Computation of ALP – Section 92C, Rule 10B, Rule 10CA

The Institute of Chartered Accountants of India

Transfer Pricing - September 2021

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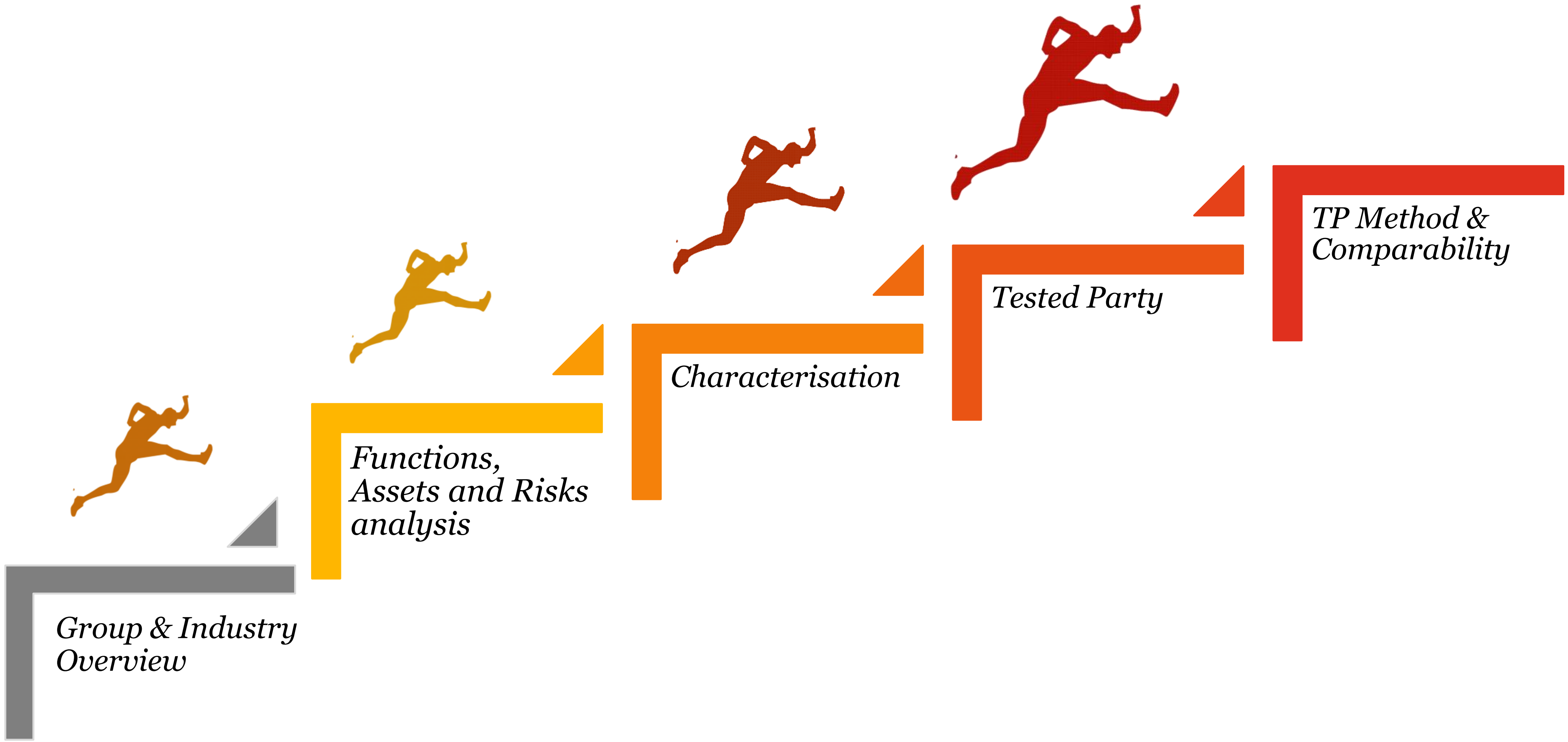
Computation of ALP – S. 92C, Rule 10B & 10CA

Contents

- *Transfer pricing analysis - Snapshot*
- *Arm's Length principle*
- *TP Methods with case studies*
- *Rule 10CA*

Transfer Pricing analysis – A Snapshot



Arm's Length principle

Steps involved in determining the arm's length price

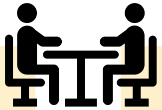
1. Identification of the "international transaction/(s)" or specified domestic transaction/(s);
2. Identification of the functions performed, assets employed, and risks assumed ('FAR') by the taxpayer and the Associated Enterprises
3. Deciding the characterization of the entities who are party to the transaction based on the analysis of FAR
4. Identification / selection of the tested party
5. Ascertaining the most appropriate method ('MAM')
6. Determination of the arm's length price by applying the method chosen

**Based on ICAI Guidance note on Transfer Pricing*

Arm's Length principle

Arm's Length Price: Price at which independent enterprises deal with each other, where the conditions of their commercial and financial relations ordinarily are determined by market forces.

As per section 92F of the Income tax act 1961- "Arm's 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;



Significance of the principle

- Parity between MNCs and independent enterprises
- Determining the real taxable profits
- Reduction in artificial price distortion
- Minimization of double taxation
- Accurate measure of economic contribution

Practical difficulties in application of an ALP

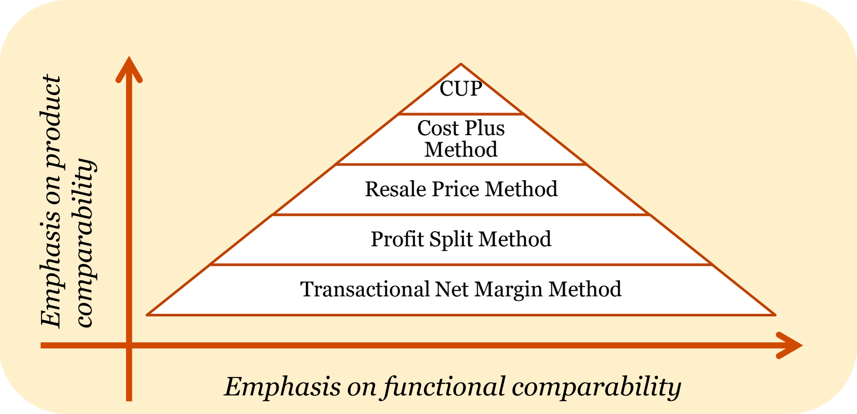
- Difficulty in comparison in a few cases
- Availability and reliability if Data
- Absence of market price
- Absence of comparable market price for intangibles
- Admin burden
- Time lag

**Source: ICAI material on Transfer pricing*

Section 92C : Computation of Arm's Length Price (read with rule 10B)

The **arm's length price** in relation to an **international transaction / specified domestic transaction** shall be determined by any of the following methods, being the **most appropriate method ('MAM')** :

(*a*) comparable uncontrolled price method ('CUP');
(*b*) resale price method ('RPM');
(*c*) cost plus method ('CPM') ;
(*d*) profit split method ('PSM');
(*e*) transactional net margin method (TNMM');
(*f*) such other method as may be prescribed *(Rule 10 AB)* by the Board.



*(Note: **Rule 10AB:** Any method that 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 relevant facts.*

The first proviso to section 92C(2): where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices.

The second proviso to section 92C(2): if the variation between the arm's length price, so determined and price at which the transaction has actually been undertaken does not exceed such percentage **not exceeding 3%**

Note: In case of a wholesale distributor, instead of 3%, 1% of the transaction price will be considered.

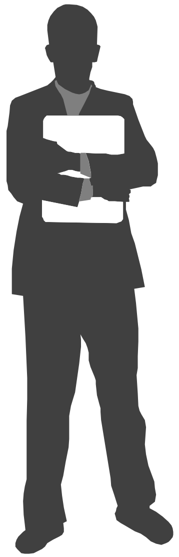
Tested party and comparability

Tested party

- Selection of the "most appropriate method"
- Selected based on the functional analysis
- Tested party is the least complex entity for which reliable comparables can be found

Selection of time period

Rule 10B(5) states that: The data to be used in analysing the comparability of an uncontrolled transaction with an international transaction shall be the **data relating to the current financial year or the year immediately preceding the current financial year**.



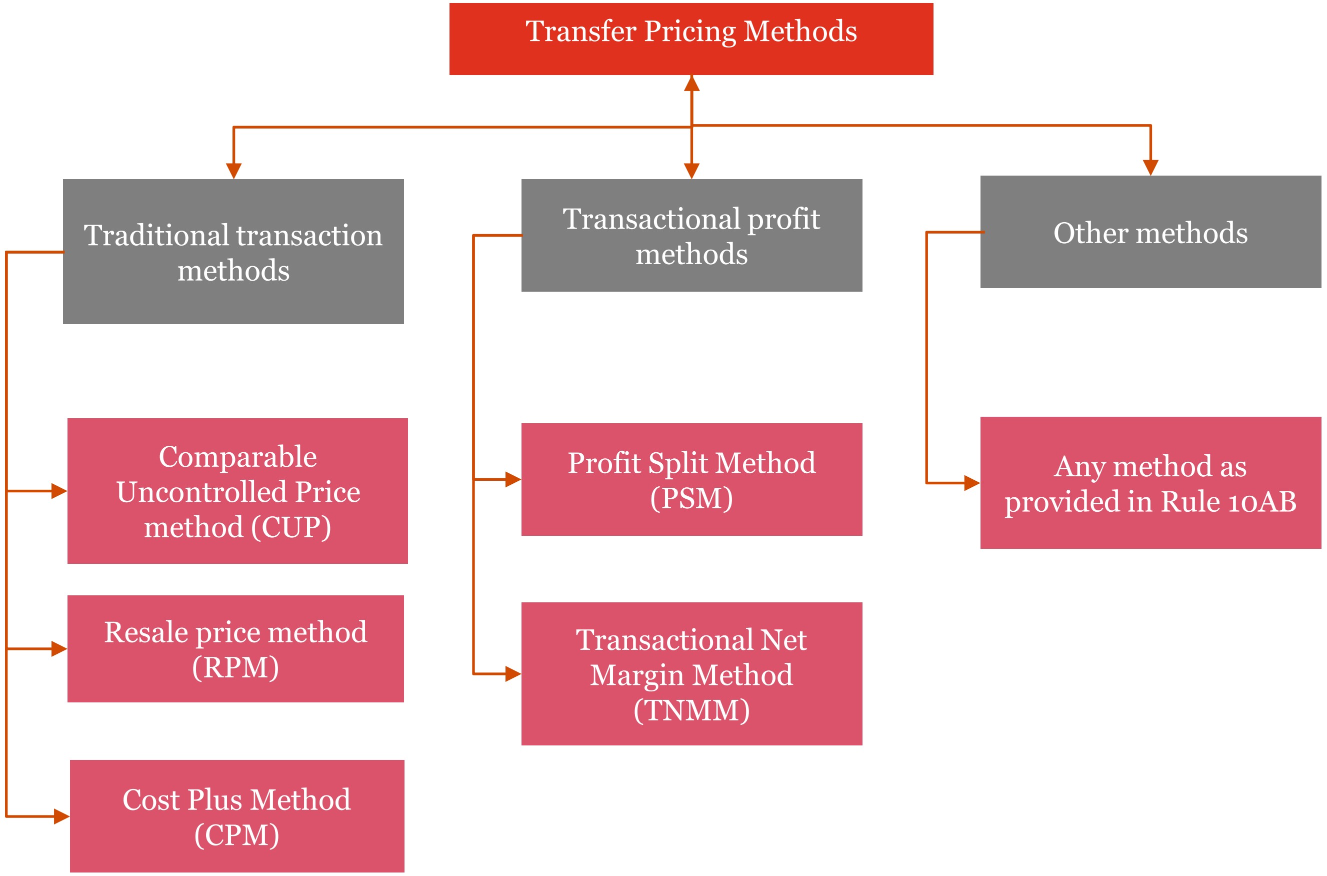
Rule 10B(2)

Comparability – how does one compare meaningfully ?

Comparability with uncontrolled transaction needs to be evaluated having regard to:

- distinctive nature of the property transferred, or services provided;
- functions performed taking into account the assets employed or to be employed;
- risks assumed by the respective parties' contractual terms of the transaction;
- market conditions.

Most appropriate method



Key aspects to be considered when applying MAM

- Consider strength and weakness of recognized methods
- Appropriateness of the method considered based on:
  - Functional analysis
  - Availability of reliable information
  - Degree of comparability between controlled and uncontrolled transaction
  - Reliability of comparability adjustments, if any

Computation of ALP – CUP Method

Comparable uncontrolled price method (CUP)

↓

Method applied when there is similar transactions between unrelated parties

↓

Identify price charged/paid for property transferred/ services provided under any 'comparable uncontrolled transaction'

↓

Adjust for differences, between the international transaction and the comparable uncontrolled transaction which could materially affect the price in the open market. Eg: Terms of contract, credit period, transportation costs etc.

↓

Price adjusted for the said differences is the ALP

Typical transactions in respect of which the CUP method may be adopted are:
(a) Transfer of goods;
(b) Provision of services;
(c) Royalty for use of Intangibles;
(d) Interest on loans.

Key aspects to be borne in mind while application of CUP method

High degree of product comparability is required

<u>Other adjustment areas:- UN Practical Manual on TP</u>

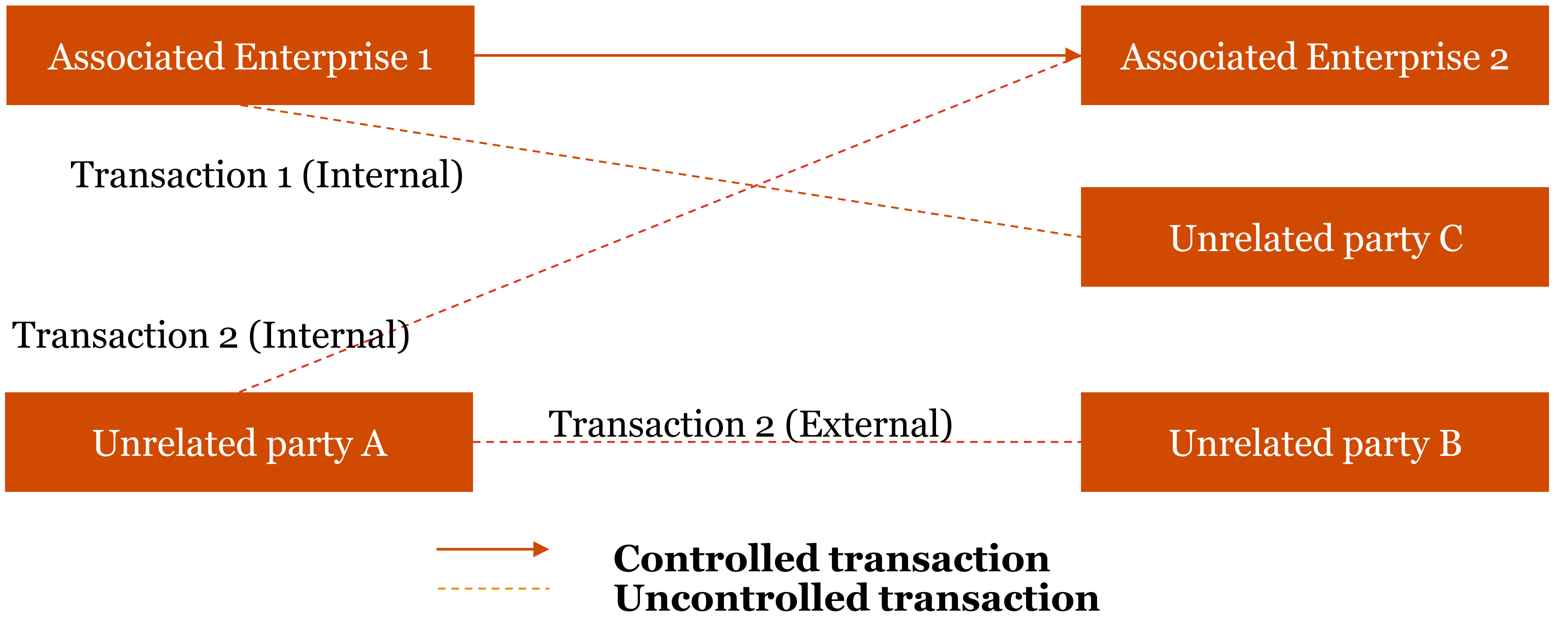
- *Type and quality of products*
- *Terms of delivery*
- *Volume of sales and related discounts*
- *Product characteristics*
- *Contratual terms*
- *Risks*
- *Geographical factors*

Comparable Uncontrolled Price Method (CUP)

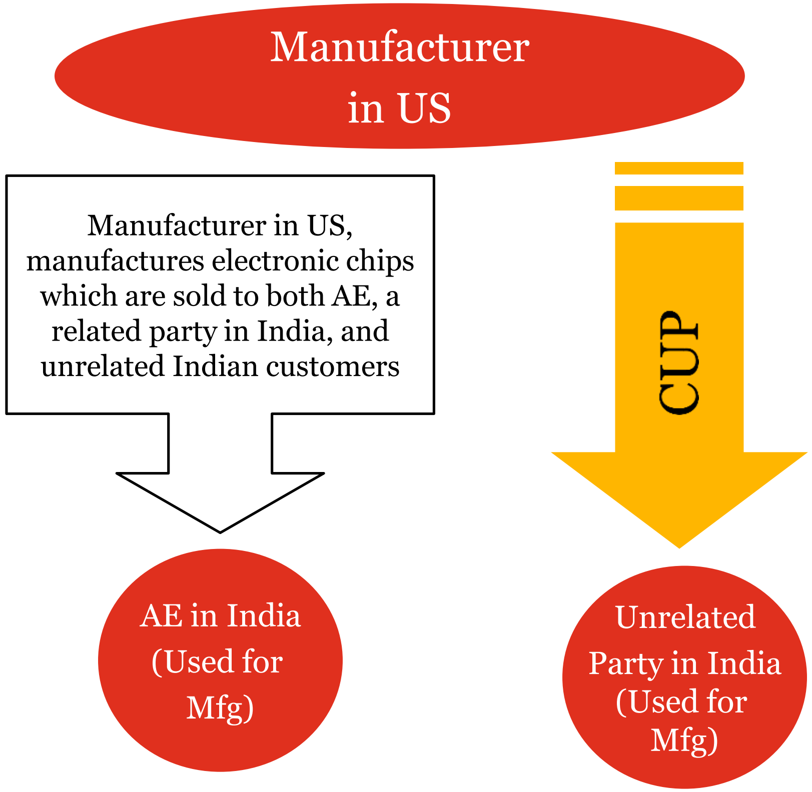
CUP can be either "Internal" or "External"

- **Internal** – When the tax payer enters into a similar transaction (as entered with AE) with an uncontrolled party
- **External** - Comparable uncontrolled transactions which involve a transaction between two parties, neither of which is an associated enterprise

Illustration

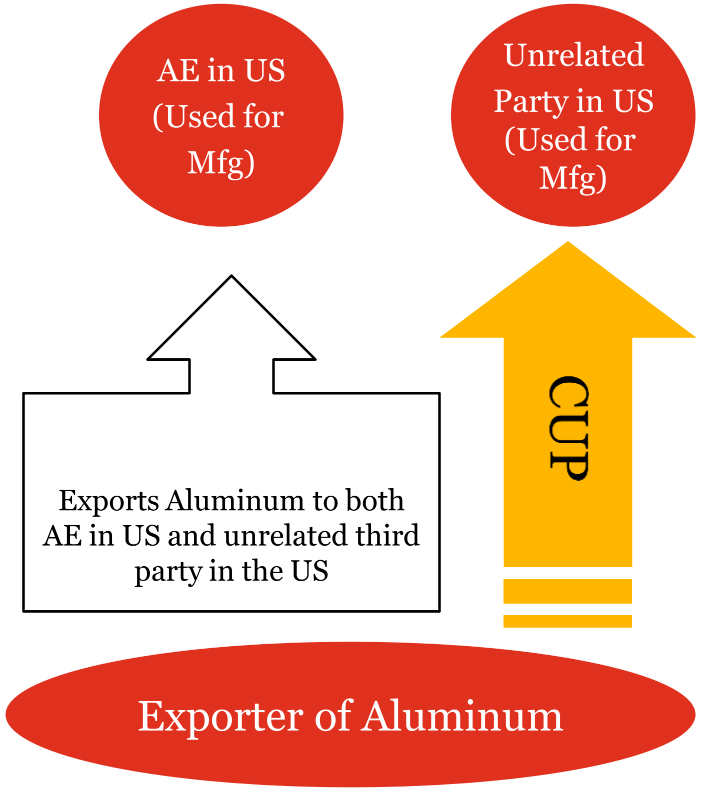


CUP method - Illustration



Sale price to unrelated party may be used to benchmark sale to group entity in India

If the basis for determining the transfer price is through rates prescribed by commodity exchanges, the rate could be considered as CUP



CUP method– Practical issues and challenges

Unique and valuable trademarks / intangibles associated with products

Fundamental differences in product

Often difficult to obtain identical transaction due to difference in volume / geography / end user / contractual terms

Making reliable / accurate adjustments not always feasible

Indirect evidences of CUP – Can data from public exchanges / quotations be used?

Should CUP include comparison of "pricing basis"?

Computation of ALP – Resale Price method ('RPM')

Resale Price Method (RPM)

↓

Method applied when item purchased from AE is resold to an unrelated party

↓

Identify the resale price at which the product is resold to third party

↓

Reduce the resale price by the normal gross profit margin on a comparable uncontrolled transaction & expenditure incurred (Customs duty etc)

↓

Adjust for differences materially affecting the gross profit margin (GM) in the open market

↓

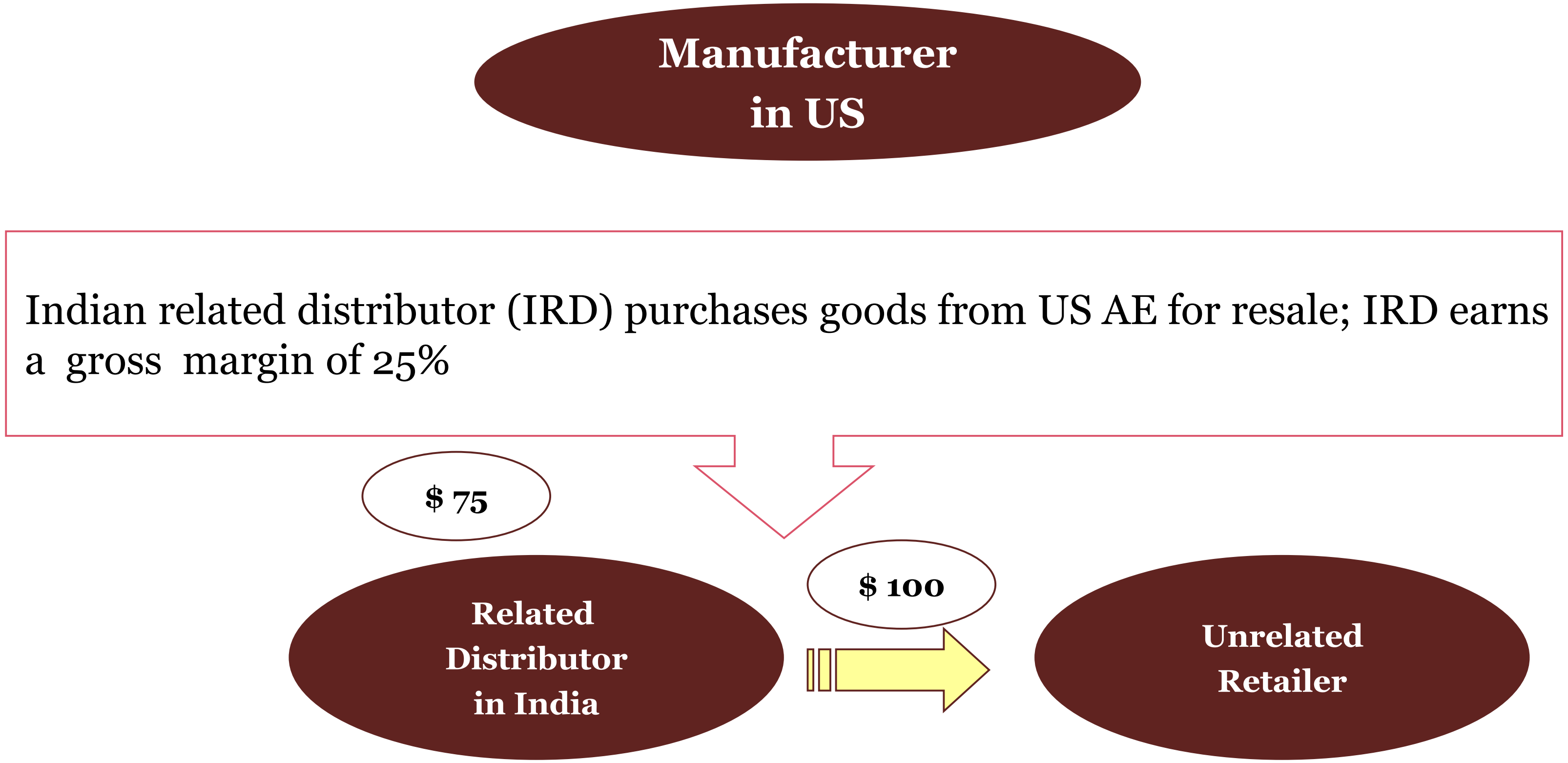
Price adjusted for the said differences is the ALP

Key aspects while applying RPM

- compares the **Gross profit margins** earned in transactions entered between unrelated and related parties
- Required high level of functional comparability
- Usually used to test transactions involving **i. e when the tested party purchases products/ acquired services from related parties and resells the same to independent parties.**
- Appropriate when the reseller **does not add substantial value** to be product or service

Price charged to independent enterprise	A	INR 100,000
Resale price margin (25%)	B	INR 25,000
Arm's length price	C =(A-B)	INR 75,000

RPM method - Illustration



25% resale margin earned by IRD, if within comparable arm’s length range, satisfies arm’s length test

RPM method – Practical issues and challenges

Lack of availability of Gross margin data

Generally used by comparison with “internal comparable”, due to lack of reliable data

Minor product difference might not distort the end result completely, but to be given due consideration coupled with high degree of functional comparability

Impact of intangibles (trade marks / brand names etc.) to be duly considered

Cost plus method ('CPM')

Cost Plus Method (CPM)

↓

Method applied when semi-finished goods are sold to AEs

↓

Identify direct and indirect cost of production incurred

↓

Determine normal GP markup to the costs by an unrelated entity in a comparable uncontrolled transaction

↓

Adjust the normal GP mark up for functional and other differences materially affecting the GP in the open market

↓

Total cost increased by adjusted markup is the ALP

Key aspects while applying CPM

- Determines ALP by adding the appropriate GP margin to the AE's cost of producing products or rendering services.
- The GP margin charged should reflect the **functions performed** by an entity and should include a **return on the capital used** and **risk assumed** by the entity.

Associated Enterprise 1 → Associated Enterprise 2

Cost to Associated enterprise 1	A	INR 500,000
Gross profit mark-up (50%)	B	INR 250,000
Arm's length price	C = (A+B)	INR 750,000

CPM – Practical issues and challenges

Focuses on gross profit margins, which are heavily influenced by the scope, intensity of functions and accounting methods

Requires high level of comparability between the tested party and the comparables in terms of functions performed

Difference in the cost base may require adjustment for proper comparability

Profit Split Method (‘PSM’)

Profit Split Method (PSM)

- Applied where there is transfer of unique intangibles or multiple international transactions
- Determined the combined NP of the AEs arising out of International transaction
- Evaluate relative contribution of each enterprise in earning of the combined NP on the basis of FAR analysis
- Split the combined NP amongst the enterprises in the proportion of market returns & residual profits in the proportion of relative contribution
- ALP to be determined on the basis of profit apportioned.

Key aspects while applying PSM

- Applicable when international transactions involving unique intangibles or when there are multiple international transactions which are closely inter-related that they cannot be evaluated separately for the purpose of determining the arm’s length price of any one transaction.
- Evaluates whether the allocation of the combined operating profit/loss attributable to one or more controlled transactions at arms length with reference to the relative value of each controlled taxpayer’s contribution to the combined profit/loss.
- Allocation of profits must be made in accordance with one of the following allocation methods:

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

B) Residual profit split - *Following the two-step process:*

a) Allocate income to routine contributions
b) Allocate residual profit

PSM - Illustration

Net profits from combined transactions (USD 100 Million)

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

Residual profits (USD 30 Million)

Residual Profit share for Related party X

Residual profit split based on each party's ownership of non-routine intangibles

(ex: network reach, efficiency of sales and marketing team etc.)

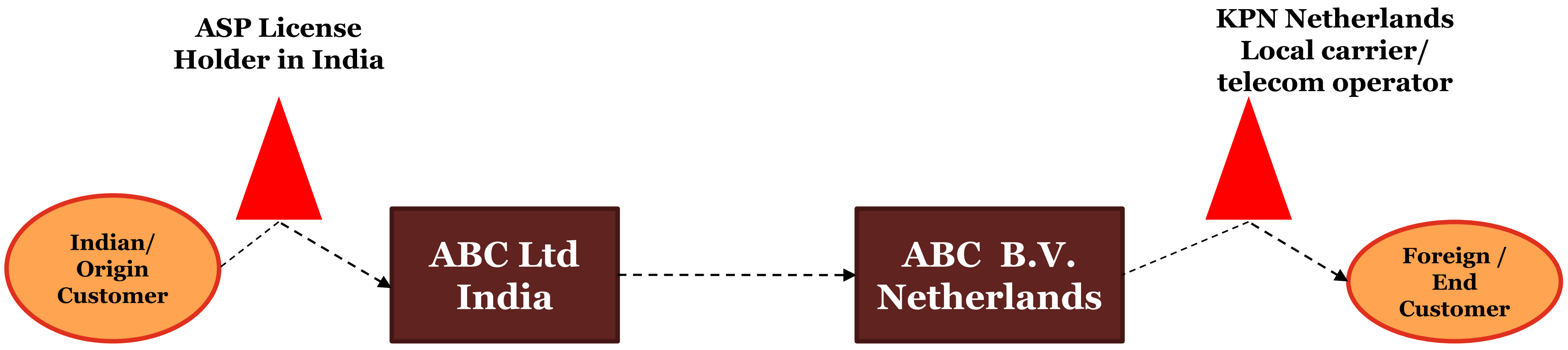
Residual Profit share for Related party Y

Total profits for related party X:

1. Income from specific contribution (eg: say 40% by X and 60% by Y) made by X = USD 28 Million (i.e USD 70 Million * 40%)

2. Income as residual profit (assuming 50:50): USD 15 Million (i.e USD 30 Million * 50%)

PSM – Illustration



Unique Contributions/ Value Added Drivers

(ABC Ltd and group entities)

- Network reach (Under sea cables)
- Selling and marketing functions
- Profit split on relative contribution of value drivers by each entity

PSM – Practical issues and challenges

Third parties in general do not use profit split method to establish transfer prices

Evaluation and measurement of the value drivers / intangibles – element of subjectivity

Requires use of data from foreign locations

Difficulty in calculating the combined revenue and costs for all the AEs

Transactional Net Margin Method (‘TNMM’)

Transactional Net margin method (TNMM)

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Compute NP margin of the enterprise from the international transaction with the AE having regard to cost incurred/sales effected/assets employed

↓

Compute the NP margin realized by the enterprise or unrelated enterprise in a comparable uncontrolled transaction by applying the same base.

↓

Adjust the NP margin realized from comparable uncontrolled transactions to account for the differences affecting the NP margin in the open market.

↓

Compare the NP margin relative to costs/sales/assets of the AE with NP margin of uncontrolled party of comparable transactions

↓

Adjusted NP margin is the ALP

Key aspects while applying TNMM

- Most frequently used and practical method
- Comparison at operating margin level
- Broad level of similarity of functions, Assets and risks (FAR)
- Selection of the right comparables and PLI are critical factors

Illustration

Given price	A	USD 10,000
Operating expenses	B	USD 2,000
Net profit (5% of price)	C = (A+B)	USD 500 (Comparable)

AE 1 has purchased raw materials from its **AE 2** and manufactures goods for sale to third parties. The similar transaction is entered into by unrelated parties with net margin of 5% of sale price.

Thus, if **AE1 earns net margin of 5% of sale price**, then its transaction of purchase of raw materials **from AE2 will be at arm's length.**

TNMM

Illustration – Selected comparables – sample extract

S.No	Company name	Wtd. Avg. Operating profits/ Operating costs
1	A Ltd	1.94%
2	B Ltd	2.21%
3	C Ltd	4.94%
4	D Ltd	8.34%
5	E Ltd	10.05%
6	F Ltd	10.82%
7	G Ltd	11.52%
8	H Ltd	15.83%
	Mean	***8.21%***
	Median	***9.20%***
	35th percentile	***4.94%***
	65th percentile	***10.82%***
	Count	***8***

The analysis shows that the range of weighted average Operating profits/ operating costs (Profit Level Indicator) of comparable companies is **4.94% to 10.82% with a median of 9.20%.** Hence, prices of international transactions of the tested party that achieve an operating profit / Operating costs between is **4.94% to 10.82% or are higher** would meet the arm's length standard required under the Indian Regulations as per the third proviso to section 92C(2) of the Act read with Rule 10CA(4) of the Rules.

TNMM – Practical issues and challenges

Aggregation v/s Transactional analysis

Entrepreneur v/s captive – need for risk adjustment?

Lack of availability of data at the time of undertaking transaction / documentation

Most Appropriate Method – General applicability

Method	International transaction Type
CUP	Loans, Royalties, Service fee, transfer of tangibles , guarantee fees
RPM	Marketing operations of finished products, where distributor does not perform significant value addition to product
CPM	Sale of finished / semi-finished goods or services
PSM	Transactions involving provision of integrated services by more than one enterprise or involving unique intangibles
TNMM	Provision of services, manufacture / distribution of finished goods
Other	Purchase of secondhand capital goods involving chartered engineer's certificates, buy-back of shares as per the valuation report of independent accountants

Power of the Assessing Officer ('AO') with respect to determination of ALP

The AO may proceed to determine the arm's length price if any of the following conditions are satisfied:

- the price charged or paid in an international transaction or specified domestic transaction **has not been determined on the basis of the most appropriate method.**
- any information and document relating to an international transaction or specified domestic transaction has **not been kept and maintained as mandated.**
- the information or data used in computation of the arm's length price is **not reliable or correct**.
- the assessee **had failed to furnish, within the specified time, any information or document** which he was required to furnish.

Note:

- *If any information is not submitted as requested at the time of assessment proceedings, the AO* ***would have power to substitute the arm's length price based on information in*** *his possession.*

- *The substitution of the arm's length price by the Assessing Officer shall be* ***preceded by an opportunity of hearing*** *being given to the assessee to show cause why* ***such substitution of the arm's length price should not be made.***

QUIZ – Question 1

P Ltd is engaged in the business of transmitting data from a destination in one country, to a destination in a different country in a secured manner. This transaction requires deployment of assets and functions of different associated enterprises, located in different geographical locations, to ultimately deliver services. The most appropriate method that could be adopted in this scenario would be ?

A. Resale Price Method
B. Comparable uncontrolled Price Method
C. Profit Split Method
D. All of the above

QUIZ – Question 2

During the year A Ltd availed subcontracting services from its associated enterprise in relation to a contract awarded by X Ltd. (an unrelated third party) to A Ltd. The entire work under the main contract with X Ltd. has been subcontracted by A Ltd. to subcontractors on back-to-back basis. The Most appropriate method that could be adopted in this scenario would be ?

A. Resale Price Method
B. Comparable uncontrolled Price Method
C. Transactional Net Margin Method
D. Profit split method

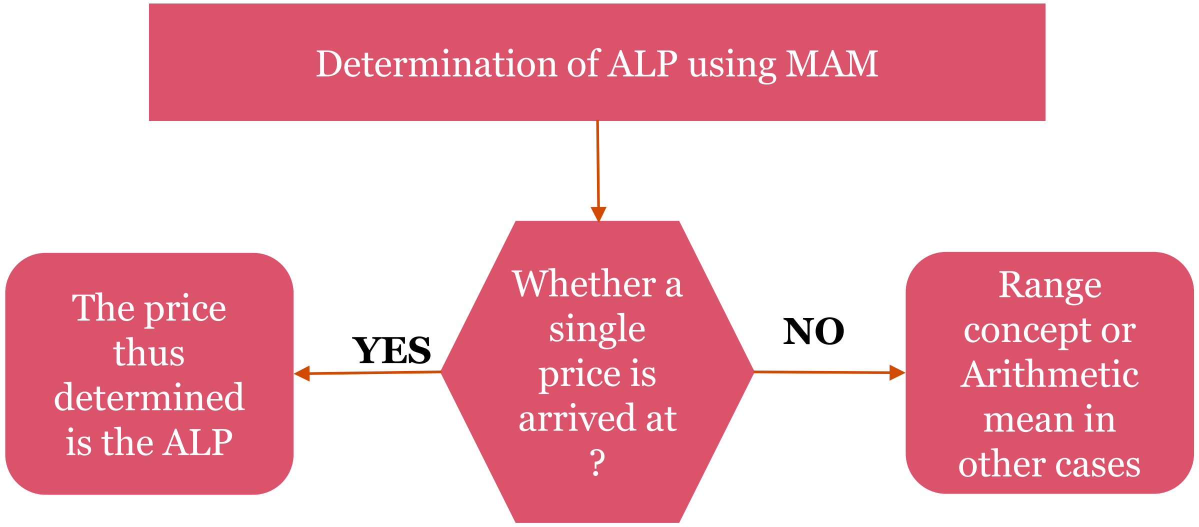
QUIZ – Question 3

A Ltd is engaged in purchase and distribution of cosmetic products in the Indian Market from its Associated Enterprises (‘AE’). A Ltd was responsible for marketing the products and creation of a distribution network in India. In the given scenario, A Ltd distributes the products purchased from its AE without further processing the products. The Most appropriate method that could be adopted in this scenario would be ?

A. Resale Price Method
B. Comparable uncontrolled Price Method
C. Transactional Net Margin Method
D. Profit split method

Section 10CA – Computation of ALP in certain cases

In case of international transactions undertaken on or after 1.4.2014, when more than one price is determined by the MAM, the ALP would be computed in a manner as specified in Rule 10CA



Application of multiple year data for construction of a dataset – Multiple year data allowed only for determination of ALP for TNMM, RPM, CPM

Range Concept:

When to apply ?

- MAM is CUP, RPM, CPM, or TNMM
- Data set constructed is has more than 6 entries

How to apply ?

- Arrange the values in ascending order
- Where the actual transaction falls within the 35^{th} and 65^{th} percentile of the dataset, the value of transaction will be accepted to be the arm's length price.
- Where the transfer price does not fall within the above range, then the median of the dataset shall be taken as the Arm's Length price.

Section 10CA – Computation of ALP in certain cases

Illustration 1: *The data for the current year of the entities undertaking comparable uncontrolled transactions is available at the time of furnishing return of income by the assessee and based on the same, 7 enterprises have been identified to have undertaken the comparable uncontrolled transaction in the current year. All the identified comparable enterprises have also undertaken comparable uncontrolled transactions in* ***a period of two years preceding the current year****.*

The Profit level Indicator(PLI) used in applying the most appropriate method ***is operating profit as compared to operating cost(OP/OC).*** *The weighted average shall be based upon the weight of OC as computed below :*

S.No	Name	OC and OP	Year 1	Year 2	Year 3 (Current Year)	Aggregation of OC and OP	Weighted average (total of OP/ total of OC)
1	A	OC	100	150	225	475	12%
		OP	12	10	35	57	
2	B	OC	80	125	100	305	8.2%
		OP	10	5	10	25	
3	C	OC	250	230	250	730	9%
		OP	22	26	18	66	
4	D	OC	180	220	150	550	6%
		OP	-9	22	20	33	
5	E	OC	140	100	125	365	2.2%
		OP	21	-8	-5	8	
6	F	OC	160	120	140	420	11.9%
		OP	21	14	15	50	
7	G	OC	150	130	155	435	10.57%
		OP	21	12	13	46	

Section 10CA – Computation of ALP in certain cases

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

Percentile	Formula	Result	Value to be selected
35th percentile	Total number of data points in the set * 35% (7*35%)	2.45	3rd value*
65th percentile	Total number of data points in the set * 65% (7*65%)	4.55	5th value*
Median	Total number of data points in the set * 50% (7*50%)	3.50	4th value*

** Value referred here is the place value in the dataset as arranged in ascending order.*

Section 10CA – Computation of ALP in certain cases

Illustration 2 : Where the dataset comprises of 20 data points (arranged in ascending order) and the percentiles computed are whole numbers:

Percentile	Formula	Result	Value to be selected
35^{th} percentile	Total number of data points in the set * 35% (20*35%)	7	Mean of the 7^{th} & 8^{th} value
65^{th} percentile	Total number of data points in the set * 65% (20*65%)	13	Mean of the 13^{th} and 14^{th} value
Median	Total number of data points in the set * 50% (20*50%)	10	Mean of the 10^{th} & 11^{th} value

If the transaction falls within the range, then the same shall be deemed to be the ALP. If the transaction price falls outside the range, the ALP shall be the median of the dataset.

QUIZ – Question 4

Z Ltd is engaged in the business of export of coffee beans to A Inc. USA, the parent company. Z Ltd is characterized as the tested party based on the FAR analysis. 4 comparable companies were identified based on the search process. In order to determine the arm's length price, we would use which of the following ?

A. Arithmetic mean
B. Median
C. Range between 35^{th} and 65^{th} percentile
D. Inter-quartile range (25^{th} to 75^{th} percentile)

How to select Filters/ Selection of PLI/Case Studies

Key aspects

- *Typically used Profit level indicators*
- *Data sources and time period*
- *Selection of filters*
- *Case Studies*

Selection of a profit level indicator ('PLI')

1 A profit level indicator (PLI) is selected to test the profitability of tested party. The selected ratio measures relationships between profits and costs incurred or resources employed.

2 PLI should always have an untainted base (denominator) like adopting cost as base for export transactions and revenue as base for import transactions. An untainted denominator would therefore be more reliable.

The selection of the appropriate PLI depends upon a number of factors such as:

a) the nature of the activities of the tested party,

b) the reliability of the available data with respect to comparable uncontrolled transaction,

c) the extent to which a particular PLI is likely to produce a reasonable determination of the income that the tested party would have earned in an arm's length transaction, taking into account all of the facts and circumstances of the particular transactions under review.

Overview of various PLIs

Method	PLI	Formula	Typically used for
RPM	Gross margin	Gross Profit/Sales	Distributor
CPM	Gross cost plus margin	Gross Profit/DICOP (Direct & Indirect Cost of Production)	Manufacturer
TNMM	Return on total costs	Operating Profit/Total operating expenses	Manufacturer / Service provider
TNMM	Operating margin	Operating Profit/Net sales or net turnover	Manufacturer / Distributor
TNMM	ROA	Operating Profit/Operating Assets	Manufacturer
TNMM	OP/ VAE	Operating Profit/ Value Added expenses	Manufacturer who are economically processors
TNMM	ROCE	Operating Profit/ Capital Employed*	Manufacturer
TNMM	Berry ratio	Gross profit / Operating expenses	Low risk Distributor

** Capital employed usually calculated as total assets – cash and investments*

Sources of data & Selection of time period

Sources of Data & Selection of time period

Internal comparables

Can be obtained through discussions with management of all the entities involved in the transaction.

External comparables

Sources include:

- Government (e.g. statutory public filing requirements and government trade department publications).
- Commercial databases (Eg: Orbis, Capitaline TP database, Compustat, Royaltystat, ktMINE, TP catalyst)
- Foreign source or non-domestic comparables
- Industry associations.
- Knowledge of employees

Selection of time period

Rule 10B(5) states that:
the data to be used in analysing the comparability of an uncontrolled transaction with an international transaction shall be the **data relating to the current financial year** in which the controlled transaction has been entered into or **the year immediately preceding the current financial year**.

It is suggested that companies from databases to be selected when:

- They had relevant financial data for FY 2020-21 ('L'); or
- They had relevant financial data for FY 2019-20 ('L-1').

Basic filters while performing a search

Types of filters used during a search process

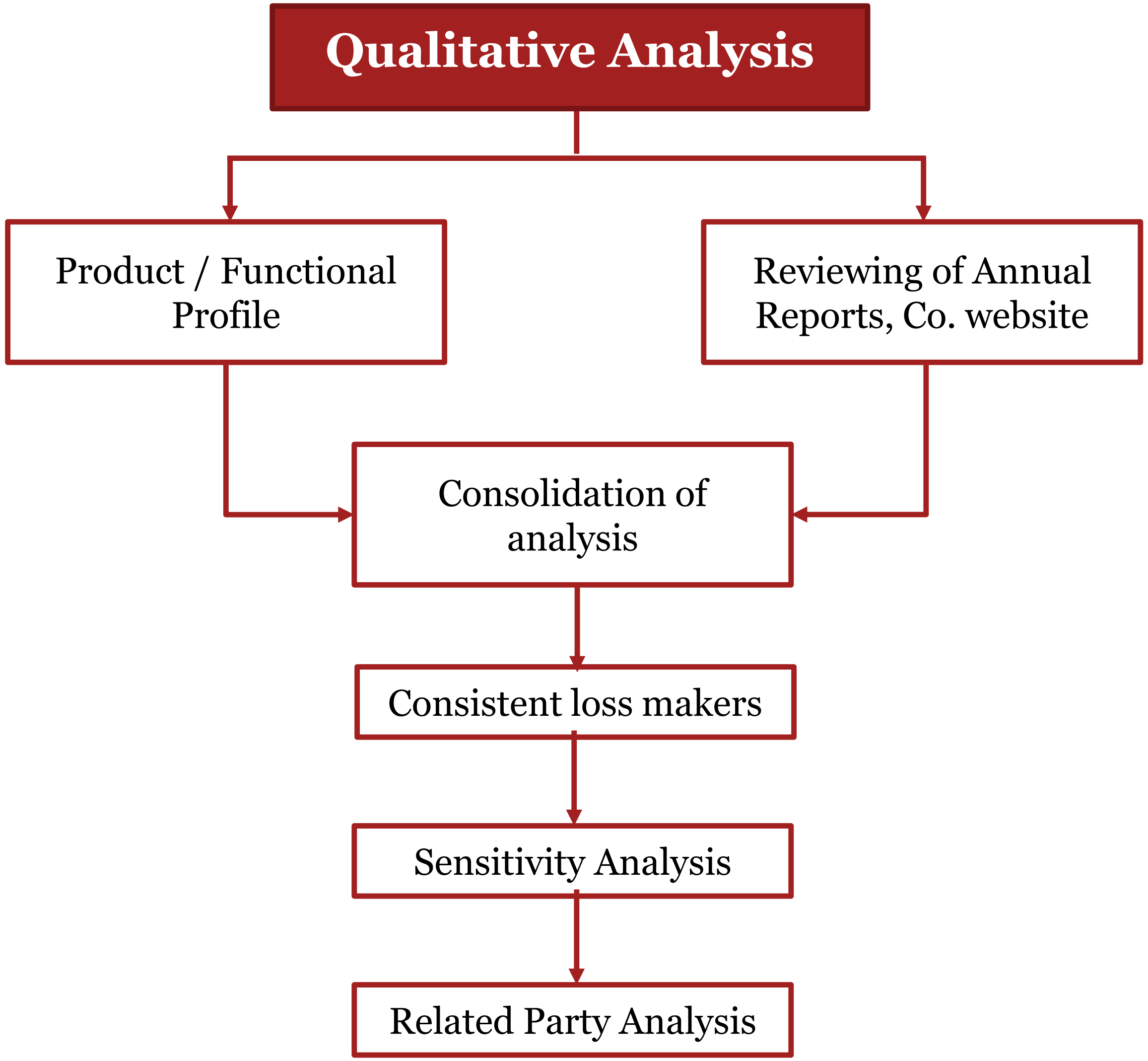
Criteria	Examples
Size/scale	Sales, Assets or Number of Employees
Intangible-related criteria	Ratio of Net Value of Intangibles/Total Net Assets Value, or ratio of Research and Development ("R&D")/Sales where available
Country of sales	Importance of export sales (Foreign Sales/Total Sales), where relevant
Stock holding	Inventory in absolute or relative value, where relevant
Other criteria	Special situations such as start-up companies, bankrupted companies, etc. when such peculiar situations are obviously not appropriate comparisons

Illustrations of quantitative Filters

Basic Quantitative Filters
Sales > 0 in 1 out of 3 years
Sales Mfg / Sales, Sales Trdg / Sales
Industry
Ownership
Networth
Sales > INR 1 crore
Net Fixed Assets/Intangibles

Specific Quantitative Filters
Export
R&D
Employee cost
Inventory
VAE/ Total Sales

Qualitative Analysis & RPT filter



RPT filter

Particulars	Amount
RPT operating revenue	A
Total Sales	X
Computation of RPT ratio	A/X

Related Party Filter is applied to reject companies having Related Party Transactions ('RPT') to total sales more than specific thresholds. This filter is applied to ensure that the comparable transactions are uncontrolled.

Case studies

Case Study 1

Company A (Group) in US

Production Schedule

Finished Products

Company B (Manufacturer) in India

Functions of Company A

- *Requisition for finished products*
- *Product design and specification*
- *Marketing and Selling of products*

Functions of Company B

- *Procurement of Raw Materials based on specifications received from Company A*
- *Manufacturing of required products as per the specifications of the group*
- *Warehousing functions*
- *Quality Control as per specifications of group*
- *Export and related activities*

Illustrative Qualitative and Quantitative filters

Quantitative Criteria

- Keep companies with Turnover > INR 1 Cr for current year or previous year (L/L-1) (to exclude start up companies)
- Networth>= 0 for current year or previous year (L/L-1) (to exclude companies which have eroded their net worth)
- Ownership filter (to exclude govt. companies)
- Function filter (to select only manufacturers)
- Industry filter (to select companies from the industry in which the tested party operates)

Qualitative Criteria

- Involved in buying raw materials and converting them into finished goods.
- If clearly mentioned about contract manufacturing activity in the annual report.
- Post analysis of qualitative information check for inventory (whether owns inventory).
- The company has substantial amount of job work income.

RPT Screen

- Keeping companies that have RPT < 25% for current or previous years (L /L-1)

Excerpt from search summary

Search Summary	Criteria	Results	Entity	Segment
Tested Party FYE	03/31/2020			
Timeframe (years)	3			
Aligned Dates	FY20:4/1/2019 - 3/31/2020;FY19:4/1/2018 - 3/31/2019;FY18:4/1/2017 - 3/31/2018;			
Financial Values	shown in ₹ 10,000,000			
Mode	India			
Currency	INR			
Data Vendors (in priority order)	Capitaline TP Entity, Capitaline TP Segment			
Forex	Non-Operating			
Related Party Transaction Analysis	On			
Data Set	2020-04 Capitaline	59,292	55,282	4,010
Company Type (no finance, bank, insurance or trading services)	Yes	40,685	36,675	4,010
Turnover greater than 0 for L or L-1	Yes	10,108	6,098	4,010
	Total After Removing Duplicates and Before Quantitative Screening:	**10,108**	**6,098**	**4,010**
Quantitative Screen	**Value**	**Impact**	**Entity**	**Segment**
Turnover >= INR 1 crore for L or L-1	Keeping companies and segments that have Turnover greater than or equal to INR 1 crore for L or L-1.	-909	-566	-343
Net Worth >= 0 for L or L-1	Keeping companies and segments that have Net Worth greater than or equal to 0 for L or L-1.	-535	-390	-145
Ownership, Function, Industry & Segment Screens	**Value**	**Impact**	**Entity**	**Segment**
Ownership	Keeping only companies and segments with Ownership equal to "Private owned"	-357	-122	-235
Function	Keeping only companies and segments with Function equal to "Manufacturer"	-3,494	-2,185	-1,309
Industry	Keeping only companies and segments with Industry similar to that of tested party	-3,911	-2,294	-1,617
	Total Before Qualitative Screening:	**733**	**541**	**192**
Qualitative and RPT Screen		**Impact**	**Entity**	**Segment**
Qualitative Review	Keeping only comparable companies and segments	-675	-484	-191
RPT < 25% for L or L-1	Keeping companies that have RPT < 25% for L or L-1	-48	-47	-1
	Total remaining in Working Set:	**0**	**0**	**0**
	Total marked as Accepted:	**10**	**10**	**0**

Case Study 2

Company A (Group) in US

Request for support functions

Provision of IT services

Company B (Service provider) in India

Functions of Company A

- *Designing corporate strategy*
- *Design of IT & system solutions*
- *Supply chain management*
- *Sales and marketing functions*
- *Quality assurance*

Functions of Company B

- *IT support services (within the framework laid down by Company A)*
- *Staff recruitment*
- *Quality Control as per specifications of group*
- *General administration*

Illustrative Qualitative and Quantitative filters

<u>Quantitative Criteria</u>

- Keep companies having Turnover> INR 1 Cr for current year and previous year (to exclude start up companies)
- Keep companies with Networth>= 0 current year and previous year (to exclude companies which have eroded their net worth)
- Keep companies with R&D to Turnover <= 3% (to exclude companies with high R&D cost)
- Keep Companies with NFA / Sales <= 200% (to exclude companies engaged in manufacturing or hold substantial assets which are not utilized for the provision of services)

<u>Qualitative Criteria</u>

- Keep companies that are closely linked to the business description of the tested party (Company B).
- Certain key words may be used for the search process.
- If clearly mentioned about captive service provision activity in the annual report.

Excerpt from search summary

Search Summary	Criteria	Results	Entity	Segment
Tested Party FYE	03/31/2020			
Timeframe (years)	3			
Alignment Rule	12 & 0			
Aligned Dates	FY20:4/1/2019 - 3/31/2020;FY19:4/1/2018 - 3/31/2019;FY18:4/1/2017 - 3/31/2018;			
Financial Values	shown in ₹ 10,000,000			
Mode	India			
IQR Method	India_CBDT			
Currency	INR			
Data Vendors (in priority order)	Capitaline TP Entity, Capitaline TP Segment			
Forex	Non-Operating			
Data Set	2020-04 Capitaline	59,292	55,282	4,010
Company Type (no finance, bank, insurance or trading services)	Yes	40,685	36,675	4,010
Turnover greater than 0 for L or L-1	Yes	10,108	6,098	4,010
	Total After Removing Duplicates and Before Quantitative Screening:	**10,108**	**6,098**	**4,010**
Quantitative Screen	**Value**	**Impact**	**Entity**	**Segment**
Turnover >= INR 1 crore for L or L-1	Keeping companies and segments that have Turnover greater than or equal to INR 1 crore for L or L-1.	-909	-566	-343
Net Worth >= 0 for L or L-1	Keeping companies and segments that have Net Worth greater than or equal to 0 for L or L-1.	-535	-390	-145
R&D to Turnover	Keeping companies that have R&D to Turnover less than or equal to 3.00%	-87	-87	0
Net Fixed Assets to Turnover	Keeping companies that have Net Fixed Assets to Turnover less than or equal to 200.00%	-309	-309	0
Ownership, Function, Industry & Segment Screens	**Value**	**Impact**	**Entity**	**Segment**
Ownership	Keeping only companies and segments with Ownership equal to "Private owned"	-338	-103	-235
Function	Keeping only companies and segments with Function equal to "Service Provider"	-5,489	-3,279	-2,210
Segment Type	Keeping only segments with Segment equal to "Business Segment"	-285	0	-285
	Total Before Qualitative Screening:	**2,156**	**1,364**	**792**
Qualitative Screen		**Impact**	**Entity**	**Segment**
Qualitative Review	Keeping only comparable companies and segments	-2,148	-1,357	-791
	Total remaining in Working Set:	**0**	**0**	**0**
	Total marked as Accepted:	**8**	**7**	**1**

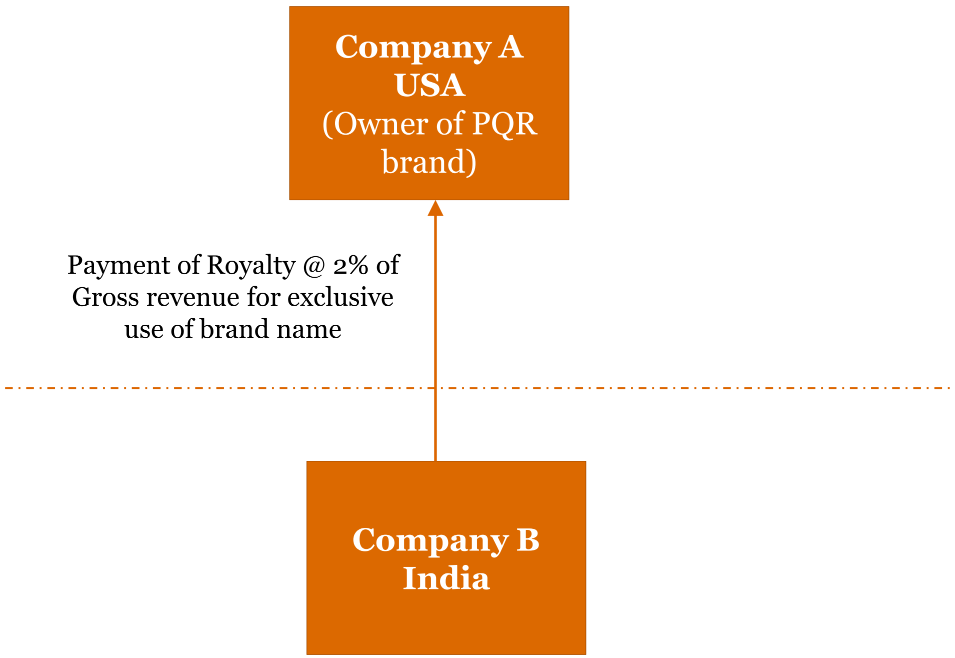
Case study 3

Company A, based in USA is the owner of PQR brand of cosmetics. Company A has entered into a marketing and distribution agreement for the PQR brand of cosmetics with Company B, based in India for the Asia Pacific region for a period of 15 years. Company A has also granted an exclusive license to use the brand name PQR and related service-marks to Company B. PQR brand is a well-established brand across the world and has continued to earn profits for the Group. For the use of PQR brand, Company B is required to pay a royalty of 2% of the gross revenues ('GR') to Company A. For the purpose of benchmarking the transaction, CUP method was selected and a search was conducted which provided the following comparable agreements:

Parameters / Agreement	1	2	3	4	5
Exclusivity	Non-Exclusive	Exclusive	Exclusive	Exclusive	Exclusive
Region	Sri Lanka	India	Middle East	India	Nepal
Period	50 years	100 years	10 years	5 years	15 years
Brand visibility	High	Medium	Low	Low	Medium
Pricing model	5% of GR	1% of NR	5 years – 0% 5 years – 1% of GR	Loss – 0% Profit – 1% of GR	1% of GR

Which of the above agreements are comparable? Provide reasons for the same.

Case study 3



Benchmarking approach for Royalty - CUP

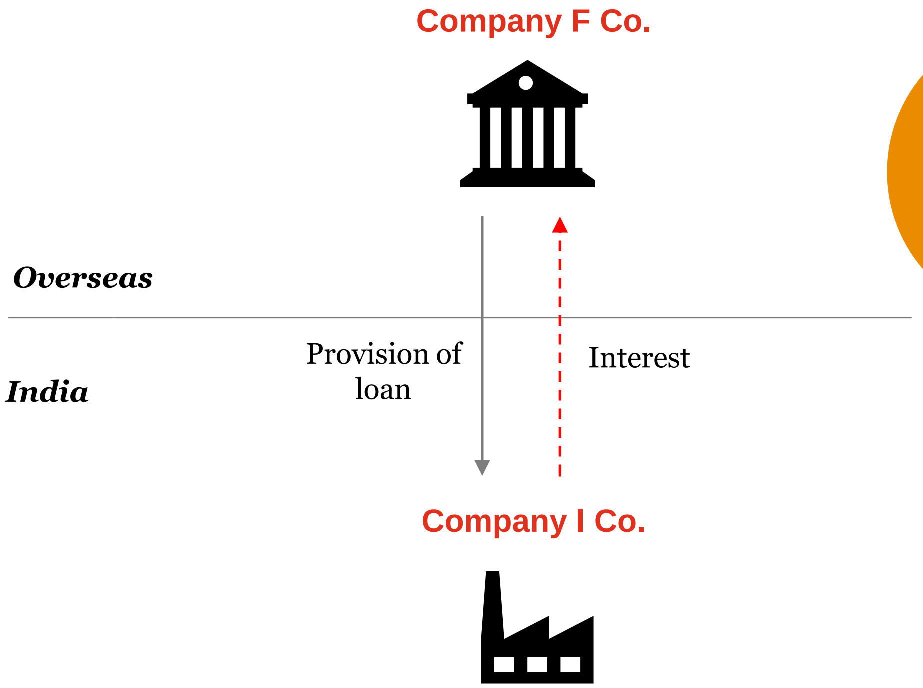
- **Step 1 -** Benchmarking analysis using various databases. Identify a list of third-party agreements, available on the database for licensing of such similar technology/right;
- **Step 2 -** Carry out a detailed analysis of the comparable agreements
- **Step 3 -** Identify an arm's length royalty rates based on the search process.
- Factors to be considered for applying CUP - exclusivity; extent and useful life; geographic scope; stage of development of intangible; rights to enhancements, revisions and updates; basis of payment and expectation of future benefit.

ALP of Financial Transactions

Contents

Intra-group financial arrangement

- Capital structuring by MNCs has acquired significant relevance both from the viewpoint of business / funding and tax cost optimization.
- Many companies obtain funding across the multinational group, in order to service liquidity provision, long term funding, and other operational needs.



Section 92B – Capital financing

1

Finance Act 2012 amended the definition of "international transaction" to include capital financing retrospectively w.e.f 1 April 2002

2

Capital financing includes:

- *any type of long-term or short-term borrowing,*
- *lending or guarantee,*
- *purchase or sale of marketable securities*
- *any type of advance, payments or deferred payment or receivable*

any other debt arising during the course of business

Key Types of Intra-Group Loans / Debt Instruments

Key Features	Inbound Loans			Outbound Loans
	Non Convertible Debentures ('NCDs')	Compulsorily Convertible Debentures ('CCDs')	External Commercial Borrowings ('ECBs')	Term Loans
Currency	INR	INR	Foreign Currency/INR	Foreign Currency
Collateral	Secured/ Unsecured	Unsecured	Secured/ Unsecured	Unsecured
Purpose	Acquisition/ Restructuring, Working Capital	Acquisition/ Restructuring, Working Capital	Capital expenditure/ General corporate	Working Capital, Acquisition etc.
Regulations	RBI	RBI, SEBI, FDI	RBI	RBI

Determination of arm's length price

Setting arm's length pricing arrangements for intra-group financial transactions is particularly complicated since the pricing of such transactions is inherently subjective. This subjectivity results in benchmarking approaches that may be perfectly acceptable in one jurisdiction but not in the other.

Some of key items to be assessed in case of Financial transactions *

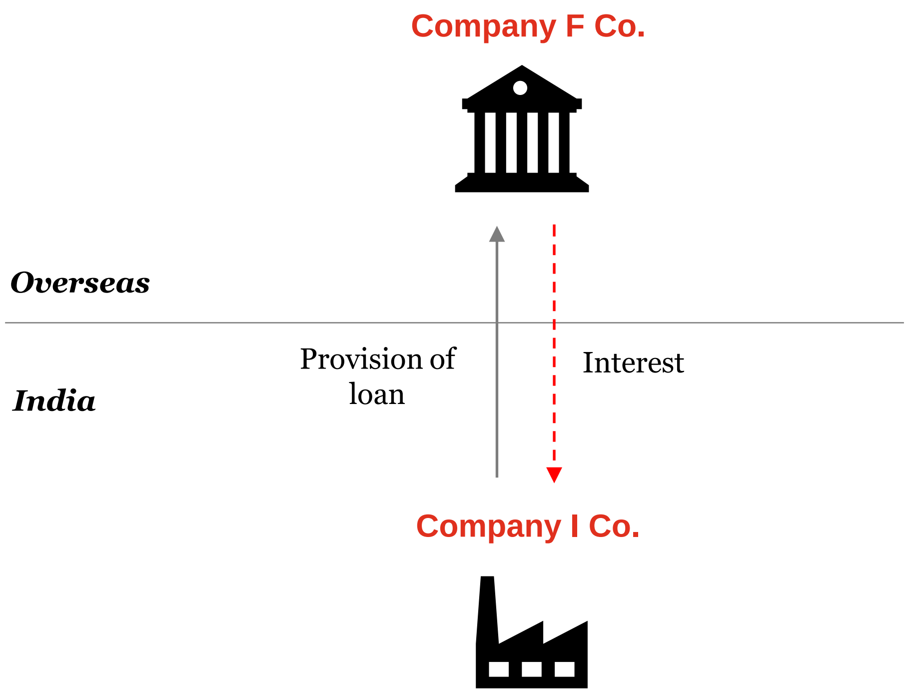
- Nature
- Purpose
- Duration
- Covenants (i.e., Terms) of the agreement

*As per ICAI Guidance Note on Section 92E – page 79

Most appropriate method for determining ALP

Intra Group Loans	CUP Method/ Other Method
Notional interest on delayed receivables	CUP Method/ Other Method
Guarantee	Other Method

Benchmarking – Intra Group Loans



Benchmarking approach for Intra group Loan- CUP

- Estimation of credit assessment score of the Company F based on the standalone credit rating.
- Search for and identify third party debt instruments comparable to the intra-group loans in order to estimate an appropriate interest rate.
- Adjust the interest rates to reflect the interest rates charged by Company I
- Factors to be considered for applying CUP – Credit rating, tenor, currency of the loan, year of loan transaction, geographic location, terms and conditions, basis of interest rate (fixed/floating) etc.

INR	*Foreign Currency*
SBI Prime lending rate	LIBOR + Spread

Factors to be considered to determine ALP

ABC Inc, USA
(lender or subscriber)

XYZ Ltd, India
(Borrower or issuer)

ABC proposes to invest in XYZ by subscribing to its Compulsorily convertible debentures (CCDs)

TP Approach to determine the ALP

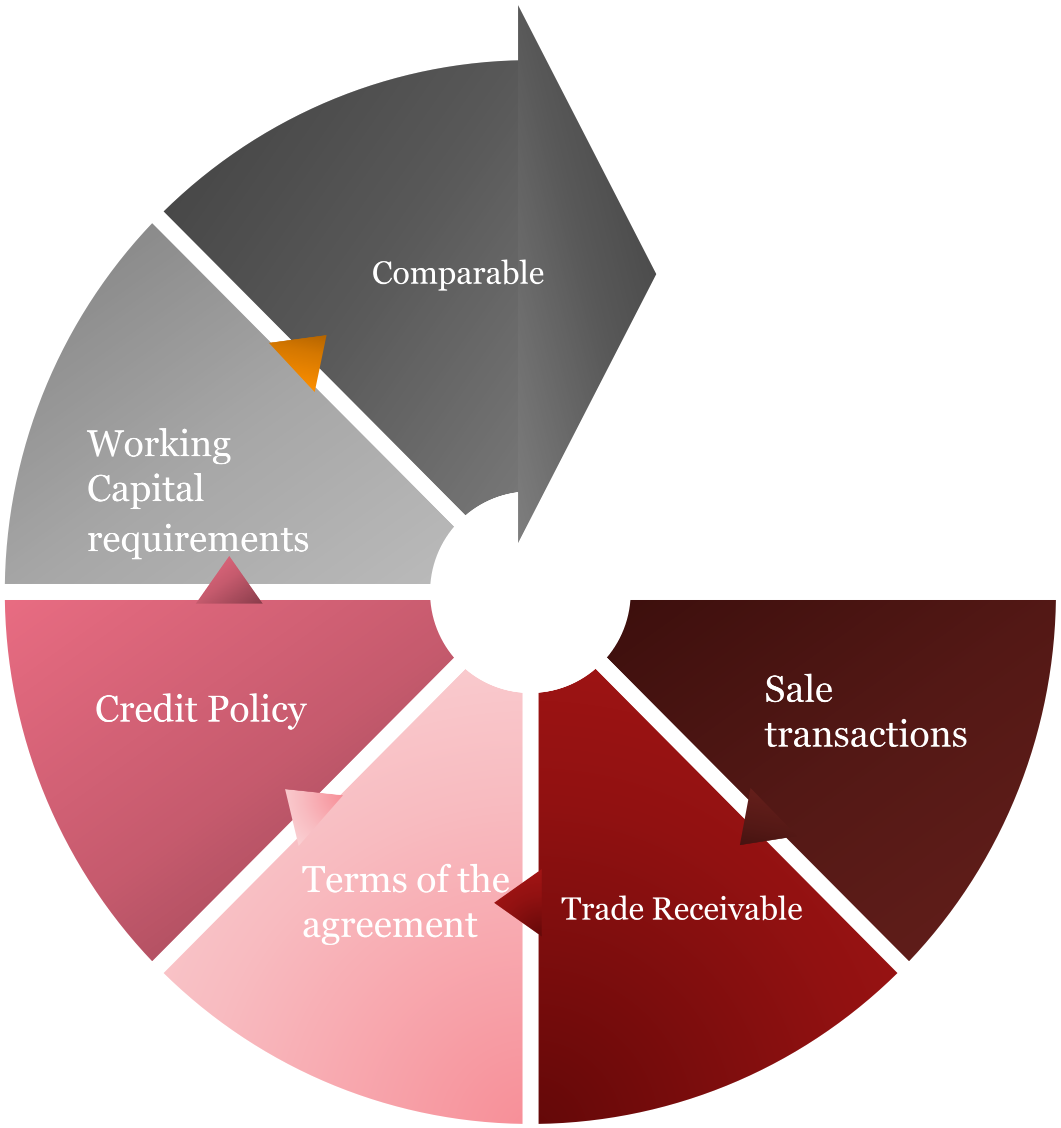
- CCD instrument - terms and conditions
- Currency – INR denominated
- Credit rating
- Terms and conditions considered:
  - Tenor – Longer the tenor, higher the coupon rate;
  - Security – Unsecured and unguaranteed instrument - higher coupon rate vs secured instrument;
  - Moratorium – Time value of money – Longer moratorium period – higher coupon rate;
  - Conversion option with both, lender and issuer; and
  - Conversion price – Fair market value at the time of conversion.

Factors to be considered to determine ALP

Snap shot – Pricing grid

Years >>			5 years			10 years		
Particulars	**No. of comparables**	**Range**	**No Moratorium**	**6 Month Moratorium**	**12 Month Moratorium**	**No Moratorium**	**6 Month Moratorium**	**12 Month Moratorium**
Secured - Guaranteed	8	35th percentile	10.20%	10.40%	10.74%	10.27%	10.46%	10.86%
		Median	10.38%	10.59%	10.94%	10.66%	10.87%	11.30%
		65th percentile	11.24%	11.49%	11.90%	11.84%	12.11%	12.64%
Secured - Unguaranteed	6	35th percentile	11.13%	11.37%	11.78%	11.46%	11.71%	12.21%
		Median	12.30%	12.60%	13.10%	12.60%	12.91%	13.51%
		65th percentile	13.48%	13.84%	14.44%	13.73%	14.11%	14.83%
Unsecured -Unguaranteed*	5	Mean	13.86%	14.24%	14.88%	14.10%	14.51%	15.26%
		+ 3%	14.28%	14.67%	15.33%	14.52%	14.95%	15.72%
		- 3%	13.44%	13.81%	14.43%	13.68%	14.07%	14.80%

Trade Receivables



Credit period offered to AE as per the Agreement

↓

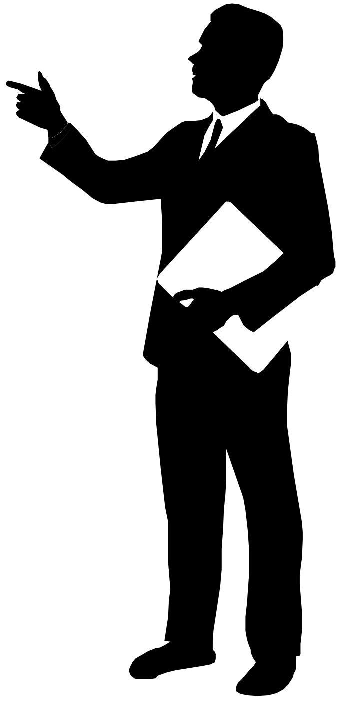
To Adjust for the credit period of receivables

↓

Working Capital Adjustment (WCA)

↓

= Average Trade receivables + Average Inventories – Average Trade payables



Interest on outstanding Trade Receivables

Adjusted ('Adj') Margins of tested party [A]

Compare

Adj Margins of comparable companies [B]

ALP within range

ALP outside range

No TP adjustment

TP adjustment = Median of B – Adj margin of A **(To be reported)**

Interest rate is determined based on credit rating

Extraordinary delay in collection of receivables

Compute arm's length interest

Interest on receivables **(To be reported in Clause 14)**

QUIZ – Question 5

ABC Limited, India has provided a loan of USD 10 million to its subsidiary, XYZ Inc., USA on 3rd September 2019. During the FY 2020-21, XYZ Inc., USA pays interest @ 7% p.a on the intra-group loan as per the terms of the agreement and determined to be at arm's length interest rate in FY 2019-20. The balance is still outstanding on the intra group loan during the FY 2020-21. Which transaction should be disclosed in Form 3CEB during the FY 2020-21?

A. Loan transaction and receipt of interest income
B. Only loan transaction
C. Only receipt of interest income

Reporting Requirement under Clause 14 of Form 3CEB

14.	Particulars in respect of lending or borrowing of money : Has the assessee entered into any international transaction(s) in respect of lending or borrowing of money including any type of advance, payments, deferred payments, receivable, non-convertible preference shares/ debentures or any other debt arising during the course of business as specified in Explanation (i)(c) below section 92B (2)? (*a*) Name and address of the associated enterprise with whom the international transaction has been entered into. (*b*) Nature of financing agreement. (*c*) Currency in which transaction has taken place (*d*) Interest rate charged/paid in respect of each lending/borrowing. (*e*) Amount paid/received or payable/receivable in the transaction— (*i*) as per books of account;
	(*ii*) as computed by the assessee having regard to the arm's length price. (*f*) Method used for determining the arm's length price [*See* section 92C(1)]

VVF Limited (ITA No. 846/ Mum/2016)

Facts of the case:

VVF Limited is producer and exporter of chemicals and a leading manufacturer of toilet soaps and personal care products.

During the AY 2011-12, VVF Limited had provided corporate guarantee to its AE and charged a guarantee fee at the rate of 1.68% on the basis of the internal CUP.

It had also provided intra-group loan to its foreign associated enterprise.

TPO made an adjustment on account of the below:

- Corporate guarantee issued to its AEs – charged markup of 1.75% based on bank rates
- Interest on foreign currency loan given to AE – charged LIBOR + 3% on application of internal CUP available for earlier AY
- Characterization of Share application money as loan and consequent interest

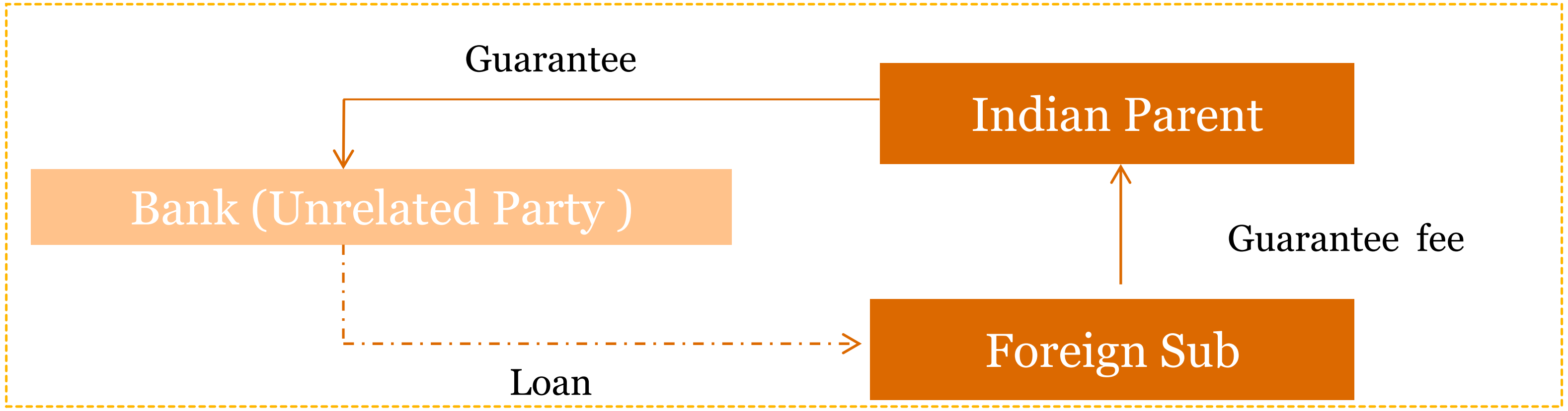
Contentions of the Assessee and decision of Income Tax Appellate Tribunal:

- Corporate guarantee is not an international transaction - Rejected
- Guarantee fee charged on 1.68% on the basis of internal CUP – Sustained
- Interest rate for loan based on internal CUP for current AY is LIBOR + 2.68% - Sustained
- Shares were not allotted, and the share application money was refunded. Both are genuine transactions – Directing AO to look into the issue

General Issues in Loan transactions

- Incomplete loan agreements
- Amendment to loan not factored in while setting price
- Shareholders contribution – No interest charge
- Naked bank quotes
- Charging risk free rates for interest and not accounting for credit risk
- Different instruments for CUP analysis

Intra-Group Guarantee



Purpose

Credit / Financial guarantee provides credit enhancement to the guaranteed party, either:
- to access cheaper funding or
- to access capital markets

Type

Nature of guarantee in an inter-company context:
- Explicit Guarantee – formal contract; legal requirement to pay lender upon default
- Implicit Guarantee – e.g. Letter of comfort, keepwell agreements, etc.

Intra-Group Guarantee - Implicit or explicit

What is the purpose of the transaction?

A Shareholder service?

"…no service would be received where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member, or where the enterprise benefitted from the groups reputation deriving from global marketing and public relations campaigns. In this respect, **passive association** should be **distinguished** from **active** promotion of the MNE group's attributes that positively enhances the profit making potential of particular members of the group." (OECD Guidelines 2017, para 7.13)

Example

- Implicit support

A Beneficial service?

"The question whether an intra-group service has been rendered (…) should depend on whether the [guarantee] provides a group [company] with **economic or commercial value** (…). This can be determined by considering whether an independent enterprise in comparable circumstances would have been willing to pay for the [guarantee]." (OECD Guidelines 2017, para 7.6)

Examples

- Explicit support
  - Financial
  - Operating / Performance

Benchmarking – Guarantee

Benchmarking approach for Guarantee - Other Method

- Evaluation of the terms and conditions of the debt/guarantee arrangement.
- Assessment of the credit quality of the borrower and estimation of its credit rating
- Identification of external comparables based on the terms and conditions of the tested transaction. Information available on public sources like the NSE or NSDL, or databases like Bloomberg or ThomsonReuters.
- Adjustment of the interest/coupon rates of comparables for any differences arising

1. Interest Saving Approach

- Considers the 'interest saved' for the borrower by calculating the difference of the rate applicable to the borrower in a stand-alone scenario vis-à-vis parental guarantee
- Estimate difference between actual interest paid and rate payable without a guarantee

2. Risk of Loss Approach

- Calculates the effective cost for parent entity for providing guarantee by taking into account the amount at risk and default rate of borrower.
- Estimates the expected loss over term of loan plus a return on that expected loss

Financial Guarantees - OECD Guidelines on Financial transactions

BEPS Focus Points	Summary
Accurate delineation of the transactions	Accurate delineation can be used as a guiding framework for which intercompany transactions should be respected as debt –including the volume of debt
	Functional analysis is necessary for accurate delineation
Consideration of the options realistically available to each party	Each party will consider all options realistically available, and therefore may only enter into the transaction if there is no better option to meet commercial goals
Contractual terms	Contractual arrangements between related parties may not include all necessary information or may not accurately reflect the actual behavior of the parties
Remuneration	If the guarantee provides a credit enhancement in addition to the implicit support, it should be compensated
Pricing	Several pricing approaches are listed (CUP, yield approach, cost approach, valuation of expected loss, capital support method)
Impact of recipient's credit	If a guarantee contributes to an increased debt capacity of the recipient, there may be a recharacterization of the increased capacity/rating

Reporting Requirement of Guarantee under Clause 15

Aspect	Considerations
Disclosure	Financial guarantees provided/received to/from AEs
Documentation	• Identify from Contingent Liability and RPT Schedule in audited financials. • Determine nature from facility agreement. • Obtain Management representation letter for all guarantees*
Benchmarking	Other Method – Interest saving approach or Risk of loss approach
Issues	• Disclosure of Implicit guarantees or Letter of Comfort ? • When guarantee is to be disclosed? • If no guarantee fees charged ? • Whether guarantee can be considered as shareholding activity and no charge required?

Disclosure is mandatory as it is a specific clause and approach / position can be substantiated by way of notes to avoid stringent penal consequences of non-disclosure

*As per ICAI Guidance Note on Section 92E – refer clause (d) in page 157

Reporting Requirement of Guarantee under Clause 15 (contd.) :

15.	Particulars in respect of transactions in the nature of guarantee: Has the assessee entered into any international transaction(s) in the nature of guarantee? If yes, provide the following details: (*a*) Name and address of the associated enterprise with whom the international transaction has been entered into. (*b*) Nature of guarantee agreement (*c*) Currency in which the guarantee transaction was undertaken (*d*) Compensation/ fees charged/ paid in respect of the transaction (*e*) Method used for determining the arm's length price [*See* section 92C(1)]

Guarantee – Indian Rulings

- Everest Kento Cyliners Ltd - Bombay HC (ITA No. 1165/Mum/2013),
- Nimbus Communications Ltd (I.T.A. No. 3664/Mum/2010)

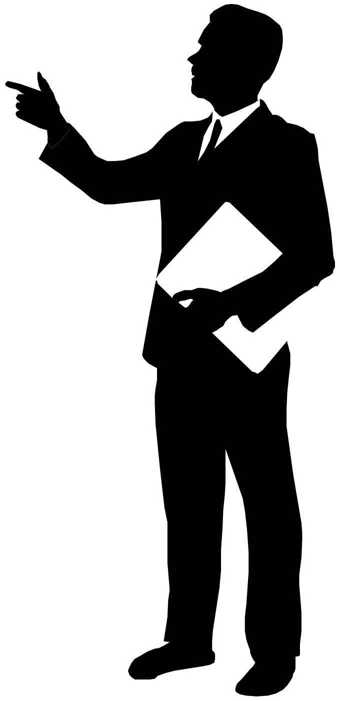
- Naked Bank quotes considered inappropriate

- Bharti Airtel Limited (ITA No. 5816/Del/2012),
- Micro Ink Limited (ITA No. 2873/Ahd/10),
- TVS Logistics Services Limited (ITA No. 458/Mds/2016)

- Provision of a corporate guarantee would not constitute an international transaction unless the same has a bearing on the profits, income, losses or assets of the taxpayer
- Explanation to Section 92B enlarges the scope of definition of 'international transaction' and accordingly cannot be said to be retrospective in effect
- When the issuance of corporate guarantee is in the nature of quasi-capital or shareholder activity, it does not amount to a service

- Redington India Ltd- Madras HC (I.T.A.No.513/Mds/2014 & I.T.A.No.619/Mds/2014)
- Prolifics Corporation Ltd (ITA No. 237/Hyd/2014

- Explanation to Section 92B on 'international transaction' is said to be retrospective in effect.



Summary of Issues in Financial transactions

Intra-group loans	Guarantee	Interest on outstanding receivables
• Arm's length interest on lending transactions to be charged. • Tribunals/ Courts have held that the rate of interest must be based on the **currency in which the loan is granted**. • Accordingly, a foreign currency loan would call for a **LIBOR/EURIBOR** based interest rate ALP while loans granted in Indian currency calls for **Indian PLR** based ALP. • This has been reiterated in the **Safe Harbour Rules** 2017 as well.	• **Naked Bank quoted rates** • **Shareholder activity** – absence of bearing on profits, income, losses or assets of the enterprise. • Courts are split on the **retrospectivity** and the **applicability** of the amendment to corporate guarantee transactions. • The Courts have over time, fixed ALP of a corporate guarantee in the **range of 0.5% to 1%.** • Safe Harbour Rules 2017 also rationalized margin at **1% p.a. of amount guaranteed**.	• These are mostly trade receivables from AEs that are outstanding for **more than a reasonable period**. • Delayed for **some peculiar reasons** like regulatory issues or poor financial conditions of the AEs/ overseas customers. • Such delays by the AEs lead into a **TP adjustment** on this account. • The overdue receivables from AEs are treated as **deemed unsecured loan** by the authorities and adjustments for **notional interest** are made on the same.

Thank you