TRANSFER PRICING

LEARNING OUTCOMES

After studying this chapter, you would be able to -

- **appreciate** the need for incorporation of transfer pricing provisions in the Income-tax Act, 1961;
- **examine** the meaning and significance of arm’s length principle and the practical difficulties in application of arm’s length principle;
- **appreciate** the meaning and significance of the terms “associated enterprise”, “international transaction”;
- **analyze** the functions performed, assets used and risks assumed to determine the arm’s length price of an international transaction;
- **determine** the arm’s length price of an international transaction using the most appropriate method;
- **pinpoint** the responsibilities of a person entering into an international transaction to keep and maintain prescribed information and documents;
- **examine** the country-by-country reporting requirements and related matters incorporated in the income-tax law in compliance with BEPS Action Plan 13;
identify the circumstances when the Assessing Officer can invoke the power to determine the arm’s length price;

identify the cases where secondary adjustments have to be made;

appreciate the mechanisms for dispute resolution in transfer pricing cases, including filing of objections before Dispute Resolution Panel, filing of appeal, adoption of safe harbour and entering into advance pricing agreements;

appreciate the specific anti-avoidance measures incorporated in the Income-tax Act, 1961 in respect of transactions with persons located in notified jurisdictional areas;

appreciate the provisions incorporated in the Income-tax Act, 1961 restricting interest deduction claimed by an entity in respect of borrowings from an associated enterprise in line with BEPS Action Plan 4;

integrate, analyse and apply the relevant provisions to make computations and address issues relating to transfer pricing.
1.1 INTRODUCTION

Transactions between related entities may have inherent advantage as compared to transactions between unrelated entities. Such advantage may be by means of price concessions, extended credit period, reduced interest rates, lower logistics expenses, etc. With the advent of globalization, multinational companies (MNCs) have established presence in all parts of the world and are conducting business seamlessly. They can enjoy the privileges of doing business with related parties whereas companies which deal with unrelated parties in an open market are not able to exploit such benefits. Therefore, in order to ensure safe and fair dealing among all companies and markets, the need to introduce regulations for transfer pricing was felt.

In addition to price related benefits, MNCs may also bear in mind the goal of minimizing tax burden and maximizing profits but the two tax jurisdictions/countries also need to ensure that they are not losing their fair share of tax revenue in such cases. This has given rise to an internationally accepted practice that such ‘transfer pricing’ should be governed by the Arm’s Length Principle (ALP) and the transfer price should be the price applicable in case of a transaction of arm’s length. In other words, the transaction between associates should be priced in the same way as a transaction between independent enterprises. Today, transfer pricing is one of the most important issues faced by MNCs as they attempt to fairly distribute their profits amongst the companies within the group. While on the other hand, the tax authorities implement transfer pricing regulations and strengthen the enforcement in order to prevent a loss of revenue for each regime where these companies are incorporated. The net result of this dichotomy is that transfer pricing has become a major tax issue for the companies.

The principles governing the taxation of MNCs are embodied in the OECD Model Tax Convention of Income and Capital (OECD Model Convention), which serves as the basis for the bilateral income-tax treaties between Organization of Economic Cooperation and Development (OECD) member countries and between OECD member and non-OECD member countries. According to these guidelines, “Transfer prices” are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises. Two enterprises are “associated enterprises” if one of the enterprises participates directly or indirectly in the management, control or capital of the other or if both enterprises are under common control. Since international transfer pricing involves more than one tax jurisdiction, any adjustment to the transfer price in one jurisdiction requires a corresponding adjustment in the other jurisdiction. If a corresponding adjustment is not made, double taxation will result.
1.2 WHAT IS TRANSFER PRICING?

Transfer pricing as a concept traditionally began with the amount charged by one segment of an enterprise for a product or service that it supplied to another segment of the same enterprise. With the evolution of MNC concept, segments of the enterprise started spreading as independent entities operating in various parts of the globe. Accordingly, the term has evolved to mean *price which is charged between two or more entities of a MNC [associated enterprises (AEs)] operating in different countries.*

For example, common business transactions between the AEs are in the nature of purchase and sale of assets, raw materials, finished goods and provision of services. Due to the lack of a natural conflict between the parties involved in commercial transactions in a group scenario, most MNCs, given their wide geographical presence, have a possibility to use their position to arrange business transaction to favourably exploit tax positions. By structuring transactions in a way which is most beneficial to the MNC from a tax perspective, the MNC is basically able to steer and manage where it books its profits and therefore also can influence actively the tax burden.

This, the tax administrators believe is unjust. Thus, to protect each country’s fair share in an MNC’s total profit, the tax authorities have established principles under which it can be assumed that related parties deal with each other as if they were independent and this principle is called the arm’s length principle.

**Example:**

*X Limited, a trader of goods, purchases and sells goods as below:*

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Related parties</th>
<th>Unrelated parties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases</td>
<td>8,00,000</td>
<td>5,00,000</td>
</tr>
<tr>
<td>Sales</td>
<td>10,00,000</td>
<td>10,00,000</td>
</tr>
<tr>
<td>Profits</td>
<td>2,00,000</td>
<td>5,00,000</td>
</tr>
</tbody>
</table>

By increasing the costs of purchases from related parties, X Ltd has reduced its taxable profits in said jurisdiction.

1.3 MEANING OF THE TERM “ARM’S LENGTH PRINCIPLE”

The Arm’s Length Price (ALP) of a transaction between two associated enterprises is the price that would be paid if the transaction had taken place between two comparable independent and unrelated parties, where the consideration is only commercial.

The Arm’s Length Principle, in the context of taxation, is explained in the OECD Model Tax Convention as under:

“Where conditions are made or imposed between two associated enterprises in their commercial
or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

The OECD transfer pricing guidelines provides guidance on the application of the arm’s length principle in order to arrive at the proper transfer pricing range between associated enterprises. Market forces determine business relations between independent parties. The arm’s length principle seeks to adjust the profits between two associated enterprises by comparing the same as if the transaction is carried out between two independent enterprises. It treats each enterprise as a separate independent entity rather than as inseparable parts of a single unified business.

### 1.4 SIGNIFICANCE OF ARM’S LENGTH PRINCIPLE

There are several reasons as to why the OECD member countries and other countries have adopted the arm’s length principle.

**Parity between MNCs and independent enterprises** – A major reason is that the ALP provides broad parity of tax treatment for MNCs and independent enterprises. Since the ALP puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages and disadvantages that would otherwise distort the relative competitive positions of these entities. The ALP, thus promotes the growth of international trade and investment by removing these tax considerations from economic decisions.

**Determines real taxable profits** - The transfer price adopted by a multinational has a direct bearing on the proportional profit it derives in each country in which it operates. If inadequate or excessive consideration is paid for the transfer of goods, services or intangible property between the members of an MNC group, the income calculated for each of those members will be inconsistent with their relative economic contributions. An ‘arm’s length’ price – a price two independent firms operating at arm’s length would agree on – is needed to determine taxable profits earned in each country. The arm’s length doctrine permits the taxing authorities to rectify the accounts of the enterprise so as to reflect correctly the income that the establishment would have earned if it were an independent enterprise.

**Reduction of artificial price distortion** - If the ALP is not followed, an MNC will sell goods/provide services to a controlled entity in a high tax regime at a high price (which exceeds the market price) and to an entity in a low-tax regime or a tax haven at a low price (which is lower than the market price). This would result in extreme price distortion of goods and services in the international market.

**Minimization of double taxation** – The ALP is an international concept and it represents the international norm. The potential for double taxation is minimized, since in international transfer pricing, adjustment to the transfer price in one tax jurisdiction requires a corresponding adjustment in the other tax jurisdiction.
Accurate measurement of economic contribution – The ALP provides accurate measurement of the fair market value of the economic contribution units of an MNC. The focus of the ALP is to ensure that the proper amount of income is attributed to where it is earned. This result in each unit of the MNC earning a return commensurate with its economic contribution and risk assumed.

1.5 PRACTICAL DIFFICULTIES IN APPLICATION OF ALP

There are, however, certain practical difficulties in applying the ALP, which are described hereunder:

True comparison difficult in certain cases – The commercial and financial conditions governing a transaction between independent enterprises are, by and large, never similar to those existing between associated enterprises. As a result, there cannot be a true comparison. The economies of scale and integration of various business activities of the associated enterprise may not be truly appreciated by arm’s length principle. Further, associated enterprises may enter into transactions which independent enterprises may not enter into, like say, licensing of valuable intangible or sharing the benefits of research. The owner of an intangible may be hesitant to enter into licensing arrangements with independent enterprises for fear of the value of the intangible being degraded. In contrast, he may be prepared to offer terms that are less restrictive to associated enterprises because the use of the intangible can be closely monitored. Further, there is no risk to the overall group’s profit from a transaction of this kind between members of an MNC group. In such situations, where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the ALP is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises.

Availability of data and reliability of available data – There may be difficulty in getting adequate and reliable information and data in order to apply arm’s length principle. The comparison of controlled and uncontrolled transactions between associated and independent enterprises usually requires a large quantum of data. Easily accessible information may be incomplete and difficult to interpret while the relevant and required information may be difficult to obtain due to geographical constraints or secrecy and confidentiality aspects. In other cases, information about an independent enterprise which could be relevant may not exist at all. Due to these difficulties, the tax administration and tax payers may have to exercise reason and judgment when applying the ALP.

Absence of market price – There must be a reasonably reliable and comparable uncontrolled market price. The ALP does not meet this condition because of the nature of the market place. A market price is an outcome of unique negotiations. It may be possible to know the price range, but it is very difficult to know the actual market price unless a market transaction actually takes place.

Absence of comparable market price for “intangible” transactions - The ALP reaches a comparable uncontrolled market price that is reasonably reliable for standard transactions where the price range is narrow and market price is certain. However, the ALP generally fails to achieve a comparable market price for transactions involving intangibles because they are unique. The unique nature of these transactions creates a very wide price range.
Administrative burden - In certain cases, the arm’s length principle may result in an administrative burden for both the taxpayer and the tax administrations of evaluating significant numbers and types of cross-border transactions.

Time lag - Although an associated enterprise normally establishes the conditions for a transaction at the time it is undertaken, at some point the enterprise may be required to demonstrate that these are consistent with the arm’s length principle. The tax administration may also have to engage in the verification process perhaps some years after the transactions have taken place. It may result in substantial cost being incurred by the taxpayer and the tax administration. It is also difficult to appreciate the business realities which prevailed at the time when the transactions were entered into. This may lead to bias against the tax payer.

In spite of the practical difficulties listed above, OECD member countries are of the view that the ALP does provide a sound basis to appreciate the transfer pricing between associated enterprises. It has so far provided acceptable solutions to both taxpayers and the tax administrations. The experience gained so far should be effectively used to remove the practical difficulties and improve the administration.

1.6 EVOLUTION OF TRANSFER PRICING IN INDIA

Post the globalization/ liberalization in 1991, the enhanced presence of MNCs in India and their ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions, made the issue of transfer pricing a matter of serious concern for the Indian exchequer. Just like their global counterparts, the Indian tax authorities presumed the ability/intention of the MNCs to resort to transfer pricing as tool to shift profits and thereby erode the Indian tax base. This presumption ultimately laid to the evolution of the transfer pricing regulations in India.

Pre 2001 scenario: Prior to the introduction of comprehensive transfer pricing regulations by the Finance Act, 2001, certain basic provisions existed under the income-tax and the customs and excise legislation. While provisions like erstwhile Section 92 and Rule 10 did exist in law (which empowered the Assessing Officers to examine inter-company transactions of MNC group), however, given their restricted scope/ methodology, it was felt over a period of time that the same were not sufficient enough to prevent the erosion of the Indian tax base on account of inter-company transactions undertaken by MNC members. There was no detailed statute on transfer pricing. Further, the term “related parties” found mention under the company law and the anti-trust legislation.

In Mazagaon Dock Ltd v. CIT, the concept of transfer pricing was considered by the Supreme Court with reference to section 42 of the Indian Income-tax Act, 1922, when the law relating to transfer pricing was in its rudimentary stage. The question before the Supreme Court was whether the transaction between the non-resident British companies and the Indian company were at arm’s length. If not, whether it is covered within the scope set out under section 42(2) of the Indian Income-tax Act, 1922. It was observed that section 42 states that it is not the question of the non-residents carrying on business in the abstract but of their carrying on business with the resident. The arrangement has to be looked into and decided on the taxability.
The Apex court rejected the contentions of the Indian company and held that profits, if any foregone, must be taxed. The court expressed the view that the fact, that the dealings were such as to yield no profit, was immaterial.

Section 42(2) in the Indian Income-tax Act, 1922 dealt with the situation concerning ‘Transfer pricing’. On the enactment of the Income-tax Act, 1961 (the Act), the provisions of section 42(2) were incorporated in this Act in the form of section 92 with minor changes to bring out the purport of the section more clearly. Section 92 was backed by Rule 10 and 11 of the Income-tax Rules, 1962.

For invoking section 92, certain requisite conditions had to exist. These were:

(i) The business was transacted between a resident and a non-resident.
(ii) There was a close connection between the two.
(iii) On the account, the course of business was so arranged that the business produces either no profit or less than normal profit to the resident.

If the conditions at (i) to (iii) were found to exist, the Assessing Officer was empowered under the Act to:

- determine the amount of profits, which may reasonably be deemed to have been derived from such business; and
- include such amount in the total income of the resident.

Rules 10 and 11 provided the methodology for working out the normal profit to be included in the income of the resident assessee in the circumstances mentioned earlier. The normal profit could be calculated:

(i) at such percentage of the turnover so accruing or arising as the Assessing Officer may consider to be reasonable, or
(ii) 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, or
(iii) in such other manner as the Assessing Officer may deem suitable.

Section 92 as it existed prior to its amendment, was not sufficient to deal with complex cases of transfer pricing. Its primary shortcomings were:

- The section applied only to ‘businesses’ between a resident and a non-resident. Since business demands a continuity of relationship, isolated transactions were outside its purview.
- The section was not wide enough in its scope to cover cases of transfer of services or intangibles.
- The section was not applicable in the case where a non-resident entered into a transaction with another non-resident. Therefore, business transactions between a permanent
establishment of a non-resident company and a non-resident were not covered.

- The section provided for adjustment of profits instead of adjustment of prices and the rules prescribed for estimating profits were not scientific.
- The concept of ‘close connection’ was not defined, leading to arbitrariness in applying the said provisions.
- No detailed rules for necessary documentation were prescribed to defend actions by the Revenue authorities.

In March 1999, the Standing Committee on Finance realised that the existing transfer pricing policy framework may not be effective to curb transfer pricing abuse in India. In view of the above, the Central Board of Direct Taxes (CBDT) set up an Expert Group on Transfer Pricing in November, 1999 to determine whether any amendments were necessary in the Act and if so to suggest a regulatory framework for the same.


**Post 2001 scenario:** The Finance Act, 2001 introduced Transfer Pricing Regulations for curbing tax avoidance and manipulation of intra-group transactions by abusing transfer pricing. Specifically, the memorandum to the Finance Act, 2001 stated that:

> “The increasing participation of multinational groups in economic activities in the country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in such intra-group transactions, thereby, leading to erosion of tax revenues. With a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises, new provisions are proposed to be introduced in the Income-tax Act.”

Accordingly, sections 92 to 92F had been included in Chapter X of the Income-tax Act, 1961, through the Finance Act, 2001, providing for a transfer pricing mechanism based on computation of income from cross-border transactions. The following conditions must be satisfied in order to attract the special provisions of Chapter X relating to avoidance of tax:

(i) There must be an international transaction;
(ii) Such international transaction should be between two or more associated enterprises either or both of whom are non-residents;
(iii) Such international transaction should be in the nature of:
   (a) purchase, sale or lease of tangible or intangible property; or
INTERNATIONAL TAXATION

(b) provision of service; or

(c) lending or borrowing money; or

(d) any other transaction having a bearing on the profits, income, losses or assets of such enterprise.

(iv) Further, such transaction may also involve allocation or apportionment of, or any contribution to any cost or expenses incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of the associated enterprises on the basis of mutual agreement or arrangement between such associated enterprises.

(v) Such international transaction must be done at arm's length price and if such international transaction has been done at less than the arm's length price, it shall require determination of income or apportionment of cost or expense on the basis of arm's length price.

(vi) The above adjustment should either result in an increase of income or decrease of loss returned by the assessee. In other words, the adjustment should not have the effect of reducing the income chargeable to tax or increasing the loss.

The provisions of Chapter X apply to international transactions entered into with effect from 1st April, 2001. Rules 10A to 10E have been inserted in the Income-tax Rules, 1962 by a notification dated 21st August, 2001. These sections and rules of the Income-tax Act, 1961 and the Income-tax Rules, 1962 respectively, will affect all non-corporate and corporate assesseees who have dealings with non-residents for import or export of goods, properties or services. In other words, price paid for import of goods, properties or services and price received for export of goods, properties or services will be subject to scrutiny by the Assessing Officer. Therefore, it is necessary to make a detailed study of these provisions. All assessseees who have such dealings with non-residents will have to keep detailed records as prescribed under the Rules and will have to furnish audit report every year with the return of income about their international transactions.

1.7 COMPUTATION OF INCOME FROM TRANSACTION WITH NON-RESIDENT [SECTION 92]

Section 92 provides that any income arising from an “international transaction” shall be computed having regard to “the arm's length price”. For this purpose, the allowance for any expense or interest shall be determined on the basis of arm's length price. The section further provides that in an international transaction between two or more “associated enterprises” when there is a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expenses in connection with a benefit, service or facility provided to any one or more of such enterprises, the allocation of cost, expenses etc. shall be determined having regard to arm’s length price of such benefit, service or facility. Similarly, the price received for exports and amounts received for services rendered to associated enterprise will be determined on the basis of arm’s...
length price. It will be noticed that in the international transaction, the income or expense will have to be at arm’s length price, if the transaction is between associated enterprises.

The objective of transfer pricing provisions is to protect the tax base of India and to ensure that due to inter-company transactions, there is no reduction in the taxable profits or the taxes paid by the Indian taxpayer. The reverse, however, does not hold true.

Section 92(3) provides that the transfer pricing provisions contained in Section 92 shall not apply if the same has the effect of reducing the income chargeable to tax or increasing the loss of the assessee for the year under consideration.

The same can be understood with the help of the following example:

**Example:**

<table>
<thead>
<tr>
<th>Case</th>
<th>Income as determined by assessee</th>
<th>Income as per ALP</th>
<th>Expenses claimed by assessee</th>
<th>Expenses as per ALP</th>
<th>Profit/ Loss as per assessee</th>
<th>Profit/ Loss after applying TP provisions</th>
<th>Has TP resulted in reduction of taxable income/ increase of losses?</th>
<th>Will TP provisions apply?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>100</td>
<td>150</td>
<td>70</td>
<td>70</td>
<td>30</td>
<td>80</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>2</td>
<td>100</td>
<td>90</td>
<td>70</td>
<td>70</td>
<td>30</td>
<td>20</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>3</td>
<td>100</td>
<td>90</td>
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<td>110</td>
<td>(10)</td>
<td>(20)</td>
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<td>No</td>
</tr>
<tr>
<td>4</td>
<td>100</td>
<td>100</td>
<td>70</td>
<td>110</td>
<td>30</td>
<td>(10)</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

**1.8 ASSOCIATED ENTERPRISES**

Associated enterprises are those which are owned or controlled by the same or common entity/ person. Section 92A of the Act defines the term ‘Associated Enterprises’ for the purpose of provisions relating to Transfer Pricing. As per Section 92A(1) of the Act, associated enterprise refers to:

a) an enterprise 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.
Example: A Ltd. directly participates in management of B Ltd.

Therefore, both A Ltd. & B Ltd. are associated enterprises.

Now, consider a situation where A Ltd. directly participates in management of B Ltd. and B Ltd. directly participates in management of C Ltd. In such situation, A Ltd. has direct participation in management of B Ltd. but has an indirect participation in management of C Ltd.

Therefore, in such scenario, C Ltd. is also an associated enterprise of A Ltd.

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 enterprises

Then, those two enterprises are associated enterprises.
Example: Mr. A directly has control in A Ltd. and B Ltd. In such a scenario, both A Ltd. & B Ltd. are associated enterprises since they have a common person i.e. Mr. A, who controls both entities A Ltd. & B Ltd.

Deemed Associated Enterprises

Two enterprises are deemed to be associated enterprises if they fall under any one or more of the situations contained in section 92A(2). This section provides 13 such situations during which associated enterprise relationship is deemed to be established. Two enterprises are deemed to be associated enterprise if:

(i) Enterprise ownership - One enterprise holds 26% or more of the voting power, directly or indirectly, in the other enterprise.

Example: A Ltd. holds 33% of voting power in B Ltd. and B Ltd. holds 40% voting power in C Ltd.

\[ A \overset{33\%}{\rightarrow} B \overset{40\%}{\rightarrow} C \]

In above situation, A Ltd. holds 33% of voting power in B Ltd. directly and 40% of voting power in C Ltd. indirectly (i.e. through B Ltd.). Therefore, both B Ltd. & C Ltd. are deemed associated enterprises of A Ltd.

(ii) Voting power by common person - Any person or enterprise holds 26% or more of the voting power, directly or indirectly, in each of two different enterprises.

Example: Mr. A holds 40% of voting power in both X Ltd. and Y Ltd. where neither X Ltd. has any holding in Y Ltd. nor Y Ltd. has any holding in X Ltd.

\[ \text{Mr. A} \]

\[ X \text{ Ltd.} \quad 40\% \quad 40\% \quad Y \text{ Ltd.} \]

In this situation, since Mr. A directly holds 40% of voting power in both X Ltd. and Y Ltd., X Ltd. & Y Ltd. will be deemed associated enterprises.

(iii) Lender - One enterprise advances loan to the other enterprise of an amount of 51% or more of the book value of the total assets of such other enterprise.

Example: Book value of total assets of Y Ltd. is ₹100 crores. X Ltd. advances loan of ₹60 crores to Y Ltd.
Since, in this case, X Ltd. advances loan of ₹ 60 Crores to Y Ltd, which is 60% of the book value of total assets of Y Ltd. Hence, X Ltd. & Y Ltd. are deemed associated enterprises.

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

*Example:* P Inc. has total loan of 1 million dollars from XYZ Bank of America. Out of that, A Ltd., an India company, guarantees 20% of total borrowings in case of any default made by P Inc.

*In such scenario, since, A Ltd. guarantees 20% of total borrowings of P Inc., P Inc. and A Ltd. are deemed associated enterprises.*

(v) **Appointment of Board by other enterprise** - One Enterprise appoints more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of another enterprise, or

*Example:* X Ltd. has 15 directors on its Board. Out of that, Y Ltd. has appointed 8 directors. In such case, X Ltd. and Y Ltd. are deemed associated enterprises.

(vi) **Appointment of Board of two different enterprises by same person(s)** - More than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons.

*Example:* Mr. A appointed 9 directors out of 15 directors of X Ltd. and appointed 2 executive directors on the board of Y Ltd. In such case, since a common person i.e. Mr. A appointed more than half of the directors in X Ltd. and appointed 2 executive directors in Y Ltd., both X Ltd. and Y Ltd. are deemed associated enterprises.

(vii) **Dependence on intangibles** - The manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent (i.e. 100%) 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 entity is the owner or in respect of which the other enterprise has exclusive rights.

(viii) **Dependence on supply in manufacturing process** - 90% or more of raw materials and consumables required for the manufacture or processing of goods or articles or business carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, where the prices and other conditions relating to the supply are influenced by such other enterprise.

(ix) **Dependence on sale** - 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.
(x) **Individual control** - 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 his relatives.

*Example:* Mr. A and Mr. B are relatives. Mr. A has control over X Ltd. and Mr. B has control over Y Ltd. Therefore, both X Ltd. and Y Ltd. will be deemed associated enterprises.

(xii) **Control by Hindu Undivided Family** - Where one enterprise is controlled by a Hindu undivided family (HUF) and the other enterprise is controlled by a member of such HUF or by relative of a member of such HUF or jointly by such member and his relative.

(xii) **Holding in a firm, association of persons or body of individuals** – Where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds 10% or more interest in firm/AOPs/BOIs.

(xiii) **Mutual interest relationship** - There exists between the two enterprises, any relationship of mutual interest, as may be prescribed.

**Meaning of Enterprise:** The term “enterprise” is defined in section 92F(iii) to mean a person (including its certain specified Permanent Establishment) who is, or has been, or is proposed to be, engaged in any activity.
relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or know-how, patents, copy rights, trade-marks, licences, 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, or

- the provision of services of any kind, or in carrying out any work in pursuance of a contract, or in investment, or providing loan or in the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate, whether such activity or business is carried on, directly or through one or more of its units or divisions or subsidiaries, or whether such unit or division or subsidiary is located at the same place where the enterprise is located or at a different place or places.

For this purpose, the term “Permanent establishment” is defined in section 92F(iiiia) to include a fixed place of business through which the business of the enterprise is wholly or partly carried on.

1.9 INTERNATIONAL TRANSACTION

(1) International transaction [Section 92B(1)]

As per section 92B of the Act, an international transaction means:

(i) a transaction between two or more associated enterprises, either or both of whom are non-residents; and

(ii) transaction in the nature of:

(a) sale/ purchase/ lease of tangible property; or

(b) sale/ purchase/ lease of intangible property; or

(c) provision of services; or

(d) lending/ borrowing money; or

(e) any other transaction having a bearing on profits, income, losses or assets of such enterprises; or

(f) mutual agreement or arrangement between two or more associated enterprise for the 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.

(2) Deemed international transaction [Section 92B(2)]

Where, in respect of a transaction entered into by an enterprise with a person other than an associated enterprise (hereinafter referred to as “other person”),
there exists a prior agreement in relation to the relevant transaction between the other person and the associated enterprise or,

where the terms of the relevant transaction are determined in substance between such other person and the associated enterprise; and

either the enterprise or the associated enterprise or both of them are non-residents,

then such transaction entered into between the enterprise and the other person shall be deemed to be an international transaction entered into between two associated enterprises, whether or not such other person is a non-resident.

Example:

If A Ltd., an Indian company, has entered into an agreement for sale of product X to Mr. B, an unrelated party, on 1/6/2019 and Mr. B has entered into an agreement for sale of product X with C Inc., a non-resident entity, which is a specified foreign company in relation to A Ltd., on 30/5/2019, then, the transaction between A Ltd. and Mr. B shall be deemed to be an international transaction entered into between two associated enterprises, irrespective of whether or not Mr. B is a non-resident.

Note – C Inc. is deemed to be an associated enterprise of A Ltd. since it is a specified foreign company in relation to A Ltd., which means that A Ltd. holds 26% or more in the nominal value of the equity share capital of C Inc.
The scope of “international transaction” shall include:

<table>
<thead>
<tr>
<th>Transactions</th>
<th>Amplification of scope of terms used</th>
</tr>
</thead>
</table>
| (1) Purchase, sale, transfer, lease or use of tangible property | Tangible property includes -
• building,
• transportation vehicle,
• machinery, equipment, tools, plant,
• furniture,
• commodity or
• any other article, product or thing; |
| (2) Purchase, sale, transfer, lease or use of intangible property, including transfer of ownership or the provision of use of certain rights | “Use of certain rights” refer to –
• land use,
• copyrights, patents, trademarks, licences, franchises,
• customer list, marketing channel, brand, commercial secret,
• know-how,
• industrial property right,
• exterior design or practical and new design or
• any other business or commercial rights of similar nature. |
| (3) Capital financing | • any type of long-term or short-term borrowing,
• lending or guarantee,
• purchase or sale of marketable securities or
• any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business. |
| (4) Provision of services | • provision of market research,
• market development,
• marketing management,
• administration,
• technical service,
• repairs,
• design,
• consultation,
• agency,
• scientific research,
• legal or accounting service. |
(5) Business restructuring or reorganization entered into by an enterprise with an associated enterprise. All such transactions are included in the definition of "international transaction", whether or not it has bearing on the profit, income, losses or assets of such enterprises at the time of the transaction or at any future date.

(4) Further, the expression “intangible property” shall include

<table>
<thead>
<tr>
<th>Type of intangible asset in relation to</th>
<th>Examples of each type of intangible asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Marketing</td>
<td>• Trademarks</td>
</tr>
<tr>
<td></td>
<td>• trade names</td>
</tr>
<tr>
<td></td>
<td>• brand names</td>
</tr>
<tr>
<td></td>
<td>• logos</td>
</tr>
<tr>
<td>(2) Technology</td>
<td>• Process patents</td>
</tr>
<tr>
<td></td>
<td>• patent applications</td>
</tr>
<tr>
<td></td>
<td>• technical documentation such as laboratory notebooks</td>
</tr>
<tr>
<td></td>
<td>• technical know-how</td>
</tr>
<tr>
<td>(3) Artistic</td>
<td>• literary works and copyrights</td>
</tr>
<tr>
<td></td>
<td>• musical compositions</td>
</tr>
<tr>
<td></td>
<td>• copyrights</td>
</tr>
<tr>
<td></td>
<td>• maps</td>
</tr>
<tr>
<td></td>
<td>• engravings</td>
</tr>
<tr>
<td>(4) Data processing</td>
<td>• proprietary computer software</td>
</tr>
<tr>
<td></td>
<td>• software copyrights</td>
</tr>
<tr>
<td></td>
<td>• automated databases</td>
</tr>
<tr>
<td></td>
<td>• integrated circuit masks and masters</td>
</tr>
<tr>
<td>(5) Engineering</td>
<td>• industrial design</td>
</tr>
<tr>
<td></td>
<td>• product patents</td>
</tr>
<tr>
<td></td>
<td>• trade secrets</td>
</tr>
<tr>
<td></td>
<td>• engineering drawing and schematics</td>
</tr>
<tr>
<td></td>
<td>• blueprints</td>
</tr>
<tr>
<td></td>
<td>• proprietary documentation</td>
</tr>
<tr>
<td>(6) Customer</td>
<td>• customer lists</td>
</tr>
<tr>
<td></td>
<td>• customer contracts</td>
</tr>
<tr>
<td></td>
<td>• customer relationship</td>
</tr>
<tr>
<td></td>
<td>• open purchase orders</td>
</tr>
</tbody>
</table>
(7) **Contract**

- favourable supplier
- contracts,
- licence agreements
- franchise agreements
- non-compete agreements

(8) **Human**

- trained and organised work force
- employment agreements
- union contracts

(9) **Location**

- leasehold interest
- mineral exploitation rights
- easements
- air rights
- water rights

(10) **Goodwill**

- institutional goodwill
- professional practice goodwill
- personal goodwill of professional
- celebrity goodwill
- general business going concern value

(11) methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, or technical data;

(12) any other similar item that derives its value from its intellectual content rather than its physical attributes.

**Meaning of Transaction**

As per section 92F(v) of the Act, “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.

Section 92F(v) provides an inclusive definition of the term “transaction”. Based on the reading of the section, it is evident that it is not necessary that for a transaction undertaken between two enterprises there needs to be a formal written agreement between them. It is only relevant whether a transaction has been entered into in substance. The section also negates the requirement as to the legal enforceability of agreement or understanding.
1.10 SPECIFIED DOMESTIC TRANSACTIONS

It is common knowledge that the under invoicing of sales and over invoicing of expenses is ordinarily revenue neutral in case of a domestic transaction. However, shifting of profits from a profit making entity to related entity which is into losses or from one group entity to another to take undue advantage of tax incentive (tax holiday or any other), can create unwarranted situation of significant revenue loss to the Government.

To understand such situations in a greater detail, following examples can be referred to:

**Example 1: Profit shifting from a domestic tariff area (DTA) unit to a tax holiday unit**

**Actual situation**

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Tax Holiday Unit</th>
<th>DTA Unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Rate</td>
<td>-</td>
<td>30%</td>
</tr>
<tr>
<td>Income from related party transaction ('RPT')</td>
<td>100</td>
<td>-</td>
</tr>
<tr>
<td>Other income</td>
<td>300</td>
<td>300</td>
</tr>
<tr>
<td>Expenses in relation to RPT</td>
<td>-</td>
<td>100</td>
</tr>
<tr>
<td>Other expenses</td>
<td>200</td>
<td>50</td>
</tr>
<tr>
<td>Profit / (loss)</td>
<td>200</td>
<td>150</td>
</tr>
<tr>
<td>Tax</td>
<td>0</td>
<td>45 (i.e. 150 * 30%)</td>
</tr>
</tbody>
</table>

**Shifting of profits**

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Tax Holiday Unit</th>
<th>DTA Unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Rate</td>
<td>-</td>
<td>30%</td>
</tr>
<tr>
<td>Income from related party transaction ('RPT')</td>
<td>250</td>
<td>-</td>
</tr>
<tr>
<td>Other income</td>
<td>300</td>
<td>300</td>
</tr>
<tr>
<td>Expenses in relation to RPT</td>
<td>-</td>
<td>250</td>
</tr>
<tr>
<td>Other expenses</td>
<td>200</td>
<td>50</td>
</tr>
<tr>
<td>Profit / (loss)</td>
<td>350</td>
<td>0</td>
</tr>
<tr>
<td>Tax</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>
Example 2: Profit shifting from a profit making entity to a related loss making concern.

Actual situation

<table>
<thead>
<tr>
<th>Particulars</th>
<th>ABC Ltd.</th>
<th>XYZ Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Rate</td>
<td>30%</td>
<td>30%</td>
</tr>
<tr>
<td>Income from related party transaction ('RPT')</td>
<td>100</td>
<td>-</td>
</tr>
<tr>
<td>Other income</td>
<td>300</td>
<td>300</td>
</tr>
<tr>
<td>Expenses in relation to RPT</td>
<td>-</td>
<td>100</td>
</tr>
<tr>
<td>Other expenses</td>
<td>700</td>
<td>50</td>
</tr>
<tr>
<td>Profit / (loss)</td>
<td>(300)</td>
<td>150</td>
</tr>
<tr>
<td>Tax</td>
<td>0</td>
<td>45 (i.e. 150 * 30%)</td>
</tr>
</tbody>
</table>

Tax planning to shift profits

<table>
<thead>
<tr>
<th>Particulars</th>
<th>ABC Ltd.</th>
<th>XYZ Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Rate</td>
<td>30%</td>
<td>30%</td>
</tr>
<tr>
<td>Income from related party transaction ('RPT')</td>
<td>250</td>
<td>-</td>
</tr>
<tr>
<td>Other income</td>
<td>300</td>
<td>300</td>
</tr>
<tr>
<td>Expenses in relation to RPT</td>
<td>-</td>
<td>250</td>
</tr>
<tr>
<td>Other expenses</td>
<td>700</td>
<td>50</td>
</tr>
<tr>
<td>Profit / (loss)</td>
<td>(150)</td>
<td>0</td>
</tr>
<tr>
<td>Tax</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

In order to provide objectivity in determination of income from domestic related party transactions and determination of reasonableness of expenditure between related domestic parties, the provisions of section 92 have been extended to include within its ambit the specified domestic transactions.

The transfer pricing provisions and other related provisions pertaining to Specified Domestic Transaction are discussed in detail in “Chapter 1: Transfer pricing and other provisions to check avoidance of tax” of Module 4: Part II- International Taxation of Paper 7: Direct Tax Laws and International Taxation.

1.11 COMPUTATION OF ARM’S LENGTH PRICE (SECTION 92C)

“Arm's length price” is defined in section 92F(ii) to mean price which is applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions.

Section 92C deals with the method for determining arm’s length price and the factors which are to be considered for applicability or non-applicability of a particular method to a given situation. The factors as well as methods incorporated in this section are not exhaustive and the CBDT may prescribe further factors and methods.
It provides that the arm’s length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely -

(a) comparable uncontrolled price method;
(b) resale price method;
(c) cost plus method;
(d) profit split method;
(e) transactional net margin method;
(f) such other method as may be prescribed by the Board.

Accordingly, the Board has prescribed that the other method for determination of arm’s length price in relation to an international transaction shall be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts. [Rule 10AB]

Section 92C(2) provides that the most appropriate method out of the above methods has to be applied for determination of arm’s length price, in the prescribed manner.

Rule 10B(1) prescribed the manner to determine the arm’s length price under the five methods as stated in above diagram in respect of any goods, property or services purchased or sold under any international transaction.
(1) **Comparable uncontrolled price method:**

A comparable uncontrolled price is the price agreed between unconnected parties for the transaction of goods or services under similar circumstances.

Mechanism to determine CUP is as follows:

(i) Identification of price charged or paid for property transferred or services provided under any comparable uncontrolled transaction(s).

(ii) Such price is adjusted to account for differences, if any, between the international transaction and comparable uncontrolled transactions or between the enterprises entering into such transactions which could materially affect the price in the open market can be made.

(iii) Adjusted price arrived above taken to be as arm’s length price in respect of the property transferred or services provided in the international transaction.

**Meaning of “Uncontrolled transaction”:** Uncontrolled transaction means a transaction between enterprises other than associated enterprises, whether resident or non-resident.

The comparable uncontrolled price method requires a high degree of comparability of products, services and functions and such comparability can be improved by carrying out necessary reasonable adjustments, in respect of differences arising on account of various factors such as quality of the product or service, contractual terms, credit terms, transport terms, level of the market (i.e. wholesale, retail, etc.), geographic market in which the transaction takes place, etc.

A Comparable uncontrolled price can be determined as follows:
Transaction between AE1 and AE2 are subject to transfer pricing. Transaction #1 and #2 are internal transaction since it is entered by AEs with unrelated parties and Transaction #3 is external transaction since it is entered between unrelated parties. Hence, controlled transaction need to be compared with either Transaction #1 (If AE1 is the tested party) or Transaction #2 (If AE2 is the tested party) or Transaction #3.

In the given example, AE1 and AE2 are parties to a controlled transaction. Assume, AE1 provides back office support services to AE2 (i.e. engaged in manufacturing of goods). The functions performed, assets deployed and risk assumed for back office support services is less complex vis-à-vis the functions performed, assets deployed and risk assumed in manufacturing activities. Hence, AE1 must be selected as tested party which has least complex functional profile. Accordingly, controlled transaction need to be compared with Transaction #1 i.e., between unrelated party and AE1.

**ILLUSTRATION 1**

US Ltd., a US company has a subsidiary, IND Ltd. in India. US Ltd. sells computer monitors to IND Ltd. for resale in India. US Ltd. also sells computer monitors to CMI Ltd., another computer reseller. It sells 50,000 computer monitors to IND Ltd. at ₹11,000 per unit. The price fixed for CMI Ltd. is ₹10,000 per unit. The warranty in case of sale of monitors by IND Ltd. is handled by IND Ltd. However, for sale of monitors by CMI Ltd., US Ltd. is responsible for the warranty for 3 months. Both US Ltd. and IND Ltd. offer extended warranty at a standard rate of ₹1,000 per annum. On these facts, how is the assessment of IND Ltd. going to be affected?

**SOLUTION**

US Ltd., the foreign company and IND Ltd., the Indian company are associated enterprises since US Ltd. is the holding company of IND Ltd. US Ltd. sells computer monitors to IND Ltd. for resale in India. US Ltd. also sells identical computer monitors to CMI Ltd., which is not an associated enterprise. The price charged by US Ltd. for a similar product transferred in comparable uncontrolled transaction is, therefore, identifiable. Therefore, Comparable Uncontrolled Price (CUP) method for determining arm’s length price can be applied.

While applying CUP method, the price in comparable uncontrolled transaction needs to be adjusted to account for difference, if any, between the international transaction (i.e. transaction between US Ltd. and IND Ltd.) and uncontrolled transaction (i.e. transaction between US Ltd. and CMI Ltd.) and the price so adjusted shall be the arm’s length price for the international transaction.

For sale of monitors by CMI Ltd., US Ltd. is responsible for warranty for 3 months. The price charged by US Ltd. to CMI Ltd. includes the charge for warranty for 3 months. Hence arm’s length price for computer monitors being sold by US Ltd. to IND Ltd. would be:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>No.</th>
<th>₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale price charged by US Ltd. to CMI Ltd.</td>
<td></td>
<td>10,000</td>
</tr>
</tbody>
</table>
1.26   INTERNATIONAL TAXATION

| Less: Cost of warranty included in the price charged to CMI Ltd. (₹ 1,000 x 3 /12) | 250 |
| Arm’s length price | 9,750 |
| Actual price paid by IND Ltd. to US Ltd. | 11,000 |
| Difference per unit | 1,250 |
| No. of units supplied by US Ltd. to IND Ltd. | 50,000 |
| Addition required to be made in the computation of total income of IND Ltd. (₹ 1,250 x 50,000) | 6,25,00,000 |

No deduction under chapter VI-A would be allowable in respect of the enhanced income of ₹ 6.25 crores.

**Note:** It is assumed that IND Ltd. has not entered into an advance pricing agreement or opted to be subject to Safe Harbour Rules.

**2) Resale price method**

The resale price method (RPM) is a method which compares the gross margins (i.e. gross profit over sales) earned in transactions between related and unrelated parties for the determination of the ALP. The RPM requires high level of functional comparability and is mainly applicable where the controlled party is a distributor.

The RPM evaluates whether the amount charged in a controlled transaction is at arm’s length by reference to the gross margin realised in comparable uncontrolled transactions. RPM can be computed as follows:

1. Identification of resale price by tested party i.e., the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or provided to an unrelated enterprise.
2. Resale price is reduced by normal gross profit margin with reference to uncontrolled transaction(s).
3. Such price reduced by expenses incurred (customs duty etc.) in connection with purchase of the product/ services.
4. This price may be adjusted to account for functional and other differences, if any, including differences in accounting practices which could materially affect the gross profit margin in the open market.
5. Adjusted price arrived above taken to be as arm’s length price

RPM is generally used to test transactions involving distribution function, i.e. when the tested party purchases products/ acquires services from related party and resells the same to independent parties. The use of RPM is appropriate where the reseller does not add substantially to the value
of the product/services. Where the transactions are not comparable in all ways and the differences have a material effect on price, one has to make adjustments to eliminate the effect of those differences. For this purpose, consideration of operating expenses associated with functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses.

Using RPM as the most appropriate method, ALP can be computed as follows:

AE2 has purchased goods from AE1 and re-sold to independent enterprise at USD 100. A similar transaction is entered into by unrelated parties with resale price margin of USD 25. Thus, the arm’s length price arrived at is USD 75 (i.e. market value of goods at which AE2 should have purchased from AE1 (assuming no other costs for AE2 for simplicity purposes).

(3) Cost plus method

The Cost Plus Method (‘CPM’) determines an arm’s-length price by adding an appropriate gross profit margin to an associated entity’s costs of producing goods or services. The gross profit margin should reflect the functions performed by an entity and should include a return for capital used and risks assumed by the entity.

Mechanism to compute ALP based on CPM is as follows:

(i) Identification of direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise.

(ii) Determination of amount of normal gross profit mark-up to such costs arising from the transfer or provision of the same or similar property or services by the enterprise or by an unrelated enterprise in comparable uncontrolled transaction or transactions.

(iii) The normal gross profit mark-up determined above is adjusted to account for functional and
other differences, if any, which could materially affect such profit mark-up in the open market.

(iv) Adjusted gross profit mark-up added to total costs identified in (i) above.

(v) Sum arrived above is taken to be arm’s length price in relation to the supply of property or provision of services by the enterprise.

This method probably is most useful where semi-finished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.

Using CPM as the most appropriate method, ALP can compute as follows:

<table>
<thead>
<tr>
<th>Cost Plus Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Associated</td>
</tr>
<tr>
<td>Enterprise 1</td>
</tr>
<tr>
<td>Arm’s length price?</td>
</tr>
<tr>
<td>Associated</td>
</tr>
<tr>
<td>Enterprise 2</td>
</tr>
</tbody>
</table>

\[
\begin{align*}
\text{Cost of Associated Enterprise 1} &= \$500 \\
+ \text{Gross profit mark-up (50\%)} &= \$250 \\
\text{Arm’s length price} &= \$750
\end{align*}
\]

AE2 has purchased manufactured goods from AE1. A similar transaction is entered into by unrelated parties with gross profit margin of USD 250. Thus, the arm’s length price arrived at is USD 750 i.e. market value of goods at which AE2 should have purchased from AE1.

If there are differences between the controlled and uncontrolled transactions that would affect the gross profit mark-up, adjustments should be made to the gross profit mark-up earned in the comparable uncontrolled transaction. For this purpose, consideration of the operating expenses associated with the functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses.

(4) Profit split method

This is a method which may be applicable mainly in international transactions involving transfer of unique intangibles or in multiple international transactions which are so inter-related that they cannot be evaluated separately for the purpose of determining the arm’s length price of any one transaction.

The Profit Split Method (PSM) evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is at arm’s length with reference to the relative value of each controlled taxpayer’s contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most prominently identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions (relevant business activity).
Profit split method, generally, is applied as per following steps:

(i) Determination of combined net profit of the associated enterprises arising out of international transaction in which they are engaged.

(ii) Evaluation of relative contributions by each enterprise to the earning of such combined net profit on the basis of functions performed, risks assumed and assets employed by each enterprise. This evaluation is to be made on the basis of reliable external market data which can indicate how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances.

(iii) Splitting of combined net profit amongst the enterprises in proportion to their relative contributions, as evaluated above.

(iv) Profit thus apportioned to the assessee is taken into account to arrive at the arm’s length price in relation to the international transaction.

Allocation of profits must be made in accordance with one of the following allocation methods:

(a) Comparable profit split - Under this method, uncontrolled taxpayer’s percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity.

(b) Residual profit split - Following the two-step process:
   
   i. Allocate income to routine contributions
   
   ii. Allocate residual profit

The following example explains the PSM:

```
Net Profits from all Transactions (USD 100M)

Minus functional/assets returns to each party based on market benchmarks (USD 70M)

Residual Profit (USD 30M)

Residual Profit Share for Related Party X

Residual Profits split, based on each party’s ownership of non-routine intangibles (example network reach, efficiency of sales and marketing team, etc.)

Residual Profit Share for Related Party Y
```
Suppose in the above example, Net profit margins from all transactions were USD 100M. Depending on the contribution of each AE, the net profit of USD 70M will be distributed to all AEs (i.e. Allocate income to routine contributions). Further, after the respective contribution is allocated specifically, the residual profit of USD 30M will be distributed among AEs based on various factors.

Total profit for Related Party X:
1. Income for specific contribution (suppose 40% by X and 60% by Y) made by X: USD 28M (i.e. USD 70M x 40%)
2. Income as residual profit (i.e. 50:50) (allocated considering various factors): USD 15M (i.e. 30M x 50%)

Total Arm’s length profit of related party X: USD 43M (USD 28M + USD 15M)

(5) Transactional net margin method

Under the Transactional net margin method (TNMM), an arm’s-length price is determined by comparing the net profit margin in relation to an appropriate base (example costs, sales, assets) of the tested party with the net profit margin in relation to the same base, of an uncontrolled party engaged in comparable transactions.

The following steps are required to determine ALP using TNMM:

(i) Computation of net profit margin realized by the enterprise from the international transaction with an AE having regard to costs incurred or sales effected or assets employed or having regard to any other relevant base.

(ii) Computation of net profit margin realized by the enterprise or an unrelated enterprise in a comparable uncontrolled transaction by applying the same base as above.

(iii) Net profit margin realized from uncontrolled transaction is adjusted to account for differences, if any, which could materially affect the net profit margin in the open market.

(iv) The net profit margin realized by the enterprise referred in (i) above is established to be the same as net profit margin referred in (iii) above.

(v) The net profit margin thus established is taken into account to arrive at an arm’s length price for the international transaction.

The following example explains the TNMM:

<table>
<thead>
<tr>
<th>Given price</th>
<th>=</th>
<th>$10 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>=</td>
<td>$______?</td>
</tr>
<tr>
<td>Gross profit</td>
<td>=</td>
<td>?</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>=</td>
<td>$ 2 000</td>
</tr>
<tr>
<td>Net profit (5% of price)</td>
<td>=</td>
<td>$ 500 Comparable</td>
</tr>
</tbody>
</table>

AE1 has purchased raw materials from its AE2 and manufactures goods for sale to third parties. The similar transaction is entered into by unrelated parties with net margin of 5% of sale price.
Thus, if AE1 earns net margin of 5% of sale price, then its transaction of purchase of raw materials from AE2 will be at arm’s length.

The following table summarises the application of method and its preferences on a general basis (The below table is illustrative only and not binding – Applicability of methods can change depending on the facts of each case):

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Commodities/Oil</td>
<td>√</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payment of Interest</td>
<td>√</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Distribution of goods</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Provision of Services</td>
<td></td>
<td></td>
<td>√</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>Contract manufacturing</td>
<td></td>
<td>√</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manufacturing</td>
<td></td>
<td></td>
<td>√</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payment of Royalty</td>
<td>√</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Multiple transactions involving intangibles</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>√</td>
</tr>
<tr>
<td>Management Charges</td>
<td></td>
<td>No Specified Method</td>
<td>Benefit test and acceptable allocation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales of shares, Intangible Assets (trademark, brand name etc.)</td>
<td></td>
<td>No Specified Method</td>
<td>Can rely on valuation report under the other method</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(6) **Other Method as may be prescribed by the CBDT**

The Other method allows the use of ‘any method’ which takes into account

(i) the price which has been charged or paid or

(ii) would have been charged or paid for the same or similar uncontrolled transactions with or between non-associated enterprises, under similar circumstances.

The various data which may possibly be used for comparability purposes under this method could be third party quotations, valuation reports, tender/Bid documents, documents relating to the negotiations, standard rate cards, commercial & economic business models; etc.
For applying the above methods, the comparability of the international transaction with an uncontrolled transaction is to be judged with reference to the following factors:

(i) The specific characteristics of the property transferred or services provided in either transaction;

(ii) The functions performed, taking into account assets employer or to be employer and the risks assumed, by the respective parties to the transactions;

(iii) The contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;

(iv) Conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

Rule 10B(3) provides that an uncontrolled transaction shall be comparable to an international transaction

- if none of the differences between the transactions being comparable or between the enterprises entering into such transactions is likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market or

- reasonably accurate adjustments can be made to eliminate the material effects of such differences.

Data to be used for analyzing the comparability of an uncontrolled transaction with an international transaction

The data to be used for analyzing the comparability of an uncontrolled transaction and an international transaction should relate to the financial year (current year) in which the international transaction has been entered into.

In case the most appropriate method for determination of ALP of a transaction entered into on or after 1.4.2014 is the resale price method or cost plus method or the transactional net margin method, then, the data to be used for analyzing the comparability of an uncontrolled transaction with an international transaction shall be –

(a) the data relating to the current year; or

(b) 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 the data relating to the current year is subsequently available at the time of determination of arm’s length price of an international transaction during the course of any assessment proceeding for the assessment year relevant to the current year, then, such data 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 of the relevant assessment year.
Methods for computing ALP [Section 92C]

**CUP Method**
- This method is applied where there are similar transaction(s) b/w unconnected parties
- Identify price in a comparable uncontrolled transaction (CUCT)
- Adjust the price for material differences in terms of contract, credit, transport etc.
- Adjusted price is ALP

**Resale Price Method (RPM)**
- This method is applied where item obtained from AE is resold to unrelated party
- Identify the RP at which the item is resold to unrelated party
- Reduce the RP by the normal GP margin on CUCT & expenditure incurred (customs duty) w.r.t. purchase
- Adjusted price is ALP

**Cost Plus Method (CPM)**
- This method is generally applied where semi-finished goods are sold to AEs
- Identify direct & indirect COP incurred for property transferred or services provided to AE
- Determine normal GP mark up to such costs by an unrelated enter in CUCT
- ALP to be determined on the basis of profit apportioned.

**Profit Split Method (PSM)**
- This method is applied where there is transfer of unique intangibles or in multiple International Transaction
- Determine combined NP of the AEs arising out of International Transaction
- Split the combined NP amongst the enterprise in proportion to market returns; & residual profits in proportion to their relative contribution
- Adjusted NP margin relative to costs/sales/assets of the AE with NP margin of uncontrolled party in comparable transactions

**Transactional Net Margin Method (TNMM)**
- Compute NP margin of the enterprise from International Transaction with AE having regard to cost incurred/sales effected/assets employed
- Compute the NP margin realised by the enterprise or unrelated enterprise in a CUCT by applying the same base
- Adjust NP margin realised from CUCT to a/c for differences affecting NP margin in the OM
- ALP to be determined on the basis of profit apportioned.

Total Costs ↑d by adjusted mark up = ALP

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(7) Selection of tested party

The tested party will be the participant in the controlled transaction whose profitability/ pricing attributable to the controlled transactions can be verified based on the most appropriate data and requiring the fewest & most reasonable adjustments, and for which reliable data regarding uncontrolled comparables can be located.

Consequently, in most cases the tested party will be the “least complex” of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.

In the given example, AE1 and AE2 are parties to a controlled transaction. Assume, AE1 provides back office support services to AE 2 (i.e. engaged in manufacturing of goods). The functions performed, assets deployed and risk assumed for back office support services is less complex vis-à-vis the functions performed, assets deployed and risk assumed in manufacturing activities. Hence, AE1 must be selected as tested party which has least complex functional profile.

(8) Selection of Profit Level Indicator

A profit level indicator (PLI) is selected to test the profitability of tested party. PLIs are ratios that measure relationships between profits and costs incurred or resources employed. A variety of PLI’s can be calculated in any given case.

It is a practice to adopt the denominator of the PLI as being un-tainted or less-tainted. A tainted income or expense would mean one that is received from an AE or paid to an AE and therefore cannot be considered to be independent or at arm’s length. Untainted on the other hand would mean revenue or costs which relate to transactions with independent third parties and are therefore more reliable.

In above example, the revenue from back support services will be tainted because it is received from related party. So, the PLI, in the above case, should be costs.
The following table briefly summarises the various PLIs used:

<table>
<thead>
<tr>
<th>Overview of Various Profit Level Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Return on Assets (ROA)</strong></td>
</tr>
<tr>
<td><strong>Return on Capital Employed (ROCE)</strong></td>
</tr>
</tbody>
</table>

*Johnson Matthey India (P.) Ltd. Vs Deputy Commissioner of Income-tax ([2016] 380 ITR 43 (Delhi)) – It was held that reliability of ROCE as a PLI depends upon extent to which composition of assets/capital deployed by tested party and their valuation is similar to that of comparables and if balance sheet does not accurately reflect average use of capital throughout year, ROCE would be less reliable.*

| **Operating Margin (OM)** | Operating profit divided by sales |
| **Return on Total Costs (ROTC)** | Operating profit divided by total costs |
| **Return on Cost of Goods Sold** | Gross profit divided by cost of goods sold |
| **Berry Ratio** | Gross profit divided by operating expenses |

(9) **Most Appropriate Method**

Rule 10C deals with the determination of most appropriate method. Under this Rule, the method which is best suited to the facts and circumstances and which provides the most reliable measure of an arm’s length price in relation to the international transaction will be considered to be the most appropriate method.

For the purpose of selecting the most appropriate method, the following factors should be taken into account:

(i) The nature and class of the international transaction;

(ii) The class, or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;

(iii) The availability, coverage and reliability of data necessary for application of the method;

(iv) The degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;

(v) The extent to which reliable and accurate adjustments can be made to account for difference, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;
(vi) The nature, extent and reliability of assumptions required to be made in application of a method.

(10) Manner of computation of Arm’s length price (Applicable for international transactions undertaken on or after 1.4.2014) [Third proviso to section 92C(2)]

In case of an international transaction undertaken on or after 1.4.2014, where more than one price is determined by the most appropriate method, the ALP shall be computed in the prescribed manner specified in Rule 10CA.

Computation of arm’s length price in certain cases (Rule 10CA)

Determination of arm’s length price using one of the prescribed methods

The price thus determined is the arm’s length price

Whether a single price is arrived at?

Yes

No

As per range concept, if prescribed conditions are satisfied (covered in later sections),

(or)

By applying Arithmetic Mean in any other case

Rule 10CA(1) provides that where in respect of an international transaction, the application of the most appropriate method referred to in section 92C(1) results in determination of more than one price, then, the arm’s length price in respect of such international transaction has to be computed on the basis of the dataset constructed by placing such prices in an ascending order as provided in Rule 10CA(2).

Application of multiple year data for construction of dataset

Multiple year data allowed only in cases where determination of ALP is done using TNMM, RPM or CPM
Where the most appropriate method is the resale price method or cost plus method or 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, [not being the enterprise undertaking the international transaction referred to in sub-rule (1)], has in either or both of the two financial years immediately preceding the current year undertaken the same or similar comparable uncontrolled transaction then,-

(i) the most appropriate method used to determine the price of the comparable uncontrolled transaction undertaken 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) the weighted average of the prices, computed in accordance with the manner provided in sub-rule (3), of the comparable uncontrolled transactions undertaken in the current year and in the aforesaid period preceding it shall be included in the dataset instead of the price referred to in sub-rule (1).

Further, where the most appropriate method is the resale price method or cost plus method or transactional net margin method where the comparable uncontrolled transaction has been identified on the basis of the data relating to the financial year immediately preceding the current 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 financial year immediately preceding the said financial year undertaken the same or similar comparable uncontrolled transaction then,-

(i) the price in respect of such uncontrolled transaction shall be determined by applying the most appropriate method in a similar manner as it was applied to determine the price of the comparable uncontrolled transaction undertaken in the financial year immediately preceding the current year; and

(ii) the weighted average of the prices, computed in accordance with the manner provided in sub-rule (3), of the comparable uncontrolled transactions undertaken in the aforesaid period of two years shall be included in the dataset instead of the price referred to in sub-rule (1).

Also, in such cases, where the use of data relating to the current year for determination of ALP subsequently at the time of assessment establishes that,-

(i) the enterprise has not undertaken same or similar uncontrolled transaction during the current year; or

(ii) 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 uncontrolled transaction in the financial year immediately preceding the current year or the financial year immediately preceding such financial year, the price of comparable uncontrolled transaction or the
weighted average of the prices of the uncontrolled transactions, as the case may be, undertaken by such enterprise shall **not** be included in the dataset.

Rule 10CA(3) provides that where an enterprise has undertaken comparable uncontrolled transactions in more than one financial year, then for the purposes of sub-rule (2) the weighted average of the prices of such transactions shall be computed in the following manner, namely:-

<table>
<thead>
<tr>
<th>Method used to determine the prices</th>
<th>Manner of computation of weighted average of the prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i) The resale price method</td>
<td>By assigning weights to the quantum of sales which has been considered for arriving at the respective prices</td>
</tr>
<tr>
<td>(ii) The cost plus method</td>
<td>By assigning weights to the quantum of costs which has been considered for arriving at the respective prices</td>
</tr>
<tr>
<td>(iii) The transactional net margin method</td>
<td>By assigning weights to the quantum of costs incurred or sales effected or assets employed or to be employed, or as the case may be, any other base which has been considered for arriving at the respective prices.</td>
</tr>
</tbody>
</table>

**Range Concept:** Rule 10CA(4) provides that where the most appropriate method applied is –

(i) a method other than the profit split method or a method prescribed by the CBDT under section 92C(1)(d)/(f); and

(ii) the dataset constructed in accordance with sub-rule (2) consists of six or more entries, an arm’s length range beginning from the thirty-fifth percentile of the dataset and ending on the sixty-fifth percentile of the dataset shall be constructed.

If the price at which the international transaction has actually been undertaken is within the said range, then, the price at which such international transaction has actually been undertaken shall be deemed to be the arm’s length price [Rule 10CA(5)].

If the price at which the international transaction has actually been undertaken is outside the said arm’s length range, the arm’s length price shall be taken to be the median of the dataset [Rule 10CA(6)].

**When to apply range concept?**

• Most appropriate method selected is Comparable uncontrolled price method, resale price method, cost plus method or transactional net margin method and
• The dataset constructed has six or more entries.

**How to apply?**

• Arrange the values in the dataset in the ascending order.
• Where the actual transaction price falls within 35th and 65th percentile of the dataset, the value of transaction will be accepted to be arm’s length price.
• Where the transfer price does not fall within the above range, then median of dataset shall be taken as the Arm’s Length price.
<table>
<thead>
<tr>
<th>Term</th>
<th>Meaning</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>the thirty-fifth percentile of a dataset (having values arranged in an ascending order)</td>
</tr>
<tr>
<td>(b)</td>
<td>the sixth-fifth percentile of a dataset (having values arranged in an ascending order)</td>
</tr>
<tr>
<td>(c)</td>
<td>the median of the dataset (having values arranged in an ascending order)</td>
</tr>
</tbody>
</table>

**Example 1:** Where the data set comprises 7 data points (arranged in ascending order), and the percentiles computed are not whole numbers

<table>
<thead>
<tr>
<th>Percentile</th>
<th>Formula</th>
<th>Result</th>
<th>Value to be selected</th>
</tr>
</thead>
<tbody>
<tr>
<td>35th</td>
<td>Total no. of data points in dataset x 35% = [7 x 35%]</td>
<td>2.45</td>
<td>3rd value*</td>
</tr>
<tr>
<td>65th</td>
<td>Total no. of data points in dataset x 65% = [7 x 65%]</td>
<td>4.55</td>
<td>5th value*</td>
</tr>
<tr>
<td>Median</td>
<td>Total no. of data points in dataset x 50% = [7 x 0.5]</td>
<td>3.50</td>
<td>4th value*</td>
</tr>
</tbody>
</table>

* Value referred to here is the place value in the data set as arranged in ascending order.

**Example 2:** Where the data set comprises 20 data points (arranged in ascending order), and the percentiles computed are whole numbers.

<table>
<thead>
<tr>
<th>Percentile</th>
<th>Formula</th>
<th>Result</th>
<th>Value to be selected</th>
</tr>
</thead>
<tbody>
<tr>
<td>35th</td>
<td>Total no. of data points in dataset x 35% = [20 x 35%]</td>
<td>7</td>
<td>Mean of 7th &amp; 8th value</td>
</tr>
<tr>
<td>65th</td>
<td>Total no. of data points in dataset x 65% = [20 x 65%]</td>
<td>13</td>
<td>Mean of 13th &amp; 14th value</td>
</tr>
</tbody>
</table>
Median | Total no. of data points in datasets × 50% = [20 × 0.5] | 10 | Mean of 10th & 11th value
--- | --- | --- | ---

If the transaction price falls within the range, then the same shall be deemed to be the ALP. If the transaction price falls outside the range, the ALP shall be taken to be the Median of the data set.

**Range concept not applicable:**

In a case where the provisions of Rule 10CA(4) are not applicable, the arm’s length price shall be the arithmetical mean of all the values included in the dataset. However, if the variation between the arm’s length price so determined and price at which the international transaction has actually been undertaken does not exceed such percentage not exceeding 3% of the latter, as may be notified by the Central Government in the Official Gazette in this behalf, the price at which the international transaction has actually been undertaken shall be deemed to be the arm’s length price [Rule 10CA(7)].

### 1.12 FUNCTIONS, ASSETS AND RISK (FAR) ANALYSIS

Functions, Assets and Risk (‘FAR’) analysis is an analysis of the functions performed, taking into account assets used and risks assumed by associated enterprises (AEs) in controlled transactions.

A method of finding and organizing facts about a business in terms of the functions performed, assets used (including intangible property) and risks assumed by such business to:

- identify how they are divided among the AEs; and
- assess the importance of each function in the overall value chain.

FAR analysis is the starting point in determining the arm’s length price of an international transaction.

Let us take an example. Can we compare a manufacturer with a logistic service provider? The answer is “No”. Both of them will perform different functions, employ different kind of assets and undertake different type of risks. How would one determine whether the entity is a manufacturer or a logistic service provider? Simply, by undertaking FAR analysis.

![Diagram](https://via.placeholder.com/150)

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Components of a FAR analysis

The FAR analysis should direct the reader unambiguously to the correct conclusion about the characterization of the entity. For understanding the FAR, it is important to understand the entire value chain of the business that one is analyzing. A detailed discussion of the three elements of the FAR is as under:

(a) **Functions performed:** Functions performed are the activities that are carried out by each of the parties to the transaction. In performing functional analysis, important and significant functions are considered. Such functions add more value to the transactions and therefore, are expected to fetch higher returns for the entity performing such functions. Thus, the focus should not only be on identifying the maximum number of functions but on identification of critical functions performed by the related parties.

While functions performed depends on the facts of the case, some of the important functions that are generally observed and examined in a transaction are:

- Research and development
- Budgeting
- Purchasing and materials management
- Manufacturing, production or assembly work
- Warehousing and inventory
- Marketing and distribution
- Business process management/ administrative functions
- Scheduling
- Supervision

The above may differ based on the kind of entity for which one is undertaking FAR analysis. For example, in case of trading entity, the research & development related functions, or manufacturing related functions may not be present.

Having identified the principle functions performed by the parties in the controlled transaction, the next step is to compare the same with the functions performed in the uncontrolled transactions to determine the extent of comparability.
(b) **Assets employed:** As regards assets employed, one needs to identify the assets (tangible as well as intangible) used by the entities being compared in relation to the transaction under consideration. The analysis of assets employed into tangible assets and intangible assets is of vital importance.

The existence of intangible assets in the form of technical knowhow, trademarks, patents, etc. contribute to the super normal growth in profits of an enterprise.

However, an entity which owns only tangible assets which are used in normal course of operations such as computers, furniture & fixture, plant and machinery, etc. is expected to earn routine/normal profits as earned by other companies engaged in similar business.

(c) **Risks assumed:** Risk study involves identification of various risks that are assumed by each of the parties to the transaction. It is commonly understood that risk and return go hand in hand. In the open market, more the risks assumed by an enterprise, higher the returns that it expects. Conversely, in case where the risks undertaken by the enterprise in a transaction are minimal, the returns expected to be generated from such transactions should also normally be lower. An illustrative list of risks is provided below:

<table>
<thead>
<tr>
<th>Nature of risks</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market risk</td>
<td>Risk relating to increased competition and relative pricing pressures, change in demand patterns and needs of customers, inability to develop/penetrate in a market, etc.</td>
</tr>
<tr>
<td>Inventory risk</td>
<td>Risk associated with management of inventory in case of 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.</td>
</tr>
<tr>
<td>Credit risk</td>
<td>Risk relating to default in receivables by customers.</td>
</tr>
<tr>
<td>Product liability risk</td>
<td>Risk associated with product failures including non-performance to generally accepted or regulatory standards. This could result in product recalls and possible injuries to end-users.</td>
</tr>
<tr>
<td>Foreign exchange risk</td>
<td>Risk relating to the potential impact on profits that may arise because of changes in foreign exchange rates.</td>
</tr>
<tr>
<td>R&amp;D risk</td>
<td>Risk associated with loss incurred due to unsuccessful R&amp;D expenditure</td>
</tr>
<tr>
<td>Capacity Utilization risk</td>
<td>Risk associated with loss of profits due to unutilized capacity</td>
</tr>
<tr>
<td>Attrition risk</td>
<td>Risk associated with losing trained personnel which contribute to the success of the enterprise</td>
</tr>
</tbody>
</table>
Risk study is an important exercise as it facilitates adjustments based on differences in risks that are undertaken in a controlled transaction as compared to uncontrolled transactions. A careful analysis of the risks assumed by the transacting entities would determine the true characterization of each of the parties to the transaction. For instance, a distributor solely engaged in purchasing goods for the purpose of resale without performing any value addition may be characterized as a low risk distributor whereas a distributor who performs significant value addition in terms of packing goods, holding inventory, incurring advertisement and promotional expenditure, undertaking market risk, etc. may be characterized as a ‘full-fledged distributor’.

Conclusion

In practice, one cannot compare all the functions, risks and assets employed. Hence, a crucial step in the comparability analysis is the comparison of the “economically significant” functions performed, risks assumed and assets employed (i.e. such functions, assets and risks that are likely to have an impact on cost/expenses, prices, profits arising in a transaction) by the associated enterprises with those by the independent parties which have been selected as potentially comparable for benchmarking the arm’s length price of the controlled transactions.

To summarize, FAR analysis is central/core to the transfer pricing analysis. It helps in:

- Determining the nature of functions performed by the taxpayer and AE(s);
- On the basis of the above, determining true and correct characterization of the entities;
- Providing guidance on selection of most appropriate method for transfer pricing analysis; and
- Determining parameters for establishing comparability and undertaking economic adjustments.

An illustrative list of functions, assets and risks for a different entities is provided below:

<table>
<thead>
<tr>
<th>Type of entity</th>
<th>Functions</th>
<th>Assets</th>
<th>Risks</th>
</tr>
</thead>
</table>
| Manufacturer   | - Budgeting  
                    - Administration  
                    - Product strategy and design  
                    - R&D  
                    - Purchasing  
                    - Product manufacturing  
                    - Quality control  
                    - Inventory management  
                    - Logistics  
                    - Marketing | - Intangibles – Patents, technical knowhow, trademarks, etc.  
                    - Plant & Machinery  
                    - Storage/warehouse  
                    - Office equipment  
                    - Land & Building  
                    - Vehicles | - Business risk  
                    - Inventory risk  
                    - Scheduling risk  
                    - Product liability risk  
                    - Credit and collection risk  
                    - Foreign exchange fluctuation risk |
The above list is only illustrative and will depend totally on the facts of the case. There can be further difference within the types of entities, such as Manufacturer (full-fledged manufacturer, contract manufacturer, and toll manufacturer), Trader (full-fledged trader, limited risk distributor), etc.

### 1.13 CONCEPT OF COMPARABILITY ADJUSTMENTS

An uncontrolled transaction should be considered comparable to the controlled transaction only if there are no material differences (in terms of functions, assets and risks) between the transactions being compared or the enterprises entering into such transactions which would materially affect the prices or costs charged or margins arising in such transactions in the open market.

Comparability adjustments can take various forms. Some examples of prevalent comparability adjustments are provided below:

<table>
<thead>
<tr>
<th>Nature of comparable adjustment</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Working capital adjustment</td>
<td>The levels of inventories, cash on hand, debtors, creditors, other current assets and liabilities impact the level of free reserves that the company has to fulfill its day-to-day working capital requirements and the consequent levels of borrowings it needs to make to fund its working capital requirements. The extent to which companies extend and receive credit in the form of accounts payable and receivable affects their sales and cost of sales. The</td>
</tr>
</tbody>
</table>
Transfer Pricing

Selling price incorporates two elements: the price of the product and the time value of money lent.

Presumably, if a company were to make all sales on a cash basis, it would be willing to accept a slightly lower price for its products than if the company were to allow its customers to pay at a later date. Of course, the argument works in reverse for companies that hold accounts payable.

For example, two companies sell the same product for the same base price, but one company sells the product on a cash basis while the other extends credit and charges a slightly higher price above the base price to cover the time value of money lent to the customer.

Without an adjustment for the different terms of sale, it would appear that the company that sold its product for cash earned a lower gross margin than the other firm.

When different terms of purchase and sale distort the cost of goods sold, analysis of related party transactions can also be distorted. As a result, the cost of goods sold and sales of the comparable companies needs to be adjusted so that the terms of purchase and sale are same across all the companies.

A working capital adjustment is undertaken to adjust the margins of the comparable companies and align them with the tested party.

| Capacity Utilization adjustment | This adjustment is to bring entities with different level of capacity utilization at par with each other for comparison purpose. Capacity utilization by enterprises is an essential factor affecting net profit margin in open market because lower capacity utilization results in higher per unit cost, which, in turn results in lower profits. For example, if an entity A Ltd. is utilizing 50% of its capacity while entity B Ltd. is operating at full capacity, it may not be appropriate to compare A Ltd. and B Ltd. without undertaking this adjustment. The level of capacity utilization of the resources (plant and machinery, fixed assets, etc.) impacts the direct and fixed costs of the company. For example, if a company has high installed capacity but less utilized capacity, it shall be incurring heavy fixed costs and not earning proportionate revenue for the same. This in effect, impacts the profitability of the company. A capacity utilization adjustment is undertaken to eliminate such differences in the profitability of the tested party and the comparable companies. |
| Risk adjustments | Risk adjustment is mainly relevant in case of captive entities (entities providing services or selling goods only to its associated enterprises) or low risk bearing entities. For comparison of tested party with comparable companies, risk profiles of each of them should ideally be similar. The comparables that would be identified might have different risk profiles as compared to tested party and in case the difference is material, adjustment would be required. Accordingly, risk adjustment is made to |
1.46 INTERNATIONAL TAXATION

| Accounting adjustments | This adjustment is carried out to bring the entity being compared at par with the taxpayer in terms of differences in accounting policies being followed. |

1.14 DOCUMENTATION AND COMPLIANCES

(1) **Documentation requirement under the Income-tax Act, 1961**

Transfer pricing documentation is the documentation maintained to review Transfer Pricing arrangements for transactions taking place between different entities of the same group (also known as intra-group transactions). The primary objective of the transfer pricing documentation is to review the arm’s length (fair price) nature of the transactions taking place between different entities of an Multi National Company.

(1) **Persons responsible for keeping and maintaining prescribed information and document** - Section 92D imposes responsibility on every person

(i) who enters into an international transaction to keep and maintain such information and documents in respect thereof as may be prescribed by CBDT

(ii) being a constituent entity of an international group, to keep and maintain the prescribed information and documentation in respect of an international group.

The constituent entity is required to keep and maintain the information and document irrespective of the fact whether or not any international transaction is undertaken by such constituent entity.

The constituent entity has to furnish the information and document to the authority prescribed under section 286(1), i.e., Director General of Income-tax (Risk Assessment) in the prescribed manner, on or before prescribed date

(2) **Information and documents to be kept and maintained for prescribed period** - The CBDT is empowered to prescribe the period for which the information and documents shall be kept and maintained.

(3) **Assessing Officer & Commissioner (Appeals) empowered to require persons entering into international transaction to furnish prescribed information and documents** - The Assessing Officer or the Commissioner (Appeals) may, in the course of any proceedings under the Income-tax Act, require any person who has entered into an international transaction to furnish any such prescribed information or documents within a period of 30 days from the date of receipt of a notice issued in this regard. The requisition period may, on request, be extended further for a period not exceeding thirty days by the Assessing Officer or the Commissioner (Appeals).
(2) Information and documents to be kept and maintained under section 92D [Rule 10D]

As per Rule 10D(1) of the Income-tax Rules, 1962, the transfer pricing documentation requirement under section 92D(1)(i) should contain the following details:

(a) Ownership structure of the assessee with details of shares or other ownership interest held therein by other enterprise;
(b) Profile of the multinational group and basic details of associated enterprises with whom assessee has entered into international transaction;
(c) Business description of the business of the assessee and associated enterprises and the industry in which the assessee operates;
(d) Nature and terms (including price) of the international transactions, details of property transferred or services provided and quantum and value of each such transaction;
(e) Description of functions performed, risks assumed and assets employed by the assessee and associated enterprises;
(f) 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;
(g) Record of uncontrolled transaction (if any) for analysing comparability of international transaction with such uncontrolled transaction(s);
(h) Record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction or specified domestic transactions.
(i) Description of method considered for determining ALP, most appropriate method along with the explanations as to why such method was selected and applied;
(j) Analysis performed to determine the arm’s length price of the transactions between related parties, etc.
(k) Assumptions, policies and price negotiations, if any, which critically affected the determination of the arm’s length price;
(l) Details of transfer pricing adjustment(s) made (if any) and consequent adjustment made to the total income for tax purposes.
(m) Any other information, data or document including information or data relating to associated enterprise which may be relevant for determining ALP.
Rule 10D(2) provides that in a case where the aggregate value of international transactions does not exceed ₹ 1 crore, it will not be obligatory for the assessee to maintain the above information and documents.

However, it is provided that in the above cases also the assessee will have to substantiate that the income arising from the international transactions with associated enterprises, as disclosed by the accounts, is in accordance with section 92. This will mean that, even if the aggregate value of the international transactions is less than ₹ 1 crore, the assessee will have to maintain adequate records and evidence to show that the international transactions with associated enterprises are on the basis of arm’s length principle.

**Information to be supported by authentic documents [Rule 10D(3)]**

The information to be maintained by the assessee, is to be supported by authentic documents. These documents may include the following:

(i) Official publications, reports, studies and data bases from the Government of the country of residence of the associated enterprise, or of any other country;

(ii) Reports of market research studies carried out and technical publications brought out by institutions of national or international repute;

(iii) Price publications including stock exchange and commodity market quotations;

(iv) Published accounts and financial statements relating to the business affairs of the associated enterprises;

(v) Agreements and contracts entered into with associated enterprises or with unrelated enterprises in respect of transactions similar to the international transactions;

(vi) Letters and other correspondence documenting any terms negotiated between the assessee and the associated enterprise;

(vii) Documents normally issued in connection with various transactions under the accounting practices followed.

It is also provided that the information and documents to be maintained should be contemporaneous and should exist latest by the date specified for getting the audit report. In the case of international transactions which continue to have effect over more than one financial year, fresh documents will not be required to be maintained for each year if there are no significant change which may affect the determination of arm’s length price.

The above information and documents are required to be maintained for a period of eight years from the end of the relevant assessment year.
(3) Structure of Transfer Pricing documentation

The illustrative structure of Transfer Pricing Study can be summarized as below:

<table>
<thead>
<tr>
<th>Executive Summary</th>
<th>Group Overview</th>
<th>Industry analysis</th>
<th>Functional analysis</th>
<th>Economic analysis</th>
<th>Conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Brief description of the business profile of the overall group</td>
<td>• Brief description of the Group’s business activities/operations/division</td>
<td>• Background of the industry</td>
<td>• Functions performed</td>
<td>• Search process</td>
<td>• High level summary of the Transfer Pricing study including transactions involving Most appropriate method etc.</td>
</tr>
<tr>
<td>• Brief description of the business profile of the assessee including AE with whom the company has undertaken international taxation</td>
<td>• Brief overview of the nature of business operations of the assessee</td>
<td>• Key drivers</td>
<td>• Assets utilized</td>
<td>• Comparable details</td>
<td></td>
</tr>
<tr>
<td>• Overview of international and specified domestic transactions</td>
<td>• Factual informational of the Group during relevant period such as turnover, number of employees etc.</td>
<td>• Challenges</td>
<td>• Risks assumed</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Information pertaining to various products and services offered by the group</td>
<td>• Future outlook</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Significant development during the year and etc.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(a) Executive Summary

The Executive summary section of the Transfer Pricing documentation captures high level analysis of the entire Transfer Pricing documentation and summarizes the results of benchmarking analysis performed to determine arm’s length price of the international transaction(s) undertaken during the relevant period.
(b) Group Overview

This section includes a brief description of Group’s as well as the taxpayer’s business operations.

**How to source the information?**

- The annual report of the Group is considered to be the most reliable and authentic source for information pertaining to nature of business operations, shareholding structure, products and services offered, etc.
- In case of unavailability of annual report, reliance could be placed upon other sources such as website of the Group, reference websites, publicly available databases like Prowess, Capitaline, etc.

The Group overview could be illustrated by way of the following example:

<table>
<thead>
<tr>
<th>Associated Enterprise 1, a bicycle manufacturer in Country 1, sells bicycles to Associated Enterprise 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2.</th>
</tr>
</thead>
<tbody>
<tr>
<td>In the instant case, the Group overview would include the following broad headings:</td>
</tr>
<tr>
<td><strong>Brief description of the business operations of the Group</strong> – including range of products/services offered, geographical presence, sales trend during past years, etc.</td>
</tr>
<tr>
<td><strong>Brief description of business operations of Associated Enterprise 1 and Associated Enterprise 2</strong> – including details of products/services offered, date of incorporation, regional presence, shareholding pattern/structure, etc.</td>
</tr>
</tbody>
</table>

(c) Industry Overview

This section provides an understanding of the taxpayer/company’s relative positioning in the industry vis-à-vis other players and overall justification of the taxpayer’s financial results. The key objectives of industry overview are to:

- Determine taxpayer’s position within the industry;
- Provide information about the market share of the client;
- Establish linkage of industry overview with functional and economic analysis;
- Highlight the key growth drivers of the industry;
- Determining threats/challenges and opportunities pertaining to the industry; and
- Provide information about past trends and future projections of the industry.

The industry overview could be illustrated by way of following example:

<table>
<thead>
<tr>
<th>Continuing the same example as above, where Associated Enterprise 1, a bicycle manufacturer in Country 1, sells bicycles to Associated Enterprise 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2, the following broad heads could be included while drafting the industry overview:</th>
</tr>
</thead>
</table>
**Industry structure** – Types of bicycles produced and sold in the market, market size, demand-supply gap analysis, etc.

**Characteristics of bicycle industry** – Distribution channels, brief overview of legal regulations affecting the industry, factors affecting demand, sales trend of each category of bicycles relating to past 5-6 years, factors affecting demand, etc.

**Key growth drivers of the industry** and the potential regulatory as well as competitive threats affecting the industry, complete SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis of the industry.

**Way forward** – Future projections pertaining to industry growth and potential challenges anticipated

**(d) Functional Analysis**

As discussed earlier in detail, for every international transaction, the following analysis needs to be undertaken:

1. Identify which entity bears significant risks
2. Characterize entities based on the functions performed
3. Determine functions performed by the Indian entity and AE
4. Identify tangible and intangible assets used
5. Determine pricing mechanism/strategy used

**(e) Economic Analysis**

Economic (or Benchmarking) analysis means analyzing or comparing the transfer price i.e. prices set in controlled environment with that of uncontrolled environment. This would broadly involve the following steps:

1. Selection of Tested Party
2. Choice of PLI
3. Selection of MAM
4. Selection of database
5. Selection of comparable companies
6. Arm’s length price
The entire benchmarking process is illustrated with the help of following example:

**Facts of the case:** AE 1, a bicycle manufacturer in Country 1, sells bicycles to AE 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2.

Let AE 2 be selected as the tested party and TNMM be selected as the most appropriate method. The most appropriate PLI is ‘Operating Profit/Sales’.

For benchmarking the international transaction pertaining to import of bicycle by AE 2, the following steps need to be undertaken:

- **Selection of time period:** The Act prescribes the use of current year data in which the transaction has been undertaken. However, if the data for current year is not available for comparable companies at the time of furnishing return of income by the assessee for the assessment year, the taxpayer may consider data relating to the financial year immediately preceding the current year.

- **Undertaking search for comparables:** Assuming that in the above case study, Associated Enterprise 2 i.e. the tested party is situated in India, the search for comparable companies engaged in the business of distribution of bicycles could be undertaken by using databases such as Prowess, Capitoline, etc. Illustratively, the selection of comparables would involve application of common filters such as:
  1. Selection of comparables having sales greater than ₹ 1 crore;
  2. Selection of comparables having net worth greater than 0 (zero);
  3. Selection of comparables having trading sales/total sales greater than 50%;
  4. Selection of comparables having segment related to bicycle sales;
  5. Rejection of comparables having Related party transactions/Sales > 25%; and/or (Illustrative)
  6. Qualitative criteria: Selection of comparables engaged in distribution of bicycles.

If required, the appropriate adjustments could be carried out to account for differences in the type and quality of products, risk incurred, geographical factors, etc.
The process of selection of comparables can be illustrated as under:

Universe of comparable companies ➔ Final set of comparable companies

Application of quantitative and qualitative filters such as Turnover, net worth, sales vs services, related party transactions, etc

(f) **Conclusion**

The Conclusion section of Transfer Pricing documentation captures high level summary of the Transfer Pricing documentation, primarily including the transactions involved, most appropriate method and PLI used and the results of the benchmarking analysis.

In case the tested party is incurring losses, the justification for the same is included in this section.

**Summary of Transfer Pricing Documentation**

- **Inputs**
  - Industry Overview
  - Group Overview
  - Functional Analysis and Selection of the tested party

- **Economic analysis**
  - Selection of the most appropriate method
  - Benchmarking/ Search process
  - Qualitative analysis/ Adjustment

- **Output**
  - Arm’s Length Price

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(4) Audit Report [Section 92E]:

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 the specified date on the prescribed form.

Rule 10E provides that the auditor’s report shall be in Form No.3CEB. It requires the auditor 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. He has also to give his opinion whether the prescribed information and documents relating to the above transactions have been kept by the assessee. Further, he has to state that the particulars stated in the Annexure to his report are true and correct. The Annexure is in two parts.

In the first part of the Annexure, general information of the assessee is required to be reported. In the second part of the Annexure, the particulars about the international transactions are required to be stated. Broadly stated these particulars include list of associated enterprises, particulars and description of transactions relating to purchase, sales, provisions of service, loans, advances, etc.

“Specified date” shall have the same meaning as assigned to due date in Explanation 2 below sub-section (1) of section 139. The due date for filing of transfer pricing report under section 92E in Form 3CEB is 30th November of the assessment year.

(5) Penalties

Stringent penalties are provided in various sections for non-compliance with the above provisions. These are as under:

Penalty for failure to report any international transaction or any transaction deemed to be an international transaction: Under section 270A, penalty@50% of tax payable on under-reported income is leviable. However, the amount of under-reported income represented by any addition made in conformity with the arm’s length price determined by the Transfer Pricing Officer would not be included within the scope of under-reported income under section 270A, where the assessee had maintained information and documents, as prescribed under section 92D, declared the international transactions under Chapter X and disclosed all material facts relating to the transaction.

Failure to report any international transaction or any transaction deemed to be an international transaction to which the provisions of Chapter X applies would constitute ‘misreporting of income’ under section 270A(9), in respect of which penalty@200% would be attracted.

Penalty for failure to keep and maintain information and documentation [Section 271AA]: In order to ensure compliance with the transfer pricing regulations, section 271AA provides that, the Assessing Officer 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 him, if the person:
(1) fails to keep and maintain any such document and information as required by section 92D(1) or section 92D(2);

(2) fails to report such international transaction which is required to be reported; or

(3) maintains or furnishes any incorrect information or document.

Penalty for failure to furnish information or document under section 92D [Section 271G]

Section 271G provides that if any person who has entered into an international transaction fails to furnish any such information or document as required by Assessing Officer or TPO or Commissioner (Appeals) within a period of 30 days from the date of receipt of a notice issued in this regard, then such person shall be liable to a penalty up to 2% of the value of each international transaction.

Penalty for failure to furnish report under section 92E [Section 271BA]

If any person fails to furnish a report from an accountant, the Assessing Officer may direct that such person shall pay, by way of penalty, a sum of ₹ 1 lakh.

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

Notes:
- The penalty u/s 271AA shall be in addition and not in substitution of penalty u/s 271BA.
- If the assessee proves that there was reasonable cause for the failure, no penalty would be leviable under section 271BA, 271G and 271AA.
1.15 SPECIFIC REPORTING REQUIREMENTS – COUNTRY BY COUNTRY REPORTING

(i) Requirements as per OECD report on Action 13 of BEPS Action Plan

The report provides for:

(a) revised standards for transfer pricing documentation; and
(b) a template for country-by-country reporting of income, earnings, taxes paid and certain measure of economic activity.

(ii) Three-tier structure mandated by BEPS

The BEPS report recommends that countries adopt a standardised approach to transfer pricing documentation; it mandates the following three-tier structure:

<table>
<thead>
<tr>
<th>Document</th>
<th>Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Master File</td>
<td>Standardised information relevant for all multinational enterprises (MNE) group members</td>
</tr>
<tr>
<td>(2) Local file</td>
<td>Specific reference to material transactions of the local taxpayer</td>
</tr>
<tr>
<td>(3) Country-by-country report</td>
<td>Information relating to the global allocation of the MNE’s income and taxes paid; and Indicators of the location of economic activity within the MNE group.</td>
</tr>
</tbody>
</table>

(iii) Advantages of the three tier structure [as per BEPS Report]:

(a) Taxpayers will be required to articulate consistent transfer pricing positions;
(b) Tax administrations would get useful information to assess transfer pricing risks;
(c) Tax administrations would be able to make determinations about where their resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries.

(iv) Country-by-country Report: Reporting Requirements of MNEs

The Country-by-Country (CbC) report has to be submitted by parent entity of an international group to the prescribed authority in its country of residence. This report is to be based on consolidated financial statement of the group.

(a) MNEs have to report annually and for each tax jurisdiction in which they do business:
   (1) the amount of revenue;
   (2) profit before income tax; and
   (3) income tax paid and accrued.
(b) MNEs have to report their total employment, capital, accumulated earnings and tangible assets in each tax jurisdiction.

(c) MNEs have to identify each entity within the group doing business in a particular tax jurisdiction and provide an indication of the business activities each entity engages in.

(v) Master File: Objective & Features

(a) The master file would provide an overview of the MNE groups business, including:

1. the nature of its global business operations,
2. its overall transfer pricing policies, and
3. its global allocation of income and economic activity

in order to assist tax administrations in evaluating the presence of significant transfer pricing risk.

(b) The master file is intended to provide a high-level overview in order to place the MNE group’s transfer pricing practices in their global economic, legal, financial and tax context.

(c) The master file shall contain information which may not be restricted to transaction undertaken by a particular entity situated in particular country.

(d) Thus, information in master file would be more comprehensive than the existing regular transfer pricing documentation.

(e) The master file shall be furnished by each entity to the tax authority of the country in which it operates.

(vi) Implementation of international consensus in India

India is one of the active members of BEPS initiative and part of international consensus. For the purpose of implementing the international consensus, a specific reporting regime in respect of CbC reporting and also the master file has been incorporated in the Income-tax Act, 1961. The essential elements have been incorporated in the Income-tax Act, 1961 while remaining aspects would be dealt with in detail in the Income-tax Rules, 1962.

(vii) Elements relating to CbC reporting requirement and related matters which have been incorporated in the Income-tax Act, 1961 [Section 286]

(a) Threshold limit for applicability of CbC reporting [Sub-section (7)]: The reporting provision shall apply in respect of an international group for an accounting year, if the total consolidated group revenue as reflected in the consolidated financial statement (CFS) for the accounting year preceding such accounting year is above a threshold to be prescribed i.e., ₹ 5,500 crore.

Where the total consolidated group revenue of the international group, as reflected in the consolidated financial statement, is in foreign currency, the rate of exchange for the
calculation of the value in rupees of such total consolidated group revenue shall be the telegraphic transfer buying rate (TTBR) of such currency on the last day of the accounting year preceding the accounting year [Rule 10DB(7)].

(b) **Time limit for furnishing CbC report [Sub-section (2)]:** The parent entity of an international group or the alternate reporting entity, if it is resident in India shall be required to furnish the report in respect of the group to the Director General of Income-tax (Risk Assessment) for every reporting accounting year, within a period of twelve months from the end of the said reporting accounting year for which the report is being furnished, in Form No. 3CEAD.

(c) **Details to be furnished by constituent entity resident in India [Sub-section (1)]:** Every constituent entity, resident in India, of an international group having parent entity that is not resident in India, shall notify the Director General of Income-tax (Risk Assessment) at least two months prior to the due date for furnishing CbC report –

1. whether it is the alternate reporting entity of the international group; or
2. 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.

The report shall be furnished in Form No. 3CEAC.

(d) **Details/ information to be included in CbC report [Sub-section (3)]:** It should contain aggregate information in respect of:

1. the amount of revenue,
2. profit and loss before income-tax,
3. amount of income-tax paid and accrued,
4. details of stated capital, accumulated earnings, number of employees, tangible assets other than cash or cash equivalent in respect of each country or territory along with details of each constituent’s incorporation country and residential status, nature and details of main business activity or activities of each constituent entity and any other information as may be prescribed.

This shall be based on the template provided in the OECD BEPS report on Action Plan 13.

(e) **Furnishing of CbC report by resident constituent entity [Sub-section (4)]:** A constituent entity of an international group resident in India, other than the parent entity or the alternate reporting entity, shall be required to furnish CbC report in Form No. 3CEAE within the twelve months from the end of the reporting accounting year to the Director General of Income-tax (Risk Assessment), if the parent entity of the group is resident of a country or territory,-

1. in which it is not obligated to file report of the nature of CbC report;
2. with which India does not have an arrangement for exchange of the CbC report; or
(3) There has been a systemic failure of the country or territory i.e., such country is not exchanging information with India even though there is an agreement and this fact has been intimated to the entity by the prescribed authority.

However, in case the parent entity of the constituent entity is resident of a country or territory, where, there has been a systemic failure of the country or territory and the said failure has been intimated to such constituent entity, the period for submission of the report would be six months from the end of the month in which said systemic failure has been intimated.

(f) Nomination of one constituent entity for furnishing CbC report [Proviso to sub-section (4)]: If there are more than one such constituent entity of the group, resident in India, other than the parent entity or the alternate reporting entity, then the group can nominate (under intimation in writing on behalf of the group to the prescribed authority), then, one constituent entity that shall furnish the report on behalf of the group. This entity would then furnish the report.

(g) No obligation to furnish CbC report in certain cases [Sub-section (5)]: If an international group, having parent entity which is not resident in India, had designated an alternate entity for filing its report with the tax jurisdiction in which the alternate entity is resident and such alternate entity has furnished such report on or before the date specified by that country or territory, then, the entities of such group operating in India would not be obliged to furnish report if

- the report is required to be furnished under the law for the time being in force in the said country or territory
- the report can be obtained under the agreement of exchange of such reports by Indian tax authorities
- No systemic failure in respect of the said country or territory has been conveyed to any constituent entity of the group that is resident in India
- the said country or territory has been informed in writing by the constituent entity that it is the alternative reporting entity on behalf of the international group
- the same has been informed to the prescribed authority by the entity in accordance with section 286(1).

(h) Entity to furnish documents and information called for [Sub-section (6)]: The DGIT (Risk Assessment) may call for such document and information from the entity furnishing the report as it may specify in notice in writing for the purpose of verifying the accuracy. The entity shall be required to make submission within thirty days of receipt of notice or further period if extended by the prescribed authority, but extension shall not be beyond a further period of 30 days.
(viii) Penalty for non-furnishing of the report by any reporting entity which is obligated to furnish such report [Section 271GB(1) & (3)]

<table>
<thead>
<tr>
<th>Period of delay/default</th>
<th>Penalty</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Not more than a month</td>
<td>₹ 5,000 per day</td>
</tr>
<tr>
<td>(b) beyond one month</td>
<td>₹ 15,000 per day for the period exceeding one month</td>
</tr>
<tr>
<td>(c) Continuing default even after service of order levying penalty either under (a) or under (b)</td>
<td>₹ 50,000 per day of continuing failure beginning from the date of service of order</td>
</tr>
</tbody>
</table>

(ix) Penalty for failure to produce information and documents within prescribed time [Section 271GB(2) & (3)]

<table>
<thead>
<tr>
<th>Default</th>
<th>Penalty</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Failure to produce information and documents before prescribed authority within the period allowed u/s 286(6)</td>
<td>₹ 5,000 per day of continuing failure, from the day immediately following the day on which the period for furnishing the information and document expires.</td>
</tr>
<tr>
<td>(b) Continuing default even after service of penalty order</td>
<td>₹ 50,000 per day for the period of default beyond the date of service of order.</td>
</tr>
</tbody>
</table>

(x) Penalty for submission of inaccurate information in the CBC report [Section 271GB(4)]

If the reporting entity has provided any inaccurate information in the report, the penalty would be ₹ 5,00,000 if,-

(a) the entity has knowledge of the inaccuracy at the time of furnishing the report but does not inform the prescribed authority; or

(b) 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 fifteen days of such discovery; or

(c) the entity furnishes inaccurate information or document in response to notice of the prescribed authority under section 286(6).

(xi) Non-levy of penalty if reasonable cause for failure is proved [Section 273B]

Section 273B provides for non-levy of penalty under various sections if the assessee proves that there was reasonable cause for such failure. Section 271GB has been included within the scope of section 273B. Therefore, the entity can offer reasonable cause defence for non-levy of penalties mentioned above.

(xii) Maintenance and furnishing of Master file: Consequent amendments in the Income-tax Act, 1961

<table>
<thead>
<tr>
<th>Section</th>
<th>Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) 92D(1)(ii)</td>
<td>Every person, being constituent entity of an international group, has</td>
</tr>
</tbody>
</table>
to keep and maintain the prescribed information and document in respect of the international group. Constituent entity has to keep and maintain such prescribed information and document irrespective of the fact whether or not any international transaction is undertaken by such constituent entity.
The rules shall, thereafter, prescribe the information and document as mandated for master file under OECD BEPS Action 13 report;

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(2)</td>
<td>92D(4)</td>
</tr>
<tr>
<td>(2)</td>
<td>The information and document shall also be furnished to the prescribed authority u/s 286(1) within such period as may be prescribed and the manner of furnishing may also be provided for in the rules</td>
<td></td>
</tr>
<tr>
<td>(3)</td>
<td>271AA(2)</td>
<td>For non-furnishing of the information and document to the prescribed authority, a penalty of ₹ 5 lakh shall be leviable.</td>
</tr>
<tr>
<td>(4)</td>
<td>273B</td>
<td>Reasonable cause defence against levy of penalty shall be available to the entity.</td>
</tr>
</tbody>
</table>

(xiii) Meaning of certain terms [Section 286(9)]

<table>
<thead>
<tr>
<th>Term</th>
<th>Meaning</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Accounting year</td>
<td><strong>Case</strong></td>
</tr>
<tr>
<td>(i)</td>
<td>In a case where the parent entity is resident in India; or</td>
</tr>
<tr>
<td>(ii)</td>
<td>In any other case</td>
</tr>
<tr>
<td>(b) Agreement</td>
<td>A combination of all of the following agreements, namely – (i) an agreement referred to in section 90(1) or section 90A(1); or (ii) an agreement for exchange of the CbC report referred to in section 286(2) as may be notified by the Central Government.</td>
</tr>
<tr>
<td>(c) Alternate reporting entity</td>
<td>Any constituent entity of the international group that has been designated by such group, in the place of the parent entity, to furnish the CbC report in the country or territory in which the said constituent entity is resident on behalf of such group.</td>
</tr>
<tr>
<td>(d) Constituent entity</td>
<td>(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</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td><strong>(iii)</strong></td>
<td>any permanent establishment of any separate business entity of the international group included in sub clause (i) or sub 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</td>
</tr>
</tbody>
</table>
| **(e)** | Group | This 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 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 listed on a stock exchange in the country or territory of which the parent entity is resident. |
| **(f)** | Consolidated financial statement | 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 |
| **(g)** | International group | 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; |
| **(h)** | Parent entity | 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 sub clause (i) or sub clause (ii), that includes the separate financial statement of the first mentioned constituent entity. |
| **(i)** | Permanent establishment | Meaning assigned to it in clause (iii) of section 92F i.e., includes a fixed place of business through which the business of the enterprise is wholly or partly carried on. |
| **(j)** | Reporting accounting | The accounting year in respect of which the financial and operational results are required to be reflected in the report to be furnished every year by the parent entity or the alternate reporting entity, resident in India, in respect of |
year

the international group of which it is a constituent under section 286(2) or by a constituent entity of an international group referred to in section 286(4).

(k) Reporting entity

The constituent entity including the parent entity or the alternate reporting entity, that is required to furnish a report referred to in section 286(2) and 286(4).

(l) Systemic 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 section 286(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

1.16 TRANSFER PRICING ASSESSMENT

Transfer pricing assessment procedure in India is captured graphically as below:

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(1) Power of Assessing Officer to determine ALP [Section 92C(3) & (4)]

Section 92C(3) and (4) gives power to the Assessing Officer to determine the arm’s length price under the following circumstances and also empowers the Assessing Officer to re-compute total income of the assessee having regard to arm’s length price determined by him. It also provides that deduction under section 10AA and Chapter VI-A shall not be allowed from the additional income computed by him.

For example, if the total income declared by the assessee in his return of income is, say ₹ 7 lakhs and the total income computed by the Assessing Officer applying the arm’s length principle is, say ₹ 9 lakhs, the difference of ₹ 2 lakhs will not qualify for deduction under section 10AA or Chapter VI-A.

The Assessing Officer may invoke the power to determine arm’s length price if during the course of any proceeding, he is of the opinion that, on the basis of material or information or documents in his possession:

(a) The price charged or paid in an international transaction has not been determined in accordance with section 92C(1) and (2); or

(b) Any information and documents relating to an international 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) The information or data used in computation of the arm’s length price is not reliable or correct; or

(d) The assessee has failed to furnish within the specified time, any information or documents which he was required to furnish by a notice issued under section 92D(3).

Before invoking the power to determine arm’s length price, an opportunity of being heard is to be given to the assessee.

Second proviso to section 92C(4) provides that if the total income of an associated enterprise is computed under this section on the determination of arm’s length price paid to another associated enterprise, from which tax is deducted or deductible at source, the income of the other associated enterprise shall not be recomputed on this count.

For example, if “A” Ltd. has paid royalty to “B” Ltd. (Non-Resident) @10% of sales and tax is deducted at source, “B” Ltd. cannot claim refund if the Assessing Officer has determined 8% as arm’s length price in the case of “A” Ltd. and disallowed 2% of the royalty amount.

Bright Line Test – To cater to the Indian market, MNC sets up subsidiaries in India. The Indian subsidiaries act as a distributor/provider of goods/services and generally incurred certain expenses, which are popularly known as Advertisement, marketing and sale promotion expenditure ("AMP expenses") for marketing and promotion of the products imported by them.
The intellectual property rights ("IPR") in products/services and the brands lies with the parent entities. To test that whether the transaction is at ALP or not and to determine the excess/non-routine advertising, marketing and promotion (AMP) expenditure incurred by the taxpayer for building brand of its associated enterprises in India, Revenue Authorities' sometimes adopt the Bright Line Test ("BLT"). The issue under consideration is whether bright line test can be used by the Assessing Officer to determine the excess/non-routine advertising, marketing and promotion (AMP) expenditure incurred by the taxpayer for building brand of its associated enterprises in India.

The Delhi High Court, in Bausch & Lomb Eyecare (India) (P.) Ltd. v. Addl. CIT [2016] 381 ITR 227, held that advertisement expense is not an international transaction and there is no machinery provision for computation of AMP expense adjustment.

In Sony Ericsson Mobile Communications India (P) Ltd v. CIT (2015) 374 ITR 118, the Delhi High Court held that bright line test has no statutory mandate and a broad-brush approach is not mandated or prescribed. It further opined that the exercise to separate “routine” and “non-routine” advertising, marketing and promotion or brand building exercise by applying the bright line test of non-comparables should not be sanctioned.

Applying the rationale of the above rulings of the High Court, the Revenue Authorities' are not justified in adopting the "Bright Line Test" for disallowing or adjusting the advertisement expenditure in computing arm's length price.

(2) Reference to Transfer Pricing Officer [Section 92CA]

This section provides for a procedure for reference to a Transfer Pricing Officer (TPO) of any issue relating to computation of arm’s length price in an international transaction. The procedure is as under -

(i) The option to make reference to TPO is given to the Assessing Officer. Where the assessee has entered into an international transaction in any previous year and if Assessing Officer considers it necessary or expedient to do so he may refer the computation of the arm’s length price in relation to the said international transaction to the TPO. This option is not, however, available to the assessee.

(ii) The Assessing Officer has to take the approval of the Principal Commissioner of Income-tax (PCIT)/Commissioner of Income-tax (CIT) before making such a reference.

(iii) Any Joint/ Deputy/Assistant Commissioner of Income-tax, authorised by CBDT, can be appointed as TPO.

(iv) When such reference is made, TPO would serve a notice to the assessee requiring him to produce on a date specified in the notice, any evidence on which the assessee relied in support of the computation of arm’s length price made by him in relation to the international transaction.
The TPO can also determine the ALP of other international transactions identified subsequently in the course of proceedings before him as if such transaction is referred to the TPO by the Assessing Officer under section 92CA(1) [Sub-section (2A)].

Where in respect of an international transaction, the assessee has not furnished the report under section 92E 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 under section 92CA(1) [Sub-section (2B)].

The TPO has to pass an order determining the arm’s length price after considering the evidence, documents, etc. produced by the assessee and after considering the material gathered by him. He has to send a copy of his order to Assessing Officer as well as the assessee.

The order of the Transfer Pricing Officer determining the arm’s length price of an international transaction is binding on the Assessing Officer and the 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)].

In order to provide sufficient time to the Assessing Officer to complete the assessment in a case where reference is made to the Transfer Pricing Officer, section 92CA(3A) provides for determination of arm’s length price of international transactions by the Transfer Pricing Officer at least 60 days before the expiry of the time limit under section 153 or section 153B for making an order of assessment by the Assessing Officer. This provision would apply in a case where reference is made on or after 1.6.2007 or in a case where reference is made before that date but the order of the Transfer Pricing Officer is pending on that date [Sub-section (3A)].

In many cases, it becomes necessary to seek information from foreign jurisdictions for the purpose of determining the arm's length price by the TPO. At times, proceedings before the TPO may also be stayed by a court order.

Taking into consideration such cases, it has been provided that where assessment proceedings are stayed by any court or where a reference for exchange of information has been made by the competent authority under an agreement referred to in section 90 or 90A, the time available to the Transfer Pricing Officer 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.

The TPO has power to rectify his order under section 154 if any mistake apparent from the record is noticed. If such rectification is made, the Assessing Officer has to rectify the assessment order to bring it in conformity with the same.
(xii) The TPO 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 once the above reference is made to him.

(3) Secondary adjustment [Section 92CE]

(i) Meaning of Primary Adjustment and Secondary Adjustment

“Primary adjustment” to a transfer price means the 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, as the case may be, of the assessee.

"Secondary adjustment" means an adjustment in the books of accounts of the assessee and its associated enterprise to reflect that the actual allocation of profits between the assessee and its associated enterprise 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.

(ii) Forms of Secondary Adjustment - As per the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD transfer pricing guidelines), secondary adjustment may take the form of constructive dividends, constructive equity contributions, or constructive loans.

(iii) Alignment of economic benefit of the transaction with the arm’s length position - The provisions of secondary adjustment are internationally recognised and are already part of the transfer pricing rules of many leading economies in the world. Whilst the approaches to secondary adjustments by individual countries vary, they represent an internationally recognised method to align the economic benefit of the transaction with the arm’s length position.

(iv) Cases where secondary adjustment has to be made - In order to align the transfer pricing provisions in line with OECD transfer pricing guidelines and international best practices, section 92CE provides that the assessee shall be required to carry out secondary adjustment where the primary adjustment to transfer price:

(a) has been made *suo motu* by the assessee in his return of income; or
(b) made by the Assessing Officer has been accepted by the assessee; or
(c) is determined by an advance pricing agreement entered into by the assessee under section 92CC *on or after the 1.4.2017*; or
(d) is made as per the safe harbour rules framed under section 92CB; or
(e) is arising as a result of resolution of an assessment by way of the mutual agreement procedure under an agreement entered into under section 90 or 90A for avoidance of double taxation.
(v) **No requirement of secondary adjustment in certain cases** - Such secondary adjustment, however, shall not be carried out if, the amount of primary adjustment made in the case of an assessee in any previous year does not exceed `1 crore or the primary adjustment is made in respect of A.Y.2016-17 or an earlier assessment year.

(vi) **Non-repatriation of excess money by the associated enterprise 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, as the case may be, of the assessee, the excess money or part thereof, as the case may be, which is available with its associated enterprise, if not repatriated to India within the time as may be prescribed, shall be deemed to be an advance made by the assessee to such associated enterprise and the interest on such advance, shall be computed as the income of the assessee, in the prescribed manner.

**Such excess money or part thereof may be repatriated from any of the associated enterprises of the assessee which is not resident in India.**

“**Excess money**” means the difference between the arm’s length price determined in primary adjustment and the price at which the international transaction has actually taken place.

(vii) **Time limit for repatriation of excess money or part thereof**

Rule 10CB(1) prescribes the time limit for repatriation of excess money i.e., on or before **90 days** from the date given in column (3) in the cases mentioned in column (2) of the table below:

<table>
<thead>
<tr>
<th>Case</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i)</td>
<td>Where primary adjustments to transfer price has been made <em>suo-moto</em> by the assessee in his return of income</td>
</tr>
<tr>
<td>(ii)</td>
<td>If primary adjustments to transfer price as determined in the order of the Assessing Officer or the appellate authority has been accepted by the assessee</td>
</tr>
</tbody>
</table>
(iii) Where agreement for advance pricing has been entered into by the assessee under section 92CD the due date of filing of return u/s 139(1)

(iv) Where option has been exercised by the assessee as per the safe harbour rules under section 92CB the due date of filing of return u/s 139(1)

(v) Where agreement under the Mutual agreement procedure under a DTAA has been entered into u/s 90 or 90A the due date of filing of return u/s 139(1)

(viii) **Rate of interest for the purpose of computation on interest on excess money or part thereof, if not repatriated within the prescribed time**

Rule 10CB(2) prescribes the rate at which the per annum interest income shall be computed in case of failure to repatriate the excess money within the above time limit. The interest would be computed at the rates mentioned in column (3) in respect of the cases mentioned in column (2) of the table below:

<table>
<thead>
<tr>
<th>(1)</th>
<th>Case</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Where the international transaction is denominated in Indian rupee</td>
<td>At the one year marginal cost of fund lending rate of SBI as on 1st April of the relevant previous year + 3.25%</td>
</tr>
<tr>
<td></td>
<td>Where the international transaction is denominated in foreign currency</td>
<td>At six month London Interbank Offered Rate (LIBOR) as on 30th September of the relevant previous year + 3.00%</td>
</tr>
</tbody>
</table>

(ix) **Option to pay additional income-tax, if the excess money not repatriated:** In a case where the excess money or part thereof has not been repatriated within the prescribed time as mentioned above, the assessee has the option to pay additional income-tax @ 20.9664% (i.e., tax@18% plus surcharge@12% plus cess@4%) on such excess money or part thereof, as the case may be.

Where additional income-tax is so paid by the assessee, he will not be required to make secondary adjustment and compute interest from the date of payment of such tax. This implies that he would, in any case, be required to compute interest upto the date of payment of such additional tax.

The additional income-tax so paid by the assessee shall be treated as the final payment of tax in respect of excess money or part thereof not repatriated and no further credit would be allowed to the assessee or to any other person in respect of the amount of additional income-tax so paid.
Further, no deduction in respect of the amount on which such additional income-tax has been paid, would be allowed under any other provision of the Act.

(4) **Dispute Resolution Mechanism**

The evolving tax dispute resolution mechanism in India consists of the following forums:

- Filing of objections before the Dispute Resolution Panel or Appeal before the Commissioner of Income Tax (Appeals);
- Appeal before the Income Tax Appellate Tribunal;
- Appeal before the High Court / Supreme Court;
- Safe Harbour Rules;
- Advance Pricing Agreement; and
- Mutual Agreement Procedure

Each of the above dispute resolution mechanisms have been explained in the subsequent paragraphs.

(i) **Filing of objections before the Dispute Resolution Panel [Section 144C]**

Key features of the DRP process is listed below:

- To facilitate expeditious resolution of disputes, a collegium comprising of three Principal Commissioners or Commissioners of Income-tax has been constituted by the CBDT.
- The following assesses are eligible for filing objections before the DRP:-
  - A Foreign Company
  - Any person in whose case variation arises on account of order of Transfer Pricing Officer
- The Assessing Officer shall, forward a draft of the proposed order of assessment 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.
- Assessee can file his acceptance to the Assessing Officer or can file his objections against the draft assessment order with the DRP and the Assessing Officer within **thirty days** of the receipt of the draft order.
- Upon acceptance by assessee or no objection received from assessee within the specified time, the Assessing Officer, notwithstanding anything contained in section 153 or section 153B, shall complete the assessment and pass the assessment order **within one month from the end of the month** in which the acceptance is received or 30 days expires.
The Dispute Resolution Panel shall, in a case where any objections are received, issue such directions, as it thinks fit, for the guidance of the Assessing Officer to enable him to complete the assessment.

After considering draft order, all objections, evidence etc., the DRP issues binding directions to the Assessing Officer.

The Dispute Resolution Panel may, before issuing any such directions make such further enquiry, as it thinks fit; or cause any further enquiry to be made by any income tax authority and report the result of the same to it.

In a case where the proposed direction are prejudicial to the interest of the assessee or the interest of the revenue, the direction cannot be issued without giving an opportunity of being heard to the assessee and the Assessing Officer, as the case may be.

The Dispute Resolution Panel may confirm, reduce or enhance the variations proposed in the draft order. However, it cannot set aside any proposed variation or issue any direction for further enquiry and passing of the assessment order.

The power of the DRP to enhance the variation includes the power to consider any matter arising out of the assessment proceeding relating to the draft order. This power to consider any issue shall be irrespective of whether the matter was raised by the eligible assessee or not.

If the members of the DRP differ in opinion on any point, the point shall be decided according to the opinion of the majority of the members.

Every direction issued by the DRP shall be binding on the Assessing Officer.

Such direction has to be issued within nine months from the end of the month in which the draft order is forwarded to the eligible assessee.

Upon receipt of such direction, the Assessing Officer has to complete the assessment in accordance with the same, within one month from the end of the month in which the direction is received. There is no requirement of providing any further opportunity of being heard to the assessee.

The order of the Assessing Officer is directly appealable before the Tribunal.

The CBDT may make rules for the purpose of efficient functioning of the DRP and expeditious disposal of the objections filed by the eligible assessee.

DRP does not have jurisdiction over the assessment orders are passed by the Assessing Officer declaring based on the provisions of GAAR and with the prior approval of Principal Commissioner or Commissioner, as referred under section 144BA(12).
The procedure to be followed by the assessee under DRP route is depicted below:

AO to determine ALP u/s 92C(3) → Taxpayer to file objections with DRP → DRP to pass directions

AO may also refer determination of ALP to the TPO with the prior approval of PCIT/CIT

Taxpayer to substantiate transfer price as ALP to TPO → AO to pass Draft order → AO to pass final order

TPO to determine ALP by passing an order → Intimation to taxpayer & AO by sending copy of order → AO order appealable before Tribunal

(ii) **Appeal before the Commissioner of Income Tax (Appeals) – [Sections 246A, 249 & 250]**

Key features of the appeal before CIT (A) is listed below:

- **First Appellate Authority**
- **Appeal may be against the orders including:**
  - Assessment order passed u/s 143(3) or 144 of the Income-tax Act
  - Intimation passed u/s 143(1)
  - Reassessment order passed u/s 147 or 150 (re-computation)
  - Assessment or reassessment of search cases u/s 153(A)
  - Rectification Order made u/s 154
  - Order made under section 92CD(3)
- **Time Limit - Appeal has to be filed within 30 days of date of service of the notice of demand related to assessment order issued by the Assessing Officer**
- **Prescribed 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**
The following table enumerates the key differences between the DRP and the appeal process before the CIT (A):

<table>
<thead>
<tr>
<th>Aspect</th>
<th>DRP</th>
<th>CIT(A)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constitution</td>
<td>Case heard by 3 Principal Commissioner or Commissioners</td>
<td>Case heard by a single Commissioner</td>
</tr>
<tr>
<td>Time limit for filing objections/</td>
<td>Objections need to be filed along with all necessary submissions</td>
<td>An appeal filed within 30 days of date of service of demand notice or</td>
</tr>
<tr>
<td>appeal</td>
<td>within 30 days of receipt of the draft order.</td>
<td>the date on which intimation of order sought to be appealed against</td>
</tr>
<tr>
<td></td>
<td></td>
<td>is served, as the case may be.</td>
</tr>
<tr>
<td>Condonation of delay</td>
<td>No power to condone delay</td>
<td>Discretion of CIT(A)</td>
</tr>
<tr>
<td>Filing Fees</td>
<td>No filing fees</td>
<td>₹ 250 to ₹ 1,000, depending upon assessed income</td>
</tr>
<tr>
<td>Stay of demand</td>
<td>Automatic stay of demand as the order is a draft order.</td>
<td>A stay application to be filed with the Income-tax Officer requesting</td>
</tr>
<tr>
<td></td>
<td></td>
<td>for a stay of demand. In case the stay is rejected, the demand to be</td>
</tr>
<tr>
<td></td>
<td></td>
<td>paid off is decided by the Income-tax Officer.</td>
</tr>
<tr>
<td>Time limit for completion</td>
<td>To be completed within a period of 9 months from the end of the</td>
<td>The Commissioner (Appeals) may decide the appeal within a period of</td>
</tr>
<tr>
<td></td>
<td>month in which the draft order is forwarded to the assessee.</td>
<td>one year from the end of the financial year in which such appeal is</td>
</tr>
<tr>
<td></td>
<td></td>
<td>filed before him.</td>
</tr>
<tr>
<td>Penalty Proceedings</td>
<td>No penalty proceedings can be initiated until the matter is</td>
<td>Typically penalty proceedings are initiated by the ITO and a stay of</td>
</tr>
<tr>
<td></td>
<td>disposed</td>
<td>penalty would need to be filed.</td>
</tr>
<tr>
<td>Next steps on completion of</td>
<td>Once the order of the DRP is passed, the same is sent to the</td>
<td>Once the order of the CIT(A) is passed, the same is sent to the</td>
</tr>
<tr>
<td>proceedings</td>
<td>assessing officer who will pass a final assessment order.</td>
<td>assessing officer who will pass an order giving effect to the order of</td>
</tr>
<tr>
<td></td>
<td></td>
<td>the CIT(A).</td>
</tr>
</tbody>
</table>

The CBDT has issued a press release dated 30.12.2015 stating that as part of the endeavor of the Income-tax Department to digitize various functions of the Department for providing efficient taxpayer services, electronic filing of appeal before CIT(Appeals) is being made mandatory for persons who are required to file the return of income electronically.
(iii) Appeal before the Income Tax Appellate Tribunal [Sections 253 & 254]

Key features of the appeal process before the Income Tax Appellate Tribunal is listed below:

- Once the order of the Assessing Officer after giving effect to DRP directions or CIT(A) are issued, 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.

- If the revenue authorities have filed an appeal on a matter where the CIT(A) has held in favor of the assessee, then Principal Commissioner or Commissioner of Income-tax can direct Assessing officer to file an appeal on order of CIT(A) filed before the Tribunal;

- In the case of an order arising pursuant to directions of the DRP, the demand becomes payable and a stay application will need to be filed with the AO requesting for a stay of demand;

- In case the stay application is rejected by the AO, the demand is to be paid by the assessee. Alternatively, the assessee can prefer a stay application before the Tribunal;

- An order is passed by the Tribunal after hearing arguments from both the assessee and the Revenue authorities.

- Once the order of the Tribunal is issued, an order giving effect will need to be passed by the AO and consequential demands paid off /refunds issued.

(iv) Appeal before the High Court / Supreme Court [Sections 260A & 260B/ Sections 261 & 262]

Key features of the appeal process before the High Court is listed below:

- Appeal lies to High Court against decision given by Appellate tribunal

- Appeal can be filed by the aggrieved –
  - Principal Chief Commissioner; or
  - Chief Commissioner; or
  - Principal Commissioner; or
  - Commissioner; or
  - Assessee

- Condition precedent
  - Appeal shall be heard by not less than 2 judges of the High Court
  - If HC satisfied that the case involves a ‘substantial question of law’
• Substantial Question of Law means:
  ➢ Issue must be debatable
  ➢ Not previously settled by Law of Land
  ➢ Should not be settled by a binding precedent
  ➢ Must have a material bearing on decision of the case

• Time Limit for filing an appeal - Appeal to be preferred within 120 days from the date of receipt of the Tribunal’s order

• Filing Fee and Jurisdiction
  ➢ Fee is decided as per relevant court rules and Code of Civil Procedure
  ➢ Jurisdiction is decided on the basis of the location of AO who framed the disputed order

Key features of the appeal process before the Supreme Court is listed below:

• Appeal lies to Supreme Court against decision given by the High Court.

• Condition precedent
  ➢ High Court should certify that the case is fit for appeal
  ➢ If High Court refuses – application to Supreme Court can be made under Article 136 of the Constitution for special leave

• Decision of Supreme Court becomes the Law of the Land

The monetary tax limits for Departmental appeal filing before ITATs, HCs and SCs are as follows:

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Appeals in income-tax matters</th>
<th>Monetary Limits (in ₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Before ITAT</td>
<td>50,00,000</td>
</tr>
<tr>
<td>2.</td>
<td>Before High Court</td>
<td>1,00,00,000</td>
</tr>
<tr>
<td>3.</td>
<td>Before Supreme Court</td>
<td>2,00,00,000</td>
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</table>

(v) Safe Harbour Rules

In order to reduce the increasing number of transfer pricing audits and prolonged disputes, the Finance (No. 2) Act, 2009 with retrospective effect from 1.4.2009 inserted section 92CB to provide that determination of arm’s length price under section 92C or Section 92CA shall be subject to Safe Harbour rules. Section 92CB(2) empowers the CBDT to prescribe safe harbour rules\(^1\).

Safe Harbour means circumstances in which the income-tax authorities shall accept the transfer price declared by the assessee.

\(^1\) The Safe Harbour Rules relevant for A.Y. 2020-21 are yet to be notified by the CBDT as on the date of release of the Study Material. These rules, when notified, will form part of the webhosted Statutory Update.
(vi) Advance Pricing Agreements

What is APA?

In order to gain certainty prior to entering into an international transaction with an AE, the taxpayers have an option of applying for an Advance Pricing Agreement (APA) and obtaining results before the transaction is actually undertaken. The same has the potential to reduce litigation for the taxpayer and provide certainty for a longer period of time.

An APA is an agreement between a taxpayer/applicant and the CBDT, which determines the arm’s length price of future intercompany transactions. It can also be used for existing intercompany transactions. The taxpayer/applicant mutually agree on the transfer pricing methodology to be applied and its application, in relation to the taxpayer’s international transactions for certain future period of time.


Once an APA has been entered into with respect to an international transaction, the arm’s length price with respect to that international transaction, for the period specified in the APA, will be determined only in accordance with the APA. The APA shall be binding on the person as well as the Income-tax authorities for the specified transaction and period as covered in the APA.

Types of APA

The APA scheme envisages three types of APA’s, viz.

- Unilateral APA – Agreement between the assessee and CBDT
- Bilateral APA – Agreement between the assessee and CBDT subsequent to and based on agreement between competent authorities of India with the competent authority in the other country regarding appropriate transfer pricing method or the ALP
- Multilateral APA - Agreement between the assessee and CBDT subsequent to and based on agreement between competent authorities of India with the competent authorities in the other countries regarding appropriate transfer pricing method or the ALP

Request for bilateral or multilateral APA can be accepted by the Indian competent authority where:

- A tax treaty exists between India and other contracting state containing an article on ‘Mutual Agreement Procedure’;
- The corresponding APA program exists in the other country.

[In case of international transactions leading to economic double taxation arising out of TP adjustments; presently it seems Indian Competent Authority accepts bilateral/ multilateral]
APA only if the said tax treaty contains provisions similar to article 9(2) of the OECD model convention on ‘Associated Enterprises’

Advantages of APA program

The APA program is designed to:

- Provide certainty with regard to determination of ALP of the international transaction (viz. transactions covered by the APA);
- Impart flexibility in developing practical approaches for complex transfer pricing issues;
- Reduce the risk of potential double taxation through bilateral and multi-lateral APA;
- Reduce compliance costs by eliminating the risk of transfer pricing audit and resolving long drawn and time consuming litigation;
- Reduce the burden of record keeping, as the taxpayer knows in advance the required documentation to be maintained to substantiate the agreed terms and conditions of the agreement.

Applicability of APA

Section 92CC enables the Board (with the approval of the Central Government), to enter into an APA with any person undertaking an international transaction.

(i) Purpose of APA: The APA shall relate to an international transaction to be entered into by such person. The APA shall be entered into for the purpose of determination of the arm’s length price or specifying the manner in which arm’s length price shall be determined, in relation to such international transaction.

(ii) Manner of determination of Arm’s Length Price in APA: The manner for determination of arm’s length price referred above may include methods referred to in section 92C(1) or any other method with necessary adjustments or variations.

(iii) Non-applicability of section 92C or section 92CA: In case an APA has been entered into in respect of any international transaction, the arm’s length price in relation to that transaction shall be determined in accordance with that APA notwithstanding any contrary provisions contained in section 92C or section 92CA i.e., the provisions of the APA shall apply overriding the provisions of section 92C or section 92CA, which are normally applicable for determination of arm’s length price.

(iv) Validity of APA: The APA shall be valid for such period as specified in the agreement, which shall in no case exceed five consecutive previous years.

(v) Binding nature of APA: The APA so entered into shall be binding on:

(a) the person in whose case, and in respect of the transaction in relation to which, the APA has been entered into; 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.

(vi) **Not binding of APA:** The APA shall not be binding if there is any change in law or facts having bearing on such APA.

(vii) **Conditions to declare APA as void ab initio:** In case the Board finds that the APA so entered into has been obtained by the person by way of fraud or misrepresentation of facts, the Board is empowered to pass an order declaring any such APA to be void ab initio, with the approval of Central Government.

(viii) **Consequences of declaration of an APA as void ab initio:** As a result of declaration of an APA as void ab initio:

(a) all the provisions of the Act shall apply to such person as if such APA had never been entered into.

(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 any period of limitation under this Act (for example period of limitation specified in the section 153, 153B etc). This is irrespective of anything contained in any other provision of the Act.

(c) In case the period of limitation after exclusion of the above mentioned period is less than 60 days, such remaining period of limitation shall be extended to 60 days.

(ix) If an application is made by a person for entering into an APA, then, the proceeding, in respect of such person for the purpose of the Act, shall be deemed to be pending.

(x) **Prescribed scheme for APA:** The Board is empowered to prescribe a scheme specifying the manner, form, procedure and any other matter generally in respect of the APA.

**Prescribed Advance Pricing Agreement Scheme for the purpose of section 92CC [Rule 10F to 10T]:** In exercise of the powers conferred in section 92CC(9) read with section 295 of the Income-tax Act, 1961, the CBDT has prescribed rules specifying an Advance Pricing Agreement (APA) Scheme. Some of the important provisions of the scheme are briefed hereunder –

(1) **Persons eligible to apply [Rule 10G]:** Any person who has undertaken an international transaction or is contemplating to undertake an international transaction, shall be eligible to enter into an agreement under these rules.

(2) **Pre-filing Consultation [Rule 10H]:**

(a) Any person proposing to enter into an agreement under these rules may, by an application in writing, make a request for a pre-filing consultation in the prescribed form to the Director General of Income-tax (International Taxation).
(b) The pre-filing consultation shall, among other things,-
   (i) determine the scope of the agreement;
   (ii) identify transfer pricing issues;
   (iii) determine the suitability of international transaction for the agreement;
   (iv) discuss broad terms of the agreement.

(c) The pre-filing consultation shall –
   (i) not bind the Board or the person to enter into an agreement or initiate
       the agreement process;
   (ii) not be deemed to mean that the person has applied for entering into an
        agreement.

(3) Application for advance pricing agreement [Rule 10-I]

(a) Any person who is eligible to apply may enter into agreement may, if such person
    desires to enter into an agreement furnish an application in the prescribed form
    along with proof of payment of requisite fee as specified, to the Director General
    of Income-tax (International Taxation) in case of unilateral agreement and to the
    competent authority in India in case of bilateral or multilateral agreement.

(b) The application may be filed at any time -
   (i) before the first day of the previous year relevant to the first assessment
       year for which the application is made, in respect of transactions which
       are of a continuing nature from dealings that are already occurring; or
   (ii) before undertaking the transaction in respect of remaining transactions.

   Note - The applicant may withdraw the application for agreement at any time before
   the finalisation of the terms of the agreement. However, application fees paid shall
   not be refunded on withdrawal of application by the applicant.

(4) Approval of Central Government: The agreement shall be entered into by the
    Board with the applicant after its approval by the Central Government.

(5) Terms of the agreement [Rule 10M]

(a) An agreement may among other things, include –
   (i) the international transactions covered by the agreement;
   (ii) the 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 item (ii) or (iii);
(v) critical assumptions i.e., the factors and assumptions that are so critical and significant that neither party entering into an agreement 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;

(vii) the conditions, if any, other than provided in the Act or these rules.

(b) The agreement 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 agreement has been entered into.

(c) The binding effect of agreement shall cease only if any party has given due notice of the concerned other party or parties.

(d) In case there is a change in any of the critical assumptions or failure to meet the conditions subject to which the agreement has been entered into, the agreement can be revised or cancelled, as the case may be.

(6) Furnishing of Annual Compliance Report [Rule 10-O]: The assessee shall furnish an annual compliance report in quadruplicate in the prescribed form 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 agreement, whichever is later.

(7) Compliance Audit of the agreement [Rule 10P]:

(a) The Transfer Pricing Officer having the jurisdiction over the assessee shall carry out the compliance audit of the agreement for each of the year covered in the agreement. For this purpose, the Transfer Pricing Officer may require –

(i) the assessee 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) the assessee to submit any information, or document, to establish that the terms of the agreement has been complied with.

(b) 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.

(8) Revision of an agreement [Rule 10Q]:

(a) An agreement, after being entered, may be revised by the Board either suo moto or on request of the assessee or the competent authority in India or the Director General of Income-tax (International Taxation), if—
(i) there is a change in critical assumptions or failure to meet a condition subject to which the agreement has been entered into;

(ii) there is a change in law that modifies any matter covered by the agreement but is not of the nature which renders the agreement to be non-binding; or

(iii) there is a request from competent authority in the other country requesting revision of agreement, in case of bilateral or multilateral agreement.

(b) Except when the agreement is proposed to be revised on the request of the assessee, the agreement shall not be revised unless an opportunity of being heard has been provided to the assessee and the assessee is in agreement with the proposed revision.

(c) The revised agreement shall include the date till which the original agreement is to apply and the date from which the revised agreement is to apply.

(9) Cancellation of an agreement [Rule 10R]:

(a) An agreement shall be cancelled by the Board for any of the following reasons:

(i) the compliance audit has resulted in the finding of failure on the part of the assessee to comply with the terms of the agreement;

(ii) the assessee has failed to file the annual compliance report in time;

(iii) the annual compliance report furnished by the assessee contains material errors; or

(iv) the assessee is not in agreement with the revision proposed in the agreement or the agreement is to be cancelled under rule 10RA(7);

(b) The Board shall give an opportunity of being heard to the assessee, before proceeding to cancel an application.

(c) The order of cancellation of the agreement shall be in writing and shall provide reasons for cancellation and for non-acceptance of assessee’s submission, if any.

(d) The order of cancellation shall also specify the effective date of cancellation of the agreement, where applicable.

(e) The order under the Act, declaring the agreement as void ab initio, on account of fraud or misrepresentation of facts, shall be in writing and shall provide reason for such declaration and for non-acceptance of assessee’s submission, if any.
(10) Mere filing of an application for an agreement under these rules shall not prevent the operation of Chapter X of the Act for determination of arms’ length price under that Chapter till the agreement is entered into. [Rule 10T(1)].

(11) The negotiation between the competent authority in India and the competent authority in the other country or countries, in case of bilateral or multilateral agreement, shall be carried out in accordance with the provisions of the tax treaty between India and the other country or countries. [Rule 10T(2)].

(ix) **Provision for Roll back in APA Scheme [Section 92CC]**

(a) In order to reduce current pending as well as future litigation in respect of the transfer pricing matters, section 92CC(9A) provides roll back mechanism in the APA scheme.

(b) Accordingly, the APA may, subject to such prescribed conditions, procedure and manner, provide for determining the ALP or for specifying the manner in which ALP is to be determined in relation to an international transaction entered into by a person during any period not exceeding four previous years preceding the first of the previous years for which the APA applies in respect of the international transaction to be undertaken.

The CBDT has, vide Notification No.23/2015 dated 14.3.2015, in exercise of the powers conferred by 92CC(9A) read with section 295, following 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 relation to an international transaction:

<table>
<thead>
<tr>
<th>Rule</th>
<th>Particulars</th>
<th>Conditions, Procedure &amp; Manner of determination of ALP</th>
</tr>
</thead>
<tbody>
<tr>
<td>10F(ba)</td>
<td>Definition of Applicant</td>
<td>A person who has made an application.</td>
</tr>
<tr>
<td>10F(ha)</td>
<td>Definition of Rollback year</td>
<td>Any previous year, falling within the period not exceeding four previous years preceding the first of the five consecutive previous years referred to in section 92CC(4).</td>
</tr>
<tr>
<td>10MA</td>
<td>Roll back of the agreement</td>
<td>The said rule provides the following:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1. The agreement 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 (hereinafter referred as &quot;rollback provision&quot;).</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. <strong>Conditions for applying for rollback provisions:</strong></td>
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<td></td>
<td>The agreement shall contain rollback provision in respect of an international transaction subject to the following, namely:-</td>
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<tr>
<td></td>
<td></td>
<td>(i) the international transaction is same as the</td>
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</table>
1. **Non-applicability of Rollback provision:** Rollback provision shall not be provided in respect of an international transaction for a rollback year, if,-

(i) the determination of arm’s length price of the said international transaction for the said year has been 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; or

(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.

2. **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 for determination of arm’s length price of the same international transaction to be undertaken in any previous year to which the agreement applies, not being a rollback year.

3. **Fees for filing application for rollback provision:** The applicant may furnish along with the application for advance pricing agreement, the request for rollback provision in Form No. 3CEDA with proof of payment of an additional fee of ₹ 5 lakh.
<table>
<thead>
<tr>
<th>10RA</th>
<th>Procedure for giving effect to rollback provision of an Agreement</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rule 10RA has been inserted to provide the “Procedure for giving effect to rollback provision of an Agreement” as follows:</td>
</tr>
<tr>
<td></td>
<td>(i) The applicant shall furnish modified return of income referred to in section 92CD in respect of a rollback year to which the agreement applies along with the proof of payment of any additional tax arising as a consequence of and computed in accordance with the rollback provision.</td>
</tr>
<tr>
<td></td>
<td>(ii) The modified return in respect of rollback year shall be furnished along with the modified return to be furnished in respect of first of the previous years for which the agreement has been requested for in the application.</td>
</tr>
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<td></td>
<td>(iii) 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 for that year, the said appeal to the extent of the subject covered under the agreement shall be withdrawn by the applicant before furnishing the modified return for the said year.</td>
</tr>
<tr>
<td></td>
<td>(iv) 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 agreement, 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.</td>
</tr>
<tr>
<td></td>
<td>(v) 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 of an agreement containing rollback provision having been entered into along with a copy of the same as soon as it is practicable to do so.</td>
</tr>
<tr>
<td></td>
<td>(vi) 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.</td>
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</table>

Subsequent to the notification of the rules, the CBDT has issued *Circular No. 10/2015 dated 10.6.2015* adopting a Question and Answer format to clarify certain issues arising out of the said Rules. The questions raised and answers to such questions as per the said Circular are given hereunder:
Question 1

Under rule 10MA(2)(ii) there is a condition that the return of income for the relevant roll back year has been or is furnished by the applicant before the due date specified in Explanation 2 to section 139(1). It is not clear as to whether applicants who have filed returns under section 139(4) or 139(5) of the Act would be eligible for roll back.

Answer

The return of income under section 139(5) can be filed only when a return under section 139(1) has already been filed. Therefore, the return of income filed under section 139(5) of the Act, replaces the original return of income filed under section 139(1). Hence, if there is a return which is filed under section 139(5) to revise the original return filed before the due date specified in Explanation 2 to sub-section (1) of section 139, the applicant would be entitled for rollback on this revised return of income.

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.

Note – A belated return filed under section 139(4) can also be revised under section 139(5). In such a case, the revised return would replace the belated return. Therefore, an applicant would not be entitled for roll back provisions on a revised return which replaces a belated return.

Question 2

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 international transaction for which a rollback provision is to be allowed should be the same as the one proposed to be undertaken in the future years and in respect of which the agreement has been reached. There cannot be a situation where rollback is finalised for a transaction which is not covered in the agreement for future years. 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 for which the agreement applies.

The word “materially” is generally being defined in the Advance Pricing Agreements being entered into by CBDT. According to this definition, the word “materially” will be interpreted consistently with its ordinary definition and in a manner that a material change of facts and circumstances would be understood as a change which could reasonably have resulted in an agreement with significantly different terms and conditions.
Question 3

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. Accordingly, if the covered international transaction(s) were not in existence during any of the rollback years, the applicant can apply for rollback for the remaining years. Similarly, if in any of the rollback years for the covered international transaction(s), the applicant fails the test of the rollback conditions contained in various provisions, then it would be denied the benefit of rollback for that rollback year. However, for other rollback years, it can still apply for rollback.

Question 4

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).

Question 5

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

It is clarified that in case the terms of rollback provisions contain specific agreement between the Board and the applicant that the agreed determination of ALP or the agreed manner of determination of ALP is subject to the condition that the ALP would get modified to the extent that it does not result in reducing the total income or increasing the total loss, as the case may be, of the applicant as declared in the return of income of the said year, the rollback provisions could be applied. For example, if the declared income is ₹ 100, the income as adjusted by the TPO is ₹ 120, and the application of the rollback provisions results in reducing the income to ₹ 90, then the rollback for that year would be determined in a manner that the declared income ₹ 100 would be treated as the final income for that year.

Question 6

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. Sub-rules (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.

This is because the rollback provision has been introduced for the benefit of the applicant and is applicable at its option. Accordingly, if the rollback provision cannot be given effect to for any of the rollback years on account of the applicant not taking the actions specified in sub-rules (2), (3), (4) or (6), the entire agreement gets vitiated and will have to be cancelled.

Question 7

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 8**

*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 term. 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.

**Question 9**

*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.

**Question 10**

*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 11**

*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.
Question 12

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.

Question 13

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 form 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

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, 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.

Section 92CD provides for the following procedure for giving effect to an APA

(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 under the provisions of section 139 in respect of any assessment year relevant to a previous year to which the APA applies, then, such person shall, within a period of three months from the end of the month in which the said
agreement was entered into, furnish a modified return, notwithstanding any contrary provision contained in section 139.

(ii) Such modified return shall be in accordance with and limited to the provisions of such APA i.e., modifications can only be made on account of such APA in the return to be filed.

(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 in this section.

(iv) If the assessment or reassessment proceedings for an assessment year relevant to a previous 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 in accordance with 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.

**However, with effect from 1.9.2019, Assessing Officer shall pass an order modifying the total income of the relevant assessment year determined in such assessment or reassessment, as the case may be, having regard to and in accordance with the APA, instead of proceeding to assess or reassess the total income.**

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 relevant to the previous 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 mentioned 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 for an assessment year shall be deemed to have been completed where -

(a) an assessment or reassessment order has been passed; or

(b) no notice has been issued under section 143(2) till the expiry of the limitation period provided under the said section.
(vii) Mutual Agreement Procedure (MAP)

The mutual agreement procedure is a well-established means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. This procedure, described and authorized by Article 25 of the OECD Model Tax Convention, can be used to eliminate double taxation that could arise from a transfer pricing adjustment.

Article 25 sets out three different areas where mutual agreement procedures are generally used. The first area includes instances of “taxation not in accordance with the provisions of the Convention” and is covered in paragraphs 1 and 2 of the Article. Procedures in this area are typically initiated by the taxpayer. The other two areas, which do not necessarily involve the taxpayer, are dealt with in paragraph 3 and involve questions of “interpretation or application of the Convention” and “the elimination of double taxation in cases not otherwise provided for in the Convention”. Paragraph 10 of the Commentary on Article 25 makes clear that Article 25 is intended to be used by competent authorities in resolving not only problems of juridical double taxation but also those of economic double taxation arising from transfer pricing adjustments made pursuant to paragraph 1 of Article 9 (Article 9 – Associated enterprises).

**Juridical double taxation**

When source rules overlap, double taxation may arise i.e. tax is imposed by two or more countries as per their domestic laws in respect of the same transaction, income arises or is deemed to arise in their respective jurisdictions. This is known as “juridical double taxation”.

**Economic double taxation**

‘Economic double taxation’ happens when the same transaction, item of income or capital is taxed in two or more states but in hands of different person.

(a) Categories of Disputes covered under MAP

- **Specific case provisions**: Arise where a person who is resident of a contracting state considers that the actions of one or both the contracting states results or will result in taxation not in accordance with the provisions of a DTAA.
- **General interpretative provisions**: Includes issues relating to interpretation or application of the treaty. General in nature and could be initiated *suo moto* by.
- **Cases not provided for in DTAA**: Provides for elimination of double taxation in cases not provided in DTAA.
(b) Mechanism under MAP

Tax dispute

Applicant approaches the Competent Authority (CA) in country of residence (home country)

Yes

Dispute capable of unilateral resolution

Should be resolved by Competent Authority of home country

No

Should be resolved by consultation

(c) Need for MAP

- Double Taxation Avoidance Agreements ('tax treaties') are available for capturing and curtailing juridical double taxation.
- Tax treaties generally do not cover instances of economic double taxation.
- MAP provides relief in cases of economic double taxation.
- MAP also provides relief in cases where automatic relief, such as tax credits, tax exemption, etc. are not available

(d) Steps involved in the MAP application process

- Brief facts and background of the case must be summarized
- Contentions of Indian Revenue must be summarized in the application
- The net tax and interest impact only by virtue of transfer pricing adjustment is computed
- Take note of transactions only relating to one country (in one application), e.g. USA, UK, etc.
- All documents including tax returns, TP study, notices, submissions, orders, etc. must be furnished.
- Relevant judicial precedence and their applicability to taxpayer’s case must be demonstrated.
(e) Typical MAP process in India

- Overseas Taxpayer can invoke CA proceedings if there is double taxation or taxation not in accordance with the tax treaty.
- MAP application is possible even before exhaustion of domestic remedies.
- If overseas CA considers the application appropriate, application forwarded to the Indian CA.
- Overseas CA could request Taxpayer for additional information.
- Indian CA, on receipt of MAP request from overseas CA, could consider the same for discussion.
- Additional information could be requested before the resolution is expected.
- Communication to Tax Officer, in case the matter is resolved between the CAs and accepted by the Taxpayer.
- Solution to be given effect to within 90 days if taxpayer consents.
- Overseas and India CAs would initiate negotiation and attempt to reach an amicable resolution.
- CAs may set up certain procedures/guidelines which they will adhere to during the negotiation process.
- In case the CAs reach a resolution, the proposed agreement would be communicated to the Taxpayer for his acceptance.
- Taxpayer has option not to accept the agreement in case it is detrimental.

(f) Outcome of MAP process:

- The Assessing Officer gives effect of the decision of the MAP, after receiving instructions from the CCIT / DGIT (within 90 days of receiving instructions).
- If taxpayer is aggrieved by decision of the Competent Authority, he may reject the decision and go ahead with the remedies under the domestic law.
- If remedies are not granted by the domestic law, the taxpayer may apply to the Competent Authorities again for subsequent years.
- Decision of a Competent Authority is generally case specific and not a precedent for the taxpayer for subsequent years or other taxpayers on same issues.

(g) Drawbacks of the MAP process:

- Time limits under domestic law may make corresponding adjustments unavailable if those limits are not waived in the relevant tax treaty.
- Mutual agreement procedures may take too long to complete.
- Taxpayer participation may be limited.
- Published procedures may not be readily available to instruct taxpayers on how the procedure may be used; and
There may be no procedures to suspend the collection of tax deficiencies or the accrual of interest pending resolution of the mutual agreement procedure.

Indian Statutory regime – MAP

<table>
<thead>
<tr>
<th>MAP- Indian Statutory Regime</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Rule 44G</strong></td>
<td><strong>Rule 44H</strong></td>
</tr>
<tr>
<td>Applicable to resident assessee</td>
<td>Indian Competent Authority receives a reference from Competent Authority outside India, he shall call for records and endeavor to arrive at a resolution.</td>
</tr>
<tr>
<td>Aggrieved by action of the tax authority outside India</td>
<td>Resolution arrived at shall be communicated to Chief Commissioner or Director General of Income-tax in writing.</td>
</tr>
<tr>
<td>Such action is not in accordance with the agreement or tax laws</td>
<td>Assessee can give his acceptance to the resolution and withdraw the appeal, if any, pending on the issue which was the subject matter for adjudication under MAP.</td>
</tr>
<tr>
<td>May make an application to Competent Authority in Form 34F in India to invoke MAP</td>
<td>Assessing Officer to give effect to MAP within 90 days of receipt of the same by Chief Commissioner or Director General of Income-tax, subject to conditions fulfilled.</td>
</tr>
</tbody>
</table>

1.17 TRANSFER OF INCOME TO NON RESIDENTS [SECTION 93]

Section 93 hits at transactions which are effected with a view to avoiding liability to taxation. For the purpose, the word “non-resident” also includes a person who is not ordinarily resident. In order to attract the provisions of this section, all the following conditions must be satisfied:

(a) There is a transfer of assets - whether movable or immovable and whether tangible or intangible.

(b) The transfer is made by any person in India or outside irrespective of his residential status or citizenship.

(c) The transfer is made either alone or in connection with associated operations.

(d) The assets transferred directly yield income chargeable to tax under this Act.

(e) The transfer of assets is effected in such a manner that the income becomes payable to a person outside India who is either a non-resident or a not ordinarily resident in India.

(f) The transferor acquires any right by virtue of which he gets the power to enjoy the income whether immediately or in future.

(g) The Assessing Officer is satisfied that avoidance of liability to tax in India is the purpose of the transfers.

In particular, this section deems any income of a non-resident person which, if it were the income of a resident person, would be chargeable to tax in India (in the absence of this Section), as the income of the resident person in India for all purposes of the Act provided that all the conditions
stated above are satisfied. This section also covers a variety of transactions constituting a transfer including cases where assets are transferred to a non-resident person and the transferor indirectly derives income under the guise of obtaining loans or repayment of loans. If the aforesaid conditions are fulfilled, the income from the assets transferred should be treated as the income of the transferor and would accordingly be taxable in his hands. Therefore, where assets are transferred to a body corporate outside India, in consideration of shares allotted by it to the transferor, he (the transferor), will become assessable under this section in respect of the income of the company derived by it from those assets. This section will not, however, apply to cases where it is shown to the satisfaction of the Assessing Officer that (i) neither the transfer nor any associated operation had for its purpose or for one of its purposes the avoidance of liability to taxation or (ii) it is provided to the satisfaction of the Assessing Officer that the transfer was effected for *bonafide* commercial purpose and with no intent to avoid tax.

The income which is deemed to be that of the transferor under this section may also arise as a result of the transfer in connection with associated operations. However, in this case also, the treatment of the income would be the same.

**Meaning of “associated operation”:** The expression ‘associated operation,” in relation to a transfer, means an operation of any kind effected by any person in relation to:

(i) any of the assets transferred;

(ii) any assets representing, whether directly or indirectly, any of the assets transferred;

(iii) any income arising from such assets;

(iv) any assets representing, whether directly or indirectly, the accumulation of income arising from such assets.

**Meaning of “Assets”:** It includes property or rights of any kind.

**Meaning of “transfer”:** In relation to rights, transfer includes the creation of those rights.

**Meaning of “benefit”:** It includes a payment of any kind.

In order to determine the liability of the assessee in respect of the deemed income it is immaterial if the income or benefits from the transfer (i) are actually received or not or (ii) are received or are receivable in cash or kind or (iii) are receivable directly or indirectly. For purposes of this section, a person is deemed to have the power to enjoy the income of a non-resident if:

(i) the income, 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 same form of the income or otherwise;

(ii) the receipt or accrual of the income operates to increase value of any assets held by the transferor or for his direct or indirect benefit;

(iii) the transferor receives or is entitled to receive at any time any benefit out of the income or out of any money available for the purpose by reason of the effect or successive effects of the associated operations on that income and the assets which represent that income;
(iv) the transferor is in a position to obtain for himself the beneficial enjoyment of the income by exercising any power of appointment or power of revocation or otherwise, whether with or without the consent of any other person, or

(v) the transferor is able to control directly or indirectly the application of the income in any manner whatsoever.

However, in determining whether a person has the power to enjoy the income due regard shall be had to the substantial result and effect of the transfer and any associated operations must be taken into consideration irrespective of the nature or form of the benefits.

It may be noted that where an assessee has been charged to tax in respect of a sum deemed to be his income under this section, the subsequent receipt of that sum by the assessee, whether as income or in any other form, shall not be liable to tax in his hands at the time of receipt.

1.18 INTRODUCTION OF SPECIFIC ANTI AVOIDANCE MEASURES IN RESPECT OF TRANSACTIONS WITH PERSONS LOCATED IN NOTIFIED JURISDICTIONAL AREA [SECTION 94A]

The objective of anti-avoidance measures is to discourage assessees from entering into transactions with persons located in countries or territories which do not have effective information exchange mechanism with India. The following are the anti-avoidance measures introduced -

(i) The Central Government empowered to notify any such country or territory outside India as a NJA (Notified Jurisdictional Area), having regard to the lack of effective exchange of information with such country or territory.


Cyprus was specified as a "notified jurisdictional area" (NJA) under section 94A of the Income-tax Act, 1961 vide Notification No. 86/2013 dated 01.11.2013. The said Notification No. 86/2013 was subsequently rescinded vide Notification No. 114 dated 14.12.2016 and Notification No. 119 dated 16.12.2016 with effect from the date of issue of the notification.

The CBDT has, vide this Circular, clarified that Notification No. 86/2013 has been rescinded with effect from the date of issue of the said notification, thereby, removing Cyprus as a notified jurisdictional area with retrospective effect from 01.11.2013.

(ii) A transaction where one of the parties thereto is a person located in a NJA would be deemed to be an international transaction then all parties to the transaction to be deemed as associated enterprises, and accordingly, all the provisions of transfer pricing to be attracted in case of such a transaction. However, the benefit of permissible variation between the ALP and the transfer price [provided for in the second proviso to section
Such transaction may be in the nature of –

1. purchase, sale or lease of tangible or intangible property or
2. provision of service or
3. lending or borrowing money or
4. any other transaction having a bearing on the profits, income, losses or assets of the assessee. It may include a mutual agreement or arrangement for allocation or apportionment of, or contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided by or to the assessee.

Person located in a NJA shall include a person who is a resident of the NJA and a person, not being an individual, which is established in the NJA. It would also include a permanent establishment of any other person in the NJA.

Payments made to any financial institution located in a NJA would not be allowed as deduction unless the assessee authorizes the CBDT or any other income-tax authority acting on its behalf to seek relevant information from the financial institution on behalf of the assessee.

No deduction in respect of any other expenditure or allowance, including depreciation, arising from the transaction with a person located in a NJA would be allowed unless the assessee maintains the relevant documents and furnishes the prescribed information.

Any sum credited or received from a person located in a NJA to be deemed to be the income of the recipient-assessee if he does not explain satisfactorily the source of such money in the hands of such person or in the hands of the beneficial owner, if such person is not the beneficial owner.

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%.

ILLUSTRATION 2

A Ltd., an Indian company, provides technical services to a company, XYZ Inc., located in a NJA for a consideration of ₹ 40 lakhs in October, 2019. It charges ₹ 42 lakhs for similar services rendered to PQR Inc., which is not located in a NJA. PQR Inc. is not an associated enterprise of A Ltd.

Discuss the tax implications under section 94A read with section 92C in respect of the above transaction of provision of technical services by A Ltd. to XYZ Inc.

SOLUTION

Since XYZ Inc. is located in a NJA, the transaction of provision of technical services by the Indian
company, A Ltd., would be deemed to be an international transaction and XYZ Inc. and A Ltd. would be deemed to be associated enterprises. Therefore, the provisions of transfer pricing would be attracted in this case.

The price of ₹ 42 lakhs charged for similar services from PQR Inc, being an independent entity located in a non-NJA country, can be taken into consideration for determining the arm’s length price (ALP) under Comparable Uncontrolled Price (CUP) Method.

Since the ALP is more than the transfer price, the ALP of ₹ 42 lakhs would be considered as the income arising from the international transaction between A Ltd. and XYZ Inc.

It may be noted that the benefit of permissible variation between the ALP and transfer price is not available in respect of a transaction entered into with an entity in NJA.

**ILLUSTRATION 3**

Mr. X, a non-resident individual, is due to receive interest of ₹ 5 lakhs during March 2020 from a notified infrastructure debt fund eligible for exemption under section 10(47). He incurred expenditure amounting to ₹ 10,000 for earning such income. Assuming that Mr. X is a resident of a NJA, discuss the tax implications under section 94A, read with sections 115A and 194LB.

**SOLUTION**

The interest income received by Mr. X, a non-resident, from a notified infrastructure debt fund would be subject to a concessional tax rate of 5% under section 115A on the gross amount of such interest income. Therefore, the tax liability of Mr. X in respect of such income would be ₹ 26,000 (being 5% of ₹ 5 lakhs plus health and education cess@4%).

Under section 194LB, tax is deductible @5% (plus health and education cess@4%) on interest paid by such fund to a non-resident. However, since X is a resident of a NJA, tax would be deductible@30% (plus health and education cess@4%) as per section 94A, and not @5% specified under section 194LB. This is on account of the provisions of section 94A(5), which provides that “Notwithstanding anything contained in any other provision of this Act, where a person located in a NJA is entitled to receive any sum or income or amount on which tax is deductible under Chapter XVII-B, the tax shall be deducted at the highest of the following rates, namely–

(a) at the rate or rates in force;
(b) at the rate specified in the relevant provision of the Act;
(c) at the rate of thirty per cent.”

Mr. X can, however, claim refund of excess tax deducted along with interest.

**1.19 LIMITATION OF INTEREST DEDUCTION IN CERTAIN CASES [SECTION 94B]**

(1) **Preference of debt over equity as a measure to finance businesses:** Debt and equity are the instruments through which a company is generally financed or capitalized. The manner in which a company is capitalized has a major impact on the amount of taxable
profit as the tax laws of countries generally provide for a deduction in respect of interest paid or payable while arriving at the taxable profit. However, the dividend paid on equity contribution is not deductible. Therefore, the higher the level of debt in a company, and thus, the amount of interest it pays, the lower will be its taxable income. Due to this reason, debt is considered a more tax efficient method of finance than equity. Multinational groups are often able to structure their financing arrangements to maximize tax benefits.

(2) **Tax Rules to prevent shifting of profits through excessive interest payments**: In order to address this issue, tax rules are in place in each country to fix a ceiling limit on the amount of interest deductible in computing a company's profit for tax purposes. Such rules are designed to counter cross-border shifting of profit through excessive interest payments, with the objective of protecting a country's tax base.

(3) **Relevant Action Plan of BEPS**: Under the initiative of the G-20 countries, the Organization for Economic Co-operation and Development (OECD) in its Base Erosion and Profit Shifting (BEPS) project had taken up the issue of base erosion and profit shifting by way of excess interest deductions by the MNEs in Action Plan 4 and recommended certain measures in its final report.

(4) **Insertion of provision in the Income-tax Act, 1961 in line with BEPS Action Plan 4**: Section 94B has, accordingly, been inserted in the Income-tax Act, 1961, in line with the recommendations of OECD BEPS Action Plan 4, to provide that interest expenses claimed by an entity to its associated enterprises shall not be deductible in computation of income under the “Profits and gains of business or profession” to the extent that it arises from excess interest.

**Excess interest** shall mean an amount of

- total interest paid or payable* in excess of 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) of the borrower in the previous year or
- interest paid or payable to associated enterprise for that previous year

whichever is less.

*Total interest paid or payable may be interpreted as interest paid or payable to non-resident associated enterprise as per the intent expressed in section 94B(1) and also the Explanatory Memorandum to the Finance Bill, 2017.

(5) **Applicability**: The provision shall be applicable to an Indian company, or a permanent establishment of a foreign company in India, being the borrower who incurs expenditure by way of interest or similar nature in respect of any form of debt issued by a non-resident who is an 'associated enterprise' of the borrower.

However, the provision of this section would be applicable only where the expenditure by way of interest or of similar nature exceeds ₹1 crore, in respect of any form of debt issued by a non-resident, being an 'associated enterprise' of such borrower.
(6) **Meaning of debt:** 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”.

(7) **Provision of guarantee and deposit of matching amount deemed to be debt issued:** Where the debt is issued by a lender which is not associated 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

(8) **Carry forward of excess interest:** The disallowed interest expense can be carried forward up to eight assessment years immediately succeeding the assessment year for which the disallowance was first made and claimed as deduction against the income computed under the head "Profits and gains of business or profession" to the extent of maximum allowable interest expenditure.

(9) **Businesses excluded from applicability of the provisions of section 94B:** Taking into consideration the special nature of business of Banks and Insurance business, an Indian company or permanent establishment of a foreign company which is engaged in these business have been excluded from the applicability of the provisions of this section.

**Limitation of interest deduction (Section 94B): A Summary**

| Is the borrower an Indian company or a PE of a Foreign company? |
|--------------------------|------------------|
| Yes | No |
| Is the borrower a bank or Insurance company? | Yes | Section 94B would not apply |
| No | |
| Does the interest paid to NR AE exceed ₹ 1 crore? | Yes | Excess Interest not allowable as deduction |
| | No | |
| | | Disallowed interest can be carry forward for 8 A.Y. for deduction against PGBP income to the extent of maximum allowable interest expenses |
| | | Total interest paid or payable in excess of 30% of EBITDA or Interest paid or payable to AE for that previous year, whichever is lower |

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