TRANSFER PRICING

DATED 8.6.2017

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India has signed the historic multilateral convention to implement tax treaty related measures to prevent Base Erosion and Profit Shifting (BEPS), at Paris with More than 65 countries, including India, signed the convention.
In order to curb revenue loss through treaty abuse and BEPS strategies by ensuring that profits are taxed where substantive economic activities generating the profits are carried out and where value is created.. http://www.thehindubusinessline.com

BEPS- Action Plan 13 – TP documentation and CbC reporting

- Three tiered standard approach
- Master file at group level to be made available to all tax jurisdictions – high level information of the global business
- Local file specific to each country
- CbC report to be filed annually for each jurisdiction showing revenue, profit and tax along with number of employees, stated capital, retained earnings, and tangible assets apart from business activity carried on
- To be applied to groups with consolidated revenue of 750 million Euro

SAFE HARBOUR RULES (Section 92CB)
NOTIFICATION No. 46/2017 dated 7th June, 2017

Eligible international transaction	Threshold limit prescribed	Safe harbor margin
Provision of software development services &information technology enabled services with insignificant risks (Software)	Up to Rs 100 Crore	17 % or more on total operating costs
	Above Rs 100 Crore to 200 crore	18 % or more on total operating costs
Provision of information technology enabled services (ITES)	Up to Rs 100 Crore	17 % or more on total operating costs
	Above Rs 100 Crore to upto 200 crore	18 % or more on total operating costs
Provision of knowledge processes outsourcing services with insignificant risks (KPO)	& (EC/OC >60%) (Employee cost/ operating cost)	24 % or more on total operating costs
	& (EC/OC >40%)	21 % or more on total operating costs
	& (EC/OC <=40%)	18 % or more on total operating costs
Advancing of intra-group loan (In INR Currency)	Interest rate declared in relation to the eligible international txn not less than SBI rate as on 1st april of relevant previous year plus	
	has CRISIL credit rating between AAA to A or its equivalent	Plus 175 basis points
	CRISIL credit rating of BBB-, BBB or BBB+ or its equivalent;	Plus 325 basis points
	CRISIL credit rating between BB to B or its equivalent	Plus 475 basis points
	CRISIL credit rating between C to D or its equivalent; or	Plus 625 basis points
	not available & amount less than RS. 100 crore	Plus 425 basis points

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Advancing of intra-group loan (In foreign Currency)	Interest rate declared in relation to the eligible international txn not less than SBI rate as on 1st april of relevant previous year plus	
	has CRISIL credit rating between AAA to A or its equivalent	Plus 150 basis points
	CRISIL credit rating of BBB-, BBB or BBB+ or its equivalent;	Plus 300 basis points
	CRISIL credit rating between BB to B or its equivalent	Plus 450 basis points
	CRISIL credit rating between C to D or its equivalent; or	Plus 600 basis points
	not available & amount less than RS. 100 crore PY	Plus 400 basis points
Providing corporate guarantee	The commission or fee declared in relation to the international transaction is at the rate of 1.00% on the amount guaranteed	
Provision of specified contract R&D services wholly or partly relating to software development with insignificant risks	24% or more , where the value of eligible interenational txn not exceed Rs. 200 crore	
Provision of contract R&D services wholly or partly relating to generic pharmaceutical drugs with insignificant risks	24% or more , where the value of eligible interenational txn not exceed Rs. 200 crore	
Manufacture and export of core auto components	12% or more on total operating costs	
Manufacture and export of noncore auto components where 90% or more of total turnover during the relevant previous year is in the nature of original equipment manufacturer (OEM) sales	8.5% or more on total operating costs	
Receipt of low value-adding intra-group services	entire value of the international transaction is less than Rs. 10 crore = Markup is 5% (inclusive) (Provided that the method of cost pooling, the exclusion of shareholder costs and duplicate costs from the cost pool and the reasonableness of the allocation keys used for allocation of costs to the assessee by the overseas associated enterprise, is certified by an accountant.";)	

What is Transfer Pricing?

Finance Act, 2001 introduced Transfer Pricing Regulations for curbing tax avoidance and manipulation of intra-group transactions by abusing transfer pricing. Comprehensive Transfer Pricing regulations introduced in India in the year 2001

- Memorandum to the Finance Act, 2001 stated that:
- *"The increasing participation of multinational groups in economic activities in the country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in such intra-group transactions, thereby, leading to erosion of tax revenues.* ***With a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises, new provisions are proposed to be introduced in the Income Tax Act."***

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Overview of Legislative Framework

Relevant Provisions under Section 92

Computation of Income

International Transaction	Section 92B
Specified Domestic Transaction	Section 92BA
Associated Enterprises	Section 92A
Arm's Length Price	Section 92C + Rule 10B / 10C
Documentation and Report	Section 92D and Section 92E

Elements of Information & Documentation Requirements

Statutory Obligations

Penalty Provisions

List of Documentation

Details of Information & Documentation
Two types of I&D: • **Those to be furnished along with the Return** - Section 92E requires submission of report from an accountant by persons entering into international transaction along with Return of Income • **Those to be kept and maintained for production before Tax Authorities** - should be produced before Tax Authorities within 60 days, maximum

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Accountant's Report in Form No. 3CEB – Why?

Section 92E

Every person

who has entered into an international transaction or Specified Domestic Transaction (SDT) during a previous year

Shall obtain a report from an Accountant and furnish such report

On or before the specified date in the prescribed form

Duly signed and verified in the prescribed manner by such Accountant

And setting forth such particulars as may be prescribed

Rule 10E

The report from an accountant required to be furnished under Section 92E by every person who has entered into an international transaction or a specified domestic transaction during a previous year shall be in Form No. 3CEB and be verified in the manner indicated therein.

Features of Form No. 3CEB

- Due Date 30th November

- No exemption from filing Form No. 3CEB – Even if international transaction of INR 1

- Applicable for Domestic Transactions if SDT > INR 20 crores

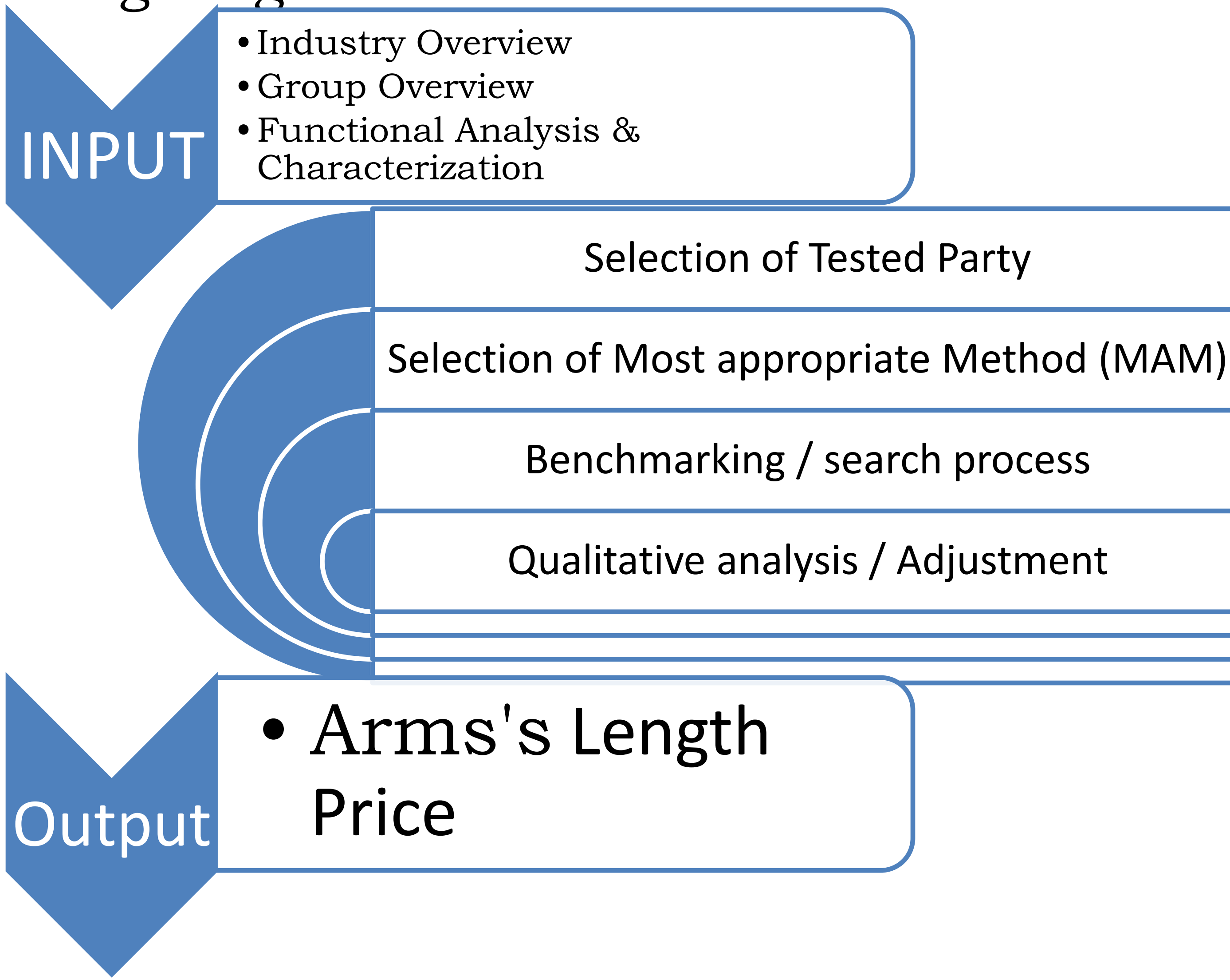
- Definition of Specified Domestic Transactions Modified by the Finance Bill 2017

- Applies to both Residents and Non- Residents (Foreign Companies, Branches, Permanent Establishments)

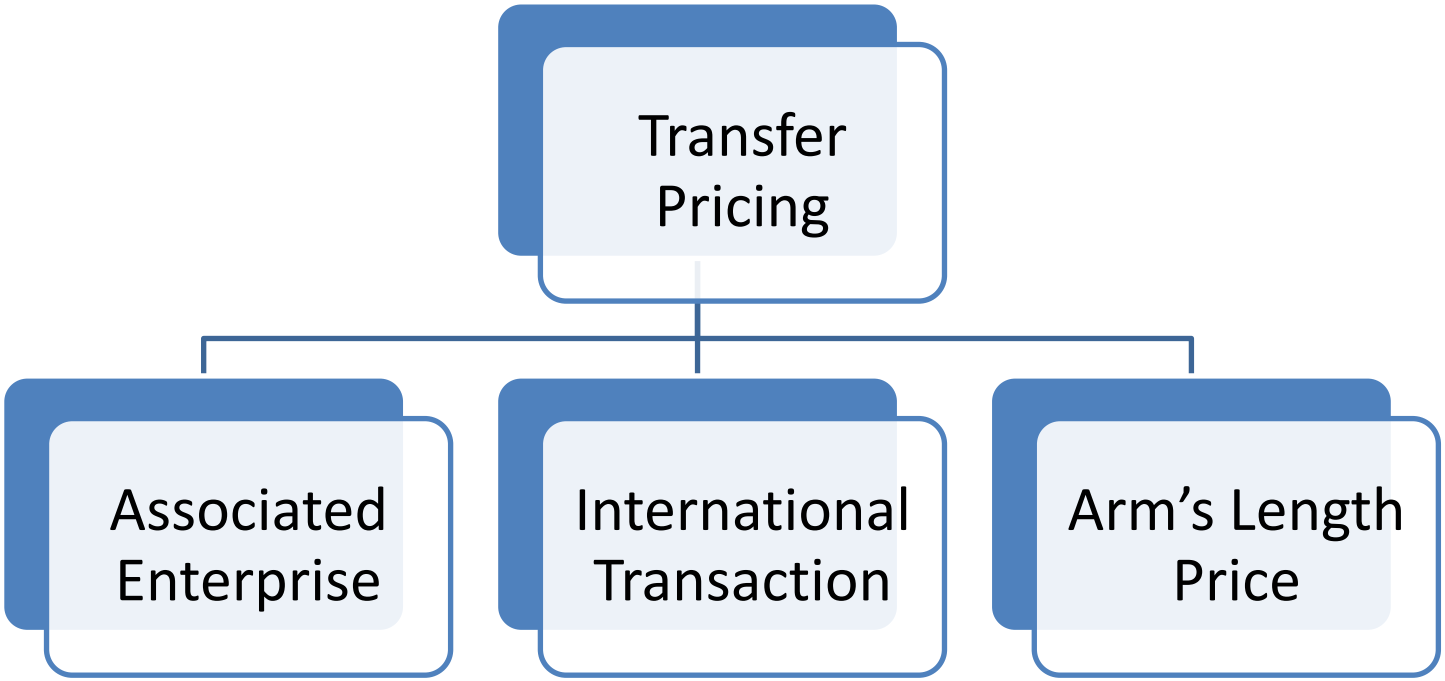
- Information as required in respective clauses must be provided

- Can be issued by Statutory Auditors or any other Chartered Accountant in practice satisfying independence requirements [*Accountant - Section 92F(i) read with Explanation below Section 288(2)*]

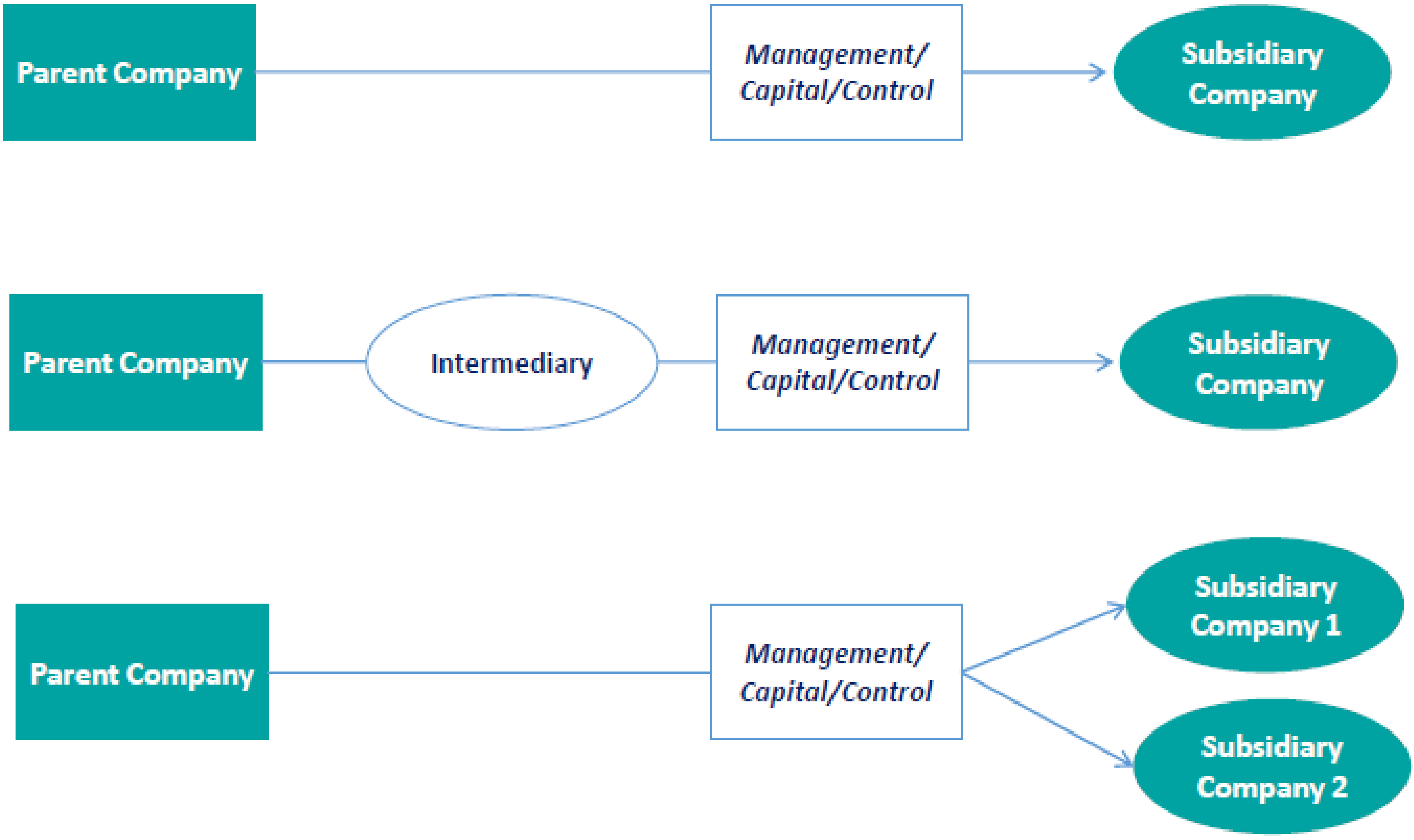
The entire TP Study could be summarised with the help of following diagram:



- Important Concepts
- Any income arising to associated enterprises from an international transaction shall be computed having regard to the Arm's Length Price



Associated Enterprises - Section 92A of the Act - Primary Association



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International Transaction -Section 92B of the Act

- Transaction between two or more associated enterprises, **either** or **both** of whom are **non-residents**
- In the nature of -
  - Purchase, sale or lease of tangible or intangible property, or
  - Provision of services, or
  - Lending or borrowing money, or
  - Any other transaction having a bearing on the profits, income, losses or assets of such enterprises,
  - Any mutual agreement or arrangement on allocation or apportionment or any contribution of cost or expenses

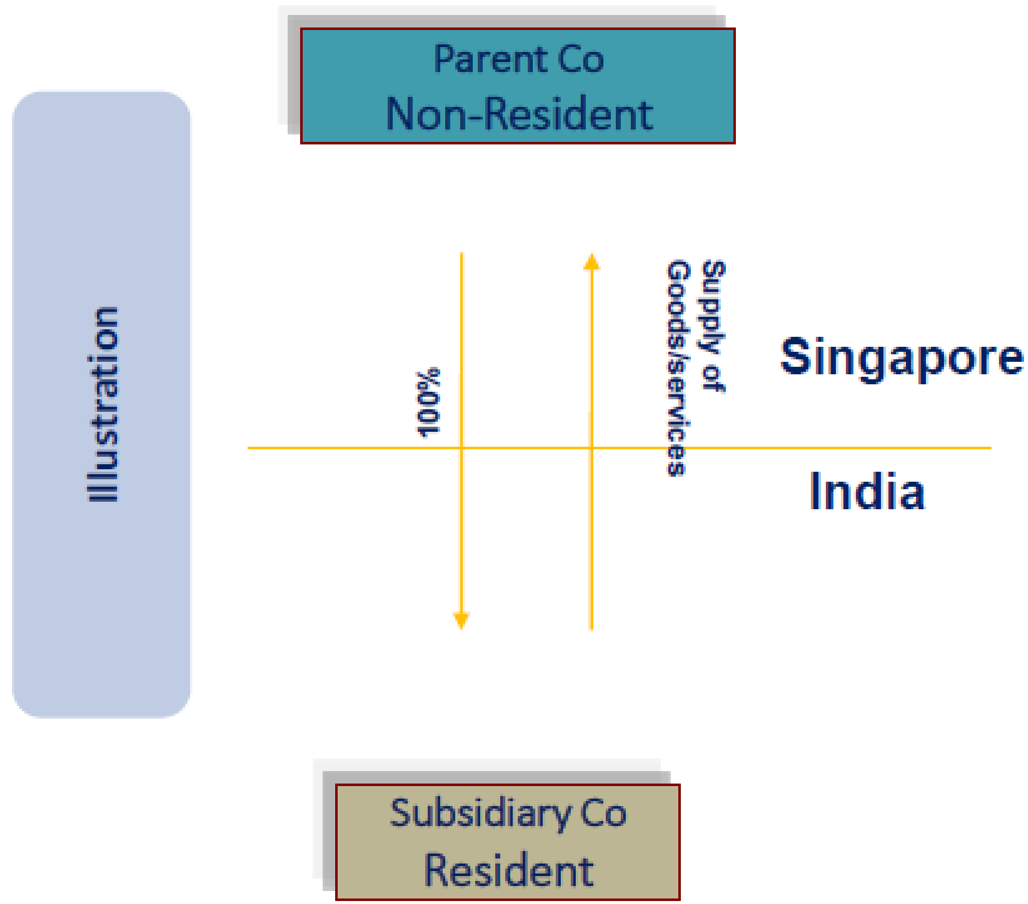
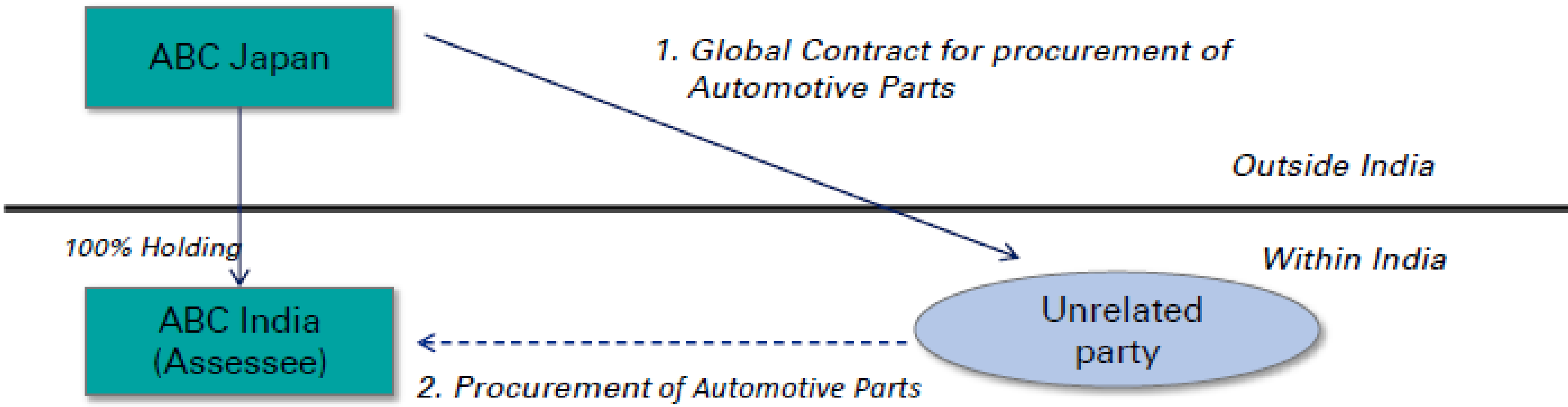


Illustration 1 : Deemed International Transactions

Procurement of automotive parts from an unrelated party under a Global Contract



In the above scenario, procurement of automotive parts by ABC India from Unrelated/ Third Party will be considered as a deemed international transaction for ABC India because:

1) there exists a <u>prior agreement</u> between ABC Japan (related party of ABC India) and Unrelated Party,
2) <u>terms</u> of the transaction (i.e. price and/ or other terms) entered into by ABC India with Unrelated Party are <u>determined by ABC Japan</u>; and
3) Third/Unrelated Party is RESIDENT in India.

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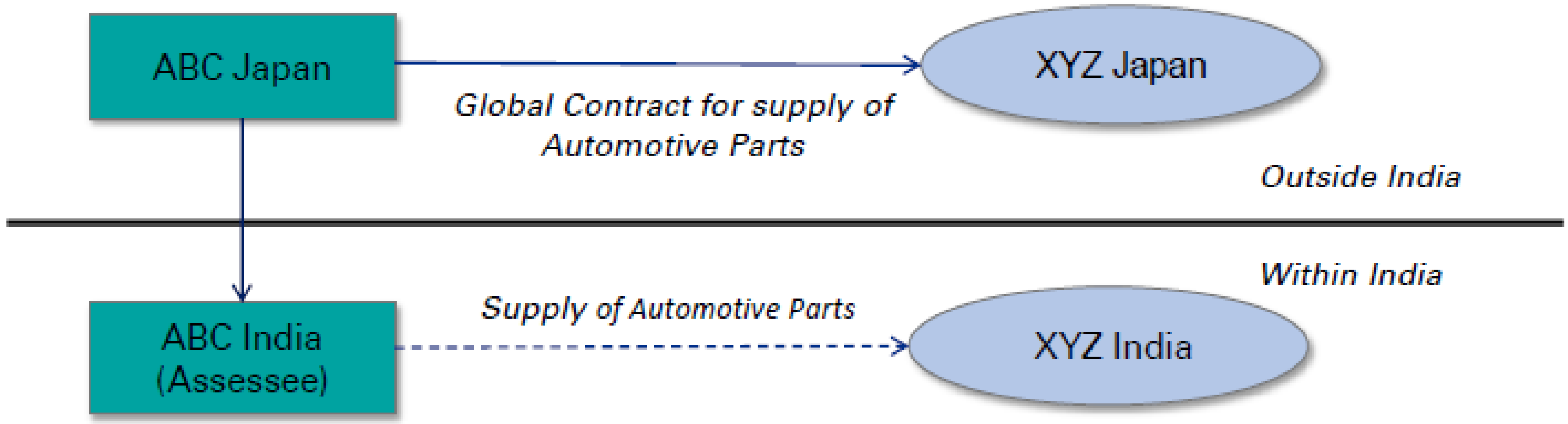
Illustration 2: Deemed International transactions

Supply of automotive parts to an unrelated party under a Global Contract



1) The transaction between ABC India and XYZ India has been entered based on the global arrangement for supply of automotive parts between their respective parent companies ABC Japan and XYZ Japan

2) In the example under consideration, XYZ India (i.e. the unrelated party) is contracting with ABC India at the behest of and based on the understanding with its own parent i.e. XYZ Japan. The price and other terms at which ABC India supplies automotive parts to XYZ India is the price which has been agreed between ABC Japan and XYZ Japan.

3) The local contract for supply of automotive parts will be considered as deemed international transaction as the terms of local contract are substantially effected by the contract entered between ABC Japan and XYZ Japan.

__NOTE__: Please note that while the above examples are in relation to procurement / sale of raw materials/ finished goods, however these provisions shall also be applicable in case of service agreements, global arrangement with banks for any financial transaction, purchase/sale of intangible asset, purchase/sale of capital asset/ tangible asset, etc. subject the conditions as prescribed under Section 92B(2) of the Act

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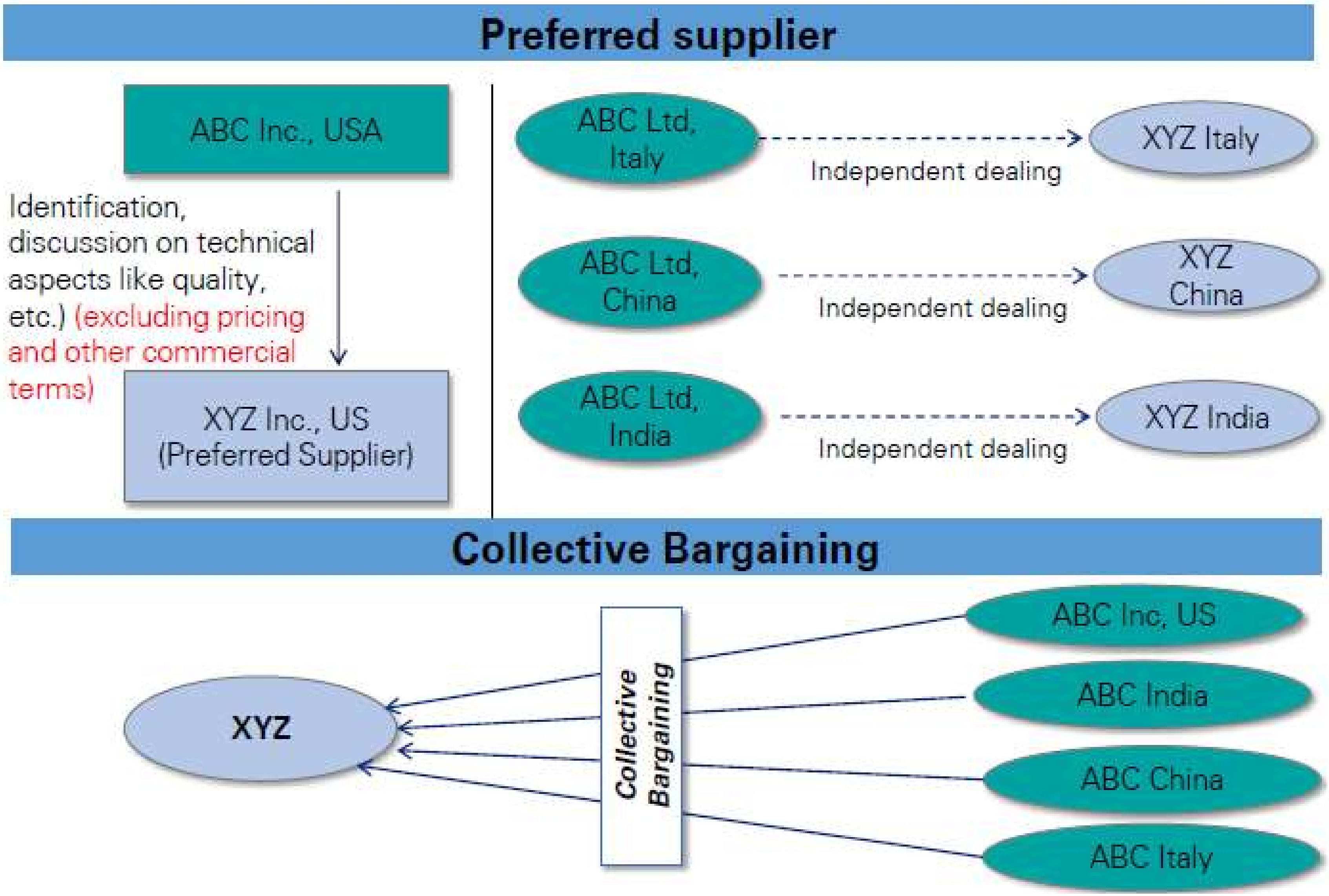
Exceptions to deemed international transactions



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Deemed International Transaction - Jurisprudence

Facts of the case- Swaranandhra Case

- IJM India ("IJMII") entered into a joint venture with Andhra Pradesh Housing Board ("AP-HB") and formed Swarnandhra IJMII Integrated Township Development Company ("Swarn")
- IJMII rendered project management services to Swarn pursuant to an agreement between IJM AE and Swarn
- **T1** -- Payment to IJMII (construction contractor)
- Swarn entered into transactions with IJMII - **TPO applied Section 92B(2); as per TPO, terms determined in substance between the Swarn and the AE**

Key Findings of ITAT

- Though Section 92B(2) is a part of section 92B it is to **be read as an extension of Section 92A(2) of the Act and not as an extension of Section 92B(1).**
- For Section 92B(2) to apply, Section 92B(1) should first be attracted- in this case Section 92B(2) cannot be applied/ attracted

Legislative intent – Identify transactions wherein **intermediary** is used to break a transaction in order to circumvent TP provisions i.e. substance over legal form

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Framework of Transfer Pricing Regulations

Arm's Length Principle :

- {A transaction in which the buyers and sellers of a product act independently and have no relationship to each other. The concept of an **arm's length** transaction is to ensure that both parties in the deal are acting in their own self interest and are not subject to any pressure or duress from the other party.}
- 'Arms length price' means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions [Section 92F(ii)]
- Arm's length price in relation to an international transaction is to be determined using the most appropriate method having regard to the nature/ class of transaction, class of associated persons or such functions as may be performed by such persons or such other relevant factors as may be prescribed

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Arm's length standard

- A controlled transaction meets the arm's-length standard if the results of the transaction are consistent with the results that would have been realized by uncontrolled taxpayers.
- Since we often can't identify identical transactions, we try to identify comparable transactions in order to compute arm's length price
- Arm's length principle
- International standard that OECD member countries have agreed for determining transfer prices

Set forth in **Article 9 of the OECD Model Tax Convention**

- *"[When] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.“*
- Treats members of group as if they were independent entities
- Provides that the taxation authorities may for the purpose of calculating tax liabilities of AEs, re-write the accounts of the enterprises if arm's length principle not followed.

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Income Accrue arrise in India

Section	Description
9(1)(i)	Income arising directly / indirectly through or from any Business Connection (BC) in India or through or from any property, asset or source of income in India or through transfer of a capital asset situated in India
9(1(v)	Interest paid by Govt. or a resident (unless for a business or income source outside India)
9(1)(vi)	Royalties paid by Govt. or a resident (unless for a business or income source outside India)
9(1)(vii)	FTS paid by Govt. or a resident (unless for a business or income source outside India)

Non -resident shall be liable to
file return of Income in the above cases. If such case
involves international transactions, non-resident is
also required to file a Form 3CEB

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Comparability Analysis and Functional Analysis i.e. Functions, Assets & Risks (FAR)

Comparability Analysis

- Application of arm's length principles for benchmarking of any controlled transaction essentially involve establishing its comparability with uncontrolled transactions or uncontrolled enterprise(s)
- Comparison of price / margin is undertaken only after establishing comparability
- Comparability is the cardinal principle under the Transfer Pricing regulations
- Transfer pricing theory meets practice in comparability analysis.[UN TP manual]

Steps for determination of arm's length price:

- ✓ Characterization of controlled and uncontrolled transitions or enterprise(s)
- ✓ Establishing comparability between the two.
- ✓ Comparison of prices or margins of the two transactions or enterprise(s) by applying the most appropriate method
- ✓ Factors to be considered for judging comparability for determination of ALP or for selection of the most appropriate method are provided in sub-rule (2) of rule 10B.
- ✓ Specific characteristics of property transferred or services provided.
- ✓ Functions performed, assets employed or risks assumed by the parties.
- ✓ Contractual terms, etc.
- ✓ Conditions prevailing in the market.

a. Characteristics of the property transferred or services provided.

- Effect of the characteristics of the property transferred or services provided on the selection of the most appropriate method.

Price based method	Strict test, level of comparability
GP based method	Broad product comparability required, some difference – likely to effect
Net profit based method	Product comparability not required

b. Functions performed, assets employed and risks assumed by the respective parties to the transaction (Functional analysis).

- Activities that are carried out by participating entity.
- Critical / significant functions only to be considered.
- Example of important functions – R&D, process engineering, manufacturing / services, marketing and distribution , warehousing sourcing / purchases.
- Examples of assets employed- Tangible or intangible assets, human capital generally not considered.
- Examples of risks assumed – function risks, product risks, collection risks, enterprise risks, credit risks, marketing risks.

c. Contractual terms of the transactions which lay down how the responsibilities, risks and benefits are to be divided between the respective parties to the transaction

- Contractual terms for greater impact on CUP method.
- In profit base method, such as TNMM, if broadly terms of the contract are similar, minor variation made for significant influence on the profit margin (e.g. captive service provider, special conditions as to minimum profit margin, etc.

d. Conditions prevailing in the market in which the respective parties to the transactions operate.

- Sub-clause (d) of Rule 10B(2) requires the respective parties to the transaction to consider the conditions prevailing in the market in which they operate, including:

  (a) Geographical location

  (b) Size of the markets and level of competition

  (c) The laws and government orders in force

  (d) Overall economic development

  (e) Level of competition

  (f) Whether markets are retail or wholesale

- **Factors to be considered while undertaking comparability analysis to include the functions performed by the tested party and the comparable entities, value addition in respect of products and services, the business model and the assets and resources employed**
- **Entities engaged in provision of low end BPO services cannot be regarded as comparable to entities providing KPO services**
- **Comparability under TNMM may be less sensitive to dissimilarities between tested party and the uncontrolled entities, however, that cannot be a consideration for diluting the standards of comparability**

FAR Analysis

- **Functional analysis identifies and compares**
  - **Economically significant activities**
  - **Assets used &**
  - **Risks assumed**
- **FAR analysis -** exercise to determine and document **significant economic activities** performed by the enterprise and its AEs in an International Transaction
- The allocation of these activities between those entities involved in the transaction so each entity can be fully **characterised**
- **Price charged** in any transaction reflects the functions performed (taking into account the risks assumed and assets used)
- FAR analysis essential to determine **comparability**
- FAR analysis is an exercise to identify **significant economic activities** performed by the taxpayer and the associated enterprise with the objective of characterizing the entities involved in an transaction
- FAR analysis involves an analysis of economically significant functions performed, assets employed and risks assumed by the transacting entities
- Rule 10B(2) of the Rules provides that comparability of an international transaction with an uncontrolled transaction shall be judged with reference to the functions performed, assets employed and risks assumed by the transacting entities

FAR Analysis – Components

– Functions performed

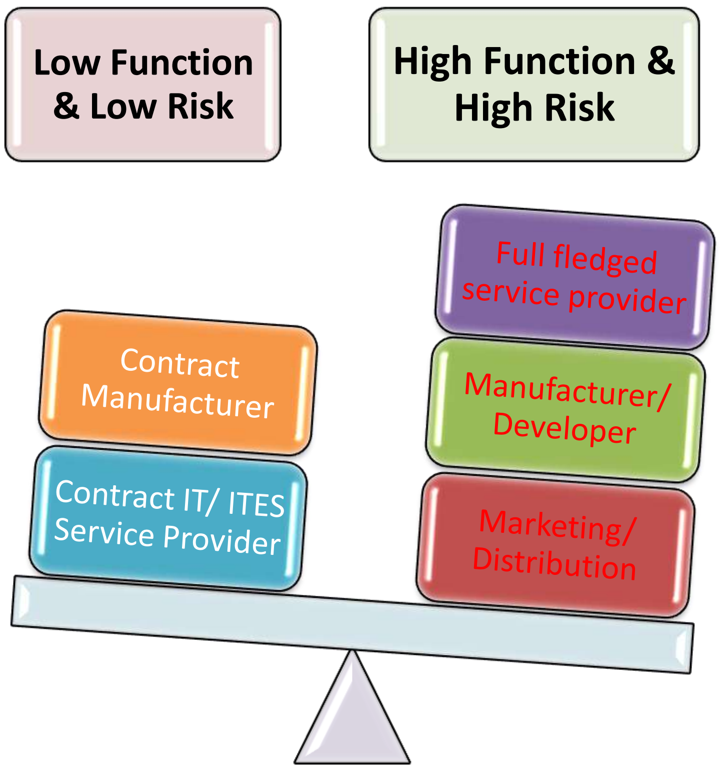
- Activities carried out by each of the parties to the transaction
- Focus should be on identification of critical functions which add value to the international transactions
- Principal functions performed by the entities in a controlled transaction are compared with the functions performed in uncontrolled transactions

Assets employed

- The type of assets and their nature needs to be understood
- Help in determination of their contribution to the business process / economic activity
- Facilitates understanding of respective roles played by the entities participating in the international transaction
- Knowledge of assets owned and employed by the entities facilitates determination of the profit margin to be earned by them

– Risks Undertaken

- Probable variability of future outcomes or returns
- As the risk increases, the expected return should increase as well
- Potential risks are company and industry specific
- Only important risks should be described and quantified
- Important to distinguish between which entity bears risks as per legal terms and which one bears as per the economic substance of the transaction



Importance

- Comprehensive FAR leads to in-depth understanding of the business and related commercial considerations
- Allows correct characterization of the business
- Helps setting up of an appropriate pricing model for inter company transactions
- Robust FAR analysis - foundation of a sound economic analysis

Economic Analysis

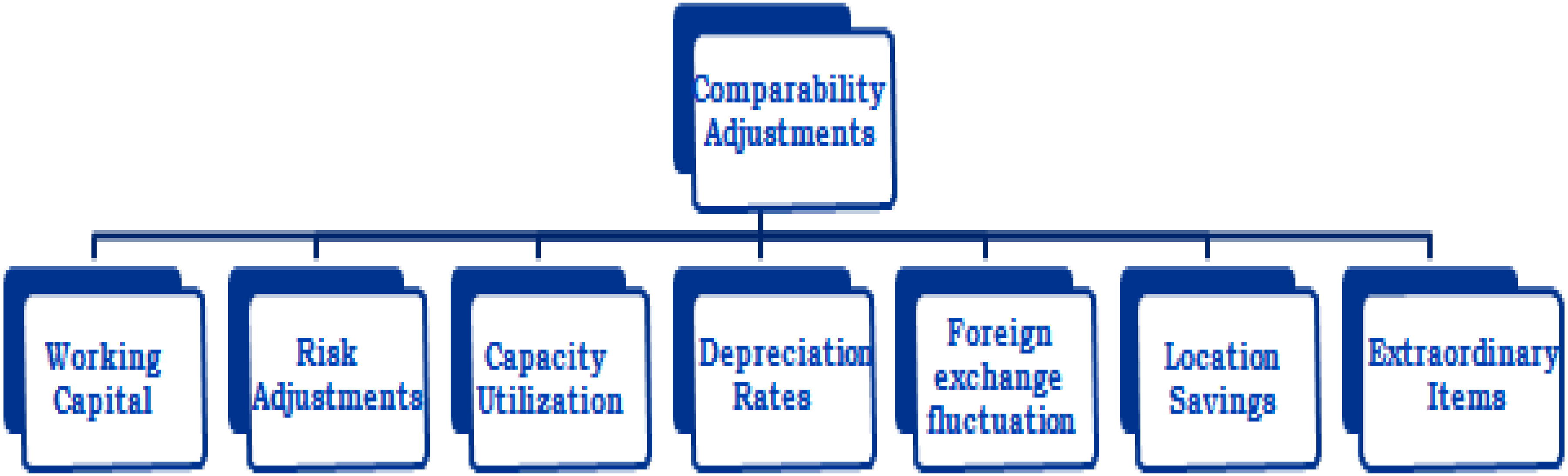
- Economic analysis refers to selection and application of the most appropriate method to establish arm's length price in relation to transactions undertaken between associated enterprises
- Proper characterization of the transacting entities on the basis of in-depth functional analysis is the foundation of economic analysis
- Economic analysis involves (i) selection of tested parties, (ii) selection of most appropriate methods, (iii) Application of most appropriate method and (iv) identifying and making appropriate comparability adjustments

Selection of Tested Party

- Participant in an international transaction with whose reference the international transaction is tested
- The tested party is the one:
  - to which a transfer pricing method can be applied in the most reliable manner; and
  - for which the most reliable comparables can be found, i.e. entity with less complex functional profile.
- Tested party is therefore the **least complex** of the transacting entities [UN TP guidelines]
- The term 'tested party' has not been defined in the Indian transfer pricing regulations.
- The Indian transfer pricing regulations does not prohibit the use of foreign associated enterprise as the tested party

Comparability adjustments

- Types of adjustments



Working capital adjustment

Working Capital Adjustment

Economic Rationale

Money has a time value..a rupee received/ paid today, worth more than a rupee received/ paid a year from now

Transfer Pricing Perspective

- An **attempt** to **adjust** for the **differences** in time value of money (tested party vis-à-vis comparables),
- To **enhance and increase the reliability** of the comparables vis- à-vis comparables

Computation

Working Capital = Accounts receivable + Inventory – Accounts payable

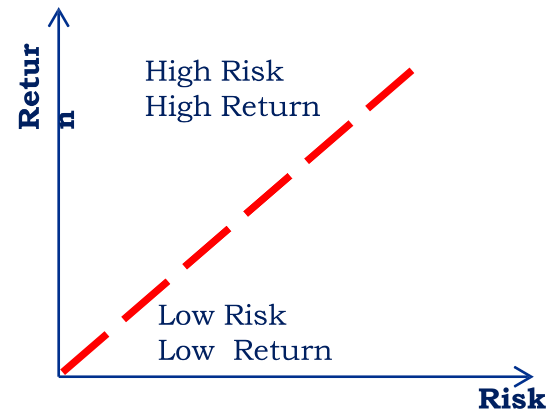
What to adjust while performing working capital adjustment

Working Capital Adjustment aims to **enhance and increase comparability** by making adjustments for differences in time value of money. The adjustments are made for:

- **Accounts receivable differences**
- **Accounts payable differences**
- **Inventory level difference**

Risk adjustment

In the open market in theory, increased risk normally is compensated by an increase in the expected return.



Why Risk Adjustment?

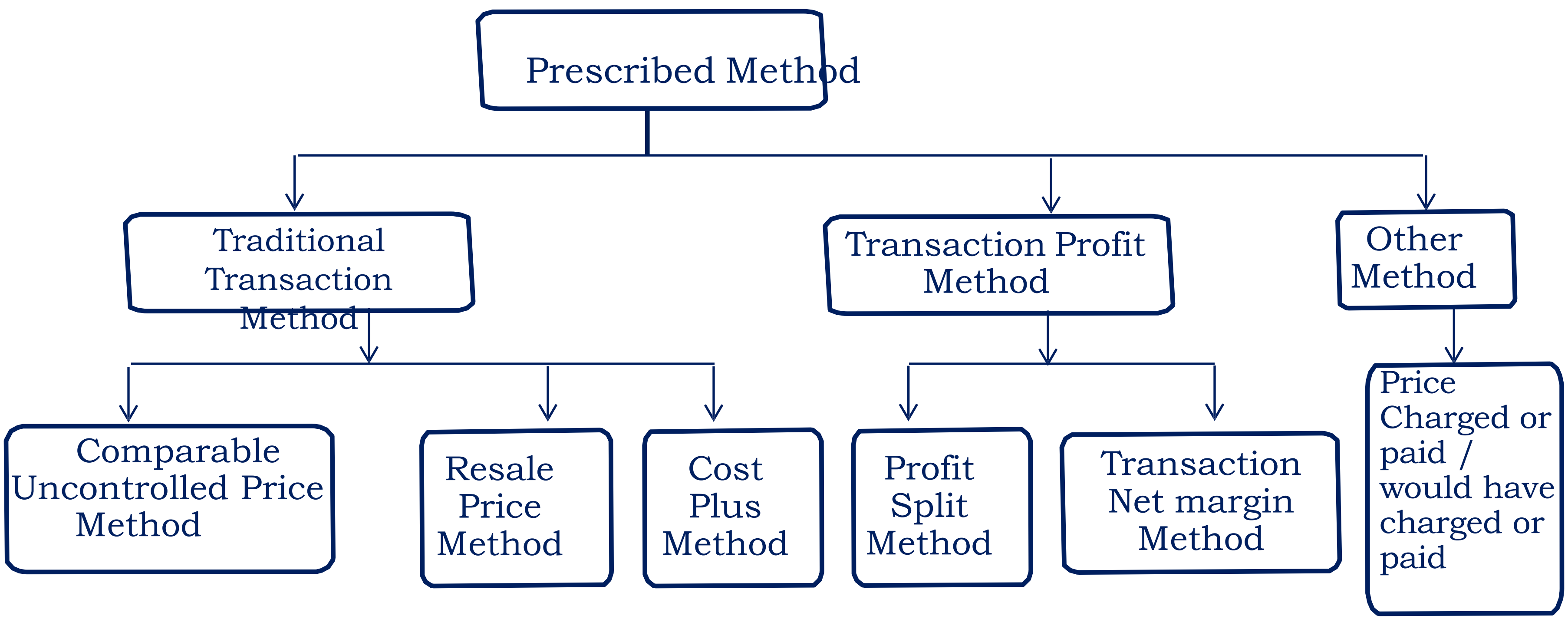
- **For greater comparability between controlled and uncontrolled transactions**
- **To account for differences in the risk profiles of the comparables and the tested party**

Risks

- Financial Risk
- Business Risk
- Liquidity Risk
- Country Risk

Methods prescribed under Indian TP Regulations

- Section 92C(1) prescribes six methods to compute arm's length price ('ALP') in relation to international transaction or specified domestic transaction
  - Most Appropriate Method ('MAM') to be selected
  - No hierarchy prescribed

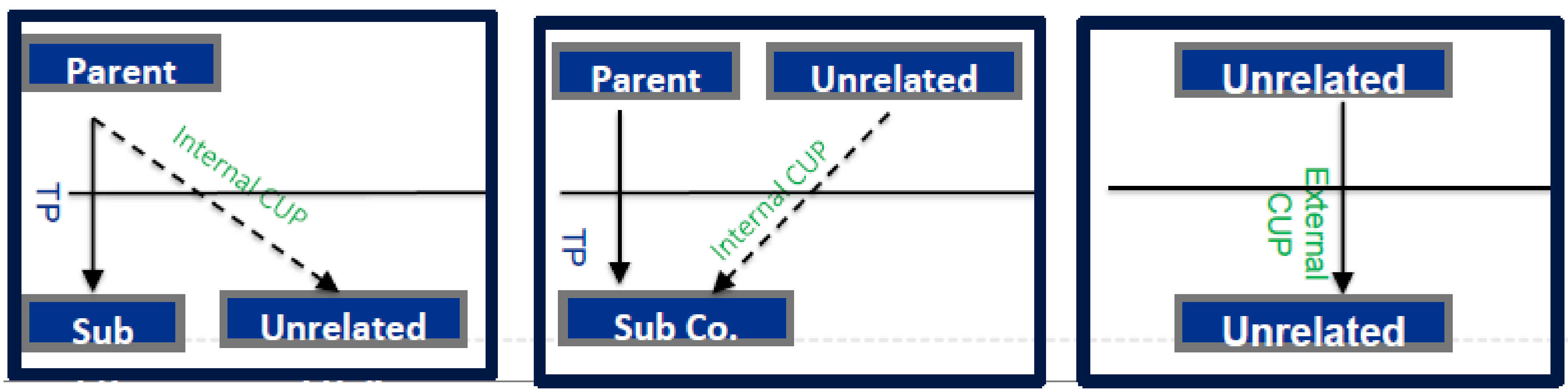


Most appropriate method

Method	Comparability considerations
CUP	Most direct, but requires stringent reliability standards. Strict comparability, similarity of products, minor difference may effect price.
RPM	Operates in the manner similar to TNMM, internal benchmark may not be available, reliable GP data may not be available. Emphasis on functional comparability and less stringent product comparability
CPM	Operates in the manner similar to TNMM, internal benchmark may not be available, reliable GP data may not be available. Emphasis on functional comparability and less stringent product comparability
TNMM	In practice often used as a method of last resort. Broad Functional Comparability (less rigorous than RPM, CPM) product comparability desirable but not necessary.
PSM	Rigorous method but seldom used in practice. External comparables for corroborating the split. Comparability criteria similar to TNMM
Any other method as provided in Rule 10AB	Computation of ALP on the basis of price charged or chargeable from a non-associated enterprise under same or similar uncontrolled transaction

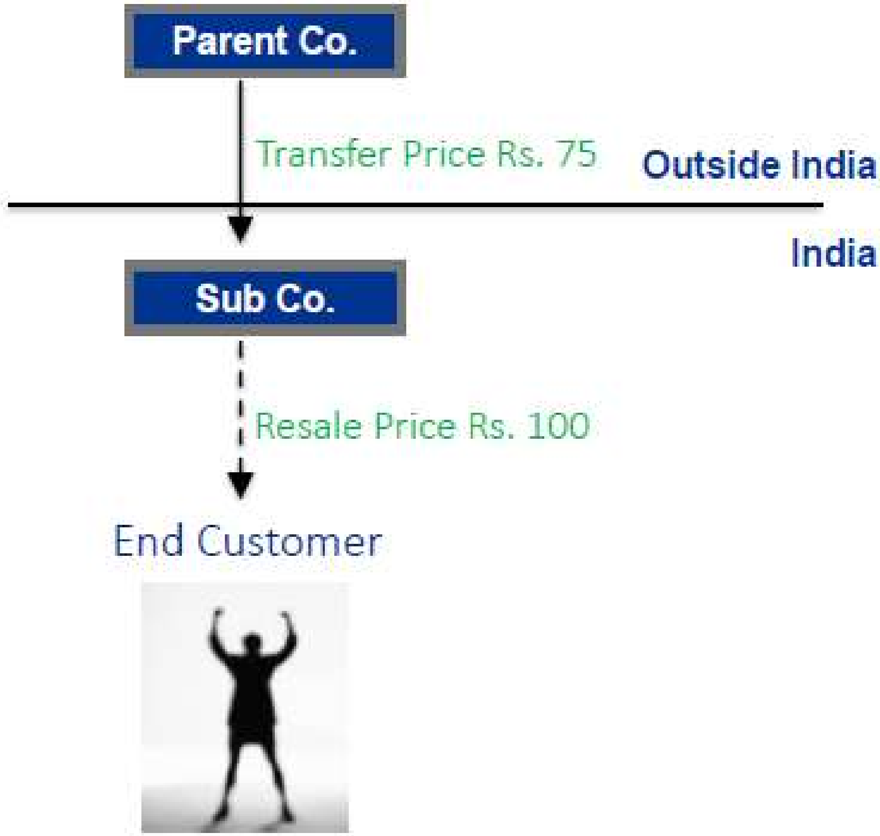
Comparable Uncontrolled Price Method

- Most Direct Method
- Prices are benchmarked without any reference to the profits
- Requires strict comparability in products, contractual terms, economic terms, etc.
  - Volume/ quantity of product
  - Credit terms
  - Geographic market
  - Other terms of contract
- Two types of CUPs available - Internal CUP & External CUP
- Typically Internal CUP is preferred over External CUP due to higher degree of comparability



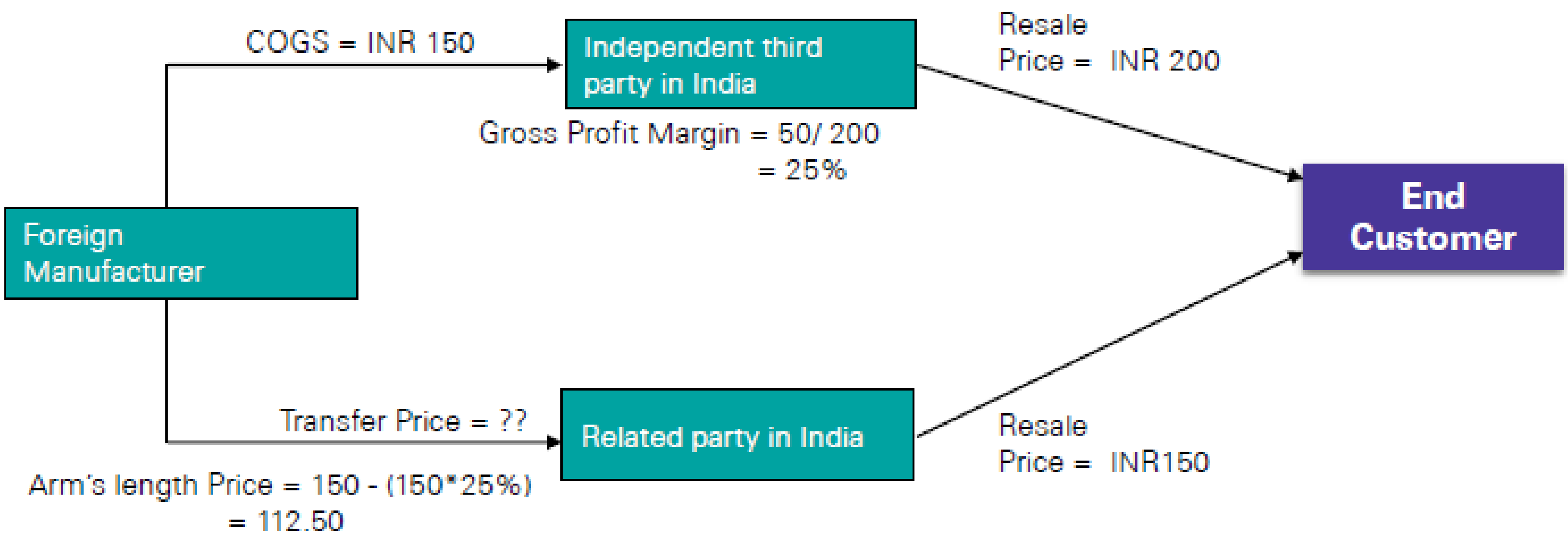
Resale Price Method

- Compares resale **Gross Margin**
- Preferred method for a distributor - buying purely finished goods from a group company
- Comparability is relatively less dependent on strict product comparability and additional emphasis is on similarity of functions performed & risks assumed
- Used when reseller does not add substantial value to the goods and does not apply intangible assets to add value
- Difficult to apply where goods are further processed before resale



Price paid by Sub Co. to AE is at arm's length if the 25% resale margin earned by Sub Co. is more than margins earned by similar Indian distributors

Application of RPM

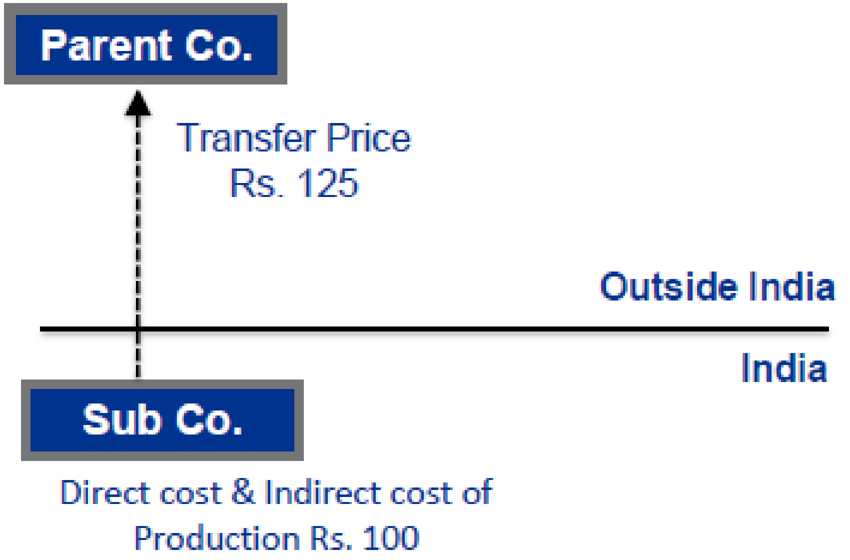


- Sale to independent third party at INR 150 and sale to end customer by third party at INR 200
- Sale to end customer by related party at INR 150

Particulars	Amount (INR)
Gross Profit	50 i.e. (200-150)
Gross Margin	25% i.e. (50/200)
Arm's Length Purchase Cost	112.50 i.e. [150 – (25% 0f 150)]

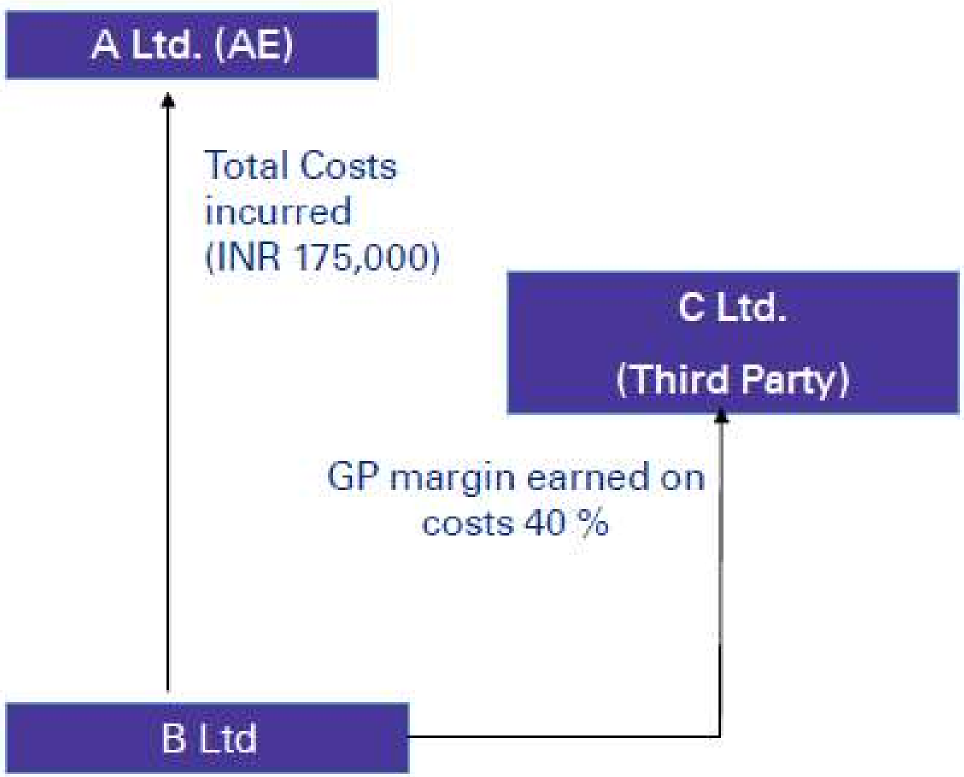
Cost Plus Method

- Compares and identifies mark-up earned on direct and indirect costs of production incurred with that of comparable independent companies
- Preferred method in case-
  - Semi-finished goods sold between related parties
  - Contract manufacturing agreement
- To be applied in cases involving manufacture, assembly or production of tangible products or services that are sold/ provided to AEs
- Comparability under this method is relatively not as much dependent on close physical similarity between the products.
- Larger emphasis on functional comparability



Price charged by Sub Co. to AE is at arm's length if the 25% mark-up on cost is more than that of similar Indian assemblers

Application of CPM



B Ltd. – Provision of services to A Ltd. and C Ltd.

ALP computation for provision of services from B Ltd. to A Ltd.	
Direct and Indirect Costs for services to A Ltd.	175,000
GP mark-up in comparable uncontrolled transaction with C Ltd. – i.e. arm's length mark-up	40 %
ALP for services to A Ltd.	245,000

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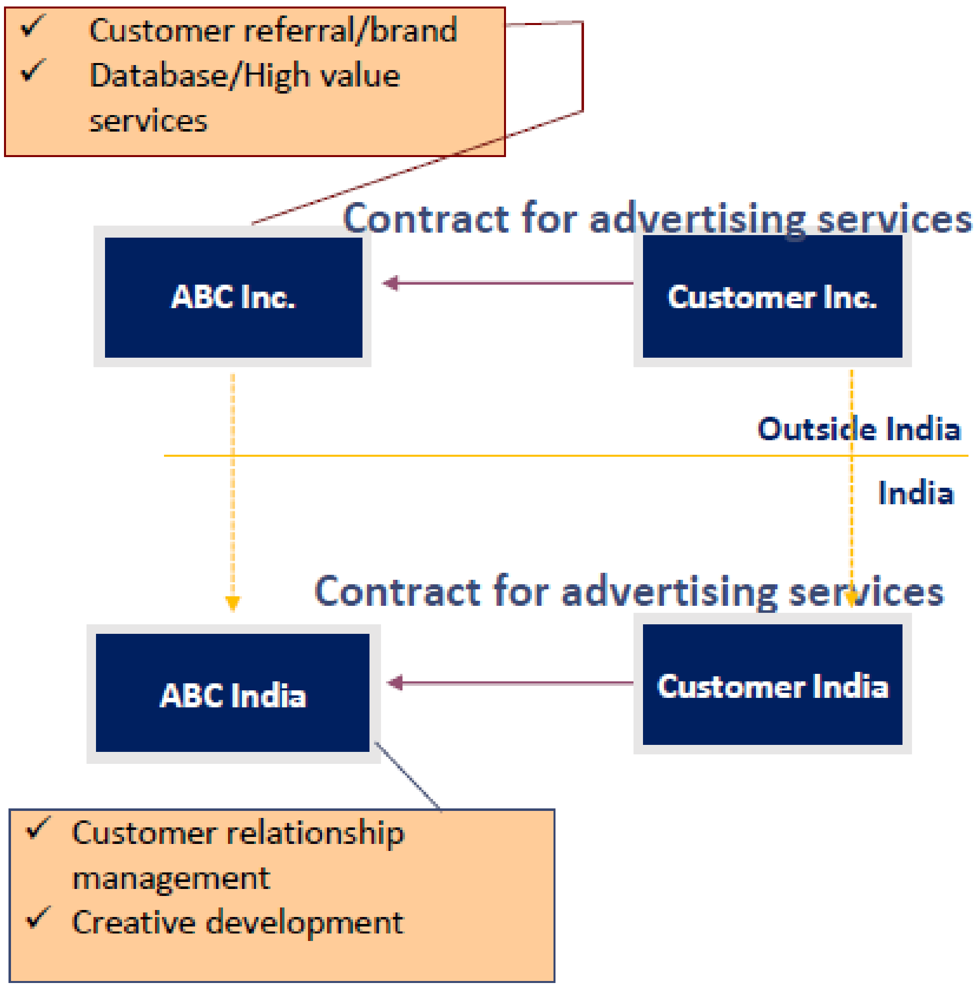
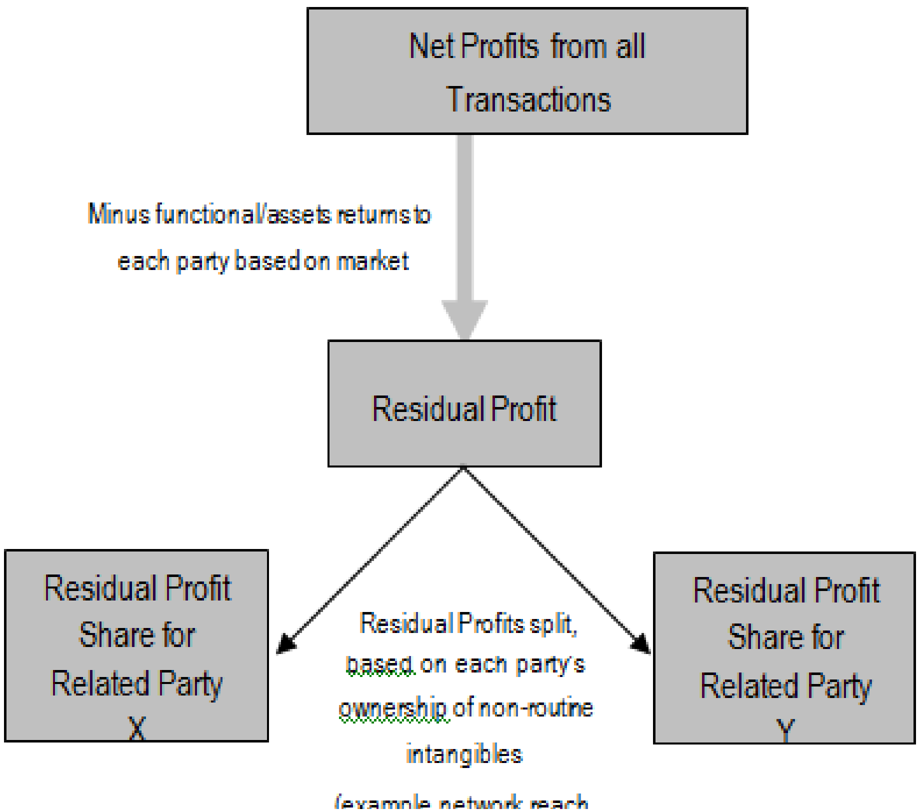
Profit Split Method

- To be applied in cases involving-
  - transfer of unique intangibles; or
  - in multiple international transactions that cannot be evaluated separately
- Calculates the combined operating profit resulting from an inter-company transaction based on the relative value of each AEs contribution to the operating profit
- Evaluates allocation of combined profit/loss in controlled integrated transactions
- The contribution made by each party is based upon a functional analysis and valued, if possible, using external comparable data

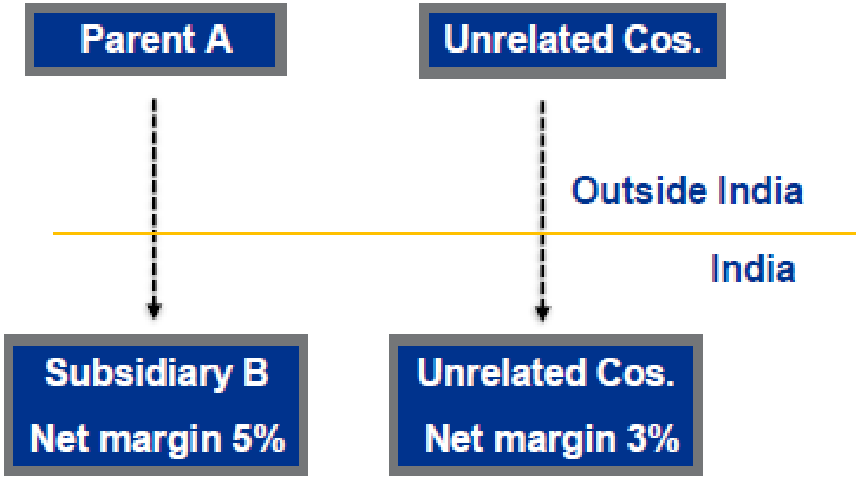


- PSM generally applies to transactions related to intangible and is more relevant in the telecommunication industry, pharmaceuticals, courier or similar industry where intangible plays a vital role and are employed by both the transacting parties.
- The following chart explains the PSM:



Transactional Net Margin Method 1/2

- Most frequently used method, due to lack of availability of data for application of other methods
- Examines net operating profit from transactions as a percentage of a certain base (can use different bases i.e. costs, turnover, etc)
- Both internal TNMM and external TNMM are possible
- Broad level of product comparability and high level of functional comparability
- Applicable for most categories of transaction and often used to supplement analysis under other methods



Transactional Net Margin Method 2/2

- Grouping of transaction - Relevant controlled transactions require to be aggregated to test whether the controlled transaction earn a reasonable margin as compared to uncontrolled transaction
- **Selection of tested party - Least complex entity**
- Selection of Profit Level Indicator such as Operating Margin, Return on Value added expenses, Return on assets – Unaffected by transfer price
- Benchmarking exercise (**on Databases**)
  - Entity with similar industry classification to the tested party – through search in Prowess and Capitaline plus databases
  - Screen entities by applying appropriate quantitative filters, such as mfg sales <75%, R&D exp >5%, Advertisement exp >5%.
  - Review financial and textual information available in the public database of the selected entities – for qualitative filters
  - Computation of ALP

Usually regarded as an indirect and one-sided method, but is most widely adopted

Other Method

- CBDT has notified the "Other method" vide a Notification

- Applicable from FY 2011-12

Rule 10AB - ***"any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts."***

- Effectively this implies that "quotations" rather than "actual prices" charged or paid can also be used

- Could also cover new instances of ALP computation which would now arise due to the various amendments introduced in the Finance Act 2012 – Expansion of definition of "international transaction" and introduction of domestic transfer pricing

- To maintain proper documentation specifying the rejection reasons for non-application of other five methods and appropriateness of the "other method"

Summary of Methods

Profit & Loss Account– *used as a base*

Particulars	Amount (In INR)
Manufacturing Income	xxx
Trading Income	xxx
Total Income	**xxx**
Purchase of raw material	xxx
Purchase of finished goods	xxx
Change in Stock	xxx
Personnel Cost	xxx
Selling & Distribution Expenses	xxx
Administrative Expenses	xxx
Finance Cost	xxx
Depreciation	xxx
Total Expenses	**xxx**
Profits	xxx
Taxes	xxx

Comparable Uncontrolled Price Method

Gross Profit

Resale Price Method

Cost Plus Method

Net Profit

TNM Method

Profit Split Method

Choice of PLIs

Method	PLI	Formula	Typically used for
RPM	Gross margin	Gross Profit/Sales	Distributor
Cost Plus	Gross cost plus margin	Gross Profit/DICOP (Direct & Indirect Cost of Production)	Manufacturer
TNMM	Return on total costs	Operating Profit/Total Costs	Manufacturer/ Service provider
TNMM	Operating margin	Operating Profit/Net sales or net turnover	Manufacturer/ Distributor
TNMM	ROA	Operating Profit/Operating Assets	Manufacturer
TNMM	ROCE	Operating Profit/ Capital Employed	Manufacturer

- **BERRY RATIO:**
  - The Berry ratio is the ratio of gross profit to operating expenses (“GP/OE”)
  - It is named after American economist Charles Berry, who first applied it in the transfer pricing court case E.I. du Point de Nemours&Co .V. The du Pont case involved a distributor which also performed related marketing services
  - When evaluating the performance of the distribution business, Professor Berry compared the ratio of GP/OE to third party comparable companies ratio of GP/OE
  - Berry ratio helped evaluate return on the purely value adding distribution activities based on the assumption that cost of distribution activities was fully captured in operating expenses
  - As per OECD approach, berry ratio can be particularly useful in situations in which the entity engaged in the business as a trade intermediary, the value of services performed by the entity is adequately reflected by operating expenses, the value of functions performed and assets employed in the controlled transactions is not proportionate to sales and when the entity does not perform any significant operations such as manufacturing or processing
  - Typically, a low risk high volume trading business involving back to back trading without any value addition to the goods traded and does not own or use any intangible assets

- 35/65 percentile Concept- Illustration-1

Sl. No.	Name	Year 1	Year 2	Year [Current Year]	Aggregation of OC and OP	Weighted Average
1	2	3	4	5	6	7
1	A	OC=100 OP = [illegible]	OC = 150 OP = [illegible]	OC = 225 OP = 35	Total OC = 475 Total OP = 57	OP/OC = 12%
2	B	OC = 80 OP = 10	OC= 125 OP = 5	OC = 100 OP = 10	Total OC = 305 Total OP = 25	OP/OC = 8.20%
3	C	OC 250 OP = 22	OC = 230 OP = 26	OC = 250 OP = 18	Total OC = 730 Total OP = 66	OP/OC = 9%
4	D	OC 180 OP = (-)9	OC = 220 OP = 22	OC = 150 OP = 20	Total OC = 550 Total OP = 33	OP/OC = 6%
5	E	OC 140 OP = 21	OC = 100 OP = (-)8	OC = 125 OP = (-) 5	Total OC = 365 Total OP = 8	OP/OC = 2.20%
6	F	OC 160 OP = 21	OC = 120 OP = 14	OC = 140 OP = 15	Total OC = 420 Total OP = 50	OP/OC = 11.90%
7	G	OC 150 OP = 21	OC = 130 OP = 12	OC = 155 OP = 13	Total OC = 435 Total OP = 46	OP/OC = 10.57%

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

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

- For construction of the arm's length range the data place of thirty-fifth and sixty-fifth percentile shall be computed in the following manner, namely:
- Total no. of data points in dataset * (35/100)
- Total no. of data points in dataset * (65/100)
- Thus, the data place of the thirty-fifth percentile = 7*0.35 = 2.45.
- Since this is not a whole number, the next higher data place, i.e; the value at the third place would have at least thirty five percent. of the values below it. The thirty-fifth percentile is therefore value at the third place, i.e, 8.2%.
- The data place of the sixth-fifth percentile is = 7*0.65 = 4.55.

- Since this is not a whole number, the next higher data place, i.e; the value at the fifth place would have at least sixty five percent. of the values below it. The sixty-fifth percentile is therefore value at fifth place, i.e, 10.57%.
- The arm's length range will be beginning at 8.2% and ending at 10.57%.
- Therefore, if the transaction price of the international transaction or the specified domestic transaction has OP/OC percentage which is equal to or more than 8.2% and less than or equal to 10.57%, it is within the range. The transaction price in such cases will be deemed to be the arm's length price and no adjustment shall be required.However, if the transaction price is outside the arm's length range, say 6.2%, then for the purpose of determining the arm's length price the median of the dataset shall be first determined in the following manner:
- The data place of median is calculated by first computing the total number of data point in the data set * (50/100). In this case it is 7 * 0.5 = 3.5.
- Since this is not a whole number, the next higher data place, i.e; the value at the fourth place would have at least fifty percent. of the values below it (median).
- The median is the value at fourth place, i.e., 9%. Therefore, the arm's length price shall be considered as 9% and adjustment shall accordingly be made.

Illustration 2.- The data of the current year is available in respect of enterprises A , C, E, F and G at the time of furnishing the return of income by the assessee and the data of the financial year preceding the current year has been used to identify comparable uncontrolled transactions undertaken by enterprises B and D. Further, if the enterprises have also undertaken comparable uncontrolled transactions in earlier years as detailed in the table, the weighted average and dataset shall be computed as below:

Sl. No.	Name	Year 1	Year 2	Year [Current Year]	Aggregation of OC and OP	Weighted Average
1	2	3	4	5	6	7
1	A	OC = 100 OP = 12	OC = 150 OP = 10	OC = 225 OP = 35	Total OC = 475 Total OP = 57	OP/OC **12%**
2	B	OC = 80 OP = 10	OC = 125 OP = 5		Total OC = 205 Total OP = 15	OP/OC **7.31%**
3	C	OC = 250 OP = 22	OC = 230 OP = 26	OC = 250 OP = 18	Total OC = 730 Total OP = 66	OP/OC **9%**
4	D		OC = 220 OP = 22		Total OC = 220 Total OP = 22	OP/OC = **10%**
5	E			OC = 100 OP = (-) 5	Total OC = 100 Total OP = (-)5	OP/OC (-)5%
6	F	OC = 160 OP = 21	OC = 120 OP = 14	OC = 140 OP = 15	Total OC = 420 Total OP = 50	OP/OC **11.90%**
7	G	OC = 150 OP = 21	OC = 130 OP = 12	OC = 155 OP = 13	Total OC = 435 Total OP = 46	OP/OC **10.57%**

Illustration 2.- The data of the current year is available in respect of enterprises A , C, E, F and G at the time of furnishing the return of income by the assessee and the data of the financial year preceding the current year has been used to identify comparable uncontrolled transactions undertaken by enterprises B and D. Further, if the enterprises have also undertaken comparable uncontrolled transactions in earlier years as detailed in the table, the weighted average and dataset shall be computed as below:

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

S.I. No.	1	2	3	4	5	6	7
Values	(-)5%	7.31%	9%	10%	10.57%	11.9%	12%

If during the course of assessment proceedings, the data of the current year is available and the use of such data indicates that B has failed to pass any qualitative or quantitative filter or for any other reason the transaction undertaken is not a comparable uncontrolled transaction, then, B shall not be considered for inclusion in the dataset. Further, if the data available at this stage indicates a new comparable uncontrolled transaction undertaken by enterprise H, then, it shall be included. Recomputed as under:

Sl. No.	Name	Year 1	Year 2	Year 3 [Current Year]	Aggrega of OC an	Weighted Average
1	2	3	4	5	6	7
1	A	OC = 100 OP = 12	OC = 150 OP = 10	OC = 225 OP = 35	Total OC Total OP	OP/OC = 12%
2	C	OC = 250 OP = 22	OC = 230 OP = 26	OC = 250 OP = 18	Total OC Total OP	OP/OC = 9%
3	D		OC = 220 OP = 22	OC = 150 OP = 20	Total OC Total OP	OP/OC = 11.35%
4	E			OC = 100 OP = (-)	Total OC Total OP	OP/OC = (-)5%
5	F	OC = 160 OP = 21	OC = 120 OP = 14	OC = 140 OP = 15	Total OC Total OP	OP/OC = 11.90%
6	G	OC = 150 OP = 21	OC = 130 OP = 12	OC = 155 OP = 13	Total OC Total OP	OP/OC = 10.57%
7	H	OC = 150 OP = 12		OC = 80 OP = 10	Total OC Total OP	OP/OC = 9.56%

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

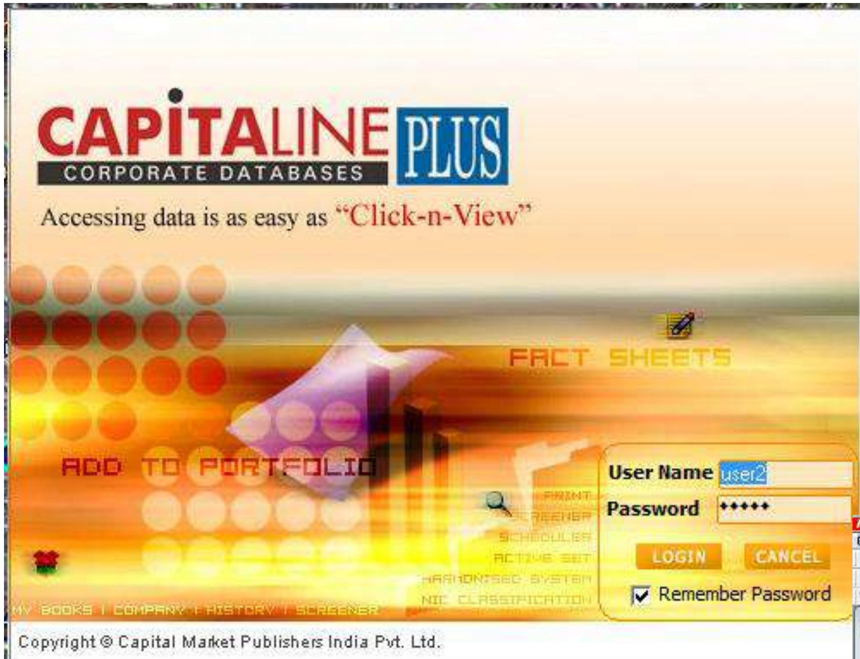
S.I. No.	1	2	3	4	5	6	7
Values	(-)5%	9%	9.56%	10.57%	11.35%	11.9%	12%

Illustration 3.- In a given case the dataset of 20 prices arranged in ascending order is as under:

Sl. No.	Profits (in Rs. Thousands)
1	42
2	43
3	44
4	44.5
5	45
6	45.25
7	47
8	48
9	48.15
10	48.35
11	48.45
12	48.48
13	48.5
14	49
15	49.1
16	49.35
17	49.5
18	49.75
19	50
20	50.15

- Applying the formula given in the Illustration 1, the data place of the thirty-fifth and sixty-fifth percentile is determined as follows:
- Thirty-fifth percentile place = 20* (35/100) = 7. Sixty-fifth percentile place =20* (65 /100) = 13.
- 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 =Rs. 47,500
-
- Similarly, the sixty-fifth percentile will be average of thirteenth and fourteenth place prices. This is (48.5+49) / 2 = 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 =Rs. 48,400
- Thus, the arm's length range in this case shall be from Rs. 47,500 to Rs. 48,750.
- Consequently, any transaction price which is equal to or more than Rs 47,500 but less than or equal to Rs 48,750 shall be considered to be within the arm's length range.".

- DATA BASE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Form 3CEB certificate: Accountant to Certify

"FORM NO. 3CEB

[*See* rule 10E]

Report from an accountant to be furnished under section 92E relating to international transaction(s) and specified domestic transaction(s)

1. *I/We have examined the accounts and records of ____ (name and address of the assessee with PAN) relating to the international transaction (s) and the specified domestic transaction(s) entered into by the assessee during the previous year ending on 31st March, ________.

2. In*my/our opinion proper information and documents as are prescribed have been kept by the assessee in respect of the international transaction(s) and the specified domestic transactions entered into so far as appears from *my/our examination of the records of the assessee.

3. The particulars required to be furnished under section 92E are given in the Annexure to this Form. In*my/our opinion and to the best of my/our information and according to the explanations given to *me/us, the particulars given in the Annexure are true and correct.

:

**Signed
Name
Address :
Membership No. :

Place : ____________
Date : ___________

Framework

Identify transactions

- Identify inter company Transactions/ arrangements that would be covered within the ambit of International/ Domestic TP provisions
- Map the transactions and document the current policy of pricing/allocation

Understand implications

- Review the agreements/documents in support of the current inter company pricing/allocations
- Analyze whether the current pricing policy of the group are in line with the arm's length principle
- Technical assessment of the arrangements to evaluate applicability of TP provisions and possible approach for establishing ALP for the arrangements where TP applies

Compliance requirements

- Maintain prescribed TP documentation as stipulated under Rule 10D of the Rules within the prescribed due date
- File Form 3CEB online

Impact assessment

- Undertake Functional analysis of the identified transactions
- Undertake a benchmarking analysis

Penalties

Section 271 BA: Penalty to failure to furnish Accountant's report in Form 3CEB under Section 92E of the Income-tax Act, 1961 ('the Act')

- INR 100,000.

Section 271 AA: Penalty for failure to keep and maintain information and document prescribed under Section 92D of the Act, failure to report a transaction, or maintaining or furnishing incorrect information / document.

- 2% of the value of international transactions or SDT

Section 271 G: Penalty for failure to furnish document prescribed under Section 92D of the Act.

- 2% of the value of international transactions or SDT, if such transaction had the effect of directly or indirectly transferring the right of management or control in relation to the Indian concern

Section 271 J: Penalty on professionals for furnishing incorrect information in statutory report or certificate

- INR 10,000 for furnishing of any incorrect information in any report furnished by registered valuer or merchant banker.

CA. ASHWANI RASTOGI

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9990999281

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