Module – 1 – Transfer Pricing

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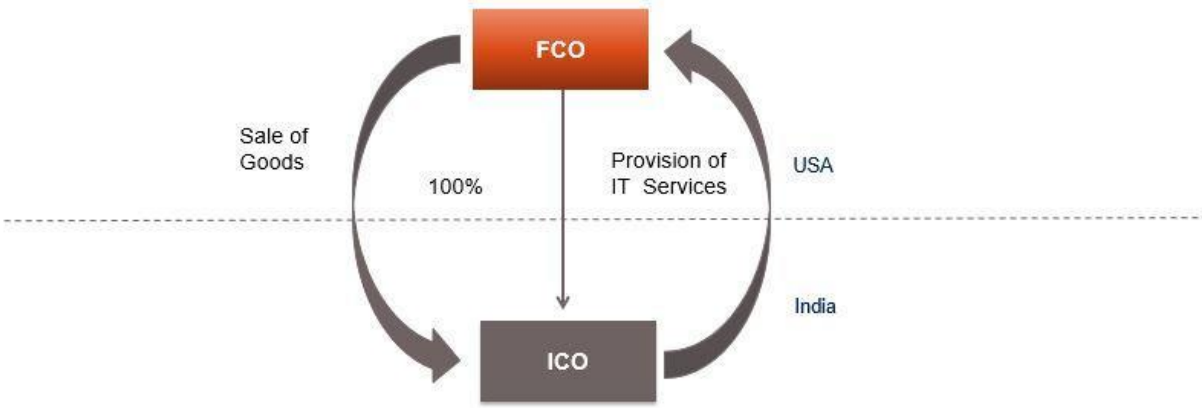
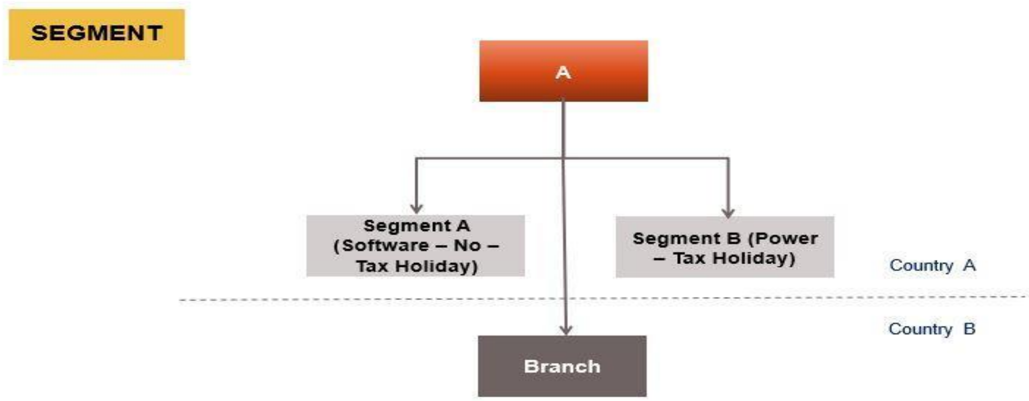
1. **TRANSACTION OF SALE OF GOODS OR PROVISION OF SERVICES**



2. **EVOLUTION OF TRANSFER PRICING**

Transfer pricing, was introduced for setting the right (i.e., arm's length) price, that should be charged for **product sold or services rendered**
by one segment of an enterprise (Segment A), to another segment (Segment B)/ Branch, of the **same enterprise**.

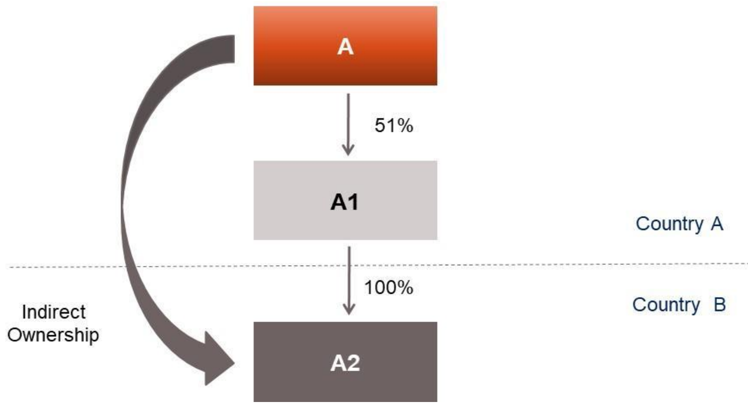


3. INTRODUCTION TO TRANSFER PRICING

With cross border economic growth, companies became Multi National Enterprise (MNE's) wherein they incorporated separate companies (instead of segment) in various countries.

EVOLUTION OF TRANSFER PRICING

ENTITIES



4. MEANING OF TRANSFER PRICE

Transfer Price, means the **price**, which is **charged** between two or more entities of a MNE [Associated Enterprises (AE' s)] **operating in different countries**.

INTRODUCTION TO TRANSFER PRICING

EXAMPLE: -

X Ltd. operates in Country A, wherein the tax rates are 30%. It intends to sell goods costing USD 100 to a customer in Country B for USD 150.

CASE I – IF GOODS ARE SOLD DIRECTLY TO A CUSTOMER IN COUNTRY B

In such a case, its **profit** would be: -

= (Sale Price – Cost)

= USD 150 - USD 100

= **USD 50**

Tax = 30% of profit = 30% of USD 50 or **USD 15**

X Ltd. saved USD 5 in taxes (USD 15 in CASE I Vs. USD 10 in CASE II) by selling goods via subsidiary C ltd. located in Country Y

<u>CASE II – IF GOODS ARE SOLD IN COUNTRY B VIA SUBSIDIARY IN ANOTHER COUNTRY</u>

To save taxes, X Ltd. incorporated a subsidiary in Country Y, namely Subsidiary C, where tax rate is 10% and sold the goods to C for USD 125, which in turn, sold the goods to buyer in Country B for USD 150.

In such a case, tax is computed as under: -

Tax = (Tax in Country A) + (Tax in Country Y)

= (125 - 100) *30 + (150 - 125) *10%

= 7.5 + 2.5 = USD 10

5. WHAT IS TRANSFER PRICING?

Different countries have different rules on taxation, in terms of tax rates, tax exemptions etc.
Unrelated entities, usually transact business, at prices which are driven by **commercial considerations**. However, in case of Multi National Enterprise, transaction between group companies, may be structured in a manner, whereby the **maximum profits accrue in jurisdiction with low/ Nil rates of taxes**. This is achieved through contracts and prices, which are driven by tax rates, rather than commercial considerations.

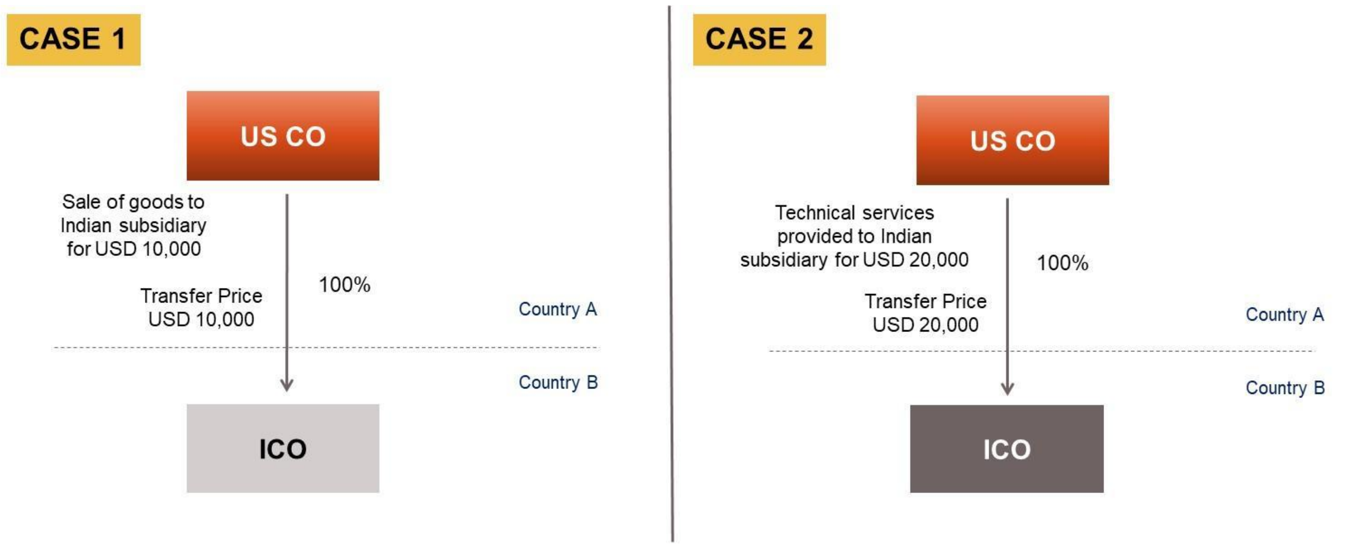
IN ORDER TO CURB THESE PRACTICES, AND ENSURE, THAT TAX IS PAID IN JURISDICTION, *WHERE ECONOMIC ACTIVITIES TAKES PLACE*, THE CONCEPT OF TRANSFER PRICING WAS

TRANSFER PRICING - CONCEPT

Transfer pricing is, **arriving at** of the price for goods and services, which are transacted between controlled **legal entities** (branches /companies) within an enterprise, whether in same or different countries, under the **assumption that they were independent parties**.

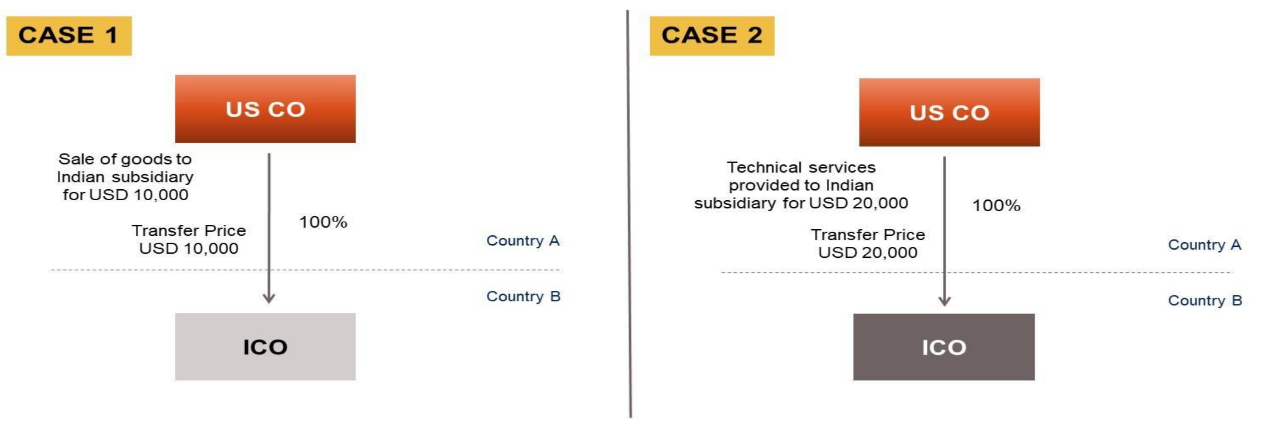
For example, if a parent company sells goods to a subsidiary company, the price received would be covered under Transfer Pricing.

TRANSFER PRICE



Transfer price is the price of goods/services between Associated Enterprise

TRANSACTION – SALE OF GOODS/ SUPPLY OF SERVICES



Transfer price is the price of goods/services between Associated Enterprise

COMMON BUSINESS TRANSACTIONS, BETWEEN GROUP COMPANIES WITHIN A MNE

- Sale Transactions - Purchase, sale or lease of tangible or intangible property; or
- Service Transactions - Provision of services; or
- Financing Transactions - Lending or borrowing money
- Investment Transactions - Investment in Shares, Debentures

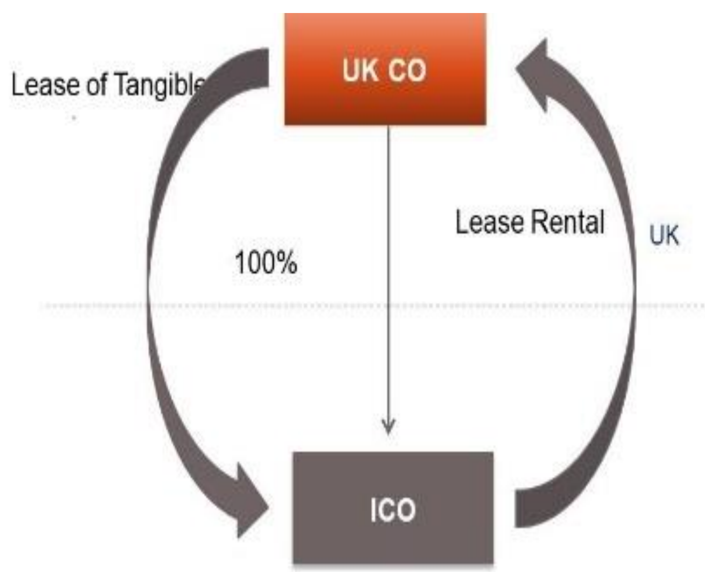
Notes : -

- **Prices shown in books are not different from actual transaction price, i.e. there is no under-invoicing or over-invoicing.**
- **While, actual price charged is correctly reported in books, it is different from arm's length price.**

Lease of tangible equipment

ICO India Private Limited (India) acquires equipment on lease basis from its group concern UK CO. International (UK) at a lease rental of USD 10,000 per month.

This is a transaction of leasing of tangible property. Thus, arm's length price of such leasing transaction would be determined under transfer pricing provisions.

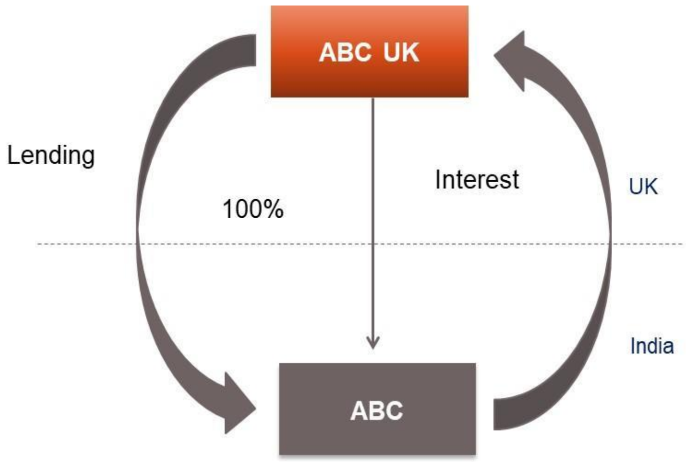


Lending and borrowing

ABC Ltd. (India) borrows USD 10,000 from its group concern, ABC International Ltd. (UK) at interest rate of 3% p.a.

In this case, the transaction is of lending or borrowing of money.

Thus, arm's length price of interest rate would be determined under transfer pricing provisions.

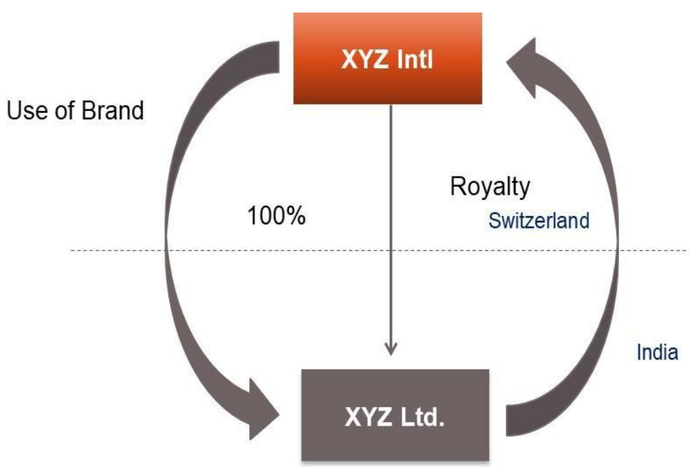


Use of brand

XYZ Ltd. makes royalty payment to its group concern, XYZ International (Switzerland) for use of Brand.

In this case, the transaction is of use an intangible asset.

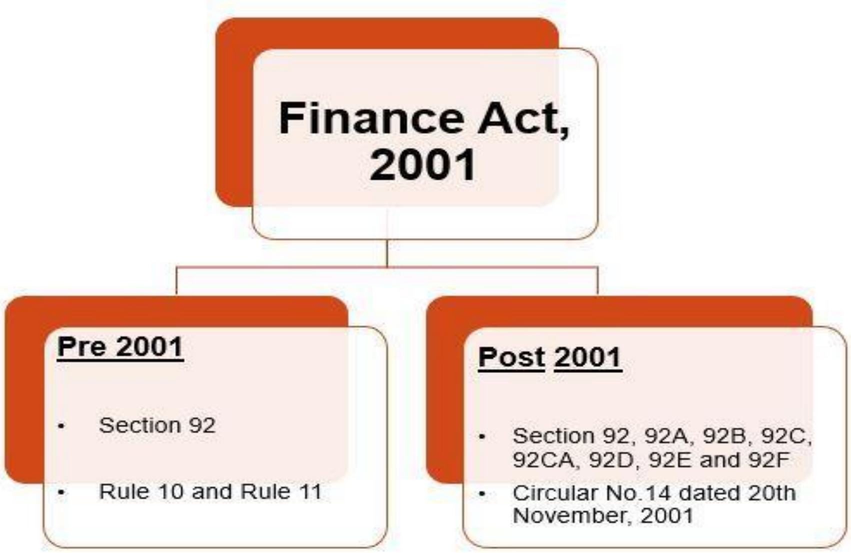
Thus, arm's length price of royalty payments would be determined under transfer pricing provisions.



TRANSACTION – SALE OF GOODS/ SUPPLY OF SERVICES

Transfer price is the price of goods/services between associated enterprise

Transfer pricing scenario in India



6. EVOLUTION OF TRANSFER PRICING IN INDIA [PRE-2001 ERA] – SECTION 92

Section 92 of the IT Act, 1961 was the only section dealing specifically with cross border taxation in case of MNEs. Section 92 was applicable when the following conditions were satisfied:

- There was a business transaction **between** a resident and a non-resident,
- There was a **close connection** between a resident and a non-resident,
- **Due to** close connection, they arranged business in such a manner that **there were no/ less than normal profit** to resident.

Where these conditions existed, the Assessing Officer was empowered to **determine the reasonable amount of profits**, that could have been derived from such business (applying methodology provided under Rules 10 and 11) and include such amount in the total income of the resident.

EVOLUTION OF TRANSFER PRICING IN INDIA [PRE-2001 ERA] – RULE 10

As per Rule 10 and 11, normal profit could be calculated: **-**

a. such **% of the turnover** so accruing or arising as the AO may consider **reasonable**, or

b. on any amount which **bears the same proportion to the total profits and gains** of the business of such person, **as the receipts** so accruing or arising bear **to the total receipts** of the business:

$$\frac{\text{Total Profits X Receipts related to business transaction with AE}}{\text{Total receipts}}$$

c. in **such other manner** as the AO may deem suitable.

EVOLUTION OF TRANSFER PRICING IN INDIA [PRE-2001 ERA] – SHORTCOMINGS

- Provides for adjustment of ***profit*** Vs ***adjustment of prices***.

- No detailed rules for necessary documentation to substantiate basis of price between parties.
- Isolated transactions were outside Section 92 - Business demands a continuity of relationship.
- Transfer of services or intangibles not covered.
- Not applicable in the case where a non-resident entered into a transaction with another non-resident.

7. EVOLUTION OF TRANSFER PRICING IN INDIA [PRE-2001 ERA] – REPLACEMENT OF EXISTING LAW

With a view to provide detailed statutory framework and to curb tax avoidance, the law dealing with Transfer Pricing was introduced by: -

- Substituting the then existing Section 92 with Section 92, 92A, 92B, 92C, 92CA, 92D, 92E and 92F; and
- Detailed Circular No.14 explaining the Transfer Pricing provisions.

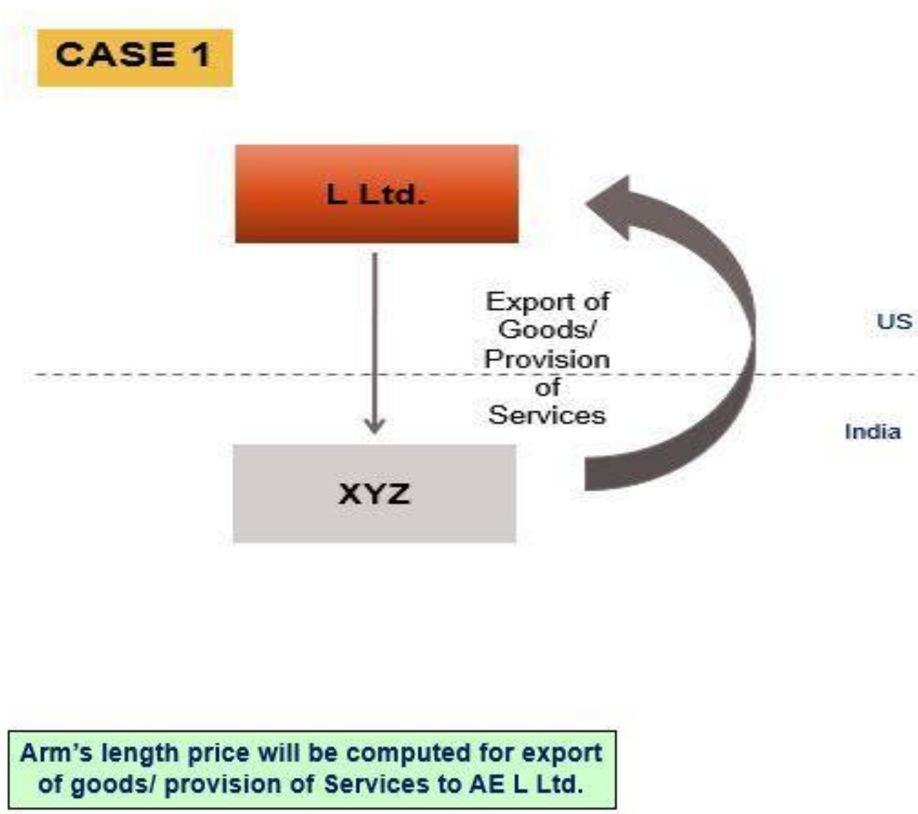
WHILE INDIAN LEGISLATION IS NOT COMPLETELY ALIGNED TO OECD TP GUIDELINES, THESE GUIDELINES HAVE BEEN EXTENSIVELY RELIED BY INDIAN COURTS/ TRIBUNALS

8. COMPUTATION OF INCOME HAVING REGARD TO THE ALP – SECTION 92 - APPLICABILITY OF ARM'S LENGTH PRINCIPLE

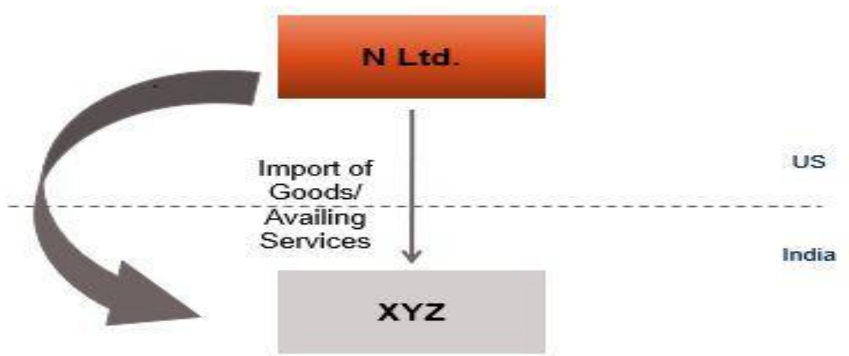
- Any **income arising** from international transaction shall be computed on the basis of arm's length price.
    - Exports to its non-resident AE L Ltd.
    - Service provided to AE L Ltd.
- Any **expense/ allowance for any interest, for computing income for international transaction** shall also be computed on the basis of arm's length price of such expense/interest.
    - Service received from AE N Ltd.
    - Import from its non-resident AE N Ltd.

- The cost or expenses allocated or apportioned between Associated enterprises under a **mutual agreement** or **arrangement** shall be at arm's length price.
- Any contribution to any cost, expenses, for obtaining any benefit/service/facility to AE shall also be computed on the basis of the ALP of such benefit/service/facility

COMPUTATION OF INCOME HAVING REGARD TO THE ALP – SECTION 92



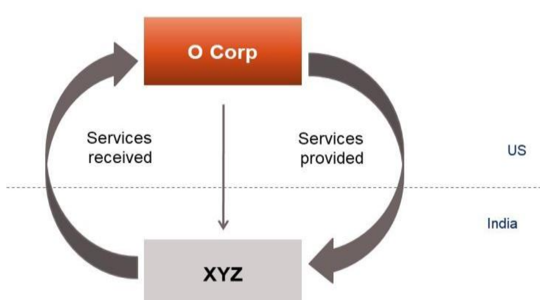
CASE 2



Arm's length price will be computed for import of goods/ provision of Services to AE N Ltd.

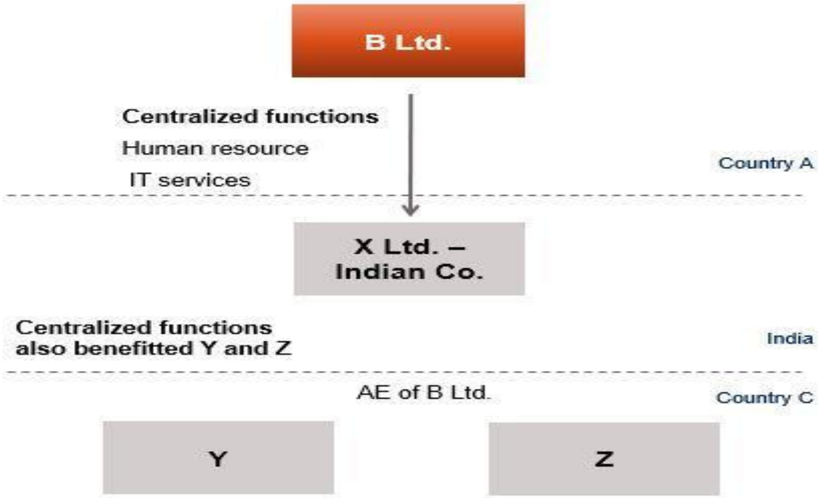
COMPUTATION OF INCOME HAVING REGARD TO THE ALP – SECTION 92

CASE 3



Arm's length price will be computed for services received/ provided to Associated enterprise O Corp

COMPUTATION OF INCOME – SECTION 92 – MUTUAL AGREEMENT FOR COST ALLOCATION

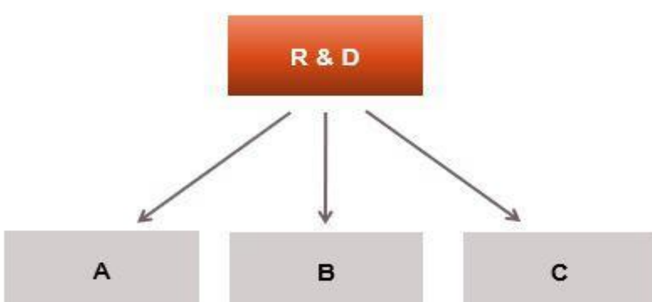


<u>EXAMPLE</u>: -

- B Ltd., an AE of X Ltd. carries out certain centralized functions like Human Resource, obtaining finance, IT services etc., for several group companies, including X Ltd.

- In this case, cost of such centralized functions allocated between X Ltd., Y and Z, having regard to the arm's length price of services obtained by each of these enterprises, using common basis, like time spent by common resource, etc.

COMPUTATION OF INCOME HAVING REGARD TO THE ALP – SECTION 92



<u>EXAMPLE</u>: -

- Associated enterprises A, B and C agreed to carry out a joint activity, such as research and development, for their mutual benefit.

- In this case, cost allocation will be made amongst associated enterprises having regard to the arm's length price.

9. COMPUTATION OF INCOME HAVING REGARD TO THE ALP – SECTION 92 - BASE EROSION CONCEPT

NON-APPLICABILITY OF ARM'S LENGTH PRINCIPLE

- The transfer pricing provisions are intended to ensure that **profits taxable in India are not understated (or losses are not overstated)** by declaring lower receipts or higher outgoings (expenditure or other deductions) than those which would have been declared by persons entering into similar transactions with unrelated parties in the same or similar circumstances.
- The basic intention underlying the transfer pricing regulations is to **prevent shifting of profits** by manipulating prices charged by overseas entity or paid by Indian entity in international transactions**, thereby eroding the country's tax base**.

Therefore, transfer pricing provision should not be applied in cases where the adoption of the arm's length price would result in a decrease in the overall tax incidence in India in respect of the parties involved in the international transaction.

> **Note : -**
>
> **The principle of arm's length price shall not apply where its applicability would result in reducing the income or increasing the loss.**

COMPUTATION OF INCOME HAVING REGARD TO THE ALP – SECTION 92

EXAMPLE: -

ABC Ltd. purchased goods at USD 200 per unit from its AE in USA. However, it was purchasing the same material at USD 250 per unit from independent third party located in USA. Evaluate whether the ALP should be USD 200 or USD 250?

SOLUTION: -

In this case, arm's length price would be USD 250 per unit, which would increase the purchasing cost of ABC Ltd. and consequently, reduce its taxable profits by USD 50 per unit.

Thus, transfer pricing provisions would not be applied in this case and the actual transaction price of USD 200 per unit will be considered for computation of income.

10. ASSOCIATED ENTERPRISES – SECTION 92A (1)

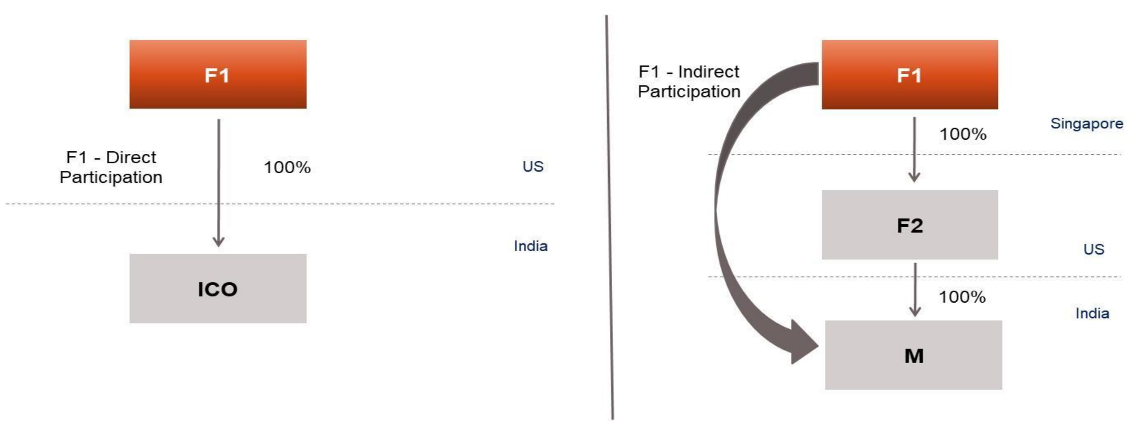
Transfer pricing provisions are applicable for international transaction **between Associated enterprise**.

As per Section 92A (1) of the Act, Associated enterprise refers to an **enterprise**: -

a). which participates **directly** or **indirectly** or through **one or more intermediaries** in:

- **Management** of the other enterprise, **or**
- **Control** of the other enterprise, **or**
- **Capital** of the other enterprise.

ENTERPRISE – DIRECT OR INDIRECT PARTICIPATION



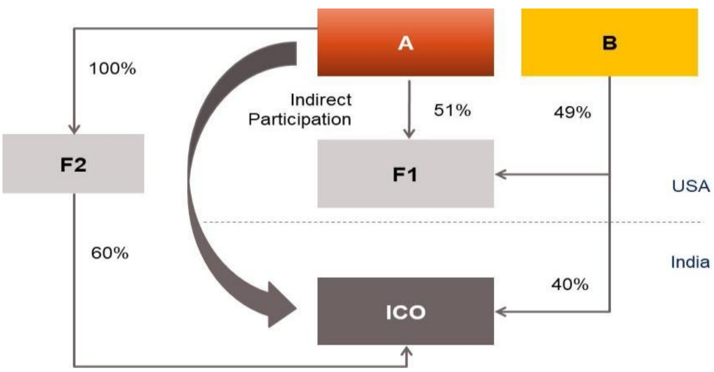
Participation could be in Management, Control or Capital

ASSOCIATED ENTERPRISES – SECTION 92A (1)

b). If **one or more persons**, participates directly or indirectly, or through one or more intermediaries in: -

- Management of the two different enterprises;
- Control of two different enterprises;
- Capital of two different enterprise.

MORE THAN ONE PERSON – DIRECT OR INDIRECT PARTICIPATION



A participates directly in F1 and indirectly in ICO + B participates directly in F1 and ICO.
Hence F1 and ICO are AE's.

11. DEEMED ASSOCIATED ENTERPRISES – SECTION 92a (2)

READERS INFORMATION: -

The general application of definition of AE may not be sufficient to to cover all cases of tax manipulation by various Enterprise. **For example**, if an enterprise (A) participates to the extent of 2% in the capital of another enterprise (B), it may not result in an exercising influence on B so as to exercise control on transactions. However, if A is the only purchaser of goods produced by B, it may still be able to exercise control on prices of B.

In order to address this situation, the concept of deemed AE, is introduced in Section 92A (2).

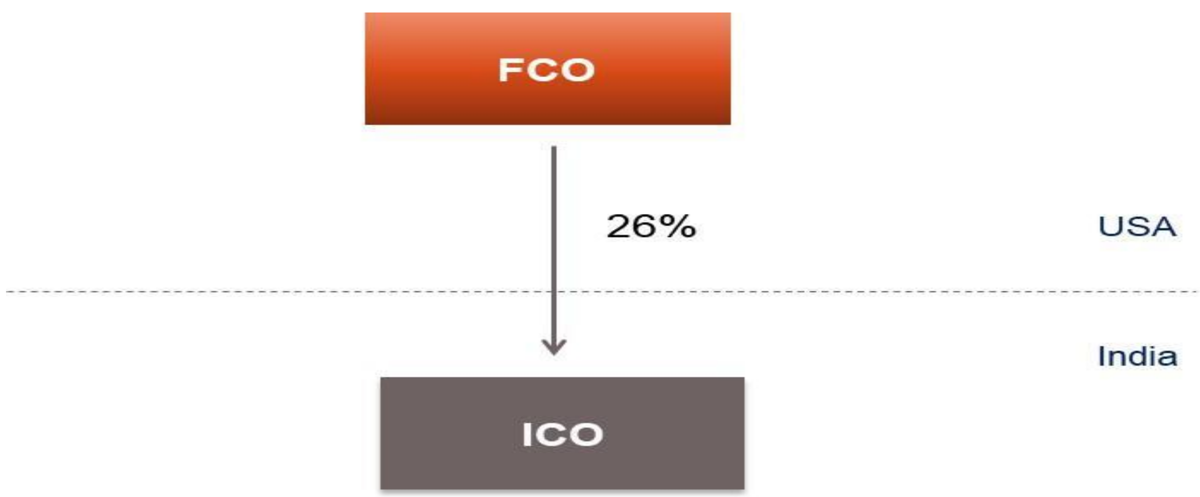
Section 92A (2) provides two enterprises shall be deemed to be associated enterprises if, **at any time during the previous year** they satisfy any one or more of following 13 conditions:-

DEEMED ASSOCIATED ENTERPRISES – ENTERPRISE OWNERSHIP > 26%

(i) **One enterprise** holds, **directly or indirectly**, shares carrying **26% or more** of the **voting power** in the other enterprise.

Note : -
Only equity shares carry voting rights. Thus, generally where an enterprise is holding more than 26% Preference shares in another enterprise, they shall not be regarded as AE.

DEEMED ASSOCIATED ENTERPRISES – ENTERPRISE OWNERSHIP > 26%



Facts:

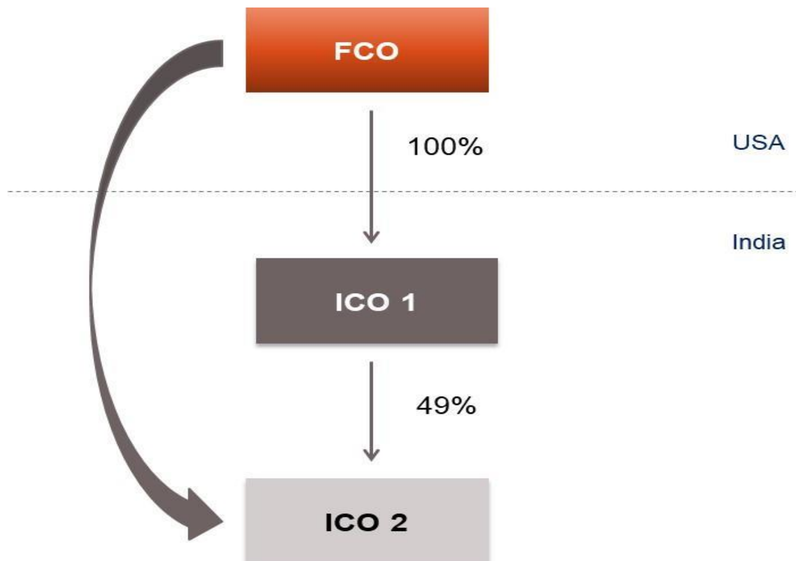
- FCO holds 26% Equity Shares in ICO (all equity shares carry equal voting rights) .

Issue:

- Whether FCO and ICO will be deemed to be Associated enterprise?

Solution:

- Since, FCO directly holds 26% voting rights in ICO, both the enterprise are deemed to be Associated enterprise.



Facts:

- FCO holds 100% equity shares (all equity shares carry equal voting rights) in ICO 1.
- ICO 1 holds 49% equity shares (all equity shares carry equal voting rights) in ICO 2.

Issue: Who all will be the Associated enterprises?

Solution:

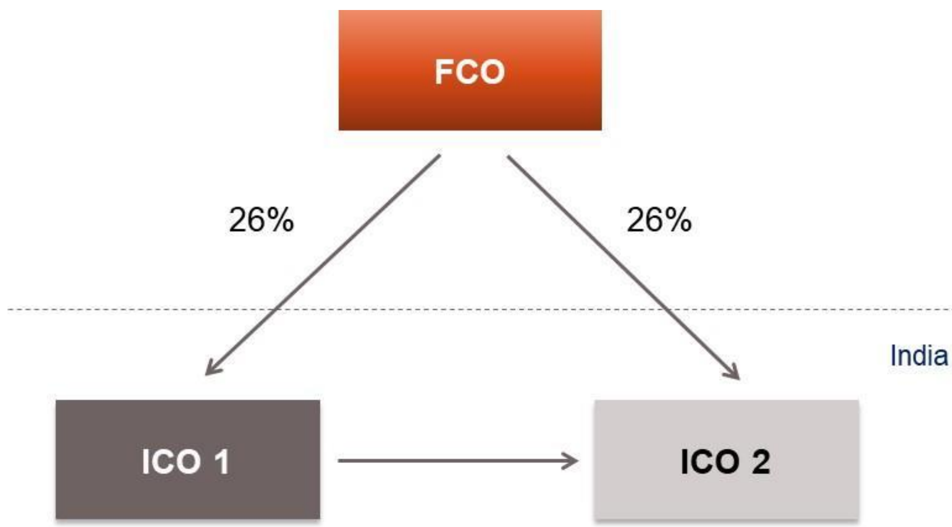
- Since, FCO directly holds 100% voting rights in ICO 1, both the enterprise are deemed to be Associated enterprise.

- Since, ICO 1 directly holds 49% voting rights in ICO 2, both the enterprise are deemed to be Associated enterprise.

- FCO and ICO 2 will also be deemed to be the Associated enterprise because FCO indirectly holds more than 26% voting rights in ICO 2.

DEEMED ASSOCIATED ENTERPRISES – VOTING POWER/ OWNERSHIP > 26%

(ii) Any **person or enterprise** holds, **directly or indirectly** (to be discussed), shares carrying **26% or more** of the **voting power** in **each** of such enterprises.



Facts:

- FCO holds 26% equity shares in ICO 1;
- FCO also holds 26% shares in ICO 2.

Issue:

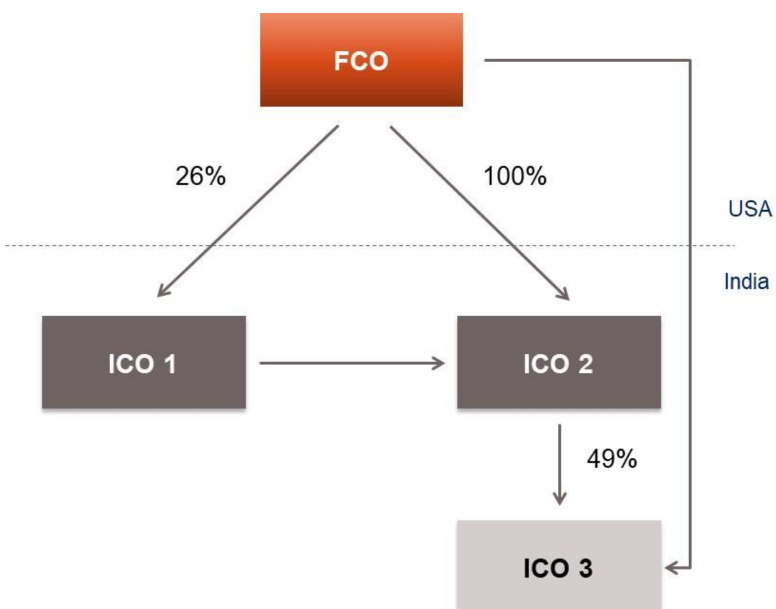
- Who all will be the Associated enterprises?

Solution:

- Since, FCO directly holds 26% voting rights in ICO 1, both the enterprise are deemed to be the Associated enterprise.

- Since, FCO directly holds 26% voting rights in ICO 2, both the enterprise are deemed to be the Associated enterprise.

Since, common person FCO holds 26% voting rights in each of the enterprise ICO 1 and ICO 2, hence ICO 1 and ICO 2 will also be deemed to be the Associated enterprise



<u>Facts</u>:

- FCO holds 26% equity shares in ICO 1;
- FCO also holds 100% shares in ICO 2;
- ICO 2 holds 49% shares in ICO 3.

Issue:

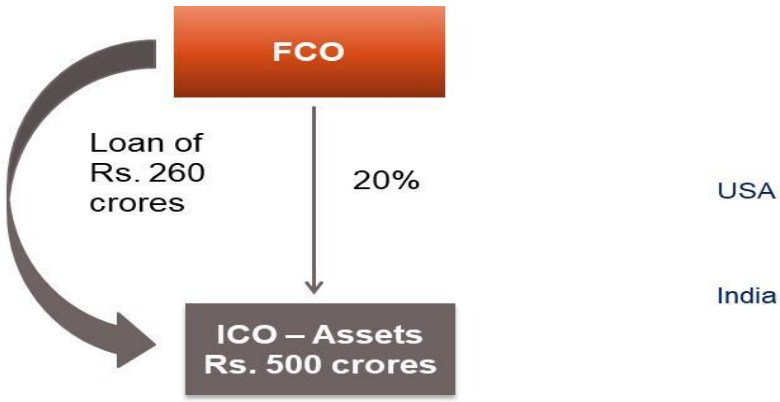
- Who all will be Associated enterprises, based on the given facts?

SOLUTION: –

- FCO holds 26% voting rights in ICO 1, both are deemed to be Associated enterprise.
- FCO holds 100% voting rights in ICO 2, both are deemed to be Associated enterprise.
- ICO 2 holds 49% shares in ICO 3, both are deemed to be Associated enterprise.
- Since, common person FCO holds 26% and more voting rights in ICO 1 and ICO 2, hence ICO 1 and ICO 2 will also be deemed to be Associated enterprise.
- FCO holds 100% voting rights in ICO 2 and ICO 2 holds 49% voting rights in ICO 3, hence, FCO indirectly holds more than 26% voting rights in ICO 3, and hence both FCO and ICO3 will be deemed to be Associated enterprise.
- Since, FCO indirectly holds more than 26% voting rights in ICO 3 and FCO directly holds 26% voting rights in ICO 1, hence, ICO 1 and ICO 3 will be deemed to be Associated enterprise.

DEEMED ASSOCIATED ENTERPRISES – SECTION 92A(2) - LOAN OF 51% OR MORE OF TOTAL BOOK VALUE OF ASSETS

(iii) A **loan advanced** by one enterprise to the other enterprise constitutes **51% or more** of the **book value of the total assets** of the other enterprise.



Since FCO has advanced loan of more than 51% of book value of total assets to ICO, FCO and ICO are Associated enterprise.

<u>Facts</u>:

- FCO holds 20% voting rights in ICO.
- Balance sheet of ICO is as under:

Liabilities	Amount	Assets	Amount
Share Capital	240	Building	100
		Land	100
		Plant & Machinery	200
Loan from FCO	260		
		Inventories	100
Total	**500**	**Total**	**500**

<u>Issue</u>:

- Whether FCO and ICO will be deemed to be Associated enterprise ?

<u>EXAMPLE 2</u>: -

In the above case, what would be the answer, if the loan amount was **255 crores** assuming other facts remain same?

<u>SOLUTION</u>: -

Since, FCO has advanced loan of **51%** of book value of total assets to ICO, FCO and ICO would be deemed to be the **Associated enterprise**.

<u>EXAMPLE 3: -</u>

In the above case, what if the loan amount was 250 crores? Other facts remain same.

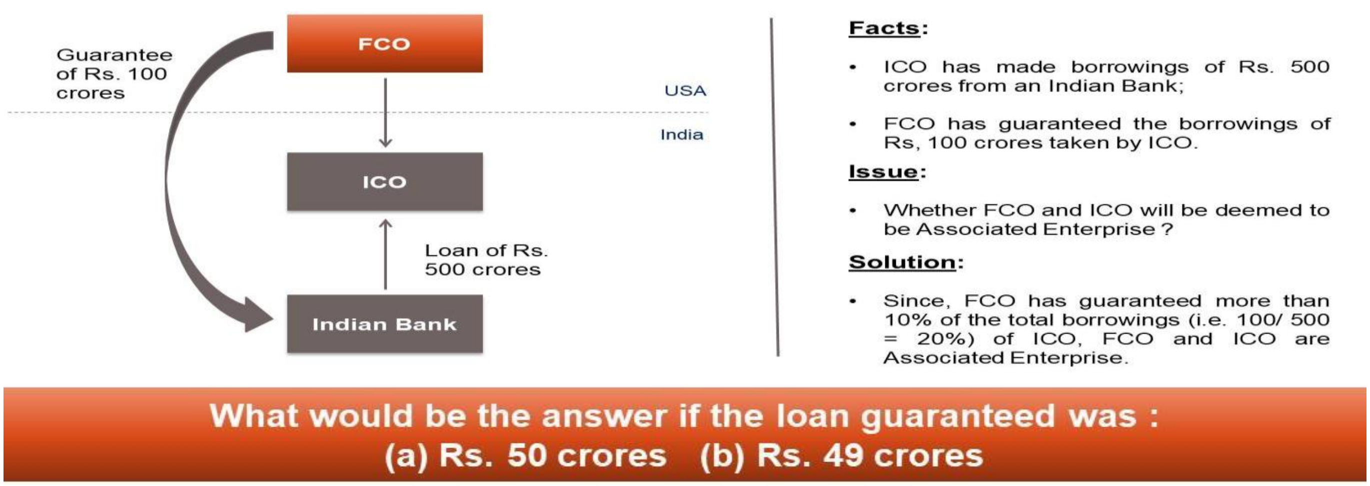
SOLUTION: -

Since, FCO has advanced loan of less than 51% of book value of total assets to ICO, FCO and ICO would not deemed to be the Associated enterprise.

DEEMED ASSOCIATED ENTERPRISES – SECTION 92A(2) – GUARANTOR OF BORROWINGS

(iv) One enterprise guarantees 10% or more of the **total borrowings** of the other enterprise.

DEEMED ASSOCIATED ENTERPRISES – SECTION 92A(2) – GUARANTOR OF BORROWINGS



DEEMED ASSOCIATED ENTERPRISES – SECTION 92a(2) - APPOINTMENT OF GOVERNING BOARD

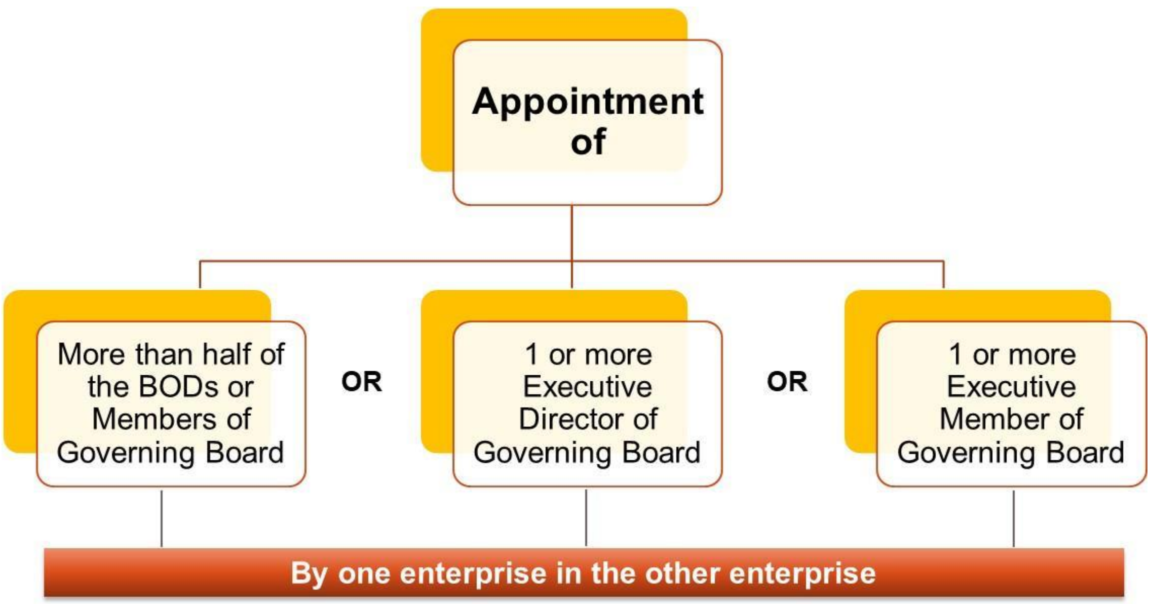
(v) One enterprise **appoints**

- **More than half** of the **Board of Directors or members** of the Governing Board, or

- One or more **Executive Directors** of the Governing Board, or
- One or more **Executive Members** of the Governing Board of one enterprise, are appointed by the other enterprise.

Note : -

Actual appointment of directors is relevant for the application of this clause. Merely because the person has the power to appoint without actual appointment will not make two enterprises Associated enterprise.



EXAMPLE 1: -

In the following case, list out the Associated enterprises of ICO 1:

- FCO 1 has made the appointment of 12 out of 20 Board of Directors of the Governing Board in ICO 1.
- FCO 2 has made the appointment of Mr. B as Executive Director of the Governing Board in ICO 1.
- FCO 3 has made the appointment of Mr. C as an Executive Member of the Governing Board in ICO 1.
- FCO 2 has made the appointment of Mr. B as Executive Director of the Governing Board in ICO 1.

- FCO 3 has made the appointment of Mr. C as an Executive Member of the Governing Board in ICO 1.

SOLUTION: -

- Since, **more than half** of Board of Directors in Governing Board in ICO 1 have been appointed by FCO 1, FCO 1 and ICO 1 are deemed to be Associated enterprise.

- Since, **an Executive Director** in the Governing Board has been appointed in ICO 1 by FCO 2, FCO 2 and ICO 1 are deemed to be Associated enterprise.

- Since, **an Executive Member** in the Governing Board has been appointed in ICO 1 by FCO 3, FCO 3 and ICO 1 are deemed to be Associated enterprise.

DEEMED ASSOCIATED ENTERPRISES – SECTION 92A(2) - APPOINTMENT OF GOVERNING BOARD BY OTHER ENTERPRISE

EXAMPLE 2: -

- FCO has the power to appoint **three out of five directors** of Governing Board of ICO. However, due to certain disputes it was able to appoint only one director during FY 2016-17.
- Whether FCO and ICO are Associated enterprise?

SOLUTION: -

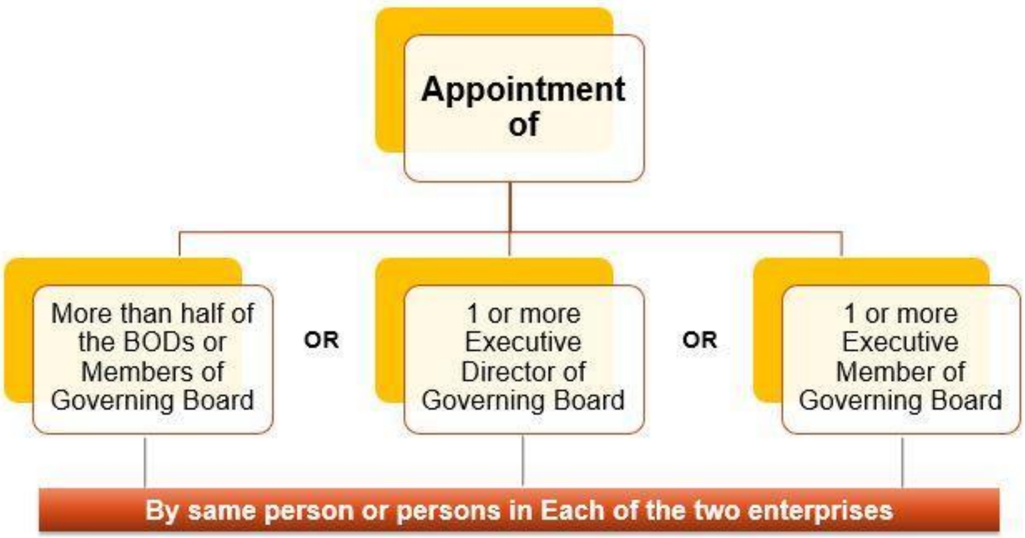
- Since, FCO has made appointment of **less than 50%** of Board of Directors of the Governing Board of ICO, FCO and ICO would **not** be considered as **Associated enterprise**.

DEEMED ASSOCIATED ENTERPRISES – SECTION 92A(2) - APPOINTMENT OF BOARD OF 2 DIFFERENT ENTERPRISES BY SAME PERSON

(vi)

- **More than half** of the **Board of Directors or members** of the Governing Board, or
- **One or more Executive Directors** of the Governing Board, or
- **One or more Executive Members** of the Governing Board

of each of the two enterprises, are **appointed by same person or persons**.



EXAMPLE: -

FCO 1, (US Company) has made the following appointments in ICO, (Indian Company) and FCO (US Company):

- An **Executive Director** in both FCO and ICO; or
- **8 out of 12, Directors on Board** in FCO and **7 out of 13, Directors on Board** in ICO.

SOLUTION: -

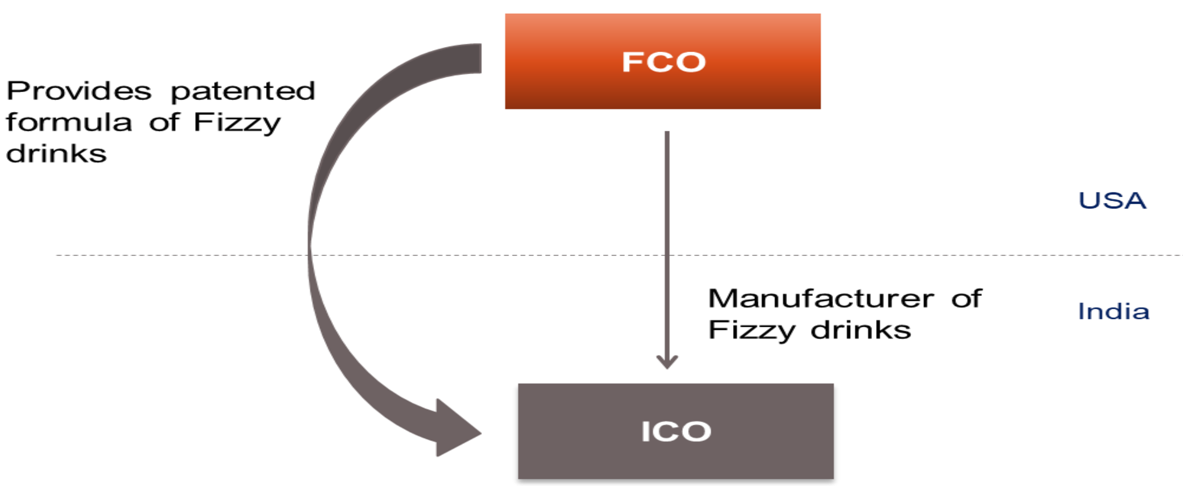
- An **Executive Director** has been appointed in FCO and ICO by FCO 1, hence, FCO 1 & FCO and FCO 1 & ICO are deemed to be the Associated enterprise.

- Since FCO 1, a common person has appointed more than half of Board of Directors of the Governing Board in FCO and ICO and also appointed an Executive Director, FCO and ICO are Associated enterprise.
- **More than half** of Board of Directors in FCO and ICO have been appointed by FCO 1, hence, FCO 1 & FCO, and FCO 1 & ICO are deemed to be the Associated enterprise.

DEEMED ASSOCIATED ENTERPRISES – SECTION 92a(2) - DEPENDENCE ON INTANGIBLES

(vii)

- The **business** of one enterprise or **manufacture** or **processing** of goods or articles by one enterprise is **wholly dependent** on
- the 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**, or
- in respect of which the other enterprise has **exclusive rights**.



Facts:

- ICO (India) manufactures Fizzy drinks by using patented formula owned by a FCO (USA).
- The manufacture of Fizzy drink by ICO is wholly dependent on use of secret patented formula owned by a FCO

Issue:

- Whether FCO and ICO will be deemed to be Associated enterprise?

Solution:

Both the enterprises will be deemed to be Associated enterprise u/s 92A(2)(vii) because the business of ICO is wholly dependent on the use of patent provided by FCO

DEEMED ASSOCIATED ENTERPRISES – SECTION 92a(2) - DEPENDENCE ON RAW MATERIALS AND CONSUMABLE

(viii)

90% or more of **raw materials and consumables** required for the manufacture or processing of goods or articles or carrying on of business 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.

The comparison is to be made based on the value of raw material and consumables.

FCO and ICO will be deemed to be Associated enterprise because 90% or more than 90% of the goods are supplied by FCO 1 to ICO i.e. the person specified by the other enterprise (FCO) and price and other conditions are specified by FCO.

<u>Facts</u>:

- ICO manufactures chairs, using plastic manufactured by FCO.
- FCO sub-contracted the reshaping part of plastics to FCO 1.
- FCO 1 reshapes the plastic purchased from FCO and on the instructions of FCO sells it to ICO.
- 95% of the plastic consumed by ICO was supplied by FCO 1 out of total plastic consumed by it amounting Rs. 190 crores.
- Prices and other conditions are decided by FCO in terms of contract between FCO and FCO 1.

<u>Issue</u>:

- Who all will be deemed to be the Associated enterprise?

<u>EXAMPLE 2</u>: -

In the above case, what if the raw material supplied by FCO amounts to **Rs. 170 crores** out of total raw material consumed of Rs. 200 crores? Other facts remain same.

<u>SOLUTION</u>: -

Since, FCO has supplied **less than 90%** of the raw material required by ICO, both are **would not be** deemed to be the **Associated enterprise**

EXAMPLE 3: -

In the above case, what if the raw material supplied by FCO amounts to **Rs. 180 crores** out of total raw material consumed of Rs. 200 crores? Other facts remain same.

SOLUTION: -

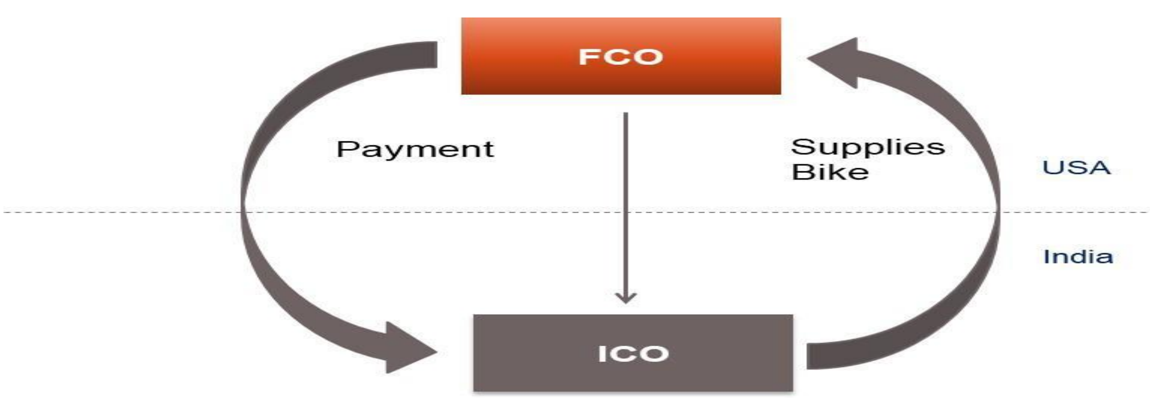
Since, FCO has supplied **90%** of the raw material required by ICO, both are deemed to be the **Associated enterprise**.

DEEMED ASSOCIATED ENTERPRISES – SECTION 92a(2) - DEPENDENCE ON SALE

(ix)

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.



Facts:

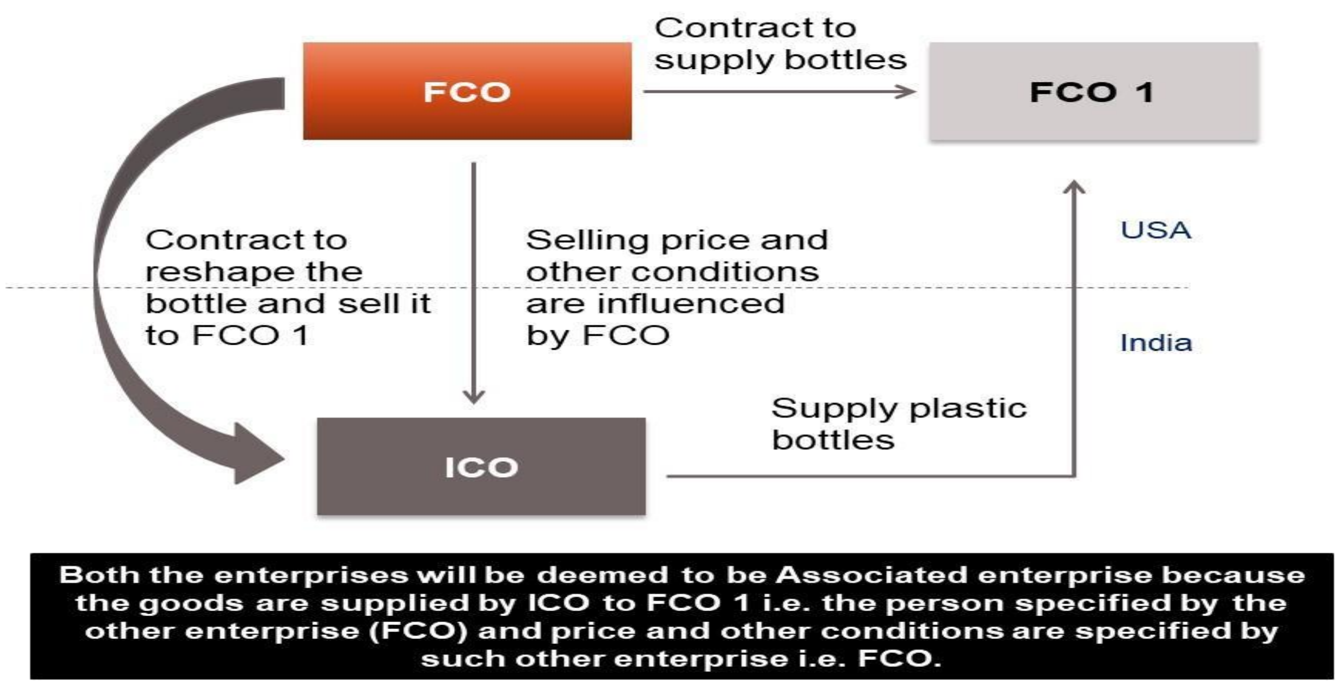
- ICO is engaged in manufacturing of bikes in India.
- It supplied all the bikes it made to FCO, a US Company.

<u>Issue:</u>

- Whether FCO and ICO will be deemed to be Associated enterprise?

<u>Solution</u>:

- Since ICO has supplied all the bikes manufactured by it, both FCO and ICO will be deemed to be Associated enterprise .



<u>Facts</u>:

- FCO 1, a US Co. is engaged in the business of branding and trading of plastic bottles in the market. FCO 1 uses the plastic bottles manufactured by FCO.
- FCO sub-contracts the manufacturing of bottle to ICO.
- ICO imports plastic from FCO, reshapes the plastic imported from FCO in bottles and on instructions of FCO, sells it to FCO 1.
- Price and other conditions of such sale are influenced by FCO.

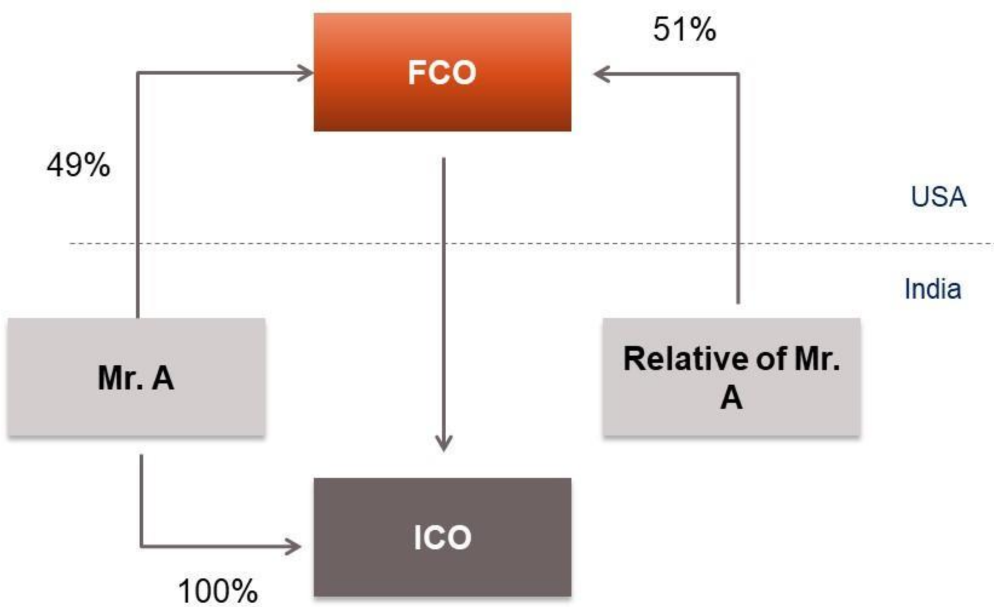
Issue:

- Whether FCO 1 and ICO will be deemed to be the Associated enterprise ?

DEEMED ASSOCIATED ENTERPRISES – SECTION 92a(2) - INDIVIDUAL CONTROL

(x) 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.



Facts:

- Mr. A controls Indian company (ICO), and
- Foreign Company (FCO) is controlled by
  - Mr. A
  - Relative of Mr. A

- Jointly by Mr. A and relative of Mr. A.

Issue:

- Whether FCO & ICO will be deemed to be Associated enterprise ?

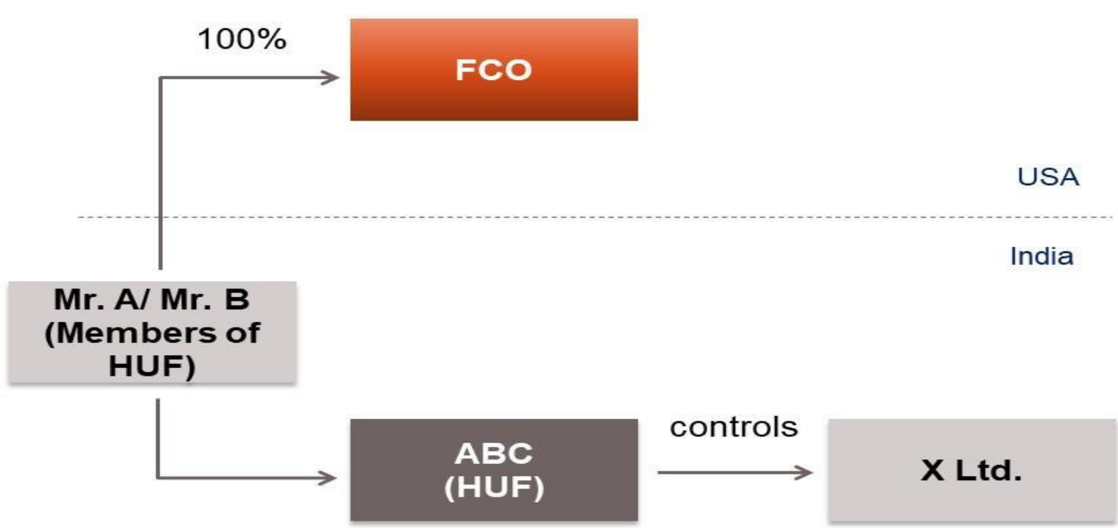
Solution:

- Since, FCO is controlled by Mr. A/ Relative of Mr. A/ Jointly by Mr. A and his relative who has 100% voting rights in ICO, hence, both FCO and ICO will be deemed to be the Associated enterprise.

DEEMED ASSOCIATED ENTERPRISES – SECTION 92a(2) - CONTROL BY HUF

(xi) Where **one enterprise** is **controlled by a HUF**, the **other enterprise** is **controlled by**

- a member of such HUF, or
- a relative of a member of such HUF, or
- jointly by such member and his relative.



Facts:

- HUF controls X Ltd., and
- Mr. A and Mr. B are the members of HUF.

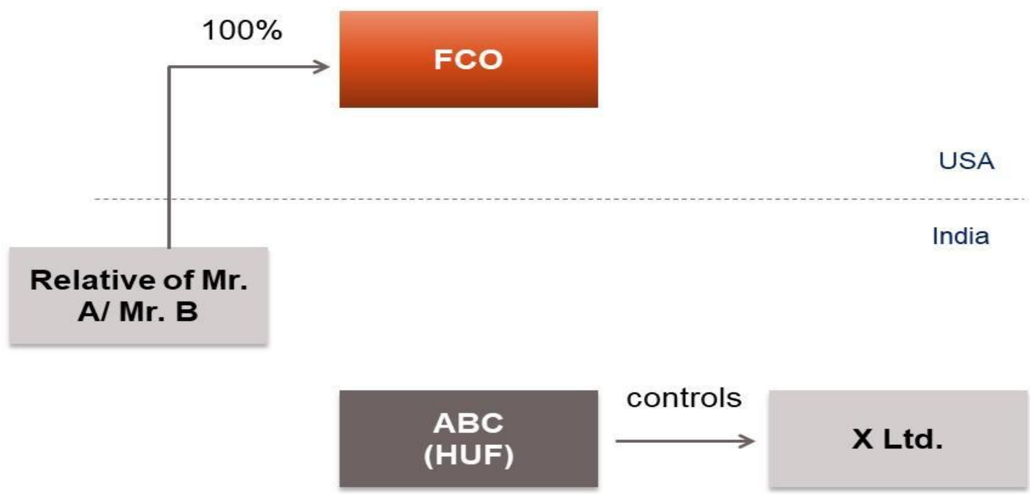
- Members of HUF control FCO.

Issue:

- Whether FCO & X Ltd. will be deemed to be Associated enterprise?

Solution:

- Since, FCO is controlled by members of HUF and HUF controls X Ltd., hence, both FCO and X Ltd. will be deemed to be the Associated enterprise.



Facts:

- HUF controls X Ltd., and
- Mr. A and Mr. B are the members of HUF.
- Relative of Mr. A/ Mr. B control FCO.

Issue:

- Whether FCO & X Ltd. will be deemed to be Associated enterprise ?

Solution:

- Since, FCO is controlled by relative of members of HUF and HUF controls X Ltd., hence, both FCO and X Ltd. will be deemed to be the Associated enterprise.

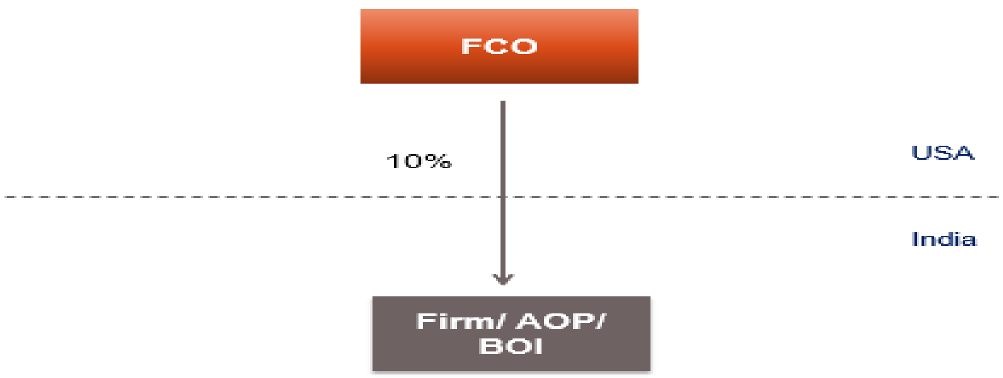
DEEMED ASSOCIATED ENTERPRISES – SECTION 92a(2) - HOLDING NOT LESS THAN 10% IN A FIRM

(xii)

Where **one enterprise** is a

- Firm,
- Association of Persons ("AOP"), or
- Body of Individuals ("BOI"),

the **other enterprise holds 10% or more interest** in such Firm, AOP or BOI.



<u>Facts</u>:

- FCO holds 10% voting rights in a firm/ an association of persons or body of individuals, incorporated in India.

<u>Issue</u>:

- Whether FCO and Firm/ AOP/ BOI will be deemed to be the Associated enterprise?

<u>Solution</u>:

- Both the enterprise will be deemed to be Associated enterprise because FCO holds not less than 10% interest in the Firm/ AOP/ BOI.

<u>DEEMED ASSOCIATED ENTERPRISES – SECTION 92a(2) - MUTUAL INTEREST RELATIONSHIP</u>

(xiii)

There exists between two enterprises, any relationship of **mutual interest**, as may be prescribed.

DEEMED ASSOCIATED ENTERPRISES – SECTION 92a(2)

NOTES: -

For identification of Associated enterprise, any of the aforesaid relationship should exist at any time during the previous year.

It is not necessary that such relationship should exist throughout the year or atleast for some duration of time, before the relationship of Associated enterprise shall be deemed to exist.

QUESTION AND ANSWERS ON ASSOCIATED ENTERPRISE

QUESTION 1: -

- A Ltd.(India) holds **26% non-voting Preference shares** in AB International (Mauritius).

- Whether A Ltd. and AB International would be Associated enterprise?

SOLUTION: -

A Ltd. and AB International are **not AE**. It may be noted that Preference shares do not carry any voting rights. Thus, A Ltd. does not hold shares carrying 26% voting rights in AB International.

QUESTION 2 : -

- D Ltd. (India) holds **100% Equity shares** in V International (USA). Further, V International holds **100% Equity shares** in Z International (UK).

- Who all would be the Associated enterprises ?

SOLUTION : -

- **D Ltd. & V International** are Associated enterprise, since D Ltd. owns > 26% voting rights in V International.

- **V International and Z International** are Associated enterprise, since V International owns > 26% voting rights in Z International.

- **D Ltd. and Z International** would also be Associated enterprise as D Ltd. indirectly holds more than 26% voting rights in Z International.

QUESTION 3: -

- G Ltd. (India) holds **30% Equity shares** in VZ Ltd. (India). It also holds **25% Equity shares** in XZ International (UK).

- Who all would be the Associated enterprises?

SOLUTION: -

- **G Ltd. & VZ Ltd.** are Associated enterprise, since G Ltd. owns > 26% voting rights in VZ Ltd.

- **VZ Ltd. and XZ** International are **not Associated enterprise** as G Ltd. does not hold 26% voting rights in XZ International.

QUESTION 4: -

- Y Ltd. (India) holds **30% Equity shares** in R Ltd. (India) and **40% Equity shares** in Z International (UK).

- Who all would be the Associated enterprises?

SOLUTION: -

- **Y Ltd. & R Ltd.** are Associated enterprise, since Y Ltd. owns > 26% voting rights in R Ltd.

- **Y Ltd. & Z International** are Associated enterprise, since Y Ltd. owns > 26% voting rights in Z International.

- **R Ltd. and Z International** are **Associated enterprise** as Y Ltd. holds more than 26% voting rights in both the Companies.

<u>QUESTION 5</u>: -

- X Ltd. (India) holds **10% Equity shares** in Z International (Switzerland) as on April 1, 2016. It further acquired Equity shares in Z International so that its aggregate shareholding reached at 30% as on November 1, 2016.

- Whether X Ltd. and Z International would be the Associated enterprise ?

<u>SOLUTION</u>: -

- X Ltd. and Z International are Associated enterprise for F.Y. 2016-17.

- The condition of 26% voting right should exist **at any time during the previous year**.

- Once that condition is satisfied, then both enterprises shall be deemed to be AE for the entire year.

<u>QUESTION 6</u> : -

- R Ltd. (India) holds 35% **Equity shares** in T International (Russia) as on April 30, 2016. However, its shareholding decreased to 20% as on December 1, 2016.

- Whether R Ltd. and T International would be the Associated enterprise?

<u>SOLUTION</u>: -

- R Ltd. and T International are Associated enterprise for F.Y. 2016-17.
- The condition of 26% voting right should exist **at any time during the previous year**.
- Once that condition is satisfied, then any subsequent reduction in shareholding in same year does not affect the status of Associated enterprise.

12. INTERNATIONAL TRANSACTION [SECTION 92B]

- Transfer pricing provisions are applicable to **determine the arm's length price** of **international transaction** between Associated enterprises.
- Thus, it is essential to understand the meaning of international transaction.
- However, to understand the definition of "International Transaction", it is first important to understand the definition of "Transaction".

DEFINITION OF TRANSACTION [SECTION 92F & RULE 10A(D)]

Sections 92F provides for an inclusive definition of transaction. It defines it as under:

"Transaction" **includes**

- an **arrangement**, **understanding** **or** **action** in concert, -

  a) **whether or not** such arrangement, understanding or action is **formal or in writing**; or

  b) **whether or not** such arrangement, understanding or action is intended to be **enforceable by legal proceeding**.

For computation of arm's length price under Rule 10A of the IT Rules, Rule 10A(d) defines a Transaction as including number of closely linked transactions.

Readers Note : -

Section 92F provides an inclusive definition of the term "transaction", i.e., it can include other transactions which are not specifically covered under the above definition. Based on the plain reading of this section, it is evident that, even if there is no formal written agreement, or any intention of the parties to legally enforce a transaction it could still be a transaction for transfer pricing purposes.

EXAMPLES ON MEANING OF TRANSACTION

EXAMPLE 1: -

- ICO Private Ltd. has a **show room of home furnishings** in New Delhi. Due to high demand of furniture during Diwali, ICO places an **order** for certain furniture and furnishings **with FCO**, the overseas parent of ICO. **FCO agrees to supply** the furniture to ICO on credit basis and **agrees to formalize the arrangement after Diwali**.

- Would the transaction of sale of furnishing amount to a transaction?

SOLUTION: -

- To constitute a transaction, it is **not mandatory** to have a **formal written agreement**.

- In view of this, transaction of sale of furnishing would amount to a transaction.

EXAMPLE 2: -

- ICO manufactures shirts and trousers (in-house) for its showroom of readymade garments. FCO agrees to supply fine quality of fabric as demanded by ICO, on a no-return, full upfront payment basis, without any formal agreement. FCO supplied sub-standard quality of fabric due to which ICO suffered heavy losses.

- Would the transaction of sale of fabric amount to a Transaction?

SOLUTION: -

- To constitute a transaction for Transfer Pricing purpose, it is **not mandatory** to have a **formal written agreement**, **or** any **intention** of the parties **to legally enforce** a transaction.

- In view of this, transaction of "sale of fabric" would amount to a transaction for transfer pricing purposes.

DEFINITION OF INTERNATIONAL TRANSACTION [Section 92B]

International Transaction "Means"

Transactions between two or more **Associated Enterprises**

- **Either** or **both** of whom 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** between two AE for allocation or apportionment of, or any contribution to, any cost or expense incurred or **to be incurred** in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

Thus, International transaction should satisfy following conditions:

- It should be a transaction as defined in Section 92F
- Transaction should be between Associated enterprises.
- Either or both of the parties to transaction should be non-residents.
- Transaction relates to purchase, sale or lease of tangible or intangible property or provisions of services, or other transactions discussed above.

Case law – receipt of security premium below market value in respect of issue of shares

Vodafone India Services (P.) Ltd. v Union of India [2014] 50 taxmann.com 300 (Bombay)

Facts: -

- Vodafone India ('Assessee') issued 2,89,224 shares [face value of Rs. 10 each] on a premium of Rs. 8,509 per share to its holding company. It had determined the fair market value of equity shares at Rs. 8,519 per share.
- However, according to Assessing Officer and TPO, the assessee ought to have valued each equity share at Rs. 53,775. Accordingly, shortfall in premium to the extent of Rs. 45,256 per share (Rs 53,775 - Rs 8,519) resulted into total shortfall of receipts of Rs. 1308.91 crores.
- Both the Assessing Officer and the TPO held that said amount of Rs. 1308.91 crores would be income of the assessee.

Case law – receipt of security premium below market value

Vodafone India Services (P.) Ltd. v Union of India [2014] 50 taxmann.com 300 (Bombay)

It was held that : -

- There should be income arising from International Transaction for application of transfer pricing provisions.

- The activity of issue of shares to Associated enterprise at a price below the fair market value does not give arise to any income. Thus, transfer pricing provision are not applicable on such transaction.

- It cannot be disputed that income will not in its normal meaning include capital receipts unless it is so specified.

- The amounts received on issue of share including the premium is on capital account. Thus, receipt of security premium from associated enterprise below market value could not be considered as international transaction.

Case law – receipt of security premium below market value

CBDT's instruction No. 2/2015, dated 29-1-2015

CBDT had also accepted the aforesaid judgment of Bombay High Court that premium on issue of shares was on capital account and does not give rise to any income. Thus, premium on issue of shares not liable to transfer pricing adjustment.

EXAMPLES ON INTERNATIONAL TRANSACTION

EXAMPLE 1 : -

- A Ltd. (India), purchases raw material from its Associated enterprise AB Ltd. (India).

- Would the transaction amount to an international transaction?

SOLUTION : -

- In order to be considered as international transaction, one of the party to the transaction should be non-resident.

- In this case, neither A Ltd. nor AB Ltd. is non-resident. Thus, such transaction would not be considered as an international transaction.

- Such transaction may be covered as "Specified Domestic Transaction" where one of the entity is claiming profit linked deductions, i.e., Section 80-IA, 80-IB, 10A, etc.

EXAMPLE 2 : -

- D Ltd. (India) imports goods from E International (Switzerland). D Ltd holds 10% shares in E International.

- Would the transaction amount to an international transaction?

SOLUTION : -

- In order to be considered as international transaction, both parties should be Associated enterprise.

- In this case, D Ltd. is holding less than 26% shares in E International. Thus, D Ltd. and E International are not Associated enterprise. Thus, such transaction of import would not be considered as an international transaction.

EXAMPLE 3 : -

- C Ltd. (India) imports 10,000 units of goods from its Associated enterprise C International (Germany) at USD 50 per unit. C Ltd. (India) imports 10,000 units of goods of same quality from independent third party in Germany at USD 50 per unit.

- Whether the transaction is at arm's length price ?

- Would the transaction amount to an international transaction?

SOLUTION : -

- In this case, the transaction of import from Associated enterprise is at arm's length price as C Ltd. imports same quality of goods from third party at USD 50 per unit.

- Transaction of import from Associated enterprise would be considered as an international transaction even if transaction of import is made at arm's length price.

EXAMPLE 4 : -

- V (India) is an Associated enterprise of V International (UK). It issued certain shares at Rs. 5,000 per share (face value of Rs. 10 each and a premium of Rs. 4,990 per share) to V International. The market value of per share determined by TPO was Rs. 10,000 per share.

- Whether the receipt of premium at less than the FMV would be deemed as an international transaction ?

SOLUTION : -

- Receipt of lower premium on issue of shares to an Associated enterprise, would not be considered as an international transaction as per the Ruling of Bombay High Court in case of Vodafone and CBDT's instruction (discussed above).

DEEMED INTERNATIONAL TRANSACTION [SECTION 92B] (2)

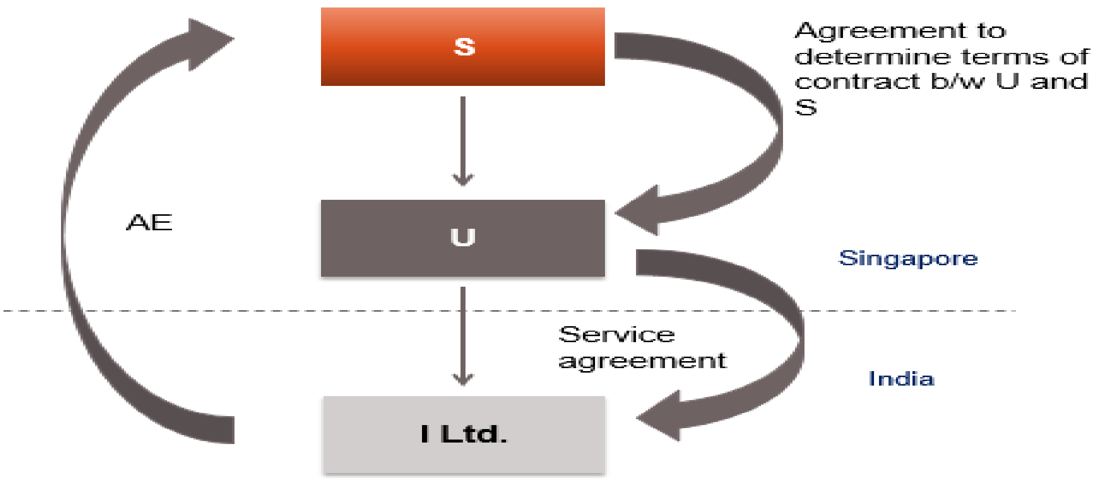
A transaction entered into by an enterprise with a person other than an Associated enterprise (i.e., independent third party) shall be deemed to be a transaction entered into between two AEs, if :

- there exists a **prior agreement** in relation to the relevant transaction between independent third party and the AE; or

- the **terms of the relevant transaction are determined in substance** between independent third party and the AE.

Note : -

The above provision shall apply where either the enterprise or its Associated enterprise or both are non-resident, irrespective of the fact whether the independent third party is a non-resident or not.



The transaction between I Ltd. and U International would be deemed as an international transaction because of prior agreement between U and S International.

Facts:

- I Ltd. of India and S International of Singapore are AE.
- I Ltd. and U International enters into an agreement for provision of services by U International (Non AE of I Ltd.).
- Terms of agreement between I Ltd. and U International will be governed by prior agreement between S International and U.

Issue:

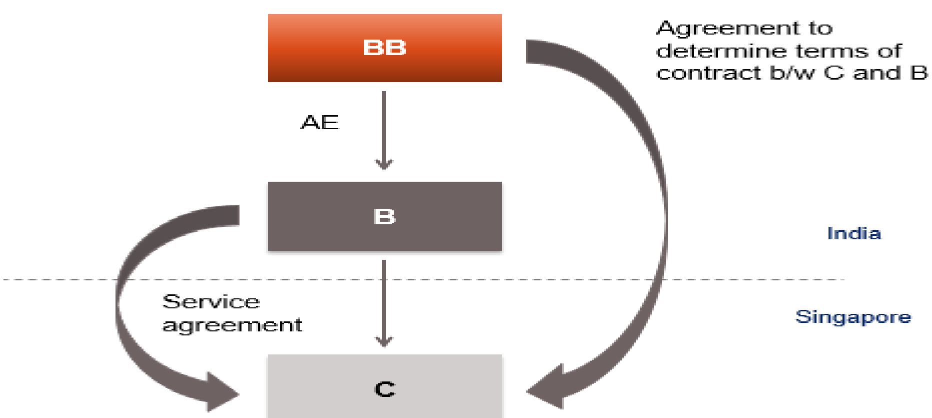
- Whether the transaction between I Ltd. and U International would be deemed as an international transaction ?

EXAMPLE 2 : -

- In the above example, if the nature and purpose of the transaction between I Ltd. and U International is entirely different from what was contemplated in the prior agreement between S and U Ltd., whether the transaction between I Ltd. and U International would be deemed as an international transaction ?

SOLUTION : -

- Transaction between I Ltd. and U International cannot be deemed as international transaction, as the nature and purpose of relevant transaction is completely different from what was contemplated in the prior agreement between U Ltd. and S International.



Facts:

- BB Ltd. and B Ltd. of India are AE. BB Ltd. entered into an agreement with C international (non AE) to determine the terms of provision of services between C International and B Ltd.
- B Ltd. and C International enter into a service agreement for provision of services.

Issue:

- Whether the transaction between B Ltd. and C International would be deemed as an international transaction ?

Solution:

- For an international transaction, one of the AE should be non-resident. In this case neither B Ltd. nor BB Ltd. is non-resident. Hence, the transaction between B Ltd. and C International cannot be deemed as international transaction.

EXPLANATION TO SECTION 92B – INTERNATIONAL TRANSACTION

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

	International Transaction shall include	**Transaction pertaining to**
Tangible property	• Purchase • Sale • Transfer • Lease • Use	• Machinery • Tools • Plant • Building • Transportation vehicle • Equipment • Furniture • Any other article product or thing • Commodity
Intangible Property	• Purchase • Sale • Transfer • Lease • Use	• Patents • Transfer of ownership • Copyrights • Licenses • Industrial property rights • Land use • Brand
Rights	• Transfer of ownership • Provision of use of certain rights	• Trademark • Franchises • Know-how • Any other business or commercial rights of similar nature • Customer List • Marketing Channel, brand, commercial secret

		• Exterior design or practical and new design

International Transaction shall include	Transaction pertaining to
Capital financing	• Long-term or short-term borrowings • Lending or • Guarantee • Purchase or sale of marketable securities • Any type of Advance • Payments or deferred payments • Receivable • Any other debt arising during the course of business
Provision of services	• Scientific research • Market development • Technical service • Market research • Design • Consultation • Marketing management • Legal or accounting service • Administrations • Repairs
Transaction of business restructuring or reorganisation, entered into by an enterprise irrespective of the fact that it has bearing on: • Profits • Income • Losses • Assets of such enterprise at the time of transaction or at any future date	Merger of Foreign AE into Indian Company

Marketing related intangibles	• Logos • Trademarks • Brand names • Trade names
Technology related intangibles	• Technical documentation such as laboratory notebooks • Process patents • Technical know-how • Patent applications
Artistic related intangibles	• Musical composition • Copyrights • Literacy works and copyrights • Engravings • Maps
Customer related intangibles	• Customer relationship • Open purchase orders • Customer contracts • Customer list
Contract related intangibles	• Favorable supplier • Contracts • License agreements • Franchise agreements • Non-compete agreements

Engineering related intangibles	• Blueprints • Industrial design • Proprietary documentation • Product patents • Trade secrets, Engineering drawings and shematics
Data processing related intangibles	• Software copyrights • Proprietary computer software • Automated database • Integrated circuit masks and masters
Human capital related intangibles	• Union contracts • Employment agreements • Trained and organised workforce
Location related intangibles	• Mineral exploitation rights • Leasehold interest • Air rights • Water rights
Goodwill related intangibles	• Personal goodwill of professional • Professional practice goodwill • Institutional goodwill • Celebrity goodwill • General business going concern value
Others	• Programmes • Technical data • Estimates • Systems • Surveys • Procedures • Studies • Methods • Forecasts • Campaigns • Customer list

Any Other similar item that derives its value from its intellectual content rather than its physical attributes	•

13. **Arms' length principle**

- The ARM's length principle is the **fundamental principle** within transfer pricing. The ARM's Length Principle basically stipulates that **related parties shall deal** with each other **as if** they were **unrelated parties**.

- The principle of arm's length stipulates that the **relation between the parties** should not affect the price at which transaction is entered.

- Commercial transaction that can be conducted between related parties are the **supply of goods, supply of services, loans, guarantee, fees, royalty transactions, sale of assets, etc.**

DEFINITION OF ARM'S LENGTH PRICE [SECTION 92F]

The concept of an arm's length price in a transaction, is that the price should be determined to **protect the best interest** of both the parties in a transaction as if, they are unrelated.

Section 92F(ii) of the Income Tax Act, 1961 defines arm's length price to mean a price –

- Which is **applied** or **proposed to be applied** in a transaction - This implies that the arm's length price can be applied to an existing or a future transaction;

- Transaction is between person **other than AEs** – The person should not be either: -

    - Associated enterprise

    - Deemed associated enterprises as per Section 92A;

- Transaction is entered in **uncontrolled conditions**, i.e., the conditions should not have been suppressed or controlled in a manner so that certain predetermined results are obtained.

Arm's Length Price ("ALP") **provides a benchmark** against which transactions between Associated Enterprise can be **compared**.

Note : -

The provisions relating to application of arm's length price are not applicable where such application results in reduction of income or increase in losses for tax purpose in India.

14. COMPUTATION OF ARM'S LENGTH PRICE [SECTION 92C]

The Arm's Length Price ("ALP") in relation to an international transaction shall be determined by any of the **following methods** (Section 92C of the Income Tax Act, 1961) : -

TRADITIONAL TRANSACTION METHOD -

Comparable Uncontrolled Price Method ('CUP')
Resale Price Method ('RPM')
Cost Plus Method ('CPM')

TRANSACTIONAL PROFIT METHODS -

Profit Split Method ('PSM')
Transactional Net Margin Method ('TNMM')

ANY OTHER METHOD PRESCRIBED BY THE CENTRAL BOARD OF DIRECT TAXES -

- Other Method prescribed in Rule 10AB – Rule 10AB provides a method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts.

Arms' length principle

- The ARM's length principle is the **fundamental principle** within transfer pricing. The ARM's Length Principle basically stipulates that **related parties shall deal** with each other **as if** they were **unrelated parties**.

- The principle of arm's length stipulates that the **relation between the parties** should not affect the price at which transaction is entered.

COMPARABLE UNCONTROLLED PRICE ("CUP") METHOD

The ALP can be ascertained under CUP Method, where: -

- Concerned company buys, or sells **similar** goods or services in **comparable transactions** with **unrelated** enterprises; or

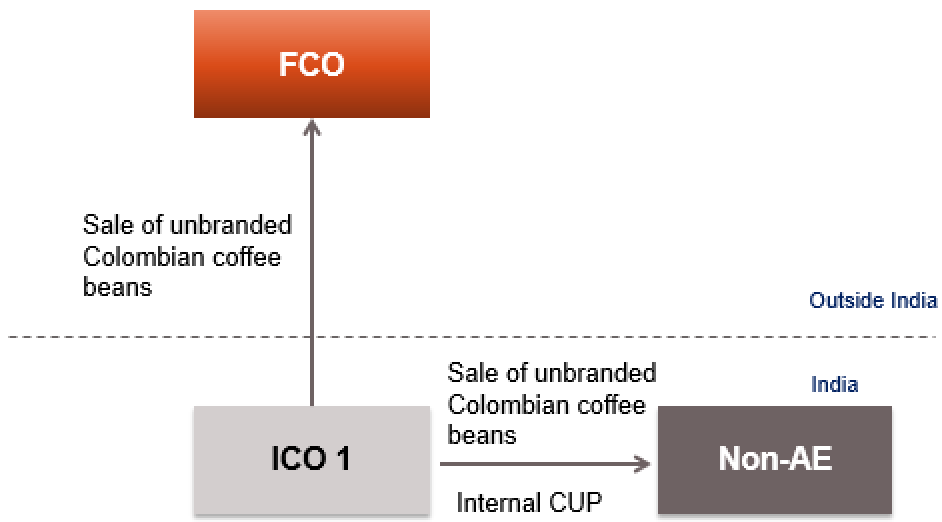
- **Unrelated enterprises** buy or sell **similar** goods or services, as is being done between the AE.

Note : -

The fundamental principle of this method is identification of identical transaction:-

- **Entered into by taxpayer with unrelated enterprise – This is termed as internal CUP; or**
- **Entered into between unrelated parties – This is termed as external CUP.**

INTERNAL CUP



Facts:

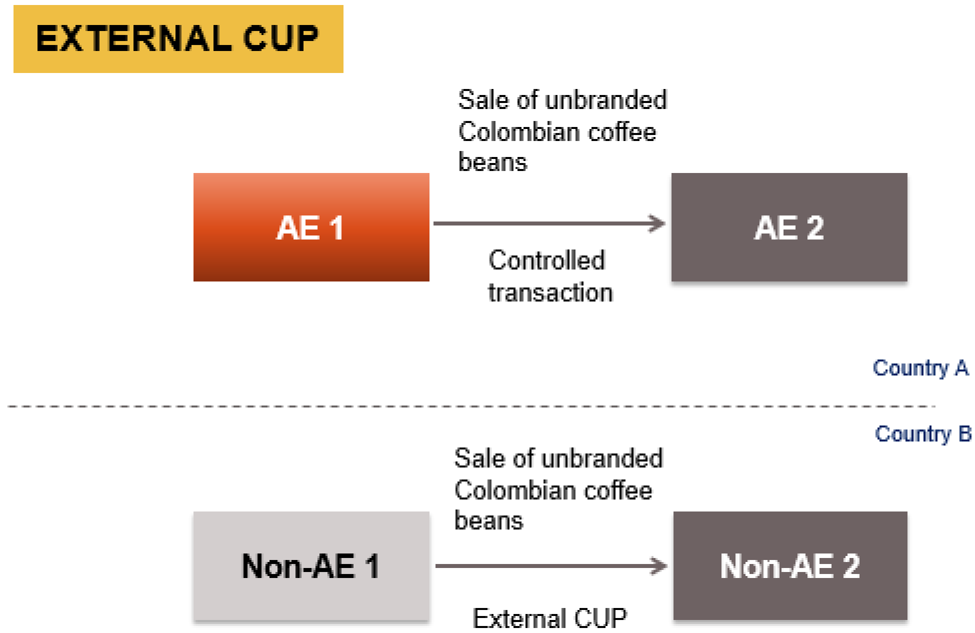
- ICO 1 sold unbranded Colombian coffee beans to ICO 2 (non AE).
- ICO1 sold unbranded Colombian coffee beans of similar type, quality and quantity to FCO.

Issue:

- Identify the nature of transaction as
  a. Internal CUP and
  b. Controlled transaction.

Solution:

- Transaction between ICO1 and FCO is a controlled transaction.
- Transaction between ICO 1 and ICO 2 is an internal CUP.



<u>Facts</u>:

- AE 1 sold unbranded Colombian coffee beans to AE 2.
- AE 1 did not sell any unbranded Colombian beans to third party (Non-AE).
- There is a sale of unbranded Colombian coffee beans of similar type, quality and volume between non-AE 1 non-AE 2.

<u>Issue</u>:

- Identify the nature of transaction as External CUP and Controlled transaction.

<u>Solution</u>:

- Transaction between AE 1 and AE 2 is a controlled transaction.
- Transaction between Non – AE 1 and Non AE 2 is termed as external CUP.

STEPS INVOLVED IN CUP METHOD

STEP 1 : -

Identify **prices charged from or paid** to, on transfer of goods or services in **comparable uncontrolled transaction/s**.

> **Note : -**
>
> **Comparable uncontrolled transaction could be Internal CUP or External CUP.**
>
> **However, use of Internal CUP is preferred over External CUP**

STEPS INVOLVED IN CUP METHOD

STEP 2 : -

Adjust the price so arrived at

a. for functional difference between the international transaction or the Specified Domestic Transaction (SDT) under review, and the comparable uncontrolled transactions (like quality of product or service, contractual terms, credit terms, transport terms, market level (wholesale, retail etc.));
b. **between the enterprises** entering into such transactions (size, operating environment), which could materially affect the price in the open market.

Such adjusted price will be the **arm's length price**.

EXAMPLES ON CUP METHOD

EXAMPLE 1 : -

- AE 1 sold unbranded Colombian coffee beans to **AE 2** at **Rs 5,00,000**. AE 1 sold unbranded Colombian coffee beans of similar type, quality and quantity to third party **(Non-AE)** at **Rs 4,00,000**.

- Analyse the impact of transfer pricing provisions and ascertain the ALP?

SOLUTION: -

- Price charged by AE 1 for sale of coffee beans from AE 2 is Rs. 5,00,000 and the price charged from Non-AE is Rs. 4,00,000.
- Since, the price charged from AE 2 Rs. 5,00,000 is more than the price charged from Non-AE Rs. 4,00,000, we cannot consider Rs 4,00,000 as ALP as it will reduce the taxable income of AE 1.

Hence, the ALP for sale of coffee beans by AE 1 to AE 2 shall be Rs. 5,00,000.

EXAMPLE 2 : -

- AE 1 sold unbranded Colombian coffee beans to **AE 2** at **Rs 5,00,000**. AE 1 sold unbranded Colombian coffee beans of similar type, quality and quantity to third party **(Non-AE)** at **Rs 6,00,000**.
- Analyse the impact of transfer pricing provisions and ascertain the ALP ?

SOLUTION : -

- Price charged by AE 1 for sale of coffee beans from AE 2 is Rs. 5,00,000 and the price charged from Non-AE is Rs. 6,00,000.
- Since, the price charged from Non-AE is Rs. 6,00,000, which is more than the price charged from AE 2 i.e. Rs. 5,00,000, the ALP would be Rs. 6,00,000.

- Accordingly, by applying the TP provisions, Rs. 1,00,000 (6,00,000 – 5,00,000) would be added to the income of AE 1.

EXAMPLE 3 : -

- AE 1 sold unbranded Colombian coffee beans to **AE 2** at **Rs 5,00,000**. AE 1 sold unbranded Colombian coffee beans of similar type, quality and quantity to third party **(Non-AE)** at **Rs 5,50,000** (Internal CUP). Independent third party (i.e., Non-AE) sold unbranded Colombian coffee beans of similar type, quality and quantity to third party **(Non-AE)** at **Rs 6,00,000**. (External CUP).

- Analyse the impact of transfer pricing provisions and ascertain ALP ?

SOLUTION : -

- Internal CUP should be preferred over External CUP for comparison of controlled transaction with uncontrolled transaction. Rs 6,00,000 is an External CUP.

- In this case, the ALP would be Rs 5,50,000, i.e., the price at which coffee beans were sold by AE 1 to Non-AE.

- Hence, the income of AE 1 would be increased by Rs 50,000 (5,50,000 - 5,00,000).

EXAMPLE 4 : -

- AE 1 sold unbranded Colombian coffee beans to **AE 2** at **Rs 5,00,000**. AE 3 sold unbranded Colombian coffee beans of similar type, quality and quantity to AE 4 at **Rs 5,50,000**. Independent third party (i.e., Non-AE) sold unbranded Colombian coffee beans of similar type, quality and quantity to third party **(Non-AE)** at **Rs 6,00,000**. (External CUP).

- Analyse the impact of transfer pricing provisions on **AE 1** and ascertain ALP ?

SOLUTION: -

- Transactions between two AE's are controlled transactions and such transactions cannot be considered as base for determining ALP.

- In the given case, transactions between AE 1 & AE 2 amounting Rs. 5,00,000 and AE 3 & AE 4 amounting Rs. 5,50,000 are controlled transactions and hence should not be considered for the purpose of determining ALP.

- Therefore, ALP would be Rs 6,00,000 in the case, i.e., the price at which coffee beans were sold between two Non-AE.
- Hence, the income of AE 1 would be increased by Rs 1,00,000 (6,00,000 - 5,00,000).

EXAMPLE 5 : -

- AE1 sold 1,000 bicycles to AE 2 at FOB price (Free on Board) of Rs 3,000 per bicycle.

- AE 1 sold 10,000 bicycles to Non-AE at CIF price (Cost, Insurance and Freight) of Rs 6,000 per bicycle.

- AE2 would bear the cost of insurance and freight of Rs 500 per bicycle.

- As Non-AE placed order in large volumes, AE 1 offered quantity discount of Rs 200 per bicycle.

- Sales were made to Non-AE at credit facility of three months whereas the sales to AE 2 have always been on cash basis.
- The cost of credit may be taken as 1% per month.
- Analyse the impact of transfer pricing provisions and ascertain the ALP?

EXAMPLES ON CUP METHOD

Solution: -

Particulars	Amount
Price charged from Non-AE	Rs. 6,000 per unit
Add: -	
Three months credit to Non-AE (Rs. 6,000 * 3%)	Rs. 180 per unit
Quantity discount given to Non-AE	Rs. 200 per unit
Less: -	
Value of insurance/ freight paid by Non-AE	Rs. 500 per unit
Arm's Length Price	**Rs. 5,880 per unit**
Increased income (5,880 – 3,000)	Rs. 2,880 per unit
Quantity	1,000 units
Total increased income	**Rs. 28,80,000**

No deduction shall be allowed under Chapter VI – A on such enhanced income.

JUDICIAL RULINGS ON CUP METHOD

Case laws	Held
Eli Lilly & Company vs. Commissioner - **[2016] 70 taxmann.com 260 (Delhi - Trib.)**	Where adjustments cannot be made on account of differences (credit terms, product quality and patent, etc.), CUP method cannot be considered as most appropriate method.
Bausch & Lomb Incorporated vs. Commissioner - **[2017] 85 taxmann.com 163 (Delhi - Trib.)**	CUP cannot be considered as most appropriate method where transactions are uncomparable due to difference in relationship.
Kailash Jewels Private Limited vs. ITO - **[2015] 59 taxmann.com 473 (Delhi - Trib.)**	Where nature of business of comparable companies were same, CUP method is most appropriate method.
Principal CIT vs. Toll Global Forwarding India (P) Ltd. - **[2016] 66 taxmann.com 53 (Delhi)**	When price determination for all business associates, whether associated enterprises or third party, was on same terms and profit sharing ratio, CUP method is most appropriate method.

RESALE PRICE METHOD ("RPM")

- When a resident and a related enterprise, enter into a transaction, and the purchaser or service recipient in that transaction, **resells the product/ provides services** to an unrelated enterprise, the amount calculated by **deducting a "normal profit** of the purchaser/recipient of services" **from** that **resale price** is deemed to be the arm's length price applicable to the transaction between the related parties.

RPM **compares the gross margins (i.e. gross profit over sales)** earned in transactions between related and unrelated parties for determination of Arm's length price.

NOTE : -

- RPM is generally used in case of **distribution function**, i.e., where the tested party **purchases products** or acquire services **from related parties** and **sells** the same **to independent parties**.

- The **reseller**, **does not add substantial value** to the product or services.

STEP 1 : -

Resale Price (Identify the price at which property or services are resold or provided to an unrelated party)

STEP 2 : -

Less :- Normal **gross profit margin** derived by the enterprise from the resale price of such property or services in comparable uncontrolled transactions. (**Normal Net profit margin** should not be considered as we need to reduce only gross profit margin)

> **Note : -**
>
> **The gross profit margin earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide (i.e., External Comparable).**

STEP 3 : -

Less :- Expenses incurred by the enterprise **in connection with** the purchase of property or obtaining of services (For example, if customs duty borne by purchaser).

STEP 4 : -

Add/Less:- Impact of **Functional and other differences**, (including accounting practices) between international transaction (or SDT) and the comparable uncontrolled transactions,
or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market (Adjustments **affecting only net profit margin should not be considered**).

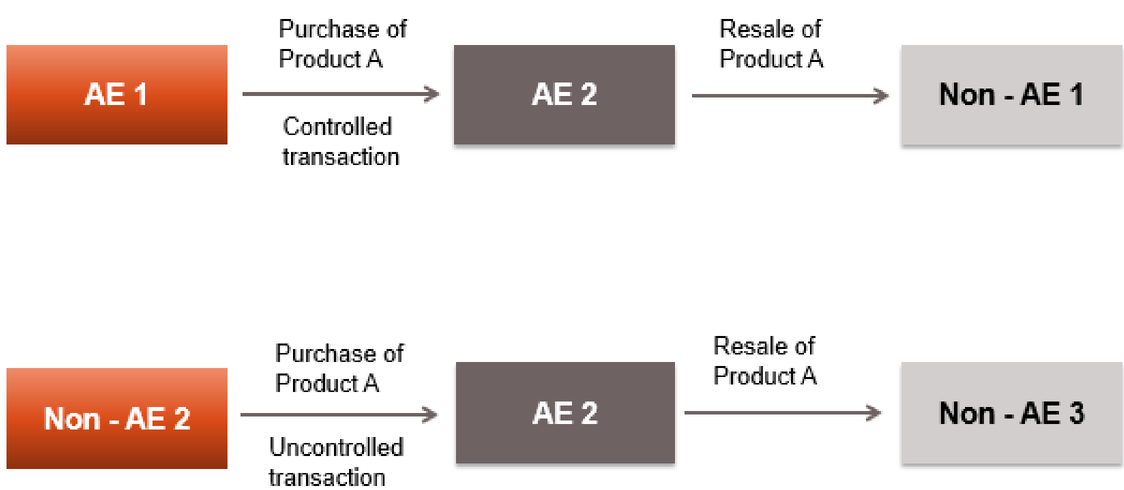
RESALE NORMAL GROSS PROFIT MARGIN

The **resale normal gross profit margin** (Step 2 above) is that margin which the enterprise would earn from purchase of the similar product from an unrelated party, and the resale of the same to another unrelated party. This comparable gross margin is determined by reference to either : -

- the resale price margin earned by re-seller in comparable uncontrolled transactions (internal comparable); or

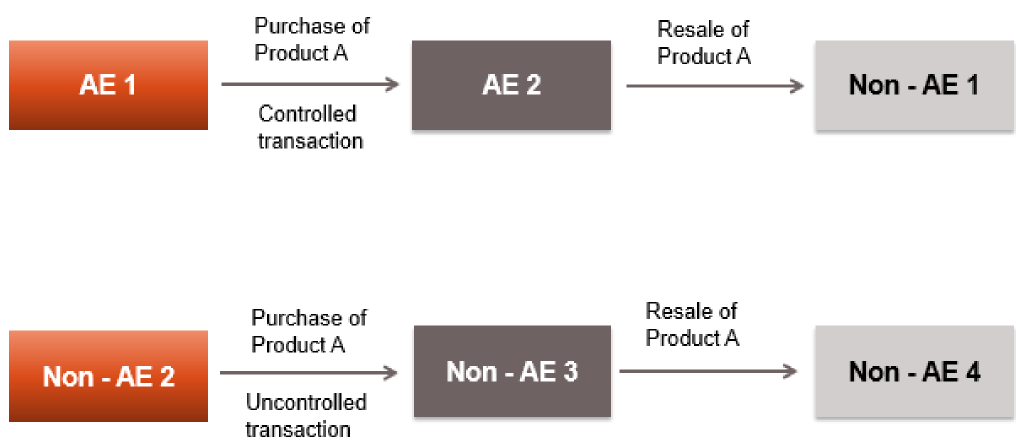
- the resale price margin earned by an independent enterprise in comparable uncontrolled transactions (external comparable).

INTERNAL COMPARABLE - RPM



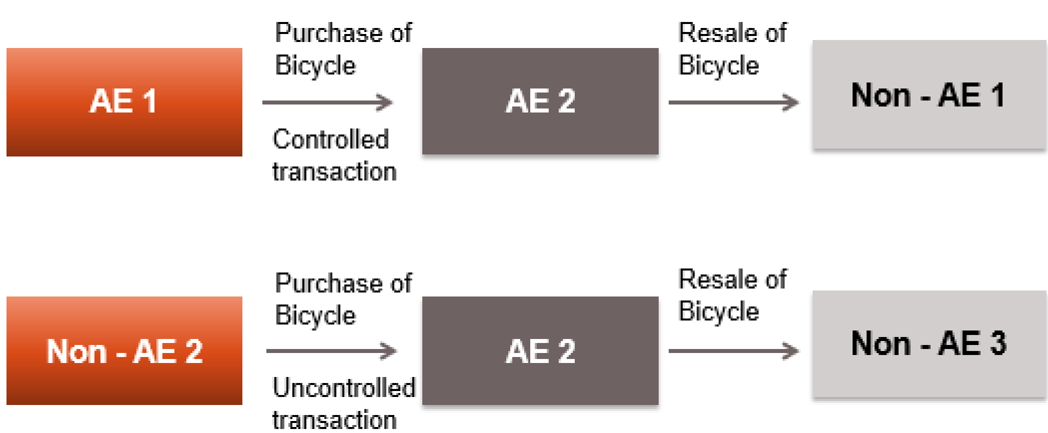
GROSS PROFIT EARNED BY AE 2 ON RESALE OF PRODUCT A TO NON - AE 3 WOULD BE INTERNAL COMPARABLE.

EXTERNAL COMPARABLE – RPM – INTERNAL COMPARABLE



GROSS PROFIT EARNED BY NON - AE 3 ON RESALE OF PRODUCT A TO NON – AE 4 WOULD BE EXTERNAL COMPARABLE.

EXAMPLE – RPM – INTERNAL COMPARABLE



Gross profit earned by AE 2 on resale of bicycle to Non - AE 3 would be Internal comparable.

Facts:

- AE 2 purchases bicycles from AE 1 at Rs. 4,50,000 and resold these bicycles to Non - AE 1 at Rs. 5,00,000.
- AE 2 purchases bicycle from Non – AE 2 and resold the same to Non – AE 3. AE 2 earned gross profit margin of 20% on sales on such transaction.
- There are no expenses in connection with purchase of bicycles and no functional or other differences which could affect the gross profit margin earned by AE 2 ?

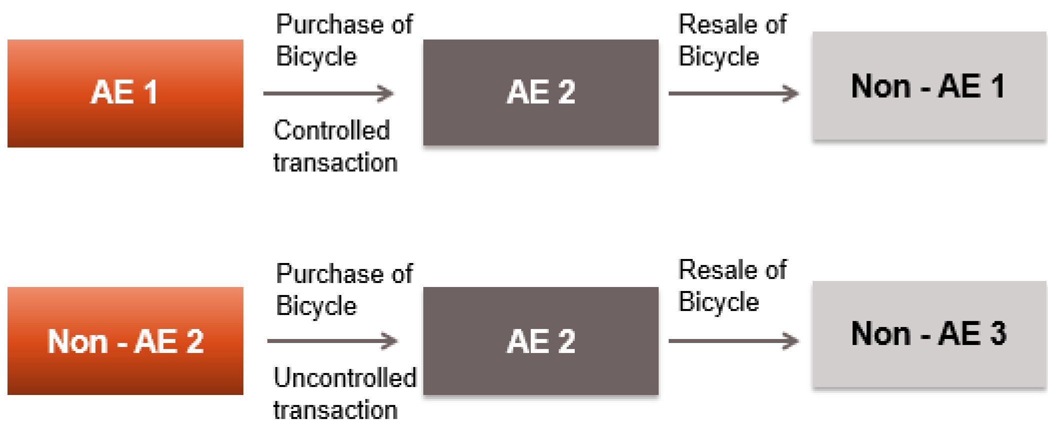
Issue:

- Compute Arms' length price under Resale Price Method?

Solution : -

Particulars	Amount
Resale price of bicycle to Non – AE 1	Rs. 5,00,000
Less: -	
Normal gross profit margin earned by internal comparable (5,00,000 * 20%)	Rs. 1,00,000
Expenses in connection with purchase of bicycle	Nil
Add/ Less: -	
Adjustment for functional and other differences	Nil
ALP of bicycle purchased from AE 1	**Rs. 4,00,000**

EXAMPLE – RPM – INTERNAL COMPARABLE



Gross profit earned by AE 2 on resale of bicycle to Non - AE 3 would be Internal comparable.

Facts:

- AE 2 purchases bicycles from AE 1 at Rs. 4,50,000.
- AE 2 resold these bicycles to Non - AE1 at Rs. 5,00,000.
- AE 2 purchases bicycles from Non – AE 2 and resold the same to Non – AE 3. AE 2 earned gross profit margin of 20% on sales on such transaction.

- AE 2 offers extended warranty of one-year to Non – AE 1. The estimated cost of extended warranty is Rs. 2,000.

Issue:

- Compute Arms' length price under Resale Price Method ?

Solution : -

Particulars	Amount
Resale price of bicycle to Non – AE 1	Rs. 5,00,000
Less: -	
Normal gross profit margin earned by internal comparable (5,00,000 * 20%)	Rs. 1,00,000
Expenses in connection with purchase of bicycle	Nil
Add/ Less: -	
Adjustment for extended warranty **(Note)**	Nil
ALP of bicycle purchased from AE 1	**Rs. 4,00,000**

NOTE : -

COST OF EXTENDED WARRANTY WOULD NOT AFFECT THE GROSS PROFIT MARGIN AS WARRANTY COSTS ARE ONLY CHARGED TO PROFIT AND LOSS ACCOUNT. THUS, NO ADJUSTMENT WOULD BE MADE FOR EXTENDED WARRANTY AS IT HAS NO EFFECT ON GROSS PROFIT MARGIN EARNED BY AE 2.

Gross profit earned by AE 2 on resale of bicycle to Non - AE 3 would be Internal comparable.

<u>Facts</u>:

- AE 2 purchases bicycles from AE 1 at Rs. 4,50,000. & resold these to Non – AE 1 at Rs. 5,00,000.
- AE 2 purchases bicycles from Non – AE 2 and resold the same to Non – AE 3. AE 2 earned gross profit margin of 20% on sales on such transaction before any discount.
- Differences in comparable transactions : -
    - AE 2 incurred freight of Rs. 20,000 on purchase from AE 1. However, no freight was incurred on purchases made from Non – AE 2.
    - Non – AE 1 purchased a larger order due to which it was given quantity discount by AE 2. Such quantity discount reduces the gross profit margin (as above) with Non – AE 1 by 3% on sales.

<u>Issue</u>:

- Compute Arms' length price under Resale Price Method ?

<u>Solution</u> : -

Particulars	Amount
Resale price of bicycle from Non – AE 1	Rs. 5,00,000
Less: -	
Normal gross profit margin earned by internal comparable (5,00,000 * 17%) **(Note)**	Rs. 85,000
Expenses in connection with purchase of bicycle from AE 1	Rs. 20,000
Add/ Less: -	
Adjustment for extended warranty	Nil
ALP of bicycle purchased from AE 1	**Rs. 3,95,000**

Note : -

Comparable gross profit margin is 20%. However, due to quantity discount gross profit margin with Non – AE 1 is reduced by 3%. Thus, comparable gross profit margin should also be reduced by 3% (i.e., from 20% to 17%).

JUDICIAL RULINGS ON RPM

Case laws	Held
Sanyo India Private Limited vs. ACIT - ***[2015] 45 CCH 98 (Bang. - Trib.)***	Sanyo India Private Limited distributed electronic and electrical products imported from its related party in Japan. It adopted RPM as the most appropriate method using gross profit margin on sales as profit level indicator. It was observed that Sanyo India Private Limited was selling goods in local market without any value addition. Hence, it was held that RPM is the most appropriate method.
CIT vs. L'Oreal India Private Limited - ***[2015] 53 taxmann.com 432 (Bombay)***	L'Oreal India Private Limited was engaged in the business of manufacturing and distribution of cosmetics and beauty products and has exclusive rights to import, manufacture, market, distribute and sell branded products, consumer products and professional products relating to L'Oreal group. Court placed reliance on OECD guidelines. L'Oreal India Private Limited bought products from its AE's and sold to unrelated parties without any further processing. Hence it was held that RPM can be adopted.

COST PLUS METHOD ("CPM")

Under Cost plus method, price is determined by adding appropriate **gross profit margin** (considering the function performed, return on capital and risk assumed by an entity) **to the AE's cost of producing goods/ providing services**.

As per the Organisation for Economic Co-operation and Development (OECD), CPM method is applicable when,

- **Semi-finished goods** are sold between Associated enterprises,
- There are **long term supply** and purchase agreements,
- There is **provision of services**,
- There is **contract manufacturing**.

STEPS INVOLVED IN CPM

STEP 1 : -

Determine the **direct and indirect costs of production** in a tested party transaction.

Note : -

Such Direct and Indirect cost should be in respect of property transferred or services provided to an Associated Enterprise.

STEP 2 : -

Determine the amount of a **normal gross profit mark-up** to such costs, arising from the transfer or provision of the same or similar goods or services : -

a. by the **enterprise**, (i.e., transfer of similar goods or services by the enterprise - **Internal comparable),** or

b. by an **unrelated enterprise** (i.e., transfer of similar goods or services between unrelated parties) - **External comparable**,

in a **comparable uncontrolled transaction**, or a number of such transactions.

STEP 3 : -

The normal gross profit mark-up determined above shall be adjusted to account for the functional and other differences.

Note : -

Adjustment is to be made only if difference could materially affect such profit mark-up in the open market.

STEP 4 : -

The costs referred to in Step 1, shall be **increased by the adjusted profit mark-up** calculated in Step 3 leads to arm's length price.

JUDICIAL RULINGS ON THE SELECTION OF CPM

Case laws	Held
Frigoglass India Private Limited vs. DCIT - ***[2014] 45 taxmann.com 101 (Delhi - Trib.)***	Frigoglass India Private Limited was engaged in manufacturing and merchandising of glass door. It applied CPM for benchmarking its international transactions relating to manufacturing activities with its related parties. AO held that, when reliable method viz. TNMM was available then there was no need to go to CPM. It was held that once taxpayer has given a methodology for working of arm's length price on selection of a particular method supported by appropriate comparables, the working can be dislodged by Tax Officer only on the basis of cogent reasons and objective findings. In this case, except theoretical assertions and generalized observations by the Tax offices, no objective findings have been given to come to a reasoned conclusion that Frigoglass India Private Limited's adoption of CPM for manufacturing segment was factually and objectively not correct.

PROFIT BASED METHODS ("PSM")

Profit-based methods **examine the profits that arise from particular transactions among Associated Enterprises**. The two profit-based transfer pricing methods, recognised by the TP legislation, as satisfying the arm's length principle are : -

- Profit Split method;
- Transactional net margin method.

PSM evaluates,
if, the **profits or loss**,
allocated to a particular entity,
out of combined operating profit,
of **controlled transaction**,
is at arm's length,
considering their individual contribution in the overall profit or loss.

> **Note : -**
>
> **PSM is typically applicable in international transactions or Specified Domestic Transactions, involving transfer of unique intangibles or in multiple international transactions which are so interrelated that they cannot be evaluated separately for determining the ALP of any one transaction.**

STEPS INVOLVED IN PSM

STEP 1 : -

Determine **combined net profit of the AEs**, arising from the controlled international transaction.

STEP 2 : -

Evaluate the **relative contribution made by each AE**, to the earning of such combined net profit.

Note : -

- Such evaluation is based on functions performed, assets employed and risks assumed by each enterprise.
- Reliable external market data on how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances, is identified for comparison with AEs functions.

STEP 3 : -

The **combined net profit** is then **splitted** amongst the enterprises in proportion to their relative contributions.

STEP 4 : -

The profit so **apportioned to the tested party**, is considered to arrive at an arm's length price of the international transaction.

ALLOCATION METHODS UNDER PSM

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

a. Comparable Profit split
b. Residual Profit split

COMPARABLE PROFIT SPLIT METHOD

- A comparable profit split is derived, from the combined operating profit of uncontrolled taxpayers whose transactions and activities are similar to those of the controlled taxpayers.
- Under this method, uncontrolled taxpayer's percentage of the combined operating profit or loss, is used to allocate the combined operating profit or loss.

RESIDUAL PROFIT SPLIT METHOD

The combined operating profit or loss from the relevant business activity is allocated between the controlled taxpayers following the two-step process :

a) Allocate operating income to each party to the controlled transactions to provide a **market return for its routine contributions** to the relevant business activity.

b) Allocate **residual profit** among the controlled taxpayers, based upon the **relative value of their contributions of intangible property** to the relevant business activity that was not accounted for as a routine contribution.

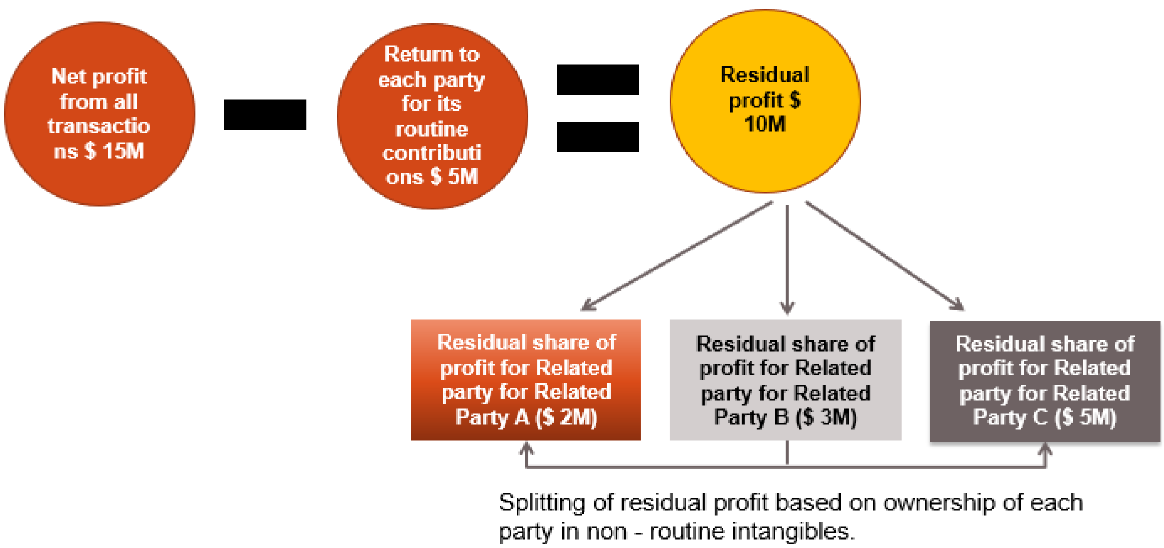
ALLOCATION OF PROFIT BASED ON PROFIT SPLIT METHOD

EXAMPLE : -

- MNC US entered into a contract for manufacturing of DAM, for which its subsidiaries in US, Singapore and India worked
- The total contract price of deal was $100M.
- Net profit earned by MNC US from the entire deal transactions was $15M, of which the routine contribution is $5M, wherein the relative efforts put in by group companies are 35%, 30% and 35% respectively.
- Non routine profit to be to be split in group companies on the basis of ownership of non-routine intangibles i.e. 20%, 30% and 50%.
- Compute the Arm's length profit of related party in US, Singapore and India in accordance with Profit Split Method?

SOLUTION : -

Parties	Distribution of income for routine transaction ($ in M) (A)	Distribution of income as residual profit ($ in M) (B)	Total arm's length profit of related parties ($ in M) (A+B)
US	**1.75** (5 * 35%)	**2** (15 - 5) * 20%	**3.75**
Singapore	**1.50** (5 * 30%)	**3** (15 - 5) * 30%	**4.50**
India	**1.75** (5 * 35%)	**5** (15 - 5) * 50%	**6.75**



JUDICIAL RULINGS ON THE SELECTION OF PSM

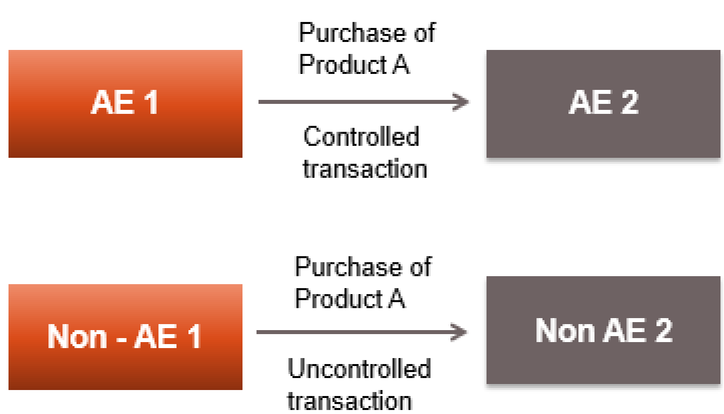
Case laws	Held
Orange Business Services India Networks Private Limited vs. DCIT - ***[2015] 63 taxmann.com 304 (Delhi - Trib.)***	The Court held that when any transaction requires deployment of functions and assets of various entities, located in different geographical locations, to deliver service which generate revenues. PSM is the most appropriate method for determining arm's length price.
Global One India Private Limited vs. ACIT - ***[2014] 44 taxmann.com 100 (Delhi - Trib.)***	Global One India Private Limited was engaged in providing internet and related network services to the group's customers in India. It adopted PSM for benchmarking its international transaction which has rejected, and AO adopted TNMM. Court accepted the PSM on the basis that Global One India Private Limited generates revenue out of operations that are highly integrated.

TRANSACTIONAL NET MARGIN METHOD ("TNMM")

- Under TNMM, the ALP is arrived at by comparing **operating profit**, relative to an appropriate base (i.e., costs, sales, assets, etc.) of the "**tested**" party

- with the operating profit of an uncontrolled party engaged in comparable transactions.

- The ratios most commonly used, express net profits as a percentage of costs (full cost or operating costs), a particular balance sheet category (example Assets, Capital Employed, etc.) or Sales/ Service receipts.



STEPS INVOLVED IN TNMM

STEP 1 : -

The net margin realised by the enterprise from an international transaction entered with an Associated Enterprise is computed, with regards to base discussed above, both for

a. the unrelated party ; and

b. the party under consideration.

STEP 2 : -

The net margin so derived is adjusted for any differences, between : -

a. international transaction and the comparable uncontrolled **transaction**, or

b. between the **enterprises** entering into such transactions

> **Note : -**
>
> **Adjustment should be made only when differences could materially affect the amount of net profit margin in the open market.**

STEP 3: -

The margin so established is taken into account to arrive at an arm's length price for the international transaction.

EXAMPLE – TNMM

EXAMPLE 1 : -

- XYZ India procures computer software ("Z") from SB Singapore @ Rs. 1,500 per Software.
- Subsequently the company incurs an additional advertisement expenditure in India of Rs. 600 per pack and the product is ultimately sold at Rs. 3,000 per Software.
- XYZ India also procures packaged software ("T") from its subsidiary company in UK @ Rs. 700 per Software.

- The company incurs an additional expenditure of Rs. 200 per Software and the product is ultimately sold at Rs. 1,200 per Software
- Compute the arm's length price as per TNMM, assuming the difference in product is not material ?

SOLUTION : -

Computation of Net profit margin realized from an unrelated party in a comparable uncontrolled transaction:

Particulars	Amount (Rs.)
Sale price of product Z	3,000
Less: -	
Purchase price	1,500
Additional expenditure in India	600
Net Profit Margin	**900**
Net profit margin ratio (% of sale)	**30%**

SOLUTION : -

Computation of Arm's length price of international transaction with the AE : -

Particulars		Amount (Rs.)
Sale price of T	(A)	1,200
Net profit margin ratio		30%
Net profit margin	(B)	360
Total Cost	**(A – B)**	**840**
Less: -		
Additional expenditure in India		200
Arm's length price per unit		**640**
Transfer price per unit		**700**
TP adjustment per unit		**60**

JUDICIAL RULINGS ON SELECTION OF TNMM METHOD

Case laws	Held
Schutz Dishman Biotech Private Limited vs. DCIT - ***[2015] 60 taxmann.com 50 (Ahmedabad - Trib.)***	Schutz Dishman Biotech Private Limited was manufacturing medicines for export. It applied TNMM for benchmarking its transactions, which was rejected, and AO applied CUP. The Court however accepted TNMM on the basis that margin earned by Schutz Dishman Biotech Private Limited PBIT was exactly similar or nearby with that earned by other uncontrolled transactions of unconnected enterprises.

OTHER METHOD

CBDT has prescribed the 'Other Method' by inserting a new rule 10AB to the Income-Tax Rules. For determination of arm's length price in relation to international transaction, the Other Method shall be
any method which takes into account
the price which has been **charged or paid**, or **would have been** charged or paid,
for the same or similar uncontrolled **transaction,**
with or **between** Non-Associated enterprises,
under **similar circumstances**,
considering all the **relevant facts**.

Following points are relevant in order to apply **"Other Method"** : -

- **Characteristics of the property transferred** or services provided;

- **Functions performed by the respective parties** to the transactions, taking into account taking into account asset employed or to be employed and the risks assumed;

- **Formal / written contractual terms of transactions** laying criterion for how responsibilities, risks and benefits are to be divided between parties to the transactions;

- **Market condition** impacting respective parties to the transactions like geographical location, market size, prevalent laws, level of competition, wholesale/ retail market etc.

15. SELECTION OF TESTED PARTY

There are various participants in an international transaction. In order to find comparables for a transaction, one of the participant is selected as tested party.

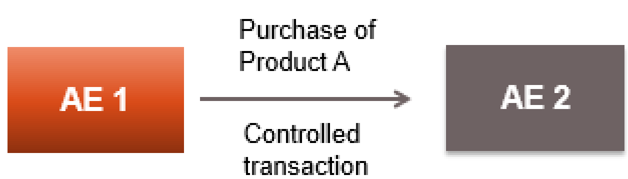
For tested party : -

a. **profitability/ pricing** can be verified based on most appropriate data and

b. The **data requires reasonable adjustments**, for which reliable data can be located.

Party which is chosen as Tested Party : -

- Is "least complex" and
- Does not own valuable intangible property

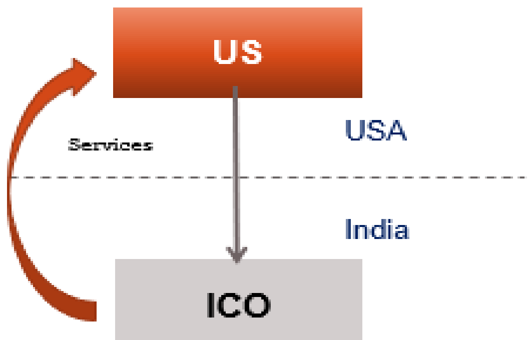


16. SELECTION OF PROFIT LEVEL INDICATOR

A profit level indicator (PLI) are **ratios that measure relationships between profits** and **cost incurred** or **resources employed**.

Generally, PLI should always have an **untainted base** (denominator) i.e. it should not be received from an AE/ paid to an AE and therefore can be considered to be independent or at arm's length.

For example, in case of IT support services provided by an Indian company to a US subsidiary company, revenue will be tainted because it is received from related party. So, the PLI, in the above case, should be costs.



Particulars	Calculations
Return on Assets (ROA)	Operating Profit / Operating assets (normally only tangible assets)
Return on Capital Employed (ROCE)	Operating profit / Capital employed (Total assets - (Cash + Investments))*
Return on Cost of Goods Sold	Gross Profit / Cost of goods sold
Berry Ratio	Gross Profit / Operating expenses
Operating Margin (OM)	Operating Profit / Sales
Return on Total Costs (ROTC)	Operating Profit / Total costs

NOTE : -

***Johnson Matthey India (P.) Ltd. Vs Deputy Commissioner of Income-tax ([2016] 380 ITR 43 (Delhi)) - ROCE as a PLI would be reliable if there is similarity in composition of assets/capital deployed (and their valuation) by tested party with that of comparables.**

17. SELECTION OF MOST APPROPRIATE METHOD - RULE 10C

The most appropriate method shall be the method : -

- Which is best suited to facts and circumstances of **each** particular international transaction [or specified domestic transaction], and

- Which **provides the most reliable measure of an arm's length price** in relation to the international transaction [or the specified domestic transaction.

FACTORS TO BE CONSIDERED TO SELECT MOST APPROPRIATE METHOD – RULE 10C(2)

Following factors should be taken into consideration in determining the most appropriate method:

- **Nature** and class **of** the **international transaction** (or specified domestic transaction).
- **Class of AEs** entering into the transaction and the functions performed by them taking into account assets employed and risks assumed.
- Availability, coverage and reliability of **data** necessary for application of the method.
- **Degree of comparability** existing between the international transaction (or specified domestic transaction) **and** the uncontrolled transaction and between the enterprises entering into such transactions.
- **Extent to which reliable and accurate adjustments can be made** to account for differences, if any, between the international transaction (or specified domestic transaction) and the comparable uncontrolled transaction or between the enterprise entering into such transactions.
- **Nature, extent and reliability of assumptions** required to be made in application of a method.

FACTORS TO BE CONSIDERED TO SELECT MOST APPROPRIATE METHOD

NOTE : -

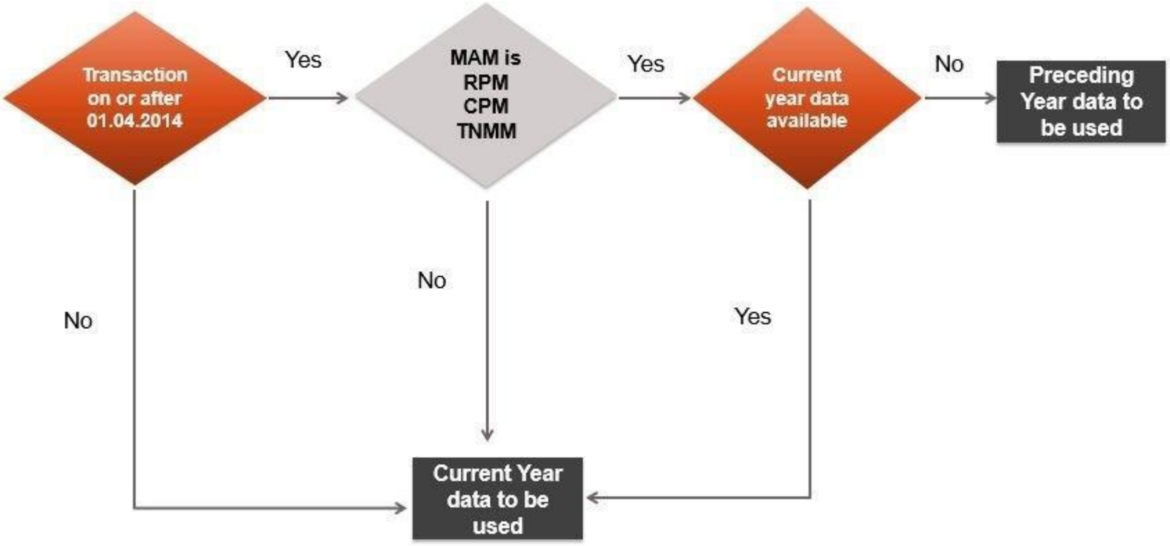
The **onus** of selecting the most appropriate method to determine the ALP is on the **taxpayer.** The taxpayer should demonstrate the correctness of its choice with supporting records and data, irrespective of the fact as to whether, the statute specifically requires him to do or not. However, the **Revenue Authorities are at their discretion to accept a particular method based** on the nature of transaction.

<u>CATEGORISATION FOR SELECTION OF MOST APPROPRIATE METHOD</u>

As per ICAI's guidance note following broad categorization should be used for selection of Most Appropriate Method ('MAM').

CUP	• Loans, service fees, transfer of tangibles, Sale/ Purchase of goods, Royalty
Resale Price Method	• Distributors not performing significant value addition to product
Cost Plus Method	• Sale of raw material/ semi-finished goods or provision of services, contract manufacturing
Profit Split Method	• Integrated services by more than one enterprise, multiple transactions
Transactional Net Margin Method	• Services, distribution of goods when RSM is inappropriate

18. DATA TO BE USED FOR ANALYZING COMPARABILITY OF AN UNCONTROLLED TRANSACTION WITH AN INTERNATIONAL TRANSACTION



Current year data : -

- The data to be used in analysing comparability of an uncontrolled transaction with an international transaction or specified domestic transaction shall be the data relating to **current year** in which the international transaction has been entered into.

RPM+TNMM+CPM – After 01.04.2014

- Where the **most appropriate method** for determination of ALP of an international transaction or specified domestic transaction entered into on or after 1.4.2014 is

    a. Resale price method, or
    b. Cost plus method, or
    c. Transactional net margin method,

then, the data to be used for analyzing the comparability of an uncontrolled transaction with an international transaction shall be –

I. the **data relating to the** **current year**; or

II. the **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 by the assessee, for the assessment year relevant to the current year.

However, where **current year data is subsequently available**

at the time of any **assessment proceedings**,
then, such data (i.e. data of **current year**) shall be used for such determination irrespective of the fact that the data was not available at the time of furnishing the return of income.

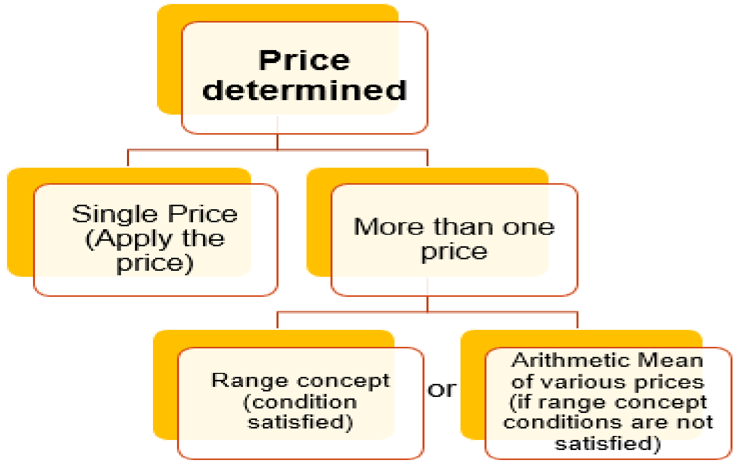
WHERE MORE THAN ONE PRICE IS DETERMINED [SECTION 92C] – FROM 01.04.2014 ONWARDS

If the price determined by the application of Most Appropriate Method is **a single price**, the same is to be applied.

However, if there are **more than one price** which are arrived at, the ALP is to be computed through : -

- In terms of the **range concept**, if certain conditions are satisfied; or
- As **Arithmetic mean** of various prices, if the range concept conditions are not satisfied.

WHERE MORE THAN ONE PRICE IS DETERMINED [SECTION 92C] – RULE 10CA



19. ARITHMETIC MEAN - WHEN MORE THAN ONE PRICE IS DETERMINED

Where more than one price is determined by use of most appropriate method, **and** the range concept is not applicable then, Arm's Length price shall be taken to be Arithmetic Mean of such prices.

Tolerance limit in case of Arithmetic Mean - (Notification No. 50/2017 dated 09.06.2017)

Actual transaction price would be taken as Arm's Length Price,
where **variation** (increase or decrease)
between the **Arm's length price** (determined by use of Arithmetic Mean), and
actual transaction price does not exceed –

- 1% of **actual transaction price** – In case of whole sale trading
- 3% of **actual transaction price** – In case of other business

Note : -
These provisions are applicable for A.Y. 2017-18 and A.Y. 2018-19.

MEANING OF "WHOLESALE TRADING"

An international transaction or specified domestic transaction of trading in goods, which fulfils the following conditions, namely:

- **Purchase cost of finished goods** is 80% or more of the **total cost** pertaining to such trading activities; and

- Average monthly closing inventory of such goods is 10% or less of sales pertaining to such trading activities.

ARITHMETIC MEAN – ALLOWABLE VARIANCE

Transaction	Actual Price	ALP by use of Arithmetic Mean	Permissible Variance (1% or 3%)	ALP to be taken
Wholesale Trading	100	102	99 – 101 (1%)	102
Wholesale Trading	100	101	99 – 101 (1%)	100
Wholesale Trading	100	99	99 – 101 (1%)	100
Other than wholesale trading	100	104	97 – 103 (3%)	104
Other than wholesale trading	100	103	97 – 103 (3%)	100
Other than wholesale trading	100	97	97 – 103 (3%)	100

ARITHMETIC MEAN – ALLOWABLE VARIANCE

EXAMPLE: -

AE 1 sold product A to AE 2 at Rs. 1,50,000. Various sale price of product A, determined under CUP method are -
Rs. 1,40,000, Rs. 1,60,000, Rs. 1,70,000, Rs. 1,80,000 and Rs. 1,90,000.
AE 1 is not a wholesale trader. Determine the arm's length price of transaction?

SOLUTION : -

Particulars	Amount (Rs.)
Arithmetic Mean [1,40,000+1,60,000+1,70,000+1,80,000+1,90,000]/5	1,68,000
Tolerance tag (3% of transaction price) of Rs. 1,50,000 – **Note 1**	4,500
Tolerance limit	1,45,500 – 1,54,500
ALP of transaction – **Note 2**	1,68,000

<u>NOTE 1</u> : -

Tolerance limit is 1% for wholesale traders and 3% for others.
Limit of 3% would be applicable in this case as AE 1 is not a wholesale trader.

<u>NOTE 2</u> : -

ALP of transaction would be the Arithmetic Mean (i.e., Rs 1,68,000)
which is outside the limit of tolerance (i.e., Rs 1,54,500)

<u>EXAMPLE</u> : -

AE 1 sold product A to AE 2 at Rs. 1,50,000. Various sale price of product A determined under CUP method are -
Rs. 1,30,000, Rs. 1,40,000, Rs. 1,55,000, Rs. 1,60,000 and Rs. 1,70,000.
AE 1 is not a wholesale trader. Determine the arm's length price of transaction.

<u>SOLUTION</u> : -

Particulars	Amount (Rs.)
Arithmetic Mean [1,30,000+1,40,000+1,55,000+1,60,000+1,70,000]/5	1,51,000
Tolerance tag (3% of transaction price) of Rs. 1,50,000 – **Note 1**	4,500
Tolerance limit	1,45,500 – 1,54,500
ALP of transaction – **Note 2**	1,50,000

NOTE 1 : -

Tolerance limit is 1% for wholesale traders and 3% for others.
Limit of 3% would be applicable in this case as AE 1 is not a wholesale trader.

NOTE 2 : -

ALP of transaction would be the actual transaction price of Rs 1,50,000 as Arithmetic Mean (i.e., Rs 1,51,000) is within the limit of tolerance (i.e., Rs 1,54,500).

20. APPLICABILITY OF RANGE CONCEPT – WHEN MORE THAN ONE PRICE IS DETERMINED

Range concept is applicable when following conditions are satisfied : -

- **More than one price** are determined by use of Most Appropriate Method
- **Transaction** is undertaken on or after **April 1, 2014**
- **Arm's length pri**ce is **determined** by use of
    - Transactional Net Profit Method (**TNMM**), or
    - Comparable uncontrolled price Method (**CUP** Method), or
    - Cost Plus Method (**CPM**), or
    - Resale Price Method (**RPM**).

- **Six or more comparables** are available in the dataset

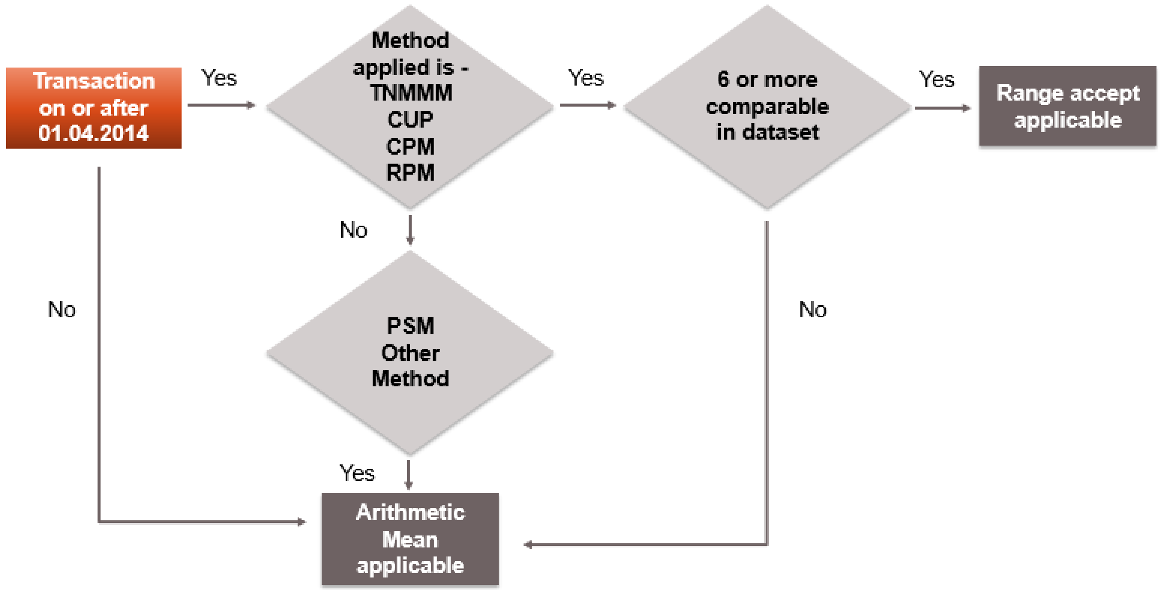
APPLICABILITY OF RANGE CONCEPT – WHEN MORE THAN ONE PRICE IS DETERMINED

NOTES : -

- Range concept is not applicable when either Profit Split Method or other method (given under Rule 10AB) is used to determine the Arm's length price.

- **All** the aforesaid conditions should be satisfied to apply range concept. Failure to satisfy any one of the aforesaid conditions would result in non-applicability of range concept.

RANGE CONCEPT – MORE THAN ONE PRICE



RANGE - WHEN DATA OF SINGLE YEAR IS USED

STEP 1: -

- **Dataset** of Prices or Profit margins should be arranged in **Ascending order**.

STEP 2: -

- Determine **35th Percentile.**

STEP 3: -

- Determine **65th Percentile**.

STEP 4: -

- **Arm's length range** will **begin from 35th** Percentile and **end on 65th** Percentile.

STEP 5 : -

- **Actual transaction price** or profit margin would be accepted if it falls in this range of 35th-65th percentile
  [No transfer pricing adjustment required in this case]

STEP 6 : -

- **Median of dataset** would be computed and taken as **arm's length price** if actual transaction price or profit margin is **outside the range** of 35th-65th percentile.

EXAMPLE 1 : -

In the given case, dataset of 7 prices arranged in Ascending order is as under:

	1	2	3	4	5	6	7
Price (Rs. in Thousands)	42	43	44	45	46	47	48

Determine the Range ?

SOLUTION : -

35th Percentile	[Number of items in dataset X 0.35]	7 * 0.35 = **2.45**
65th Percentile	[Number of items in dataset X0.65]	7 * 0.65 = **4.55**
Value of 35th Percentile	2.45 is not a whole number. Value of next higher data (i.e., 3) shall be taken	**44**
Value of 65th Percentile	4.55 is not a whole number. Value of next higher data (i.e., 5) shall be taken	**46**
Range	35^{th} - 65^{th} Percentile	44,000 - 46,000

EXAMPLE 2 : -

In the given case, dataset of 20 prices arranged in ascending order is as under:

S. No.	Profits (Rs. in Thousands)	S. No.	Profits (Rs. in Thousands)
1	42.00	11	48.45
2	43.00	12	48.48
3	44.00	13	48.50
4	44.50	14	49.00
5	45.00	15	49.10
6	45.25	16	49.35
7	47.00	17	49.50
8	48.00	18	49.75
9	48.15	19	50.00
10	48.35	20	50.15

Determine the range ?

SOLUTION : -

35th Percentile	[Number of items in dataset X0.35]	20 * 0.35 = **7**
65th Percentile	[Number of items in dataset X0.65]	20 * 0.65 = **13**
Value of 35th Percentile	35th Percentile place (i.e., 7) is a whole number. Thus, Average of prices at <u>7th and 8th place will be</u> taken	(47 + 48)/ 2 = **Rs. 47,500**
Value of 65th Percentile	65th Percentile place (i.e., 13) is a whole number. Thus, Average of prices at 13th and 14th place will be taken	(48.5 + 49)/ 2 = **Rs. 48,750**
Range	35th - 65th Percentile	Rs. 47,500 - 48,750

EXAMPLE : -

Considering the facts of earlier example, determine the Arm's Length Price in following scenarios : -

- Actual Transaction Price is Rs. 48,000 ?
- Actual Transaction Price is Rs. 45,000 ?

SOLUTION : -

In the first scenario, the Actual transaction price of Rs 48,000 is within the range. Thus, Arm's length price would be the actual transaction price, i.e., Rs 48,000.

In the second scenario, the actual transaction price of Rs 45,000 is outside the range of Rs 47,500-48,750. Thus, median of dataset would be computed to determine the arm's length price.

Median of Dataset

20 X 0.50 = 10

10 is the whole number. Thus, median will be the average of item at 10th and 11th place.
(48.35 + 48.45)/2 = 48.40

Arms' length price of transaction would be the Median of dataset, i.e., Rs 48,400.

RANGE - APPLICATION OF MULTIPLE YEAR DATA FOR CONSTRUCTION OF DATASET

Transaction identified on the basis of Current year data : -

Conditions –

- Where the most appropriate method is

  a) Resale price method, or
  b) Cost plus method, or
  c) Transactional net margin method, and

- the **comparable uncontrolled transaction** has been identified on the basis of data relating to the **current year**, and

- the enterprise undertaking the said uncontrolled transaction, has in either or both of the two immediately preceding financial years undertaken the same or similar comparable uncontrolled transaction then,-

  i. Most appropriate method used in the current year shall be applied in similar manner to the **comparable uncontrolled transaction or transactions undertaken in the aforesaid period** and the price in respect of such uncontrolled transactions shall be determined; and

  ii. **Weighted average of the prices**, of the comparable uncontrolled transactions undertaken in the current year and in the aforesaid period preceding it shall be included in the dataset.

EXAMPLE : -

- AE 1 has sold coffee beans to AE 2 in F.Y. 2016-17.

- Non-AE has sold the similar coffee beans to Non-AE 1 in F.Y. 2014-15, 2015-16 and 2016-17.
- Determine which year data should be considered to compute the range under TNMM ?

SOLUTION : -

In order to determine the range under Transactional Net Margin Method, the weighted average profit margin of F.Y. 2014-15, 2015-16 and 2016-17 of Non-AE should be taken.

Transaction identified on the basis of Preceding year data : -

- Where the most appropriate method is

  a) Resale price method, or
  b) Cost plus method, or
  c) Transactional net margin method, and

- the comparable uncontrolled transaction has been identified on the basis of data relating to the **preceding year**, and

- the **enterprise undertaking the said uncontrolled transaction**, [not being the enterprise undertaking the international transaction referred to in sub-rule (1)], **has in the immediately preceding financial year** undertaken the same or similar comparable uncontrolled transaction then,-

  a. **Price in respect of such uncontrolled transaction shall be determined** by applying the most appropriate method in similar manner as it was applied to determine the price of comparable uncontrolled transaction undertaken **in preceding year**; and

  b. **Weighted average of the prices**, of the comparable uncontrolled transactions undertaken in the **aforesaid period of two years (two years immediately preceding the current year)** shall be included in the dataset.

EXAMPLE : -

- AE 1 has sold coffee beans to AE 2 in F.Y. 2016-17.
- Non-AE 1 has sold similar coffee beans to Non-AE 2 in F.Y. 2014-15 and 2015-16.
- Comparable uncontrolled transaction has been identified on the basis of data relating to F.Y. 2015-16.
- Determine the period of range as per TNMM ?

SOLUTION : -

In order to determine the range under Transactional Net Margin Method, the weighted average profit margin of F.Y. 2014-15, 2015-16 (i.e., preceding two years) should be taken.

RANGE - NON-INCLUSION OF PRICE OF UNCONTROLLED TRANSACTIONS IN THE DATASET

NOTE : -
When the data used is relating to the **current year,** and subsequently at the time of assessment it is established that : -

- The enterprise has **not undertaken** same or similar uncontrolled transaction **during the current year**; or
- The uncontrolled transaction undertaken by an enterprise in the current year **is not a comparable uncontrolled transaction**,

then, irrespective of the fact that such an enterprise had undertaken comparable **un**controlled transaction in the any of the immediately preceding two financial years, the price of uncontrollable transactions or the weighted average of prices of the uncontrolled transactions undertaken by such enterprise **shall not be included in the dataset for computing range.**

RANGE - MULTIPLE YEAR/ SINGLE YEAR

Method	Applicability of Range	Single Year/ Multiple Year
Resale Price Method	Applicable	Multiple year data
Cost Plus Method	Applicable	
Transactional Net Margin Method	Applicable	
CUP	Applicable	Single year data
Profit Split Method	Not Applicable	
Other Method	Not Applicable	

RANGE– MANNER OF ASSIGNING WEIGHT

The weighted average of the prices shall be computed (in case of multiple year's data) in following manner :

Method	Manner of computing weight price
Resale price method	Assign weights to the **quantum of sales** which has been considered for arriving at the respective prices.
Cost Plus Method	Assign weights to the **quantum of costs** which has been considered for arriving at the respective prices.
Transactional Net Margin Method	The weighted average of the prices shall be computed with weights being assigned to the • quantum of costs incurred, or • sales effected, or • assets employed or to be employed, or • any other base

	which has been considered for arriving at the respective prices.

RANGE– MANNER OF ASSIGNING WEIGHT

EXAMPLE : -

- Based on data of comparable uncontrolled transactions/ entities undertaking such transactions, which is available at the time of furnishing return of income for FY 2015-16, 7 enterprise have undertaken the comparable uncontrolled transaction in the FY 2015-16.
- All such enterprises have also undertaken during 2 years preceding 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, based upon the weight of OC is as under :

RANGE– MANNER OF ASSIGNING WEIGHT

EXAMPLE : -

S. No.	Entity	Year 1	Year 2	Year 3 (Current year)	Aggregation of OC and OP	Weighted Average
1	A	OC = 100 OP = 12	OC = 150 OP = 10	OC = 225 OP = 35	Total OC = 475 Total OP = 57	OP/OC = 12%
2	B	OC = 80 OP = 10	OC = 125 OP = 5	OC = 100 OP = 10	Total OC = 305 Total OP = 25	OP/OC = 8.2%
3	C	OC = 250 OP = 22	OC = 230 OP = 26	OC = 250 OP = 18	Total OC = 730 Total OP = 66	OP/OC = 9%
4	D	OC = 180 OP = -9	OC = 220 OP = 22	OC = 150 OP = 20	Total OC = 550 Total OP = 33	OP/OC = 6%
5	E	OC = 140 OP = 21	OC = 100 OP = -8	OC = 125 OP = -5	Total OC = 365 Total OP = 8	OP/OC = 2.2%
6	F	OC = 160 OP = 21	OC = 120 OP = 14	OC = 140 OP = 15	Total OC = 420 Total OP = 50	OP/OC = 11.9%
7	G	OC = 150 OP = 21	OC = 130 OP = 12	OC = 155 OP = 13	Total OC = 435 Total OP = 46	OP/OC = 10.57%

SOLUTION : -

35th Percentile	[Number of items in dataset * 0.35]	7 * 0.35 = **2.45**
65th Percentile	[Number of items in dataset * 0.65]	7 * 0.65 = **4.55**
Value of 35th Percentile	2.45 is not a whole number. Value of next higher data (i.e., 3) shall be taken	8.2%
Value of 65th Percentile	4.55 is not a whole number. Value of next higher data (i.e., 5) shall be taken	10.57%
Range	35th - 65th Percentile	8.2% - 10.57%

QUESTION 1 : -

When single price is determined by use of any transfer pricing method:-

a) Range is applicable

b) Arithmetic Mean is applicable

c) A or B

d) None of the above

SOLUTION : -

d) None of the above, because there is no need to determine the tolerance limit via Range or Arithmetic Mean when single price is computed.

QUESTION 2 : -

Arithmetic Mean is applicable for : -

a) Transactions undertaken before April 1, 2014

b) Profit Split Method

c) Other Method (Rule 10AB)

d) All of the above

SOLUTION : -

d) All of the above

QUESTION 3 : -

When more than one price is determined for international transaction undertaken on March 1, 2014 : -

a) Range is applicable

b) Arithmetic Mean is applicable

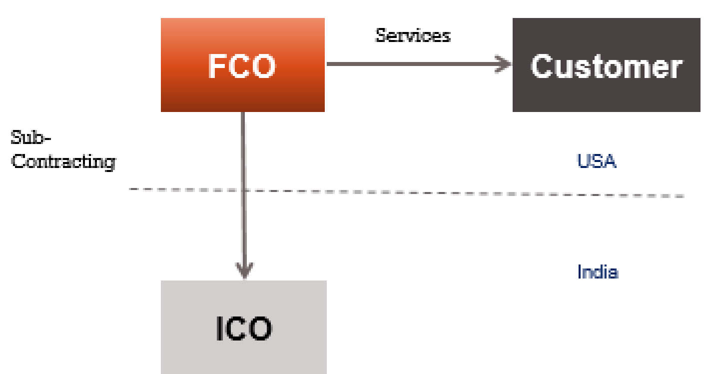
c) A or B

d) None of the above

SOLUTION : -

b) Arithmetic Mean is applicable, as Range concept is not applicable for transactions undertaken before April 1, 2014.

21. FUNCTIONS, ASSETS AND RISK (FAR) ANALYSIS



Functions, Assets and Risk ('FAR') analysis is the method of **finding and organizing facts about the business of a MNE** in terms of –

a) the **functions** performed ;

b) **assets used** (including intangible property);

c) **risks assumed** by business;

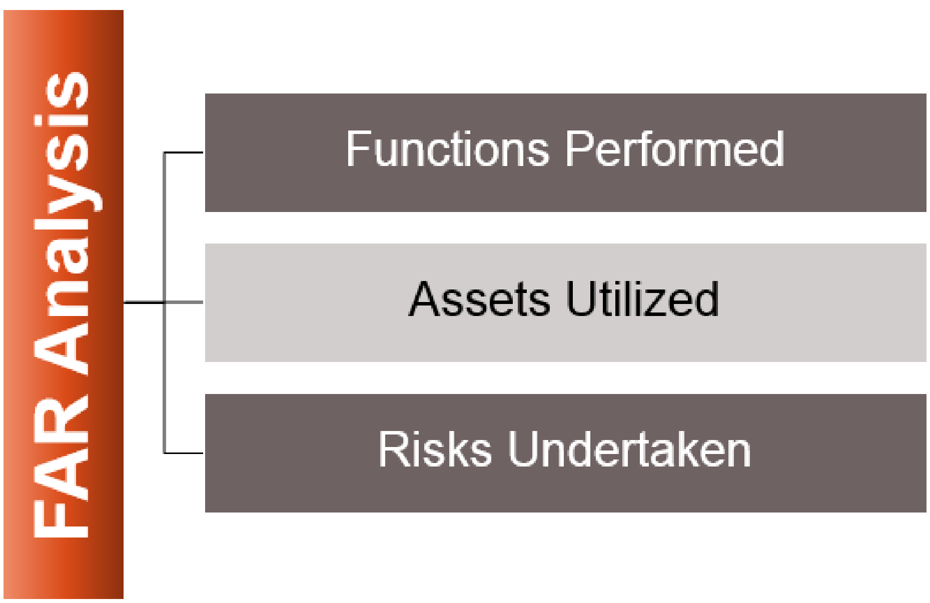
d) **Division** of FAR among the AEs; and

e) **importance of each function** in the overall value chain.

For example, a **manufacturer of software** cannot be compared with a **BPO service provider**, as he performs different functions, employs different kind of assets and undertakes different type of risks.

However, software service provider can be compared with another software service provider.

COMPONENTS OF FAR ANALYSIS



FAR ANALYSIS HELPS IN CHARACTERIZATION OF THE ENTITY AND UNDERSTANDING ENTIRE VALUE CHAIN OF BUSINESS.

COMPONENTS OF FAR ANALYSIS – FUNCTIONS PERFORMED

The **important and significant activities** carried out by each of the parties to the transaction are analysed. Functions which add more value to the transactions, are expected to fetch higher returns.

Some of the important functions (Subject to nature of business of an entity) generally observed, and examined in a transaction are as under :

- Manufacturing, production or assembly work ;
- Research and development;
- Purchasing and materials management;
- Supervision;
- Business process management/ Administrative functions
- Budgeting
- Marketing and Distribution
- Warehousing and inventory management

Once such principle functions are identified,

we compare such functions performed

in an uncontrolled transaction

to determine the extent of comparability.

COMPONENTS OF FAR ANALYSIS – ASSETS EMPLOYED

Comparability of assets used by the Assessee and **comparable entity, as well we** their **classification** (tangible as well as intangible) is an important criterion to determine mark up.

Generally, **Tangible assets** (like Plant & Machinery, Furniture & Fixture, Computers etc.) contribute to **routine/ normal profits**.

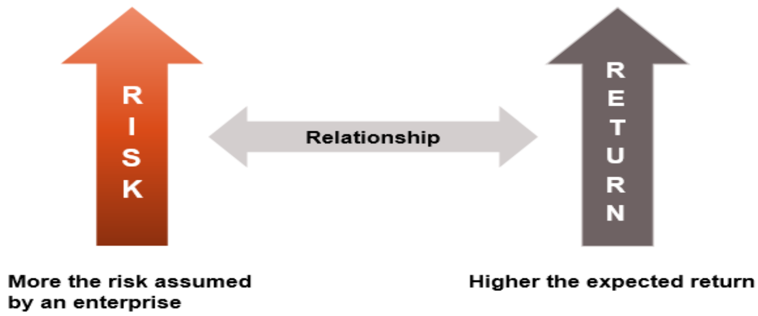
Generally **intangible assets** (like technical know-how, trademarks, patents, etc.) contribute to the **super normal growth** in profits of an enterprise.

COMPONENTS OF FAR ANALYSIS – RISK ASSUMED

This step involves identification of **risk assumed by each of the parties** to the transaction.

Extent of profit is the rewards for risk assumed. Risk and rewards are **directly proportional**. i.e. More the risk, higher the return, and lower the risk assumed, lower the return expected.

RELATIONSHIP OF RISK AND RETURN



COMMON RISK INVOLVED IN THE BUSINESS

CREDIT RISK : -

• Risk relating to non-payment of dues by the customers.

MARKET RISK : -

• Market risk arise due to increase in competition, relative pricing pressures, change in customer's needs and demand patterns, inability to develop in a market etc.

FINANCIAL RISK : -

- Financial risks relates to money management, which involves decisions on : -
  - which customers should **credit** be given and credit period?
  - **Extent** of **debt** liability?
  - **Customer dependence**, i.e., whether major income is received from one or two clients, who may default on payments ?

FOREIGN EXCHANGE RISK : -

- Risk relating to impact on profits, arising due to fluctuation in foreign exchange rates.

COMMON RISK INVOLVED IN THE BUSINESS

CAPACITY UTILIZATION RISK : -

- It refers to risk relating to **loss of profits due to unutilized capacity**.

ATTRITION RISK : -

- Risk associated with **losing key Managerial Personnel** and **Key employees**, which contribute to the enterprise's success.

INVENTORY RISK : -

Risk associated with **management of inventory**, like **overstocking** or **slow/non-moving** inventory. As a result, the enterprise may be forced to bear a **loss of margin on the inventory,** or incur additional costs to dispose-of the same.

CONTRACT TERMS – ASCERTAINING RISK

The **contract terms** of between assessee and its AE , help in determining risk assumed by each party and facilitates adjustments based on differences in risks that are undertaken in a controlled transaction as compared to uncontrolled transaction.

For example , **captive service provider operating on cost-plus basis** would have lower risk relating to receivable, marketing and credit risk which were borne by normal service provider.

FAR ANALYSIS – ADVANTAGES

In FAR analysis , "economically significant" functions performed, risks assumed, and assets employed should be considered (i.e. such functions, assets and risks that are likely to have an impact on cost/expenses, prices, profits arising in a transaction).

FAR analysis helps in:

- **Determining** the **nature of functions performed** by the assessee and AE(s);

- Determining **true and correct characterization** of the **entities** (Tested Party/ Others);
- Selection of **most appropriate method** for transfer pricing analysis; and
- Establishing **comparability and undertaking economic adjustments**.

ILLUSTRATIVE LIST OF FUNCTIONS, ASSETS AND RISKS FOR DIFFERENT ENTITIES

Activity	Manufacturer	Trader	Service provider

Functions	• Product manufacturing • Quality control • Research & Development • Purchasing • Inventory management • Logistics • Product strategy and design • Marketing • Sales • Customer support • Budgeting • Administration	• Purchasing • Inventory management • Logistics • Marketing • Sales • Customer support • Budgeting • Administration	• Budgeting • Project management • Invoicing • Training • Quality control • Design of services

Activity	Manufacturer	Trader	Service provider

Assets	• Plant & Machinery • Office equipment • Land & Building • Warehouse • Vehicles • Patents • Technical knowhow • Trademarks, etc.	• Office equipment • Land & Building • Vehicles • Warehouse	• Office equipment • Land & Building • Vehicles • Trademarks • Brand name • Logos, etc.

Activity	Manufacturer	Trader	Service provider
Risks	• Product liability risk • Business risk • Inventory risk • Scheduling risk • Credit and collection risk • Foreign exchange fluctuation risk	• Business risk • Inventory risk • Foreign exchange fluctuation risk • Credit and collection risk	• Business risk • Credit and collection risk • Foreign exchange fluctuation risk • Service liability risk • Idle time risk

22. DOCUMENTATIONS AND COMPLIANCES - DOCUMENTATION REQUIREMENT UNDER THE INCOME-TAX ACT, 1961

- Associated Enterprise undertaking intra group transactions (specified) are **required to keep** and maintain information and documents, as may be **prescribed by CBDT**.

- Transfer pricing documentation is maintained to **review Transfer Pricing arrangements for intra-group transactions** with an objective to review the **arm's length nature** of such transactions.

INFORMATION AND DOCUMENTS TO BE KEPT AND MAINTAINED U/S 92D (RULE 10D(1)) – ENTITY RELATED

- **Ownership structure of the Assessee**, with details of shares or other ownership interest held therein by other enterprise;

- **Profile of the Multinational group** of which the assessee is a part;

- **Basic details of Associated enterprises with whom** assessee has entered into international transaction (like Name, address, legal status and country of tax residence);

- **Business description of the assessee and Associated enterprises**, and the **industry** in which the Assessee operates;

- **AE wise, nature and terms** (including price) of the international transactions and specified domestic transactions, details of property transferred or services provided and quantum and value of each such transaction;

INFORMATION AND DOCUMENTS TO BE KEPT AND MAINTAINED U/S 92D (RULE 10D(1)) – PRICE RELATED

- **Description of functions performed, risks assumed and assets employed** by the assessee and Associated enterprises;

- Records of economic and market analysis, budgets, forecasts, financial estimates for the business as a whole and for each division or product separately which may have a bearing on such transaction;

- Record of uncontrolled transaction (if any), including their nature, terms and conditions, for analysing comparability of international transaction and specified domestic transactions with such uncontrolled transaction(s);

- Record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction or specified domestic transactions.

- Description of method considered for determining ALP, most appropriate method along with the explanations as to why such method was selected, and applied;

- Analysis performed to compare the transactions and to determine the arm's length price of the transactions between related parties, etc. Actual workings carried out for such transaction should be considered.

- Assumptions, policies and price negotiations, if any, which critically affected the determination of the arm's length price;

INFORMATION AND DOCUMENTS TO BE KEPT AND MAINTAINED U/S 92D (RULE 10D(1)) – TRANSACTION RELATED

- Details of **transfer pricing adjustment(s) made** (if any) to the transfer price to align them to ALP, and consequent adjustment made to the total income for tax purposes.

- **Any other information, data or document including information** or data relating to Associated enterprise which may be relevant for determining ALP.

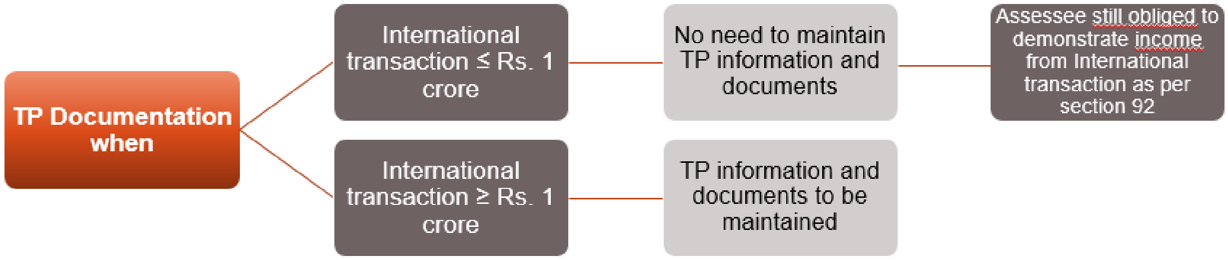
EXEMPTION THRESHOLD FOR DOCUMENTATION - RULE 10D(2)

Where the **aggregate** value of international transactions is **Rs. 1 crore or less**,

the assessee is not obliged to maintain the information and documents

required under Rule 10D(1).

TRANSFER PRICING DOCUMENTATION – RULE 10D



The threshold limit of Rs. 1 crore to maintain information and documents is applicable only for international transactions with AE and not for specified domestic transactions.

EXAMPLE : -

Indian subsidiary company (ICO) purchases raw material from its foreign parent company for Rs 1.50 crores during the PY 2017-18. Whether ICO is required to maintain information and documents under Rule 10D(1) ?

SOLUTION : -

ICO is required to maintain information and documents under Rule 10D(1) for the PY 2017-18 as the aggregate value of international transaction with AE is more than Rs 1 crore.

TRANSFER PRICING DOCUMENTATION – RULE 10D – POINTS TO CONSIDER

- Even though value of **international transaction** is **not more than Rs 1 crore**, the **assessee** is still under an **obligation** to **substantiate** that that the income arising from the international transactions with Associated enterprises, is in accordance with section 92.

- The **threshold limit of Rs 1 crore** to maintain information and documents is applicable only for international transactions with AE and **not for specified domestic transactions**. For Specified domestic transactions separate set of information and documents are required to be maintained if value of specified domestic transaction is **more than Rs 20 crore** during the Financial Year (Rule 10D(2)).

- Assessee would be liable to pay **penalty @ 2% of value of international transaction** if it fails to keep information and documents as required under Rule 10D(1) (Section 271AA).

STRUCTURE OF TRANSFER PRICING DOCUMENTATION

If a company is required to maintain documents under Rule 10D(1), it can maintain a Transfer Pricing Study , which can have the following Illustrative structure : -

Executive Summary	• Brief description of business profile of the group to which the company belongs • Brief business profile of the Assessee • Brief business profile of the AE with whom the company has undertaken international transaction • Overview of international transactions • Overview of specified domestic transactions

Group Overview	• Brief description and overview of the Group's : - • Business operations • Divisions • Factual informational of the Group during relevant period such as turnover, number of employees etc. • Information pertaining to various products and services offered by the group • Significant development during the year
Industry Analysis	• Background of the industry, in which the company operates • Key drivers • Challenges • Future outlook of the industry
Functional Analysis	• Functions performed by each of the entities in a transaction • Assets utilized in the rendering of the above functions • Risks assumed by each of the entities in a transaction
Economic Analysis	• Search process – Database searched, publicly available information, other sources • Comparable details
Conclusion	• High level summary of the Transfer Pricing study including transactions involving Most appropriate method etc.

STRUCTURE OF TRANSFER PRICING DOCUMENTATION - GROUP OVERVIEW

A brief description of Group's business operations and taxpayer's business operations.

The information relating to the Group overview can be obtained from several sources, including : -

- Annual report of the Group - Information pertaining to nature of business operations, shareholding structure, products and services offered, etc. can be obtained from Annual report of the Group.

- Other sources such as : -

    - Group website and other reference websites ,
    - Publicly available databases like Prowess, Capitaline, etc.

STRUCTURE OF TRANSFER PRICING DOCUMENTATION - GROUP OVERVIEW-EXAMPLE

X Ltd., a software development company in USA, sells softwares to an independent customer in India. Its AE, an Indian company, ICO Ltd. provides IT support to X Ltd. in connection with maintenance of the software.

In the instant case, the Group overview would include the following broad headings : -

Brief description of the business operations of the Group –

- Range of products/services offered (software, type of software, nature of services), geographical presence (US, India or other countries),

Brief description of business operations of X Ltd. and ICO Ltd. –

- Date of incorporation, shareholding and ownership structure, details of products/services offered.

STRUCTURE OF TRANSFER PRICING DOCUMENTATION – INDUSTRY OVERVIEW

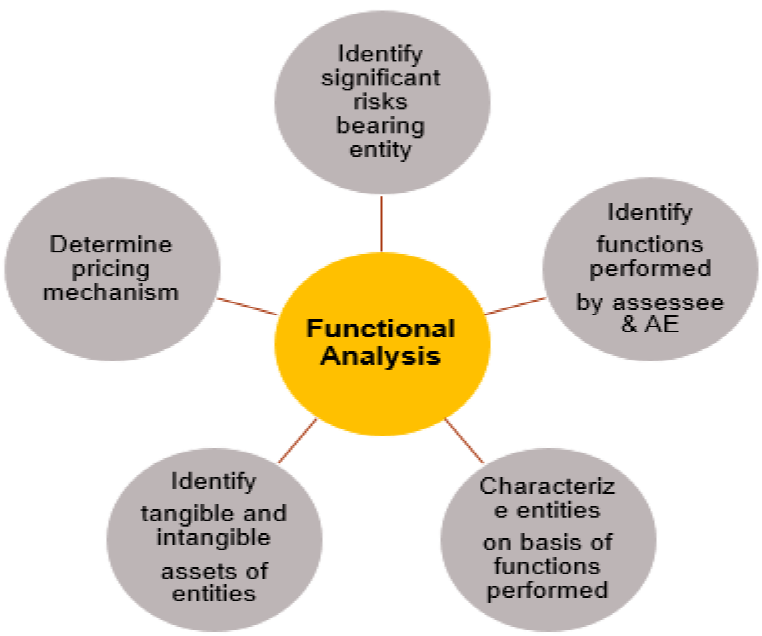
It provides an understanding of company's relative position in the industry vis-à-vis other players. The objective of the industry overview are : -

- Taxpayer's position within the industry;
- Market share of the taxpayer in the industry;
- How industry overview is linked to the functional and economic analysis;

- Key growth drivers , challenges and opportunities, past trends and future projections of the industry;
- Overall justification of the taxpayer's financial results.

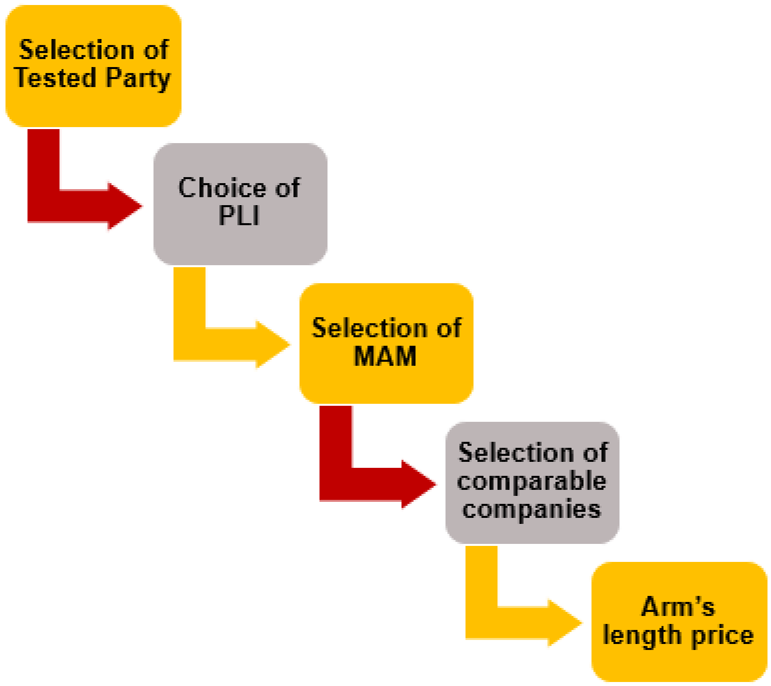
23. FUNCTIONAL ANALYSIS

FOR EVERY INTERNATIONAL TRANSACTION, FUNCTIONAL ANALYSIS NEEDS TO BE UNDERTAKEN



24. ECONOMIC ANALYSIS

Economic analysis involves comparison of prices set in controlled environment are compared with that of uncontrolled environment, which involves the following steps : -



25. AUDIT REPORT - SECTION 92E

Every person who **enters into an international transaction** during a previous year is required to obtain a report from a Chartered Accountant, and furnish such report on or before 30th November of the relevant assessment year in Form No.3CEB. This report is in two parts :

First Part of Form No. 3CEB : - **Auditor has to state** that **he has examined the accounts** and records of the assessee, relating to the international transactions entered into by the assessee during the relevant year.

Second Part of Form No. 3CEB : - **Particulars about the international transactions** are required to be stated like : -

- list of associated enterprises;
- particulars and description of transactions relating to purchase, sales, provisions of service, loans, advances, etc.

26. PENALTY FOR UNDER-REPORTING OF INCOME – SECTION 270A

Penalty @ 50% of tax payable is leviable on under-reported income u/s 270A.

Note : -

Addition made in conformity with ALP, determined by TPO would not be considered underreported income if : -

- **Assessee has maintained information and documents, as per section 92D,**
- **Declared the international transactions under Chapter X; and**
- **Disclosed all material facts relating to the transaction.**

PENALTY FOR UNDER-REPORTING OF INCOME –SECTION 270A

EXAMPLE : -

- ICO imports raw material from its foreign subsidiary at Rs. 5 lakhs during the P.Y. 2017-18. ICO has maintained documents for such international transaction as per Section 92D and included such transactions in income-tax return and Form No.3CEB at Rs. 5 lakhs. During assessment proceedings, the TPO determined the ALP of such transaction at Rs. 3 lakhs.

- Calculate the amount of penalty to be levied on ICO for misreporting of income u/s 270A ?

SOLUTION : -

- Addition made by AO in conformity with the ALP determined by the TPO **would not be considered as under-reported income of ICO**, as assessee had already disclosed such transaction in Form No. 3CEB and the income-tax return. Thus, no penalty will be levied on ICO u/s 270A.

27. PENALTY FOR MISREPORTING OF INCOME - SECTION 270A

Failure to report any

international transaction, or

deemed international transaction [as referred to in Section 92B(2)], or

specified domestic transaction

to which the provisions of transfer pricing [i.e., Chapter X] applies

would constitute **'misreporting of income'** u/s 270A(9), and

it would attract **penalty @ 200% of tax payable** due to misreporting of income.

PENALTY FOR MISREPORTING OF INCOME - SECTION 270A

EXAMPLE : -

- ICO provided consultancy services to its foreign parent but failed to report such transaction in Form 3CEB and income-tax return. During assessment, the AO identified such transaction and made additions of Rs. 10 lakhs in accordance with ALP determined by TPO.

- Determine the penalty leviable on ICO u/s 270A ?

SOLUTION : -

- Failure to report international transaction would constitute misreporting of income. It would attract penalty of 200% of tax payable under Section 270A. Calculation of penalty is given hereunder : -

Particulars	Amount (Rs.)
Additions made by TPO	10,00,000
Tax at 30% [A]	3,00,000
Education Cess and Secondary and Higher Education Cess (3%*3,00,000) [B]	9,000
Total tax payable [A+B]	3,09,000
Penalty for misreporting of income [3,09,000*200%]	6,18,000

28. PENALTY FOR FAILURE TO KEEP AND MAINTAIN INFORMATION AND DOCUMENTATION - SECTION 271AA

Section 271AA provides that, the

AO or Commissioner (Appeals) may direct the person entering into an international transaction to pay a penalty @ 2% of the **value of each international transaction** entered into by such person, if such person : -

- **Fails to keep and maintain** any such **document and information**, as required by section 92D(1) and section 92D(2)

> **Note** : -
> **As per Rule 10D(5), transfer pricing information and documents should be kept and maintained for a period of 8 years from the end of relevant assessment year.**

- Fails to **report such international transaction** which is required to be reported; or
- Maintains or furnishes any **incorrect information or document** : -

> **Note** : -
> **Failure to furnish TP report in Form No 3CEB may attract penalty of Rs. 1,00,000 u/s 271BA.**
> **Penalty u/s 271AA shall be in addition to penalty u/s 271BA.**

PENALTY FOR FAILURE TO KEEP AND MAINTAIN INFORMATION AND DOCUMENTATION – POINTS TO CONSIDER

- Penalty @ **2% shall be computed on ALP of international transaction**. Actual transaction price should not be considered to compute such penalty.

EXAMPLE : -

ICO provides services to its foreign AE. It failed to keep information and documents for such international transaction as required under Section 92D. The actual price of such services is Rs.

5 lakhs but its Arm's length price was determined at Rs. 10 lakhs. Calculate the amount of penalty to be levied determined by Assessing Officer or Commissioner (Appeal) ?

SOLUTION : -

ICO would be liable to pay penalty @ 2% of the ALP of international transaction amounting Rs. 20,000 (10,00,000 * 2%).

- Failure to **report international transaction** would attract penalty under both the Sections 270A and 271AA (i.e., 200% penalty and 2% penalty).

EXAMPLE : -

ICO provides services to its foreign AE. It failed to report such international transaction in income-tax return and Form No. 3CEB. During assessment, the AO has identified such transaction and made additions of Rs. 5 lakhs in accordance with arm's length price determined by TPO.

a) Whether ICO is liable to pay penalty under both the sections 270A and 271AA ?

b) Calculate the amount of penalty ?

SOLUTION : -

- ICO would be liable to penalty@ 200% [of tax payable] and @ 2% [of value of international transaction] under both the sections 270A and 271AA, respectively.
- Calculation of penalty is given hereunder:

Particulars	Amount (Rs.)
Addition made by Transfer Pricing Officer	5,00,000
Tax payable on such misreporting of income @ 30% [5,00,000 * 30%]	1,50,000
Add: Education Cess and Secondary and Higher Education Cess [1,50,000 * 3%]	4,500
Total tax payable on misreporting of income	1,54,500
Penalty on misreporting of income under Section 270A [1,54,500 * 200%]	3,09,000
Penalty u/s 271AA [5,00,000 * 2%]	10,000
Total Penalty [3,09,000 + 10,000]	3,19,000

- Penalty@ 2% shall be levied on **value of each international transaction** for which default is made by assessee u/s 271AA.

EXAMPLE : -

ICO has effected following transactions during the P.Y. 2017-18 : -

a) Reports international transaction in Form No. 3CEB and income-tax return. However, addition of Rs. 15 lakhs is made by AO as per the ALP determined by the TPO.

b) Furnished some incorrect information in Form No. 3CEB for international transaction (Arms' length price of such international transaction is Rs. 5 lakhs)

c) Failed to report international transaction in Form No. 3CEB and income tax return. Thereafter such transaction is identified by AO and he made additions of Rs. 30 lakhs (i.e. Arms' length price). Tax payable due to such misreporting income is Rs. 9.27 lakhs.

Calculate the amount of penalty payable by assessee on aforesaid transactions ?

SOLUTION : -

- Penalty @ 2% is payable on each transaction wherein assessee made some default [as referred to in Section 270AA] and not on aggregate value of all transactions. Thus, no penalty would be levied for transaction reported under point a.
- Calculation of penalty is given hereunder:

Particulars	Amount (Rs.)
Arm's length price of transaction at point c	30,00,000
Penalty @ 2% u/s 271AA [30,00,000 * 2%]	60,000
Penalty @ 200% of tax payable on transaction at point c [9,27,000 * 200%] [A]	18,54,000
Total penalty payable on aforesaid defaults [A] + [B]	**19,14,000**

29. PENALTY FOR FAILURE TO FURNISH INFORMATION OR DOCUMENT U/S 92D - SECTION 271G

If any person

who has entered into an

international transaction, or specified domestic transaction

fails to furnish any such information or document

as required by Assessing Officer or Commissioner (Appeals)

within a period of **30 days from**

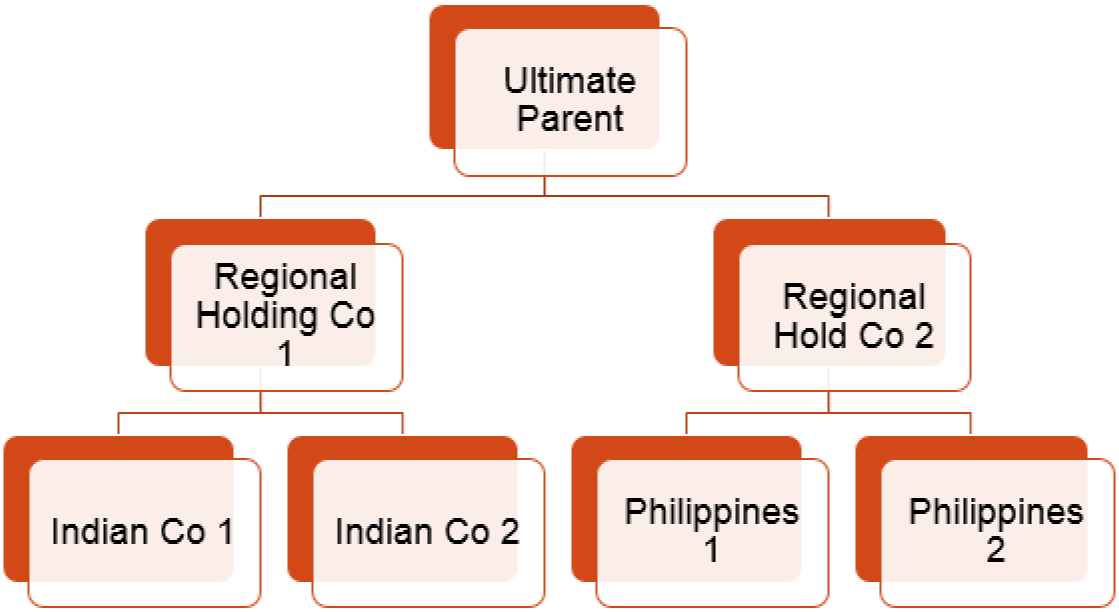
the date of receipt of a notice,

then such person shall be liable to a **penalty up to**

2% of the value of international transactions or specified domestic transaction.

Note : - **Such period of 30 days can be further extended by AO or the Commissioner (Appeals) on the request of assessee. In that case, the extended period shall be considered to levy penalty**

30. COUNTRY BY COUNTRY REPORTING



OBJECTIVES OF COUNTRY BY COUNTRY REPORTING

The key objectives of the CbCR are as under: -

a) The Report requires taxpayers to **articulate consistent transfer pricing position, across the globe.**

b) The Report will **provide tax administration with useful information to assess TP risk.**

c) It will facilitate tax administrations to determine about **where their resources can most effectively be deployed**, and in the event of audit, provide information to commence and targeted audit enquiries.

BACKGROUND OF COUNTRY BY COUNTRY REPORTING

a) **Section 92D of the IT Act** requires maintenance of prescribed information and documents, relating to the international transactions and specified domestic transactions.

b) The OECD report on **Action Plan 13 of BEPS**, provides for revised standards for transfer pricing documentation and a template for country-by-country reporting of income, earnings, taxes paid and certain measure of economic activity. It is recommended in the BEPS report, that the countries should adopt a standardized approach to transfer pricing documentation.

c) Country-by-Country reporting mandates **a three tiered structure of documentation at the group and local level.**

THREE TIER STRUCTURE OF DOCUMENTATION

Three-tiered structure of documentation as mandated by BEPS consists of : -

i. a **MASTER FILE** containing standardized information relevant for all multinational enterprises (MNE) group members. It provides high level overview of group's global business operations and global transfer pricing policies.

ii. a **LOCAL FILE** referring specifically to material transactions of the local taxpayer; and

iii. a **COUNTRY-BY-COUNTRY** report containing certain information relating to the global allocation of the MNE's income and taxes paid, together with certain indicators of the location of economic activity within the MNE group.

MASTER FILE AND COUNTRY-BY-COUNTRY REPORTING

- **Section 286** of the IT Act requires Multinational Enterprises (MNEs) and Indian Multinational Enterprises to report annually CbC report for **financial year 201617 and onwards.**
- **Rule 10DA** lays down the procedure in relation to filing of **Master file**; and
- **Rule 10DB** lays down the procedure **CbCR** filings.

MASTER FILE - RULE 10DA - MONETARY THRESHOLD FOR MAINTENANCE OF MASTER FILE

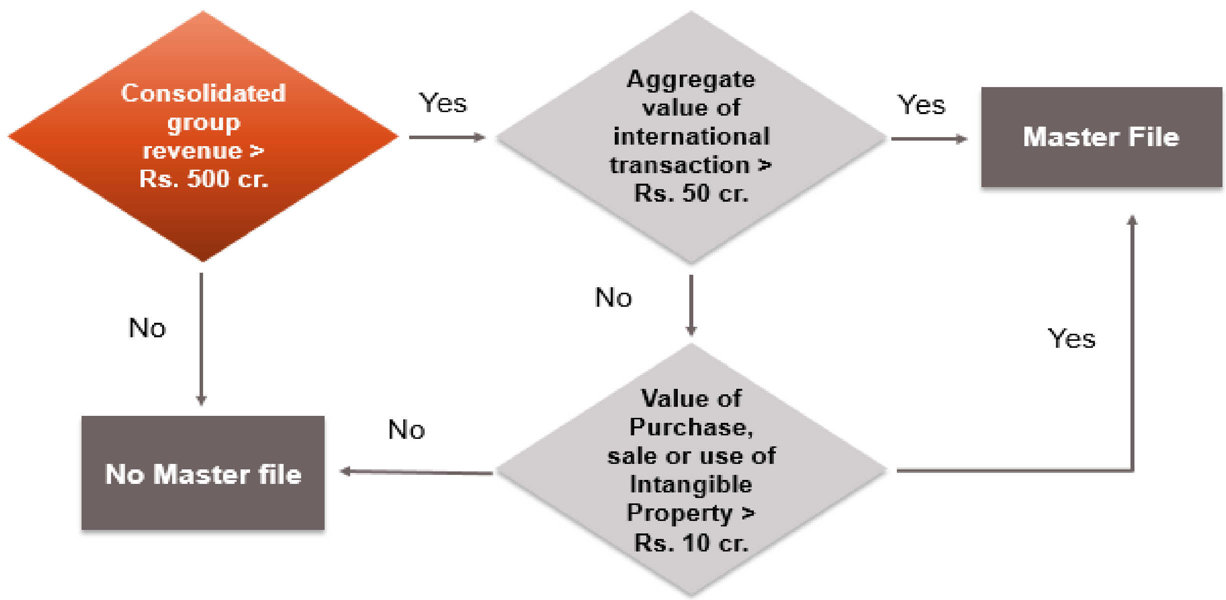
International group shall maintain information and documents in Master file when –

a) **Consolidated group revenue** of the international group **is more than Rs 500 crores** (as reflected in Consolidated Financial Statements of the international group), and

b) The **aggregate value of international transaction –**

- Is **more than Rs. 50 crores** during the accounting year as per books of account, or
- Is more than Rs. 10 crores in respect of purchase, sale, transfer, lease or use of intangible property.

MONETARY THRESHOLD FOR MAINTENANCE OF MASTER FILE



MASTER FILE [RULE 10DA]

<u>MANNER OF FILING OF MASTER FILE : -</u>

a) Form 3CEAA for Master file :

The information of international group shall be furnished in master file in Form 3CEAA. Such form consists of two parts –

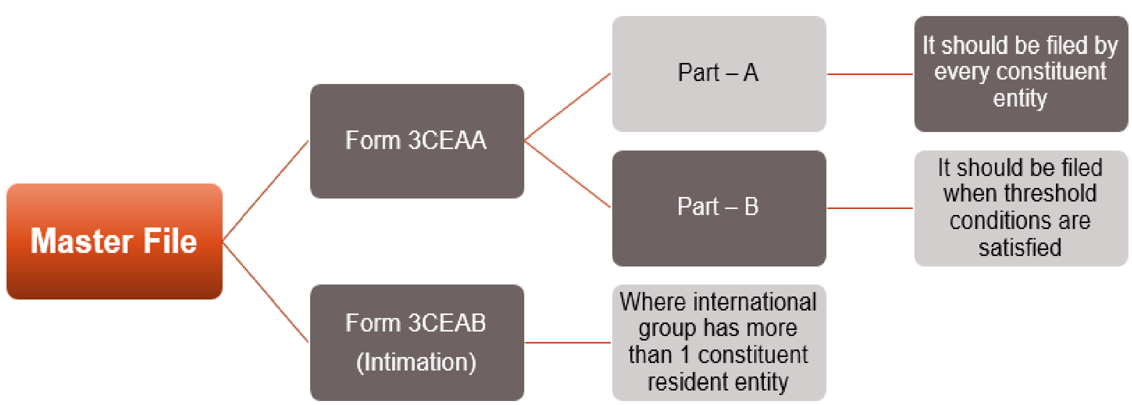
- **Part A of Form 3CEAA** : - It needs to be filed by every constituent entity of international group even if dual-threshold of group revenue (i.e., Rs 500 crores) and international transaction (i.e., Rs 50/10 crores) is not satisfied.

- **Part B of Form 3CEAA** : - It needs to be filed by constituent entity which satisfies the aforesaid condition of dual-threshold.

b) Form 3CEAB for intimation :

Where international group has **more than one constituent entities** resident in India, it should **designate one of the entity** for filing of master file in Form 3CEAA. In such case, Form 3CEAA has to be filed by such designated constituent entity and intimation of same should be filed in Form 3CEAB.

MANNER OF FILING OF MASTER FILE



MASTER FILE RULE 10DA - TIME-LIMIT FOR FILING OF MASTER FILE IN FORM 3CEAA

SUBJECT TO PROVISION OF FINANCE BILL 2018

MASTER FILE - RULE 10DA - INFORMATION TO BE MAINTAINED FOR MASTER FILE

Key information and documents required for Master File includes –

- Description of function, asset and risk analysis ("**FAR**") of all the **constituent entities** that contribute **atleast 10% of the revenue** or **assets** or **profits** of the group.
- Description of **financial arrangement** of the group including names and address of **top ten unrelated lenders**.
- List of all **entities of international group** which are **engaged in development and management of intangible property.**

COUNTRY-BY-COUNTRY REPORT - RULE 10DB

MONETARY THRESHOLD FOR MAINTENANCE OF COUNTRY-BY-COUNTRY REPORT : -

As per Rule 10DB, where the consolidated group revenue of international group **exceeds Rs 5500 crores** for filing of Country-by-Country report.

INTIMATION IN FORM 3CEAC : -

Indian entity, having a parent entity resident outside India, will be required to provide information on or before the prescribed date in Form 3CEAC :-

a. Whether it is an alternate reporting entity of the international group; or

b. The details of the parent entity or the alternate reporting entity, if any of the international group, and the country of territory of which the said entities are resident.

MANNER AND DUE DATE OF FILING OF COUNTRY-BY-COUNTRY REPORT

Category	Requirement	Due date of filing of CbCR	
		FY 2016-17	FY 2017-18 onwards
Parent Entity or alternate reporting entity, resident in India	File CbCR in Form 3CEAD for every reporting accounting year	March 31, 2018	On or before due date of filing of income-tax return
Constituent entity resident in India (whose parent entity is not a resident in India)	File CbCR in Form 3CEAD for every reporting accounting year	March 31, 2018	On or before due date of filing of income-tax return

Note : -

- **Constituent entity resident in India (whose parent entity is not resident in India) need to submit intimation in Form 3CEAC to specify whether it is alternate reporting entity of the group or details of parent entity, etc. Form 3CEAC should be filed at least two months before the due date of furnishing of CbCR.**

CBC REPORTING BY INDIAN ENTITY WHERE IT IS MEMBER OF INTERNATIONAL GROUP

a) **A resident constituent entity of an International group** shall be required to furnish CbC report to the prescribed authority, if the **parent entity of the group is resident** :

- In a **country with which India does not have an arrangement for exchange of the CbC** report; or
- **Such country is not exchanging information with India** even though there is an agreement (i.e. existence of **systematic failure**); and
- This fact has been **intimated to the entity by the prescribed authority.**

b) **In case where more than one Indian resident entities are constituents of international group**, the report shall be furnished by the entity, which is **nominated by the international group** (provided information of such nomination has been conveyed to prescribed authority in writing on behalf of the group).

SAFEGUARDS TO AVOID DUPLICATION

- An entity in India is **not required** to furnish CbC report, if following conditions are satisfied:

  a) an **alternate reporting entity of the international group has furnished report** with the tax authority of the **country** or territory **in which such entity is resident** on or before the date specified;

  b) **the report** is **required to be furnished** under the law for the time being in force in the said country or territory;

  c) the said country or territory has **entered into an agreement with India providing for exchange of the CbC report;**

  d) the prescribed authority has **not conveyed to entity** of the group that is resident in India, any **systemic failure** in respect of the said country or territory;

  e) the **alternate reporting entity informed in writing to the said country** or territory on behalf of the international group; and

  f) the **prescribed authority** has been informed by the entities in India

NON-COMPLIANCE WITH CBC PROVISIONS

PENALTY FOR NON-FURNISHING OF REPORT : -

Where an entity which is required to furnish report under CbC provisions, fails to do so within the prescribed time, penalty shall be payable -

- At Rs. 5,000 per day where period of default is **less than a month**, or
- At Rs. 15,000 per day where default period **exceeds a month**, or
- At Rs. 50,000 per day in case of **continuing default** even after service of order levying penalty.

PENALTY FOR FAILURE TO PRODUCE INFORMATION AND DOCUMENTS: -

In case information called by prescribed authority for determination of accuracy of CbC report is not submitted within the time specified in the notice, reporting entity shall be penalized by **Rs 5,000/- per day after expiry of the period specified in such notice.**

Further, for any default that continues even after service of order levying penalty, then penalty for default beyond date of service of penalty order shall be Rs 50,000/- per day

PENALTY FOR FILING OF INACCURATE INFORMATION IN CBC REPORT

If an entity has provided any inaccurate information in the CbC report, penalty would be Rs. 500,000/- if

i. The **entity has the knowledge of the inaccuracy** at the time of furnishing the report but does not inform the prescribed authority; or

ii. The entity discovers the inaccuracy after the report is furnished and fails to inform the prescribed authority and furnish correct report within a period of 15 days of such discovery; or

iii. The entity furnishes inaccurate information or document in response to notice of the prescribed authority.

EXEMPTION FROM PENALTY : -

Section 273B provides for non-levy of penalty u/s 271GB if the assessee proves that there was **reasonable cause** for such failure.

MAINTENANCE AND FURNISHING OF MASTER FILE

Penalty for non-furnishing of information and documents to the prescribed authority u/s 286(1) shall be Rs. 5,00,000.

Note : -

- **There shall be no penalty if there is any reasonable cause for non-furnishing of information and documents to the prescribed authority.**

DEFINITION OF "INTERNATIONAL GROUP"

It means any group that includes,

i. **two or more enterprises** which are resident of different countries or territories; or

ii. an **enterprise, being a resident of one country** or territory, which carries on any business through a **permanent establishment in other countries** or territories;

DEFINITION OF GROUP

"Group" includes **a parent entity** and **all the entities in respect of which**, for the reason of **ownership or control**, a consolidated financial statement for financial reporting purposes,

i. is required to be prepared **under any law** for the time being in force, or as **per the accounting standards** of the country or territory of which the parent entity is resident; or

ii. **would have been required to be prepared** had the equity shares of any of the enterprises were to be **listed on a stock exchange** in the country or territory of which the parent entity is resident.

DEFINITION OF CONSTITUENT ENTITY

"Constituent Entity" means,

i. any **separate entity of an international group that is included in the consolidated financial statement** of the said group for financial reporting purposes, or may be so included for the said purpose, if the equity share of any entity of the international group were to be listed on a stock exchange;

ii. any such entity that is **excluded from the consolidated financial statement** of the international group solely on the **basis of size or materiality**; or

iii. any **permanent establishment** of any **separate business entity** of the international group included in clause (i)* or clause (ii)*, if **such business unit prepares a separate financial statement for such permanent establishment** for financial reporting, regulatory, tax reporting or internal management control purposes

DEFINITION OF PARENT ENTITY

"Parent Entity" means a **constituent entity**, of an international group holding, directly or indirectly, an **interest in one or more of the other constituent entities** of the international group, such that,

i. it **is required to prepare a consolidated financial statement** under any law for the time being in force or the accounting standards of the country or territory of which the entity is resident; or

ii. it **would have been required** to prepare a consolidated financial statement had the equity shares of any of the enterprises were listed on a stock exchange,

and, there is no other constituent entity of such group which, due to ownership of any interest, directly or indirectly, **in the first mentioned constituent entity, is required to prepare a consolidated** financial statement, under the circumstances referred to in clause (i) or clause (ii), that includes the separate financial statement of the first mentioned constituent entity

DEFINITION OF REPORTING ENTITY

"Reporting Entity" means

- the **constituent entity** including
    - the parent entity, or

- the alternate reporting entity,

- that is **required to furnish** a report as per CbC reporting provisions.

DEFINITION OF ALTERNATE REPORTING ENTITY

"Alternate Reporting Entity" means

- any **constituent entity** of the international group
- that has been **designated by such group**, in the place of the parent entity,
- **to furnish the report** of the nature referred to in sub-section (2)
- in the **country or territory in which the said constituent entity is resident** on behalf of such group;

DEFINITION OF SYSTEMATIC FAILURE

"Systemic Failure" with respect to a country or territory means that the country or territory **has an agreement with India** providing for exchange of report of the nature referred to in sub-section (2), but

i. in violation of the said agreement, it has **suspended automatic exchange**; or

ii. has **persistently failed to automatically provide to India the report** in its possession in respect of any international group having a constituent entity resident in India.

DEFINITION OF ACCOUNTING YEAR

"**Accounting Year**" means,

i. a **previous year**, in a case where the parent entity or alternate reporting entity is resident in India; or

ii. an **annual accounting period**, with respect to which the parent entity of the international group prepares its financial statements under any law for the time being in force or the applicable accounting standards of the country or territory of which such entity is resident, in any other case.

DEFINITION OF AGREEMENT

"Agreement" means

- an agreement referred to in section 90(1) or section 90A(1); or
- any agreement as may be notified by the Central Government in this behalf.

DEFINITION OF CONSOLIDATED FINANCIAL STATEMENT

"**Consolidated Financial Statement**" means the financial statement of an international group in which the assets, liabilities, income, expenses and cash flows of the parent entity and the constituent entities are presented as those of a single economic entity.

COUNTRY BY COUNTRY REPORTING

TOPICS COVERED: -

- Objective of Country by Country reporting (CbCR).
- Background of CbCR
- Applicability of CbCR
- Safeguards to avoid Duplicity
- Non-compliance with CbCR provisions
- Definitions of various terms used in this chapter

31. SPECIFIED DOMESTIC TRANSACTIONS INTERNATIONAL TAXATION

TRANSFER PRICING ON INCOME FROM DOMESTIC RELATED PARTY TRANSACTIONS - [SECTION 92(2A)]

Specified Domestic Transactions were covered under transfer pricing regime to –

a) **Determine income** from domestic related party transactions ; and

b) Determine **reasonableness of expenditure** between domestic related parties.

c) Section 92(2A) provides that,

any allowance for an **expenditure** or **interest** or **allocation of any cost** or **expense** or

any income in relation to the specified domestic transaction

shall be computed having regard to the arm's length price

except

if such allowance for expense or interest

reduces the income chargeable to tax or

increases the loss.

MEANING OF "SPECIFIED DOMESTIC TRANSACTION" - [SECTION 92BA]

Specified domestic transaction has been defined to **mean** **any** of the following transactions (other than international transaction), namely,-

a. **Inter-unit transfer of goods** **and services** at **less than** fair market value on the date of transfer **by**
an **undertaking** or

unit or

enterprise or

eligible business to **other** **business** carried on by the assessee or **vice** **versa**

[Section 80A].

MEANING OF "SPECIFIED DOMESTIC TRANSACTION" - [SECTION 92BA] - ELIGIBLE BUSINESS : -

It means any business wherein following deductions were claimed : -

- Deduction in respect of profit and gains of enterprise engaged in **infrastructure development** [Section 80-IA].
- Deduction in respect of profit and gains of an enterprise engaged in **SEZ development** [Section 80-IAB].
- Deduction in respect of profit and gains of an undertaking **other than infrastructure development** [Section 80-IB].
- Deduction in respect of undertakings in **certain SEZ** [Section 80-IC].
- Deduction in respect of profit and gains from business **of Hotels and convention centres in specified areas** [Section 80-ID].
- Deduction in respect of undertakings **in North Eastern States** [Section 80-IE].
- Deduction in respect of business of **collecting and processing of bio-degradable waste** [Section 80JJA].
- Deduction in respect of **employment of new workmen** [Section 80JJAA]
- Deduction in respect of certain income of **offshore banking units and international financial service centre** [Section 80LA].
- Deduction in respect of **income of co-operative society** [Section 80P]

b. Inter-unit **transfer** of goods or services between eligible business and other business at less than fair market value on the date of transfer [Section 80-IA(8)];

c. Business between the assessee carrying on **eligible business** and other person, where **business transacted produces more than ordinary profits** in eligible business [as referred to section 80-IA(10)]

ELIGIBLE BUSINESS : -

It means any business wherein following deductions were claimed:

- Deduction in respect of profit and gains of enterprise engaged in infrastructure development [Section 80-IA].
- Deduction in respect of profit and gains of an enterprise engaged in SEZ development [Section 80-IAB].
- Deduction in respect of profit and gains of an undertaking other than infrastructure development [Section 80-IB].

- Deduction in respect of undertakings in certain SEZ [Section 80-IC].
- Deduction in respect of profit and gains from business of Hotels and convention centres in specified areas [Section 80-ID].
- Deduction in respect of undertakings in North Eastern States [Section 80-IE].

d. Transaction under **Chapter VI-A or section 10AA, where provisions of section 80-IA(8) or section 80-IA(10)** are applicable;

e. Any other prescribed transaction.

THRESHOLD FOR SPECIFIED DOMESTIC TRANSACTION

The aggregate of SDT transactions entered into by the assessee in the previous year should exceed a sum of Rs 20 crore, to be considered as specified domestic transaction.

EXAMPLE: -

B Private limited was engaged in the business of Hotels and claimed exemption under Section 80-ID. BB Private ltd. was group concern of B but it is not claiming any profit linked deduction. BB private limited has used the hotel space of B private limited for certain event and paid Rs 15 crores. Whether such transaction would be covered as specified domestic transaction, assuming B does not have any other specified transactions ?

SOLUTION: -

The aggregate SDT entered into by the assessee in the previous year should exceed a sum of Rs 20 crore to be considered as specified domestic transaction. Thus, such transaction could not be considered as specified domestic transaction.

COMPUTATION OF ARM'S LENGTH PRICE AND INCOME OF A SPECIFIED DOMESTIC TRANSACTION [SECTIONS 92 & 92C]

The arm's length price in respect of the specified domestic transaction shall be computed under section 92 (Computation of income) and 92C (Computation of ALP) as they apply to the international transaction.

MAINTENANCE OF INFORMATION AND DOCUMENTS AND FURNISH REPORT OF AN ACCOUNTANT [SECTION 92D & 92E

The provisions of **section 92D and 92E relating to maintenance of information and documents and furnish report of audit** have been made applicable to a specified domestic transaction as they apply to an international transaction.

NOTE :

Where aggregate value of international transaction does not exceed Rs 1 crores, there is an exemption from maintenance of information and documents. There is no such exemption in case of specified domestic transactions. However, the provisions of specified domestic transactions would apply only when aggregate value of transaction during the year exceed Rs 20 crores.

EXAMPLE : -

Two domestic companies (i.e., part of same group) entered into a transaction of Rs 15 crores during the previous year 2016-17. Whether they are required to maintain documents and furnish audit report under Section 92E ?

SOLUTION : -

The aggregate value of transactions entered during the previous year 2016-17 are less than Rs 20 crores. Thus, such transaction could not be considered as specified domestic transaction. Since such transaction are outside the purview of specified domestic transaction, there is no need to maintain documents and furnish audit report.

PENALTY PROVISIONS APPLICABLE TO SPECIFIED DOMESTIC TRANSACTIONS

Section	Nature of default	Quantum of penalty
271BA	Failure to furnish transfer pricing report (Form 3CEB) under section 92E	Rs. 1,00,000
271AA	Failure to keep and maintain information and documents as per section 92D	2% of value of each specified domestic transaction
	Failure to report specified domestic transaction	
	Furnishing of incorrect information or documents	
271G	Failure to furnish information or documents within prescribed time under section 92D(3)	
270A	Failure to report any specified domestic transaction (It would constitutes misreporting of Income)	200% of tax payable

MARKET VALUE TO BE THE ARM'S LENGTH PRICE OF GOODS OR SERVICES IN A SPECIFIED DOMESTIC TRANSACTION [SECTION 80A & 80-IA(8)]

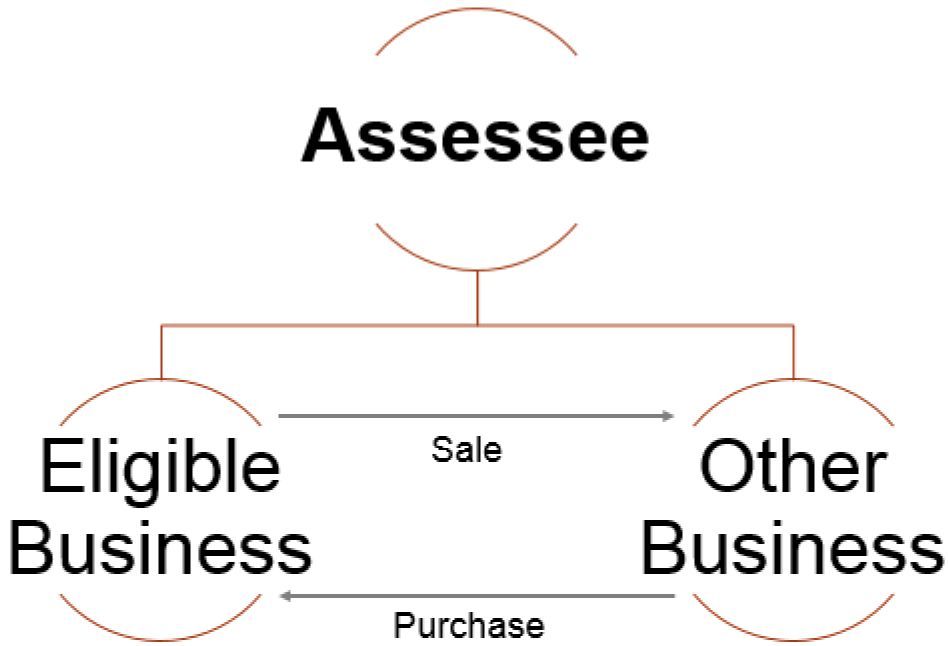
Section **80A(6)** provides that where the goods or services held for the purpose of the undertaking or unit or enterprise or eligible business are transferred to any other business carried on by the assessee or vice-versa, the transfer price of such goods and services **shall be determined at the market value** of such goods or services as on the date of transfer.

"**Market value**" is **defined** in Clause (iii) of *Explanation* to section 80A(6) to mean **arm's length price as defined under section 92F** of such goods or services, **if aggregate value of all such transaction specified in section 92BA exceeds Rs 20 crores.**

For **Section 80-IA(8), market value**, shall mean –

1. Open **market price**; or

2. **Arm's length price** as defined under **section 92F.**



PROFIT FROM TRANSACTIONS BETWEEN AN ASSESSEE CARRYING ON "ELIGIBLE BUSINESS" AND OTHER ASSESSEES TO BE DETERMINED AS PER ARM'S LENGTH PRICE [SECTION 80-IA(10)]

The Assessing Officer is empowered to make an adjustment while computing the profit and gains of the eligible business where –

- A transaction **between the assessee carrying on the eligible business under section 80-IA** ; and
- **any other person**

is so arranged that the **transaction produces excessive profits to the eligible business.**

If the aforesaid arrangement is a specified domestic transaction referred to in section 92BA, profit of such transaction shall be determined having regard to arm's length price as defined under section 92F**.**

MARKET VALUE TO BE THE ARM'S LENGTH PRICE OF GOODS OR SERVICES IN A SPECIFIED DOMESTIC TRANSACTION [SECTION 80A & 80-IA(8)]

EXAMPLE : -

In given example, both the DTA unit and Tax holiday unit, are under common ownership and are related parties for the purpose of specified domestic transactions.

SITUATION 1 : Transaction at fair market value

DTA unit – Tax Rate 30%		Tax holiday unit – Tax Rate Nil	
Particulars	**Amount (In crores)**	**Particulars**	**Amount (In crores)**
Sale	150	Sale to DTA unit	100
Purchases from ICO1	100	Expense	70
Other expense	10	Profit	30
Profit	40		
Tax [15*30%]	12	Tax	Nil
Overall tax incidence – Rs 12 crore + Nil = Rs 12 crore			

MARKET VALUE TO BE THE ARM'S LENGTH PRICE OF GOODS OR SERVICES IN A SPECIFIED DOMESTIC TRANSACTION [SECTION 80A & 80-IA(8)]

SITUATION 2 : Transaction at more than fair market value for shifting of profit to tax holiday unit

DTA unit – Tax Rate 30%		Tax holiday unit – Tax Rate Nil	
Particulars	**Amount (In crores)**	**Particulars**	**Amount (In crores)**
Sale	150	Sale to DTA unit	140
Purchases from ICO1	140	Expense	70
Other expense	10	Profit	70
Profit	Nil		
Tax	Nil	Tax	Nil
Overall tax incidence – Nil + Nil = Nil			

NOTE : Tax holiday unit has sold goods to DTA unit at Rs 140 crore instead of its fair market value of Rs 100 crore. This arrangement has been made in order to shift profit from DTA unit to tax holiday unit. Accordingly, the DTA unit has claimed higher deduction and such excessive profits were not taxable in the hands of Tax holiday unit.

MARKET VALUE TO BE THE ARM'S LENGTH PRICE OF GOODS OR SERVICES IN A SPECIFIED DOMESTIC TRANSACTION [SECTION 80A & 80-IA(8)]

How aforesaid loophole under Situation 2 is curbed after introduction of provisions of specified domestic transactions?

DTA unit – Tax Rate 30%		Tax holiday unit – Tax Rate Nil		
Particulars	**Amount (In crores)**	**Particulars**		**Amount (In crores)**
Sale	150	Sale	(A)	140
Purchases from ICO1	140	Expense	(B)	70
Other expense	10	Actual profit	(A)-(B)=(C)	70
Profit	Nil	Profit as per arm's length price	(D)	30
Tax	Nil	Addition by AO	(C) – (D)=(E)	40
		Tax liability on additions made by AO [40*30%]		12

TRANSFER PRICING RULES FOR SPECIFIED DOMESTIC TRANSACTIONS [NOTIFICATION NO. 41/2013 DATED 10.06.2013]

With effect from A.Y 2013-14, the **transfer pricing rules for international transactions** have been suitably amended and **made applicable specified domestic transactions as well.**

DEFINITION OF "ASSOCIATED ENTERPRISE" [RULE 10A]

"Associated Enterprise" shall –

i. have the same meaning as assigned to it in **section 92A**; and

ii. in relation to a specified domestic transaction entered into by an assessee, **include -**

  a) Persons referred to in **section 40A(2)(b)** for transaction referred to in section 40A(2)(a);

  b) Other **units or** undertakings or businesses referred to in **section 80A** or **section 80-IA(8);**

  c) Any other person referred to in **section 80-IA(10)** in respect of a transaction referred to therein;

  d) Other units, undertakings, enterprises or business of such assessee, or other person referred to in **section 80-IA(10)** or **10AA** or the transactions referred **to in Chapter VI-A** to which the provisions of **section 80- IA(8)** or **section 80-IA(10)** are applicable.

DEFINITION OF "ENTERPRISE" [RULE 10A]

"Enterprise" includes a unit, or an enterprise, or an undertaking or a business of a person who undertakes such transaction.

DETERMINATION OF ALP UNDER SECTION 92C - [RULE 10B]

Following methods are prescribed for determination of arm's length price in relation to an international transaction : -

a. Comparable Uncontrolled Price ('CUP') method;

b. Resale Price Method

c. Cost Plus Method

d. Profit Split Method

e. Transactional Net Margin Method

f. Any other Method

Such methods shall also be made applicable to determine arm's length price of specified domestic transactions.

MOST APPROPRIATE METHOD - [RULE 10C]

Rule 10C(1) provides that the most appropriate method shall be the method : -

- Which is **best suited** to facts and circumstances of **each** particular international transaction, and
- Which provides the **most reliable measure of an arm's length price** in relation to the international transaction, as the case may be].

Rule 10C(2) specifies the factors to be taken into account in selecting the most appropriate method.

SUCH RULE HAS NOW BEEN MADE APPLICABLE FOR SPECIFIED DOMESTIC TRANSACTIONS AS WELL.

TRANSFER PRICING RULES FOR SPECIFIED DOMESTIC TRANSACTIONS

INFORMATION AND DOCUMENTS TO BE KEPT AND MAINTAINED UNDER SECTION 92D [RULE 10D] : -

As per Rule 10D(1), every person who has entered into an international transaction shall be required to maintain certain information and documents. However, there is an exemption from maintenance of information and documents where aggregate value of international transaction is Rs 1 crore or less.

NOW SUCH INFORMATION AND DOCUMENTS SHOULD ALSO BE KEPT AND MAINTAINED FOR SPECIFIED DOMESTIC TRANSACTIONS. HOWEVER, NO SUCH EXEMPTION IS AVAILABLE IN CASE OF SPECIFIED DOMESTIC TRANSACTIONS.

TRANSFER PRICING RULES FOR SPECIFIED DOMESTIC TRANSACTIONS

REPORT FROM AN ACCOUNTANT TO BE FURNISHED UNDER SECTION 92E : -

Every person who enters into an international transaction during a previous year is required to obtain a report from a chartered accountant and furnish such report on or before due date of filing of return of income in **Form No.3CEB**. This provision is **also made applicable for specified domestic transactions as well.**

AMENDMENTS MADE BY THE FINANCE ACT, 2017

The existing provisions of Section 92BA provided that any expenditure for which payment is required to be made to related persons under Section 40A(2)(b) were also considered as specified domestic transaction. **With effect from AY 2017-18, with a view to reduce the domestic transfer pricing compliance burden, payments under Section 40A(2)(b) are specifically excluded from Section 92BA.**

Provisions of specified domestic transaction **will now be applicable only if one of the entities involved is claiming profit linked deduction** (i.e., Section 80-IA, 80-IB, 80-IC, 10AA, etc).

Such amendment has given relief to taxpayers which were liable to domestic transfer pricing even when both the related parties were taxable at same rate of 30% and there was no shifting of profits in order to save tax of overall group.

EXAMPLE : -

ICO and ICO1 are part of same group concern, i.e., both are related parties.

SITUATION 1 : Transaction at fair value

ICO (Indian Company) – Tax Rate 30%		ICO1 (another Indian company) – Tax Rate 30%	
Particulars	**Amount (In crores)**	**Particulars**	**Amount (In crores)**
Sale	50	Sale to ICO	30
Purchases from ICO1	30	Expense	15
Other expense	5	Profit	15
Profit	15		
Tax [15*30%]	4.5	Tax [15*30%]	4.5
Overall tax incidence on Indian group concern – Rs 4.5 cr + Rs 4.5 cr = Rs 9 cr			

<u>SITUATION 2</u> : Transaction at more than fair value

ICO (Indian Company) – Tax Rate 30%		ICO1 (another Indian company) – Tax Rate 30%	
Particulars	**Amount (In crores)**	**Particulars**	**Amount (In crores)**
Sale	50	Sale to ICO	40
Purchases from ICO1	40	Expense	15
Other expense	5	Profit	25
Profit	5		
Tax [5*30%]	1.5	Tax [25*30%]	7.5
Overall tax incidence on Indian group concern – Rs 1.5 cr + Rs 7.5 cr = Rs 9 cr			

In both the situations the overall tax incidence comes out to be same even when there is transfer of goods from ICO1 to ICO at more than fair value. With effect from AY 2017-18, such transactions could not be considered as specified domestic transactions since non of the entities are claiming profit linked deduction.`

<u>EXAMPLE</u> : -

Indian company (ICO) paid salary of Rs 30 crores to its director during the PY 2016-17. Whether such payment would be considered as specified domestic transaction ?

SOLUTION : -

Payment made to director would be considered as payment to related person under Section 40A(2)(b). However, with effect from AY 2017-18 payments under Section 40A(2)(b) are specifically excluded from Section 92BA. Thus, provisions of specified domestic transaction would not apply in this situation.

SAFE HARBOUR RULES SDT

SAFE HARBOUR RULES FOR SPECIFIED DOMESTIC TRANSACTION

CBDT vide **Notification No. 11/2015 dated 04.02.2015**
in exercise of the powers conferred by section 92CB and 92D, read with section 295, inserted Rules 10TH, 10THA, 10THB, 10THC, & 10THD and
has prescribed the safe harbour rules for specified domestic transaction as well.

ELIGIBLE ASSESSEE WHO CAN OPT FOR SAFE HARBOUR RULES – RULE 10THA

Eligible assessee means a person who has **exercised a valid option** for application of safe harbour rules, and who is a : -

- **Government company engaged** in the business of **generation,** supply, transmission or distribution of **electricity;** or
- **co-operative society** engaged in the business of **procuring and marketing milk and milk products**.

DEFINITION OF GOVERNMENT COMPANY AS PER SECTION 2(45) OF THE COMPANIES ACT, 2013:

Government company **means** any company
in **which 51% or more**
of the **paid-up share capital**
is held by **State Government** or Governments, or
partly by the **Central Government** and partly by one or more State Governments, and includes a **company which is a subsidiary company of such a Government company**.

ELIGIBLE SPECIFIED DOMESTIC TRANSACTION FOR SAFE HARBOUR RULES – RULE 10THB

THE ELIGIBLE SPECIFIED DOMESTIC TRANSACTION MEANS A SPECIFIED DOMESTIC TRANSACTION UNDERTAKEN BY AN ELIGIBLE ASSESSEE AND WHICH COMPRISES OF : -

i. **supply** of electricity; or
ii. **transmission** of electricity ; or
iii. **wheeling** of electricity; or
iv. **purchase of milk or milk products** by a co-operative society from its members.

SAFE HARBOUR – CIRCUMSTANCES (RULE 10THC)

The transfer price declared by the eligible assessee in respect of specified domestic transactions shall be **accepted by the income-tax authorities**, if it is in accordance with followings circumstances:

Eligible Specified Domestic Transaction	Circumstances
1. Supply of electricity, transmission of electricity, wheeling of electricity	The tariff in respect of supply or transmission or wheeling of electricity is determined by Appropriate Commission or the methodology for determination of the tariff is approved by the Appropriate Commission in accordance with the provisions of the Electricity Act, 2003. As per section 2(4) of the Electricity Act, 2003, **"Appropriate Commission"** means the Central Regulatory Commission referred to in sub-section (1) of section 76 or the State Regulatory Commission referred to in section 82 or the Joint Commission referred to in section 83, as the case may be.

The transfer price declared by the eligible assessee in respect of specified domestic transactions shall be accepted by the income-tax authorities, if it is in accordance with followings circumstances:

Eligible Specified Domestic Transaction	Circumstances
2. Purchase of milk or milk products by a co-operative society from its members	The price of milk or milk products is determined at a rate which is fixed on the basis of the quality of milk, namely, fat content and Solid Not FAT (SNF) content of milk ; and – a) the said rate is irrespective of,- i. the quantity of milk procured; ii. he percentage of shares held by the members in the co-operative society; iii. the voting power held by the members in the society; and b) such prices are routinely declared by the co-operative society in a transparent manner and are available in public domain

NO COMPARABILITY ADJUSTMENT AND ALLOWANCE : -

No comparability adjustment and allowance under the second proviso to section 92C(2) (i.e. Arithmetic Mean or Range concept) shall be made to the transfer price declared by the assessee and accepted by the income-tax authority.

MAINTENANCE OF INFORMATION AND DOCUMENTS : -

The provisions relating to maintenance of information and document and submission of report in Form No. 3CEB in respect of specified domestic transaction **shall apply** irrespective of the fact that the assessee exercises his option for Safe Harbour Rules.

PROCEDURE UNDER SAFE HARBOUR RULES FOR SPECIFIED DOMESTIC TRANSACTION – RULE 10THD

I. FURNISHING OF FORM 3CEFB : -

a. The assessee shall furnish **a Form 3CEFB** to the Assessing Officer **on or before due date of furnishing of return of income** for exercising the option of safe harbour.

II. VERIFICATION BY ASSESSING OFFICER : -

On **receipt of Form 3CEFB** the assessing officer shall verify whether

i. The **assessee** exercising the option **is an eligible assessee**; and
ii. The **transaction** in respect of which option is exercised is an **eligible specified domestic transaction**

before the option for safe harbour by the assessee is treated to be validly exercised.

III. NOTICE FOR FURNISHING OF INFORMATION OR DOCUMENTS : -

Where the Assessing Officer **doubts the valid exercise** of safe harbour option he may require the assessee, to furnishing information or documents or other evidence as he may consider necessary, within the time specified in such notice.

IV. ORDER DECLARING SAFE HARBOUR OPTION AS INVALID : -

Where -

a) the assessee **does not furnish** the information or documents or other evidence required by the Assessing Officer; or
b) the **Assessing Officer** finds that the assessee is **not an eligible assessee**; or
c) the **Assessing Officer finds** that the specified domestic transaction in respect of which the safe harbour option has been exercised is **not an eligible specified domestic transaction**; or
d) the **tariff is not in accordance with** the circumstances specified for eligible specified domestic transaction,

the Assessing Officer shall, by order in writing, declare the option exercised by the assessee to be invalid and cause a copy of the said order to be served on the assessee:

However **no order declaring the option exercised by the assessee to be invalid shall be passed without giving an opportunity of being heard to the assessee.**

V. **TIME LIMIT FOR DECLARING SAFE HARBOUR OPTION AS INVALID BY ASSESSING OFFICER : -**

The Assessing Officer shall pass the order declaring the option exercised by the assessee as invalid within a period of **3 months from the end of the month in which Form 3CEFB is received by him**.
No order can be passed by Assessing Officer declaring the option as invalid unless an opportunity of being heard is given to the assessee.

VI. **FILING OF OBJECTIONS AGAINST THE ORDER OF ASSESSING OFFICER DECLARING THE OPTION TO BE INVALID : -**

If the **assessee** objects to the order of the Assessing Officer declaring the option to be invalid, he may **file his objections with** the **Principal Commissioner** or the **Commissioner** or the **Principal Director or the Director,** to whom the Assessing Officer is subordinate, **within 15 days of receipt of the order** of the Assessing Officer.

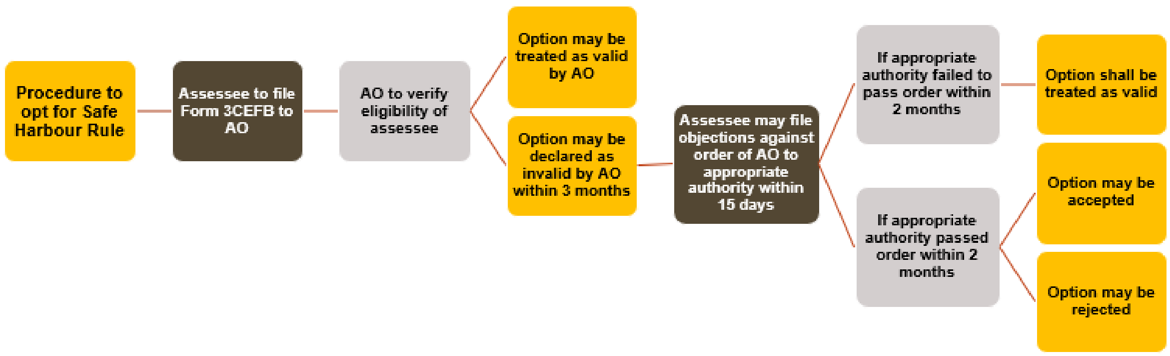
VII. **RECEIPT OF OBJECTION AGAINST THE ORDER OF ASSESSING OFFICER DECLARING THE OPTION TO BE INVALID : -**

On receipt of the objection from assessee the Principal Commissioner or the Commissioner or the Principal Director or the Director, **shall pass appropriate order, within a period of 2 months from the end of the month in which the objection filed by the assessee is received**, after providing an opportunity of being heard to the assessee.

VIII. **DEEMED ACCEPTANCE OF SAFE HARBOUR OPTION : -**

If the Assessing Officer or the Principal Commissioner or the Commissioner or the Principal Director or the Director, **does not pass an order within**

aforesaid time then the option for safe harbour exercised by the assessee shall be treated as **valid**.



INFORMATION AND DOCUMENTS TO BE KEPT AND MAINTAINED FOR SPECIFIED DOMESTIC TRANSACTION – RULE 10D(2A)

INFORMATION AND DOCUMENTS TO BE KEPT AND MAINTAINED BY GOVERNMENT COMPANY ENGAGED IN THE BUSINESS OF GENERATION, SUPPLY, TRANSMISSION, OR DISTRIBUTION OF ELECTRICITY ARE AS FOLLOWS : -

i. a **description of the ownership structure** of the assessee enterprise with details of shares or other ownership interest held therein by other enterprises;

ii. a broad **description of the business of the assessee** and the industry in which the assessee operates, and of the business of the associated enterprises with whom the assessee has transacted;

iii. the **nature and terms (including prices) of specified domestic transactions** entered into with each associated enterprise and the quantum and value of each such transaction or class of such transaction;

iv. a record of **proceedings, if any, before the regulatory commission** and orders of such commission relating to the specified domestic transaction

v. a record of the **actual working carried out for determining the transfer price** of the specified domestic transaction;

vi. the **assumptions, policies and price negotiations**, if any, which have critically affected the determination of the transfer price; and

vii. **any other information, data or document,** including information or data relating to the associated enterprise, which may be relevant for determination of the transfer price;

INFORMATION AND DOCUMENTS TO BE KEPT AND MAINTAINED BY A CO-OPERATIVE SOCIETY ENGAGED IN THE BUSINESS OF PROCURING AND MARKETING MILK AND MILK PRODUCTS : -

i. a **description of the ownership structure of the assessee** co-operative society with details of shares or other ownership interest held therein by the members;

ii. **description of members** including their addresses and period of membership;

iii. the **nature and terms (including prices) of specified domestic transactions** entered into with each member and the quantum and value of each such transaction or class of such transaction;

iv. a record of the **actual working carried out for determining the transfer price** of the specified domestic transaction;

v. the **assumptions, policies and price negotiations**, if any, which have critically affected the determination of the transfer price;

vi. the **documentation regarding price being routinely declared in transparent** manner and being available in public domain; and

vii. any **other information, data or document** which may be relevant for determination of the transfer price.

SAFE HARBOUR RULES - INTERNATIONAL TRANSACTION

32.SAFE HARBOUR RULES FOR INTERNATIONAL TRANSACTION

- Transfer Pricing involves lot of dispute amongst taxpayers and tax authorities, on how much should be the margins/ what should be the ALP

- "Safe harbour" is a mechanism to reduce litigation, and implies **circumstances under which, the tax authorities shall accept the Transfer Price declared by the taxpayer**.

- Safe harbour rules, provides **minimum operating margins in relation to an operating expense**, which a taxpayer is expected to earn from certain international transactions. If that will be acceptable to the tax authorities.

- "Safe harbour Rules generally contain the following : -
  - **Sector** in which the assessee operates;
  - **Turnover** for which they are covered;
  - **Margin that should be earned** by them to be eligible for Safe Harbour Rules

- The transfer price declared by assessee shall be accepted by tax authorities if it is in accordance with the followings circumstances: -

SAFE HARBOUR RULES - SOFTWARE DEVELOPMENT SERVICES

S. No.	Eligible International Transaction	Circumstances	
	Rule 10TC	**Rule 10TD**	
(i)	Provision of **software development services** with insignificant risk (other than R&D Services)	**Operating profit margin***	**Value of international transaction**
		17% or more	Rs. 100 cr. or less
		18% or more	Greater than Rs. 100 cr. but upto Rs. 200 cr.

$$\text{*Operating Profit Margin} = \frac{\text{Operating Profit}}{\text{Operating expenses}} \times 100$$

"SOFTWARE DEVELOPMENT SERVICES" MEANS : -
a) business application software and information system development using known methods and existing software tools;
b) support for existing systems;
c) Converting or translating computer languages;
d) adding user functionality to application programmes
e) adaptation of existing software; or
f) preparation of user documentation
NOTE : IT DOES NOT INCLUDE ANY R&D SERVICES (INCLUDING CONTRACT R&D SERVICES).

SAFE HARBOUR RULES - INFORMATION TECHNOLOGY ENABLED SERVICES

S. No.	Eligible International Transaction	Circumstances	
	Rule 10TC	Rule 10TD	
(ii)	Provision of **information technology enabled Services** with insignificant risk (other than R&D services)	**Operating profit margin***	**Value of international transaction**
		17% or more	Rs. 100 cr. or less
		18% or more	Greater than Rs. 100 cr. but upto Rs. 200 cr.

SAFE HARBOUR RULES - INFORMATION TECHNOLOGY ENABLED SERVICES

"INFORMATION TECHNOLOGY ENABLED SERVICES" MEANS THE FOLLOWING BUSINESS PROCESS OUTSOURCING SERVICES PROVIDED MAINLY WITH THE ASSISTANCE OR USE OF INFORMATION TECHNOLOGY, NAMELY : -
a) back office operations
b) call centres or contact centre services
c) data processing and data mining
d) insurance claim processing
e) legal databases
f) creation and maintenance of medical transcription excluding medical advice
g) translation services
h) Payroll

"INFORMATION TECHNOLOGY ENABLED SERVICES" MEANS THE FOLLOWING BUSINESS PROCESS OUTSOURCING SERVICES PROVIDED MAINLY WITH THE ASSISTANCE OR USE OF INFORMATION TECHNOLOGY, NAMELY : -
i) remote maintenance
j) revenue accounting
k) support centres
l) website services
m) data search integration and analysis
n) remote education excluding education content development
o) clinical database management services excluding clinical trials
NOTE : IT DOES NOT INCLUDE ANY R & D SERVICES WHETHER OR NOT IN THE NATURE OF CONTRACT R & D SERVICES.

SAFE HARBOUR RULES - KNOWLEDGE PROCESS OUTSOURCING SERVICES

S. No.	Eligible International Transaction	Circumstances		
	Rule 10TC	Rule 10TD		
(iii)	Provision of **knowledge process outsourcing services** with insignificant risk	**Operating profit margin***	**Employee Cost to Operating Expense**	**Value of international transaction**
		24% or more	60% or more	Rs. 200 crore or less
		21% or more	40% or more but less than 60%	
		18% or more	40% or less	

“KNOWLEDGE PROCESS OUTSOURCING SERVICES” MEANS THE FOLLOWING BUSINESS PROCESS OUTSOURCING SERVICES PROVIDED MAINLY WITH THE ASSISTANCE OR USE OF INFORMATION TECHNOLOGY REQUIRING APPLICATION OF KNOWLEDGE AND ADVANCED ANALYTICAL AND TECHNICAL SKILLS, NAMELY : -
a) geographic information system
b) human resources services
c) engineering and design services
d) animation or content development and management
e) business analytics
f) financial analytics
g) market research
NOTE : IT DOES NOT INCLUDE ANY R&D SERVICES WHETHER OR NOT IN THE NATURE OF CONTRACT R&D SERVICES

SAFE HARBOUR RULES - INTRAGROUP LOANS TO NON-RESIDENT WOS IN INDIAN CURRENCY

S. No.	Eligible International Transaction	Circumstances		
	Rule 10TC	Rule 10TD		
(iv)	Advancing of intragroup loans to non-resident wholly owned subsidiary where the amount of loan is denominated in Indian Rupees (INR)	The interest rate declared is not less than the one-year marginal cost of funds lending rate of SBI as on 1st April of the relevant previous year plus		
		%	**CRISIL rating of Associated Enterprise or its equivalent**	**Value of international transactions**
		1.75%	Between AAA to A	No threshold
		3.25%	BBB-, BBB, BBB+	
		4.75%	Between BB to B	
		6.25%	C to D	
		4.25%	Credit rating of AE is not available and the loan to AE including loans to all AEs does not exceed Rs.100 crore in aggregate as on 31st March of the relevant P.Y.	

“INTRA-GROUP LOAN” MEANS LOAN ADVANCED TO WHOLLY OWNED SUBSIDIARY BEING A NON-RESIDENT, WHERE THE LOAN –
a) is sourced in **Indian rupees**
b) 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
c) does **not include credit line or any other loan facility which has no fixed term** for repayment;

SAFE HARBOUR RULES - INTRAGROUP LOANS TO NON-RESIDENT WOS IN FOREIGN CURRENCY

S. No.	Eligible International Transaction	Circumstances		
	Rule 10TC	Rule 10TD		
(v)	Advancing of intragroup loans to non-resident wholly owned subsidiary where the amount of loan is denominated **in foreign currency**	The interest rate declared **is not less than the six-month London Inter-Bank Offer Rate (LIBOR) of the relevant foreign currency** as on 30th September of the relevant previous year plus		
		%	**CRISIL rating of Associated Enterprise or its equivalent**	**Value of international transactions**
		1.50%	Between AAA to A	No threshold
		3.00%	BBB-, BBB, BBB+	
		4.50%	Between BB to B	
		6.00%	C to D	
		4.00%	Credit rating of AE is not available and the loan to AE including loans to all AEs does not exceed Rs. 100 crore in aggregate as on 31st March of the relevant P.Y.	

SAFE HARBOUR RULES FOR INTERNATIONAL TRANSACTION

S. No.	Eligible International Transaction	Circumstances	
	Rule 10TC	Rule 10TD	
(vi)	Providing **corporate guarantee to wholly owned subsidiary** **"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– a) letter of comfort; b) implicit corporate guarantee; c) performance guarantee; or d) any other guarantee of similar nature.	The interest rate declared is **not less than the six-month London Inter-Bank Offer Rate (LIBOR) of the relevant foreign currency** as on 30th September of the relevant previous year plus	
		Amount guaranteed	**The commission or fee declared in relation to the eligible international transaction is at the rate**
		Rs. 100 crore or less	1% p.a. or more on the amount guaranteed
		Above Rs. 100 crore*	
		***Condition:** The credit rating of the associated enterprise done by an agency registered with the SEBI is of the adequate to the highest safety	

SAFE HARBOUR RULES - CONTRACT R & D SERVICES

S. No.	Eligible International Transaction	Circumstances	
	Rule 10TC	Rule 10TD	
(vii)	Provision of **contract R & D services** wholly or partly relating to software development with insignificant risk.	**Operating profit margin**	**Value of international transaction**
		24% or more	Rs. 200 cr. or less

SAFE HARBOUR RULES FOR INTERNATIONAL TRANSACTION

“CONTRACT RESEARCH AND DEVELOPMENT (R&D) SERVICES WHOLLY OR PARTLY RELATING TO SOFTWARE DEVELOPMENT” MEANS THE FOLLOWING, NAMELY : -
a) R & D **producing new theorems and algorithms** in the field of theoretical computer science ;
b) development of information technology at the level of operating systems, programming languages, data management, communications software and software development tools ;
c) development of Internet technology ;
d) research into methods of designing, developing, deploying or maintaining software ;

"CONTRACT RESEARCH AND DEVELOPMENT (R&D) SERVICES WHOLLY OR PARTLY RELATING TO SOFTWARE DEVELOPMENT" MEANS THE FOLLOWING, NAMELY : -
e) software development that produces advances in generic approaches for capturing, transmitting, storing, retrieving, manipulating or displaying information;
f) experimental development aimed at filling technology knowledge gaps as necessary to develop a software programme or system;
g) R & D on software tools or technologies in specialized areas of computing (image processing, geographic data presentation, character recognition, artificial intelligence and such other areas
h) upgradation of existing products where source code has been made available by the principal except where the source code has been made available to carry out routine functions like debugging of the software.

S. No.	Eligible International Transaction	Circumstances	
	Rule 10TC	**Rule 10TD**	
(viii)	Provision of **contract R & D services** wholly or partly relating to **generic pharmaceutical drugs** with insignificant risk **"Generic pharmaceutical drug"** means a drug that is comparable to a drug already approved by the regulatory authority in dosage form, strength, route of administration, quality and performance characteristics, and intended use	**Operating profit margin**	**Value of international transaction**
		24% or more	Rs. 200 cr. or less

SAFE HARBOUR RULES - CORE AUTO COMPONENTS

S. No.	Eligible International Transaction	Circumstances	
	Rule 10TC	**Rule 10TD**	
(ix)	Manufacture and export of **core auto components**	**Operating profit margin**	**Value of international transaction**
		12% or more	No threshold

"CORE AUTO COMPONENTS" MEANS
a) engine and engine parts, including piston and piston rings, engine valves and parts cooling systems and parts and power train components;
b) transmission and steering parts, including gears, wheels, steering systems, axles and clutches;
c) suspension and braking parts, including brake and brake assemblies, brake linings, shock absorbers and leaf springs;

S. No.	Eligible International Transaction	Circumstances

	Rule 10TC	Rule 10TD	
(x)	Manufacture and export of non-core auto components **Condition:** 9% or more of total turnover during the previous year is in nature of original equipment manufacturer sales. **"Non-core auto components"** mean auto components other than core auto components.	**Operating profit margin**	**Value of international transaction**
		8.5% or more	No threshold

SAFE HARBOUR RULES - LOW VALUE-ADDING INTRA GROUP SERVICES

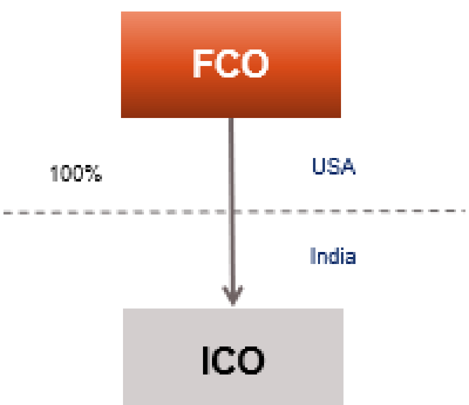
S. No.	Eligible International Transaction	Circumstances	
	Rule 10TC	Rule 10TD	
(xi)	Receipt of low value-adding Intra group services	**Mark-up on cost**	**Value of international transaction**
		*5% or less	Rs. 10 crore or less
		*The cost allocation methodology should be certified by an accountant	

“LOW VALUE-ADDING INTRA GROUP SERVICES” MEANS SERVICES THAT ARE PERFORMED BY ONE OR MORE MEMBERS OF A MULTINATIONAL ENTERPRISE GROUP ON BEHALF OF ONE OR MORE OTHER MEMBERS OF THE SAME MULTINATIONAL ENTERPRISE GROUP AND WHICH : -
a) are in the nature of support services;
b) are not part of the core business of the multinational enterprise group, i.e., such services neither constitute the profit-earning activities nor contribute to the economically significant activities of the multinational enterprise group;
c) are not in the nature of shareholder services or duplicate services;
d) neither require the use of unique and valuable intangibles nor lead to the creation of unique and valuable intangibles;
e) neither involve the assumption or control of significant risk by the service provider nor give rise to the creation of significant risk for the service provider; and
f) do not have reliable external comparable services that can be used for determining their arm's length price

SAFE HARBOUR RULES FOR INTERNATIONAL TRANSACTION

HOWEVER, INTRA GROUP SERVICES DOES NOT INCLUDE THE FOLLOWING SERVICES, NAMELY : -
a) research and development services;
b) manufacturing and production services;
c) information technology (software development) services;
d) knowledge process outsourcing services;
e) business process outsourcing services;
f) purchasing activities of raw materials or other materials that are used in the manufacturing or production process;
g) sales, marketing and distribution activities;
h) financial transactions;
i) extraction, exploration, or processing of natural resources; and
j) insurance and reinsurance.

MEANING OF ACCOUNTANT



An accountant referred to in the Explanation below section 288(2) of the Act and includes any person recognised for undertaking cost certification by the Government of the country where the associated enterprise is registered or incorporated or any of its agencies, who fulfils the following conditions, namely : -

i. if he is a **member or partner in any entity engaged in rendering accountancy or valuation services** then, -

a. the entity or its affiliates have presence in **more than two countries**; and

b. the **annual receipt** of the entity in the year preceding the year in which cost certification is undertaken **exceeds** **R**s. 10 crore;

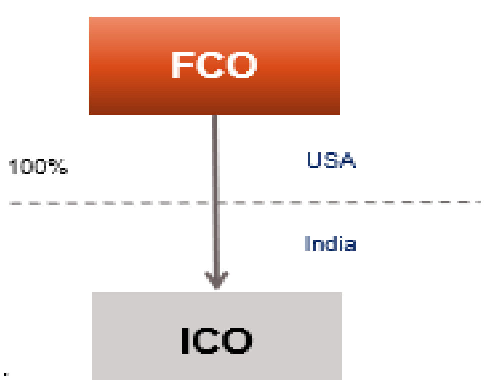
ii. if he is **pursuing the profession of accountancy individually** or is a valuer then, -

a. his **annual receipt** in the year preceding the year in which cost certification is undertaken, from the exercise of profession, **exceeds Rs. 1 crore**; and
b. he has professional **experience of not less than 10 years.**

MEANING OF OPERATING EXPENSE - INCLUSION

The costs incurred in the previous year by the assessee in relation to the international transaction during the course of its normal operations including : -

- **costs** relating to **Employee Stock Option Plan** or similar stock-based compensation provided for by the AE of the assessee to the employees of the assessee,
- **reimbursement to associated enterprises** of expenses incurred by the AE on behalf of the assessee,
- **amounts recovered from** AE **on account of expenses incurred by the assessee** on behalf of those AE and which relate to normal operations of the assessee ; and
- **depreciation and amortisation expenses** relating to the assets used by the assessee,



MEANING OF OPERATING EXPENSE - EXCLUSIONS

However, the costs incurred in the previous year by the assessee in relation to the international transaction during the course of its normal operations **does not include** the following, namely :
-

(i) **interest** expense;

(ii) provision for **unascertained liabili**ties;

(iii) **pre-operating** expenses;

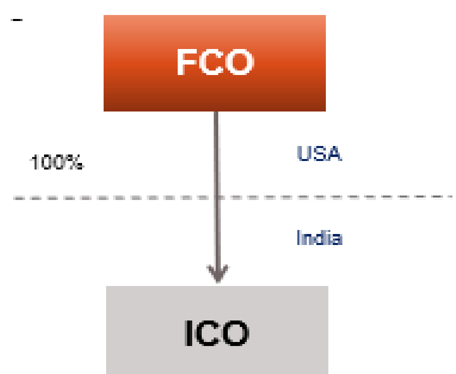
(iv) loss arising on account of **foreign currency fluctuations**;

(v) **extraordinary** expenses;

(vi) **loss** on **transfer of assets** or investments;

(vii) expense on account of **income-tax**; and

(viii) **other expenses** not relating to normal operations of the assessee



MEANING OF OPERATING REVENUE

The **revenue earned by the assessee in the previous year in relation to the international transaction** during the course of its normal operations **including** costs relating to Employee Stock Option Plan or similar stock-based compensation provided for by the associated enterprises of the assessee to the employees of the assessee **but not including** the following, namely : -

(i) interest income;

(ii) income arising on account of foreign currency fluctuations;

(iii) income on transfer of assets or investments;

(iv) refunds relating to income-tax;

(v) provisions written back;

(vi) extraordinary incomes; and

(vii) other incomes not relating to normal operations of the assessee.

MEANING OF OPERATING PRORIT MARGIN

In relation to operating expense, "operating profit margin" means the **ratio of operating profit,** being the operating revenue in excess of operating expense, **to** the **operating expense** expressed in terms of percentage.

$$\textbf{Operating Profit Margin} = \frac{\text{Operating Profit}}{\text{Operating expenses}} \times 100$$

MEANING OF EMPLOYEE COST

It includes, -

i. **salaries** and wages;
ii. **gratuities**;
iii. contribution to **Provident Fund** and other funds;
iv. the value of **perquisites** as specified in clause (2) of section 17;
v. **employment related allowances**, like medical allowance, dearness allowance, travel allowance and any other allowance;
vi. **bonus** or commission by whatever name called;
vii. lump sum payments received at the time of **termination of service or superannuation** or voluntary retirement, such as gratuity, severance pay, leave encashment, voluntary retrenchment benefits, commutation of pension and similar payments;

viii. expenses incurred on **contractual employment of persons** performing tasks similar to those performed by the regular employees;

(ix) **outsourcing expenses**, to the extent of employee cost, wherever ascertainable, embedded in the total outsourcing expenses. However, where the extent of employee cost embedded in the total outsourcing expenses is not ascertainable, eighty per cent of the total outsourcing expenses shall be deemed to be the employee cost embedded in the total outsourcing expenses;

(x) **recruitment** expenses;

(xi) **relocation** expenses;

(xii) **training** expenses;

(xiii) **staff welfare** expenses; and

(xiv) **any other expenses** related to employees or the employment.

MEANING OF RELEVANT PREVIOUS YEAR

The previous year relevant to the assessment year in which the **option for safe harbour is validly exercised.**

SAFE HARBOUR RULES FOR INTERNATIONAL TRANSACTION

NOTES :

1. The above provisions shall apply for **A.Y. 2017-18, A.Y.2018-19 and A.Y.2019-20.**

2. **No comparability adjustment** shall be made to the transfer price declared by assessee and accepted under the Safe Harbour Rules given.

3. Safe harbour rules shall **not be applicable** in respect of eligible international transaction entered into with an AE **located notified Jurisdiction Area under section 94A** or in **a no tax** or **low tax** country.

4. Provisions of the IT Act, requiring **maintenance of information and documents and furnishing of report in Form No 3CEB, shall apply** irrespective of the fact that the assessee exercises his option for safe harbour Rules in respect of such transaction.

EXAMPLE 1: -

In following situations examine and discuss whether transfer price declared by assessee would be accepted when it had exercised a valid option of safe harbour rules:

International transaction with foreign AE	Aggregate value of international transaction during PY	Operating profit margin
Adding user functionality to application programmes		
Case- I	90	15%
Case -II	160	17%

<u>SOLUTION</u> : -

Providing user functionality to application programmes of foreign AE would be covered in the definition of 'software development services' under Safe Harbour Rules. Transfer price declared by assessee would be accepted -

a. When the operating profit margin of assessee is 17% or more and value of international transaction is Rs 100 crore or less or

b. When the operating profit margin of assessee is 18% or more and value of international transaction is Rs 200 crore or less.

<u>CASE - I</u> : -

Since the value of international transaction is less than Rs 100 crores the safe harbour margin should be 17% or more. In this case the safe harbour margin is 15%. Thus, income-tax authorities are not bound to accept the transfer price declared by assessee .

<u>CASE – II</u> : -

Since the value of international transaction is above Rs 100 crores but less than Rs 200 crores the safe harbour margin should be 18% or more. However, in this case the safe harbour margin is 17%. Thus, income-tax authorities are not bound to accept the transfer price declared by assessee.

EXAMPLE 2: -

In following situations examine and discuss whether transfer price declared by assessee would be accepted when it had exercised a valid option of safe harbour rules:

International transaction with foreign AE	Aggregate value of international transaction during PY	Operating profit margin
Call centre services		
Case -I	80	17.5%
Case-II	210	18%

SOLUTION : -

Call centre services provided to foreign AE would be covered in the definition of 'Information Technology Enabled Services' under Safe Harbour Rules. Transfer price declared by assessee would be accepted –

a. When the operating profit margin of assessee is 17% or more and value of international transaction is Rs 100 crore or less or

b. When the operating profit margin of assessee is 18% or more and value of international transaction is Rs 200 crore or less.

CASE - I : -

Since the value of international transaction is less than Rs 100 crores the safe harbour margin should be 17% or more. In this case the safe harbour margin is 17.5%. Thus, income-tax authorities are bound to accept the transfer price declared by assessee .

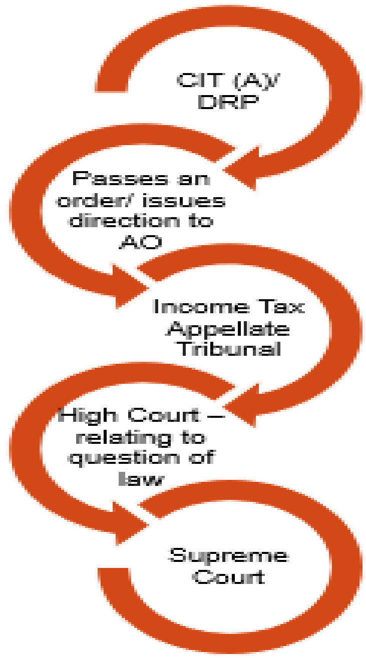
Case - II : -

In case of call centre services, the value of international transaction should not exceed Rs 200 crores. However, in this case the value of international

transaction is Rs 210 crores. Thus, income-tax authorities are not bound to accept the transfer price declared by assessee.

33. TRANSFER PRICING ASSESSMENT procedure in India

34. APPEAL PROCEDURE



35. POWER OF ASSESSING OFFICER TO DETERMINE THE ARM'S LENGTH PRICE

Section 92C(3) gives power to AO to determine the arm's length price in relation to international transaction and specified domestic transaction under the following circumstances : -

a. The price charged or paid in an international transaction **has not been determined in accordance with section 92C(1) and 92C(2);**

Note : -
• **Section 92C(1) prescribes that arm's length price of international transaction shall be determined as per the transfer pricing methods [i.e., CUP, TNMM, RPM, PSM, CPM and Other method].**
• **Section 92C(2) prescribed that most appropriate transfer pricing method shall be used to determine arm's length price.**

b. Any **information and documents relating** to an international transaction or specified domestic transaction has **not been kept** and maintained by the assessee in accordance with the provisions contained in section 92D(1) and the rules made in this behalf (Rule 10D); or

c. Use of unreliable or incorrect information or data in computation of the arm's length price); or

d. Failure to furnish any information or documents required by a notice issued u/s 92D(3) within the specified time.

NOTE : -

- **As per section 92D(3), the Assessing Officer or the Commissioner (Appeals) during the course of assessment proceedings, may require any person to furnish TP information and documents within 30 days.**

POWER OF ASSESSING OFFICER TO DETERMINE THE ARM'S LENGTH PRICE – NO DEDUCTIONS

POINTS TO CONSIDER : -

i. Section 92C(4) empowers the Assessing Officer to re-compute total income of assessee where Arm's length price is determined by him in aforesaid situations.
ii. Proviso to section 92C(4) provides that deduction under section 10A or section 10AA or section 10B or Chapter VI-A shall not be allowed from the additional income computed by Assessing Officer on basis of Arm's Length Price.

For example : - Total income declared by the assessee in his ITR = 10 lakhs; and
Total income computed by AO applying the arm's length principle = 13 lakhs.
Difference = 3 lakhs, will not qualify for deduction under section 10AA or Chapter VI-A.

RECOMPUTATION OF INCOME OF COUNTERPARTY AE

iii. Section 92C further provides that where the total income of an AE is computed on the basis of arm's length price **paid** to another Associated Enterprise, **from which tax is deducted at source** [or deductible at source], the income of the other AE shall not be recomputed on this count.

POWER OF ASSESSING OFFICER TO DETERMINE THE ARM'S LENGTH PRICE

EXAMPLE : -

Particulars	Amount (Rs.)
Sales made by ICO (Indian Company)	1000
Royalty paid by ICO to its foreign AE (5% of sales)	50
TDS deducted @ 10%	5
ALP determined by AO (3% of sales)	30
Disallowance made by AO (2% of sales)	20

Foreign AE claims that its income should be re-computed on the basis of ALP of Rs. 30 determined by AO, and therefore excess TDS should be refunded (Rs. 2 (i.e. 10% of Rs. 20)).

Analyse the situation ?

SOLUTION : -
As per Section 92C, where the total income of an AE is computed on the basis of ALP paid to another AE, from which tax is deducted at source, the income of the other AE shall not be recomputed on this count.
Therefore, income of foreign AE shall not be recomputed .

36. REFERENCE TO TRANSFER PRICING OFFICER [SECTION 92CA]

Section 92CA provides following procedure for reference by the AO to a TPO for determining the ALP of an international transaction or specified domestic transaction –

Option of making reference to TPO : - The Assessing Officer has the option to make reference to TPO for determining the Arm's length price of international transaction or specified domestic transaction, **if he considers it necessary to do so**. Such option is not available to the assessee.

Prior approval : - Approval of the **Principal Commissioner** of Income-tax(PCIT)/ Commissioner of Income-tax (**CIT**) is required before making reference to TPO.

Authorisation: - CBDT can authorise any Joint/Deputy/Assistant Commissioner of Income Tax for appointment as TPO.

Notice to produce evidence by the TPO :- When such reference is made, TPO shall serve notice to the assessee requiring him to produce evidence in support of the computation of ALP determined by him.

TRANSACTION IDENTIFIED DURING THE COURSE OF PROCEEDINGS :-
The TPO can also determine the ALP of other international transactions [**other than international transaction referred to TPO**] which comes to his notice subsequently in the course of proceedings before him [Sub-section (2A)].

TRANSACTION DEEMED TO BE REFERRED TO TPO [SUB-SECTION (2B)] : -

Where the assessee has **not furnished** the transfer pricing report u/s 92E in respect of an international transaction and **such transaction comes to the notice of the TPO** during the course of proceeding before him, the transfer pricing provisions shall apply as if such transaction is referred to the TPO by the Assessing Officer u/s 92CA(1) [Sub-section (2B) is applicable with retro-effect from June 1, 2002].

Power given under Section 92CA(2B) to be exercised for pending cases: -
Nothing contained in sub-section (2B) of Section 92CA
shall empower the AO, either to assess or reassess u/s 147 or
pass an order enhancing the assessment or
reducing a refund or otherwise increasing the liability of the **assessee u/s 154**,
for any assessment year
the **proceedings for which have been completed before 1st July, 2012**. [Sub-section (2C)].

> **Note : -**
>
> **The power given to the TPO under sub-section (2B) to determine arm's length price in respect of the transaction not reported by the assessee, can be exercised only in respect of the cases pending before the Assessing Officer. Completed assessments cannot be reopened u/s 147 by exercising such powers.**

Order of TPO : - The TPO shall pass an order in writing determining the arm's length price after considering the evidence, documents, etc. produced by the assessee and after considering the material gathered by him. TPO has to **send a copy of his order to Assessing Officer and Assessee**.

Order of TPO binding on AO : - The order of the Transfer Pricing Officer determining the arm's length price of an international transaction or specified domestic transaction **is binding on the Assessing Officer**.

Computation of income on the basis of ALP : - On receipt of order of TPO, Assessing Officer **shall** proceed to compute the total income in conformity with the arm's length price determined by the Transfer Pricing Officer [Sub-section (4)].

REFERENCE TO TRANSFER PRICING OFFICER - [SECTION 92CA] - TIME-LIMIT FOR PASSING ORDER

ALP shall be determined by TPO at least 60 days before the expiry of the time limit for completion of assessment by Assessing Officer u/s 153 or u/s 153B (Section 92CA(3A)).

> **Note : -**
>
> **This provision shall apply where reference is made on or after 1.6.2007 or where reference is made before 01.06.2007 but the order of the TPO is pending on that date.**

REFERENCE TO TRANSFER PRICING OFFICER [SECTION 92CA]

EXAMPLE : -

During scrutiny assessment, the AO has referred the case to TPO to determine the arm's length price of international transaction of assessee for AY 2018-19. Determine the time-limit for TPO to pass order determining the arm's length price of international transaction ?

SOLUTION : -

Arm's length price shall be determined by TPO at least 60 days before the expiry of the time limit for completion of assessment by Assessing Officer.
As per Section 153, the Assessing Officer has to complete scrutiny assessment within 18 months from the end of AY in which income was first assessable. However, in case of reference to TPO such time limit would be extended by 12 months. Thus, normal time limit for completion of assessment is September 30, 2021 (i.e., 18 months + 12 months). Accordingly, the TPO shall pass order till August 1, 2021 (i.e., **60 days earlier than** the due date of completion of assessment).

EXCLUSIONS IN COMPUTING TIME LIMIT FOR PASSING THE ORDER BY TPO : -

Where the Competent Authority **seeks information from foreign jurisdictions** under an agreement referred to in Section 90/90A
for the purpose of determining the arm's length price or
where proceedings before the **TPO are stayed by a court order**,
proviso to section 92(3A) provides that,
if the **time available to the TPO for making an order** [after excluding the time for which assessment proceedings were stayed or the time taken for receipt of information, as the case may be,]

is less than 60 days, then,

such remaining period shall be **extended to 60 days**.

37. RECTIFICATION OF TPO ORDER

Where any **mistake apparent from the record is noticed by the TPO**, he has the power to rectify his order under section 154. If such rectification is made, the AO **has to** rectify the assessment order to bring it in conformity with the same.

NOTE : -

Since the rectification shall be made by TPO u/s 154, TPO cannot make rectification after expiry of 4 years from the end of FY in which order sought to be amended by TPO was passed.

RECTIFICATION OF TPO ORDER – EXAMPLE

On July 1, 2017, TPO passed the order, determining the arm's length price of an international transaction for AY 2014-15. Determine the time-limit for passing rectification order by TPO if there is an apparent mistake in such order ?

SOLUTION : -

TPO can make rectification in his order in case of apparent mistake, within 4 years from the end of FY in which order sought to be amended was passed. In this case, TPO wants to rectify his order passed on July 1, 2017. Accordingly, he can make rectification within 4 years from the end of FY 2017-18. Thus, rectification can be made by TPO till March 31, 2022.

38. POWERS OF TPO

Where reference is made to TPO, he can **exercise all or any of the powers specified in** clause (a) to (d) of section 131(1) or section 133(6) or section 133A for determination of arm's length price.

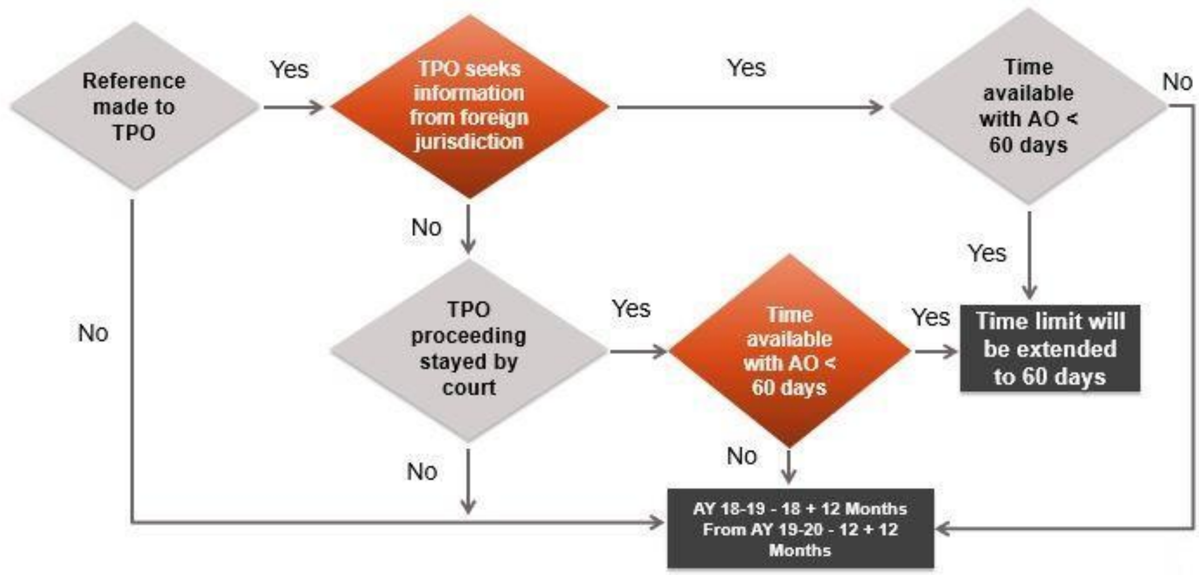
NOTE : -

- **Section 131(1)** specifies following powers:
  a. Discovery and inspection;
  b. Enforcing the attendance of any person and examining him on oath;
  c. Compelling the production of books of account and other documents; and
  d. Issuing commissions.

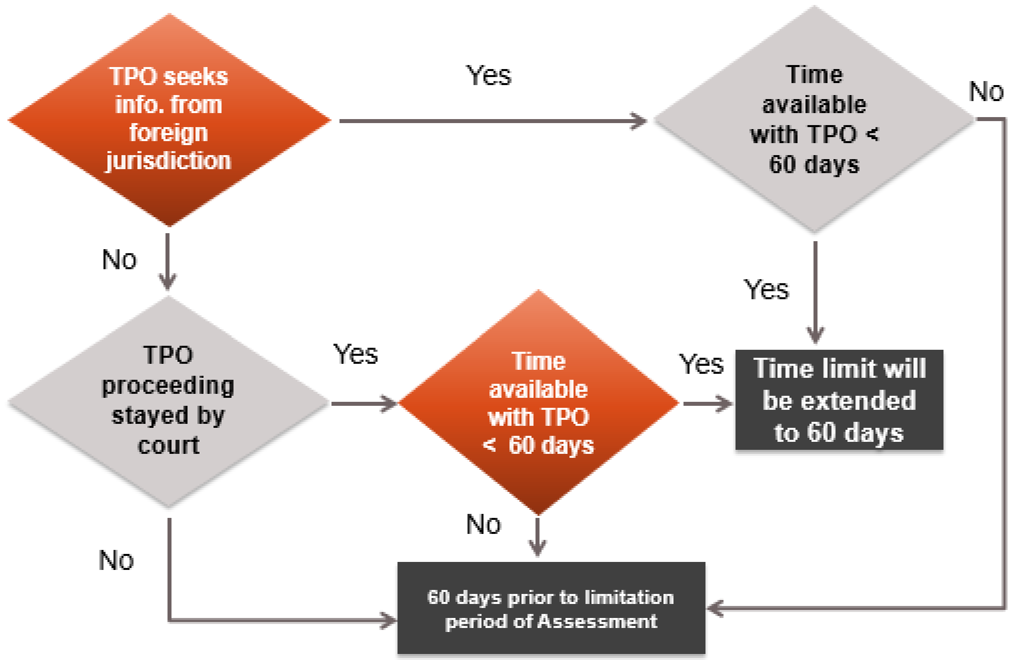
- **Section 133(6)** - TPO may require any person to furnish such information which will be useful for the purpose of enquiry under the IT Act.

- **Section 133A** - TPO may exercise power to impound books of account, place identification marks, etc.

TIME LIMIT FOR AO TO COMPLETE ASSESSMENT PROCEEDINGS



TIME LIMIT FOR TPO TO PASS ORDER



39. SECONDARY ADJUSTMENT – SECTION 92CE

The Finance Act, 2017 has inserted the provision of **"Secondary adjustment"** to reflect that the actual allocation of profits between the assessee and its AE are consistence with the transfer price determined as a result of primary adjustment, thereby **removing imbalance between cash account and actual profit of the assessee**. The provision of secondary adjustment are applicable from the AY 2018-19.

MEANING OF SECONDARY ADJUSTMENT – SECTION 92CE(3)(V)

> "Secondary adjustment" means an **adjustment**
> **in the books of accounts** of
> the assessee and its AE to reflect that the
> actual allocation of profits between the assessee and its AE
> are **consistent with the transfer price** determined
> as a result of primary adjustment,
> thereby **removing** the imbalance between
> **cash account and actual profit** of the assessee.

FORMS OF SECONDARY ADJUSTMENT

As per the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, secondary adjustment may be in the form of

a. Constructive dividends,
b. Constructive equity contributions, or
c. Constructive loans.

The provisions of secondary adjustment seek to align the economic benefit of the transaction with the arm's length position.

Note : -

In case of constructive dividend, excess profit transferred to overseas company would be treated as deemed dividend. However, in case of constructive equity contribution, excess profit would be deemed as equity contribution. India has adopted the concept of constructive loans for secondary adjustment.

CASES WHERE SECONDARY ADJUSTMENT TO BE MADE

Section 92CE(i) provides that the assessee shall make **secondary adjustment** where the **primary adjustment** to transfer price has been : -

a. **made suo motu** by the assessee in his return of income; or
b. made **by** the **Assessing Officer** and has been **accepted by** the **assessee**; or
c. **determined by an advance pricing agreement** entered into by the assessee u/s 92CC; or
d. **made** as per the **safe harbour rules** framed u/s 92CB; or
e. arising as a result of resolution of an assessment by way of the **mutual agreement procedure**.

NOTES : -

1. As per Section 92CE(3)(iv) **"Primary adjustment"** to a transfer price means
   - **determination** of transfer price
   - **in accordance with** the arm's length principle

- **resulting in an increase** in the total income or **reduction in the loss**, of the assessee.

2. **Secondary adjustment** shall be made only when transfer pricing **adjustment** (i.e., primary adjustment) **is accepted by assessee** in aforesaid circumstances. Thus, secondary adjustment shall **not** be made when primary adjustment is **challenged by assessee** before income-tax authorities.

EXAMPLE : -

Analyse the following situations and determine whether secondary adjustment could be made ?

a. ICO (Indian company) has imported certain goods from foreign AE for Rs 20 crores, for which it offered the ALP of 18 crores.
b. ICO has filed ITR and TP report. AO made additions of Rs 5 crores on basis of ALP determined by TPO. Assessee challenged the order before Commissioner (Appeals).
c. ICO has made additions of Rs 10 crore on basis of APA and filed the modified return.
d. ICO filed the income-tax return on basis of MAP and made additions of Rs 4 crores.

SOLUTION : -

a. Secondary adjustment shall be made only when transfer pricing adjustment (i.e., primary adjustment) is accepted by assessee. In this case suo-motu addition made by assessee in its income-tax return will be considered as primary adjustment. Accordingly secondary adjustment can be made subject to non satisfaction of repatriation condition.

b. Secondary adjustment shall be made only when transfer pricing adjustment (i.e., primary adjustment) is accepted by assessee. In this case assessee has not accepted the primary adjustment made by Assessing Officer and therefore secondary adjustment cannot be made.

c. Where the primary adjustment to transfer price has been determined by an APA, secondary adjustment can be made subject to non satisfaction of repatriation condition.
d. Where the primary adjustment to transfer price has been arrived as a result of resolution of an assessment by way of the MAP, Secondary adjustment can be made.

NON-REPATRIATION OF EXCESS MONEY BY THE AE DEEMED TO BE AN ADVANCE

Where, as a result of primary adjustment to the transfer price,
there is an increase in the total income or
reduction in the loss of the assessee,
the excess money which is available with its AE,
if not repatriated to India within the specified time,
shall be deemed to be an advance made by the assessee to such AE and
the interest on such advance,
shall be computed as the income of the assessee, at the prescribed rates.

NOTE :
"Excess money" means the difference between the arm's length price of international transaction [determined in primary Adjustment] and the price at which the international transaction has actually taken place.

EXAMPLE : -

ICO sold goods to its foreign AE located in UK at Rs 10 crores during F.Y. 2017-18. TPO determined the ALP of such sale at Rs 13 crores. The AO made transfer pricing adjustment of Rs 3 crores. Calculate following items:

a. Primary adjustment ?
b. Excess money available with foreign AE ?
c. Additions to be made due to Secondary adjustment ?

SOLUTION : -

a. The transfer pricing adjustment of Rs 3 crores made by Assessing Officer will be the Primary Adjustment.

b. Foreign AE would have paid Rs 13 crores to ICO instead of Rs 10 crores if transaction was carried out at Arm's length price. Thus, excess money of Rs 3 crores (13-10) available with foreign AE should be repatriated to India within specified time.

c. In case excess money is not repatriated to India within prescribed time-limit, such excess money of Rs 3 crores would be deemed as advance made by ICO to foreign AE and interest on such excess money shall be added to the income of the assessee due to secondary adjustment.

TIME-LIMIT FOR REPATRIATION OF EXCESS MONEY TO INDIA – RULE 10CB

S. No.	Situation	Time-limit for repatriation of excess money
1	Where primary adjustments to transfer price has been **made suo-moto by the assessee** in his return of income	Within **90 days from the due date of filing of return** u/s 139(1)
2	If primary adjustments determined in the **order of the Assessing Officer** or the **appellate authority** has been **accepted** by the assessee	Within 9**0 days from the date of the order** of Assessing Officer or Appellate authority
3	Where **agreement for advance pricing** has been entered into by the assessee under section 92CD	Within **90 days from the due date of filing of return** u/s 139(1)
4	Where option of **safe harbour rules** has been opted by the assessee under section 92CB	Within **90 days from the due date of filing of return** u/s 139(1)
5	Where agreement has been made by the assessee under the **Mutual agreement procedure**	Within **90 days from the due date of filing of return** u/s 139(1)

EXAMPLE 1 : -

ICO (Indian Company) has imported certain goods from its foreign AE at Rs 20 crores. It determined arm's length price of such transaction at Rs 15 crores. It made transfer pricing addition of Rs 5 crores in its income-tax return filed on November 30, 2018 for PY 2017-18. Determine the time-limit for repatriation of excess money to India ?

<u>SOLUTION</u> : -

Excess money available with foreign AE would be Rs 5 crores [i.e., the difference between actual transaction price (Rs 20 crores) and arm's length price of Rs 15 crores]. In case primary adjustment has been made by assessee in its income tax return, excess money should be repatriated to India within 90 days from the due date of filing return of income. Thus, excess money of Rs 5 crores should be repatriated to India till February 28, 2019.

<u>EXAMPLE 2</u> : -

In the above example assume that assessee has opted for safe harbour rules. Other facts remain unchanged. Determine the time-limit for repatriation of excess money in such case.

<u>SOLUTION</u> : -

In this case also the excess money shall be repatriated to India within 90 days from the due date of filing of return. Thus, the time-limit for repatriation of excess money to India would be same (i.e., February 28, 2019).

SECONDARY ADJUSTMENT - TIME-LIMIT FOR REPATRIATION OF EXCESS MONEY TO INDIA – RULE 10CB

<u>EXAMPLE 3</u> : -

ICO (Indian Company) has sold goods to its foreign subsidiary at Rs 10 crores during the FY 2017-18. The TPO determined the arm's length price of such transaction at Rs 12 crores. Accordingly, the Assessing Officer made additions of Rs 2 crores in its order dated <u>August 1, 2021</u>. The ICO accepts the order of Assessing Officer. Determine the time-limit for repatriation of excess money to India ?

<u>SOLUTION</u> : -

Excess money available with foreign AE would be Rs 2 crores [i.e., the difference between actual transaction price (Rs 10 crores) and arm's length price of Rs 12 crores]. In case this case, excess money should be repatriated to India within 90 days from the date of order of assessing officer.

Thus, excess money of Rs 2 crores should be repatriated to India till October 30, 2021.

EXAMPLE 4 : -

ICO (Indian Company) entered into an APA on September 1, 2018 for PY 2017-18. It filed its income tax return on November 30, 2018 as per the arm's length price determined under APA. Determine the time-period for repatriation of excess money ?

SOLUTION : -

Excess money should be repatriated to India within 90 days from the due date of filing of income tax return. Thus, excess money should be repatriated to India till February 28, 2019.

EXAMPLE 5 : -

In the previous example assume that Indian company has filed its income tax return on November 15, 2018. Other facts remain unchanged. Determine the time-period for repatriation of excess money ?

SOLUTION : -

Excess money should be repatriated to India within 90 days from the due date of filing of income tax return. In this case period of 90 days should be counted with reference to November 30, 2018 even if income tax return has been filed before the due date of filing of return. Thus, excess money should be repatriated to India till February 28, 2019.

RATE AT WHICH INTEREST INCOME SHALL BE COMPUTED UNDER SECONDARY ADJUSTMENT - RULE 10CB

The excess money which is available with its AE, if not repatriated to India within the aforesaid time-limit, shall be deemed to be an advance made by the assessee to such

AE. The interest income on such advance, shall be computed as per the following rate of interest :

Situation	Rate of interest
Where the international transaction is denominated in Indian rupee	One-year marginal cost of fund lending rate of SBI as on 1st April of the relevant previous year + 3.25%
Where the international transaction is denominated in foreign currency	Six-month London Interbank Offered Rate (LIBOR) as on 30th September of the relevant previous year + 3.00%

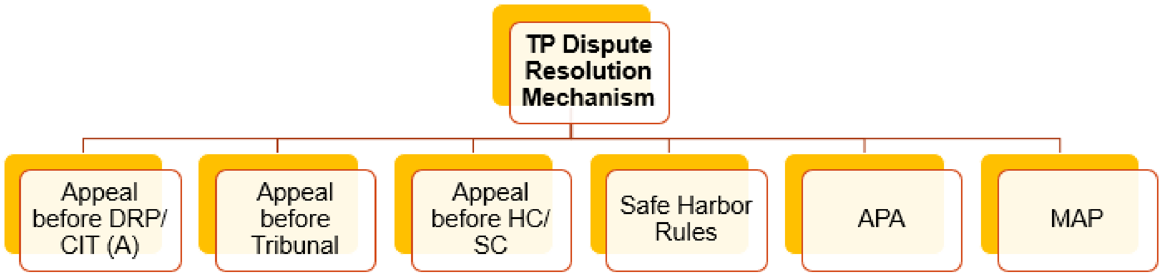
EXEMPTION FROM SECONDARY ADJUSTMENT

Secondary adjustment shall not be carried out if, the amount of primary adjustment in any previous year does not exceed Rs 1 crore **and** the primary adjustment is made in respect of A.Y.2016-17 or an earlier assessment year.

40. DISPUTE RESOLUTION MECHANISM UNDER TRANSFER PRICING

The tax dispute resolution mechanism under transfer pricing in India consists of the following forums : -

- **DRP** or Appeal before the **Commissioner of Income Tax (Appeals)**;
- Income Tax Appellate **Tribunal;**
- The **High Court / Supreme Court**;
- **Safe Harbour** Rules;
- **Advance Pricing Agreement**; and
- **Mutual Agreement Procedure**



DISPUTE RESOLUTION PANEL - [SECTION 144C] – FEATURES

FEATURES OF DRP ARE LISTED BELOW : -

a. CBDT has constituted a panel [DRP] comprising of **three Principal Commissioners or Commissioners of Income-tax**.

b. The following assessees are **Eligible assessees** for filing objections before the DRP:-
   a. **Foreign Company**.

   b. Any person in whose case **variation arises on account of order of Transfer Pricing Officer**, passed, under Section 92CA(3).

c. The AO shall, forward a "**proposed assessment order** (draft order)" to the eligible assessee if he **proposes** to make [on or after 1st October, 2009] any **variation in the income or loss returned** which is prejudicial to the interest of such assessee.

d. Assessee can **file objections** against the **draft order** with the DRP within **30 days** of the **receipt of the draft order.**

e. Where any objections are received from assessee, DRP shall **issue directions for guidance of the AO** to enable him to complete the assessment (after considering draft order, all objections, evidence, etc.). Such direction should be issued **within nine months from the end of the month in which the draft order is forwarded to the eligible assessee**.

f. Before issuing any such directions, **DRP may** : -

   - make **further enquiry itself**; or

- cause any further enquiry to be **made by any income tax authority** and report the result of such enquiry to DRP.

g. The Dispute Resolution Panel may : -
   - **confirm** the additions proposed by AO;
   - **reduce** the additions proposed by AO; or
   - **enhance** the additions proposed by AO
   - in the draft order.

Note : -

DRP cannot set aside any proposed variation or issue any direction for further enquiry and passing of the assessment order.

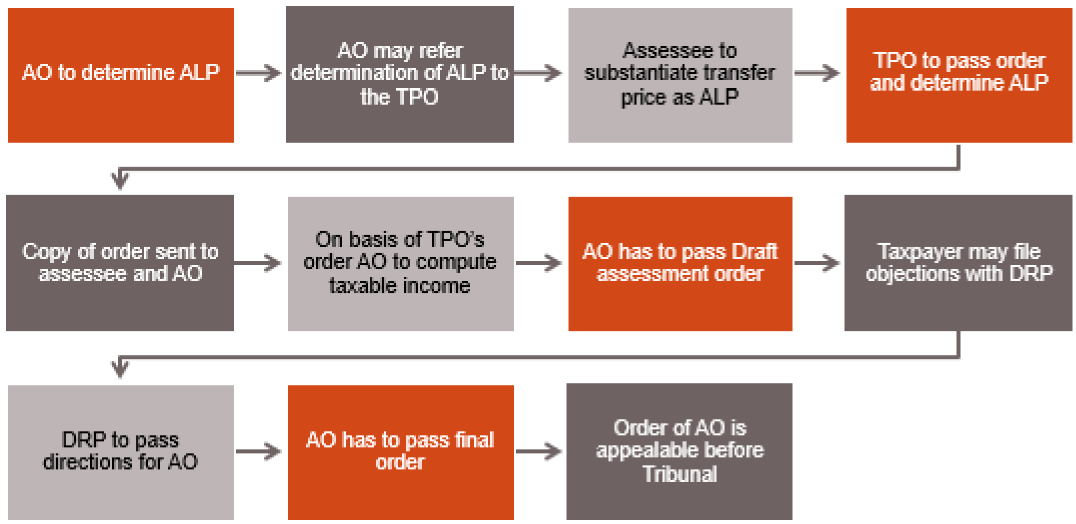
h. Upon receipt of such direction of DRP, the **Assessing Officer shall complete the assessment in accordance with such direction**, within **one month** from the end of the month in which the direction is **received without** providing any further **opportunity** of being heard to the assessee.

k) Such order of the Assessing Officer is **directly appealable before the Tribunal.**

Note : -

AO has to pass order within aforesaid time-limit notwithstanding time-limit of assessment given under Section 153/153B.

PROCEDURE TO BE FOLLOWED BY ASSESSEE UNDER DRP ROUTE



DISPUTE RESOLUTION MECHANISM - APPEAL BEFORE THE COMMISSIONER OF INCOME TAX (APPEALS) – [SECTIONS 246A, 249 & 250]

Appeal may be made before CIT(A) against : -

a. Assessment order passed **u/s 143(3) or 144** of the IT Act.
b. Intimation **u/s 143(1).**
c. Reassessment order **u/s 147 or 150** (re-computation).
d. Assessment or reassessment in **search cases u/s 153(A).**
e. Rectification **Order u/s 154.**
f. Assessment or reassessment order under **Section 92CD(3)**

NOTES : -

- **Section 150** deals with assessment/ re-assessment/ re-computation is made in order to give effect of any finding or direction contained in an order passed by any Income tax authority or by a court.

- **Section 153A** prescribes assessment procedure in case of search and seizure.

- **Section 92CD(3)** deals with assessment/ re-assessment/ re-computation of total income by the AO where APA has been entered by the assessee.

- AO to determine ALP u/s 9**2C(3).**

- **Appeal before CIT(A)** has to be filed **within 30 days of receipt of assessment order** alongwith demand notice issued by the AO.

- **Filing fee** is to be paid at the time of filing appeal.

- The CIT(A) cannot set-aside the order passed by the Assessing Officer

KEY DIFFERENCES BETWEEN THE DRP AND THE APPEAL PROCESS BEFORE THE CIT (A)

Aspect	DRP	CIT (A)
Constitution	Case heard by **3 Commissioners**	Case heard by a single Commissioner
Time limit for filing objections/ Appeal	Objections should be filed within 30 days of receipt of the draft AO order	An appeal may be filed within 30 days of the date on which intimation of concerned order is served
Condonation of delay	No condonation	Condonation at the discretion of CIT(A)
Filing Fees	Nil	Rs 250 to Rs 1,000, depending upon assessed income
Stay of demand	Automatic stay as the order is a draft order	Stay application to be filed with the Tax Officer, and if rejected, demand is to be paid (as deducted by AO)
Time limit for completion	DRP should issue direction within 9 months from the end of the month in which the draft order is forwarded to the assessee	May be decided within a year from the end of the financial year in which such appeal is filed

KEY DIFFERENCES BETWEEN THE DRP AND THE APPEAL PROCESS BEFORE THE CIT (A)

Aspect	DRP	CIT (A)
Penalty Proceedings	**No penalty** proceedings until matter is disposed	Generally, penalty proceedings are **initiated by AO** with order and stay application of penalty needs to be filed
Next steps on completion of Proceedings	Upon receipt of direction of DRP, the **Assessing Officer shall complete the assessment** and pass final order	Order of the CIT(A) once passed, is **sent to the AO** who will pass an assessment order giving effect to the order of the CIT(A)

NOTE :

The CBDT's press release, dated 30.12.2015, mandates electronic filing of appeal before CIT(Appeals) for persons who are required to file the return of income electronically.

DISPUTE RESOLUTION MECHANISM - APPEAL BEFORE THE INCOME TAX APPELLATE TRIBUNAL [SECTIONS 253 & 254]

Features of the appeal process before the Income Tax Appellate Tribunal are listed below:

Once the AO's order is issued after giving effect to DRP directions or CIT(A),
an appeal can be filed with
the Income-tax Appellate Tribunal ('the Tribunal')
within a period of 60 days from the date
on which the order sought to be appealed against is
communicated to the
assessee or
the Principal Commissioner or
Commissioner

- The Principal Commissioner or Commissioner of **Income-tax can direct Assessing officer to file an appeal before Tribunal** on a matter where the CIT(A) has held in favour of the assessee.

- If any **demand is payable pursuant to the DRP directions**, a stay application will need to be filed with the AO requesting for a stay of demand, where order is passed.

- If the **stay application is rejected by AO**, the demand is either to be **paid** by the assessee or assessee can prefer a **stay application before the Tribunal.**

- The Tribunal should pass order after **hearing arguments** from both the assessee and the Revenue authorities.

- After order of Tribunal is issued, **AO shall pass an order giving effect to ITAT** and consequential demands would be paid off by assessee/ refund would be issued to Assessee.

DISPUTE RESOLUTION MECHANISM - APPEAL BEFORE THE HIGH COURT [SECTION 260A]

- Assessee or revenue aggrieved by any order passed by the Tribunal **may file appeal before High Court.**

- Appeal can be **filed by** the aggrieved –

  a. Principal Chief Commissioner; or
  b. Chief Commissioner; or
  c. Principal Commissioner; or
  d. Commissioner; or
  e. Assessee

Appeal should relate to question of law : -

- HC shall admit appeal if it is satisfied that the case involves a '**substantial question of law**', and
- Appeal shall be heard by at least 2 judges of the High Court.
- Substantial Question of Law implies that the appeal related to

  a. **Debatable** issue;
  b. Issue **not settled by Law of Land**;
  c. Issue **not s**ettled by a **binding precedent**;
  d. Has a **material bearing on decision of the case**

TIME LIMIT : -

- Appeal can be filed **within 120 days from the date of receipt of the Tribunal's order**

- **Jurisdiction** of High Court is decided on the basis of the **location of AO** who has passed the disputed order in a particular case.

DISPUTE RESOLUTION MECHANISM - APPEAL BEFORE THE SUPREME COURT [SECTIONS 261 & 262]

- Appeal can be filed with Supreme Court against order of the High Court (within 90 days of the service of judgment under Code of Civil Procedure, 1908) provided High Court certifies that the case is fit for appeal before the Supreme Court.

- However, if High Court refuses to certify it to be a fit case, then special leave petition (SLP) can be made before the Supreme Court under Article 136 of the Constitution.

- Any Decision of Supreme Court becomes the Law of the Land

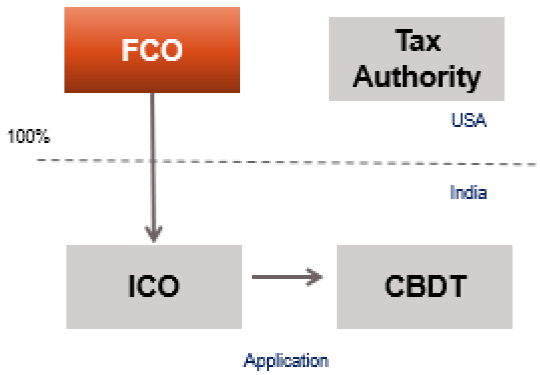
DISPUTE RESOLUTION MECHANISM - THE MONETARY TAX LIMITS

The monetary tax limits for Departmental appeal before ITATs, HCs and SCs are as follows : -

Appeal by revenue authorities	Monetary limit of tax
Before ITAT	Rs. 10,00,000
Before High Court	Rs. 20,00,000
Before Supreme Court	Rs. 25,00,000

41. ADVANCE PRICING AGREEMENT

WHAT IS ADVANCE PRICING AGREEMENT ('APA') ?



a. An APA is an **agreement** **between a tax payer/applicant and the CBDT**,
   i. which **determines the arm's length price** of future intercompany transactions; or
   ii. determines the **manner in which ALP is to be computed**.

b. APA can also be used for **existing intercompany transactions** (i.e., under roll back provisions of APA).

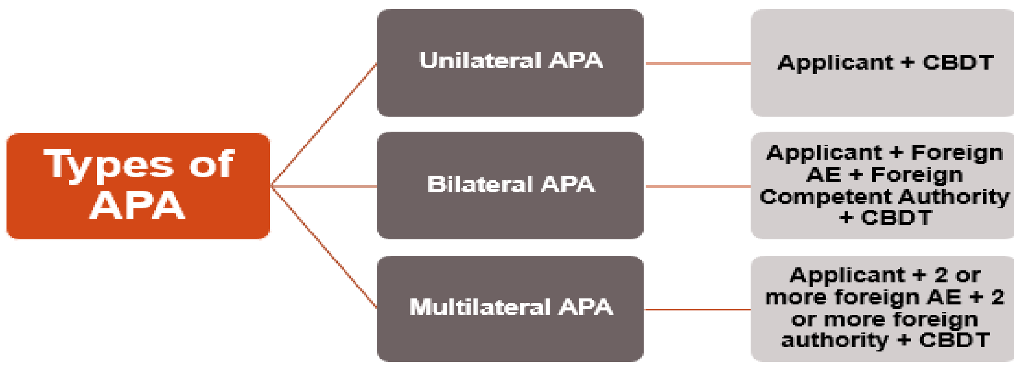
c. APA provisions are contained in **Section 92CC and Section 92CD** of the Income-tax Act, 1961 and **Rules 10F to 10T** of the Income-tax Rules, 1962.

APPLICATION OF APA – BINDING NATURE

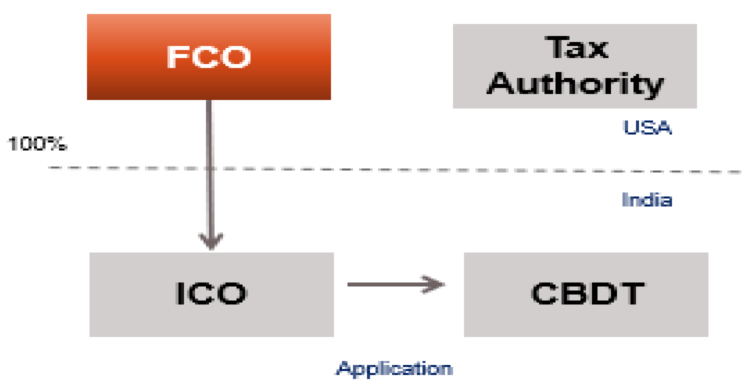
Once an APA has been entered into
with respect to an international transaction,
the arm's length price
with respect to that international transaction,
will **be determined only in accordance with the APA**,
for the period specified in the APA.

> **NOTE :**
>
> **SUCH APA IS BINDING ON PERSONS AND IT AUTHORITIES.**

TYPES OF APA – UNILATERAL, BILATERAL AND MULTILATERAL



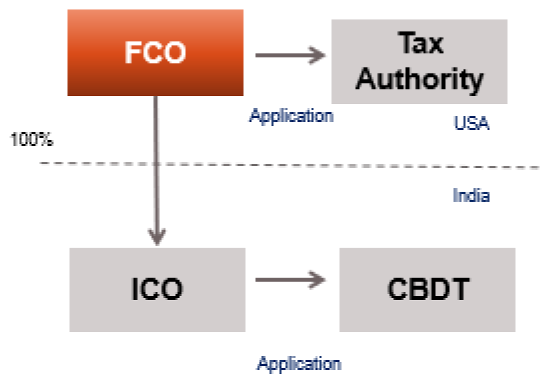
TYPES OF APA - UNILATERAL APA



- Unilateral APA is an Agreement **between** the assessee (applicant) and **CBDT**;
- It **does not involve** any **Treaty Partner** (i.e., foreign authority);
- It does **not guarantee** that the Arm's Length Price/ Transfer Pricing method determined under APA **shall be accepted by the country of residence** of foreign AE. Accordingly, it does not completely eliminate double taxation risk.

TYPES OF APA - BILATERAL APA

Bilateral APA is an agreement **between**
Applicant (i.e., assessee),
Foreign AE,
Foreign authority, and
CBDT



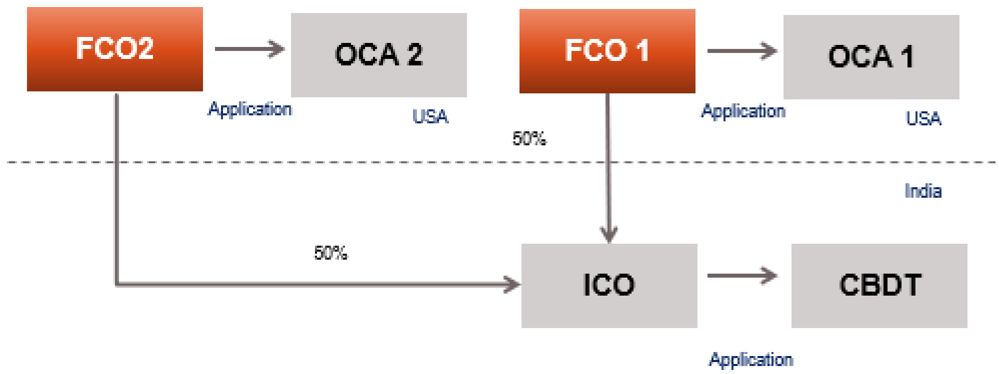
NOTE :

- In bilateral APA, **applicant** is required to **make** an **application** with **competent authority of India** and **simultaneously** the **applicant or its AE** should also apply to **Competent Authority of other Country**.
- The **two competent authorities** are required to **reach an arrangement** through Mutual Agreement Procedure (to be discussed later), **which has to be accepted by applicant** before bilateral APA can be entered into.

TYPES OF APA - MULTILATERAL APA

involves

Applicant (i.e., the taxpayer),
Two or more **AE**s,
Two or more **foreign tax authori**ties, and
CBDT



NOTE :

- In Multilateral APA, **applicant** is required to make an application with **competent authority of India** and simultaneously the **applicant or its AE** should apply to **competent authorities of the other Countries**.
- **CBDT** has to reach an **arrangement through MAP with competent authorities** of more than one Country. Mutual Agreement Procedure has to be **accepted by applicant** before multilateral APA can be entered into.

REQUIREMENTS TO REQUEST FOR BILATERAL OR Multilateral APA

Request for bilateral or multilateral APA can be accepted by the Indian competent authority on satisfaction of **following conditions**:

a. India has a **tax treat**y (i.e., DTAA) with the **Other Contracting State**, **and** such treaty has an **Article on 'Mutual Agreement Procedure' (MAP);**

b. **Corresponding APA program** is also there in the other country.

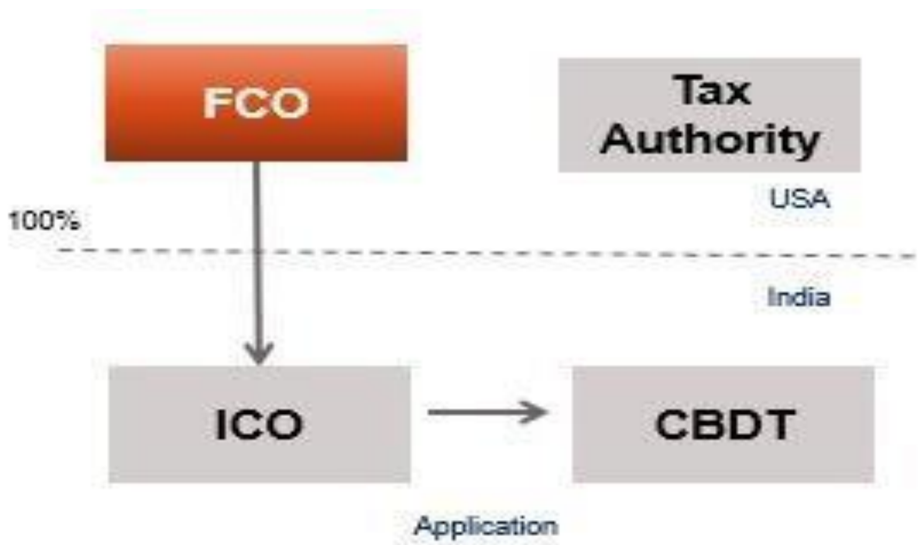
ADVANTAGES OF APA PROGRAM

The APA program is designed to provide following advantages : -

a. **Certainty** over determination of ALP of covered international transaction;

b. Flexibility in developing **practical approaches** for complex transfer pricing issues;
c. **Reduce risk** of potential **double taxation** via Bilateral and Multi-lateral APA;
d. **Reduce compliance costs** by eliminating the risk of transfer pricing audit and resolving time consuming litigation;
e. **Reduce the burden of record keeping**, as required documentation of the APA are known in advance.

PURPOSE OF APA – SECTION 92CC



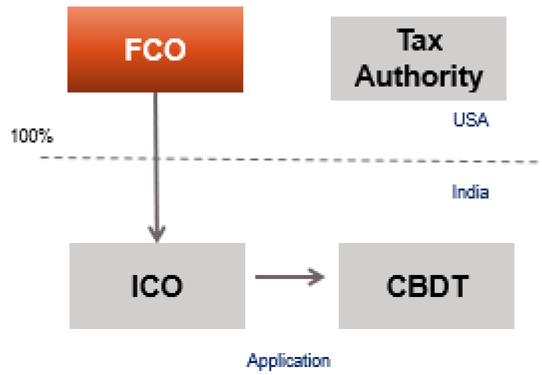
The APA shall be entered into
for the **purpose of determination of**
the arm's length price or
specifying the manner (i.e., method of determining arm's length price)
in which arm's length price shall be determined,
in relation to **international transaction**.

> **NOTE :**
> **APA IS NOT APPLICABLE FOR SPECIFIED DOMESTIC TRANSACTIONS.**

MANNER OF DETERMINATION OF ALP IN APA – SECTION 92CC

The manner for determination of

arm's length price in the APA, may include
CUP, TNMM, RPM, etc. [as defined in section 92C(1)] or
any other method, with necessary adjustments or variations as may be decided in APA.



ALP OF INTERNATIONAL TRANSACTION IN CASE OF APA – SECTION 92CC

In case an APA has been entered into
in respect of any international transaction,
the **arm's length price of that transaction shall be determined in accordance with that APA**

> **NOTE :**
> **The provisions of Section 92C or section 92CA, which are normally applicable for determination of arm's length price shall not be applicable in such a case.**

EXAMPLE : -

ICO (Indian company) , which avails consulting services from its foreign AE, has entered into an APA with CBDT and ALP under APA was determined at Rs. 10 lakh under APA.

a. Whether Assessing officer can challenge such arm's length price and make reference to transfer pricing officer (u/s 92CA) to determine arm's length price of such transaction ?

b. Whether Assessing officer can challenge arm's length price determined under APA on the ground that arithmetic mean method under Section 92C is not used, where more than one price is available ?

APPLICABILITY OF APA – SECTION 92CC

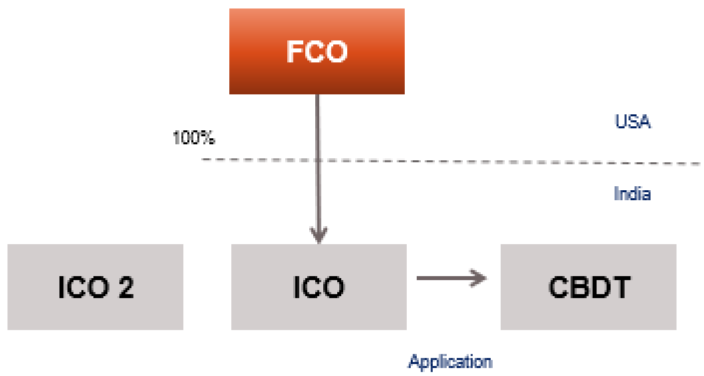
SOLUTION : -

The provisions of the APA shall override the provisions of section 92C or section 92CA, which are normally applicable for determination of arm's length price. Thus, the Assessing officer cannot challenge arm's length price determined under APA on aforesaid grounds.

VALIDITY PERIOD OF APA – SECTION 92CC

The APA shall be valid for the period specified therein subject to a maximum period of more than **5 consecutive previous years**.

BINDING NATURE OF APA – SECTION 92CC



The APA shall be binding on : -

a. **The person**
who has entered into an APA,
in respect of the transaction specified in APA; and

b. **The Principal Commissioner** or
Commissioner and
the **income-tax authorities subordinate to him**,
in **respect of the said person** and the said transaction.

NOTE :

The manner of determining arm's length price under APA is not binding on any other person (other than person who has entered into an APA) who also wants to enter into similar transaction.

EXAMPLE : -

ICO (Indian Company) entered into APA with CBDT to determine arm's length price of Silk Cotton, to be imported from Foreign Company (UK). ICO 1 (another Indian company) wants to import same silk cotton from its Foreign Company (UK). ICO 1 wants to adopt same method as determined under APA of ICO with CBDT.

Analyse the followings situations :

a. Whether ICO1 can adopt method specified in APA ?

b. What would be your answer if ICO1 is a subsidiary of ICO ?

APPLICABILITY OF APA – SECTION 92CC

SOLUTION : -

a. APA is binding **only on the applicant** who has entered into an APA and not on any other person. Thus, **ICO1 cannot** adopt method specified in APA entered by ICO.
b. APA is binding only on the applicant who has entered into an APA and not on any other person. Therefore, **answer will remain same even if ICO1 is a subsidiary of ICO**.

APPLICABILITY OF APA in case of change in law or facts – SECTION 92CC

The APA shall not be binding on the applicant or income-tax authorities if there is

- **any change in law ; or**
- **any change facts**

which have impact on such APA.

CONDITIONS TO DECLARE APA AS VOID AB INITIO – SECTION 92CC

If the CBDT finds that the APA has been obtained

by the person
by way of fraud or
misrepresentation of facts,
the **CBDT may declare such APA to be *void ab initio***,
with the approval of Central Government.

> **NOTE :**
>
> **Declaration of APA as void ab initio means that APA would be declared as void from the beginning of the first year from which the APA was applied.**

CONSEQUENCES OF DECLARATION OF AN APA AS VOID AB INITIO – SECTION 92CC

Declaration of an APA as void ab initio has following repercussions :

a. IT Act provisions would be applicable to applicant, assuming the APA was never entered.

CONSEQUENCES OF DECLARATION OF AN APA AS VOID AB INITIO – SECTION 92CC

EXAMPLE : -

ICO has entered into an APA with CBDT for international transactions on 31.12.2016, during PY 2016-17. Such APA was declared as void ab initio by CBDT during PY 2017-18 on September 30, 2017 . Whether ICO can adopt the transfer pricing method declared in APA while computing its taxable income of AY 2017-18 ?

SOLUTION : -

When APA is declared as void-ab-initio then, all the provisions of the Act shall apply to such person, as if such APA had never been entered into. Thus, such APA would be void from the beginning when such APA was entered into (i.e., from PY 2016-17). Accordingly, the ICO cannot adopt the transfer pricing method arrived at in the APA while computing its taxable income of AY 2017-18.

Declaration of an APA as *void ab initio* has following repercussions :

b. The period beginning with the
   date of such APA and
   ending on the **date of order declaring the APA as void ab initio**,
   shall be excluded
   for the purpose of computation of period of limitation
   under the Act (viz., period of limitation specified in the
   Section 153, 153B, etc).

ICO has made APA with CBDT on October 30, 2018 for international transactions entered with foreign subsidiary during the PY 2017-18. However, it was discovered that the ICO has misrepresented certain facts and accordingly, such APA was declared as void-ab-initio by CBDT on November 20, 2018. Calculate the period of limitation for completing scrutiny assessment under Section 143(3) for AY 2018-19 ?

SOLUTION : -

As per Section 153 of the IT Act, scrutiny assessment should be completed within 18 months from the end of AY in which income was assessable [For AY 2018-19]. Thus, the normal time-limit to complete the scrutiny assessment for AY 2018-19 is September 30, 2020.

However, the period beginning with the date of APA and ending on the date when APA was declared as void-ab-initio (i.e., **21 days**) should be excluded from the limitation period under Section 153. Thus, the normal time-limit under Section 153 (i.e., September 30, 2020) would be further extended by 21 days. The extended period to complete assessment would be October 21, 2020.

NOTE :

In case the period of limitation after exclusion of the above-mentioned period [i.e., the period beginning from date of APA till its is declared as void] is less than 60 days, such remaining period of limitation shall be extended to 60 days.

PROCEEDING DEEMED TO BE PENDING IN CASE OF APA– SECTION 92CC

If an application is made by a person for entering into an APA, then, the proceeding in respect of such person shall be deemed to be pending.

APA RULES

Advance Pricing Agreement Scheme has been prescribed for the purpose of section 92CC vide Notification No.36/2012 dated 30.8.2012 and Notification No.23/2015 dated 14.3.2015. The CBDT has prescribed rules specifying an APA Scheme.

PERSON ELIGIBLE TO APPLY FOR APA – RULE 10G

Any person

i. who **has undertaken** an international transaction; or

ii. is **contemplating to undertake** an **international transaction**,

shall be eligible to enter into an APA under these rules.

> **NOTE :**
>
> **APA IS NOT APPLICABLE FOR SPECIFIED DOMESTIC TRANSACTIONS.**

PRE-FILING CONSULTATION UNDER APA - RULE 10H

a. Any person proposing to enter into an APA **may**,
by an application in writing,
make a request for a pre-filing consultation

in the **Form No. 3CEC**

to the Director General of Income-tax (International Taxation).

> **NOTE :**
>
> 1. **Generally, the purpose of pre filing consultation is to enable the assessee and CBDT to assess the possibility of entering into an APA.**
> 2. **Pre-filing consultation process is not mandatory for applicants proposing to enter into an APA.**

b. The pre-filing consultation shall be for the purpose of :

i. **Determining the scope** of the Advance Pricing agreement;
ii. **Identifying transfer pricing issues** which could be covered under APA;
iii. Whether the **given** international transaction is **suitable** for the agreement;
iv. Discussion on **broad terms** of the agreement.

c. The pre-filing consultation shall :

i. **not bind** the CBDT or the proposed applicant to initiate APA process;
ii. **not be deemed** to mean that the **person has applied** for entering into an APA.

APPLICATION FOR APA - RULE 10I

1. An **eligible person** can apply for APA in **Form No. 3CED** (proof of payment of requisite fee required).
2. Such application shall be **furnished to** :
   1. **Director General of Income-tax (International Taxation)** in case of **unilateral** APA and
   2. to the **competent authority in India** in case of **Bilateral** or **Multilateral** APA.

TIME LIMIT FOR FILING APA - RULE 10I

The APA application may be filed at any time -

1. **Before the first day of PY relevant to the first AY for which the application is made**, in respect of **transactions** of a **continuing nature from dealings that are already occurring**; or
2. **before undertaking the transaction** in respect of **remaining transactions.**

NOTE :

APA APPLICATION CAN BE WITHDRAWN AT ANY TIME BEFORE THE FINALIZATION OF THE TERMS OF THE AGREEMENT.

EXAMPLE 1 : -

ICO has undertaken transaction for sale of product A to its foreign subsidiary during the PY 2015-16, 2016-17 and 2017-18. It intends to apply for APA for same transaction, to be undertaken in the PY 2018-19. Determine the time limit for filing APA application ?

<u>SOLUTION</u> : -

In this case transaction of sale of Product A to foreign subsidiary is continuing in nature as the ICO has undertaken the same transaction in the PY 2015-16, 2016-17 and 2017-18. Hence ICO shall file the application for APA till March 31, 2018.

<u>EXAMPLE 2</u> : -

In the previous example assume that the ICO has not undertaken transaction of sale of product A to its foreign subsidiary in any of the preceding years. If other fact remain same, determine the time limit for filing of APA application for the FY 2018-19?

<u>SOLUTION</u> : -

In this case ICO needs to file the APA application before the date of proposed transaction.

APPROVAL OF CENTRAL GOVERNMENT

The APA shall be entered into by the CBDT with the applicant after taking approval from the Central Government.

TERMS OF APA - RULE 10M – INCLUSIONS IN AN APA

a. **An APA may among other things, include :**

i. **Covered international transactions** covered by the APA;
ii. **agreed** transfer pricing **methodology**, if any;
iii. Determination of **arm's length price**, if any;
iv. **Definition** of any **relevant term** to be used in agreed TP methodology/ determination of ALP.
v. **Critical assumptions** i.e., the factors and assumptions that are so critical and significant that neither party will continue to be bound by the agreement, if any of the factors or assumptions is changed;
vi. **Rollback provision** referred to in **Rule 10MA** [i.e., APA terms would be applicable for preceding 4 years];
vii. The conditions, if any, **other than provided in the Act** or these rules.

TERMS OF APA - RULE 10M - CHANGE IN CONDITIONS/ CRITICAL ASSUMPTIONS

- The **APA shall not be binding** on the **Board** or the **assessee** if
  - there is a **change** in any of critical assumptions or
  - **failure to meet** conditions subject to which the APA has been entered into.

- In such a case the agreement can be **revised or cancelled**, as the case may be.

- The binding effect of agreement, shall cease, **only if any party has given due notice** of the concerned other party or parties.

Furnishing of annual compliance report - Rule 10-O

The assessee shall furnish an
annual compliance report in quadruplicate in
Form No. 3CEF
to Director General of Income-tax (International Taxation) for
each year covered in the agreement, within

- 30 days of the due date of filing income-tax return for that year, or
- within 90 days of entering into an APA,

  whichever **is later.**

EXAMPLE 1 : -
On August 1, 2018, ICO entered into an APA with CBDT for AY 2018-19. Determine the due date of filing of compliance report by ICO ?

SOLUTION : -
Compliance report shall be filed by the applicant
within 30 days of the due date of filing income-tax return (December 30, 2018) , or
within 90 days of entering into an APA (October 30, 2018) ,
whichever, is **later**.

Step I : Count 30 days from the due date of filing of income-tax returns - December 30, 2018

Step II : Count 90 days from the date of entering into an APA - October 30, 2018.

Due date mentioned in Step I (i.e., December 30, 2018) is after the due date mentioned in Step II (i.e., October 30, 2018). Thus, the compliance report shall be filed by the applicant till December 30, 2018.

> **<u>NOTE</u> :**
>
> **The due date of filing of income-tax return by ICO is November 30, 2018 as ICO is liable to furnish TP audit report in Form 3CEB.**

<u>EXAMPLE 2</u> : -

In the previous example, assume that ICO has entered into an APA on October 31, 2018 for AY 2018-19. Determine the due date of filing of compliance report by ICO ?

<u>SOLUTION</u> : -

Step I : Count 30 days from the due date of filing of income-tax returns - December 30, 2018;
Step II: Count 90 days from the date of entering into an APA - January 29, 2019.
Due date mentioned in Step I (i.e., January 29, 2019) is after the due date mentioned in Step I (i.e., December 30, 2018). Thus, the compliance report shall be filed by the applicant till January 29, 2019.

> **<u>NOTE</u> :**
>
> **The due date of filing of income-tax return by ICO is November 30, 2018 as ICO is liable to furnish TP audit report in Form 3CEB.**

COMPLIANCE AUDIT OF THE AGREEMENT - RULE 10P

a. The **<u>Transfer Pricing Officer</u>** having the jurisdiction over the assessee shall carry out the **<u>compliance audit of the APA</u>** for each of the year covered in the agreement. For this purpose, the Transfer Pricing Officer **<u>may require the assessee to</u>** –

i. to **substantiate compliance** with the terms of the agreement,
including satisfaction of the critical assumptions,
correctness of the supporting data or
information and consistency of the application of the transfer pricing method;

ii. **submit any information**, or document, to establish compliance with the terms of the agreement.

b. The compliance audit report shall **be furnished by the Transfer Pricing Officer within 6 months from the end of the month in which the Annual Compliance Report is received** by the Transfer Pricing Officer.

EXAMPLE : -

On November 1, 2018, ICO submitted the annual compliance report for APA entered for AY 2018-19. Determine the due date of filing of compliance audit report by the TPO ?

SOLUTION : -

The compliance audit report shall be furnished by the Transfer Pricing Officer within six months from the end of the month in which the Annual Compliance Report is received by the Transfer Pricing Officer.
Thus, the due date of filing of compliance audit report by the transfer pricing officer would be May 31, 2019.

FAQ'S ON ANNUAL COMPLIANCE AUDIT

QUESTION 9 OF FAQ'S ISSUED BY CBDT VIA CIRCULAR NO. 10/2015, DATED 10.06.2015 : -

Will there be compliance audit for roll back ? Would critical assumptions have to be validated during compliance audit ?

ANSWER : -

Since rollback provisions are for past years, **ALP for the rollback years would be agreed after full examination of all the facts**, including validation of critical assumptions. Hence, compliance audit for the rollback years would primarily be to check if the agreed price or methodology has been applied in the modified return.

REVISION OF AN APA - RULE 10Q

Who can request revision ?

An APA,
may be revised by the CBDT
either

a. suo moto or
b. on request of the assessee or
c. the competent authority in India or
d. the Director General of Income-tax (International Taxation)

When can the revision be done ?

The revision can take place in following situations : -

i. change in critical assumptions or failure to meet a condition, subject to which the APA was entered into;
ii. change in law that modifies any matter covered by the APA, but is not of the nature which renders the agreement to be non-binding ; or
iii. request from competent authority in the other country requesting revision of APA, in case of bilateral or multilateral agreement.

OPPORTUNITY OF BEING HEARD :

Except in case **where the assessee has made request** for revision of APA, it shall not be revised, **unless**

a. an **opportunity of being heard** has been provided to the assessee and
b. the **assessee is in agreement** with the proposed revision.

Applicability of revised APA : -

The revised APA **shall include the date till which the original agreement is to apply** and the date from which the revised APA is to apply.

CANCELLATION OF AN APA - RULE 10R

a. An agreement shall be cancelled by the CBDT for any of the following reasons : -

i. compliance audit reveals **assessee's failure to comply with the APA terms**;

ii. **Failure** to **file** the **annual compliance report** in time;

iii. **Material errors** in the annual compliance report furnished by the assessee; or

iv. the **assessee disagrees with the proposed revision** in APA or

v. Rule 10RA(7) - When **applicant** had opted for APA with rollback provision and **failed to give effect to rollback rules**;

CANCELLATION OF AN APA - RULE 10R – FAQ

QUESTION 6 OF FAQS ISSUED BY CBDT VIA CIRCULAR NO. 10/2015, DATED 10.06.2015 : -

Rule 10RA(7) states that in case effect cannot be given to the rollback provision of an agreement in accordance with this rule, for any rollback year to which it applies, on account of failure on the part of applicant, the agreement shall be cancelled. It is to be clarified as to whether the entire agreement is to be cancelled or only that year for which roll back fails ?

ANSWER : -

The procedure for giving effect to a rollback provision is laid down in Rule 10RA. Subrules (2), (3), (4) and (6) of the Rule specify the actions to be taken by the applicant in order that effect may be given to the rollback provision. If the applicant does not carry out such actions for any of the rollback years, the entire agreement shall be cancelled.

CANCELLATION OF AN APA - RULE 10R

b. The CBDT shall give an **opportunity of being heard to the assessee**, before proceeding to cancel an application of APA.

c. The order of cancellation of the agreement

i. shall be in **writing** and

ii. shall **provide reasons for cancellation** and for non-acceptance of assessee's submission.

iii. specify the **effective date** of cancellation of the agreement, where applicable.

d. The order declaring the agreement as void ab initio, **on account of fraud or misrepresentation of facts,**

i. shall be in **writing** and

ii. shall provide **reason** for such declaration and for non-acceptance of assessee's submission.

OPERATION OF TRANSFER PRICING PROVISIONS IN CASE OF PENDING APA APPLICATION

Mere filing of an application for an APA shall not prevent the operation of Chapter X (i.e., transfer pricing provisions) of the Act for determination of arms' length price till the APA is entered into.

NEGOTIATION IN CASE OF APA

The negotiation between

the competent authority in India and the competent authority of other country or countries,

in case of bilateral or multilateral APA,

shall be carried out in accordance with the provisions of the tax treaty between India and the other country or countries.

PROVISION FOR ROLL BACK IN APA SCHEME - SECTION 92CC

In order to reduce pending as well as future litigation in respect of the transfer pricing matters, section 92CC(9A) provides for roll back mechanism in the APA scheme.

The CBDT has, vide ***Notification No.23/2015 dated 14.3.2015*, prescribed** conditions, procedure and manner for determining the arm's length price or for specifying the manner in which arm's length price is to be determined in an APA**.**

ROLL BACK MECHANISM - RULE 10MA

The APA may provide for determining the
arm's length price or
specify the manner in which arm's length price shall be determined
in relation to the international transaction
entered into by the person **during the rollback year**

> **NOTE :**
>
> **Rollback year means any previous year,**
>
> **falling within the period not exceeding four previous years,**
>
> **preceding the first year of applicability of APA, in respect of international transaction to be undertaken.**

EXAMPLE : -
ICO enters into an APA for the AY 2018-19 for international transaction with foreign AE. In this case the roll back year means AY 2017-18, 2016-17, 2015-16 and 2014-15.

CONDITIONS FOR APPLYING FOR ROLLBACK PROVISIONS – RULE 10MA

The APA shall contain rollback provision in respect of an international transaction subject to the following conditions : -

1. The **international transaction** undertaken in roll back years **should be same** as the international transaction to which the APA (other than the rollback provision) applies;

> **NOTE :**
>
> **International transaction undertaken in roll back years should be of same nature and undertaken with same AE as proposed to be undertaken in future years in APA.**

QUESTION 2 OF FAQS ISSUED BY CBDT VIA CIRCULAR NO. 10/2015, DATED 10.06.2015 : -

Rule 10MA(2)(i) mandates that the rollback provision shall apply in respect of an international transaction that is same as the international transaction to which the agreement (other than the rollback provision) applies. It is not clear what is the meaning of the word "same". Further, it is not clear whether this restriction also applies to the Functions, Assets, Risks (FAR) analysis ?

ANSWER : -

The term **same international transaction** implies that the transaction in the rollback year has to be of **same nature** and **undertaken with the same associated enterprise(s),** as proposed to be undertaken in the future years and in respect of which agreement has been reached. In the context of **FAR analysis**, the restriction would operate to ensure that rollback provisions would apply only if the **FAR analysis of the rollback year does not differ materially from the FAR validated for the purpose of reaching an agreement** in respect of international transactions to be undertaken in the future years.

EXAMPLE 1 : -

ICO wants to import silk from its foreign AE (UK) during the PY 2017-18. For said purpose it enters an APA with rollback provision. Whether roll back provision would apply for AY 2016-17 during which the silk was imported by ICO from its another foreign AE (USA) ?

SOLUTION : -

As per Question 2 of FAQs issued by CBDT, Roll back provision in APA would be made applicable for preceding four years only when international transaction undertaken in roll back years is of same nature and **undertaken with same AE** as proposed to be undertaken in future years in APA.

In this case import of silk was made with foreign AE located in USA during AY 2016-17. However, under APA same international transaction is proposed to be made with a different AE located in UK.
Thus, the roll back provision would not be applicable for silk imported during AY 2016-17.

EXAMPLE 2 : -

In above Example, suppose silk was imported from AE located in UK during the AY 2016-17. Whether rollback provision would be apply to such transaction?

SOLUTION : -

Roll back provision in APA would apply in AY 2016-17 as same international transaction was undertaken in AY 2016-17 with same AE, as proposed to be undertaken in PY 2017-18 under APA.

2. the **return of income** for the relevant rollback year has been or is furnished by the applicant **before the due date** as specified in *Explanation 2* of section 139(1) [i.e., income-tax return of rollback year has been furnished on or before November 30 of the relevant AY].

Whether applicants, who have filed belated returns under section 139(4) or revised return under section 139(5) of the Act would be eligible for roll back ?

SOLUTION

W.e.f. AY 2017-18, belated return can also be revised u/s 139(5). Thus now revise return can be filed under the following situations:

a. When the original return was filed within due date prescribed under section 139(1).
b. When the original return was filed under section 139(4).

Hence, applicant would be entitled for roll back in the year in which he has revised the original return which was filed within due date u/s 139(1).

However, rollback provisions will not be available in case of a return of income filed under section 139(4) because it is a return which is not filed before the due date.

3. The Transfer Pricing report in respect of the international transaction had been furnished by applicant in Form No. 3CEB.

EXAMPLE 1 : -

ICO enters into an APA for AY 2018-19 , and filed its income-tax return for AY 2017-18 (i.e., roll back year) on November 30, 2017, but did not file Form No. 3CEB for AY 2017-18. Can ICO avail benefit of roll-back provision for international transaction undertaken in AY 2017-18?

SOLUTION : -

Since ICO has failed to file the transfer pricing report in the year of rollback (i.e., AY 2017-18), it cannot avail benefit of rollback provision in such year.

EXAMPLE 2 : -

In previous example, assume that ICO has entered into same transaction in AY 2016-17 and it had filed both income tax return and the transfer pricing report for AY 2016-17 on due date. Other facts remain unchanged.

Can it avail benefit of rollback provision in AY 2016-17 (rollback year) , even though it had not filed transfer pricing audit report in AY 2017-18 (another rollback year)?

SOLUTION : -

Benefit of rollback would be available in AY in which conditions related to rollback are satisfied. There is no need to satisfy such conditions in all the preceding 4 years of rollback. Thus, ICO can avail benefit of rollback in AY 2016-17, even when such benefit is not available in AY 2017-18.

4. The applicability of rollback provision has been requested by the applicant for
   all the rollback years (i.e., preceding 4 years)
   in which the same **international transaction** (i.e.**,** the nature of international transaction should be same as proposed to be undertaken in APA)
   has been undertaken
   by the applicant.

> **NOTE :**
>
> **Applicant has to apply for all the preceding 4 years under roll back. However, it cannot apply for rollback in those years where same international transaction did not exist or there is some disqualification due to rollback conditions.**

QUESTION 3 OF FAQS ISSUED BY CBDT VIA CIRCULAR NO. 10/2015, DATED 10.06.2015 : -

Rule 10MA(2)(iv) requires that the application for rollback provision, in respect of an international transaction, has to be made by the applicant for all the rollback years in which the said international transaction has been undertaken by the applicant. Clarification is required as to whether rollback has to be requested for all four years or applicant can choose the years out of the block of four years ?

ANSWER : -

The applicant does not have the option to choose the years for which it wants to apply for rollback. The applicant has to **either apply for all the four years or not apply at all**. However, if the covered international transaction(s) did not exist in a rollback year or there is some disqualification in a rollback year, then the applicant can apply for rollback for less than four years.

EXAMPLE 1 : -

ICO wants to enter into an APA with rollback provision for international transaction to be undertaken in AY 2018-19. It had entered into same transaction in AYs 2017-18, 2016-17, 2015-16 and 2014-15. Whether it can request for rollback provision only for AY 2016-17 and AY 2015-16?

SOLUTION : -

As per Question No. 3 of FAQ issued by CBDT, the Applicant has to apply for rollback for all the four preceding years. Otherwise it can opt for APA without rollback provision. Thus, ICO cannot apply for rollback only in two preceding years.

EXAMPLE 2 : -

In the above example, assume that ICO had entered into following international transactions in preceding years:

AY	Particulars
2017-18	Entered into same international transaction which is proposed to be undertaken in AY 2018-19 in APA and satisfies all conditions of rollback provisions
2016-17	Entered into different international transaction but satisfies all conditions of rollback provisions
2015-16	Entered into same international transaction but does not satisfies all conditions of rollback provisions
2014-15	Entered into same international transaction which is proposed to be undertaken in AY 2018-19 in APA and satisfies all conditions of rollback provisions

If other facts remain unchanged then determine the rollback years for which benefit of APA could be availed by ICO ?

SOLUTION : -

As per Question No. 3 of FAQs issued by CBDT, benefit of rollback provision would be available in those years in which same international transaction has been entered and conditions of rollback provisions have been satisfied.

In this case benefit of rollback would be available only for AYs 2017-18 and 2014-15.

5. the **applicant has made an application seeking rollback in Form 3CEDA** in accordance with sub-rule (5);

QUESTION 11 OF FAQS ISSUED BY CBDT VIA CIRCULAR NO. 10/2015, DATED 10.06.2015 : -

For already concluded APAs, will new APAs be signed for rollback or earlier APAs could be revised?

ANSWER : -

The second proviso to Rule 10MA(5) provides for revision of APAs already concluded to include rollback provisions.

NON-APPLICABILITY OF ROLLBACK PROVISION

Rollback provision shall not be provided in respect of an international transaction for a rollback year, if,-

i. **Appellate Tribunal** has **passed an order** on determination of arm's length price of the **said international transaction for the said year** at any time **before** signing of the agreement; or

EXAMPLE : -

ICO has to make APA application for international transaction of royalty to be entered into with its subsidiary (UK) during the AY 2018-19. It had also entered into same international transaction of royalty with its subsidiary in AY 2014-15. However, determination of arm's length price of said transaction of royalty has been subject matter of appeal and Tribunal has decided such issue for AY 2014-15. Whether ICO can apply for rollback for such transaction of royalty in AY 2014-15 ?

SOLUTION : -

ICO cannot apply for rollback in APA for AY 2014-15 as determination of arm's length price of royalty has been decided by Tribunal. Thus, ICO can apply for rollback provision for only three AYs 2015-16, 2016-17 and 2017-18.

ii. the application of rollback provision has the effect of **reducing the total income** or **increasing the loss**, as the case may be, of the applicant as **declared in the return of income of the said year**.

QUESTION 5 OF FAQS ISSUED BY CBDT VIA CIRCULAR NO. 10/2015, DATED 10.06.2015 : -

Rule 10MA(3)(ii) provides that rollback provision shall not be provided in respect of an international transaction for a rollback year if the application of rollback provision has the effect of reducing the total income or increasing the loss, as the case may be, of the applicant as declared in the return of income of the said year. It may be clarified whether the rollback provisions in such situations can be applied in a manner so as to ensure that the returned income or loss is accepted as the final income or loss after applying the rollback provisions.

ANSWER : -
For example, if the declared income is Rs 100, the income as adjusted by the TPO is Rs 120, and the application of the rollback provisions results in reducing the income to Rs 90, then the rollback for that year would be determined in a manner that the declared income Rs 100 would be treated as the final income for that year.

MANNER FOR DETERMINING ARM LENGTH PRICE TO BE THE SAME FOR ROLLBACK YEARS AND OTHER PREVIOUS YEARS

Where the rollback provision **specifies**
the **manner in which arm's length price shall be determined**
in relation to an international transaction
undertaken in any rollback year then
such manner shall be the **same as the**
manner which has been agreed to be provided
in the APA.

QUESTION 8 OF FAQS ISSUED BY CBDT VIA CIRCULAR NO. 10/2015, DATED 10.06.2015 : -

Rule 10MA(1) provides that the agreement may provide for determining ALP or manner of determination of ALP. However, Rule 10MA(4) only specifies that the manner of determination of ALP should be the same as in the APA. Does that mean the ALP could be different ?

ANSWER : -
Yes, the ALP could be different for different years. However, the manner of determination of ALP (including choice of Method, comparability analysis and Tested Party) would be same.

FILING APPLICATION FOR ROLLBACK PROVISION
The applicant may furnish along with the application for APA, the request for rollback provision **in Form No. 3CEDA** with proof of payment of an additional fee of Rs 5 lakh.

PROCEDURE FOR GIVING EFFECT TO ROLLBACK - RULE 10RA

Rule 10RA provides the "Procedure for giving effect to rollback provision of an APA as follows:

i. The applicant shall **furnish modified return of income** [referred to in section 92CD] in respect of a rollback year **along with the proof of payment of any additional tax** arising as a consequence of and computed in accordance with the rollback provision.

ii. The modified return shall be **furnished along with the modified return of first of the previous years** for which the Agreement has been requested for in the application.

> **NOTE :**
>
> **As per Section 92CD modified return for first of PY shall be furnished within 3 months from the end of the month in which APA was entered.**

EXAMPLE : -

On December 10, 2018, ICO concluded an APA with rollback provision for AY 2018-19. Determine the time limit for filing modified returns for AYs 2018-19, 2017-18 (rollback year), 2016-17 (rollback year), 2015-16 (rollback year) and 2014-15 (rollback year).

SOLUTION : -

The modified return shall be furnished within 3 months from the end of the month in which APA was entered. Thus, modified return of AY 2018-19 shall be furnished till March 31, 2019 along with modified returns of AYs related to rollback years (i.e., AY 2014-15 to AY 2017-18).

QUESTION 12 OF FAQS ISSUED BY CBDT VIA CIRCULAR NO. 10/2015, DATED 10.06.2015 : -

For already concluded APAs, where the modified return has already been filed for the first year of the APA term, how will the time-limit for filing modified return for rollback years be determined ?

ANSWER : -
The time to file modified return for rollback years will start from the date of signing the revised APA incorporating the rollback provisions.

iii. **WITHDRAWAL OF EXISTING PENDING APPEAL FOR ROLL BACK YEARS: -**

If any **appeal filed by the applicant**
is pending before the
Commissioner (Appeals), Appellate Tribunal or the High Court
for a rollback year,
on the issue which is the subject matter of the rollback provision,
the said appeal to the extent of the subject covered under the APA
shall be withdrawn by the applicant
before furnishing the modified return.

iv. **WITHDRAWAL OF APPEAL BY PRINCIPAL COMMISSIONER/ COMMISSIONER** : -

If any appeal **filed by the**
Assessing Officer or the Principal Commissioner or Commissioner
is **pending** before the Appellate Tribunal or the High Court
for a rollback year, on the issue which is subject matter of the
rollback provision for that year, the **said appeal to the**
extent of the subject covered under the APA,
shall be withdrawn by the
Assessing Officer or the Principal Commissioner or the Commissioner,
as the case may be, **within three months of filing of modified return by the applicant**.

QUESTION 4 OF FAQS ISSUED BY CBDT VIA CIRCULAR NO. 10/2015, DATED 10.06.2015 : -

Rule 10MA(3) states that the rollback provision shall not be provided in respect of an international transaction for a rollback year if the determination of arm's length price of the said international transaction for the said year has been the subject matter of an appeal before the Appellate Tribunal and the Appellate Tribunal has passed an order disposing of such appeal at any time before signing of the agreement. Further, Rule 10 RA(4) provides that if any appeal filed by the applicant is pending before the Commissioner (Appeals), Appellate Tribunal or the High Court for a rollback year, on the issue which is subject matter of the rollback provision for that year, the said appeal to the extent of the subject covered under the agreement shall be withdrawn by the applicant.

There is a need to clarify the phrase "Tribunal has passed an order disposing of such appeal" and on the mismatch, if any, between Rule 10MA(3) and Rule 10RA(4) ?

ANSWER : -

The reason for not allowing rollback for the international transaction for which Appellate Tribunal has passed an order disposing of an appeal is that the ITAT is the final fact finding authority and hence, on factual issues, the matter has already reached finality in that year. However, if the ITAT has not decided the matter and has only set aside the order for fresh consideration of the matter by the lower authorities with full discretion at their disposal, the matter shall not be treated as one having reached finality and hence, benefit of rollback can still be given. There is no mismatch between Rule 10MA(3) and Rule 10RA(4).

V. **INFORMING THE APPELATE AUTHORITY** : -

The **applicant**,
the Assessing Officer or
the Principal Commissioner or
the Commissioner, **shall inform**
the Dispute Resolution Panel or
the Commissioner (Appeals) or
the Appellate Tribunal or
the High Court, as the case may be,
the fact that an APA containing rollback provision has been entered into
along with a copy of the same as soon as it is practicable to do so.

PROCEDURE FOR GIVING EFFECT TO ROLLBACK - RULE 10RA- CANCELLATION OF APA

IN CASE EFFECT CANNOT BE GIVEN TO THE ROLLBACK PROVISION OF AN AGREEMENT IN ACCORDANCE WITH THIS RULE, FOR ANY ROLLBACK YEAR TO WHICH IT APPLIES, ON ACCOUNT OF FAILURE ON THE PART OF APPLICANT, THE AGREEMENT SHALL BE CANCELLED.

EXAMPLE : -

On December 20, 2017, ICO has concluded an APA with rollback provision for AY 2017-18. ICO has filed the modified return for AY 2017-18 on March 31, 2018. However, it did not file the modified returns for rollback years (i.e., AYs 2016-17, 2015-16, 2014-15 and 2013-14) till March 31, 2018. What are the consequences of this default ?

SOLUTION : -

The modified return shall be furnished within 3 months from the end of the month in which APA was entered. Thus, modified return of AY 2017-18 shall be furnished till March 31, 2018 along with modified returns of AYs related to rollback years (i.e., AY 2013-14 to AY 2016-17).

In this case, the **entire APA shall be cancelled** as the applicant failed to file the modified return of rollback years within 3 months from the end of the month in which APA was entered.

MISCELLANEOUS FAQS ON ROLLBACK PROVISION

QUESTION 7 OF FAQS ISSUED BY CBDT VIA CIRCULAR NO. 10/2015, DATED 10.06.2015 : -

If there is a Mutual Agreement Procedure (MAP) application already pending for a rollback year, what would be the stand of the APA authorities? Further, what would be the view of the APA Authorities, if MAP has already been concluded for a rollback year?

ANSWER : -

If MAP has been already concluded for any of the international transactions in any of the rollback year under APA, rollback provisions would not be allowed for those international transactions for that year but could be allowed for other years or for other international transactions for that year, subject to fulfilment of specified conditions in Rules 10MA and 10RA. However, if MAP request is pending for any of the rollback year under APA, upon the option exercised by the applicant, **either MAP or application for roll back** shall be proceeded with for such year.

QUESTION 10 OF FAQS ISSUED BY CBDT VIA CIRCULAR NO. 10/2015, DATED 10.06.2015 : -

Whether applicant has an option to withdraw its rollback application? Can the applicant accept the rollback results without accepting the APA for the future years?

ANSWER : -

The applicant has an option to withdraw its roll back application even while maintaining the APA application for the future years. However, it is **not possible to accept the rollback results without accepting the APA** for the future years. It may also be noted that the fee specified in Rule 10MA(5) shall not be refunded even where a rollback application is withdrawn.

QUESTION 13 OF FAQS ISSUED BY CBDT VIA CIRCULAR NO. 10/2015, DATED 10.06.2015 : -

In case of merger of companies, where one or more of those companies are APA applicants, how would the rollback provisions be allowed and to which company or companies would it be allowed ?

ANSWER : -

The agreement is between the Board and a person. The principle to be followed in case of merger is that the person (company) who makes the APA application would only be entitled to enter into the agreement and be entitled for the rollback provisions in respect of international transactions undertaken by it in rollback years. **Other persons (companies) who have merged with this person (company) would not be eligible for the rollback provisions**.

To illustrate, if A, B and C merge to survive as C and C is the APA applicant, then the agreement can only be entered into with C and only C would be eligible for the rollback provisions. A and B would not be eligible for the rollback provisions. To illustrate further, if A and B merge to form a new company C and C is the APA applicant, then nobody would be eligible for rollback provisions.

QUESTION 14 OF FAQS ISSUED BY CBDT VIA CIRCULAR NO. 10/2015, DATED 10.06.2015 : -

In case of a demerger of an APA applicant or signatory into two or more companies (persons), who would be eligible for the rollback provisions?

ANSWER : -

The same principle as mentioned in the previous answer, i.e., the person (company) who makes an APA application or enters into an APA would only be entitled for the rollback provisions, would continue to apply. To illustrate, if A has applied for or entered into an APA and, subsequently, demerges into A and B (two entities), then only A will be eligible for rollback for international transactions covered under the APA. As B was not in existence in rollback years, availing or grant of rollback to B does not arise.

PROCEDURE FOR GIVING EFFECT TO AN APA – SECTION 92CD

i. In case a person has entered into an APA and
prior to the date of entering into such **APA**,
he has furnished the return of income
for assessment year to which the APA applies,
then, such person shall,
within a period of 3 months
from the end of the month in which the said APA was entered into,
furnish a modified return,
notwithstanding any contrary provision contained in section 139.

EXAMPLE : -

On December 30, 2017, ICO has concluded an APA with rollback provision for AY 2017-18. However, it has already filed the income-tax return on November 30, 2017 for AY 2017-18. What is the procedure for giving effect to APA?

SOLUTION : -

ICO has to file the modified income-tax return for AY 2017-18 till March 31, 2018 along with the return for rollback years.

ii. Modifications can only be made in income-tax return on account of such APA.

iii. All other provisions of this Act shall apply as if the modified return is a return furnished under section 139, unless anything to the contrary is provided.

iv. If the **assessment or reassessment proceedings for an assessment year to which the APA applies have been completed before the expiry** of period allowed for furnishing of modified return, the Assessing Officer shall, in a case where **modified return is filed** as per the provisions of this section, proceed to **assess or reassess** or re-compute the total income of the relevant assessment year having regard to and **in accordance with the APA**.

Such order for assessment or reassessment or re-computation of total income shall be **passed within a period of 1 year from the end of the financial year in which the modified return was furnished**. This shall apply notwithstanding the period of limitation contained under section 153 or 153B or 144C.

The appeal against such order shall lie to Commissioner (Appeals) [Section 246A]

v. Where the **assessment** or **reassessment** proceedings for an assessment year to which the APA applies, are **pending** on the date of filing of modified return, the Assessing Officer shall proceed to complete the assessment or reassessment proceedings in **accordance with the APA** taking into consideration the modified return so furnished.

In this case, the time period of completion of pending assessment or reassessment [given under section 153 or 153B or 144C] shall be extended by 12 months. This shall apply notwithstanding the period of limitation contained under section 153 or 153B or 144C.

vi. The assessment or reassessment proceedings shall be deemed to have been completed where :

1. an assessment or reassessment order has been passed; or
2. no notice has been issued under section 143(2) till the expiry of the limitation period provided under the said section.

42. MUTUAL AGREEMENT PROCEDURE

MEANING OF MAP

MAP is a special **facilitative procedure** set out in various tax treaties that **allows designated government representatives** of Treaty partners (”referred to as Competent Authorities") to **work together**, and **resolve international tax disputes**, including cases of double taxation arising out of application of the Convention.

MAP can be **used to eliminate double taxation** that could arise from a transfer pricing adjustment.

APPLICATION OF MAP

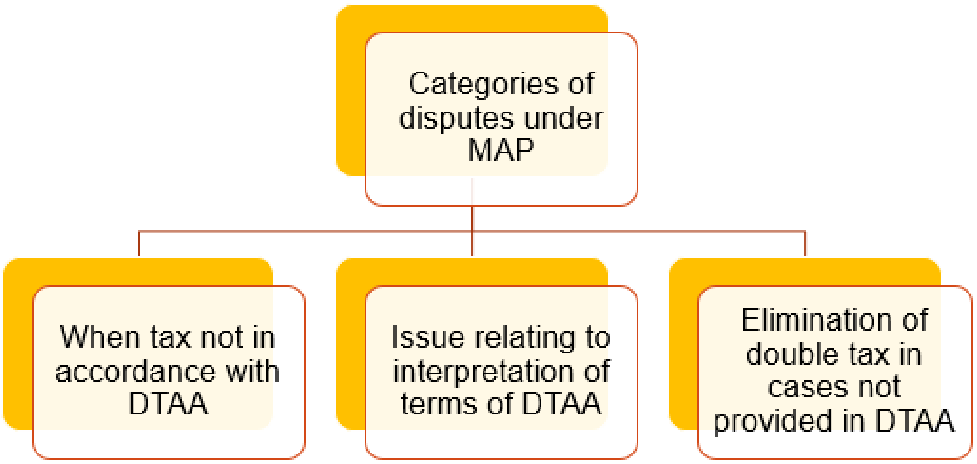
As per Article 25 of the OECD Model tax convention, mutual agreement procedures are generally used in the following cases:

a. Where **taxation is not in accordance with the provisions** of the convention (Generally initiated by the taxpayer)

b. Resolve the **Questions of Interpretation** or **application of the convention** and the **elimination of double taxation in cases not otherwise provided** for in the convention

MAP can be used to resolve problems of juridical double taxation and economic double taxation arising from transfer pricing adjustments made pursuant to paragraph 1 of Article 9 (Article 9 – Associated Enterprises)

CATEGORIES OF DISPUTES COVERED UNDER MAP

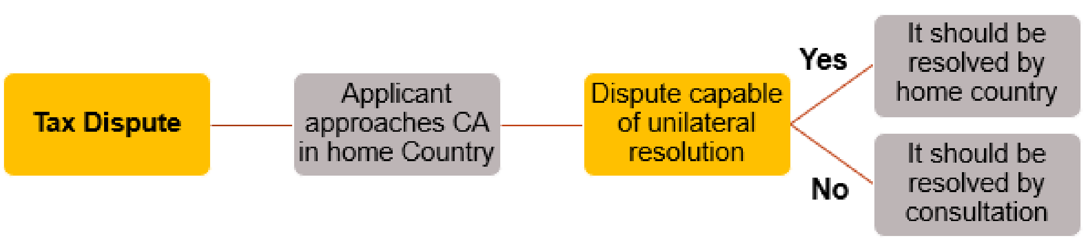


JURIDICAL DOUBLE TAXATION AND ECONOMIC DOUBLE TAXATION MEANING OF MAP

a. **Jurisdictional double taxation**: It may arise when tax is imposed by two or more countries as per their domestic laws, in respect of the same transaction.

b. **Economic double taxation:** It may arise when the same transaction, item of income or capital is taxed in two or more states but in hands of different person.

MECHANISM UNDER MAP



NEED FOR MAP

MAP provides relief in cases of economic double taxation as Tax treaties (i.e., DTAAs) generally do not cover instances of economic double taxation.

MAP also provides relief in cases where automatic relief are not available, such as tax credits, tax exemption, etc.

APPLICATION FOR GIVING EFFECT TO MAP

Where a person considers
that the actions of one or both of the Contracting States
result or **will result** for him in taxation not in accordance with the provisions of this Convention,
he **may**,
irrespective of the remedies provided by the **domestic law** of those States,
present his case to the competent authority of the **Contracting State of which he is a resident** or **national.**
This case must be presented within three years of the date of receipt of notice of the action which gives rise to taxation not in accordance with the Convention.

STEPS INVOLVED IN THE MAP APPLICATION PROCESS

1. **Brief facts and background** of the case should be summarized.

2. **Contentions of Indian Revenue** should be summarized in the MAP application.

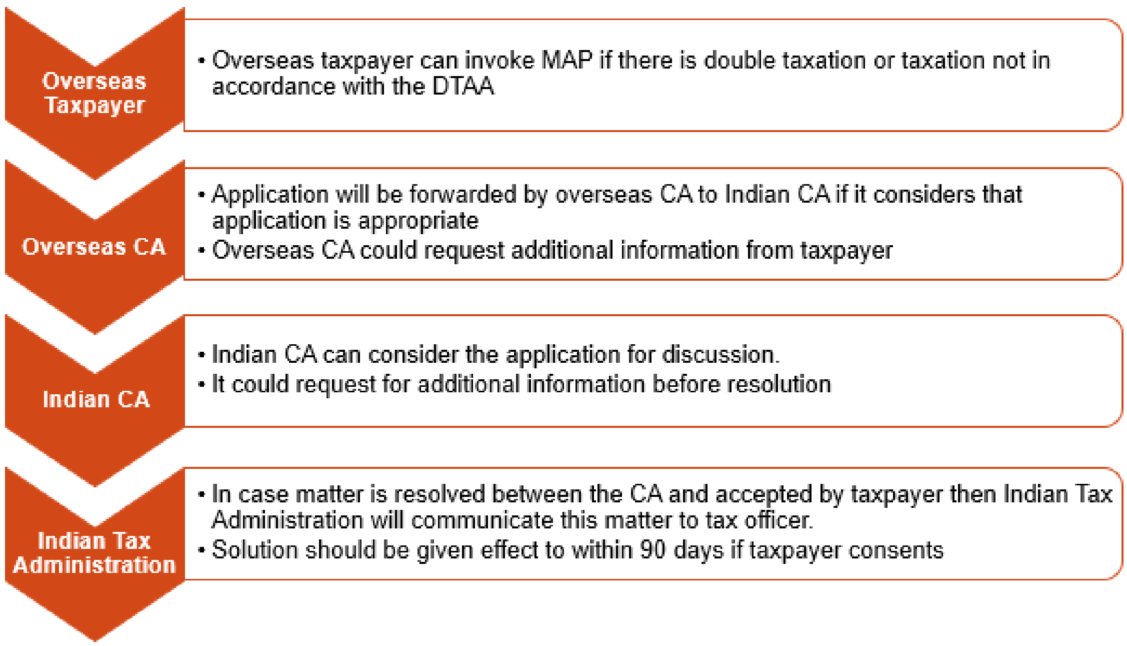
3. The **net tax and interest impact** by virtue of transfer pricing adjustment is computed.

4. Take note of **transactions only relating to one country** (in one application), e.g. USA, UK, etc.

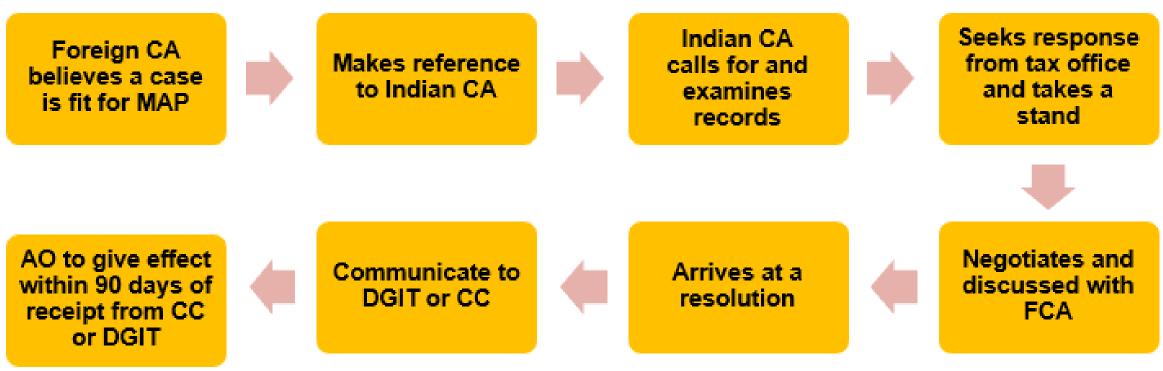
5. **All documen**ts including tax returns, TP study, notices, submissions, orders, etc. should be furnished.

6. Relevant **judicial precedence** and their **applicability** to taxpayer's case must be demonstrated.

TYPICAL MAP PROCESS IN INDIA



INDIAN STATUTORY REGIME – MAP [RULE 44H] – ACTION BY INDIAN COMPETENT AUTHORITY ON REFERENCE FROM FOREIGN COMPETENT AUTHORITY



If assesse accepts MAP resolution between two CA's and withdraws relevant pending appeals, AO shall give effect to MAP resolution.

OUTCOME OF MAP PROCESS

1. The Assessing Officer **gives effect** of the decision of the MAP within 90 days of receiving instructions from the CCIT / DGIT

2. If **taxpayer is not satisfied with the decision** of the Competent Authority, he may **reject the decision** and **go ahead with the remedies** under the domestic law

3. If remedies are not granted under the domestic law, the **taxpayer may apply to the Competent Authorities again for subsequent years**.

4. **Decision** of a Competent Authority is **case specific** and **not a precedent** for the taxpayer for subsequent years or other taxpayers on same issues.

DRAWBACKS OF THE MAP PROCESS

1. **Time limits under domestic law** may make corresponding adjustments **unavailable** if limits are not waived in the relevant tax treaty.

2. MAP may take **too long** to complete.

3. Taxpayer **participation** may be **limited.**

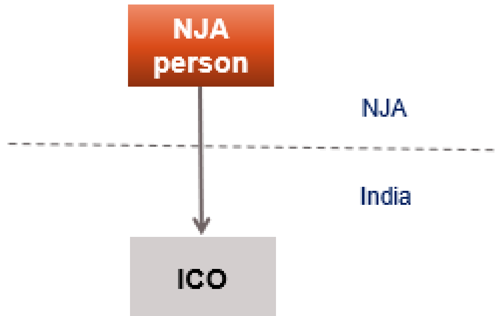
4. **Published procedures may not be readily available** to instruct taxpayers on how the procedure may be used; and

5. There may be **no procedures to suspend the collection of tax deficiencies** or the accrual of interest pending resolution of the MAP.

43. MISCELLANEOUS TRANSFER PRICING PROVISIONS

OBJECTIVE OF INTRODUCTION OF SECTION 94A

Discourage assessees from entering into transactions with persons located in countries or **territories which do not exchange tax information with India**.



NOTIFIED JURISDICTIONAL AREA - SECTION 94A

The Central Government may notify any country or territory outside India as a **Notified Jurisdictional Area** (NJA), if such country or territory **does not share tax information with India.**

Till now India has **only notified Cyprus** as notified jurisdictional area on November 01, 2013 for not sharing tax information with India (vide notification no. SO3307(E) dated November 01, 2013).

However, **Cyprus was removed** from the list of NJA on December 14, 2016 (vide notification no. SO4033 (E) dated December 14, 2016)

APPLICABILITY OF TP PROVISIONS ON TRANSACTIONS ENTERED WITH PERSONS LOCATED IN nja - SECTION 94A

If the assessee enters into a **transaction** where one of the parties to the transaction is a **person located in a NJA** then :

a. all parties to the transaction would be deemed as AE;

b. Such transaction would be deemed to be **international transaction** as per section 92B; and

c. All the provisions of transfer pricing would be attracted in case of such transactions.

NOTE : -

- In the above case the benefit of permissible variation between the ALP price and Transfer price (as per second proviso to section 92C(2) would not be available.
- Transaction may be nature of
  - purchase, sale or lease of tangible or intangible property or
  - provision of service or
  - lending or borrowing money or
  - any other transaction having a bearing on the profits, income, losses or assets of the assessee including a mutual agreement or arrangement for allocation of common expenditure.

PERSON LOCATED IN NJA - SECTION 94A

Person located in a NJA shall include

a. a person who is a **resident** of the NJA; or

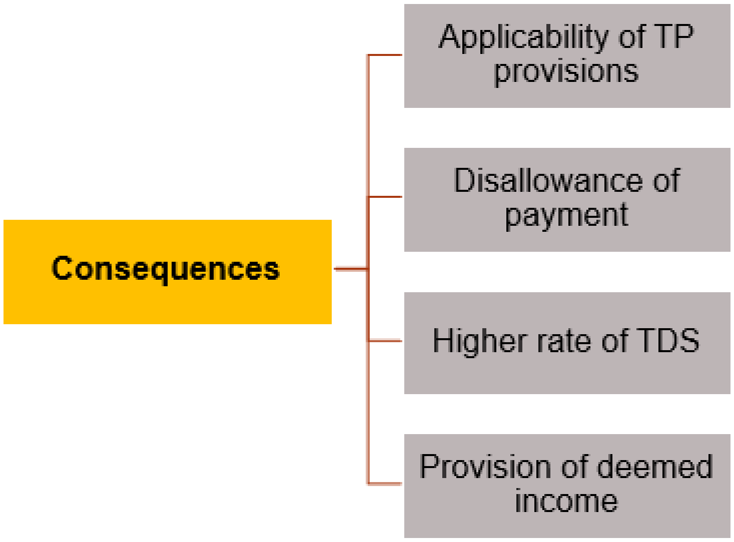
b. a **person,** not being an individual, which is **established in the NJA**; or

c. **Permanent establishment** of any person (other than person resident/ established in NJA) **in** the **NJA**.

NOTE : -

- As per section 92F(iiia) Permanent establishment includes a fixed place of business through which business of the enterprise is wholly or partly carried on.

Consequences of declaration of any country as NJA – section 94A



NOTE : -

- **Consequences of declaration of any country as NJA :**
  - **TP provision would apply where one of the parties in transaction located in NJA.**
  - **Payment made to person located in NJA would be disallowed (unless certain conditions are satisfied).**
  - **Payment made to person located in NJA would attract higher rate of TDS.**
  - **Any receipt from the person located in NJA would be deemed as income of recipient (unless certain conditions are satisfied).**

DISALLOWANCE OF PAYMENT MADE TO PERSON LOCATED IN NJA - SECTION 94A

I. Any **payment** made to **financial institution** shall be disallowed unless the assessee **authorizes** the CBDT or any other income tax authority acting on CBDT behalf to seek information of assessee from such financial institution.

II. Any other **expenditure or allowance, including depreciation**, arising from the transaction with a person located in a NJA

shall be `
unless the assessee maintains or furnishes prescribed information.

TDS APPLICABILITY ON PAYMENT MADE TO PERSON LOCATED IN NJA - SECTION 94A

Where payment is made to a person located in NJA then TDS shall be deducted at the highest of the following rates :

- rates specified in the relevant provision of the Income-tax Act, 1961; or
- **rate or rates in force**; or
- 30%.

NOTE : -
As per section 2(37A) Rate or Rates in force means rate specified in the :
- **IT Act, 1961 ; or**
- **the Finance Act; or**
- **Tax treaty (DTAA)**

whichever is applicable

RECEIPT FROM PERSONS LOCATED IN NJA DEEMED TO BE INCOME OF RECEIPINT/BENEFICIAL OWNER - SECTION 94A

Where assessee has **received or credited** any sum from a person located in a NJA then it shall be **deemed as income of the assessee/beneficial** owner for that PY. However, such deeming provision would **not apply** where the assessee explains the source of such income in the hands of payer or beneficial owner.

RECEIPT FROM PERSONS LOCATED IN NJA DEEMED TO BE INCOME OF RECEIPINT- SECTION 94A

EXAMPLE : -

CBDT has notified Country X as NJA u/s 94A on April 01, 2017 due to lack of effective exchange of tax information with India. On August 01, 2017, Mr. A has received a loan of Rs.

10,00,000 from his Uncle Mr. C who is resident of Country X. Since Mr. A has received money from a person located in NJA, such money would be deemed as income of Mr. A if he fails to explain the source of income in the hands of his Uncle Mr. C

CONSEQUENCES OF DECLARATION OF ANY COUNTRY AS NJA – SECTION 94A

EXAMPLE 1 : -

ICO (Indian Co.) sells product X to FCO located in NJA @ Rs. 3,00,000. It sells same quality of product X to FCO1 @ Rs. 3,50,000. Discuss the tax implication u/s 94A ?

SOLUTION : -

If the assessee enters into a transaction where one of the parties to the transaction is a person located in NJA then

a. all parties to the transaction would be deemed as AE;

b. Such transaction would be deemed to be international transaction as per section 92B; and

c. All the provisions of transfer pricing would be attracted in case of such transactions.

   Since FCO is located in NJA, ICO and FCO would be deemed as AE and transaction of sale of product to FCO would be deemed as international transaction. Sale of product X @ Rs. 3,50,000 would be comparable uncontrolled transaction, thus it would be considered to arrive at income arising from international transaction.

EXAMPLE 2 : -

ICO received technical services from FCO located in NJA @ Rs. 3,00,000. The rate of TDS on Fees for technical services u/s 115A is 10%. Discuss the tax implication u/s 94A ?

SOLUTION : - As per the provision of section 94A the rate of TDS in respect of any payment made to a person located in the NJA, on which tax is deductible at source, will be the higher of the following rates –

1. rates specified in the relevant provision of the Income-tax Act, 1961; or
2. rate or rates in force; or
3. 30%.

The amount of TDS is Rs. 30,000 (10%) as per normal provision of the Income Tax Act, 1961. However, the higher rate of TDS of 30% would be attracted in this case as the payee (FCO) is located in NJA. Accordingly the amount of TDS u/s section 94A would be Rs. 90,000 (30%).

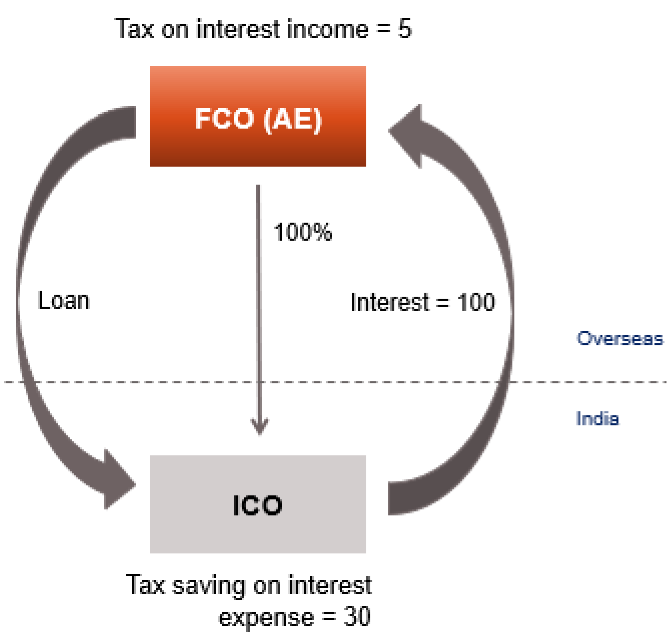
INTRODUCTION OF THIN CAPITALIZATION NORMS

Capital structure of a company comprises of : -

- Debt - Interest on which may be tax deductible; and
- Equity – Dividend on equity are not deductible for tax purpose.

If the ratio of Debt to Equity is high, the company is said to be **highly leveraged or thinly capitalized**.

To claim tax deduction on interest and thereby reduce their tax liabilities, foreign parent companies generally thinly capitalized their Indian subsidiaries , in absence of any thin capitalization norms in India.



<u>EXAMPLE</u> : -

Particulars	ICO	FCO
Revenue	1000	100
Interest expense	100	-
PBT	900	
Tax rate	30%	5%
Tax	270	5
Tax saving due to interest	30	-
Net tax benefit to AEs	25 (30 – 5)	

ICO has saved tax of Rs. 30 on payment of interest to FCO. On the other hands FCO has paid tax of Rs. 5 on interest income received from ICO. Thus the overall tax benefit to MNC group is Rs. 25 (30-5).

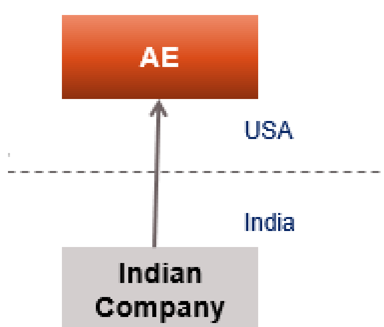
<u>INSERTION OF SECTION 94B – LIMITATION ON INTEREST DEDUCTION</u>

"Base Erosion And Profit Shifting (BEPS) Action Plan 4" of OECD deals with Shifting of Profit by way of excessive interest deduction.

The Finance Act, 2017 has inserted **Section 94B** to restrict the excessive interest deduction in line with recommendation of OECD BEPS Action Plan 4

DISALLOWANCE OF INTEREST DEDUCTION - SECTION 94B

Interest **paid/ payable** by assessee to its AE shall not be deductible in computation of income under the head "profit and gains of business or profession" to the extent that it arises from **excess interest**.



> **NOTE** : -
>
> - Excess Interest shall means
>   a) Total Interest paid or payable (i.e. total interest paid/ payable to AE and non-AE) in excess of 30% of its earning before interest, taxes, depreciation, and amortization (EBITDA) of the borrower in the PY ; or
>   b) Interest paid/ payable to AE for that previous year
>
>   Whichever is less

APPLICABILITY OF SECTION 94B

Provision of section 94B shall be applicable to

an **Indian company**,

or a **permanent establishment of a foreign company** in India,

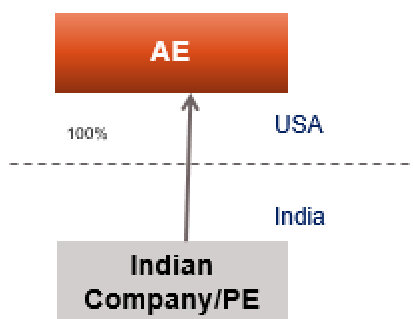
being the borrower (i.e., borrower is Indian co. or PE of foreign company)

who incurs any expenditure by

way of interest or

similar nature

in respect of **any form of debt issued by** a **non-resident AE of the borrower.**



> **NOTE** : -
>
> - AE shall have the same meaning as assigned to it in the provision of transfer pricing u/s 92A

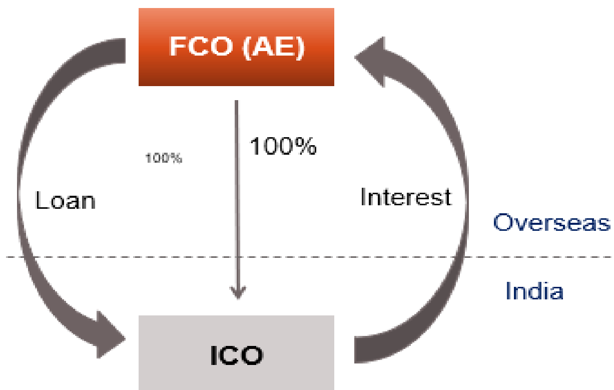
CONDITIONS : -

However, the provision of this section would be applicable :

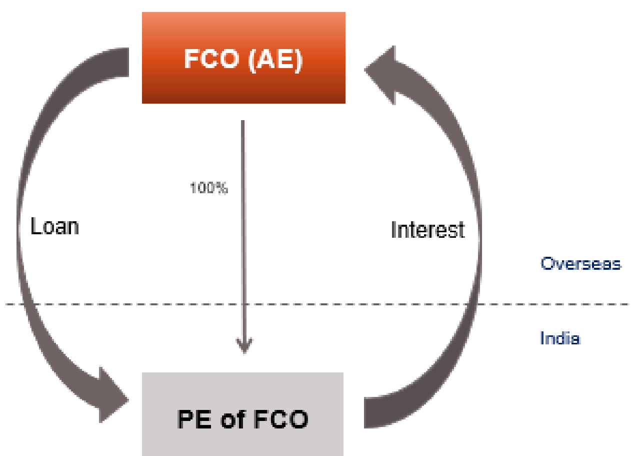
a. Where **interest** is **deductible** in computing **income chargeable** under the head **profit and gains of business and profession**

b. Where expenditure by way of interest or of similar nature **exceeds Rs. 1 crore,** in respect of any form of debt issued by a non-resident AE of such borrower.

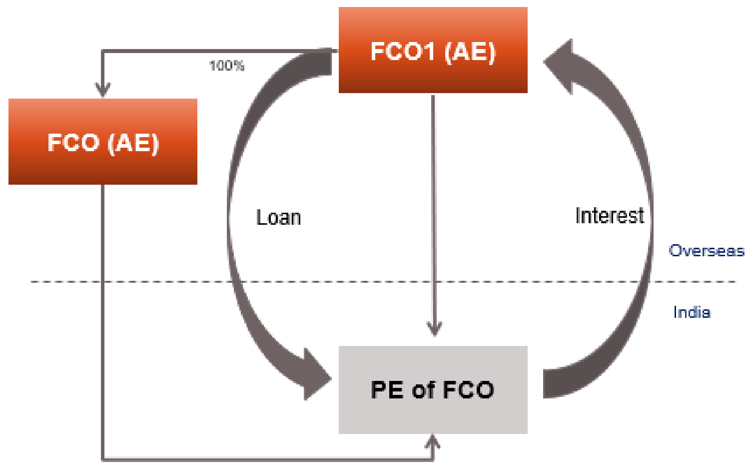
CASE 1



CASE 2



CASE 3



EXAMPLE : -

ICO has taken External Commercial Borrowing of Rs. 20 cr. from its foreign parent and paid interest of Rs. 1.5 cr. (5 % p.a.). Whether such interest payment would attract disallowance under section 94B ?

SOLUTION : -

Provision of section 94B would be applicable where expenditure by way of interest or of similar nature exceeds Rs. 1 crore, in respect of any form of debt issued by a non-resident AE of such borrower. In this case provision of section 94B would be attracted as the amount of interest payment to foreign AE exceeds Rs. 1 cr.

MEANING OF DEBT - SECTION 94B

Debt means –

Any **loan, financial instrument, finance lease, financial derivative, or**

any arrangement that gives rise to interest,

discounts or **other finance charges**

that are deductible in the computation of income

chargeable under the head “Profits and gains of business or profession”.

INTEREST EXPENSE INCURRED FOR AE AND NON-AE – SECTION 94B

<u>EXAMPLE 1</u> : -

Particulars	Amount (in crores)
EBITDA of ICO (Borrower)	200
30% of EBITDA	60
Interest paid to foreign AE	10
Interest paid to non-AE	70
Total interest expense	80
Total interest in excess of 30% of EBITDA (80-60) (A)	20
Interest paid to AE (B)	10
Lower of A and B	10
Interest to be disallowed u/s 94B	10

INTEREST EXPENSE INCURRED ONLY FOR AE – SECTION 94B

<u>EXAMPLE 2</u> : -

Particulars	Amount (in crores)
EBITDA of ICO (Borrower)	200
30% of EBITDA	60
Interest paid to foreign AE	80
Interest paid to non-AE	0
Total interest expense	80
Total interest in excess of 30% of EBITDA (80-60) (A)	20
Interest paid to AE (B)	80
Lower of A and B	20
Interest to be disallowed u/s 94B	20

INTEREST EXPENSE INCURRED ONLY FOR NON AE – SECTION 94B

EXAMPLE 3 : -

Particulars	Amount (in crores)
EBITDA of ICO (Borrower)	200
30% of EBITDA	60
Interest paid to foreign AE	0
Interest paid to non-AE	90
Total interest expense	90
Total interest in excess of 30% of EBITDA (90-60) (A)	30
Interest paid to AE (B)	0
Lower of A and B	0
Interest to be disallowed u/s 94B	0

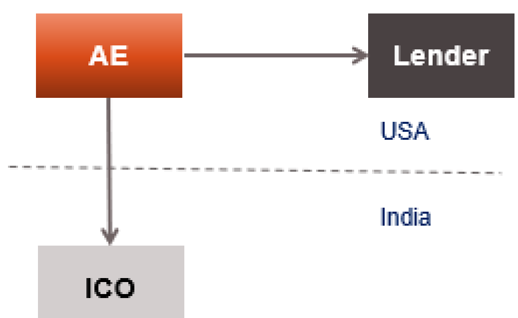
DEBT DEEMED TO BE ISSUED BY AE – SECTION 94B

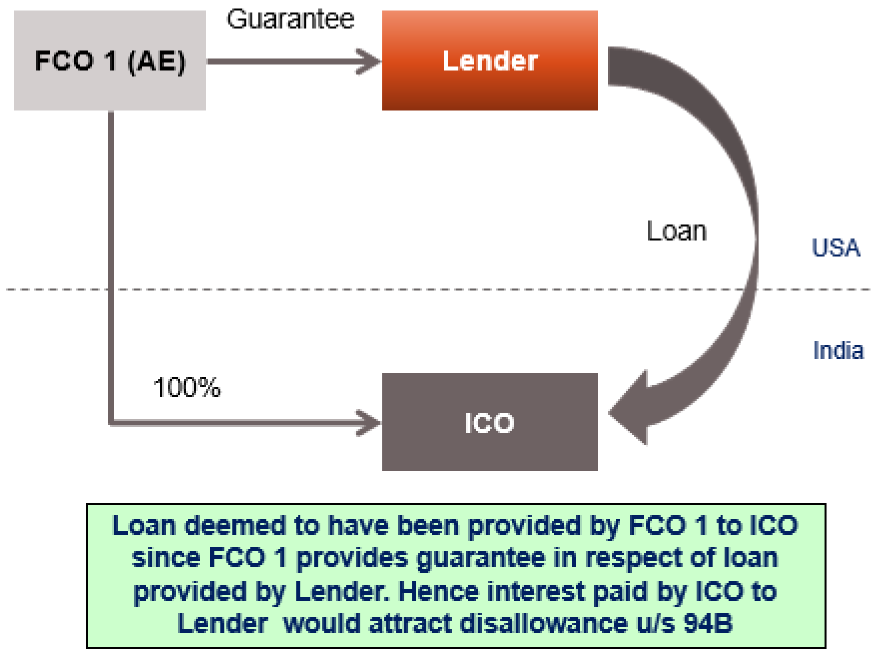
Where the debt is issued by a lender which is not AE

but an associated enterprise either : -

- provides an implicit or explicit **guarantee** to such lender or
- deposits a corresponding and **matching amount of funds** with the lender,

such debt shall be **deemed to have been issued** by an associated enterprise.



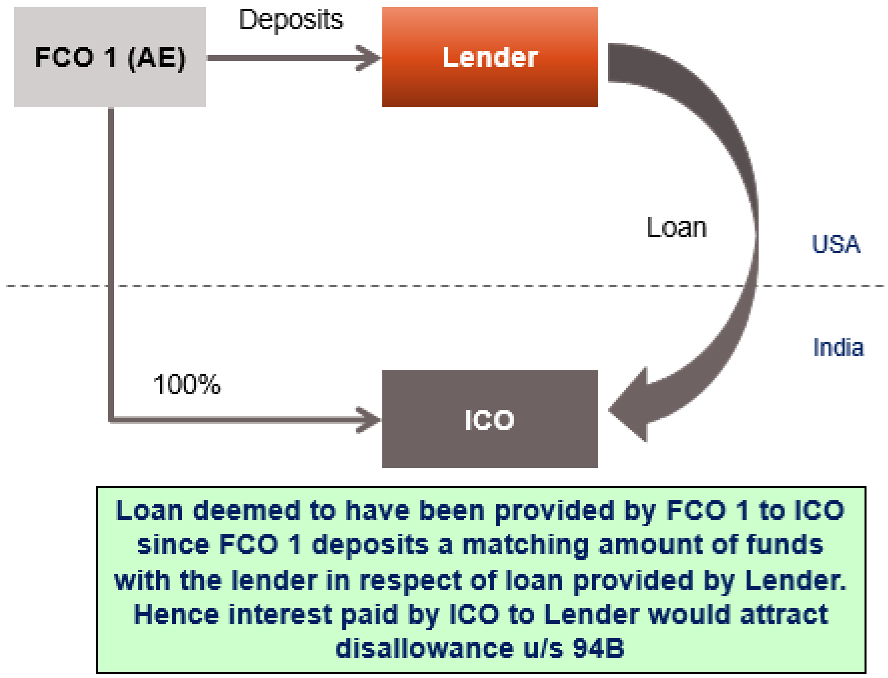


Facts :

- FCO 1 owns 100% shareholding in ICO
- Lender provides loan of Rs. 20 cr.to ICO.
- FCO 1 provides guarantee in respect of loan given by Lender to ICO
- ICO paid interest to Lender of Rs. 2 cr.

Issue :

- Whether interest paid by ICO to Lender would attract disallowance u/s 94B ?



Facts :

- FCO 1 owns 100% shareholding in ICO
- Lender provides loan of Rs. 20 cr.to ICO.
- FCO 1 deposits amount of Rs. 20 cr. With Lender in respect of loan given to ICO.
- ICO paid interest to Lender of Rs. 2 cr.

Issue :

- Whether interest paid by ICO to Lender would attract disallowance u/s 94B ?

EXEMPTION FROM APPLICABILITY OF SECTION 94B

Provision of section 94B shall **not be applicable to**

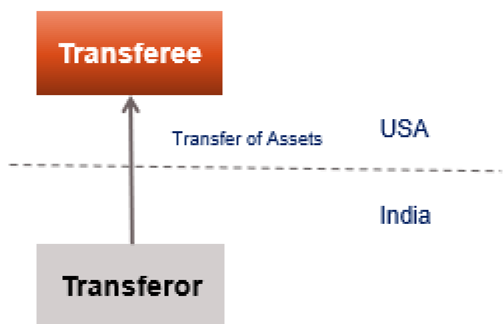
an Indian company or permanent establishment of a foreign

company

which is engaged in the **business of banking or Insurance**

AVOIDANCE OF INCOME TAX BY TRANSFER OF INCOME TO NON RESIDENT – SECTION 93

Section 93 covers transactions which are designed to avoid tax liability by way of **transfer of asset to non resident persons**. This section also covers variety of transactions where assets are transferred to non resident person and the **transferor indirectly derives income under the guise of obtaining loans or repayment of loans.**



AVOIDANCE OF INCOME TAX BY TRANSFER OF INCOME TO NON RESIDENT – SECTION 93

As per the provisions of section 93(1)(a) **income from the transferred asset** would be deemed as the income of the transferor, where the following conditions are satisfied : -

i. There is a **transfer of assets** (whether movable or immovable and whether tangible or intangible) to non resident person;

ii. due to such transfer the **income** from such assets **become payable to non resident;**

iii. **transferor** acquires power to **enjoy the income** whether immediately or in future;

iv. **transfer is made by any person in India or outside** irrespective of his residential status or citizenship;

v. transfer is made **either alone or in connection with associated operations**;

vi. the assets transferred directly yield **income chargeable to tax** (i.e. income should not be exempt from income tax) under this Act.

Section 93(1)(a) is attracted where transferor has **power to enjoy income** from the transferred assets. However 93(1)(b) is applicable where the transferor either **before, or after the transfer, is entitled to receive any capital sum**. The payment of which is connected with transferor or any associated operations thus in such case also income of the non resident from the transferred asset would be deemed as income of the transferor.

Capital sum means

i. **Any sum paid or payable by way of loan or repayment of loan;**

ii. **And any other sum paid/ payable otherwise then as income, being a sum which is not payable for full consideration in money or money's worth.**

POWER TO ENJOY THE INCOME OF NON RESIDENT

A person shall be **deemed to have power to enjoy the income** of non resident person if

i. The income is in fact, so dealt with by any person as to be calculated at **some point of time to enure for the benefit of the transferor** (whether in the form of income or not).

ii. the receipt or accrual of the income operates to **increase the value of any assets held by transferor** or for his benefit;

iii. transferor receives or is entitled to receive at any time **any benefit out of that income** or out of monies which are or will be available for the purpose due to effects of the associated operations on that income and the assets which represent that income;

iv. transferor has **power to obtain for himself, whether with or without the consent of other person, the beneficial enjoyment of the income** (by means of exercising any power of appointment or power of revocation or otherwise),

v. **Transferor has the direct or indirect power to control the application of income**

ASSOCIATED OPERATIONS

Associated operations in relation to any transfer means an operation of any kind affected by any person in relation to –

i. any of the **assets transferred**, or

ii. Any **assets representing**, whether directly or indirectly any of the **assets transferred**;

iii. The **income arising** from any such assets or

iv. any **assets representing, whether** directly or indirectly, the **accumulation of income** arising from such assets.

SUBSEQUENT RECEIPT OF DEEMED INCOME – SECTION 93

Where any income of non resident has been deemed as income of transferor under the provisions of section 93, and that income has been subsequently received then it shall not be deemed to form part of his income for the purpose of Section 93.

NON APPLICABILITY OF SECTION 93 IN BONA-FIDE COMMERCIAL TRANSACTION

The provision of this section shall not apply if the transferor shows to the satisfaction of AO that:

a) Neither the transferor nor any associated operations **had the purpose of avoidance of tax liability ;** or
b) the transfer and all associated operations were **bona-fide commercial transaction** and were not designed for the purpose of Income Tax avoidance.

IMPACT OF SECTION 40(A)(I) DISALLOWANCE ON SECTION 94B

EXAMPLE 4 : -

Particulars		Amount (in crores)
EBITDA of ICO (Borrower)		100
30% of EBITDA		30
Interest paid to foreign AE 1		70
Interest paid to foreign AE 2		10
Total interest expense	(A)	80
Disallowance under section 40(a)(i)	(B)	10
Interest deductible	(A-B)	70
Total interest in excess of 30% of EBITDA (80-30)		50
Interest paid to AE		80
Lower of A and B	(C)	50
Disallowance u/s 94B (50-10)	(C - B)	40

NOTE : -

Provision of section 94B would be applicable where interest is deductible in computing income chargeable under the head profit and gains of business and profession. In example 4 interest paid to AE 2 of Rs. 10 crore is not deductible due to disallowance under section 40(a)(i). Accordingly such interest of Rs. 10 crore should not be consider for disallowance under section 94B.