VIRTUAL COACHING CLASSES
ORGANISED BY BOS, ICAI

FINAL LEVEL
PAPER 7: DIRECT TAX LAWS & INTERNATIONAL TAXATION

Transfer Pricing
Faculty: Mr Sudarshan Rangan

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Warm-up

- TP
- ALP
- AEs
- APA
- SHR
- TPO
- MAM
- DRP
- CbCR
Session 1 – Agenda

• Introduction
• What is TP?
• Why TP?
• Legislative Framework – Indian Income Tax Law
• ALP
• International Transactions
• Associated Enterprises
• Thin Capitalization
Objectives

- You should be able to discuss and explain the
  - Fundamentals of Transfer Pricing from a tax perspective.
  - Indian legal framework on TP
  - Thin Capitalization
Setting the tone
What is Common?

LG  Coca-Cola  Infosys
TATA  HYUNDAI  Nestlé
Why MNEs?

- Theory of Firm (to maximize profits)
- Doing business in another country
- Transaction Costs
- Also litigation cost
- When will you set up an entity in another country?
- Economies of Scale - Firms’ costs of production are less than the costs of outsourcing the production.
- Minimize cost through integration of economies
- Jargons - Supply Chain, Value Chain etc.
Common Features

- Common Control
- Common Goals
- Common Resources
- Fully integrated
- MNE in-house to Outsourcing (where there is no competitive advantage)
- Different Organizational Structure
  - Functional Structure
  - Divisional Structure
  - Matrix Structure

- Eg: Group A- Country 1 – R&D, Co2- Manufacturer, Co 3- Marketing
- Intra-group trade more than 30% of all international transactions.
What is Transfer Pricing?

• Transfer pricing is the general term for the “pricing of cross-border, intra-firm transactions between related parties”.

• In business economics a transfer price is considered to be the amount that is charged by a part or segment of an organization for a product, asset or service that it supplies to another part or segment of the same organization.

• Transfer pricing therefore refers
  ◦ to the setting of prices for transactions
  ◦ between associated enterprises
  ◦ involving the transfer of property or services.
Transfer Pricing and Tax
Transfer pricing & Tax

- The OECD defines “Transfer Pricing” as the pricing at which an Enterprise transfers physical goods and intangible goods and provides services to Associated Enterprises.

- Transfer Pricing refers to pricing of international transactions between two or more associated enterprises (AEs).

- Due to special relationship between related parties, transfer price may be different than the price that would have been agreed between unrelated parties – Controlled Transaction.

- A price between unrelated parties is known as the “arm’s length” price.
International transactions:
- goods
- services
- intangibles
- loans

Transfer price

Arm’s length price
Example - TP

Manufacturer Profit = INR 1000 – INR 200 = INR 800

Profit of Distributor
INR 4000 – INR 1000 = INR 3000

Overall Group Profit: INR 800 + INR 3000 = INR 3800
Example – Arm’s Length Principle

Raw Materials → Manufacturing

Manufacturer Profit = INR 2000 – INR 200 = **INR 1800**

Finished Product

INR 1000 (TP adjustment)

Profit of Distributor

INR 4000 – INR 1000 = **INR 3000**

Customers

INR 4000

Overall Group Profit: INR 1800 + INR 3000 = **INR 4800**
Transfer Pricing Issues

**TAXPAYER**
- Global structures – so sharing of costs /overheads.
- Economic Double Taxation
- Obtain Tax Arbitrage and reduce MNE’s effective tax cost.
- Different countries different tax rates and tax policies.
- Tax certainty is missing

**TAX ADMINISTRATION**
- Both Governments want to tax.
- Tax Avoidance- Profit Shifting Strategies.
- Protecting tax base
- Cross-border trade is essential.
- TP for developing and low-developing economies- Revenue loss.
BEPS – Profit Shifting – TP Main Factor
Legislative Framework
Before going into the Act – Treaty

• Article 9 of Tax Treaties (Refer OECD MC/UN MC)

• Treaties does not create taxing rights. They are only shield and not ‘sword’.

• Provides for pricings and adjustments.

• How to determine them is left to domestic law.
## Income Tax Act – Overview of Sections

### Chapter X – Special Provisions Relating to Avoidance of Tax

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## Income Tax Act – Overview of Sections

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### Other Anti Avoidance Provisions

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<th>Section</th>
<th>Description</th>
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<td>93</td>
<td>Avoidance of Income Tax by transactions resulting in transfer of income of non-residents</td>
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<td>94A</td>
<td>Base Erosion Payment - Certain Notified Jurisdiction</td>
</tr>
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<td>94B</td>
<td>Thin Capitalization</td>
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</table>
Transfer Pricing in India - Background

- Prior to April 1, 2001
  - Basic provisions (Section 92 etc) existed but were rarely applied
  - Expert Group set up in November 1999 to study global transfer pricing practices (impact of liberalization)

- Finance Act 2001 wef April 1, 2002 (AY 2002-03) onwards
  - Comprehensive legislation introduced in Union Budget 2001
  - Detailed Rules providing guidance for application of the legislation framed
Transfer Pricing in India - Background

- Finance Minister speech excerpt:

“The presence of multinational enterprises in India and their ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions has made the issue of transfer pricing a matter of serious concern. I had set up an Expert Group in November 1999 to examine the issues relating to transfer pricing. Their report has been received, proposing a detailed structure for transfer pricing legislation. Necessary legislative changes are being made in the Finance Bill based on these recommendations.”

(Mr. Yashwant Sinha, Finance Minister, February 28, 2001)
Applicability

• Section 92(1) —
  
  • Any income arising from an international transaction shall be computed having regard to the arm’s length price

  Explanation - the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arm’s length price

• Delineating:
  
  • There must be some “income arising”;
  
  • Such income must arise “from” an “international transaction”;
  
  • Such income “shall “be computed having regard to the “arm’s length price”.
Applicability

Section 92(3) -

The provisions are not intended to be applied in case determination of arm’s length price reduces the income chargeable to tax or increases the loss as the case may be.

Example:

i) ABC India had borrowed loan from its parent ABC Germany for at an interest rate of 4%. While benchmarking the interest transaction, ABC India found out that similar rate of interest charged by an uncontrolled enterprise is 8% and hence in this regard, sought to increase the expense to this effect and reduce its total income.
International transaction (Section 92B)

• Transactions between two or more associated enterprises, either or both of whom are non-residents

• Associated Enterprises – Section 92A
Meaning of Associated enterprises – 92A(1)

Direct or indirect participation (through one or more intermediaries) in management, control or capital.

Both A and B are associated enterprises of C

D and E are also associated enterprises of C since they have a common ultimate parent (A)
Deemed Associated enterprises (Section 92A(2))

<table>
<thead>
<tr>
<th>Equity Holding</th>
<th>Management</th>
<th>Activities/Commercial</th>
<th>Control</th>
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<tbody>
<tr>
<td>a)  ( &gt;= 26% ) direct / indirect holding by enterprise</td>
<td>f) Appointment &gt; 50% of Directors / one or more Executive Director by an enterprise OR</td>
<td>g) 100% dependence on use of intangibles for manufacture / processing / business</td>
<td>j) One enterprise controlled by an individual and the other by himself or his relative or jointly</td>
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<tr>
<td>b) By the same person in each of the enterprise</td>
<td>ii) Appointment by same person in each enterprise</td>
<td>h) Direct / indirect supply of ( &gt;= 90% ) Raw Materials under influenced prices and conditions</td>
<td>k) One enterprise controlled by HUF and the other by itself, a member or his relative or jointly</td>
</tr>
<tr>
<td>c) Loan ( &gt;= 51% ) of Total Assets</td>
<td></td>
<td>i) Sale under influenced prices and conditions</td>
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<tr>
<td>d) Guarantees ( &gt;= 10% ) of debt</td>
<td></td>
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<tr>
<td>e) ( &gt; 10% ) interest in Firm / AOP / BOI</td>
<td></td>
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</tbody>
</table>
Practice

1) Substantial Voting Power-
What If B Ltd holds 40% of preference shares with no voting power?

2) Appointment of BOD/ Executive Director-
There are 10 directors in both B Ltd and C Ltd. A Ltd by virtue of an agreement between B Ltd and C Ltd, has the right to appoint more than half of the BOD in B Ltd and C Ltd. At the moment the directors have been appointed by the B Ltd and C Ltd, A Ltd has not exercised its right. Whether B Ltd and C Ltd are AE's?
Practice

3) 90% supply
A Ltd, a manufacturer purchases 100% of packing materials from X Inc, a Chinese entity which are used to ship its manufactured goods to its clients. Whether A Ltd and X Inc are AEs?

4) Trading
X Ltd, Indian entity a trader sells 40% of its trade commodities to an independent party, Y GMBH a German entity who however influences the price. Whether X Ltd and Y GMBH are AEs? Will your answer differ if X Ltd sells all its goods.
Practice

5) Enterprise

- Ayur Private Limited is an Indian Company, it has a branch in Vienna, Austria which provides marketing support services. Whether TP provisions will attract?

- ABC GMBH, German Company has a branch office in Chennai, India. The branch office provides captive software development activity for ABC GMBH and is only a cost centre. ABC GMBH wants to know whether the Indian Branch office is a AE?

- Puma Germany has a liaison office in Coimbatore, whether the Indian LO is a AE?
Session 1 – Debrief/ Recap

• Why TP?
• Legislative Framework – Indian Income Tax Law – Section 92
• Associated Enterprises
• Concept of Permanent Establishment

(Section 92F- "permanent establishment", referred to in clause (iii), includes a fixed place of business through which the business of the enterprise is wholly or partly carried on;)

• Thin Capitalization
Applicability

- Section 92(1) —
  - Any income arising from an international transaction shall be computed having regard to the arm’s length price

  **Explanation** - the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arm’s length price

- Delineating:
  - There must be some “income arising”;
  - Such income must arise “from” an “international transaction”;
  - Such income “shall “be computed having regard to the “arm’s length price”.
Deemed AE- Section 94A(2)(i)

Notified Jurisdictional Area (NJA)

- Country not cooperating (lack of effective exchange of information)
- Transaction with persons in NJA, such person will become a deemed AE
- Cyprus was notified and subsequently rescinded.

"Notwithstanding anything contained in any other provision of this Act, where a person located in a NJA is entitled to receive any sum or income or amount on which tax is deductible under Chapter XVII-B, the tax shall be deducted at the highest of the following rates, namely –

- (a) at the rate or rates in force;
- (b) at the rate specified in the relevant provision of the Act;
- (c) at the rate of thirty per cent.”
Practice - Section 94A(2)(i)

• A Ltd., an Indian company, provides technical services to a company, XYZ Inc., located in a NJA for a consideration of Rs. 40 lakhs in October, 2020.

• It charges Rs. 42 lakhs for similar services rendered to PQR Inc., which is not located in a NJA. PQR Inc. is not an associated enterprise of A Ltd.

• Discuss the tax implications under section 94A read with section 92C in respect of the above transaction of provision of technical services by A Ltd. to XYZ Inc.
Thin Capitalisation – Limitation on interest deduction – Section 94B

- In line with BEPS Action Plan 4; Finance Act 2017 introduced Section 94B to limit interest deduction in the hands of an Indian taxpayer on borrowings obtained from its foreign AE or even from third parties,

Conditions applicable to all borrower :
- engaged in business other than banking and insurance.
- Borrower incurs expenditure in nature of interest or similar consideration exceeding 1 crore in any FY
- Such interest is deductible as tax expense
- Debt is issued by Non resident AE or third party with either implicit or explicit guarantee by foreign AE

• If the above conditions are satisfied, then the excess interest would be disallowed. Interest deduction would be limited to 30% of EBITDA or actual interest amount (whichever is less)
Thin Capitalisation – Limitation on interest deduction – Section 94B

Elements of section 94B(1)

- **Payer:** Indian Co. / PE of Foreign Company
- **Payment:** Interest / similar expense
- **Quantum:** 1 Crore
- **Character:** Debt issued
- **Source:** Non resident being an AE

Proviso expanded

- **Source:** Third party deemed as AE for implicit or explicit guarantee.

- **Disallowance:** Excess interest above 30% of EBITDA
International transaction (Section 92B)

- Section 92B(1) – International Transaction (Exhaustive)

- Section 92B(2) – Deemed International Transaction
International transaction - Section 92B(1)

• International transaction means a Transactions between two or more associated enterprises, either or both of whom are non-residents

• ‘Transaction’ defined in Section 92F
  ◦ As per this definition, a transaction includes any arrangement, understanding or action, whether formal or informal, whether oral or in writing, whether legally enforceable or not

• Transaction relates to:
  ◦ 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 the enterprises; or
  ◦ mutual agreements or arrangements for allocation or apportionment of, or any contribution to, any cost or expense incurred
Deemed AE & International Transaction - Section 92B(2)

An unrelated company (3rd party) is deemed to be an associated enterprise of a company (A) and subject to transfer pricing regulations if

- a prior agreement exists between A’s AE and 3rd party in relation to services rendered by A to the 3rd party; or

- terms of transaction are determined in substance by A’s AE and 3rd party.
Practice- Whether D’ITA?

Foreign Co has a global procurement organization that identifies, appoints, and negotiates with global vendors to supply to Foreign Co’s affiliates (including India Co) at terms agreed by Foreign Co and the vendors.
Practice- Whether D’ITA?

Foreign Co

Terms/ Conditions determined by F Co

Outside India

India

India Co (AE of FCo) → Contract Manufacturer

Indian Co enters into an arrangement with a third party contract manufacturer for manufacture & purchase of goods.

The terms are determined in substance by Foreign Co.
Specified Domestic transactions (‘SDT’)

- From FY 2016-17, SDT would be applicable only if there is:
  - Transfer of goods and services by tax holiday undertaking with other undertakings of the taxpayer
  - Business transacted by the tax holiday undertaking with other 'closely connected entities'
  - Any other notified transaction

- Finance Act 2016 has enhanced the limit of INR 5 Crores to INR 20 Crores \textit{w.e.f 1.04.2016} on an aggregate basis in order to apply the provisions of SDT.
Specified Domestic transactions (‘SDT’)  

- Domestic Transfer Pricing Regulations are relevant under two situations:  
  ◦ In Transactions between loss-making and profit-making related entities; and  
  ◦ In Transactions between two related units (of the same taxpayer) having 
    differential tax rates

- Section 80A (6), 80IA(8) and 80IA(10) including SEZ.
- Section 80-IA(10) applies to transactions between assessee and any other person which results in excessive profits in the hands of the assessee:
  ◦ *Either owing to 'Close Connection' with other person;*  
  ◦ *For any other reason.*

- Safe harbour provisions (Rule 10 TH to THD)
Next – Arm’s Length Price

• Section 92(1) –

  • Any income arising from an international transaction shall be computed having regard to the arm’s length price

  Explanation - the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arm’s length price
ALP

- Concept introduced in 1932 by an American lawyer Mitchell B Carroll.
- For attribution of profits amongst MNEs in different countries. “Methods of Allocating Taxable Income”
- Introduced as a legal fiction
- Used in contract law as well
- The arm’s length principle is thus the accepted guiding principle in establishing an acceptable transfer price under Article 9 of the UN Model.

Source: Britannica.com
ALP

• The rationale for the arm’s length principle itself is that because the market governs most of the transactions in an economy it is appropriate to treat intra-group transactions as equivalent to those between independent entities. The arm’s length principle is argued to be acceptable to everyone concerned as it uses the marketplace as the norm.

• Inspired from Model Convention and defined under the Income Tax Act.
  • Sec. 92F(ii) "arm's length price" means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions

• An ‘uncontrolled transaction’ means a transaction between enterprises other than associated enterprises, whether resident or non resident –Rule 10A(ab)
Application of ALP

1. Identification of the commercial or financial relations
2. Recognition of the accurately delineated transaction (Comparability analysis-FAR Analysis)
3. Selection of the most appropriate transfer pricing method
4. Application of the most appropriate transfer pricing method
Section 92C - Computation of ALP

- ALP shall be determined by any of the six methods, being the most appropriate method (MAM)

- Transfer pricing methods are ways of establishing arm’s length prices or profits from transactions between associated enterprises.

- When multiple ALP’s then - Arithmetic Mean or Range

- No exemption under sec 10A or 10B or under chapter VIA on the addition to income due to adjustment to ALP.

- Value of IT can be disturbed only if:
  (a) ALP not determined as MAM.
  (b) Information not maintained as per sec 92D.
  (c) Information used is not reliable.
  (d) Failure to furnish information as per sec 92D(3).
Most Appropriate Method

• The starting point in selecting a method is an understanding of the controlled transaction (inbound or outbound), in particular based on the functional analysis which is necessary regardless of which transfer pricing method is selected.

• The functional analysis is a major part of selecting the transfer pricing method as it helps:
  ◦ To identify and understand the intra-group transactions;
  ◦ To identify the characteristics that would make a particular transaction or function suitable for use as a comparable;
  ◦ To determine any necessary adjustments to the comparables
  ◦ To check the relative reliability of the method selected; and
  ◦ Over time, to determine if modification of the method is appropriate because the transaction, function, allocation of risks or allocation of assets have been modified.
Section 92 C - Most Appropriate Method

OECD prefers traditional methods over transactional methods

Indian rules prescribe no guidance – legal view it to follow chronological order of the methods in the Act

Any other method prescribed by the Central Board of Direct Taxes- Sixth Method

- **Traditional Transaction Methods**
  - Comparable Uncontrolled Price
  - Resale Price Method
  - Cost Plus Method

- **Transactional Profit Methods**
  - Profit Split Method
  - Transactional Net Margin Method

- **Other Methods**
  - Global Formulary Apportionment
  - Third party quotations, Reports etc.
Comparable Uncontrolled Price Method
Rule 10B(1)(a)

- Usually considered the most appropriate method for all transactions
- Compares the price charged in a controlled transaction with the price in an uncontrolled transaction
- Requires strict comparability in products, contractual terms, economic terms, etc
Comparable Uncontrolled Price Method

Step 1: Identification of price charged or paid in comparable transaction(s)

Step 2: Such price adjusted to account for differences if any between international transaction and uncontrolled transaction(s)

Step 3: Adjusted price arrived above taken to be arm’s length price
Comparable Uncontrolled Price Method

- **Internal CUP**
  - Manufacturer A
  - Related party - Manufacturer B
  - Non-related party

- **External CUP**
  - Non-related party A
  - Non-related party B
The CUP Method is appropriate especially in cases where an independent enterprise buys or sells products that are identical or very similar to those sold in the controlled transaction or in situations where services are rendered that are identical or very similar to those rendered in the controlled transaction.
Question 2 – SM

MaxMicro Ltd, Indian Company a mobile phone manufacturer undertakes the following sale transactions:

<table>
<thead>
<tr>
<th></th>
<th>Units</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td>Trump Inc, AE in USA</td>
<td>250,000</td>
<td>INR 3000 per unit – FOB basis</td>
</tr>
<tr>
<td>Koirala Ltd, Nepal – Third Party</td>
<td>35,000</td>
<td>INR 5,800 per unit – CIF basis</td>
</tr>
</tbody>
</table>

Other information:
- Freight and insurance paid by MaxMicro Ltd is INR 700 per unit.
- Sales to Koirala are under free warranty for two years. No warranty to Trump Inc USA. Warranty cost is INR 500 per unit.
- Quantity discount of INR 200 per unit provided to Trump Inc due to huge volume.
- Compute the ALP and increase in total income of Max Micro Ltd.
Resale Price Method - Rule 10B(1)(b)

• Preferred method for a distributor buying purely finished goods from a group company (if no CUP available)

• Compares the resale gross margin earned by associated enterprise with the resale gross margin earned by comparable independent distributors

• An arms’ length gross margin should be sufficient for a reseller to cover its operating expenses and make an appropriate operating profit (in light of its functions and risks)

Financial Ratio is GP Margin. Net Sales - COGS
Resale Price Method

**Step 1**
Identification of resale price by tested party

**Step 2**
Resale price reduced by normal gross profit with reference to uncontrolled transaction(s)

**Step 3**
Such price reduced by expenses incurred (customs duty etc.) in purchase of the product/services.

**Step 4**
This price may be adjusted to account for functional and other differences if any

**Step 5**
Adjusted price arrived above taken to be arm’s length price
Resale Price Method - Exercise

- Assault Corp, France and Sunil Co, India are AE.
- Sunil Co imports 3000 engine for electric vehicles at Rs 7500 per unit.
- Sold to Indian customer at Rs 11,000 p.u.
- Sunil imported similar products from HAL Ltd, URP and sold for a GP margin of 20% on Sales.
- Assault HAL offered discount of INR 1500 p.u. HAL Assault offered only INR 500 p.u.
- Freight cost for imports from Assault, France INR 1200 p.u.
- Freight cost for HAL INR 200 p.u.
- Determine the ALP and amount of increase in Sunil Co. Ltd.
## Resale Price Method

**Transaction:** Import of goods from associated enterprises for resale to unrelated parties

<table>
<thead>
<tr>
<th>Description</th>
<th>Code</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual resale price earned by XYZ India from sale of group company products to unrelated enterprises</td>
<td>A</td>
</tr>
<tr>
<td>Less: Comparable gross profit margin</td>
<td>B</td>
</tr>
<tr>
<td>Cost of Sales (A-B)</td>
<td>C</td>
</tr>
<tr>
<td>Less: Expenses related to the purchase from group companies</td>
<td>D</td>
</tr>
<tr>
<td>ALP for products procured from group companies during the year (C-D)</td>
<td>E</td>
</tr>
</tbody>
</table>
Cost Plus Method Rule 10B(1)(c)

• It is typically applied to manufacturing or assembling activities and relatively simple service providers.

• Compares the gross profit on costs the associated enterprise earns with the gross profit on costs earned by comparable independent companies.

• Preferred method for:
  • manufacturer supplying semi-finished goods
  • company providing services

**Diagram**

- Contract Manufacturer A (Indian)
- Cost + 30%
- Associated Enterprise B (Austria)
- ALP?
- Europe Market
Cost Plus Method

1. Identification of direct and indirect costs of production incurred in tested party transactions
2. Identification of normal gross profit with reference to uncontrolled transaction(s)
3. Normal gross profit adjusted to account for functional and other differences if any
4. Adjusted gross profit added to total costs identified in step 1
5. Sum arrived above is taken to be arm’s length price
Cost Plus Method

Transaction: Export of raw material and electronic components by XYZ India to associated enterprises

<table>
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<tr>
<th>Description</th>
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<tbody>
<tr>
<td>Direct and Indirect cost of production incurred by XYZ India</td>
</tr>
<tr>
<td>Add: Comparable gross profit margin</td>
</tr>
<tr>
<td>ALP for products sold to AEs during the year (A+B)</td>
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</tbody>
</table>
CPM-Exercise

- AE1 Ltd., an unrelated party, develops software for various customers, who include AE2 Ltd. and M Ltd (URP).

- AE1 Ltd., during the year billed AE2 Ltd. INR 2,00,000. The total cost (direct and indirect) for executing this work was INR 1,75,000.

- AE1 Ltd., provided similar services to M Ltd., and earned a gross profit (GP) of 50% on costs.

- Whether the transaction between AE1 and AE2 is at Arm’s length? If not, Determine the ALP and the increase in income.
Profit Split Method-Rule 10B(1)(d)

- Appropriate for transactions which are not capable of being evaluated separately
- Calculates the combined operating profit resulting from a whole inter-company transaction based on the relative value of each associated enterprise's contribution to the operating profit
- The contribution made by each party is determined on the basis of a division of functions performed, valued, if possible using external comparable data
- Applicable for analysing tangible, intangible or services issues

Example: In a MNE Group,

Company A – Design and Manufacture of Electric Components
Company B – Then uses it to manufacture Electric Products

Company C – Acts as a distributor for selling it to Final Consumers
Profit Split Method-Rule 10B(1)(d)

- Use where parties are so interdependent that it is not possible to identify closely comparable transactions
- Based on expected rather than actual profits
- Requires consolidated Profit & Loss numbers i.e. both parties
- Relies heavily on the judgement of the profit splitter
- Complex Method
Transactional Net Margin Method - Rule 10B(1)(e)

- The TNMM is used to analyze transfer pricing issues involving tangible property, intangible property or services.
- Examines net operating profit from transactions as a percentage of a certain base (can use different bases i.e. costs, turnover, etc) in respect of similar parties.
- Ideally, operating margin should be compared to operating margin earned by same enterprise on uncontrolled transaction.
- Less product comparability than traditional transaction methods.
- Applicable for any type of transaction and often used to supplement analysis under other methods.
- Most frequently used method in India, due to lack of availability of comparable uncontrolled prices and gross margin data required for application of the comparable uncontrolled price method/ cost plus method/ resale price method.
Transactional Net Margin Method

- Computation of net profit as a percentage of a certain base realised from the international transaction.

- Computation of net profit realised by the tested party or an unrelated enterprise in a comparable uncontrolled transaction.

- Net profit from uncontrolled transaction adjusted to account for differences if any.

- The net profit thus established is taken into account to arrive at an arm’s length price for the international transaction.
**TNMM – Example**

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<tr>
<th></th>
<th>Comparable A</th>
<th>Comparable B</th>
<th>Comparable C</th>
<th>Comparable D</th>
<th>Tested Party</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>100 000</td>
<td>120 000</td>
<td>125 000</td>
<td>130 000</td>
<td>122 000</td>
</tr>
<tr>
<td><strong>COGS</strong></td>
<td>80 000</td>
<td>92 400</td>
<td>95 000</td>
<td>89 700</td>
<td>92 720</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td>20 000</td>
<td>27 600</td>
<td>30 000</td>
<td>40 300</td>
<td>29 280</td>
</tr>
<tr>
<td><strong>Operating expenses</strong></td>
<td>18 000</td>
<td>24 000</td>
<td>25 000</td>
<td>32 500</td>
<td>24 400</td>
</tr>
<tr>
<td><strong>Operating profit</strong></td>
<td>2 000</td>
<td>3 600</td>
<td>5 000</td>
<td>7 800</td>
<td>4 880</td>
</tr>
<tr>
<td><strong>Operating profit margin</strong></td>
<td>2%</td>
<td>3%</td>
<td>4%</td>
<td>6%</td>
<td>4%</td>
</tr>
</tbody>
</table>

**OP Margin – Operating Profit/ Sales**
TNMM – Example

- AE 1 is an Indian Company manufactures Wireless mouse and sells it to AE 2. No internal CUT is available. It has benchmarked with one company which is similar to it in Market, J Ltd.

<table>
<thead>
<tr>
<th>Financials</th>
<th>AE1 Ltd (INR in crores)</th>
<th>J Ltd (INR in crores)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>130</td>
<td>200</td>
</tr>
<tr>
<td>Operating Exps</td>
<td>85</td>
<td>120</td>
</tr>
<tr>
<td>Interest paid</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>Net Profits</td>
<td>40</td>
<td>70</td>
</tr>
</tbody>
</table>

- Determine the operating margin of AE1 Ltd and J Ltd from a TP perspective. Comment on the ALP on the transactions between AE 1 and AE2 and determine whether any adjustment is warranted.
The Methods

**TURNOVER**
(COST OF SALES)

**GROSS PROFIT**
(DISTRIBUTION AND ADMINISTRATION EXPENSES)

**OPERATING PROFIT**

- Comparable Uncontrolled Price
- Resale Price Method
- Cost Plus Method
- TNMM
- Profit Split Method
Profit Level Indicator - PLI

Is a ratio which shows the benefit derived by an enterprise (Gross Profit/Net profit/Operating Profit) over Sales/Asset employed/Cost

PLI is used for the sake of measurability and comparability between comparable companies

Particular PLI used depends on the method selected for arriving at Arms Length Price

Gross Profit margin is used as PLI in CPM

Some of PLI used in TNMM method are PBT/sales, PBIT/sales, Cash Profit/Sales, PBIT/Assets employed and operating Profit/operating cost

PLI should always have an untainted base
Sixth Method - Other Method – Rule 10AB

- **Uncontrolled transaction can be compared by the following basis**
  
  (a) Third party quotations/ invoices;
  
  (b) Valuation reports;
  
  (c) Tender/Bid documents;
  
  (d) Documents relating to the negotiations;
  
  (e) Standard rate cards;
  
  (f) Commercial & economic business models; etc.

- **Useful when third party comparable is difficult**
Sixth Method - example

- AE1 Ltd. owns certain registered patents which it has developed by undertaking research and development. It is a subsidiary of AE2 Ltd., a foreign company. AE1 Ltd. has sold its registered patents to AE2 Ltd., for 50 crores. The price has been determined based on a valuation report obtained from an independent valuer. The sale of patents is a unique transaction and AE1 Ltd or AE2 Ltd. has not entered into similar transactions with third parties and hence no internal or external CUP is available.

AE1 Ltd. may select the Other Method as the most appropriate method and use the independent valuation report for comparability purposes
Last Session – Debrief/ Recap

- Concept of PE (How foreign co doing business in India will have ‘nexus’ to pay tax in India. Eg. Branch office of a Foreign Co.
- International transactions between AEs must be at ALP.
- Determination of Arms Length Price – ALP
- Comparability is the main factor
- Six Methods
- CUP and TNMM commonly used methods.
Beta Inc. having its business in Singapore has advanced a loan of SD 1,60,000 to Beta Ltd, Mumbai. Book value of total assets of Beta Ltd was ₹ 125 lakhs. Beta Ltd provides software backup support to Beta Inc. Beta Ltd has spent 50,000 manhour during the financial year 2018-19 for the services rendered to Beta Inc. The cost for Beta Ltd is SD 75 / manhour. Beta Ltd has billed Beta Inc. at SD 90.75 / manhour.

Gama Ltd. in Mumbai which has a similar business model, provides software backup support to Olive Inc. in Penang, Malaysia. Gama Ltd’s cost and operating profits are as hereunder:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>INR in lakhs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct costs</td>
<td>600</td>
</tr>
<tr>
<td>Indirect costs</td>
<td>200</td>
</tr>
<tr>
<td>Operating profits</td>
<td>200</td>
</tr>
</tbody>
</table>

(1) Calculate Arm’s Length Price for the transaction between Beta Ltd. and Beta Inc. based on the above data of Gama Ltd. using the Transactional Net Margin Method. Assume ISD = ₹ 45.

(2) Explain, if there is any adjustment to be made to the total income of Beta Ltd.

Note: SD = Singapore Dollars

(6 Marks)
Price applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions

Determination of arm’s length prices using one of the six methods

Whether a single price is Arrived?

Yes

No

The price thus determined is the arm’s length price

Range

Or

Arithmetic Mean (AM by +/- 3% is the arm’s length price)
Use of multiple year data

• Introduced in Finance Act 2014 and applicable for transactions entered into post April 1, 2014 i.e. FY 2014-15 and subsequent years

• Applicable where RPM, CPM and TNMM are selected as most appropriate method

• Weighted average of current year plus previous two years, where data is available could be used for determining data values of comparable set

• In case current year data is not available at time of filing return of income, the same will be used at the time of assessment if available

• Data values so determined for comparables to be placed in ascending order for purpose of determining ALP
Application of Range

- Introduced in Finance Act 2014 and applicable for transactions entered into post April 1, 2014 i.e. FY 2014-15 and subsequent years
- Applicable where CUP, RPM, CPM and TNMM are selected as most appropriate method
- In case data set contains 6 or more comparable companies, ALP shall be determined based on 35th to 65th percentile of data values in the comparable set.
- If the transaction price falls within the above mentioned range, then the same shall be at arm’s length. If the transaction price falls outside the range, the median shall be considered as ALP.
- If the comparables are less than 6 / in case of use of PSM or Other method, the arithmetic mean of the comparables shall be used for determination of ALP. Benefit of variation of +/- 3% is available
Example on use of Range

**Illustration:** Where the data set comprises of 7 data points arranged in an ascending order and the percentile computed are not whole numbers

<table>
<thead>
<tr>
<th>Percentile</th>
<th>Formula</th>
<th>Result</th>
<th>Value to be selected</th>
</tr>
</thead>
<tbody>
<tr>
<td>35&lt;sup&gt;th&lt;/sup&gt;</td>
<td>No. of data points<em>35% = 7</em>35%</td>
<td>2.45</td>
<td>3&lt;sup&gt;rd&lt;/sup&gt; value</td>
</tr>
<tr>
<td>65&lt;sup&gt;th&lt;/sup&gt;</td>
<td>No. of data points<em>65%=7</em>65%</td>
<td>4.55</td>
<td>5&lt;sup&gt;th&lt;/sup&gt; value</td>
</tr>
<tr>
<td>Median</td>
<td>Total no. of data points *50%</td>
<td>3.50</td>
<td>4&lt;sup&gt;th&lt;/sup&gt; value</td>
</tr>
</tbody>
</table>

**Illustration:** Where the data set comprises of 20 data points arranged in an ascending order and the percentile computed are whole numbers

<table>
<thead>
<tr>
<th>Percentile</th>
<th>Formula</th>
<th>Result</th>
<th>Value to be selected</th>
</tr>
</thead>
<tbody>
<tr>
<td>35&lt;sup&gt;th&lt;/sup&gt;</td>
<td>No. of data points<em>35% = 20</em>35%</td>
<td>7.00</td>
<td>Mean of 7&lt;sup&gt;th&lt;/sup&gt; and 8th value</td>
</tr>
<tr>
<td>65&lt;sup&gt;th&lt;/sup&gt;</td>
<td>No. of data points<em>65%=20</em>65%</td>
<td>13.00</td>
<td>Mean of 13&lt;sup&gt;th&lt;/sup&gt; and 14th value</td>
</tr>
<tr>
<td>Median</td>
<td>Total no. of data points *50%</td>
<td>10.00</td>
<td>Mean of 10&lt;sup&gt;th&lt;/sup&gt; and 11th value</td>
</tr>
</tbody>
</table>
Secondary Adjustments (SA) – Sec 92CE

• Introduced in Finance Act 2017 applicable with effect from AY 2017-18 ➔ Sec 92CE

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

• A “secondary adjustment” has been defined to mean an “adjustment in the books of accounts of the taxpayer and its AE to reflect that the actual allocation of profits between the taxpayer and its AE are consistent with the transfer price determined as a result of primary adjustment”
Secondary adjustments... Sec 92CE

- Applicable where Primary adjustment in case of assessee exceeds INR 1 Crore

- Applicable only if primary adjustment on account of following scenario:
  - suo-moto stand taken by the taxpayer in the return of income;
  - made by the Assessing Officer (AO), which has been accepted by the taxpayer
  - determined in an APA;
  - made as per safe harbour rules; and
  - settlement under MAP,
Example – Arm’s Length Principle

Manufacturer Profit = INR 2000 – INR 200 = **INR 1800**

Profit of Distributor = INR 4000 – INR 1000 = **INR 3000**

Overall Group Profit: INR 1800 + INR 3000 = **INR 4800**
Secondary adjustments – Sec 92CE

<table>
<thead>
<tr>
<th>International Transaction</th>
<th>ALP of Sales</th>
<th>Primary TP Adjustment accepted by taxpayer</th>
</tr>
</thead>
<tbody>
<tr>
<td>S’ India to S’ Brazil – INR 1000 – Sale Price</td>
<td>2000</td>
<td>1000</td>
</tr>
</tbody>
</table>

- Increase in S’ India profit by INR 1000 (primary adjustment) does not address from the benefit obtained from retention of INR 1000 by S’ Brazil.

- Primary (suo-moto) adjustment does not address the issue of remittance of INR 1000 from S Brazil to S’ India and reflect the actual allocation of profit in the books of A Ltd and B Ltd.

- As per the provisions of the secondary adjustment, S’ India is to bring Rs. 1000 from S’ Brazil, within the specified period of time.

- If S’ India does not bring the amount, Rs. 1000 shall be considered as advance given by S’ India to S’ Brazil and interest shall be charged on the same.
Secondary adjustments...

- Amount considered as secondary adjustment need to be repatriated to India in favour of the Indian tax payer from concerned AE.

- If not repatriated from AE within prescribed time limit, would be deemed as advance made to AE by Indian tax payer and interest would be computed on such advance and taxed in the hands of Indian tax payer.

<table>
<thead>
<tr>
<th>Type of Primary adjustment</th>
<th>Time for repatriation</th>
<th>Applicable interest rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjustment by tax authorities and accepted by taxpayer</td>
<td>90 days from relevant order</td>
<td>One year marginal cost of fund lending rate of State Bank of India as of 1 April of the relevant FY plus 325 basis point</td>
</tr>
<tr>
<td>By taxpayer</td>
<td>90 days from date of filing of return</td>
<td>Six month London Interbank Offered Rate as of 30 September of the relevant FY plus 300 basis points</td>
</tr>
<tr>
<td>APA, Safe harbour or MAP</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
1. The Transfer Pricing Officer (TPO) while carrying out the transfer pricing assessment for Assessment Year 2021-22, has arrived at an arms-length rate interest of 4% on the loan obtained BY Indian AE1 Ltd from its parent entity in Cyprus. The Indian AE1 ltd had paid interest at 8% amounting to 16 crores (Interest paid 16 crores). Accordingly, the TPO has made a primary adjustment to the tune of INR 8 crores for AY 2021-22. AE1 Ltd has not gone on an appeal on the said matter. In this regard,

a) You are required to explain whether any secondary adjustment to made under Section 92CE of the Act? What would be your answer, if the assessee had opted to file an appeal with before the CIT(Appeals). (3 marks)

b) What are the consequences for the Indian taxpayer?
The Transfer Pricing Process – Practical Steps

• Functional and risk characterization of entities

• Selection of tested party (least complex entity)

• Identification of transaction classes

• Selection of method for benchmarking each class

• Application of method

• Documentation
Documentation-Section 92D- Rule 10D

- **Entity related**
  - Profile of industry
  - Profile of group
  - Profile of Indian entity
  - Profile of associated enterprises

- **Price related**
  - Transaction terms
  - Functional analysis (functions, assets and risks)
  - Economic analysis (method selection, comparable benchmarking)
  - Forecasts, budgets, estimates

- **Transaction related**
  - Agreements
  - Invoices
  - Pricing related correspondence (letters, emails etc)

- *Contemporaneous* documentation requirement
- Documentation to be retained for 8 years from from the end of the relevant AY
- Documentation is not required to be maintained if the *aggregate value* of all international transactions does not exceed *one crore rupees*
Accountant’s report (Form 3CEB)

- Obtained by every tax payer filing a return in India and having international transaction
- To be filed by ONE MONTH PRIOR to due date for filing return of income i.e. 31\textsuperscript{st} October of the Assessment Year.

Essentially comments:
- whether the tax payer has maintained the transfer pricing documentation as required by the legislation,
- whether as per the transfer pricing documentation the prices of international transactions are at arm’s length, and
- certifies the value of the international transactions as per the books of account and as per the transfer pricing documentation are “true and correct”
Penalties-Section 270A and Section 271

<table>
<thead>
<tr>
<th>Section</th>
<th>Nature of default</th>
<th>Penalty</th>
</tr>
</thead>
<tbody>
<tr>
<td>270A(9)</td>
<td>Failure to report any International transaction or deemed International transaction to which the provision of Chapter X applies would constitute ‘misreporting of income’</td>
<td>200% of the tax payable on under-reported income</td>
</tr>
<tr>
<td>271BA</td>
<td>Failure to furnish a report from an accountant as required under section 92E</td>
<td>₹ 1 lakh</td>
</tr>
<tr>
<td>271G</td>
<td>Failure to furnish info or doc as required by Assessing Officer or CIT(A) u/s 92D(3) within 30 days from the date of receipt of notice or extended period not exceeding 30 days, as the case may be.</td>
<td>2% of the value of the International transaction for each failure</td>
</tr>
<tr>
<td>271AA</td>
<td>(1) Failure to keep and maintain any such document and information as required by section 92D(1)/(2); (2) Failure to report such International transaction which is required to be reported; or (3) Maintaining or furnishing any incorrect information or document.</td>
<td>2% of the value of each such International transaction</td>
</tr>
</tbody>
</table>

Notes:
- The penalty u/s 271AA is in addition and not in substitution of penalty u/s 271BA.
- If the assessee proves that there was reasonable cause for the failure, no penalty would be leviable under section 271BA, 271G and 271AA.
Assessment & Appeal Procedure

- Reference to TPO- Section 92CA
- TPO to determine ALP and send the TPO order to AO.
- TPO order is binding on the AO.
- TPO has sufficient powers to invoke similar to AO.

**Appeal – TP Disputes**

- Dispute Resolution Panel – Section 144C
- CIT Appeals – Section 246A
Dispute Prevention- Safe Harbour Rules, 2017

• SHR not notified for AY 2021-22
• Rules in 10 TA, made in 2017 is applicable till AY 2020-21. Reduction in Safe Harbour (SH) rates for most of the eligible transactions, along with other changes made to the specified circumstances.
• Only for certain assessee and international transactions.
• Rule 10TE – Procedural framework
  • Form 3CEFA
• No SHR for AE in Section 94A
• SHR for SDT – Rule 10THC (Govt co. in Electricity, Co-op Society- Milk products)
Dispute Prevention- APA

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

- Any person who has undertaken an international transaction; or

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

Types
- Unilateral
- Bilateral
- Multilateral
APA - Phases

Phase 1 – Feasibility Study
Phase 2 - Pre filing Consultation
Phase 3- Application
Phase 4 – Negotiation
Phase 5 – Execution
Phase 6 – Annual Compliance Report
Phase 7 – Compliance Audit
Phase 8 – Renewal

APA Tenure – 5 years
Roll back – 4 years
Modified Return of Income
APA – Advantages

• Certainty on the transfer pricing issues;
• Avoidance of possible audit along-with penalty and ligation costs;
• Efficient management of transfer pricing issues;
• Potential elimination of double taxation;
• Fewer compliance costs for MNE groups;
• Favourable environment for FDI and
• Ability to deal with contentious issues in open years
APA – Disadvantages

- Future estimation precisions
- Closure of APA requires substantial time;
- APA demands huge resources, both, in terms of costs and personnel;
- Unilateral APA does not eliminate the risk of double taxation;
- Cumbersome APA procedures can multiply the tax compliances;
- Potential misuse of the secret information shared by the taxpayer to the tax authorities, wastage of resources in case an APA cannot be finalized;
- and
- APA does not altogether eliminate the transfer pricing audit.
THANK YOU