



# Transfer Pricing

## Overview

# Agenda

- Concept of Transfer Pricing – Domestic and International
- Associated enterprise
- International transaction
- Arm's length price
- Transfer pricing methods
- TP documentation
- Planning and structuring to manage issues
- Case Laws & Recent Trends





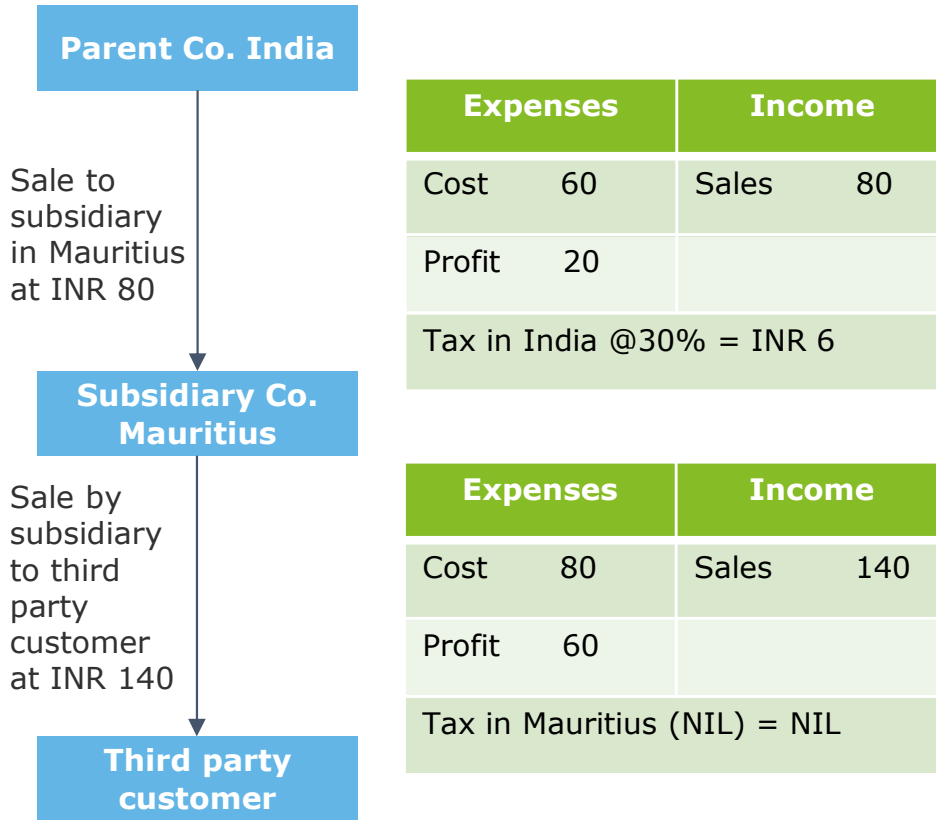
# **Concept of Transfer Pricing**

# The Concept of Transfer Pricing

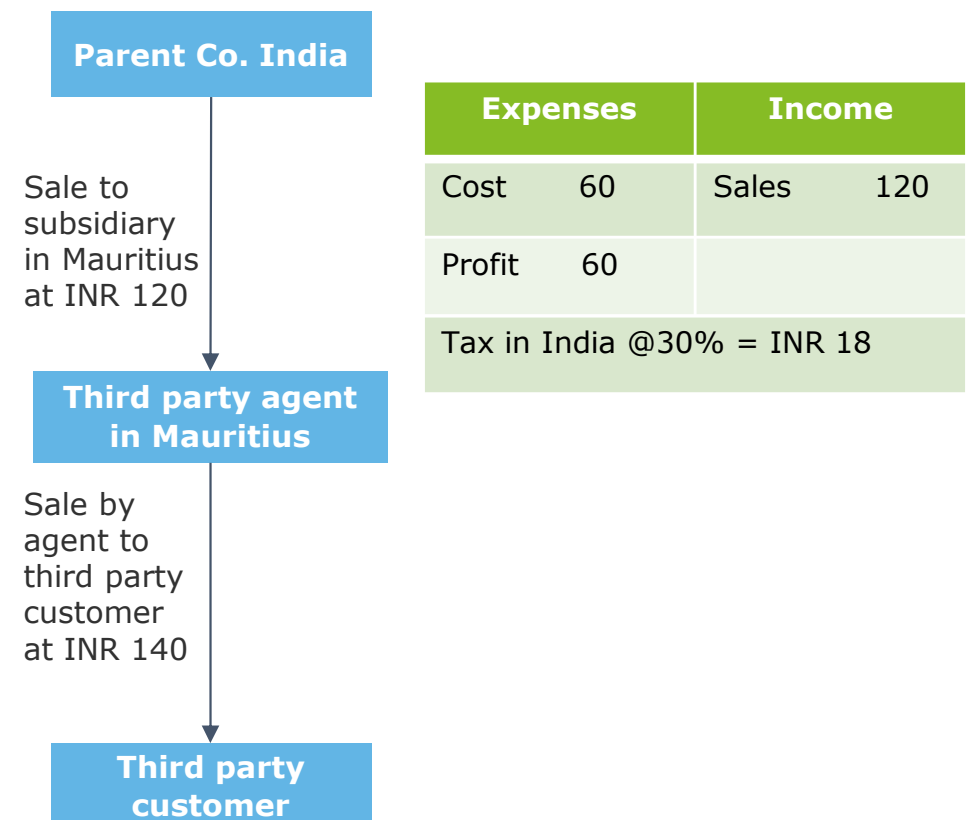
- Transfer price means the value or price at which transactions take place amongst related parties.
- Why is transfer pricing important?
  - Rise in large number of MNCs
  - Increase in number of cross border transactions
  - Existence of different tax rates & rules in different jurisdictions
  - Transactions between group companies – not determined by market forces of demand and supply
- Transfer Pricing is significant because they can be used by MNCs to their advantage to minimize tax incidence

# Why transfer pricing?

## Situation 1 – Possibility of manipulation of profits



## Situation 2 – Prices driven by market forces

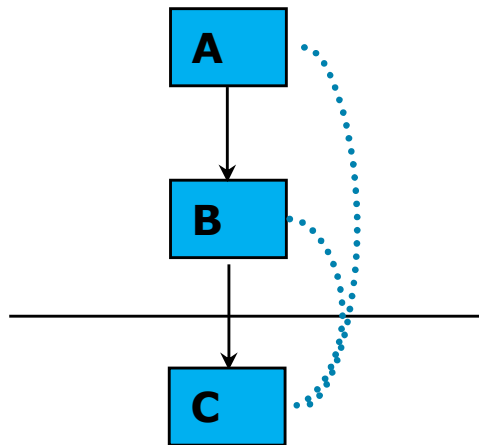


**Transfer pricing is essential to reduce shifting in profits which result in unfair tax distribution among nations**

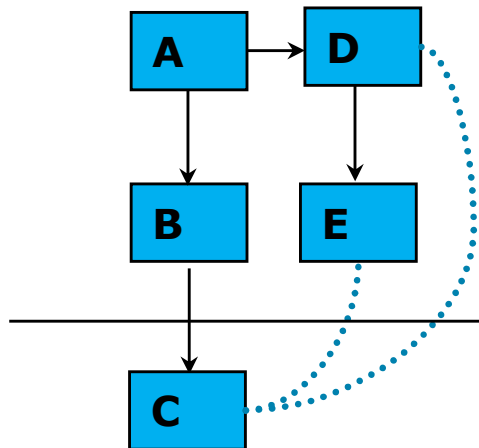


**Associated enterprise**

# Meaning of Associated enterprises ('AE') (Sec 92A)



Both A and B are AEs of C



D and E are also AEs of C since they have a common ultimate parent (A)

Section 92A(1):

- Direct or indirect participation (through one or more intermediaries) in management, control or capital
- As per ICAI guidance notes:
  - Capital: Refers to the amount invested in an enterprise by its owners
  - Management/Control: Individual along with his relative has power to control to make crucial decisions regarding the enterprise i.e., a proactive and not reactive power
- If any condition is satisfied then it will be associated enterprise for the whole year.

# Associated Enterprises – Sec 92A of the Act – Secondary Association

## **Enterprises deemed to be AEs [Section 92A(2)]:**

- one has direct or indirect share holding carrying not less than 26% voting power in the other
- common parent / person holds 26% of voting power in both enterprises
- one advances loan constituting not less than 51% of book value of total assets of the other enterprise
- one provides guarantees of not less than 10% of total borrowings of the other enterprise
- Appoints more than half of board of directors of one enterprise or one or more executive directors are appointed by the other enterprise
- Appoints more than half of the board of directors of both enterprises are appointed by the same person or persons
- one enterprise is wholly dependent on use of IPRs of the other enterprise for manufacturing
- At least 90% of raw materials and consumables required by a enterprise are supplied by the other enterprise, or by persons specified by the other enterprise, and prices and conditions relating to supply are influenced by such other enterprise



# Associated Enterprises – Sec 92A of the Act – Secondary Association

## **Enterprises deemed to be AEs [Section 92A(2)]:**

- Goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and prices and conditions relating thereto are influenced by such other enterprise
- Both enterprises controlled by same the same individual singly or jointly with relatives
- One enterprise controlled by HUF and other controlled by member of HUF or his relative or jointly
- One enterprise being a firm, association of persons or body of individuals, the other enterprise holds not less than 10% interest therein
- There exists between the two enterprises, any relationship of mutual interest, as may be prescribed



# **International transaction**

# Meaning of International Transactions (Sec 92B)

## **MEANING OF INTERNATIONAL TRANSACTION [AS PER 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, and
- shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

## **DEFINITION OF "TRANSACTION" [UNDER SECTION 92f(v)]:**

- "transaction" includes an arrangement, understanding or action in concert, whether or not such arrangement, understanding or action is-
- (a) formal or in writing or
- (b) is intended to be enforceable by legal proceeding.

# Enhanced definition of International Transaction (w.e.f. 1 April 2002)

## International Transaction

### Tangible Property

- Purchase, Sale, Transfer, Lease / Use of property / article/ product / thing
- Includes Building, Vehicle, machinery etc.

### Intangible Property

- Purchase, Sale, Transfer, Lease / Use of IP
- Includes Transfer of ownership / use of rights / other commercial right
- Location savings
- Assembled workforce;
- Market premium

### Capital Financing

- Long / short term borrowing / lending
- Guarantee
- Purchase/Sale Securities
- Advances / receivables, Payments /any debt etc

### Provision of Services

- Market Research / Development
- Technical Service
- Scientific Research
- Legal / Accounting Service etc.

### Business Restructuring

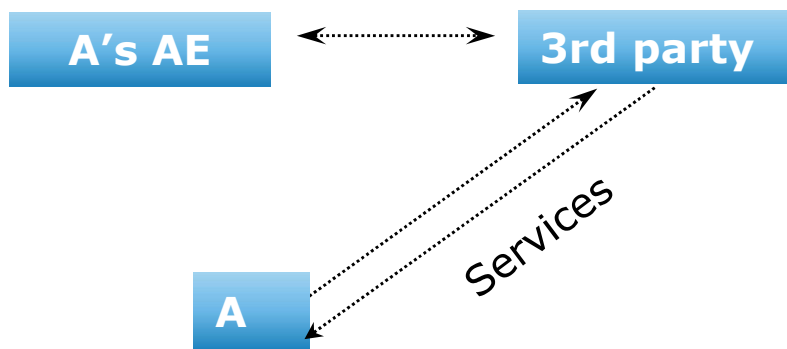
- Transaction of Business restructuring / reorganization with AE irrespective of bearing profit / income / loss or assets – at the time of transaction / future date

## Specified Domestic Transactions Section 92BA

- Transfer Pricing was earlier limited to 'International Transactions'.
- The Finance Act 2012, extended the scope of Transfer Pricing provision to Specified Domestic Transactions ("SDT").
- The Specified Domestic Transactions include the following:
  - Tax Holiday/ Deductions claimed by the taxpayer
  - Transfer of goods or services between various businesses of same taxpayer
  - More than ordinary profits derived from transactions with closely connected persons
- Transfer Pricing provisions to apply to the 'above mentioned Specified Domestic Transactions' if the aggregate value exceeds INR **20 crores**.

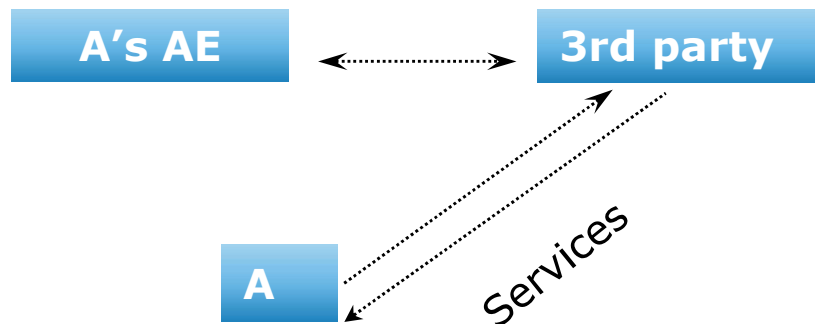
# Deemed International Transaction- Sec 92B(2)

## Prior agreement



- A transaction with an unrelated company (resident or non-resident) is deemed to be an international transaction and subject to transfer pricing regulations if
  - a **prior agreement** exists between A's AE and unrelated party in relation to services rendered by A to the 3rd party; or
  - **terms of transaction** are determined in substance by A's AE and 3rd party
- Amendment in Finance Act, 2014.

## Determination of terms

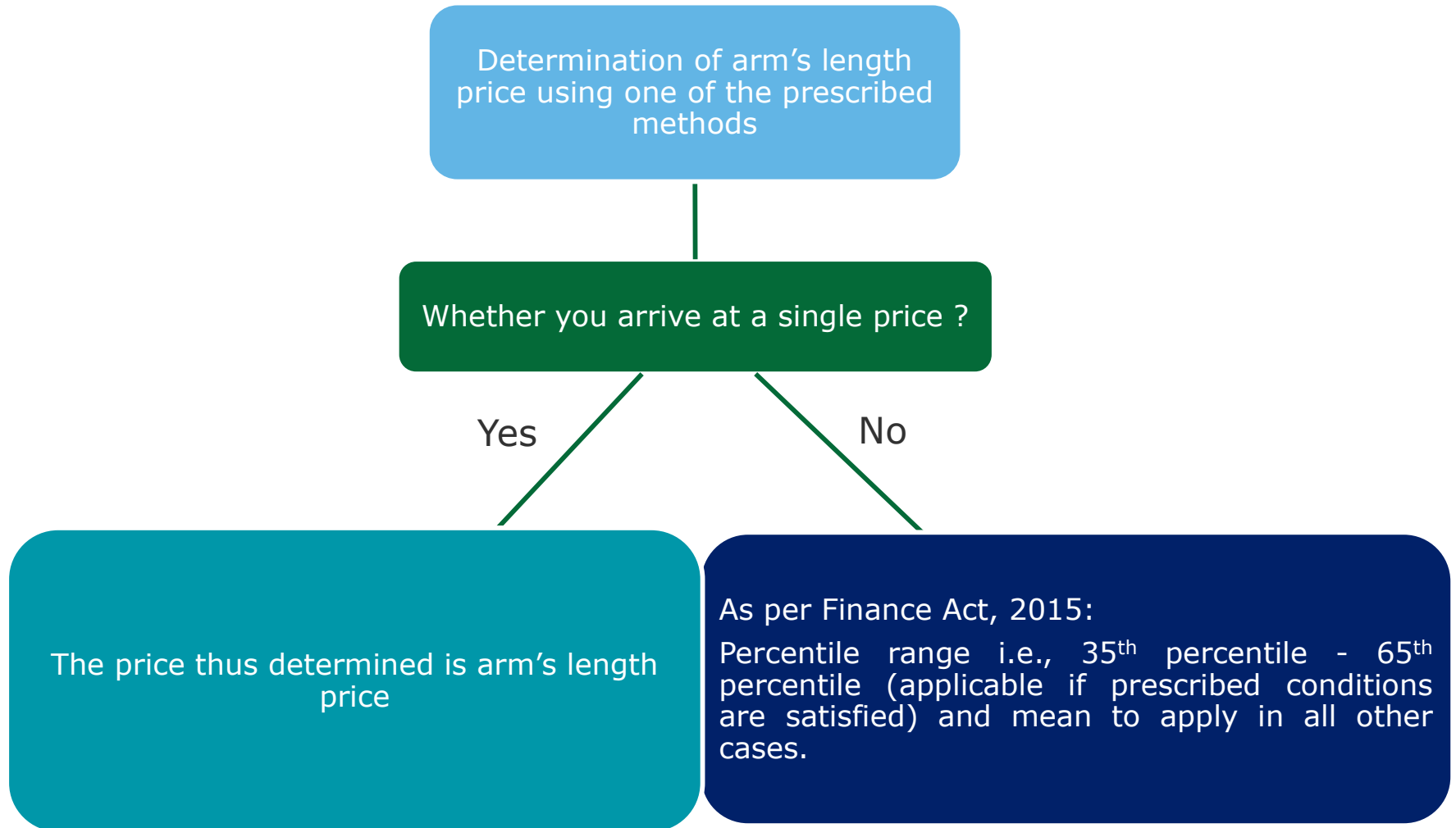




**Arm's length price**

# Arm's Length Price ('ALP')

Price applied or proposed to be applied in a transaction between persons other than AEs, in uncontrolled conditions

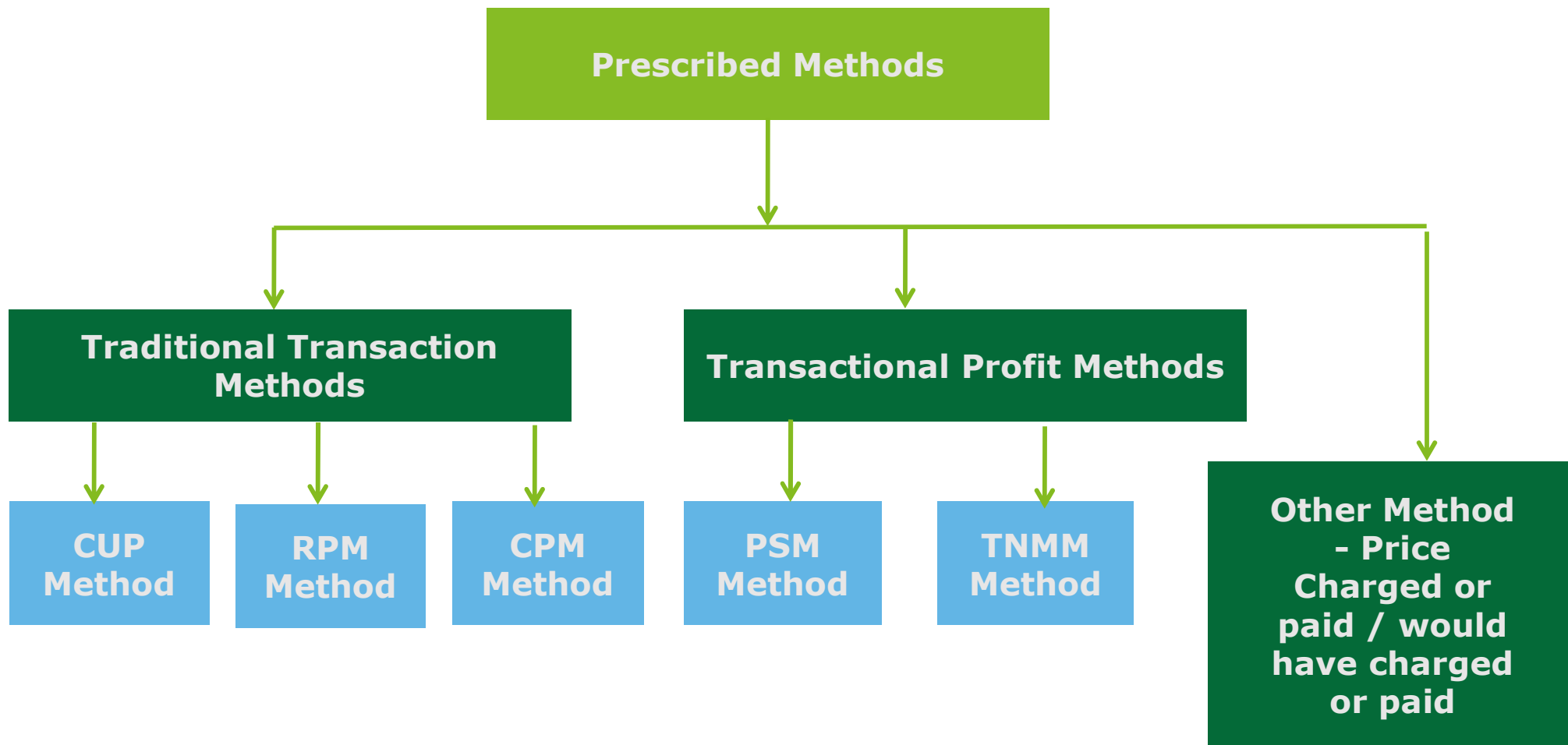






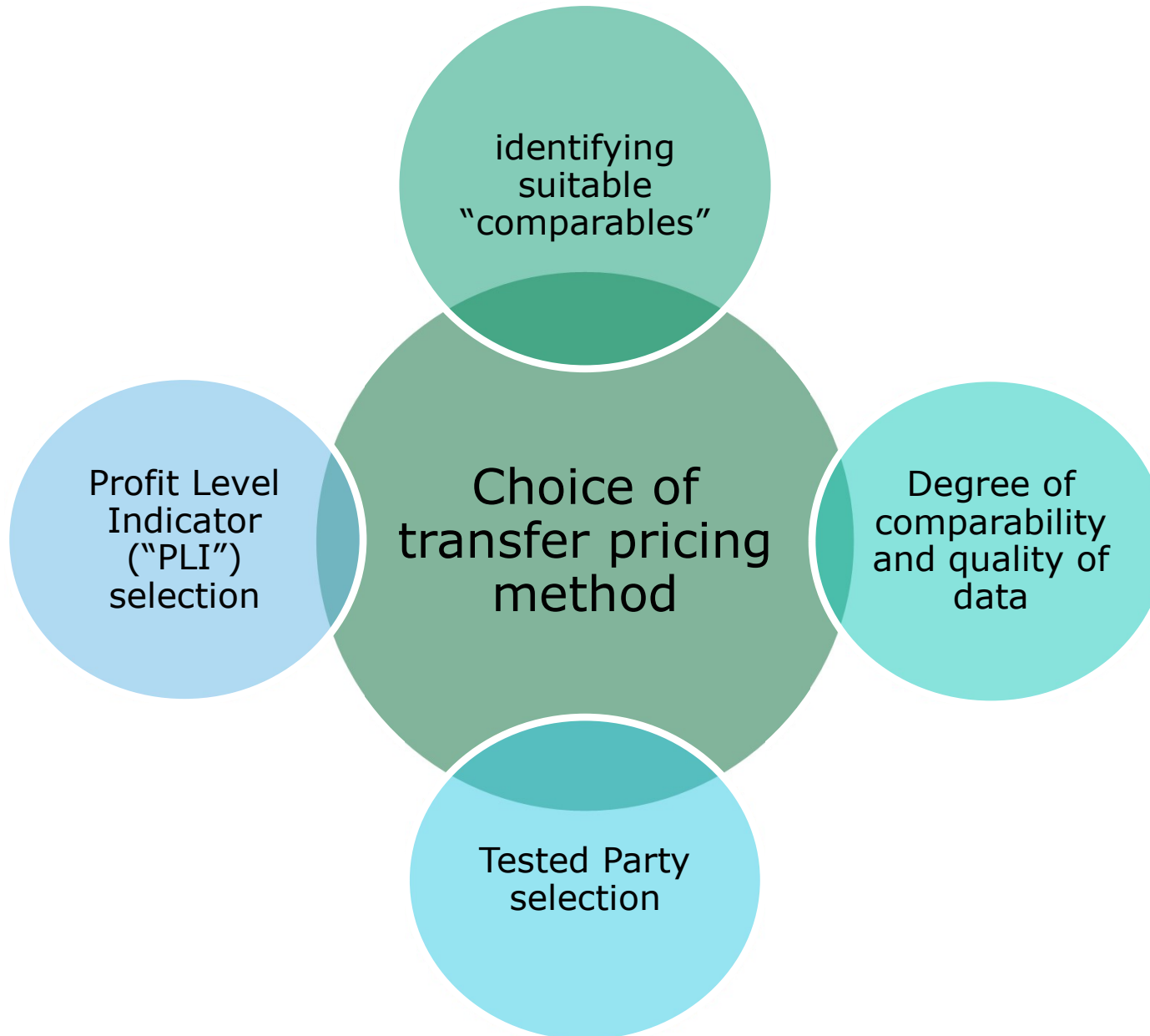
# **Transfer pricing methods**

# ALP Computation - Overview of Methods



**No hierarchy or preference of methods prescribed under the Act**

## Choice of transfer pricing method:



# Overview of Transfer Pricing Methods

- ✓ Degree of comparability between related and third-party transactions:
  - Functions
  - Contractual terms
  - Risks
  - Economic conditions
  - Nature of goods and services supplied
- ✓ Quality of data and assumptions:
  - Completeness & Accuracy of data
  - Reliability of assumptions
  - Sensitivity of results to deficiencies in data & assumptions
- ✓ Rejection with clear and compelling basis

**The Method that provides most reliable measure of an arm's length result given the facts & circumstances**

# Transfer Pricing Methods – A comparative statement

Method	Measurement Focus	Comparability Requirements	Indicative difference requiring adjustments
CUP	Price	<ul style="list-style-type: none"> <li>• Similar products</li> <li>• Similar conditions</li> </ul>	<ul style="list-style-type: none"> <li>• Product quality</li> <li>• Contractual terms</li> <li>• Level of market</li> <li>• Intangible property</li> <li>• Transaction date</li> <li>• Foreign Exchange</li> </ul>
RPM	Gross Income	<ul style="list-style-type: none"> <li>• Similar functions (no value addition)</li> <li>• Risk</li> <li>• Contractual terms</li> <li>• Similar product group</li> </ul>	<ul style="list-style-type: none"> <li>• Inventory levels</li> <li>• Turnover rates</li> <li>• Operating expenses</li> <li>• Foreign currency risks</li> <li>• Accounting differences</li> </ul>
CPM	Gross Income	<ul style="list-style-type: none"> <li>• Similar functions</li> <li>• Risk</li> <li>• Contractual terms</li> <li>• Similar product group</li> </ul>	<ul style="list-style-type: none"> <li>• Operating Complexity</li> <li>• Operating expenses</li> <li>• Foreign currency risks</li> <li>• Accounting differences</li> </ul>

# Transfer Pricing Method – A comparative statement

Method	Measurement Focus	Comparability Requirements	Indicative difference requiring adjustments
TNMM	Operating Income	<ul style="list-style-type: none"> <li>• Functions</li> <li>• Asset</li> <li>• Risks</li> </ul>	<ul style="list-style-type: none"> <li>• Economic risk adjustment</li> <li>• Accounting differences</li> <li>• Foreign currency risk</li> </ul>
PSM	Profit	<ul style="list-style-type: none"> <li>• Functions performed - Routine &amp; non-routine</li> <li>• Value drivers</li> <li>• Industry value indicators</li> <li>• Multiple transactions</li> </ul>	

# Summary of Rules

<b>MAM</b>	<b>Cumulative condition</b>	<b>Manner of determination of ALP</b>
<b>RPM, CPM or TNMM</b>	Number of comparables are six or more	<ul style="list-style-type: none"> <li>• Use Multiple year data (weighted average figures)</li> <li>• 35<sup>th</sup> to 65<sup>th</sup> percentile of the dataset</li> <li>• ALP = Median if transaction price does not fall within the range of 35<sup>th</sup> to 65<sup>th</sup> percentile</li> </ul>
<b>RPM, CPM or TNMM</b>	Number of comparables are less than six	<ul style="list-style-type: none"> <li>• Use Multiple year data (weighted average figures)</li> <li>• ALP = arithmetic mean</li> <li>• Tolerance band of +/- 3% or 1% applicable</li> </ul>
<b>CUP method</b>	Number of comparables are six or more	<ul style="list-style-type: none"> <li>• Use only single year data</li> <li>• 35<sup>th</sup> to 65<sup>th</sup> percentile of the dataset- AL range</li> <li>• ALP = Median if transaction price does not fall within the range of 35<sup>th</sup> to 65<sup>th</sup> percentile</li> </ul>

## Summary of Rules

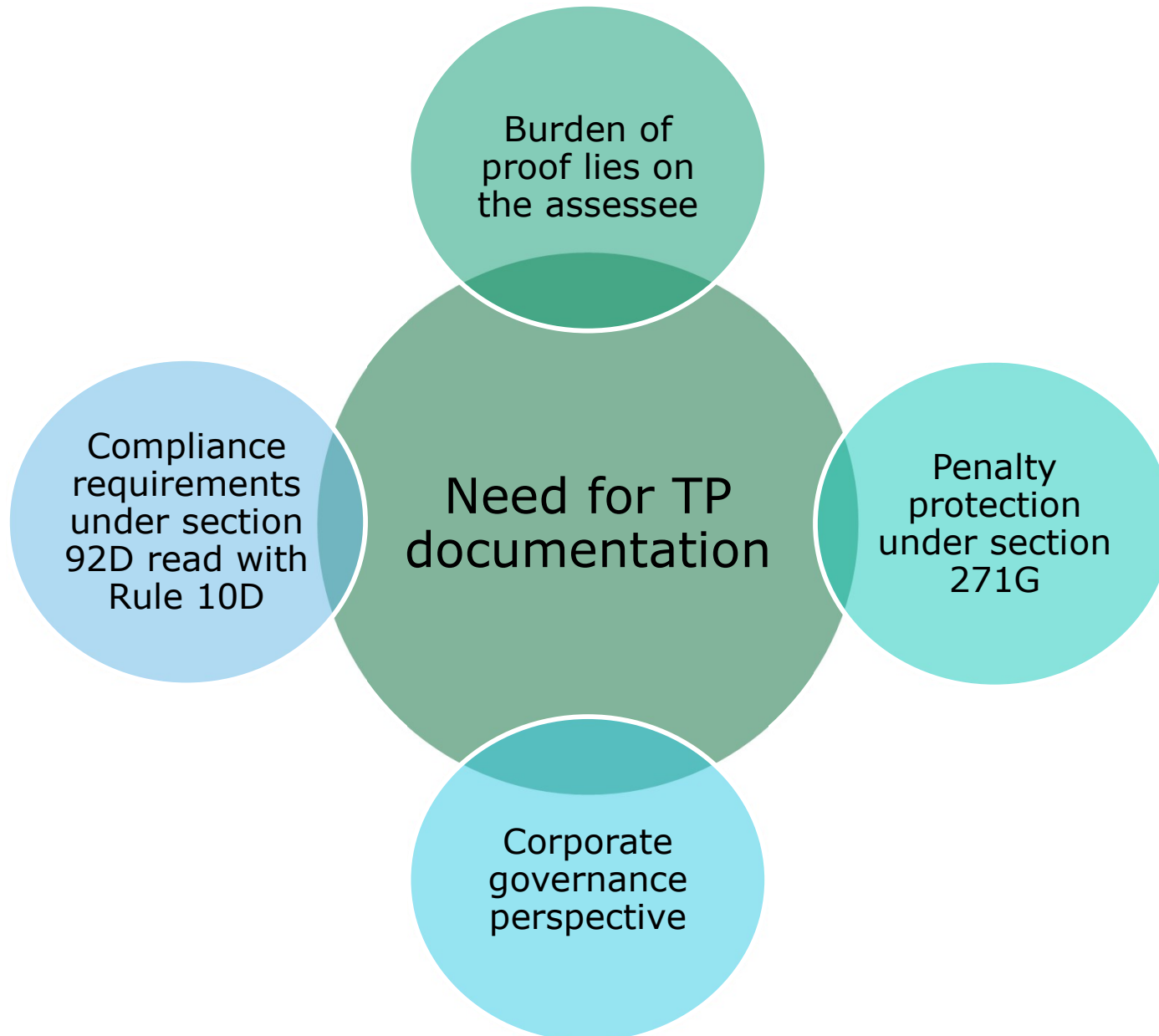
Condition	Cumulative condition	Manner of determination of ALP
<b>CUP Method</b>	Number of comparables are less than six	<ul style="list-style-type: none"><li>• Use only single year data</li><li>• ALP = arithmetic mean</li><li>• Tolerance band of +/- 3% or 1% applicable</li></ul>
<b>In case PSM or the Other Method has been applied as the most appropriate method</b>		<ul style="list-style-type: none"><li>• Use only single year data</li><li>• ALP = arithmetic mean</li><li>• Tolerance band of +/- 3% or 1% applicable</li></ul>





# **Indian Transfer Pricing Documentation**

# Need for Transfer Pricing Documentation in India



# Resources and Databases available to assist with transfer pricing

- ✓ The Indian Transfer Pricing Portal:
  - This website maintained by the Central Board of Direct Taxes (CBDT) provides information on transfer pricing regulations and guidance in India.
  - It includes guidance on transfer pricing methods, advance pricing agreements, transfer pricing documentation requirements, and access to relevant forms and instructions.
- ✓ The Indian Transfer Pricing Handbook:
  - This is a comprehensive guide to transfer pricing in India, published by the CBDT.
  - It provides detailed information on the Indian transfer pricing regulations and guidance on applying the various transfer pricing methods.
- ✓ The Indian Transfer Pricing Database:
  - This is a database of transfer pricing comparables maintained by the CBDT.
  - It includes financial data and other relevant information on Indian companies that can be used as comparables in transfer pricing analyses.
- ✓ External databases:
  - Several external databases can be used to gather comparable data for transfer pricing analyses in India.
  - These include databases such as Bloomberg, Capital IQ, and Compustat.

# Transfer Pricing Documentation (1/2)

## List of mandatory documents as per Rule 10D

### Entity related

- Ownership structure
- Profile of multinational group
- Business description / Profile of Industry

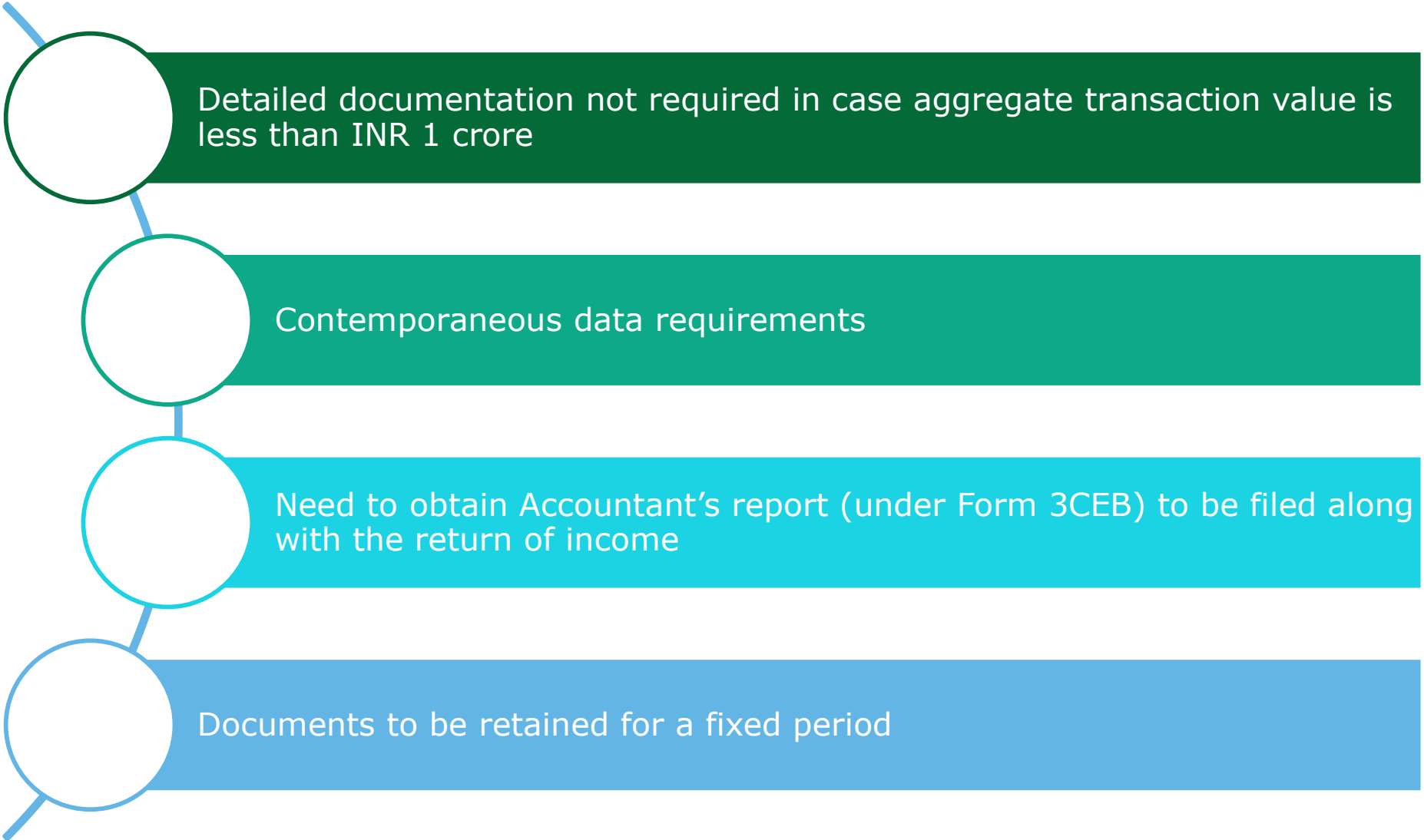
### Price related

- Nature and terms (including price) of international transactions
- Description of functions performed, risk assumed and assets employed (functional analysis)
- Records of economic and market analysis (economic analysis)
- Record of budgets, forecasts, financial estimates
- Any other record of analysis (if, any) to evaluate comparability of international transaction with uncontrolled transaction(s)
- Description of method considered with reasons of rejection of other methods
- Details of transfer pricing adjustment(s) made (if, any)

### Transaction related

- Any other information e.g., data, documents like invoices, agreements, price related correspondence etc.

# Instructions for maintaining Transfer Pricing Documentation



Detailed documentation not required in case aggregate transaction value is less than INR 1 crore

Contemporaneous data requirements

Need to obtain Accountant's report (under Form 3CEB) to be filed along with the return of income

Documents to be retained for a fixed period



## **Manage risk around Transfer Pricing**

# Managing Transfer Pricing risks

- Ensure TP documentation properly covers details regarding the controversy surrounding TP and PE
- Monitor legislative changes
- Keep intra-group agreements updated
- It is a mechanism for dispute resolution through a negotiated settlement
- Use of APAs to avoid future litigation



## **Case Laws & Recent Trends**



## SELECTION OF COMPARABLES ISSUE

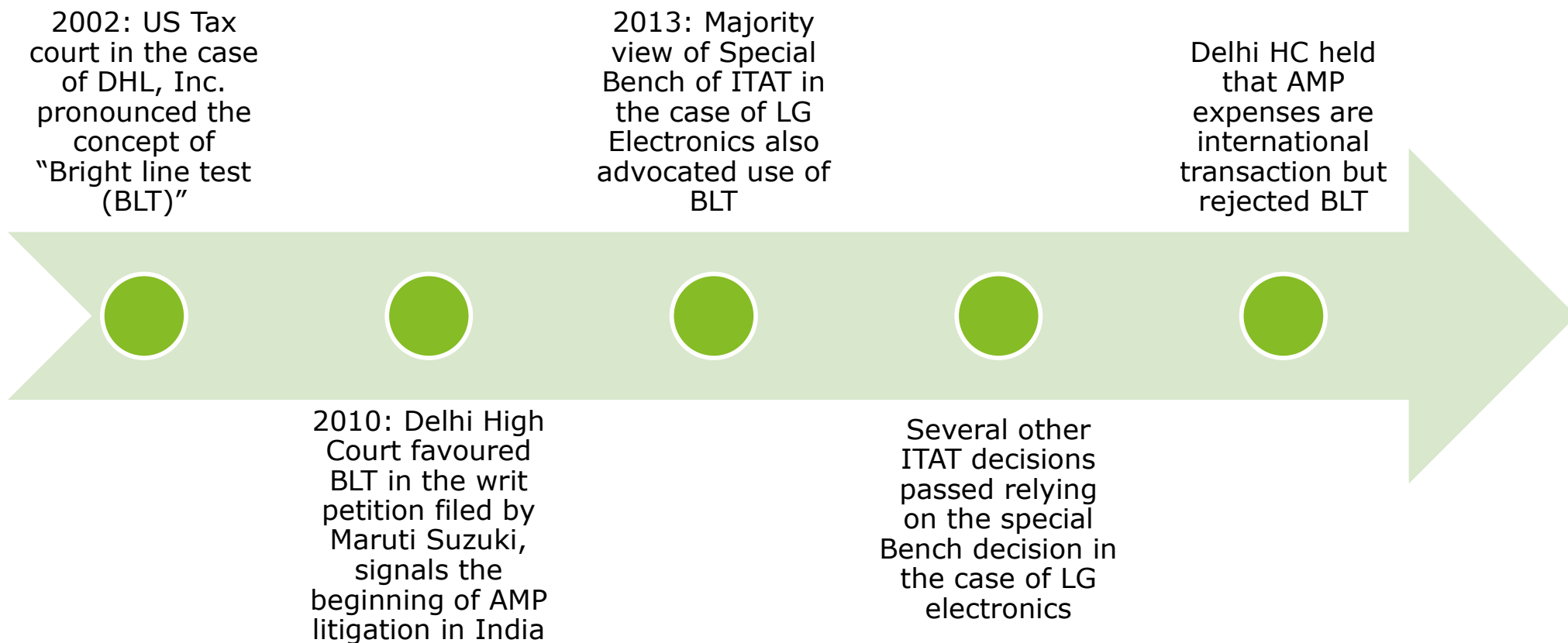
- Usually, selection of comparables is always in dispute. More often than not, the question on comparables travels up to High Courts.
- Various High Courts have held that the determination of the arm's length price ("**ALP**") by the Income-tax Appellate Tribunal ("**ITAT**") in transfer pricing disputes is final and cannot be subject to judicial scrutiny in an appeal before High Court unless there is any perversity established in the ITAT order.
- Thus, it was settled by High Courts that the Tribunal, being the final fact-finding authority, is the final appellate authority for transfer pricing disputes.
- However, the Supreme Court Recent decision in the case of **Softbrands India [2023]** while deciding on the issue that "Whether the High Court is precluded from considering the determination of the arm's length price determined by the Tribunal overturned the High Court decisions and held that the High Court" could also examine the question of comparability of two companies or selection of filters and examine whether the same is done judiciously, and based on the relevant material/evidence on record.
- The Apex Court, in this regard, observed that Chapter X of the Act needs to be adhered to along with the Rules while determining the ALP. Thus, any deviation therefrom would lead to substantial question of law before the Hon'ble High Court as per Section 260A of the Act.
- Furthermore, the Apex Court held that any deviation in the determination of ALP contrary to the statutory guidelines shall be tantamount as perverse and thus would warrant the Hon'ble High Court to investigate the matter as a question of substantial law.

## **INTEREST ON OUTSTANDING RECEIVABLES**

- It in the context of interest on outstanding receivables being a separate international transaction or imputation of interest for delay in payment, has been one of the most contentious issues under Indian Transfer Pricing regulations.
- Thus, the assessee has taken various contentions in this regard:
  - Interest on outstanding receivables is subsumed in working capital adjustment: Working capital adjustment takes into account the impact of outstanding receivables on the profitability. Thus, appropriate adjustments need to be considered to bring parity in the working capital investment of the taxpayer and the comparables, rather than looking at the receivable independently. A reference is drawn towards the OECD Transfer Pricing Guidelines which provide that “Making a working capital adjustment is an attempt to adjust for the differences in time value of money between the tested party and potential comparables with an assumption that the difference should be reflected in profits”. Cases: Kusum Healthcare Pvt Ltd. (Del HC and ITAT), IQOR India Services (P.) Ltd. (Delhi - Trib.), Orange Business Services (Delhi - Trib.), Trend Micro India (Delhi - Trib.) etc.
  - Outstanding receivables should not be benchmarked on standalone basis: Courts have held that when transactions are inter-connected, combined consideration may be the most reliable means of determining the ALP: Sony Ericsson Mobile (Delhi), Kusum Healthcare (Delhi HC & ITAT)
  - If the taxpayer is a debt free company, then adjustment in respect of interest on receivables is not warranted: Bechtel India Pvt. Ltd. (Delhi HC & ITAT), Boeing India (P.) Ltd. (Delhi), Avaya India Pvt. Ltd. (Delhi – Trib.), Global Logic India Ltd (Delhi - Trib.)

## AMP ISSUE

- The AMP expenses are the expenses incurred by an Indian Company for the promotion of its products or services, where it is acting as a manufacturer/distributor/provider of goods/services.



- Other landmark judgements such as: Bausch & Lomb Eyecare India Pvt Ltd. (Delhi HC), Haier Appliances India Pvt Ltd. (Delhi HC), Sharp Business Systems (India) Pvt Ltd. (Delhi HC)

## CORPORATE GUARANTEE

- A 'Corporate Guarantee' is provided by the Company either to the Customer or to the Bank for giving loans to the sister concerns / AEs of the said company. Since, it is exposed to risk in case of default by subsidiary, it should hence be compensated by way of guarantee-fee. Further, the subsidiary may derive benefits in the nature of lower interest rates on account of higher credit rating due to the guarantee.
- **Corporate Guarantee is an International Transaction by Virtue of 2012 Amendment:** The definition of 'international transaction' was amended by virtue of Finance Act, 2012 ("the Amendment") with retrospective effect from April 1, 2002, wherein "capital financing" included "guarantee".
- **Providing Corporate Guarantee to an Associated Enterprise is an Intra - Group Service:** No service would be received where AE by reason of affiliation alone has a credit rating higher than what it would if it were unaffiliated. Intra-group service would exist where higher credit rating were due to guarantee by another group member. (OECD para 7.13)
- Cases:
  - Everest Kanto Cylinder Ltd. (Bom HC & ITAT): Held that Corporate Guarantee is an 'international transaction' distinguishing Bharti Airtel (Delhi ITAT). The court rejected rate of 3% used by the TPO relying on quotes from bank's website. Instead, the court held that 0.5% guarantee commission relying on internal CUP can be considered to be at arm's length.
  - Glenmark Pharmaceuticals Ltd. (Bom HC & ITAT): The court explained the distinction between corporate guarantee and bank guarantee. It was also held that the bank guarantee quotes given on public websites not good external CUPs unless they are adjusted as per Rule 10B to factors like risk profile of respondents for guarantee, financial position of applicants, quantum of amount, terms of guarantee, etc.

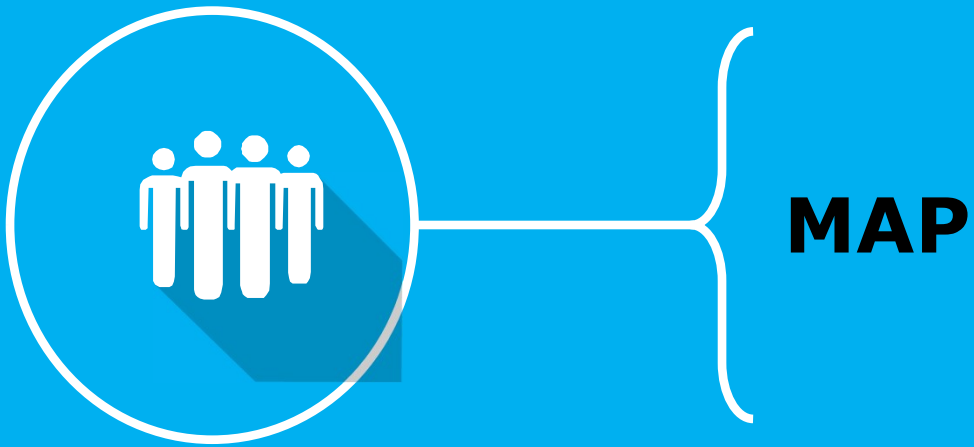
## **GUARANTEE COMMISSION (contd.)**

- Letter of Comfort:
  - A letter of comfort is a written document that provides a level of assurance that an obligation will ultimately be met. A letter of comfort is often couched in vague wording, in order to prevent the issuer from being saddled with a legally enforceable obligation.
  - Case: Indian Hotels Company Ltd. (Mumbai - Trib.)
    - Letter of comfort outside the ambit of international transaction
    - The assessee has not bound itself for repaying the loans in the event of default by AE
  - Case: Tata International Ltd. (Mumbai - Trib.)
    - The issuance of Letter of Comfort by assessee has no bearing on the profit, income or loss as the assessee did not incur any cost for issuing such LOC.
    - It does not constitute international transaction.
    - It concluded that there is a fundamental difference between guarantee and LOC.
    - Rejected re-characterization of LOC as guarantee.



# Advance Pricing Agreements (“APA”)

- APA scheme was introduced on July 1, 2012.
- Taxpayers can file for unilateral or bilateral or multilateral APA(s) depending on their facts and circumstances.
- An optional pre-filing consultation has been prescribed – which can be on a “no-name” basis also.
- APA is allowed for a maximum period of 5 years (advance years) and the roll back, normally, for a block of 4 years preceding the advance APA years.
- For continuing transactions, APA applications is required to be filed before the first day of the financial year which is part of the advance years (i.e., if the APA years are from FY 2023-24 to 2028-29, application needs to be filed on or before March 31, 2023)
- For new transactions, APA application should be filed before the commencement of such transaction.





# Mutual Agreement Procedure ("MAP")

- Mutual Agreement Procedure ("MAP") is an alternate mechanism for the resolution of international tax disputes incorporated in the double tax avoidance agreement (DTAA) of many countries.
- It entails resolution of disputes through the intervention of the Competent Authorities ('CAs') of each country who evolve a mutually acceptable solution
- It is a mechanism for dispute resolution through a negotiated settlement
- Scope is limited to only issues pertaining to tax treaties and does not extend to domestic tax laws. It may resolve issues including:
  - Adjustment arising from Transfer Pricing assessment
  - Issues relating to existence of Permanent Establishment
  - Characterization of income
  - Attribution of profits to Permanent Establishment
  - Issue pertaining to determination of residential status under the tax treaty
  - Interpretation of provisions of tax treaty
- Relief under MAP **is in addition** to the dispute resolution mechanisms available under domestic tax laws

Thank You