

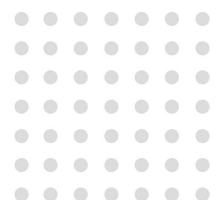
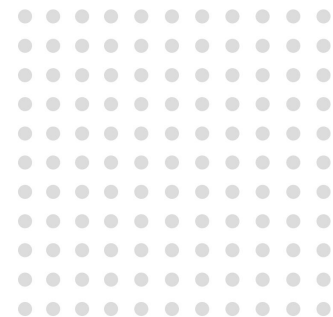
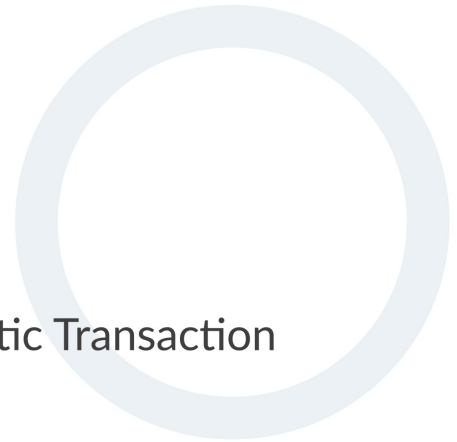
Transfer Pricing Provisions: Basic Concepts & Overview

2021
SEPTEMBER



POINTS OF DISCUSSION

- What is Transfer Pricing?
- Historical Background
- Applicability
- Meaning of Associated Enterprise
- International Transaction and Specified Domestic Transaction
- How to select the most appropriate method?
- Computation of ALP
- Range Concept and Variability
- Brief Compliances



• WHAT IS TRANSFER PRICING? •

- Transfer Pricing as a concept traditionally began with the **amount charged by one segment of an enterprise for a product or service that is supplied to another segment of the same enterprise.**
- With the evolution of the concept of Multinational Enterprise (MNE), the segments of the enterprise started spreading as independent entities across the globe.
- Accordingly, the term Transfer Price has evolved to mean price which is charged between two or more entities of an MNE (Associated Enterprises, AE) operating in different countries.
- There is a possibility, an MNE may use its wide geographical presence to arrange the affairs in a manner through which it may favourably exploit the tax systems in different countries.
- Transfer Pricing is a whole set of compliance and regulation mechanisms to protect the country's fair share of tax in the total profit of the MNE.
- **Arm's Length Principle** is established to judge the fairness of dealings of, which assumes related parties deal with each other as if they were independent.

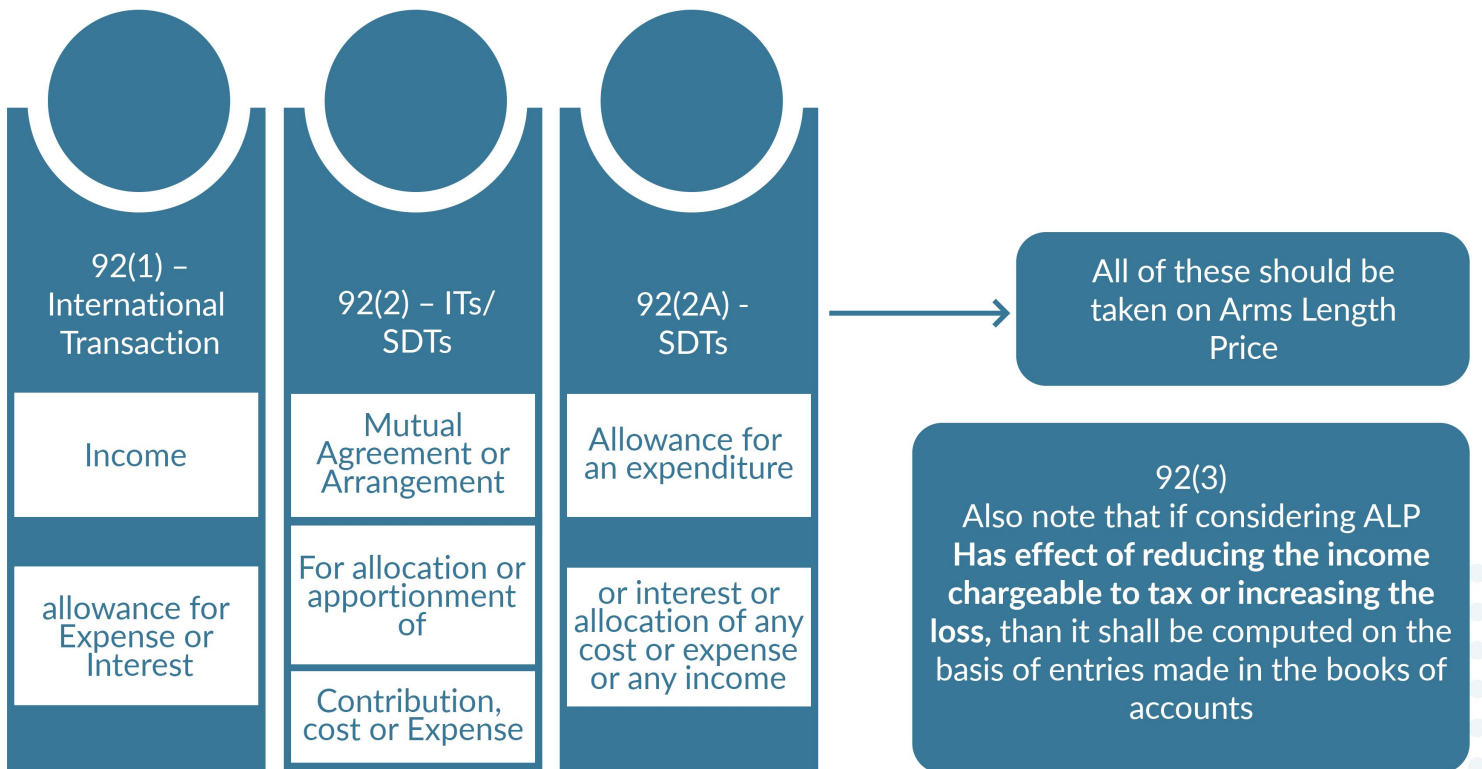
• HISTORICAL BACKGROUND •

- Transfer pricing was first initiated in United States through its Revenue Act, 1921.
- Comprehensive guidelines on Transfer Pricing have been issued by the Organisation for Economic Co-operation and Development (OECD) and United Nations.
- In India, **Union Budget 2001** introduced the new framework of transfer pricing regulation which can lead to computation of reasonable, fair and equitable profits and tax in India (emphasis provided by Finance Act 2001).

APPLICABILITY

When the Transfer pricing regulations are applicable?

INTERNATIONAL TRANSACTION/ SPECIFIED DOMESTIC TRANSACTIONS (SDTs)

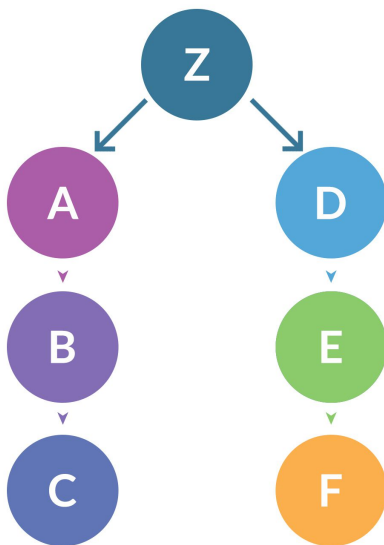


MEANING OF ASSOCIATED ENTERPRISE

Associated Enterprises: 92A(1)

"associated enterprise", in relation to another enterprise, means an enterprise:

- > which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or
- > in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.



>Control
>Management
>Capital

- ▶ {Z & A}, {A & C}, {A & B}, {B & C}, {Z & B}, {D & E}, {D & F} and {E & F} are associated Enterprises under [92A(1)(a)]
- ▶ {C & F}, {B & E}, {A & D}, {B & F}, {E & C}, {A & E}, {B & D}, {A & F} and {C & D} are also Associated Enterprises [92A(1)(b)]

Associated Enterprises (AE): 92A(2)

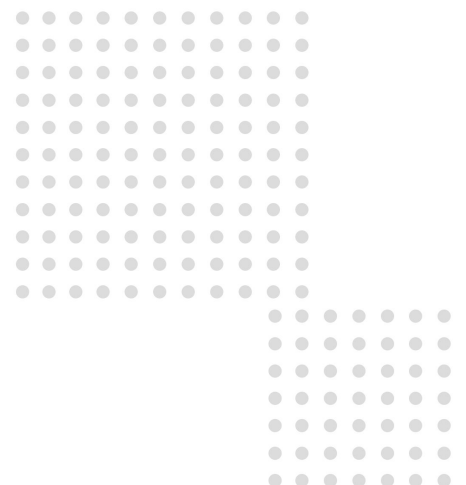
Two enterprises shall deemed to be associated enterprises if, at any time during the previous year, there is a relation based on the following parameters:

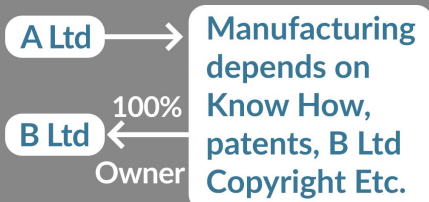

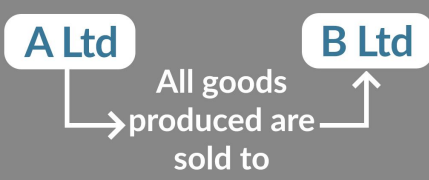
- > Substantial Voting Power
- > Loan or Guarantee
- > Apportionment of Majority of Directors/Members or one or more Executive directors/executive members of Governing Board
- > Dependence
- > Control
- > Interest

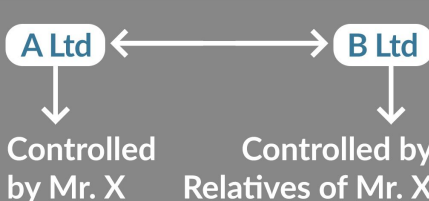
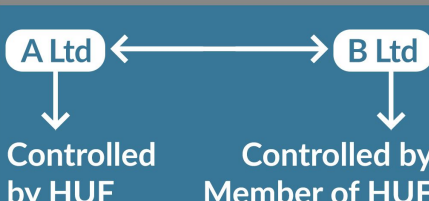


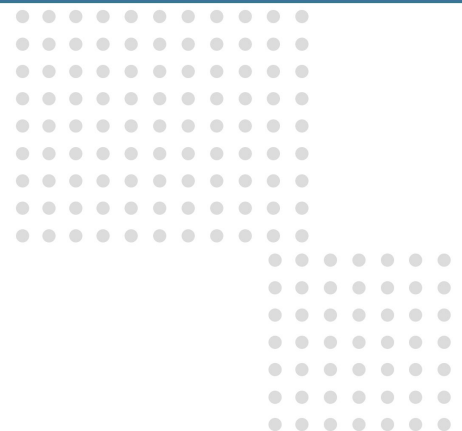
Associated Enterprises: 92A(2)

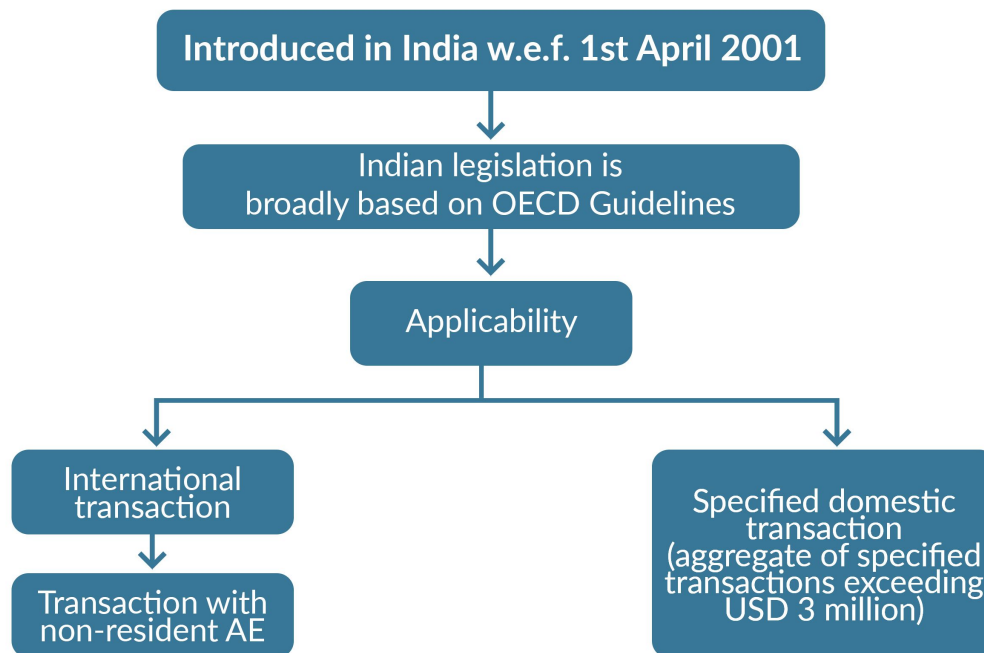
Based on	Condition	Example
Substantial Voting Power	One enterprises holds 26% or more of the voting power directly or indirectly in the other enterprise.	<pre> graph LR A((A)) -- 33% --> B((B)) B -- 100% --> C((C)) </pre>
	Any person or enterprise holds 26% or more of the voting power directly or indirectly in each of two different enterprises	<pre> graph TD MrA((Mr. A)) -- 40% --> BLtd((B Ltd)) MrA -- 40% --> CLtd((C Ltd)) BLtd <--> CLtd </pre>
Loan or Guarantee	One Enterprises advances loan to other Enterprise of an amount of 51% or more of the Book value of total assets of other enterprise.	Book Value of Assets of A Ltd. = Rs. 100 Cr B Ltd loan to A Ltd = More than or Equal to 51 Cr.
	One enterprise guarantees 10% or more of total borrowings of the other enterprise.	P Inc. (America) has total loan of 1 Million USD From Bank in USA A Ltd (India) Guaranteed 10% or More of Loan
Appointment of Majority of Directors	One enterprise appoints more than half of: 1. The Board of Directors or 2. Members of Governing Board or One or more executive directors or executive members of Governing Board	<pre> graph TD A[A Ltd] --- B1[15 Directors on Board] B1 --- B2[Out of this 8 are appointed by B Ltd.] </pre>
	Same person appoint for each of the 2 enterprise: 1. More than half of directors or members of governing board 2. One or more Executive directors or executive members of Governing Board	<pre> graph TD MrA((Mr. A)) -- 8 Directors --> BLtd((B Ltd)) MrA -- 2 Executive Directors --> CLtd((C Ltd)) BLtd <--> CLtd </pre>



Based on	Condition	Example
Dependence	Manufacturing Process in 100% dependent on the intangibles of which other enterprises is the owner or have exclusive Rights	
	90% or more of the raw material required for the manufacturing is supplied by other Enterprise or person specified by other enterprise or price or other conditions are influenced by other enterprise.	
	Good or Articles manufactured by one enterprise are sold to the other Enterprise or to person specified by other enterprise or price or other conditions are influenced by other enterprise.	

Control	Where one enterprise is controlled by an individual and other enterprise is controlled by individual or any of its relative or jointly by individual and relative.	
	Where one enterprise is controlled by HUF and other enterprise is controlled by HUF or any of its Member or jointly by HUF and Member	
Interest	Where one enterprise is a firm, AOP, BOI and other enterprise hold 10% or more Interest in firm/AOP/BOI	
	There exist between two enterprises, any relationship of mutual Interest , as may be prescribed	





As per **OECD**, glossary of tax terms,

“Generally speaking, enterprises are associated where the same persons participate directly or independently in the management, control or capital of both enterprises, i.e. both enterprises are under common control.”

Definitions of AE in all major tax treaties of India including with US, UK, Singapore, Japan, UAE, etc. have been worded similar to OECD.

Deemed AE as per Indian Income Tax Act			
Capital	Management	Activities	Control
26% direct or indirect holding	Appointment of more than half of directors/ members of governing body	Business wholly dependent on the intangibles of the other enterprise	Common control by an individual
By the same person in both the enterprises	Appointment of one or more executive directors/ members of governing board	Supply of > 90% of raw materials or consumables for manufacture by the other enterprise or by person specified by other enterprise (with prices and other conditions influenced by other enterprise)	Control by relative of individual or jointly
Loan \geq 51% of total assets	Above appointment by same person in both the enterprises	Sales to other enterprise or under price and conditions influenced by other enterprise	Control by HUF and/ or member of the HUF/ relative of member or jointly
Guarantee \geq 10% of borrowings			Firm, AOI, BOP - other enterprise holding not less than 10% interest

INTERNATIONAL TRANSACTION & SPECIFIED DOMESTIC TRANSACTION

International Transaction 92B(1)

Transaction between

Two or more associated enterprises, where either or both are non residents

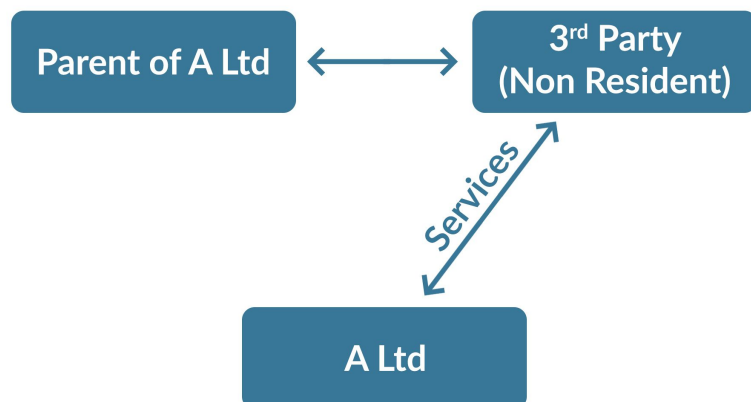
In nature of →

1. Purchase, sale or lease of tangible or intangible property; or
2. Provision of Services; or
3. Lending or Borrowing Money; or
4. Any other transaction having a bearing on the profits, income, losses or assets of the enterprises; or
5. Mutual agreements or arrangements for allocation or apportionment of, or any contribution to, any cost or expense incurred

Deemed International Transaction 92B(2)

Transactions with Non-AE companies deemed to be international transactions and will be subject to transfer pricing regulations in the following conditions

Prior Agreement / Determination of Terms



- ▶ Transaction between A and 3rd party will be international Transaction, if either:
- ▶ A prior agreement exists between A's parent and 3rd party in relation to services rendered between A Ltd and 3rd party; or
- ▶ Terms of transaction are determined in substance by A Ltd's parent and 3rd party

Specified Domestic Transactions 92BA

Following transactions **other than International Transactions** will be covered under the ambit of Transfer Pricing Taxation if aggregate value of transactions exceeds **20 Crore Rupees**:

- > any transaction referred to in **section 80A**;
- > any transfer of goods or services referred to in **section 80-IA(8)**;
- > any business transacted between the assessee and other person as referred to **section 80-IA (10)**;
- > any transaction, referred to in **any other section under Chapter VI-A or section 10AA**, to which provisions of **section 80IA(8) or section 80-IA (10)** are applicable;
- > any business transacted between the persons referred to in **section 115BAB(6)**;
- > any other transaction as may be prescribed,

Basically these transactions include domestic transactions between related persons or eligible unit and non-eligible unit of the same person wherein either of them is enjoying the benefit of tax holiday or relief in taxation rates.

- > **80A** - As per section 80A(6) when a taxpayer claiming deduction under various sections, interalia, sections 80-IA, 80-IAB, 80-IB, 80-IC, 80-ID, 80-IE etc., carries certain transactions with its associated entities, these transactions should be carried out at fair market value. So, if a transaction is covered under section 80A, then it will be treated as a specified domestic transaction.
- > **80IA(8)** - Section 80-IA provides for deductions in respect of profits and gains from industrial undertakings or enterprises engaged in infrastructure development, telecommunication services, power generation, etc. Section 80-IA(8) covers inter-unit transfer of goods and services by an entity claiming deduction under section 80-IA.
- > **80IA(10)** - A taxpayer claiming deduction under section 80-IA may enter into business transaction with other person with whom he has close connection. The transaction may be arranged in such a manner that the profit earned by the taxpayer from such transaction is more than the normal profit. By doing so the profit of other entity is diverted to the taxpayer and in tune the taxpayer will not pay tax on the profit so diverted.
- > **10AA** - Section 10AA provides for exemption in respect of income generated by a unit located in Special Economic Zone.

Under Chapter VI-A there are various sections under which the taxpayer can claim deduction. Only those sections of Chapter VI-A are relevant to which the provisions of section 80-IA(8) and (10) are applicable.

- > **115BAB** - In case of domestic company, from AY 2020, assessee shall have the option tax shall be computed at the rate of 15%.

● HOW TO SELECT THE MOST APPROPRIATE METHOD? ●

Computation of arm's length price: Sec 92C

The arm's length price in relation to an international transaction or specified domestic transaction shall be determined by any of the following methods, being the most appropriate method, having regard to

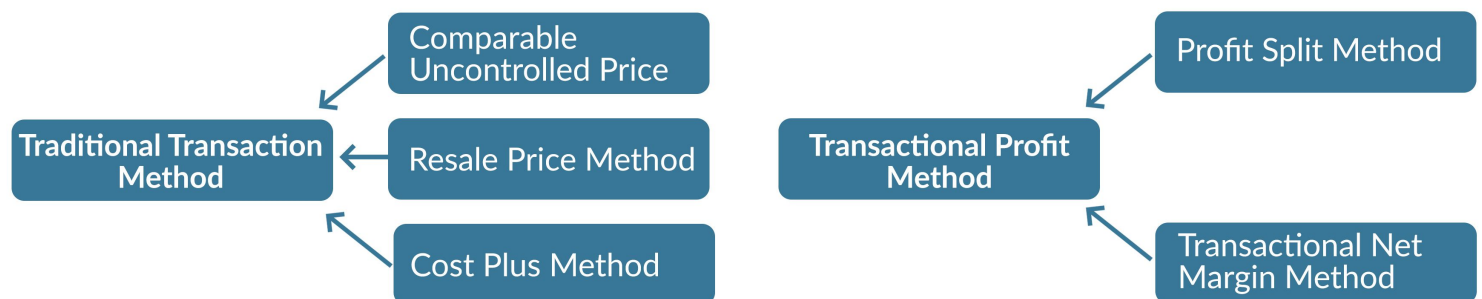
- > the nature of transaction;
- > class of transaction;
- > class of associated persons;
- > functions performed by such persons; or
- > such other relevant factors as the Board may prescribe⁴, namely :—

Most Appropriate Method (Rule 10C)

- > The nature and class of the transaction;
- > The class or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;
- > The availability, coverage and reliability of data necessary for application of the method;
- > The degree of comparability existing between the transaction and the uncontrolled transaction and between the enterprises entering into such transactions;
- > The extent to which reliable and accurate adjustments can be made to account for differences, if any, between the transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;
- > The nature, extent and reliability of assumptions required to be made in application of a method.

• COMPUTATION OF ALP •

Computation of arm's length price: Sec 92C



The most appropriate method referred to in sub-section (1) shall be applied, for determination of arm's length price, in the manner as may be prescribed method.

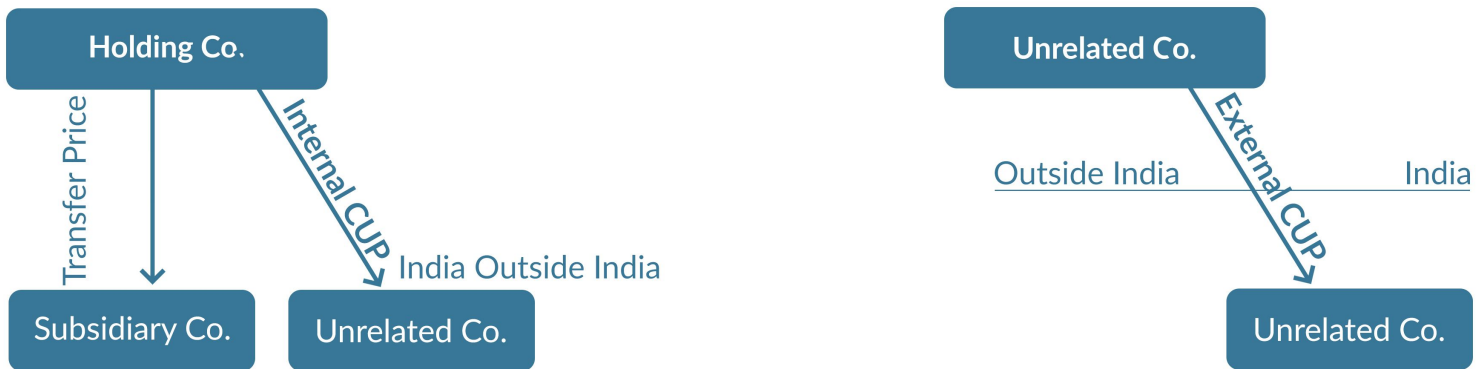
Comparable Uncontrolled Price Method

Rule 10B

- > the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified;
- > Such price is adjusted to account for differences, if any, between the international transaction or the specified domestic transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market;
- > 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 or the specified domestic transaction.

Comparable Uncontrolled Price(CUP) Method

- This method is the most direct method for Determining the ALP
- In this method prices are compared with the transactions with similar Product, contractual, economic etc terms and conditions.
- Both **Internal CUP and External CUP** are taken into consideration for best results
- OECD prioritise Internal CUP over External CUP as comparability is much higher in case of Internal CUP as in External one



➤ Factors to be considered for determination of ALP under CUP Method

1. The specific characteristics of the property transferred, or services provided in either transaction

- Similarity of Product or services which are delivered under the transaction
- Brand of the Product
- Quality of the Product/Services
- Warranty and after Sale Services offered

2. The functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions

3. Contractual Terms – Risks and Benefit terms agreed upon by both parties

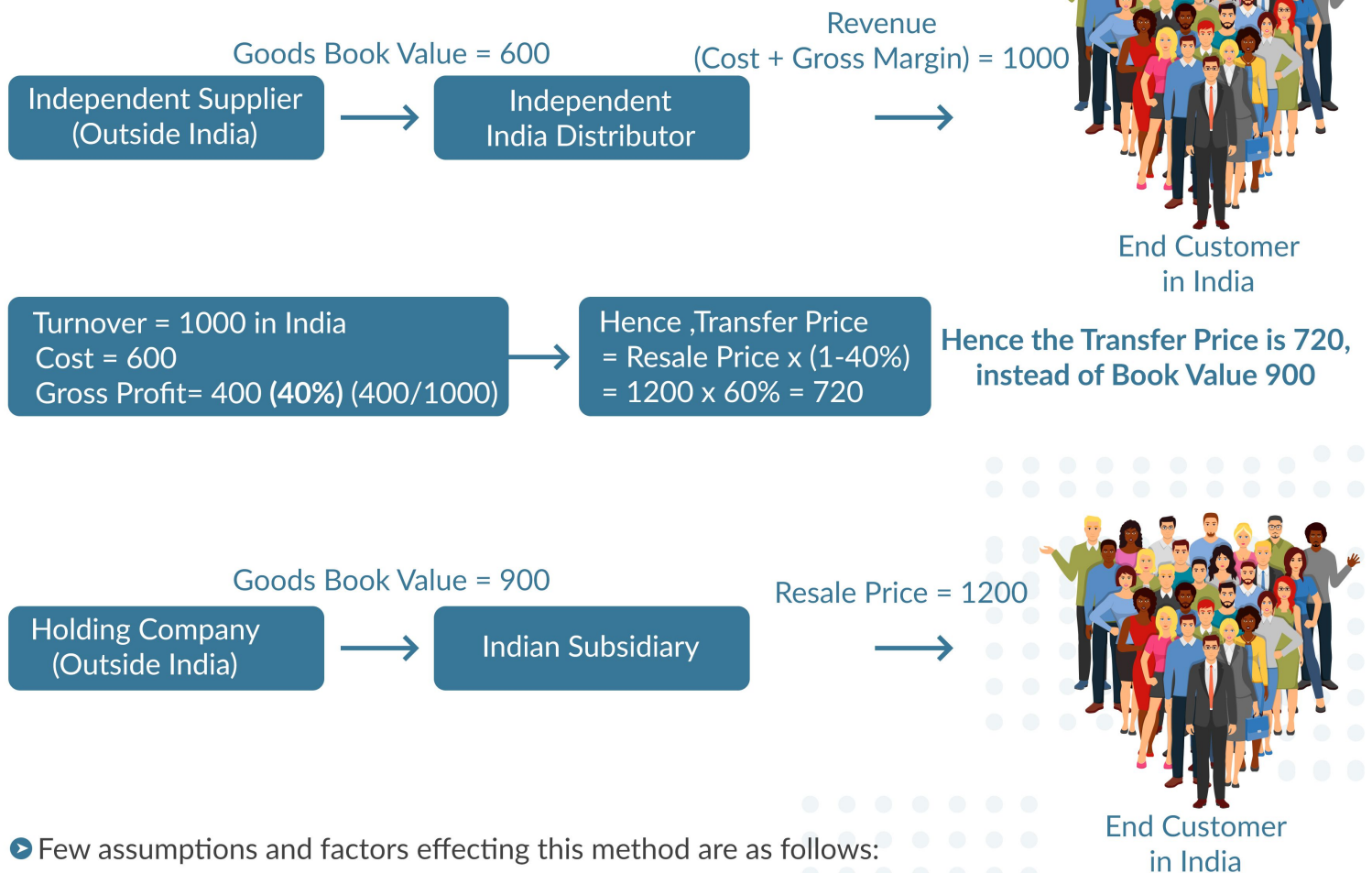
4. Prevailing Market Conditions:

- Geographical Conditions
- Market Size
- Statutory conditions
- Labor cost and other economic situation of market
- Competition in Market

Resale Price Method (RPM)

- ▶ 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 should be identified.
- ▶ Following adjustments should be made to such resale price:
 - > For Normal Gross profit margin
 - > For expenses incurred in connection with for purchase of property or obtaining of services
 - > For functional and other differences, including any differences in accounting practices which should materially affect the gross profit margin in the open market.
- ▶ The adjusted price determined in above step will be considered as Arm's Length Price

Illustration - RPM



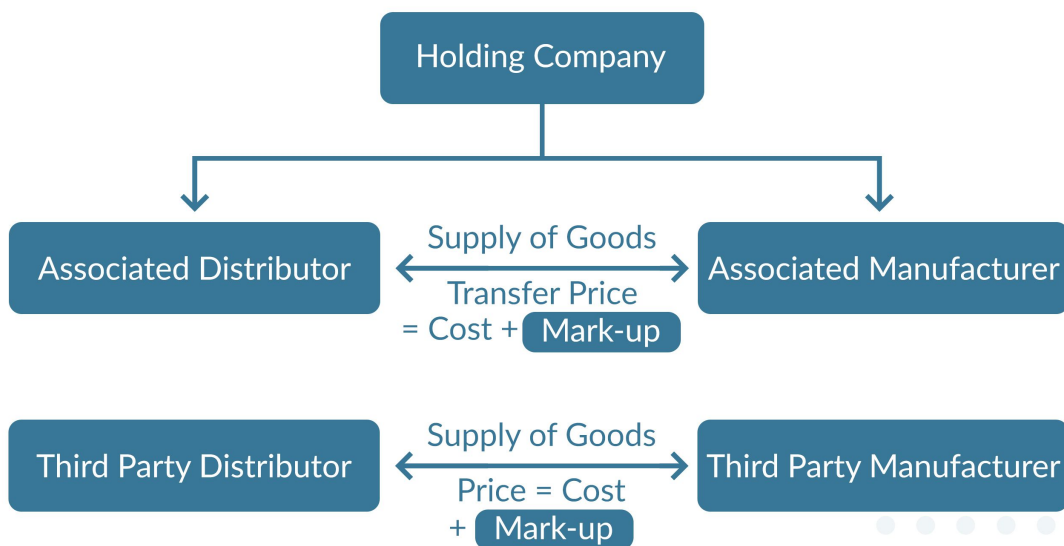
- ▶ Few assumptions and factors effecting this method are as follows:

1. The resale price method is typically used to determine profitability of a distributor.
2. It focuses on resale function performed by the distributor and gross margin as functional return.
3. It assumes that the reseller / distributor has not added substantial value to the tangible goods by physically altering the goods before resale.
4. Packaging, repackaging, labeling, or minor assembly that does not result in substantial value addition should be ignored.
5. It may be difficult to find data because of accounting differences
6. It is one sided method and may lead to extreme result on supplier's side.

Cost Plus Method (CPM)

- Under this method, the direct and indirect cost of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprises should be determined
- The amount of a normal gross profit mark-up to such cost arising from the transfer or provision of same or similar property or services by the enterprise, or by an unrelated enterprise in comparable uncontrolled transaction or transactions should be determined.
- The above normal gross profit markup can be adjusted to take into account the functional and other differences which could materially affect such profit mark-up in the open market.
- Costs referred to in first point should be increased by the adjusted profit mark-up as stated in previous point and the price so arrived at will be considered as the arm's length price.

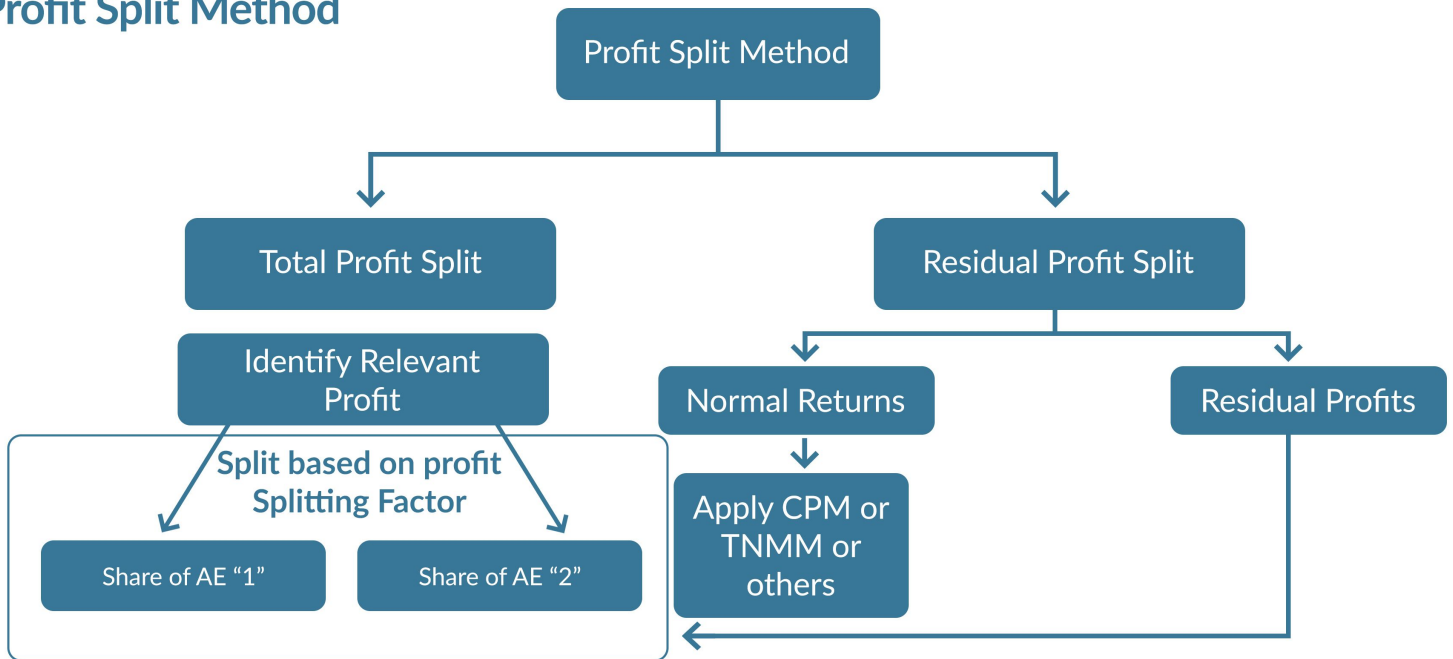
Illustration



Profit Split Method (PSM)

- Profit Split Method, which may be applicable mainly in transactions involving transfer of unique intangibles or 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—
- Under this method combined profit of associated enterprises are first calculated.
- 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
- the combined net profit is then split amongst the enterprises in proportion to their relative contributions, as evaluated in second point;
- The profit thus apportioned to the assessee is taken into account to arrive at an arm's length price

Profit Split Method



Transactional Net Margin Method (TNMM)

- ▶ In this method, the net profit margin realized by the enterprises from a relevant transaction with an associated enterprise is computed having regard to costs incurred or sales effected, or assets employed or having regard to any other relevant base.
- ▶ The net profit margin realized by the enterprise or by an unrelated enterprises from a comparable uncontrolled transactions by applying the same base as in above point is computed. This profit margin is adjusted to take into account the differences which could materially affect the net profit margin in the open market having regard to those transactions and comparable uncontrolled transactions or having regard to the enterprises entering to such transactions.
- ▶ If the net profit margin realized by the enterprise in first point is established to be the same as the net profit margin as in second mentioned point, then the same is taken into consideration to arrive at an arm's length price in relation to the transaction.

Relevant Period for Comparable Data

Rule 10B(4) & Rule 10B(5)

- ▶ For CUP and PSM data for the same year is to be taken in which International transaction or specified domestic transaction has been entered into.
- ▶ For RPM, CPM & TNMM following period shall be relevant:
 - ▶ The data relating to the current year; or [2020-21]
 - ▶ The data relating to the 2 financial years immediately preceding the current year, if the data relating to the current year is not available at the time of furnishing the return of income by the assessee, for the assessment year relevant to the current year. [2019-20, 2018-2019]

Also note that where the data relating to the current year is subsequently available at the time of determination of arm's length price of an international transaction or a specified domestic transaction during the course of any assessment proceeding for the assessment year relevant to the current year, then, such data shall be used for such determination irrespective of the fact that the data was not available at the time of furnishing the return of income of the relevant assessment year.

Other Provisions (ALP)

► If during the Assessment of any income by the officer, officer is of the view that:

- ALP not determined in accordance with the said provisions, or
- Information and Documents required to be maintained are not kept, or
- Data or information used in not reliable or correct, or
- Assessee failed to furnish the requisites

Officer can determine such ALP in accordance with such provisions, after serving a notice to the assessee

► **Any other method**, other than discussed can also be used which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts.

► Such as Third party quotation, valuation report, etc.

• RANGE CONCEPT AND VARIABILITY •

Rule 10 CA – Range Concept

► Where in respect of transactions the application of most appropriate method results in **determination of more than one Price** the ALP shall be computed as under:

- A Dataset shall be constructed by placing the price in ascending order.
- Where the dataset constructed consist of **6 or more entries**, an arm's length range beginning from the **35th Percentile** of the dataset and ending on **65th percentile** of the dataset shall be constructed.
- If price at which the transactions has actually been undertaken is **within range** as calculated above, the **price at which transaction actually undertaken**, shall be ALP.
- In a case where dataset consists of **less than 6 entries**, then ALP shall be the **arithmetical mean** of all the values included in the data set

► 35% percentile = Total No. of entries in dataset x $[35/100]$

► 65% percentile = Total No. of entries in dataset x $[65/100]$

► Median = Total No. of entries in dataset x $[50/100]$

- If the numbers calculated above is a fractional N, then the next higher number which is the whole number shall be taken and the value in the dataset placed at this whole number shall be the 35th / 65th / Median.
- If the number calculated above is a whole number, then the arithmetical average of values in dataset at this number and values in dataset at next higher number shall be the 35th / 65th / Median.
- Tolerance band of 1% for wholesale traders and 3% in all other cases is acceptable.

Illustration

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

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

Thirty-fifth percentile place = $20 * (35/100) = 7$.

Since the thirty-fifth percentile place is a **whole number**, it shall be the average of the prices at the seventh and next higher, i.e.; eighth place. This is $(47+48)/2 = \text{Rs.}47,500$.

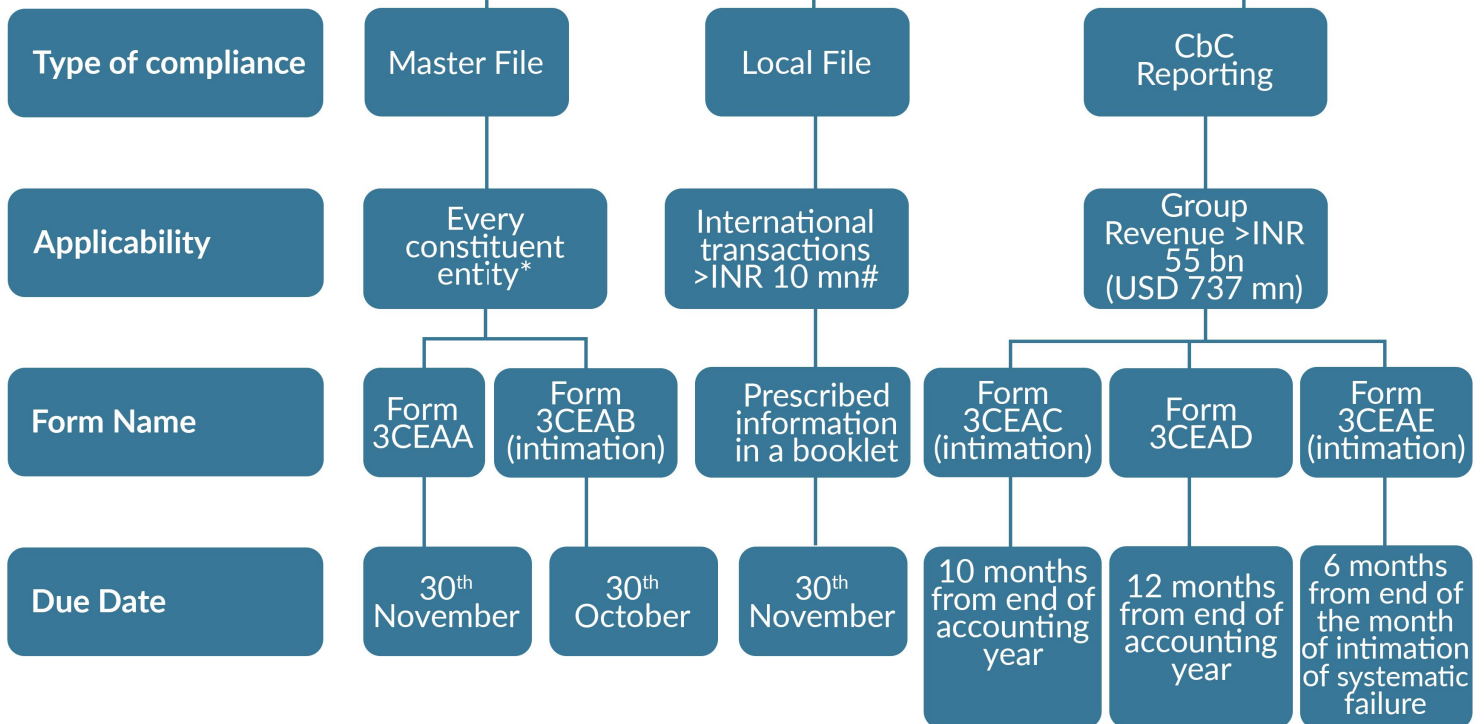
Sixty-fifth percentile place = $20 * (65/100) = 13$.

Similarly, the sixty-fifth percentile will be average of thirteenth and fourteenth place prices. This is $(48.5+49)/2=\text{Rs.}48,750$

The **median** of the range (the fiftieth percentile place) = $20*(50/100)=10$ Since the fiftieth percentile place is a whole number, it shall be the average of the prices at the tenth and next higher, i.e.; eleventh place. This is $(48.35+48.45)/2= \text{Rs.}48,400$. Thus, the arm's length range in this case shall be from Rs.47,500 to Rs.48,750.

BRIEF COMPLIANCES

Transfer Pricing Documentation w.e.f. 1st April 2016









* There is an exemption from detailed master file (only an intimation needs to be filed) where the Group Revenue < INR 5 bn (USD 67 mn) (subject to other conditions).

Accountant's certificate in Form 3CEB is to be obtained on or before 31st October, where there is any international transaction with group entities.

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