WIRC Session on Transfer Pricing Regulations & Arm's Length Price Determination

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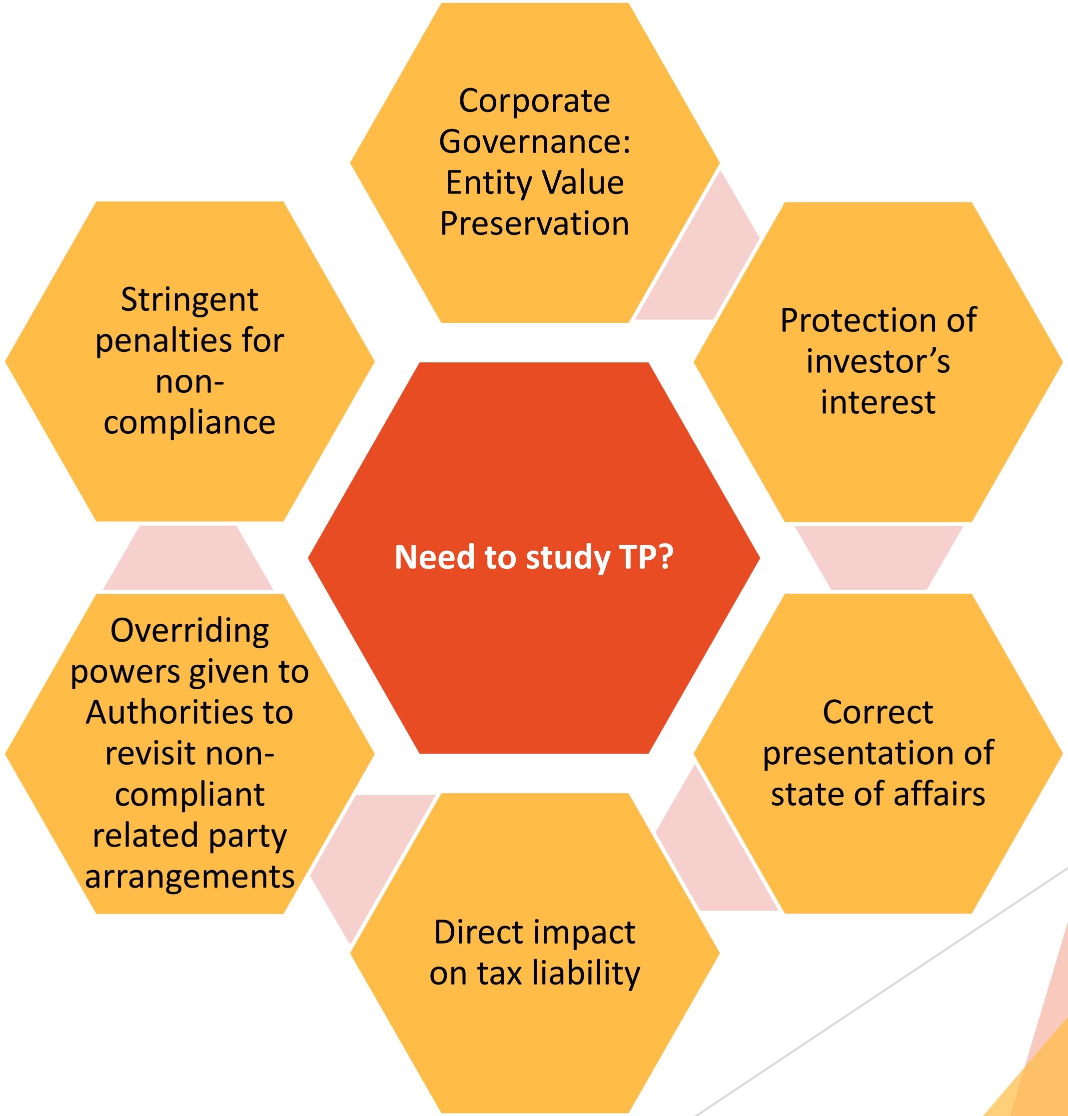
What is Transfer Pricing ('TP')?

- Simply put, analysis of terms of transactions between related parties or those influenced by them to ensure that they are at (independent) market prices
- Used in different contexts:
  - Income Tax
    - International tax
    - Domestic tax
    - General Anti Avoidance Regulations ('GAAR')
  - Indirect Tax Laws
  - Companies Act / SEBI Rules - Corporate Governance/ Accounting Framework



Income Tax Law: TP Regulations (‘TPR’)

Approach to TPR: Broad Framework

- Identify:

Enterprise [Sec 92F (iii)] → Associated Enterprise ('AE') [Sec 92A] → Transaction [Sec 92F(v)] → International Transaction [Sec 92B] → Specified Domestic Transaction [Sec 92BA]

- Undertake:

Group/ Industry Overview → Nature and terms of transactions under review → Functions-Assets-Risks ('FAR') Analysis → Characteri-sation of parties → Economic Analysis: determine arm's length price ('ALP') → Documentation / filing compliance

International Tax: Section 92

- Section 92 of the Income Tax Act, 1961 (‘Act’) provides that any income/ expenditure arising from an international transaction shall be computed having regard to ALP
- Assessee to maintain prescribed documentation and undertake prescribed filings
- **What is Associated Enterprise:** Section 92A of the Act defines the term AE
- Section 92A(1) provides general principles while Section 92A(2) list down various scenarios in which persons will be deemed to be associated enterprises

Direct or indirect participation by one enterprise in another **or** by same person(s) in both the enterprises

- Capital
- Management
- Control

- The term Enterprise is very widely defined in Section 92F(iii) to include persons engaged in a variety of activities as defined therein and includes a Permanent Establishment

Section 92A(2): Deemed AEs

...For the purposes of sub-section (1), two enterprises shall be deemed to be associated enterprises if, <u>at any time during the previous year</u>,

Section 92A(2) Clause	Form of Participation	Form of Relationship
a	Capital	Participation in capital (voting power) equal to more than 26%
b		Participation in capital (voting power) equal to more than 26% in each of such enterprises
c		Loan given is equal to or more than 51% of book value of assets
d		Guarantee given is greater than or equal to 10% of borrowings
e	Management	Appointment of more than half of the directors
f		Appointment of more than half of the directors of each of the two enterprises by same person or persons

Section 92A(2): Deemed AEs

Section 92A(2) Clause	Form of Participation	Form of Relationship
g	Control - commercial relationship	Dependence on know how, patent, trademark, licences etc.
h		Supply of raw materials more than or equal to 90%
i		Control to who and at what price goods are sold
j	Control – other commercial relationship	Control by an individual or is relative
k		Control by member HUF or his relative
l		Control equal to or more than 10% in a Firm/ AOP/ BOI
m	Others	Existence of mutual interest as may be prescribed

AE Identification: Certain Nuances

- Interplay between subsections of Section 92A: Whether to be read in isolation (View 1) or cumulatively (View 2)
  - **Memorandum to Finance Bill, 2002:** *It is proposed to amend sub-section (2) of the said section to clarify that the mere fact of participation by one enterprise in the management or control or capital of the other enterprise, or the participation of one or more persons in the management or control or capital of both the enterprises shall not make them associated enterprises, unless the criteria specified in sub-section (2) are fulfilled.*
  - Mumbai Tribunal in the case of Kaybee Private Limited [TS-233-ITAT-2015(Mum)-TP] decided in favour of **View 1**
  - **The Gujarat High Court decided in favour of View 2 in the case of Veer Gems [TS-545-HC-2017 (Guj)-TP]. Special Leave Petition filed by the revenue against the said order before the Supreme Court was dismissed**
  - The Karnataka HC in the case of Page Industries Limited [TS-19-HC-2021(Kar)-TP] held that while Page Industries was completely dependent on franchise rights given by Jockey USA for manufacturing and selling of Jockey branded goods in India since the latter did not participate in the management control or capital of Page Industries as envisaged by Section 92A(1), they could not be held to be AEs

AE Identification: Certain Nuances

- AE relationship could exist at any point during a given financial year – Need for evaluation on a real time basis
- Conditions specified in the provision to be satisfied for determining AE relationship
  - Mere reporting in Form 3CEB not sufficient - Sanchez Capital Services Private Limited [TS-640-ITAT-2012(Mum)-TP]
  - Deeming provisions to be interpreted strictly:
    - Aggregation across entities for purpose testing provisions not permitted

      (c) a loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise {Sovereign Safe Ship Management Private Limited [TS-189-ITAT-2020(Mum)-TP]}

      (h) ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise {Elder Exim [TS-689-ITAT-2017(Mum)-TP]}
    - Ignoring parts of the subsection not permitted [TS-189-ITAT-2020(Mum)-TP]

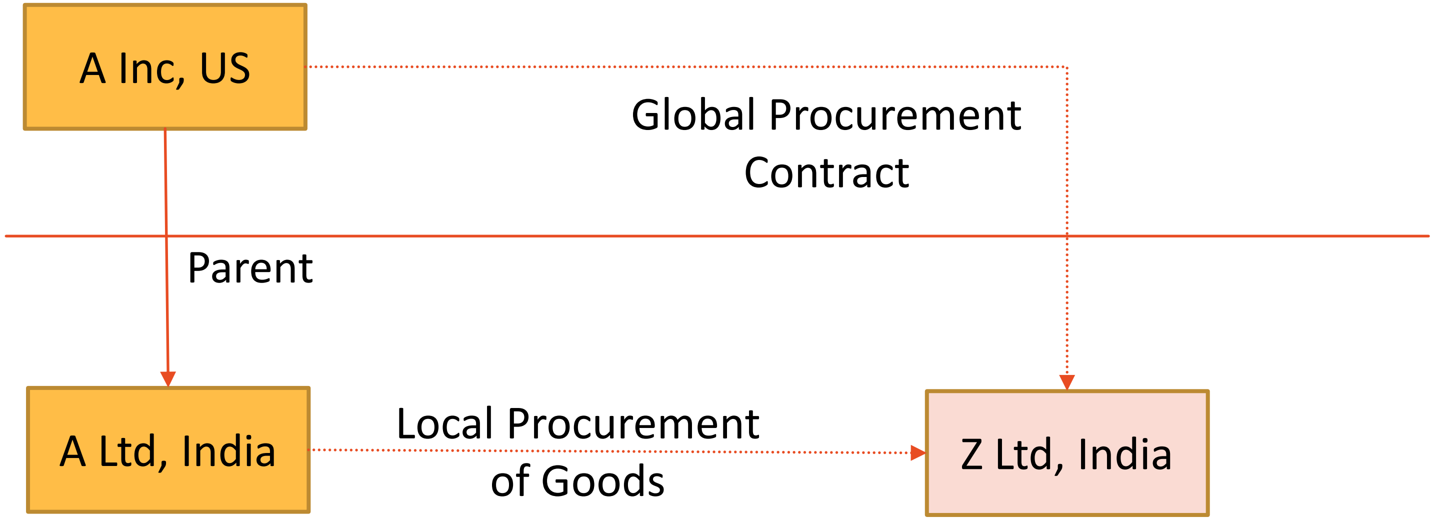
      (i) the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise {WB Engineers International Private Limited [TS-404-ITAT-2015(Pun)-TP]}

International Transaction: Section 92B(1)

- What is **Transaction**: As per Section 92F(v), Transaction includes an arrangement understanding or action and concert, whether or not (i) such arrangement, understanding or action is formal or in writing; (ii) or intended to be enforceable by legal proceeding
- Section 92B(1) defines **International Transaction** as one between two or more AEs, either or both of whom are non-resident(s)
  - Term is very widely defined and includes transactions pertaining to goods, tangible and intangible, services, financing, business restructuring or re-organisation, cost allocation and any other transaction having a bearing on the profits, income, losses or assets of such enterprises
  - Meaning of intangible property extensively defined - includes marketing, technology, artistic, data processing, engineering, customer, contract, human capital, location, goodwill related intangibles, methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data and any other similar item that derives its value from its intellectual content rather than its physical attributes

Deemed International Transaction: Section 92B(2)

- Transaction entered into by an enterprise with a person other than an AE is deemed to be an international transaction entered into between 2 AEs if:
  - there exist a prior agreement in relation to the relevant transactions between such other person and the AE; or
  - terms of the relevant transaction at determined in substance between such other person and the AE
  - where the enterprise or the AE or both of them are non-resident irrespective of whether such person other person is a non-resident or not



Specified Domestic Transaction ('SDT'): Section 92BA

- Current scope of SDT includes transactions between undertakings of a taxpayer (where atleast one is a tax holiday unit) and transactions by taxpayer (enjoying tax holiday or Concessional Tax Rate) with closely connected persons
  - any transaction referred to in section 80A
  - any transfer of goods or services referred to in sub-section (8) of section 80-IA
  - any business transacted between the assessee and other person as referred to in sub-section (10) of section 80-IA
  - any transaction, referred to in any other section under Chapter VI-A or section 10AA, to which provisions of sub-section (8) or sub-section (10) of section 80-IA are applicable
  - **any business transacted between the persons referred to in sub-section (6) of section 115BAB**
  - 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 rupees**

Concessional Tax Regime (‘CTR’): Section 115BAB

- To give impetus to “Make in India” program, the section was introduced which provides for a beneficial tax regime for newly set up manufacturing companies (‘Eligible Company’)
- Tax rate as low as 15% plus surcharge and cess apply
- Checks put in place on similar lines as those applicable to tax holiday units to ensure that the benefits of this provision are not abused.
  - provision states that where it appears to the AO that going to the close connection between the Eligible Company 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 ordinary profits, beneficial tax rate is restricted to the profits as may be reasonably determined to have been derived therefrom
  - where aforesaid arrangement involves SDT, profits to be determined having regard to ALP
  - Excess profits, as determined by the AO, taxable at the highest rate of 30%

Ordinary Profits versus ALP?

Certain Other Provisions where TPR relevant/ useful

Section 40A(2): Provides for disallowance of excessive expenditure in cases where payment is made to a related party (‘RP’) and such expenditure is excessive or unreasonable having regard to *inter alia* **Fair Market Value (‘FMV’)** of goods/ services/ facilities for which payment is made

Section 94A: If an assessee enters into a transaction where one of the parties is a person located in notified area, all the parties to the transaction shall be deemed to be AEs, transaction specified in section 94A will be deemed to be an international transaction and **consequently prescribed provisions of TPR shall apply**

GAAR as provided in Sections 95 to 102 empower the Revenue Authority to deny tax benefit of transactions or arrangements which lack commercial substance and the only purpose of such a transaction is achieving the tax benefit [Impermissible avoidance agreement (‘IAA’). **IAA means an agreement the main purpose of which is to obtain a tax benefit and it *inter alia* creates rights or obligations which are not ordinarily created between persons dealing at arms length**

Undertaking FAR Analysis and Economic Analysis ('EA')

Undertaking FAR Analysis

- Finding and documenting relevant facts about the functions performed, assets employed and risks undertaken in a transaction or set of transactions
- Critical to correctly characterize/ compare the functions performed for the controlled transaction vis-à-vis comparable uncontrolled transaction. Thus, properly done a FAR analysis aids in:
  - ascertaining the **Tested Party**
  - assessing the importance of each function to the overall arrangement
  - determining the value driver in pricing decision
  - identifying significant functional differences between the tested party and comparables
  - proper determination of the **Most Appropriate Method (‘MAM’) and ALP**.

Analysis critical as profit expectation directly proportionate to intensity of FAR

…An illustrative FAR analysis – Purchase of goods for resale…

- Typical functions in a supply chain process:
  - Strategic management functions to decide the overall strategy for the group
  - Corporate function ie day-to-day management of the entity
  - Product development / protection functions – conceptualisation / design, research and development activities, patenting, protection etc.
  - Procurement functions ie sourcing and purchase of raw materials and other inputs for the production process
  - Move functions management of inbound and outbound logistics to deliver products to the customer
  - Promotion / advertisement functions
  - Sell functions including sales and distribution activities
  - After sales service

Important to carefully assess as may have PE related ramifications

...An illustrative FAR analysis – Purchase of goods for resale

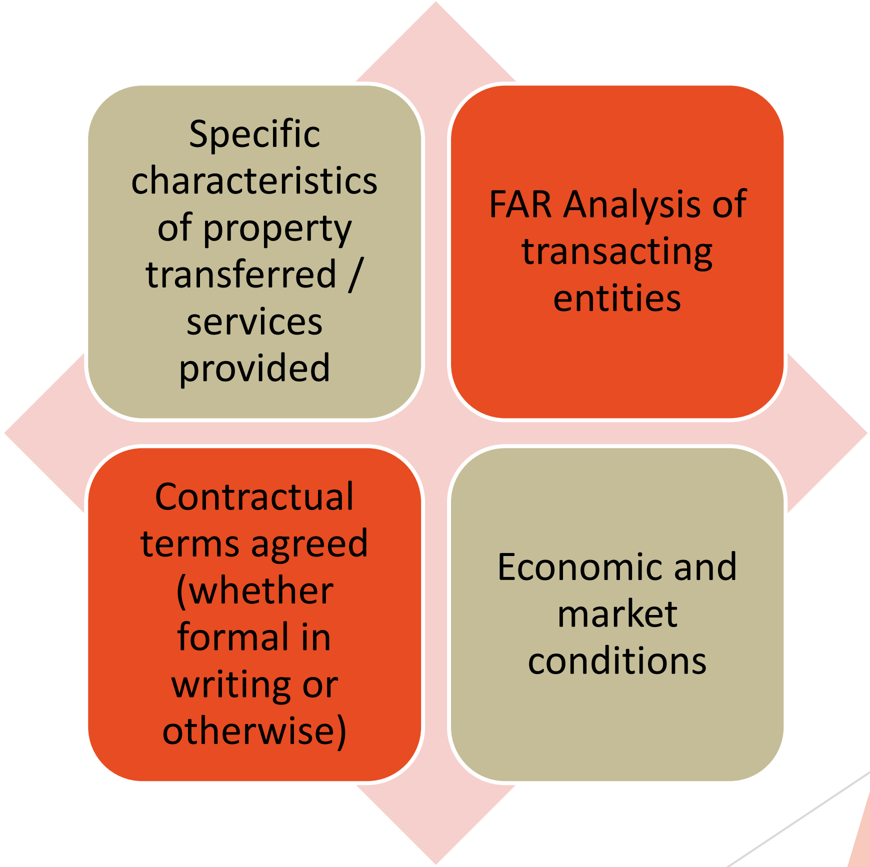
- Typical risks in a supply chain process:
  - General business risk
  - Technology obsolesce
  - Product development risk
  - Production / scheduling / capacity risk
  - Inventory risk
  - Credit / collection risk
  - Foreign exchange fluctuation risk
  - Attrition risk
  - Intangible Property related risk
- Typical assets in a supply chain process:
  - Intangibles – product design, manufacturing process etc
  - Manufacturing facilities
  - Human resources
  - Distribution network
  - After sales network
  - Capital deployed

Proper FAR analysis helps to correctly characterise the parties and determine the Tested Party

Undertaking Economic Analysis

- EA critical for determination of ALP
- Application of the arms length principle is the comparison of conditions in a controlled transaction vis-à-vis conditions in uncontrolled one
- Rule 10B prescribes six methods that can be adopted for ALP determination
- Comparable transaction/ company to be independent
- Identified comparable(s) to be substantially similar to the controlled one or whether accurate adjustments to iron out material differences can be made

Key factors determining comparability [Rule 10C(2)]



General pointers for identification of Comparables

- Identification of both internal & external comparables
  - Internal: comparing similar arrangements undertaken either by the assessee or its AE(s)
  - External: comparing similar arrangements undertaken by other players in the market where the tested party operates
- Internal comparables given preference over external
- Tested party could be either the Indian entity or its overseas AE(s)
- Indian tax office generally gives preference to Indian comparables
- Critical to document data availability at the stage of pricing a transaction/ preparing the annual TP Study report to build defense against potential TP litigation

Selection of MAM

- Six methods prescribed by the Indian TPR [Rule 10B]:
  - Comparable Uncontrolled Price (CUP) Method
  - Resale Price Method (RPM)
  - Cost Plus Method (CPM)
  - Profit Split Method (PSM)
  - Transactional Net Margin Method (TNMM)
  - Other / Sixth Method
- Factors to be considered in undertaking any comparability analysis & selecting the MAM: [Rule 10C]
  - Nature/ class of transaction | Class of AEs (having regard to FAR)
  - Comparable data: availability, coverage and reliability | degree of comparability
  - Whether accurate adjustments to iron out differences can be made
  - Reliability of any assumptions used in the analysis

Comparable Uncontrolled Price (CUP) Method [Rule 10B(1)(a)]

- Requires comparison of price
- Most direct and preferred method as it analyses price as against other methods which focus on profit
- Degree of comparability "high" – often a challenge to get!
- Commonly used for testing
  - Product pricing
  - Royalty rates
  - Financing transaction terms
- Suitable adjustments to be made to iron out differences for volume, credit terms, etc
- Not suitable where product/ terms of the contract unique and/ or accurate adjustments to eliminate differences not possible

Resale Price Method (RPM) [Rule 10B(1)(b)]

- Applicable in a resale situation ie where property/ goods/ services purchased/ procured from an AE are resold/ provided onwards to a third party
- **Reseller expected to retain an arm's length gross profit**

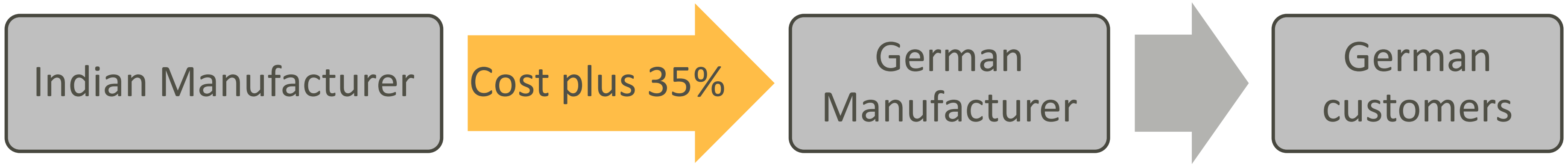
Software licensor → 70 → Indian Distributor → 100 → Indian customers

GP in independent cases: 25% on Sales

- Ideal where reseller does not add substantial value to the goods or services and does not employ/ develop intangible assets to add value
- Product similarity threshold lower than that for CUP
- Focus more on activity similarity and availability of gross margin data – available at times for pure distribution companies
- Better when goods sold within a short span else price may need to be adjusted for items such as inventory holding cost, exchange rate fluctuations
- If intensity of FAR of the tested party and comparables substantially different, then method may need to be rejected

Cost Plus Method (CPM) [Rule 10B(1)(c)]

- **CPM is applied to compare the gross profit margin**
  - Relevant for sale of goods as well as provision of services to AEs
- Requires determining of:
  - direct & indirect costs of production / rendering services
  - arm's length normal gross profit mark-up to be earned thereon



GP in independent cases: 35% on Production cost

- Higher level of comparability required in terms of: FAR profiles | accounting policies
- If not, check if accurate adjustments can be made to eliminate the differences
- As sufficient data for comparison/ making accurate adjustments is generally not available in public domain, difficult to apply this method in most cases

Profit Split Method (PSM) [Rule 10B(1)(d)]

- Applicable in cases involving transfer of unique intangibles or in multiple international transactions which cannot be evaluated separately

Compute combined net profit from international transaction

Determine relative contributions by each enterprise based on FAR analysis

Splitting combined proft in ratio of relative contributions

Allocated profit used to compute ALP

- Not a simple method to apply :
  - involves application of subjective parameters to split returns which may be easily challenged and maybe difficult to defend
  - restating revenue and costs of all participating entities on a common basis
  - Increased level of disclosures (including of overseas AEs' information)
- Growing interest by tax authorities in India in cases involving contract R&D companies, distributors with substantial brand building spend etc.

Transaction Net Margin (TNMM) [Rule 10B(1)(e)]...

- Most widely used method
  - threshold for similarity between tested party and comparables lower than in other cases - net margins are less affected by transactional differences than are prices as in the case of CUP and gross margins as in the case of RPM/ CPM
  - comparable data relatively easier to procure as databases available – important to apply correct filters
  - lateral comparables also used at times
  - closely linked international transactions can be benchmarked using combined TNMM approach (aggregation)
  - Also used as a secondary method
- Requires comparison of margin at a net level – Profit level indicators can be selected based on facts of the case (eg return on cost or sales or assets deployed)
  - Comparison to be done of the untainted side
  - Adjustments can be made to eliminate differences in risks assumed/ working capital employed/ forex risk impact/ marketing cost expended etc

TNMM: Identifying comparable companies to computing ALP

Some Quantitative filters for identifying comparables

- Relevant financial year(s) data not available
- Insufficient financial information
- RPT more than identified threshold
- Persistent loss maker/ sick company (if appropriate)

Some Qualitative filters for identifying comparables

- Different product/ service (need to drill down to specifics)
- Different business model (broker vs investment advisor | commission agent vs distributor | manufacturer vs assembler
- Different stage of business
- Different asset intensity
- Intangibles involved

Some economic adjustments for computing ALP

- Working Capital
- Depreciation
- Customs Duty
- Risk
- Capacity
- Marketing intensity

Sixth/ Other Method [Rule 10AB]

- Effective 1 April 2012, CBDT introduced Rule 10AB notifying the "Other Method"
- Enabling provision to use 'any method' which takes into account
  - the price which has been charged or paid or
  - would have been charged or paid for

  the same or similar uncontrolled transactions, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts
- Useful where application of the earlier mentioned five specific methods difficult on account of absence/ lack of comparable data or due to uniqueness of transactions
  - Typical Transactions: Transfer of intangibles | business restructuring related payment| cost allocations | unique services/ arrangements | financial transactions etc
- Various data which may possibly be used for comparability purposes could be*:
  - Third party quotations/ invoices | Valuation reports | Tender/Bid documents | Documents relating to the negotiations | Standard rate cards | Commercial & economic business models etc.

** ICAI Guidance Note on Report under Section 92E of the Income-tax Act, 1961*

Rules for use of Range & Multiple year data

Use of Multiple Year Data (Rule 10B)

- Old Rules: limited ability to use Multiple Year Data
  - Permitted use of data relating to the relevant financial year and of prior 2 years if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared
- New Rules:
  - Applicability: transactions entered into on or after 1 April 2014
  - Which methods: RPM, CPM, TNMM
  - Which data can be used:
    - **For comparability analysis:** relating to the relevant financial (Current) year data and where the same is not available data of immediately preceding year. If basis data available at scrutiny stage, if a company is not comparable for current year, it would be rejected.
    - **For margin computation:** relating to the relevant financial (Current) year data and pertaining to up to two preceding financial years may be used
  - Rules permit the tax office to use relevant year data, if available during assessment, even if not available to assessee at the stage of return filing

Range Concept

- Old Range concept
  - Which methods: All
  - When triggered: Comparables > 1
  - Comfort zone: +/- 3% (1% in case of wholesale) of transfer price
  - Not in range: Mean of the comparables set would be taken as ALP and adjustment shall accordingly be made
- New Range concept
  - Applicability: transactions entered into on or after 1 April 2014
  - Which methods: CUP, RPM, CPM & TNMM
  - When triggered: Comparables 6 or more
  - Comfort zone: Data points lying within 35th & 65th percentile of the set [See Rule 10CA]
    - Not aligned with global practices where 25th to 75th percentile accepted
  - Not in range: Median of the comparables set would be taken as ALP and adjustment shall accordingly be made
- Where transaction not eligible for new range benefit, old range continues to apply

Summary: Use of Multiple Year data/ Range

Method	Use of Multiple Year data	Use of Range
CUP	No	Yes
RPM	Yes	Yes
CPM	Yes	Yes
PSM	No	No
TNMM	Yes	Yes
Sixth Method	No	No

Illustration: Computation of ALP (TNMM) [Rule 10CA]

Sl. No.	Name	Year 1	Year 2	Current Year	Aggregation of OC and OP	Weighted Average
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%

Sl. No.	1	2	3	4	5	6	7
Values	2.2%	6%	8.2%	9%	10.57%	11.9%	12%

- 35th (7*.35 = 2.45 rounded off to 3)
- 65th (7*.65 = 4.55 rounded off to 5)
- Arm's length range = 8.2% to 10.57%
- Median (7*. 5 = 3.5 rounded off to 4) = 9%

Alternate approaches for Benchmarking | Dispute Resolution

Safe Harbour Rules (‘SHR’) [Rule 10CB]...

- Safe Harbour means circumstances in which the income-tax authorities shall accept
  - transfer price or
  - income, deemed to accrue or arise under Section 9(1)(i)

  as the case may be, declared by the assessee
- Availability/ Applicability
  - Covers specific industry/ transactions
  - Taxpayer needs to opt for it (by filing Form 3CEFA) by due date of filing Tax Return
  - Stringent timelines provided to tax office to process the request, else application is deemed to be valid
  - Not applicable, if AE is resident of country with tax rate less than 15% | is a notified Territory
  - Separate regime in itself. Its Rules cannot be applied in case this regime not opted for
- Benefits:
  - Taxpayers: Tax Certainty |Reduced cost and effort spent for compliance and litigation
  - Tax Office: Reduced administrative burden/ cost

Some examples of extant Safe Harbour Rates

Eligible International Transaction	(Minimum) Safe Harbour Rate / Circumstances
Provision of software development services or IT enabled Services	Operating Profit / Operating Expense (OPM) • 17% till Rs 100 crore of transaction value • 18% for transaction value above that but upto Rs 200 crore
Provision of KPO services	Value of international transaction does not exceed Rs. 200 crore and OPM • 24% where Employee Cost/ Operating Expense (EC/OE) is at least 60% • 21% where (EC/OE) is 40% but less than 60% • 18% where (EC/OE) does not exceed 40%
Manufacture and export of core auto components	12% OPM
Provision of corporate guarantee	1% pa of amount guaranteed
Receipt of low value-adding intra-group services	Value of the international transaction, including a mark-up not exceeding 5% does not exceed Rs. 10 crore 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 AE, is certified by an accountant

Safe Harbour is not ALP and hence may lead to double taxation

Advance Pricing Agreement (‘APA)

- APA is an agreement between the assessee and the CBDT determining the ALP or specifying the manner in which the same shall be determined
- Salient features
  - Could be Unilateral, Bilateral or Multilateral
  - Can cover Ongoing transaction/ proposed transactions
  - Validity for future: upto 5 years with possible renewal for additional 5 years
  - Roll back option available for prior 4 years
  - Pre-filing consultation option available: can be done anonymously
  - Option to withdraw APA application available
  - Can be cancelled by APA authorities in certain cases
- Prescribed compliance: Annual compliance report followed by compliance audit | filing Revised Return offering additional income to tax | remitting funds into India (Secondary adjustment)

Secondary Adjustment [Section 92CE]

- Applicable where Primary TP Adjustment done on or after AY 2017-18 and is of a sum of > INR 1 crore in following cases:
  - Voluntary adjustment
  - Adjustment made by tax office accepted by assessee
  - Adjustment determined by an APA
  - Adjustment made as per SHR
  - Adjustment as a result of a MAP
- Provisions aimed at aligning tax profits with books of accounts/ protecting forex reserves
- Requires amount equal to Primary TP adjustment to be brought into India within 90 days from applicable dates failing which said amount is treated as a deemed advance and interest is computed thereon as per prescribed rules
- Interest rates
  - Where transaction is in Indian Rupees: MCLR as on April 1 of relevant previous year plus 325 bps
  - In case of foreign currency transaction: 6 month LIBOR as on 30th Sept of relevant previous year plus 300 bps
- Option given to get remittance from any non-resident AE. If remittance not possible, assessee can pay one time tax at 18% (plus applicable surcharge and cess)

Summary: Process Flow

1. Group overview/ Transaction level understanding
2. Economic conditions
3. FAR Analysis
4. Selecting Tested Party
5. Selecting MAM
6. Identifying comparable data
7. Selecting PLI
8. Analysis of comparable data (quantitative and qualitative)
9. Making adjustments to iron out differences
10. Repeat step 5 onwards if required
11. Determine ALP/ Range | opt for Safe Harbour | apply APA price
12. If not at ALP, undertake Primary & Secondary Adjustment

Global Developments: Consequent Impact on Indian TPR

Global developments – consequent impact on India: Relevant BEPS Action Plans

- Action Plan 4: "Limiting Base Erosion involving Interest Deductions and Other Financial Payments" introduced to tackle the issue of high interest pay-outs
  - Introduction of Section 94B
- Action Plan 8-10: focuses on substance over form and aligning the value creation with the TP outcome
  - Increased/ updated guidance for benchmarking/ documentation (eg introduction of DEMPE concept for analyzing intangible transactions)
- Action Plan 13: New minimum standards in relation to transfer pricing documentation
  - Objective: develop rules regarding TP documentation to enhance transparency to enable tax administration:
    - conduct an informed TP risk assessment
    - collect useful information that could be used while conducting audit of TP practice of the entities
  - Outcome: 3-tier approach suggested: Local File, Master file & CbCR

Section 94B – Thin Capitalisation…

- Section 94B introduced wef FY 2017-18 providing limitation of deduction of interest expense
- Applicable to:
  - Indian Company (excluding Banking or Insurance Company) | PE of a Foreign Company
- Trigger: Deduction claimed for expenditure by way of interest or of similar nature (in excess of INR 1 crore) in respect of any debt covered under Section 94B in the particular FY towards debt from:
  - non-resident AE | third party, if based on guarantee or funds provided by an AE
- In the context of third party loans:
  - Term "Guarantee" not defined | Covers Explicit & Implicit Guarantee:
    - Explicit Guarantee could be understood as an express agreement or a contract of guarantee
    - Implicit Guarantee has much wider ramifications
- 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"

…Section 94B – Thin Capitalisation

- Interest as per Section 2(28A): interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized

- Disallowance of **(lower of)**: Interest paid/payable above 30% of EBITDA **or** Interest paid/payable to AE

EBITDA	1,000	1,000
Interest (A)	**200**	**400**
30% of EBITDA	300	300
Interest less 30% of EBITDA (B)	Nil	100
Disallowance (lower of A & B)	Nil	100
Allowed Interest expense	**200**	**300**

- Carry forward & set off of interest expense
  - Interest expenditure that is not wholly deducted in a particular year can be carried forward (for a maximum of 8 years immediately succeeding the year in which excess interest is disallowed) for set off against profits of those succeeding years

TP Compliance

TP compliances…

- OECD Transfer Pricing Guidelines ('TPG') have recommended a three tiered approach to TP documentation:
  - **Local file (TP Study Report or TPSR):** containing detailed information on all the relevant material about intercompany transactions of the particular group entity in each country
  - **Master File ('MF'):** capturing global information about the MNC group, including specific information on business value drivers, intangibles, financial activities, etc
  - **Country by Country Report ('CbCR') :** Providing details of income, earnings, taxes paid, and certain measures of the economic activity, applicable only to groups above a prescribed threshold of Turnover
- Pursuant to above, Indian TPR now require maintaining/ filing following TP documentation/ intimation
  - Maintain TPSR: as per Section 92D rw Rule 10D (by 31 October of relevant AY)
  - File Accountant's Report in Form 3CEB [by 31 October of relevant AY (Sec 92E)]
  - MF (where applicable) – timelines discussed in later slides
  - CbCR (where applicable)- timelines discussed in later slides

Mandatory documentation requirements (Rule 10D)…

- Ownership details
- Group & Business Overview
- Relationship, addresses, legal status and country details of AEs
- Industry Overview
- Nature, terms & value of international transaction | Details of properties and services of international transaction
- FAR Analysis of Taxpayer & AE
- Economic Analysis
  - Relevant data collected and analyzed for uncontrolled transactions for comparability
  - Comparable data used and comparison with other enterprises and adjustments made for difference
- Market analysis, forecasts, budgets & financial estimates with divisional and product split having bearing on international transactions
- Method considered and applied with reasoning for individual or class of transactions & justification

…Mandatory documentation requirements (Rule 10D)

- Other Miscellaneous evidences relied upon
  - Official publications, reports, databases from the Government
  - Agreements entered into by AE's or third parties
  - Published accounts & financial statements
  - Published market prices (Exchanges)
  - Letters and correspondences between AE's
  - Market Research Studies
  - Internet Downloads
  - Management Reports
  - Transaction documents as per accounting policies
- Assumptions, policies, price negotiations which have critical effect
- Other supporting data or document for price determination

What is Masterfile – OECD guidance

- Documentation intended to provide an overview of an MNE group's global business model, specifically covering the following aspects:
  - organizational structure
  - description of the various businesses including important drivers of profits, supply chain of group largest product/services, names of important geographic markets for the main product lines
  - written functional analysis describing the principal contributors,
  - a list of important service arrangements between members of the MNE group
  - description of important business restructuring transactions, acquisitions, divestitures during the fiscal year
  - intangibles used in the businesses
  - intercompany financial transactions including group's TP policies regarding inter-company financing
  - financial and tax positions including consolidated financial statements for the fiscal year concerned
  - details of MNE group's existing APA and other tax rulings

Indian regulations provide for disclosures over and above OECD norms

MF: Indian regulations

- Trigger: consolidated group revenue exceeding Rs. 500 crore and value of International Transactions:
  - > INR 50 crore or > INR 10 cr (if pertaining to intangibles)
- Report of MF has to be submitted in Form 3CEAA
  - Comprises 2 parts: Part A – General Information | Part B – Detailed information
  - Due date: by tax filing due date - 30 November of relevant AY
  - Part A is to be filled by every constituent entity ('CE') of an international group ('Group') regardless of whether it qualifies under the threshold for furnishing MF
  - Group having multiple CE may designate one to file the MF – Form 3CEAB to be filed 30 days prior to tax filing due date
- Additional requirements under Indian MF regulations
  - list of all entities of Group along with their addresses
  - FAR analysis of CE that contribute at least 10% of revenues/ assets/ profits to Group
  - list of all entities of the Group engaged in development and management of intangible property along with their addresses
  - names and addresses of the top ten unrelated lenders

What is CbCR?

- An aggregate tax jurisdiction wide information in respect of each entity of Group:
  - Revenue / Profit & loss before Income-tax
  - Amount of Income-tax paid and accrued
  - Details of capital /Accumulated earnings
  - Number of employees
  - Tangible assets other than cash or cash equivalent
  - Details of each constituent entity including country of incorporation & tax residency
  - Nature of main business activities of each constituent entity
- Applicable to CE of Group having total consolidated group revenue of Rs 6,400 crore or more for preceding accounting year

Indian CbCR threshold and format aligned with OECD norms

CbCR: Filing requirements as per Indian regulations

- File Intimation regarding Ultimate Parent Entity / ARE (surrogate parent) (in Form 3CEAC) in other cases where CE resident in India: in Form No. 3CEAC two months prior to the due date for furnishing CbCR
- File CbCR in Form 3CEAD
  - Where Indian company is parent entity or alternate reporting entity (ARE) resident in India: within a year from the end of the reporting accounting year
  - If the parent entity is resident in a country with which India does not have an agreement for exchange of information : within a year from the end of the reporting accounting year
  - There has been a systematic failure on the part of the country/ entity to comply: within 6 months from the end of month in which such failure is intimated to the Indian CE
- File Intimation regarding designated CbCR filing entity in India in Form 3CEAE, where there are multiple Indian CE

Importance of TP documentation

- Why TP documentation:
  - Mandated by Regulations (Section 92D/ 286) – non compliance carries penal risk
  - Basis for Accountant to issue Form 3CEB
  - Burden of proof on taxpayer to demonstrate compliance and build defense against TP adjustments that may be proposed by tax office
  - To mitigate penal risk in an adjustment case
- Why Form 3CEB:
  - Mandated by Regulations (Section 92E)
  - Penal consequences in case of non-filing
  - Assumed non-maintenance of TP documentation and non-reporting and related penal ramifications?!

TP compliances applicable to non-residents??

- TP compliances applicable to even foreign residents having India sourced income
  - Documentation maintained by Indian counterpart not an adequate defence
- Significant penalties for non-compliance
  - Depending on facts, advisable to comply even where non-taxability argument is being made
- ALP for Indian resident may not necessarily be ALP for the overseas AE
  - Indian regulations do not permit a corresponding relief in the hands of the other party if a transfer pricing party is made to the income of one of the transacting entities
  - Also, base erosion argument cannot be applied summarily – factual analysis important – Special Bench ruling in the case of Instrumentarium to be taken into account

TP Scrutiny

TP Scrutiny / Audit

- Selection for scrutiny
  - Automated selection – risk based parameters [mandatory reference to a Transfer Pricing Officer (TPO)]
  - Manual: reference to TPO in following cases
    - Accountant's Report in Form No. 3CEB not filed
    - TP Adjustment INR 10 Crores or more in previous year
    - Under Search and seizure : Findings on TP issues have been recorded
- TPO authorized to scrutinize additional transactions that he comes across even if not referred to him
- Order of TPO binding on Assessing Officer – order to be incorporated in AO's order
- DRP route available in case TP adjustment is made
- Attempt to reduce number of cases selected for TP audit but scrutiny by TPO have increased both in scope and complexity
  - Complexity will increase further with introduction of CBCR / Master File regulations
  - Heightened focus on contribution of each entity in the value chain

TP Scrutiny / Audit: Some issues

- Compensation not commensurate to value addition done, be it services provided or contribution to IP by Indian companies
- Payment for use of IP/ cost sharing/ technical services
- Outbound Companies: Non-levy of consideration for use of IP/ services
- Business Restructuring/ shifting of FAR without compensation
- Selection of comparables | Economic Adjustments claimed
- Inadequate Documentation | Poor Disclosures

TP Penalties

Penalty provisions

Section	Default	Penalty
271AA(1)	Failure to maintain TP documentation	2% of the value of the IT/ SDT
	Failure to report transaction	2% of the value of the IT/ SDT
	Maintains or furnishes an incorrect information or document	2% of the value of the IT/ SDT
271BA	Failure to furnish Form 3CEB	Rs 100,000
271G	Failure to furnish any information or document called for by the AO/ TPO	2% of the value of the IT/ SDT
271AA(2)	Failure to furnish MF	Rs 500,000
271GB	Failure to furnish CbCR or further information (called for) in respect of CbCR	INR 5,000 – 50,000 per day, depending upon period of delay

Penalty provisions

Section	Default	Penalty
271GB	Providing inaccurate information in CbCR	INR 500,000
271(1)(c) (upto AY 2016-17)	In case of TP adjustment during the course of audit by Indian tax authorities	100% - 300% of tax on TP adjustment
270A (AY 2017-18 and onwards)	In case of TP adjustment during the course of audit by Indian tax authorities	• 50% of tax on TP adjustment in case of under-reporting • 200% of tax on TP adjustment in case of mis-reporting

273B provides for non-levy of penalty where there is reasonable cause for the default

Thank you!

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