

TRANSFER PRICING COMPLIANCES : A PRACTITIONER'S HANDBOOK



Committee for Capacity Building of CA Firms and Small & Medium
Practitioners (CCBCAF & SMP)

The Institute of Chartered Accountants of India

(Set up by an Act of Parliament)

New Delhi

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Foreword

Growth, acquisition, diversification and other expansion activities have led to creation of large business groups that have multiple strategically independent units that are associated together. With the opening up of Indian economy, the spread of such businesses has also extended beyond national boundaries to different parts of the world. A critical issue facing such organizations is how to price the products that are transferred between independent units belonging to same group. Setting *transfer prices* that are not proper can lead to problems of incorrect financial statements for these independent units.

The concept of transfer pricing refers to determination of prices of goods, services and intangible transactions between associated enterprises that belong to the same business group. A sound base for determining transfer prices should be on the *arm's length principle* as per which prices can be obtained assuming the transactions are undertaken between unrelated parties in uncontrolled conditions.

Due to growth of international transactions, tax authorities perceive transfer pricing as highly complex tax issue. Role of transfer pricing in income tax revenues is gaining importance. Thus, the governments of several countries have been intensifying their efforts for streamlining legislation relating to how to set such prices.

Transfer pricing is one of the important and upcoming stream in the practice portfolio of Small and Medium Practitioners ('SMP'). The Institute of Chartered Accountants of India is supporting the SMPs by providing them adequate knowledge and skills. I am pleased to know that the Committee for Capacity Building of CA Firms and Small & Medium Practitioners (CCBCAF & SMP) of the Institute of Chartered Accountants of India is bringing out a book on "**Transfer Pricing Compliances: A Practitioner's Handbook**".

It is really heartening that the aforesaid publication has been written to enhance the knowledgebase of the practitioners. I appreciate the efforts put in by the contributors for preparing the basic draft of this book and compliment the Chairman of the Committee and his team for publishing the aforesaid book.

CA. Jaydeep Narendra Shah
President, ICAI

Preface

Transfer pricing has assumed enormous significance in the modern economic context. Increasing participation of multi-national groups in economic activities in India has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same group. Hence, there was a need to introduce a uniform and internationally accepted mechanism of determining reasonable, fair and equitable profits and tax in India in the case of such multinational enterprises. Accordingly, the Finance Act, 2001 introduced law of transfer pricing in India through sections 92A to 92F of the Income tax Act, 1961 which guides computation of the transfer price and suggests detailed documentation procedures.

The TP Provisions were introduced with intent to protect India's right to collect a fair share of tax in respect of cross border transactions. In simpler terms, TP Provisions were introduced to ensure that an international transaction between two associated enterprises is made at an arm's length price so that both the countries involved get a proper share of profits in their respective jurisdiction. The term "international transaction" has been defined in section 92B of the Income-tax Act. Prior to the amendment proposed by the Budget 2012, the section provided that besides the specific transactions contained in the section, any other transactions which have a bearing on the profit, income, losses or assets shall also be treated as international transaction. Section 92 of the Income-tax Act (which is the charging section for transfer pricing) provides that any income arising from an international transaction shall be computed having regard to the arm's length price (ALP). Knowledge is always evolving; more so with Transfer Pricing in India.

At our end, we have tried our level best to incorporate the "typical" or "frequently asked" questions and answers on Transfer Pricing compliances. I hope this book on "Transfer Pricing Compliances : A Practitioner's Handbook", published by the Committee for Capacity Building of CA Firms and Small & Medium Practitioners (CCBCAF&SMP), ICAI will be a very useful support material for Practitioners.

I place on record my deep sense of gratitude to CA. Hrishikesh Gogte & CA. Aditya Panse for preparing the draft of this publication thereby sharing their relevant experience and expertise amongst members. I appreciate the efforts put in by the members of CCBCAF & SMP, Working Group on Research &

Publications and Dr. Sambit Kumar Mishra, Secretary, CCBCAF & SMP and other officials of the Secretariat who have provided necessary support for publishing the aforesaid book.

With warm regards

Chairman
Committee for Capacity Building of CA Firms and
Small & Medium Practitioners (CCBCAF&SMP), ICAI

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Chapter 1

Introduction to Transfer Pricing

Question 1

Give a brief overview of the transfer pricing environment in India.

Answer

Transfer Pricing provisions were introduced in India in the year 2001. The provisions of Chapter X came into force on 1 April 2002.

Transfer Pricing provisions exist in almost all of developing and developed countries of the world, including the US, UK, Australia, Brazil, Russia, etc.

It has been more than 10 years since the introduction of Transfer Pricing provisions in India. The practice of Transfer Pricing is on the course of maturing both from the Income-tax Department's side as well as the assessee's side.

Transfer Pricing additions (i.e. increase in taxable income of the assessee) have been increasing steadily over the year. The last completed round of Transfer Pricing assessments witnessed a whopping sum of ₹ 45,000 crores added to the taxable incomes of the assessee across India.

Naturally, there has been an exponential increase in the Transfer Pricing litigation, with about 300 decisions from the Income Tax Appellate Tribunal and certain decisions from various High Courts.

Question 2

Which Sections of Income Tax Act 1961 cover the Transfer Pricing regulations in India? What are the compliances required to be done under Indian Transfer Pricing Regulations ('ITPR')?

Answer

The provisions relating to Transfer Pricing in India is contained in Chapter X of the Income-tax Act, 1961. It has been supplemented with the introduction of Rule 10A to Rule 10E of the Income-tax Rules, 1962; which stipulate various procedural matters relating to Transfer Pricing.

Every assessee subject to Transfer Pricing in India has to comply with the following requirements:

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- (a) The assessee has to maintain prescribed documentation in relation to the intra-group transactions; and
- (b) The assessee has to obtain and submit an Accountant's Report in Form 3CEB duly signed and verified by a Chartered Accountant.

References: Section 92D, Rule 10D, Section 92E

Question 3

What are the due dates for the compliances under ITPR?

Answer

The Accountant's Report in Form 3CEB has to be filed on or before 30 November of every year; whereas the documentation has to be maintained before the due date, i.e. 30 November.

References: Section 92E, Rule 10E, Form 3CEB, Section 92D, Rule 10D

Question 4

When an assessee is required to comply with Transfer Pricing provisions?

Answer

The assessee is required to comply with Transfer Pricing provisions when:

- (a) The assessee has entered into an **international transaction** or a **specified domestic transaction**; with
- (b) It's Associated Enterprise outside India (in case of an international transaction) or within India (in case of a specified domestic transaction).

References: Section 92(1), 92B, 92BA

Question 5

What is the need for introduction of provisions relating to Transfer Pricing?

Answer

One of the most prevalent forms of shifting taxable profits outside a particular jurisdiction (i.e. a country) is inflating or deflating the prices of transactions between two units of multinational enterprises, resulting into tax avoidance. In the wake of liberalization, privatization and globalization adopted by India in the year 1992, there was a spate of multinational companies setting up

operations in India. Thus, a need of curbing such tax avoidance measures was felt necessary. Instruction No. 12/2001 dated 23-8-2001 states that:

"The aforesaid provisions have been enacted with a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profit and tax in India so that the profits chargeable to tax in India do not get diverted elsewhere by altering the prices charged and paid in intra-group transactions leading to erosion of our tax revenues."

This principle is also known as "tax base erosion theory".

References: Instruction No. 12/2001 dated 23-8-2001

Question 6

Whether the import price accepted for custom valuation can be considered as an arm's length price in lieu of the compliances under ITPR?

Answer

Special Valuation Branch ('SVB') is a Branch of the Custom House, specializing in investigating the transactions involving relationship between the supplier and the importer and certain other special features like Technical Collaboration between the parties, etc. Special Valuation Branch examines the influence of relationship on the invoice value of the imported goods in respect of transactions between related parties.

Transfer Pricing provisions are separate law in itself, and thus, it cannot be used in lieu of the compliances under ITPR. Further, the methods of identification of Associated Enterprises / Related Parties and the valuation methods / methods used for determination of arm's length price in the respective laws are not aligned with each other.

Further, the policy objectives and the roles of SVB and the Transfer Pricing provisions are exactly opposite. To put it simply, the role of the SVB is to ensure whether the prices of goods imported from the related parties are artificially **reduced** in order to reduce the payment of Customs Duty. However, in case of Transfer Pricing provisions, there is an incentive to the assessee to **increase** the prices of goods imported from related parties in order to reduce the taxable income in India.

References: <http://www.chennaicustoms.gov.in/imports/svb.htm>

Question 7

Is Transfer Pricing applicable only to International Transactions?

Answer

No. Finance Act, 2012 has widened the scope of Transfer Pricing to specified domestic transactions as well.

References: Chapter 10 (Domestic Transfer Pricing)

Question 8

The assessee's parent company / subsidiary outside India already have Transfer Pricing documentation in place. Can it be used for demonstrating arm's length from Indian perspective?

Answer

Arm's length price from India's perspective and arm's length price from the overseas enterprises' perspective need not be aligned with each other. Consider the following example:

A Ltd., a pharmaceutical company in India exports its products to B Ltd. in the UK, which functions as its distributor. The net profit margin earned by similar pharmaceutical distributors in the UK is 12%, whereas B Ltd. earns 20%.

- *From perspective of Transfer Pricing law in the UK, the transaction is at arm's length, since A Ltd. earns more than its comparable companies; **BUT***
- *From perspective of Transfer Pricing law in India, the transaction is **NOT** at arm's length, since the comparables are earning only 12%, and B Ltd. should have earned maximum of 12% in order to be at arm's length from India perspective.*

Further, the procedural rules (for e.g. the past years considered for benchmarking, the use of arithmetic mean / median / inter quartile range, etc.) may be different for each jurisdiction.

Thus, the Transfer Pricing documentation of related party outside India cannot be used as such for determining arm's length from an Indian perspective. Having said that, such documentation can be of immense use in preparing the Transfer Pricing documentation of Indian Group Company.

Question 9

Whether the Income Tax Department carries out any kind of scrutiny of the Transfer Pricing compliances made by the assessee?

Answer

The primary responsibility of determining and applying an arm's length price is on the assessee. However, the Assessing Officer is empowered to determine the arm's length price and compute the total income of the assessee accordingly, subject to the conditions provided therein.

The Assessing Officer refers such case to the Transfer Pricing Officer, who proceeds to conduct a "Transfer Pricing assessment" in order to determine the arm's length price, which the Assessing Officer incorporates in his Assessment Order.

References: Section 92C (3), Section 92CA

Question 10

What is arm's length?

Answer

Arm's length price is defined as "a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions".

The terms "transaction", "person" and "associated enterprise" are defined in Income-tax Act, 1961.

The entire premise of Transfer Pricing provisions is that the relation between the transacting parties (e.g. buyer is a holding company and seller is a subsidiary or vice versa) should not affect the price at which the transaction is entered. Thus, the transactions should be valued as if they had been carried out between unrelated parties; each acting in his own best interest. The term "arm's length" has its source in Article 9 of the OECD Model Tax Convention and is the framework for bilateral treaties between OECD countries, and many non-OECD governments, too. It is discussed in great detail in the OECD Transfer Pricing Guidelines.

References: Section 92F (ii), Article 9 of the OECD Model Tax Convention

Question 11

Is Transfer Pricing applicable only to Companies?

Answer

No. Transfer Pricing is applicable to transactions between "Associated Enterprises". Section 92F (iii) states the "enterprise means a **person** (including a permanent establishment of such person)..."

According to Section 2(31), "person" includes an individual, a Hindu undivided family, a company, a firm, an association of persons or a body of individuals, a local authority, and every artificial juridical person, not falling within any of the preceding sub-clauses.

Hence, Transfer Pricing is applicable to Transactions between any of the entities covered in the definition of person. For e.g. it would be applicable to transactions between an individual and an HUF, provided other conditions are met.

References: Section 92F (iii), Section 2(31)

Question 12

Section 92(1) mentions "income". Whether the Transfer Pricing provisions are applicable only to "income" of the assessee; and not to "expenses"?

Answer

Section 92(1) mentions "any income arising from an international transaction..." Thus, it is undoubtedly applicable to "income".

Explanation to Section 92 (1) clarifies that allowance for any expense shall also be determined having regard to arm's length price.

Thus, transfer pricing is applicable to both income as well as expenses.

References: Section 92(1)

Question 13

Can Transfer Pricing provisions reduce the income chargeable to tax in hands of the assessee?

Answer

No. Section 92(3) specifically provides that if arm's length price has an effect of reducing the income chargeable to tax or increasing the loss, as the case may be, then the Transfer Pricing provisions would not apply.

References: Section 92(3)

Question 14

What is the status of OECD Guidelines in the context of Transfer Pricing in India?

Answer

No. India is not a member of OECD as of date. India is one of the many non-member economies with which the OECD has working relationships in addition to its member countries. However, India has ratified "the Convention on Mutual Administrative Assistance in Tax Matters" developed jointly by the Council of Europe and the OECD; making it the first country outside the membership of the OECD and the Council of Europe to become a Party to the Convention.

OECD Transfer Pricing Guidelines are not "law" as far as India is concerned. However, it cannot be denied that the Guidelines contain a robust and developed guidance on Transfer Pricing matter. Hence, various benches of Hon'ble Tribunals have relied upon OECD Guidelines from time to time, especially when Transfer Pricing provisions in Income-tax Act are silent on any particular matter. OECD Guidelines are widely used amongst practitioners as well.

References: OECD website (www.oecd.org).

Question 15

The assessee is a tax holiday unit. Thus, with whatever profits, it will still pay no tax. Does it still require compliance with Transfer Pricing provisions?

Answer

It is nowhere mentioned in Transfer Pricing provisions the tax holiday units are not required to comply with Transfer Pricing provisions. The Assessing Officer does not require to demonstrate tax avoidance before invoking Transfer Pricing provisions. This has been made clear by the ruling by ITAT in case of **Aztec Software**.

In fact, if the Transfer Pricing Officer enhances the income of such an assessee by re-computing the arm's length price ("transfer pricing addition" in common parlance), no deduction under section 10A or section 10B or under Chapter VI-A shall be allowed in respect of such enhanced income.

References: Proviso to Section 92C (4), Aztec Software vs. ACIT 294 ITR (AT) 32

Chapter 2

Associated Enterprises

Question 16

What is an “Associated Enterprise”?

Answer

“Associated Enterprise” is defined in Section 92A. Section 92A (1) is the main source of definition of Associated Enterprise, which prescribes “participation in management, control and capital” as the factor for determining whether an enterprise is an Associated Enterprise.

The concept of “Associated Enterprises” has its origins in Article 9 of the OECD Model Tax Convention. The definition provided in Section 92A (1) is loosely modeled on Article 9.

Clause (a) of Section 92A (1) provides for a linear structure; i.e. Holding company and a Subsidiary company are Associated Enterprises of each other. Clause (b) provides for a lateral structure, where, for e.g. Fellow subsidiaries are Associated Enterprises of each other.

References: Section 92F (iii), Section 92A (1), Article 9 of OECD Model Tax Convention

Question 17

What is a “Deemed Associated Enterprise”?

Answer

Section 92A (2) provides for 13 situations where two enterprises are deemed to be Associated Enterprises because some specific conditions exist between them. The conditions include 26% shareholding, loans given or taken, guarantees, common directors, dependence in terms of technical know-how or raw materials, etc.

All the conditions in Section 92A (2) are situations where one enterprise is in a position to exercise “control” over the other enterprise.

References: Section 92A (2)

Question 18

Is it possible that two independent entities can be considered as associated enterprises?

Answer

Yes. In certain situations, even two independent entities can be considered as Associated Enterprises, due to provisions of Section 92A (2).

Basically, Section 92A (2) is a “deeming fiction”; which mandates that if certain conditions are fulfilled, one enterprise will be *deemed to* participate in the “management, control or capital” of the other enterprise, and thus be Associated Enterprise.

Consider the following examples:

Example 1:

ABC Private Limited, a recently incorporated entity, has obtained a loan of ₹ 10 crores from ICICI Bank for setting up the manufacturing facility. The book value of total assets of ABC Private Limited is ₹ 15 crores. ABC Private Limited is not related to ICICI Bank in any way. Let us analyze the situation from perspective of Section 92A (2) (c):

The loan advanced by ICICI Bank (one enterprise) to ABC Private Limited (the other enterprise) constitutes 66.67% of the book value of the total assets of ABC Private Limited (the other enterprise). Thus, ICICI Bank and ABC Private Limited are **deemed to be Associated Enterprises because the extent of loan exceeds 51% of the book value of the assets of ABC Private Limited.**

Example 2:

Tata Motors Limited uses Saint Gobain glass panes in its automobiles. The glass panes need to be cut in appropriate shape in order to fit in the car. Saint Gobain subcontracts cutting of glass panes to PQR Private Limited. PQR Private Limited purchases glass sheets from Saint Gobain, cuts them and sells them to Tata Motors.

Let us analyze the situation from perspective of Section 92A (2) (i):

The goods or articles (cut glass panes) manufactured or processed by PQR Private Limited (one enterprise), are sold to the Tata Motors (person specified by the other enterprise, i.e. Saint Gobain), and the prices and other conditions relating thereto are influenced by Saint Gobain (other enterprise).

There can be numerous examples like this, which are observable in day-to-day practice. One needs to analyze the business relationships properly in order to identify deemed Associated Enterprises.

References: Section 92A (2)

Question 19

At what point in time during the year it is determined whether an enterprise is an Associated Enterprise?

Answer

If the conditions for treating an enterprise as Associated Enterprise are fulfilled at **any time during the previous year**, the enterprise would be determined as Associated Enterprise for that Assessment Year. Arm's length price is to be determined for the entire period.

References: Section 92A

Question 20

When two enterprises do not fall under any of the situation mentioned in Section 92A (2), whether by applying the provisions of Section 92A (1), two enterprises can be considered as Associated Enterprises?

Answer

The core of Section 92A (1) is "participation in management, control or capital". None of the terms "management", "control" or "capital" are defined in Income-tax Act. The provisions of Section 92A(2) can be classified as participation in either management, control or capital.

The overriding condition for being an Associated Enterprise is "participation in management, control or capital". Section 92A (2) lists only specific examples. If a situation does not get covered by Section 92A(2), but it can be demonstrated that there is a "participation in management, control or capital", then the enterprise can be treated as an Associated Enterprise.

References: Section 92A (1) and 92A

Question 21

If both the assessee and its deemed Associated Enterprise are assessee's resident in India, is the transaction between them an "international transaction"?

Answer

No. Section 92B requires that **either or both** of the Associated Enterprises which are party to the transaction should be non-resident. However, if such a transaction is covered by sections mentioned in Domestic Transfer Pricing provisions, it would be subject to Transfer Pricing provisions.

Thus, the situation would be as follows:

Transactions between	Whether subject to Transfer Pricing provisions?
Resident – Non-resident	Yes
Non-resident – Non-resident	Yes
Resident – Resident	Yes, if covered under Domestic Transfer Pricing Otherwise, No

References: Section 92B and Section 92BA

Question 22

Is a Permanent Establishment in India of an enterprise outside India be subject to Transfer Pricing provisions?

Answer

Permanent Establishment is an enterprise as per Section 92F (iii). The residential status of Permanent Establishment is “non-resident”.

Example:

ABC GmbH has a Permanent Establishment in India. ABC GmbH also has a subsidiary in India, ABC India Private Limited.

The applicability of Transfer Pricing provisions in above case is as follows:

First Party to the transaction	Residential status of First Party	Second Party to the transaction	Residential status of Second Party	Applicability of Transfer Pricing provisions
Permanent Establishment of ABC GmbH	Non-Resident	ABC GmbH	Non-resident	Applicable
Permanent Establishment of ABC GmbH	Non-Resident	ABC India Private Limited	Resident	Applicable

References: Section 92F (iii)

Question 23

Is a Branch / Liaison Office in India of an enterprise outside India subject to Transfer Pricing provisions?

Answer

The residential status of Branch / Liaison Office in India of an enterprise outside India is that of "non-resident". Hence, same principle as above would apply. Since the LO is not taxable in India as they do not indulge in income generating activities, TP provisions would not apply to LOs.

Chapter 3

International Transactions

Question 24

What does “international transaction” mean and what does it include?

Answer

Section 92F (v) defines “transaction”. The definition virtually widens the scope of the word “transaction” by allowing it to be written or unwritten, or legally enforceable or not enforceable.

Section 92B defines the term international transaction. The conditions for a transaction being an “international transaction” are as follows:

- It should be between two or more Associated Enterprises
- Either or both of these Associated Enterprise should be non-resident

Explanation to Section 92B (2) was inserted by Finance Act, 2012 with retrospective effect from 1/04/2002 to clarify the meaning of the term “international transaction”. The explanation includes various transactions were contradicting opinions could have been possible. This, inter alia, includes:

- guarantee, payments or deferred payment or receivable;
- a transaction of business restructuring or reorganisation, entered into by an enterprise with an associated enterprise, irrespective of the fact that it has bearing on the profit, income, losses or assets of such enterprises at the time of the transaction or at any future date;
- customer related intangible assets, such as, customer lists, customer contracts, customer relationship, open purchase orders;
- human capital related intangible assets, such as, trained and organised work force, employment agreements, union contracts
- goodwill related intangible assets, such as, institutional goodwill, professional practice goodwill, personal goodwill of professional, celebrity goodwill, general business going concern value

References: Section 92F (v), Section 92B

Question 25

What is to be determined first: "Associated Enterprise" or "international transaction"?

Answer

According to the provisions of Section 92B, an "international transaction" means a transaction between two or more associated enterprises. Hence, if there is a transaction with an overseas company, but the assessee and that overseas company is not an Associated Enterprise; the transaction would not be subject to Transfer Pricing.

Hence, the order of determination is as follows:

1. Associated Enterprises
2. Residential status of the Associated Enterprise and the assessee
3. International transactions between such Associated Enterprises

References: Section 92B (1)

Question 26

What is the meaning of the term "deemed international transactions"?

Answer

Section 92B (2) stipulates the deeming provision in respect of international transaction. It basically states that where there is a transaction with a Third Party, but the key terms of the transaction are determined between the Associated Enterprise and the Third Party; transactions with such Third Party are "deemed international transactions".

Example

LMN Group is very particular about the quality of their products. To maintain the quality, they have designated (third party) "authorized vendors" who provide the raw material of standard quality. The terms in respect of quality, quantity and price are pre-negotiated and pre-decided by LMN Group centrally. LMN India purchases the raw material from the authorized vendors.

In this case, the actual transaction is between LMN India and Third Party authorized vendor. However, since the terms of the transaction are determined in substance between the authorized vendors (such other person) and LMN Group (the Associated Enterprise) would be treated as deemed international transaction.

References: Section 92B (2)

Question 27

Is it necessary that an international transaction should have a bearing on profits of the assessee in India?

Answer

According to provisions of Section 92(1), income / expense / interest arising from an international transaction shall be computed having regard to the arm's length price. However, section 92B defines international transaction to include "*.....any other transaction having a bearing on the profits, income, losses or assets of such enterprises.....*".

Further, Explanation to Section 92B states that the expression "international transaction" shall include transactions relating to tangible property, intangible property, financing transactions, services and business restructuring.

Hence, it is not necessary for an international transaction to have a bearing on profits of the assessee in India.

References: Section 92(1)

Question 28

In case of "deemed international transaction", whether mere reporting in Accountant's report is sufficient or one needs to determine the arm's length nature of this transaction?

Answer

A deemed international transaction, for all practical purposes is an international transaction. According to provisions of Section 92(1), income / expense / interest arising from an international transaction shall be computed having regard to the arm's length price.

Thus, arm's length price is to be calculated for deemed international transactions as well.

References: Section 92(1)

Question 29

What are the major amendments in the concept of international transaction by the Finance Act, 2012?

Answer

Explanation to Section 92B inserted by Finance Act, 2012 states that the expression "international transaction" shall include transactions relating to tangible property, intangible property, financing transactions, services and

business restructuring. It gives a further list of 12 items which are included in the expression "intangible property". *References: Explanation to Section 92B*

Question 30

When one transaction between the client and a third party is considered as a deemed international transaction, whether it is required to report/evaluate arm's length nature of other transactions (which are not controlled transactions) between the client and the third party?

Answer

No. Existence of a "deemed international transaction" does not make a third party an "Associated Enterprise". The scope of Transfer Pricing provisions in this case is restricted only to the specific "deemed international transaction".

Other transactions between the third party and the assessee which are not covered by the definition of "deemed international transaction" are neither required to be reported nor arm's length price has to be computed for such transactions.

Chapter 4

Methods for Determination of Arm's Length

Question 31

Is there any hierarchy of methods which should be followed?

Answer

Under the ITPR the assessee has to select one of the methods prescribed by the law to determine the arm's length nature of its international transactions. The methods prescribed under ITPR are as follows:

- Comparable Uncontrolled Price Method
- Resale Price Method
- Cost Plus Method
- Profit Split Method
- Transactional Net Margin Method
- Other Method

Under ITPR, no particular method has been accorded a greater or lesser priority. All the methods prescribed under ITPR are considered at par and the assessee is not required to follow any hierarchy while identifying the most appropriate method.

References: Section 92C

Question 32

What are various factors for determination of "most appropriate method"?

Answer

Rule 10C (2) provides for the following factors which are required to be considered in selection of most appropriate method.

- Nature and class of the international transaction;
- 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;

- Availability, coverage and reliability of data necessary for application of the method;
- Degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;
- Extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;
- Nature, extent and reliability of assumptions required to be made in application of a method.

Each of the above point is explained below:

- Nature and class of the international transaction

It is important to understand the nature and class of each international transaction so as to determine the most appropriate method for such transaction. It is important to evaluate the background of the international transaction, availability of the information of the international transaction and comparable transactions to identify the method that could be possibly adopted for determining the arm's length results.

- Functions, assets and risk analysis

One of the important points while selecting a method is the functional analysis of the transaction. The functional analysis helps in understanding the contractual terms of the transaction and lays down the responsibilities, assets employed and risk undertaken by each transacting entity. Once the functional analysis is performed and the functionality of the entity as regards the transactions subject to review (or the entity as a whole) has been completed, most appropriate method is selected to determine the arm's length price.

- Availability of data

For all transfer pricing methods access to information on comparables is necessary. Deficiency in data used or lack of

Methods for Determination of Arm's Length

reliability of the data source will have an impact on selection of the method.

- Degree of comparability

Controlled and uncontrolled transactions are regarded as comparable if their economically relevant attributes and the circumstances surrounding them are sufficiently similar to provide a reliable measure of an arm's length result. It is observed that in practical world two transactions are rarely completely alike. Therefore it is important to evaluate the degree of comparability between two transactions.

- Adjustments

If the circumstances under which the transactions to be compared are carried out are different then the requirement for making reasonably accurate adjustment arises. It is important to evaluate the differences and identify whether it is possible or not to make adjustments so as to bring the transactions at comparable level.

- Assumptions

Under each method, it is required to make certain assumptions. It is important to evaluate the reasonableness of the assumptions made while selecting the most appropriate method. Further such assumptions should be documented appropriately mentioning how reliable the results from the method would be in light of the assumptions made.

References: Rule 10C

Question 33

Are comparability standards same for all the methods?

Answer

The comparability standards are different for each method. The details of the same are provided below:

- CUP

CUP method is usually applied when the comparable transaction is identical or nearly similar to the controlled transaction. Even minor differences between the transactions could make the transaction incomparable. Under CUP method along with the product

comparability, the business functions surrounding the transaction are also required to be compared.

- **CPM / RPM**

Under CPM/RPM more weightage is given to the attributes such as functions performed economic circumstances etc as compared to product similarity. Although broader product differences can be allowed under CPM/RPM, the property transferred in the controlled transaction must be comparable to that of the uncontrolled transaction.

- **PSM**

PSM is to be applied in a situation where transaction involves transfer of unique intangibles or multiple interrelated transactions which cannot be evaluated separately. PSM is generally applied where both associated entities possess unique intangible and none can be selected as tested party for one sided analysis.

- **TNMM**

TNMM is generally applied for transactions where CPM/RPM can't be adequately applied. TNMM is more tolerant to the functional differences in the transactions as compared to CPM/RPM. TNMM requires comparability at a broad functional level and product differences are acceptable provided it does not materially affect the net operating margin.

Question34

Explain practical application of each method prescribed under ITPR along with the examples

Answer

- **CUP method**

Under CUP method the price charged for property or services transferred in a controlled transaction is compared with the price charged for property or services transferred in a comparable uncontrolled transaction. Under this method the comparable could be internal CUP or external CUP

Illustration of "Internal CUP"

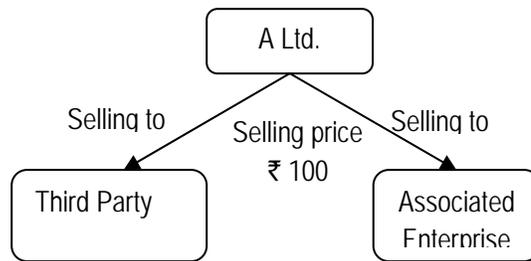
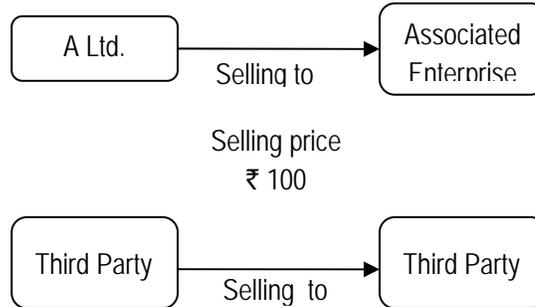


Illustration of "External CUP"



Following are the transactions where the CUP method is usually applied

- i. Payment of royalty
- ii. Interest on external commercial borrowings
- iii. Transactions where the prices are dependent on the prices quoted in the commodity market
- iv. Where intangible goods are sold to both related and unrelated entities under similar circumstances, similar volume and in same geography

- **CPM**

Under CPM, arm's length price is determined by comparing the gross profit mark up on the direct and indirect costs of producing goods or rendering services from the controlled transaction with that of the uncontrolled transaction.

Under internal CPM, the gross profit mark up on the direct and indirect costs of producing goods or rendering services of controlled

transaction is compared with the gross profit mark up of comparable uncontrolled transaction of the tested party.

Under external CPM: The gross profit mark up on the direct and indirect costs of producing goods or rendering services of tested party in controlled transaction is compared with the gross profit mark-up earned by the independent third parties in a comparable uncontrolled transaction.

Following are the transactions where the CPM method is usually applied

- i. Sale of semi-finished goods
- ii. Where Indian entity renders limited set of services with respect to which the risk is ultimately borne by the associated enterprise – e.g. India entity renders marketing support service where the authority to conclude contract lies with the associated enterprise.

- **RPM**

Under the RPM, gross profit margin earned from the controlled transactions compared with the gross profit margin earned in a comparable uncontrolled transaction with unrelated parties. RPM is applicable when the property is purchased or service is obtained from an associated enterprise and resold to an unrelated party. Thus, RPM is applicable in case of distributors and not manufacturers.

It is important to note that that when the goods are purchased from third parties and sold to associated enterprises, RPM cannot be applied since RPM is applicable only in situation where the goods are purchased from associated enterprises and sold to third party.

Under internal RPM the gross profit from sale of goods which were procured from associated enterprises is compared with the gross margin from sale of goods procured by the assessee from third parties. Whereas in case of external RPM such comparison is made with the gross margin earned by an independent third party which is functionally comparable to the assessee.

- **PSM**

PSM evaluates whether the allocation of the combined operating profit or loss attributable to the controlled transaction is at arm's length as compared to the relative value of contribution of each AE to the combined operating profit or loss.

Methods for Determination of Arm's Length

PSM is applicable in the cases where transaction involves transfer of unique intangibles or in multilayer international transactions.

Example of Application of PSM

Indian subsidiary is engaged in manufacturing engines which are used by the associated enterprise in manufacturing cars under its own brand name. The profits under PSM would be bifurcated between the Indian entity and the associated enterprise depending upon contribution of each to the final product.

- **TNMM**

Under TNMM, arm's length price is determined by comparing the net profit margin of the tested party from controlled transaction with net profit margin earned by tested party from comparable uncontrolled transactions (i.e. Internal TNMM) or with that of an uncontrolled party engaged in a comparable uncontrolled transaction (i.e. External TNMM). TNMM is considered as the method of last resort and is usually applied in the situation where the other method can't be applied.

Question 35

In case more than one method can be used to determine the arm's length transaction then which methods should be considered as most appropriate method?

Answer

In case it is possible to determine the arm's length nature of the transactions using more than one method, the assessee should consider the following factors while concluding on selection of one method as the most appropriate method:

- The extent of similarity between the controlled transactions and the comparable transaction, considering the type of comparability that is required under each pricing method;
- The reliability and extent of information (specifically financial information required under the based methods) available for the comparable transactions;
- The possibility and reliability computation of adjustments that can be made under each method ;

- The number and quality of presumptions that are required to be made under each method.
- If traditional transaction methods (CUP, RPM, CPM) can be applied with equal reliability vis-à-vis Transactional profit method (TNMM and PSM) then traditional transaction method may be preferred.

Question 36

While applying the profit based methods, instead of testing the profits of the client viz. Indian entity, can one test the profits earned by the associated enterprise from transactions with Indian entity?

Answer

While applying the profit based methods, determination of tested party plays a very significant role since one needs to identify a set of comparables and compare the same with the transfer prices of the tested party. The tested party is generally the participant in the international transaction whose profitability attributable to the controlled transaction can be verified using the most reliable data and requiring the fewest and most reliable adjustments and for which reliable data regarding the uncontrolled comparable companies can be located. Thus as prescribed in paragraph 3.19 of the OECD guidelines, in most of the cases the tested party will be the one that has the less complex functional analysis.

In the case of *Development Consultants Pvt. Ltd v DCIT (2008) 115 TTJ (Cal) 577*, the Tribunal inter alia held that the tested party should be the least complex and have lesser risk as compared to other transacting parties. Further, the Tribunal in *Ranbaxy Laboratories Ltd v ACIT (2008) 114 TTJ (Del) 1* has observed that the foreign associated enterprises can be taken as a tested party for comparability analysis depending upon the facts and circumstances of each case.

In view of the above, under the profit based methods either the Indian entity or the associated enterprise can be considered as the tested party for comparability based on the complexity of the functions performed by it.

References: OECD Guidelines, Judgments given by the Tribunal

Question 37

Once a method is considered as the most appropriate method for one financial year, can it be changed in the subsequent year?

Answer

The assessee has to select one of the methods as most appropriate method for evaluation of arm's length nature of its transaction. The method considered as most appropriate method for one year could be changed in the subsequent year only when there is a cogent reason to do so. In case there is any significant change in facts of the case or any of the factors of selection of most appropriate method as provided under Rule 10C (2) mentioned above and such change requires a change in method, the assessee can deviate from the method considered as the most appropriate method in the earlier year. The assessee should appropriately document the reason for change in method in the TP documentation

References: Rule 10C

Question 38

What are "internal comparables"? Should it be preferred over "external comparables"?

Answer

There are two types of comparables:

- **Internal comparable**
Internal comparable means comparable transactions between one of the parties to the controlled transaction i.e. assessee or the associated enterprise and an independent party.
- **External comparables**
External comparable means comparable transactions between two independent parties, neither of which is a party to the controlled transaction.

Comparison

The most important benefit of internal comparability is that internal comparables may have a more direct and closer relationship to the transaction under review than external comparables due to one party to the transaction being the same and to the use of identical accounting standards. Further, the functional assets and risk analysis of such comparable would be easily available as compared to the external comparables. Also, carrying out the benchmarking analysis with the help of internal comparables would be more economic as compared to external comparables as it does not involve usage of any external databases. Thus, normally internal comparables are

preferred over external comparables as they show a higher degree of comparability.

In the case of Abhishek Auto Industries Ltd (2010) TII 54 (Delhi), the Tribunal held that the best comparability for a controlled transaction is the transactions of the tested party itself (i.e. internal comparable uncontrolled transactions).

Question39

What if the international transaction entered into by the assessee is unique? What if no method can be applied?

Answer

It is very much possible in the practical world that there are certain transactions which are so unique in nature that none of the method specified under ITPR can be considered as most appropriate method. However no exemption is given for such kind of transactions from testing the arm's length nature. The assessee is required to make reasonable assumptions and adjustments and apply one of the methods prescribed under the ITPR. Further, CBDT has notified a Rule 10AB for the application of sixth method specified under section 92C(1)(f) of the Income-Tax Act, 1961. This Rule provides that the assessee can apply any method other than the five methods to determine the ALP of international transaction provided the method 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. Notification of "other method" gives flexibility to taxpayer and tax administrators to determine the ALP of international transactions in situation when one method does not technically fall within the specified five methods or five methods may not be applied to determine the ALP. These situations are:

1. Determination of arm's length valuation of intangibles following Income method or capitalization method (Discounted Cash Flow methods)
2. Determination of valuation of share transfer
3. Bonafide offers/bid may not be technically considered as CUP as CUP requires the identification of actual transaction, but the same may be considered as "Other Method" provided the bonafide offer and the controlled transactions are similar and circumstances are also similar

Methods for Determination of Arm's Length

The examples, given above, are not exhaustive. These are just to explain the situations under which "Other method" may be applied

Question 40

Can arm's length be concluded using any other method, apart from those specified under the law?

Answer

Section 92C of the Act expressly provides the methods which can be used by the assessee for determining the arm's length nature of its international transactions. In addition to prescribed five methods, the section provides for use of any other method which is prescribed by the Board. Thus arm's length nature of a transaction can't be tested using any method unless it is provided under Section 92C or prescribed by the Board separately. However since the Rule 10AB, dealing with the application of sixth method prescribed under section 92C(1)(f) of the Act, is general in nature, any other method meeting the condition prescribed under Rule 10AB will still be considered as prescribed method under the Act. Please refer to answer of question No. 39

References: Section 92C

Question 41

Whether a profit based method can be applied in case where the transaction is not having any bearing on profit & loss account of the assessee?

Answer

No. The profit based methods use PLI, which is an outcome of income / expense which contain the transactions with Associated Enterprises. PLI calculated in such manner is an indicator of pricing of international transactions.

However, in cases where the transaction is not having any bearing on profit & loss account, the income / expenses pertaining to that particular transaction have not been considered while calculating the PLI.

Thus, since the PLI does not contain the effect of such transaction, a profit based method cannot be applied in such cases.

Chapter 5: Benchmarking

Question 42

Is the arm's length price required to be always determined on a "transaction-by-transaction" basis?

Answer

One of the important aspects of the transfer pricing is whether the arm's length nature of each individual international transaction is required to be evaluated or a group of international controlled transactions having close nexus can be evaluated together. In this regard, OECD Guidelines Para 3.9 states that 'Ideally, in order to arrive at the most precise approximation of arm's length conditions, the arm's length principle should be applied on a transaction-by-transaction basis. However, there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. Such transactions should be evaluated together using the most appropriate arm's length method'. Further the problem arises while carrying out a search for comparables, as third party information is not often available at the transaction level in the public databases. In the absence of transaction level data, entity level information is frequently used in practice. It must be noted that any application of the arm's length principle, whether on a transaction by transaction basis or on an aggregation basis, needs to be evaluated on a case by case approach, applying the relevant methodologies to the facts as they exist in that particular case.

Therefore, in an ideal scenario, transfer pricing analysis should be carried out on transaction by transaction basis, however it is very much possible that the separate transactions are so closely associated/linked with each other that the arm's length method cannot be adequately applied on a transaction-by-transaction basis. In such a scenario aggregation approach would be more relevant for determination of arm's length price.

References: OECD Guidelines

Question 43

Can one controlled transaction be compared with another controlled transaction?

Answer

As per Rule 10B the transactions with the associated enterprise is to be compared with a comparable uncontrolled transaction or number of such transactions. As per Rule 10A (a), an uncontrolled transaction means a transaction between enterprises other than associated enterprises. Thus a controlled transaction cannot be compared with another controlled transaction.

References: Rule 10A and 10B

Question 44

For identifying a set of comparables which databases are usually used in India? Whether there are any databases which can be used to identify the comparable uncontrolled transactions?

Answer

To carry out a search for Indian comparable Companies, Prowess (a product of Centre for Monitoring Indian Economy) and Capitaline Plus (a product of Capital Market Publishers India Private Limited) are the two commonly used databases. At present the databases are having the financial information for more than 20,000 companies. These databases are updated after regular intervals incorporating the details of additional companies. The user should access the latest update of the database while carrying out the search.

Further in case margin earned by the associated enterprise i.e. the foreign entity is to be tested, there are various databases which can be used on the basis of the region in which the associated enterprise is located. Details of some of the databases are provided below

- **OSIRIS** - It is an independent database of companies operating in the worldwide region. It has been produced by Bureau van Dijk which holds information derived from annual returns on more than 55,000 public limited companies in the worldwide region
- **AMADEUS**- It is an independent database of companies operating in the European region produced by Bureau van Dijk which holds information derived from annual returns for three million + companies.

- **OneSource-** OneSource is a global business information database providing key company, executive and industry intelligence. The content in this database are selected from over 2500 different sources, supplied by the world's premier information providers and seamlessly integrated into one, easy-to-use database Further, following are the details of some of the databases which are used to identify comparable uncontrolled transactions.
- **Royalty stat-** Royalty Stat is the premier database of royalty rates and service fees for transfer pricing and valuation. This database is useful for finding comparative royalty rates for licensing intangible property, determining buy-in payments for cost sharing arrangements, valuing intangible property for mergers and acquisitions.
- **ktMINE -** ktMINE is an interactive intellectual property database that provides direct access to royalty rates, actual license agreements and detailed agreement summaries.

Question 45

By which date the search for comparables should be carried out on the databases/public domain?

Answer

Rule 10D (4) of the Act mentions that the documents/information to be maintained by the assessee should as far as possible be contemporaneous and should exist latest by the due date of filing the return. In view of the same, the search for comparables should be carried out on a date which is close to the date of filing the tax return. The date for carrying out the search should be decided based on the time required for completing the entire benchmarking analysis.

References: Rule10D

Question 46

Under the profit based methods, what criteria's can be applied to identify an appropriate set of comparables?

Answer

At present the financial information for more than 20,000 Companies is available on the Indian databases. Therefore it becomes important to apply appropriate selection criteria's to determine a reasonable set of comparables.

We have provided below certain filters which can be applied while carrying out the search for comparables

- a. Availability of financial data:
This is the basic filter to select only those companies for which the financial information for the period under consideration is available.
- b. Industry Selection
Based on the business profile of the Companies, the databases have bifurcated all the companies under different Industry heads. Therefore it becomes highly important to make a proper selection of the Industry heads. E.g. In case the assessee is into manufacturing of auto components, one should ensure that all the industry heads which could possibly have the manufacturing Companies of auto components under it should be selected.
- c. Rejection of Government owned Companies
Many a times the main intention of the Government owned Companies is to serve the society unlike the private Companies which are primarily focused on making profits. Therefore, a filter can be applied to remove the Government owned Companies whose profit might be lesser than the normal margins earned by other Companies in that industry .
- d. Sales
Based on the size of the operation of the assessee, an appropriate sale filter can be applied to identify the companies having the size of operation in the same range that of the assessee.
- e. Word based search
The word based search refers to search on the databases with the help of word which are linked to the business of the assessee. E.g. In case the assessee is in the business of Distribution of medicines, the search could be based on the words such as 'distributor', 'distri', 'trade', 'medical', 'medicine' etc.

References: Indian benchmarking databases – Prowess and CapitalinePlus

Question 47

Can I use the information about the competitors available with the client as the comparable data for the purpose of determination of arm's length transactions / whether the data which is not available in the public domain can be used for the comparability analysis?

Answer

The ITPR do not provide any specific guidelines with respect to use of such information. An inference can be drawn from the OECD Guidelines which in Para 3.30 suggests that Commercial databases in which the accounts filed by various Companies with the relevant administrative bodies are compiled and presented in an electronic format should be considered for search of comparables. Further, in Para 3.33 OECD guidelines suggest that in addition to the commercial databases any other publically available information can be used for the purpose of comparability analysis.

A question may arise whether the tax authorities can use the data not available in the public domain during the course of the assessment proceedings. In this regard the Bangalore bench of Income Tax Appellate Tribunal in the recent case of Genisys Integrating Systems (India) Pvt Ltd (ITA No.1231 (Bang.)/2010) has concluded that if any information is sought to be used against the Taxpayer, then such information has to be furnished to the Taxpayer and the Taxpayer's objections have to be considered by the TPO, before coming to a conclusion. Further, if the Taxpayer seeks an opportunity to cross examine the party from whom information is sought under s 133(6), the Taxpayer shall be provided with such an opportunity.

References: OECD Guidelines, Judgments given by the Income tax appellate tribunal

Question 48

At the time of preparing the transfer pricing study the comparables data for the year under consideration might not be available in Public domain, what should be done in such case?

Answer

As per Rule 10B(4) the data for the current year viz. the year in which the transaction is entered into should be used to compute the margin earned by the comparables. Data for two earlier years can be used only when such data/information could have an influence on the determination of transfer prices in relation to the transactions being compared. Further, Rule 10D(4)

provides that the information and documents to be used should as far as be contemporaneous and should exist latest by the date of filing the tax return. Therefore, it is an obligation on the assessee to carry out search for the comparables on/before the due date of filling return. It is a practical difficulty that while carrying out the search for comparables (which is usually done in two or three months after end of the financial year) that the data for comparables for the year under consideration is not available on the databases. It has been observed that even if the search is carried out on a date which is very close to the due date of filing Form 3CEB, the data for the year under consideration for many of the Companies in the databases would not be available.

In such situation, in view of contemporaneous documentation requirement determining the comparables margin using the data for current year is practically impossible. Considering the lack of information available at the time of preparing the TP documentation and flexibility given by the Law for use of multiple year data viz. past two years data can be used for carrying out the analysis. However, the previous two years data should be used only in the circumstances mentioned in Section Rule 10B (4). Given the practical difficulty, Indian companies are using the latest three year data to the extent available till the date of filing of return of income. The legality of such use is being litigated and is subjudiced.

References: Rule 10B, 10D

Question 49

Whether a comparable can be rejected solely because it is making a high profit or a high loss?

Answer

The concept of rejecting the comparables on account of loss making/high profit making behavior is neither mentioned in the ITPR nor do the OECD guidelines make a mention of the same. The conclusive factor for determining inclusion or exclusion of any comparable is the functional profile, assets employed and the risks assumed by the Company and not the losses/profits made by the Company.

In almost every industry there are companies that make losses as well as there are companies which make high profits. The loss making/high profit making companies are as much a part and parcel of an industry as are other companies. The elimination of companies merely because they are loss making/high profit making would tantamount to eliminating major spectrum of

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comparable companies. The only important point that needs to be analyzed is that whether the losses/high profits are on account of some extraordinary circumstances which merits an omission of such comparable.

Further, it is important to note that the arithmetic mean is a measure of central tendency and the arm's length price takes into consideration each of the values in the normal distribution. The elimination of loss making/high profit making companies would introduce skewness in the set of comparables that would result in the mean being determined to be much different than what should ordinarily be the case.

We have provided below a summary of recent judicial decisions which also indicates that exclusion of a loss making/high profit making comparable is not justified.

Decision and citation	Extract (Emphasis supplied)
Sony India Private Limited (2008-TII-08-ITAT-DEL-TP)	<i>Paragraph 119 - It is no doubt true that loss and competition are normal incident of business and merely on above factors, exclusion may not be justified.</i>
Teva India Pvt. Ltd. (ITA No. 6107/Mum/2009)	<i>Paragraph 15 - We have heard the arguments of both the sides and also perused the relevant material on record. It is observed that a similar issue was involved in assessee's own case for the immediately preceding year i.e. 2003-04 and the Tribunal vide its order dated 13.10.2010 passed for the said year in ITA No. 1547 & 1966/M/2009 has restored the same to the file of the A.O. with a direction to decide the same afresh in the light of the decision of Delhi Bench of ITAT in the case of Sony India P. Ltd. 288 ITR (AT) 53 wherein it was held that a comparable could not be excluded only on the ground of losses except in cases where there are other factors justifying exclusion of the said comparables.</i>
Quark Systems Pvt Ltd (2010-TII-02-ITAT-CHD-SB-TP)	<i>Paragraph 25 - While we agree that merely because a comparable is making loss, it cannot be excluded from the list of comparables for the purposes of computation of arms length price.</i>
Exxon Mobil Company	<i>Paragraph 33 (xi) - ...as a general principle,</i>

Decision and citation	Extract (Emphasis supplied)
India P. Ltd. (ITA no. 8311/Mum./2010)	<i>both loss making unit and high profit making unit cannot be eliminated from the comparables unless, there are specific reasons for eliminating the same which is other than the general reason that a comparable has incurred loss or has made abnormal profits.</i>

References: Judgments given by the Income tax appellate tribunal

Question 50

Is there any condition on number of comparables to be selected?

Answer

There is no condition prescribed under ITPR on number of comparables to be selected. In the recent judgment passed by the Delhi Bench of ITAT in case of Haworth (India) Pvt Ltd vs. DCIT [ITA No. 5341/Del/2010] it has been ruled that even one comparable company can be considered as a comparable for the analysis. However, it is advisable to select a reasonable set of appropriate comparables as asset of comparables can help to reduce the effects of differences in the business characteristics of assessee and comparable companies since the range would permit a result that would occur under a variety of commercial and financial conditions.

References: Judgments given by the Income tax appellate tribunal

Question 51

Whether one can use a combination of internal and external comparables for comparability analysis?

Answer

Under the profit based methods, the assessee need to compare the net margin earned from international transaction with net margin realized by the assessee or by unrelated enterprise from a comparable uncontrolled transaction/transactions. Thus it is at the discretion of the assessee to select internal or external comparables based on the facts of the case. Internal comparables, where available and reliable are always preferable as Internal comparables may have a more direct and closer relationship to the transaction under review than external ones due to one party to the transaction being the same. Internal comparable and external comparable are selected based on their meeting comparability standards. There is

nothing to suggest that both types of comparables cannot be used together provided they both meet the comparability standards required under the facts and circumstances of the case.

Question 52

The assessee has more than one distinct business activities (e.g. manufacturing and trading). How to “split” or “segment” the profitability of the assessee qua segment?

Answer

In case the assessee is having more than one distinct business activity, it is ideal to consider the data of only that business activity/segment in which the assessee has carried out the international transactions. The question may arise as to how the profitability of such segment should be computed separately in case reporting of such segment in the financials is not required under Accounting Standard 17.

In such case as far as possible the actual income/expenses pertaining to such segment should be identified. For the income/expenses which are common between all the segments, reasonable allocation keys should be identified to allocate such income/expenses to derive the profitability for the segment under review.

Question 53

How to determine functional profile of the comparables from data available in public domain?

Answer

Functional profile of the Company is a key factor while deciding on accepting or rejecting a Company as a comparable. Therefore it is important to analyze the function profile of each Company which has cleared the quantitative filters applied while carrying out the search on the databases. The functional profile of a Company can be determined with the help of the following sources:

- **Database** – Most of the databases provides a brief snapshot of every Company which enables to understand the overall business carried out by the Company. Further the database also provides the information about the products manufactured or trades/Services provided by the Company.

- **Company web site** – The official Company web site can provide the information such as the nature of business carried out by the Company, the product/ service portfolio of the Company, key customers of the Company etc.
- **Management Discussion** –The management discussion can give an insight of the factors which have primarily affected the business of the Company during the year under consideration.
- **Notes to Accounts** – The information provided in the Notes to accounts such as segment information, installed capacity and actual production etc., can give an insight of the nature of activities carried out by the Company.

Question 54

What if the comparables have substantial related party transactions?

Answer

A comparable with significant related party transactions should be rejected since the ITPR demands comparison between controlled transactions with an uncontrolled transaction. The Bangalore Tribunal ruling in the case of Philips Software Centre Pvt Ltd vs. ACIT (26 SOT 226) has held that the comparable transactions should not have even a single rupee of related party transactions. However, a different view has been taken by the Delhi Tribunal in case of Sony India Pvt. Ltd (I.T.A.Nos.1189/Del/2005), which states that an entity can be taken as uncontrolled if its related party transactions do not exceed 10% to 15% of total revenue.

References: Judgments given by the Income tax appellate tribunal

Question 55

What is “Profit Level Indicator” (‘PLI’)? How to select an appropriate PLI?

Answer

Profit level indicator is a measure of profitability that is used to compare the comparables with tested party. While selecting the PLI it is important that the denominator should be reasonably independent from the controlled transactions (tested transaction).ITPR do not provide any specific guidelines with respect to the use of PLI. Accordingly it is at the discretion of the assessee to select the appropriate PLI based on the selection of the method

and business profile of the Company. We have provided below information about usage of certain PLIs

- **Gross profit/Cost of production** – In case CPM is considered as the most appropriate method, Gross profit on Cost of production is the PLI which is usually adopted. Under the CPM, the gross profit refers to the mark up computed on direct and indirect cost of production.
- **Gross profit/ Operating Income** – In case RPM is considered as the most appropriate method, Gross profit on Operating income is the PLI which is usually adopted. Under the RPM, gross profit refers to the difference between the sales price and the price at which the goods are purchased from the associated enterprise.
- **Operating Profit/Operating Cost** – Under the TNMM, in case the significant value of the transactions of the tested party pertains to receipt of income then Operating profit/Operating Cost is the PLI to be adopted
- **Operating Profit/Operating Income** - Under the TNMM, in case the significant value of the transactions of the tested party pertains to payment of expenses then Operating profit/Operating Income is the PLI to be adopted
- **Operating profit/ Assets employed** – This PLI is useful in the situation where the assets are better indicator as compared to costs or revenue for the value added by the tested party. This PLI is useful if the tangible operating assets have a high correlation to the profitability.

Question 56

What all items of income and expenses should be considered while computing the PLI?

Answer

Any income or expenditure which is having a direct nexus with the transaction/ business operation under review should be considered while computing the operating margin. Therefore, certain business income/business expenses which are provided in the financials of the Company may not be considered while computing the operating margin under Transfer Pricing on account of lack of business nexus.

In the case of TNT India Private Limited vs. ACIT (ITA No. 1442 BNG/08), the Tribunal held that only operating income and operating expenses for the relevant business activity of the taxpayer are to be taken into consideration. Other incomes, such as dividend income, profit on sale of assets, donations are to be excluded. Further, in the case of M/s DHL Express (India) Private Limited Vs ACIT (ITA No. 7360/Mum/2010), the Tribunal held that interest income, rent receipts, dividend receipts, penalty collected, rent deposits returned back, foreign exchange fluctuations and profit on sale of assets do not form part of the operational income because these items have nothing to do with the main operations of the Company

References: Judgments given by the Income tax appellate tribunal

Question 57

Is the Gross Profit under RPM and CPM is same?

Answer

In common parlance Gross Profit term is loosely used as profit level indicator under CPM and RPM. However the manner of computation of Gross Profit under both the methods is slightly different. Under the CPM, Gross margin is the mark-up on direct and indirect costs of production. Whereas under RPM, gross profit is the difference between the sales price and purchase price/cost of availing the service from the associated enterprise.

Question 58

The Financial Year of the comparables does not end on 31 March. In such case, data for which period should be considered for comparison?

Answer

Companies draw up their financial statements for statutory purposes under the Companies Act, 1956. As per Companies Act 1956, Companies are free to adopt different statutory year-ends, which may or may not coincide with the March year end. The financial statements may be independently drawn up by the Companies for tax purposes as of March 31. However for the comparability analysis we are only concerned with the statutory financial statements as the tax accounts are usually not available for such companies on public domain.

In case where the financial year of the comparables does not end on March 31, the data for the period which covers the maximum part of the year starting from April 1 and ending on March 31 should be considered. For example, while carrying out the analysis for FY 2011-12, in case for a

comparable the accounts year followed is January to December, the Financials as on December 31, 2011 should be used as it covers the major part viz. three quarters of FY 2011-12.

Question 59

The Financial Year of the assessee does not end on 31 March. In such case, data for which period should be considered for comparison?

Answer

In case the assessee is following different years which do not coincide with the March 31 year end for the statutory purpose, the tax accounts prepared by the assessee (for the financial year April to March) should be considered for comparison.

Chapter 6

Concluding on Arm's Length – General

Question 60

Under CUP method, how it is decided that the transactions are at arm's length?

Answer

In CUP method, prices of transactions with an Associated Enterprise (i.e. a controlled transaction) are compared with the prices of transactions with Third Parties (i.e. uncontrolled transactions).

The logic for determination of arm's length price is different for cost side transactions (expenses) and revenue side transactions (income). Further, the logic also differs based on whether the transactions of the assessee are compared or whether the transactions of the Associated Enterprise are compared. The following table gives a ready reckoner:

Enterprise whose transactions are considered for CUP	Nature of transaction	Example of Transactions	Rule for arm's length under CUP method from the perspective of the assessee
Assessee	Expense of the assessee	Assessee imports goods from the Associated Enterprise	Prices paid to AE are less than or equal to prices paid to Third Party
Assessee	Income of the assessee	Assessee exports goods to the Associated Enterprise	Prices received from AE are greater than or equal to prices received from Third Party
Associated Enterprise	Expense of the assessee	Associated Enterprise sells goods to the assessee	Prices received from the assessee are less than or equal to prices

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			received from the Third Party
Associated Enterprise	Income of the assessee	Associated Enterprise purchases goods from the assessee	Prices paid to the assessee are greater than or equal to prices paid to Third Party

References: Rule 10B (1)

Question 61

What is the basis to conclude that the transactions are at arm's length under profit-based methods?

Answer

Scenario 1

In case of the **assessee being the tested party**, the arm's length profit is the Profit Level Indicator ('PLI') of the comparable companies selected. Thus, the assessee should earn **at least** the arm's length PLI. If the assessee earns more than or equal to that, the transactions of the assessee are considered to be at arm's length.

Example: The assessee is the tested party. The comparable companies earn a net margin of 7%. The assessee would be at arm's length if it earns minimum 7% or more.

Scenario 2

In case of the **Associated Enterprise being the tested party**, the arm's length profit is the PLI of the comparable companies selected. Thus, the Associated Enterprise should earn **at most** the arm's length PLI. If the Associated Enterprises earns less than or equal to that, the transactions of the assessee are considered to be at arm's length.

Example: The Associated Enterprise is the tested party. The comparable companies earn a net margin of 7%. The assessee would be at arm's length if the Associated Enterprise earns maximum 7% or less.

Question 62

What is the rule regarding $\pm 3\%$?

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Answer

Second proviso to Section 92C (2) provides the rule regarding $\pm 3\%$. Broadly speaking, it states that if the variation between the arm's length price and the price of international transaction within 3%, then the price of international transaction would be considered to be at arm's length.

This can be simplified by way of a formula.

Let

a = arm's length price; and

b = price at which international transaction is actually undertaken.

If $\frac{a-b}{b} \leq 3\%$, then price deemed to be at Arm's length

References: Second proviso to Section 92C (2)

Question 63

In what manner is the rule regarding $\pm 3\%$ applicable to CUP method?

Answer

Second proviso to Section 92C (2) uses the word "price" in the context of international transaction and comparable transaction. Since CUP is a price-based transactional method, $\pm 3\%$ is directly applicable to CUP method.

Example

In case of **Expense side transactions of the assessee** (such as imports), the facts are as follows:

Particulars	Amount ₹	
Price at which international transaction is undertaken	215	<i>If the arm's length price is more than ₹ 215, the assessee's expense side international transaction would be at arm's length.</i>
Arm's length price	210	<i>However, the arm's length price is less than ₹ 215. This means that in uncontrolled situations, the assessee should have paid only ₹ 210. Apparently, the assessee is not at arm's length, if not for Second proviso to Section 92C(2)</i>

Particulars	Amount ₹	
Difference between the two prices	5	
Difference as a percentage of price of international transactions	$5/215 = 2.32\%$	However, the difference between the arm's length price and price at which international transaction was undertaken is only 2.32%. Thus, the transactions are at arm's length under CUP method.

References: Second proviso to Section 92C (2)

Question 64

How to apply $\pm 3\%$ to the international transactions under profit based methods?

Answer

It is to be noted that as per provisions of Second proviso to Section 92C (2), the word used is "price", whereas the profit-based methods use a "margin" for determining the arm's length nature of prices. However, due to specific requirements of the Second proviso to Section 92C (2), $\pm 3\%$ cannot be used directly on the margins.

The "margins" have to be converted in "prices" for application of $\pm 3\%$.

Example

LMN India is a company engaged in providing IT enabled services to LMN Inc, which pays LMN India a mark-up of 10% on costs.

In this case, 10% represents the net margin earned by LMN India. Ideally, to be at arm's length, the comparable's net profit margins have to be equal to or less than 10%. However, considering the $\pm 3\%$ rule, what can be the maximum margins of the comparables in order to comply with arm's length?

The answer is not simple $(10\% + 3\%) = 13\%$.

The international transaction is "Service income received from LMN Inc." which is priced at cost plus 10%.

- Let cost be ₹ 100.
- Therefore, the "Service income received from LMN Inc." is $(100 + 10\%) = ₹ 110$.

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- Arm's length price can exceed the price of international transaction by 3%.
- Therefore, at maximum, the arm's length price can be to an extent of (₹ 110 x 103%) = ₹ 113.30%
- In terms of percentage, the maximum arm's length margin is 13.30% of cost of ₹ 100.

Thus, ±3% computed on margins and on price can give different outcomes in case of profit-based methods.

References: Second proviso to Section 92C (2)

Question 65

Is ±3% a "standard deduction"?

Answer

Memorandum explaining the provisions of Finance Act, 2012 has clarified the situation:

"Subsequently, disputes arose regarding the interpretation of the proviso. Whether the tolerance band is a standard deduction or not, in case variation of ALP and transaction value exceeded the tolerance band. Different courts interpreted it differently.

In order to bring more clarity and resolving the controversy the proviso was substituted by Finance Act (No.2), 2009. The substituted proviso not only made clear the intent that tolerance band is not a standard deduction but also changed the base of determination of the allowable band, linked it to the transaction price instead of the earlier base of Arithmetic mean. The amendment clarified the ambiguity about applicability of tolerance band, not being a standard deduction."

Thus, it is very clear now that ±3% is **not** a standard deduction.

References: Second proviso to Section 92C (2)

Question 66

What is applicable for AY 2012-13: ±3% or ±5%?

Answer

The history of the tolerance band percentages prescribed by the Second proviso to Section 92C (2) has been as follows:

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Applicable for AYs	Percentage of tolerance band	Amended by
AY 2011-12 and Prior AYs	5%	---
AY 2012-13	Such percentage as may be notified by the Central Government	Finance Act, 2011
AY 2013-14	3%	Finance Act, 2012

The Central Government / CBDT have not prescribed any percentage for AY 2012-13. However, a tolerance band of 3% can be considered for AY 2012-13 on a conservative basis.

References: Second proviso to Section 92C (2)

Question 67

What are the economic adjustments? When can it be made?

Answer

An international transaction with an Associated Enterprise has several variable factors, such as terms of sale (CIF, FOB etc.), credit period, mode of payment, volume discounts, cash discounts, level in value chain (manufacturer, distributor, etc.) and so on. In real world, it is very difficult to get a transaction / comparable company from public domain which is exactly comparable to the international transaction in question.

In case there exist no uncontrolled transaction which is exactly comparable, the ITPR allows making "reasonably accurate adjustments" to the price / margins in order to make them comparable with the international transaction. In the jargon of Transfer Pricing, such adjustments are known as "economic adjustments".

According to Rule 10B (3), in order for a transaction to be comparable:

- (a) There should be no differences between the international transaction and the comparable transaction which materially affect the price; **OR**
- (b) If such differences exist, they should be eliminated by making "reasonably accurate adjustments".

Following are the examples of economic adjustments which have been made by the assessee's and upheld by various tribunals:

1. Adjustment for differences in working capital investment

The working capital invested by the assessee can be different than the working capital invested by the potential comparable companies. The investment in working capital has "time value of money" and thus has effect on the prices. This effect of differential investment of working capital is calculated and adjusted for in order to bring comparables to the same level as the assessee.

2. Adjustment for differential depreciation

The assessee's, in some cases, have charged depreciation at rates higher than the rates prescribed under Schedule XIV of the Companies Act, 1956; whereas the comparables have used the rates as per Schedule XIV. Needless to say, this accelerated depreciation has an effect of reducing the profitability of the assessee. Hence, the impact of differential depreciation is calculated and adjusted.

3. Adjustment for underutilisation of capacity

The cost base of the assessee and the comparables is divided into "variable costs" and "fixed costs". Underutilisation of capacity means under absorption of fixed costs, resulting into lower net profitability. In case the assessee has suffered net losses due to lower capacity utilisation, whereas the capacity utilisation of the comparables is higher, the differential impact of the underutilisation of capacity can be eliminated.

4. Adjustment for risk bearing

Consider an IT company providing services only to its Associated Enterprise, and getting paid on the basis of cost plus mark-up; and consider a company like Infosys acting as an entrepreneur. Both the companies have a different risk profile, though they belong to same industry. The key difference is the risks which are borne by Infosys, which has a material impact on the prices.

As such, Infosys cannot be compared with such risk-protected captive IT service provider. In order to make Infosys comparable, it is necessary to make an adjustment for risks borne by Infosys.

The list of economic adjustments is not exhaustive. Any adjustment can be made provided (a) there exists a difference in the assessee and the

comparable, and (b) reasonably accurate adjustment can be made to eliminate that difference.

However, a word of caution is due over here. Though various benches of the ITAT have upheld the economic adjustments *in principle*, there is no standard / unanimously accepted methodology to do the adjustments as of date.

References: Rule 10B (3)

Question 68

The international transactions with Associated Enterprise which are on the cost side are capitalized. (e.g. import of capital goods, services capitalized). Is it required to conclude on arm's length?

Answer

Section 92B(1) defines an international transaction as a transaction having a bearing on profits, income, losses or assets of the enterprises. Even though the transaction of import of capital goods does not have bearing on profits, income, losses of the assessee, it does have an impact on the assets of the assessee. Thus, the transaction on cost side is an international transaction subject to Transfer Pricing even though it is capitalized.

Further, Explanation to Section 92(1) states that the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arm's length price. Hence, claim for depreciation arising from an international transaction capitalized by the assessee is also subject to Transfer Pricing.

References: Section 92B (1), Explanation to Section 92(1)

Question 69

The assessee's transactions are at arm's length using the data of two years prior to the Financial Year. When the data of the current Financial Year becomes available, the margins of the comparables can change, and thus result into prices not being at arm's length. Is there an exposure?

Answer

This is a typical problem faced by the assessee's using profit-based method for determination of arm's length price. According to the provisions of Rule 10B(4), the data to be used in analyzing the comparability of an uncontrolled transaction with an international transaction shall be the data relating to the

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financial year in which the international transaction has been entered into. For instance, in case of determination of arm's length price for FY 2011-12, the comparables data for FY 2011-12 has to be used. This is also in line with the requirement of Rule 10D (4) which requires the documentation to be "contemporaneous". However, data of 2 years prior to the Financial Year in question can be used if it can be demonstrated that such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared.

The Income Tax Authorities tend to use the data relating to the financial year in which the international transaction has been entered into, i.e. single year data. However, if the assessee is in a position to demonstrate the role of the past 2 years' data in determining the transfer prices for the current Financial Year, the use of past 2 years data can be legally justified. If the assessee is not in a position to demonstrate such influence, then there is an exposure at time of Transfer Pricing assessment.

References: Rule 10B(4), Proviso to Rule 10B(4), Rule 10D(4)

Chapter 7

Concluding on Arm's Length – Some Specific Transactions

Question 70

The assessee has obtained an External Commercial Borrowing ('ECB') from its Associated Enterprises by obtaining approval from RBI. Is RBI approval sufficient for transaction to be at arm's length?

Answer

The requirement of RBI approval is from various perspectives such as (a) priority lending (for e.g. infrastructure projects are preferred); (b) prudent debt management; (c) ensuring that the borrowing is made from recognized sources / banking channels; and so on. Thus, the objective of RBI approval is exercising control over overseas borrowings.

The objective of Transfer Pricing provisions in relation to ECB is to determine whether the rate of interest and other commercial terms of the ECB obtained from an Associated Enterprise are comparable to the similar loan available in open market.

The objectives of the RBI approval and Transfer Pricing provisions are different; though the objectives of RBI approval are broader. It can be argued that from a policy perspective that the objectives of Transfer Pricing provisions are automatically taken care while designing the Automatic Route / obtaining RBI approval.

From a compliance perspective, Income-tax Act and FEMA remain two separate laws requiring separate compliances. Therefore; RBI approval in itself is not in itself the justification of arm's length characteristics.

References: Master Circular no. 9/2011-12 on External Commercial Borrowings and Trade Credits issued by RBI

Question 71

Interest rates for ECB keep on changing every year. Does the assessee need to negotiate for the interest rate every year based on changes in RBI Norms?

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Answer

No. The arm's length characteristic of ECB interest should be analysed at the point in time ECB loan was granted. which is generally based on "LIBOR + Spread". LIBOR is a variable component and spread is fixed. Therefore it is important to ensure that rate of interest is fixed in a manner which is not only RBI compliant but should also be within arm's length range. Any subsequent changes in the allowable ECB interest rates by RBI do not result in renegotiation of terms of loan. Hence, for all practical purposes, the changes in the allowable interest rates are irrelevant for determination of arm's length price.

Example

The assessee has obtained ECB from its Associated Enterprise on 1 January 2012, for a period of 4 years. The interest rate allowed for ECB as per Master Circular was "6 month LIBOR plus 350 basis points", which was agreed with the Associated Enterprise. Thus, for AY 2012-13, "6 month LIBOR plus 350 basis points" can be considered as an indicator of arm's length price.

The Master Circular was withdrawn on 1 July 2012. The updated Master Circular reduced the ceiling of allowable interest rate to "6 month LIBOR plus 200 basis points". However, the assessee has continued to pay interest at the rate of "6 month LIBOR plus 350 basis points".

Commercially, just because RBI has reduced the ceiling does not result in the assessee renegotiating the interest rates with the Associated Enterprise if the assessee and the Associated Enterprise were at arm's length at time of entering the transaction itself.

References: Master Circular no. 9/2011-12 on External Commercial Borrowings and Trade Credits issued by RBI

Question 72

Is there any need to determine the arm's length nature if the transactions (whether receipts or payments) between the assessee and the Associated Enterprise are on cost to cost basis?

Answer

Let us take two cases separately.

Payments on a cost-to-cost basis (Reimbursement of expenses to Associated Enterprises)

Practically, it is a common occurrence where the Associated Enterprise has incurred some expenses on behalf of the assessee, which it later charges to the assessee by way of a debit note. The fact that the Associated Enterprise has recovered only the cost is in fact an indicator of arm's length nature.

However, the assessee needs to demonstrate the genuineness of the expenditure, along with the evidences.

Receipts on a cost-to-cost basis (Recovery of expenses from Associated Enterprises)

A converse case may also happen, where the assessee has incurred certain expenditure on behalf of the Associated Enterprise which has been recovered by way of a credit note.

It is fine to recover only the cost if it is a case of "pure" expenses, i.e. without any value addition done by the assessee. In case there is any value addition done by the assessee, it may require a reward for the value addition in form an arm's length mark-up.

Example

1. IJK India has incurred certain travel costs relating to the global tax manager who had come to visit India.
2. IJK India has set up a procurement team which helps the Associated Enterprises to identify and develop vendors from India.

In case of (1) above, it is justified even if the recovery is made at cost-to-cost and no mark-up is charged. However, in case of (2) above, IJK India is definitely providing a service to its Associated Enterprise and thus should be receiving an arm's length mark-up.

In case of Recovery of expenses, always the first question to ask is "is there any service element in this transaction?" If the answer is "yes", then recovery of costs without any mark-up would not be compliant with arm's length principle.

Question 73

The Associated Enterprise has set up a "shared service centre" to provide services to various Group Companies across the world. A portion of cost is debited to the assessee along with a mark-up. Whether the transaction is at arm's length?

Answer

There are two parts to this transaction, discussed below:

Concluding on Arm's Length Some Specific Transactions

(a) Costs of shared service centre

This transaction is similar to that mentioned in the question above. The Associated Enterprise is incurring costs on behalf of the assessee. The same logic relating to demonstrating the genuineness etc. applies over here.

Besides, the shared service centre typically provides services to multiple group companies across the world. The cost of the shared service centre is pooled together and is shared between the group companies based on a pre-decided "allocation key". Generally, the allocation key is based on specific usage, for e.g. in case of shared service centre for IT, allocation key typically is "number of users" of each group company.

In order to demonstrate genuineness of the expenditure, it is important for the assessee to have a break-up of the expenses of the service centre, and the insight on the methodology of allocation, including the allocation keys.

(b) Mark-up charged by the shared service centre

The shared service centre is providing services. Hence, it is natural that they will charge an arm's length mark-up. (Or else, they will have Transfer Pricing issues from their side: reverse situation of the one covered in the question above!)

The arm's length nature of the mark-up charged by the shared service centre needs to be demonstrated. Care must be taken to align this exercise with ITPR.

Question 74

The assessee has imported second-hand capital goods from the Associated Enterprise. The assessee has obtained a certificate from a Registered Valuer / Chartered Engineer according to the Customs regulations. Whether the price of import of capital goods be considered to be at arm's length?

Answer

The objective of the provision in Customs regulations behind making a compulsory valuation for import of second-hand capital goods is that the importer should not declare a lower value to avoid payment of Customs duty. On the contrary, Transfer Pricing would be mindful of whether the importer is declaring higher value for import of second-hand capital goods, so as to declare lower taxable profits. Hence, the objectives of Customs regulations and Transfer Pricing provisions are exactly contrary to each other.

However, the certificate from a Registered Valuer / Chartered Engineer mentions the "fair market value" of the capital goods in question. Hence, it can be used as a "comparable uncontrolled price".

Question 75

The assessee has paid Royalty to the Associated Enterprise. The rate of Royalty is approved by the RBI. (Alternatively, the rates are consistent with the "Automatic Route".) Whether the transaction of payment of Royalty is at arm's length?

Answer

The answer is on similar lines as question no. 70.

Question 76

What are Guarantee Fees? What are the factors required to be considered while evaluating arm's length in respect of Guarantee Fees?

Answer

Often, credit rating of a subsidiary is not enough for the enterprise to obtain loan from third party banker. In such a situation, the parent company, which enjoys a better credit rating, "guarantees" the borrowings of the subsidiary. The arrangement is that if the subsidiary defaults on repayment, the amount would be recovered from the parent company.

The guarantor, i.e. the parent company, is in fact, bearing the default risk on behalf of the borrower, i.e. the subsidiary company. Thus, giving a guarantee is akin to providing a service. The guarantor thus charges a "fee" for the services it provides, which is usually as a percentage of borrowings.

Borrower / payer of Guarantee Fees	Guarantor / receiver of Guarantee Fees	Comments
Indian assessee	Associated Enterprise	Arm's length guarantee fee has to be determined. <i>Indian Tax Authorities would be convinced of arm's length nature if there is "nil" guarantee fee charged.</i>
Associated Enterprise	Indian assessee	Arm's length guarantee fee has to be determined.

Concluding on Arm's Length Some Specific Transactions

Determining the arm's length guarantee fees is a difficult task as there is no data/information available in public domain. Further, even if a comparable transaction is available, the terms of the borrowings are rarely identical. The simplest way to benchmark the guarantee fees is to follow "opportunity cost approach", also known as "interest savings approach".

Example

XYZ Plc is a UK subsidiary of XYZ Limited, India. XYZ Plc is in need of funds and has approached the banks for loan. The interest rate offered by the bank (based on standalone credit rating of XYZ Plc) is LIBOR plus 450 basis points. XYZ Limited, India is a renowned multinational enterprise, with a good market standing and a robust group credit rating. The bank in the UK offers that in case XYZ Limited guarantees the loan, the rate of interest would be LIBOR plus 350 basis points. Thus, the benefit derived by guarantee of XYZ Limited is to the tune of 100 basis points, i.e. 1%. Therefore, **maximum** guarantee fee which should be payable to XYZ Limited is 1% of the borrowing.

Question 77

The assessee has extended an interest-free loan to its Associated Enterprise. Will the transaction be at arm's length from an Indian Transfer Pricing perspective?

Answer

No. There have been various legal precedents which have stated unequivocally that interest free loan given to the Associated Enterprises is **not** an arm's length transaction. Naturally, arm's length interest has to be charged (or at least offered to tax in India). The question is about what is arm's length interest in such situation? There are several possibilities:

- Internal comparable loan, if any
- Benchmark Prime Lending Rate (BPLR) of Indian banks
- Base Rate of Indian banks
- LIBOR plus "x" basis points, where "x" is determined by a benchmarking exercise
- EURIBOR plus "x" basis points, where "x" is determined by a benchmarking exercise

Which of the above possibilities is to be taken as a comparable, depends on facts and circumstances of each case. Recently, various Tribunals have been applying "LIBOR plus" as an indicator of arm's length prices.

Chapter 8

Transfer Pricing Documentation

Question 78

What all documents are required to be maintained under ITPR? Does the assessee need to comply with all the requirements of Rule 10D?

Answer

Rule 10D (1) lays down thirteen different types of information and documents that a person has to keep and maintain. The information and documents prescribed under Rule 10D can be classified into three types:

- enterprise-wise documents –
These are documents that describe the enterprise, the relationships with other associated enterprise, the nature of business carried out, etc. This information is, largely, descriptive [clauses (a) to (c)].
- transaction-specific documents –
These are documents that explain the international transaction in greater detail. It includes information with regard to each transaction (nature and terms of the contract, etc.), description of the functions performed, assets employed and risks assumed by each party to the transaction, economic and market analyses, etc. This information is both descriptive and quantitative in nature [clauses (d) to (h)].
- Computation related documents –
These are documents which describe and detail the methods considered

Rule 10D provides an exhaustive list of the documents required to be maintained by the assessee. The requirements mentioned in Rule 10D are voluminous and it is very much possible that all the clauses might not be applicable in case of the assessee. The assessee need not have to comply with all the requirements of Rule 10D. The nature and extent of documentation required to be maintained by the assessee would depend upon the nature and complexity of the international transaction carried out by the assessee.

References: Rule 10D, ICAI Guidance Note on International transactions

Question 79

Is there any threshold above which it is compulsory to maintain Transfer Pricing documentation?

Answer

Rule 10D (2) provides that the assessee is not required to prepare and maintain documentation prescribed under Rule 10D (1) in case where the aggregate value as recorded in the books of accounts of international transactions entered into by the assessee does not exceed one crore rupees. It is important to note that even though the assessee need not require to maintain the TP documentation where the transaction value is less than one crore, the onus is still on the assessee to substantiate the arm's length nature of its international transactions.

From the above, it can be construed that any assessee having aggregate value of international transactions of more than one crore is required to compulsorily maintain the transfer pricing documentation.

References: Rule 10D (1) Rule 10D(2)

Question 80

Will it be legally correct if one prepares the Transfer Pricing Documentation at the time of assessment?

Answer

Rule 10D (4) requires that the information and documents required to be maintained should be contemporaneous and should exist latest by the last date for filling the return of income (which is November 30 as per the extant provisions). Therefore it will be violation of ITPR in case the documentation is prepared at the time of assessment.

References: Rule 10D (4)

Question 81

Whether the documentation prepared for one year can be used in subsequent years?

Answer

Rule 10D (1) prescribes that the assessee is required to "keep and maintain" the documents. The word "keep and maintain" means regular updation of information and not writing them up once and for all the year ends. Further,

certain sections of TP documentation prepared for one year might not be relevant for the subsequent year requiring updation of the TP documentation. For instance, Function Assets and Risk analysis shall have to be updated considering the changes in the international transactions carried out by the assessee or changes in functions performed by the parties to the transactions. Further the benchmarking analysis shall have to be updated considering the financial data/transactional data for the year under consideration.

However, Rule 10D (4) provides that the TP documentation is not required for each year in case the international transaction continues to have effect over more than one year provided there is no significant change in such international transaction.

References: Rule 10D

Question 82

The assessee already has most of the information prescribed by Rule 10D available with its Accounts / Finance Department. Does the assessee need to maintain any separate Transfer Pricing documentation?

Answer

It is very much possible that the accounts/finance department of the assessee has most of the information prescribed under Rule 10D. However maintaining a separate documentation enables the assessee to capture all the specific details of the international transactions in a structured manner. Maintaining an independent TP documentation enables the assessee to collate all the information/documents prescribed under Rule 10D at one place. Further, the TP documentation can be submitted to the tax authorities at the time of assessment.

References: Rule 10D

Question 83

What are different modes of maintaining Transfer Pricing documentation?

Answer

The transfer pricing documentation can be maintained either in the form of a loose leaf binder or in the form of a transfer pricing study report. The loose leaf binder gives flexibility to the user to collate the documents and arrange

them appropriately as and when they are generated. Additionally, loose binder enables the user to maintain authentic documents which otherwise would be difficult to incorporate in the transfer pricing study report.

Alternatively, the assessee can prepare a comprehensive transfer pricing study report to compile all the information required to be maintained under ITPR at one place. The date on which the TP report is prepared by the assessee can be mentioned on the TP report which can be considered as an evidence for maintaining contemporaneous documentation. Further, when the tax authorities ask to submit the TP documentation, a TP report which comprises of all the information with respect to the relevant clauses under Section 10D can be submitted. Rule 10D read with Section 92D do not provide any specimen for preparing and maintaining the TP documentation thus it is at the discretion of the assessee to choose the mode in which the TP documentation is to be maintained. For the convenience of the readers, a format in which the TP report can be prepared is enclosed in **Annexure 'A'**.

Question 84

What all information should be captured under the Function, Asset and Risk ('FAR') Analysis?

Answer

Functional analysis is carried out with a purpose to identify the functions performed, assets employed and risks assumed by the assessee and its associated enterprise with respect to each international transaction. The purpose of functional analysis is to gather all the necessary information, facts in order to evaluate the inter company pricing. Usually the remuneration earned by an entity varies with the importance of function performed, the nature of capital assets employed and risks undertaken. It is therefore important to trace out the functions, assets employed and risk assumed by the assessee and the associated enterprise with respect to the controlled transaction. As part of the TP documentation, Functional analysis can be carried out for each international transaction. Some of the important functions that are important and examined as part of the functional analysis are provided below:

- Product conceptualisation and designing
- Research and development
- Material requirement planning
- Manufacturing

- Import administration and clearance
- Advertising and marketing
- Distribution
- Warehousing

The functional analysis should provide the factual and accurate information about the transaction.

After evaluating the functional profile, it is required to identify the nature of assets used by or between the associated enterprises. It is important to see whether any intangibles are being created by either of the entities at the time of executing the transaction.

Risk analysis provides for the risk assumed by the parties to the transaction. More the risk assumed by an enterprise, higher the reward which it shall expect from the international transaction. We have provided below an illustrative list of risks that could be performed by the transacting entities

- Product failure risk
- Market risk
- Research and development risk
- Credit risk
- Inventory risk
- Foreign exchange risk
- Capacity utilisation risk

The important question that may arise is whether the functional analysis is required to each international transaction or a functional analysis of a type/group of international transaction should be carried out. In this regard it is important to note that Rule 10A(d) a transaction includes a number of closely linked transactions. Accordingly, in case the separate transactions are so closely linked that they cannot be evaluated separately, then they can be considered together for the functional analysis.

References: Rule 10A, 10D

Question 85

Is Transfer Pricing documentation required to be submitted at time of filing of Form 3CEB?

Answer

Under the Transfer pricing documentation, the assessee need to prepare and maintain the information prescribed under Rule 10D read with Section 92D. The TP documentation is not required to be submitted at the time of filing the Form 3CEB. TP documentation will have to be submitted by the assessee to the tax department at the time of assessment proceedings as and when requested to demonstrate the arm's length nature of its international transactions.

Question 86

What are the consequences if the Transfer Pricing documentation is not maintained?

Answer

The assessee is required to prepare and maintain the information/documents as prescribed by Rule 10D in respect of its international transactions with associated enterprises. The TP documentation is required to be produced before the tax authorities whenever called for. If the assessee fails to maintain prescribed information/ documents, a penalty can be imposed of an amount equal to 2% of value of international transactions.

The question may arise that whether penalty is imposable in case where the tax authorities find small defects in maintenance of documents by the assessee. In such a situation the assessee can argue that no penalty is leviable as the assessee has ensured substantial compliance with the law.

Question 87

For how much period Transfer Pricing documentation has to be preserved?

Answer

Rule 10D (3) prescribes that the TP documentation is required to be kept and maintained by the assessee for a period of eight years from the end of the relevant assessment year.

References: Rule 10D

Question 88

What happens if the Transfer Pricing documentation is not contemporaneous?

Answer

Rule 10D (4) prescribes that the TP documentation as far as possible be contemporaneous and should exist latest by the date of filing return. The term contemporaneous as per the oxford dictionary means "existing or occurring in the same period of time". The contemporaneous documentation can be the one which should exist at the time of carrying out the transaction with the associated enterprise. In any case the documents are required to be compiled latest by the date of filing the return. In case the assessee fails to maintain contemporaneous documentation, it shall be construed that the assessee has not maintained the TP documentation as per the provisions of Rule 10D which attracts a penalty of 2% of value of international transactions carried out by the assessee.

References: Rule 10D

Chapter 9

Accountant's Report in Form 3CEB

Question 89

What all details/documents are required to be collated for Accountant's Report?

Answer

We have provided below an exhaustive list of documents/ information which is required to be collated at the time of preparing the Accountant's report.

- Copy of the audited financials of the Company along with notes to accounts, Director's report and management discussion.
- Copy of the tax audit report
- Copy of the Group transfer pricing policy, if any.
- Details of the shareholding structure of the Company
- Basis of pricing for each international transaction in case of absence of any Group transfer pricing policy
- Copies of agreements associated enterprises with respect to each international transaction.
- Details of the international transactions carried out by the assessee with its associated enterprise.
- Back up working for the related party schedule, CIF value of imports, FOB value of exports and income/expenditure in foreign currency.
- Computation of profitability (transactional level/segment level/entity level based on the facts of the case)
- Copy of the TP documentation prepared by the Company.
- Sample copies of invoices/vouchers with respect to each international transaction
- Ledger extracts of the associated enterprises
- In case of payment of royalty, computation of royalty
- In case of allocation of costs, back up working for the cost allocations

- Details of transactions carried out with the associated enterprises without any consideration
- Reconciliation between set of comparables considered for last year vis-à-vis current year.
- Details of reimbursements received/paid along with documentary evidences on sample basis.
- Copy of the order received from Special Valuation Bench ('SVB')

Question 90

What are the matters on which the Accountant is expected to express his opinion in Form 3CEB?

Answer

In the Form 3CEB, the Accountant is required to express his opinion as to whether the assessee in connection with its international transactions with the associated enterprise, has maintained appropriate documentation and information as prescribed by Rule 10D. Further the Accountant expresses his opinion as to whether the particulars required to be furnished as part of Form 3CEB are "True and correct".

References: Section 92E and Rule 10D

Question 91

Whether the Accountant needs to evaluate the Transfer Pricing documentation maintained by the assessee before signing the Form 3CEB?

Answer

As mentioned earlier, in the Accountant's report, the Accountant has to express his opinion as to whether the assessee has maintained appropriate documentation. Thus, TP documentation is a pre requisite for issuing the Accountant's report. The Accountant should thoroughly review the TP documentation maintained by the assessee before issuing Form 3CEB.

Question 92

Whether the Accountant's Report has to be filed with Income-tax Authorities? If so, which Authority?

Answer

Section 92E provides that every person who has entered into the international transactions/specified domestic transactions is required to

obtain a report from an accountant in prescribed format and shall furnish such report on or before the specified date. The Accountant's report is required to be manually submitted to the concerned Assessing Officer (Even though the income tax return can be filed online, the Accountant's report has to be filed manually).

References: Section 92E

Question 93

It is possible to file a revised form 3CEB?

Answer

As per the ITPR, the Accountant's Report is required to be submitted by the date for filing the income tax return. With respect to the income tax return, the Act provides a mechanism of filing a revised return under certain specified conditions within a period of one year from the end of the relevant assessment year or before the completion of the assessment. However, there is no express provision in the Act for submitting revised Form 3CEB. The assessee can approach the concerned income tax office with a specific request in writing for acceptance of a revised Form 3CEB stating the reasons for revision.

Question 94

Whether an accountant can issue a "qualified" Accountant's Report?

Answer

Yes, the Accountant can issue a qualified Accountant's report in case he is of the opinion that documents maintained by the assessee do not comply with the requirements of Rule 10D or the information is not true and correct. The accountant should suitably qualify his report or disclose discrepancies in his report depending upon the facts and circumstances of each case. The accountant should state the qualification in the report making it comprehensive and self-explanatory.

Question 95

Whether the amount of transactions reported should be basic or including freight, insurances and taxes?

Answer

In the Accountant's report the actual value of international transactions excluding freight insurance, taxes and other incidental charges is required to

be reported. It is important to find the amount debited/credit to AE's account to report the value in Form 3CEB.

Question 96

Whether the Accountant has to "conclude" on arm's length nature of prices in Accountant's Report or whether his duty stops at mere "reporting" of international transactions?

Answer

The Accountant's job is restricted to ensure that the appropriate documents are maintained by the assessee and information furnished in the Accountant's report is true and correct. It is not the responsibility of the Accountant to evaluate the TP documentation and conclude on the arm's length nature of the international transactions of the assessee. For instance, the Accountant need not have to verify whether the assessee has selected the method properly, selected the appropriate set of comparables etc. The statements with respect to the information to be furnished in the Accountant's report are to be compiled and authenticated by the assessee. The Accountant has to ensure that all the details with respect to the international transactions are appropriately captured. Thus at no time the Accountant has to conclude on the arm's length nature of the international transactions of the assessee.

References: ICAI Guidance Note on International transactions

Question 97

Is there any prescribed format for Accountant's Report?

Answer

Yes, the prescribed format of the Accountant's report is provided in Rule 10E (Form 3CEB) of Income-tax Rules, as well as Guidance Note issued by ICAI.

References: "Guidance Note on report on international transactions" issued by ICAI

Question 98

What are the penalties for incorrect / inaccurate Accountant's Report?

Answer

Section 271AA provides that if any person in respect of an international transaction or specified domestic transaction fails to report such transaction which he is required to do so or furnishes an incorrect information or

document then the Assessing Officer or Commissioner (Appeals) may direct that such person shall pay, by way of penalty, a sum equal to two per cent of the value of each international transaction

References: 271AA

Question 99

What is the penalty for non-filing of Form 3CEB?

Answer

Section 271BA provides that the failure on part of the assessee to furnish the Accountant's report may attract penalty of ₹ 100,000

References: 271BA

Question 100

How to ensure that all the relevant transactions are captured in Accountant's Report?

Answer

It is important to ensure that all the relevant transactions are appropriately captured while preparing the Accountant's report. The basis source of information for the transactions with associated enterprises is the related party schedule as provided in the notes to accounts. It is important to note that the related party schedule may not provide details of transactions with all associated enterprises as there is a difference in the definition of related party and associated enterprise.

In addition to the related party schedule it is important to analyze the backup data for the information provided under "CIF value of imports" "FOB value of exports", "transactions in foreign currency" etc for identifying the transactions with associated enterprises. Further, an analysis of debtors dump and creditors dump can provide the details of the nature of transactions carried out with the associated enterprises. The Accountant should also obtain a management representation with respect to the deemed international transactions carried out by the assessee as it is practically difficult for an Accountant to ensure that all the deemed international transactions are captured appropriately.

Question 101

How to ensure that names and addresses of the Associated Enterprises are accurately reported?

Answer

The accountant can obtain a sample copy of invoice/ voucher for each international transaction from the assessee to verify and confirm that names and addresses of the associated enterprise are accurately reported. The accuracy of names and addresses can also be verified from the details of all entities available on the website of the Group entity/parent entity.

Question 102

Can an Accountant rely on Management Representations while signing an Accountant's Report?

Answer

The accountant must obtain a Management Representation Letter in respect of all oral representations explicitly or implicitly given to him by the assessee or where the Accountant is having no other means of obtaining evidence. The letter should indicate and document the continuing appropriateness of the representations made to him and reduce the possibility of any misunderstanding concerning the matters which are the subject of the representations. However, where it is possible for the Accountant to directly verify the matters in such case mere obtaining of a management representation letter will not be sufficient compliance with the Generally Accepted Auditing Standards.

References: ICAI Guidance Note on International transactions.

Chapter 10

Domestic Transfer Pricing

Question 103

What prompted the introduction of application of Transfer Pricing provisions to Domestic Related Party Transactions? What is the objective behind introduction of Domestic Transfer Pricing provisions?

Answer

The Supreme Court in the case of *CIT v/s Glaxo Smith Kline Asia (P) Ltd.*, in its order has, after examining the complications which arise in cases where fair market value is to be assigned to transactions between domestic related parties, suggested that Ministry of Finance should consider appropriate provisions in law to make transfer pricing regulations applicable to such related party domestic transactions.

This prompted the introduction of Domestic Transfer Pricing, with effect from 1 April 2013, i.e. AY 2013-14 and subsequent AYs.

References: CIT v/s Glaxo Smith Kline Asia (P) Ltd., Memorandum explaining the provisions of Finance Bill, 2012

Question 104

What are considered as “Associated Enterprises” for Domestic Transfer Pricing (SDT)?

Answer

The term Associated Enterprise for Domestic Transfer Pricing has not been dealt through a separate provision. However, the definition of specified domestic transaction, defined in section 92BA of the Act, contains the references of the entities who would be characterized as associated entities for SDT.

Question 105

What are “Specified Domestic Transactions” (‘SDT’)? Why are certain transactions treated as SDT?

Answer

The underlying objective of the Transfer Pricing provisions is "protection of tax base from erosion". In case of transactions between assessee's exposed to similar rates of tax, there is no erosion of tax base.

For e.g. An Indian holding company sells goods at less than market price to its subsidiary. This has an effect of reducing the taxable income of the holding company, and increases the taxable income of the subsidiary company.

If the holding company and subsidiary company have similar "effective tax rates", then there is no erosion of tax base, and thus the tax revenue.

In the above example, if the subsidiary company is subject to tax holiday, it will have effect of erosion of tax base:

- (a) Taxable income of holding company would be reduced as a result of selling at a low price to the subsidiary, thus resulting into lower tax burden; and
- (b) Increased income of subsidiary company would not be subject to tax (but would be subject to MAT), owing to the tax holiday status.

Therefore, in order to counter such situations, the transfer pricing regulations are extended to the transactions entered into by domestic related parties or by an undertaking with other undertakings of the same entity for the purposes of section 40A, Chapter VI-A (i.e. Section 80A, 80IA) and section 10AA.

References: Section 92BA, Memorandum explaining the provisions of Finance Bill, 2012

Question 106

Is there any threshold for SDT to be covered by Transfer Pricing provisions?

Answer

Yes. The transactions can be considered as SDT only when sum of all transactions covered by section 40A, Chapter VI-A (i.e. Section 80A, 80IA) and section 10AA exceeds ₹ 5 crores in aggregate during the Previous Year.

The various situations are as follows:

Ref	Value of international transactions during the Previous Year	Value of domestic transactions covered by section 40A, Chapter VI-A (i.e. Section 80A, 80IA) and section 10AA during the Previous Year	Applicability of Transfer Pricing provisions
1	Re. 1	Less than or equal to ₹ 5 crores	Transfer Pricing is applicable to international transactions only. Accountant's Report has to be obtained for transactions of Re. 1. Documentation as per Section 92D and Rule 10D may not be maintained. <i>The threshold of ₹ 5 crores for applicability of Transfer Pricing provisions is only for Domestic transactions and not international transactions.</i>
2	Greater than ₹ 1 crores	Less than or equal to ₹ 5 crores	Transfer Pricing is applicable to international transactions only. Accountant's Report has to be obtained for transactions of Re. 1. Documentation as per Section 92D and Rule 10D needs to be maintained for international transaction.
3	<i>Nil</i>	Less than or equal to ₹ 5	Transfer Pricing not applicable

Transfer Pricing Compliances: A Practitioner's Handbook

Ref	Value of international transactions during the Previous Year	Value of domestic transactions covered by section 40A, Chapter VI-A (i.e. Section 80A, 80IA) and section 10AA during the Previous Year	Applicability of Transfer Pricing provisions
		crores	
4	<i>Nil</i>	Greater than 5 crores	Transfer Pricing is applicable to SDT only. Accountant's Report has to be obtained. Documentation as per Section 92D and Rule 10D needs to be maintained for SDT.
5	Re. 1	Greater than 5 crores	Transfer Pricing is applicable to international transactions as well as SDT. Accountant's Report has to be obtained for Re.1 of international transactions and full value of SDT. Documentation as per Section 92D and Rule 10D needs to be maintained for SDT, but may not be maintained for international transaction, as it does not exceed ₹ 1 crore.
6	Greater than ₹ 1 crores	Greater than 5 crores	Transfer Pricing is applicable to international transactions as well as SDT. Accountant's Report has to be obtained for Re.1 of international transactions and

Ref	Value of international transactions during the Previous Year	Value of domestic transactions covered by section 40A, Chapter VI-A (i.e. Section 80A, 80IA) and section 10AA during the Previous Year	Applicability of Transfer Pricing provisions
			full value of SDT. Documentation as per Section 92D and Rule 10D needs to be maintained for SDT as well as international transaction.

References: Section 92BA, Rule 10D(2), Section 92E

Question 107

Whether the transactions between two units of the same entity will be covered under Domestic Transfer Pricing provisions?

Answer

Yes, such cases may arise especially when the one of the transacting party is "eligible business / unit / undertaking" as defined by the tax holiday sections mentioned above.

Question 108

Whether Director's remuneration is an SDT for which arm's length price has to be determined?

Answer

Section 40A(2)(a) requires the Assessing Officer to determine whether the expenditure incurred in respect of payments made to persons mentioned in Section 40A(2)(b) are excessive or unreasonable having regard to the fair market value of the goods.

In relation to a company, Director is a person mentioned u/s 40(A)(2)(b)(2)(ii). Thus, any payment made to the Director of the company,

including Director's Remuneration is subject to Transfer Pricing provisions, for which arm's length has to be determined.

References: Section 40A (2)(a), Section 40A(2)(b)

Question 109

What type of domestic transactions which are covered under SDT?

Answer

Section 92BA, which defines SDT refers to various sections of the Income-tax Act. All the sections mentioned do not cover all the transactions between the related parties. The situation is as follows:

Section referred to in Section 92BA	Transactions covered
Section 40A	This section covers only expenditure incurred, and not income from Related Parties.
Section 80A	Only transactions in respect of goods or services are covered by Section 80A(6). This covers both income and expenditure.
Section 80-IA	This section covers both income and expenditure.
Section 10AA	This section covers both income and expenditure.

References: Section 92BA, Section 80A, Section 80-IA, Section 10AA

Question 110

Can an adjustment of Transfer Prices in hands of one party to SDT affect the income of other party to SDT?

Answer

No. It is not provided in the Finance Act, 2012 that an adjustment of Transfer Prices in hands of one party to SDT is eligible for reduction of income in hands of other party to SDT.

Example

The salary paid to the wife of the director of a company is not considered to be at arm's length, and the non-arm's length portion is disallowed. The fact that it has been disallowed in the hands of the director of the company does not mean that the taxable income of the wife would be reduced correspondingly.

Annexure A
Suggested format of Transfer Pricing
Study Report

Transfer Pricing Compliances

***Transfer Pricing
Documentation***

Contents

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Section I

Executive Summary

(Kindly note that providing an executive summary is not a requirement under ITPR. However such summary is useful for a quick understanding of the analysis)

Background:

- a. Snapshot of the Indian entity
- b. Snapshot of the Group

Economic Analysis:

- a. Selection of Tested Party:
- b. Summary of Economic Analysis:
- c. Outcome of the analysis and Conclusion:

Section II

Transfer Pricing Documentation

1. Rule 10D (1) (a)

A description of the ownership structure of the assessee enterprise with details of shares or other ownership interest held therein by other enterprises

Name of the shareholder	Relationship	No. of shares held	%age shareholding	Amount (Rs.)

Rule 10D (1) (b)

A profile of the multinational group of which the assessee enterprise is a part along with the name, address, legal status and country of tax residence of each of the enterprises comprised in the group with whom international transactions have been entered into by the assessee, and ownership linkages among them

- Details of the Indian entity
- Details of the Group/associated enterprises

2. Rule 10D (1) (c)

A broad description of the business of the assessee and the industry in which the assessee operates, and of the business of the associated enterprises with whom the assessee has transacted.

- Introduction
- Background
- Industry Structure
- Growth
- Challenges
- Future Outlook

3. Rule 10D (1) (d)

The nature and terms (including prices) of international transactions entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction.

The international transactions entered into by the assessee company during the financial year have been tabulated below:

Name of the Associated Enterprise (AE)	Nature of Transaction	Amount (Rs.)	Terms of transaction

4. Rule 10D (1) (e)

A description of the functions performed, risks assumed and assets employed or to be employed by the assessee and by the associated enterprises involved in the international transaction

Introduction

Importance of functional analysis.

Graphical representation of the business model:

Nature of international transaction

- Functions performed by assessee
- Functions performed by Associated Enterprises

Risks assumed

Risk profiling the assessee vis-à-vis its AEs provided in table below:

Risk Category and description	Exposure to assessee	Exposure to associated enterprises

Classification/Characterization (Applicable for profit based methods only)

5. Rule 10D (1) (f)

A record of the economic and market analyses, forecasts, budgets or any other financial estimates prepared by the assessee for the business as a whole and for each division or product separately, which may have a bearing on the international transactions entered into by the assessee

6. Rule 10D (1) (g)

A record of uncontrolled transactions taken into account for analyzing their comparability with the international transactions entered into, including a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the international transactions.

7. Rule 10D (1) (h)

A record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction.

8. Rule 10D (1) (i)

A description of the methods considered for determining the arm's length price in relation to each international transaction or class of transaction, the method selected as the most appropriate method along with explanations as to why such method was so selected, and how such method was applied in each case.

9. Rule 10D (1) (j)

A record of the actual working carried out for determining the arm's length price, including details of the comparable data and financial information used in applying the most appropriate method, and adjustments, if any, which were made to account for differences between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions.

a. Selection of Most Appropriate Method:

Rule 10B (1) of the Act prescribes the following methods for the purposes of sub-section (2) of section 92C, i.e. for determination of the arm's length price in relation to an international transaction. The methods prescribed and their applicability for the assessee's international transaction, are given below:

Comparable Uncontrolled Price (“CUP”)

Rule 10B (1) (a) of the Act prescribes that:

- i. the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified;
- ii. such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market;
- iii. the adjusted price arrived at under sub-clause (ii) is taken to be an arm’s length price in respect of the property transferred or services provided in the international transaction;

Applicability:

Resale Price Method (“RPM”)

Rule 10B (1) (b) of the Act prescribes that:

- i. the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise, is identified;
- ii. such resale price is reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction, or a number of such transactions;
- iii. the price so arrived at is further reduced by the expenses incurred by the enterprise in connection with the purchase of property or obtaining of services;
- iv. the price so arrived at is adjusted to take into account the functional and other differences, including differences in accounting practices, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market;
- v. the adjusted price arrived at under sub-clause (iv) is taken to be an arm’s length price in respect of the purchase of the property or

obtaining of the services by the enterprise from the associated enterprise;

Applicability:

Cost Plus Method ("CPM")

Rule 10(B) (1) (c) of the Act prescribes that:

- i. the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined;
- ii. the amount of a normal gross profit mark-up to such costs (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions, is determined;
- iii. the normal gross profit mark-up referred to in sub-clause (ii) is adjusted to take into account the functional and other differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market;
- iv. the costs referred to in sub-clause (i) are increased by the adjusted profit mark-up arrived at under sub-clause (iii);
- v. the sum so arrived at is taken to be an arm's length price in relation to the supply of the property or provision of services by the enterprise;

Applicability:

Profit Split Method ("PSM")

As per Rule 10B(1)(d) of the Act, this method may be applicable mainly in international transactions involving transfer of unique intangibles or in multiple international transactions which are so interrelated that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction, by which:

- i. the combined net profit of the associated enterprises arising from the international transaction in which they are engaged, is determined;

- ii. the relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances;
- iii. the combined net profit is then split amongst the enterprises in proportion to their relative contributions, as evaluated under sub-clause (ii);
- iv. the profit thus apportioned to the assessee is taken into account to arrive at an arm's length price in relation to the international transaction :

Provided that the combined net profit referred to in sub-clause (i) may, in the first instance, be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of international transaction in which it is engaged, with reference to market returns achieved for similar types of transactions by independent enterprises, and thereafter, the residual net profit remaining after such allocation may be split amongst the enterprises in proportion to their relative contribution in the manner specified under sub clauses (ii) and (iii), and in such a case the aggregate of the net profit allocated to the enterprise in the first instance together with the residual net profit apportioned to that enterprise on the basis of its relative contribution shall be taken to be the net profit arising to that enterprise from the international transaction;

Applicability:

Transactional Net Margin Method ("TNMM")

Rule 10(B) (1) (c) of the Act prescribes that:

- i. the net profit margin realised by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;
- ii. the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;

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- iii. the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;
- iv. the net profit margin realised by the enterprise and referred to in sub-clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii);
- v. The net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction.

Applicability:

- b. Selection of Profit Level Indicator (Applicable only in case where profit based method is selected)
- c. Computation of Profit Level Indicator (Return on ____): Calculation of return on ___ of the assessee
- d. Search for uncontrolled comparables:
 - Databases Considered
 - Selection of time period
 - Search Process

Summary of Search Process – Prowess

Criteria and reason for usage	No. of Companies passing the criterion

Search from Capitaline Plus

Summary of Search Process – Capitaline Plus

Criteria and reason for usage	No. of companies passing the criterion

Consolidation

The final number of companies from Prowess and Capitaline Plus as well as final number of comparable segments has been consolidated for further analysis. This totals to ___:

Database	No. of Companies
A.	
B.	
Total No. of Companies	

Elimination of Companies having Related Party Transactions

The total numbers of comparable companies and/or segments at this stage were __.

From the above, based on information available on the databases, we eliminated companies having significant related party transactions which have an impact on the operating profit. This resulted in the number of comparables reducing from __ to __.

Accordingly, we were then left with __ comparable companies and/or segments.

Determination of arm's length result:

Name of the company	Source of data	PLI
Mean		

e. Conclusion on Arms Length Price

10. Rule 10D (1) (k)

The assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's length price\

11. Rule 10D (1) (l)

Details of the adjustments, if any, made to transfer prices to align them with arm's length prices determined under these rules and consequent adjustment made to the total income for tax purposes.

12. Rule 10D (1) (m)

Any other information, data or document, including information or data relating to the associated enterprise, which may be relevant for determination of the arm's length price.

13. Rule 10D (3)

Authentic documents supporting the information maintained under Rule 10D (1)

The assessee has maintained following documents to support the information maintained under Rule 10D (1):

Type of information	Reference
(a) official publications, reports, studies and data bases from the Government of the country of residence of the associated enterprise, or of any other country;	
(b) reports of market research studies carried out and technical publications brought out by institutions of national or international repute;	
(c) price publications including stock exchange and commodity market quotations;	
(d) published accounts and financial statements relating to the business affairs of the associated enterprises;	
(e) agreements and contracts entered into with associated enterprises or with unrelated enterprises in respect of transactions similar to the international transactions;	
(f) letters and other correspondence documenting any terms negotiated between the assessee and the associated enterprise;	
(g) documents normally issued in connection with various transactions under the accounting practices followed.	

Appendix A: Business Description of comparable companies

Name of the Database

1. Names of the Companies

The views expressed in this publication are Authors' professional views. It need not necessarily represent the views of the organization in which the Authors are associated.

Ideally, the authors suggest that the reader should refer to following publications while using this book:

- Income-tax Act, Rules, Circulars and Notifications
- Guidance Note on report on International Transaction under section 92E of the Income-tax Act, 1961 (Transfer Pricing) issued by the ICAI
- Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued by the Organisation for Economic Cooperation and Development (OECD) in July 2010
- Model Tax Convention on Income and Capital issued by OECD
- Relevant DTAA's entered into by India

Feedback Page

This is the first edition of the Handbook by the Committee, and, obviously, therefore there is scope for improvement. We intend to make it as useful as possible in its present format. The committee, therefore, hopes to keep updating this Handbook on a regular basis in order to make it more functional.

We solicit comments and suggestions from practitioners and others to improve the usefulness of the Handbook. In particular, we will welcome the views of the practitioners on enhancement of their knowledgebase.

Your valuable inputs may be sent to ccbcaf@icai.org.

We are thankful to CA. Hrishikesh Gogte and CA. Aditya Panse for preparing the draft of this book on Transfer Pricing Compliances: A Practitioner's Handbook.

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