated Enterprises'. This was a much awaited clarification, as access to MAPs will open up a preferred avenue for dispute resolution, and access to Bilateral APAs will go a long way in providing certainty and avoid double taxation with respect to TP positions taken by multinational groups.

As discussed above, Section 92CC of the Act empowers the CBDT to enter into an APA with any taxpayer for determining the arm's length price or specifying the manner in which the arm's length price is to be determined, in relation to international transactions. There appeared to be ambiguity whether or not Section 92CC of the Act covers attribution of profit to permanent establishment. While the CBDT vide its FAQ No. 23¹ clarified that APA application can be filed for profit attribution to permanent establishment, the same was not coming out clearly from the language of Section 92CC of the Act. To clear this ambiguity, Finance Act, 2020 amended Section 92CC of the Act to cover profit attribution to permanent establishment. The amended Section 92CC of the Act inter-alia provided that central government may enter into APA for determining "*income referred to in clause (i) of sub-section (1) of Section 9 of the Act, or specifying the manner in which said income is to be determined, as is reasonably attributable to the operations carried out in India by or on behalf of that person, being a non-resident.*"

1.3 Objectives of the APA Program

The APA program is designed to:

- Provide certainty with regard to determination of ALP of the international transaction (viz. transactions covered by the APA);
- Impart flexibility in developing practical approaches for complex transfer pricing issues;
- Reduce the risk of potential double taxation through bilateral and multi-lateral APA;
- Reduce litigation costs by eliminating the risk of transfer pricing audit and resolving long drawn and time consuming litigation; and

¹Taxpayer Information Series - 43 (see the link:

[https://www.incometaxindia.gov.in/booklets%20%20pamphlets/advance-pricing-agreement-guidance-with-faqs-\(tpi-43\).pdf](https://www.incometaxindia.gov.in/booklets%20%20pamphlets/advance-pricing-agreement-guidance-with-faqs-(tpi-43).pdf))

6.4 International Tax — Transfer Pricing

- Reduce the burden of record keeping, as the taxpayer knows in advance the required documentation to be maintained to substantiate the agreed terms and conditions of the agreement.

1.4 APA Team

The Indian APA rules provide for constitution of an APA team (Team) which shall consist of income tax authorities and experts from economics, statistics, law and other necessary fields. For unilateral APAs, the Principal Chief Commissioner of Income Tax (International Tax and Transfer Pricing) [‘Pr. CCIT (Intl & TP)’] would be responsible, who will be supported by the Commissioner of Income Tax (APA).

For bilateral / multilateral APAs, the Competent Authority of India would be responsible, supported by Director APA. Further, there are teams reporting to the Commissioner (APA) in three major cities – Delhi, Mumbai and Bangalore to facilitate the process.

1.5 The APA Process

The APA scheme involves the following process:

- Pre-filing consultation (***made optional at the request of the Applicant***);
- Filing of the APA application (including roll back if so desired by applicant);
- Acceptance / Rejection of the APA application;
- Assignment of an APA application to the APA team;
- Actions by the taxpayer, the assessing officer and the transfer pricing officer while the APA is negotiated;
- Amendment to an APA application;
- Examination and analysis of an APA application;
- Conversion of a unilateral APA into a bilateral APA (If the applicant so chooses);
- Withdrawal of an APA application (This can be done at any time before signing of APA agreement);
- Negotiation between applicant and CBDT;
- Entering into a unilateral APA;
- Negotiation by the competent authority in bilateral / multilateral APA and entering into an APA (where the applicant has applied for bilateral or multilateral APA);
- Action by taxpayer and the assessing officer on entering into an APA;
- Furnishing of Annual compliance report;
- Compliance audit of the agreement;

- Cancellation and revision of APA; and

Each of the above steps involved in the APA process has been briefly explained as under:

1.5.1 Pre-filing consultation

Before a formal APA application can be made, the taxpayer has the option to request for a pre-filing meeting consultation by making an application to Pr. CCIT (International Taxation).

Holding of a pre-filing consultation was a mandatory provision prescribed at the time of launch of the APA program, vide Finance Act 2012. However, the CBDT vide the notification dated 14th March 2015 [No. S.O. 758(E)], has made the holding of a pre-filing consultation optional at the request of the taxpayer.

The purpose of the pre-filing consultation is to enable the applicant and the APA team to assess the possibility of entering into an APA. An APA pre-filing application can be made by the taxpayer in the prescribed Form No. 3CEC.

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

The discussion in a pre-filing consultation is not binding on any of the parties. If the applicant wants to maintain anonymity, the same is also allowed and to that extent the details in the application form may be omitted. However, in such cases, the identity of the authorized representatives must be disclosed in the application form along-with sufficient information about the business operation and international transaction in order to make any discussion meaningful.

The understanding reached on various issues in the pre-filing consultations would be reduced in writing and a copy of the same is given to the applicant.

1.5.2 Filing of the APA application

Where a pre-filing consultation meeting is sought by a taxpayer, the taxpayer may choose to file the APA application after the suitability of entering into an APA is determined by the APA team. The taxpayer can file an APA application at or any time before the commencement of the first assessment year proposed to be covered by the APA application. An application for entering into an APA can be made in prescribed Form No. 3CED. Before filing the APA application, the taxpayer is also required to pay the fee computed as under:

Aggregate value of international transactions (INR) during the APA period	Fee (INR)
Amount not exceeding 100 crores	10 Lacs
Amount exceeding 100 crores but not exceeding 200 crores	15 Lacs
Amount exceeding 200 crores	20 Lacs

The fee shall be payable by means of electronic transfer directly to the designated account of the Government of India. Further, the proof of payment of fee is also to be enclosed with the

6.6 International Tax — Transfer Pricing

APA application in Form No. 3CED. The fee paid is non-refundable, except when the APA application is not allowed to be proceeded with under Rule 10K of the Rules.

The CBDT, by way of Notification No. 53/2017 dated 16 June 2017 has revised the APA application form (i.e. Form 3CED). The new form additionally requires the following information:

- For AEs with whom APA is requested: Registration/ identification number used for identification of AE (of the country/ territory in which the AE is resident);
- For immediate parent company and ultimate parent company of the applicant: name, address, country of residence, and registration/ identification number used for identification of the company (of the country/ territory in which the company is resident)

Guidance regarding furnishing of the APA application

The following guidance are to be followed for furnishing of the APA application:

Type of Application	Guidance provided
Unilateral APA Application	Application to be furnished in Triplicate to the Principal Chief Commissioner of Income-tax (International Taxation)
Bilateral / Multilateral APA Application	Application to be furnished in Triplicate to the Competent Authority of India [Joint Secretary-FT&TR-1] in the Ministry of Finance. The Applicant or its AE must initiate the procedure of entering into an APA with the other country as well and furnish evidence to the Competent Authority of India regarding the same

1.5.2.1 Time-limit for furnishing of APA application

The APA application must be filed within the time-limit provided under Rule 10-I(3).

- If the **international transaction is of a continuing nature**, from dealings that have already occurred, the **application must** be filed before the first day of the previous year relevant to the first assessment year which the application seeks to cover.

For example, if the APA application seeks to cover 5 years starting from AY 2018-19 to AY 2022-23, the application must be filed before 31 March 2017.

- However, if the international transaction is yet to be undertaken by the applicant, the APA application may be filed at any time before undertaking of such transaction.

For example, if the applicant is going to enter into a new transaction for the first time (i.e. these transactions are not from dealings that are of a continuous nature starting 1 December 2017 and the APA application is made before 01 December 2017, the applicant has the choice to include AY 2018-19 as the first assessment year in the APA application.

1.5.3 Acceptance / Rejection of the APA application

Preliminary processing of the APA application shall be carried out in accordance with Rule 10K. In case the application is defective, the Pr. CCIT (International Taxation) / Competent Authority

is required to serve a deficiency letter. If the defect is not removed within the time allowed, or the application is not in accordance with the understanding reached in pre-filing consultation as per under Rule 10H, the application may be rejected after providing an opportunity of being heard to the applicant. Application fee paid will be refunded in case the application is rejected. However, the application shall not be rejected in any other circumstance.

1.5.4 Actions by the taxpayer, the assessing officer and the transfer pricing officer while the APA is negotiated

Since processing and negotiation of an APA application takes time, it is possible that the assessment process by the assessing officer ('AO') or the transfer pricing audit by the transfer pricing officer ('TPO'), with respect to the years covered by the APA, the assessment proceedings will continue as normal.

Such proceedings by the AO or the TPO shall continue without taking cognizance of the fact that the APA process with respect to that year has already been started. Filing of an APA application shall not have any impact on the pending assessments and the taxpayer will be required to maintain all the documents and submit all reports necessary under the Income-tax Act till the finalization of the APA followed by the furnishing of the modified return.

1.5.5 Amendment to an APA application

The applicant may request in writing for an amendment to its application at any time before the finalization of the terms of the agreement. This may be allowed by the Pr. CCIT (International Taxation) [for unilateral APA] or the competent authority of India and the competent authority of the other country [for bilateral / multilateral APA], if such an amendment does not have the effect of altering the nature of the original application. The applicant is also required to pay the additional fee, if any, due to the amendment. The request for conversion of unilateral APA application to bilateral or multilateral APA application will not be taken to have the effect of altering the nature of the original application.

1.5.6 Assignment of an APA application to the APA team

If an application is allowed to be proceeded with under Rule 10K, it shall be dealt with as under:

- In case of a unilateral application, the Pr. CCIT (International Taxation) shall assign it to one of the APA teams. The APA team shall examine the APA application and undertake negotiation with the applicant. The APA team shall make an endeavor to arrive at a negotiated settlement with the applicant. In case such a mutual agreement on relevant issues has been arrived at, the mutually agreed draft agreement shall be put up to the Pr. CCIT (International Taxation). The Pr. CCIT shall, on being satisfied, send it to the Board for its consideration.
- In case of a bilateral and multilateral APA, the competent authority of India shall send the application to Pr. CCIT (International Taxation) for necessary enquiry, analysis and for preparation of draft report (draft Indian position paper). The Pr. CCIT shall assign it to

6.8 International Tax — Transfer Pricing

one of the APA teams. The APA team shall then carry out detailed enquiry and analysis and prepare a draft Indian position paper in consultation with the Pr. CCIT (International Taxation), the competent authority of India or its representatives and the applicant. The draft Indian position paper shall be forwarded by the Pr. CCIT (International Taxation) to the competent authority of India.

1.5.7 Examination and analysis of an APA application

In terms of Rule 10L(2) of the Rules, the APA team or the Competent Authority of India have been vested the following powers for examination and analysis of an APA application:

- hold meetings with the applicant on such time and date as it deem fit;
- call for additional document or information or material from the applicant;
- visit the applicant's business premises; or
- make such inquiries as it deems fit in the circumstances of the case.

The applicant is expected to give full cooperation for this purpose. The APA team is required to do detailed functional analysis and examine the APA application in a reasonable and fair manner taking into consideration all the evidences and information produced by the applicant or collected by it.

1.5.8 Conversion of a unilateral APA into a bilateral APA

A unilateral APA can be converted into a bilateral APA before the mutually agreed draft agreement is forwarded by the Pr. CCIT (International Taxation) to the Board. While converting a unilateral APA application to a bilateral APA application, the applicant or its AE needs to make a similar request with the competent authority of the other country.

The bilateral request of the applicant shall be forwarded by the Pr. CCIT to the competent authority in India.

The competent authority of India shall decide whether the bilateral request is allowable based on the existence of appropriate provision on lines of OECD Model Article 9(2)² in the tax treaty between India and the other country and also on the existence of an APA scheme in that other country. If the request is allowed, then the application would be processed as a bilateral APA application.

1.5.9 Entering into a unilateral APA

On receipt of mutually agreed draft agreement, the Board may, with the approval of the Central Government, enter into an APA with the applicant. On behalf of the applicant, the APA shall be signed by the person who is competent to sign its Income-tax Return. Terms of APA will be in accordance with Rule 10M.

Once APA has been entered into, the Pr. CCIT (International Taxation) shall send a copy of the APA to the commissioner of income tax having jurisdiction over the applicant. It may be noted that once a unilateral APA has been entered into, there will not be any MAP benefit available to

² Presence of Article 9(2) in tax treaties is now not a prerequisite for applying for a bilateral APA

the applicant with respect to the covered transactions for the APA and rollback period.

1.5.10 Negotiation by the competent authority in bilateral / multilateral APA and entering into an APA

After receiving the draft Indian position paper, the competent authority of India will then carry out negotiation with the other competent authority (ies) in accordance with the provision of Rule 44GA.

During this process the competent authority of India will be free to deviate from the draft Indian position paper in order to arrive at negotiated settlement. The competent authority may require the applicant to file additional information and may conduct such enquiry as appropriate. The applicant will not be a part of the negotiation between the two competent authorities but he may be consulted for this purpose by the Indian Competent Authority.

On successful completion of negotiations, the competent authority in India shall formalize a negotiation arrangement with the competent authority in the other country (ies) and intimate the same to the applicant. The applicant is required to convey acceptance or otherwise of the arrangement within 30 days of such communication.

Where the taxpayer accepts the mutually agreed arrangement, the competent authority in India and the applicant shall prepare a mutually agreed draft agreement and the APA agreement shall be entered into by the Board with the applicant after its approval by the Central Government. On behalf of the applicant, the APA shall be signed by the person who is competent to sign its Income-tax Return. Terms of APA will be in accordance with Rule 10M. Once an APA has been entered into, the competent authority of India shall send a copy of it to the Commissioner of Income tax having jurisdiction over the applicant.

In case of failure to reach a mutually agreed arrangement, the applicant shall be informed of the failure to reach an arrangement with the competent authority of the other country (ies). However, the applicant shall have an option to convert the request for bilateral APA to unilateral APA (without payment of additional fee) and inform the competent authority of India in writing. In such cases, the competent authority in India will forward all the information and documents (except the documents provided by the competent authority of the other country subject to confidentiality clause of the concerned DTAA) to the Pr. CCIT (International Taxation) who shall in turn examine the request of unilateral APA as per prescribed procedure.

1.5.11 Action by taxpayer and the assessing officer on entering into an APA (Section 92CD of the Act)

Where in respect of an assessment year covered in the APA, a return of income has been filed prior to the date of entering into an APA, then **within three months of entering into APA**, the applicant is required to **file a modified return** in accordance with and limited to the APA terms. The modified return shall be deemed to be a return under Section 139 of the Act and all the provisions of the Act shall apply accordingly. If the assessment or reassessment for the years covered under APA is pending, the assessing officer is required to complete that assessment or reassessment in accordance with the APA taking into consideration the modified return so furnished. Where the assessment or the reassessment has already been completed the

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assessing officer shall reassess or re-compute the total income of the relevant assessment year having regard to and in accordance with the APA.

It may be kept in mind that a particular assessment year may involve many international transactions and not all international transactions may be covered international transactions under the APA. The assessment of international transactions which are not covered international transactions under APA will not be affected by entering into of an APA.

In case where a reference to TPO is pending with respect to any covered transaction of APA, the assessing officer shall inform the TPO about the filing of modified return in respect of that transaction. This communication shall be sent immediately after filing of the modified return by the applicant with respect to such covered transaction. On receipt of such communication, the Transfer Pricing Officer shall not proceed further for auditing the covered transaction. Similarly, if the covered transaction is pending before the Dispute Resolution Panel (DRP), the assessing officer shall inform the DRP immediately after filing of modified return by the applicant. On receipt of communication from the assessing officer, the DRP shall not give any direction with respect to the covered transaction. In this regard the attention is invited to Rule 10P(6), which states that the regular audit of the covered transactions shall not be undertaken by the TPO if an agreement has been entered into under Rule 10L except where the agreement has been cancelled under Rule 10R.

The procedures consequent to the filing of the modified return in relation to the covered transaction for the assessment years, included in the term of the APA, would include:

- Withdrawal of any appeal pending before the CIT(Appeal) by the applicant with respect to the covered transaction(s);
- Withdrawal of appeal filed before the ITAT / HC / SC by the department as well as the applicant with respect to the covered transaction(s); or
- Withdrawal of objections filed before the DRP by the applicant with respect to the covered transaction(s);

The assessing officer would not be required to make any adjustment for the covered transaction except in accordance with APA.

1.5.12 Furnishing of Annual Compliance Report

The applicant is required to file annual compliance report in quadruplicate in Form 3CEF to Pr. CCIT (International Taxation) for each year covered in the agreement. The annual compliance report is required to be filed within 30 days of the due date of filing the income tax return for the assessment year relevant to the previous year or within 90 days of entering into an agreement, whichever is later. The filing of Annual Compliance report is in addition to the modified return that is required to be filed.

1.5.13 Compliance audit of the agreement

The compliance audit shall be carried out by the jurisdictional TPO in accordance with Rule 10P and shall be required to be completed within six months from the end of the month in which the ACR is received by the TPO. The compliance audit will be carried out only to ensure compliance

with the terms of the APA, including satisfaction of the critical assumptions and consistency of the application of the TPM. The TPO has to submit the report to the Pr. CCIT in case of unilateral APA and to the competent authority in India in case of bilateral or multilateral APA. The Finance (No.2) Act, 2019 has amended Section 92CD of the Act which clarifies the intent of the Government that once an APA is signed, and a modified return has been filed, the Assessing Officer (AO) only needs to modify the total income (already determined in an assessment or reassessment) such that it aligns with the APA outcome – and the AO shall pass an order for this limited purpose. The AO is not required to undertake a fresh assessment or reassessment or re-computation (as seemed to have been the reading of the erstwhile provision).

1.5.14 Cancellation and revision of APA

The cancellation and revision of APA may be carried out in accordance with Rule 10Q and 10R respectively. In case of revised agreement, the procedure as regard to original agreement shall be repeated. That is the taxpayer will be required to file the modified return for the period after the revision of the APA within three months and the assessing officer will reassess or re-compute the total income of the relevant assessment year having regard to and in accordance with the revised agreement. For example, if APA is signed for AY 2014-15 to AY 2018-19. The agreement is signed on 31 December 2014 by which time the return of income for AY 2014-15 has already been filed in accordance with Section 139 of the Act. The assessee is required to file the modified return for AY 2014-15 by 31 March 2015 i.e. within a period of three months from the end of the month in which the said agreement was entered into (31 December 2014).

1.5.15 Withdrawal of an APA Application

The applicant can withdraw APA application by filing a request in form 3CEE at any time before the finalization of the term of the agreement (i.e. before sending of the draft agreement by the Pr. CCIT to the Board in case of unilateral APA request and before sending of the mutually agreed arrangement by the competent authority to the Board in case of bilateral or multilateral APA request). The fee paid shall not be refunded on withdrawal of application

1.5.16 APA roll-back

The Finance (No.2) Act, 2014 introduced the rollback provisions under the Advance Pricing Agreement (APA) program. The roll back provisions were made applicable to the APAs signed or applied post 1 October 2014. The rules have been notified on 14 March 2015 by CBDT vide Notification No. S.O. 758 (E) of 2015, setting out the applicability and the requirement for applying rollback.

Some of the salient features of the rollback rules are as highlighted below:

- The international transaction proposed to be covered under the rollback is to be the same as covered under the main APA;
- The rollback provisions shall be applied for all the rollback years in which the relevant international transaction has been undertaken;
- The manner in which ALP has been determined in relation to an international transaction shall be consistent for all the years covered under the APA including the rollback years

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- To be eligible for the applicability of the rollback provisions, the applicant should have filed Return of Income and Form No. 3CEB (Accountants Report) on or before the statutory due date;
- The rollback provision will not be applicable for a particular year where the Income Tax Appellate Tribunal has passed an order disposing off the appeal prior to the date of signing of the APA;
- In case the application of the rollback provisions would result in reduction of the income offered to tax or increasing the loss as declared in the Return of Income for a particular year, the rollback provision will not be applicable for that year;
- The application for rollback is to be filed on or before 31 March 2015 in the case of applications filed before 01 January 2015 as well as in few cases where APA has been entered into before 1 January 2015;
- Going forward the application for rollback has to be made (Form No. 3CEDA) along with the main APA application;
- An additional fee of five lakh rupees is to be paid along with the rollback application;
- Important procedural aspects for giving effect to the rollback provisions include:
 - Filing of modified return of income;
 - Withdrawal of the Appeals pending before different appellate forums (i.e. commissioner of appeals, Tax Courts, High Court etc.) by the taxpayers and the Revenue authorities; and
 - In case the effect to the rollback provision cannot be given on account of failure on the part of the applicant, the agreement shall be cancelled

Pursuant to the notifications of the APA roll-back rules, the CBDT has also issued a clarification in the form of Frequently Asked Questions (FAQs) on 12 June 2015. The FAQs clarify certain ambiguities around the implementation of the roll-back rules, which had been brought to attention by various stakeholders.

1.6 Critical Assumptions

- The term 'critical assumptions' is defined in Rule 10F(f). It means the factors and assumptions that are so critical and significant that neither party entering into an agreement will continue to be bound by the agreement if any of those factors or assumptions is changed. APA will define critical assumptions in the agreement. These critical assumptions will depend on the facts of each case;
- Decisions about an ALP or the suitability of a particular transfer pricing methodology would be made on the basis of the facts existing at the time. If particular circumstances are held as central to the decision, any changes in them would materially affect the ALP

or the suitability of the transfer pricing methodology or the way it would need to be applied. These circumstances would need to be addressed by the taxpayer / applicant and be included in the APA request in Form No.3CED as 'critical assumptions'. Critical assumptions should be noted even where they are not within the applicant's control;

- The terms and conditions of the APA will specify the critical assumptions. Critical assumptions may include operational, legal, tax, financial, accounting and economic conditions or assumptions;
- The TPO would at time of compliance audit also determine whether critical assumptions as mentioned in the agreement are met;
- In case of breach of critical assumptions the Assessee or the TPO should notify, at the earliest, about such a breach to the Pr. CCIT (International Tax) in case of unilateral APA or to the Competent Authority in case of Bilateral / Multilateral APA along with supporting documents. In these circumstances, the Assessee may request for future course of action as to whether the APA has to be revised or cancelled;
- The Board or the Pr. CCIT (International Tax) or the competent authority may also on its own, having noticed any breach of critical assumptions, seek to revise the APA or cancel the APA after due information and consultation with the taxpayer; and
- In case of breach of critical assumptions if the APA cannot be revised to the acceptance of all the parties (including the competent authority of other country / countries) to the APA then the APA would be liable to be cancelled.

1.7 Legal Effect of an APA

- An APA is binding on the Assessee who entered into an APA in relation to the covered transactions and on the Commissioner of Income-tax and other income-tax authorities subordinate to him in respect of that Assessee and that transaction. If the Assessee complies with the terms and conditions of the APA, the tax administration will not contest the ALP or the application of the TPM to the covered transactions in the APA in the case of the Assessee for the years to which the APA specifically relates.
- The APA shall not be binding on the Assessee or the Commissioner, if
 - There is a change in law or facts having bearing on the agreement so entered [Section 92CC(6) of the Act];
 - The agreement has been obtained by the Assessee by fraud or misrepresentation of facts-the agreement void ab-initio [Section 92CC(7) of the Act];
 - There is any change in any of the critical assumptions or there is failure on the part of the Assessee to meet conditions subject to which the agreement has been entered into-the agreement can be revised or cancelled [Rule 10M(4)];
 - The agreement is cancelled under Rule 10R.

1.8 Renewing an APA

- A new application has to be filed by the taxpayer after the expiry of the APA term with the Pr. CCIT (International Taxation) and the competent authority in India as the case may be;
- The renewal request will follow the same forms and procedures as in initial APA request except that pre-filing consultation is not required;
- The renewal application would be treated as a fresh application and procedure and fee would apply accordingly;
- The renewal request may be filed well in advance before the expiration of the terms of the existing APA.

1.9 Advance Pricing Agreement – Recent Updates

The table below provides a status of APA applications filed so far:

Financial Year	No. of APA Applications filed	No. of Agreements signed	No. of Applications disposed due to other reasons	No. of Applications under processing
2012-13	146	92	20	34
2013-14	232	108	40	84
2014-15	206	51	19	136
2015-16	132	15	3	114
2016-17	101	3	-	98
2017-18	168	2	-	166
2018-19	170	-	-	170
Total	1155	271	82	802

Source: Annual Report on APA Programme of India released by CBDT for FY 2018-19

The CBDT signed India's first bilateral APA with a Japanese company. The APA has been finalized in a period of about one and a half years, which is shorter than time normally taken in finalizing APA's internationally.

The APAs signed pertain to various sectors of the economy like telecommunication, IT, automobile, pharmaceutical, beverage, oil exploration, banking, finance & insurance, etc. and relate to various segments like non-binding investment advisory services, trading, manufacturing, royalty fees, corporate guarantee, engineering design services, marine products, contract R&D, cargo handling support services, software development services and ITeS (BPOs), marketing support services, business support services, etc. It is interesting to note that a lot of APA applications are from the IT & ITeS sector, consistent with the litigation trends that have been observed.

UNIT-II	Special consideration for: <ul style="list-style-type: none"> • Intra group services • Intangible property • Cost Contribution arrangements
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2.1 Special consideration for Intra Group Services

2.1.1 Introduction

Intra group services ('IGS') refers to provision of services by a member of a MNE group to another member of the same MNE group. With the rapid rise of globalization in the late 20th century, the international community began to take note of several transfer pricing challenges associated with IGS.

Guidance on transfer pricing issues in relation to IGS can be elaborately found in the OECD TP Guidelines. Though in the initial guidelines, no express guidance was there pertaining to IGS, an entire chapter (Chapter VII) was later dedicated to the discussion with regard to the transfer pricing aspects of IGS by the report on intangible property and services, adopted by the Committee of Fiscal Affairs ("CFA") on January 23, 1996, and was noted by the OECD council on April 11, 1996.

The United Nations Practical Manual on Transfer Pricing for Developing Countries (UN Manual) released in 2013 and revised in 2017 and 2021 respectively also includes a brief discussion on IGS. UN Manual recognizes the risks posed by IGS in relation to the transfer pricing front to the jurisdictions all across the globe.

2.1.2 Chapter VII-OECD Guidelines

The analysis of IGS involves two broad issues which are discussed here-in-under:

- **Whether intra group services are actually provided** - This part of the analysis involves determination that whether any service has actually been rendered which warrants a charge under the arm's length principle. In this connection, certain tests have to be performed which are elaborated in the subsequent paragraphs:
 - **Benefit Test** - The guiding factor involved in this test is to ascertain whether the performance of an activity entails any commercial or economic benefit for the MNE for which the same is performed. The key factor here is to ascertain that whether the activity for which the charge is being paid actually carries some worth for which an independent party would be willing to incur a charge, either in the form of payment to a third party or performing the same in-house. The application of benefit test would determine if the activity being performed actually constitutes some IGS for which a charge is warranted. The application of this test depends on the analysis of actual facts and circumstances.
 - **Shareholders Activity** - There are some activities performed by a group member for other group members solely in its capacity of being a shareholder for these members.

These activities are termed as shareholders activity and do not constitute as IGS. It is pertinent to note that activities performed by the shareholder solely in the capacity of shareholder which entails no benefit for the recipient only constitute a shareholder activity. The following are some of the illustrations of shareholder activity:

- (a) Costs relating to stock exchange listing of the parent;
- (b) Costs relating to preparation of consolidated financial statements;
- (c) Costs relating to compliance of the parent with tax laws;
- (d) Costs relating to financial reporting of the parent as per their regulations.

The fact that whether an activity constitutes a shareholder activity needs to be analyzed in detail depending on the facts of the case. There may be the case that activity being performed actually entails some benefit to the recipient for which an independent party would be willing to pay. In that case that activity would constitute as IGS.

- **Duplicative service** - An activity which is a mere duplication of work which is already performed by an entity itself or being availed from a third party does not normally constitute an IGS. A great caution must be adopted to determine whether there is any duplication of work. Merely the fact that an entity has the resources available for the performance of a work does not render the activity being performed to be duplicative. The key here is to determine whether the same activity for which charge is being paid by a MNE is already being performed or availed by the same MNE. In some cases an activity may constitute just a temporary duplication and hence, might be considered as an IGS. The nature of the work being performed, the facts and circumstances of the case must be analyzed in great detail before reaching to a conclusion in this regard.
- **Incidental Benefits** - Sometimes an activity performed by a member of a MNE for itself or some group entities entail some incidental benefits for other group entities as well. Normally, the incidental benefits should not be treated as an IGS because in third party circumstances no third party would like to pay for an incidental benefit.
- **Centralised services** - Activities relating to the group as a whole are centralised in the parent company or one or more group service centres. The activities may include administrative services, strategic decision making, financial services, assistance in the fields of production, etc. These type of activities would ordinarily be considered IGS because they are the type of activities that independent enterprises would have been willing to pay for or to perform for themselves.
- **Form of the remuneration** - In considering whether a charge for the provision of services would be made between independent enterprises, it would also be relevant to consider the form that an arm's length consideration would take had the transaction occurred between independent enterprises dealing at arm's length. For example, in respect of financial services such as loans, foreign exchange and hedging, all of the remuneration may be built into the spread and it would not be appropriate to expect a further service

fee to be charged if such were the case. Thus, the question is whether the availability of such services is itself a separate service for which an arm's length charge (in addition to any charge for services actually rendered) should be determined. Further, a parent company or one or more group service centres may be on hand to provide services such as financial, managerial, technical, legal or tax advice and assistance to members of the group at any time. In that case, a service may be rendered to AEs by having staff, equipment, etc. available. An IGS would exist to the extent that it would be reasonable to expect an independent enterprise in comparable circumstances to incur "standby" charges to ensure the availability of the services when the need for them arises.

- **Determining an arm's length charge for an IGS**

Once it is established that an IGS has been rendered, the next step involves identification of the methods adopted by the MNE for the charge of that IGS. The arrangements for charging out for rendition of IGS can be classified into two broad methods viz. direct charge and indirect charge. Direct charge includes cases when AEs are charged out specifically for the rendition of the services. In this type of arrangement the service being rendered and the criterion adopted for calculating the charge for the same can be readily identified. Direct charge out method can be conveniently adopted when the services are rendered to independent entities as well. On the contrary, indirect charge out method involves cases when the charge out methodology is not certain or when the service being rendered is not readily identifiable. Indirect charge out method may be expedient to follow in certain instances especially in the circumstances when services are being rendered to multiple entities and proportion of value of services rendered to each individual entity cannot be ascertained with precision.

Cost allocation and cost apportionment methods are of great significance in the case of an indirect charge. Allocation methodology adopted must be fair and reasonable and correspond to a logical and scientific basis. The arm's length analysis of an IGS essentially involves establishing the appropriateness of the allocation basis and the appropriateness of the charge-out method adopted as a whole.

The calculation of the arm's length charge for an IGS involves an understanding of the perspectives of both service provider and the service recipient. The selection and the application of the most appropriate transfer pricing method to determine an arm's length charge for an IGS requires application of the guidelines as elaborated in Chapter I-III of the OECD Guidelines. The cost base to be used must be determined in accordance with the facts of the case and FAR profile of both the service provider and the service recipient. Further the ascertainment of return or mark-up also should be consistent with the nature of the services being performed and FAR profile of both the service provider and the service recipient.

The illustrative list of intra-group services also included in the OECD Guidelines is as follows:

- Management services
- Research and development services (including software development relating to the core business of the MNE group)

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- Manufacturing and production services (including contract manufacturing services)
- Purchasing activities relating to raw materials or other materials that are used in the manufacturing or production process
- Sales, marketing and distribution activities
- Financial transactions
- Extraction, exploration, or processing of natural resources
- Insurance and reinsurance

2.1.3 BEPS and Low Value Added IGS

As a part of the Action plan 10 to curb BEPS, OECD in October 2015 has released final report replacing the existing Chapter VII of the OECD guidelines and has incorporated specific guidelines relating to low value-adding intra group services. Further, the final report on Action plan of 2015 intends to provide specific guidance with respect to appropriate charge for low value IGS, routine management charges and head office charges and seeks to prevent the scope for base erosion through excessive payment towards these charges. These were subsequently incorporated as Part D of Chapter VII on Intra-Group Services in OECD Guidelines, 2022.

In the final report, low value-adding services are defined as services that do not form part of the core services of the group, are of supporting nature, do not involve creation or use of valuable intangibles and do not involve the assumption or control of significant risks.

Some of the illustration of the low value-adding IGS which are specifically discussed in the final report are enlisted here-in-under:

- Accounting and auditing;
- Processing and management of accounts receivables and payables;
- Human resources activities;
- Monitoring and compilation of data relating to health, safety, environmental and other standards regulating the business;
- IT support services;
- Internal and external communications and public relations support services;
- Legal services;
- Activities with regard to tax obligations; and
- General services of administrative or clerical nature.

A simplified charge mechanism for low value-adding IGS would involve application of benefit test, identification of pool of costs incurred for provision of services, allocation of such costs on scientific basis and applying a mark-up on the costs. The final report advocates charge of a mark-up of 5% for the consideration of the low value-added intra-group services. The rigors of the benefit test has been proposed to be reduced to some extent in the case of low value- adding IGS. Further, the final report proposes following documentation requirements for the low value

adding IGS:

- A description of categories of low value-adding IGS, the identity of the beneficiaries, the reasons justifying that each category of services constitute low value-adding intra-group services, the rationale for provision of such services, a description of benefits/expected benefits to arise from provision of such services, a description of selected allocation keys along with the reasons justifying the allocation keys and confirmation of the mark-up applied;
- Written contracts or agreements for the provision of the services in the form of a contemporaneous document identifying the entities involved, the nature of the services, and the terms and conditions under which the services are provided;
- Documentation and calculations showing the determination of the cost pool and of the mark-up applied thereon; and
- Calculation showing the application of the specified allocation keys.

2.1.4 UN Manual and India's Position

UN Manual emphasizes the need of an adequate documentation for IGS. Documentation should include among other things the nature of the services rendered, evidences depicting the actual rendition of the services and the basis for calculation of arm's length charge for such services.

Indian Tax Administration has recognized IGS as a high risk area in its stand as detailed in the Part D, Country Practices of the UN TP Manual. Practically also, the instances of adjustments made by the tax authorities towards consideration for IGS are quite prevalent. Indian Tax Authorities are quite mindful in dealing with the transactions pertaining to payment of management charges, headquarter charges, etc. The tax authorities normally challenge the actual conduct of the parties alleging that no services have been rendered which actually warrants a charge. The benefits which are claimed to be accrued from these charges and the need for the receipt of the services are often challenged. The Safe Harbour Rules have specified a new category of safe harbour for low value adding intra-group services which have been discussed in detail in subsequent sections.

Although the higher authorities (ITATs and High Courts) have in several rulings propounded that it is the sole prerogative of an entity if it wants to avail any service and the business expediency of an enterprise can't be questioned by the tax authorities in analyzing the arm's length nature of an IGS. However, still the onus of demonstrating the benefits obtained from the availing of such services have to be discharged by the taxpayers.

Indian tax authorities are also questioning the transactions pertaining to outbound IGS where IGS is rendered by an Indian MNE to its AEs situated abroad. In these cases, the mark-up charged by the Indian MNE is often challenged.

The CBDT notified the amended Safe Harbour Rules which laid down the low value-adding intra-group services. Rule 10TA(ga) defines low value-adding intra-group services as services that are performed by one or more members of a multinational enterprise group on behalf of one or more other members of the same multinational enterprise group and which, -

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

but does not include the following services, namely:

- (i) research and development services;
- (ii) manufacturing and production services;
- (iii) information technology (software development) services;
- (iv) knowledge process outsourcing services;
- (v) business process outsourcing services;
- (vi) purchasing activities of raw materials or other materials that are used in the manufacturing or production process;
- (vii) sales, marketing and distribution activities;
- (viii) financial transactions;
- (ix) extraction, exploration, or processing of natural resources; and
- (x) insurance and reinsurance.

The Safe Harbour Rules prescribe a mark-up of not exceeding 5% for such low value-adding intra-group services provided the value of international transaction (including mark-up) does not exceed INR 10 crores and the method of cost pooling, the exclusion of shareholder costs and duplicate costs from the cost pool and the reasonableness of the allocation keys used for allocation of costs by the overseas AE, is certified by an accountant.

2.2 Special consideration for Intangibles

2.2.1 Introduction

The complexities involving the transfer pricing aspects concerning the development, transfer and use of the intangible property are well documented ones and have invited attention of the international tax fraternity.

To appreciate various transfer pricing complexities associated with the intangible property rights it is pertinent to understand the concept of an intangible from a transfer pricing perspective.

An intangible property may be explained as something of no physical existence which fetches economic benefits for the person exercising control over it. In various existing texts such as OECD Guidelines (revised in 2010) and UN TP manual, a generic definition of intangible property is absent. Though several illustrative categories and definitions have been detailed no

single generic definition can be found in these texts. However, OECD in its final report on Action Plan 8-10 released in October 2015 puts forward a generic definition of an intangible. In the final report, which replaces the chapter VI of the OECD Guidelines (special consideration for intangibles), the word intangible is defined as *something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances*. Hence, clearly this definition of intangible emphasizes more on the commercial value rather than any accounting or legal definition for the identification of an intangible.

An intangible property relevant for transfer pricing perspective is definitely a broader term than an intangible asset recognized for accounting purposes or intangibles protected by any law. Any cost incurred entailing significant economic value for the parties for which a compensation is warranted in a third party situation may constitute an intangible for transfer pricing purposes even though the same may not be recorded as an intangible asset for accounting purpose.

It is also important to distinguish an intangible from a local market condition and other comparability factors which although may affect the value of intangibles but are not intangibles in themselves. The final report on Action 8 specifically has incorporated discussion on several such factors such as group synergies, market specific characteristics and assembled workforce which play an important consideration for arm's length analysis but do not constitute as intangibles in themselves.

In the final report as found in the erstwhile Chapter VII of the OECD Guidelines and the UN Manual, Intangibles are classified into two broad categories namely trade intangibles and marketing intangibles. Further, the final report also discusses distinction in intangibles in the form of soft intangibles and hard intangibles, routine and non-routine intangibles and other classes and categories of intangibles.

Trade intangibles are intangibles which relate to the production of goods and provision of services and are typically developed through research and development. Technical know-how, patents are some of the illustrations of trade intangibles.

Marketing intangibles are the intangibles which aid in the commercial exploitation of a product or a service such as trademarks, brand name, and customer lists etc.

The final report on Action 8 defines a marketing intangible as "*an intangible that relates to marketing activities, aids in the commercial exploitation of a product or service, and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers*".

Some of the illustrative lists of intangibles as commonly referred are discussed here-in-under:

- **Patents-** Patent is an exclusive right conferred to the owner to exclusively use an invention for a limited period of time within a specified jurisdiction.

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- **Know-how and trade secrets-** Know-how and trade secrets are proprietary information or knowledge that assist or improve a commercial activity, but that are not registered for protection in the manner of a patent or trademark.
- **Trademarks, trade names and brands-** A trademark is a unique name, symbol, logo or picture that the owner may use to distinguish its products and services from those of other entities.
- **Rights under contracts and government licenses-** They may include, among others, a government grant of rights to exploit specific natural resources or public goods, or to carry on a specific business activity.
- **Licenses and similar limited rights in intangibles-** Limited rights in intangibles transferred by means of a license or other similar contractual arrangement are intangibles themselves.
- **Goodwill and ongoing concern value-** Goodwill in the common parlance may be termed as the reputational value as enjoyed by an enterprise in an open market. In some instances, goodwill may constitute as a separate intangible asset and in some circumstances goodwill may only constitute as another comparability factor which must be taken into account to ascertain the arm's length nature of a transaction.

2.2.2 Application of the arm's length principle

The final report on Action 8 discusses the transfer pricing aspects of the intangibles as involved in a transfer of intangible. A discussion is also incorporated with regard to hard-to-value intangibles and the marketing activities undertaken by the enterprises not owning the brand/trade name.

The report incorporates a broad framework with regard to the application of the arm's length principle in the case of ownership, development, maintenance, protection and exploitation of intangibles. The proposed framework requires the following steps for analyzing transactions involving intangibles:

- Identification of intangibles used or transferred in the transaction;
- Identification of contractual arrangements with emphasis on determining legal ownership of intangibles
- Identification of all the parties performing functions, employing assets and assuming risks in relation to development, enhancement, maintenance, protection and exploitation of the intangibles;
- Confirmation of consistency between the contractual legal arrangements and conduct of the parties;
- Identification of controlled transactions in relation to development, enhancement, maintenance, protection and exploitation of the intangibles including the conduct of the parties and their relative contributions in the functions performed, risks assumed and assets used in the aforesaid activities;

- Determination of ALP for the contribution which should be commensurate to the functions performed, risks assumed and assets deployed by the parties.

The fundamental principle which is propounded here by the OECD is that being legal owner of intangibles in itself does not confer a right to enjoy all the returns derived from the exploitation of the intangibles. The legal owner of an intangible refers to the person who possess the legal rights over that intangible. All the entities who are responsible for contributing to the development, enhancement, maintenance, protection and exploitation of intangibles are entitled to commensurate returns arising from the exploitation of the intangible asset. However, the arm's length remuneration in consideration for the contribution by the entities must be calculated in accordance with the guidance enshrined in chapters I-III of the OECD Guidelines. In some instances, it may be possible that the functions in relation to development, enhancement, maintenance, protection and exploitation of intangibles are outsourced to the other entities but the control over the performance of functions is ultimately retained by the legal owner of the intangibles. In such cases also the legal owner will have to compensate the entities performing the function commensurate to the functions performed by them. However, still a proportion of the return would be retained by the legal owner. But, in the cases where neither the functions are performed by the legal owner nor the control is exercised by them, the legal owner will be not be entitled to any remuneration.

Similarly, entities deploying assets and assuming risks in relation to the intangibles will also be entitled for the commensurate returns from the intangibles.

In some cases, the anticipated returns from the intangibles while ascertaining the arm's length remuneration for a transaction involving an intangible would differ from the actual ex post returns. Now whether the unanticipated returns (positive or negative) are required to be shared between the parties performing functions, assuming risks and deploying assets in relation to the intangibles would depend on several factors such as:

- Whether the parties bear the risks for unanticipated events;
- Whether the parties possess the financial capacity to bear the risks arising from unanticipated events;
- The level of functions performed by each entity;
- Terms and conditions as determined between the parties;
- Whether the arrangement as determined is reflected in the conduct of the parties; and
- Whether the conduct actually adheres to the arm's length standard.

Some of the illustrative cases which may require the application of the above principles include:

- Development and enhancement of marketing intangibles;
- Research and development and process improvement arrangements; and
- Payments for the use of the company name.

The application of arm's length standard in the transactions pertaining to transfer of intangibles

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also involves great complexities. The following factors must be analyzed in great detail in the before proceeding with the arm's length analysis for intangible transfers:

- The nature of intangibles or the nature of rights in relation to the intangibles being transferred and whether there are any restrictions attached to the rights being transferred;
- Whether intangible has been transferred on standalone basis or transferred as combination of one or more intangibles;
- Whether intangible has been transferred in combination with other business assets; and
- Whether intangible has been transferred in combination with transactions pertaining to sale of goods or rendition of services.

Further, specific attention must be given to the following factors in the application of the arm's length standard:

- Nature of the rights in intangibles (exclusive or non-exclusive);
- Extent and duration of legal protection;
- Geographic scope of the intangible;
- Stage of development of the intangibles;
- Rights to enhancements, revisions and updates; and
- Expectation of future benefits.

The nature of the intangibles being transferred or the rights being transferred and the degree of functions performed, risks assumed and assets deployed, the business reasons for entering into the transactions, the perspectives of the parties involved, competitive adjustments conferred by the intangibles and the expected future benefits from the intangibles are some of the factors which must be taken into consideration for the application of a TPM in the transactions involving transfer of intangibles. Further, reliable comparability adjustment wherever possible should be undertaken. The data for comparability could be drawn from the commercial databases or proprietary compilations of publicly available license or similar agreements. An understanding of the facts will allow application of the most appropriate method. Where comparability analysis identifies reliable information related to comparable uncontrolled transactions, the ALP for transfer of intangible could be determined basis of such comparables after making appropriate adjustments. In some situations, a transactional PSM could be adopted to determine the ALP where comparable data is not possible to be identified. The OECD in June 2018 set out "Revised Guidance on the Application of the Transactional Profit Split Method" clarifies and significantly expands the guidance on when a profit split method may be the most appropriate method.

In some instances, valuation techniques are also used in estimating the arm's length consideration for intangibles. The application of a valuation technique must be in consistency with the guidance available in Chapter I-III of the OECD Guidelines. Caution must be taken with respect to following factors in application of the valuation techniques:

- Accuracy of financial projections;
- Assumptions in relation to growth rates;
- Discount rates;
- Estimation of expected useful life of intangibles;
- Underlying assumptions involved; and
- Form of payment.

Further, there are some kind of intangibles whose valuation is highly uncertain at the time of the transfer. These intangibles may be referred as hard-to-value intangibles. A great caution is to be exercised in determination of the arm's length remuneration for these types of intangibles especially in determining whether the ex-post returns for these intangibles be considered in the arm's length analysis.

It is also to be noted that final report on Action Plan-8 of OECD addresses several issues especially guidance in relation to application of PSM in the transactions involving intangibles, guidance in relation to hard to value intangibles etc. A rigorous transfer pricing analysis by taxpayers is required to ensure that transfers of hard-to-value intangibles are priced at arm's length. Resolution of cases of double taxation arising from application of approach of hard-to-value intangibles through access to the mutual agreement procedure (MAP) under the applicable Treaty should be considered.

Hard-to-Value Intangibles (HTVI)

In BEPS Action Plan 8-10, the OECD has mentioned Hard-to-Value Intangibles (HTVI), as intangibles or rights in intangibles for which, at the time of the transaction, no reliable comparables existed, and projections of future cash flows expected to be derived from the transferred intangibles or assumptions used in valuing the intangibles were highly uncertain. Normally, HTVI may have one or more of the following characteristics³:

- The intangible is only partially developed at the time of the transfer.
- It is not expected to be exploited commercially until several years following the transaction.
- It is integral to the development of other hard-value intangibles.
- It is expected to be exploited in a novel manner, making reliable projections from past developments unavailable.
- It is transferred to an associated enterprise for a lump sum payment.
- It is used in connection with or developed under a cost contribution arrangement or similar arrangements.

In order to rebut any adverse inference taxpayers should maintain documents to show the determination of original projections, including how risks were considered and probabilities of future events were dully taken into account.

³ Richard Schmidtke and Sajeev Sidher in Deloitte Global Transfer Pricing, November 2015

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It is preferable for taxpayers to have the transaction covered by a multilateral or bilateral APAs.

2.2.3 India and the AMP controversy

As the transfer pricing legislation has developed in India, the tax administrators' focus has shifted from the routine issues such as comparability, use of relevant year data etc. to more advanced concepts such as intangibles, location, savings etc. One specific issue which is at the center of the transfer pricing controversy is whether advertising, marketing and promotion ("AMP") expenses incurred by the licensed manufacturer/distributor in India contributes to the value of brand owned by parent company and whether additional remuneration is warranted for the incurrence of such expenses. The issue has travelled to various income tax appellate tribunals/ High Courts across the country and now the issue is pending before the Supreme Court of India in a batch of appeals. The broad issues in this relation which are subject matter of this entire controversy are listed here-in-under:

- Whether AMP is a separate international transaction; if yes, how to benchmark the AMP cost; and
- If AMP is an international transaction, whether arm's length price of such transaction has to be analyzed separately or in conjunction with the transaction pertaining to purchase of raw materials/finished goods.

Even after the Hon'ble High Court has given its ruling on the issue, the controversy is far from over and has already reached to the doors of the apex court of the country.

Further, Indian tax authorities also generally question the royalty payments by the Indian MNEs to its foreign parent.

Generally, taxpayers are advised to maintain robust documentation supporting the pricing arrangements adopted for the transaction pertaining to intangibles to avoid protracted litigation.

Example 1

Company A, resident of country X manufactures watches which are marketed in many countries around the world under the R trademark and trade name. Company A is the registered owner of the R trademark and trade name. R watches have never been marketed in country Y, however, and the R name is not known in the country Y market.

Company A decides to enter the country Y market and incorporates a wholly owned subsidiary in country Y, Company S, to act as its distributor in country Y. Company S is obligated to develop and execute the marketing plan for Country Y. Further, Company S actually bears the costs and assumes the risks of its marketing activities. We need to determine the extent to which the marketer/distributor can share in the potential benefits from those activities with Company A.

Solution:

A thorough comparability analysis identifies several uncontrolled companies engaged in marketing and distribution functions under similar long-term marketing and distribution

arrangements.

The level of marketing expense Company S incurs exceeds that incurred by the identified comparable independent marketers and distributors. Assume further that the high level of expense incurred by Company S reflects its performance of additional or more intensive functions than those performed by the potential comparables and that Company A and Company S expect those additional functions to generate higher margins or increased sales volume for the products. Given the extent of the market development activities undertaken by Company S, it is evident that Company S has made a larger functional contribution to development of the market and the marketing intangibles and has assumed significantly greater costs and assumed greater risks than the identified potentially comparable independent enterprises. There is also evidence to support the conclusion that the profits realised by Company S are significantly lower than the profit margins of the identified potentially comparable independent marketers and distributors.

Based on these facts, it is evident that by performing functions and incurring marketing expenditure substantially in excess of the levels of function and expenditure of independent marketer/distributors incomparable transactions,

In this example, the proposed adjustment is based on Company S's having performed functions, assumed risks, and incurred costs that contributed to the development of the marketing intangibles for which it was not adequately compensated under its arrangement with Company A. If the arrangements between Company S and Company A were such that Company could expect to obtain an arm's length return on its additional investment during the remaining term of the distribution agreement, a different outcome could be appropriate.

There is an inconsistency between Parent A's asserted entitlement to returns derived from exploiting the Product X intangibles and its failure to bear the costs associated with the risks supporting that assertion. A transfer pricing adjustment would be appropriate to remedy the inconsistency. In determining the appropriate adjustment, it would be necessary to determine the true transaction between the parties. In doing so, it would be appropriate to consider the risks assumed by each of the parties on the basis of the course of conduct followed by the parties over the term of the agreement, the control over risk exercised by Parent A and the subsidiary.

If it is determined that the true nature of the relationship between the parties is that of a limited risk distribution arrangement, then the most appropriate adjustment would likely take the form of an allocation of the recall and product liability related costs from the subsidiary to Parent A. Alternatively, although unlikely, if it is determined on the basis of all the relevant facts that the true nature of the relationship between the parties includes the exercising control over product liability and recall risk by the subsidiary, and if an arm's length price can be identified based on the comparability analysis, an increase in the distribution margins of the subsidiary for all years might be made to reflect the true risk allocation between the parties.

Example 2

Company Z is a company engaged in software development consulting. In the past Company Z has developed software supporting ATM transactions for client Bank A. In the process of doing so, Company Z had created and retained an interest in proprietary copyrighted software code that is potentially suitable for use by other similarly situated banking clients, albeit with some revision and customization.

Company Y, an associated enterprise of Company Z, enters into a separate agreement to develop software supporting ATM operations for another bank, Bank B. Company Z agrees to support its AE by providing employees who worked on the Bank A engagement to work on Bank B engagement. Those employees have access to software designs and know-how developed in the Bank A engagement, including proprietary software code.

Bank B is provided by Company Y with a software system for managing its ATM network, including the necessary licence to utilise the software developed in the project. The code developed in the Bank. Determine the remuneration for Company Y.

Solution

A transfer pricing analysis of these transactions should recognise that Company Y received two benefits from Company Z which require compensation. First, it received services from the Company Z employees that were made available to work on the Bank B engagement.

Second, it received rights in Company Z's proprietary software which was utilised as the foundation for the software system delivered to Bank B. The compensation to be paid by Company Y to Company Z should include compensation for both the services and the rights in the software.

2.3 Special consideration for Cost Contribution Arrangements (CCA)

2.3.1 Introduction

It is commonly observed that, for joint developments of certain intangible assets, MNEs have mechanism to share the common costs and the interest arising out of the developed intangible assets. Generally, a CCA is found when a group of companies with a common need for particular activities decides to centralize or undertake jointly the activities in a way that minimizes costs and risks to the benefit of each participant to the CCA.

CCAs are commonly observed for joint development of intangibles, joint funding or sharing of costs and risk, for developing or acquiring property or for obtaining services. CCAs help in structuring and planning of the international commercial agreements and provides MNEs with difficult and complicated transfer pricing issues, with specific reference to intangible properties.

From a transfer pricing perspective, the arm's length nature of the contribution made by each enterprise in the CCA, would need to be established under comparable uncontrolled circumstances. As per Indian TP regulations, transactions with respect to CCAs are included

within the ambit of transfer pricing but no specific guidelines are provided to address the analysis and documentation of such transactions. However, OECD TP Guidelines 2017 provides guidance for determining the arm's length nature of contributions made under a CCA. Further, Action 8-10 of the BEPS Final Report (Aligning Transfer Pricing Outcomes with Value Creation) released on 6 October 2015 provides general guidance for determining whether the conditions established by associated enterprises for transactions covered by a CCA are consistent with the arm's length principle. These were subsequently incorporated in Chapter VIII of OECD Guidelines, 2022.

In doing so, the guidance contained in this chapter addresses some of the opportunities for BEPS resulting from the use of CCAs.

2.3.2 Definition of CCA:

As per Para 8.3 of the OECD Guidelines, 2022:

“A CCA is a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants.”

The OECD Guidelines set out the framework for CCA analysis to ensure that:

- The same analytical framework for delineating the actual transaction, including allocating risk, is applicable to CCAs as to other kinds of contractual arrangements.
- The same guidance for valuing and pricing intangibles, including hard-to-value intangibles, is applicable to CCAs as to other kinds of contractual arrangements.
- The analysis of CCAs is based on the actual arrangements undertaken by associated enterprises and not on contractual terms that do not reflect economic reality.
- An associated enterprise can only be a participant to the CCA if there is a reasonable expectation that it will benefit from the objectives of the CCA activity and it exercises control over the specific risks it assumes under the CCA and has the financial capacity to assume those risks.
- Contributions made to a CCA, with specific focus on intangibles, should not be measured at cost where this is unlikely to provide a reliable basis for determining the value of the relative contributions of participants, since this may lead to non-arm's length results.

Considering the above definition, following are the important aspects of a CCA:

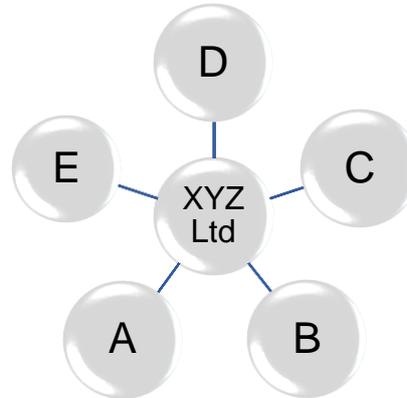
- CCA is a contractual agreement, rather than a judicial entity/ a permanent establishment of the participant;
- The contractual agreement provides the starting point for delineating the actual transaction. In this respect, no difference exists for a transfer pricing analysis between a

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CCA and any other kind of contractual arrangement where the division of responsibilities, risks, and anticipated outcomes as determined by the functional analysis of the transaction is the same;

- A CCA does not require the participants to combine their operations in order, for example, to exploit any resulting intangibles jointly or to share the revenues or profits. Rather, CCA participants may exploit their interest in the outcomes of a CCA through their individual businesses;
- CCA permits sharing the economic ownership & exploiting the intangible property without payment of royalty or any other consideration and in a CCA, legal ownership of developed intangible property is vested in only one participant but all the participants have effective ownership interest.
- A key feature of a CCA is the sharing of contributions. In accordance with the arm's length principle, at the time of entering into a CCA, each participant's proportionate share of the overall contributions to a CCA must be consistent with its proportionate share of the overall expected benefits to be received under the arrangement.
- In a CCA there is always an expected benefit that each participant seeks from its contribution, including the attendant rights to have the CCA properly administered.
- Each participant's interest in the results of the CCA activity should be established from the outset, even where the interest is inter-linked with that of other participants, e.g. because legal ownership of developed intangibles or tangible assets may be vested in only one of them but all of them have certain rights to use or exploit the intangibles or tangible assets as provided in the contractual arrangements (for example, perpetual, royalty-free licences for the territory in which the individual participant operates).
- CCA permits pooling of funds from several entities & support development of intangible property for the benefit of all participants;
- A CCA for the sharing in the development of intangibles can eliminate the need for complex cross-licensing arrangements and associated allocation of risk, and replace them with a more streamlined sharing of contributions and risks, with ownership interests of the resulting intangible(s) shared in accordance with the terms of the CCA. However, the streamlining of flows that may result from the adoption of a CCA does not affect the appropriate valuation of the separate contributions of the parties.

The following example can be considered to understand a CCA:



Example 1: Concept of CCA

In the above figure, XYZ Ltd. is a R&D centre and A, B, C, D & E are participant entities at various geographical locations. Each participant brings in consideration in return for the Technical know-how they get from XYZ Ltd. Participants also share the cost & risk of XYZ Ltd. This arrangement once entered as a contractual framework, becomes a CCA.

Example 2

An MNE group which manufactures products through three enterprises which each operate a production site and have their own R&D teams engaged in various projects to improve production processes. Those three enterprises enter into a CCA aimed at generating production process improvements, and as a result pool their expertise and share the risks. Since the CCA grants each participant rights to the outcomes of the projects, the CCA replaces the cross-licensing arrangements that may have resulted in the absence of a CCA and if the enterprises had individually developed certain intangibles and granted rights to one another.

2.3.3 Types of CCA

The CCAs can be classified in the following two categories:

- Development CCAs - those established for the joint development, production or the obtaining of intangibles or tangible assets;
- Services CCAs - those for obtaining services.

The key differences in the above mentioned CCAs are that development CCAs are expected to create ongoing, future benefits for participants, while services CCAs will create current benefits only. Development CCAs, in particular with respect to intangibles, often involve significant risks associated with what may be uncertain and distant benefits, while services CCAs often offer more certain and less risky benefits.

- **Development CCA**

In such a CCA, each participant is accorded separate rights to exploit the intangible property, for example in specific geographic areas or applications. It is possible that only one of the participants is the legal owner of the property, but economically all the participants are co-owners. In cases where a participant has an effective ownership interest in any property developed by the CCA and the contributions are in the appropriate proportions, there is no need for a royalty payment or other consideration for use of the developed property consistent with the interest that the participant has acquired. For example, in pharmaceutical industries, CCA could be found to spread or share risk of commercial failure or financial loss. The benefit of Development CCAs are generally medium or long term.

- **Services CCA**

Services CCA are entered to share the cost and risk for obtaining the same services. For example, MNEs may decide to pool resources for acquiring centralized management services, or for the development of advertising campaigns common to the participants markets. The benefit of services CCA are generally realized in the period during which services are performed.

2.3.4 Differences between Intra-Group services and CCA

CCA should not be misunderstood with intra-group services. Intra-group services can be understood as an activity for which an independent enterprise would have been willing to pay or perform for itself. Whereas, CCAs allow parties to share the costs and risks of developing, producing, or obtaining assets, services or rights. What distinguishes contributions to a CCA from an ordinary intra-group transfer of property or services is that part or all of the compensation intended by the participants is the expected benefits to each from the pooling of resources and skills. CCA involve transfer of economic ownership in the form of intangible property, while intra-group services do not involve such transfers. Also, unlike intra-group services, there is a need of formal contractual agreement between participants to enter into CCA.

- **Application of Arm's length principle**

For the conditions of a CCA to satisfy the arm's length principle, a participant's contributions must be consistent with what an independent enterprise would have agreed to contribute under comparable circumstances given the benefits it reasonably expects to derive from the arrangement. Independent enterprises enter into arrangements to share costs and risks when there is a common need from which the enterprises can mutually benefit. For instance, independent parties at arm's length might want to share risks (*e.g.*, of high technology research) to minimize the loss potential from an activity, or they might engage in a sharing of costs or in joint development in order to achieve savings, perhaps from economies of scale, or to improve efficiency and productivity, perhaps from the combination of different individual strengths and spheres of expertise. More generally, such arrangements are found when a group of companies with a common need for particular activities decides to centralize or undertake jointly the activities in a way that minimizes costs and risks to the benefit of each participant.

The expectation of mutual and proportionate benefit is fundamental to the acceptance by independent enterprises of an arrangement for pooling resources and skills. Independent enterprises would require that the value of each participant's proportionate share of the actual overall contributions to the arrangement is consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement.

To apply the arm's length principle to a CCA, it is therefore a necessary precondition that all the parties to the arrangement have a reasonable expectation of benefit. The next step is to calculate the value of each participant's relative contribution to the joint activity, and finally to determine whether the allocation of CCA contributions (as adjusted for any balancing payments made among participants) accords with their respective share of expected benefits.

It should be recognised that these determinations may bear a degree of uncertainty. The potential exists for contributions to be allocated among CCA participants so as to result in an overstatement of taxable profits in some countries and the understatement of taxable profits in others, measured against the arm's length principle. For that reason, taxpayers should be prepared to substantiate the basis of their claim with respect to the CCA.

Therefore, to determine the arm's length nature of CCA contribution, following points need to be kept in mind:

- (a) Determination of parties to the agreement who have the expectation of benefit from entering into a CCA;
- (b) Calculation of each participant's relative contribution to the joint activity; and
- (c) Determining the appropriateness of the allocation of CCA contributions.

Each of the above mentioned points is discussed in detail as follows:

- **Determination of participants**

The fundamental concept to a CCA is the mutual benefit derived out of the results of a CCA. Therefore, a participant must be assigned a beneficial interest in the property or services that are the subject of the CCA, and have a reasonable expectation of being able directly or indirectly (e.g. through licensing arrangements or sales, whether to associated or independent enterprises) to exploit or use the interest that has been assigned. The participant must also have the capability and authority to control the risks associated with the risk bearing opportunity under the CCA. Sometimes, an associated enterprise or a third party can be designated for carrying out all or part of the activities under CCA. In such cases of contract research and/or manufacturing, an arm's length charge would be appropriate to compensate the company for services being rendered to the CCA participants. This would be the case even where, for example, the company is an affiliate of one or more of the CCA participants and has been incorporated in order to secure limited liability exposure in case of a high risk research and development CCA activity. The arm's length charge for the company would be determined based on functions performed, assets used, and risks assumed.

- **The amount of each participant's contribution**

As mentioned in above paragraphs, under the arm's length principle, the value of each participant's contribution should be consistent with the value that independent enterprises would have assigned to the contribution in comparable circumstances. Therefore, the application of the arm's length principle would take into account, inter alia, the contractual terms and economic circumstances particular to the CCA, e.g. the sharing of risks and costs. However, it is unlikely to be a straightforward matter to determine the relative value of each participant's contribution except where all contributions are made wholly in cash, for example, where the activity is being carried on by an external service provider and the costs are jointly funded by all participants. The contribution should recognize all contributions made by the participants, including property or services that are used partly in the CCA activity and also partly in the participant's separate business activities. Any savings arising from subsidies or tax incentives should also be considered while determining the participant's contribution. Balancing payments also play an important role in determining the contribution. Balancing payments should maintain the arm's length condition that each participant's proportionate share of the overall contributions be consistent with its proportionate share of the overall expected benefits to be received under the arrangement.

- **Appropriateness of allocation keys**

Allocation of participant's share of contribution should be consistent with the participant's proportionate share of the overall benefits expected to be received under the arrangement. The direct method to allocate the contribution could be based on estimated additional income to be generated or costs to be saved by each participant's as a result of the CCA. Otherwise, allocation keys could be considered for reflecting the participant's contribution. The allocation keys include sales, units used, production or sale, gross or operating profit, etc. However, whether any particular allocation key is appropriate depends on the nature of the CCA activity and the relationship between the allocation key and the expected benefits. Irrespective of the allocation method, adjustments must be made for differences in the expected benefits to be received by the participants. *E.g.* in the timing of their expected benefits.

2.3.5 Concept of balancing payments

A CCA will be considered consistent with the arm's length principle where the value of each participant's proportionate share of the overall contributions to the arrangement (taking into account any balancing payments already made) is consistent with the participant's share of the overall expected benefits to be received under the arrangement. Where the value of a participant's share of overall contributions under a CCA at the time the contributions are made is not consistent with that participant's share of expected benefits under the CCA, the contributions made by at least one of the participants will be inadequate, and the contributions made by at least one other participant will be excessive. In such a case, the arm's length principle would generally require that an adjustment be made. This will generally take the form of an adjustment to the contribution through making or imputing a (further) balancing payment. Such balancing payments increase the value of the contributions of the payer and decrease that

of the payee.

Thus, when a participant's share of expense is reduced as a part of the review or when a CCA receives a payment from participant when his share increases it is called as Balancing Payment /Receipt. The need of balancing payments arises due to change in the estimation of the accrued benefits or based on the comparison of the actual results to the expected benefits.

The balancing payments are treated as a cost to the payer and as a reimbursement of cost to the recipients.

2.3.6 Buy-in and Buy-out adjustments

There can be situations wherein, a new entity joins an already active CCA and/or an existing participants withdraws out of the CCA. In case of an entrance, the new entity joining an existing CCA might obtain an interest in any results of prior CCA activity, such as intangible property developed through the CCA, work in-progress and the knowledge obtained from past CCA activities. In such a case, the previous participants effectively transfer part of their respective interests in the results of prior CCA activity. Under the arm's length principle, any transfer of pre-existing rights from participants to a new entrant must be compensated based upon an arm's length value for the transferred interest. This compensation is called a "buy-in" payment. The amount of a buy-in payment should be determined based upon the arm's length value of the rights the new entrant is obtaining, taking into account the entrant's proportionate share of overall expected benefits to be received under the CCA.

In case of an exit from the CCA, a participant who leaves the CCA may dispose of its interest in the results of past CCA activity (including work in progress) to the other participants. The disposal of its interest in the results of past CCA activities to the other participants should be compensated according to the arm's length principle. This compensation is called a "buy-out" payment.

In case of termination of CCA, the arm's length principle would require that each participant receive a beneficial interest in the results of the CCA activity consistent with the participant's proportionate share of contributions to the CCA throughout its term (adjusted by balancing payments actually made including those made incident to the termination). Alternatively, a participant could be compensated according to the arm's length principle by one or more other participants for surrendering its interest in the results of the CCA activity.

2.3.7 Recommendations for structuring and documenting CCAs

A CCA should be structured in a manner that conforms to the arm's length principle. A CCA at arm's length normally would meet the following conditions:

- (a) The participants would include only enterprises expected to derive mutual benefits from the CCA activity itself, either directly or indirectly (and not just from performing part or all of that activity).
- (b) The arrangement would specify the nature and extent of each participant's beneficial interest in the results of the CCA activity, as well its expected respective share of benefits;

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- (c) No payment other than the CCA contributions, appropriate balancing payments and buy-in payments would be made for the beneficial interest in property, services, or rights obtained through the CCA;
- (d) The value of participants' contributions would be determined in accordance with these Guidelines and, where necessary, balancing payments should be made to ensure the proportionate shares of contributions align with the proportionate shares of expected benefits from the arrangement.
- (e) The arrangement may specify provision for balancing payments and/ or changes in the allocation of contributions prospectively after a reasonable period of time to reflect material changes in proportionate shares of expected benefits among the participants.; and
- (f) Adjustments would be made as necessary (including the possibility of buy-in and buy-out payments) upon the entrance or withdrawal of a participant and upon termination of the CCA.

The transfer pricing documentation standard set out under Chapter V of the OECD TP Guidelines on Documentation requires reporting under the master file of important service arrangements and important agreements related to intangibles, including CCAs. The local file requires transactional information including a description of the transactions, the amounts of payments and receipts, identification of the associated enterprises involved, copies of material intercompany agreements, and pricing information including a description of reasons for concluding that the transactions were priced on an arm's length basis. It would be expected that in order to comply with these documentation requirements, the participants in a CCA will prepare or obtain materials about the nature of the subject activity, the terms of the arrangement, and its consistency with the arm's length principle. Implicit in this is that each participant should have full access to the details of the activities to be conducted under the CCA, the identity and location of the other parties involved in the CCA, the projections on which the contributions are to be made and expected benefits determined, and budgeted and actual expenditures for the CCA activity, at a level of detail commensurate with the complexity and importance of the CCA to the taxpayer. All this information could be relevant and useful to tax administrations in the context of a CCA and, if not included in the master file or local file, taxpayers should be prepared to provide it upon request. The information relevant to any particular CCA will depend on the facts and circumstances. It should be emphasized that the information described in this list is neither a minimum compliance standard nor an exhaustive list of the information that a tax administration may be entitled to request.

The following information would be relevant and useful concerning the initial terms of the CCA:

- (a) A list of participants;
- (b) A list of any other associated enterprises that will be involved with the CCA activity or that are expected to exploit or use the results of the subject activity;
- (c) The scope of the activities and specific projects covered by the CCA;

- (d) The duration of the arrangement;
- (e) The manner in which participants' proportionate shares of expected benefits are measured, and any projections used in this determination;
- (f) the manner in which any future benefits (such as intangibles) are expected to be exploited
- (g) The form and value of each participant's initial contributions, and a detailed description of how the value of initial and ongoing contributions is determined and how accounting principles are applied consistently to all participants in determining expenditures and the value of contributions;
- (h) The anticipated allocation of responsibilities and tasks associated with the CCA activity between participants and other enterprises;
- (i) The procedures for and consequences of a participant entering or withdrawing from the CCA and the termination of the CCA; and
- (j) Any provisions for balancing payments or for adjusting the terms of the arrangement to reflect changes in economic circumstances

Over the duration of the CCA term, the following information could be useful:

- (a) Any change to the arrangement (e.g. in terms, participants, subject activity), and the consequences of such change;
- (b) A comparison between projections used to determine the share of expected benefits from the CCA activity with the actual share of benefits ; and
- (c) The annual expenditure incurred in conducting the CCA activity, the form and value of each participant's contributions made during the CCA's term, and a detailed description of how the value of contributions is determined.

2.3.8 Case Study

The following case study would help in understanding the practical aspects of CCA:

Three Companies (X, Y & Z Co) enter into a CCA with ABC Ltd, Switzerland. Total cost incurred by ABC Ltd for the year 2008-09 is INR 40 Crores.

Scenario 1: In this scenario, projected sales figure for the next 3 years for 3 companies are given below:

Year	X Co.			Y Co.			Z Co.		
	Without R&D	With R&D	Incremental sales	Without R&D	With R&D	Incremental sales	Without R&D	With R&D	Incremental sales
Y1	20	25	5	15	23	8	14	20	6
Y2	30	35	5	20	27	7	34	44	10

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	X Co.			Y Co.			Z Co.		
Y3	40	45	5	35	41	6	45	53	8
Average Benefit	5			7			8		

Question: How the cost should be apportioned between the three companies.

Answer: As mentioned in previous paragraphs the cost should commensurate with the expected benefits out of the CCA. Accordingly, the cost of INR 40 crores should be apportioned in the ratio of the incremental sale that each participant is going to generate i.e. 5: 7: 8. Therefore, payment of X Co., Y Co. and Z Co. would be INR 10 Crores, INR 14 Crores and INR 16 Crores respectively.

Scenario 2: In this scenario, actual sales figure for the 3 years for 3 companies are given below:

	X Co.			Y Co.			Z Co.		
Year	Without R&D	With R&D	Incremental sales	Without R&D	With R&D	Incremental sales	Without R&D	With R&D	Incremental sales
Y 1	20	23	3	15	21	6	14	22	8
Y2	30	35	5	20	26	6	34	48	14
Y3	40	44	4	35	41	6	45	53	8
Average Benefit	4			6			10		

Question: How the cost should be apportioned between the three companies and what should be the balancing payment/receipts based on the actual results?

Answer: The cost should be apportioned in the ration of incremental sale i.e. 4:6:10. Therefore, the revised cost contribution of X Co., Y Co. and Z Co. would be INR 8 Crores, INR 12 Crores and INR 20 Crores respectively.

The balancing payments/receipts arising out of the difference between the projected result and actual results would be as follows:

Participant	Actual Contribution (A)	Revised Contribution (B)	Balancing Payment/(Receipts) (B-A)
X Co.	10	8	(2)
Y Co.	14	12	(2)
Z Co.	16	20	4

UNIT-III**Business restructuring****3.1 Introduction and background**

The advent of the 21st century has witnessed the global business environment becoming more dynamic and complex. The dynamic business environment has exposed the MNEs to many uncertainties. The dynamic business environment coupled with economic uncertainties has led to the rapid restructuring of operations by the MNEs. Some of the reasons for restructuring include the wish to maximise synergies and economies of scale, to streamline the management of business lines and to improve the efficiency of the supply chain, taking advantage of the development of web-based technologies that has facilitated the emergence of global organisations. Furthermore, business restructurings may be needed to preserve profitability or limit losses, e.g., in the event of an over-capacity situation or in a downturn economy.

Before we delve into the technicalities of the business restructuring and various challenges it poses from a transfer pricing perspective, it is pertinent that we understand the business restructuring as a broad concept.

Though there is no universal definition of business restructuring, business restructuring can be understood as a change in functions, risks or assets of a MNE emanating from a strategic decision of the MNE group. In simplified words, any change in the business arrangements in the MNE group may be termed as business restructuring. A business restructuring may result in greater/lesser allocation of functions, risks and assets to a particular entity depending on the facts of the case. Following illustrations of business restructuring transactions will be helpful in building the understanding with regard the concept of business restructurings from a practical viewpoint:

- Conversion of an independent service provider into a limited risk service provider;
- Conversion of a full-fledged distributor into a limited risk distributor;
- Conversion of a full-fledged R&D center into a contract R&D service provider;
- Conversion of full-fledged manufacturers into contract/toll manufacturers;
- Transfer of IPRs to a central entity;
- The concentration of functions in a regional or central entity with a corresponding reduction in scope or scale of functions carried out locally, etc.

Thus, as evident from the above illustration business restructuring impacts the functional, assets and risk profile of the MNEs participating in the restructuring process.

With the widespread occurrence of business restructurings across the world, various new tax and transfer pricing issues emerged. Many MNEs indulged in restructurings in a view to transform into tax efficient structures. Changes in existing business arrangements resulted into the change in functional, assets and risk profile and subsequently resulted in new cross border transactions between the members of MNE. A business restructuring may potentially give rise

to events which have the potential effect to distort the tax base of a tax jurisdiction if not properly dealt with.

Gradually the international community started taking cognizance of the various transfer pricing and tax consequences arising from a restructuring transaction. On 1st January 2008, Germany amended its Tax Act and introduced rules to cover the tax and transfer pricing of the business restructuring transactions. Gradually most developed tax jurisdictions such as Australia, France, etc. also introduced various provisions to tackle this issue in their respective legislations. In January 2007, CFA of OECD decided to refer the work on transfer pricing aspects of business restructurings to a newly created working party no. 6 special session on business restructuring. On 19 September 2008, OECD released a discussion draft on the new chapter for business restructurings for public comments. The new chapter was subsequently finalized and was approved by the CFA on 22 June, 2010 to be incorporated as chapter IX of in the OECD TP Guidelines. Thus, the revised OECD TP Guidelines incorporating the Chapter IX, approved by the council of OECD was released on July 22, 2010. These were further supplemented by a revision adopted by CFA on 31 December 2016 and approved by the CFA on 3 April 2017. Thus, the revised OECD TP Guidelines approved by the council of OECD was released in July 2017 and subsequently in January 2022.

3.2 Business Restructuring (Chapter-IX, OECD Guidelines 2022)

Though there is no legal or universally accepted definition of business restructuring, it could be understood as a cross-border re-organisation of the commercial or financial relations between associated enterprises, including the termination or substantial renegotiation of existing arrangements. The Chapter IX addresses various practical issues which may arise on the practical application of the arm's length principle in the context of business restructurings. It is pertinent to understand that this chapter is only relevant for the transaction between two associated enterprises in the context of Article 9 of the OECD Model Tax Convention⁴ and tries to develop pragmatic and simplistic approaches which facilitate the application of the arm's length principle to a transaction involving business restructuring. Thus, the chapter intends to provide guidelines to analyze whether the conditions imposed in a transaction of business restructuring between two or more associated enterprises corresponds to the conditions that would have been imposed in a similar transaction between two independent entities.

The entire discussion in the chapter-IX is divided into two separate parts:

- **Part I** provides guidance with regard to determination of the arm's length compensation for the restructuring itself; and
- **Part II** provides guidance with regard to determination of the arm's length compensation post restructuring-controlled transactions.

3.2.1 Part I: Determination of the arm's length compensation for the restructuring itself

A business restructuring may involve cross-border transfers of something of value, e.g., of

⁴ The Article 9 deals with adjustments to profits that may be made by respective tax jurisdictions for tax purposes where transactions have been entered into between AEs on non-arm's length basis.

valuable intangibles. It may also or alternatively involve the termination or substantial renegotiation of existing arrangements, e.g., manufacturing arrangements, distribution arrangements, licenses, service agreements, etc.

The arm's length principle requires an evaluation of the conditions made or imposed between associated enterprises, at the level of each of them. The fact that a business restructuring may be motivated by sound commercial reasons at the level of the MNE group, e.g., in order to try to derive synergies at a group level, does not answer the question whether it is arm's length from the perspectives of each of the restructured entities.

A. Understanding the restructuring itself

The application of the arm's length principle to a business restructuring must start, as for any controlled transaction, with the identification of the commercial or financial relations between the associated enterprises involved in the business restructuring and the conditions and economically relevant circumstances attaching to those relations. Aspects of identifying the commercial or financial relations between the parties which are particularly relevant to determining the arm's length conditions of business restructurings as discussed under Chapter IX of the OECD Guidelines 2022 are as below:

- **Accurate delineation of the transactions comprising the business restructuring: functions, assets and risks before and after the restructuring –**

To ascertain the arm's length nature of the restructuring transaction, it is imperative to accurately delineate the transactions occurring between the restructured entity and one or more other members of the group. The accurate delineation of the transactions comprising the business restructuring requires performing a functional analysis that seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed before and after the restructuring by the parties involved.

- Risks are of critical importance in the context of business restructurings since business restructurings often result in local operations being converted into low risk operations remunerated with a relatively low return. Thus, an examination of the allocation of risks between associated enterprises before and after the restructuring is an essential part of the functional analysis. At arm's length, a party would not be expected to lay off a risk that is perceived as economically insignificant in exchange for a substantial decrease in its profit potential.

Understanding the business reasons for and the expected benefits from the restructuring, including the role of synergies -

The drivers of the restructuring transaction must be analyzed to ascertain whether it corresponds to the arm's length nature. When the potential synergies are explained as a possible driver behind the restructuring, it is a good practice that the expected synergies are documented in detail by the parties. Further, materialization of synergies may not necessarily result in an increase in profits for the group as compared to that before restructuring but may also result in increased profits as compared to would have been earned if the restructuring had not taken place. Also, it is not essential that the expected

synergies will always materialize.

- **Other options realistically available to the parties –**

It is also imperative that the other alternative transactions available to the parties entering into restructuring transaction must be analyzed in detail. It must be understood that mere availability of a more lucrative alternative structures before the parties does not simply mean that the transaction between the parties be regarded differently to its actual form or be regarded to be inconsistent with the arm's length standard. However, the availability of the other lucrative options may be a crucial factor in analyzing the pricing of the restructuring transaction as in an uncontrolled transaction, parties are expected to exploit the most profitable option available before it.

- **Transfer pricing documentation for business restructurings –**

As part of their transfer pricing documentation, MNE groups are recommended to document their decisions and intentions regarding business restructurings, especially as regards their decisions to assume or transfer significant risks, before the relevant transactions occur, and to document the evaluation of the consequences on profit potential of significant risk allocations resulting from the restructuring.

B. Recognition of the accurately delineated transactions that comprise the business restructuring

There can be group-level business reasons for an MNE group to restructure. However, it is not sufficient from a transfer pricing perspective that a restructuring arrangement makes commercial sense for the group as a whole; the arrangement must be arm's length at the level of each individual taxpayer, taking account of its rights and other assets, expected benefits from the arrangement, and realistically available options. Where a restructuring makes commercial sense for the group as a whole on a pre-tax basis, it is expected that an appropriate transfer price would generally be available to provide arm's length compensation for each accurately delineated transaction comprising the business restructuring for each individual group member participating in it.

Business restructurings often lead MNE groups to implement global business models that are hardly if ever found between independent enterprises, taking advantage of the very fact that they are MNE groups and that they can work in an integrated fashion. This lack of comparables does not mean that the implementation of such global business models is not arm's length. Every effort should be made to determine the pricing for the restructured transactions as accurately delineated under the arm's length principle.

C. Reallocation of profit potential as a result of a business restructuring

Profit potential

“Profit potential” is defined as “expected future profits” under Para 9.40 of Chapter IX of the OECD Guidelines 2022. In some cases, it may encompass losses. The notion of “profit potential”

is often used for valuation purposes, in the determination of an arm's length compensation for a transfer of intangibles or of an ongoing concern, or in the determination of an arm's length indemnification for the termination or substantial renegotiation of existing arrangements, once it is found that such compensation or indemnification would have taken place between independent parties in comparable circumstances.

If an entity has no discernible rights or other assets at the time of the restructuring, then it has no compensable profit potential. On the other hand, if an entity has considerable rights or other assets at the time of the restructuring it may have considerable profit potential, which must ultimately be appropriately remunerated in order to justify the sacrifice of such profit potential.

Reallocation of risks and profit potential

The OECD Guidelines provides guidance on the analysis of reallocation of risk in order to determine whether the party allocated risk following the business restructuring controls the risk and has the financial capacity to assume the risk. The steps for analysing risk in a controlled transaction, in order to accurately delineate the actual transaction in respect to that risk, can be summarised as follows:

- Identify economically significant risks with specificity;
- Determine how specific economically significant risks are contractually assumed by the associated enterprises under the terms of the transaction;
- Determine through a functional analysis how the associated enterprises that are parties to the transaction operate in relation to assumption and management of the specific economically significant risks, which enterprises perform control functions and risk mitigation functions, which enterprises encounter upside or downside consequences of risk outcomes, and which enterprises have the financial capacity to assume the risk;
- Interpret the information and determine whether the contractual assumption of risk is consistent with the conduct of the associated enterprises and other facts of the case;
- Where the party assuming risk does not control the risk or does not have the financial capacity to assume the risk, apply the guidance on allocating risk; and
- The actual transaction as accurately delineated should be priced taking into account the financial and other consequences of risk assumption, as appropriately allocated, and appropriately compensating risk management functions.

D. Transfer of something of value (e.g., an asset or an ongoing concern)

A transaction of business restructuring may result in transfers of tangible assets, of intangibles and rights in intangibles, and of activities (ongoing concern). Arm's length standard warrants an attachment of an arm's length remuneration for such transfers.

Transfer of tangible assets

Business restructuring generally may involve transfer of some tangible assets such as equipment, inventories etc. Transfer of inventories in a restructuring transaction may give rise to transfer pricing difficulties. In a situation when a full-fledged manufacturer/distributor is converted into a toll manufacturer/inventory stripped distributor, such manufacturer/distributor may have to transfer the inventories of raw materials/finished goods to its AE. Ascertainment of arm's length remuneration for such transfer will involve the application of principles as propounded by OECD Guidelines in an ordinary controlled transfer. Thus, the process of ascertainment of arm's length remuneration will entail undertaking a functional analysis (covering the transition period over which the transfer has been implemented) and selection of a tested party and most appropriate method.

Transfer of Intangible assets

A restructuring transaction may also involve transfer of certain intangible assets. The determination of the arm's length remuneration for those intangibles may be a complex exercise because not all intangibles are readily identifiable. Intangibles include inter-alia patents, trademarks copyrights, designs, technical know-how which may be technically protected and also customer lists, distribution channels, unique names, assembled workforce which may not be legally protected. Both the aspects of transferor and transferee should be taken into account while determining the arm's length compensation for transfer of such intangibles. Some illustrative intangible transfers which are expressly discussed in this section are briefed as following:

- **Centralization of operations** - Sometimes when several local operations of a MNE group are centralized to a centralized location, it may involve transfer of several intangibles from local operations to centralized operations. The arm's length remuneration of such transfers must be determined taking into account the FAR profile of both the transferor and transferee in relation to the transfer. Further, sometimes even after the transfer of intangibles local operations continue to exploit the intangibles under the arrangement. In such cases transaction in entirety must be considered for an arm's length analysis.
- **Transfers of intangibles at a point in time when its valuation is highly uncertain** - In cases, where valuation of intangibles is highly uncertain at the time of transfer, caution should be adopted while determination of arm's length price of such transfers. The use of hindsight be the tax authorities in making a transfer pricing adjustment based on ex-post analysis must be avoided. Mere uncertainty in valuation of intangibles at the time of transfer does not mandate an ex-post analysis. The guiding factor is the behavior of parties in a similar uncontrolled situation.
- **Local intangibles** - Local intangibles are also important to take into consideration at the time of a restructuring. The transfer of intangibles by the transferor calls for a commensurate arm's length compensation. Also, when local intangibles accrue to the restructured entity, such intangibles should be taken into account to determine the post restructuring arm's length remuneration.

- **Contractual rights** - Transfer of valuable contractual rights in a restructuring transaction also calls for a commensurate arm's length remuneration. Further, sometimes voluntary termination of contracts between two unrelated entities in restructuring transaction must be closely examined as such termination may entail certain benefits to an associated enterprise.

Transfer of activity (ongoing concern)

In some instances, a restructuring transaction may also result into transfer of an activity on a going concern basis. The activity being transfer may encompass of several closely linked elements such as tangible and intangible assets, functions, liabilities, etc., all of which are required to be taken into account for determining the arm's length compensation for such activity. Valuation of such elements may be done on a separate basis or in aggregation. Sometimes, it may also be case that a loss-making activity is transferred in the course of a restructuring transaction. In such cases several factors such as behavior of parties in an uncontrolled situation, financial costs and risks entailed with continuation of such activity, expected synergies from such transfer must be considered to determine whether transfer of such an activity warrants a compensation for the transferee. Similarly, in cases, when an activity is voluntarily outsourced to an entity resulting in substantial future cost savings for the transferor, all the factors associated with such transfers must be analyzed to determine the necessity for attributing some compensation to the transferor for such transfer.

E. Indemnification of the restructured entity for the termination or substantial renegotiation of existing arrangements

Apart from transfer of tangible and intangible assets, a restructuring transaction may also involve in termination or substantial renegotiation of existing contractual relationships. The termination or renegotiation of the contractual relationship consequences in the change in the allocation of risks between the parties and subsequent change in the profit potential of the parties. Now, whether the contract negotiations or termination warrants indemnification for the aggrieved party requires an examination of the circumstances at the time of the re-structuring, rights and assets of the parties and other options available before the parties. The following four factors provide useful guidance in determining whether the termination or renegotiation of contractual relationships in restructuring warrants an indemnification for the party suffering the detriment and if warranted, the quantum of such indemnification:

- Contractual terms - whether the contract provides for any indemnification clause;
- Adherence to the arm's length standard - whether the conditions of the arrangement including the existence of indemnification or no indemnification clause adheres to the arm's length;
- Applicable commercial law - whether any applicable commercial legislation or case law bestows the right to claim indemnification for the aggrieved entity; and
- Willingness to indemnify - whether in an arm's length situation, another party would be willing to indemnify the aggrieved party.

Thus, to conclude, a detailed analysis in the light of factors as discussed above would provide

useful guidance to the parties in arriving at an arm's length solution of the transactions undertaken at the time of restructuring.

3.2.2 Part II: Determination of the arm's length compensation post restructuring controlled transactions

The arm's length standard applies to the transactions undertaken after restructuring in the same manner as it applies to the transaction structured as such from the beginning. The comparability standard and the standard on the selection of most appropriate method apply in the same manner as they apply to any other transaction. However, there might be some factual peculiarities involved in an arrangement post restructuring which though not affect the application of the arm's length standard but may affect the comparability analysis and consequently may affect the arm's length outcome. The selection and application of a transfer pricing method to the post restructured transaction would require a detailed prognosis of the FAR profile of the entities, both before and after the restructuring. There also may be situations where there is an inter-link between the compensation for the restructuring and the remuneration for the post restructuring transaction which must be analyzed in detail while doing arm's length analysis of the post-restructuring transactions. An entirety of arrangements would require evaluation to determine the arm's length compensation for the restructuring and post-restructuring transactions. Further in some situations comparison between the pre and post restructuring transactions also may provide useful guidance in the application of the arm's length standard in the post restructuring transactions.

Location savings is also an important aspect which is to be considered in the arm's length analysis for the post restructuring transactions. In a restructuring transaction, location savings can be derived when a MNE group relocates some of its activities from a high cost jurisdiction to a low cost jurisdiction. In determining how location savings are to be shared between two or more AEs, it is necessary to consider (i) whether location savings exist; (ii) the amount of locations savings; (iii) the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and (iv) where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings.

3.3 Business restructuring transactions in the Indian Context

The Indian transfer pricing regulations introduced in the year 2001 require any income arising from an international transaction to be computed in accordance with the arm's length standard. The transfer pricing provisions are incorporated in the Indian tax legislation as a machinery provision and thus, a transaction falls within ambit of the Indian transfer pricing regulations when such transaction is otherwise taxable in accordance with the provisions of Income Tax Act, 1961. Initially, business restructuring was not a separate international transaction within the ambit of the Indian transfer pricing regulations. However, Finance Act 2012 specifically included business restructuring as a separate international transaction thus bringing it within the ambit of Indian transfer pricing regulations. Accordingly, appropriate disclosure of the transaction at the time of submitting accountant's report becomes necessary. The Indian transfer pricing

guidelines do not provide elaborate discussion on transaction falling within the purview of business restructuring.

UNIT-IV	Dispute Resolution
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4.1 Dispute Resolution Mechanism

The evolving tax dispute resolution mechanism in India consists of the following forums:

- Filing of objections before the Dispute Resolution Panel;
- Appeal before the Commissioner of Income Tax (Appeals);
- Appeal before the Income Tax Appellate Tribunal;
- Appeal before the High Court / Supreme Court;
- Safe Harbour Rules;
- Mutual Agreement Procedure; and
- Advance Pricing Agreement.

Each of the above dispute resolution mechanisms have been explained in the subsequent paragraphs.

4.2.1 Filing of objections before the DRP

Key features of the DRP process is listed below:

- To facilitate expeditious resolution of disputes, a panel comprising three Commissioners of Income Tax has been constituted
- Assessee eligible for filing objections before the DRP includes:-
 - Foreign Companies
 - Any person in whose case transfer pricing adjustment is made

The Finance Act, 2020, with effect from 1 April 2020, has expanded the scope of the DRP to include:

- i. cases where any variation prejudicial to the interest of the taxpayer is proposed (i.e. even where the returned income or loss remains unchanged—for instance, change in tax rate applied on returned income); and
 - ii. all non-residents within scope of eligible Assessee and not merely foreign companies.
- Assessee can file objections against the draft assessment order before the DRP
 - After considering all objections, the DRP issues directions to the Assessing Officer ('AO').
 - The DRP also has power to enhance the adjustment made by the TPO
 - The AO to pass a final order on the basis of directions issued by the DRP
 - The final order of the AO is directly appealable before the Tribunal by the Assessee.

- The directions of DRP are binding on the AO and the order of the AO pursuant to such DRP directions are non-appealable by the Department. This is subject to an exception for the AO orders pursuant to the DRP directions issued for any objection filed by the assessee on or after 1 July 2012 and before 1 June 2016, where the Final orders post DRP directions were appealable before the Tribunal by the Department.
- The DRP shall not set aside any proposed variation or issue direction for further inquiry .

4.2.2 Appeal before the Commissioner of Income Tax (Appeals) – ['CIT(A)']

Key features of the appeal before CIT(A) is listed below:

- First Appellate Authority
- Appeal may be against some of the following orders:
 - Assessment order passed u/s 143(3) or 144 of the IT Act
 - Intimation passed u/s 143(1)
 - Reassessment order passed u/s 147 or 150 (re-computation)
 - Assessment or reassessment of search cases u/s 153(A)
 - Rectification Order made u/s 154
 - Order u/s 163 treating the Assessee as an agent of non-resident
 - Order imposing a penalty u/s 271
 - Order made u/s 201 levying interest for delay in remitting TDS / failure to deduct tax at source
- Time Limit - Appeal has to be filed within 30 days of receipt of demand notice along-with assessment order issued by the AO
- Prescribed filing fee is to be paid at the time of filing appeal
- The CIT(A) cannot set-aside the order passed by the AO
- Provisions have been laid out under Rule 46A for admission of additional evidence.

The following table enumerates the key differences between the DRP and the appeal process before the CIT(A):

Aspect	DRP	CIT(A)
Constitution	Case heard by 3 Commissioners	Case heard by a single Commissioner
Time limit for filing objections / appeal	Objections need to be filed along with all necessary submissions within 30 days of the draft AO order.	An appeal filed within 30 days of the final AO order.

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Aspect	DRP	CIT(A)
Condonation of delay	No power to condone delay	Discretion of CIT(A)
Filing Fees	No filing fees	Rs. 250 to Rs. 1,000, depending upon assessed income
Stay of demand	Automatic stay of demand as the order is a draft order	A stay application to be filed with the ITO requesting for a stay of demand. In case the stay is rejected, the demand to be paid off is decided by the ITO
Time limit for completion	To be completed within a period of 9 months from the end of the month of the order of the lower tax authorities	No time limit for completion of process
Penalty Proceedings	No penalty proceedings can be initiated until the matter is disposed	Typically, penalty proceedings are initiated by the ITO and a stay of penalty would need to be filed
Next steps on completion of proceedings	Once the order of the DRP is passed, the same is sent to the ITO who will pass a final assessment order	Once the order of the CIT(A) is passed, the same is sent to the ITO who will pass an order giving effect to the order of the CIT(A) and consequential demands paid off / refunds issued

The CBDT has issued a press release dated 30 December 2015 stating that as part of the endeavour of the Income tax Department to digitize various functions of the Department for providing efficient taxpayer services, electronic filing of appeal before CIT(Appeals) is being made mandatory for persons who are required to file the return of income electronically. It is claimed that by this change “**the burden of compliance on the taxpayers in appellate proceedings will be significantly reduce**”.

4.2.3 Appeal before the Income Tax Appellate Tribunal

Key features of the appeal process before the Income Tax Appellate Tribunal is listed below:

- Once an order arising pursuant to directions of the DRP or the CIT(A) order is issued, an appeal must be filed with the Income Tax Appellate Tribunal ('the Tribunal') within a period of 60 days from receipt of order;
- If the revenue authorities have filed an appeal on a matter where the CIT(A) has held in favour of the Assessee, then cross objections could be filed before the Tribunal;

- In the case of an order arising pursuant to directions of the DRP, the demand becomes payable and a stay application will need to be filed with the AO/ CIT requesting for a stay of demand;
- In case the stay application is rejected by the AO/ CIT, the demand is to be paid by the Assessee. Alternatively, the Assessee can prefer a stay application before the Tribunal;
- Typically, the Tribunal takes up cases within 8-10 months of filing an appeal. A notice will be issued scheduling the date of hearing;
- A paper-book containing all relevant documents to be relied on during the hearing is to be filed before the Tribunal at least seven days prior to the hearing;
- Tribunal is the last fact finding authority
- An order is passed by the Tribunal after hearing arguments from both the taxpayer and the Revenue authorities. The tribunal does not have power to enhance additions.
- Once the order of the Tribunal is issued, an order giving effect will need to be passed by the AO and consequential demands paid off / refunds issued.

4.2.4 Appeal before the High Court / Supreme Court

Key features of the appeal process before the High Court is listed below:

- Appeal can be filed by the aggrieved –
 - Chief Commissioner; or
 - Commissioner; or
 - Assessee
- Condition precedent
 - Appeal shall be heard by not less than 2 judges of the High Court
 - If High Court satisfied that the case involves a 'substantial question of law'
- Substantial Question of Law means:
 - Issue must be debatable
 - Not previously settled by Law of Land
 - Should not be settled by a binding precedent
 - Must have a material bearing on decision of the case
- Time Limit for filing an appeal - Appeal to be preferred within 120 days from the date of receipt of the Tribunal's order
- Filing Fee and Jurisdiction
 - Fee is decided as per relevant court rules and Code of Civil Procedure
 - Jurisdiction is decided on the basis of the location of AO who framed the disputed order

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Key features of the appeal process before the Supreme Court is listed below:

- Appeal lies to SC against decision given by the HC
- Condition precedent
 - HC should certify that the case is fit for appeal
 - If HC refuses – application to SC can be made under Article 136 of the Constitution for special leave
- Time Limit for filing an appeal - Within 90 days of the service of judgment under Code of Civil Procedure, 1908
- Decision of Supreme Court becomes the Law of the Land

The CBDT has revised monetary tax limits for Departmental appeal filing before ITATs and High Courts as follows:

Sr. No.	Appeals in income-tax matters	Monetary Limits (in INR)
1.	Before ITAT	5,000,000
2.	Before High Court	10,000,000
3.	Before Supreme Court	20,000,000

The revision in the monetary limits has been brought about with the objective of reducing litigation as a part of its initiatives to reduce taxpayers' grievances. The CBDT has directed that revised threshold to apply retrospectively to pending appeals and that pending appeals below revised limits to be withdrawn/not pressed.

The CBDT has further issued an office memorandum directing Pr. CCIT to constitute a collegium of CCIT comprising of two officers in their respective regions to consider withdrawal of appeals filed by the Department in cases involving tax effect above the revised monetary limit from HCs. The aforesaid collegium to consider withdrawal of appeals if:

- (i) no question of law is involved;
- (ii) issue is considered settled by the Department or
- (iii) appeal is no longer relevant in view of subsequent amendment;

CBDT states that **“These two decisions are expected to reduce pending litigation filed by the Department by 50 percent and provide relief to taxpayers facing long standing litigation”**.

4.2.5 Safe Harbour Rules

In order to reduce the increasing number of transfer pricing audits and prolonged disputes, the Finance (No. 2) Act, 2009 with retrospective effect from 1.4.2009 inserted a new Section 92CB in the Act to provide that determination of arm's length price under Section 92C or Section 92CA of the Act shall be subject to Safe Harbour rules. Vide this amendment, the Government of India

had empowered the CBDT to make Safe Harbour rules. "Safe Harbour" was defined to mean circumstances in which the income-tax authorities shall accept the transfer price declared by the Assessee.

The Prime Minister on July, 30, 2012 approved the constitution of a Committee to Review Taxation of Development Centres and the IT sector consisting of Shri N. Rangachary, Chairman of the Committee and three others (hereinafter called the Rangachary Committee) and propose the draft Safe Harbour rules. Subsequently, the Government of India approved the considered suggestion of the Rangachary Committee that it may finalize the Safe Harbour Rules in the following sector/activities:

- 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

On the basis of the recommendations of the Rangachary Committee in the first report on Taxation of Development Centres and IT Sector, CBDT has issued the following circulars:

- Circular No. 1/2013 dated 17 January 2013 on issues relating to Export of Computer Software under sections 10A, 10AA and 10B of the Act.
- Circular No. 6/2013 dated 29 June 2013 on Conditions Relevant to Identify Development Centres engaged in Contract R&D Services with Insignificant Risk.

The Government of India considered the other five reports of the Rangachary Committee and notified the Safe Harbour rules on 18th September, 2013 vide notification number S.O 2810(E). The Safe Harbour rules are applicable for 5 assessment years beginning from assessment year 2013-14. Further, the CBDT has issued Notification No. 90/2015 F.No. 142/7/2014-TPL dated 14 December 2015 by which it has amended the Safe Harbour Rule specified in Rule 10D(2A) and specified the information and documents required to be maintained by an eligible assessee. Further, the CBDT has amended the Safe Harbour Rules by issuing notification No. 46/2017 dated 7 June 2017 thereby amending the Safe Harbour Rules for existing set of eligible transactions and also specified new category of safe harbour for low value adding Intra-Group Services. Keeping its word on non-adversarial tax regime, the government has reduced erstwhile Safe Harbour rates for small taxpayers and broadened the horizon of eligible transactions. The CBDT has amended the Safe Harbour Rules by issuing notification No. 25/2020 dated 20 May 2020 specifying that the same rates as were applicable during the last

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three financial years, i.e., FY 2016-17 to FY 2018-19, would be applicable for FY 2019-20. Further, the CBDT has amended the Safe Harbour Rules by issuing notifications No. 117/2021/F dated 24 September 2021 and Notification No. 66/2022/F dated June 17, 2022 specifying that the same rates would also be applicable for FY 2020-21 and FY 2021-22 respectively, as well.

Details of the Safe Harbour provisions notified and the mark-up proposed for various types of eligible transactions have been separately covered under the topic of 'Safe Harbour Rules'.

4.2.6 Mutual Agreement Procedure

The mutual agreement procedure is a well-established means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. This procedure, described and authorized by Article 25 of the OECD Model Tax Convention, can be used to eliminate double taxation that could arise from a transfer pricing adjustment.

Article 25 sets out three different areas where mutual agreement procedures are generally used. The first area includes instances of "taxation not in accordance with the provisions of the Convention" and is covered in paragraphs 1 and 2 of the Article. Procedures in this area are typically initiated by the taxpayer. The other two areas, which do not necessarily involve the taxpayer, are dealt with in paragraph 3 and involve questions of "interpretation or application of the Convention" and the elimination of double taxation in cases not otherwise provided for in the Convention. Paragraph 9 of the Commentary on Article 25 makes clear that Article 25 is intended to be used by competent authorities in resolving not only problems of juridical double taxation but also those of economic double taxation arising from transfer pricing adjustments made pursuant to paragraph 1 of Article 9.

CBDT vide its press release dated 27 November 2017 issued clarification of India's position on the acceptance of MAP and bilateral APA in cases of countries where provisions similar to Article 9(2) of OECD Model Tax Commentary is absent. The CBDT has decided to accept Transfer Pricing MAP and bilateral APA applications regardless of the presence or otherwise of Paragraph 2 of Article 9 (or its relevant equivalent Article) in the treaty.

(a) Need for MAP

- Double Taxation Avoidance Agreements ('tax treaties') are available for capturing and curtailing juridical double taxation
- Tax treaties generally do not cover instances of economic double taxation
- MAP provides relief in cases of economic double taxation
- MAP also provides relief in cases where automatic relief, such as tax credits, tax exemption etc. are not available.

(b) Steps involved in the MAP application process

- Brief facts and background of the case must be summarized.

- Contentions of Indian Revenue must be summarized in the application.
- The net tax and interest impact only by virtue of transfer pricing adjustment is computed.
- Take note of transactions only relating to one country (in one application), e.g. USA, UK, etc.
- All documents including tax returns, TP study, notices, submissions, orders, etc. must be furnished.
- Relevant judicial precedence and their applicability to taxpayer's case must be demonstrated.

(c) Outcome of MAP process

- Decision of a Competent Authority is generally case specific and not a precedent for the taxpayer for subsequent years or other taxpayers on same issues.
- Decision of the MAP process is communicated to the taxpayer by a letter.
- The decision of the MAP process is then implemented vide Rule 44G & 44H⁵.
- The Assessing Officer gives effect of the decision of the MAP, after receiving instructions from the CCIT / Pr. CCIT (within 90 days of receiving instructions).
- If taxpayer is aggrieved by decision of the Competent Authority, he may reject the decision and go ahead with the remedies under the domestic law.
- If remedies are not granted by the domestic law, the taxpayer may apply to the Competent Authorities again for subsequent years.

(d) Drawbacks of the MAP process

- Time limits under domestic law may make corresponding adjustments unavailable if those limits are not waived in the relevant tax treaty.
- Mutual agreement procedures may take too long to complete.
- Taxpayer participation may be limited.
- Published procedures may not be readily available to instruct taxpayers on how the procedure may be used; and
- There may be no procedures to suspend the collection of tax deficiencies or the accrual of interest pending resolution of the mutual agreement procedure.

(e) Recent Update⁶

Between 1 April 2019 to 10 December 2019, bilateral meetings for resolving tax disputes under

⁵The Central Board of Direct Taxes vide a recent Notification No. G.S.R. 282(E) dated 6 May 2020 introduced amendments to Rule 44G and omitted Rule 44H, which dealt with the procedure for filing an application for and giving effect to a Mutual Agreement Procedure (MAP).

⁶Annual Report by the Ministry of Finance for FY 2019-20 and FY 2021-22

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MAP have been held with the competent authorities of USA (twice), United Kingdom, Japan (twice), Denmark, Sweden, China, Singapore, South Korea, Finland, etc. More such meetings have been scheduled till 31 March 2020 with USA, UK, Switzerland, etc. The meetings have proved to be very successful in resolving various disputes relating to double taxation. The Mutual Agreement Procedure (MAP) has proved to be a very useful instrument for India in resolving long-standing and complex issues of double taxation. During the period 1st April 2014 to 10th December 2019, approximately 660 tax disputes relating to 660 assessment years (number of taxpayers involved would be about 180) have been resolved under MAP by the Competent Authorities of India through negotiations with their counterparts of various countries. Along with the Advance Pricing Agreement (APA) scheme of the Government of India, MAP has come to be recognized as an effective and efficient alternate dispute resolution mechanism. Together, APA and MAP have helped in reducing tax disputes, fostering a non-adversarial tax regime and have helped in creating a conducive taxation environment in India.

During the period January 2021 to November 2021, in aggregate, approximately 110 TP MAP cases (assessment years) were closed with treaty partners in North America and Europe.

During the period from April 2014 till December 2021, more than 900 cases (assessment years) have been closed under MAP, which resulted in significant reduction of litigation in India.

During FY 2021-22, in aggregate, 27 non-TP MAP cases (assessment years) have been closed/resolved from 1st April, 2021 till November 2021 with United Kingdom, and 6 with the United States.

On 7 August 2020 CBDT had come out with a guidance note on MAP which also specifies cases or situations in which India will provide access to MAP.

The MAP guidance is presented in following four parts:

- Part A: Introduction and basic information;
- Part B: Access and denial of access to MAP
- Part C: Technical issues; and
- Part D: Implementation of MAP outcome

Guidance provided by CBDT is attached as Appendix 1.

After the release of guidance note on MAP dated 7 August 2020, the stakeholders have raised queries on certain related aspects of MAP, which are not covered by existing guidance. Some partner countries have also requested for clarity on certain issues, such as consequences of the Vivad se Vishwas⁷ (hereinafter referred as 'VsV') scheme on MAP. Considering all these inputs and

⁷ The Hon'ble Finance Minister Nirmala Sitharaman, on 01 February 2020 in her speech for Budget 2020, announced the Direct Tax Vivad se Vishwas Scheme which became an Act on 17 March 2020. The scheme proposed the idea of levying less or discounted payment from a taxpayer if he/she settled all disputes before the end of the particular financial year. The reason for introduction of the Scheme was to reduce the pending income tax litigations at various appellate forums and timely collection of the revenue.

suggestions for clarity, on 10 June 2022 (F. No. 500/09/2016-APA-1), CBDT had come out with updated guidance note on MAP.

The key takeaways from the said the MAP guidance 2022 are as follows:

- If the resident taxpayer has opted for VsV scheme for settlement of case involving resolution of transfer pricing adjustments and it is accepted by Indian tax authorities, then the Competent Authority of other countries/specified territories may accept MAP applications from their taxpayers (i.e. AE of Indian taxpayer) and notify Indian authorities.
- Indian authorities shall allow access to MAP but shall not deviate from the result arrived under the VsV. However, they may request the Competent Authority of the treaty partners to provide correlative relief.
- Indian authorities shall not provide access to MAP to a non-resident taxpayer who has opted for VsV scheme on the same issue, because the applicant has given up its legal right to access MAP.
- As per the Updated Guidance, recently a couple of cases have come to the notice of Competent Authorities wherein taxpayers have either suppressed information (invoking MAP in respect of adjustments made by one treaty partner without mentioning the fact that adjustment has also been made by the other treaty partner on the same transaction) or not giving the same set of comparable to the Competent Authorities particularly in cases where both BAPA and MAP are involved.
- Thus, Part E has been introduced as per which the applicant should provide all the facts of the case that can materially affect the negotiation process, such as adjustments made by Indian tax authorities as well as its treaty partner's tax authorities on the same international transaction in Form 34F - Item (k) under Rule 44G.
- The applicant shall keep the Competent Authorities as updated as possible on all material changes in the information or documentation previously submitted as part of, or in connection with, a request, as well as new information or documentation relevant to the issues under consideration.
- Emphasis is on the importance of good faith and interplay of MAP with other processes such as regular tax appeals, tax settlements, and domestic dispute resolution schemes.

Guidance provided by CBDT is attached as Appendix 2.

4.2.7 Advance Pricing Agreement

Advance Pricing Agreement (APA) provisions were introduced in India vide the Finance Act, 2012. Thereafter, the APA Scheme was notified in the Income-tax Rules on 30 August 2012.

Details of the APA provisions have been separately covered under the topic of 'Advance Pricing Agreement'.

UNIT-V	Safe Harbour
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5.1 Introduction

As per Section 92CB of the Act, 1961 the determination of ALP shall be subject to safe harbour rules. As an outcome of deliberations between the Ministry of Finance and stakeholders represented by revenue authorities, industry players and practitioners over a period of time, the CBDT notified Safe Harbour Rules ('SHR') in 2013 for certain industries / sectors. Safe Harbour is defined to mean circumstances in which the income-tax authorities shall accept the transfer price declared by the assessee. Further, the CBDT has amended the Safe Harbour Rules by issuing notification No. 46/2017 dated 7 June 2017 thereby amending the Safe Harbour Rules ('SHR 2017') for existing set of eligible International transactions and also specified new category of safe harbour for low value adding Intra-Group Services. SHR are also extended to include certain eligible specified domestic transactions undertaken by eligible taxpayers. Finance Act, 2020 has expanded the scope of SHR by amending Section 92CB of the Act to cover profit attribution to permanent establishment. Further, recently, the CBDT has issued Notification No. 25/2020 dated 20 May 2020 specifying that the same rates as were applicable during the last three financial years, i.e., FY 2016-17 to FY 2018-19, would be applicable for FY 2019-20. The CBDT has further amended the Safe Harbour Rules by issuing notification No. 117/2021/F dated 24 September 2021 and Notification No. 66/2022/F dated June 17, 2022 specifying that the same rates would also be applicable for FY 2020-21 and FY 2021-22 respectively⁸.

5.2 SHR for Eligible International Transactions

5.2.1 Rule 10TD of Income tax Rules specifies eligible international transactions and the circumstances for which the SHR can be exercised. A comparative chart between SHR 2013 and SHR 2017⁹ is as follows:

S. No.	Eligible International transaction	Circumstances under earlier rules		Circumstances under revised rules	
		Aggregate value of international transaction:	Operating profit margin to operating expense is	Aggregate value of international transaction:	Operating profit margin to
1.	Provision of Software development services				

⁸ Rule 10TD(3), 10TD(3A) and 10TD(3B)

⁹ CBDT vide its notification No. 25/2020 dated 20 May 2020 has specified that the same rates as were applicable in SRH 2017 for the last three financial years, i.e., FY 2016-17 to FY 2018-19, would be applicable for FY 2019-20. The CBDT has further amended the Safe Harbour Rules by issuing notification No. 117/2021/F dated 24 September 2021 and Notification No. 66/2022/F dated June 17, 2022 specifying that the same rates would also be applicable for FY 2020-21 and FY 2021-22 respectively.

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S. No.	Eligible International transaction	Circumstances under earlier rules		Circumstances under revised rules	
		Does not exceed INR 500 crores	not less than 20 percent	Does not exceed INR 100 crores	not less than 17 percent
		Exceeds INR 500 crores	not less than 22 percent	Exceeds INR 100 crores but does not exceed INR 200 crores	not less than 18 percent
<p>As per Rule 10TA(m) "<i>software development services</i>" means,—</p> <ul style="list-style-type: none"> (i) business application software and information system development using known methods and existing software tools; (ii) support for existing systems; (iii) converting or translating computer languages; (iv) adding user functionality to application programmes; (v) debugging of systems; (vi) adaptation of existing software; or (vii) preparation of user documentation, <p>But does not include any research and development services whether or not in the nature of contract research and development services.</p>					
2.	Provision of Information Technology Enabled Services	Aggregate value of international transaction	Operating profit margin to operating expense is:	Aggregate value of international transaction:	Operating profit margin to operating expense is:
		Does not exceed INR 500 crores	not less than 20 percent	Does not exceed INR 100 crores	not less than 17 percent
		Exceeds INR 500 crores	not less than 22 percent	Exceeds INR 100 crores but does not exceed	not less than 18 percent

S. No.	Eligible International transaction	Circumstances under earlier rules	Circumstances under revised rules							
			INR 200 crores							
<p>As per Rule 10TA(e) "<i>information technology enabled services</i>" means the following business process outsourcing services provided mainly with the assistance or use of information technology, namely:—</p> <ul style="list-style-type: none"> (i) back office operations; (ii) call centres or contact centre services; (iii) data processing and data mining; (iv) insurance claim processing; (v) legal databases; (vi) creation and maintenance of medical transcription excluding medical advice; (vii) translation services; (viii) payroll; (ix) remote maintenance; (x) revenue accounting; (xi) support centres; (xii) website services; (xiii) data search integration and analysis; (xiv) remote education excluding education content development; or (xv) clinical database management services excluding clinical trials, <p>but does not include any research and development services whether or not in the nature of contract research and development services;</p>										
3.	Provision of Knowledge Process Outsourcing Services	Operating profit margin to operating expense is not less than 25 percent	<p>The value of international transaction does not exceed INR 200 crores and:</p> <table border="1" data-bbox="1026 1503 1372 1886"> <thead> <tr> <th data-bbox="1026 1503 1198 1675">Operating profit margin to operating expense is:</th> <th data-bbox="1198 1503 1372 1675">Employee cost to operating expense is:</th> </tr> </thead> <tbody> <tr> <td data-bbox="1026 1675 1198 1783">Not less than 24 percent and</td> <td data-bbox="1198 1675 1372 1783">Atleast 60 percent</td> </tr> <tr> <td data-bbox="1026 1783 1198 1886">Not less than 21 percent and</td> <td data-bbox="1198 1783 1372 1886">40 percent or more but less</td> </tr> </tbody> </table>		Operating profit margin to operating expense is:	Employee cost to operating expense is:	Not less than 24 percent and	Atleast 60 percent	Not less than 21 percent and	40 percent or more but less
Operating profit margin to operating expense is:	Employee cost to operating expense is:									
Not less than 24 percent and	Atleast 60 percent									
Not less than 21 percent and	40 percent or more but less									

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S. No.	Eligible International transaction	Circumstances under earlier rules	Circumstances under revised rules	
				than 60 percent
			Not less than 18 percent and	Does not exceed 40 percent
<p>As per Rule 10TA(g) "<i>knowledge process outsourcing services</i>" means the following business process outsourcing services provided mainly with the assistance or use of information technology requiring application of knowledge and advanced analytical and technical skills, namely:—</p> <ul style="list-style-type: none"> (i) geographic information system; (ii) human resources services; (iii) engineering and design services; (iv) animation or content development and management; (v) business analytics; (vi) financial analytics; or (vii) market research, <p>but does not include any research and development services whether or not in the nature of contract research and development services;</p> <p>As per Rule 10TA(ca) "<i>Employee cost</i>" includes,</p> <ul style="list-style-type: none"> (i) salaries and wages; (ii) gratuities; (iii) contribution to Provident Fund and other funds; (iv) the value of perquisites as specified in clause (2) of Section 17 of the Act; (v) employment related allowances, like medical allowance, dearness allowance, travel allowance and any other allowance; (vi) bonus or commission by whatever name called; (vii) lumpsum payments received at the time of termination of service or superannuation or voluntary retirement, such as gratuity, severance pay, leave encashment, voluntary retrenchment benefits, commutation of pension and similar payments; (viii) expenses incurred on contractual employment of persons performing tasks similar to those performed by the regular employees; (ix) outsourcing expenses, to the extent of employee cost, wherever ascertainable, embedded in the total outsourcing expenses: <p>Provided that where the extent of employee cost embedded in the total outsourcing expenses is not ascertainable, eighty per cent. of the total outsourcing expenses shall be deemed to be the employee cost embedded in the total outsourcing expenses;</p>				

S. No.	Eligible International transaction	Circumstances under earlier rules	Circumstances under revised rules				
			(x) recruitment expenses; (xi) relocation expenses; (xii) training expenses; (xiii) staff welfare expenses; and (xiv) any other expenses related to employees or the employment;';				
4.	Advancing of intra-group loans referred to in item (iv) of rule 10TC where the loan amount is does not exceed INR 50 crore.	The Interest rate declared in relation to the eligible international transaction is not less than the base rate of State Bank of India as on 30th June of the relevant previous year plus 150 basis points.	NA				
5.	Advancing of intra-group loans referred to in item (iv) of rule 10TC where the loan amount exceeds INR 50 crore	The Interest rate declared in relation to the eligible international transaction is not less than the base rate of State Bank of India as on 30th June of the relevant previous year plus 300 basis points.	NA				
6.	Advancing of intra-group loans referred to in item (iv) of rule 10TC where the amount of loan is denominated in Indian Rupees (INR).	NA	Interest rate declared is not less than 1 year marginal cost of funds lending rate of State Bank of India as on 1st April of the relevant previous year plus: <table border="1" data-bbox="1023 1711 1372 1848"> <tr> <td data-bbox="1023 1711 1177 1778"></td> <td data-bbox="1177 1711 1372 1778">CRISIL Rating between:</td> </tr> <tr> <td data-bbox="1023 1778 1177 1848">175 basis points</td> <td data-bbox="1177 1778 1372 1848">AAA to A or its equivalent</td> </tr> </table>		CRISIL Rating between:	175 basis points	AAA to A or its equivalent
	CRISIL Rating between:						
175 basis points	AAA to A or its equivalent						

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S. No.	Eligible International transaction	Circumstances under earlier rules	Circumstances under revised rules	
			325 basis points	BBB-,BBB or BBB+ or its equivalent
			475 basis points	BB to B or its equivalent
			625 basis points	C to D or its equivalent
			425 basis points	Where credit rating of the associated enterprise is not available and the amount of loan advanced to the associated enterprise including loans to all associated enterprises in Indian Rupees does not exceed a sum of one hundred crore rupees in the aggregate as on 31st March of the relevant previous year
7.	Advancing of intra-group loans referred to in item (iv) of rule 10TC where the amount of loan		The interest rate declared in relation to the eligible international transaction is not less than the six-month London Inter-Bank Offer Rate of the relevant foreign current as on 30th	

S. No.	Eligible International transaction	Circumstances under earlier rules	Circumstances under revised rules													
	is denominated in foreign currency.		September of the relevant previous year plus: <table border="1" data-bbox="1023 562 1372 1704"> <thead> <tr> <th data-bbox="1023 562 1166 629">Basis points:</th> <th data-bbox="1166 562 1372 629">CRISIL Rating between:</th> </tr> </thead> <tbody> <tr> <td data-bbox="1023 629 1166 696">150 basis points</td> <td data-bbox="1166 629 1372 696">AAA to A or its equivalent</td> </tr> <tr> <td data-bbox="1023 696 1166 797">300 basis points</td> <td data-bbox="1166 696 1372 797">BBB-, BBB or BBB+ or its equivalent</td> </tr> <tr> <td data-bbox="1023 797 1166 864">450 basis points</td> <td data-bbox="1166 797 1372 864">BB to B or its equivalent</td> </tr> <tr> <td data-bbox="1023 864 1166 931">600 basis points</td> <td data-bbox="1166 864 1372 931">C to D or its equivalent</td> </tr> <tr> <td data-bbox="1023 931 1166 1704">400 basis points</td> <td data-bbox="1166 931 1372 1704">Where credit rating of the associated enterprise is not available and the amount of loan advanced to the associated enterprise including loans to all associated enterprises in Indian Rupees does not exceed a sum of one hundred crore rupees in the aggregate as on 31st March of the relevant previous year</td> </tr> </tbody> </table>		Basis points:	CRISIL Rating between:	150 basis points	AAA to A or its equivalent	300 basis points	BBB-, BBB or BBB+ or its equivalent	450 basis points	BB to B or its equivalent	600 basis points	C to D or its equivalent	400 basis points	Where credit rating of the associated enterprise is not available and the amount of loan advanced to the associated enterprise including loans to all associated enterprises in Indian Rupees does not exceed a sum of one hundred crore rupees in the aggregate as on 31st March of the relevant previous year
Basis points:	CRISIL Rating between:															
150 basis points	AAA to A or its equivalent															
300 basis points	BBB-, BBB or BBB+ or its equivalent															
450 basis points	BB to B or its equivalent															
600 basis points	C to D or its equivalent															
400 basis points	Where credit rating of the associated enterprise is not available and the amount of loan advanced to the associated enterprise including loans to all associated enterprises in Indian Rupees does not exceed a sum of one hundred crore rupees in the aggregate as on 31st March of the relevant previous year															
<p>As per Rule 10TA(f) "<i>intra-group loan</i>" means loan advanced to wholly owned subsidiary being a non-resident, where the loan—</p> <p>(i) is sourced in Indian rupees;</p>																

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S. No.	Eligible International transaction	Circumstances under earlier rules	Circumstances under revised rules
		(ii) is not advanced by an enterprise, being a financial company including a bank or a financial institution or an enterprise engaged in lending or borrowing in the normal course of business; and (iii) does not include credit line or any other loan facility which has no fixed term for repayment;	
8.	Corporate Guarantee where amount guaranteed does not exceed INR 100 crore	The commission or fee declared in relation to the eligible international transaction is at the rate not less than 2 per cent per annum on the amount guaranteed	The commission or fee declared in relation to the eligible international transaction is at the rate not less than 1 per cent per annum on the amount guaranteed
9.	Corporate Guarantee where amount guaranteed exceeds INR 100 crore and the credit rating of the AE, done by an agency registered with SEBI is of the adequate to highest safety	The commission or fee declared in relation to the eligible international transaction is at the rate not less than 1.75 per cent per annum on the amount guaranteed	The commission or fee declared in relation to the eligible international transaction is at the rate not less than 1 per cent per annum on the amount guaranteed
<p>As per Rule 10TA(c) "<i>corporate guarantee</i>" means explicit corporate guarantee extended by a company to its wholly owned subsidiary being a non-resident in respect of any short-term or long-term borrowing.</p> <p>Explanation.—For the purposes of this clause, explicit corporate guarantee does not include letter of comfort, implicit corporate guarantee, performance guarantee or any other guarantee of similar nature;</p>			
10.	Provision of contract	Operating profit margin to operating expense is not less than 30 percent	Operating profit margin to operating expense is not less

S. No.	Eligible International transaction	Circumstances under earlier rules	Circumstances under revised rules
	research and development services wholly or partly relating to software development		than 24 percent where the value of the international transaction does not exceed INR 200 crore
<p>As per Rule 10TA (aa) "contract research and development services wholly or partly relating to software development" means the following, namely:—</p> <ul style="list-style-type: none"> (i) research and development producing new theorems and algorithms in the field of theoretical computer science; (ii) development of information technology at the level of operating systems, programming languages, data management, communications software and software development tools; (iii) development of Internet technology; (iv) research into methods of designing, developing, deploying or maintaining software; (v) software development that produces advances in generic approaches for capturing, transmitting, storing, retrieving, manipulating or displaying information; (vi) experimental development aimed at filling technology knowledge gaps as necessary to develop a software programme or system; (vii) research and development on software tools or technologies in specialised areas of computing (image processing, geographic data presentation, character recognition, artificial intelligence and such other areas);or (viii) upgradation of existing products where source code has been made available by the principal, [except where the source code has been made available to carry out routine functions like debugging of the software]; 			
11.	Provision of contract research and development services wholly or partly relating to generic pharmaceutical drugs	Operating profit margin to operating expense is not less than 29 percent	Operating profit margin to operating expense is not less than 24 percent where the value of the international transaction does not exceed INR 200 crore

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S. No.	Eligible International transaction	Circumstances under earlier rules	Circumstances under revised rules
As per Rule 10TA(d) " <i>generic pharmaceutical drug</i> " means a drug that is comparable to a drug already approved by the regulatory authority in dosage form, strength, route of administration, quality and performance characteristics, and intended use;			
12.	Manufacture and export of core auto components	Operating profit margin to operating expense is not less than 12 percent	Operating profit margin to operating expense is not less than 12 percent
As per Rule 10TA(b) " <i>core auto components</i> " means,—			
(i) engine and engine parts, including piston and piston rings, engine valves and parts cooling systems and parts and power train components;			
(ii) transmission and steering parts, including gears, wheels, steering systems, axles and clutches;			
(iii) suspension and braking parts, including brake and brake assemblies, brake linings, shock absorbers and leaf springs;			
13.	Manufacture and export of non-core auto components	Operating profit margin to operating expense is not less than 8.5 percent	Operating profit margin to operating expense is not less than 8.5 percent
As per Rule 10TA(h) " <i>Non-core auto components</i> " mean auto components other than core auto components.			
14.	Receipt of low value adding intra-group services from one or more members of its group	NA	Value of international transaction including 5 percent mark-up does not exceed INR 10 crores. Further, method of cost pooling, the exclusion of shareholder costs and duplicate costs from the cost pool and the reasonableness of the allocation keys used for allocation of costs to the assessee by the overseas associated enterprise is certified by an accountant

S. No.	Eligible International transaction	Circumstances under earlier rules	Circumstances under revised rules
			<p>As per Rule 10TA(ga) "<i>low value-adding intra-group services</i>" means services that are performed by one or more members of a multinational enterprise group on behalf of one or more other members of the same multinational enterprise group and which,—</p> <ul style="list-style-type: none"> (i) are in the nature of support services; (ii) are not part of the core business of the multinational enterprise group, i.e., such services neither constitute the profit-earning activities nor contribute to the economically significant activities of the multinational enterprise group; (iii) are not in the nature of shareholder services or duplicate services; (iv) neither require the use of unique and valuable intangibles nor lead to the creation of unique and valuable intangibles; (v) neither involve the assumption or control of significant risk by the service provider nor give rise to the creation of significant risk for the service provider; and (vi) do not have reliable external comparable services that can be used for determining their arm's length price, but does not include the following services, namely: — (i) research and development services; (ii) manufacturing and production services; (iii) information technology (software development) services; (iv) knowledge process outsourcing services; (v) business process outsourcing services; (vi) purchasing activities of raw materials or other materials that are used in the manufacturing or production process; (vii) sales, marketing and distribution activities; (viii) financial transactions; (ix) extraction, exploration, or processing of natural resources; and (x) insurance and reinsurance
			<p>As per Rule 10TA(j) "<i>operating expense</i>" means the costs incurred in the previous year by the assessee in relation to the international transaction during the course of its normal operations including 6[costs relating to Employee Stock Option Plan or similar stock-based compensation provided for by the associated enterprises of the assessee to the employees of the assessee, reimbursement to associated enterprises of expenses incurred by the associated enterprises on behalf of the assessee, amounts recovered from associated enterprises on account of expenses incurred by the assessee on behalf of those associated enterprises and which relate to normal operations of the assessee and] depreciation and amortisation expenses relating to the assets used by the assessee, but not including the following, namely: —</p> <ul style="list-style-type: none"> (i) interest expense; (ii) Provision for unascertained liabilities; (iii) Pre-operating expenses; (iv) Loss arising on account of foreign currency fluctuations; (v) Extraordinary expenses; (vi) Loss on transfer of assets or investments; (vii) Expense on account of income-tax; and

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S. No.	Eligible International transaction	Circumstances under earlier rules	Circumstances under revised rules
			<p>(viii) Other expenses not relating to normal operations of the assessee:</p> <p>Provided that reimbursement to associated enterprises of expenses incurred by the associated enterprises on behalf of the assessee shall be at cost:</p> <p>Provided further that amounts recovered from associated enterprises on account of expenses incurred by the assessee on behalf of the associated enterprises and which relate to normal operations of the assessee shall be at cost;</p>
			<p>As per Rule 10TA(k) "<i>operating revenue</i>" means the revenue earned by the assessee in the previous year in relation to the international transaction during the course of its normal operations 8[including costs relating to Employee Stock Option Plan or similar stock-based compensation provided for by the associated enterprises of the assessee to the employees of the assessee] but not including the following, namely:—</p> <ul style="list-style-type: none"> (i) Interest income; (ii) income arising on account of foreign currency fluctuations; (iii) income on transfer of assets or investments; (iv) refunds relating to income-tax; (v) provisions written back; (vi) extraordinary incomes; and (vii) other incomes not relating to normal operations of the assessee. <p>As per Rule 10TA(l) "<i>operating profit margin</i>" in relation to operating expense means the ratio of operating profit, being the operating revenue in excess of operating expense, to the operating expense expressed in terms of percentage.</p>
			<p>As per Rule 10TA(a) "<i>accountant</i>" means an accountant referred to in the Explanation below sub-section (2) of Section 288 of the Act and includes any person recognised for undertaking cost certification by the Government of the country where the associated enterprise is registered or incorporated or any of its agencies, who fulfils the following conditions, namely:—</p> <ul style="list-style-type: none"> (I) if he is a member or partner in any entity engaged in rendering accountancy or valuation services then, — <ul style="list-style-type: none"> (i) the entity or its affiliates have presence in more than two countries; and (ii) the annual receipt of the entity in the year preceding the year in which cost certification is undertaken exceeds ten crore rupees; (II) if he is pursuing the profession of accountancy individually or is a valuer then, — <ul style="list-style-type: none"> (i) his annual receipt in the year preceding the year in which cost certification is undertaken, from the exercise of profession, exceeds one crore rupees; and

S. No.	Eligible International transaction	Circumstances under earlier rules	Circumstances under revised rules
(ii) he has professional experience of not less than ten years.]			
<ul style="list-style-type: none"> For the purpose of identifying an eligible assessee, with insignificant risk, referred in 10TB (1) (i), and (iv), (v) the TPO shall have regard the factors which have been specified under Rule 10TB(2) and (3) respectively of Income Tax rules, 1962. 			

5.2.2 Procedure

Rule 10TE of the Income-tax Rules, 1962 lays down the procedure to be adopted for exercising SHR as follows:

(1) For the purposes of exercise of the option for safe harbour the assessee shall furnish a Form 3CEFA, complete in all respects, to the Assessing Officer on or before the due date specified in Explanation 2 below sub-section (1) of Section 139 of the Act for furnishing the return of income for—

- (i) the relevant assessment year, in case the option is exercised only for that assessment year; or
- (ii) the first of the assessment years, in case the option is exercised for more than one assessment year:

Provided that the return of income for the relevant assessment year or the first of the relevant assessment years, as the case may be, is furnished by the assessee on or before the date of furnishing of Form 3CEFA.

(2) The option for safe harbour validly exercised shall continue to remain in force for the period specified in Form 3CEFA or a period of five years whichever is less:

Provided that the assessee shall, in respect of the assessment year or years following the initial assessment year, furnish a statement to the Assessing Officer before furnishing return of income of that year, providing details of eligible transactions, their quantum and the profit margins or the rate of interest or commission shown:

Provided further that an option for safe harbour shall not remain in force in respect of any assessment year following the initial assessment year, if—

- (i) the option is held to be invalid for the relevant assessment year by the Transfer Pricing Officer under sub-rule (11) or by the Commissioner under sub-rule (8) in respect of an objection filed by the assessee against the order of the Transfer Pricing Officer under sub-rule (11), as the case may be; or
- (ii) the eligible assessee opts out of the safe harbour, for the relevant assessment year, by furnishing a declaration to that effect, to the Assessing Officer:

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Provided also that nothing contained in this sub-rule shall apply to the option for safe harbour validly exercised under sub-rule (3B) of rule 10TD.

Provided also that in case of the option for safe harbour validly exercised under sub-rule (2A) of rule 10TD, the word "three" shall be substituted for "five".

(3) On receipt of Form 3CEFA, the Assessing Officer shall verify whether—

- (i) the assessee exercising the option is an eligible assessee; and
- (ii) the transaction in respect of which the option is exercised is an eligible international transaction,

before the option for safe harbour by the assessee is treated to be validly exercised.

(4) Where the Assessing officer doubts the valid exercise of the option for the safe harbour by an assessee, he shall make a reference to the Transfer Pricing Officer for determination of the eligibility of the assessee or the international transaction or both for the purposes of the safe harbour.

(5) For the purposes of sub-rule (4) and sub-rule (10), the Transfer Pricing Officer may require the assessee, by notice in writing, to furnish such information or documents or other evidence as he may consider necessary, and the assessee shall furnish the same within the time specified in such notice.

(6) Where—

- (a) the assessee does not furnish the information or documents or other evidence required by the Transfer Pricing Officer; or
- (b) the Transfer Pricing Officer finds that the assessee is not an eligible assessee; or
- (c) the Transfer Pricing Officer finds that the international transaction in respect of which the option referred to in sub-rule (1) has been exercised is not an eligible international transaction,

the Transfer Pricing Officer shall, by order in writing, declare the option exercised by the assessee under sub-rule (1) to be invalid and cause a copy of the said order to be served on the assessee and the Assessing Officer:

Provided that no order declaring the option exercised by the assessee to be invalid shall be passed without giving an opportunity of being heard to the assessee.

(7) If the assessee objects to the order of the Transfer Pricing Officer under sub-rule (6) or sub-rule (11) declaring the option to be invalid, he may file his objections with the Commissioner, to whom the Transfer Pricing Officer is subordinate, within fifteen days of receipt of the order of the Transfer Pricing Officer.

(8) On receipt of the objection referred to in sub-rule (7), the Commissioner shall after providing an opportunity of being heard to the assessee pass appropriate orders in respect of the validity or otherwise of the option exercised by the assessee and cause a copy of the said order to be

served on the assessee and the Assessing Officer.

(9) In a case where option exercised by the assessee has been held to be valid, the Assessing officer shall proceed to verify whether the transfer price declared by the assessee in respect of the relevant eligible international transactions is in accordance with the circumstances specified in sub-rule (2) 14aa[or, as the case may be, sub-rule (2A)] of rule 10 TD and, if it is not in accordance with the said circumstances, the Assessing Officer shall adopt the operating profit margin or rate of interest or commission specified in sub-rule (2) 14ab[or, as the case may be, sub-rule (2A)] of rule 10TD.

(10) Where the facts and circumstances on the basis of which the option exercised by the assessee was held to be valid have changed and the Assessing Officer has reason to doubt the eligibility of an assessee or the international transaction for any assessment year other than the initial Assessment Year falling within the period for which the option was exercised by the assessee, he shall make a reference to the Transfer Pricing Officer for determination of eligibility of the assessee or the international transaction or both for the purpose of safe harbour.

Explanation.—For purposes of this sub-rule the facts and circumstances include:—

- (a) functional profile of the assessee in respect of the international transaction;
- (b) the risks being undertaken by the assessee;
- (c) the substantive contractual conditions governing the role of the assessee in respect of the international transaction;
- (d) the conduct of the assessee as referred to in sub-rule (2) or sub-rule (3) of rule 10TB; or
- (e) the substantive nature of the international transaction.

(11) The Transfer Pricing Officer on receipt of a reference under sub-rule (10) shall, by an order in writing, determine the validity or otherwise of the option exercised by the assessee for the relevant year after providing an opportunity of being heard to the assessee and cause a copy of the said order to be served on the assessee and the Assessing Officer.

(12) Nothing contained in this rule shall affect the power of the Assessing Officer to make a reference under Section 92CA of the Act in respect of international transaction other than the eligible international transaction.

(13) Where no option for safe harbour has been exercised under sub-rule (1) by an eligible assessee in respect of an eligible international transaction entered into by the assessee or the option exercised by the assessee is held to be invalid, the arm's length price in relation to such international transaction shall be determined in accordance with the provisions of Sections 92C and 92CA of the Act without having regard to the profit margin or the rate of interest or commission as specified in sub-rule (2) 14ac[or, as the case may be, sub-rule (2A)] of rule 10TD.

(14) For the purposes of this rule,—

- (i) no reference under sub-rule(4) shall be made by an Assessing Officer after expiry of a period of two months from the end of the month in which Form 3CEFA is received by him;

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- (ii) no order under sub-rule (6) or sub-rule (11) shall be passed by the Transfer Pricing Officer after expiry of a period of two months from the end of the month in which the reference from the Assessing officer under sub-rule(4) or sub-rule (10), as the case may be, is received by him;
- (iii) the order under sub-rule (8) shall be passed by the Commissioner within a period of two months from the end of the month in which the objection filed by the assessee under sub-rule (7) is received by him.

(15) If the Assessing Officer or the Transfer Pricing Officer or the Commissioner, as the case may be, does not make a reference or pass an order, as the case may be, within the time specified in sub-rule (14), then the option for safe harbour exercised by the assessee shall be treated as valid.

5.3 SHR for Specified Domestic Transactions

5.3.1 Where an eligible assessee has entered into an eligible specified domestic transaction in any previous year relevant to an assessment year and the option for SHR as specified under rule 10THD has been validly exercised, then transfer price declared by the assessee in respect of such transaction for that assessment year shall be accepted by the income tax authorities provided they are in accordance with circumstances specified below as per Rule 10THC:

S. No.	Eligible SDT	Circumstances
1.	Supply of electricity, transmission of electricity, wheeling of electricity	The tariff in respect of supply of electricity, transmission of electricity, wheeling of electricity, as the case may be, is determined or the methodology for determination of the tariff is approved by the Appropriate Commission in accordance with the provisions of the Electricity Act, 2003 (36 of 2003).
2.	Purchase of milk or milk products by a cooperative society from its members	The price of milk or milk products is determined at a rate which is fixed on the basis of the quality of milk, namely, fat content and Solid Not FAT (SNF) content of milk ; and— (a) the said rate is irrespective of— (i) the quantity of milk procured; (ii) the percentage of shares held by the members in the co-operative society; (iii) the voting power held by the members in the society; and (b) Such prices are routinely declared by the co-operative society in a transparent manner and are available in public domain.

5.3.2 Procedure

Rule 10THD of the Income-tax Rules, 1962 lays down the procedure to be adopted for exercising SHR as follows:

(1) For the purposes of exercise of the option for safe harbour the assessee shall furnish a Form 3CEFB, complete in all respects, to the Assessing Officer on or before the due date specified in Explanation 2 to sub-section (1) of Section 139 of the Act for furnishing the return of income for the relevant assessment year:

Provided that the return of income for the relevant assessment year is furnished by the assessee on or before the date of furnishing of Form 3CEFB:

Provided further that in respect of eligible specified domestic transactions, other than the transaction referred to in clause (iv) of rule 10THB, undertaken during the previous year relevant to the assessment year beginning on the 1st day of April, 2013 or beginning on the 1st day of April, 2014 or beginning on the 1st day of April, 2015, Form 3CEFB may be furnished by the assessee on or before the 31st day of March, 2016

Provided also that in respect of eligible specified domestic transactions, referred to in clause (iv) of rule 10THB, undertaken during the previous year relevant to the assessment year beginning on the 1st day of April, 2013 or beginning on the 1st day of April, 2014 or beginning on the 1st day of April, 2015, Form 3CEFB may be furnished by the assessee on or before the 31st day of December, 2015.

(2) On receipt of Form 3CEFB, the Assessing Officer shall verify whether—

- (i) the assessee exercising the option is an eligible assessee; and
- (ii) the transaction in respect of which the option is exercised is an eligible specified domestic transaction,

before the option for safe harbour by the assessee is treated to be validly exercised.

(3) Where the Assessing Officer doubts the valid exercise of the option for the safe harbour by an assessee, he may require the assessee, by notice in writing, to furnish such information or documents or other evidence as he may consider necessary, and the assessee shall furnish the same within the time specified in such notice.

(4) Where—

- (a) the assessee does not furnish the information or documents or other evidence required by the Assessing Officer; or
- (b) the Assessing Officer finds that the assessee is not an eligible assessee; or
- (c) the Assessing Officer finds that the specified domestic transaction in respect of which the option referred to in sub-rule (1) has been exercised is not an eligible specified domestic transaction; or
- (d) the tariff is not in accordance with the circumstances specified in sub-rule (2) of rule 10THC,

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the Assessing Officer shall, by order in writing, declare the option exercised by the assessee under sub-rule (1) to be invalid and cause a copy of the said order to be served on the assessee:

Provided that no order declaring the option exercised by the assessee to be invalid shall be passed without giving an opportunity of being heard to the assessee.

(5) If the assessee objects to the order of the Assessing Officer under sub-rule (4) declaring the option to be invalid, he may file his objections with the Principal Commissioner or the Commissioner or the Principal Director or the Director, as the case may be, to whom the Assessing Officer is subordinate, within fifteen days of receipt of the order of the Assessing Officer.

(6) On receipt of the objection referred to in sub-rule (5), the Principal Commissioner or the Commissioner or the Principal Director or the Director, as the case may be, shall after providing an opportunity of being heard to the assessee, pass appropriate orders in respect of the validity or otherwise of the option exercised by the assessee and cause a copy of the said order to be served on the assessee and the Assessing Officer.

(7) For the purposes of this rule,—

- (i) no order under sub-rule (4) shall be made by an Assessing Officer after expiry of a period of three months from the end of the month in which Form 3CEFB is received by him;
- (ii) the order under sub-rule (6) shall be passed by the Principal Commissioner or Commissioner or Principal Director or Director, as the case may be, within a period of two months from the end of the month in which the objection filed by the assessee under sub-rule (5) is received by him.

(8) If the Assessing Officer or the Principal Commissioner or the Commissioner or the Principal Director or the Director, as the case may be, does not pass an order within the time specified in sub-rule (7), then the option for safe harbour exercised by the assessee shall be treated as valid.

5.3.3 Information and documents to be kept and maintained under Section 92D of the Act as per Rule 10D(2A)

(a) The eligible assessee, referred to in clause (i) of rule 10D shall keep and maintain the following information and documents, namely:-

- (i) a description of the ownership structure of the assessee enterprise with details of shares or other ownership interest held therein by other enterprises;
- (ii) a broad description of the business of the assessee and the industry in which the assessee operates, and of the business of the associated enterprises with whom the assessee has transacted;
- (iii) the nature and terms (including prices) of specified domestic transactions entered into with each associated enterprise and the quantum and value of each such transaction or class of such transaction;

- (iv) a record of proceedings, if any, before the regulatory commission and orders of such commission relating to the specified domestic transaction;
- (v) a record of the actual working carried out for determining the transfer price of the specified domestic transaction;
- (vi) the assumptions, policies and price negotiations, if any, which have critically affected the determination of the transfer price; and
- (vii) any other information, data or document, including information or data relating to the associated enterprise, which may be relevant for determination of the transfer price;

(b) the eligible assessee, referred to in clause (ii) of rule 10THA, shall keep and maintain the following information and documents, namely:-

- (i) a description of the ownership structure of the assessee co-operative society with details of shares or other ownership interest held therein by the members;
- (ii) description of members including their addresses and period of membership;
- (iii) the nature and terms (including prices) of specified domestic transactions entered into with each member and the quantum and value of each such transaction or class of such transaction;
- (iv) a record of the actual working carried out for determining the transfer price of the specified domestic transaction;
- (v) the assumptions, policies and price negotiations, if any, which have critically affected the determination of the transfer price;
- (vi) the documentation regarding price being routinely declared in transparent manner and being available in public domain; and
- (vii) any other information, data or document which may be relevant for determination of the transfer price.

The information specified in Rule 10D(2A) shall be supported by authentic documents, which may include the following:

- (a) official publications, reports, studies and data bases from the Government of the country of residence of the associated enterprise, or of any other country;
- (b) reports of market research studies carried out and technical publications brought out by institutions of national or international repute;
- (c) price publications including stock exchange and commodity market quotations;
- (d) published accounts and financial statements relating to the business affairs of the associated enterprises;
- (e) agreements and contracts entered into with associated enterprises or with unrelated enterprises in respect of transactions similar to the international transactions 56e[or the

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specified domestic transactions, as the case may be];

- (f) letters and other correspondence documenting any terms negotiated between the assessee and the associated enterprise;
- (g) documents normally issued in connection with various transactions under the accounting practices followed.

Key aspects of the SHR 2017 are as follows:

- Adoption of SHR is optional.
- Applicable from Assessment Year 2017-18 and two immediately following Assessment Years (i.e., AY 2018-19 and AY 2019-20). Further, the said provision has been extended to AY 2020-21 and AY 2021-22.
- Valid for maximum three years.
- Option to opt out of the safe harbour is available.
- SHR will not apply if the AE is located in a territory notified under Section 94A of the Act or low tax (less than 15 percent rate) country or territory.
- Eligibility criteria is prescribed in detail and involves a time bound procedure for determination of the eligibility by the tax authority.
- Taxpayers opting for SHR need to also comply with the regular documentation and filing requirements (filing of the Accountant's Report).
- SHR are also extended to include certain eligible specified domestic transactions undertaken by eligible taxpayers, such as supply of electricity by a generating company, transmission of electricity and wheeling of electricity, and dairy cooperative societies (i.e. societies procuring and marketing milk).
- Introduction of Low Value adding Intra Group Services ('LVA IGS'):

The definition of LVA IGS has been provided, which amongst others includes those services which are in the nature of support services, not part of the core business of the taxpayer, not in the nature of shareholder or duplicate services, etc. The SHR 2017 states that the mark-up should be upto 5% and the total value of international transaction (including a mark-up of upto 5%) should be less than or equal to INR 10 crore.

However, the SHR 2017 also prescribes requirement of certification from an accountant for the method of cost pooling, exclusion of shareholder cost and duplicate costs from the cost pool and the reasonableness of the allocation keys used for allocation of costs to the assessee by the overseas associated enterprise.

UNIT-VI**Secondary Adjustment****6.1 Introduction and background**

Transfer pricing provisions seek to ensure that there is fair and equitable allocation of taxable profits amongst the tax jurisdictions. In cases where the underlying transaction is held not to be at arm's length, a primary adjustment is made to align the transfer price with the ALP which is known as primary adjustment. However, it does not address the additional cash benefit which accumulates from the non-arm's length pricing of the underlying primary transaction (i.e. the other AE has effectively retained such excess/differential funds).

For example: Company A in India has rendered services to its affiliate, say Company B in US, resulting in a net profit of 10 percent on costs. However, it is determined that in an arm's length scenario, Company A should have earned 15 percent margin (instead of current 10 percent), and an adjustment (of differential 5 percent) is made to the services transaction [known as the 'primary adjustment']. However, this primary adjustment does not address the benefit obtained by Company B by retaining the differential 5 percent profits in cash.

The provisions on secondary adjustment seek to target such cash/fund benefit by seeking repatriation of such excess funds lying with the AE. Any funds not repatriated by the AE will be termed as an "advance" given by the Assessee to the AE and notional interest rate, as prescribed, will be added to the income of the Assessee by way of a secondary adjustment.

The OECD Guidelines define the term secondary adjustments as "an adjustment that arises from imposing tax on a secondary transaction". A secondary transaction is further defined as "a constructive transaction that some countries will assert under their domestic legislation after having proposed a primary adjustment in order to make the actual allocation of profits consistent with the primary adjustment."

The secondary adjustment rules are an internationally recognised approach and already part of the TP regulations in many leading economies, including the United States, Canada, France and other EU Member States, albeit in different forms/approaches (such as constructive dividends, constructive equity contributions and constructive/deemed loans).

Seeking to align Indian TP regulations with OCED Guidelines and international best practices, the Government introduced Section 92CE in the Act to permit secondary adjustments in certain cases.

6.2 Secondary Adjustment provisions in India

The newly inserted Section 92CE of the Act provides as under:

"92CE. (1) *Where a primary adjustment to transfer price,—*

- (i) *has been made suo motu by the assessee in his return of income;*
- (ii) *made by the Assessing Officer has been accepted by the assessee;*
- (iii) *is determined by an advance pricing agreement entered into by the assessee under Section 92CC of the Act;*

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- (iv) *is made as per the safe harbour rules framed under Section 92CB of the Act; or*
- (v) *is arising as a result of resolution of an assessment by way of the mutual agreement procedure under an agreement entered into under Section 90 or Section 90A of the Act for avoidance of double taxation,*

the assessee shall make a secondary adjustment:

Provided *that nothing contained in this section shall apply, if,—*

- (i) *the amount of primary adjustment made in any previous year does not exceed one crore rupees; or*
- (ii) *the primary adjustment is made in respect of an assessment year commencing on or before the 1st day of April, 2016.*

Provided further *that no refund of taxes paid, if any, by virtue of provisions of this sub-section as they stood immediately before their amendment by the Finance (No. 2) Act, 2019 shall be claimed and allowed.*

(2) Where, as a result of primary adjustment to the transfer price, there is an increase in the total income or reduction in the loss, as the case may be, of the assessee, the excess money which is available with its associated enterprise, if not repatriated to India within the time as may be prescribed, shall be deemed to be an advance made by the assessee to such associated enterprise and the interest on such advance, shall be computed in such manner as may be prescribed.

Explanation—For the removal of doubts, it is hereby clarified that the excess money or part thereof may be repatriated from any of the associated enterprises of the assessee which is not a resident in India.

3(2A) Without prejudice to the provisions of sub-section (2), where the excess money or part thereof has not been repatriated within the prescribed time, the assessee may, at his option, pay additional income-tax at the rate of eighteen per cent on such excess money or part thereof, as the case may be.

(2B) The tax on the excess money or part thereof so paid by the assessee under sub-section (2A) shall be treated as the final payment of tax in respect of the excess money or part thereof not repatriated and no further credit therefore shall be claimed by the assessee or by any other person in respect of the amount of tax so paid.

(2C) No deduction under any other provision of this Act shall be allowed to the assessee in respect of the amount on which tax has been paid in accordance with the provisions of sub-section (2A).

(2D) Where the additional income-tax referred to in sub-section (2A) is paid by the assessee, he shall not be required to make secondary adjustment under sub-section (1) and compute interest under sub-section (2) from the date of payment of such tax.

(3) For the purposes of this section, —

- (i) *"associated enterprise" shall have the meaning assigned to it in sub-section (1) and sub-section (2) of Section 92A of the Act;*

- (ii) "arm's length price" shall have the meaning assigned to it in clause (ii) of Section 92F of the Act;
- (iii) "excess money" means the difference between the arm's length price determined in primary adjustment and the price at which the international transaction has actually been undertaken;
- (iv) "primary adjustment" to a transfer price, means the determination of transfer price in accordance with the arm's length principle resulting in an increase in the total income or reduction in the loss, as the case may be, of the assessee;
- (v) "secondary adjustment" means an adjustment in the books of account of the assessee and its associated enterprise to reflect that the actual allocation of profits between the assessee and its associated enterprise are consistent with the transfer price determined as a result of primary adjustment, thereby removing the imbalance between cash account and actual profit of the assessee."

The salient features of the new provisions are listed below:

- Applicable where primary adjustment is made in certain cases i.e.
 - Made on a suo-moto basis by taxpayer in its return of income;
 - Made in audit proceedings by tax officer and accepted by taxpayer;
 - Determined under Advance Pricing Agreement ("APA");
 - Made under the Safe Harbour regulations; or
 - Arising from resolution under Mutual Agreement Procedure ("MAP")]
- These provisions shall take effect from FY 2016-17
- These provisions would not apply in cases where the amount of primary adjustment does not exceed INR one crore or primary adjustment is made in respect of assessment year commencing on or before 1 April 2016.

The CBDT, vide Notification no. 52/2017 dated 15 June 2017 prescribed the rate and manner of computing interest, etc. The interest rate will be as follows:

- For an international transaction denominated in INR – one year marginal cost of fund lending rate of State Bank of India as on 1st of April of the relevant previous year plus 325 basis points
- For an international transaction denominated in foreign currency – six month LIBOR as on 30th September of the relevant previous year plus 300 basis points

Overall, the taxpayers need to be more cautious while pricing their intra-group dealings to ensure they are appropriately priced to reflect arm's length scenario, as failure to do so may entail secondary adjustment in the form of deemed interest, and as discussed above, may also result in double taxation.

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The Finance (No. 2) Act, 2019 in order to address the concerns and make the secondary adjustment regime more effective has provided the following:

- i. Remittance of excess money (or part thereof) can be received from an AE (being non-resident) other than the AE with which the excess money is supposed to be received by way of the primary adjustment;
- ii. in a case where the excess money or part thereof has not been repatriated in time, the assessee will have the option to pay additional income-tax at the rate of eighteen per cent on such excess money or part thereof in addition to the existing requirement of calculation of interest till the date of payment of this additional tax. The additional tax is proposed to be increased by a surcharge of twelve per cent;
- iii. the tax so paid shall be the final payment of tax and no credit shall be allowed in respect of the amount of tax so paid;
- iv. the deduction in respect of the amount on which such tax has been paid, shall not be allowed under any other provision of this Act; and
- v. if the assessee pays the additional income-tax, he will not be required to make secondary adjustment or compute interest from the date of payment of such tax.
- vi. The amendments proposed in para (i) above will take effect retrospectively from the 1 April 2018 and will, accordingly, apply in relation to the assessment year 2018-19 and subsequent assessment years.

Further, the amendments proposed in points (ii) to (v) will be effective from 1 September 2019.

UNIT-VII	Thin Capitalization
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7.1 Introduction and background

India has time and again shown its commitment to BEPS initiative of the OECD and introduced several reforms in domestic tax legislation to plug loopholes, strengthen information sharing between the contracting states and prevent double non-taxation. In line with its commitment, recently vide Finance Act 2017, the government has introduced measures to curb thin capitalization in India.

As per the Background Paper for country tax administration released by the OECD:

“A company is typically financed (or capitalized) through a mixture of debt and equity. Thin capitalization refers to the situation in which a company is financed through a relatively high level of debt compared to equity. Thinly capitalized companies are sometimes referred to as ‘highly leveraged’ or ‘highly geared’.”

Thus, thin capitalization refers to a situation where an entity has a high proportion of debt as compared to equity. As a result of such high debt, the taxpayer can claim excessive deduction of interest payment on such debt from their taxable income. This is more tax friendly compared to paying a dividend on the equity, which cannot be claimed as a tax deductible expense and would also result in an additional tax liability by way of a dividend distribution tax (DDT). For this reason, debt is often considered to be a more tax efficient method of financing vis-a-vis equity, and often leads to thin capitalization.

The tax-impact of thin capitalization can also be understood in the below example:

Particulars		Scenario A (D/E ¹⁰ Ratio of 1:1)	Scenario B (D/E Ratio of 4:1)
Equity	(A)	500	200
Debt (Interest rate 10% p.a.)	(B)	500	800
Profit before interest and tax	(C)	200	200
Less: Interest expenses	(D=B*10%)	50	80
Profit before tax	(E)	150	120
Tax @ 25%	(F=E*25%)	38	30
Profit after tax	(G)	113	90
Dividend distribution tax @ 15%	(H=G*15%)	17	14
Net dividend distribution	(I)	96	77
Total taxes paid	(J=F+H)	54	44

¹⁰ Debt/Equity Ratio

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Particulars		Scenario A (D/E ¹⁰ Ratio of 1:1)	Scenario B (D/E Ratio of 4:1)
Effective tax rate (%)	(K=J/C)	27%	22%
Return on equity (%)	(L=I/A)	19%	38%

Multinational groups are often able to structure their financing arrangements to maximize these benefits. For this reason, country's tax administrations often introduce rules that place a limit on the amount of interest that can be deducted in computing a company's profit for tax purposes. Such rules are designed to counter cross-border shifting of profit through excessive interest payments, and thus aim to protect a country's tax base. Many countries around the globe have, thus, come out with thin capitalization rules as an anti-tax avoidance measures to curb abusive use of artificial loan financing in cross border transactions.

Globally there are several approaches to curtail thin capitalization, which have also been discussed in the OECD paper, "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments" (BEPS Action Plan 4). Some of the methods adopted by certain jurisdictions to prevent thin capitalization are listed below:

- (a) Fixed Ratio: Rules that limit the level of interest expense or debt in an entity, with reference to a fixed ratio of debt/equity, interest/earning, etc.
- (b) Arm's length basis: Rules that compare the level of interest or debt in an entity with the position had the company been dealing entirely with third parties.
- (c) Specified percentage: Rules that disallow a specified percentage of interest expenses in an entity irrespective of the nature of the payment or to whom it is made.
- (d) Anti-avoidance Rules: Targeted anti-avoidance rules that disallow interest on specific transactions.

7.2 Thin Capitalization Rules in India

Prior to Finance Act 2017, there were no formal thin capitalization rules in India, and such disallowance, if any, could be affected only through transfer pricing provisions (i.e. restricting the payment of interest to AE to arm' length), or disallowance under Section 40A(2)(b) of the Act.

In view of BEPS initiative and report on Action Plan 4, the Government vide Finance Act 2017 inserted a new Section 94B in the Act to bring Indian legislation in line with the recommendations of OECD BEPS Action Plan 4. The said section provides as under:

"94B. (1) *Notwithstanding anything contained in this Act, where an Indian company, or a permanent establishment of a foreign company in India, being the borrower, incurs any expenditure by way of interest or of similar nature exceeding one crore rupees which is deductible in computing income chargeable under the head "Profits and gains of business or profession" in respect of any debt issued by a non-resident, being an associated enterprise of*

such borrower, the interest shall not be deductible in computation of income under the said head to the extent that it arises from excess interest, as specified in sub-section (2) :

Provided that where the debt is issued by a lender which is not associated but an associated enterprise either provides an implicit or explicit guarantee to such lender or deposits a corresponding and matching amount of funds with the lender, such debt shall be deemed to have been issued by an associated enterprise.

(1A) Nothing contained in sub-section (1) shall apply to interest paid in respect of a debt issued by a lender which is a permanent establishment in India of a non-resident, being a person engaged in the business of banking.¹¹

(2) For the purposes of sub-section (1), the excess interest shall mean an amount of total interest paid or payable in excess of thirty per cent of earnings before interest, taxes, depreciation and amortisation of the borrower in the previous year or interest paid or payable to associated enterprises for that previous year, whichever is less.

(3) Nothing contained in sub-section (1) shall apply to an Indian company or a permanent establishment of a foreign company which is engaged in the business of banking or insurance.

(4) Where for any assessment year, the interest expenditure is not wholly deducted against income under the head "Profits and gains of business or profession", so much of the interest expenditure as has not been so deducted, shall be carried forward to the following assessment year or assessment years, and it shall be allowed as a deduction against the profits and gains, if any, of any business or profession carried on by it and assessable for that assessment year to the extent of maximum allowable interest expenditure in accordance with sub-section (2):

Provided that no interest expenditure shall be carried forward under this sub-section for more than eight assessment years immediately succeeding the assessment year for which the excess interest expenditure was first computed.

(5) For the purposes of this section, the expressions—

- (i) "associated enterprise" shall have the meaning assigned to it in sub-section (1) and sub-section (2) of section 92A;
- (ii) "debt" means any loan, financial instrument, finance lease, financial derivative, or any arrangement that gives rise to interest, discounts or other finance charges that are deductible in the computation of income chargeable under the head "Profits and gains of business or profession";
- (iii) "permanent establishment" includes a fixed place of business through which the business of the enterprise is wholly or partly carried on."

The salient features of the thin capitalization rules in India are listed below:

- Applicable to borrowers, being an Indian company or Permanent Establishment (PE) of a foreign company, who pay interest in respect of any form of debt issued to a non-resident

¹¹ Inserted vide Finance Act, 2020, w.e.f. 1st April 2021

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or to a PE of a non-resident and who is an 'Associated Enterprise' of the borrower. Further, the debt shall also be deemed to be treated as issued by an AE where it provides an implicit or explicit guarantee to the lender or deposits a corresponding and matching amount of funds with the lender

- The provisions restrict the payment of interest by an entity to its AE Enterprise to the extent of 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid or payable to associated enterprise, whichever is less
- In order to target only large interest payments, it is proposed to provide for a threshold of interest expenditure of INR one crore, exceeding which the provision would be applicable
- The provisions also allow for carry-forward of disallowed interest expense to eight assessment years immediately succeeding the assessment year for which the disallowance was first made and deduction against the income computed under the head "Profits and gains of business or profession to the extent of maximum allowable interest expenditure
- Excludes Banks and Insurance business from the ambit of these provisions keeping in view the special nature of these businesses
- This amendment will take effect from 1 April 2018 and will, accordingly, apply in relation to AY 2018-19 and subsequent years.
- The newly inserted sub-section (1A) excludes from the scope of Section 94B of the Act, interest paid by a taxpayer to a foreign bank's branch in India (i.e. a PE of a non-resident bank) on loans of the said branch. This amendment will take effect from 1 April 2021 and will, accordingly, apply in relation to AY 2021-22 and onwards.

While the introduction of thin capitalization rules is in line with international practice, it may put additional burden and restraint upon taxpayers resorting to intra-group borrowings. It would, thus, be necessary for Indian subsidiaries of MNE groups to consider the impact of thin capitalization rules in borrowings.

Module G

Specified Domestic Transactions

1. Introduction

Transfer pricing regulations have been extended vide Finance Act, 2012 beyond international transactions to include¹ transactions by an undertaking with other undertakings of the same entity for the purposes of Section 10AA of the Act and Chapter VI-A. These regulations relating to SDTs are popularly known as Specified Domestic Transfer Pricing regulations and are applicable from Assessment Year ('AY') 2013-14 onwards.

Accordingly, w.e.f. AY 2013-14, all the compliance requirements relating to transfer pricing documentation, accountant's report, etc. equally apply to SDTs as they do for international transactions amongst associated enterprises.

2. Genesis of Domestic Transfer Pricing in India

Although the transfer pricing regulations were introduced in India in 2001, until 2012 they, normally, covered only those transactions which were between two or more associated enterprises, either or both whom were non-residents (international transactions). In-fact before March 2012, there was no precise methodology prescribed in the Act to determine reasonableness of expenditure to re-compute income in relation to a domestic related party transaction. The Hon'ble Supreme Court in case of Glaxo SmithKline² statedⁱ the need to extend existing transfer pricing provisions to domestic transactions in certain situations. Accordingly, and in view of providing objectivity in determination of income and reasonableness of expenditure and also to create legally enforceable obligation on taxpayers to maintain proper documentation in relation to domestic related party transactions, amendments were made through the Finance Act, 2012 to widen the scope of Indian transfer pricing regulations and extend its reach to SDTs, by introducing section 92BA in the Act. This included expenditure covered under section 40A (2) (b) of the Act, and transactions covered under certain section in Chapter VI-A, or section 10A or section 10AA of the Act, The threshold of 5 crore rupee was provided, which was increased to 20 crore rupees by the Finance Act, 2015. The implementation of the provisions in respect of section 40A (2) (b) of the Act was found to create inconvenience and hence dropped by the Finance Act, 2017. Subsequently, the Finance Act, 2019 (w.e.f. AY 2020-21) extended the provisions to any business transacted between the persons referred to in section 115BAB (6) of the Act.

Consequent to the above-mentioned amendments, following transactions are covered within

¹ Payments to specified persons under section 40A(2)(b) excluded from the purview of SDT by Finance Act 2017

² CIT v. Glaxo Smithkline Asia Private Limited [2010] 195 Taxmann 35 (SC). Please refer end-note (i) for the relevant portion of the judgment.

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the ambit of domestic transfer pricing regulations:

- Transfer of goods and services between the tax holiday undertaking and other undertakings of the taxpayer.
- Business transacted between the tax holiday undertaking and other 'closely connected entities.
- Business transacted between the persons referred to in section 115BAB (6) of the Act.
- Any other notified transaction.

3. Intent of Law

It's a common knowledge that the under-invoicing of sales and over-invoicing of expenses is ordinarily revenue neutral in case of a domestic transaction where both entities are under normal taxation regime. 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. To understand such situations in a greater detail, following illustrations can be referred to.

Illustration 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%)

For illustration purpose only

Tax planning to shift 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

For illustration purpose only

Illustration 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 * 30%)

For illustration purpose only

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

For illustration purpose only

Note: Of course, the situational impact will be mitigated in future years having regard to reduction in carry forward of losses. Accordingly, tax base erosion is not an issue here in simpler situations.

Domestic transfer pricing provisions were introduced to avoid such situations and curtail the leakage of revenue, i.e. by putting an obligation on the taxpayer to document and report its

7.4 International Tax — Transfer Pricing

specified domestic transactions and substantiate the arm's length nature of the same.

Further, the extension of transfer pricing provisions to domestic transactions is intended to bring objectivity to determination of income and reasonableness of expenditure by doing away with ambiguity as regards the application of FMV standard. As mentioned earlier, before the introduction of domestic transfer pricing, the Act only contained provisions which empowered an assessing officer ('AO') to disallow excessive and unreasonable expenditure or re-work the quantum of tax holiday being claimed where the transactions are carried out with certain specified persons / closely associated persons. Based on the provisions other than domestic transfer pricing, the allowability of an expense or a quantum of tax holiday is computed having regard to FMV of goods or services or ordinary profits that a business is expected to earn. Since the term FMV is open to generic interpretation, in certain cases it resulted in subjective approach being adopted to disallow expenditure or reduce the quantum of profit linked tax deduction giving rise to prolonged litigation. Introduction of the concept of Arm's Length Price ('ALP') in this context is definitely a welcome step for reducing litigation to a great extent.

Following table compares the concepts of FMV and ALP for more clear understanding:

Table 1: Comparison: FMV and ALP

Particulars	FMV	ALP
Meaning	The price which goods or services fetch on sale in the open market	A price applied in an uncontrolled transaction in similar circumstances
Computation Mechanism	No precise method prescribed	Most appropriate method out of six prescribed methods
Transaction Value	Any market pricing point can be treated as fair market value	If more than one price is available, arithmetic mean of such prices / range of prices (subject to conditions) considered as ALP
Tolerance Band / Deviation	No deviation permitted from fair market value	Deviation of plus / minus three ³ percent is permitted

4. Transactions Specified

The term 'Specified Domestic Transaction' has been defined by Section 92BA of the Act which was inserted by way of an amendment through the Finance Act, 2012 and amended by the Finance Acts, 2015, 2017 and 2019. The amendment has also impacted other sections viz. Sections 92, 92C, 92CA, 92D, 92E, 80A /80-IA /10AA of the Act.

As per Section 92BA of the Act, specified domestic transaction in case of an assessee *means*

³One percent in certain cases.

any of the following transactions⁴, *not being an international transaction*, namely:-

- (i) Any transaction referred to in Section 80A of the Act
- (ii) Any transfer of goods or services referred in Section 80-IA(8) of the Act
- (iii) Any business transacted between the assessee and other person as referred to in Section 80-IA(10) of the Act
- (iv) Any transaction, referred to in any other section under Chapter VI-A or Section 10AA of the Act, to which provisions of Section 80-IA(8) of the or Section 80-IA(10) of the Act are applicable
- (v) Any business transacted between the persons referred to in section 115BAB (6) of the Act.
- (vi) Any other transactions as may be prescribed.

AND where, the aggregate of such transactions entered into by the assessee in previous year exceeds a sum of *twenty*⁵ crore rupees.

Other prominent sections impacted are;

- Section 92 of the Act: sub-section 2A: according to which, any allowance for an expenditure or interest or allocation of any cost or expense or any income in relation to the specified domestic transaction shall be computed having regard to the arm's length price.
- Amendments to Sections 92C, 92D, 92E and 92CA of the Act: pursuant to which computation of ALP, documentation, compliances and assessments in respect of the SDTs will be governed by the afore-mentioned sections.
- Corresponding amendment to Section 80A(6) of the Act: the expression "market value" in relation to any goods or services sold, supplied or acquired means the arm's length price as defined in clause (ii) of Section 92F of the Act of such goods or services, if it is an SDT as referred to in Section 92BA of the Act.
- Corresponding amendment to Section 80IA(8) of the Act: "market value", in relation to any goods or services, means the arm's length price as defined in clause (ii) of Section 92F of the Act, where the transfer of such goods or services is an SDT as referred to in Section 92BA of the Act.
- Corresponding amendment to Section 80IA(10) of the Act: in case the aforesaid arrangement involves an SDT as referred to in Section 92BA of the Act, the amount of profits from such transaction shall be determined having regard to arm's length price as

⁴ Payments to specified persons under section 40A(2) excluded from the purview of SDT by Finance Act 2017

⁵The threshold of twenty crore rupees is applicable with effect from AY 2016-17. Earlier, i.e. from AY 2013-14 to AY 2015-16, the threshold was five crores rupees.

7.6 International Tax — Transfer Pricing

defined in clause (ii) of Section 92F of the Act.

- Business transacted between the persons referred to in section 115BAB (6) of the Act.
- Snapshot of impact on transfer pricing sections:

Section		Impact / relevance with provisions of section 92BA (Y/N)
92	Computation of income having regard to ALP	Y
92A	Meaning of Associated Enterprise	N
92B	Meaning of International Transaction	N
92C	Methods of computation of ALP	Y
92CA	Reference to TPO	Y
92CB	Safe Harbour rules	N
92CC	Advance Pricing agreement	N
92CD	Effect of TP agreement	N
92CE	Secondary adjustment in certain cases	N
92D	Maintenance of information and documents	Y
92E	Accountant's Report	Y
92F	Definitions	N

5. Basic Scheme

Only those domestic transactions which are specified under Section 92BA of the Act are considered as SDTs if their aggregate value exceeds INR 20 crores (approximately USD 2.57mn.)⁶; and if such transactions fall within the ambit of SDTs, the concerned transacting entities have to adhere to necessary documentation, reporting and compliance requirements. Hence, to be compliant with the domestic transfer pricing regulations, every taxpayer needs to consider the following:

- Do I / Does my enterprise have any 'related party(ies)' / 'closely connected entity(ies)' as defined / considered in the specific sections referred to under Section 92BA of the Act?
- If the answer to the above is in the affirmative, does the aggregate value of transactions with such persons exceeds INR 20 crores?
- If answers to both above-mentioned questions is in the affirmative (i.e. I / we have SDTs on my / our books), then:
 - Does the expense / income in relation to such SDTs has been computed having regard to the arm's length price?
 - Whether I / we have sufficient documentation to substantiate the same?

⁶@ 77.65 INR/USD

- Have I / we appointed a Chartered Accountant to certify the same?

Accordingly, following aspects are important from the domestic transfer pricing perspective:

1. Identification of 'related party(ies)' / 'closely connected entity(ies)',
 - 1A. Identification of transactions with such entities, determining the aggregate value of such transactions and eventually, establishing whether the transactions are SDTs,
2. Carrying out transfer pricing analysis of every SDT, which should cover:
 - a. FAR analysis as applicable,
 - b. Comparability analysis,
 - c. Selection and application of the MAM to ascertain the ALP,
 - d. Benchmarking analysis,
 - e. Determination of ALP and comparing the same with the price charged in case of the SDT under consideration, and
 - f. finally, documentation of the above-referred economic analysis and the result
3. Obtaining a report from an accountant in a prescribed manner, and furnish the same to the tax department before the specified date and before furnishing of the return of income.

These aspects are discussed in detail in the sections below.

6. Identification of Related Parties / Closely Connected Persons and Ascertaining SDTs

Based on the above definition of SDT, following types of transactions are covered:

Clause of Section 92BA of the Act	Section referred to in Section 92BA of the Act	Nature of transactions (income / expense)	Inter-unit / entity level transactions covered
(i)	40A(2)(b)	Deleted vide Finance Act 2017	Deleted vide Finance Act 2017
(ii)	80A	Both income and expense transactions are covered. Further, Section 80A(6) of the Act covers only transactions involving transfer of goods or services.	Only inter-unit transfer is covered. Further Section 80A(6) of the Act is applicable only to transfer between unit eligible for profit-linked deduction and any other business/ unit of the assessee.

7.8 International Tax — Transfer Pricing

Clause of Section 92BA of the Act	Section referred to in Section 92BA of the Act	Nature of transactions (income / expense)	Inter-unit / entity level transactions covered
(iii)	80-IA(8)	Both income and expense transactions are covered. Further, Section 80-IA(8) of the Act covers only transactions in respect of goods or services.	Only inter-unit transfer is covered. Further Section 80-IA(8) of the Act is applicable only to transfer between unit eligible for profit-linked deduction and any other business/ unit of the assessee.
(iv)	80-IA(10)	Any business transacted. This will include both income and expense transactions.	Only transactions between different entities which are “closely connected” are covered.
(v)	Chapter VI-A or Section 10AA of the Act	Any business transacted. This will include both income and expense transactions.	Both inter-unit as well as transactions with distinct entities are covered.
(va)	Section 115BAB (6)	Any business transacted. This will include both income and expense transactions.	All transaction is covered
(vi)	Any other transactions as may be prescribed	As of now Central Board of Direct Taxes (“CBDT”) has not prescribed any transaction.	

6.1 Transactions Covered under Sections 80A, 80-IA and 10AA of the Act

Five types of transactions of tax holiday unit fall within the purview of SDT:

Section	Transaction	Inter-unit/ Entity level transactions
92BA(ii)	Any transaction referred to in Section 80A of the Act	Covers inter-unit transfer of goods or services
92BA(iii)	Any transfer of goods or services referred in Section 80-IA(8) of the Act	

Section	Transaction	Inter-unit/ Entity level transactions
92BA(iv)	Any business transacted between the assessee and other person as referred to in Section 80-IA(10) of the Act.	Covers transaction of tax holiday unit/ undertaking with closely connected person
92BA(v)	Any transaction, referred to in any other section under Chapter VI-A or Section 10AA of the Act, to which provisions of Section 80-IA(8) of the Act or Section 80-IA(10) of the Act is applicable.	Covers both inter-unit transfer as well transaction with distinct entity
92BA(va)	Any transaction between persons referred to in sub-section (6) to section 115BAB of the Act.	All transaction is covered

6.1.1 Section 80A of the Act – Deduction to be made in computing total income

The second limb of Section 92BA of the Act refers to any transaction referred to in section 80A of the Act. While other sub-sections of Section 80A of the Act regulate the quantum of deduction sub-section (6) involves fair pricing of any transaction. Though the reference in Section 92BA of the Act is to Section 80A of the Act in general, on a closer examination i.e. combined reading of section 92BA and Section 80, it becomes clear that the reference is merely to sub-section (6) of Section 80A of the Act. The Finance Act, 2012 has made corresponding amendment to Section 80A(6) of the Act to incorporate the meaning of expression “market value” referred to in that sub-section. The amended sub-section (6) to Section 80A of the Act provides that in case of domestic transfer pricing, the market value shall be computed at ALP. Thus, it may be concluded that reference to Section 80A of the Act in clause (ii) of Section 92BA of the Act is to be analysed mainly as reference to sub-section (6) to Section 80A of the Act.

Section 80A(6) of the Act covers the following transfers of goods or services:

- where any goods or services held for the purposes of the undertaking or unit or enterprise or eligible business are transferred to any other business carried on by the assessee; or
- where any goods or services held for the purposes of any other business carried on by the assessee are transferred to the undertaking or unit or enterprise or eligible business

Thus, only inter-unit transfer of goods or services between the eligible unit and any other business of the assessee are covered by Section 80A(6) of the Act. This section requires that the inter-unit transfer should take place at “market value”. In case where inter-unit transfer constitutes SDT, the expression “market value” means the arm’s length price as defined under Section 92F(ii) of the Act.

7.10 International Tax — Transfer Pricing

Therefore, this provision requires that the inter unit transfer of goods or services between eligible and other units of the same taxpayer should be recognized at market value of such goods or services on the date of transfer for the purpose of computing deduction admissible to the taxpayer under specified sections of Chapter VI-A. The provision covers income as well as expenditure of the eligible unit. If threshold of INR 20 crores is not crossed, the same will continue to be governed by un-amended provisions of Section 80A(6) of the Act and FMV will be computed on general principles.

The provisions currently in force which grant profit linked tax holiday deductions, and which are regulated by Section 80A(6) of the Act and, consequently, subject to Domestic Transfer Pricing are as follows:-

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

6.1.2 Section 80IA-(8) and (10) of the Act – Deduction in respect of profits and gains from industrial undertaking or enterprises engaged in infrastructure development, etc.

Section 80-IA(8)

Section 80-IA(8) of the Act covers following types of transfers:

- Goods or services held for the purposes of the eligible business are transferred to any other business carried on by the assessee; or
- Goods or services held for the purposes of any other business carried on by the assessee are transferred to the eligible business.

Section 80-IA(8) of the Act requires that when there is inter-unit transfer of goods or services and if the consideration received/ paid as recorded in the accounts of the eligible unit/ business is not at market value, in such case profits and gains of eligible business should be determined by substituting market value of goods or services in place of its recorded value. However, in situation where the aforesaid basis of computing profits and gains presents exceptional difficulties then the proviso to Section 80-IA(8) of the Act empowers the AO to compute profits and gains of eligible business on such reasonable basis as the AO may deem

fit.

In order to determine market value, the Finance Act, 2012 has amended the provision of Section 80-IA(8) of the Act. As per the amendment where the inter-unit transfer of goods or services constitutes SDT, then in such case “market value” of goods or services shall be arm’s length price as defined in Section 92F(ii) of the Act. However, where the inter-unit transfer does not constitute SDT, the market value is the price that such goods or services would ordinarily fetch in the open market.

The above provisions enable re-computation of eligible profits on the basis of recognized principles of accounting as regards allocation of common costs and determination of transfer price of both goods and services purchased or sold when assessee has more than one undertaking. However, it is pertinent to note that as regards applicability to Section 80-IA(8) of the Act the SDT provisions do not directly impact taxable profits which are included in the gross total income but require adjustment if any only to the quantum of deduction. Therefore, only the quantum of deduction will be adjusted (if at all) applying ALP principles.

Section 80-IA(10)

Section 80-IA(10) of the Act empowers the AO to re-compute the profits and gains of the eligible business entitled to profit linked deduction, where it appears to the AO that due to the close connection between the assessee carrying on the eligible business to which this section applies and any other person or for any other reason, the course of the business between them is so arranged that the business transacted between them produces to the assessee more than the ordinary profits which might be expected to arise in such eligible business. In such case the AO shall take the amount of profits as may be reasonably deemed to have been derived from such business to compute the profits and gains of such eligible business of the assessee for the purposes of the deduction under this section.

The Finance Act, 2012 has inserted a proviso to Section 80-IA(10) of the Act. As per the proviso, where the arrangement referred to in Section 80-IA(10) of the Act is SDT, the amount of profits from such transaction shall be determined having regard to arm’s length price as defined in Section 92F(ii) of the Act.

However, it may be noted that the provisions will apply only if it is proved that there is an intention to shift profits from a taxable business to an eligible business entitled to the tax holiday (both existing in India). In other words, it implies a deliberate act, by which the assessee arranged its affairs so that it produced more than ordinary profits.

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Example for 80IA(8) & (10):

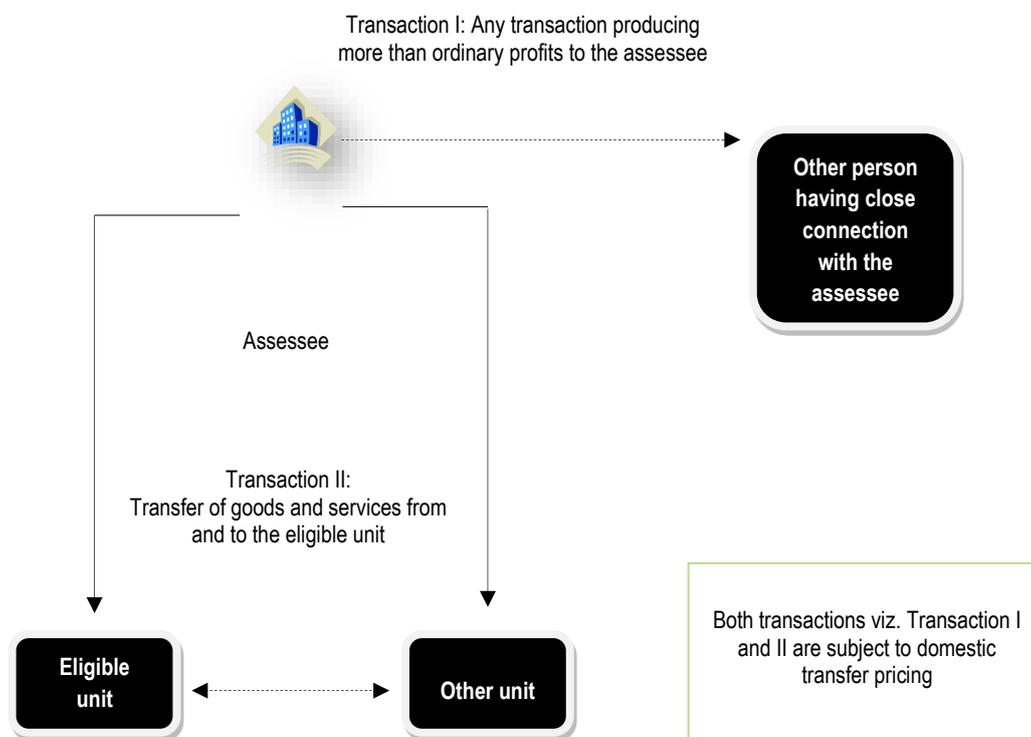


Illustration from the perspective of Section 80-IA(8) of the Act: In the above illustration (transaction II), assume that the value of goods / services transferred by eligible unit to the other unit is INR 500. Whereas the market value of the same is only INR 300. Therefore, the ALP of the above transaction will be treated at INR 300 as per the domestic transfer pricing provisions and balance INR 200 will be considered as excessive and disallowed under domestic transfer pricing.

Illustration from the perspective of Section 80-IA(10) of the Act: (transaction I) assuming that the assessee is operating in the infrastructure industry and is eligible for deductions under Section 80-IA of the Act. The operating margin of the assessee is 60% whereas the average operating margin of the comparable companies in the same business is only 20%. In this case, the Arm's length margin will be treated as 20% and balance 40% could be considered as 'more than ordinary profits' as per domestic transfer pricing provisions.

6.1.3 Transactions to which provisions of Sections 80IA(8) and 80IA(10) of the Act apply

The fifth limb of the SDT definition covers any transaction, referred to in any other section under Chapter VI-A or Section 10AA of the Act, to which provisions of Section 80-IA(8) or Section 80-IA(10) of the Act is applicable.

Section 80-IA(8) and (10) of the Act is referred in the various provisions of the Act. Out of

these provisions, the relevant provisions which are still effective includes following:

Section	Deduction
10AA	Special provisions in respect of newly established units in Special Economic Zones.
80-IAB	Deductions in respect of profits and gains by an undertaking or enterprise engaged in development of Special Economic Zone.
80-IAC	Special provision in respect of specified business
80-IB	Deduction in respect of profits and gains from certain industrial undertakings other than infrastructure development undertakings.
80-IC	Special provisions in respect of certain undertakings or enterprises in certain special category states.
80-ID	Deduction in respect of profits and gains from business of hotels and convention centers in specified area.
80-IE	Special provisions in respect of certain undertakings in North-Eastern states.

6.1.4 Transactions to which provisions of Sections 115BAB (6) of the Act apply

Section 115BAB of the Act provides a lower rate of taxation, 15%, to domestic companies which satisfy certain conditions laid down in the section. Subsection (6) is an anti-tax avoidance measure which reads as follows:

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

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

Provided further that the amount, being profits in excess of the amount of the profits determined by the Assessing Officer, shall be deemed to be the income of the person.

6.2 Threshold

Once the required transactions are identified, it is pertinent to ascertain the aggregate value of all relevant domestic transactions since only if, the aggregate of such transactions entered into by the assessee in previous year exceeds a sum of twenty⁷crore rupees, the transactions

⁷The threshold of twenty crore rupees is applicable with effect from AY 2016-17. Earlier, i.e. from AY 2013-14 to AY 2015-16, the threshold was five crore rupees.

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are considered as SDTs. It may be noted that the threshold of INR 20 crores is required to be examined every year by adopting values as reported by an assessee on the basis of entries in the books of account.

Snapshot of implications: (i). aggregate value crosses INR 20 crores and (ii). Aggregate value does not cross INR 20 crores.

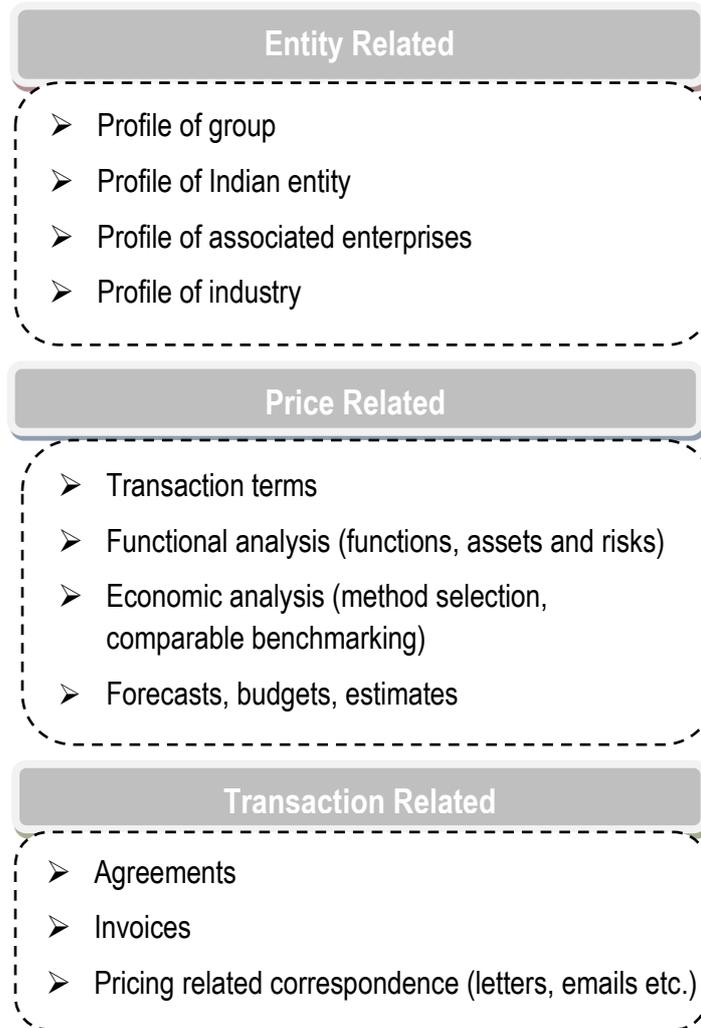
Particulars	If aggregate transaction value exceeds INR 20 crores	If aggregate transaction value does not exceed INR 20 crores
Section 80-IA(8) and (10) of the Act		
Applicability of TP provisions	Applicable	Not applicable
Basis of measurement	ALP	Price that goods or services would ordinarily fetch in the open market
Methods for assessment	Six methods prescribed u/s 92C of the Act	No prescribed method
Consequences of transactions not as per market forces	Re-computation of tax holiday deduction having regard to ALP	Re-computation of tax holiday deduction having regard to market value and reasonableness of profits derived by the tax holiday unit
Compliance requirements	Maintenance of transfer pricing documentation and furnishing of Accountants Report (in Form no. 3CEB) to the tax authorities	No specific compliance requirement
Reporting requirements	Form no. 10CCB reporting; and Reporting transactions in the Accountant's Report	Form no. 10CCB reporting

7. Transfer Pricing Analysis of Every SDT and Documentation

As a result of entering into SDTs with related parties, a taxpayer will be required to maintain robust documentation to demonstrate that such transactions have been carried out having regard to the arm's length price. The SDTs were previously reported by taxpayers vide tax audit reports and the onus was on the revenue authorities to test whether the transactions were carried out at FMV. However, since there is a shift of emphasis from the FMV concept to the ALP concept, it is imperative to follow the transfer pricing provisions contained in the Chapter X to comply with the provisions in case the domestic transactions are SDTs. Accordingly, all of the documentation requirements equally apply to SDTs as they do for international transactions amongst associated enterprises. This study material contains other

sections which cover a detailed discussion relating to functional, comparability and benchmarking analysis and documentation and hence only a brief overview is provided in relation to the documentation and compliance requirements under domestic transfer pricing provisions.

Snapshot of contents of Transfer Pricing Documentation u/s 92D and Rule 10D:



- Contemporaneous documentation requirement – Rule 10D
- Documentation to be retained for 8 years from the end of relevant assessment year

No specific documentation requirement if the value of international transactions/Specified Domestic Transaction is less than one crore

8. Obtaining a report from an accountant in a prescribed manner, and furnishing the same to the tax department⁸

It is mandatory for all taxpayers to obtain an independent accountant's report prescribed in the Form no. 3CEB in respect of all SDTs. Such report has to be furnished on or before the specified date. The form requires the accountant to give an opinion on maintenance of proper information and prescribed documents by the taxpayer. The accountant is required to certify the correctness of an extensive list of prescribed particulars.

8.1. Burden of proof:

The initial burden of proving the arm's length nature of a transaction primarily lies with the taxpayer. Subsequently, the onus shifts to the tax authorities to provide reasons for rejection of the results documented by the taxpayer.

9. Other Relevant Aspects / Provisions

9.1 Transfer pricing assessment:

Although a threshold of aggregate value of domestic transactions to be termed as SDTs has been prescribed (INR 20 crores), no such limit is prescribed for compulsory scrutiny in case of SDTs.

Where the value of domestic transactions is below INR 20 crores, the assessing officer can test the transactions having regard to FMV. However, if it exceeds INR 20 crores the transfer pricing assessment procedure as per Section 92CA of the Act will apply. A separate section of this study material contains a detailed discussion in relation to transfer pricing assessments.

9.2 Penal Consequences:

Like all other procedural provisions even the penal consequences in connection with SDTs are same as that of the international transactions. Following is the snapshot of penalties

⁸ This has been elaborately discussed in "Guidance Note on Report Under Section 92E of The Income Tax Act, 1961" by ICAI

applicable in case of various defaults:

Section	Penalty type	Quantum of penalty
271AA	Failure to maintain prescribed information / documentation	2% of transaction value
	Failure to report a transaction	
	Furnishing of incorrect information	
271G	Failure to furnish information / documents during assessment	2% of transaction value
271(1)(c) ⁹	Adjustment to income during the assessment	100% to 300% of tax sought to be evaded
270A ¹⁰	Under reporting and misreporting of income	When the under-reporting is not because of mis-reporting, the penalty would be 50 % of tax payable on the under-reported income.
		When the under-reporting of income is because of mis-reporting, the penalty would be 200% of the tax payable on the under-reported income.
271BA	Failure to furnish accountant's report u/s/ 92E of the Act	INR 100,000

In addition to the above, taxable income enhanced as a result of SDT adjustment, does not qualify for various tax holidays / concessions.

10. Conclusion

The Domestic Transfer Pricing provisions have ramifications across industries which benefit from the preferential tax policies such as SEZ units, infrastructure developers or operators of telecom services, industrial park developers, power generation or transmission etc. Apart from this, business conglomerates having significant intra-group dealing are largely impacted.

Internationally, the concept of domestic transfer pricing is not new as countries such as UK, Australia, Russia, etc. already have domestic transfer pricing provisions as part of their local legislation. Since the transfer pricing legislation in India has matured over the period of time, it will be relatively easier for the tax authorities to administer the inclusion of domestic transfer pricing provisions along with well-established cross-border transfer pricing regulations.

⁹ Not applicable from AY 2017-18 onwards

¹⁰ Applicable from AY 2017-18 onwards

7.18 International Tax — Transfer Pricing

Endnote: Supreme Court Judgment that set stage for the domestic transfer pricing law in India:

'CIT v. Glaxo Smithkline Asia Private Limited [2010] 195 Taxmann 35 (SC) - Relevant portion reproduced. (Contains Hon'ble Supreme Court's views in relation to domestic transfer pricing): -

'...The main issue which needs to be addressed is, whether Transfer Pricing Regulations should be limited to cross-border transactions or whether the Transfer Pricing Regulations be extended to domestic transactions? In the case of domestic transactions, the under-invoicing of sales and over-invoicing of expenses ordinarily will be revenue neutral in nature, except in two circumstances having tax arbitrage—

[i] If one of the related Companies is loss making and the other is profit making and profit is shifted to the loss making concern; and

[ii] If there are different rates for two related units [on account of different status, area based incentives, nature of activity, etc.] and if profit is diverted towards the unit on the lower side of tax arbitrage. For example, sale of goods or services from non-SEZ area [taxable division] to SEZ unit [non-taxable unit] at a price below the market price so that taxable division will have less profit taxable and non-taxable division will have a higher profit exemption.

All these complications arise in cases where fair market value is required to be assigned to the transactions between related parties in terms of Section 40A(2) of the Income Tax Act, 1961 ['Act', for short]. To get over this situation, we are of the view that the matter needs to be examined by Central Board of Direct Taxes ['CBDT', for short]. We are informed that the matter has been examined by CBDT and it is of the view that amendments would be required to the provisions of the Act if such Transfer Pricing Regulations are required to be applied to domestic transactions between related parties under Section 40A(2) of the Act.

In order to reduce litigation, we are of the view that certain provisions of the Act, like Section 40A(2) and Section 80IA(10), need to be amended empowering the Assessing Officer to make adjustments to the income declared by the assessee having regard to the fair market value of the transactions between the related parties. The Assessing Officer may thereafter apply any of the generally accepted methods of determination of arm's length price, including the methods provided under Transfer Pricing Regulations. However, in number of matters, we find that, many a times, the Assessing Officer is constrained by non-maintenance of relevant documents by the taxpayers as, currently, there is no specific requirement for maintenance of documents or getting specific transfer pricing audit done by the taxpayers in respect of domestic transactions between the related parties. One of the suggestions which needs consideration is whether the law should be amended to make it compulsory for the taxpayer to maintain Books of Accounts and other documents on the lines prescribed under Rule 10D of the Income - Tax Rules in respect of such domestic transactions and whether the taxpayer should obtain an audit report from his Chartered Accountant so that the taxpayer maintains proper documents and requisite Books of Accounts reflecting the transactions between related entities as at arm's length price based on generally accepted methods specified under the Transfer Pricing Regulations? Normally, this Court does not make recommendations or suggestions. However, as stated above, in order to reduce litigation occurring in complicated matters, we are of the view that the question of amendment, as indicated above, may require consideration expeditiously by the Ministry of Finance. In the meantime, CBDT may also consider issuing appropriate instructions in that regard. Accordingly, we direct the Registry to forward copies of this Order both to the Ministry of Finance and CBDT for consideration.'

Module H

Transfer Pricing Assessment Procedure in India

Assessment/Audit is an integral part of entire transfer pricing process for a MNE group. Transfer pricing analysis is conducted to ensure that there is an arm's length allocation of profit/Revenue between the group entities.

The transfer pricing analysis conducted by an entity (including documentation) is put to test during a transfer pricing audit. A transfer pricing officer would normally examine the international transactions following domestic transfer pricing regulations, clarifications issued by the Income Tax Department from time to time, and take guidance from OECD/UN Manuals on transfer pricing, apart from international practices followed.

Considering the fact that transfer pricing analysis tend to be subjective and may have more than one accurate solution disputes arise between taxpayers and tax authorities and in such cases, recourse is taken to higher appellate authorities. Appellate process in India is long drawn and takes considerable amount of time and effort. Consequently, taxpayers look for alternate dispute resolution mechanism such as Advance Pricing Agreement and Safe Harbour scheme.

During the assessment/audit process initially the TPO, generally calls for and examines the following:

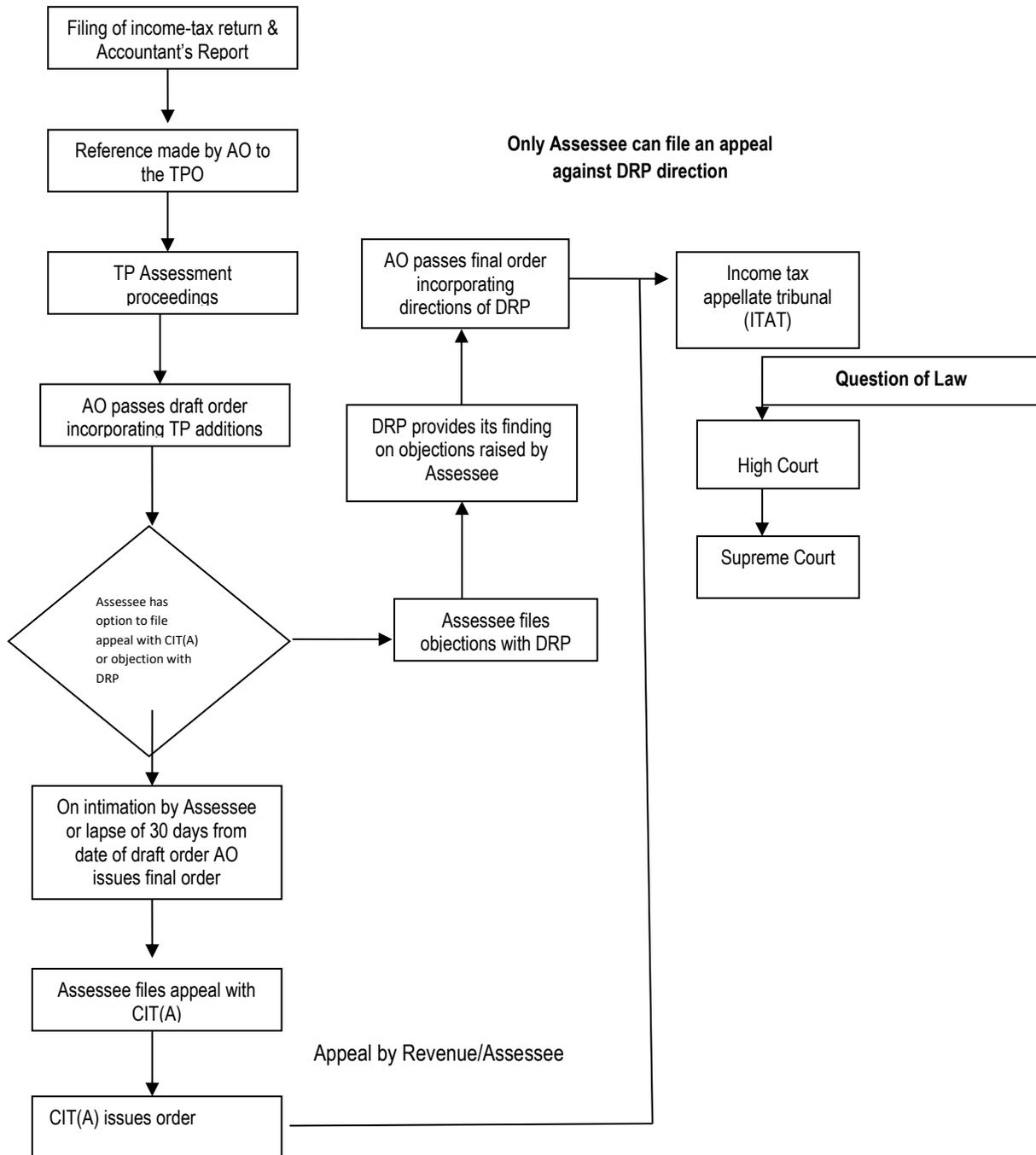
1. TP Report;
2. Agreements;
3. Facts concerning functions, assets and risks associated with international transactions / Specified Domestic Transaction;
4. Explanation for entering into a transaction with AE,
5. Documentary evidence supporting the value of international transactions / specified domestic transactions
6. If there has been any adjustment in the earlier years, then a note on the same highlighting why the same adjustment should not be made during the concerned year?

Based on the information and explanations provided by the taxpayer with respect to international transactions further information/ clarification may be called for by the transfer pricing officer either at the time of personal hearing or by issuing a follow up letter/ notice.

As the facts regarding transactions are better known to taxpayers, a comprehensive and complete response are expected by the tax department.

8.2 International Tax — Transfer Pricing

A typical audit process in India is depicted as below:



The time limit for transfer pricing assessment has been reduced to 33 months vide Finance Act, 2016. This time limit is further reduced to 30 months and 24 months in respect of an order

of assessment relating to the assessment year commencing on 1st April 2018 and 1st April 2019 respectively.¹

The time limit for completion of TP assessment for the respective years is given in the table below:

Particulars	Due Date
AY 2018-19	60 days before 30 th September, 2021
AY 2019-20	60 days before 31 st March, 2022
AY 2020-21	60 days before 30 th September 2023 ²
AY 2021-22	60 days before 31 st December, 2023

Reference to Transfer Pricing Officer

Section 92CA of the Act provides for provisions pertaining to reference to be made to the Transfer Pricing Officer.

The Central Government, in its endeavour to eliminate face-to-face interaction between taxpayers and Tax Officers notified Faceless Assessment Scheme, 2019 ('FAS', earlier referred to as 'E-Assessment Scheme, 2019') in September 2019. Under this scheme, the provisions of Section 92CA and section 144C of the Act were to apply to the assessment made in accordance with the FAS. After this first notification, there were several notifications and orders that were issued by the Income-tax Department, Government of India with respect to the FAS.

It may be noted that as per the Taxation and Other Laws (Relaxation and Amendment of Certain Provisions) Act, 2020 (TOL Act) enacted on 29th September 2020, Sections 92CA and 144C of the Act were amended to specifically include the scheme of faceless assessment therein. In addition, vide the TOL Act, a new section 144B on 'Faceless Assessment' was also introduced, to be effective from 1st April 2021, which inter alia includes assessments undertaken through the DRP route.

Thus, it is evident that Transfer Pricing assessments and DRP proceedings statutorily fall within the scope of the FAS. Further, on or after 1st November 2020, the Central Government is meant to notify a scheme for conducting Transfer Pricing assessments (section 92CA of the Act) under the FAS and also issue directions thereof (not later than 31st March 2024).

¹ Further, in view of the challenges faced by taxpayers in meeting the statutory and regulatory compliance requirements across sectors due to the outbreak of COVID-19, the CBDT had issued a Notification (No. 35 of 2020) on 24th June, 2020 and a press release to further extend time limit for completion of assessments for AY 2017-18 till 31st March 2021 and therefore, Transfer Pricing assessments for AY 2017-18 was to be completed 60 days before 31st March 2021.

² Amended vide Finance Act, 2022

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Therefore, the implementation of faceless Transfer Pricing assessments / DRP proceedings is subject to a scheme and directions thereof being notified by the Central Government, under sub-sections (8) and (9), respectively, of section 92CA of the Act and under sub-sections (14B) and (14C), respectively, of section 144C of the Act.

Since scheme/ directions for Transfer Pricing assessment/DRP processes have been shifted to 2024, Transfer Pricing assessments / DRP proceedings are meant to be conducted as before, i.e., not as faceless assessments and this may continue to be so, until the aforesaid scheme/ directions are notified.

The provisions relating to the reference to be made to the Transfer Pricing Officer along with the amendments made under Section 92CA of the Act are as follows:

- (1) Where any person, being the assessee, has entered into an international transaction or specified domestic transaction in any previous year, and the Assessing Officer considers it necessary or expedient so to do, he may, with the previous approval of the Principal Commissioner or Commissioner, refer the computation of the arm's length price in relation to the said international transaction or specified domestic transaction under Section 92C of the Act to the Transfer Pricing Officer. The CBDT issued instruction no. 3/2016 wherein it prescribed additional mandatory criterion to select cases for TP scrutiny and clarified role of AO/TPO. These have been discussed later in this document. Herein, it may be noted that in view of the guidelines issued by the CBDT in Instruction 3/2003 is mandatory for the AO to make a reference to the TPO as has been held by Hon'ble Supreme court in case of M/s. S.G. Asia Holdings (India) Pvt. Ltd. (Civil Appeal No. 6144 of 2019). Further, due to changes in number of legislative, procedural and structural changes, the Instruction 3/2003 was replaced with Instruction 15/2015, dated 16th October 2015. Furthermore, based on the suggestions and representations made by various stakeholders from time to time, the Instruction 15/2016 was further replaced with Instruction 3/2016.
- (2) Where a reference is made under sub-section (1), the Transfer Pricing Officer shall serve a notice on the assessee requiring him to produce or cause to be produced on a date to be specified therein, any evidence on which the assessee may rely in support of the computation made by him of the arm's length price in relation to the international transaction or specified domestic transaction referred to in sub-section (1).
- (2A) Where any other international transaction other than an international transaction referred under sub-section (1), comes to the notice of the Transfer Pricing Officer during the course of the proceedings before him, the provisions of this Chapter shall apply as if such other international transaction is an international transaction referred to him under sub-section (1).

- (2B) Where in respect of an international transaction, the assessee has not furnished the report under Section 92E of the Act and such transaction comes to the notice of the Transfer Pricing Officer during the course of the proceeding before him, the provisions of this Chapter shall apply as if such transaction is an international transaction referred to him under sub-section (1).
- (2C) Nothing contained in sub-section (2B) shall empower the Assessing Officer either to assess or reassess under Section 147 of the Act or pass an order enhancing the assessment or reducing a refund already made or otherwise increasing the liability of the assessee under Section 154 of the Act, for any assessment year, proceedings for which have been completed before the 1st day of July, 2012.
- (3) On the date specified in the notice under sub-section (2), or as soon thereafter as may be, after hearing such evidence as the assessee may produce, including any information or documents referred to in sub-section (3) of Section 92D of the Act and after considering such evidence as the Transfer Pricing Officer may require on any specified points and after taking into account all relevant materials which he has gathered, the Transfer Pricing Officer shall, by order in writing, determine the arm's length price in relation to the international transaction or specified domestic transaction in accordance with sub-section (3) of Section 92C of the Act and send a copy of his order to the Assessing Officer and to the assessee.
- (3A) Where a reference was made under sub-section (1) before the 1st day of June, 2007 but the order under sub-section (3) has not been made by the Transfer Pricing Officer before the said date, or a reference under sub-section (1) is made on or after the 1st day of June, 2007, an order under sub-section (3) may be made at any time before sixty days prior to the date on which the period of limitation referred to in Section 153 of the Act, or as the case may be, in Section 153B of the Act for making the order of assessment or reassessment or re-computation or fresh assessment, as the case may be, expires:

Provided that in the circumstances referred to in clause (ii) or clause (x) of Explanation 1 to Section 153 of the Act, if the period of limitation available to the Transfer Pricing Officer for making an order is less than sixty days, such remaining period shall be extended to sixty days and the aforesaid period of limitation shall be deemed to have been extended accordingly.
- (4) On receipt of the order under sub-section (3), the Assessing Officer shall proceed to compute the total income of the assessee under sub-section (4) of Section 92C of the Act in conformity with the arm's length price as so determined by the Transfer Pricing Officer.
- (5) With a view to rectifying any mistake apparent from the record, the Transfer Pricing Officer may amend any order passed by him under sub-section (3), and the provisions of Section 154 of the Act shall, so far as may be, apply accordingly.

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- (6) Where any amendment is made by the Transfer Pricing Officer under sub-section (5), he shall send a copy of his order to the Assessing Officer who shall thereafter proceed to amend the order of assessment in conformity with such order of the Transfer Pricing Officer.
- (7) The Transfer Pricing Officer may, for the purposes of determining the arm's length price under this section, exercise all or any of the powers specified in clauses (a) to (d) of sub-section (1) of section 131 or sub-section (6) of Section 133 or Section 133A of the Act.
- (8) The Central Government may make a scheme, by notification in the Official Gazette, for the purposes of determination of the arm's length price under sub-section (3), so as to impart greater efficiency, transparency and accountability by—
- (a) eliminating the interface between the Transfer Pricing Officer and the assessee or any other person to the extent technologically feasible;
 - (b) optimizing utilisation of the resources through economies of scale and functional specialisation;
 - (c) introducing a team-based determination of arm's length price with dynamic jurisdiction.
- (9) The Central Government may, for the purpose of giving effect to the scheme made under sub-section (8), by notification in the Official Gazette, direct that any of the provisions of this Act shall not apply or shall apply with such exceptions, modifications and adaptations as may be specified in the notification:

Provided that no direction shall be issued after the 31st day of March, 2024.

- (10) Every notification issued under sub-section (8) and sub-section (9) shall, as soon as may be after the notification is issued, be laid before each House of Parliament.]

Explanation.— For the purposes of this section, "Transfer Pricing Officer" means a Joint Commissioner or Deputy Commissioner or Assistant Commissioner authorised by the Board to perform all or any of the functions of an Assessing Officer specified in Sections 92C and 92D in respect of any person or class of persons.

The Central Board of Direct Taxes ("CBDT") has issued guidelines [F.No.225/81/2022/ITA-II] for compulsory selection of returns for complete scrutiny during Financial Year ("FY") 2022-23 and related procedure to be followed in this regard.

Apart from the regular parameters like survey cases, search & seizure cases, reassessment cases and cases relating to registration/ approvals under various sections of the Income-tax Act, 1961 ("the Act"), CBDT has added the following additional criteria for compulsory

selection of returns for complete scrutiny for FY 2022-23 which would be relevant for transfer pricing assessee':

Criteria	Parameter	Procedure for compulsory selection
Cases involving addition in an earlier assessment year(s) on a recurring issue of law or fact and/or law and fact	<p>Where the addition in an earlier assessment year(s) on a recurring issue of law or fact and/or law and fact (including transfer pricing issue) is:</p> <p>a. Exceeding Rs.25L in eight metro charges at Ahmedabad, Bengaluru, Chennai, Delhi, Hyderabad, Kolkata, Mumbai and Pune;</p> <p>b. Exceeding Rs.10L in charges other than eight metro charges;</p> <p>And where such an addition:</p> <p>1. Has become final, as no further appeal has been preferred against the assessment order; or</p> <p>2. Has been upheld by the Appellate Authorities in favour of Revenue; even if further appeal of assessee is pending, against such order.</p>	<p>The Assessing Officer shall prepare a list of cases falling under this parameter with prior administrative approval of Pr.CIT/Pr.DIT/CIT/DIT concerned.</p> <p>The list of such cases shall be submitted by the Pr.CIT/Pr.DIT/CIT/DIT to the Pr.CCIT concerned for onward transmission to NaFAC with a copy marked to DGIT (Systems).</p> <p>Notice u/s 143(2) of the Act shall be served on the assessee through NaFAC.</p>

Further, CBDT has stated that selection and transfer of cases to NaFAC, wherein assessments have to be completed in faceless manner, shall be completed positively by May 31, 2022. In cases selected for compulsory scrutiny, service of notice u/s 143(2) shall be completed by June 30, 2022, in line with Finance Act 2021 amendments [which reduced the time limit for service of notice u/s 143(2) to 3 months from the end of the FY in which the return is filed]. Further, the various dispute resolution mechanism forums and the relevant process has been explained in 4.2 of Module F.

Glossary

Associated Enterprise (AE)	Associated Enterprise as per the provisions of Income-tax Act, 1961
ALP	Arm's Length Price
AMP	Advertising, Marketing and Promotion
AO	Assessing Officer
Advance Pricing Agreement (APA)	Advance Pricing Agreement is a procedure to settle Transfer pricing issues by the taxpayer by negotiating with the competent revenue authorities for determination of 'arm length price' as per applicable transfer pricing methods before entering into a transaction(s).
Advance Ruling	To save the taxpayer from being saddled with uncertainty, an Authority for Advance Ruling has been set up which gives 'Advance Ruling' on Income Tax matters pertaining to an investment venture in India , in advance which are binding in nature.
Ambulatory Interpretation	It means interpretation of the Tax Treaty by the contracting States as per their respective tax laws prevalent at the time the treaty is being applied.
Base erosion and Profit Shifting (BEPS)	It refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to tax haven jurisdictions when there is no or insignificant economic activity to reduce corporate tax liabilities.
CBDT	The Central Board of Direct Taxes
CCA	Cost Contribution Arrangements
CFA	Committee of Fiscal Affairs
CIT (A)	Commissioner of Income Tax (Appeals)
CPM	Cost Plus Method
COGS	Cost of Goods Sold
CUP	Comparable Uncontrolled Price
CUT	Comparable Uncontrolled Transaction
Capital Export Neutrality	The principle that investors should pay equivalent taxes on capital income, regardless of the country in which the income is earned.

Capital Import Neutrality	The principle that all investments within a country should face the same tax burden regardless of the residential status of the investor.
Consolidated Tax Regime	Consolidated Tax Regime is a system which treats a group of wholly owned or majority-owned companies and other entities (such as trusts and partnerships) as a single entity for tax purposes. Head entity of the group is responsible for all or most of the group's tax obligations.
Controlled Foreign Company (CFC)	A controlled foreign company is a corporate entity that is registered and conducts business in a different jurisdiction or country than the residency of the controlling owners.
DGIT	Director General of Income Tax
DRP	Dispute Resolution Panel
DTA	Domestic Tariff Area
Distributive rule	The basic purpose of Distributive clause in Tax Treaties is to lay down principles on which basis will be decided the right of the jurisdiction to levy tax.
Double Non Taxation	It is a situation where an income is not taxed in either of the contracting states to a treaty by virtue of the right to tax being given to one state and the income being exempt in that state.
Double Taxation	Double taxation is the levying of tax by two or more jurisdictions on the same income, asset, or financial transaction, as the case may be.
Double Tax Avoidance Agreement (DTAA)	A Double Tax Avoidance Agreement (DTAA) is essentially a bilateral agreement entered into between two countries, whose basic objective is to promote and foster economic trade and investment between them by avoiding double taxation.
Dual Residence	It is possible to be resident for tax purposes in more than one country at the same time. This is known as dual residence.
Dualist view	Dualists view emphasizes the difference between national and international law, and require the translation of the latter into the former. DTAA becomes part of the National Legal system by specific incorporation / legislation in case of Dualistic View. Accordingly International law has to be national law as well, or it is no law at all.
EBITDA	Earnings before Interest, Tax, Depreciation and Amortization
EUJTPF	European Union Joint Transfer Pricing Forum
Economic and Juridical Double Taxation	Double taxation is juridical when the same person is taxed twice on the same income by more than one state. Double

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	taxation is economic if more than one person is taxed on the same item.
Entry into force	Entry into Force is the effective date from which the provisions of various bilateral Tax Treaties will come into force as per applicable OECD, UN or US Model Tax conventions.
Exemption with progression method	It means income earned in the source Country, though considered as exempt, is included in total income in the Country of residence for purpose of determining effective tax rate.
FAR	Functions, Assets and Risk
Fiscal Residency	Fiscal Residency, also known as Tax Residence is a test determining status of Residence of a person (including Companies) for the purpose of levy of tax in a state depending on domicile, place of management, close connection, etc. A person can be Fiscal Resident of two states at the same time wherein Tie-Breaker rules need to be applied.
Force of Attraction Rule	It implies that if a Foreign Enterprise sets up a Permanent Enterprise in Source state, all income derived by the foreign enterprise whether through PE or not will be taxable in source state.
Host Country	The country where source of income is situated is known as Host country.
IGS	Intra-Group Services
ITAT/ the tribunal	Income Tax Appellate Tribunal
Instrument of Ratification	Instrument of Ratification refers to a notification issued by a state to its counterpart state that it has made necessary changes in its local laws pursuant to the treaty.
International Offshore Financial Centres (IOFCs)	International Offshore Financial Centres are those tax jurisdictions where bulk of financial sector activities are of non residents. It is characterized by large number of financial institutions majority of whose ownership is with non-residents not opened to meet local needs but because of tax havens, secrecy and anonymity.
Last Better Offer Approach	It is the approach which is used in the Arbitration process to moderate the position of the negotiators so that the likeliness of its acceptance increases.
MAM	Most Appropriate Method
MNEs	Multinational Enterprises

Monist View	Monists view accept that the internal and international legal systems form a unity. International Law and National Law are part of the same system of Law and thus DTAA overrides domestic law.
Most Favoured Nation (MFN)	MFN clause is usually found in Protocols and Exchange of Notes to DTCs. This clause helps in avoiding discrimination amongst residents of different countries. Once this clause is part of a treaty, the residents of contracting states get equal treatment as was earlier given to resident of other states.
Mutual Agreement Procedure (MAP)	The process of resolution of tax disputes arising between contracting States (of a tax treaty) by the competent authorities thereof.
Non Discrimination Clause	It is a clause found in many Tax Treaties whose aim is to ensure that there is no discrimination between the local assesseees and foreign assesseees as far as taxation is concerned.
OECD	Organisation for Economic Cooperation and Development
OECD Model Convention	OECD Model Tax Convention of Income and Capital
OECD TP Guidelines	OECD Transfer Pricing guidelines for Multinational Enterprise and Tax Administration
Pr. CCIT	Principal Chief Commissioner of Income Tax
PLI	Profit-Level Indicator
PSM	Profit Split Method
Permanent Establishment (PE)	A permanent establishment is a fixed place of business which generally gives rise to income in a particular jurisdiction. The term is defined in many income tax treaties. It is a fixed place of business through which the business of an enterprise is wholly or partly carried on.
Protocol	A protocol in essence is a Treaty entered into between two countries at a later point of time, which nevertheless forms an essential part of the Tax Treaty and can be referred to while applying the earlier treaty entered into between the countries.
R & D	Research and Development
RPM	Resale Price Method
RPT	Related Party Transaction
Ring Fencing	It means to financially separate a company from its parent

G.5 International Tax — Transfer Pricing

	company to make it immune from Financial ups and downs of parent company.
Round Tripping	Round tripping is where money is routed back into the country by local investors through tax havens. The income is sourced in the same country where the shareholder is resident but the income passes through a company resident in another country for tax reasons.
SWOT	Strengths, Weaknesses, Opportunities and Threats
Specific Anti Avoidance Rules (SAAR)	Specific Anti Avoidance Rules are provisions that identify with precision the type of transactions to be dealt with and prescribe against the tax consequences of such treatment.
Safe harbor rules	Safe Harbor rules are those which when followed for certain international transactions, relieve the taxpayer of much complications as arm length price declared by him under transfer pricing will be accepted by tax authorities.
Shell/ Conduit company	Conduit Company is a company which is set up in connection with a tax avoidance scheme. Whereby income is paid by a company to the conduit and then redistributed by that company to its shareholders as dividends, interest, royalties, etc.
Stateless person	A person who is not considered as a 'national' by any State under the operations of its law.
Static Interpretation	It means interpretation of the Tax Treaty by the contracting States as per their respective tax laws prevalent at the time of signing of treaty.
Switch over clause	It is a clause in a Tax Treaty to facilitate switching over by a taxpayer for foreign tax credit from exemption method to the credit method essentially to avoid Double Non Taxation.
the Act/ Act	The Income Tax Act, 1961
TPR	Transfer Pricing Regulations
TPO	Transfer Pricing Officer
TNMM	Transactional Net Margin Method
Tax Equity	It implies that Each country whether being a country of Residence or a country of source must be entitled to its fair share of revenue. Also, taxpayers involved in cross border transactions must neither be saddled with additional levy of tax nor be given any undue concessions which results in discrimination.

Tax Information Exchange Agreement	Tax Information Exchange Agreement is a bilateral or multilateral agreement which gives legal authority to the contracting states to exchange tax related information by tax jurisdictions with the counterparts which was otherwise not possible.
Tax Inversion	Tax inversion means relocation of a company's legal domicile to a lower - tax nation, usually while retaining its material operations in its higher-tax country of origin.
Tax Residency Certificate (TRC)	It is a certificate issued by the government of a state to which a person belongs containing certain details concerning his or her residential status for claiming the benefit of any Tax Treaty in source state.
Tax Sparing Clause	Under the Tax sparing clause there is a provision where a country applies a tax credit against taxes owed on foreign income which is equivalent to the tax exemption provided by the foreign country.
Tax Terrorism	A situation where tax officials take undue advantage of powers conferred upon them for discharging their functions.
Tax Treaty	Government – to - Government agreement to prevent Double Taxation and Tax evasion by the resident of one country earning an income in the other.
Thin Capitalisation	A company is said to be thinly capitalised when its capital is made up of a much greater proportion of debt than equity, i.e. its gearing, or leverage, is too high. Also, the debt portion is financed by the parent co. and the purpose is to minimise tax expenses and nothing else.
Tie-Breaker Test	It is a test which is used to determine the predominance situation in cases where a person becomes fiscal resident in both the contracting states under a treaty.
Transfer Pricing (TP)	Transfer pricing refers to pricing the goods and services sold between associated and/ or controlled and/ or related legal entities within a group. It is the setting of the price for goods and services sold between controlled (or related) legal entities.
Treaty Shopping	The practice of structuring a multinational business to take advantage of more favourable tax treaties available in certain jurisdictions. For eg. a situation where a person, who is resident in one country (say the “home” country) and who earns income or capital gains from another country (say the “source” country), is able to benefit from a tax treaty between the source country and yet another country (say the “third” country).

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Triangular Taxation	Triangular Taxation refers to a situation where tax incidence on a particular stream of income is typically triggered in three countries. Eg: A company resident of country A sets up a branch in country B which has some economic transactions generating income in country C.
UN TP Manual	United Nations Practical Manual on Transfer Pricing for Developing Countries
Underlying Tax Credits	A method employed by a home country to provide fiscal incentives for outbound investments by home-based multinational companies in which the total tax cost on foreign dividends is capped at the level of the home country's corporate tax rate.
Unilateral (Tax) relief	It refers to the relief scheme which can be provided to the tax payer by home country irrespective of whether it has any agreement with other countries or has otherwise provided for any relief at all in respect of double taxation. The purpose is to eliminate cascading effect of double Taxation.