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TRANSFER PRICING

Purpose: To protect the interest of Indian Economy against any tax avoidance practices adopted by an assessee by way of minimizing tax liability in India through manipulating the prices/costs charged, paid or recovered in case of an "International Transaction". However of late transfer pricing provisions are also applied on 'Specified Domestic Transactions' as well as transactions entered into with the persons located in 'notified jurisdictional area'.

The transfer pricing provisions thereby ensure the protection of the interest of the Government of India by comparing the "Actual Transaction Price" with the "Arm's Length Price".

MEANING OF THE TERM 'INTERNATIONAL TRANSACTION'

An 'international transaction' means a transaction which fulfills all the conditions mentioned below:-

CONDITION 1	The transaction is entered into between two or more associated enterprises.	**CONDITION 2**	Either or Both of the associated enterprises are non-resident.	**CONDITION 3**	The transaction is in the nature of:- a) Purchase, Sale or Lease of tangible or intangible property or b) Provision of services or c) Lending or borrowing money or d) Any other transaction having a bearing on the profits, income, losses or assets of such enterprises. e) And shall include the mutual agreement of allocation or apportionment of cost or expense.

From the definition mentioned above its evident that not every 'cross-border transaction' is an 'international transaction' only those transactions which satisfy the three conditions mentioned above are international transactions. The definition tabulated above provides a lot of stress on the concepts of associationship. From the view point of the Government it can be understood that a transaction between the independent parties are generally close to the real market price however in case of an associated party transaction the transaction price might have been so fixed to lead lesser/lower payment of income tax to the Government. Thus to plug any kind of tax avoidance practice transfer pricing provisions are enacted, under which the actual transaction price (ATP) shall be compared with the arm length price (ALP) and whichever is favorable to Revenue, shall be applied.

It may be noted that scope of the term "international transaction" is large enough to cover all kind of financial transactions which have an impact on computation of total income of the assessee.

MEANING OF THE TERM 'ASSOCIATED ENTERPRISE'

As per Section 92A two parties can be associated with each other if:-

a) one person holds management, control or capital participation in other enterprise (e.g. if A Ltd has appointed 4 out of 5 directors in B Ltd then both the companies are associated enterprises) or
b) a same person holds management, control or capital participation in two or more enterprises (e.g. if X Ltd hold 70% and 60% equity in Y Ltd and Z Ltd respectively then Y Ltd and Z Ltd are also associated enterprises).

Section 92A(1) assumes the associationship based on direct as well as indirect participation both. However sub-section (1) of section 92A does not define any limit of participation regarding management, control or capital. Thus certain limits have been specified under sub-section (2), which if satisfied between two parties, they will be treated to be associated enterprises.

As per section 92A (2) two enterprises shall be deemed to be associated enterprises if at any time during the previous year:-

(a) One enterprise holds, directly or indirectly, shares carrying not less than 26% of voting power in the other enterprise

Example1. P Ltd holds 70% equity capital in Q Ltd thus both the companies are associated with each other (direct association).
Example2. If example 1 above if Q Ltd further holds 60% equity in R Ltd then P Ltd and R Ltd shall also be treated as associated enterprises (indirect association).

(b) Any person or enterprise holds, directly or indirectly, shares carrying not less than 26% of the voting power in each of such enterprises

Example: A Ltd. holds 30% equity in B Ltd. and 43% equity in C Ltd. due to clause (b), B Ltd and C Ltd both shall be deemed to be associated enterprises.

(c) A loan advanced by one enterprise to the other enterprise constitutes not less than 51% of the book value of the total assets of the other enterprise

Example: Alfa Ltd has financed ₹ 50 crores to Alto Ltd. Book value of total assets of Alto Ltd is ₹ 80 crores. As per clause (c) both the companies are associated.

(d) One enterprise guarantees not less than 10% of the total borrowings of other enterprise.

Example: Hemco Ltd has given a guarantee of a loan of ₹ 25 crores taken by Ariel Ltd. The total borrowings of Ariel Ltd are ₹ 200 crores. As per clause (d) both the companies are associates of each other.

(e) More than half of 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.

Example: Global Inc. has appointed 6 out of 8 directors on the board of Square Industries (India) Ltd thus both the companies are associated enterprises.

(f) More than half of the directors or members of the governing board, or one or more of the executive directors of members of the governing board, of each of two enterprises are appointed by the same person or persons.

Example: H Ltd. holds 3 director positions on the board of G Ltd (total 5 directors) and 4 director positions on board of J Ltd (total 6 directors). Here G Ltd and J Ltd are also associated enterprises.

(g) The manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent of the use of know-how, patents, copyrights, trade-marks, licenses, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner of or in respect of which the other enterprise has exclusive rights.

Example: Vikram Tyres is the sole manufacturer of "ULTIMA" brand tubeless tyres in India which is a patented product of Pacific Tyres, Germany. The technology of tyre manufacture is completely provided by Pacific Tyres. In this case Vikram Tyres and Pacific Tyres are associated enterprises.

(h) 90% 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.

Example: Quick Fix India (P.) Ltd is selling adhesive gums in India for which it imports all the raw material (except for packaging) from Fast Gum Inc. (U.S.), thus both the enterprises are associated to each other.

(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.

Example: Testa Ltd. exports its major production of vitrified tiles to Axis Tiles (Pty) Ltd. (South Africa) as per the demand raised and price fixed by Axis Tiles Ltd., thus both the enterprises shall be associated enterprises.

(j) 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.

Example: Ajit is selling imitation jewellery item from India to his elder brother Akash in Japan. This transaction is between associated enterprises thus covered under transfer pricing provisions.

(k) Where one enterprise is controlled by a HUF, the other enterprise is controlled by a member of such HUF or by a relative of a member of such HUF or jointly by such member and his relative.

Example: Madhur has given a loan of ₹ 25 lacs @ 8% from funds of his HUF to Magma Steels, Brazil which is owned by Rahul (Madhur's wife's brother). Here Madhur and Rahul both shall be treated as associated enterprises.

(l) Where one enterprise is a Firm, AOP or BOI, the other enterprise holds not less than 10% interest in such Firm, AOP or BOI.

Example: Royal Consultancy Services (an Indian firm) has entered into a collaboration agreement with Apex & Co. (UK based firm) as per which certain technical consultancy shall be provided by Royal Consultancy. Apex & Co. has appointed Mr. Ravi (an existing partner in Royal Consultancy) as partner for 15% share in it. Here both the firms are associated enterprises.

Can an International Transaction between non-associated enterprises be also covered under transfer pricing provisions?

Prima-facie a transaction between non-associated enterprises can't be covered under transfer pricing provisions however as per section 92B (2) 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 associated enterprises, if there exists a prior agreement in relation to the relevant transaction between such 'other person' and 'the associated enterprise' or the terms of the relevant transaction are determined in substance between such other person and the associated person.

The Finance Act 2014 made an amendment in section 92B to clarify the doubt that whether in the nature of transactions referred above the other person (i.e. unrelated person) should be a non-resident or not, it is now clarified that residential status of 'the other person' is not relevant i.e. he/it may be resident or non-resident. However it is certainly required that the enterprise or the associated enterprise or both of them are non-resident.

Example: Sun Optical (P.) Ltd, New Delhi is a subsidiary of Sun Optical Inc. US. The holding company i.e. Sun Optical Inc. has agreed to purchase certain 50,000 units of sun glasses form Shine Optical, Gurgaon on the ground that it purchases the sun glasses from Sun Optical (P.) Ltd, New Delhi only. In this case, the transaction of purchase-sale of glasses between Sun Optical (P.) Ltd and Shine Optical is prima facie not covered by transfer pricing provisions but by virtue of the above mentioned provisions of section 92B(2) the transaction shall be deemed to be the one entered into between associated enterprises hence transfer pricing provisions shall apply.

Are transfer-pricing provisions mandatory?

If the conditions mentioned under section 92B(1) as mentioned above are satisfied then transfer pricing provisions are mandatory. The only exception to this rule applies in the circumstance mentioned under section 92(3) i.e. transfer pricing provisions shall not apply in a case where the computation of income or determination of allowance, expense. etc as per transfer pricing provisions has the effect of reducing the income chargeable to tax or increasing the loss computed on the basis of books of account in respect of the previous year in which the international transaction was entered into.

Example: Gravita Exports (India) Ltd. has exported silicon chips to its subsidiary Gravita Impex Ltd., South Africa @ ₹ 5,000 per chip. The similar chips are exported from India @ ₹ 4,800 per chip by other manufacturers. In this case if transfer pricing provision is applied and arm length price is assumed to be ₹ 4,800 per chip, this would result in reduction of income of Gravita Exports (India) Ltd. thus transfer pricing provisions shall not apply.

METHODS FOR COMPUTATION OF ARM'S LENGTH PRICE

There are six methods of determining arm length price (ALP) provided in the income tax law:-

- **a) Comparable Uncontrolled Price Method**
- **b) Resale Price Method**
- **c) Cost Plus Method**
- **d) Profit Split Method**
- **e) Transactional Net Margin Methods.**
- **f) Other Method***

The determination of most appropriate method of arm length price (ALP) determination shall be done having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by associated persons or other relevant factors as the CBDT may prescribe. Wherever possible, comparable uncontrolled price method is given preference over the other methods to determine ALP. However the other methods may also be applied depending on the requirement of facts and circumstances.

Conceptually speaking we know that transfer pricing provisions require the comparison between an independent transaction price with that of an associated transaction. For this purpose, the arm length price is derived from the independent transaction price after making suitable adjustments i.e. there could be different factors or reasons which may be existing between the two transactions due to which price charged in one transaction may not be equivalent to the price charged in other transaction, thus such reasons or factors of differences are required to be identified and quantified to arrive at the figure of arm length price.

*The CBDT has prescribed one more method namely 'Other Method' by inserting Rule 10AB in the Income Tax Rule 1962 which is reproduced below:

"The other method for determination of arm's length price 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 of similar uncontrolled transaction, with or between non-associates enterprises, under similar circumstances, considering all the relevant facts." Thus the scope of ALP determination is now so wide that where any of the five methods could not be applied any other methods, found appropriate, may also be applied.

<u>Illustrative list of factors affecting the difference is as below:-</u>

- a) Quality & quantity of product
- b) Warranties or guarantees provided
- c) Credit terms
- d) Transport terms e.g. FOB sales v. CIF sales
- e) Wholesale or retail market
- f) Monopoly vs. Competition
- g) Actual date of transaction
- h) Foreign currency risk involved
- i) Geographical market position i.e. the location of market
- j) Alternatives actually available to the parties

After quantifying the effect of one or more of the factors enumerated above the independent transaction price is adjusted (increased or reduced) to arrive at arm length price. Such ALP is then compared with the actual transaction price to check if ALP is beneficial to revenue, then it is applied otherwise not.

Example on computation of Arm Length Price (ALP):-

Ludhiana Computer Exports Pvt. Ltd., India exported 50,000 heavy duty printers to its subsidiary company Colombo Exports Pvt. Ltd, Sri Lanka @ ₹ 12,000/- unit. At the same time it exported 10,000 same quality printers to Malaysia based firm Koton Computers @ ₹ 13,500/- unit. The comparison of price in two transactions has revealed following functional differences:

a) Toner used in export to subsidiary company was costing ₹ 1,200/- whereas in case of Koton Computers the cost was ₹ 1,400/-
b) Sales to Koton Computers are made with 2 years replacement warranty which accounts for 5% of the sales price, whereas no such warranty was provided in case of sales to subsidiary.
c) Colombo Exports Pvt. Ltd has borne freight & insurance expenses of ₹ 200 per piece whereas in case of Koton Computers it was ₹ 250 per piece which was borne by Indian Company.
d) A same quality computer is sold by Samsong (I) Ltd @ ₹ 15,000/- per unit to UK.

Computation of Arm Length Price:-

		₹
Price per printer charged from Koton Computers		13,500.00
Less:		
a) Adjustment for toner cost	(-)	200.00
b) Adjustment for warranty cost(5% of Sales)	(-)	675.00
c) Extra cost borne for CIF transfer	(-)	250.00
Arm Length Price		**12,375.00**

Thus assessee should report income from 50,000 computers @ ₹ 12,375/- due to applicability of transfer pricing provisions.

In computation of ALP in above case, we may apply comparable uncontrolled price method. We have not compared the price charged by Samsong (I) Ltd due to the reason that internal comparables are given preference over external comparables.

How to Determine the Most Appropriate Method

Rule 10B of Income Tax Rules has provided the manner of computation of Arm Length Price (ALP) under each of the five methods named under section 92C but such methods do not contain a specific formula rather the methods have been elaborated theoretically to be applied in the context of given facts & circumstances. The law requires an assessee to apply the most appropriate method to determine the ALP. Given an option, the comparable uncontrolled price method shall be given a preference over all other methods for determination of ALP. Based on the OECD guidelines the applicability of different methods under appropriate circumstances can be understood hereunder:-

Method	**Applicability Circumstances/Trade/Industry**
Comparable Uncontrolled Price Method	➤ Sale/Purchase of Goods, Commodities ➤ Lending/Financing

Resale Price Method	⅄ Trading business ⅄ Distribution of finished goods
Cost Plus Method	⅄ Providing of Services ⅄ Processing work ⅄ Transfer of semi-finished goods
Profit Split Method	⅄ Transactions involving integrated services provided by more than one enterprises
Transactional Net Margin Method	⅄ Integrated services requiring allocation of profits at net margin level than gross margin level.

Determination of Arm Length Price (ALP) is whose responsibility?

ALP determination is prima-facie assessee's responsibility i.e. an assessee has to determine the ALP on his own by using the most appropriate method.

DETERMINATION OF ARM'S LENGTH PRICE BY THE ASSESSING OFFICER

In certain circumstances the Assessing Officer (AO) may proceed to determine the ALP i.e. if the AO is of the opinion that:-

a) The price charged or paid in an international transaction has not been determined by using the appropriate method or
b) Any information and document relating to an international transaction has not been kept and maintained by the assessee in accordance with provisions of Sec 92D or
c) The information or data used in computation of ALP is not reliable or correct or
d) The assessee has failed to furnish, within specified time, any information or document which he was required to furnish by a notice issued under section 92D(3).

In the circumstances mentioned above the AO shall proceed to determine the ALP on the basis of such material or information or document available with him. However, while determining ALP on his own, the AO is supposed to provide an opportunity of being heard to the assessee.

What are the consequences if the Arm Length Price (ALP) is determined by the AO?

In case the ALP is determined by the AO (which is unfavorable to the assessee the income of the assessee may increase or the expenditure may be disallowed) as per **Explanation 7 to Sec 271(1)(c)** such enhancement of income of disallowance of expenditure shall be treated to be concealed income of the assessee proves to the satisfaction of AO the price charged or paid in the relevant transaction was computed in accordance with the provisions of Sec 92C and in the manner prescribed under that section, in good faith and with due diligence.

In addition to it, due to determination of ALP by the AO if the total income of the assessee enhances, such enhanced income shall not be subject to provisions of Chapter VIA, 10A, 10AA or 10AB i.e. the enhanced income can't be subjected to exemptions or deductions under specified sections.

One more point, where the ALP computed by AO is applied in the case of 'an associated enterprise' the income of the 'other associated enterprise' shall not be recomputed by reason of determination of ALP in the case of first mentioned enterprise. This may result into double taxation of income.

DETERMINATION OF ARM'S LENGTH PRICE BY THE TRANSFER PRICING OFFICER: S 92CA

In the case of an assessee who has entered into an international transaction in any previous year, if the Assessing Officer (AO) considers it necessary or expedient so to do then he (AO) may with the previous approval of CIT refer the ALP computation to the Transfer Pricing Officer (TPO).

On receipt of a reference the TPO shall **serve** a notice on the assessee requiring him to produce evidence/s in support of the ALP computation made by him. Based on the hearing of evidence and/or documents produced by the assessee and after considering such evidence as the TPO may require to be produced and after taking into account all relevant material gathered by TPO, he shall by order in writing, determine the ALP.

TPO shall send a copy of his order to the AO and to the assessee. On receipt of such order the AO shall proceed to compute the total income of assessee in accordance with the ALP determined by TPO.

Can Transfer Pricing Officer (TPO) invoke his valuation powers in relation to an international transaction not referred to him?

According to section 92(2A), where any international transaction (other than the one referred to him), comes to the notice of TPO during the course of the proceedings before him, he can proceed for valuation of even such other transaction, as if such international transaction was also referred to him. However where no reference is made to the TPO or the reference was made and valuation is already provided by the TPO then he can't exercise the power vested in him under section 92CA(2A).

Section 92CA was further amended by the Finance Act 2012 to provide that where in a case the assessee has not reported a transaction in the report submitted by the Chartered Accountant under section 92E (form 3CEB) then Assessing Officer may not be generally in a position to refer such transaction to the TPO. However TPO himself may notice such a transaction during the course of pendency of proceedings before him, thus the amendment has empowered the TPO to value arm's length price even such kind of transactions.

Example: A reference to TPO was made by the AO in the case of M/s Kinetic Exports, India for certain transactions made with related party M/s Renault Fabrications, Germany. However during the course of proceedings before TPO he found that M/s Kinetic Exports has also entered into certain international transactions with M/s Alpas Modulars, US (a related party) and himself determined ALP. Such determination of ALP can be made notwithstanding the fact that no reference was made by the AO to TPO for transactions undertaken with M/s Alpas Mudulars, US.

Time Limit: Order of ALP determination may be made by TPO at any time before sixty days period the date on which the time limit of making an assessment order as provided under section 153 or 153B expires. It may be noted that as per provisions of Section 153 and 153B in all such cases where a reference to TPO is made by the AO the time limit of completion of assessment is extended by 12 months. For example the normal 143(3) time lime for AY 2016-17 is 31.3.2019, however if the assessee's case was referred to TPO then the last date will be 31.3.2020.

It may also be noted, for the purposes of determining ALP the TPO shall have all the powers provided under section 131, 133 & 133A. Even TPO may pass a rectification order in the manner provided under section 154 if a mistake apparent from record is subsequently found.

It may be noted that in all such cases where a transfer pricing variation arises as a consequence of the order passed by TPO the procedure provided under section 144C [i.e. Dispute Resolution Panel (DRP)] shall be adhered to. In brief, in such cases the AO shall prepare and provide a draft assessment order to the assessee who may object against the same to the DRP and based on the DRP's direction the AO shall then make a final assessment order. For details students may refer "Chapter – 31: Some Important Assessment & Recovery Provisions".

DOCUMENTATION REQUIRED FOR TRANSFER PRICING COMPLAINCE

As per Section 92D every assessee who has entered into an international transaction shall keep and maintain the prescribed information and documents. Such information and documents have been prescribed under Rule 10D to the Income Tax Rules, 1962. These information/documents can be bifurcated into Primary & Supportive documents.

Primary Documents:-

a) Ownership Details like ownership structure, profile of multinational group, country of tax residence of associated enterprises etc.
b) Business details like description of assessee's & relevant industry including business of associated enterprises.
c) Nature and terms of international transactions along with transactional details
d) Description of functions performed, risks assumed and assets employed or to be employed in international transactions
e) Record of comparative uncontrolled transaction with transactional details.
f) Record of the analysis performed to evaluate comparability of uncontrolled transactions with the international transaction
g) Description of methods considered for determining the ALP
h) Record of actual working carried out for determining the ALP including details of comparable data, financial information used, adjustments made etc.
i) Assumptions, policies and price negotiations affecting ALP determination.
j) Other relevant information.

Supportive Authentic Documents:

a) Official publications, reports, studies and data base from the Govt. of the country of residence of the associated enterprise or of any other country.
b) Market research reports
c) Price publication by stock exchange, commodity market quotations etc.
d) Published accounts of associated enterprise.
e) Agreements and contracts with associated enterprises and unrelated enterprises for similar international transactions
f) Letters/correspondence etc documenting the terms negotiated between associated enterprises.
g) Documents normally issued in connection with various transactions.

The above mentioned documents/information should be available with the assessee before the due date of submission of return of income.

However in a case where the aggregate value of international transactions entered into by the assessee does not exceed ₹ 1 Crore, the above mentioned information/documents may not be maintained but in such case the assessee should be able to substantiate, on the basis of the material available with him, that income arising from international transactions entered into by him has been computed in accordance with Section 92.

It may be noted that information and documents mentioned above shall be kept and maintained by the assessee for a period of 8 years from the end of relevant assessment year.

SAFE HARBOUR RULES

SAFE HARBOUR is a legal concept whereby a person who meets the required rules is protected from adverse legal proceedings. In the context of Income Tax Law 'safe harbour' means circumstances in which the income tax authorities shall accept the transfer price declared by the assessee. The Central Board of Direct Taxes (CBDT) was first empowered by the Finance Act 2009 to make rules for 'safe harbour' in transfer pricing proceedings by way of insertion of section 92CB in the Income Tax Act. Accordingly, CBDT has prescribed rules 10TA to 10TG in this regard through Notification no. 73/2013 dated 18.09.2013.

'Safe harbor rules' prescribed by CBDT apply on certain eligible international transactions, which are entered into between eligible assessee and its associated enterprises. As per Rule 10TE for the purposes of exercise of the option of 'safe harbour' the assessee shall furnish a form 3CEFA to the Assessing Officer on or before the date of expiry of section 139(1) time limit. Safe harbour once applied can prevail for a maximum period of 5 assessment years.

Rule 10TD further provides a table as per which if an eligible transactions is entered into within a prescribed range or percentage the price declared by the eligible assessee i.e. the actual transaction price shall be accepted as the transfer price. This is a big relief to the assessee as due to safe harbor applicability the transfer pricing disputes shall not arise during the course of assessment.

The safe harbour rules generally cover following types of transactions within their ambit:

a. The provision of software development services, where aggregate value of such transactions during the previous year does not exceed ₹100 crores.
b. The provision of information technology services, where aggregate value of such transactions during the previous year does not exceed ₹ 100 crores.
c. The provision of knowledge process outsourcing, where aggregate value of such transactions during the previous year does not exceed ₹ 100 crores.
d. Advance of intra-group loan
e. Provision of corporate guarantee
f. Provision of contract research and development services, wholly or partly relating to software development
g. Provision of contract research and development services, wholly or partly relating to generic pharmaceutical drugs.
h. Manufacture and export of core auto components
i. Manufacture and export of non-core auto components.

The relevant portion of Rule 10TD specifying 'Safe Harbour' is reproduced below for ready reference:

(1) Where an eligible assessee has entered into an eligible international transaction and the option exercised by the said assessee is not held to be invalid under rule 10TE, the transfer price declared by the assessee in respect of such transaction shall be accepted by the income-tax authorities, if it is in accordance with the circumstances as specified in sub-rule.

(2) The circumstances referred to in sub-rule (1) in respect of the eligible international transaction specified in column of the Table below shall be as specified in the corresponding entry in column (3) of the said Table:-

S.No	Eligible International Transaction	Circumstances
1.	Provision of software development services referred to in item (i) of rule 10TC.	The operating profit margin declared by the eligible assessee from the eligible international transaction in relation to operating expense incurred is – (i) not less than 20 per cent., where the aggregate value of such transactions entered into during the previous year does not exceed a sum of five hundred crore rupees; or (ii) not less than 22 per cent., where the aggregate value of such transactions entered into during the previous year exceeds a sum of five hundred crore rupees.
2.	Provision of information technology enabled services referred to in item (ii) of rule 10TC.	The operating profit margin declared by the eligible assessee from the eligible international transaction in relation to operating expense is – (i) not less than 20 per cent., where the aggregate value of such transactions entered into during the previous year does not exceed a sum of five hundred crore rupees; or (ii) not less than 22 per cent., where the aggregate value of such transactions entered into during the previous year exceeds a sum of five hundred crore rupees.
3.	Provision of knowledge process outsourcing services referred to in item (iii) of rule 10TC.	The operating profit margin declared by the eligible assessee from the eligible international transaction in relation to operating expense is not less than 25 per cent..
4.	Advancing of intra-group loans referred to in item (iv) of rule 10TC where the amount of loan does not exceed fifty crore rupees.	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.
5.	Advancing of intra-group loans referred to in item (iv) of rule 10TC where the amount of loan exceeds fifty crore rupees.	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.

6.	Providing corporate guarantee referred to in sub-item (a) of item (v) of rule 10TC.	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.
7.	Providing corporate guarantee referred to in sub-item (b) of item (v) of rule 10TC.	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.
8.	Provision of contract research and development services wholly or partly relating to software development referred to in item (vi) of rule 10TC.	The operating profit margin declared by the eligible assessee from the eligible international transaction in relation to operating expense incurred is not less than 30 per cent.
9.	Provision of contract research and development services wholly or partly relating to generic pharmaceutical drugs referred to in item (vii) of rule 10TC.	The operating profit margin declared by the eligible assessee from the eligible international transaction in relation to operating expense incurred is not less than 29 per cent.
10.	Manufacture and export of core auto components referred to in item (viii) of rule 10TC.	The operating profit margin declared by the eligible assessee from the eligible international transaction in relation to operating expense is not less than 12 per cent.
11.	Manufacture and export of non- core auto components referred to in item (ix) of rule 10TC.	The operating profit margin declared by the eligible assessee from the eligible international transaction in relation to operating expense is not less than 8.5 per cent.

(3) The provisions of sub-rules (1) and shall apply for the assessment year 2013-14 and four assessment years immediately following that assessment year.

(4) No comparability adjustment and allowance under the second proviso to sub-section of section 92C shall be made to the transfer price declared by the eligible assessee and accepted under sub-rules (1) and above.

(5) The provisions of sections 92D and 92E in respect of an international transaction shall apply irrespective of the fact that the assessee exercises his option for safe harbour in respect of such transaction.

AUDIT REPORT

As per section 92E every person who has entered into an international transaction or specified domestic transactions shall obtain a report of an accountant (i.e. Chartered Accountant) in the prescribed form 3CEB and such report should be furnished before the due date of furnishing the return of income with the Department.

CONSEQUENCES OF NON-COMPLIANCE

Various provisions under which penalties may be levied against an assessee for non-compliance of transfer pricing provisions, are as below:-

Section 271(1)(c) Explanation 7: In case any amount is added or disallowed in computing the total income of an assessee u/s 92C(4) (i.e. computation of ALP by the AO) then the amount so added or disallowed shall be deemed to be concealed income of the assessee unless the assessee proves to the satisfaction of the AO, CIT or CIT(A) that the price charged or paid in the relevant international transaction was computed in accordance with section 92C and in the manner prescribed therein, in good faith and with due diligence.

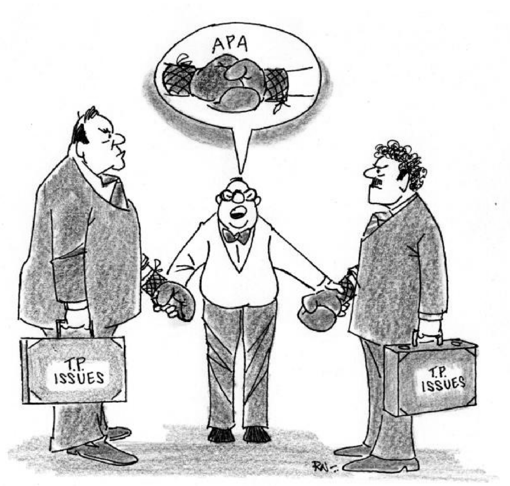
Section 271AA: If the assessee fails to keep and maintain the information and documents required u/s 92D then a penalty equal to 2% of value of each international transaction may be levied on him.

Section 271BA: Non-furnishing of report in form 3CEB can attract penalty of a sum of ₹ 1 Lac.

Section 271G: If the assessee fails to furnish any such information or documents as required by the assessing officer or the transfer pricing officer then he may be directed to pay by way of penalty a sum equal to 2% of the value of such international transactions.

The penal provisions mentioned above are applicable in relation to international transactions, specified domestic transactions as well as notified jurisdictional area transactions.

ADVANCE PRICING AGREEMENT (APA): SECTION 92CC & 92CD



Why "Advance Pricing Agreements"?

As we all know that 'international transactions' certainly attract the implications of transfer pricing provisions. Any non-compliance of transfer pricing provisions may not only vary the income computations but may also attract the severe penal consequences. Thus it was thought appropriate to come out with the concept of "Advance Pricing Agreements" wherein the CBDT is empowered to enter into an advance pricing agreement with any person consequently determining the Arm's Length Price (ALP) or specifying the manner in which the ALP is to be determined.

The purpose of this scheme is to ensure more clarity and certainty in ALP determination.

Procedure:

Under this scheme the CBDT and assessee may enter into an advance pricing agreement whereby either the ALP of an international transaction or the manner of determination of such ALP may be determined which will be binding on the revenue and assessee both. However the key features of the procedure are:

Transactions Covered: A set of international transactions executed or proposed over a fixed period of time.

Parties to the APA: CBDT & Assessee

Purpose of APA: To determine the ALP or specify the manner in which the ALP shall be calculated.

How ALP is calculated: ALP is calculated as per the provisions of section 92C but further adjusted for any adjustments or variations if necessary.

Validity Period: The APA shall be valid for such previous years as are specified in the agreement which shall in case exceed five consecutive previous years.

Roll-back Provisions: A new sub-section (9A) is inserted in section 92CC by the Finance (No.2) Act 2014 to provide that an advance pricing agreement, may, subject to such conditions, procedure and manner as may be prescribed, provide for determining the ALP or specify the manner in which ALP shall be determined in relation to the international transaction entered into by the person during any period not exceeding 4 previous years preceding the first of the previous years from which the advance pricing agreement commences and the ALP of such international transaction shall be determined in accordance with the said agreement.

These provisions can be titled as **'roll-back provisions'** because they provide for ALP applicability determined by an APA even on those transactions which are entered into prior to the APA period. These provisions are expected to provide relief to the taxpayers from litigation process.

Applicability of APA: The APA shall be binding on the assessee and the Principal Commissioner or the Commissioner (including his subordinates), in respect of the transaction in relation to which the agreement has been entered into.

Non-applicability of APA: The APA shall not be binding if there is any change in law or facts having bearing on the APA.

Invalidity of APA: If it is subsequently found that agreement has been obtained by the person (i.e. assessee) by fraud or misrepresentation of facts then the APA shall be declared to be void-ab-initio.

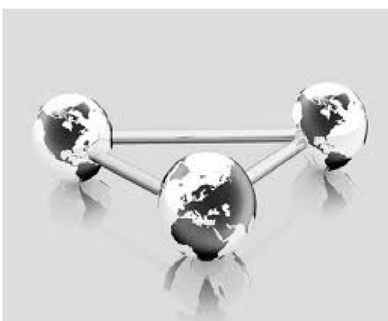
Impact on Return (ROI) already Filed: if any person has entered into an APA and prior to the date of entering into an agreement any return of income has been furnished under section 139 for any assessment year relevant to a previous year to which such agreement applied, such person shall furnish, within a period of 3 months from the end of the month in which the said agreement was entered into, **a modified return** in accordance with and limited to the agreement.

Impact on Assessment or Reassessment proceedings pending on the date of filing Modified Return: In such case the Assessing Officer shall proceed to complete the assessment or reassessment proceedings in accordance with the agreement taking into consideration the modified return so furnished. In such circumstances the time limit of completion of such pending assessment shall be extended by a further period of 12 months.

Example: M/s Akash Agri Exports Pvt. Ltd. has entered into an APA with the revenue on 30.12.2015 for a transaction entered into by it with its subsidiary abroad on 1.9.2014. However it had already filed its return for the AY 2015-16 on 17.09.2015. Now as per the above paragraphs the assessee is required to file a modified return upto 31.03.2016 and if we assume that an assessment under section 143(2) was already initiated against the assessee on 02.11.2015 then the time limit of completion of assessment shall be extended by further 12 months thus new date of completion of assessment shall be 31.3.2019.

Impact on Assessment or Reassessment already Completed: Where assessment or reassessment proceedings for an assessment year relevant to a previous year to which the agreement applies have been completed before the expiry of period allowed for furnishing of modified return the assessee is still required to file a modified return and the Assessing Officer shall proceed to assess or re-assess or recomputed the total income of the relevant assessment year having regard to and in accordance with the agreement. In such circumstance the AO shall pass an order of reassessment within a period of one year from the end of the financial year in which the modified return is furnished.

TRANSACTIONS WITH PERSONS LOCATED IN NOTIFIED JURISDICTIONAL AREA: SECTION 94A



To ensure discouraging the transactions entered into by a resident assessee which a person located in a country or jurisdiction where such country/jurisdiction does not effectively exchange information with India, certain important measures are inserted by virtue of section 94A in the Income Tax Act 1961.

This section provides certain disadvantageous positions which an assessee may book which he/it deals with a person of notified jurisdiction area where necessary cooperation is not received by the Revenue.

Section 94A(1): This sub-section provides power to the Central Government to notify any country or territory outside India, having regard to the lack of effective exchange of information by it with India, as a notified jurisdictional area (NJA).

Section 94A(2): Where an assessee enters into a transaction with a person located in NJA, then

a) All the parties to the transaction shall be deemed to be associated enterprises and
b) The provisions of section92A to 92F (i.e. transfer pricing provisions) shall apply on such transactions.

(Thus transactions with a person located in NJA shall be subject to transfer pricing provisions. However provisions of second proviso to section 92C i.e. notified percentage variation shall not apply in other words benefit of marginal difference between ATP and ALP shall not be ignored)

Section 94A(3)(a): The deduction in respect of payment to any financial institution located in NJA shall not be allowed under the Income Tax Act unless the assessee furnishes an aurthorisation in the prescribed form authorizing the CBDT or other income tax authority acting on its behalf to seek relevant information from the said financial institution on behalf of such assessee and

Section 94A(3)(b): Even the deduction in respect of other expenditure or allowance (including depreciation) shall not be allowed which arises from the transaction with a person located in NJA unless the assessee maintained such other documents and furnished the information as may be prescribed.

Section 94A(4): Where a person received any sum from a person located in NJA then he shall be under onus to satisfactorily explain the source of such money in the hands of himself or the beneficial owner. If he/it fails to do so, the amount received shall be deemed to be the income of the recipient assessee.

<u>Section 94A(5):</u> TDS Provision: A person making payment to other person who is located in NJA shall be required to deducted tax either:

a) At the rate in force;
b) At the rate specified in the Income Tax Act; or
c) At the rate of 30% - whichever is higher

However such person (from whom TDS is so deducted) is liable to be taxed at a lower rate he may claim a refund of the excess tax deducted at source.

<u>"Person located in notified jurisdiction area" shall include:</u>

a) A person who is resident of the NJA;
b) A person, not being an Individual, which is established in the NJA; or
c) A Permanent Establishment of a person not falling in sub-clause (a) or (b), in the NJA

SPECIFIED DOMESTIC TRANSACTIONS & TRANSFER PRICING PROVISIONS : SECTION 92 & 92BA

The Finance Act 2012 has widely increased the scope of transfer pricing provision by even covering certain domestic transactions in its ambit. As a new sub-section (2A) was inserted in section 92 to provide that an allowance for expenditure or any income in relation to the "specified domestic transaction" shall be computed having regard to the Arm's Length Price (ALP).

Here the term "specified domestic transaction" means:

a. Any expenditure in the nature of section 40A (2).
b. Transaction referred to in section 80A i.e. inter unit transfers or transfers to the related parties.
c. Transaction covered under subsection (8) or sub section (10) of section 80IA (i.e. inter unit transfers or transactions with related parties)
d. Transactions referred to in any other section of chapter VI-A or section 10AA, to which provisions of section 80IA (8) or 80IA (10) are applicable etc.

However the transactions mentioned above shall be subject to transfer pricing provisions only when the aggregate value of all the transactions during the year exceeds **₹ 20 crores** *(enhanced from ₹ 5 crores to 20 crores wef AY 2016-17).*

The provisions of 'international transfer pricing' as provided under section 92, 92C, 92D and 92E equally apply on 'specified domestic transactions'. However this may also be noted that the benefit of advance pricing agreement is not yet provided in relation to the 'specified domestic transactions'.

PRACTICAL QUESTIONS ON DETERMINATION OF ARM'S LENGTH PRICE

Q1. Suzuki Maruti India Ltd., New Delhi has declared an income of ₹ 650 crores as per the provisions of income tax law. However it has entered into certain international transactions during the year which may require further adjustment for income tax computation:

a. 25,000 cars sold to Suzuki Motors Ltd, Japan which holds 41% equity in Suzuki Maruti India Ltd. @ ₹ 4,50,000/- per car. However similar cars were sold to Honda Motors Ltd, Japan for ₹4,65,000 per car basis. However the cars sold to Honda Motors were carrying specially designed wheel caps costing ₹ 500/wheel extra.

b. Royalty payment of ₹ 60 crore was made to Suzuki Motors Ltd. Japan for providing technology for developing engines. However similar technology was provided by Suzuki Motors Ltd. to Honda Motors Ltd., India at an annual royalty payment of ₹ 55 crores.
c. A loan of ₹ 300 crore was provided by Suzuki Motors Ltd., Japan was provided at LIBOR + 4% rate whereas other Indian entities in similar business have borrowed the amount at LIBOR + 4.5% rate. The total interest paid during the year was ₹ 18 crores.

You are required to compute the total income of the company under income tax provisions.

Solution: Considering the provisions of transfer pricing as provided specifically under section 92C, the revised taxable income of the assessee i.e. Suzuki Maruti India Ltd. is computed below:

	₹ in Crores
Income reported by assessee before transfer pricing adjustments	650.00
Transfer Pricing Adjustments:	
a. Add: Adjustment for cars sold in Japan (see working note 1)	32.50
b. Add: Adjustment for Royalty Payment made excessive (see working note 2)	5.00
c. Add: Adjustment for Interest paid to the associated enterprise (see working note 3)	0.00
Taxable Income of the Assessee	**687.50**

Working note 1: Since similar car is sold to non-associated enterprise @ ₹ 4,65,000/- thus by applying comparable uncontrolled price method ₹ 15,000 per car addition could be made in total income. However ₹ 15,000/- shall be reduced by ₹ 2,000/- (₹ 500 X 4) due to wheel cap feature not provided in car sold to associated enterprise. The final addition for point one therefore comes to ₹32.50 crores = 25000 cars X ₹13000/car.

Working note 2: Royalty paid to Suzuki Motors, Japan is excess by ₹ 5 crore hence while applying transfer pricing provisions the income of the assessee shall increase by such amount.

Working note 3: The interest paid to the related party @ LIBOR + 4.0% is certainly lower as compared to the market rate of interest of LIBOR + 4.5% thus no adjustment shall be made in total income computation by considering the provisions of section 92(3).

Q2. X Ltd (an Indian Company) sells various kinds of garment products according to the requirement of its clients all across the world. The company has sold following products in the current financial year to following vendors:

Product Type	Trousers	T-Shirts	Office Wear Shirt	Formal Shirt
Sold To	Polo International (US)	Axis (UK based Subsidiary Co.)	John Miller	John Player
Price Charged	₹ 1,400	₹ 1,000	₹ 1,200	₹ 1,500
Quantity Sold	2,00,000 pcs	2,50,000 pcs	1,50,000 pcs	1,90,000 pcs

Company maintains a gross profit margin of 30% on the selling price. In case of sale to Axis (subsidiary co.) the company has provided a purchase invoice received from Mudra Garments Ltd. reflecting per piece cost of ₹ 850/-. Following functional difference were noted between transaction with Axis and other parties:

a) Sales to non-associated party is made with a specialised packaging for which 3% margin is included in the selling price.

b) Tagging on the product required by the client consumes a cost of ₹ 3 per piece whereas in case of sales made to Axis no tagging is done.

c) Products sole to non-associated parties involve a credit period of 6 months for which 0.5% per month margin on selling price is ensured by the company.

Determine the arm's length price based on the above information.

Solution: If the costing of the product (i.e. T-Shirts) sold to Axis is ₹ 850 per unit and company maintains a 30% GP ratio on sales, the price to be charged from Axis should be: 850 X 100 /70 = ₹1214/- per piece.

Now we can discount the functional differences as below:

	₹
Ideal Price to be Charged	1214.29
Less:	
Adjustment on account of packaging (since no packaging on goods sold to Axis)	36.42
Adjustment on account of tagging (since no tagging done on goods sold to Axis)	3.00
Adjustment on account of working capital cost (3% of selling price for 6 month)	36.42
Arm's Length Price	1138.45
Profit Difference to arise due to ALP Applicability [2,50,000 pcs X (1138.45-1000)]	3,46,12,500.00

THINK & JUDGE:

1. Transfer pricing provisions apply to every cross-border transaction.
2. Comparable uncontrolled price method it the most direct method of determining ALP.
3. In case the assessing officer decides to determine the ALP he has to refer the valuation to Transfer Pricing Officer.
4. Management, control and capital are the three basic criteria to determine the associationship between two associated enterprises.
5. Domestic transactions are not subject to transfer pricing provisions.
6. International transactions entered with reference to an advance pricing agreement may be subject to valuation by the Transfer Pricing Officer (TPO).
7. Specified domestic transactions can be subject to advance pricing agreement provisions.
8. Transfer Pricing Officer may determine ALP even on those transactions which are not referred to him by the Assessing Officer.
9. Taxation rates provided under section 94A are final rates of taxation.
10. In case of resale of goods the appropriate method for determination of Arm's Length Price will be cost plus method.