CA FINAL DIRECT TAX CLASSES BY

Anurag Singhal
CA (2005) and CPA (2008)
BIG 4 ALUMINI

SUMMARY BOOKLET ON

TRANSFER PRICING
Including Practical Case Studies

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FACE TO FACE CLASSES

CA FINAL DIRECT TAX CLASSES BY

YOUNG, DYNAMIC AND EXPERIENCED FACULTY

ANURAG SINGHAL CA (2005), CPA (USA) (2008)

THE FACULTY WHO UNDERSTANDS AND FULFILS THE REQUIREMENTS OF STUDENTS

? ?	✓	XX
WHAT STUDENTS REQUIRE	**WHY ANURAG SINGHAL IS THE RIGHT CHOICE**	**WHY NOT OTHERS**
An experienced and international class faculty	Anurag has worked with Big 4 (PwC and Deloitte) for seven years approx. Anurag has also worked with Reliance Industries Group for two and half years. Owns a tax focused consulting firm from last one year	Lacks International / MNC background
Face to face classes	Anurag's batch will be of face to face classes only for CA final students	Video sessions that too of direct tax are very boring
Students require conceptual clarity	Since Anurag has practically worked on the direct tax concepts, he has absolute clarity about the technical concepts	Conceptual clarity on old provisions but may lack in latest international tax provisions which is need of the day
Students need techniques to remember key points	Anurag will share the skill and technique to remember the technical language of direct tax	Makes you cram the provisions
Students need practical examples to understand the concept	Anurag has worked for vast number of International MNC and Indian MNC clients and therefore, he has lot of practical real life examples to share with students that will absolutely clarify the concepts	Old practical examples only – no latest and live examples
Students need experienced faculty with teaching and coaching skill set	Anurag has been teaching to CPA students (certified public accountant from USA) and various professional courses from past two years	No international experience

Batch	Mode	Days	Time	START DATE	Batch completion date
Batch I	FACE TO FACE	DAILY WEEK DAYS	5.30 PM to 9.00 PM	5TH DECEMBER 2016	Mid of March 2017

(REGISTER FOR FREE DEMO CLASSES)

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GM EDUCATION
CREATING GREAT MINDS

ANURAG SINGHAL TAX CLASSES

CA FINAL
DIRECT TAX CLASSES

PROFILE OF ANURAG SINGHAL

- Anurag has more than ten years of rich professional experience in advisory, structuring, compliance and litigation projects in Direct Tax, including Corporate Tax, Transfer Pricing, International Tax and Regulatory. He had worked with Deloitte and PwC in their Transfer Pricing and Tax& Regulatory Practice for seven years approx. He was also associated with Reliance Industries Group for two and half years in their Compliance and Taxation cell.
- Also, he has been coaching the CPA candidates (CPA from USA AICPA) and other professional students for last two years approx.
- He has extensively worked on planning studies, determining appropriate pricing models, profit attributable to permanent establishments, TP studies for compliance requirements, audit defense and litigation. Anurag has worked on TP documentation for MNCs with respect to their overseas operations as well.
- He also has substantial exposure in advising diversified clients on various issues relating to constitution of Permanent Establishment (PE), Attribution of profits to PE, Service arrangement vis-à-vis manpower arrangement, withholding tax obligations on various international / domestic payments etc. He has worked on Expat Taxation, Association of Persons, Real Estate Fund transactions including their PE Review, Funding/Exit Options.
- Anurag has extensively served a broad range of International and Indian clients across industries including automobile, industrial goods, IT, ITES, education, telecommunication, food and beverages, EPC contractors, event management, etc. on various aspects of tax and transfer pricing including tax planning, compliances, audits, dispute resolution, etc.
- Anurag has also worked / contributed on BEPS (Base Erosion and Profit Shifting), made presentations / new flash on this subject.
- Professional qualifications and affiliations:
  - Member of the Institute of Chartered Accountants of India (2005)
  - Certified Public Accountant from U.S.A. (2008)

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Contents

Transfer Pricing
Concept and Practical Case Studies

Key Terms in Transfer Pricing

- **Arm's Length Price (ALP):** The price charged in a transaction between unrelated parties
- **Transfer Price:** The price charged in a transaction between two associated enterprise
- **Uncontrolled Transaction:** Transaction between two unrelated parties
- **Controlled Transaction:** Transaction between two associated enterprises or related parties

Concept of TP is based on following factors:

- Nature of Controlled Transactions
- Analysis of functions performed, assets utilized and risks undertaken (FAR profile) in respect of transaction of a taxpayer with its associated enterprise.
- Transfer price transacted between associated enterprises
- Analysis of FAR profile of independent entities which undertake same / similar transactions as undertaken between associated enterprises.
- Arm's length price negotiated between independent entities for undertaking same / similar transactions
- Transfer Pricing is not an exact science rather it is subjective

Applicability of TP Provisions contained in Section 92 to 92F of the Act

- TP Provisions apply to International Transactions and Specified Domestic Transactions (SDT);
- Transactions between two or more Enterprises;
- Those enterprises are Associated Enterprises (AEs).

Compliance Requirements - Stepwise

- *Step 1:* Computation of income/ allowance of expenses considering Arm's length price [Section 92]
- *Step 2:* Maintenance of prescribed documentation (also called as Transfer Pricing Study) (Section 92D & Rule 10D)
  - In the Transfer Pricing Study, the Company maintains back documentation / back up of computation of Step 1.
- Obtaining of Accountant's report (CA Certificate) (under Form 3CEB) (Section 92E)
  - In this Form, CA certifies whether the transactions undertaken by the taxpayer with its AE are at ALP or not
- Step 4 - Rigorous penalties have been prescribed (under Sections 271AA, 271BA, 271G, 271(1)(c)) to ensure compliance with the arm's length principle. In case of default, such penalties may be imposed

Legislative Provisions

- **Section 92(1):** Any income or expense arising from an international transaction shall be computed considering the arm's length price
- **Section 92(3):** The TP provisions are not applicable in case determination of arm's length price reduces the income chargeable to tax or increases the loss of the taxpayer

International Transaction (Section 92B)

- Transactions between two or more AEs, either one entity or both of entities are non- residents
- Transaction relates to:
  - Purchase, sale or lease of tangible or intangible property; or
  - Provision of services; or
  - Lending or borrowing money; or
  - Any other transaction having a bearing on the profits, income, losses or assets of the enterprises; or
- Mutual agreements or arrangements for allocation or apportionment of, or any contribution to, any cost or expense incurred
  - Eg. US MNC and its subsidiaries across the world including India agreed to research and develop a drop on collective basis and each entity will share the cost. On these cost sharing arrangements also, TP provisions would be applicable
- Definition of international transaction includes:

Tangible Property	❖ Purchase, Sale, Transfer, Lease /Use of property/ article/ product/ thing ❖ Includes Building, Vehicle, machinery etc.
Intangible Property	❖ Purchase, Sale, Transfer, Lease /Use of IP ❖ Includes Transfer of ownership/use of rights/other commercial right
Capital Financing	❖ Long/short term borrowing/ lending ❖ Guarantee provided or availed ❖ Purchase/Sale of Securities ❖ Advances/receivables, Payments/any debt, etc
Provision of Services	❖ Market Research/ Development ❖ Technical Service ❖ Scientific Research ❖ Legal/ Accounting Service etc.

Business Restructuring	❖ Transaction of Business restructuring/reorganization with AE irrespective of bearing profit/income/loss or assets – at the time of transaction/future date

Associated Enterprise

Meaning of Associated enterprise (Section 92A)

Based on participation in Capital / subscription to Loan	Based on participation in management activities	Based on specific activities	Based on control of one person on another person
❖ 26% direct or indirect holding by the enterprise	❖ Appointment of more than half of the directors	❖ Supply of >90% of the raw materials	❖ Common control individual or his relative or jointly by such individual and relative of such individual
❖ 26% direct or indirect holding by the same person in both enterprises	❖ One or more executive directors	❖ Wholly dependent on the intangibles provided	❖ Control by HUF and other member of HUF / relative
❖ Loan equal to or greater than 51% of total assets	❖ Appointed by the same person in both enterprises	❖ Sales under influenced prices and conditions	
❖ Guarantee equal to or greater than 10% of borrowings			

Example

- C US holds 100% share capital of B US
- C US also holds 100% share capital of A India
- Both A and B are associated enterprises of C.
- A and B are also considered as associated enterprises to each other

Example

- C US holds 100% share capital of B US
- B US holds 100% share capital of A India
- B and A are associated enterprises

- Also, C and A are associated enterprises

Determination of arm's length price

Arm's length price

- Price applied or proposed to be applied in a transaction between independent entities in uncontrolled conditions
- Arm's length prices to be determined using one of the prescribed methods
- The final method selected for determination of ALP is called as most appropriate method
- The most appropriate method may result in one ALP or more than one ALP

Prescribed Transfer Pricing Methods - OECD Transfer Pricing Methods

Traditional Transaction Methods

- Comparable Uncontrolled Price
- Resale Price Method
- Cost Plus Method

Transactional Profit Methods

- Profit Split Method
- Transactional Net Margin Method

Other Methods

- New Method which is commonly called as 'Any Other Method'

Comparable Uncontrolled Price Method ("CUP Method")

- CUP method requires comparison of PRICE of comparable uncontrolled transaction with the controlled transaction
- Identify comparable transactions
- Adjust the price of such transactions to account for differences between the controlled transaction and the uncontrolled transaction
- The adjusted uncontrolled price is the arm's length price

Example

- Sun US sells 10 kg of coffee beans to Sun India @ USD 98 per kg (associated enterprises)
- Star US sells 8 kg of coffee beans to Moon India @ USD 100 per kg (independent enterprises)
- The price paid by Sun India is less as compared to the price exchanged in independent transaction
- The lower cost results in higher income to Indian entity (Sun India) from a controlled transaction
- Therefore, transaction between Sun US and Sun India can be said to be at ALP

KEY NOTE:

- Let's assume that Star US instead of selling to Moon India sells the same goods to Star India at the same price

- In this case, the transaction between Star US and Star India cannot be considered as a comparable for determining the ALP of transaction between Sun US and Sun India

Resale price method ("RPM")

- RPM requires comparison of GROSS MARGIN on resale of GOODS purchased from an associated enterprise
- Identify comparable transactions / companies
- Determine gross margin (Gross Profit / Sales) of the third party transactions / companies
- Adjust the gross margin for differences in FAR between the third party transactions (comparable transaction) and the related party transaction (controlled transaction)
- Determine the arm's length price of the controlled transaction based on the adjusted gross margin on comparable transactions

Example:

- X US sells goods to X India @ USD 10
- X India resells the same goods to third party customer @ USD 12 (equivalent INR)
- Y US sells goods to Z India and Z India resells the goods to third party customers @ 25% gross margin
- The price charged by X India to third party customer is USD 12 (equivalent INR)
- Therefore, cost of goods sold is USD 9 in the hands of X India
- However, X India purchased goods at USD 10, accordingly, price paid by X India cannot be said to be ALP
- Adjustment of USD 1 is required to be made to the income of the X India

Cost Plus Method

- Cost Plus Method requires comparison of GROSS MARGIN on supply of GOODS OR SERVICES to an associated enterprise
- Identify comparable transactions / companies
- Determine gross margin (Gross Profit / Cost of Goods/Services Sold) of the uncontrolled transactions / companies
- Adjust the gross margin for differences in functions, assets and risks between the third party transactions (comparable transaction) and the related party transaction (controlled transaction)
- Determine the arm's length price of the controlled transaction based on the adjusted gross margin on comparable transactions

Transactional Net Margin Method ("TNMM")

- Comparison of Net Profit comparable uncontrolled transaction / companies with the net margin of the controlled transaction
- Net margin may be computed with reference to cost, sales or any other relevant profit level indicator
- Identify comparable transactions / companies
- Adjust the price of such transactions to account for differences between the controlled transaction and the

uncontrolled transaction

- Determine the arm's length price for the related party transaction on the basis of the adjusted net margin of the uncontrolled transactions

Example

- A India is engaged into back-end software development services to its AE – A US
- A US further customize/ upgrade the software and sells to its clients in US
- The total cost incurred by A Ltd for providing software development services is INR 500
- It is remunerated from A US at cost plus 20% at net margin level
- Therefore, A India would receive INR 600 from A US
- **KEY NOTE:** In case of TNMM, the net profit percentage of A India would be compared with the net profit percentage of similar companies engaged in providing similar software development services
- If net profit percentage of B India is let say 22%, in that case, transaction of A India cannot be said to be at ALP
- If net profit percentage of B India is let say 20% or less, in that case, transaction of A India is said to be at ALP

Profits Split Method

- Split the profit from the whole transactions between various related parties based on their relative contribution
- Identify comparable transactions for every related party involved in the transaction
- Determine net profit earned by comparable companies
- Attribute profits to each related party involved
- Allocate the super normal-profit / loss to each related party involved on the basis of their relative contribution

Example

- A US, A India and A UK are engaged in developing a software
- Each entity has its own intangible let say in terms of its specialized and experienced manpower
- A US has expertize to develop the code of software
- A India has expertize in terms of conceptualization of software
- A UK has expertize in designing of software
- The software would be developed with joint efforts and contribution from each entity
- The final product would be sold to the customer
- In this case, each entity is remunerated with some percentage of net profit margin on its respective costs
- Balance profit left would be considered as super normal profit and the same would be allocated as per contribution of each entity
- This is called as split of profits between associated enterprises

Sixth Method (Any Other Method)

- Where the application of the five specific methods is not possible due to difficulties in obtaining comparable data or due to peculiar nature of transactions
- Any Other Method may be used for determining the ALP of following transactions:
    - Intangibles or business transfers,
    - transfer of unlisted shares,
    - sale of fixed assets,
    - guarantees provided and received, etc.
- Examples of application:
    - Third party quotations
    - Valuation reports
    - Commercial & economic models

Most Appropriate Method

- Rule 10C (1) – Method which provides the most reliable measure of an arm's length price in relation to an international transaction or a Specified Domestic Transaction
    - In simple words, the method which is eventually / finally used for determination of ALP of a particular transaction is called as Most Appropriate Method
    - If a taxpayer has entered into multiple transactions on which provisions of TP would be applicable;
        - Most Appropriate Method to be determined for each individual transactions; OR
        - Same Most Appropriate Method can be used for number of transactions provided those transactions are clubbed together
- Choice of Most reliable measure would depend on availability of comparable data (data of transaction between independent parties)
- Comparable data is more likely to be available for benchmarking an entity that is relatively less complex
- For a complex entity that has intangibles and multiple operations, it is very difficult to find a true comparable
- Gross margin of manufacturing comparable companies may not be possible to figure out from Schedule VI Profit and Loss Account and hence Cost Plus Method is usually very difficult to apply in practice

Comparables

- All methods require use of comparables for determining ALP
- Transfer price is set using data from comparable transactions
- Comparable transaction should be independent and similar to tested (controlled) transactions
- Factors for judging comparability (Rule 10C(2)):
    - nature of transactions undertaken (i.e. type of goods, services etc.)
    - company functions
    - risks assumed

- contractual terms (i.e. similar credit terms)
- economic and market conditions

Illustrative Practical Case Studies

Practical Case study 1

- Orange Netherlands holds 100% share capital of both Orange India and Orange UK and hence, all three are associated enterprises
- Orange Netherlands licenses technology to both Orange India and Orange UK
- It charges Royalty @ 3% of GROSS SALES from Orange UK and @ 8% of NET SALES from Orange India
- Can CUP method be applied to this transaction?

Answer

- One controlled transaction cannot be compared with another controlled transaction
  - Therefore, transaction between Orange UK and Orange Netherlands cannot be considered as a base for determining ALP of transaction between Orange Netherlands and Orange India
  - Firstly, applicability of CUP should be seen – both external CUP data and internal CUP data
  - If it is not possible to apply CUP method due to non-availability of comparable data in third party transactions, **then TNMM may be applied as the most appropriate method**

Practical Case study 2

- Go Inc. USA (owns intangibles and is complex) sells 100kgs of coffee beans at Rs 90/kg to Go India (an Indian subsidiary)
- Both Go Inc and Go India are related to each other
- Go India sells 10kgs of same goods at Rs 100/kg to third parties in India
- **Explain with reason which method to be applied to this transaction?**

Answer

- **KEY NOTE: CHOICE OF TESTED PARTY IS ALSO ONE OF THE KEY FACTORS IN BENCHMARKING PROCESS.**
- IN THIS ILLUSTRATION, THE DATA OF THIRD PARTY COMPANIES UNDERTAKING SIMILAR TRANSACTION(S) IN INDIA SHOULD BE OBTAINED
- If data of indian entity is not available then data overseas data may be used
- Choice of Most Appropriate Method would depend on the availability of comparable data
- If comparable prices for 'identical' product is available then CUP may be applied (with few/ limited adjustments)
- If gross margin of comparable distribution companies is available, RPM may be used
- Cost Plus may not be appropriate method for benchmarking an intangible-owning complex entity
- If gross margin of comparable distribution companies is not available, TNMM may be the only method that could be applied
- PSM cannot be applied since intangibles are owned by the foreign AE and not by Indian entity

Practical Case study 3

- Bell US has following two transactions
- First transaction with related party in India – Bell India – to whom it has sold 100 kg of coffee beans @ INR 90 per kg
- Second transaction with another related party in US – Bell Jem US – to whom it has sold 100 kg of coffee beans @ INR 90 per kg
- Third transaction with third party in US – ABC US - to whom it has sold 1000 kg of coffee beans @ INR 80 per kg (in equivalent dollars)
- Which method can be applied to this transaction?

Answer

- Bell US has supplied to third parties in the US at INR 80/kg (in equivalent dollars) while it has supplied to Bell India at INR 90/kg
- Transaction between Bell US and Bell Jem US cannot be considered as comparable
- Quantity supplied to third parties is substantially higher in comparison to the quantity supplied to Bell India
- Given the above, a direct comparison of the prices may not be made and hence, CUP method may not be applicable
- Appropriate adjustment for volume discount to be made (to uncontrolled transaction) before comparison with the controlled transaction
- Where such comparison is not possible, RPM or TNMM may be applied depending upon the available comparable data

Practical Case study 4

- Soft US and Soft India are associated enterprises
- Soft US developed a software
- Soft India imported the master copy of software and created duplicate copies for sale to third party customers in India
- For import of software, Soft India paid royalty payments for distribution based on net sales
- Explain with reason which method can be applied to the transactions?

Answer

- Selection of the most appropriate method would depend on available comparables
- CUP may be an appropriate method, if
    - comparable software duplicators and distributors are identified and
    - their royalty rates are available in the public domain
- In CUP data is not available, RPM and TNMM may be explored
- Since the functions of Soft India are not merely distribution, RPM may be applied only if a perfect comparable is identified
- In the absence of comparable data for RPM, TNMM may be applied as the most appropriate method

Practical Case study 5

- PQR USA and PQR India are associated enterprises
- PQR India is an entrepreneur and developed the patents (intangible related to medical drug) independently
- PQR India sold the registered patent for Rs. 50 crores based on value computed from independent valuer
- Explain with reason which method can be applied to the transactions?

Answer

- A valuer's report based on generally accepted valuation methodology is considered as reasonable estimate of comparable transactions
- I.e. an independent report can be considered to provide a base as to how third parties may value intangibles if such intangibles are to be sold to unrelated parties
- Accordingly, the valuer's report provides a computation of arm's length price
- In this case, the most appropriate method is Any Other Method - the Sixth Method as provided under the Indian TP Rules

Deemed international Transaction

- The deeming provision [Section 92 B (2)] are applicable if the following conditions would be satisfied, i.e. even a transaction between taxpayer and a third party would be covered under TP on satisfaction of either of following conditions:
    - **Condition 1:** if there existed a prior agreement between such unrelated person and the AE OR
    - the terms of the transaction are determined in substance between such unrelated person and the AND
    - **Condition 2:** Either taxpayer or AE or both need to be non-resident
    - **Condition 3:** Third party can be either resident or non-resident

Illustration on deemed international transaction:

- XYZ US has a 100% subsidiary XYZ India. Therefore, XYZ US will become AE of XYZ India
- XYZ India entered into a transaction with ABC India – which is an independent third party
- However, XYZ US entered into a prior agreement with ABC India in relation to the transaction to be entered between XYZ India and ABC India
- Whether transaction between XYZ India and ABC India is covered in TP?

Solution

- **As per latest provision – below mentioned three conditions need to be checked:**
    - **Condition 1:** There exist a prior agreement between such ABC India and XYZ US
    - **Condition 2:** XYZ US is non-resident
    - **Condition 3:** ABC India is resident
- **Since, above three conditions are satisfied, therefore,** transaction between ABC India and XYZ India would be considered as an international transaction as per section 92B(2) of the Act

Domestic TP

Introduction

- TP provisions are made applicable to CERTAIN (not all) Specified Domestic Transactions (SDTs) with effect from Financial Year 2012-13
- Taxpayers who enter into SDT are also required to maintain Transfer Pricing documentation
- The TP provisions on SDT are incorporated to determine reasonable expenditure and income eligible for tax holiday
- If aggregate value of all SDT exceed INR 200 Million (INR 20 crores), then only TP provisions would be applicable to SDT
- Allowance for expenditure or allocation of cost or expense or any income in relation to SDT to be computed having regard to Arm's Length Price (ALP)

Definition of SDT

Following are covered under the definition of SDT:

- Payments to related parties as defined under section 40A(2)(b) Tax holiday related transactions (eligible business) [Under this clause, payments FROM related parties are not covered in SDT]
- Any transaction referred to in section 80A
- Any transfer of goods/services referred to in section 80IA(8)
- Any business transaction referred to in section 80IA(10)
- Any transaction under Chapter VI-A or u/s 10AA – to which provisions of section 80IA (8) or section 80IA (10) apply
- Any other transaction as may be prescribed

Domestic TP – Applicability

- Taxpayer cannot apply TP to SDT so as to reduce total income that is subject to tax
- Monetary threshold of INR 20 Crores to be computed based on aggregate of payments and receipts to which the provisions apply during a Financial Year
- Definition of the term "related parties" is provided under Section 40A(2)(b) and it also includes entities which have common beneficial ownership
- Most of TP provisions applicable to international transactions are applicable to SDT as well. The exception is Advance Pricing Agreement (APA) provisions i.e. APA provisions are not applicable to SDT

Section 40(2) – Payments to related parties

- Payments by taxpayers to certain specified persons covered within the ambit of section 40A(2)
- If the taxpayer/assessee is a company, following persons regarded as 'specified persons' i.e. transactions between the following persons would be covered under SDT:
    - Directors of the taxpayer company or any relative of such directors

- Individuals having **Substantial Interest** (SI) in the business of taxpayer company or any relative of such individual
- Persons having a SI in the business of the taxpayer company
- Directors of the entities having SI in the business of the taxpayer company or any relatives of such directors
- Any company having the same holding company (which holds a SI) as that of the taxpayer company
- A company of which a director has a SI in the business of the taxpayer company, any director of such company or any relative of such director
- Persons/entities in which taxpayer company/its directors/ their relatives have a SI

- Payments by an individual, firm, AOP and HUF to certain specified persons are also covered within the ambit of section 40A(2)
- A person shall be regarded as having a **Substantial Interest** in a business if at any time during the previous year
  - Such person is the beneficial owner of shares carrying more than 20% of the voting power (in case of a company)
  - Such person is beneficially entitled to more than 20% of the profits of such business (in any other case)

General scope of Section 40A(2)

- Applicable to taxpayers making the payment/incurring expenditure and not to recipients of such income
- If a TP adjustment (due to decrease in expenditure) is made to payer's income, no corresponding relief would be provided to the payee (for lower income)
- If no payment is made or payment is less than ALP, in that situation, it cannot be considered as excessive/ unreasonable
  - In other words, TP adjustment would be made only if amount payment exceeds ALP
- Generally, following payments may be covered:
  - Payment towards purchase of raw materials, services, use of asset
  - Payment towards sharing of common premises/facilities
  - Payment of interest on loan
  - Payment of managerial remuneration, salary, bonus, commission, etc. to directors

Payments to related parties – Illustration

- Best Ltd has 25% shareholding in Good Ltd
- Best Ltd also has 22% shareholding in Better Ltd
- Better Ltd provided services to Good Ltd - the value of such services is INR 28 Crore
- Whether TP provisions would be applicable.

Solution

- Best Ltd. is a common shareholder of Good Ltd and Better Ltd and shareholding in both the companies exceed 20%.

- Given the above, the relationship between Good Ltd and Better Ltd is covered under Section 40A(2)(b)
- Since the value of transaction exceeds INR 20 crore, therefore, the transaction is covered under definition of SDT and provisions of TP would be applicable
- Since, the case is covered under Section 40A(2), the provisions of TP is applicable on the person who has incurred expenditure.
- Accordingly, TP provisions would be applicable on Good Ltd

Tax holiday eligible business

- SDT provisions apply to business transactions/transfers referred to in section 80A, 80IA(8), 80IA(10), 10AA, Chapter VI-A provisions
- Section **80A(6) and Section 80IA(8) require adjustment to tax holiday profits where**
    - **Goods and services of eligible business are transferred to any other business carried on by the same taxpayer and vice versa**
    - Consideration for such transfer as recorded in the accounts of eligible business does not correspond to market value of such goods/services
    - In such cases, tax authorities/ taxpayer required to recompute tax holiday claim by reference to ALP of such goods/services

General scope of Section 80A(6)/ 80IA(8)

- Covers transfer of goods/ services held by "eligible business" to another business or vice versa
- Existence of two or more separate businesses of the same taxpayer
- Transfer of goods/ services between the businesses

General scope of Section 80IA(10)

- Tax officer empowered to re-compute tax holiday profits if:
    - more than "ordinary profits" have arisen in the eligible business due to transactions between closely connected persons or for other reasons

TP compliance requirements

Transfer pricing Documentations

- Entity Related
    - Ownership Structure
    - Profile of multinational group
    - Business description/ Profile of industry
- Price Related
    - Nature and terms (including price) of international transactions
    - Description of functions performed, risk assumed and assets employed (functional analysis)
    - Records of economic and market analysis (economic analysis)

- Record of budgets, forecasts, financial estimates
- Any other record of analysis (if, any) to evaluate comparability of international transaction with uncontrolled transaction(s)
- Description of method considered with reasons of rejection of other methods

- Transaction Related
  - Details of transfer pricing adjustment made (if, any)
  - Any other information e.g. data, documents like invoices, agreements, price related correspondence etc.
  - Detailed documentation not required in case aggregate value of all international transactions does not exceed one crore rupees (twenty crores rupees in case of specified domestic transactions)
  - List of supporting documents to be maintained - Contemporaneous data requirements
  - Need to obtain Accountant's report (under Form 3CEB) to be filed along with the return of income

Accountant's report (Form 3CEB)

- To be obtained by every tax payer filing a return in India and having international transaction and / or SDT
- To be filed by due date for filing return of income
- The TP auditor is required to comment on the following:
  - whether the tax payer has maintained the transfer pricing documentation as required by the legislation,
  - whether as per the transfer pricing documentation the prices of international transactions and specified domestic transactions are at arm's length, and
  - certifies the value of the international transactions and specified domestic transactions as per the books of account and as per the transfer pricing documentation are "true and correct"

TP Penalties

Section	Default	Penalty
Section 271(1)(c)	Post - inquiry adjustment (deemed concealment of income)	100 - 300% of tax on the adjusted amount
Section 271AA	Failure to maintain documents Fails to report transactions / Maintains or furnishes incorrect documents	2% of the transaction value
Section 271G	Failure to furnish documents	2% of the transaction value
Section 271BA	Failure to furnish accountants report	Rs 100,000

Transfer Pricing Audit Process

Transfer Pricing Calendar

- Due date of completion of Transfer Pricing Documentation and filing of Form 3CEB (Accountant Report) - 30 November following the Financial Year (i.e. 30 November of Assessment year)
- Time limit for completion of assessment - 43 months from the end of the FY (i.e. 31 Oct 2016 for the FY 2012-13 i.e. AY 2013-14)
- Documentation to be retained for 8 years

Routine Audit Process

- AO to determine ALP u/s 92C(3)
- AO also may refer determination of ALP to the TPO (notification issued by CBDT which provides the circumstances in which AO has to mandatorily refer to TPO)
- Taxpayer to substantiate transfer price as ALP to TPO
- TPO to determine ALP by passing an order
- Intimation to taxpayer & AO
- AO to compute taxable income
- AO to pass Draft order

Option 1

- Taxpayer to file objections with DRP
- DRP to pass directions
- AO to pass final order
- Appeal/ Rectification

Option 2

- Taxpayer intimates to AO that he will file appeal with CIT(A)
- AO to pass final order based on draft order
- Taxpayer files appeal with CIT(A)
- Appeal/ rectification

The key difference between filing before DRP and CIT(A) are as follows:

- DRP has to provide directions within 9 months from the date of filing of objections
- No full/ part demand of additional tax need to be deposited in case taxpayer files objections before DRP

Domestic Law Dispute Resolution Process

- TPO’s Order
- AO’s draft order
- DRP objections
- Tribunal
- AO’s Final Order
- DRP order

- High Court
- Supreme Court

Advance Pricing Agreements

What is an APA? Finance Act, 2012 – Salient features

- An agreement between the Central Board of Direct Taxes (CBDT) and any person determining
  - the arm's length price (ALP) or
  - specifying the manner in which the ALP is to be determined
  - in relation to an international transaction
- Flexibility to determine arm's length price using unspecified method/ adjustments/variations, as necessary
- Valid for the periods specified in the APA and for a maximum period of 5 consecutive years and 4 earlier years
- Binding on taxpayer and tax authority, unless there is a change in facts/ law

Indian APA rules - Overview

Overview of the process

PRE-FILING	APA REQUEST	EVALUATION AND NEGOTIATION – AGREEMENT	EXECUTION AND MONITORING
Unilateral vs bilateral vs multilateral	Industry overview	Field work (functional interviews, review financial statements)	Annual report, record-keeping
Pre-filing meeting (anonymous also permitted)	Supply chain overview	Position papers – face to face meetings	Audit
Pricing study and strategy	FAR analysis	Critical assumptions	Revocation, cancellation or revision
	Proposed economic analysis	Drafting and concluding APAs	Renewal
	Proposed term		

Administrative structure in India for APAs

- UNILATERAL
  - Chairperson CBDT
  - DIRECTOR GENERAL OF INCOME TAX
  - Director APA
  - Team of Officers, economists and statisticians

- BILATERAL / MULTILATERAL
  - Chairperson CBDT
  - COMPETENT AUTHORITY
  - Director APA
  - Team of Officers, economists and statisticians
- All APAs to be approved by the Central Government
- Common team at the back end for unilateral and bilateral / multilateral APAs

Key Features & Implications

FEATURE	DESCRIPTION
Eligibility	Taxpayer who has undertaken or is proposing to undertake an international transaction
Types of APAs	Framework allows unilateral, bilateral and multilateral APAs
Pre-filing application and consultation	Prescribed format provided for pre-filing. Application will be followed by a meeting with the APA authority. Pre-filing on a no-name or anonymous basis is also permitted. Not mandatory now
Filing Fee for APA	Prescribed fee in the range of USD 18,000 to USD 37,000 depending on the value of transactions sought to be covered in the APA
Filing timeline	The application can be filed anytime (i) before the first day of the financial year for which the application is made in respect of existing or continuing transactions; or (ii) before undertaking a proposed transaction
APA application	Prescribed format provided requesting extensive details of the taxpayer's business, transactions and industry.
Evaluation and negotiation	APA authority is empowered to hold meetings with the applicant, request for additional information, and visit the applicant's business premises to arrive at its final decision
Agreement	The APA authority needs to seek approval from the Central Government to enter into the APA
Bilateral & Multilateral APAs	The CAs would negotiate the terms of the agreement. The APA process will not be initiated unless the foreign taxpayer has filed a request with the CA of his country
Post APA compliance	An Annual Compliance Report (ACR) needs to be filed for each year covered by the APA and a compliance audit would be undertaken to monitor adherence to the terms of the APA
Revision, cancellation and withdrawal of APA	APAs can be revised in the event of significant changes to the underlying terms of the agreement. Non-compliance can lead to cancellation of an APA. A taxpayer is also free to withdraw an APA application if a mutually acceptable outcome is not reached

Roll back provisions of APA

- Roll back provision introduced in APA scheme allows going back upto 4 years
- Roll-back rules provide the procedure for seeking roll-back and the circumstances in which the roll-back may be denied or may result in cancellation of the roll-back
- As per the roll-back rules, an applicant who has filed or proposes to file an APA application may seek a roll-back of the APA for the same international transaction for which an APA has been applied or is proposed to be applied
- Rules provide that a roll-back can be applied for a maximum of four years, prior to first of the previous years for which an APA is sought
- The roll-back can be applied by filing the prescribed form (Form 3CEDA), along with a filing fee of INR 500,000 with the Indian Government
- Pre-filing meeting in relation to an APA made voluntary

Applicability of Roll-back

- Applicable for the international transactions which the applicant proposes to cover as part of the APA, subject to the applicant having filed the return of income and the transfer pricing accountant's report in Form 3CEB for the relevant years for which the roll-back is sought
- The arm's length price as agreed under the APA shall be applicable for the international transactions covered under the rollback years
- Roll-back provisions not applicable for a roll-back year in case the international transaction has been subject matter of appeal such year and the ITAT has passed an order disposing off such appeal before signing of the APA
- Roll-back provisions also not applicable for a roll-back year if it has the effect of reducing total income or increasing the loss, as case may be, of the applicant as declared in the return of income of the said roll-back year

Filing timeline, application fee and form for Roll-back

- The application seeks information with respect to details of international transactions, number of years applicant wishes to cover, compliance with filing of return of income and accountant's report (Form 3CEB) and pending litigation (forum where appeal is pending and whether Appellate Tribunal has disposed off any appeal in respect of covered international transaction for any of the roll-back years)
- Applicant to withdraw past appeals relating to roll-back years to the extent of covered transactions, file a modified return of income based on the arm's length price agreed and remit additional tax liabilities, if any
- In case appeals relating to roll-back years for covered transactions are filed by Revenue Authorities, the same shall be withdrawn within three months of filing modified return of income by the applicant
- Applicant/Revenue Authorities to intimate various appellate authorities where appeal was pending of the agreement in place containing roll-back provision at the earliest
- Agreement to be cancelled, in case effect cannot be given to the roll-back provision for any roll-back year to which the agreement applies on account of failure on the part of the applicant

Use of multiple year data

This is applicable for only those international transactions or SDTs, entered into on or after 1 April 2014.

- It is provided that where the Resale Price Method (RPM), Cost Plus Method (CPM) or Transactional Net Margin Method (TNMM) is used as the MAM for the determination of the ALP of international transactions or SDT entered on or after 1 April 2014, comparability will be conducted based on
  - data relating to the current year; or
  - data relating to the financial year immediately preceding the current year, if the data relating to the current year is not available at the time of furnishing the return of income
- However it has also been provided that, during the assessment proceedings, if the current year data becomes available, the same shall be considered irrespective of the fact that such current year data was not available at the time of furnishing of return of income.

Range concept

- Till now, only “arithmetic mean” i.e. simple average concept is allowed to determine the arm’s length price
- Recently, Government has introduced "range" concept for determination of ALP
- Range Concept may provide greater flexibility to taxpayers in respect of setting of transfer price as compared to the existing ‘arithmetic mean’ approach
- A minimum of six comparables would be required in the dataset for applying the concept of range i.e. if number of comparables are less than six, then, arithmetic mean concept would continue to apply
- An arm’s length range beginning from the thirty- fifth percentile of the dataset (arranged in ascending order) and ending on the sixty-fifth percentile will be considered
- The concept of range will not be applicable in cases where the most appropriate method is selected to be the profit split method or the ‘other method’
- If the price at which the international transaction or SDT is undertaken is within the thirty-fifth percentile to sixty-fifth percentile of the dataset, the transaction shall be deemed to be at the ALP
- If the price at which the international transaction or the SDT is undertaken is outside the arm's length range (thirty-fifth percentile to sixty-fifth percentile of the dataset), the ALP of the transaction shall be taken to be the median of the dataset

- **Illustration 1** ***(From CBDT notification)*** - The data for the current year of the comparable uncontrolled transactions or the entities undertaking such transactions is available at the time of furnishing return of income by the assessee and based on the same, seven enterprises have been identified to have undertaken the comparable uncontrolled transaction in the current year. All the identified comparable enterprises have also undertaken comparable uncontrolled transactions in a period of two years preceding the current year. The Profit level Indicator (PLI) used in applying the most appropriate method is operating profit as compared to operating cost (OP/OC). The weighted average shall be based upon the weight of OC as computed below:

Sl. No.	Name	Year 1	Year 2	Year 3 [Current Year]	Aggregation of Operating Cost [OC] and Operating Profit [OP]	Weighted Average

1	2	3	4	5	6	7
1	A	OC = 100 OP = 12	OC = 150 OP = 10	OC = 225 OP = 35	Total OC = 475 Total OP = 57	OP/OC **= 12%**
2	B	OC = 80 OP = 10	OC = 125 OP = 5	OC = 100 OP = 10	Total OC = 305 Total OP = 25	OP/OC **= 8.2%**
3	C	OC = 250 OP = 22	OC = 230 OP = 26	OC = 250 OP = 18	Total OC = 730 Total OP = 66	OP/OC = **9%**
4	D	OC = 180 OP = (-)9	OC = 220 OP = 22	OC = 150 OP = 20	Total OC = 550 Total OP = 33	OP/OC = **6%**
5	E	OC = 140 OP = 21	OC = 100 OP = (-) 8	OC = 125 OP = (-) 5	Total OC = 365 Total OP = 8	OP/OC = **2.2%**
6	F	OC = 160 OP = 21	OC = 120 OP = 14	OC = 140 OP = 15	Total OC = 420 Total OP = 50	OP/OC = **11.9 %**
7	G	OC = 150 OP = 21	OC = 130 OP = 12	OC = 155 OP = 13	Total OC = 435 Total OP = 46	OP/OC = **10.57%**

- From the above, the dataset will be constructed as follows:

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

Solution

✓ For construction of the arm's length range the data place of thirty-fifth and sixty- fifth percentile shall be computed in the following manner, namely:

- Total no. of data points in dataset * (35/100)
- Total no. of data points in dataset * (65/100)

✓ Thus, the data place of the thirty-fifth percentile = 7*0.35 = 2.45. Since this is not a whole number, the next higher data place, i.e; the value at the third place would have at least thirty five percent. of the values below it. The thirty-fifth percentile is therefore value at the third place, i.e, 8.2%.

✓ The data place of the sixth-fifth percentile is = 7*0.65 = 4.55. Since this is not a whole number, the next higher data place, i.e; the value at the fifth place would have at least sixty five percent. of the values below it. The sixty- fifth percentile is therefore value at fifth place, i.e, 10.57%.

✓ The arm's length range will be beginning at 8.2% and ending at 10.57%.

✓ Therefore, if the transaction price of the international transaction or the specified domestic transaction has OP/OC percentage which is equal to or more than 8.2% and less than or equal to 10.57%, it is within the range. The transaction price in such cases will be deemed to be the arm's length price and no adjustment shall be required.

✓ However, if the transaction price is outside the arm's length range, say 6.2%, then for the purpose of determining the arm's length price the median of the dataset shall be first determined in the following manner:

- The data place of median is calculated by first computing the total number of data point in the data set * (50/100). In this case it is 7 * 0.5 = 3.5.

✓ Since this is not a whole number, the next higher data place, i.e; the value at the fourth place would have at least fifty percent. of the values below it (median).

- The median is the value at fourth place, i.e., 9%. Therefore, the arm's length price shall be considered as 9% and adjustment shall accordingly be made.

Safe Harbour Rules for determination of arm's length price in case of international transactions (Section 92CB)

Specified conditions for opting Safe Harbour Rules

- Where an ELIGIBLE assessee has entered into an eligible international transaction, the transfer price declared by the assessee in respect of such transaction shall be accepted by the income-tax authorities, if the specified conditions are satisfied:

<table>
<tr><th>S. No.</th><th>Eligible International Transaction

[Rule 10TC]</th><th>Circumstances/ Conditions / % of Safe harbor

[Rule 10TD]</th></tr>
<tr><td>(i)</td><td>Provision of software development services</td><td>The operating profit margin declared by the eligible assessee from the eligible international transaction in relation to operating expense incurred is –
<table><tr><td>Not less than the prescribed percentage</td><td>Where the aggregate value of such transactions entered into during the previous year</td></tr><tr><td>20%</td><td>does not exceed a sum of INR 500 crore</td></tr><tr><td>22%</td><td>Exceeds a sum of INR 500 crore</td></tr></table>
Software development services are defined, however, does not include any R&D services whether or not in the nature of contract R&D services</td></tr>
<tr><td>(ii)</td><td>Provision of information technology enabled services</td><td>The operating profit margin declared by the eligible assessee from the eligible international transaction in relation to operating expense incurred is –
<table><tr><td>Not less than the prescribed percentage</td><td>Where the aggregate value of such transactions entered into during the previous year</td></tr><tr><td>20%</td><td>does not exceed a sum of INR 500 crore</td></tr><tr><td>22%</td><td>Exceeds a sum of INR 500 crore</td></tr></table>
Information technology enabled services are defined, however, does not include any R&D services whether or not in the nature of contract R&D services</td></tr>
<tr><td>(iii)</td><td>Provision of knowledge process outsourcing services</td><td>The operating profit margin declared by the eligible assessee from the eligible international transaction in relation to operating expense is not less than 25%, irrespective of the aggregate value of the transactions entered into during the previous year

Knowledge process outsourcing services are defined, however, does not include any R&D services whether or not in the nature of contract R&D services</td></tr>
<tr><td>(iv)</td><td>Advancing of intra-group loans</td><td><table><tr><td>Where the amount</td><td>The Interest rate declared in relation to the</td></tr></table></td></tr>
</table>

<table>
<tr>
<td></td>
<td></td>
<td>
<table>
<tr><td>of loan does not exceed INR 50 crore</td><td>eligible international transaction is not less than the base rate of SBI as on 30th June of the relevant previous year + 1.5%</td></tr>
<tr><td>Where the amount of loan exceeds INR 50 crore</td><td>The Interest rate declared in relation to the eligible international transaction is not less than the base rate of SBI as on 30th June of the relevant previous year + 3%</td></tr>
</table>
“Intra-group loan” means loan advanced to wholly owned subsidiary being a non-resident, where the loan–
<table>
<tr><td>(i)</td><td>is sourced in Indian rupees;</td></tr>
<tr><td>(ii)</td><td>is not advanced by an enterprise, being a financial company including a bank or a financial institution or an enterprise engaged in lending or borrowing in the normal course of business; and</td></tr>
<tr><td>(iii)</td><td>does not include credit line or any other loan facility which has no fixed term for repayment</td></tr>
</table>
</td>
</tr>
<tr>
<td>(v)</td>
<td>Providing corporate guarantee</td>
<td>
<table>
<tr><td>Where the amount guaranteed -</td><td>The commission or fee declared in relation to the eligible international transaction is at the rate not less than -</td></tr>
<tr><td>does not exceed INR 100 crore.</td><td>2% p.a. on the amount guaranteed</td></tr>
<tr><td>exceeds INR 100 crore and the credit rating of the associated enterprise done by an agency registered with the SEBI is of the adequate to the highest safety</td><td>1.75% p.a. on the amount guaranteed</td></tr>
</table>
“Corporate guarantee” means explicit corporate guarantee extended by a company to its wholly owned subsidiary being a non-resident in respect of any short-term or long-term borrowing
Explicit corporate guarantee, however, does not include–
</td>
</tr>
</table>

		(i) letter of comfort; (ii) implicit corporate guarantee; (iii) performance guarantee; or (iv) any other guarantee of similar nature
(vi)	Provision of contract R&D services wholly or partly relating to software development	OP/ OC is not less than 30% Irrespective of the aggregate value of the transactions entered into during the previous year
(vii)	Provision of contract R&D services wholly or partly relating to generic pharmaceutical drugs	OP/ OC is not less than 29% Irrespective of the aggregate value of the transactions entered into during the previous year
(viii)	Manufacture and export of core auto components	OP / OC is not less than 12% Irrespective of the aggregate value of the transactions entered into during the previous year
(ix)	Manufacture and export of non-core auto components	OP/ OC is not less than 8.5% Irrespective of the aggregate value of the transactions entered into during the previous year

Practical Illustration

Examine the following transactions and discuss whether the transfer price declared by the following assessees, who have exercised a valid option for application of safe harbour rules, can be accepted by the Income-tax Authorities –

	Assessee	**International transaction**	**Aggregate value of transactions entered into in the P.Y.2015-16**	**Declared Operating Margin**	**Operating Expense**
(1)	A Ltd., an Indian Company	Provision of system support services to X Inc., which is a "specified foreign company" or "associated enterprise" in relation to A Ltd.	INR 600 crore	INR 90 crore	INR 450 crore
(2)	B Ltd., an Indian company	Provision of data processing services with the use of information technology to Y Inc.,	INR 400 crore	INR 62 crore	INR 300 crore

		its foreign subsidiary.			

Answer to specific illustration based on the above discussion

Follow these three steps to determine the answer to each of the above question:

Step 1	Step 2	Step 3
Determine the relationship between enterprises:	Determine whether the conditions laid down for eligible assesse are satisfied:	Determine the aggregate value of international transactions and the operating margin and applicability of safe harbor rules

Answer to Situation (1)

- **Determine the relationship between enterprises:**
  - It is provided that X Inc. and A Ltd. are associated enterprises
  - Further, provision of systems support services by A Ltd. (an Indian company) to X Inc. (a foreign company) is an international transaction between associated enterprises
  - Therefore, the provisions of transfer pricing are attracted in this case
- **Determine whether the conditions laid down for eligible assesse are satisfied:**
  - A Ltd is an eligible assesse since the following conditions are satisfied:
    a. Systems support services falls within the definition of "software development services" and hence, it is an eligible international transaction;
    b. A Ltd. is providing software development services to a non-resident associated enterprise; and
    c. A Ltd has exercised a valid option for safe harbour rules
- **Determine the aggregate value of international transactions and the operating margin and applicability of safe harbor rules**
  - The safe harbour rule is applicable if the aggregate value of transactions entered into in the P.Y.2015-16 exceeds INR 500 crore, and the eligible assesse should have declared an operating profit margin of 22% or more in relation to operating expense
  - However, since A Ltd. has declared an operating profit margin of only 20% (i.e., 90/450x100), therefore, condition of safe harbour rule is not satisfied as provided in Rule 10TD
  - Hence, it is not binding on the income-tax authorities to accept the transfer price declared by A Ltd

Answer to Situation (2)

✓ **Determine the relationship between enterprises:**

- Y Inc. (a foreign company) is a subsidiary of B Ltd. (an Indian company). Hence, Y Inc. and B Ltd. are associated enterprises
- Further, provision of data processing services by B Ltd. to Y Inc. is an international transaction between associated enterprises

- ❖ Therefore, the provisions of transfer pricing are attracted in this case

✓ **Determine whether the conditions laid down for eligible assesse are satisfied:**

- ❖ B Ltd is an eligible assesse since the following conditions are satisfied:
  a. Data processing services with the use of information technology falls within the definition of "information technology enabled services", and is hence, an eligible international transaction;
  b. B Ltd. is providing data processing services to a non-resident associated enterprise; and
  c. B Ltd has exercised a valid option for safe harbour rules

✓ **Determine the aggregate value of international transactions and the operating margin and applicability of safe harbor rules**

- ❖ Where the aggregate value of transactions entered into in the P.Y.2015-16 does not exceed INR 500 crore, the safe harbor rule is applicable where the eligible assesse declared an operating profit margin of not less than 20% in relation to operating expense
- ❖ In this case, since B Ltd. has declared an operating profit margin of 20.67% (i.e., 62/300x100), therefore, condition of safe harbour rule is satisfied as provided in Rule 10TD
- ❖ Hence, the income-tax authorities shall accept the transfer price declared by B Ltd in respect of such international transaction

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