

EXPOSURE DRAFT

**GUIDANCE NOTE ON REPORT
UNDER SECTION 92E OF
THE INCOME-TAX ACT, 1961
(TRANSFER PRICING)**

[Based on the law as amended by the Finance Act, 2022]

(Revised 2022)

(Last date for Comments: 1st August, 2022)



Committee on International Taxation
The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

EXPOSURE DRAFT- GUIDANCE NOTE ON REPORT UNDER SECTION 92E OF THE INCOME-TAX ACT, 1961 (TRANSFER PRICING)

Following is the Exposure Draft of the Guidance Note on Report under section 92E of the Income-tax Act, 1961 (Transfer Pricing), issued by the Committee on International Taxation of ICAI for comments. Changes have been made to the extent of amendments made by the Finance Act, 2022.

The Committee invites comments on this Exposure Draft. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide suggestions for alternative wording.

How to comment:

Comments can be sent to citax@icai.in so as to be received not later than 1st August, 2022.

Chapter 1

Introduction

Legislative Framework

1.1 In an era of liberalization and globalization of trade and investment and the emergence of digital economy, the perceptible results have been - increase in the number of cross-border transactions and the complexity and speed with which global business can be transacted.

1.2 When transactions are entered into between independent enterprises, the consideration therefore is determined by market forces. However, when associated enterprises deal with each other, it is possible that the commercial and financial aspects of the transactions are not influenced by external market forces but are determined based on internal factors. In such a situation, when the transfer price agreed between the associated enterprises does not reflect market forces and the arm's length principle, the profit arising from the transactions, the consequent tax liabilities of the associated enterprises and the tax revenue of the host countries could be distorted.

1.3 The existence of different tax rates and rules in different countries offers a potential incentive to multinational enterprises to manipulate their transfer prices to recognise lower profit in countries with higher tax rates and vice versa. This can reduce the aggregate tax payable by the multinational groups and increase the after tax returns available for distribution to shareholders.

1.4 In India, the Act for a long time did not deal with this problem in a detailed manner. The erstwhile section 92 sought to determine the amount of profits which may reasonably be deemed to have been derived from a business carried on between a resident and a non-resident which, owing to the close connection between them is so arranged that it produced, to the resident, either no profits or less than the ordinary profits which might be expected to arise in that business in case the transaction would have been entered into between two entities having no close connection. Besides, sections 40A(2); 80IA(10) and 80IB(13) of the Act provide powers to the Assessing Officer to interfere with the pricing or costing of certain transactions in certain cases in order to determine the correct quantum of deduction permissible.

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1.5 The Finance Act, 2001, recognised that international transactions between Associated Enterprises may not be subject to the same market forces that shape relations between two independent firms, and therefore introduced a set of provisions in Chapter X of the Act under the title "Special Provisions relating to avoidance of tax". The statutory framework attempts to monitor transfer prices for goods, facilities and services in order to determine that they conform to the "arm's length principle". Not only has section 92 of the Act been completely recast but new sections 92A to 92F have also been introduced to meet the desired objective of ensuring that the local tax base of a taxpayer is fair.

1.6 The relevant provisions contained in Chapter X (sections 92 to 92F) of the Act and the provisions dealing with the levy of penalties for non-compliance thereof are reproduced in **Annexure I**. The Finance Act, 2002 made certain changes to the provisions contained in sections 92A, 92C, 92F and 271F. The Finance Act, 2006 further amended section 92C. Further, the Finance Act, 2007 inserted sub-sections (3A) and (4) in section 92CA. Finance Act 2009 amended the proviso to section 92C, provided for constitution of the dispute resolution panel and empowered the Board to formulate safe harbour rules. Finance Act 2011 amended the allowable variation as per second proviso to section 92C(2) to be notified by the Central Government, and made changes to Section 92CA. The Finance Act 2012 has introduced significant amendments including inter alia clarifying the coverage of the term 'international transactions', expanding the scope of transfer pricing provisions to specified domestic transactions (Section 92BA) and providing an Advance Pricing Agreement framework (Section 92CC and Section 92CD) empowering the transfer pricing officer to determine arm's length price of an international transaction noticed during the course of proceedings before him, even if the said transaction has not been referred by the Assessing Officer, provided such transaction has not been reported by taxpayer as per requirement of Section 92E of the Income Tax Act, 1961 [Section 92CA(2B)] and expanding the scope of penalties and amending Section 147 of the Act to provide that non-reporting of transaction in report as per Section 92E would be deemed to be case of escapement of income.

Further, changes specifically in respect of arm's length price determination were introduced vide Finance (No. 2) Act 2014 and the Finance Act 2015. The Finance Bill 2014 introduced the use of multiple year data and the Finance Act (No. 2), 2014 introduced range concept for determination of arm's length price and roll-back mechanism for APA. The final rules in relation to the range concept and use of multiple year data were notified by the Central Board of Direct Taxes in October, 2015.

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1.7 Further, section 92B extended application of transfer pricing provisions to transaction entered by an Indian entity with a resident independent third party under specified circumstances. The Finance Act 2015 increased the threshold limit for the applicability of specified domestic transaction from INR 5 crores to INR 20 crores with effect from Financial Year 2015-16.

1.8 The Finance Act 2016, in line with recommendations of the BEPS Action Plan 13, inserted section 286 for furnishing of country-by-country report and inserted proviso to section 92D(1) for maintenance of Master File, with effect from Financial Year 2016-17. Further, relevant rules and forms for country-by-country and Master File were notified on 31 October, 2017.

1.9 Further, the existing penalty provisions have been rationalised along with insertion of additional penalties for non-furnishing/ maintenance of country-by-country report and Master File.

1.10 The Finance Act 2017, amended the applicability of specified domestic transactions compliance by excluding expenditure made to person referred to in Sec. 40A(2)(b) of the Act, from the ambit of the definition.

1.11 Provisions regarding secondary adjustments and limitation on interest deduction were introduced and inserted as new sections (92CE and 94B respectively) vide Finance Act, 2017. Finance Act 2017 also introduced section 271J for levying penalty on accountants for furnishing incorrect information in reports or certificates furnished under any provisions of the Act or the rules made thereunder.

1.12 The Finance (No. 2) Act, 2019 made amendments to section 92CD, 92CE, 92D and 286 of the Act. These amendments are as follows:

- Section 92CD (3) was amended to clarify that in cases where assessment or reassessment has already been completed and modified return of income has been filed by the tax payer under sub-section (1) of section 92CD, the Assessing Officers shall pass an order modifying the total income of the relevant assessment year determined in such assessment or reassessment, having regard to and in accordance with the APA. This amendment is applicable from 1 September, 2019.
- Section 92CE was amended to give clarification with regard to applicability of provision of secondary adjustment and to give an option to assessee to make one-time payment (discussed in detail at Para 1.31 of this chapter)

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- Section 286 of the Act was amended to give clarification regarding definition of the “accounting year” so as to provide that the accounting year in case of the alternate reporting entity (‘ARE’) of an international group, the parent entity of which is not resident in India, shall be the one applicable to the parent entity of ARE. The said amendment will take effect retrospectively from the 1st April, 2017 and will, accordingly, apply in relation to the assessment year 2017-18 and subsequent assessment years.

1.13 The Finance Act, 2020 made certain amendments to sections 92CB, 92CC, 92F and 94B. These amendments are as follows:

- Section 92CB and 92CC of the Act was amended to include attribution of profits to the PE of a non-resident under clause (i) of sub-section (1) of section 9 of the Act.
- Section 92F of the Act amended the definition of term “specified date” to mean the date one month prior to the due date for furnishing the return of income under sub-section (1) of section 139 for the relevant assessment year.
- Section 94B of the Act was amended to exclude interest paid or payable in respect of a debt issued by a lender which is a permanent establishment in India of a non-resident, being a person engaged in the business of banking.
- On 17 June 2022, Central Board of Direct Taxes (‘CBDT’) has issued Notification No. 66 /2022/F. No. 370142/26/2022-TPL. Vide this Notification; the CBDT has extended the Safe Harbour Rules (‘SHR’) to Assessment Year (‘AY’) 2022-23 relevant to the previous year 2021-22.

1.14 *Faceless Assessment:* The Taxation and Other Laws (Relaxation and Amendment of Certain Provisions) Act, 2020 amended section 92CA of the Act and inserted clause (8) to (10) w.e.f from 1.11.2020 to extend the provision of faceless assessment to transfer pricing also.

Sub-section (9) of the said section further provides that for the purposes of giving effect to the aforesaid scheme, the Central Government may by notification in the Official Gazette direct that any of the provisions of the Act shall not apply or shall apply with such exceptions,

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modifications and adaptations as may be specified. It was provide that no direction shall be issued after the 31st day of March, 2022.

By virtue of Finance Bill, 2022, the last date for issuing directions/notification for faceless determination of arm's length price under section 92CA, faceless Dispute Resolution Panel under 144C, Faceless appeal/proceedings before the Appellate Tribunal under section 253/section 255 of the IT Act have now been extended from March 31, 2022 to March 31, 2024.

- 1.15 *Non filing of repetitive appeals* - A new section 158AB has been inserted after section 158AA by the Finance Act, 2022 in order to prevent filing of repetitive appeals.

These amendments are also included in the Annexure. The Rules prescribed in this regard by the Central Board of Direct Taxes are reproduced in **Annexure II**. The relevant extracts from the Memorandum explaining the provisions of the Finance Act, 2001, Finance Act, 2002, Finance Act, 2006, Finance Act, 2007, Finance Act, 2009, Finance Act, 2011, Finance Act 2012, Finance (No. 2) Act 2014, Finance Act 2015, Finance Act 2016, Finance Act, 2017, Finance (No. 2) Act, 2019 Finance Act 2020, The Taxation And Other Laws (Relaxation And Amendment Of Certain Provisions) Act, 2020 and Finance Act, 2022 are given in **Annexure III**. The Central Board of Direct Taxes has issued Circulars explaining the provisions and clarifying certain related aspects. These circulars are given in **Annexure IV**.

Terms and abbreviations used

- 1.16 In this Guidance Note the following terms and abbreviations occur often in the text. A brief explanation of such terms and abbreviations is given below. Further, reference to a section without reference to the relevant Act means that the section has reference to the Income-tax Act, 1961.

(a) Act

The Income-tax Act, 1961.

(b) Accountant

Accountant means a chartered accountant within the meaning of the Chartered Accountants Act, 1949 and as referred to in section 288 of the Act.

(c) Arm's Length Price (ALP)

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ALP as defined under section 92F(ii) of the Act.

(d) AS

The Accounting Standards issued, prescribed and made mandatory by the ICAI or as under section 2(2) of Companies Act, 2013 and the Companies (Accounting Standards) Rules, 2006.

(e) AS (IT)

Income Computation and Disclosure Standards notified by the Central Government under section 145(2) of the Act.

(f) SA

Standards on Auditing prescribed under Section 143(10) of the Companies Act 2013.

(g) Associated enterprises (AEs)

An AE as defined under section 92A of the Act.

(h) APA

Advance Pricing Agreement

(i) BEPS

Base Erosion and Profit Shifting

(j) Board/ CBDT

The Central Board of Direct Taxes constituted under the Central Boards of Revenue Act, 1963.

(k) Circular

A circular or instructions issued by the Board under section 119(1) of the Act.

(l) CUT

Comparable Uncontrolled transaction

(m) CUP Method

Comparable Uncontrolled Price Method

(n) RPM

Resale Price Method

(o) PSM

Profit Split Method

(p) CPM

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Cost Plus Method

(q) TNMM

Transactional Net Margin Method

(r) Enterprise

An enterprise as defined under section 92F (iii) of the Act.

(s) ICAI

The Institute of Chartered Accountants of India.

(t) International transaction

International transaction as defined under section 92B of the Act.

(u) OECD

Organisation for Economic Co-operation and Development.

(v) OECD Guidelines

Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations by OECD - provides guidance on the application of the "arm's length principle"

(w) Report

The report of an accountant under section 92E of the Act.

(x) Rules

The Income-tax Rules, 1962.

(y) Specified date

Specified date as stipulated under clause (iv) of section 92F of the Act.

(z) Specified domestic transaction

Specified domestic transaction as defined under section 92BA of the Act.

(za) Transaction

A transaction as defined under section 92F(v) of the Act.

(zb) Transfer Pricing Officer (TPO)

An officer as defined in explanation to section 92CA.

Objective of the Guidance Note

1.17 The provisions relating to computation of income from international transactions between AEs having regard to ALP are applicable with effect

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from assessment year 2002-03. According to section 92E of the Act, every person who has entered into an international transaction or a specified domestic transaction¹ 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. An accountant is required to discharge his function in this regard from assessment year 2002-03.

1.18 The object of this guidance note is to provide guidance to accountants in discharging their responsibilities under section 92E of the Act. It intends to:

- (i) assist in understanding the respective responsibilities of the taxpayer enterprise and the accountant;
- (ii) guide the accountant as to the nature and scope of information to be obtained by him from the taxpayer enterprise to enable him to conduct the examination;
- (iii) provide guidance on the verification procedures to be adopted by the accountant for giving the report and the prescribed particulars in the annexure thereto; and
- (iv) explain the circumstances where a disclosure or qualification or disclaimer may be required from the accountant while giving his report.

Applicability of the provisions

1.19 The provisions contained in Chapter X of the Act are applicable to an international transaction entered into between two or more AEs either or both of whom are non-residents. Also, in the case of a specified domestic transaction, not being an international transaction as covered as per section 92BA of the Act these provisions are attracted.

1.20 International transaction covers transaction 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 and income, losses or assets of such enterprises and includes a mutual agreement or arrangement between two or more AEs 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

¹ The provisions relating to Specified Domestic Transactions are applicable with effect from assessment year 2013-14.

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provided or to be provided to any one or more of such enterprises. Further, the expression 'international transaction' has been clarified vide Finance Act 2012 with retrospective effect from 1 April 2002 to include a wide variety of arrangements.

1.21 According to section 92B(2) of the Act, a transaction entered into by an enterprise with a person other than an AE, shall be deemed to be a transaction between two AEs if there exists a prior agreement in relation to the relevant transaction between such other person and the AE or the terms of the relevant transaction are determined in substance between such other person and the AE. Consequently the provisions of this chapter shall apply even in the aforementioned cases. This provision has been further amended to include transactions irrespective of whether such unrelated person is a resident or non-resident, as long as either the enterprise or the AE is non-resident.

1.22 As per section 92(3), these provisions are not intended to be applied in cases where the effect of application of these provisions reduces income chargeable to tax in India or increases the loss, as the case may be.

1.23 *Safe Harbour (Section 92CB of the Act)*

The Finance Act 2009 empowered the Board to frame safe harbour rules. Safe harbour means circumstances in which the tax authorities shall accept the transfer price as declared by the taxpayer. The safe harbour rules ('SHR') were notified in September 2013. In the rules, safe harbour rates were prescribed for specific nature of international transactions.

The CBDT, vide a notification dated 7 June 2017, revised the existing SHRs in India.

The revised SHRs apply for Assessment Year (AY) 2017-18 and two immediately following AYs i.e. upto AY 2019-20. The earlier SHRs were applicable from AY 2013-14 and four immediately following AYs i.e. upto AY 2017-18. For AY 2017-18, the taxpayer can choose from old or new rules whichever is more beneficial.

CBDT by way of notification dated May 20, 2020 has extended provisions of safe harbour rules to AYs 2020-21 and 2021-22 (Substituted for "assessment years 2020-21 and 2021-22" by the Income-tax (Eighteenth Amendment) Rules, 2022) as well.

1.24 *Key highlights*

Rationalisation of safe harbour rates -The safe harbour rates for all contract services have been moderated.

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Upper turnover threshold of INR 200 crore introduced for all contract service providers [Software Development, (ITeS), KPO, R&D for IT and generic pharmaceutical drugs].

Introduction of safe harbour for receipt of low value adding intra group services- The safe harbour provisions have been extended to receipt of such services by Indian entities under the revised SHRs. The revised SHRs in this regard also lay down a requirement for the applicant to get the method of cost pooling, exclusion of shareholder costs and duplicate costs from cost pool and the reasonableness of the allocation keys used for allocation of costs certified by an accountant. In this regard, the definition of an accountant has also been incorporated in the revised SHRs.

Introduction of safe harbour rates on loans advanced in foreign currency - The revised SHRs have prescribed safe harbour rates based on London Inter-bank Offer Rate (LIBOR) for loans advanced to AEs denominated in foreign currency and based on State Bank of India's marginal cost of funds lending rate for loans advanced to AEs denominated in INR. The revised SHRs have also prescribed staggered rates (spread over the applicable base rates) depending upon the credit rating of the overseas borrower, subject to such credit ratings being approved by CRISIL (formerly Credit Rating Information Services of India Limited)

1.25 The Safe harbour rates as per the old and new rules are tabulated below:

Categories of international transactions	Safe harbour rates - old rules [as per sub Rule (2) of rule 10TD of Income-tax Rules, 1962] applicable from AY 2013-14 to AY 2017-18	Safe Harbour rates - revised rules [as per sub Rule (2A) of rule 10TD] applicable from AY 2017-18 to AY 2019-20 (extended to be applicable for AYs 2020-21 and 2021-22 also)
Provision of Software development services and Information Technology Enabled services (ITeS), with insignificant risks	Operating profit margin to operating expense where the aggregate value of such transactions does not exceed a sum of INR500 crore – not less than 20 per cent	Operating profit margin to operating expense where the aggregate value of such transactions does not exceed INR100 crore –

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Categories of international transactions	Safe harbour rates - old rules [as per sub Rule (2) of rule 10TD of Income-tax Rules, 1962] applicable from AY 2013-14 to AY 2017-18	Safe Harbour rates - revised rules [as per sub Rule (2A) of rule 10TD] applicable from AY 2017-18 to AY 2019-20 (extended to be applicable for AYs 2020-21 and 2021-22 also)
	where the aggregate value of such transactions exceeds INR500 crore – not less than 22 per cent.	- not less than 17 per cent - where the aggregate value of such transactions exceeds INR100 crore but does not exceed INR200 crore - not less than 18 per cent.
Provision of KPO services, with insignificant risks	Operating profit margin to operating expense not less than 25 per cent	The value of international transaction does not exceed INR200 crore and the operating profit margin to operating expense is – - Not less than 24 per cent, if the employee cost to operating expense is at least 60 per cent - Not less than 21 per cent, if the employee cost to operating expense is 40 per cent or more but less than 60 per cent; or - Not less than 18 per cent, if the employee cost to

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Categories of international transactions	Safe harbour rates - old rules [as per sub Rule (2) of rule 10TD of Income-tax Rules, 1962] applicable from AY 2013-14 to AY 2017-18	Safe Harbour rates - revised rules [as per sub Rule (2A) of rule 10TD] applicable from AY 2017-18 to AY 2019-20 (extended to be applicable for AYs 2020-21 and 2021-22 also)
		operating expense does not exceed 40 per cent.
Provision of Intra-group loan to Wholly Owned Subsidiary (WOS)	Interest rate equal to or greater than the base rate of State Bank of India (SBI) as on 30th June of the relevant previous year: - plus 150 basis points where the amount of loan does not exceed INR50 crore - plus 300 basis points where amount of loan exceeds INR50 crore	<u>The threshold of INR50 crore has been removed</u> Different safe harbour rates have been prescribed for <u>Loan denominated in Indian Rupees (INR)</u> Refer table 1 below <u>Loan denominated in foreign currency</u> Refer table 1 below
Provision of Corporate guarantee to WOS	- where the amount guaranteed does not exceed INR100 crore - Commission or fee of 2 per cent or more per annum - where the amount guaranteed exceeds INR100 crore, and the credit rating of the borrower, by a Securities and Exchange Board of	The differential rates of 2 per cent and 1.75 per cent have been moderated down to a standard rate of 1 per cent irrespective of the amount guaranteed. However the requirement for the credit rating of the borrower to be certified by a SEBI registered agency and such credit rating to be

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Categories of international transactions	Safe harbour rates - old rules [as per sub Rule (2) of rule 10TD of Income-tax Rules, 1962] applicable from AY 2013-14 to AY 2017-18	Safe Harbour rates - revised rules [as per sub Rule (2A) of rule 10TD] applicable from AY 2017-18 to AY 2019-20 (extended to be applicable for AYs 2020-21 and 2021-22 also)
	India (SEBI) registered agency is of the adequate to highest safety-Commission or fee of 1.75 per cent or more per annum	of adequate to highest safety still remains for amount guaranteed exceeding INR100 crore
Provision of specified contract research and development services (Contract R&D services), with insignificant risks, wholly or partly relating to software development	Operating profit margin to operating expense not less than 30 per cent	The operating profit margin to operating expense not less than 24 per cent, where the value of the international transaction does not exceed INR200 crore.
Provision of contract R&D services, with insignificant risks, wholly or partly relating to generic pharmaceutical drugs	Operating profit margin to operating expense not less than 29 per cent	The operating profit margin to operating expense not less than 24 per cent, where the value of the international transaction does not exceed INR200 crore.
Manufacture and export of: • core auto components • non-core auto components where 90 per cent or more of total turnover relates to Original	Operating profit margin to operating expense: • not less than 12 per cent • not less than 8.5 per cent	Operating profit margin to operating expense: • not less than 12 per cent • not less than 8.5 per cent

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Categories of international transactions	Safe harbour rates - old rules [as per sub Rule (2) of rule 10TD of Income-tax Rules, 1962] applicable from AY 2013-14 to AY 2017-18	Safe Harbour rates - revised rules [as per sub Rule (2A) of rule 10TD] applicable from AY 2017-18 to AY 2019-20 (extended to be applicable for AYs 2020-21 and 2021-22 also)
Equipment Manufacturer sales		
Receipt of low value-adding intra-group services		Aggregate value of such transactions (including a mark-up not exceeding 5 per cent), does not exceed INR10 crore. Method of cost pooling, exclusion of shareholder costs and duplicate costs from cost pool and the reasonableness of the allocation keys used for allocation of costs to be certified by an accountant.

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Table 1 – Safe harbour rates prescribed for loans advanced to AE

CRISIL credit rating of AE	<u>Loan in INR</u> - Interest rate not less than one-year marginal cost of funds lending rate of State Bank of India as on 1 April of the relevant previous year plus basis points as below	<u>Loan in Foreign currency</u> - Interest rate not less than six-month London Inter-Bank Offer Rate of the relevant foreign currency as on 30 September of the relevant previous year plus basis points as below
between AAA to A or its equivalent	175 basis points	150 basis points
BBB-, BBB or BBB+ or its equivalent	325 basis points	300 basis points
between BB to B or its equivalent	475 basis points	450 basis points
between C to D or its equivalent	625 basis points	600 basis points
Credit rating not available and aggregate amount of loan advanced to all AEs as on 31 March of the relevant previous year < INR100 crore	425 basis points	400 basis points

Further, safe harbour provisions have also been prescribed for the following specified domestic transactions:

S No.	Nature of specified domestic transaction	Circumstances
1.	Supply of electricity,	The tariff in respect of supply of

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S No.	Nature of specified domestic transaction	Circumstances
	transmission of electricity, wheeling of electricity referred to [in clause (i), (ii) or (iii) of rule 10THB, as the case may be]	electricity, transmission of electricity, wheeling of electricity, as the case may be, is determined [or the methodology for determination of the tariff is approved] by the Appropriate Commission in accordance with the provisions of the Electricity Act, 2003 (36 of 2003).
2.	Purchase of milk or milk products referred to in clause (iv) of rule 10THB.	The price of milk or milk products is determined at a rate which is fixed on the basis of the quality of milk, namely, fat content and Solid Not Fat (SNF) content of milk; and- (a) the said rate is irrespective of,- (i) the quantity of milk procured; (ii) the percentage of shares held by the members in the co-operative society; (iii) the voting power held by the members in the society; and (b) such prices are routinely declared by the cooperative society in a transparent manner and are available in public domain.”.

To exercise the option of safe harbour, the taxpayer is required to file specified form (Form No 3CEFA for International Transactions and Form 3CEFB for Specified Domestic Transactions) with the AO on or before due date of furnishing the return of income with required details for:

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- the relevant assessment year, in case the option is exercised only for that assessment year; or
- the first of the assessment years, in case the option is exercised for more than one assessment years.

The taxpayer can opt out of the safe harbour regime from the second year onwards, by filing a declaration to that effect with the AO.

The revised safe harbour rules were applicable for a period of three years until AY 2019-20. CBDT vide its power under section 92CB by way of notification dated May 20, 2020 has extended provisions of safe harbour rules to AY 2020-21 and AY 2021-22 as well.

1.26 *APA (Section 92CC of the Act)*: Finance Act 2012 introduced APAs wherein the Board, with the approval of the Central Government may enter into APAs with any person to determine the ALP or specify the manner in which the ALP is to be determined, in relation to an international transaction to be entered into by that person. The scope is enhanced by Finance Act, 2020 to include income referred to in clause (i) of sub-section (1) of section 9.

APAs presents a proactive measure for resolving transfer pricing disputes in a cooperative manner. The Indian APA regulations, in short, provide for the following:

- Unilateral / bi-lateral/ multilateral APAs - Unilateral APA is an arrangement between the taxpayer and the Indian tax administration (CBDT) whilst a bilateral / multilateral APA involves not only the taxpayer and the Indian tax administration but also the taxpayer's affiliates (with whom he transacts) and their tax administration.
- APA would be applicable for existing as well as new transactions. For an existing transaction, the taxpayer seeking an APA needs to file its application before the commencement of the fiscal year for which it seeks to apply.
- The provision to provide for a roll back mechanism was brought into the Act vide Finance Act (No. 2) 2014, with effect from 1 October 2014. The Board has announced detailed rules explaining the roll back provisions and the procedure for giving effect to them. The roll back is available for 4 previous years.
- There are procedures in place for renewal, amendments, withdrawals and revisions of APA.

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1.27 Roll-back provisions

The roll back provision was brought into the Act vide Finance (No. 2) Act 2014, with effect from 1 October, 2014. The Board has announced detailed rules explaining the roll back provisions and the procedure for giving effect to them. Apart from that, the Board has made another key amendment, wherein pre-filing consultation has been made optional for the taxpayer.

Roll back is available for four previous years, preceding the first previous year covered in the APA. Further:

- Application requesting for roll back should be made in Form 3CEDA for the relevant roll back years.
- International transactions covered under roll back should be same as covered in the APA.
- Return of income of the applicant for roll back year ought to be furnished on or before the due date for filing return.
- Accountant's Report in Form 3CEB for the roll back years should have been filed on or before the due date.
- Roll back application should cover all the roll back years (i.e., the years falling with the block of four years) in which the international transaction has taken place.
- Roll back provisions shall not be provided, in respect of an international transaction, if the Income-tax Appellate Tribunal has passed an order disposing off an appeal relating to determination of ALP of the international transaction, at any time before signing of the APA agreement; or application of roll back has the effect of reducing total income or increasing the total loss.
- The manner of determining ALP in the roll back years with respect to any particular international transaction will be same as the manner agreed in the regular APA.

1.28 Annual Compliance Report ('ACR') and ACR Audit (Rule 100 and 10P)

- Once the APA is entered into, the assessee is required to furnish ACR to Director General of Income-tax (International Taxation) for each year covered in the APA.

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- The ACR is required to be furnished in quadruplicate in Form 3CEF for each year covered in the APA within 30 days from the due date of filing return of income for that year or within 90 days of entering into an APA whichever is later.
- Director General of Income-tax (International Taxation) would send one copy of ACR to competent authority of India, one copy to Commissioner of Income-tax who has jurisdiction over the income-tax assessment of the assessee and one copy to the Transfer Pricing Officer having jurisdiction over the assessee
- Transfer Pricing Officer would carry out compliance audit for each year covered in the APA and shall furnish his compliance audit report to Director General of Income-tax (International Taxation) in case of unilateral APA and to the competent authority in case of bilateral or multilateral APA within 6 months from end of the month in which ACR is received by Transfer pricing Officer from Director General of Income-tax (International Taxation)
- Regular transfer pricing assessment of transactions covered under APA would not be undertaken by the Transfer Pricing Officer
- CBDT released its Third Report (2018-19) on APA in November 2019 (available at [https://www.incometaxindia.gov.in/Lists/Latest%20News/Attachments/360/FINAL ANNUAL REPORT 29 11 19.pdf](https://www.incometaxindia.gov.in/Lists/Latest%20News/Attachments/360/FINAL%20ANNUAL%20REPORT%2029%2011%2019.pdf)) . As per the report a total of 944 unilateral and 211 Bilateral APA were filed till date out of which 271 (i.e. 240 unilateral and 31 bilateral) agreements were signed with the taxpayer while remaining were in process. The agreement signed covered diverse nature of transactions including Provision of Software Development Services, Provision of IT enabled Services, Receipt of Intra-group Services, Provision of Sales /after Sales Support Services, Payment of Guarantee Fee and Merchanting Trade. In majority of cases Transactional Net Margin Method was followed, while there are a few cases where Profit Split Method was followed. Further as per the Press release dated 31st March 2022, 62 APAs were signed in 2021-22, 31 APAs were signed in the year 2020-21 and 57 APAs were signed in 2019-20. (Source CBDT website:

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<https://incometaxindia.gov.in/Lists/Press%20Releases/Attachments/1068/Press-Release-Signing-of-62-Advance-Pricing-Agreements-by-CBDT-in-FY-2021-22-dated-31-03-2022.pdf>)

1.29 Use of multiple year data and the range concept:

Central Board of Direct Taxes (CBDT) on October 20, 2015 issued the final rules i.e., Rule 10B(5) and Rule 10CA to give effect to the use of 'multiple year data' and 'range concept'. These rules are applicable to international transactions and specified domestic transactions that are entered into by taxpayers on or after 1 April, 2014. Rule 10CA contains illustrations of application of the arm's length range concept.

Multiple year data

- Multiple year data (of the comparable companies for the purpose of comparability analysis) is applicable only in cases where Resale Price Method (RPM), Cost Plus Method (CPM) or Transactional Net Margin Method (TNMM) has been selected as the Most Appropriate Method.
- Thus, in cases where CUP, PSM or Other Method are selected as the Most Appropriate Method, multiple year data of comparable companies cannot be used.
- For each comparable selected (under RPM, CPM or TNMM), the data of the current year is required to be considered. In case such data is not available at the time of furnishing the return of income, data pertaining to upto two preceding financial years may be used.

To illustrate, say if the current year is Year zero and the financial year preceding that is Year 1 and the year prior to such year is Year 2, then it is worth noting that the rules do not envisage a situation wherein a comparable is selected only if it has data relating to Year 2.

- If a comparable is selected on the basis of preceding year data (say Year 1 and Year 2), but is not found to be comparable for the current year (Year 0) for qualitative or quantitative reasons, then such comparable would need to be rejected from the data set.
- When using multiple year data, data for each comparable shall be the weighted average of the selected years. An illustration explaining the computation is provided below:

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	Year 0	Year 1	Year 2	Total	
Operating Profit	250	300	350	900	OP/TC for the comparable would be $900/5400 = 16.7\%$
Total Cost	1700	1800	1900	5400	

- Further, the rules provides that in the event current year data becomes available during the course of the assessment proceedings, then the same shall be used by the TPO for the purpose of the analysis.

Application of range

- As per the rules, the 'range concept' shall be applicable when: (a) the MAM is either; Comparable Uncontrolled Price (CUP) Method, RPM, CPM, or TNMM; and (b) there are at least 6 entries in the dataset. Where these conditions are not fulfilled, 'arithmetic mean' shall continue to apply, as before, along with the tolerance range benefit (3% or 1%)

For determination of the range, the margins in the data set (i.e., set of comparable companies) are required to be arranged in ascending order and the arm's length range would be data points lying between the 35th and 65th percentile of the data set. The computation mechanism of range, is explained by way of illustrations below:

Illustration 1: Where the data set comprises 7 data points (arranged in ascending order), and the percentiles computed are not whole numbers

Percentile	Formula	Result	Value to be selected
35 th	Total no. of data points in dataset * 35% = $[7 * 35\%]$	2.45	3 rd value*
65 th	Total no. of data points in dataset * 65% = $[7 * 65\%]$	4.55	5 th value*
Median	Total no. of data points in datasets * 50% = $[7 * 0.5]$	3.50	4 th value*

* Value referred to here is the place value in the data set as arranged in ascending order.

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

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Percentile	Formula	Result	Value to be selected
35 th	Total no. of data points in dataset*35% = [20 * 35%]	7	Mean of 7 th & 8 th value
65 th	Total no. of data points in dataset*65% = [20* 65%]	13	Mean of 13 th & 14 th value
Median	Total no. of data points in datasets*50% = [20 * 0.5]	10	Mean of 10 th & 11 th value

If the transaction price 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 taken to be the Median of the data set.

1.30 Three tier documentation structure

The three-tiered documentation structure (applicable with effect from Financial Year 2016-17) would consist of a “Master File”, “Local File” and “Country-by-Country Report” (CbC Report). The Master File seeks to capture information regarding the taxpayer’s global operations and their transfer pricing policies. Rule 10DA prescribes information to be furnished in Master File and related rules. The Local File would capture entity-specific information with reference to the related party transactions. In the Indian context, the existing transfer pricing documentation requirements as per Rule 10D of the Income Tax Rules, 1962 (the Rules) already encompasses the Local File requirements. The CbC Report would be applicable for large multinational enterprises (MNEs)² and would capture key metrics of all entities in the group such as revenue, taxes paid, capital employed, headcount, etc (as defined in section 286 of the Act). Further, Rule 10DB prescribes rules relating to CbC Report.

1.31 Secondary adjustment

Secondary adjustment means an adjustment in the books of accounts of the taxpayer and its associated enterprise to reflect that the actual allocation of profits between the taxpayer and its associated enterprise are consistent with the transfer price determined as a result of primary adjustment, thereby

² Having annual consolidated group turnover of over INR 5500 Crores million in the immediately preceding financial year

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removing the imbalance between cash account and actual profit of the taxpayer.

The taxpayer shall be required to carry out secondary adjustment where the primary adjustment to transfer price:

- has been made suo motu by the taxpayer in his return of income; or
- made by the Assessing Officer or the appellate authority³, as the case may be has been accepted by the taxpayer; or
- is determined by an advance pricing agreement entered into by the taxpayer under section 92CC. Finance (No. 2) Act, 2019 amended this clause to restrict the secondary adjustment provisions to only those advance pricing agreements which have been signed on or after 1 April 2017. This is a retrospective amendment meant to apply from AY 2018-19; or
- is made as per the safe harbour rules framed under section 92CB; or
- is arising as a result of resolution of an assessment by way of the mutual agreement procedure under an agreement entered into under section 90 or 90A.

Where as a result of primary adjustment to the transfer price, there is an increase in the total income or reduction in the loss, as the case may be, of the taxpayer, the excess money which is available with its associated enterprise, if not repatriated to India within the time as prescribed (see table below), shall be deemed to be an advance made by the taxpayer to such associated enterprise and the interest on such advance, shall be computed as the income of the taxpayer, in the manner as prescribed⁴ below.

Type of primary adjustment	Time limit for repatriation	Applicable interest rate for delayed receipts	
		Transaction in INR	Transaction in foreign currency

³ Section 92CE of the Income Tax Act 1961 only refers to Assessing Officer but the notification No GSR 590(E) [52/2017 (F.No. 370142/12/2017-TPL)], dated 15-6-2017 refers to Appellate Authority along with the Assessing Officer. The term Appellate Authority has not been defined in the notification.

⁴ Rules in relation to secondary adjustment provisions have been notified vide CBDT Notification No. 52/2017, F.No.370142/12/2017 -TPL

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Type of primary adjustment	Time limit for repatriation	Applicable interest rate for delayed receipts	
		Transaction in INR	Transaction in foreign currency
Adjustment made by the Indian Tax Authority and accepted by the taxpayer	On or before 90 days from the date of relevant order	One year marginal cost of fund lending rate of State Bank of India as of 1 April of the relevant FY plus 325 basis points	Six month London Interbank Offered rate as of 30 September of the relevant FY plus 300 basis points
Suo-moto adjustment by the taxpayer	On or before 90 days from the due date of filing return of income (or modified return as may be applicable in case of an APA)		
Adjustment pursuant to, Safe Harbour			
Adjustment pursuant to APA	On or before 90 days from: a) from the date of filing of return of income if the APA has been entered into on or before the due date of filing of return for the relevant previous year (b) from the end of the month in which the APA has been entered into if the said agreement has been entered		

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Type of primary adjustment	Time limit for repatriation	Applicable interest rate for delayed receipts	
		Transaction in INR	Transaction in foreign currency
	into after the due date of filing of return for the relevant previous year.		
Adjustment pursuant to MAP	On or before ninety days from the date of giving effect by the Assessing Officer under rule 44H to the resolution arrived at under MAP		

Excess money means the difference between the arm's length price determined in primary adjustment and the price at which the international transaction has actually been undertaken.

Primary adjustment to a transfer price means the determination of transfer price in accordance with the arm's length principle resulting in an increase in the total income or reduction in the loss, as the case may be, of the taxpayer.

Finance (No. 2) Act, 2019 further amends section 92CE to:

- enable Assessee to repatriate excess money from any of the Associated enterprises of the Assessee which is not resident in India; and
- provide an option to Assessee to pay additional income-tax at the rate of 18% on such excess money or part thereof which is not repatriated to India, instead of treating it as deemed advance made by the taxpayer to such associated enterprise and calculating the interest income on such advance, as discussed in above table.

Secondary adjustment would not be applicable, if (i) the amount of primary adjustment made in the case of a taxpayer in any previous year does not

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exceed one crore rupees and (ii) the primary adjustment is made in respect of an assessment year commencing on or before 1 April 2016.⁵

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⁵Finance (No. 2) Act, 2019, has made it clear that the two conditions relating to applicability of secondary adjustment are alternate conditions by replacing the word “and” with an “or”. Further this amendment is retrospective from assessment year 2018-19

Chapter 2

Responsibility of an Enterprise and the Accountant

Responsibility of an Enterprise

2.1 Section 92D provides that every person who has entered into an international transaction or specified domestic transaction, during a previous year, shall keep and maintain such information and documents, prescribed by the Board, as will assist the Assessing Officer/ Transfer Pricing Officer to compute the income arising from that transaction, having regard to the ALP.

2.1.1. Rule 10D prescribes the information and documents required to be kept and maintained under section 92D ie, Local File. Further Rule 10DA prescribes information and document to be kept and maintained under proviso to sub-section (1) of section 92D ie, Master File. Master file needs to be submitted to the prescribed authority on or before the due date for furnishing the return of income as specified under sub-section (1) of section 139.

2.1.2. Section 286 provides that every parent entity or alternate reporting entity (designated by parent) of an international group that is resident in India, shall for every reporting accounting year, furnish a report in the form and manner as may be prescribed, within the due date provided in Rule 10DB(4). In case of a constituent entity resident in India, the parent of which is not resident in India, such entity shall notify whether it is the alternate reporting entity of the international group or the details of the parent entity/ alternate reporting entity and the country of which such entities are resident. Further, Rule 10DB prescribes rules relating to furnishing of CbC Report.

2.2 This responsibility of an enterprise to keep and maintain prescribed documents arises because of its unique position of being in control and custody of information that is necessary to verify whether the international transaction or specified domestic transaction to which it was party was carried out on the arm's length principle.

2.3 OECD in Transfer Pricing Guidelines, 2017 asserts the three main objectives of maintaining transfer pricing documentation:

"1. To ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and other

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conditions for transactions between associated enterprises and in reporting the income derived from such transactions in their tax returns;

2. to provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment; and

3. to provide tax administrations with useful information to employ in conducting an appropriately thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction, although it may be necessary to supplement the documentation with additional information as the audit progresses.”

2.4 The requirement to keep and maintain such information and documents as prescribed in Rule 10D ie, Local File with respect to an international transaction has, however, been waived in the case of those persons who have entered into international transactions the aggregate value of which, as recorded in the books of account, does not exceed one crore rupees - Rule 10D(2).

2.5 Persons who are so exempted from the mandatory requirement of keeping and maintaining information and documents prescribed as per Rule 10D shall, nevertheless, on the basis of the material in their possession, have to substantiate that the income on the international transactions entered into by them has been computed in accordance with the provisions of section 92 -proviso to Rule 10D(2).

2.6 By virtue of sub-section (2) of section 92D, the Board is empowered to prescribe the period for which the assessee must maintain the prescribed information and records. Pursuant thereto, the Board has stipulated that the prescribed information and documents prescribed as per Rule 10D (ie, Local File) and Rule 10DA (ie, Master File) be kept and maintained for a period of eight years from the end of the relevant assessment year - Rule 10D(5) and Rule 10DA(7). For example: For Financial Year 2018-19, an Assessee has to maintain prescribed information and documents for 8 years from the end of the relevant assessment year (2019-20), i.e. until Financial Year 2028-29.

2.7 Under section 92D (3), the Assessing Officer or the Commissioner (Appeals) during the course of any proceeding under the Act may require a person who has entered into an international transaction or specified domestic transaction to furnish any information or document, which he was expected to maintain under section 92D (1). The person shall furnish the information or document called for within thirty days from the date of receipt of a notice issued in this regard.

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2.8 Where, for any reason, the person is unable to produce the required information or documents within the stipulated period of thirty days, the Assessing Officer or Commissioner (Appeals) may, on an application made by the person, extend the period by a further period or periods not exceeding, in all, thirty days.

2.9 Under section 92E, every person who has entered into an international transaction or specified domestic transaction 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. "Specified date" means the date one month prior to the due date for furnishing the return of income under sub-section (1) of section 139 for the relevant assessment year.

The above-mentioned Explanation reads as under:

"In case of an assessee who is required to furnish a report referred to in section 92E, the due date means the 31st day of October of the assessment year."

Accountant's responsibility

2.10 The term "accountant" has been defined in clause (i) of section 92F as under:

"accountant" shall have the same meaning as in the *Explanation* below sub-section (2) of section 288.

The above-mentioned Explanation reads as under:

"accountant" means a chartered accountant as defined in clause (b) of sub-section (1) of section 2 of the Chartered Accountants Act, 1949 (38 of 1949) who holds a valid certificate of practice under sub-section (1) of section 6 of that Act, but does not include [except for the purposes of representing the assessee under sub-section (1)]—

- (a) in case of an assessee, being a company, the person who is not eligible for appointment as an auditor of the said company in accordance with the provisions of sub-section (3) of section 141 of the Companies Act, 2013 (18 of 2013); or
- (b) in any other case,—
 - (i) the assessee himself or in case of the assessee, being a firm or association of persons or Hindu undivided family, any

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- partner of the firm, or member of the association or the family;
- (ii) in case of the assessee, being a trust or institution, any person referred to in clauses (a), (b), (c) and (cc) of sub-section (3) of section 13;
 - (iii) in case of any person other than persons referred to in sub-clauses (i) and (ii), the person who is competent to verify the return under section 139 in accordance with the provisions of section 140;
 - (iv) any relative of any of the persons referred to in sub-clauses (i), (ii) and (iii);
 - (v) an officer or employee of the assessee;
 - (vi) an individual who is a partner, or who is in the employment, of an officer or employee of the assessee;
 - (vii) an individual who, or his relative or partner—
 - (I) is holding any security of, or interest in, the assessee:
Provided that the relative may hold security or interest in the assessee of the face value not exceeding one hundred thousand rupees;
 - (II) is indebted to the assessee:
Provided that the relative may be indebted to the assessee for an amount not exceeding one hundred thousand rupees;
 - (III) has given a guarantee or provided any security in connection with the indebtedness of any third person to the assessee:
Provided that the relative may give guarantee or provide any security in connection with the indebtedness of any third person to the assessee for an amount not exceeding one hundred thousand rupees;
 - (viii) a person who, whether directly or indirectly, has business relationship with the assessee of such nature as may be prescribed;
 - (ix) a person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction.

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2.10.1 Therefore, the meaning of "accountant" now applies for the definition of an "Authorised Representative" under section 288(2). As a result, in order to be appointed as an Authorised Representative for an assessee for any proceedings under the Act, a Chartered Accountant must have a certificate of practice. However, a Chartered Accountant having any other qualification specified in section 288 may be appointed as an Authorised Representative.

2.10.2 Therefore, after this amendment, a Chartered Accountant who does not satisfy both the following conditions cannot be appointed as an Authorised Representative for an assessee:

- He/she does not have a certificate of practice; and
- He/she does not have any other specified qualification.

2.11 Though the section refers to the accounts being examined by an accountant, which means a chartered accountant as defined above, the examination can also be done by a firm of chartered accountants. This has been a recognised practice under the Act. In such a case, it would be necessary to state the name of the partner who has signed the report on behalf of the firm. The accountant signing the report as a partner of a firm or in his individual capacity should give his membership number below his name.

2.12 As per the decision taken by the Council of the ICAI, all attest functions undertaken by the members have to bear a UDIN issued by the ICAI. The same needs to be mentioned on the document being signed/ attested by the member.

2.13 Section 92E does not stipulate that only the statutory auditor appointed under the Companies Act or other similar statute should perform the examination. The examination can, therefore, be conducted either by the statutory auditor or by any other chartered accountant in practice having certificate of practice.

2.14 The issue of a report under section 92E, being a recurring assignment for expressing a professional opinion, the accountant accepting the assignment should communicate with the accountant who had done the examination in the earlier year, as provided in the Chartered Accountants Act. In the case of a person whose accounts of the business or profession have been audited under any other law (i.e. a company, a co-operative society, etc. which is required to get the accounts audited under a Statute), it is not necessary to communicate with the statutory auditor if he had not done the examination in the earlier year. Attention of the members is invited to the detailed discussion in the publication of ICAI, "Code of Ethics" under clause

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(8) of Part I of the First Schedule to the Chartered Accountants Act, 1949 vide **Annexure V**.

2.15 The accountant should obtain from the assessee a letter of appointment for conducting the examination as mentioned in section 92E. It is advisable that such an appointment letter should be signed by the person competent to sign/verify the return of income in terms of the provisions of section 140 or by any person who has been authorized by the company to make such an appointment. The accountant should get the statement of particulars, as required in the annexure to the report, authenticated by the assessee before he proceeds to verify the same. The accountant is required to submit his report to the person appointing him viz. the assessee.

2.16 The appointment of the accountant in the case of a company need not be made at the general meeting of the members. It can be made by the Board of Directors or even by any officer, if so authorised by the Board in this behalf. The appointment in the case of a firm or a proprietary concern can be made by a partner or the proprietor or a person authorised by the assessee. It is possible for the assessee to appoint two or more chartered accountants for carrying out the examination, in which case, the report will have to be signed by all the chartered accountants. In case of disagreement, they can give their reports separately. In this regard, attention is invited to SA – 299(Revised) Joint Audit of Financial Statements, wherein the principle is laid down as under:

The joint auditors are required to issue common audit report, however, where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. A joint auditor is not bound by the views of the majority of the joint auditors regarding the opinion or matters to be covered in the audit report and shall express opinion formed by the said joint auditor in separate audit report in case of disagreement. In such circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to the separate audit report(s) issued by the other joint auditor(s). Further, separate audit report shall also make reference to the audit report issued by other joint auditors. Such reference shall be made under the heading "Other Matter Paragraph" as per SA 706(Revised), "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report".

The same analogy shall apply to the report to be given under section 92E .

2.17 The Act prohibits a relative or an employee of the assessee being appointed as an accountant under section 92E. Also, as per a decision of the Council (reported in the Code of Ethics under clause (4) of Part I of Second

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Schedule), a chartered accountant who is in employment of a concern or in any other concern under the same management cannot be appointed as an auditor of that concern. Therefore, an employee of an assessee or an employee of a concern under the same management cannot examine the accounts and records of an assessee under section 92E.

2.18 An accountant responsible for writing or the maintenance of the books of account of the assessee should not examine such accounts. This principle will apply to the partner of such an accountant as well as to the firm in which he is a partner. In view of this, an accountant who is responsible for writing or the maintenance of the books of account, his partner or the firm in which he is a partner should not accept the examination assignment under section 92E in the case of such an assessee.

2.19 Similarly, an internal auditor of the assessee cannot conduct the examination if he is an employee of the assessee. However, an accountant or a firm of accountants appointed as tax consultants of the assessee can conduct the examination under section 92E.

2.20 No separate guidelines have been prescribed for fees under section 92E. The Institute has recommended fees for professional services on the basis of time devoted by the accountant and his assistants. The scale of fees recommended by the Committee for Capacity Building of CA firms and Small & Medium Practitioners for professional assignment is given in **Annexure VI**. The Council has also clarified that the scale does not include fees chargeable in respect of non-qualified assistants and that the chartered accountants are free to negotiate the terms in respect of such assistants with the clients.

2.21 It will be appreciated that no uniform fees can be recommended for the reporting function exercised under section 92E of the Act. The accountant should charge fees depending upon the responsibility involved and taking into consideration the work involved in such examination. It is necessary that members of the profession should also maintain reasonable standards of professional fees.

2.22 A question may arise whether an accountant appointed under section 92E can be held responsible if he does not complete the examination and give his report before the specified date. The answer to this question will depend on the facts and circumstances of the case. Normally, it is the professional duty of a chartered accountant to ensure that the examination accepted by him is completed before the due date. If there is any unreasonable delay on his part, he is answerable to the Institute if a complaint is made by the client. However, if the delay in the completion of

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examination is attributable to his client, the accountant cannot be held responsible. In view of the fact that the Act does not give any discretion to the tax authorities to extend the time limit for furnishing of the report, the examination has to be completed within the time limit provided in the Act. It is, therefore, necessary that a chartered accountant should not accept assignments which he cannot complete within the specified date.

2.23 In the case of an examination, the accountant is required to express his opinion as to whether the assessee has maintained the proper information and documents, as prescribed, in respect of the international transactions entered into by him. As regards the statement of particulars to be annexed to the report, he is required to give his opinion as to whether the particulars are true and correct. In giving his report the accountant will have to use his professional skill and expertise and apply such tests as the circumstances of the case may require, considering the contents of the report.

2.24 Section 143 of the Companies Act, 2013 gives certain powers to the auditors to call for the books of account, information, documents, explanations, etc. and to have access to all books and records whether kept at the registered office of the Company or at any other place. The accountant is advised to obtain all the books of accounts, information, documents, explanation etc. from the enterprise to enable him to discharge his responsibility under the Act in a satisfactory manner. If, however, the assessee does not produce any particular record or fails to provide any specific information or explanation called for, the accountant will be required to report the same and accordingly qualify his report.

2.25 The report by the accountant given under section 92E sets forth such particulars as have been prescribed in Form 3CEB. In order that the accountant may be in a position to explain any question which may arise later on, it is necessary that he should keep detailed notes about the evidence on which he has relied upon while conducting the examination and also maintain all his working papers. Such working papers should include his notes on the following, amongst other matters:

- (a) work done while conducting the examination and by whom;
- (b) explanations and information given to him during the course of the examination and by whom;
- (c) decision on the various points taken;
- (d) the judicial pronouncements relied upon by him while making the report;
- (e) certificates issued by the client

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- (f) representation letter issued by the management of the assessee; and
- (g) annexure to Form No.3CEB duly filled in and authenticated by the client.

2.26 Attention is also invited to the "SA 230 - Audit Documentation" which provides that documentation should serve as a sufficient and appropriate record of the basis for the accountant's report. Further, the documentation should be prepared on a timely basis and the accountant should document all matters which are important in providing evidence that the examination was planned and performed in accordance with the applicable legal and regulatory requirements.

2.27 While test checks may suffice in the conduct of a statutory audit for the expression of the accountant's opinion as to whether the accounts depict a true and fair' view, the accountant may be required to apply reasonable tests on the total information to be prepared by the assessee in respect of certain items in the prescribed form. While the entity may have to prepare the details for the entire year, the accountant may have to ensure that no items have been omitted in the information furnished and a reasonable test check would reveal whether or not the information furnished is correct. Accountant should exercise professional judgement while placing reliance on the documents, information and evidences provided by the assessee. The Accountant should take an appropriate Management Representation Letter from the assessee.

2.28 The extent of check undertaken would have to be indicated by the accountant in his working papers. The accountant is advised to design his examination programme in such a manner, which will reveal the extent of checking undertaken by the accountant and ensures that adequate documentation is maintained in support of the information being certified by him.

2.29 The accountant may rely upon the audit conducted by an internal auditor or by an outside professional firm appointed as internal auditor, by using his own judgement as to the degree of reliance which he wishes to place on the work of the internal auditor relevant to the examination. The degree of reliance would depend on the areas of work covered by the internal auditor and relevant for purposes of the examination, particularly by reference to working papers/documents of the internal auditor and ensuring that reasonable checks/tests have been applied to transactions covered by the internal auditor, to satisfy himself about the authenticity of the ultimate information.

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2.30 It would be in the interest of the accountant to obtain and scrutinise the programme of work and procedures adopted and the relevant working papers and documents obtained by the internal auditor in evidence of the work carried out by him. Further, the accountant will have the sole responsibility for the report issued and the responsibility will not be reduced by the accountant's use of the work of the internal auditors. Further, the accountant shall determine:

- (a) Whether the work of the internal auditors is likely to be adequate for the purposes of the examination; and
- (b) If so, the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures

Reference may be made to the Standards on Auditing: Using the Work of Internal Auditors [SA 610 (Revised)] – vide **Annexure VII**.

2.31 Primarily, it would be necessary for the accountant to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help him to reduce the risk of material misstatement to an acceptably low level. Reference may be made to the Standards on Auditing: SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment (and SA 520, Analytical Procedures).

2.32 The accountant must ensure that he receives a standard Management Representation Letter in respect of all oral representations explicitly or implicitly given to him. The letter should indicate and document the continuing appropriateness of the representations made to him and reduce the possibility of any misunderstanding concerning the matters which are the subject of the representations. Further, in relation to certain transactions, such as deemed international transactions, free of cost services/ goods, etc. the extent of reliance placed by the Accountant on the assessee is higher as compared to transactions such as sales/ purchase of goods, provision of services, etc. In these cases while the Accountant should exercise due professional judgement and care, the onus to identify and disclose such transactions (i.e., deemed international transactions, free of cost services/ goods, etc.) is with the assessee. Therefore in such scenario Accountant is entitled to place reliance on management representation letter issued by the assessee. However, it may be noted that in respect of matters that may be directly verified by the accountant, mere obtaining of a

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management representation letter will not be sufficient compliance with the Generally Accepted Auditing Standards.

2.33 If the assessee is unable to obtain relevant information in respect of the overseas branches duly certified by the overseas accountant, the relevant facts should be suitably disclosed and reported upon.

2.34 Where Accountant's Report is issued to non-resident assessee and such non-resident is not statutorily required to maintain books of accounts in India under any law, the Accountant should place reliance on Form 26AS, invoices, agreements etc. The Accountant may also place reliance on documents, information and accounts maintained by the Indian assessee with whom the non-resident assessee has entered into international transaction(s).

2.35 Paragraph 3 of Form No. 3CEB requires the accountant to state whether the prescribed particulars are furnished in the annexure to the report and whether in his opinion and to the best of his information and according to the explanations given to him, they are true and correct. The accountant may have a difference of opinion with regard to the particulars furnished by the assessee and he has to bring these differences under various clauses in Form No. 3CEB. The accountant should make a specific reference to those clauses in Form No. 3CEB in which he has expressed his reservations, difference of opinion, disclaimer etc. in this paragraph.

2.36 In case the prescribed particulars are given in part or piecemeal to the accountant or the relevant form is incomplete and the assessee does not give the information against all or any of the clauses, the accountant should not withhold the entire report. In such a case, he can qualify his report on matters in respect of which information is not furnished to him. In the absence of relevant information, the accountant would have no option but to state in his report that the relevant information has not been furnished by the assessee. As a good practice, the Accountant should provide a note detailing the rationale of Accountant. Such note should be provided along with the Accountant's Report.

2.37 Accountant should communicate basis for each position taken to the Enterprise in writing.

Professional misconduct

2.38 When any question relating to professional misconduct in connection with the examination arises, the accountant would be liable under the

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Chartered Accountants Act, 1949 and the ICAI's disciplinary jurisdiction will prevail in this regard.

2.39 Finance Act 2017 had introduced section 271J for levying penalty on accountants for furnishing incorrect information in reports or certificates furnished under any provisions of the Act or the rules made thereunder. The Assessing Officer or the Commissioner (Appeals), in such cases, may direct the accountant to pay a sum of **ten thousand rupees** for each such report or certificate.

EXPOSURE DRAFT

Chapter 3

Associated Enterprises

Associated enterprises and deemed associated enterprises

The term “associated enterprise” is defined in two parts – the term “enterprise” is defined in section 92F (iii) of the Act while the term “associated enterprise” is defined in section 92A of the Act.

Meaning of enterprise:

The term ‘enterprise’ is defined under clause (iii) of section 92F of the Act wherein “enterprise” means a person (including a permanent establishment of such person) who is, or has been, or is proposed to be, engaged in any activity, relating to,

- the production, storage, supply, distribution, acquisition or control of articles or goods, or know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights, or
- the provisions of services of any kind, or
- in carrying out any work in pursuance of a contract, or
- in investment, or
- providing loan or
- in the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate,
- Whether such activity or business is carried on, directly or through one or more of its units or divisions or subsidiaries, or whether such unit or division or subsidiary is located at the same place where the enterprises is located or at a different place or places.

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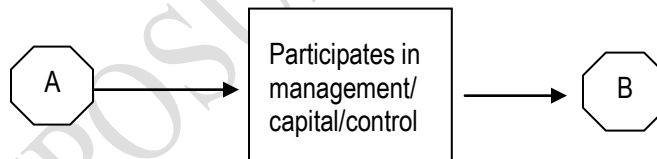
While the term is defined to mean a person engaged in the past, present or in the future in any activity relating to tangibles, intangibles, facilities or services with widest possible modes, forms or pattern of operation, it also includes a permanent establishment of such person. "Permanent Establishment" referred to in clause (iii)(a) of section 92F of the Act, includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.

3.1 Two or more enterprises can be regarded as 'associated enterprises' only if the provisions of section 92A are satisfied. Section 92A defines 'associated enterprise', wherein sub-section (1) provides a source definition, whereas, sub-section (2) provides for deeming provision which enumerates 13 situations, fulfilment of any of which at any time during the relevant previous year would deem to make the two enterprises an associated enterprises.

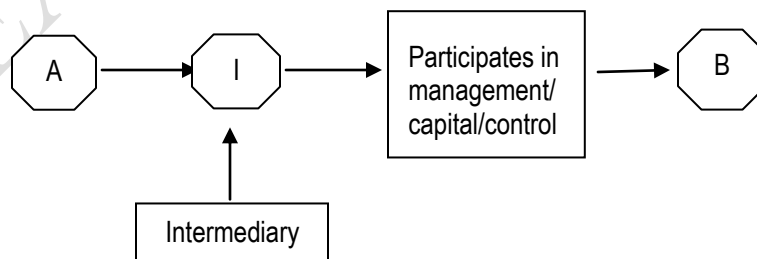
Source definition [Section 92A(1)]

3.2 According to sub-section (1), an enterprise which participates directly or indirectly or through one or more intermediaries, in the management or control or capital of the other enterprise shall be regarded as an associated enterprise. This can be understood as follows:

Situation 1 - Direct Participation:



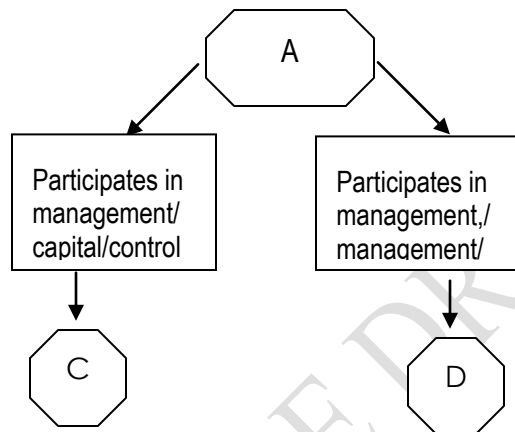
Situation 2 - Participation through Intermediary



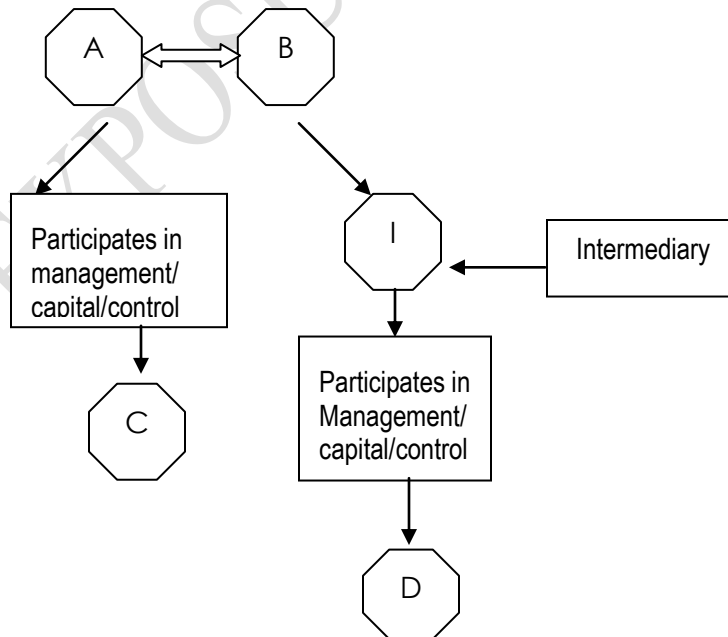
In both the situations detailed above, B will be an associated enterprise of A.

Associated Enterprises

3.3 Similarly, an enterprise in respect of which one or more persons who participate in its management or control or capital, directly or indirectly, or through one or more intermediaries are the same persons who participate in a similar manner in the management or control or capital of the other enterprise shall be regarded as an associated enterprise. This proposition can be understood by the following diagrammatic presentation:



In the above situation, C and D are associated enterprises by virtue of A participating in the management or capital or control of both C and D.



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In the above example, A and B, conjointly and simultaneously, participate in the management, capital and control of C and D. Consequently, C and D are to be construed as associated enterprises.

Deemed definition of Associated Enterprise [Section 92A(2)]

3.4 The Finance Act, 2002 had amended sub-section (2) of section 92A to the effect that **for the purposes of sub-section (1)**, two enterprises shall be deemed to be associated enterprises if, at any time during the previous year any of the conditions mentioned in clauses (a) to (m) are satisfied. The provisions of sub-section (2) of section 92A supplements the definition of associated enterprise given in sub-section (1) by enlisting various situations under which two enterprises shall be deemed to be associated enterprises.

It may be noted that when Finance Act, 2002 had amended sub-section (2) of section 92A, the memorandum to the Finance Bill, 2002 explained the said amendment as under:

“It is proposed to amend sub-section (2) of the said section to clarify that the mere fact of participation of one enterprise in the management or control or capital of the other enterprise or the participation of one or more persons in the management or control or capital of both the enterprises shall not make them associated enterprise unless the criteria specified in sub-section (2) are fulfilled.”

Considering the above, for interpreting the AE relationship provided in sub-section (1), the situations mentioned in sub-section (2) need to be referred. In other words, sub-section (1) is dependent on situations given under sub-section (2) of section 92A.

Each of these situations specified in clauses (a) to (m) of sub-section (2) of section 92A are discussed here below with suitable illustration, wherever considered necessary. It may be noted that for the purposes of these clauses, two enterprises would be associated enterprises if the conditions stipulated therein are fulfilled at any time during the previous year. Besides, in clauses (c) to (m) the words ‘directly’ or ‘indirectly’ have not been used which indicates the intention of the legislature that indirect control is not envisaged in these clauses. Therefore, direct relationship between two enterprises is relevant for the purposes of clauses (c) to (m) in order to determine whether they are associated enterprises.

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3.5 One enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise.

[Section 92A(2)(a)]

Two enterprises shall be associated enterprises based on the shareholding of one enterprise in the other if the investing enterprise holds shares carrying not less than twenty-six per cent of the voting power in the other enterprise. Holding for this purpose includes indirect holding too.

As the terms used are “shares” and “voting power”, it is apparent that this clause applies only to those cases where the investee enterprise is a company. However, the investor enterprise need not be company and could be any person.

Further, this clause uses terms “...shares carrying not less than twenty-six per cent of the voting power....”. Accordingly, it is essential that the “shares” should carry voting power. If the shareholding in the investee company does not carry any voting power (for example preference shares with no voting rights) than such shareholding should not be taken into consideration for computing threshold limit of twenty-six per cent.

3.6 Any person or enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in each of such enterprises.

[Section 92A(2)(b)]

Under this clause, two enterprises are deemed associated enterprises, even though one enterprise may not hold any shares in the other enterprise. This clause comes into play when one person or enterprise simultaneously holds shares carrying not less than twenty-six per cent voting power in each such enterprise.

Hence for this clause to apply:

- both the investee enterprises have to be companies.
- one person or enterprise simultaneously holds shares carrying 26% or more voting power in each of them.
- Both the enterprises need not hold any shares in each other if they have common 26% or more voting right held by a company.
- Shareholding may be direct or indirect.

Guidance Note on Report under Section 92E of the Income-tax Act, 1961

For example, if AA of UK holds 26% voting power in BB of Germany and also in CC of India, then BB and CC shall be deemed to be associated enterprises. Even for this clause, shareholding may be direct or indirect holding and shares should carry voting power.

3.7 A loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise.

[Section 92A(2)(c)]

Where the lender enterprise's loans to the borrower enterprise constitute 51% or more of the 'book value' of the total assets of the borrowing enterprise, then both the lender and the borrower enterprises would be treated as 'associated enterprises'. 'Book value' of assets means value of assets appearing in books of account.

It is important to note that requirement is whether the loan advanced is 51% or more of the book value of total assets of the borrower enterprise and not 51% or more of the market value of assets of the borrower-enterprise.

Example:

Suppose Enterprise X gives a loan of \$100 million to Enterprise Y on 01-04-2020. At that time, the book value of assets of enterprise B was \$200 million. On 26-4-2020, enterprise Y repays \$ 10 million. On 31-3-2021, due to booking of impairment losses, the book value of assets of enterprise Y is \$ 180 million. At that time, loan outstanding is \$ 90 million (i.e., \$ 100 million minus \$ 10 million repaid).

Loan outstanding on book value of the assets of Y comes out 50% ($90/180 \times 100 = 50\%$). However, the requirement is to check the % of loan advanced on book value i.e., 55% ($100/180 \times 100 = 55\%$). So, in this case, X and Y will be associated enterprises.

Book value of assets: The term 'book value' has been defined by ICAI in its Guidance Note on Terms used in Financial Statements as the amount at which an item of asset is shown in the books. The term asset is defined in the Framework for Preparation and Presentation of Financial Statements (hereafter referred as "the Framework") issued by ICAI. The following are the features of an asset :

- It is a resource.
- It arises out of past transactions or events.
- It is controlled by the enterprise.

Associated Enterprises

- Future economic benefits are expected from it

Apart from the above, the following are, also, important:

- *Intangible Assets*: Intangible assets are assets so these must be included in book value of assets.
- *Accumulated Losses*: The accumulated losses, shown in assets side only because they have debit balance, are not assets and will not be included in book value of assets because there are no future economic benefits.
- *Deferred Revenue Expenditure*: The enterprise does not control the expected future economic benefits from deferred revenue expenditure. Hence, they are not assets.
- **All the items on asset** side of balance sheet which satisfy the definition of 'assets' in the Framework should be taken at 'book value'. Moreover, the book value of assets only should be taken without deducting book value of liabilities.

3.8 **One enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise.**

[Section 92A(2)(d)]

Where the guarantor enterprise guarantees 10% or more of the total borrowing of the enterprise seeking guarantee, then they would become 'associated enterprises'.

Rule 10TA(c) provides the definition of term corporate guarantee. Corporate guarantee means explicit corporate guarantee extended by a company to its wholly owned subsidiary being a non-resident in respect of any short-term or long-term borrowing.

Explanation.—For the purposes of Rule 10TA (c), explicit corporate guarantee does not include letter of comfort, implicit corporate guarantee, performance guarantee or any other guarantee of similar nature;

It may be mentioned that as the clause does not specify the nature of guarantee, a view is possible that it includes all types of guarantees.

Guidance Note on Report under Section 92E of the Income-tax Act, 1961

3.9 *More than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise.*

[Section 92A(2)(e)]

Where one enterprise has appointed

- (a) more than one-half of the board of directors or members of the governing board; or
- (b) one or more executive directors or executive members of that board in another enterprise

the two enterprises shall be deemed to be associated enterprises.

This clause refers to “board of directors” and “governing board”. As per section 2(10) of the Companies Act, 2013, the term “board of directors” would refer to the “collective body of directors of a company”. The term “governing board”, correspondingly, would refer to a body or council that has the executive authority to manage the affairs of the enterprise to which it relates. These enterprises could be artificial juridical non-corporate bodies.

For the purposes of this clause, the appointment of even one person to the post of executive director or executive member would make the enterprises associated enterprises.

It is important to note that merely having the power to appoint (50% of directors/one or more executive directors) is not enough. Actual exercise of the power is necessary to make both enterprises associated enterprises.

3.10 *More than half of the directors or members of the governing board, or one or more of the executive directors or executive members of the governing board of each of the two enterprises are appointed by the same person or persons.*

[Section 92A(2)(f)]

Clause (f) is an extension of the principle laid down in clause (e). This clause is applicable where the same person has:

- (a) appointed more than one-half of the board of directors or members of the governing board; or

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- (b) appointed one or more executive directors or executive members of the governing board of two or more enterprises or
- (c) as combination of (a) and (b), same person(s) appoints one or more executive directors or executive members in one enterprise and 50% or more of the directors/ members in the other.

For example, the appointment of seven out of twelve members of board of directors of B Ltd. and six out of ten members of the board of directors of C Ltd. is controlled and has been made by A Ltd. By virtue of clause (f), B Ltd. and C Ltd. are associated enterprises.

Further, if the appointment of the executive director of B Ltd. and six out of ten members of the board of directors of C Ltd. have been made by A Ltd., then B Ltd. and C Ltd. shall be regarded as associated enterprises.

For the purpose of both the clauses (e) and (f) , two enterprises shall be deemed to be associated enterprises only when one of the enterprise exercises its right and actually appoints one executive director/ member to the board or more than half of the Board of directors at any time during the year.

The mere right to appoint one executive director or executive member or more than half of the Board of directors by one enterprise to the Board of another enterprise would not make both the entities as associated enterprises.

3.11 *The manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights.*

[Section 92A(2)(g)]

Two enterprises are deemed to be associated:

- if one is wholly dependent on the other
- for the use of know-how, patents, copyrights etc.
- for the manufacture or processing of goods or articles or business carried on by such enterprise.

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It should be noted that such know-how, patents, copyrights etc. must be either owned by the other enterprise or the exclusive rights thereto must vest with the other enterprise. If an Indian enterprise is wholly dependent on the licence granted by a non-resident enterprise for manufacture or processing of goods or articles or business carried out by the Indian enterprise both enterprises shall be deemed to be associated enterprises. The clause will equally be applicable in case where the overseas entity is wholly dependent on the license / brand owned by the Indian entity.

Section 92A(2)(g) applies only if the manufacture or processing of or business carried out by one enterprise is wholly dependent upon the intangible assets of the other. That is, if an enterprise manufactures more than one article or thing and it uses the know-how of the other for one article or thing, manufacture of all the articles or goods carried out by the first enterprise is not wholly dependent on the intangible asset of the other enterprise and hence section 92A(2)(g) does not apply here.

The important phrase here is 'wholly dependent' and hence, it would first be imperative to determine whether a particular enterprise is dependent 'wholly' on the use of intangibles owned by the other enterprise. The word 'wholly' denotes complete dependence and hence, should be distinguished from the word 'mainly'.

Under this clause, all types of manufacturing, distribution and service-related businesses are covered.

3.12 *Ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise.*

[Section 92A(2)(h)]

There are two situations dealt with in this clause and they are as follows:

- (i) 90% or more of the raw materials and consumables required for manufacturing or processing of goods or articles are supplied by the other enterprise,

or

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- (ii) 90% or more of the raw materials and consumables required for manufacturing or processing of goods or articles are supplied by persons specified by the other enterprise,

and

the prices and other conditions relating to supply (by the specified person) are influenced by the other enterprise.

Since this clause relates to manufacture or processing of goods, it is important to note that the 90% criteria should be applied exclusively to raw materials and consumables used for manufacturing and processing only.

3.13 *The goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise.*

[Section 92A(2)(i)]

Where the goods or articles manufactured and processed by one enterprise, (say, enterprise A) are sold

- (i) to another enterprise (say, enterprise B)

or

- (ii) sold to another enterprise (say, enterprise C) specified by enterprise B,

and

the prices and other conditions relating thereto are influenced by enterprise B, then enterprises A and B shall be associated enterprises.

While in clause (h), a minimum criteria of 90% has been mentioned, no such quantification has been done in clause (i). It would be imperative to analyze the contractual terms & conditions, actual conduct of parties to the transaction, etc. to conclude whether there exists any influence by an enterprise on another enterprise and hence, whether the said clause is triggered or not. This clause covers only sale of goods manufactured or processed and not the sale of traded goods.

Prima facie, it may be inferred that even when sales of one enterprise to the other enterprise is insignificant (assuming less than 1%) and that other enterprise can influence the prices at which the goods are sold, these two

Guidance Note on Report under Section 92E of the Income-tax Act, 1961

enterprises may be treated as associated enterprises. However, this may not be the intention of the legislation, as this may not give rise to “control” by one of the enterprise over the other, which is a *sine qua non* for invoking the status of associated enterprises under third limb of test laid down by section 92A(1). Therefore, it is important that the test of ‘influence’ be established with actual conduct and backed up by the documentary evidences.

In this clause, the Seller and buyer are deemed AEs u/s 92A(2)(i) only if buyer's influence on terms of sale is “dominant influence”. For deeming buyer and seller enterprises to be AEs under section 92A(2)(i), buyer must have dominant influence over prices and other conditions of sale amounting to de facto control of buyer over seller.

3.14 *Where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual.*

[Section 92A(2)(j)]

This clause deals with a situation where one enterprise is controlled by an individual and the other enterprise is also controlled by –

- (i) such individuals; or
- (ii) his relative; or
- (iii) jointly by such individual and his relative then both the enterprises shall be deemed as associated enterprises.

The word ‘control’ can be interpreted to mean that the individual along with his relatives has the power to make crucial decisions regarding the management and running of the two enterprises.

The word ‘relative’ is defined under section 2(41) of the Act as follows:

“relative”, in relation to an individual, means the husband, wife, brother or sister or any lineal ascendant or descendant of that individual”

3.15 *Where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family, or by a relative of a member of such Hindu undivided family, or jointly by such member and his relative.*

[Section 92A(2)(k)]

This clause envisages control of the two enterprises by the same Hindu undivided family and includes control by -

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- (i) a member of the Hindu undivided family, or
- (ii) by a relative of a member of such Hindu undivided family, or
- (iii) jointly by such member and his relatives.

3.16 *Where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association of persons or body of individuals*

[Section 92A(2)(l)]

This clause seeks to cover non-corporate bodies like partnership firms, association of persons and body of individuals. Sub-clause (v) of clause (31) of section 2 of the Act defines the term 'person' to include these entities.

In case of partnership firm or association of persons or body of individuals, the other enterprise must hold not less than 10% interest in such firm, association of persons or body of individuals to be regarded as an associated enterprise.

3.17 *There exists between the two enterprises, any relationship of mutual interest, as may be prescribed.*

[Section 92A(2)(m)]

This residuary clause enables the CBDT to widen the scope by adding any relationship of mutual interest from time to time that will make any two enterprises as associated enterprises. However, no such relationship of mutual interest has yet been prescribed.

3.18 *If an assessee enters into a transaction where one of the parties to the transaction is a person located in a notified jurisdictional area, then all the parties to the transaction shall be deemed to be associated enterprises within the meaning of section 92A*

[Section 94A(2)(i)]

As per Section 94A(1), the Central Government may, specify a country or territory as a notified jurisdictional area. The Central Government had specified Cyprus as a notified jurisdictional area. However, the same has been rescinded vide notification no. 114 dated 14-12-2016. Therefore, at present there is no such notified jurisdictional area.

This clause seeks to cover transactions with persons located in notified jurisdictional areas where there is a lack of effective exchange of information. The relationship with the "person" is not specified in the section. Accordingly,

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a person could be a related or an unrelated person and therefore a person could also include an AE [i.e. an enterprise covered under section 92A(1)/(2)]

Relationship between Head Office and Permanent Establishment (Branch Office and any fixed place of business)

3.19 For a foreign enterprise, a branch office in India would qualify to be a permanent establishment ('PE') and considered as a separate enterprise than the foreign enterprise or the head office in terms of section 92F(iii) read with section 92B(1). Accordingly, transfer pricing provisions would apply on transactions between foreign enterprise and PE in India (branch office or any fixed place of the business).

3.20. Attention here is invited to a situation where an Indian enterprise is having a branch office in a foreign jurisdiction. In such a scenario, the definition of permanent establishment as per section 92F(iii)(a) loses its substance and there the transactions between the Indian head office and its foreign branch office (branch office accounts being consolidated in the head office / company-wide accounts) would not be subject to transfer pricing provisions as per Indian Income tax Act. It is important to note that transaction between the foreign branch of India enterprise and other foreign associated enterprise will be subject to transfer pricing provision.

Example: I.Co has a branch in the USA. I. Co also has a subsidiary company the USA, US Co. The USA branch is rendering certain services to the US Co. Since I.Co and USA branch are same legal entity for the application of Indian TP regulation, hence the transaction between US branch and US Co. will be considered as transaction between I.Co and US Co.

Associated Enterprises in relation to 'Specified Domestic Transactions (SDT)'

3.21 Rule 10A(a)(ii) of the Rules defines "Associated Enterprise" for purpose of SDT as follows:

- (a) the persons referred to in clause (b) of sub-section (2) of section 40A of the Act in respect of a transaction referred to in section 40A(2)(a) of the Act; (omitted by Finance Act 2017, with effect from 1 April 2017)

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- (b) other units or undertakings or businesses of the same assessee in respect of a transaction referred to in section 80A of the Act or, as the case may be, sub-section (8) of section 80-IA of the Act;
- (c) any other person referred to in sub-section (10) of section 80-IA of the Act in respect of a transaction referred to therein;
- (d) other units, undertakings, enterprises or business of the assessee, or other person referred to in sub-section (10) of section 80-IA of the Act, as the case may be, in respect of a transaction referred to in section 10AA of the Act or the transactions referred to in Chapter VI-A to which the provisions of sub-section (8) or, as the case may be, the provisions of sub-section (10) of section 80-IA of the Act are applicable;

Associated Enterprises as per OECD and UN Framework

3.22 OECD Framework – The OECD Model tax convention defines Associated Enterprise in Article 9, which reads as under:

1. Where:

- a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
- b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State

and in either case conditions are made or imposed between the two 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.

3.23 UN Framework – Para 1 of Article 9 of UN Model Convention defines Associated Enterprise, which reads as under:

1. Where:

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- (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or*
- (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,*

and in either case conditions are made or imposed between the two 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.

3.26 As can be seen from above, the Indian TP Regulations cast a broad net for two entities to be regarded as associated which is much wider in scope than the definition as per OECD and UN model conventions.

Chapter 4

International Transaction

Definition

4.1 The terms “international transaction” is defined in two steps – the term “transaction” is defined in section 92F(v) of the Act, while the term “international transaction” is defined in section 92B of the Act. Hence, before proceeding to analyse the expression “international transaction”, it would be useful to take note of the definition of the term “transaction”. The term ‘transaction’ has been defined in clause (v) of section 92F as under:-

“(v) transaction includes an arrangement, understanding or action in concert:

- (i) whether or not such arrangement, understanding or action is formal or in writing; or
- (ii) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceedings”.

This definition is an inclusive definition and therefore wider in its scope. As per this definition, a transaction includes any arrangement, understanding or action, whether formal or informal, whether oral or in writing, whether legally enforceable or not.

Therefore, in order to characterise a “transaction” as “international transaction”, it has to be demonstrated that the transaction arose in pursuant to an arrangement, understanding or action in concert. Such an arrangement is between the two parties and not any unilateral action by one of the parties without any binding obligation on the other or without any mutual understanding or contract. If one of the party by its own volition is incurring any expenditure for its own business purpose, then without there being any corresponding binding obligation on the other party or without any such kind of an arrangement actually existing in writing or oral or otherwise, it cannot be characterized as international transaction within the scope and definition of Section 92B (1).” Therefore, necessary factual analysis to be carried out to establish that AEs have any arrangement, understanding or action in concert.

4.2 Section 92B defines an “international transaction” in the following manner:

Guidance Note on Report under Section 92E of the Income-tax Act, 1961

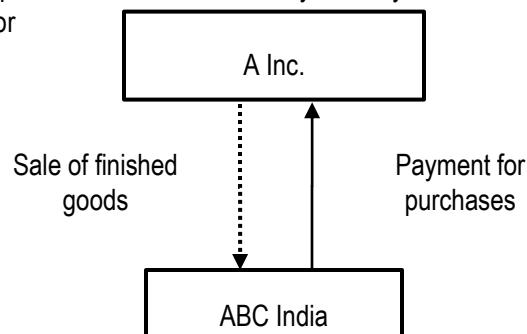
“For the purposes of this section and sections 92, 92C, 92D and 92E, “international transaction” means a transaction between two or more AEs, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or 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 AEs 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 such enterprises - section 92B(1)”.

“A transaction entered into by an enterprise with a person other than an AE shall, for the purposes of sub-section (1), be deemed to be an international transaction entered into between two AEs, if there exists a prior agreement in relation to the relevant transaction between such other person and the AE; or the terms of the relevant transaction are determined in substance between such other person and the AE where the enterprise or the AE or both of them are non-residents irrespective of whether such other person is a non-resident or not - section 92B(2)”.

From the above, it can be seen that sub-section (1) of section 92B defines the term “international transaction” in an exhaustive manner; and sub-section (2) of section 92B deems a transaction entered into between two enterprises in certain situations, as an international transaction between AEs.

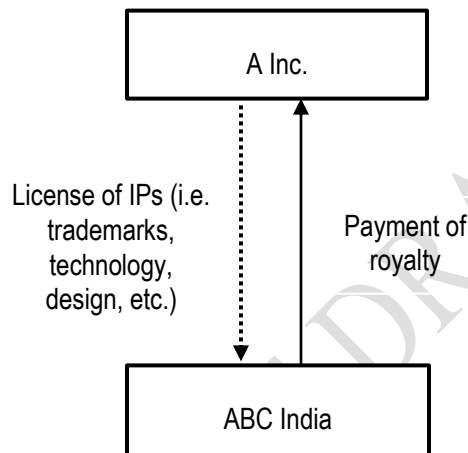
4.3 The definition of international transaction under the transfer pricing regulations is very wide in its scope and has been further clarified vide Finance Act 2012 with retrospective effect from 1 April, 2002 to include:

- (i) the purchase, sale, transfer, lease or use of tangible property including building, transportation vehicle, machinery, equipment, tools, plant, furniture, commodity or any other article, product or thing; or

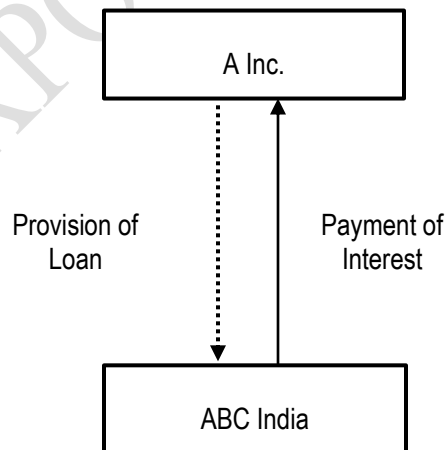


International Transaction

- (ii) the purchase, sale, transfer, lease or use of intangible property, including the transfer of ownership or the provision of use of rights regarding land use, copyrights, patents, trademarks, licences, franchises, customer list, marketing channel, brand, commercial secret, know-how, industrial property right, exterior design or practical and new design or any other business or commercial rights of similar nature; or

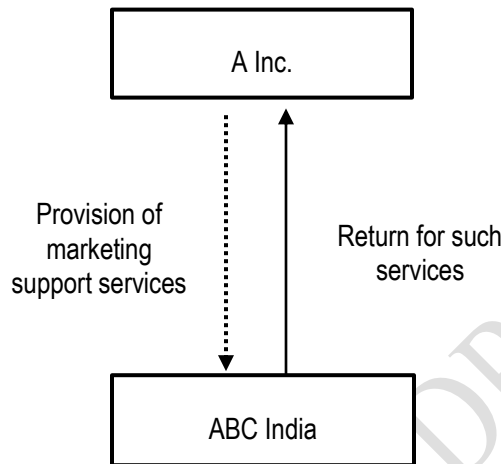


- (iii) capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business; or



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- (iv) provision of services, including provision of market research, market development, marketing management, administration, technical services, repairs, design, consultation, agency, scientific research, legal or accounting service; or



- (v) a transaction of business restructuring or reorganization, entered into by an enterprise with an AE, irrespective of the fact that it has a bearing on the profits, income, losses, or assets of such enterprises at the time of transaction or at any future date.

4.3.1 It shall also include a mutual agreement or arrangement between two or more AEs 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, facility provided or to be provided to any one or more such enterprises.

Business Restructuring

4.3.2 It is relevant to note that a transaction of business restructuring or reorganization has been clarified to be an international transaction irrespective of whether it has a bearing on the profits, income, losses or assets of the enterprise. However, the Act does not define business restructuring. In this respect, guidance may be drawn from the OECD guidelines, which defines business restructuring as cross border re-organisation of the commercial or financial relations between AEs including the termination or substantial renegotiation of existing arrangements. Relationships with third parties (e.g. suppliers, sub-contractors, customers) may be a reason for the restructuring or be affected by it.

International Transaction

4.3.3 Restructuring could be in the form of operational change (in functional, asset and risk profile of the entity) or organizational change (in ownership structure/management of the entity). It could include a change in the nature or scope of transactions among controlled entities, a shift in the allocation of risks, a change in responsibility for specific functions or commencement or termination of a relationship, etc.

4.3.4 Examples of transactions relating to business restructuring will include transactions such as conversion of a full-fledged manufacturer into a contract manufacturer, conversion of a full-fledged distributor into a low risk distributor, merger of two AEs to form a single entity, demerger of a business unit of an enterprise with an AE, etc. These are mere examples of what could fall within the definition of the term 'business restructuring', however the accountant should take care and evaluate the necessary facts / conditions to assess whether a particular transaction will fall within the said definition.

4.4 Any transaction between an enterprise and a person other than an AE will be deemed to be an international transaction with an AE as per sub-section (2) of section 92B under certain situations. This deeming provision is intended to cover cases where an independent third party (irrespective of whether it is a resident or non-resident) can be interposed by two AEs to remain out of the transfer pricing provisions of the Act.

Deemed International Transaction

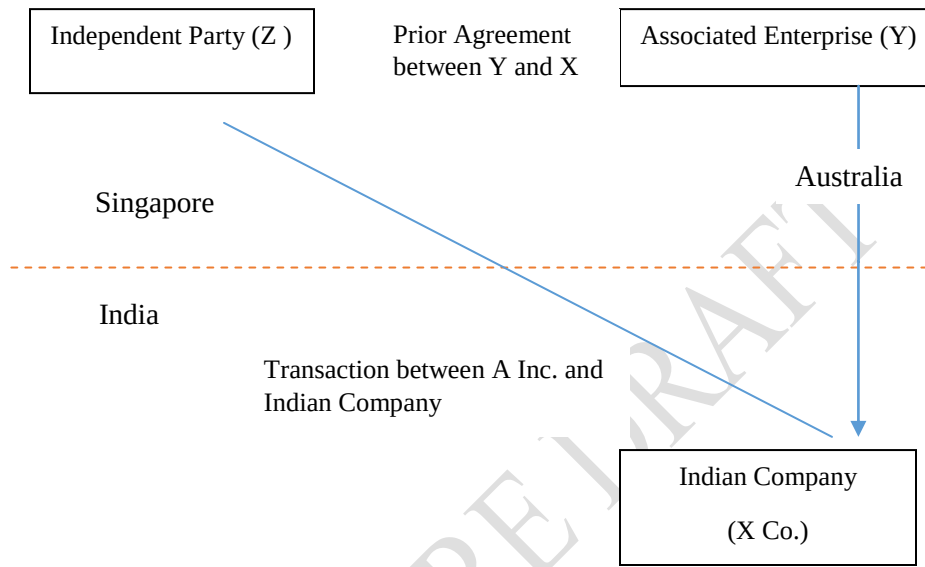
4.5 According to sub-section (2) of section 92B, a transaction between an enterprise and an unrelated person shall be deemed to be a transaction between AEs if in relation to that transaction -

- (i) there exists a prior agreement between such other person and the AE; or
- (ii) the terms of the relevant transaction are determined in substance between such unrelated person and the AE.

4.6 For example, enterprise X of India and enterprise Y of Australia are AEs. Enterprise Z of Singapore is not an AE of enterprise X. Enterprise Y and enterprise Z enter into an agreement for determining the terms of transactions between enterprise X and enterprise Z. The transaction as may be entered between enterprise X and enterprise Z which is governed by such an agreement existing between Y and Z shall be deemed to be a transaction

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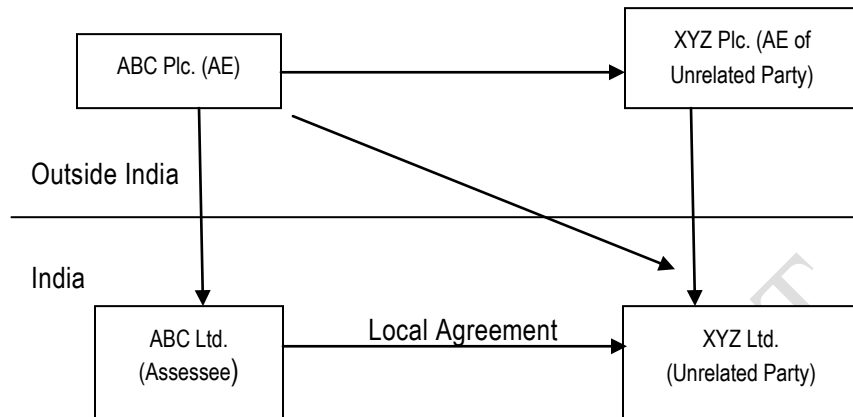
between two AEs. In this example the transaction could still be a deemed international transaction if Enterprise Z was an Indian resident.



4.7 Finance Act (No.2) 2014 has amended the said section w.e.f 1-4-2015 to provide that even where the unrelated third party is located in India, the transaction between the Indian entity and the unrelated third party will be deemed as an international transaction between the Indian entity and its AE located overseas. In the above case even if Z is an Indian resident, the transaction between X Co. and Z would be treated as deemed International Transaction.

The amended provisions would certainly cover within its ambit a three party scenario under the provisions of section 92B(2). However, a four party situation would need a detailed analysis / evaluation by the accountant. The same is explained in the form of example below:

International Transaction



In the said case, ABC Plc. which is based outside India enters into an agreement with XYZ Plc. (an unrelated party) to procure (raw material) from XYZ Plc and all its subsidiaries on a global basis.

Pursuant to the said agreement, ABC Ltd. which is a subsidiary of ABC Plc. procures raw material from XYZ Ltd which is a subsidiary of XYZ Plc.

In light of the facts provided above, whether the arrangement between ABC Ltd. and XYZ Ltd. will be deemed to be an international transaction under Section 92B(2) of the Act for ABC Ltd.? Such cases should be analysed in detail by the accountant (having regard to the underlying facts and circumstances) before reaching to a conclusion.

Impact of Amendment

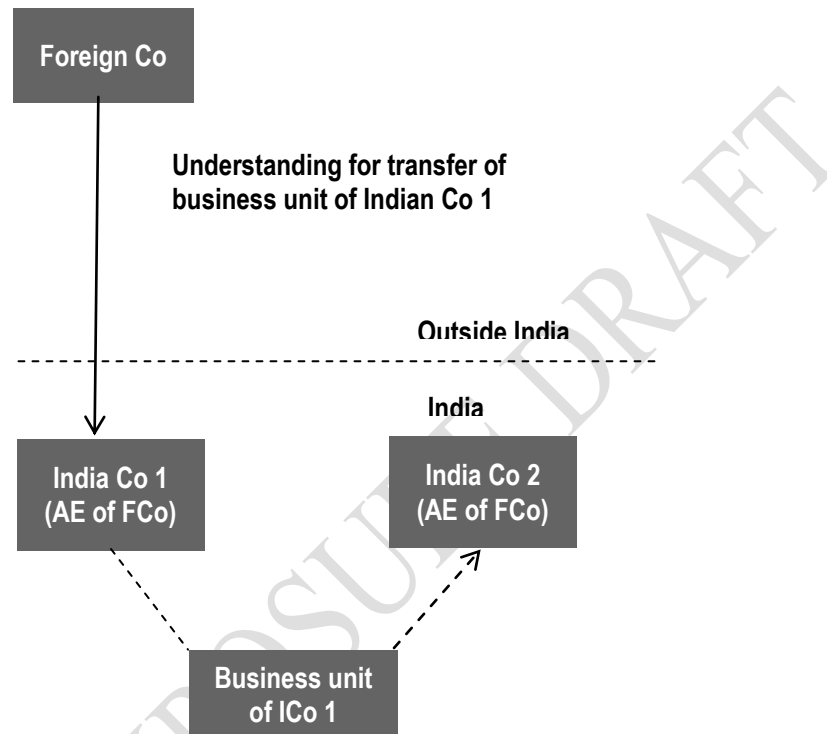
- The tax authorities may evaluate whether the profits earned in India is lower because of the influence of a non-resident AE on that transaction.
- As per the amendment, domestic transactions which are influenced by a Non-resident AE would also be covered within the scope of TP provisions.
- Care should be taken to properly report and disclose such transactions to avoid levy of penalty under Section 271AA.
- Amendment may not cover transaction between two resident parties in India who are AEs. (Meaning of an AE and the scenarios where 2

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persons can be regarded as AEs has been defined under section 92A(1) and 92A(2), respectively)

Example of Deemed International Transaction:

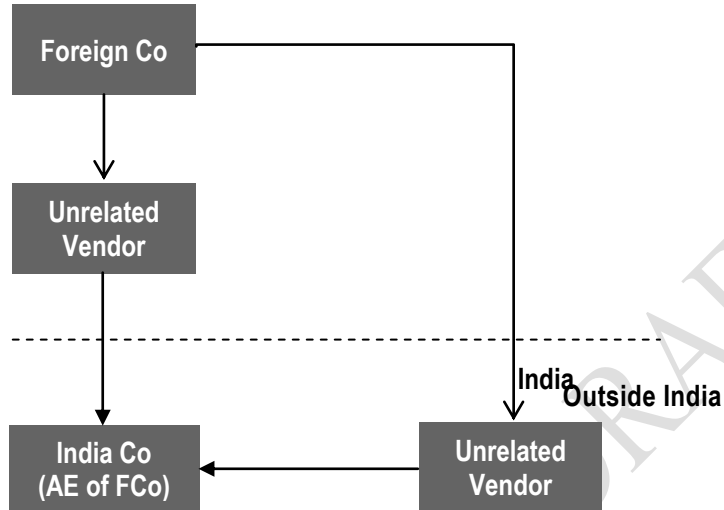
Case 1



Foreign Co has two subsidiaries in India (I Co 1 and I Co 2). I Co 1 proposed to transfer one of its business undertakings to I Co 2. There is an understanding that I Co 1 has with F Co regarding transfer of this business as well as the terms and conditions of transfer.

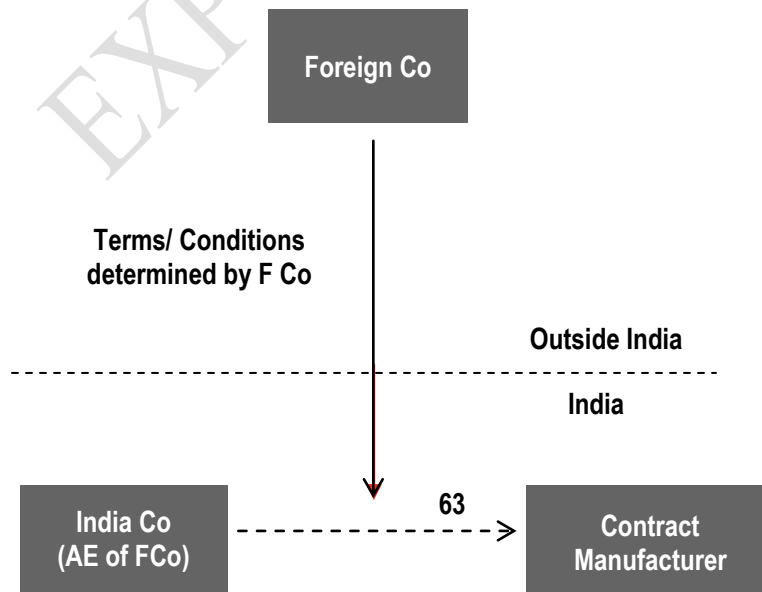
Since I Co 1 and I Co 2 are AEs, provisions of section 92B(2) should not apply to the transaction of sale of business unit.

However, sale of a business undertaking can involve termination/renegotiation of an existing contract, which can be based on an understanding between I Co1 and F Co. In such case, an international transaction of 'business restructuring' can exist between I Co 1 and F Co as per the provisions of section. 92B(1) read with section 92F(v) of the Act.

International Transaction
Case 2:

Foreign Co. has a global procurement organization that identifies, appoints, and negotiates with global vendors to supply to Foreign Co's affiliates (including India Co) at terms agreed by Foreign Co and the vendors.

Such transaction would be covered under the amended provision.

Case 3:

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Indian Co. enters into an arrangement with a third party contract manufacturer for manufacture & purchase of goods. The terms are determined in substance by Foreign Co.

Such transaction would be covered under the amended provision

Tangible and intangible property

4.8 Tangible property has an existence in physical form. Any property other than tangible is intangible property. *OECD Guidelines 2022 defines intangible as something which is not a physical asset or a financial asset¹, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.* OECD guidelines *illustratively lists* patents, know-how, trademarks, names and brands, rights under contracts and government licenses, goodwill, group synergies as intangible items.

4.9 Finance Act, 2012 inserted an explanation to Section 92B of the Act w.e.f 1-4-2012, which clarifies the expression “intangible property” for purposes of the Indian transfer pricing regulations to include-

- (i) marketing related intangibles assets, such as, trademarks, trade names, brand names, logos; or
- (ii) technology related intangibles assets, such as, process patents, patent applications, technical documentation such as laboratory notebooks, technical know-how; or
- (iii) artistic related intangible assets, such as, literary works and copyrights, musical compositions, copyrights, maps, engravings ; or
- (iv) data processing related intangible assets, such as proprietary computer software, software copyrights, automated databases, and integrated circuit masks and masters; or

¹ According to the OECD Guidelines 2022, a financial asset is any asset that is cash, an equity instrument, a contractual right or obligation to receive cash or another financial asset or to exchange financial assets or liabilities, or a derivative. Examples include bonds, bank deposits, stocks, shares, forward contracts, futures contracts and swaps.

International Transaction

- (v) engineering related intangible assets, such as industrial design, product patents, trade secrets, engineering drawing and schematics, blueprints, proprietary documentation; or
- (vi) customer related intangible assets, such as, customer lists, customer contracts, customer relationship, open purchase orders; or
- (vii) contract related intangible assets, such as, favourable supplier, contracts, licence agreements, franchise agreements, non-compete agreements; or
- (viii) human capital related intangible assets, such as, trained and organised workforce, employment agreements, union contracts; or
- (ix) location related intangible assets, such as leasehold interest, mineral exploration rights, easements, air rights, water rights; or
- (x) goodwill related intangible assets, such as, institutional goodwill, professional practice goodwill, personal goodwill of professional, celebrity goodwill, general business going concern value; or
- (xi) methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; or
- (xii) any other similar item that derives its value from its intellectual content rather than its physical attributes.

Given the wide scope of the phrase 'international transaction' and more particularly as regards 'intangible property' the accountant will need to exercise due diligence that all relevant transactions are considered and included in the report, whether these are included in the books of accounts or records of the assessee or not. The accountant should also review the record of any pending or past transfer pricing assessments or appeals of the assessee to identify any transaction not otherwise apparent from the books of accounts or records of the assessee. Where the accountant is unable to verify all such transactions due to any reason, and/ or relies upon explanations/ representations made to it by the assessee, and/ or there is a difference of opinion between the accountant and the assessee, such aspect should be included in the accountant's report as a note or qualification, as appropriate.

4.10 One of the most important aspects is to identify the intangibles, which are owned by the Group and the Indian entity. While, the above explanation provides detailed insights into the kind of intangibles, identification of

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intangibles, is an intensive process and requires detailed understanding of the industry and business model of the group and the Indian entity. The accountant can refer to the value driver analysis performed in the Master File, key customer contracts, customer relationships, vendor lists, etc. as reference points to identify intangibles, apart from the legally owned intangibles.

4.11 With respect to marketing intangible and particularly advertisement, marketing and promotional ('AMP') expenses, the accountant will need to exercise due diligence to establish whether the AMP expenses are incurred by AE in India to cater to the needs of the customers in the local market and not incurred at the instance or behest of overseas AE nor there was any mutual understanding or arrangement or allocation or contribution by the AE towards reimbursement of any part of AMP expenditure incurred by it for the purpose of its business. For carrying out this exercise cases decided on this should be kept in mind.

Services, finances, and costs etc.

4.12 "Provision of services" refers to trade related services like intellectual property rights and trade related investments. According to the OECD guidelines, there are two main issues while analysing intra-group services:

- (i) whether an intra-group service that should be charged for has been provided; and
- (ii) what the charge should be in accordance with the arm's length principle.

In this regard, the accountant may refer to the following aspects while determining whether the intra-group services have been rendered:

(a) Benefits test -The basis to decide whether a service has been provided is set out in the guidelines as 'whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself. If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's length principle'. Services benefiting a group of enterprises as a whole should be allocated amongst the group in a way that matches the benefit received.

International Transaction

(b) Shareholder activities –An activity that a group member (usually the parent company or a regional holding company) performs solely because of its ownership interest in one or more other group members i.e. in its capacity as shareholder. This type of activity would not be considered to be an intra-group service, and thus would not justify a charge to other group members. This type of activity may be referred to as a “shareholder activity”.

Certain illustrative examples for Shareholder activities can be:

- (i) juridical structure of the parent company itself such as meetings of shareholders of the parent, issuing of shares in the parent company, stock exchange listing of parent company and cost of supervisory board;
- (ii) reporting requirements of parent company including consolidation of reports, parent company’s audit of subsidiary’s accounts carried out exclusively in the interest of parent company, preparation of consolidated financial statements of the MNE;
- (iii) raising funds for the acquisition of its participations and costs relating to the parent company’s investor relations such as communication strategy;
- (iv) raising funds for the acquisition of its participations and costs relating to the parent company’s investor relations such as communication strategy;
- (v) ancillary to the corporate governance of the MNE as a whole.

(c) Duplicative activities – An activity which is undertaken by one group member that merely duplicate(s) a service that another group member is performing for itself, or that is being performed for such other group member by a third party(s) are considered to duplicative activities. An exception may be where the duplication of services is only temporary, for example, where an MNE group is reorganising to centralise its management functions. Another exception would be where the duplication is undertaken to reduce the risk of a wrong business decision (e.g. by getting a second legal opinion on a subject). Furthermore, the fact that a company performs, for example, marketing services in-house and also is charged for marketing services from a group company does not of itself determine duplication, since marketing is a broad term covering many levels of activity. The Accountant shall examine the information provided by the taxpayer to determine whether the intra-group services are different, additional, or complementary to the activities

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performed in-house. The benefits test would then apply to those non-duplicative elements of the intra-group services.

(d) – *Incidental Benefits* - There can be some cases where an intra-group services performed by a group member such as a shareholder or coordinating centre relates only to some group members but incidentally provides benefits to other group members. Examples could be, analysing the question whether to reorganize the group, to acquire new members, or to terminate a division. These activities could constitute intra-group services to the particular group members involved, for example those members who may make the acquisition or terminate one of their divisions, but they may also produce economic benefits for other group members not directly involved in the potential decision since the analysis could provide useful information about their own business operations. The incidental follow-on benefits that ordinarily would not cause these other group members to be treated as receiving an intra-group service because the activities producing the benefits would not be ones for which an independent enterprise ordinarily would be willing to pay.

Similarly, an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to it being part of a larger concern, and not to any specific activity being performed. For example, 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 deliberate concerted action involving global marketing and public relations campaigns.

Capital financing transactions

4.13 The AEs often enter into transactions of capital financing including borrowing, lending, guarantee arrangements, etc. The pricing of these arrangements will have a bearing on the profits or losses of the AEs and hence are included as part of the definition of 'international transaction'. These transactions of capital financing including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business are expressly covered as international transactions vide Finance Act 2012. The accountant will need to carefully identify and report such transactions and

International Transaction

particularly equity and preference capital, debentures, guarantees provided or received, etc. Advance payments received or made and debts arising during the course of business shall need to be carefully considered and reported by the accountant however ensuring that there is no duplication or overlap with reporting of the principal transactions to which such advances or debts relate to, unless the accountant identifies factors which cause such advances or debts as separate transactions.

The OECD has released “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations” in January 2022 incorporating discussion on transfer aspects of financial transactions in Chapter X. It seeks to provide guidance for determining whether the conditions of certain financial transactions between associated enterprises are consistent with the arm’s length principle. This may be referred to while analysing financial transactions for the purposes of the certificate under section 92E of the Act.

The accountant shall consider disclosing the transactions in relation to advance, payments or deferred payment or receivable or any other debt arising during the course of business either by way of a note in the ‘detailed observation/remarks’ section of the respective underlying primary transaction to which such balances pertain to or make a separate disclosure of such balances along with a description of the underlying primary transaction to which it is closely linked.

Cost contribution arrangement

4.14 Agreement or arrangement represents understanding, and not a transaction as ordinarily understood as being some business or dealing, which is carried on or transacted between two or more persons. It is reciprocal to contribute to the cost or incur expenditure for the mutual advantage or to share according to the agreement or the arrangement. Such agreement or arrangement is not in the nature of conveying any property or provision of services or lending or borrowing and is known as ‘cost contribution arrangement’.

4.15 The cost contribution arrangements, as aforesaid, are arrangements between business enterprises to share the costs and risks of jointly developing, producing, or obtaining assets, services or rights. Its conditions should be in conformity with arm’s length principle and therefore, a participant’s contributions must be consistent with what an independent enterprise would have agreed to contribute under comparable circumstances

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given the benefits it reasonably expects to derive from the arrangement. The accountant should gain an understanding of the transaction and make appropriate reporting for the same.

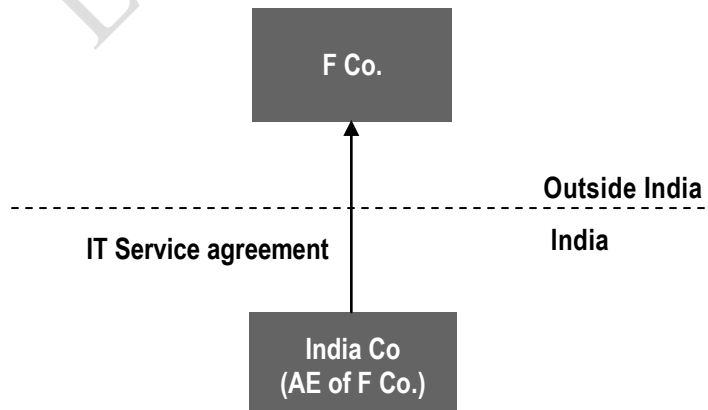
Free of cost transfer of goods or services

4.16 When determining whether or not international transaction exist in the books of accounts or records of the Assessee, the Accountant also need to consider the free of cost goods / services rendered / availed by the Assessee. A reference can also be placed on the positions adopted by the taxpayer under for GST for such free of cost goods / services by the Assessee.

4.17 The Accountant will need to carefully examine the necessary facts/ conditions to assess and identify such transactions not otherwise apparent from books of accounts or records of the Assessee and make appropriate reporting for the same. Where amounts are recognized on a notional basis in the books of accounts due to applicable accounting standards or otherwise, the same should be in conformity with arm's length principle. Examples of such transactions may include free of cost employee stock option plans, free of cost software / software related services, free of cost management services, etc.

4.18 To the extent there is an intentional set-off or where the pricing of the principal transaction is determined (basis functions performed, assets employed and risks assumed) after considering the free of cost transfers, a separate disclosure of such free of cost transfers may not be necessary. However, the fact of such set-off could be included in the accountant's report as a note. Same is the case with 'shareholder activities' and 'incidental benefits' that are not compensable.

Example:



International Transaction

F Co. has entered into a service agreement with India Co. for provision of IT services. As per the inter-company agreement, F Co. provides the necessary software/ tools, provides management oversight, and supervises the work carried out by India Co. The compensation to India Co. is agreed having regard to the roles and responsibilities of both the parties, including the free of cost software/ management services received by India Co. In such a case, a separate disclosure of such free of cost transfers may not be necessary.

4.19 The primary responsibility for the disclosing of such transactions rests with the taxpayer and the Accountant is entitled to place reliance on the representations provided by the taxpayer as to the details / completeness of such transactions.

Cross-border transactions- Interplay of section 9 and section 92A

4.20 For a transaction to be an international transaction, it should satisfy the following two conditions cumulatively:

- (a) it must be a transaction between two AEs; and
- (b) at least one of the two enterprises must be a non-resident.

4.21 transaction is considered to be a cross-border transaction if it originates in one country and gets concluded in another country. A cross-border transaction may or may not be an international transaction within the meaning of Chapter X of the Act. Similarly, a transaction which is not a cross-border transaction may still be an international transaction for the purpose of the said chapter if it falls within the ambit of the definition of "international transaction".

4.22 For example, it may be assumed that there are two US companies which are AEs. If the Indian subsidiary of one such US (holding) company enters into a transaction with the Indian branch or the permanent establishment in India of the other US company, this transaction, even though it has originated, executed and concluded within India, shall be an international transaction as it is between two AEs and one of the party is a non-resident.

4.23 In alternative, assume that there is an Indian company which is the holding company of two Indian (subsidiary) companies. The two Indian companies are AEs since they are subsidiaries of a common holding company. If one such Indian subsidiary company enters into a transaction

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with the foreign branch of the other Indian subsidiary company, such transaction shall not be regarded as an international transaction. In this case, even though the transaction is between two AEs, both the parties to the transaction are residents. For a transaction to be regarded an international transaction, either or both the parties must be non-residents. An important aspect to be noted here is that even though the above mentioned transaction is not an international transaction but it may be covered under domestic transfer pricing, subject to fulfilment of conditions prescribed under section 92BA, as per the amendments made vide Finance Act 2012 and the ALP would have to be determined having regard to transfer pricing provisions.

4.24 Even where a transaction is between two non-resident AEs, the provisions of chapter X of the Act shall apply so long as the income arising therefrom is assessable within the perview of the Act. It is possible that an international transaction between two AEs, both of whom are non-residents, may not attract the provisions of chapter X of the Act if the income from such transaction is not taxable in India and falls outside the scope of total income assessable under the Act.

Chapter 4A

Specified Domestic Transactions

4A.1 Transfer pricing regulations have been extended vide Finance Act 2012 to include transactions entered into with domestic related parties or by an undertaking with other undertakings of the same entity for the purposes of section 40A (now omitted), Chapter VI-A and section 10AA. Domestic transfer pricing provisions are applicable from Assessment Year 2013-14 onwards.

4A.2 All of the compliance requirements relating to transfer pricing documentation, accountant's report, etc shall equally apply to specified domestic transactions as they do for international transactions amongst associated enterprises.

Definition

4A.3 The definition of section 92BA which defines Specified Domestic Transaction (SDT) has been amended vide Finance Act, 2017 to omit transactions in the nature of expenditure for which payment has been made or would be made to persons specified in section 40A(2)(b). The said amendment is applicable for assessment year 2017-18 i.e. previous year 2016-17.

Section 92BA defines SDT which is covered by TP regulations as under:

"For the purposes of this section and sections 92, 92C, 92D and 92E, "specified domestic transaction" in case of an assessee means any of the following transactions, not being an international transaction, namely:—

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

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— any other transaction as may be prescribed,

and where the aggregate of such transactions entered into by the assessee in the previous year exceeds a sum of Rupees Twenty Crores.

Threshold Limit

4A.4 The above referred transactions will be regarded as SDT only if the aggregate value of all the above specified transactions exceeds the threshold limit of Rupees 20 Crores (w.e.f 1st April 2016 onwards). If the threshold limit is crossed, the taxpayer will be required to comply with TP requirements with reference to all the transactions regardless of the fact that the value of transactions under one of the limbs may be very small or nominal. Thus, there is no internal threshold for each limb of the definition.

4A.5 The threshold limit for SDT can be computed either on net basis (i.e. without including indirect tax levies like service tax, VAT, etc.) if the assessee is availing credit of those indirect taxes or on gross basis if the assessee is not availing credit, depending upon the method of accounting regularly followed. A useful reference may be made to the paragraph relating to Sales, Turnover, Gross Receipts under Guidance Note on Tax Audit u/s. 44AB issued by the Institute for the purpose of determining the threshold limit.

4A.6 Transactions covered under section 80A, 80-IA and 10AA

Section 92BA extends to:

- (i) any transaction referred to in section 80A;
- (ii) any transfer of goods or services referred to in sub-section (8) of section 80-IA;
- (iii) any business transacted between the assessee and other person as referred to in sub-section (10) of section 80-IA;
- (iv) any transaction, referred to in any other section under Chapter VI-A or section 10AA, to which provisions of sub-section (8) or sub-section (10) of section 80-IA are applicable

4A.7 Transactions covered under section 80A

Section 80A applies to deductions to be made in computing total income under Chapter VI-A. Though the reference in section 92BA is to section 80A in general, on a closer examination, it becomes clear that the reference is merely to sub-section (6) of section 80A and not to any other sub-section since other sub-section of section 80A merely regulates the quantum of deduction and does not involve fair pricing of any transaction. This is also

Specified Domestic Transactions

supported by corresponding amendment made to section 80A(6) by Finance Act 2012 to amend the meaning of expression 'market value' referred to in that sub-section and to provide that in case of specified domestic transactions, the market value shall be computed at arm's length price.

4A.8 Section 80A (6) of the Act provides that

"Notwithstanding anything to the contrary contained in section 10A or section 10AA or section 10B or section 10BA or in any provisions of this Chapter under the heading "C— Deductions in respect of certain incomes", where any goods or services held for the purposes of the undertaking or unit or enterprise or eligible business are transferred to any other business carried on by the assessee or where any goods or services held for the purposes of any other business carried on by the assessee are transferred to the undertaking or unit or enterprise or eligible business and, the consideration, if any, for such transfer as recorded in the accounts of the undertaking or unit or enterprise or eligible business does not correspond to the market value of such goods or services as on the date of the transfer, then, for the purposes of any deduction under this Chapter, the profits and gains of such undertaking or unit or enterprise or eligible business shall be computed as if the transfer, in either case, had been made at the market value of such goods or services as on that date.

Explanation — For the purposes of this sub-section, the expression "market value",—

- (i) *in relation to any goods or services sold or supplied, means the price that such goods or services would fetch if these were sold by the undertaking or unit or enterprise or eligible business in the open market, subject to statutory or regulatory restrictions, if any;*
- (ii) *in relation to any goods or services acquired, means the price that such goods or services would cost if these were acquired by the undertaking or unit or enterprise or eligible business from the open market, subject to statutory or regulatory restrictions, if any;*
- (iii) ***in relation to any goods or services sold, supplied or acquired means the arm's length price as defined in clause (ii) of section 92F of such goods or services, if it is a specified domestic transaction referred to in section 92BA "***

4A.9 This provision requires that the inter unit transfer of goods or services between eligible and other units of the same taxpayer should be recognized at market value of such goods or services as on the date of transfer for the

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purpose of computing deduction admissible to the taxpayer under specified sections of Chapter VI-A. The provision covers income as well as expenditure of the eligible unit. Further, if threshold of INR 20 crore is not crossed the same will continue to be governed by un-amended provisions of section 80A(6) of the Act and FMV will be computed on general principles

4A.10 The provisions currently in force which grant profit linked tax holiday deductions and which are regulated by section 80A(6) and, consequently, subject to Domestic transfer pricing are as follows:-

- 80-IA – Infrastructure development, etc
- 80-IAB – SEZ development
- 80-IAC – Startup business
- 80-IB – Industrial undertakings
- 80-IBA – Development and building house projects
- 80-IC – Industrial undertakings or enterprises in special category states
- 80-ID – Hotels and convention centres in specified area
- 80-IE – Undertakings in North-Eastern states
- 80JJA – Collection and processing of bio-degradable waste
- 80JJAA – Employment of new workmen
- 80LA – Offshore Banking units and International Financial Services Centre
- 80P – Co-operative societies

4A.11 Transfers referred to in section 80-IA(8)

The second limb of section 92BA refers to any transfer of goods or services referred to in sub-section (8) of section 80-IA. Section 80-IA (8) covers inter-unit transfer of goods and services.

Section 80-IA(8) reads as under:

“Where any goods or services held for the purposes of the eligible business are transferred to any other business carried on by the assessee, or where any goods or services held for the purposes of any other business carried on by the assessee are transferred to the eligible business and, in either case, the consideration, if any, for such transfer as recorded in the accounts of the eligible business does not correspond to the market value of such goods or

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services as on the date of the transfer, then, for the purposes of the deduction under this section, the profits and gains of such eligible business shall be computed as if the transfer, in either case, had been made at the market value of such goods or services as on that date"

Provided that where, in the opinion of the Assessing Officer, the computation of the profits and gains of the eligible business in the manner hereinbefore specified presents exceptional difficulties, the Assessing Officer may compute such profits and gains on such reasonable basis as he may deem fit.

Explanation.—For the purposes of this sub-section, "market value", in relation to any goods or services, means—

- (i) *the price that such goods or services would ordinarily fetch in the open market; or*
- (ii) ***the arm's length price as defined in clause (ii) of section 92F, where the transfer of such goods or services is a specified domestic transaction referred to in section 92BA.***

4A.12 The above provision entitles the assessing officer to compute profits and gains of eligible business based on market value of goods and services transferred between an eligible and a non-eligible business only if the consideration for such transfer (if any) as recorded in the books of accounts of the eligible business does not correspond to the market value of the goods or services. By virtue of the amendment made to the above explanation vide Finance Act 2012, on lines of extension of Explanation to section 80A(6) defining market value, the Explanation under this provision has also been expanded to provide that the market value shall be computed at arm's length price if the inter unit transfer constitutes specified domestic transaction.

4A.13 Transfers referred to in section 80-IA(10)

The third limb of section 92BA refers to business transacted between the assessee and any other person as referred to in sub-section (10) of section 80-IA.

4A.14 Section 80-IA(10) reads as under:

"Where it appears to the Assessing Officer that, owing to the close connection between the assessee carrying on the eligible business to which this section applies and any other person, or for any other reason, the course of business between them is so arranged that the business transacted between them produces to the assessee more than the ordinary profits which

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might be expected to arise in such eligible business, the Assessing Officer shall, in computing the profits and gains of such eligible business for the purposes of the deduction under this section, take the amount of profits as may be reasonably deemed to have been derived therefrom."

"Provided that in case the aforesaid arrangement involves a specified domestic transaction referred to in section 92BA, the amount of profits from such transaction shall be determined having regard to arm's length price as defined in clause (ii) of section 92F."

4A.15 Section 80-IA (10) applies to transactions between the assessee and any other person which results in excessive profits in the hands of the assessee:

- (a) either owing to close connection with other person; or
- (b) for any other reason.

The dealings between taxpayer and other person get covered by section 80-IA(10) provided the course of business between them is so arranged that the transaction produces more than ordinary profits in the eligible business.

4A.16 Transactions in other provisions to which section 80-IA(8)/(10) apply

Specified domestic transactions as defined in section 92BA also refer to any transaction, referred to in any other section under Chapter VI-A or section 10AA, to which provisions of section 80-IA(8) and section 80-IA(10) are applicable.

The following profit linked incentive provisions under Chapter VI-A are also governed by provisions of section 80-IA(8) and section 80-IA(10) and hence will be subject to Domestic TP:-

- 80-IAB- Deductions in respect of profits and gains by an undertaking or enterprise engaged in development of Special Economic Zone.
- 80-IAC- Special provisions in respect of specified business
- 80-IB- Deduction in respect of profits and gains from certain industrial undertakings other than infrastructure development undertakings
- 80-IBA- Deduction in respect of profits and gains from housing projects
- 80-IC- Special provisions in respect of certain undertakings or

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enterprises in certain special category States

- 80-ID- Deduction in respect of profits and gains from business of hotels and convention centres in specified area
- 80-IE- Special provisions in respect of certain undertakings in North-Eastern States

4A.17 Transactions between the persons referred to in sub-section (6) of section 115BAB

Section 115BAB was introduced by the Taxation Laws (Amendment) Act, 2019 providing for a concessional tax rate of 15% to a domestic company if specified conditions are satisfied. Sub-section (6) of this section reads as follows:

(6) Where it appears to the Assessing Officer that, owing to the close connection between the person to which this section applies and any other person, or for any other reason, the course of business between them is so arranged that the business transacted between them produces to the person more than the ordinary profits which might be expected to arise in such business, the Assessing Officer shall, in computing the profits and gains of such business for the purposes of this section, take the amount of profits as may be reasonably deemed to have been derived therefrom:

Provided that in case the aforesaid arrangement involves a specified domestic transaction referred to in [section 92BA](#), the amount of profits from such transaction shall be determined having regard to arm's length price as defined in clause (ii) of [section 92F](#):

Provided further that the amount, being profits in excess of the amount of the profits determined by the Assessing Officer, shall be deemed to be the income of the person.

Hence, if a company is seeking benefits of lower rate of tax under section 115BAB then auditor should examine whether transaction would be covered under the first proviso to sub-section (6) as mentioned above and take action accordingly.

Chapter 5

Arm's Length Price

Meaning and determination

5.1 In commercial parlance, an arm's length price is the price at which independent enterprises deal with each other, where the conditions of their commercial and financial relations ordinarily are determined by market forces. Section 92F(ii) of the Act, defines the arm's length price as a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises ('AE'), in uncontrolled conditions.

5.2 The steps involved in the determination of the arm's length price can be summarised as follows:

- (i) identification of the "international transaction/(s)" or specified domestic transaction/(s);
- (ii) identification of the functions performed, assets employed, and risks assumed ('FAR') by the taxpayer and the AE being parties to the transaction(s);
- (iii) deciding the characterisation of the entities who are party to the transaction based on the analysis of functions performed, assets employed and risks assumed;
- (iv) deciding if the international transactions or specified domestic transactions are closely linked or not [Rule 10A(d)] and accordingly functional analysis to be done using aggregation of transaction or transaction by transaction approach;
- (v) identification / selection of the tested party (for application of resale price method, cost plus method and transactional net margin method);
- (vi) identification of the most appropriate method which will, inter-alia, include:
 - a) identification of an "uncontrolled transaction" - Rule 10A (ab);
 - Review of existing internal uncontrolled transaction, if any;

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- Determination of available sources of information on external comparables where such external comparables are needed taking into account their relative reliability.

Identification and comparison of specific characteristics embodied in international transactions or specified domestic transactions and uncontrolled transactions-Rule 10B(2);

- b) finding out whether uncontrolled transactions and international transactions or specified domestic transactions can be compared by reconciling/resolving differences, if any - Rule 10B(3);
- (vii) ascertaining the most appropriate method by applying the tests laid down - Rule 10C;
- (viii) determination of the arm's length price by applying the method chosen - Rule 10B(1).

Please note that step (vi) is a repetitive exercise (in respect of each of the prescribed methods) until a satisfactory conclusion is reached thereby leading to selection of the most appropriate method out of the methods prescribed under Section 92C(1) of the Act. Further, no particular method has been accorded any priority under the Indian Transfer Pricing legislation. The most appropriate method is to be selected having regard to the nature of the transaction(s), functions performed by the parties involved in the transaction(s) and other relevant factors.

Example – ABC India is engaged in distribution of XYZ brand printers in the Indian market, which are manufactured by ABC Inc. (a US based group entity). Apart from the distribution of printers, ABC India also imports printer cartridges and other spares from its group entity ABC Inc, which are used in the after-sales business. The international transactions in this case are import of printers and import of cartridges & spares.

The typical steps involved in determination of the arm's length price in the above example could be as follows:

Identify international transactions

1. Import of printers; and
2. Import of cartridges and spares.

Decide if the transactions are closely linked

In the present case, if ABC India follows a business strategy where it targets to sell the printers to penetrate the market and thereafter get recurring business through sale of cartridges, then the transaction of import of printers and import of cartridges and spares could be said to be closely linked, and may be evaluated using aggregation approach.

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FAR analysis

Undertake an in-depth FAR analysis of ABC India and ABC Inc. For instance, ABC India performs functions in the nature of procurement, quality control, inventory management, marketing and sales promotion (limited) etc., employs assets in the nature of office premises, warehouses etc. and assumes limited market and inventory risks amongst others. On the other hand, ABC Inc. performs functions in the nature of corporate strategy formulation, product research and development, manufacturing, pricing etc., employs assets in the nature of manufacturing know-how, brand, manufacturing facilities, warehouses etc. and assumes product liability, research and development, market risks amongst others.

Characterization of the parties involved in the aforementioned transactions and accordingly selecting the tested party

If after an in-depth FAR analysis of ABC India and ABC Inc, ABC India is characterised as a limited risk distributor and ABC Inc. is characterised as a full-fledged manufacturer and further reliable comparable data for ABC India can be found, then typically ABC India being the entity with the least complex FAR shall be selected as the tested party.

Ascertaining the most appropriate method and determination of the arm's length price

After a careful examination of the facts and circumstances of the case and further after applying the tests laid down in Rule 10C, in the instant case, the resale price method could be selected as the most appropriate method. Further, in case where no internal comparable data is available, external comparable data could be identified through available sources of information and accordingly the arm's length price can be ascertained.

5.3 Section 92C(1) stipulates that the arm's length price is to be determined by adopting any one of the following methods, being the most appropriate method:

- Comparable Uncontrolled Price method (CUP method)

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- Resale Price Method (RPM)
- Cost Plus Method (CPM)
- Profit Split Method (PSM)
- Transactional Net Margin Method (TNMM)
- Other Method (OM) as prescribed by the Board and provided in Rule 10AB¹.

5.4 Rule 10C(1) lays down the general guidelines in the selection of the most appropriate method. The Rule states that the method to be selected shall be the one best suited to the facts and circumstances of each international transaction or specified domestic transaction and that provides the most reliable measure of the arm's length price.

5.5 Rule 10C(2) lists the specific factors that should be taken into account in the process of selecting the most appropriate method. These factors are as under:

- (i) nature and class of international transactions or specified domestic transactions;
- (ii) class or classes of AEs entering into the transaction and the functions performed by them taking into account the assets employed or to be employed and risks assumed by such enterprises;
- (iii) availability, coverage and reliability of data necessary for application of the method. For instance, data relating to transactions entered into by the enterprise itself would be more reliable than the data relating to transactions entered into by third parties;
- (iv) the degree of comparability existing between the international transaction or specified domestic transaction and uncontrolled transaction and between enterprises entering into such transactions
- (v) the extent to which reliable and accurate adjustments can be made to account for the difference between the transactions.
- (vi) the nature, the extent and reliability of assumptions required to be made in application of a method.

¹ Rule 10AB vide Notification No. 18/2012 [F. NO. 142/5/2012-TPL] dated 23 May 2012, applicable for assessment year 2012-13 and onwards

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5.6 Rule 10C, inter alia, specifies that the availability, coverage and reliability of data and whether reasonably accurate and reliable adjustments could be made as the relevant considerations in selecting the most appropriate method. In actual practice, the choice of most appropriate method depends not only on the nature and character of international transaction or specified domestic transaction but also on the availability of comparable transactions and data. Hence, the selection of most appropriate method is a process of applying both the criteria. It may happen that what appears to be most appropriate method on the basis of nature of international transaction or specified domestic transaction may not be eventually selected because of non-availability of comparable data. The following example would clarify. An enterprise may buy from its AE and resell in India. The transaction itself suggests that the most appropriate method is Resale Price Method (RPM). There may not be any internal comparable transaction available. Even an external comparable may not be available. Even if an external comparable is available, the available data may not be sufficient to determine the Arm's length Gross Profit. Therefore, RPM may not be most appropriate method and some other method is to be chosen. The selection of most appropriate method is a process of continuously evaluating the nature and characteristics of international transactions or specified domestic transactions and the comparable transactions.

5.7 The factors referred to above are to be applied cumulatively in selecting the most appropriate method. The reference therein to the terms 'best suited' and 'most reliable measure' indicates that the most appropriate method will have to be selected after a meticulous appraisal of the facts and circumstances of the international transaction or specified domestic transaction. Further, the selection of the most appropriate method shall be for each particular international transaction or specified domestic transaction. The term 'transaction' itself is defined in rule 10A(d) to include a number of closely linked transactions. Therefore, though the reference is to apply the most appropriate method to each particular transaction, keeping in view, the definition of the term 'transaction', the most appropriate method may be chosen for a group of closely linked transactions. Two or more transactions can be said to be linked when these transactions emanate from a common source being an order or a contract or an agreement or an arrangement and the nature, characteristics and terms of these transactions are substantially flowing from the said common source. For example, a master purchase order is issued stating the various terms and conditions and subsequently,

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individuals orders are released for specific quantities. The various purchase transactions are closely linked transactions.

5.8 It may be noted that in order to be closely linked transactions, it is not necessary that these transactions need to be identical or even similar. For example, a collaboration agreement may provide for import of raw materials, sale of finished goods, provision of technical services and payment of royalty. Different methods may be chosen as the most appropriate methods for each of the above transactions when considered on a standalone basis. However, under particular circumstances, one single method may be chosen as the most appropriate method covering all the above transactions as the same are closely linked.

5.9 There is yet another category of transactions which may be identical or similar though not closely linked. For example, independent purchase transactions having identical or similar nature, characteristics, terms and conditions are not closely linked transactions because these transactions do not emanate from a common source. However, under particular circumstances, one single method may still be chosen as the most appropriate method covering all the above transactions.

The following examples, [referred in the OECD Transfer Pricing Guidelines (2017)], may be useful in this regard:

“Examples may include 1. Some long-term contracts for the supply of commodities or services, 2. rights to use intangible property, and 3. pricing a range of closely-linked products (e.g. in a product line) when it is impractical to determine pricing for each individual product or transaction.” (Para 3.9)

“Another example where a taxpayer's transactions may be combined is related to portfolio approaches. A portfolio approach is a business strategy consisting of a taxpayer bundling certain transactions for the purpose of earning an appropriate return across the portfolio rather than necessarily on any single product within the portfolio. For instance, some products may be marketed by a taxpayer with a low profit or even at a loss, because they create a demand for other products and/or related services of the same taxpayer that are then sold or provided with high profits (e.g. equipment and captive aftermarket consumables, such as vending coffee machines and coffee capsules, or printers and cartridges). Similar approaches can be observed in various industries. Portfolio approaches are an

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example of a business strategy that may need to be taken into account in the comparability analysis and when examining the reliability of comparables.” (Para 3.10)

5.10 It is not uncommon to notice transactions which are not only dissimilar or unidentical but are also not linked. For example, there may be transactions of purchase, sale and provision of technical service. In such case, wherever internal comparables are available, appropriate method should be used if the circumstances so justify.

5.11 Section 92C(2) provides that most appropriate method referred to in section 92C(1) shall be applied, for determination of arm's length price, in the manner as prescribed in Rule 10B. The first proviso to section 92C(2) provides that 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) provides that 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 as may be notified² by the Central Government in the Official Gazette, the price at which the international transaction [or the specified domestic transaction] has been undertaken will be deemed to be the arm's length price. The variation is to be computed with reference to the actual price at which the international transaction [or the specified domestic transaction] has been undertaken. This proviso shall be applicable for assessment or reassessment proceedings pending before an Assessing Officer as on 1 October 2009.

5.12 The aforesaid amended second proviso refers to arm's length price (and not 'arithmetic mean' – as was the case in Finance Act 2002), and a view can be adopted that it is applicable to any 'arm's length price'

² Notification dated 13 September 2019, the rate of 1 percent for wholesale trading transaction and 3 percent in all other cases for financial year 2018-19

CBDT has also defined the term "wholesale trading" as "an International Transaction or a Specified Domestic Transaction of trading in goods, which fulfills the following conditions, namely:

- a) purchase cost of finished goods is 80% or more of the total cost pertaining to such trading activities; and
- b) average monthly closing inventory of such goods is 10% or less of sales pertaining to such trading activities.

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determined (whether as a single comparable price, or as arithmetic mean of multiple comparable prices). Notably, only one method out of the 6 methods can be identified as the most appropriate method for a given transaction. Such most appropriate method may lead to a single comparable price or multiple prices. The arm's length price is the single comparable price or arithmetic mean of multiple comparable prices arrived at by application of the most appropriate method.

5.13 The proviso provides that the arithmetical mean of such prices shall be the arm's length price

A. ALP determined by assessee

CUT1	ALP1	INR 7,600
CUT2	ALP2	INR 7,380
CUT3	ALP3	INR 7,320

Arithmetic mean as per proviso	INR 7,433
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ALP determined	INR 7,433
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Assuming that the Indian taxpayer sells a product to its AE, in the above example, if the transfer price is equal to or above INR 7,433, it would be treated as being arm's length from an Indian transfer pricing perspective.

However, if the transfer price was less than INR 7,433, then it could vary from ALP only to the extent of the notified percent (not exceeding 3 percent) of the actual value of international transaction. An example to illustrate this is as follows:

Scenario 1: Transfer Price is INR 7,000 and ALP is INR 7,433

Difference between the transaction price and arm's length price	INR 433
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3% of the transaction value	INR 210
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Since the difference between the transaction price and the arm's length price is more than 3% of the transaction price, the transaction will be considered not to be at arm's length

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

Scenario 2: Transfer Price is INR 7,250 and ALP is INR 7,433

Difference between the transaction price and arm's length price	INR 183
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3% of the transaction value	INR 218
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Since the difference between the transaction price and the arm's length price is less than 3% of the transaction price, the transaction will be considered to be at arm's length

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

5.14 A third proviso to this section has been inserted vide Finance (No. 2) Act 2014 stating that "where more than one price is determined by the most appropriate method, the arm's length price in relation to an international transaction or specified domestic transaction undertaken on or after the 1st day of April, 2014, shall be computed in such manner as may be prescribed and accordingly the first and second proviso shall not apply". With the introduction of the new mechanism, the provisions of first and second proviso (i.e. arithmetic mean and tolerable range) shall not apply.

CBDT vide Notification No. 83/2015 has introduced the use of the range concept as well as the use of multiple year data. Detailed discussion on the same is provided in Chapter 1 of this publication.

Uncontrolled transaction

5.15 Rule 10A(ab) defines an "uncontrolled transaction" to mean "a transaction between enterprises other than associated enterprises, whether resident or non-resident". When an uncontrolled transaction has been entered into, it could be said that it has been contracted under "uncontrolled conditions".

5.16 An uncontrolled transaction can be between:

- a resident and a non-resident; or
- a resident and a resident; or
- a non-resident and a non-resident.

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5.17 While selecting, uncontrolled transaction / companies, due care should be taken to identify / make appropriate adjustment for the differences between the international transaction [or specified domestic transaction] being evaluated and the comparable transaction so selected to ensure an appropriate comparison.

Comparable uncontrolled transactions

5.18 Rule 10B(2), lays down the criteria for comparability between international transactions [or specified domestic transactions] and uncontrolled transactions. This process is not quantitative but qualitative and involves exercise of judgment. The criteria listed in Rule 10B(2) are:

- 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.

Distinctive nature of the property and services

5.19 The following are some of the characteristics to be assessed vis-à-vis the property transferred or service provided:

In the case of transfer of tangible property:

- the physical features of the property;
- its quality and reliability; and
- the availability and volume of supply.

In the case of provision of services:

- the nature and extent of the services.

More specifically for financing services in the nature of intra-group funding/ loan transactions, corporate guarantee loan arrangements, etc., the following characteristics needs to be assessed:

- the nature/ type of the financial transaction;
- the purpose of the transaction; and

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- the duration and covenants of the financial transaction; etc

In the case of intangibles:

- the form of the transaction (eg. licensing or sale);
- the terms of the transaction;
- the type of property (eg. patent, trademark or know-how);
- the duration and extent of protection;
- anticipated benefits from the use of the property etc.

The following examples, taken from New Zealand transfer pricing guidelines, may be referred to

- An alkaline battery would sell at a premium to a standard (zinc carbon) battery, because the superior quality alkaline battery would be expected to last significantly longer than the standard battery.
- A battery with a known brand would sell for more than an unknown brand, even if the quality of the two batteries were identical. Other things being equal, consumers would be expected to prefer the battery with an established reputation for reliability.
- A multi coloured battery may sell for more than an equivalent black battery, depending on the extent to which consumer's preference is influenced by packaging.

Whether the transactions as illustrated in the aforesaid examples can be taken as comparable transactions or not would depend on the availability of data for making the reasonably accurate adjustments for the differences that affect prices / profits in the open market.

5.20 Further, the following guidance, from the OECD Transfer Pricing Guidelines (2017), may also be referred to:

"Para 1.108 Depending on the transfer pricing method, this factor must be given more or less weight. Among the methods described at Chapter II of these Guidelines, the requirement for comparability of property or services is the strictest for the comparable uncontrolled price method. Under the comparable uncontrolled price method, any material difference in the characteristics of property or services can have an effect on the price and would require an appropriate adjustment to be considered. Under the resale price method and cost plus method, some differences in the characteristics of property or

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services are less likely to have a material effect on the gross profit margin or mark-up on costs. Differences in the characteristics of property or services are also less sensitive in the case of the transactional profit methods than in the case of traditional transaction methods. This however does not mean that the question of comparability in characteristics of property or services can be ignored when applying these methods, because it may be that product differences entail or reflect different functions performed, assets used and/or risks assumed by the tested party.

Para 1.109 In practice, it has been observed that comparability analyses for methods based on gross or net profit indicators often put more emphasis on functional similarities than on product similarities. Depending on the facts and circumstances of the case, it may be acceptable to broaden the scope of the comparability analysis to include uncontrolled transactions involving products that are different, but where similar functions are undertaken. However, the acceptance of such an approach depends on the effects that the product differences have on the reliability of the comparison and on whether or not more reliable data are available. Before broadening the search to include a larger number of potentially comparable uncontrolled transactions based on similar functions being undertaken, thought should be given to whether such transactions are likely to offer reliable comparables for the controlled transaction."

Analysis of functions performed

5.21 Functions are defined as the activities that each of the entities engaged in a particular transaction perform as a part of its operations. This functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions. To illustrate, provided below are some typical functions undertaken in the context of manufacturing, research & development and distribution:

- raw material procurement
- production scheduling
- manufacturing of the products
- inventory management of raw materials and finished goods

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- product research, design and development
- developing and administering budgets
- production planning and scheduling
- quality control
- packaging and labelling of products
- warehousing
- sales and marketing
- technical services
- shipping of products to customers
- administrative services
- after sales support

Analysis of assets employed

5.22 Transactions that are proposed to be compared should be analysed for the assets employed. In this context, some of the following points may be noted;

- a) Whether assets are owned or leased
- b) Whether activity is capital or labour intensive
- c) Presence or absence of intangibles
- d) Are the assets unique in nature (like an Intellectual Property)

Typical intangible assets could be as follows:

- Patents
- Unpatented technical know-how
- Formulae
- Trademarks and brand names
- Trade names
- Copyrights
- Technical information
- Customer list

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- Franchises
- Marketing channel
- Highly qualified personnel

5.23 Intangibles can be ordinarily divided into two categories: manufacturing and marketing. Manufacturing intangibles are characterised as one of the two types – patents or non-patented technical know-how – and arise out of either research and development activity or the production engineering activities of the manufacturing plant.

5.24 Marketing intangibles include trademarks, corporate reputation, the distribution network and the ability to provide services to customers before and / or after the sale.

5.25 While carrying out the above analysis, it is necessary to assess whether the assets employed in the respective transactions significantly affect their comparability.

5.26 Further, it is not necessary that the assets are recorded in the balance sheet for it to have significant value for transfer pricing purposes. Even in cases where the assets (say intangibles) are not recorded in the balance sheet, due consideration should be given to the same while undertaking the functional analysis.

Analysis of risks assumed

5.27 An entity's return is usually reflective of the risks assumed by it – higher the risks, higher are the returns.

5.28 Transactions that are proposed to be compared should be analysed for the risk-content. Some of the significant risks present in a normal transaction are:

Nature of risks	Particulars
1. Financial risk	a. Capital contribution b. Method of funding c. Funding of losses
2. Product risk	a. Design and development of product b. Up-gradation of product

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Nature of risks	Particulars
	c. After Sales Service d. Risks associated with R & D e. Product liability risk f. Intellectual property risk if any
3. Market risk	a. Development of market including advertisement and product promotion etc. b. Business volume risk c. Assured sales risk d. Fluctuations in demand and prices.
4. Credit risk	a. Risk of bad debts
5. Foreign exchange risk	a. Risk on account of fluctuation of foreign currency exchange rates
6. Capacity utilisation risk	a. Risks on account of under-utilisation of capacity

5.29 It is important to align the ability to control and manage risk based on the actual activities. One cannot bear the risk contractually if there is no ability to control and manage such a risk. For example: A Co cannot be considered to be assuming risks in a scenario where it does not have the ability to control the decisions that lead to arising of such risks or it does not have financial wherewithal to withstand the loss arising from such risks.

5.30 Further, sometimes the risk profile within the AEs may be contractual and also backed by substance and it might be difficult to identify third parties with identical risk profile. For example: Capacity utilisation risk might not be borne by the customer in a third party scenario which might be the case in the transaction with the AE. In such a situation, adjustment for difference in risks should be considered for comparability and arm's length price computation purposes.

Characterisation

5.31 Characterisation is the process of assessing and determining the nature of the transacting entity (in a given international transaction or

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specified domestic transaction) as a licensed manufacturer / contract manufacturer / entrepreneur distributor / low risk distributor etc., based on the functional analysis which facilitates the process of selection of the tested party which in turn assists in the choice of the most appropriate method and also in the identification of the uncontrolled transactions for comparability purposes.

5.32 Characterisation of the related parties is an important component to a transfer pricing analysis and is used as the foundation in conducting the economic analysis. Characterisation of an entity (for transfer pricing purposes) refers to the process by which an entity is classified in a particular category based on the analysis of the functions, assets and risks of the said entity. For eg. based on an analysis of the functions, assets and risks of a given entity it could be classified as a manufacturer (entrepreneur, contract, toll etc.) or as a distributor (entrepreneur, normal risk, low risk etc.) or as a service provider.

5.33 In a typical scenario, a manufacturer and a distributor can be characterised as follows:-

a) Manufacturing set-up

Having regard to illustrative functions / risk / asset, the manufacturer could be characterized as follows:

Parameters	Full Fledge Manufacturer	Licensed Manufacturer	Contract Manufacturer	Toll Manufacturer
Produces on	Own behalf	Own behalf	Principal	Principal
Intellectual Property	Owens the IP	Does not own the IP but uses the IP owned by Principal on license basis	Does not own	Does not own
Materials	Owens	Owens	Owens	Does not own
Production scheduling	Does for own	Does for own	Done by Principal	Done by Principal

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Parameters	Full Fledge Manufacturer	Licensed Manufacturer	Contract Manufacturer	Toll Manufacturer
Selling and distribution function	Performs	Performs	Does not perform	Does not perform
Bears market risk	Yes	Yes	Limited	Limited
Bears inventory risk	Yes	Yes	Limited	No
Bears capacity utilisation risk	Yes	Yes	No	No
Bears credit risk	Yes	Yes	No	No

b) Distribution set-up

Having regard to illustrative functions / risk / asset, the distributor could be characterized as follows:

Parameters	Commission agent	Limited risk distributor	Normal risk distributor	Entrepreneur distributor
Takes title	No	Yes	Yes	Yes
Credit risk	No	Limited	Yes	Yes
Inventory risk	No	Limited	Yes	Yes
Marketing responsibilities	No	Limited	Limited	Yes
Foreign exchange risks	No	No	Yes	Yes

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Tested party

5.34 Comparable Uncontrolled Price Method is a two sided method i.e., either of the parties to the international transaction [or the specified domestic transaction] can be selected as the tested party. However, for the application of Cost plus Method, Resale Price Method or Transactional Net Margin Method, it is necessary to choose one of the parties to the transaction as the tested party whose profitability needs to be tested (i.e. mark-up on costs, gross margin, or net profit margins) and compare the profitability of the tested party's transactions with uncontrolled internal or external comparables, as the case may be. On the other hand, profit split method, may require combination of one sided or two-sided method depending upon methodology used.

5.35 The choice of the tested party should be consistent with the functional analysis of the transaction, and the characterisation of the entities.

5.36 The tested party generally would be the less complex party to the controlled transaction and should be the party in respect of which most reliable data for comparability is available. It may be possible that the tested party could be the group entity (AE) which is party to the transaction. To illustrate, say in a transaction pertaining to the sale of goods by a US company (an entrepreneur and owner of significant Intellectual Property) to its India subsidiary (a limited risk distributor), the Indian entity should be selected as the tested party since its functions are less complex as compared to the US company and data of comparable distributors will be more easily available for the purpose of benchmarking.

5.37 While making such an analysis, even the foreign entity could also be selected as the tested party. For instance where an Indian entrepreneur sells goods to its US subsidiary which acts as a low risk distributor, the US entity should be selected as the tested party. In such scenarios, the members should check if detailed information / analysis is maintained by the Company.

Contractual terms

5.38 The important contractual terms of the transactions should be ascertained to determine whether transactions as well as the transaction pricing / margin are comparable or not. Some of the contractual terms that need to be examined are:

- terms of delivery

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- CIF, C&F, FOB
- terms of payment
- discount, if any
- credit period
- warranty period
- installation services

5.39 An example of how contractual terms may affect transfer pricing may be seen in the following example, which has been taken from Para B.2.3.2.7 of the United Nations Practical Manual on Transfer Pricing for Developing Countries (2017).

“Consider Company A in one country, an agricultural exporter, which regularly buys transportation services from Company B (its foreign subsidiary) to ship its product, cocoa beans, from Company A’s country to overseas markets. Company B occasionally provides transportation services to Company C, an unrelated domestic corporation in the same country as Company B. However, the provision of such services to Company C accounts for only 10 per cent of the gross revenues of Company B and the remaining 90 per cent of Company B’s revenues are attributable to the provision of transportation services for cocoa beans to Company A. In determining the degree of comparability between Company B’s uncontrolled transaction with Company C and its controlled transaction with Company A, the difference in volumes involved in the two transactions, volume discount if any, and the regularity with which these services are provided must be taken into account where such factors would have a material effect on the price charged.”

5.40 It should be noted that in practice, information concerning the contractual terms of potentially comparable uncontrolled transactions may not be available, particularly where external comparables are used for the analysis. The effect of deficiencies in the information in establishing comparability will differ depending on the type of transaction being examined and the transfer pricing method applied.

5.41 Further, the revised OECD Transfer pricing guidelines, 2017 provides for a vigilant approach for testing the arm’s length nature of an international transaction by not just evaluating the on-paper agreement or the contractual terms, but also by scrutinizing the actual business conduct of the transacting

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parties, the commercial viability of the transaction, the practical feasibility considered by geographical locations, employment of assets, assumption of risks, etc.

5.42 The following example from Para 1.44 of the OECD Transfer Pricing Guidelines (2017) illustrates the concept of clarifying and supplementing the written contractual terms based on the identification of the actual commercial or financial relations. *“Company P is the parent company of an MNE group situated in Country P. Company S, situated in Country S, is a wholly-owned subsidiary of Company P and acts as an agent for Company P’s branded products in the Country S market. The agency contract between Company P and Company S is silent about any marketing and advertising activities in Country S that the parties should perform. Analysis of other economically relevant characteristics and in particular the functions performed, determines that Company S launched an intensive media campaign in Country S in order to develop brand awareness. This campaign represents a significant investment for Company S. Based on evidence provided by the conduct of the parties, it could be concluded that the written contract may not reflect the full extent of the commercial or financial relations between the parties. Accordingly, the analysis should not be limited by the terms recorded in the written contract, but further evidence should be sought as to the conduct of the parties, including as to the basis upon which Company S undertook the media campaign.”*

5.43 To the extent possible, adjustments should be attempted to even out the difference between the comparables and the tested party. In the event such adjustments are not possible or where the situation requires too many adjustments, the reliability of the method used as well as the analysis performed may require a revisit and probably it would be relevant to use an alternate method.

Market conditions

5.44 The market conditions in which uncontrolled transactions and international transactions [or the specified domestic transaction] are conducted must be evaluated to judge their comparability. Some of the different market conditions are:

- geographical location and size
- regulatory laws and government orders
- cost of labour and capital

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- level of competition
- nature of market whether wholesale/retail
- overall economic development

5.45 Many of the above conditions are not amenable to reasonably accurate adjustments. The market conditions would be more relevant in determining the comparability only and therefore, unless transactions take place in the same market conditions, they will not be comparable.

5.46 An example of impact of the aforesaid differences is provided below:

The taxpayer is engaged in the manufacturing and trading of pharmaceutical products. The taxpayer has sold Product A to its AE in Thailand and also to a third party in Vietnam. The details are provided below:

Particulars	Sale to an AE	Sale to a third party
Country	Thailand	Vietnam
Quantity exported	30,000	1,000
Average selling price per unit (in USD)	10	20
Usage	Wholesale Trading	Retail Trading

Prima facie, one may say that the sale of Product A to the AE in Thailand is not at arm's length since the same product has been sold to a third party in Vietnam at a much higher price. However, one has to analyse the following factors before arriving at a conclusion:

a) Geographical differences, market conditions and size of the markets

The price at which a product is sold in one country cannot be compared with the price at which the same product is sold in another country because of the impact on account of geographical differences i.e. country specific demand/supply factors, market conditions, regulations and government orders in force, level of competition, availability of substitute products, consumer purchasing power, etc. which could have a bearing on the price.

b) Volume

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It is essential to evaluate the impact of the difference in volumes transacted with an AE and an independent third party respectively and accordingly make a suitable adjustment to eliminate the difference. For instance, in the above example, the quantity exported to the AE is 30,000 units vis-à-vis 1,000 to the third party. In an arm's length scenario, any third party would ideally ask for a volume discount. Therefore, unless it is demonstrated that the volume has no impact on the pricing of the transaction under consideration, an appropriate adjustment should be made.

c) Laws and government orders in force

The Government orders which are prevalent in Thailand and Vietnam would also be relevant and may need to be examined.

d) Level of market

Export prices of the same product sold to an AE and a third party respectively are bound to be different if the AE and the third party are at different levels of market in the entire value chain. In other words, in the above example, the AE operates as a wholesale trader which is the second level in the entire value chain whereas the third party operates as a retail trader which is the third level in the entire value chain.

As stated above, it would be critical to evaluate if reliably accurate adjustment on account of the aforesaid differences could be made to eliminate the differences, and in the absence of such an adjustment the transaction cannot be considered as comparable.

Business strategies, commercial considerations and economic principles

5.47 Economic principles and prevailing business conditions are fundamental to any transfer pricing evaluation. Therefore, business strategies adopted by enterprises and market conditions faced by taxpayers are relevant factors for determining comparability with uncontrolled transactions/margins, and must be carefully considered during the comparability analysis. While the Indian TP regulations do not specifically recognize / provide for analysis of the business strategies, the OECD Guidelines duly recognize the need to analyse the business strategies while undertaking the comparability analysis. Some examples where business strategies/ economic realities could be relevant are:

- market strategies such as entry strategies, market penetration, loss leadership etc. followed by some companies may result in losses in

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the initial /interim years, as a part of a bigger strategy of building market share and reaping subsequent benefits therefrom.

- In case of start up operations, enterprises are generally not able to recover their initial set-up costs etc. during the initial few years of operations. It is not appropriate in such cases to compare the taxpayers profit/ margins with the margins earned by established comparables that are at a different stage of operations.

5.48 It is not necessary that all the criteria specified in Rule 10B(2) should be cumulatively applied while selecting comparable transactions. The relevance of these criteria depends on the method chosen as most appropriate method. For instance, when CUP is chosen as the most appropriate method, the nature of the property and service, the functions performed, risk undertaken and the terms of contract become critical in choosing the comparable transaction. It can generally be stated that criteria mentioned in rule 10B(2) need to be applied with more rigour when comparability is done at transactional level. But when the comparability is done at enterprise level, it becomes difficult to apply the criteria like contractual terms, nature of products or services etc. In other words, a rigorous analysis of functions performed, assets used and risk taken (FAR) is difficult when enterprise level comparisons are made in CPM, RPM, TNMM or PSM.

5.49 The above analysis is carried out to determine whether the uncontrolled transactions and international transactions or specified domestic transaction are comparable. Rule 10B(3) states that an uncontrolled transaction shall be comparable to an international transaction or specified domestic transaction if:

- (i) none of the differences between transactions or enterprises are likely to materially affect the price or cost charged or paid in or profit arising from, such transactions in the open market; or
- (ii) reasonably accurate adjustments can be made to eliminate material effects of differences.

5.50 If there are no differences, the transactions are comparable straight away. If the differences can be adjusted with reasonable accuracy, then the transactions are comparable, subject to adjustments. If, however, the differences cannot be adjusted with reasonable accuracy, the transactions are to be ignored and the search for comparable transactions would need to commence all over again. For instance, under TNMM where margins are to

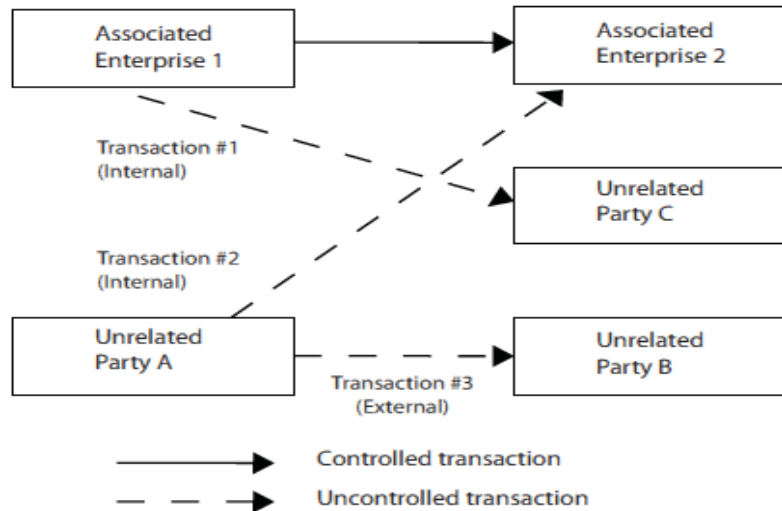
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be compared, the margin of a 1,000 crore company cannot be compared with that of a 10 crore company. The two most obvious reasons are the size of the two companies and the relative economies of scale under which they operate. The fact that they operate in the same market on a "level playing field" may not make them comparable enterprises. Some of the other factors/ criteria which could be considered for the purpose of comparability analysis, in order to identify the uncontrolled transactions are:

- level of fixed assets as a percentage of total sales, level of operating expenses as a percentage of sales;
- level of investment in intangible assets; and
- differences in the level of risks assumed by the parties viz. market risk, human resources, quality, contract risk, credit/ collection risks etc.

5.51 It is important to note that the transactions entered into by AEs with unrelated party ("internal comparables") would provide more reliable and accurate data as compared to transactions by and between third parties ("external comparables"). OECD's Guidelines on Transfer Pricing recognize the fact that external comparables are difficult to obtain and, also, it may be incomplete and difficult to interpret. Hence for these reasons, internal comparables are preferred to external comparables.

5.52 To illustrate say, the controlled transaction involves the sale of watches by AE1, a watch manufacturer in Country1, to AE2, a watch importer in Country 2, which purchases, imports and resells the watches to unrelated watch dealers in Country 2.

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In the above example, one can identify the following comparable transactions (assuming the characteristics of the products are same in all the scenarios)

(a) Internal comparables

The price charged for watches sold in a comparable uncontrolled transaction between AE 1 and Unrelated Party C (i.e. transaction #1);

The price charged for watches sold in a comparable uncontrolled transaction between AE 2 and Unrelated Party A (i.e. transaction #2)

(b) External comparables

The price paid for watches sold in a comparable uncontrolled transaction between Unrelated Party A and Unrelated Party B (i.e. transaction #3)

5.53 The analysis of the uncontrolled transactions is made to assess their comparability with the international transaction or specified domestic transaction.

5.54 A question arises as to what should be the number of comparable uncontrolled transactions to be selected. In other words, is it sufficient to have just one CUT or is it necessary that a reasonable number of CUTs should be selected? Both the Act and the Rules do not prescribe the number of CUTs to be chosen. An analysis of section 92C(2) read with the proviso thereto and Rule 10B(1) would show that selection of even one CUT is permissible. The proviso to section 92C(2) uses the expression “provided

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that where more than **one price** is determined by the most appropriate method.....". This indicates that selection of multiple CUTs is not required as a rule and if an assessee adopts multiple CUTs the proviso would be applicable. This is further strengthened by the language adopted in Rule 10B(1) which clearly permits adoption of even a single CUT. For example, Rule 10B(1)(a)(i) uses the expression "*.....in a comparable uncontrolled transaction, or a number of such transactions...*" (*emphasis supplied*). Similar expression is used in other clauses of Rule 10B(1). It is possible to have a single most appropriate CUT. Therefore, it may be said that if one most appropriate CUT is selected, such CUT would represent ALP. However, if more than one CUT is available the proviso to section 92C(2) would be applicable.

5.55 Rule 10B(4) provides that the data to be used in analysing the comparability of an uncontrolled transaction with an international transaction [or a specified domestic transaction] shall be the data relating to the financial year in which the international transaction [or the specified domestic transaction] has been entered into. Within the same financial year, the CUT may precede or succeed an international transaction.

5.56 The proviso to Rule 10B(4), further states that data relating to a period of not more than 2 years preceding such financial year may also be considered, if such data reveals facts which could have an influence on the determination of the transfer prices in relation to transactions being compared. Multiple year data has been permitted to be used vide Finance (No. 2) Act 2014.CBDT vide Notification No. 83/2015 has issued detailed guidance on the use of the multiple year data for the purpose of comparability analysis. Discussion on the same is detailed in Chapter 1 of this publication.

5.57 Further, the OECD in its Transfer Pricing Guidelines (2017) in Para 3.76 to 3.79 also supports the use of multiple year data. It states that in order to obtain a complete understanding of the facts and circumstances surrounding the controlled transaction, it generally might be useful to examine data from both the year under examination and prior years. The analysis of such information might disclose facts that may have influenced (or should have influenced) the determination of the transfer price. For example, the use of data from past years will show whether a taxpayer's reported loss on a transaction is part of a history of losses on similar transactions, the result of particular economic conditions in a prior year that increased costs in the subsequent year, or a reflection of the fact that a

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product is at the end of its life cycle. Such an analysis may be particularly useful where a transactional profit method is applied. Multiple year data can also improve the understanding of long term arrangements. Multiple year data will also be useful in providing information about the relevant business and product life cycles of the comparables. Differences in business or product life cycles may have a material effect on transfer pricing conditions that needs to be assessed in determining comparability. The data from earlier years may show whether the independent enterprise engaged in a comparable transaction was affected by comparable economic conditions in a comparable manner, or whether different conditions in an earlier year materially affected its price or profit so that it should not be used as a comparable. Multiple year data can also improve the process of selecting third party comparables for example by identifying results that may indicate a significant variance from the underlying comparability characteristics of the controlled transaction being reviewed, in some cases leading to the rejection of the comparable, or to detect anomalies in third party information.

5.58 The Other Method (OM) offers more flexibility and permits comparison by use of a “price which has been charged or paid, or would have been charged or paid” thereby allowing use of bonafide quotations, bids, proposals as comparable transactions or prices, and also economic and commercially justifiable models and similar approaches.

Power of Assessing Officer

5.59 According to section 92C(3), the Assessing Officer may himself proceed to determine the arm's length price if any of the following conditions are satisfied:

- (i) 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.
- (ii) any information and document relating to an international transaction or specified domestic transaction has not been kept and maintained as mandated.
- (iii) the information or data used in computation of the arm's length price is not reliable or correct.
- (iv) the assessee had failed to furnish, within the specified time, any information or document which he was required to furnish.

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5.60 If any of the above conditions are satisfied, the power to determine the arm's length price may be exercised in any proceeding for the assessment of income. The Assessing Officer also, is required to determine the arm's length price in accordance with section 92C(1) and (2) only, which states that the arm's length price will have to be arrived at on the basis of the most appropriate method. The Assessing Officer may determine the arm's length price on the basis of the material or information or document available with him. Even where such determination is made by the Assessing Officer, if more than one price may be determined by the most appropriate methods, the arm's length price shall be taken to be arithmetical mean of such prices.

5.61 The information, which the assessee may be called upon to furnish, in the absence of which the Assessing Officer would have power to substitute the arm's length price, should be that which the assessee has in his possession and is capable of being furnished.

5.62 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.

5.63 When the Assessing Officer substitutes the arm's length price on the basis of material or information or document in his possession, he may accordingly re-compute the total income of the assessee. No deduction under section 10A or 10B or Chapter VIA shall be allowed in respect of the amount of income by which the total income of the assessee is enhanced. The restriction on the admissibility of an exemption / deduction is only under sections 10A or 10AA or 10B or Chapter VI-A. It appears that deduction under section 10C may be available on the enhanced income.

5.64 The income of one of the AEs may be recomputed by substituting the actual price paid/charged to another AE for any property or service with the arm's length price. When this substitution takes place it results in a re-computation of the total income of such AE. This re-computation would, however, not entitle the other AE to demand a re-computation of its total income. Consequently, it would not be entitled to a refund of any tax. For example, if XYZ Ltd. has paid royalty of INR 100 to its AE ABC Ltd., it would have deducted INR 20 as tax under section 115A read with section 195 and remitted the balance of INR 80 to ABC Ltd. If the Assessing Officer computes the arm's length price of royalty to be INR 75 and substitutes it for the actual amount paid, i.e. INR 100, ABC Ltd., will not be able to demand either a re-

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computation of the royalty income received by it or a refund of tax in excess of what is due on the basis of the arm's length price.

5.65 Section 92CA(2A) inserted by Finance Act 2011 with effect from 1 June 2011 provides that where an international transaction not referred to the Transfer Pricing Officer by the Assessing Officer comes to the notice of the Transfer Pricing Officer, then such international transaction can be examined by the Transfer Pricing Officer as if it was referred to him. Further, section 92CA(2B) inserted by Finance Act 2012 with retrospective effect from 1st June 2002 provides that where an assessee has not furnished an accountant's report under section 92E and an international transaction comes to the notice of the Transfer Pricing Officer, then such international transaction can be examined by the Transfer Pricing Officer as if it was referred to him.

EXPOSURE DRAFT

Chapter 6

Methods of Computation of Arm's Length Price

Meaning of relevant terms

6.1 The various methods of computation of arm's length price are prescribed in Rule 10B. For this purpose, certain terms are defined in Rule 10A as under:

Rule 10A - Meaning of expressions used in computation of arm's length price.

For the purposes of this rule and rules 10AB to 10E,-

- (a) 'uncontrolled transaction' means a transaction between enterprises other than AEs, whether resident or non-resident;***
- (b) 'property' includes goods, articles or things, and intangible property;***
- (c) 'service' includes financial services; and***
- (d) 'transaction' includes a number of closely linked transactions.***

Further, Section 92F(v) of the Act defines the term 'transaction' as below:

'Transaction' includes an arrangement, understanding or action in concert -

- (A) whether or not such arrangement, understanding or action is formal or in writing; or***
- (B) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceeding.***

6.2 Rule 10B stipulates the methods of determination of arm's length price. The relevant portion of the rule dealing with each of the methods prescribed is extracted here below and suitable explanations thereof are given along with illustrations encompassing several adjustments for enabling better understanding of the principles involved and the type of working called for.

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Comparable Uncontrolled Price Method (CUP Method)

6.3 Rule 10B(1)(a) - Comparable uncontrolled price method, by which,-

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

6.4 The comparable uncontrolled price method is considered as one of the traditional transaction methods of determining the arm's length price. Two other traditional transaction methods are the Resale Price Method and the Cost Plus Method.

6.5 Typical transactions in respect of which the comparable uncontrolled price method may be adopted are:

- (a)** Transfer of goods;
- (b)** Provision of services;
- (c)** Royalty for use of Intangibles;
- (d)** Interest on loans.

6.6 The OECD in its Transfer Pricing Guidelines (2022) observes as under:

Para 2.14 "The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. If there is any difference between the two prices,

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this may indicate that the condition of the commercial and financial relations of the AEs are not at arm's length, and that the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction."

6.7 Comparable uncontrolled transactions which involve a transaction between one of the enterprises and an uncontrolled party, are referred to as internal comparables. Comparable uncontrolled transactions which involve a transaction between two parties, neither of which is an associated enterprise, are called external comparables.

6.8 Further, OECD Transfer Pricing Guidelines (2022) has additionally incorporated the application of quoted prices under the CUP methodology while establishing arm's length nature of commodities' transfer between AEs. The guidelines have broadened the applicability of the CUP method and have alleviated the arm's length determination for commodity transactions. Paras 2.19, 2.20 and 2.22 are relevant. These read as follows:

Para 2.19: Under the CUP method, the arm's length price for commodity transactions may be determined by reference to comparable uncontrolled transactions and by reference to comparable uncontrolled arrangements represented by the quoted price. Quoted commodity prices generally reflect the agreement between independent buyers and sellers in the market on the price for a specific type and amount of commodity, traded under specific conditions at a certain point in time. A relevant factor in determining the appropriateness of using the quoted price for a specific commodity is the extent to which the quoted price is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled transactions comparable to the controlled transaction. Accordingly, depending on the facts and circumstances of each case, quoted prices can be considered as a reference for pricing commodity transactions between associated enterprises. Taxpayers and tax administrations should be consistent in their application of the appropriately selected quoted price.

Para 2.20: For the CUP method to be reliably applied to commodity transactions, the economically relevant characteristics of the controlled transaction and the uncontrolled transactions or the uncontrolled arrangements represented by the quoted price need to be comparable. For commodities, the economically relevant characteristics include, among others, the physical features and quality of the commodity; the contractual

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terms of the controlled transaction, such as volumes traded, period of the arrangements, the timing and terms of delivery, transportation, insurance, and foreign currency terms. For some commodities, certain economically relevant characteristics (e.g. prompt delivery) may lead to a premium or a discount. If the quoted price is used as a reference for determining the arm's length price or price range, the standardised contracts which stipulate specifications on the basis of which commodities are traded on the exchange and which result in a quoted price for the commodity may be relevant. Where there are differences between the conditions of the controlled transaction and the conditions of the uncontrolled transactions or the conditions determining the quoted price for the commodity that materially affect the price of the commodity transactions being examined, reasonably accurate adjustments should be made to ensure that the economically relevant characteristics of the transactions are comparable. Contributions made in the form of functions performed, assets used and risks assumed by other entities in the supply chain should be compensated in accordance with the guidance provided in these Guidelines.

2.22: A particularly relevant factor for commodity transactions determined by reference to the quoted price is the pricing date, which refers to the specific time, date or time period (e.g. a specified range of dates over which an average price is determined) selected by the parties to determine the price for commodity transactions...

6.9 The steps involved in the application of this method are:

- (i) Identify the price charged or paid in comparable uncontrolled transactions;
- (ii) The above price should be adjusted for transaction level differences on the basis of functions performed, assets used and risks taken (FAR) analysis and enterprise level differences if any;
- (iii) The adjusted price is the arm's length price;

6.10 On the aspect of comparability for application of the CUP method, the United Nations ('UN') in its Practical Manual on Transfer Pricing for Developing Countries (2021) has observed as under:

"B.4.2.2.3. Product comparability should be closely examined in applying the CUP Method. A price may be materially influenced by differences between

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the goods or services transferred in the controlled and uncontrolled transactions. The CUP Method is appropriate especially in cases where an independent enterprise buys or sells products that are identical or very similar to those sold in the controlled transaction or in situations where services are rendered that are identical or very similar to those rendered in the controlled transaction.

B.4.2.2.4. Although product comparability is important in applying the CUP Method, the other comparability factors should not be disregarded. Contractual terms and economic conditions are also important comparability factors. Where there are differences between controlled and uncontrolled transactions, adjustments should be made to enhance reliability”.

6.11 Given that the CUP Method compares the prices of the products, it is warranted that high degree of similarity on all aspects (such as products / services, terms of the transaction etc.) be established between the products being compared.

The UN in the Practical Manual on Transfer Pricing for Developing Countries (2021) observes as under:

B.4.2.2.5 Reasonably accurate adjustment may be made for differences in:

- *The type and quality of the products. (E.g. unbranded Kenyan coffee beans as compared with unbranded Brazilian coffee beans);*
- *Delivery terms. (e.g. AE 1 sells similar bicycles to AE 2 and Unrelated Party C. All relevant information on the controlled and uncontrolled transactions is available to AE1, and hence it is probable that all material differences between the transactions can be recognized. The uncontrolled price can be adjusted for the difference in delivery terms to eliminate the effect of this difference on the price);*
- *Volume of sales and related discounts. (E.g. AE 1 sells 5000 bicycles to AE 2 for US\$90 per bicycle, while it sells 1000 similar bicycles to Unrelated Party C. The effect of the differences in volume on price should be analysed, and if the effect is material, adjustments should be made perhaps based on volume discounts in similar markets);*
- *Product characteristics. (E.g. the uncontrolled transactions to an unrelated party involve bicycles on which modifications have been made. However, the bicycles sold in the controlled transactions do not include these modifications. If the product modifications have a*

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material effect on price, then the uncontrolled price should be adjusted to take into account this difference in price);

- *Contractual terms. (E.g. AE 1 sells the bicycles to AE 2 offering a 90 day credit term but the contract terms dictate that all sales to Unrelated Party C are Cash On Delivery);*
- *Risk incurred. (E.g. AE 1 is exposed to inventory risk related to sales by AE 2 and the risk that customers of AE 2 will default on their bicycle purchase loans; whereas in the transaction between AE 1 and Unrelated Party C, the latter is exposed to the inventory risk and the risk of its customers' default. This difference in risk allocation must be analysed and its effect on price quantified before AE 2's prices and Unrelated Party C's prices can be considered comparable); and*
- *Geographical factors. (E.g. AE 1 sells bicycles to AE 2 located in South Africa, while Unrelated Party C, to which it also sells the same bicycles, is located in Egypt. The only material difference that could be identified between the controlled and uncontrolled transactions concerns the locale. To perform adjustments to account for this difference one might have to consider, for example, differences in inflation rates between South Africa and Egypt, the competitiveness of the bicycle market in the two countries and differences in government regulations if relevant).*

B.4.2.2.6. Reasonably accurate adjustments may not be possible for:

- *Unique and valuable trademarks. (E.g. assuming AE 1 is engaged in manufacturing high value branded goods, and attaches its valuable trademark to the goods transferred in the controlled transaction, while uncontrolled transaction concerns the transfer of goods that are not branded. The effect of the trademark on the price of a watch may be material. However, it will be difficult, if not impossible, to adjust for effect of the trademark on price since the trademark is an intangible asset that is unique. If reasonably accurate adjustments cannot be made to account for a material product difference the CUP Method may not be the appropriate method for the transaction); and*
- *Fundamental differences in the products. (E.g. if the products being sold are significantly different from the products sold in the proposed comparable transaction it may not be possible to adjust for the product differences).*

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In such events, CUP method should not be used for the purpose of the analysis.

B.4.2.2.7. Notwithstanding the difficulties often associated with adjustments to address the sources of non-comparability described above, the need to make adjustments should not automatically prevent the use of the CUP Method. It is often possible to perform reasonably accurate adjustments. If reasonable adjustments cannot be performed the reliability of the CUP Method is decreased. In these circumstances another transfer pricing method may be more appropriate.

Examples where it may not be possible to make reasonably accurate adjustments are given below:

- Difference in the position of the entity in the value chain: (E.g. AE 1 sells bicycles to AE 2 as also to Unrelated Party C. Further, AE 2, after purchasing the bicycles from AE 1 sells the same bicycles to Unrelated Party C.

When the bicycles are sold by AE 1 to Unrelated Party C, they are sold to the final customers for their own use, whereas the bicycles sold to AE 2, are not for the use of AE 2, but for further sales to Unrelated Party C.

From the above, it can be seen that there is an added level in the entire value chain, when the sales are to AE 2 vis-a-vis the sales made by AE 1 to Unrelated Party C. The position of an entity in the value chain impacts the price at which a product is sold due to the additional functions that may be performed by the said entity.

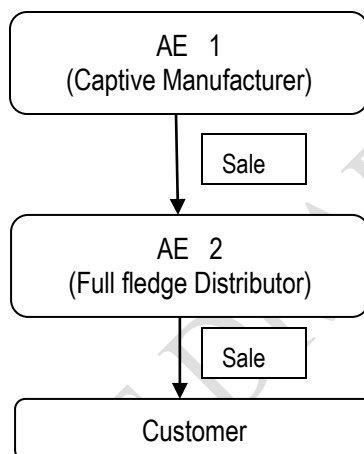
In such a case, it may not be possible to compare the transaction of sale of bicycles by AE 1 to Unrelated Party C with the transaction of sale by AE 2 to Unrelated Party C, due to the unavailability of accurate and reliable data pertaining to the margin earned by AE 1 from the sales to Unrelated Enterprise C.

- Difference in the characterisation of the entity: (E.g. AE 1 is a captive manufacturer engaged in the manufacturing of bicycles for AE 2. AE 2 is a full fledged distributor engaged in the distribution of the bicycles to the customers. The pricing for the sale made by AE 2 to the customers is governed by the prevailing market conditions.

In such a case, it may not be possible to compare the transaction of sale of bicycles by AE 1 to AE 2 with the transaction of sale of

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bicycles by AE 2 to the customers, due to the differences in the functions performed, assets employed and the risks undertaken by AE1 and AE 2 and the consequent difference in their characterisation and position in the value chain with respect to the transaction of sale of bicycles.)



6.12 The application of the CUP method can be understood with the following example:

AE1 Ltd., is an Indian company. The shareholding pattern of AE1 Ltd., is as follows:

Shareholder's name	Status	% holding
AE2 Ltd.	Foreign Company	30
AE3 Ltd.	Indian Company	30
Financial Institutions	Indian Company	10
Public		30

AE1 Ltd., is a manufacturer of compact disc (CD) writers and its customers, inter alia, include AE2 Ltd, and M Ltd, an unrelated party.

AE1 Ltd., during the year has supplied 10,000 nos. of the product to AE2 Ltd. at a price of INR 2,000 per unit and 200 nos. of the same product to AE3 Ltd., at a price of INR 2,750 per unit. AE1 Ltd., has sold 100 units of the same product to M Ltd. at INR 3,000 per unit.

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Comparison of the international transaction vis-a-vis comparable uncontrolled transaction

Particulars	International transaction (with AE2 Ltd.)	Comparable uncontrolled transaction (with M Ltd.)	Remarks
Terms	Freight on Board ('FOB')	Cost Insurance and Freight ('CIF')	Freight and insurance INR 550
Quantity discount	Yes	No	Quantity discount of INR 10 per product and a free gift (CD) of INR 20
Credit	One month	Cash and carry	Cost of credit 1.25% per month
Warranty	No warranty	Six months warranty	Cost of warranty is INR 250 per unit

Factors to be considered while determining ALP:

- (a) In the CUP method, one has to start from the price charged in the case of the comparable uncontrolled transaction.
- (b) In this illustration one has to start with the price charged by AE1 Ltd., to M Ltd.
- (c) The price charged to AE3 Ltd., cannot be considered as AE3 Ltd., is itself an AE of AE1 Ltd.
- (d) The price charged to M Ltd., will have to be increased by the value of credit which is at the rate at 1.25% p.m. (i.e. 15% p.a.). If the similar credit were offered to M Ltd., the price charged to M Ltd. would have been higher, after factoring this cost.
- (e) The price charged to M Ltd., will have to be reduced by the following;
 - (i) INR 550 representing the freight and insurance –This is for the reason that if the price to M Ltd., had been on FOB basis, it would have been less by INR 550.
 - (ii) INR 250 per unit representing the estimated cost of warranty execution for a period of six months on the basis of a technical analysis and past experience - This is for the

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reason that if the warranty was not given, the price to M Ltd. would have been lower, without factoring this cost.

- (iii) INR 10 representing the cost of each CD – This is for the reason that if similar gift had been offered to M Ltd., the effective price to M Ltd., would have been less.
- (iv) INR 20 representing a quantity discount - This is for the reason that if similar discount had been offered to M Ltd., the effective price to M Ltd., would have been less.

Computation of arm's length price under the comparable uncontrolled price method

The following points are to be noticed:

- (i) All adjustments in the course of applying this method are to be made to the price charged in the uncontrolled transaction. The presence or absence of any specific features in the uncontrolled transaction as compared to the international transaction [or the specified domestic transaction] is to be adjusted for. These features are to be evaluated in monetary terms. This is a subjective process based on objective facts.
- (ii) Only differences that would materially affect the price in the open market are required to be adjusted. Two points may be noted. Firstly, materiality would have to be judged in the light of various circumstances. If there are numerous adjustments, which are individually not material but collectively material, the necessary adjustments are required to be made. Secondly, the term 'open market', though not defined, would mean a transaction between a knowledgeable and a willing purchaser and a knowledgeable and willing seller where neither of them is influenced or compelled to act in a particular manner.

Resale Price Method (RPM)

6.13 Rule 10B(1)(b) resale price method, by which,-

- (i) ***The price at which property purchased or services obtained by the enterprise from an AE is resold or are provided to an unrelated enterprise, is identified;***

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

6.14 Typical transactions where RPM may be adopted are distribution of goods involving little or no value addition. Also, it is pertinent to note that while CUP method is a two sided method (wherein the said method can be applied using details / data of either of the transacting parties), RPM is a one sided method wherein only the margins earned by one of the transacting party i.e., the distributor, can be analysed / evaluated.

6.15 The OECD in its Transfer Pricing Guidelines (2022) has observed as under:

Para 2.35 - An appropriate resale price margin is easiest to determine where the reseller does not add substantially to the value of the product. In contrast, it may be more difficult to use the resale price method to arrive at an arm's length price where, before resale, the goods are further processed or incorporated into a more complicated product so that their identity is lost or transformed (e.g. where components are joined together in finished or semi-finished goods). Another example where the resale price margin requires particular care is where the reseller contributes substantially to the creation or maintenance of intangible property associated with the product

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(e.g. trademarks or trade names) which are owned by an AE. In such cases, the contribution of the goods originally transferred to the value of the final product cannot be easily evaluated.

Para 2.36 - A resale price margin is more accurate where it is realised within a short time of the reseller's purchase of the goods. The more time that elapses between the original purchase and resale the more likely it is that other factors – changes in the market, in rates of exchange, in costs, etc. – will need to be taken into account in any comparison."

6.16 On application of RPM, the UN in the Practical Manual on Transfer Pricing has observed as under:

"B.4.3.4.3 While product differences may be more acceptable in applying the Resale Price Method as compared to the CUP Method, the property transferred should still be broadly similar in the controlled and uncontrolled transactions. Broad differences are likely to reflect differences in functions performed, and therefore gross margins earned, at arm's length.

B.4.3.4.4 Example:

The compensation for a distribution company should be the same whether it sells washing machines or dryers, because the functions performed (including risks assumed and assets used) are similar for the two activities. It should be noted, however, that distributors engaged in the sale of markedly different products cannot be compared. The price of a washing machine will, of course, differ from the price of a dryer, as the two products are not substitutes for each other. Although product comparability is less important under the resale price method, greater product similarity is likely to provide more reliable transfer pricing results. It is not always necessary to conduct a resale price analysis for each individual product line distributed by the sales company. Instead, the resale price method can be applied more broadly, for example based on the gross margin a sales company should earn over its full range of broadly similar products."

From the above, it can be observed that RPM is more tolerant as compared to CUP toward product differences. RPM thus focuses on functional comparability. A similar level of compensation is expected for performing similar functions across different activities.

6.17 The UN in the Practical Manual on Transfer Pricing has explained that RPM can be used even for a commission agent:

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B.4.3.1.5 Other approaches are possible. For example, if the associated enterprise acts as a sales agent that does not take title to the goods, it is possible to use the commission earned by the sales agent (represented as a percentage of the uncontrolled sales price of the goods concerned) as the comparable gross profit margin.

6.18 The steps involved in the application of this method are:

- (i) identify the international transaction [or specified domestic transaction] of purchase of property or services;
- (ii) identify the price at which such property or services are resold or provided to an unrelated party (resale price);
- (iii) identify the normal gross profit margin in a comparable uncontrolled transaction whether internal or external. The normal gross profit margin is that margin which an enterprise would earn from purchase of the similar product from an unrelated party and the resale of the same to another unrelated party;
- (iv) deduct the normal gross profit from the resale price;
- (v) deduct expenses incurred in connection with the purchase of goods;
- (vi) adjust the resultant amount for the differences between the uncontrolled transaction and the international transaction [or the specified domestic transaction]. These differences could be functional and other differences including differences in accounting practices. Further these differences should be such as would materially affect the amount of gross profit margin in the open market;
- (vii) the price arrived at is the arm's length price of the international transaction [or the specified domestic transaction];

6.19 The application of RPM can be understood with the following example:

AE1 Ltd., is an Indian company. The shareholding pattern of AE1 Ltd., is as follows;

Shareholder's name	Status	% holding
AE2 Ltd.	Foreign Company	30
AE3 Ltd.	Indian Company	30

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Shareholder's name	Status	% holding
Financial Institutions	Indian Company	10
Public		30

AE1 Ltd., trades in compact disc (CD) writers. AE1 Ltd., procures CD writers both locally and in the international market. Its imports consist of CD writers purchased from AE2 Ltd. as well as other manufacturers (Non AEs).

AE1 Ltd., during the year purchased 100 CD writers from AE2 Ltd. at INR 2,900 per unit. These are resold to A Ltd., an unrelated party, at a price of INR 3,000 per unit.

AE1 Ltd., has also purchased similar products from an unrelated supplier, viz. K Ltd., and has resold the same to M Ltd., who is also an unrelated party and has earned a gross profit of 15% on sales.

Analysis of the sales transactions

Particulars	Sales to A Ltd.	Sales to M Ltd.	Impact on GP
Price	Ex shop	FOB Destination with cost of freight and insurance estimated at 2% of GP	Impact of Freight and insurance on GP is 2% as the sale price increases but corresponding expenses are not debited to trading account but to profit and loss account
Quantity discount	Yes - the cost of the same is estimated at 1% of GP	No	Impact of quantity discount on GP is 1%
Free gifts	No	One CD pack for every CD writer with no change in sale price	As cost of gift is not debited to trading account but to P & L Account, there is no impact

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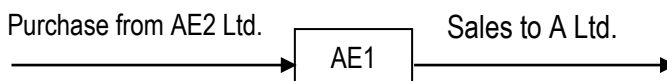
Particulars	Sales to A Ltd.	Sales to M Ltd.	Impact on GP
			on GP
Warranty	No	6 months warranty (without change in sale price) - cost of warranty is estimated at INR 250 per unit	As cost of warranty is not debited to trading account but to P&L Account, there is no impact on GP

Analysis of the purchase transactions

Particulars	Purchase from AE2 Ltd. (International transaction)	Purchase from K Ltd.	Impact
Customs duty	INR 25 per unit	INR25 per unit	No impact
Freight inwards	INR 10 per unit	Nil	Cost of purchase from K Ltd., is lower
Quantity discount	INR 15 per unit	Nil	Cost of purchase from K Ltd., is higher
Warranty	Nil	6 months warranty purchase price remaining unchanged	No impact

Factors to be considered while determining ALP:

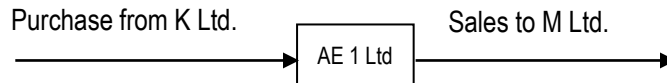
- (a) In the above example, the international transaction is the purchase transaction entered into by AE1 Ltd., with AE2 Ltd. which should be determined on the basis of arm's length price;



- (b) The comparable uncontrolled transaction is the purchase transaction

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entered into by AE1 Ltd., with K Ltd.



- (c) The starting point for arriving at the ALP of such purchase transaction is the resale price charged to A Ltd. viz. INR3,000 [Rule 10B(1)(b)(i)].
- (d) From the said resale price, the normal gross profit margin which AE1 Ltd., would earn in a comparable uncontrolled transaction should be reduced. In this example, the actual gross profit margin earned by AE 1 Ltd., in respect of its purchase from K Ltd, and its resale to M Ltd, is 15%.
- (e) The following adjustments are made to arrive at the normal GP;
- | | |
|--|-----|
| Actual gross profit margin with M Ltd. | 15% |
| Less: | |
| 1. Difference between Ex-shop and FOR prices | 2% |
| 2. Difference due to quantity discount | 1% |
| Normal gross profit margin with M Ltd. | 12% |
- Note:** While arriving at normal gross profits from the actual gross profits, only the differences in the sale transactions of AE1 Ltd., with A Ltd., and M Ltd., have been taken. The differences in the purchase transactions of AE 1 Ltd., with AE2 Ltd. and K Ltd., affecting the gross profits are taken separately as provided in sub rule (iv).
- (f) The resale price of INR3000. to M Ltd., is reduced by the normal gross profit margin of 12%. The resultant cost of sales is INR2640 (i.e. 3000-360) [Rule 10B(1)(b)(ii)].
- (g) The cost of sales so arrived at is reduced by the expenses incurred in connection with the purchase (international transaction) i.e. freight of INR 10 and customs duty of INR25. The resultant amount is INR 2605 (i.e. 2640-25-10) [Rule 10B(1)(b)(iii)].
- (h) The above amount is further adjusted to take into account functional and accounting differences between the international transaction and the comparable uncontrolled transaction with AE2 Ltd the purchase transaction with K Ltd., which will affect the amount of gross profit margin as explained below.

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- (i) The aforesaid amount of INR 2605 should be increased by INR10 being the freight incurred by AE1Ltd., in the case of purchase from AE2Ltd., but not incurred in case of purchase from K Ltd., This is for the reason that if a similar freight had been paid in respect of transaction with K Ltd, the gross profit margin from K Ltd., would have been lower and the resultant price would have been higher.
- (j) A decrease by INR15 representing the quantity discount allowed by AE2 Ltd., is to be made. This is for the reason that if a similar discount had been allowed in respect of transaction with K Ltd, the gross profit margin from K Ltd., would have been higher and the resultant price would have been lower.

Determination of arm's length price under RPM

1. AEs : AE1 Ltd. and AE2 Ltd.
2. Other enterprises : K Ltd. and M Ltd.
3. International transaction : AE1 Ltd. and AE2 Ltd.
4. Bought from AE2Ltd. and resold to : A Ltd.
5. CUT is purchase from K Ltd. and sales to M Ltd.

Details	INR /unit
Price paid to AE2 Ltd.(FOB)	2,900
Quantity	100
Purchases cost (actual) (A)	2,90,000
Actual GP Margin on sales to M Ltd.(%)	15
Normal GP Margin on sales to M Ltd.(%)	12
Price charged to A Ltd.	3,000
Less: Normal GP margin	360
Balance	2640
Less: Expenses connected with purchase (freight & customs duty paid)	35
Price before adjustment	2,605
Add:	
Freight incurred in case of purchase from AE2 Ltd.	10
Sub total	10
Less :	

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Details	INR /unit
Quantity discount allowed by AE2 Ltd.	15
Sub total	15
Arm's length price	2,600
Adjusted purchase cost (B)	2,60,000
Income increases by (A-B)	30,000

The following points are to be noticed:

- (i) RPM is to be adopted only when goods purchased from an AE are resold to unrelated parties.
- (ii) In contrast to the CUP Method, the reliability of RPM is influenced by factors that have less effect on the price of a product than on the costs of performing functions. Such differences could affect gross margins [e.g. the composition of Cost of Goods Sold ('COGS')]. These factors could include cost structures (e.g. accounting practices), business experience (e.g. start-up phase or mature business) or management efficiency.
- (iii) As provided in Rule 10B(1)(b)(iii), the expenses incurred in connection with the purchase from AE are to be reduced from cost of sales. In RPM, the arm's length purchase price is arrived at reducing the normal gross profit margin from the resale price as the first step. If the computation is stopped at this step itself, the derived purchase amount would be inclusive of such expenses. It is therefore necessary to reduce such expenses in arriving at the arm's length purchase price.
- (iv) Adjustments have to be made also for accounting practices apart from functional and other differences. Differences in accounting practices may be because:
 - (a) sales and purchases have been accounted for inclusive of taxes or exclusive of taxes;
 - (b) method of pricing the goods namely, FOB or CIF;
 - (c) fluctuations in foreign exchange.
- (v) The comparability analysis should try to take into account whether the reseller has the exclusive right to resell the goods, because exclusive rights may affect the resale price margin.

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- (vi) In actual practice, if the purchases are only from AEs, it need to be kept in mind that the resale in any financial year may be also out of opening stock. Similarly, the goods purchased during the said year may remain in closing stock. Under the RPM, the arm's length price of purchases from AE during the financial year should be determined. The process of determination under Rule 10B(1)(b) culminates in the cost of sales rather than value of purchase during the year. This 'cost of sales' should be converted into 'value of purchase'. For this purpose, the closing stock of goods purchased from AE should be added and the opening stock of purchases from AE should be deducted.
- (vii) Further, it may not possible to reliably compute the gross margin of the comparables since in India at this point of time there is no uniform accounting convention which is applicable for computing the gross margin. The companies could follow different accounting principles while recording a particular expense item. Hence, it is not possible to ensure that all the expense items have been uniformly accounted by all comparables while computing the gross margin. For example – Reporting of discounts, transportation cost, insurance and warranty cost, valuations of the inventory, etc. As a result, application of RPM using external comparable transaction could be a challenge considering the availability of the reliable data.

6.20 It is important to understand the characterisation of the AEs (based on the detailed functional analysis) before one selects RPM as the most appropriate method. This can be explained by way of an example provided below:

ABC Inc. owns valuable patents to manufacture the bicycles and has a valuable trade name. ABC Inc.'s subsidiary i.e. ABC Ltd purchases the bicycles from ABC Inc. and resells the bicycles to unrelated dealers in India. The bicycle is new in the Indian market and is not known to the Indian consumers. Further, it is assumed that comparable uncontrolled transactions are not available. The financial data under two scenarios is provided below:

Particulars	Case 1	Case 2
Sales to third parties	1,000	1,000
Cost of goods sold	700	700
Gross Profit	300	300
Gross Profit / Sales ratio	30%	30%

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Particulars	Case 1	Case 2
Value added expenses ('VAE')	50	250
VAE / Sales	5%	25%

In this case, it is important to analyse the following aspects before selecting the most appropriate method:

Case 1

- It is important to analyse the functions performed, assets employed and the risks undertaken by ABC Inc. as well as ABC Ltd. with respect to the transaction of purchase of bicycles by ABC Ltd. from ABC Inc., to determine the characterisation of the above entities and identify the tested party.
- ABC Inc. owns valuable intangibles, performs R&D activities and generally has operations that are more complex than those of the sales company (i.e. ABC Ltd).
- On the other hand, ABC Ltd is engaged in purchase of bicycles and selling it to the third parties without undertaking any significant value addition on its own.
- VAE/Sales maybe an important factor to evaluate the intensity of functions as advocated in Sony Ericsson Mobile Communications India Pvt. Ltd (ITA No 16/2014) Ruling by the High Court.
- Since the VAE in case 1 is only 5% of the sales, it can be said that the marketing spend needed create customer awareness to facilitate sale of product in the Indian market is borne by ABC Inc. and the VAE incurred by ABC Ltd is with respect to normal selling function.
- It should be noted that a foreign entity may be selected as the tested party if it is the less complex entity and if reliable data in respect of the international transaction under consideration is available.
- From the above functional analysis, ABC Ltd can be characterised as a normal risk bearing distributor and ABC Inc. is the entrepreneurial entity. As seen from the characterisation, ABC Inc. is more complex entity and therefore, it cannot be considered as a tested party. As result, ABC Ltd has been selected as a tested party in this case.

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- Since comparable uncontrolled transactions are not available, the CUP Method cannot be applied as the most appropriate method.
- ABC Ltd is engaged in purchase of bicycles from ABC Inc. are further selling it to a third party without any significant value addition. The gross profit realised by ABC Ltd can be compared using RPM as the most appropriate method in this case.

Case 2

- The VAE in case 2 is significant i.e. 25% of the sales. It can be said that ABC Ltd is engaged in developing the marketing intangible in the Indian market for ABC Inc.
- This is the case where the reseller contributes substantially to the creation or maintenance of intangible property associated with the product (e.g. trademarks or trade names) which are owned by an AE. In such cases, the contribution of the goods originally transferred to the value of the final product cannot be easily evaluated.
- Further, this activity of brand building may require to be separately evaluated for testing the arm's length nature. In case the activity of reselling and brand building are inextricably inter linked and cannot be separately evaluated, there may arise a need to evaluate a different method for testing the arm's length nature of the aforementioned closely linked transactions.
- In such cases, RPM may not be the most appropriate method and one has to take recourse to other methods prescribed under the Act.

6.21 Further, one should also evaluate the pricing mechanism, contractual terms, roles and obligations as well as the functional profile of the parties to a transaction, before the determination of the most appropriate method to benchmark the international transaction [or the specified domestic transaction].

For example – A distributor could be awarded a net profit on sales for performing the routine distribution functions. However, in such a scenario RPM may not be the most appropriate method since RPM takes into account the gross margin earned by the distributor. In such a situation, TNMM could be considered as the most appropriate method.

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Typically, RPM may be the most appropriate method in case of a normal risk distributor, who is awarded a reasonable level of gross margin for the functions performed.

Cost Plus Method (CPM)**6.22 Rule 10B(1)(c) cost plus method, by which,-**

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

6.23 Typical transactions where CPM may be adopted are:

- (a) provision of services;
- (b) joint facility arrangements;
- (c) transfer of semi finished goods;
- (d) long term buying and selling arrangements.

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6.24 The OECD in its Transfer Pricing Guidelines (2022) states as follows:

Para 2.45 "This method probably is most useful where semi-finished goods are sold between associated parties, where associated parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services."

2.46 The cost plus mark-up of the supplier in the controlled transaction should ideally be established by reference to the cost plus mark-up that the same supplier earns in comparable uncontrolled transactions ("internal comparable"). In addition, the cost plus mark-up that would have been earned in comparable transactions by an independent enterprise may serve as a guide ("external comparable").

UN Practical Manual on Transfer Pricing for Developing Countries (2021) states as under:

B.4.4.8.1 The CPM is typically applied in cases involving the intragroup sale of tangible property where the related party manufacturer performs limited manufacturing functions or in the case of intragroup provision of services.

The method usually assumes the manufacturer or service provider has low risks, because the level of the costs will then better reflect the value being added and hence the market price.

B.4.4.8.2 The CPM is also generally used in transactions involving a contract manufacturer, a toll manufacturer or a low risk assembler which does not own product intangibles and assumes little risk. The related customer involved in the controlled transaction will generally be much more complex than the manufacturer (or service provider) in terms of functions performed (e.g. conducting marketing and selling functions, coordination of production and sales, giving instructions to the contract manufacturer about the quantity and quality of production, and purchasing raw materials in some cases), risks assumed (e.g. market risk, credit risk and inventory risk) and assets used or contributed (e.g. product or other intangibles). The contract manufacturer is thus the less complex and as such should be the tested party in the transfer pricing analysis.

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4.4.8.3 The CPM is usually not a suitable method to use in transactions involving a fully-fledged manufacturer which owns or develops unique and valuable product intangibles as it will be very difficult to locate independent manufacturers with comparable product intangibles. That is, it will be hard to establish a profit mark-up that is required to remunerate the fully-fledged manufacturer for its unique and valuable intangibles. In a typical transaction structure involving a fully-fledged manufacturer and related sales companies (e.g. commissionaires), the sales companies will normally be the less complex entities involved in the controlled transactions and will therefore be the tested party in the analysis. The RPM is typically more easily applied in such cases

Also, it is pertinent to note that similar to RPM, CPM is also a one sided method wherein the margins earned by the manufacturer / service provider can be tested under this method.

6.25 The steps involved in the application of this method are:

- (i) Determine the direct and indirect cost of production in respect of property transferred or service provided to an AE.
- (ii) Identify one or more comparable uncontrolled transactions for same or similar property or service.
- (iii) Determine normal gross profit mark-up on costs in the comparable uncontrolled transaction. Such costs should be computed according to the same accounting norms. In other words, the components of costs of comparable uncontrolled transaction should be the same as those of international transaction [or the specified domestic transaction].
- (iv) Adjust the gross profit mark-up to account for functional and other differences between the international transaction [or the specified domestic transaction] and the comparable uncontrolled transaction. Such adjustments should also be made for enterprise level differences.
- (v) The direct and indirect cost of production in the international transaction [or the specified domestic transaction] is increased by such adjusted gross profit mark-up.
- (vi) The resultant figure is the arm's length price.

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6.26 With respect to CPM, The UN in the Practical Manual on Transfer Pricing states as below:

“As with the RPM, and for the same reasons, close similarity of products in the controlled and uncontrolled transactions is less important under the Cost Plus Method than under the CUP Method, while functional comparability (including comparability of risks assumed and assets used) is more important. However, because significant differences in products may necessarily result in significant differences in the functions, the controlled and uncontrolled transactions should ideally involve the manufacturing of products within the same product family. (para B.4.4.5.2)

6.27 An example on importance of functional similarity is provided below:

A Limited is engaged in manufacturing of pet bottles and sales to third party customers in the Indian market. It is also engaged in selling the manufactured pet bottles to the AE outside India. The AE further sells the pet bottles to third party customers in their respective markets.

The functional profile of A Limited with respect to sales to third parties in domestic market and AE is provided below:

Functions performed	Domestic business (Unrelated)	Export business (AE)
Manufacturing function	√	√
Marketing and distribution function	√	X
After sales support	√	X
Inventory management	√	X

Risks assumed	Domestic business	Export business
Market risk	√	X
Credit risk	√	X
Foreign exchange risk	X	√
Inventory risk-	√	X

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From the above, one could see that there are differences in the functional profile of A Limited with respect to sales made to third parties in the domestic market and to AEs. Owing to such differences, while CPM can be used for analyzing the transaction pertaining to export to the AE (by A Limited), however the gross margins earned by A Limited from such exports cannot be compared with the gross margin earned by A Limited from sale to third party customers in the Indian market.

6.28 The OECD in its Transfer Pricing Guidelines (2022) has stated the following in relation to application of CPM:

2.51 For this purpose, it is particularly important to consider differences in the level and types of expenses – operating expenses and non-operating expenses including financing expenditures – associated with functions performed and risks assumed by the parties or transactions being compared. Consideration of these differences may indicate the following:

- a) If expenses reflect a functional difference (taking into account assets used and risks assumed) which has not been taken into account in applying the method, an adjustment to the cost plus mark-up may be required.*
- b) If the expenses reflect additional functions that are distinct from the activities tested by the method, separate compensation for those functions may need to be determined. Such functions may for example amount to the provision of services for which an appropriate reward may be determined. Similarly, expenses that are the result of capital structures reflecting non-arm's length arrangements may require separate adjustment.*
- c) If differences in the expenses of the parties being compared merely reflect efficiencies or inefficiencies of the enterprises, as would normally be the case for supervisory, general, and administrative expenses, then no adjustment to the gross margin may be appropriate.*

2.55 In principle historical costs should be attributed to individual units of production, although admittedly the cost plus method may overemphasize historical costs. Some costs, for example costs of materials, labour, and transport will vary over a period and in such a case it may be appropriate to average the costs over the period. Averaging also may be appropriate across product groups or over a particular line of production.

Further, averaging may be appropriate with respect to the costs of fixed assets where the production or processing of different products is carried on simultaneously and the volume of activity fluctuates. Costs such as

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replacement costs and marginal costs also may need to be considered where these can be measured and they result in a more accurate estimate of the appropriate profit.

6.29 The application of CPM can be understood with the following example:

AE1 Ltd., is an Indian company. The shareholding pattern of AE1 Ltd., is as follows:

Shareholder's name	Status	% holding
AE2 Ltd.	Foreign Company	30
AE3 Ltd.	Indian Company	30
Financial Institutions	Indian Company	10
Public		30

AE1 Ltd., an unrelated party, develops software for various customers, who include AE2 Ltd. and M Ltd.

AE1 Ltd., during the year billed AE2 Ltd. INR 2,00,000. The total cost (direct and indirect) for executing this work was INR 1,75,000.

AE1 Ltd., provided similar services to M Ltd., and earned a gross profit (GP) of 50% on costs.

Analysis of transactions

Particulars	Transactions with AE2 Ltd.	Transactions with M Ltd.
Technology support received	Yes	No - value of technology support incurred by AE1 Ltd., is INR 17,500
Discount offered	Yes – Discount offered is INR 8,750	No
Expenses incurred by AE1 towards marketing	No	Yes – expenses incurred INR 13,125
Credit	Yes – Cost of credit is estimated at INR 2,625	No

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Factors to be considered while determining ALP:

- (a) In CPM, one has to start with the gross profit mark up which the enterprise earned in a comparable uncontrolled transaction. In this example, the comparable uncontrolled transaction is between AE1 Ltd., and M Ltd.
- (b) Such gross profit (GP) mark up needs to be adjusted for the following:
 - As AE1 Ltd., did not receive the technology support from M Ltd., it has priced its services higher resulting in it earning a higher GP with M Ltd.. The value of technology support of INR17,500 received from AE2 Ltd. is 10% of cost. Therefore, the GP with M Ltd., has to be reduced by 10%.
 - AE1 Ltd. did not provide discount to M Ltd., as volume of business from M Ltd., was not as high as that from AE2 Ltd. Had AE1 Ltd., offered similar discount to M Ltd., the GP with M Ltd., would have been lower. The discount of INR 8,750 offered to AE2 Ltd. is 5% of cost. Therefore, the GP with M Ltd., has to be decreased by 5%.
 - AE1 Ltd., has incurred INR 13,125 towards marketing functions in respect of its transactions with M Ltd., which is 7.5% of its cost. However, in its transactions with AE2 Ltd. the said functions are assumed by AE2 Ltd. Had AE1 Ltd., not incurred similar expenses with M Ltd., it would have settled for a lower GP. Therefore, the GP with M Ltd., has to be reduced by 7.5%.
 - The cost of credit of INR 2,625 provided by AE1 Ltd., to AE2 Ltd. is 1.5% of its cost. However, in its transactions with M Ltd., such credit is not provided. Had AE1 Ltd., provided similar credit to M Ltd., it would have increased its price resulting in a higher GP. Therefore, the GP with M Ltd., has to be increased by 1.5%.
- (c) The resultant gross profit mark up is the arm's length gross profit mark up.
- (d) The costs of AE1 Ltd., in its transactions with AE2 Ltd. should be increased by the arm's length gross profit mark up to arrive at the arm's length income.

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Determination of arm's length price under costs plus method

- | | | |
|--|---|---------------------|
| 1. AE | : | AE2 Ltd. |
| 2. Other unrelated enterprise | : | M Ltd |
| 3. International transaction | : | AE1 Ltd and AE2 Ltd |
| 4. Comparable uncontrolled transaction | : | AE1 Ltd. and M Ltd |

Determination of arm's length gross profit mark up

Details	%
Gross profit mark up in case of M Ltd.	50.00%
Less :	
1. Technology support from AE2 Ltd.	10.00%
2. Quantity discount to AE2 Ltd not to M Ltd.	5.00%
3. Marketing functions performed by AE1Ltd., in respect of M Ltd.	7.50%
Sub total	22.50%
Add :	
1. Cost of credit to AE2. Ltd.	1.50%
Sub total	1.50%
Arm's length gross profit mark up	29.00%

Determination of arm's length price

Details	Amount/ %
Direct and indirect costs incurred by AE1 Ltd. in respect of transactions with AE2 Ltd.	1,75,000
Arm's length gross profit mark up	29.00%
Arm's length income (A)	2,25,750
Actual price charged to AE2 Ltd. (B)	2,00,000
Income increases by (A-B)	25,750

6.30 It is also important to note that the cost plus pricing is different from CPM. This could be explained by way of the following example:

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A Limited is a captive service provider working with an assured return of 10% on the total cost incurred in connection with provision of such services to the Group. In this case, one could see that though the pricing is based on the cost plus mark-up, the same cannot itself lead to a conclusion that CPM is the most appropriate method. The costs that A Limited would be recovering from the Group may involve costs incurred below the gross profit level and thus, CPM may not be applicable in such a scenario.

The following points are to be noticed:

- (i) In this method, the direct and indirect costs of production are to be determined. The terms 'direct' or 'indirect' costs are however not defined. A reference may therefore be made to the industry practice as well as the pronouncements of the ICAI.

OECD Transfer Pricing Guidelines (2022) mentions about direct and indirect costs as under:

2.53: While precise accounting standards and terms may vary, in general the costs and expenses of an enterprise are understood to be divisible into three broad categories. First, there are the direct costs of producing a product or service, such as the cost of raw materials. Second, there are indirect costs of production, which although closely related to the production process may be common to several products or services (e.g. the costs of a repair department that services equipment used to produce different products). Finally, there are the operating expenses of the enterprise as a whole, such as supervisory, general, and administrative expenses.

2.54: The distinction between gross and net profit analyses may be understood in the following terms. In general, the cost plus method will use mark ups computed after direct and indirect costs of production, while a net profit method will use profits computed after operating expenses of the enterprise as well. It must be recognised that because of the variations in practice among countries, it is difficult to draw any precise lines between the three categories described above. Thus, for example, an application of the cost plus method may in a particular case include the consideration of some expenses that might be considered operating expenses, as discussed in paragraph 2.52.

2.59: Example of the application of cost plus method

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A is a domestic manufacturer of timing mechanisms for mass- market clocks. A sells this product to its foreign subsidiary B. A earns a 5% gross profit mark up with respect to its manufacturing operation. X, Y, and Z are independent domestic manufacturers of timing mechanisms for mass- market watches. X, Y, and Z sell to independent foreign purchasers. X, Y, and Z earn gross profit mark ups with respect to their manufacturing operations that range from 3% to 5%. A accounts for supervisory, general, and administrative costs as operating expenses, and thus these costs are not reflected in cost of goods sold. The gross profit mark ups of X, Y, and Z, however, reflect supervisory, general, and administrative costs as part of costs of goods sold. Therefore, the gross profit mark ups of X, Y, and Z must be adjusted to provide accounting consistency.

It may also be noted that determination of direct and indirect cost of manufacturing is not mandated under the mandatory format of financials under the Companies Act. This results in difficulty in applying CPM for the external comparables and therefore, CPM as the most appropriate method may fail.

Further, in the Indian scenario, it is not possible to reliably compute the gross margin of the comparables since there is no uniform accounting convention which is applicable for computing the gross margin. The companies could follow different accounting principles while recording a particular expense item. Hence, it is not possible to ensure that all the expense items have been uniformly accounted by all comparables while computing the gross margin. For example – Reporting of R&D costs, valuations of the inventory, etc. As a result, application of CPM using external comparable transaction could be a challenge considering the availability of the reliable data.

Further, reliability of CPM may also be adversely affected by factors such as cost structures, business, management efficiency and lack of reliable external comparable data etc.

- (ii) In determining the direct and indirect cost, the following factors have to be borne in mind:
 - (a) if the plant has been under utilised the costs may have to be suitably adjusted;
 - (b) absorption costing method is normally to be preferred.

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- (iii) This method is to be adopted only in cases of supply of property or services to an AE. This method is not to be applied when the enterprise is in receipt of property or services from an AE. However, in such cases, one may still evaluate the applicability of CPM as the most appropriate method by considering the AE as the tested party.

Profit Split Method (PSM)

6.31 Rule 10B(1)(d) profit split method, which may be applicable mainly in international transactions [or specified domestic transactions] involving transfer of unique intangibles or in multiple international transactions [or specified domestic transactions] which are so inter-related that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction, by which-

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

Provided that the combined net profit referred to in sub-clause (i) may, in the first instance, be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of international transaction [or specified domestic transaction] in which it is engaged, with reference to market returns achieved for similar types of transactions by independent enterprises, and thereafter, the residual net profit remaining after such allocation may be split amongst the enterprises in proportion to their relative contribution in the manner

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specified under sub-clauses (ii) and (iii), and in such a case the aggregate of the net profit allocated to the enterprise in the first instance together with the residual net profit apportioned to that enterprise on the basis of its relative contribution shall be taken to be the net profit arising to that enterprise from the international transaction [or specified domestic transaction].

6.32 Typical transactions where the profit-split method may be used are transactions involving:

- (a) integrated services provided by more than one enterprise for e.g., in case of financial service sector, where the activities performed by Indian company and foreign AEs in relation of a merger and acquisition transaction are so interrelated that it may not be possible to segregate them;
- (b) transfer of unique intangibles, for e.g. two AEs contribute their respective intangibles to develop a new product or process and earn income from such product or process.

6.33 The observations of the OECD, in its Transfer Pricing Guidelines (2022), on this method are as follows:

2.114 The transactional profit split method seeks to establish arm's length outcomes or test reported outcomes for controlled transactions in order to approximate the results that would have been achieved between independent enterprises engaging in a comparable transaction or transactions. The method first identifies the profits to be split from the controlled transactions—the relevant profits—and then splits them between the associated enterprises on an economically valid basis that approximates the division of profits that would have been agreed at arm's length. As is the case with all transfer pricing methods, the aim is to ensure that profits of the associated enterprises are aligned with the value of their contributions and the compensation which would have been agreed in comparable transactions between independent enterprises for those contributions. The transactional profit split method is particularly useful when the compensation to the associated enterprises can be more reliably valued by reference to the relative shares of their contributions to the profits arising in relation to the transaction(s) than by a more direct estimation of the value of those contributions.

2.115 References to "profits" should be taken as applying equally to losses.

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The OECD identifies strengths and weaknesses of the transactional profit split method in paras in section C.2.1 in Chapter II of OECD 2022. The application of this method depends on the nature of transactions and information about transactions available.

6.34 Determining the combined profits to be split

In this regard, the OECD in its Transfer Pricing Guidelines (2022) observes as under:

2.130 The combined profits to be split in a transactional profit split method are the profits of the associated enterprises from the controlled transactions in which the associated enterprises are engaged. The combined profits to be split should only be those arising from the controlled transaction(s) under review. In determining those profits, it is essential to first identify the relevant transactions to be covered by the transactional profit split. Where a taxpayer has controlled transactions with more than one associated enterprise, it is also necessary to identify the parties in relation to those transactions and the profits to be split among them.

2.131 In order to determine the combined profits to be split, the accounts of the parties to the transaction to which a transactional profit split is applied need to be put on a common basis as to accounting practice and currency and then combined. Because accounting standards can have significant effects on the determination of the profits to be split, accounting standards should be selected in advance of applying the method and applied consistently over the lifetime of the arrangement.

2.133 If the profit split method were to be used by associated enterprises to set transfer pricing in controlled transactions (i.e. an ex ante approach), then each associated enterprise would seek to achieve the division of profits that independent enterprises would have expected to realize from engaging in comparable transactions. Depending on the facts and circumstances, profit splits using either actual or projected profits are observed in practice.

6.35 There are two approaches to this method, namely, total profits split and residual profit split.

6.36 Total profits split: The steps involved are as follows:

- (i) Determine the combined net profit of the AEs arising from the international transactions [or the specified domestic transaction] in which they are engaged. Such profits represent the profits earned from third parties due to the combined efforts of the AEs. It may be

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noted that the 'combined net profit' referred to in the rule is not the aggregate of entire profits earned by the AEs. Example: AE1 may earn profits from certain transactions wherein there is no contribution by AE2 and vice versa. Such profits do not enter into the determination of combined net profit. Only those profits that are earned as a result of joint efforts of AE1 and AE2 should be taken as combined net profit.

- (ii) Evaluate relative contribution made by each entity involved in the transaction on the basis of:
 - (a) functions performed;
 - (b) assets employed;
 - (c) risks assumed;
 - (d) the reliable external market data indicating how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances. It may be noted that reference to 'external market data' indicates comparable uncontrolled transactions. The use of word 'external' does not preclude use of internal CUT. In the process of choosing CUTs, the function performed, assets used and risks taken (FAR) of the uncontrolled transactions would have been compared with the FAR of the international transactions [or the specified domestic transaction]. When the FAR of the international transaction [or the specified domestic transaction] and CUT are similar, the relative contribution adopted in the CUT should be applied to the international transaction [or the specified domestic transaction]. Any significant differences between the two should be suitably adjusted.
- (iii) Thereafter, split the combined net profit in proportion to the relative contribution determined as above.
- (iv) The profit so apportioned is taken to arrive at the arm's length price in relation to the international transaction [or the specified domestic transaction]. The profits so apportioned to the AE when added to the costs incurred by it in relation to international transaction [or the specified domestic transaction] would result in arm's length price.

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Residual profit split approach

6.37 In this approach, firstly, a basic return is determined for each of the enterprises and profits of each such enterprise is ascertained. This amount is reduced from the combined net profits. Residual profits are allocated on the basis of relative contribution.

Steps involved in this approach are as follows:

- (i) Determine the combined net profit of the AEs arising from the international transactions [or the specified domestic transaction] in which they are engaged.
- (ii) At the first stage, depending on functions performed, assets employed and risks assumed, determine the basic return appropriate to the respective activities. Allocate the combined net profit on the basis of above. This step results in a partial allocation of the combined net profit to each enterprise. For this purpose, the allocation is undertaken with reference to margins of comparable uncontrolled entities.
- (iii) the balance of the combined net profit is allocated on the basis of the evaluation of the relative contribution.
- (iv) the total net profit from such two-tier allocation is taken to arrive at the arm's length price. The profits so apportioned to the AE when added to the costs incurred by it in relation to international transaction [or the specified domestic transaction] would result in arm's length price.

6.38 The application of PSM can be understood with the following example:

AE1 Ltd., is an Indian company. The shareholding pattern of AE1 Ltd., is as follows;

Shareholder's name	Status	% holding
AE2 Ltd.	Foreign Company	30
AE3 Ltd.	Foreign Company	30
Financial Institutions	Indian Company	10
Public		30

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AE1 Ltd., is an investment advisory company, which in association with AE2 Ltd. assists its clients with foreign acquisitions.

AE3 Ltd., which is based in U.S.A., has worldwide presence. AE1 Ltd. is approached by M, an unrelated party for identifying potential target companies for acquisitions in the USA. In order to serve M, AE1 Ltd. and AE3 Ltd., have each contributed integrally to identification of potential target and assisting M with the acquisition process. For the above, AE1 Ltd., received consideration of US\$ 50,000. The financials are as follows;

Particulars	AE1 Ltd.	AE3 Ltd.
Revenue	30000	20000
Cost	20000	8000
Profit	10000	12000

Factors to be considered:

- The normal basic return is ordinarily calculated as a percentage of the costs incurred or gross revenues or capital employed. In this example, it is assumed as a percentage of the cost.
- Based on the FAR analysis, the basic return for AE1 Ltd., and AE3 Ltd., are determined to be 15% and 10% on cost respectively. Accordingly, the normal basic return for AE1 Ltd. in India for the aforesaid operation is US\$ 3000. The similar returns for AE3 Ltd., US\$ 800. The total basic return, thus, is US \$ 3,800.
- On the basis of functions performed, risks assumed and assets employed, the relative contribution may be taken at 70%, 30% for AE1 Ltd. and AE3 Ltd., respectively.

Determination of arm's length price under PSM:

First Approach: Total Profit Split Method

1. AEs	:	AE1 Ltd. and AE3 Ltd.
2. Ultimate delivery of product is	:	By AE3 Ltd. to M Ltd.
3. International transaction	:	Between AE1 Ltd. and AE3 Ltd.

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Details	US\$
Price charged by AE1 Ltd from M Ltd	50,000
AE3 Ltd share of revenue	20,000
AE1 Ltd share of revenue	30,000
Combined total profits	22,000
Evaluation of relative contribution	
AE1 Ltd : India return – 70%	15,400
AE3 Ltd : US return – 30%	6,600
Total	22,000
Total return for AE1 Ltd	15,400
Total cost of AE1 Ltd	20,000
Income of AE1 Ltd on arm's length price (A)	35,400
Actual revenue (B)	30,000
Increased income (A-B)	5,400

Note: In this example, the basic return is not required to be taken into account.

Second Approach: Residual profit split method

Details	US\$
Price charged by AE1 Ltd from M Ltd	50,000
AE3 Ltd share of revenue	20,000
AE1 Ltd share of revenue	30,000
Combined total profits	22,000
1. Basic return	
AE1 Ltd : India return	3,000
AE3 Ltd : US return	800
Total	3,800
2. Residual net profit	18,200
AE1 Ltd: India return – 70%	12,740
AE3 Ltd: US return – 30%	5,460
Total	18,200
Total return for AE1 Ltd (12740 + 3000)	15,740

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Details	US\$
Total cost of AE1 Ltd.	20,000
Income of AE1 Ltd. on arm's length price (A)	35,740
Actual revenue (B)	30,000
Increased income (A-B)	5,740

The following points are to be noticed:

- (a) It is the profit from a transaction with the AE that needs to be ascertained. If there are other transactions, which contribute to the profits, then the profits from transactions with AE may have to be arrived at on some approximation.
- (b) The rule itself provides an alternative method to arrive at the arm's length price being the two-tier PSM;
- (c) If in either of the alternatives, a range of figures is available, the arithmetical mean of such figures may be adopted as the arm's length price. It may however not be possible to adopt the arithmetical mean of the two alternatives.
- (d) Under the two-tier split-method, the basic rate of return may have to be adopted having regard to the profits compared to the net worth of the enterprise. Such rate of return may not be uniform for all the AEs involved in the transaction.
- (e) This is the only method for which the Rule itself has prescribed the types of transaction to which it may be applicable.
- (f) Even though the computation proceeds with the profits from a transaction, the purpose is only to arrive at the arm's length price of a transaction. It is only by substituting the arm's length price for the price in the international transaction [or the specified domestic transaction] that an adjustment may be made to the income returned.

Transactional Net Margin Method (TNMM)

6.39 Rule 10B(1)(e) transactional net margin method, by which,-

- (i) ***the net profit margin realised by the enterprise from an international transaction [or the specified domestic transaction] entered into with an AE is computed in relation to costs incurred***

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or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;

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

6.40 Typical transactions where the transactional net margin method may be adopted are:

- (a) provision of services;
- (b) distribution of finished products where RPM cannot be applied;
- (c) transfer of semi finished goods where CPM cannot be applied;
- (d) transactions involving intangibles where PSM cannot be applied.

6.41 The steps involved in the application of this method are:

- (i) Identify the net profit margin realised by the enterprise from an international transaction [or the specified domestic transaction]. Where the assessee also has transactions, segments or businesses where the international transactions [or the specified domestic transaction] with AEs are not relevant, then the net profit margin to be considered for the purposes of this TNMM method should be such net profit margin as is derived only from the transactions, segments or businesses related to the international transaction [or the specified

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domestic transaction]. The net profit margin may be computed in relation to costs incurred or sales effected or assets employed or any other relevant base.

For example,

- In case where the assessee acts as a distributor and the transaction pertains to import, the revenue may be used as base.
 - In case the transaction involves export of services/goods, costs may be taken as base provided the exporting entity acts as a contract service provider / contract manufacturer.
 - Return on capital employed or Return on assets are typically used in case of a capital intensive manufacturing set-ups where the tangible operating assets have a high correlation to profitability. For example: Return on capital employed or Return on assets could be used in case of a leasing company.
- (ii) Identify the net profit margin from a comparable uncontrolled transaction or a number of such transactions having regard to the same base; In practice, net profit margin is ascertained at segment level where segment data are available. The unallocated expenses are allocated on a reasonable basis and the segmental net profit is determined. Where segment data are not available, net profit is normally determined at enterprise level. Where internal CUT is available transaction level net profit may be determined.
- (iii) In case internal CUT is not available, external CUT is taken. In such case, as discussed above, net profit margin should be taken at enterprise level (segmental or enterprise as a whole) of comparable companies. A search should be carried out to identify comparable companies on the basis of information and data available with the assessee. Where such information and data are not available, search may be carried out with reference to database in public domain.
- (iv) The net profit margin so identified is adjusted to take into account the transaction level and enterprise level differences if any. The differences should be those that could materially affect the net profit margin in the open market;
- (v) The adjusted net profit margin is taken into account to arrive at the arm's length price in relation to the international transaction [or the

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specified domestic transaction].

6.42 The unavailability of reliable data for comparables in case of gross profit based methods such as CPM and RPM may pose difficulties in selecting them as the most appropriate method. In such circumstances, TNMM may be considered as the most appropriate method, subject to other parameters such as degree of comparability, comparability factors, functional profile, etc.

6.43 However, this should not be construed as TNMM being a residual method or method of last resort. Though, TNMM is more tolerant to differences in the product comparability as compared to the traditional methods, the comparability standard to be applied to the TNMM requires a high degree of similarity in several factors between the tested party and the independent enterprises that may adversely affect the net margins. For example: contractual terms and conditions, functions performed, risks assumed and assets employed, pricing mechanism, availability of the comparable data, etc.

6.44 Net margins may be affected by factors that have no effect or less significant effect on gross margins or prices due to the variation of operating expenses between companies. These factors may be unrelated to transfer pricing. For example – Difference in the capacity utilisation level of the tested party vis-a-vis the comparables.

6.45 Specific factors that may affect net margins include, but are not limited to:

- Barriers to entry in the industry;
- Competitive position;
- Management efficiency;
- Individual business strategies;
- Threat of substitute products;
- Varying cost structures;
- Difference in the working capital level;
- Difference in the import vs. domestic content;
- Difference in the capacity utilisation level;
- Difference in the business model: say outsourcing of some manufacturing processes vs. in-house manufacturing of all the

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processes;

- Difference in the functions: say undertaking own market / distribution channels vs. distribution through individual distributors.

6.46 If material differences between the tested party and the independent enterprises are affecting the net margins, reasonably accurate adjustments should be made to account for such differences.

6.47 The application of the transactional net margin method may be understood with the following example:

AE1 Ltd., is an Indian company

AE1 Ltd., manufactures compact disc (CD) writers and sells the same to AE2 Ltd., which is an AE of AE1 Ltd.

As AE1 Ltd., does not have similar transaction with a non AE, no internal CUT is available. As AE1 Ltd., does not have information and data to identify a comparable company, it has used the databases in public domain for carrying out the search. The result of the search may be summarised as follows:

	No. of companies
Search on the basis of following keywords:	
(a) Computer	800
(b) Computer hardware	250
(c) Computer peripherals	66
Sub total	1116
Elimination process :	
Companies with different activities	800
Companies with duplication when multiple database are used	75
Companies with no financials	90
Companies having significant operations like sales or purchases with related party	100
Companies reporting no operations	50
Sub total	1115

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Company/companies selected – Z Ltd.

1

Note: The search criteria and filters adopted above should be taken as illustrative only.

The comparison between AE1 Ltd., and Z Ltd., is carried out as follows:

Financials	AE1 Ltd. INR (in crores)	Z Ltd. INR (in crores)
Sales	130	200
Other income	5	10
Total Income	135	210
Operating expenses	85	120
Interest	5	7
Depreciation	10	12
Loss on sale of undertaking	5	0
Expenses relating to non operating income	1	3
Total expenditure	106	142
Net profits	24	58

Operating margin	AE1 Ltd. INR(in crores)	Z Ltd. INR(in crores)
Sales	130	200
Gross revenue	130	200
Operating expenses	85	120
Interest	5	7
Depreciation	10	12
Total operating cost	100	139
Operating profit	30.00	61.00

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Operating margin	AE1 Ltd. INR(in crores)	Z Ltd. INR(in crores)
Operating margin (before interest and depreciation)	52.94	66.67
Operating margin (after depreciation but before interest)	36.84	51.52

6.48 TNMM is less reliable when applied to the aggregate activities of a complex enterprise engaged in various different transactions or functions. The TNMM should thus generally not be applied on a company-wide basis if the company is involved in a number of different transactions or functions which are not properly evaluated on an aggregate basis. However, it may be possible to apply TNMM when the aggregate activities/transactions are sufficiently interlinked, as for example when similar sales functions are conducted for products in similar product lines.

6.49 The Delhi High Court in the case of Sony Ericsson Mobile Communications India Pvt. Ltd (ITA No 16/2014) has upheld that TNMM could be effective and reliable when applied to closely-linked or continuous transactions. The following example explains that segregation of advertisement, marketing and promotion ('AMP') expenses as an independent transaction would lead to absurd results:

Particular	Case 1	Case 2	Variation
Sales	1,000	1,000	1,000
Purchase price	600	500	500
Gross margin	400	500	500
AMP expense	50	150	50
Overhead expense	300	300	300
Net profit	50	50	150
TP adjustment			100
Add: Mark-up of 15%			15
Total profit			265 (115+150)

6.50 In case 2, a distributor having significant marketing functions incurred substantial expenditure on AMP, three times more than in case 1, but the purchase price being lower, the taxpayer got adequately compensated and

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hence, no adjustment. If the AMP in case 2 was INR 50, i.e., identical to case 1, and AMP of INR 100 was incurred as a separate transaction, this would be absurd if the TPO makes an adjustment, leading to a net profit of 26.5%, which seems absurd.

Thus, it may be appropriate to aggregate the transaction of purchase and marketing efforts leading to higher AMP expenses in the instant case.

6.51 However, it is important to compute profit from the international transaction [or the specified domestic transaction] if the activities are not interlinked and are separate. This can be achieved by using the segmental profitability based on appropriate assumptions and scientific allocation keys. However, in cases where such segmental profitability is not possible, differences in the profitability at the entity level cannot be loaded entirely on the international transactions [or the specified domestic transaction] and this would require application of the 'principle of proportionality'.

Particular	Taxpayer profitability	Third party profitability
Sales to AEs	40	150
Sales to Non AEs	60	
Purchases	80	90
VAE	10.50	30
Net profit	9.50	30
Net profit / Cost	10.50%	25%

6.52 From the above, it can be seen that the profitability of the taxpayer is lower by 14.50% (25%-10.50%). The entire difference cannot be attributable to the sales since the sales to AEs accounts for only 40% of the total sales. Therefore, adjustment may need to be restricted to 40% of the difference.

6.53 Rule 10B(e)(iii) requires that transaction level and enterprise level differences should be adjusted if such differences materially affect the amount of net profit margin.

In this example, following enterprise level differences could be visualised;

(a) **Working capital** – There may be differences in stock holding, debtors and creditors. Appropriate adjustment to eliminate the impact of above difference may be made by taking the prevailing interest rate. For this purpose, useful reference may be made to the guidelines issued by Internal Revenue Service of USA. However, in this example, it is assumed that the

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difference in the working capital is not significant requiring any adjustment.

(b) Cost of capital – There may be difference in the manner of funding such as equity, preference, debenture, inter corporate loans etc. In order that such difference does not impact the net profit, the operating margin on operating cost before interest is taken as profit level indicator.

(c) Assets employed – There may be difference in assets employed and the method of providing depreciation. In order that such difference does not impact the net profit, the operating margin on operating cost before depreciation is taken as profit level indicator.

(d) Assured or risk bearing business – There may be a difference in the customer/ revenue model of the assessee vis-à-vis the comparables. For example, the comparables identified may be entrepreneurs bearing the market risks of business volume, customer continuity, etc and the assessee's international transaction [or the specified domestic transaction] is in the nature of captive service provider or contract manufacturer with assured volumes and/or assured compensation and/or assured business period, etc. Such differences may be eliminated by making appropriate adjustment for low-risk or risk free business.

(e) Difference in the capacity utilisation – There may be difference in the utilisation of capacity by the tested party and the comparables. For example: The taxpayer has utilized only 41.39% of its installed capacity (i.e. 58.61% of the fixed overheads remained unabsorbed), whereas the capacity utilized by the comparables is 80.90%. As a result, the unabsorbed fixed costs, debited to the profit and loss account due to existing accounting practices, has, in fact skewed the profit level indicator of the taxpayer for the period under consideration. As a result, it would be important to compute the profitability from manufacturing activity after removing unabsorbed fixed costs (to bring the capacity utilisation of the taxpayer in line with that of the comparables) with a view to achieve meaningful comparison.

6.54 In the above table, the transaction level differences cannot be noticed. However, some transaction level differences may exist and the same may be adjusted if requisite information is available. Some of the common transaction level differences may be as follows;

- (a) Free gifts
- (b) Extended warranty (in addition to the normal one-year)
- (c) Marketing risks

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(d) Pricing - Ex-Shop or FOR-destination.

(e) Quantity discount

Table 5: Computation of arm's length price under the transactional net margin method

1. AE	:	AE2 Ltd.
2. International transaction	:	Between AE1Ltd. and AE2 Ltd.
3. Comparable uncontrolled company	:	Z Ltd.

	%
Net profit margin of Z Ltd. - i.e. operating margin on cost before interest and after depreciation	51.52
Adjustments for transaction level differences	0.00
Arm's length net profit margin	51.52

	(INR in crores)
Operating costs before interest and after depreciation	95.00
Arm's length sale revenue	143.94
Actual sales	130.00
Income increases by	13.94

The following points are to be noticed:

- (a) Different bases of determining the net profit margin [i.e. profit level indicators (PLI)] are recognised. The same basis of arriving at the net profit margin is to be adopted year after year, unless circumstances justify an alternate base;
- (b) Whichever base is selected in determining the net profit margin in an international transaction [or the specified domestic transaction], the same basis is to be adopted for arriving at the net profit margin in the comparable uncontrolled transaction;
- (c) It is recommended that operating profit margin may be used instead of net profit margin. Operating profit margin would eliminate the non-operating items (the items of revenue and costs which do not result from routine business operations such as profit on sale of assets, dividend etc.).

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Further, the operating profit margins should be computed on the basis of financial statements of the assessee and the comparable company.

- (g) The accounting treatment of expenses and depreciation is also a critical factor in computing the arm's length price. Unlike the preceding methods, the rule does not explicitly provide for adjustment on account of differing accounting practices. Nevertheless, such differing practices should also be factored in;
- (ii) It is not uncommon to find purchase transaction being an international transaction [or the specified domestic transaction] where TNMM is used. TNMM requires the determination of the net profit margin from an international transaction [or the specified domestic transaction] and purchase transaction as such does not result in net profit. However, as purchase is inextricably linked to earning net profit, TNMM may be used for establishing arm's length purchase value. In such case, comparable operating margin should be appropriately used to work back the arm's length purchase cost. This may be illustrated as follows:

Illustration 1:

1. Actual Profit and loss account of the assessee

	INR in lakhs		INR in lakhs
Opening stock-AE purchases	100	Sales of AE purchases	800
Opening stock-Non AE purchases	150	Sales of Non AE purchases	1200
Purchases from AE	500	Closing stock-AE purchases	120
Purchases from Non AE	1000	Closing stock-Non AE purchases	160
Gross profit	530		
	<u>2280</u>		<u>2280</u>
Expenses	200	Gross profit	530
Net profit	330		
	<u>530</u>		<u>530</u>

- 2. Comparable operating margin (PLI being operating profit on sale) 35%
- 3. Profit and loss account - recast to compute arm's length price of

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purchase	(INR in lakhs)		(INR in lakhs)
Opening stock-AE purchases	100	Sales of AE purchases	800
Purchases from AE(balancing figure)	460	Closing stock-AE purchases	120
Gross profit (brought back)	360		
	<u>920</u>		<u>920</u>
Expenses-allocated (in the ratio of sales)	80	Gross profit (worked back)	360
Net profits (applying TNMM margin on AE sales)	280		
	<u>360</u>		<u>360</u>
4. Arm's length value of purchase is `460 as against actual value of ` 500. Therefore, income increases by ` 40.			

Illustration 2 :

1. Profit and loss account of the assessee – Actual

	INR in lakhs		INR in lakhs
Opening stock of raw material (AE purchases)	100	Sale of finished goods	2500
Opening stock of raw material (Non-AE purchases)	150	Closing stock of raw material (AE purchases)	120
Purchases of raw material from AE	500	Closing stock of raw material (Non-AE purchases)	160
Purchases of raw material from Non-AE	1000	Closing stock of finished goods	500
Manufacturing costs	400		
Admin, selling and finance expenses	200		
Net profit	930		

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	3280		3280
2. Comparable operating margin (PLI being operating profit on sale)			45%
3. Profit and loss account - recast:			
	INR in lakhs		INR in lakhs
Opening stock of raw material (Non-AE purchases)	150	Sale of finished goods	2500
Cost of purchase from AE (net of stock)	405	Closing stock of raw material	160
(balancing figure)		(Non-AE purchases)	
Purchases of raw material from Non AE	1000	Closing stock of finished goods	500
Manufacturing costs	400		
Admin, selling and finance expenses	200		
Net profit	1125		
(arrived on basis of TNMM margin)			
	<u>3280</u>		<u>3280</u>
Arm's length Purchase value :			
Cost of purchase from AE (net of stock)			405
Add : Closing stock of Raw Material			120
Add : Closing stock of Raw Material in finished goods (see Note 1 below)			20
Less : Opening stock			<u>100</u>
Arm's length Purchase value			445
Actual purchase			500
Excess price paid			55

Notes: 1. In the above example, the raw material cost (of purchases from AE) built into closing stock of finished goods is assumed to be ` 20.

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2. It is assumed that there is no opening stock of finished goods.

Other Method (OM) of determination of arm's length price

6.55 The CBDT has inserted a new Rule 10AB by notifying the "Other Method" apart from the five methods already prescribed.

For the purposes of clause (f) of sub-section (1) of section 92C, the Other Method for determination of the arms' length price in relation to an international transaction [or the specified domestic transaction] shall be 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-AEs, under similar circumstances, considering all the relevant facts.

6.56 The introduction of the Other Method as the sixth method allows the use of 'any method' which takes into account (i) the price which has been charged or paid or (ii) would have been charged or paid for the same or similar uncontrolled transactions, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts. The various data which may possibly be used for comparability purposes could be:

- (a) Third party quotations/ invoices;
- (b) Valuation reports;
- (c) Tender/Bid documents;
- (d) Documents relating to the negotiations;
- (e) Standard rate cards;
- (f) Commercial & economic business models; etc.

6.57 It is relevant to note that the text of Rule 10AB does not describe any methodology but only provides an enabling provision to use any method that has been used or may be used to arrive at price of a transaction undertaken between non AEs. Hence, it provides flexibility to determine the price in complex transactions where third party comparable prices or transactions may not exist. The wide coverage of the Other Method would provide flexibility in establishing arm's length prices, particularly in cases where the application of the five specific methods is not possible due to reasons such as difficulties in obtaining comparable data due to uniqueness of transactions

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such as intangibles or business transfers, transfer of unlisted shares, sale of fixed assets, revenue allocation/splitting, guarantees provided and received, etc. However, it would be necessary to justify and document reasons for rejection of all other five methods while selecting the 'Other Method' as the most appropriate method. The OECD Guidelines also permit the use of any other method and state that the taxpayer retain the freedom to apply methods not described in OECD Guidelines to establish prices, provided those prices satisfy the arm's length principle.

6.58 The application of the sixth method may be understood with the following examples:

Illustration A

AE1 Ltd. is an Indian Company.

AE1 Ltd. owns certain registered patents which it has developed by undertaking research and development.

It is a subsidiary of AE2 Ltd., a foreign company.

AE1 Ltd. has sold its registered patents to AE2 Ltd., for `50 crores. The price has been determined based on a valuation report obtained from an independent valuer.

The sale of patents is a unique transaction and AE1 Ltd or AE2 Ltd. has not entered into similar transactions with third parties and hence no internal or external CUP is available.

AE1 Ltd. may select the Other Method as the most appropriate method and use the independent valuation report for comparability purposes.

Illustration B

An Indian Company (I Co) buys back its equity shares issued to its foreign AE (AE Co). I Co obtains a valuation report from an external firm identifying the fair market value of these shares. I Co purchases the shares at the value determined in the valuation report. This value denotes a price that would have been charged if a third party would have bought the same shares. Hence, I Co could use Rule 10AB and rely upon the valuation report to demonstrate this transaction to be arm's length.

Illustration C

An Indian Company (I Co) incurs hotel and travel expenses for the employees of its foreign AE (AE Co) visiting India for a global seminar, These

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expenses are paid by I Co directly to third party vendors on behalf of AE Co and recovered on a cost-to-cost basis from AE Co. Further, such activity does not entail a service element for I Co and hence does not necessitate a mark-up. Hence, I Co may select the Other Method and rely upon such back-to-back arrangement to demonstrate this recovery transaction to be arm's length.

Illustration D

An Indian Company (I Co) deposes some of its employees to its foreign AE (AE Co) through secondment. AE Co takes these individuals onboard by issuing letter of employments and is responsible for payment of the salary of the employees. I Co frequently facilitates payment of salaries to the overseas accounts of the seconded employees purely for administrative convenience. In this case, salary costs are reimbursed by AE Co to I Co on a cost-to-cost basis. Hence, I Co may select the Other Method and rely upon such back-to-back arrangement to demonstrate transaction to be arm's length.

Illustration E

Another example where this method could be used is in cases of cost allocation arrangements where a taxpayer benefits from certain services provided by a central entity of the group and has to pay a portion of the total cost incurred by the service provider. These costs are generally allocated on the basis of allocation keys like headcount, time spent, revenues etc. and a third party outside the group may not have the capability to provide identical services. Hence, in the absence of comparable prices or transactions, Rule 10AB may be applied and the cost allocation arrangement could be justified appropriately.

Most appropriate method

6.59 (1) For the purposes of sub-section (1) of section 92C, the most appropriate method shall be the method which is best suited to the facts and circumstances of each particular international transaction [or the specified domestic transaction], and which provides the most reliable measure of an arm's length price in relation to the international transaction [or the specified domestic transaction].

(2) In selecting the most appropriate method as specified in sub-rule (1), the following factors shall be taken into account, namely:-

- (a) the nature and class of the international transaction [or the specified domestic transaction];**

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- (b) *the class or classes of AEs entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;*
- (c) *the availability, coverage and reliability of data necessary for application of the method;*
- (d) *the degree of comparability existing between the international transaction [or the specified domestic transaction] and the uncontrolled transaction and between the enterprises entering into such transactions;*
- (e) *the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction [or the specified domestic transaction] and the comparable uncontrolled transaction or between the enterprises entering into such transactions;*
- (f) *the nature, extent and reliability of assumptions required to be made in application of a method.[Rule 10C].*

6.60 No particular method is suitable in every possible situation. It is not possible to provide specific rules that will cover every case. While selecting the most appropriate method, the factors prescribed in section 92C of the Act and Rule 10C(2) should be considered.

Amongst these factors, the functions performed by AEs (including assets employed and risks assumed) should be given due consideration. It is also important to ascertain the extent and reliability of the uncontrolled data that is available. The nature of the available data, and especially the amount and reliability of detail on the factors entering into a comparability analysis, are very important issues in the selection and application of a methodology.

Although it is difficult to prescribe general principles for choice of most appropriate method, the following broad categorisation may be considered as already indicated under each of the respective methods:

- (i) CUP method may be used in case of loans, service fee, transfer of tangibles, sale and purchase of goods/ commodities, etc;
- (ii) RPM is most useful in case of marketing operations of finished products, especially in case of distributors not performing significant value addition to the product;

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- (iii) CPM is normally used where raw materials or semi-finished goods are sold; where joint facility agreements or long-term buy-and-supply arrangements, or the provision of services are involved;
- (iv) PSM is normally used in cases where the transactions involve provision of integrated services by more than one enterprise. For example – One enterprise holds technology and the other enterprise holds the distribution network and both are the key intangibles for the overall success of the Group; freight forwarders and supply chain specialists.
- (v) Transactional net margin method could be used in case of manufacturing operations, sale of raw materials or semi-finished goods where CPM is not the most appropriate method, and marketing operations of finished products where RPM is not the most appropriate method.
- (vi) Other method may be used in case of royalties, commodities, transfer of intangibles and shares, etc.

6.61 For the purposes of sub-rule (1) of Rule 10B, the comparability of an international transaction [or the specified domestic transaction] with an uncontrolled transaction shall be judged with reference to the following namely:-

- (a) the specific characteristics of the property transferred or services provided in either transaction;
- (b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;
- (c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;
- (d) conditions prevailing in the markets in which the respective parties to the transaction operate, including the geographical location and size of the markets, the laws and government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

6.62 While evaluating each method the distinctive aspects of computation should be borne in mind. For instance, RPM requires functional and other

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differences including accounting practices to be adjusted to the price whereas CPM and TNMM require such differences to be adjusted to the margin.

6.63 Different methods may be chosen as most appropriate method for different transactions of the assessee as long as the rationale for each of such choices are adequately documented. Also, different methods may be chosen for the same transaction in different years as long as the rationale for each such choice made in each year is adequately documented.

Multiple Year Data and Range Concept

6.64 Appreciating that Transfer Pricing is not science but is influenced by several factors the authorities decided to move away from single year concept. At the same time, it was appreciated that with the data bases becoming robust time has come to adopt range concept for the determination of the arm's length price. Consequently, as mentioned in para 1.26 of this book, Central Board of Direct Taxes (CBDT) on October 20, 2015 issued the final rules ie, Rule 10B(5) and Rule 10CA to give effect to the use of 'multiple year data' and 'range concept'. These rules are applicable to international transactions and specified domestic transactions that are entered into by taxpayers on or after 1 April 2014. Rule 10CA (which forms part of Annexure II of this book) contains illustrations of application of the arm's length range concept. This is exhaustive and must be analysed to appreciate the approach recommended.

Vide Notification No. 124/2021[F. No. 500/1/2014-APA-II] dated 29th October, 2021 it was notified that where the variation between the arm's length price determined under section 92C and the price at which the international transaction or specified domestic transaction has actually been undertaken does not exceed one per cent. of the latter in respect of wholesale trading and three per cent of the latter in all other cases, the price at which the international transaction or specified domestic transaction has actually been undertaken shall be deemed to be the arm's length price for Assessment Year 2021-2022.

In essence, this extended the approach applied for the earlier years.

It was, further clarified that for the purposes of the notification, "wholesale trading" means an international transaction or specified domestic transaction of trading in goods, which fulfils the following conditions, namely:-

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- i. purchase cost of finished goods is eighty per cent. or more of the total cost pertaining to such trading activities; and
- ii. average monthly closing inventory of such goods is ten per cent. or less of sales pertaining to such trading activities.

EXPOSURE DRAFT

Chapter 7

Documentation and Verification

Type of information and documents

7.1 Rule 10D(1) lays down thirteen different types of information and documents that a person has to keep and maintain in relation to the international transactions undertaken in a given financial year. Broadly, these information and documents may be classified into three types:

- (i) enterprise-wise documents – These are documents that describe the enterprise, the relationships with other associated enterprise, the nature of business carried out, etc. This information is, largely, descriptive [clauses (a) to (c)].
- (ii) transaction-specific documents – These are documents that explain the international transaction in greater detail. It includes information with regard to each transaction (nature and terms of the contract, etc.), description of the functions performed, assets employed and risks assumed by each party to the transaction, economic and market analyses, etc. This information is both descriptive and quantitative in nature [clauses (d) to (h)].
- (iii) Computation related documents – These are documents which describe and detail the methods considered, actual working assumptions, policies etc., adjustments made to transfer prices and any other relevant information, data, document relied for determination of arm's length price [clause (i) to (m)].

7.2 The documentation requirements prescribed in section 92D read with Rule 10D applies not only to international transactions between associated enterprises but also to the deemed international transactions covered under Section 92B(2) of the Act as well as the specified domestic transactions covered under Section 92BA of the Act.

7.3 It is pertinent to note that the list of documents provided under Rule 10D are prescriptive in nature and it is not essential that each of the document be maintained in respect of each international transaction. While the documents like the one mentioned in point (i) and (ii) above needs to be maintained in respect of each international transaction/ specified domestic

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transaction, need for maintaining documents mentioned in point (iii) should be critically analysed and maintained for each of the transaction and member may exercise his professional judgement regarding the same.

Ownership, profile and business

7.4 A description of the ownership structure of the Assessee enterprise with details of shares or other ownership interest held therein by other enterprises.[clause (a), Rule 10D(1)].

7.5 It may be noted that the term “other enterprise” should refer to an associated enterprise with which the taxpayer has undertaken an international transaction undertaken in a given financial year. If this term were to be given the meaning provided in section 92F(iii), then it would virtually include every member in the register of members. No purpose would then be served by duplicating the contents of that register. Where the person is a company, the names of members who are associated enterprises, the number of shares held by each of them and the percentage of their holding to the total holding has to be stated.

7.6 However, where the number of members is very large, a generic classification of the ownership structure may be given, namely, holdings by Government (Central, State), Government companies, public financial institutions, nationalised and other banks, mutual funds, venture capitalists, foreign holdings, bodies corporate, directors and relatives, others. The holdings of associated enterprises must, in any case, be shown separately.

7.7 Where the person is a firm or an association of persons, the names of the partners of the firm or members of the association of persons and their profit sharing ratios have to be stated. Similar details, to the extent applicable, need to be furnished when the person is a body of individuals, trust, Hindu undivided family, etc. The description of the ownership structure should be stated as at the day on which one person became an associated enterprise of another and as at every other day on which there was change in the ownership interest of that other enterprise.

7.8 For example, assume that A Ltd., India and X Inc., USA, are associated enterprises, and the holdings of X Inc. in A Ltd. were as under:

Documentation and Verification

(a)	Total number of Rs. 10, fully paid equity shares, issued by and subscribed in A Ltd.	100,000
(b)	Total number of shares of Rs. 10, fully paid up, held by X Inc. on 1 st April, 2001	50,000
(c)	Total number of shares of Rs. 10, fully paid up, acquired by X Inc. on 24 th November, 2001 (by private purchase)	10,000
(d)	Total number of shares of Rs. 10, fully paid up, disposed of by X Inc. on 24 th February, 2002 (by private sale)	25,000

Under this clause, A Ltd. will have to report the holdings of its Associated Enterprise, as follows:

Details		Details of ownership structure					
		Period from 1.4.2001 to 23.11.2001		Period from 24.11.2001 to 23.2.2002		Period from 24.2.2002 to 31.3.2002	
		No. of shares	%	No. of shares	%	No. of shares	%
(a)	Directors, relatives and others	50,000	50	40,000	40	65,000	65
(b)	X Inc., USA (Associated Enterprise)	50,000	50	60,000	60	35,000	35

Where the ownership structure is complicated, the above tabular statement may be supplemented by a suitable diagrammatic representation of the ownership interest held by associated enterprises in the Assessee.

7.9 The regulations require the Assessee to maintain information regarding the shareholding pattern. Though there is no prescribed format for this information, following is the format that the Accountant may suggest to the Assessee.

S. No.	List of shareholders	Shareholding (%)

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Further, ownership interest held by enterprises in the Assessee enterprise, directly or indirectly through intermediaries, also needs to be maintained by the Assessee. Accordingly, the identification of the ownership and the relationship with the associated enterprises is the primary responsibility of the Assessee.

7.10 The Accountant shall verify that the Assessee maintains information regarding enterprises having direct or indirect ownership interests, through intermediaries, in the Assessee enterprise. The Accountant is required to vouch the associated enterprises relationship as governed by Section 92A(1)(a); 92A(1)(b) and 92A(2) of the Income-tax Act, using his professional judgement. The Accountant may rely on the financial statement including the representation from the management with regard to the veracity of the same.

7.11 *A profile of the multinational group of which the Assessee enterprise is a part along with the name, address, legal status and country of tax residence of each of the enterprises comprised in the group with whom international transactions or specified domestic transactions, as the case may be] have been entered into by the Assessee, and ownership linkages among them. [clause (b), Rule 10D(1)].*

7.12 As part of the profile of the multinational group, it may be advisable to maintain, amongst other things, corporate brochures, catalogues and other similar printed and / or electronic material that describe:

- The principal line(s) of business in which the group is engaged, such as manufacturing of electronic goods, trading in chemicals, wholesale trade in food grains, pharmaceuticals, etc.;
- Geographical areas in which the group one operates;
- Summarised global financials and other details such as capital invested, assets employed, turnovers achieved, incomes earned, profits made / losses incurred, etc.

7.13 With respect to each of the associated enterprises/ specified persons in the group with whom the Assessee has entered into international transaction / specified domestic transaction, the following specific details must be maintained:

- Name;
- Address;

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- Legal status (company, limited liability partnership, firm, etc.);
- Country of tax residence;
- Ownership linkages between the Assessee and the associated enterprise.

Sometimes, the establishment of ownership linkages between the Assessee and other associated enterprises is a problem for the reason that sufficient reportable information is not available. In such cases, the Assessee will have to provide only the information that is available with him.

7.14 For example, A Ltd., India, is a 100% subsidiary of H Ltd., U.K., which itself is a 100% subsidiary of R Inc., USA. R Inc. also, has another subsidiary, C Ltd., Argentina. If, A Ltd. transacts with C Ltd., it will have to report the ownership linkage between itself and C Ltd. However, this information may not be available or even forthcoming from the ultimate holding company, R Inc.

7.15 However, some of these details would also be required to be reported by the ultimate holding company under the BEPS recommended three-tiered approach to TP documentation, consisting of master file, local file and CbC reporting. The assessee could source required data from such master file or CbC report, wherever applicable.

7.16 The Assessee is required to maintain a document that describes the profile of the multinational group. The member may exercise his professional judgment to determine whether the profile prepared by the Assessee provides sufficient information regarding the group, pertinent to transfer pricing. Some of the information that may be contained in the profile are as follows:

- the name and place of incorporation of the immediate parent company;
- the name and place of incorporation of the ultimate parent company;
- the major product lines, services offered by the group;
- a brief description of the technology, brands or other intangibles owned by the group;
- name(s) of major competitors.

Any other information regarding the group that may be pertinent to the transfer pricing analysis.

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7.17 The Accountant has to verify if such a profile has been prepared and based on his understanding of the business of the Assessee and a test check of the documents and records of the Assessee, he is required to determine that the information contained in the profile is correct. In this regard, the Accountant may place reliance on the master file of the Assessee, if applicable, to verify that the information contained in the report is correct.

7.18 The Assessee is also required to provide a list of associated enterprises / specified persons from within the group, with whom the Assessee has entered into international transactions / specified domestic transactions. The following details are required to be maintained by the Assessee:

- name of the group entity (associated enterprise / specified person)
- address of the group entity
- legal status
- nature of relationship
- country of tax residence.

7.19 The Accountant should obtain written representation from management (of the taxpayer) providing him with name, address, legal status and country of tax residence of each of the enterprises comprised in the group with whom international transactions or specified domestic transactions have been entered into by the Assessee, and ownership linkages among them. He shall exercise his professional judgement and due diligence to verify that the same is *prima facie* correct. The Accountant should place reliance on the evidence/documents provided by the Assessee to satisfy himself as to the accuracy of these facts. The Accountant could verify the data from master file or CbC report, wherever applicable and prepared by the Assessee.

7.20 The Accountant shall perform certain checks in regard to the various categories and situations in which the two enterprises are associated enterprises as provided in section 92A(1) and clause (a) and (b) of section 92A(2). A reference should be made to the tax audit report. He should also check the register of members maintained by the Assessee under section 88 of the Companies Act, 2013 and the voting rights corresponding to the shares of the associated enterprise / specified persons.

7.21 A broad description of the business of the Assessee and the industry in which the Assessee operates, and of the business of the

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associated enterprises with whom the Assessee has transacted [Clause (c), Rule 10D (1)].

7.22 Under this clause, a general explanation of the business carried out by the Assessee and the associated enterprise/ specified person with whom it has transacted has to be stated. Where the Assessee/ associated enterprise / specified person are engaged in more than one line of business, the explanation will have to cover all businesses.

7.23 This explanation could typically cover areas such as:

- the business model used;
- technologies employed;
- products manufactured/traded;
- markets addressed and competition faced;
- geographic dispersion of manufacturing facilities etc.

7.24 The broad description of the industry in which the Assessee operates will include reports about the industry, which are available in the public domain. This could be material published in business newspapers, trade journals and magazines, etc. all of which provide a macro-economic perspective to the industry.

Associated Enterprises relationship with the Assessee:

7.25 The Assessee has to determine whether by virtue of clauses (c) to (m) of section 92A(2) certain enterprises shall be deemed as associated enterprises. The Accountant shall conduct the following checks to verify if the Assessee has conducted due diligence in determining whether an entity is an associated enterprise or not.

Clause (c): The Accountant should check the register of loans and investments maintained by the Assessee under section 186 of the Companies Act, 2013.

Clause (d): The Accountant shall obtain details of all the guarantees pertaining to the borrowing from the management and representation for its completeness thereof.

Clause (e): The Accountant shall obtain a representation from management detailing composition and appointment of the members of board of directors or governing board, Executive Directors and Executive Member of the

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governing board. Further the member shall check the Register of Directors maintained by the company under section 170 of the Companies Act, 2013

Clause (f): The Accountant shall obtain a representation from the management detailing composition and appointment of the members of board of directors or governing board, Executive Directors and Executive Member of the governing board. Further the member shall check the Register of Directors maintained by the both companies under section 170 of the Companies Act, 2013

Clause (g): The Accountant shall obtain a representation from the management to the fact that enterprise is wholly dependent upon the intangible assets such as know-how, patents, copyrights, trademarks, licenses, franchises, or other commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or has exclusive right.

Clause (h): The Accountant shall obtain the details of all the purchases of raw material and consumable requirement made by the Assessee and compute the party wise share of business i.e. party-wise purchases. He shall obtain representation from the management to the fact that the information provided is correct and complete.

Clause (i): The Accountant shall obtain a representation from the management to the fact that enterprise sold the goods or articles manufactured or processed by it, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise

Clause (j) (Individual): The Accountant shall obtain a representation from management providing details of controlling interests in all the affiliated parties so as to determine the common controlling interest in two companies.

Clause (k) (HUF): The Accountant shall obtain a representation from management providing details of controlling interests in all the affiliated parties so as to determine the common controlling interest in two companies.

Clause (l): The Accountant shall obtain the partnership/AOP/BOI agreement in order to determine whether any enterprise holds not less than ten per cent interest in other firm, association of persons or body of individuals.

Clause (m): The Accountant shall obtain a representation from management to the effect that there exists or does not exist between the two enterprises,

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any relationship of mutual interest in case any such relationship is prescribed by CBDT. The Accountant shall exercise his professional judgement and due diligence to verify that the same is prima facie correct.

7.26 The Accountant should obtain written representation by management detailing the overview of the business of the Assessee and a description of the business of the associated enterprises / specified persons with whom the Assessee has transacted.

7.27 Following is the illustrative checklist to carry out business analysis of the Assessee:

- (a) year of establishment/incorporation;
- (b) name and residence of the parent company (holding company);
- (c) details of the place/s (units) from where services are rendered (including area occupied, infrastructure, etc.);
- (d) activity in brief (if there is more than one unit, details of activities in each unit);
- (e) stake-holding of the parent company;
- (f) legal environment of the industry;
- (g) key value drivers of the industry;
- (h) major players in the industry;
- (i) share of business in the industry;
- (j) trends in profitability, turnover, market share etc;
- (k) Intangibles of the business.

A similar description of the business of the associated enterprises with whom the Assessee has undertaken international transactions, is also to be prepared by the Assessee. The Accountant shall verify if such description is also maintained.

Herein, it may be noted that transactions with parties under section 94A, will also come within the purview of section 92A

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Details of international transactions / specified domestic transactions

7.28 *The nature and terms (including prices) of international transactions [or specified domestic transactions, as the case may be] entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction [clause (d), Rule 10D(1)].*

7.29 The list of individual international transactions / specified domestic transactions entered into by the Assessee with each of its associated enterprises/ specified persons is required to be stated here. For ease in comprehension and verification, the details may be compiled and presented in a tabular form giving the details required.

7.30 While the data may be classified in any convenient manner, for the purpose of facilitating the study of comparability, it is suggested that the nature of the property transferred or service provided be used as the primary key.

7.31 In addition to the standard inclusions such as name of associated enterprise / specified person, product transferred or service provided, quantity, price per unit of measurement etc., the data should, also, provide information on matters such as:

- form and time of payment;
- discounts;
- shipment;
- purchase commitments;
- product returns by the customer;
- supportive services; etc.

The listing should, also, include transactions where the property has been transferred or service has been provided "free of cost". The Accountant may also obtain written representation detailing the services provided / received by associated enterprises.

7.32 The Accountant should examine the details of nature and terms (including prices) of international transactions/ specified domestic transactions entered into with each associated enterprise / specified person, details of property transferred or services provided and the quantum and the

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value of each such transaction or class of such transaction. The Accountant should verify the information provided by the Assessee, by using standard examination procedures from the books of accounts maintained by the Assessee and information/explanations obtained during the course of such examination.

7.33 A description of the functions performed, risks assumed and assets employed or to be employed by the Assessee and by the associated enterprises involved in the international transaction[or specified domestic transaction, as the case may be][clause (e), Rule 10D(1)].

7.34 The Assessee is required to undertake and describe the results of a detailed functional analysis of the business process involved in the transaction with the associated enterprise / specified person. In analysing of the business process, the study should not only cover the activities of the resident enterprise but, also, the activities of the non-resident enterprise. In other words, it is the business process that it analysed and not the enterprise.

7.35 The functional analysis should be made from the perspective of the “functions performed”, “assets employed” and “risks assumed”. Simply put, a ‘functional analysis’ is a study to determine what economically significant acts were performed in accomplishing the transactions in question and who performed them.

7.36 The role of functional analysis is to:

- (a) determine the facts with respect to a given transaction between the related parties; and
- (b) set the stage for the choice of tested party followed by the choice of the pricing method by providing the framework within which comparable transactions may be determined

7.37 The Assessee shall undertake a detailed functional analysis of the company and its associated enterprise / specified person in order to determine the functions performed, risks assumed and assets employed by the Assessee and by the associated enterprises / specified persons involved in the international transaction / specified domestic transaction. A functional analysis is a method of finding and organizing facts about a business in terms of its functions, risks and intangibles in order to identify how these are divided up between the companies involved in the transaction under review.

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The functions and risks are analyzed to determine the degree of risks undertaken, the value of the intangibles provided and whether the profits (or losses) earned by the entities are commensurate with the functions performed. Functional analysis thus helps in assessing the correct characterization of the parties to the transaction which in turn helps in selecting the appropriate tested party and consequentially the most appropriate methods and the comparables.

7.38 A functional analysis attempts to identify all value added activities. The identification of the relevant value added activity helps in identifying the specific risks associated with the transaction. In addition, functional analysis identifies specialized business assets that increase the chances of success (such as key employees or marketing intangibles).

7.39 To conduct a full functional analysis, it is necessary to gather information. To execute this, the company shall either interview or get questionnaires filled by the key personnel related to the various functions performed by the company.

7.40 The Accountant shall obtain a representation from management to the effect that the functional analysis so done is complete and covers all the functions performed by the company.

Records having a bearing on international transaction / specified domestic transaction

7.41 A record of the economic and market analyses, forecasts, budgets or any other financial estimates prepared by the Assessee for the business as a whole and for each division or product separately, which may have a bearing on the international transactions or specified domestic transactions, as the case may be] entered into by the Assessee [clause (f), Rule 10D(1)].

7.42 Whereas under clause (c) in para 7.27, above, study need to be carried out about the business in which the Assessee operated (macro). At the same time, under this clause, study of the business in which the assessee operates (micro), is to be carried out.

7.43 Where Assessee, in the normal course of their business, use general and financial and management tools (such as market analyses, marginal and absorption costing, capital and revenue budgeting, variance analysis, etc.) to control and run their business, the data captured in the

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process may be used to ascertain whether the arm's length principle has been complied with.

However, where these techniques are not in use, historical data cannot be used as a substitute.

7.44 The Accountant shall obtain copies of budgets or forecasts, if any, from the management and shall exercise his professional judgement to ensure its correctness and validity. He shall also obtain the representation from management to the effect that all the budgets and forecasts prepared are being provided. The Accountant is not required to comment on the appropriateness or otherwise of the details prepared or maintained by the Assessee. The Accountant with due care has to place reliance on the management of the Assessee to satisfy himself as to the accuracy of these facts.

It may so happen that the company is not in the practice of preparing any forecast, budgets or other financial estimates. The Accountant should then disclose this fact suitably.

7.45 A record of uncontrolled transactions taken into account for analysing their comparability with the international transactions or specified domestic transactions, as the case may be] entered into, including a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the international transactions [or specified domestic transactions, as the case may be] [clause (g), Rule 10D(1)].

7.46 This record is a compilation of the uncontrolled transactions that were identified and taken for analyzing whether they would pass the test of comparability. This is no more than raw data, prior to processing. In the process of creating this record, the enterprise has to prove the integrity of the following two critical parameters:-

- (i) The enterprise must establish that the uncontrolled transactions listed include transactions in only those products or services in respect of which the enterprise has dealt with associated enterprises / specified persons.

Assume that the enterprise manufactures various types of caustic soda (e.g., industrial grade, commercial grade, membrane grade, etc.). Also, assume that transactions with associated enterprises have been in respect of only one type of caustic soda (say, membrane

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grade). Then, when the required list is being prepared, the enterprise must ensure that the uncontrolled transactions that have been included must be only of that membrane grade and not include other types, which are irrelevant. This is especially relevant in cases where Comparable Uncontrolled Price Method is used as the most appropriate method for analysis the arm's length nature of the concerned international transaction. However, where other methods are used, say Cost Plus Method, Resale Price Method, some relaxation in the comparability parameters (evaluated for the purpose of the analysis) could be adopted whereby overall basket of products (say caustic soda in the above example) could be considered as comparable. The yardstick could be further relaxed in case Transactional Net Margin Method is used whereby companies dealing in similar products and having similar functional profiles could be considered as comparable. To illustrate, in the above example, in case Transactional Net Margin Method is used as the most appropriate method, manufacturers of chemicals (having similar functional profile as the tested party) could be considered as comparables.

- (ii) The enterprise must also confirm that the listing of uncontrolled transactions is complete and that no similar or identical transactions have been omitted.

7.47 For example, if the enterprise is dealing in electronic components (integrated circuits and printed circuit boards) and its transactions with associated enterprises have been conducted throughout the year, the enterprise must establish that the database from which the list has been compiled at least covers the period during which transactions with the associated enterprise took place.

The enterprise should maintain / provide detailed reasons as to why particular set of data points can be or cannot be considered as comparable to the international transaction / specified domestic transaction under consideration.

7.48 In order to conduct an analysis the enterprise is required to collect data regarding comparable uncontrolled transaction or comparable companies engaged in similar business. The enterprise has to prepare a search memo detailing the process of identification of comparable uncontrolled transaction and/or comparable companies. The enterprise has to provide information regarding the databases used for the search and

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economic rationale for the selection/rejection of transaction/companies. The summary of the selection/rejection process has to be documented through a search matrix. Further, the enterprise should demonstrate that the analysis undertaken to determine the comparables is scientific and does not represent a cherry picking. In summary, the enterprise must prove that the rationale used by it in the process of searching for and including/excluding uncontrolled transactions is correct, logical and complete. For the said purpose, the Assessee may place reliance on the global transfer pricing guidelines¹.

7.49 The Accountant shall examine details of the comparable transactions/data compiled by the enterprise. Further, exercising his professional judgement, the Accountant should verify that the data used to determine / analyse the arm's nature of the price of the international transaction/ specified domestic transaction is in tune with the findings of the functional analysis. This would ensure the authenticity of the price so arrived on the basis of the data.

7.50 A record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction [or specified domestic transaction, as the case may be] [clause (h), Rule 10D (1)].

7.51 The process to be described under this clause (record of analysis of data) is the naturally corollary to the process described in immediately preceding clause, clause (g) (record of compilation of data).

7.52 In trying to arrive at the comparability between uncontrolled transactions and international transactions / specified domestic transactions, the enterprise has to, amongst other things, carryout the process of resolving any differences that may exist between them. These differences could be for the reasons stated in Rule 10B (2) or for any other reason also. Under this clause, the enterprise has to detail the analysis that he has conducted on each of the uncontrolled transactions in determining whether or not it is comparable to an international transaction / specified domestic transaction.

7.53 The Accountant needs to report the details of the method adopted by the Assessee to benchmark the transaction. In this regard, Accountant is not obligated to ascertain whether the method adopted by the Assessee is the

¹². OCED guidelines / UN TP Manual

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most appropriate method (the selection of the most appropriate method is the responsibility of the Assessee; Accountant is not required to assess / comment on the appropriateness of the same). Rather, the Accountant should check the facts and the method stated has indeed been applied by the Assessee to the benchmark the transaction.

Description of methods considered and working thereof

7.54 *A description of the methods considered for determining the arm's length price in relation to each international transaction [or specified domestic transaction, as the case may be] or class of transaction, the method selected as the most appropriate method along with explanations as to why such method was so selected, and how such method was applied in each case [clause (i), Rule 10D(1)].*

7.55 When ascertaining the “most appropriate method”, the provisions of section 92C(1) and Rule 10C must be kept in mind. Given that the law envisages selection of the “most appropriate method” for ascertaining the arm's length nature of the international transaction or specified domestic transaction, it is required that each of the six prescribed methods are duly analysed before selecting one as the most appropriate.

7.56 Under this clause, the Assessee has to describe the nature of the international transaction / specified domestic transaction, explain why the method chosen is the most appropriate method (may be, even, explaining why other methods were excluded) and then detail the manner in which the method was applied to the transaction under examination. In detailing the manner in which the method was applied, a numerical exercise is not expected. This is because the detailing of the arithmetic process is included under clause (j), infra.

7.57 The OECD, in their Transfer Pricing Guidelines has set out the optimal conditions under which a particular method is more suited than another. For example, the cost plus method is “probably is most useful where semi-finished goods are sold between associated parties, where associated parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.”

By using these guidelines and analysing the intrinsic nature of the international transaction /specified domestic transaction, it may be possible

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to determine which is the most appropriate method to be applied to each transaction.

7.58 This exercise has to be carried out once for every type of international transaction / specified domestic transaction; and

7.59 As stated in para 7.53 above, the primary responsibility for selection of the most appropriate method is the responsibility of the Assessee. The Accountant is not required to assess or comment on the appropriateness of the same. It needs to report the details of the method adopted by the Assessee to benchmark the transaction.

7.60 *A record of the actual working carried out for determining the arm's length price, including details of the comparable data and financial information used in applying the most appropriate method, and adjustments, if any, which were made to account for differences between the international transaction [or specified domestic transaction, as the case may be] and the comparable uncontrolled transactions, or between the enterprises entering into such transactions [clause (j), Rule 10D (1)].*

7.61 Once the enterprise has compiled the raw data [clause (g)], analysed the data for comparability [clause (h)] and chosen the most appropriate method [clause (i)], the next step would be to perform the actual exercise of arriving at the arm's length price. This is the process that is contemplated under this clause.

7.62 Here, the enterprise will have to detail all the mathematical iterations and steps that have been undertaken to arrive at the arm's length price. Where any assumptions have been made, or where any critical factors have affected the determination of the arm's length price, the numerical effect of these factors have not only to be stated but computed. The actual listing of these assumption, factors, etc. is required to be done under the provisions of clause (k), infra. Also, detailed working in respect of the adjustments undertaken by the enterprise needs to be detailed.

7.63 In assigning numbers to qualitative factors such as policies, price negotiations, etc. there may be an element of subjectivity. The enterprise may have to conclusively establish that no element of bias has entered the computational process.

7.64 The documentation on economic analysis shall also provide for the details of the data used and data rejected with reasons thereof. Also,

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different companies follow different accounting policies and there may be differences in respect of terms of sale etc., these variations call for certain adjustments in the financial to make the data comparable. The reasons and the adjustments so made should also be recorded.

7.65 The Accountant should examine the correctness of such working and the adjustments made with reference to the relevant information and data.

7.66 *The assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's length price [clause (k), Rule 10D (1)].*

7.67 This part requires the enterprise to render a narrative description of the various assumptions, policies, price negotiations that have been considered in determining the arm's length price.

7.68 An example of an assumption affecting the determination of the arm's length price could be the buyer's commitment to purchase certain specified quantities of the product.

7.69 Examples of a policy affecting the determination of the arm's length price could be

- the enterprise's decision to make his borrowings in overseas markets (where the rates are lower than as compared with indigenous banks) and reduce the interest component in his product cost sheet
- market penetration strategy, wherein the products/ services of the enterprise could be priced lower than the market in order to create a market for itself. This could also lead to the enterprise making operating losses in the start-up phase i.e. first few years of its operations.
- credit policy of the enterprise, which would lead to different working capital cycles between enterprises operating in the same industry, thereby also affecting prices and sales realization
- sales being made by the enterprise to its associated enterprise in order to make optimal use of its production capacity (which has no alternate use) whereby the concept of marginal costing rather full costing is used to derive the transfer price

7.70 An example of a price negotiation affecting the determination of the arm's length price could be the manner in which the supplies are paid for. For example, a supply to an associated enterprise in China may get a better price if the payment is received in US Dollars instead of Chinese Yuan.

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Another example could be where an associated enterprise in Nigeria may get a better price if the letter of credit is accepted by a UK Bank rather than a local bank.

7.71 The Accountant shall obtain information about the assumptions, policies and price negotiations, if any, including understanding of the business/commercial reasons which influenced the determination of the arm's length price by way of representation from the management of the Assessee. The Accountant shall examine the functional analysis and the results of the economic analysis to determine the assumptions, policies and price negotiations that have been considered for determining the arm's length price and shall verify if the enterprise has maintained a document explicitly stating these assumptions, policies and price negotiations.

7.72 *Details of the adjustments, if any, made to transfer prices to align them with arm's length prices determined under these rules and consequent adjustment made to the total income for tax purposes [clause (I), Rule 10D(1)].*

7.73 This process requires the enterprise to prepare a reconciliation statement detailing how the actual transaction value can be compared with the arm's length price. This is a critical process in order to ensure a like to like comparison (to the extent possible). This is a two-stage process, detailed below.

7.74 Where the international transaction has certain characteristics that are absent in the uncontrolled transaction, the value of these characteristics has to be computed and reduced from the value of the international transaction.

7.75 Correspondingly, where the international transaction/ specified domestic transaction does not have certain characteristics that are present in the uncontrolled transaction, the value of these characteristics has to be computed and included in the value of the international transaction / specified domestic transaction.

Some common adjustments that are carried out to achieve the above are:

- Working capital adjustment
- Risk adjustment
- Idle capacity adjustment/ Start-up cost adjustment
- Depreciation adjustment

The enterprise would need to maintain detailed workings demonstrating the computation of the adjustments, the basis used to arrive at the same as well

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the source of data used to obtain financial information for the computation of such adjustment.

7.76 In case there is a difference between the transaction price and the arm's length price, the transaction price is required to be aligned to the arm's length price.

7.77 The Accountant shall review the adjustments (whenever required) made to transfer price / benchmarking analysis of the company so as to align it with the arm's length prices / transfer price, as determined under these rules and verify that consequent adjustment is made to the total income for tax purposes.

7.78 Any other information, data or document, including information or data relating to the associated enterprise, which may be relevant for determination of the arm's length price [clause (m), Rule 10D (1)].

7.79 This is a residuary clause that allows the enterprise to use any other extraneous reasons that may have affected its judgement in the process of complying with the arm's length principle.

7.80 An example of such a situation could be when a loss-making enterprise sells goods to an associated enterprise at less than the "arm's length price" only because this is the only way in which the enterprise may be able to absorb fixed costs/ overheads.

7.81 Where any other information, data or document has been considered relevant for the determination of arm's length price by the Assessee, the Accountant shall by placing reliance on the written representation from the management of the Assessee review the correctness of the same.

Relief from maintenance of specific records

7.82 Nothing contained in sub-rule (1) in so far as it relates to an international transaction shall apply in a case where the aggregate value, as recorded in the books of account, of international transactions entered into by the Assessee does not exceed one crore rupees:

Provided that the Assessee shall be required to substantiate on the basis of material available with him, that income or expenses as the case may be arising from international transactions entered into by him has been computed in accordance with section 92. [Rule 10D(2)]

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7.83 The ceiling limit of INR 1 crore is with reference to an Assessee and not with reference to any undertaking or unit. The limit applies with reference to all the international transactions entered into during a previous year. The amount is reckoned on the basis of the aggregate value of international transaction as recorded in the books of account of the Assessee. In case of Assessee who fall within this category in a particular previous year, relief given is from maintaining the specific records and detail documents prescribed in rule 10D. There is no exemption for such Assessee in obtaining and furnishing audit report under section 92E of the Act.

7.84 It requires to be mentioned that even in such cases, the onus lies on the Assessee to substantiate that income or expense as the case may be arising from international transaction has been computed on the basis of arm's length price. It is, therefore, necessary for those Assessee to maintain such materials or records as may enable them to discharge the burden of proof cast on them. The Accountant, in such cases, is required to examine the records so maintained and satisfy himself that the material in the possession of the Assessee is relevant and proper for the purpose of expressing his opinion in the report to be issued in Form No.3CEB.

Supporting documents

7.85 The information specified in sub-rule (1) and 2A shall be supported by authentic documents, which may include the following:

- (a) official publications, reports, studies and data bases from the Government of the country of residence of the associated enterprise or of any other country;**
- (b) reports of market research studies carried out and technical publications brought out by institutions of national or international repute;**
- (c) price publications including stock exchange and commodity market quotations;**
- (d) published accounts and financial statements relating to the business affairs of the associated enterprises;**
- (e) agreement and contracts entered into with associated enterprises or with unrelated enterprises in respect of transactions similar to the international transactions or the specified domestic transactions as the case may be;**

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- (f) *segmented financial statements in accordance with the Accounting standards as prescribed;*
- (g) *letters and other correspondence documenting any terms negotiated between the Assessee and the associated enterprise;*
- (h) *documents normally issued in connection with various transactions under the accounting practices followed.*

[Rule 10D(3)]

7.86 Rule 10D(3) provides that the information compiled, kept and maintained by the enterprise, under clauses (a) to (m) of sub-rule (1), shall, to the extent possible, be further supported by “authentic” documents that provide additional information of the nature specified therein. Most of the information required to be provided is global or macro in nature.

7.87 The above documents are required to substantiate the functional and economic analysis performed by the enterprise. The Accountant shall review the contents of the functional and economic analysis and shall verify whether the enterprise has maintained back-up data listed above to substantiate the facts and figures given in the documents listed in Rule 10D(1).

Contemporaneity of data

7.88 *The information and documents specified under sub-rules (1), (2), and (2A), should, as far as possible, be contemporaneous and should exist latest by the specified date referred to in clause (iv) of section 92F:*

*Provided that where an international transaction or specified domestic transaction continues to have effect over more than one previous year, fresh documentation need not be maintained separately in respect of each previous year, unless there is any significant change in the nature of terms of the international transaction or specified domestic transaction, in the assumptions made, or in any other factor which could influence the transfer price, and in case of such significant change, fresh documentation as may be necessary under sub-rules (1), (2) and (2A) shall be maintained bringing out the impact of the change on the pricing of the international transaction or the specified domestic transaction.***[Rule 10D(4)]**

Documentation and Verification

The information and documents specified in sub-rules (1), (2) and (2A) shall be kept and maintained for a period of eight years from the end of the relevant assessment year[Rule 10D(5)].

7.89 The Accountant may design a questionnaire and conduct interviews with the client personnel (wherever necessary) to understand if the enterprise has taken due diligence with regard to maintaining documentation. The Accountant should determine whether any changes have occurred in the business conditions under which the enterprise was operating. The enquiries may cover the following areas:

- changes in business and pricing strategy;
- changes in market conditions [demand / supply] in India and in the country where the associated enterprise is located;
- changes in the “key” value drivers of the industry;
- changes in the critical success factors that influence the company’s position in the market;
- changes in competition;
- changes in terms of contract;
- changes in sales volumes / total revenues arising as a result of the international transactions.

7.90 The above exercise would assist the Accountant in evaluating the appropriateness of the functional / economic analysis undertaken by the Assessee.

7.91 In case the changes above, are not likely to influence the economic analysis conducted in the earlier year/years, the enterprise’s role may be limited to the following:

- examine whether comparability analysis of the earlier year continues to be applicable [a comparable uncontrolled transaction in the earlier year may now have become a controlled transaction due to certain changes in the business conditions; a comparable company selected in the earlier year may now have started transacting with associated enterprises; etc.]. This is more relevant for transactions whose pricing basis as well the computation mechanism remain changed over a period of time (say royalty arrangements).

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- update the financial analysis using the fresh list of comparables [after rejecting companies / transactions that are no longer comparable] and using the financial information for the current year [this is because, the Indian economy cannot still be considered a stable economy and prices and profit levels may fluctuate significantly from year to year].
- determine the arm's length price for the current year using the result of the financial analysis conducted in the current year.

7.92 Rule 10D (4) provides that the data, information and documents on the basis of which the arm's length price has been determined should, as far as possible, be contemporaneous. At any rate, they should exist by no later than the specified date by which the report under section 92E is required to be furnished. Where the international transaction / specified domestic transaction has longevity that spans one or more previous years, the enterprise need not prepare fresh documentation in respect of the transactions conducted in every subsequent previous years.

7.93 However, when there is a significant change in the nature or terms of the international transaction or specified domestic transaction, in the assumptions made, or in any other factor, which could influence the transfer price, then fresh documentation, as appropriate, should be made to bring out the impact of the changes on the pricing of the international transaction.

7.94 The information and documents required to be maintained under section 10D shall be preserved for a period of eight years from the end of the relevant assessment year. This provision assumes significance in view of the penal and other consequences attracted due to non-production of the information and documents kept and maintained. Reference is drawn to CBDT Circular No.12 dated 23.08.2001 (**Annexure IV**) relaxing this requirement for transactions entered into during the period from 1.4.2001 to 31.8.2001.

Master File²

7.95 Further Rule 10D(A) was inserted by IT (Second Amendment) Rules, 2020, w.e.f. 1-4-2020 to provide for rules relating to applicability and preparation of master file. The said rule provides as below:

² As the Guidance Note is only in respect of section 92E of the Act, discussion on Master File is avoided. To learn more on this other materials may be studied.

Documentation and Verification

10DA. (1) Every person, being a constituent entity of an international group shall,—

- (i) if the consolidated group revenue of the international group, of which such person is a constituent entity, as reflected in the consolidated financial statement of the international group for the accounting year, exceeds five hundred crore rupees; and
- (ii) the aggregate value of international transactions,—
 - (A) during the accounting year, as per the books of account, exceeds fifty crore rupees, or
 - (B) in respect of purchase, sale, transfer, lease or use of intangible property during the accounting year, as per the books of accounts, exceeds ten crore rupees

keep and maintain the following information and documents of the international group, namely:—

- a) a list of all entities of the international group along with their addresses;
- b) a chart depicting the legal status of the constituent entity and ownership structure of the entire international group;
- c) a description of the business of international group during the accounting year including,—
 - (I) the nature of the business or businesses;
 - (II) the important drivers of profits of such business or businesses;
 - (III) a description of the supply chain for the five largest products or services of the international group in terms of revenue and any other products including services amounting to more than five per cent of consolidated group revenue;
 - (IV) a list and brief description of important service arrangements made among members of the international group, other than those for research and development services;
 - (V) a description of the capabilities of the main service providers within the international group;
 - (VI) details about the transfer pricing policies for allocating service costs and determining prices to be paid for intra-group services;
 - (VII) a list and description of the major geographical markets for the products and services offered by the international group;
 - (VIII) a description of the functions performed, assets employed and risks assumed by the constituent entities of the international group that contribute at least ten per cent of the revenues or assets or profits of such group; and

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- (IX) a description of the important business restructuring transactions, acquisitions and divestments;
- d) a description of the business of international group during the accounting year including,—
 - e) a list of all entities of the international group engaged in development and management of intangible property along with their addresses;
 - f) a list of all the important intangible property or groups of intangible property owned by the international group along with the names and addresses of the group entities that legally own such intangible property;
 - g) a list and brief description of important agreements among members of the international group related to intangible property, including cost contribution arrangements, principal research service agreements and license agreements;
 - h) a detailed description of the transfer pricing policies of the international group related to research and development and intangible property;
 - i) a description of important transfers of interest in intangible property, if any, among entities of the international group, including the name and address of the selling and buying entities and the compensation paid for such transfers;
 - j) a detailed description of the financing arrangements of the international group, including the names and addresses of the top ten unrelated lenders;
 - k) a list of group entities that provide central financing functions, including their place of operation and of effective management;
 - l) a detailed description of the transfer pricing policies of the international group related to financing arrangements among group entities
 - m) a copy of the annual consolidated financial statement of the international group; and
 - n) a list and brief description of the existing unilateral advance pricing agreements and other tax rulings in respect of the international group for allocation of income among countries.

The information and document specified under sub-rule (1) shall be furnished to the Joint ^{3A}[Director] referred to in sub-rule (1) of rule 10DB, in Form No. 3CEAA on or before the due date for furnishing the return of income as specified under sub-section (1) of section 139.

The constituent entity shall furnish Part A of Form No. 3CEAA even if the conditions specified under sub-rule (1) are not satisfied.

Documentation and Verification

Country by Country Reporting (CbCR)³

7.96 Section 286 read with Rule 10DB contains detail provision with respect preparation and submission of CbCR. The provision requires every constituent entity of an international group having turnover of 6400 crores or more to furnish following information:

- (a) whether it is the alternate reporting entity of the international group; or
- (b) the details of the parent entity or the alternate reporting entity, if any, of the international group, and the country or territory of which the said entities are resident.

Sub-section (2) of the said section provides that every alternate reporting entity or the parent entity needs to furnish a report within 12 months from the end of accounting year-. Subsection (4) also provide that any entity other than entity referred to in subsection (2) also needs to furnish the said report in cases where.

- (a) where the parent entity is not obligated to file the report of the nature referred to in sub-section (2);
- (aa) with which India does not have an agreement providing for exchange of the report of the nature referred to in sub-section (2); or
- (b) there has been a systemic failure of the country or territory and the said failure has been intimated by the prescribed authority to such constituent entity:

7.97 Rule 10DB provides rules in respect of furnishing of Report

The various requirements for filing the report are as per the various sub-rules of Rule 10DB:

"(1) The income-tax authority for the purposes of section 286 shall be the Joint Director as may be designated by the Principal Director General of Income-tax (Systems) or the Director General of Income-tax (Systems), as the case may be.

(2) The notification under sub-section (1) of section 286 shall be made in Form No. 3CEAC two months prior to the due date for furnishing of report as specified under sub-section (2) of said section.

(3) Every parent entity or the alternate reporting entity, as the case may be, resident in India, shall, for every reporting accounting year, furnish the report referred to in sub-section (2) of section 286 in Form No. 3CEAD.

³ As in respect of Master File

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(4) The period for furnishing of the report under sub-section (4) of section 286 by the constituent entity referred to in that sub-section shall be twelve months from the end of the reporting accounting year:

Provided *that in case the parent entity of the constituent entity is resident of a country or territory, where, there has been a systemic failure of the country or territory and the said failure has been intimated to such constituent entity, the period for submission of the report shall be six months from the end of the month in which said systemic failure has been intimated.*

(5) The information required to be conveyed under proviso to sub-section (4) of section 286 regarding the designated constituent entity shall be furnished in Form No. 3CEAE.

The report required to be furnished shall include following:

- (a) the aggregate information in respect of the amount of revenue, profit or loss before income-tax, amount of income-tax paid, amount of income-tax accrued, stated capital, accumulated earnings, number of employees and tangible assets not being cash or cash equivalents, with regard to each country or territory in which the group operates;
- (b) the details of each constituent entity of the group including the country or territory in which such constituent entity is incorporated or organised or established and the country or territory where it is resident;
- (c) the nature and details of the main business activity or activities of each constituent entity; and
- (d) any other information as may be prescribed.

Chapter 8

Penalties

Introduction

To ensure the compliances with regard to transfer pricing provisions, various penalty provisions are provided in the law. As per Para 4.5 of OECD TP Guidelines 2017, the three aspects which often impact on how tax administrations determine their administrative response to ensure compliances with their own transfer pricing rules are: examination practices, the burden of proof, and penalty system. Para 4.19 of OECD TP Guidelines 2017 provides that no-fault penalty is against the principles of legal systems of many jurisdictions. The Indian Income-tax Act provides the following penalties for non-compliance of transfer pricing provisions.

Penalty for concealment of income or furnishing inaccurate particulars thereof¹

8.1 The erstwhile section 271(1)(c)(iii) provides that if the Assessing Officer or the Commissioner (Appeals) or the Principal Commissioner or Commissioner is satisfied that any person has concealed the particulars of his income or furnished inaccurate particulars of such income, he may direct that such person shall pay by way of penalty, in addition to any tax payable by him, a sum which shall not be less than, but which shall not exceed three times, the amount of tax sought to be evaded by reason of the concealment of particulars of his income or the furnishing of inaccurate particulars of such income.

8.2 Explanation 7, was inserted to the aforesaid section by Finance Act, 2001 with effect from April 1, 2002. This explanation is invoked only when any amount is added or disallowed in computing the total income under section 92C(4). The explanation provides that the amount added/disallowed under this section (i.e., any addition on account of international transaction) shall be deemed to represent the income in respect of which particulars have been concealed or inaccurate particulars have been furnished.

¹ Omitted vide Finance Act 2016

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8.3 The explanation creates a rebuttable presumption of concealment or furnishing of inaccurate particulars. The burden of rebuttal is on the assessee and it does not shift to the Department. The assessee is required to prove that he has acted in good faith and with due diligence. If it is so proved, the addition/disallowance shall not be deemed to represent concealed income/inaccurate furnishing of particulars of income.

8.4 While Section 273B states that no penalty shall be imposed if the assessee proves that there was a reasonable cause for the said failure, however given that the provisions of section 273B do not apply to a penalty under section 271(1)(c), the assessee must discharge the burden laid down in Explanation 7 only to contest the non-imposition of penalty under the said section.

8.5 For non-imposition of the penalty under this section, the explanation requires the assessee to prove that the price charged or paid was computed in good faith and with due diligence.

8.6 The aforesaid section was further amended with effect from FY 2012-13 to include therein the reference of specified domestic transactions.

Penalty for under reporting and misreporting of income

8.7 Section 271(1)(c) was deleted by the Finance Act 2016 and in its place section 270A was inserted which is applicable from 1 April 2017. It seeks to levy penalty for under-reporting and misreporting of income.

8.8 Section 270A (7) of the Act prescribes a penalty of 50% of the amount of tax payable on the under-reported income. Further, Section 270A(6)(d) provides that the under-reported income for the purpose of Section 270A shall not include the amount of under-reported income represented by any addition made in conformity with the arm's length price determined by the Transfer Pricing Officer, where the assessee had:

- a) maintained information and documents as prescribed under section 92D,
- b) declared the international transaction under Chapter X, and,
- c) disclosed all the material facts relating to the transaction.

8.9 Section 270A(8) of the Act provides that where under-reported income is in consequence of any misreporting thereof by any person, the penalty shall be equal to two hundred per cent of the amount of tax payable on under-reported income. Section 270A(9)(f) of the Act provides that the

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case of misreporting of income shall include failure to report any international transaction or any transaction deemed to be an international transaction or any specified domestic transaction, to which the provisions of Chapter X apply.

Immunity from imposition of penalty

8.10 Section 270AA was inserted by the Finance Act 2016 which is applicable from 1 April 2017. It seeks to grant immunity from imposition of penalty.

8.11 Section 270AA provides that an assessee may make an application to the Assessing Officer to grant immunity from imposition of penalty under section 270A, where the assessee had (a) paid the tax and interest payable as per the order of assessment or reassessment under sub-section (3) of section 143 or section 147 within the period specified in notice of demand, and, (b) no appeal against the order referred to in clause (a) has been filed.

Section 270AA(2) of the Act provides that application shall be made within one month from the end of the month in which the order referred to in clause (a) of sub-section (1) has been received and shall be made in such form as prescribed.

8.12 The immunity is granted only after fulfilment of the conditions specified in Section 270AA(1) of the Act and after the expiry of the period of filing the appeal as specified in clause (b) of sub-section (2) of section 249. No immunity is granted in case of any proceedings for penalty initiated under the circumstances referred to in sub-section (9) of the said section 270A i.e., for under-reporting as a consequence of misreporting.

Penalty for failure to keep and maintain information and documents in respect of international transaction or specified domestic transaction

8.13 Section 271AA relates to penalty for failure to keep and maintain information and document in respect of international transactions or specified domestic transactions.

Section 271AA was substituted by a new section with effect from 1-7-2012. It provides that without prejudice to the provisions of section 270A or section

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271 or Section 271BA, if any person in respect of an international transaction or specified domestic transaction:

- (a) fails to keep and maintain prescribed documents and information as required by sub-section (1) or sub-section (2) of section 92D;
- (b) **fails to report any such transaction** which is required to be reported; or
- (c) maintains or furnishes any incorrect information or documents

the Assessing Officer or Commissioner (Appeals) may direct that such person shall pay, by way of penalty, a sum equal to two percent of the value of each international transaction/Specified domestic transaction entered into by such person.

Further, Section 271AA(2) inserted vide Finance Act 2016 prescribes penalty for failure to furnish master file by the prescribed due date as INR 5,00,000.

8.14 The above provision is without prejudice to section 270A or section 271 and Section 271BA and is invoked when 'any person' fails to keep and maintain any such information and document as required by section 92D (1) and (2) or fails to report any international transaction/ specified domestic transaction or maintains or furnishes any incorrect information or documents.

8.15 Thus, whether or not an international transaction or specified domestic transaction is determined at arm's length price, any person who has entered into such transaction, shall keep and maintain the information/document in respect of such transaction.

8.16 The penalty is invoked for failure to keep and maintain such information/documents or report the same. In other words, the person who has entered into international transaction or specified domestic transaction should both keep as well as maintain such information/documents as well as report the same. Any failure in respect of the same attracts a penalty of 2% of the value of each international transaction or specified domestic transaction entered into by him. Also, this penalty would be in addition to the penalties in section 271BA (i.e., Penalty for failure to furnish report under section 92E) and 271G (Penalty for failure to furnish information or document under section 92D).

Penalty for failure to furnish report under section 92E

8.17 Section 271BA provides that if any person fails to furnish a report from an accountant as required by section 92E, the Assessing Officer may direct that such person shall pay, by way of penalty, a sum of one hundred thousand rupees.

8.18 This penalty is invoked if any person fails to furnish a report from an accountant and the same may be levied by the Assessing Officer. The penalty shall be a sum of INR 1 lakh.

Penalty for failure to furnish information or document under section 92D

8.19 Section 271G provides that if any person who has entered into an international transaction or specified domestic transaction fails to furnish any such information or document as required by sub-section (3) of section 92D, the Assessing Officer or the Transfer Pricing Officer as referred to in section 92CA or the Commissioner (Appeals) may direct that such person shall pay, by way of penalty, a sum equal to two percent, of the value of the international transaction or specified domestic transaction for each such failure.

8.20 The aforesaid section has been further amended with effect from FY 2012-13 to include therein the reference of specified domestic transactions.

Penalty for failure to furnish information or documents under Section 286

8.21 Finance Act 2016 introduced Section 286 which requires parent entity or the alternative reporting entity, resident in India, to furnish a prescribed report within a period of twelve months from the end of the reporting accounting year.

Section 271GB of the Act provides for penalty for failure to furnish the report as prescribed under Section 286 (i.e. Country-by-country report). The penalty prescribed under Section 271GB are as follows:

Nature of penalty	Penalty (INR)
Failure to furnish the prescribed	

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Nature of penalty	Penalty (INR)
report required to be maintained by the India parent entity or alternate reporting entity in India of the international group:	
a. Where period of failure is equal to or less than 1 month	5,000 per day
b. Where period of failure is greater than 1 month	15,000 per day
c. Continuing default after service of penalty order	50,000 per day
Furnishing of inaccurate particulars (subject to certain conditions)	5,00,000
Failure to produce the information and documents within 30 days (extendable by maximum 30 days)	5,000 per day upto service of penalty order 50,000 per day for default beyond date of service of penalty order

Penalty for furnishing incorrect information in reports and certificates

8.22 The Finance Act, 2017 has introduced penalty on accountants, merchant bankers and registered valuers for furnishing incorrect information in reports and certificates issued under any provisions of the Act, by inserting section 271J to the Act.

In order to ensure that the person furnishing report or certificate undertakes due diligence before making such certification, section 271J provides that if an accountant or a merchant banker or a registered valuer, furnishes incorrect information in a report or certificate under any provisions of the Act or the rules made thereunder, the Assessing Officer or the Commissioner (Appeals) may direct him to pay a sum of ten thousand rupees for each such report or certificate by way of penalty.

For the purpose of this section,

- (a) "accountant" means an accountant referred to in the *Explanation* below sub-section (2) of [section 288](#);

Penalties

- (b) "merchant banker" means Category I merchant banker registered with the Securities and Exchange Board of India established under section 3 of the Securities and Exchange Board of India Act, 1992 (15 of 1992);
- (c) "registered valuer" means a person defined in clause (oaa) of section 2 of the Wealth-tax Act, 1957 (27 of 1957).

EXPOSURE DRAFT

Chapter 9

Scope of Examination under Section 92E

Report under section 92E

9.1 According to section 92E every person who has entered into an international transaction or specified domestic transaction 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. The report is to be given by an Accountant in Form No.3CEB as prescribed under Rule 10E. The Income Tax rules have been amended to require the filing of the said report to be done electronically. The scope, as envisaged by section 92E, is restricted to examination of accounts and records of the Assessee relating to the international transaction or specified domestic transaction entered into by the Assessee during the previous year under examination.

9.2 Further, the Accountant has to give his opinion whether “proper information and documents as are prescribed” have been kept by the Assessee in respect of the international transactions or specified domestic transaction entered into by him. The examination under section 92E is not an audit requiring opinion of the Accountant on the true and fair view of the financial statements of the enterprise.

9.3 The report consists of three paragraphs dealing with distinct aspects as summarised hereunder:

The first paragraph contains declaration about examination of the accounts and records of the Assessee in order to review the international transaction(s) and the specified domestic transaction(s).

The second paragraph involves rendering of an opinion whether proper information and documents as are prescribed under Rule 10D are maintained by the Assessee in respect of the identified international transactions and the specified domestic transaction(s), on the basis of the details furnished in Annexure to Form No.3CEB.

Scope of Examination under Section 92E

The third and the last paragraph requires expression of the opinion whether the particulars given in the Annexure to Form No.3CEB are **true and correct**.

9.4 Examination of accounts and records

Form No.3CEB

****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 transactions entered into by the Assessee during the previous year ending on 31st March,***

[Paragraph 1]

9.5 The expression “accounts and records” appearing in the report should normally refer to those accounts and records which are to be examined solely in relation to the international transactions and the specified domestic transactions entered into by the Assessee during the relevant previous year. As the expression “accounts and records” are limited to those pertaining to international transactions and the specified domestic transactions only, the said report does not require the Accountant to certify the true and fair view of the financial statements of the enterprise. Therefore, he should restrict his examination to such details and matters that in his opinion are sufficient to determine whether proper documents have been maintained with respect to international transactions and the specified domestic transactions and whether the particulars disclosed in the annexure are true and correct.

The extent of examination of the said accounts and records is a matter of professional judgment of the Accountant. However, while the Accountant is expected to make specific inquiries as regards various matters that are the subject of the Form No 3CEB, his work often comprises checking, by the application of materiality principles and on a test basis, the evidence supporting the information presented in the Form No 3CEB. Particularly in cases where the Accountant is relying on financial statements of the Assessee audited by another auditor, it is reasonable to rely on the correctness of information contained in such audited financial statements, including as regards its completeness, unless there are any obvious or significant discrepancies. In the event of such discrepancies, the Accountant would need to obtain necessary information, explanations and reconciliations as may be required from the Assessee, and report on that basis.

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The Accountant can rely upon the values of the international transactions and the specified transactions reported in the financial statements / tax audit report of the Company. However, the auditor should undertake due diligence to assess the reasonableness of the value reported therein (by undertaking test checks) and also obtain a representation from the management of the company in this regard.

9.6 The Accountant should obtain from the Assessee a complete list of “accounts and records” maintained by him (both financial and non-financial records) and identify those that need to be produced before him for examination. He should further obtain suitable representation as regards the completeness of the “accounts and records” from the Assessee.

9.7 Where the certifying Accountant is not the statutory auditor of the Assessee he should take the precaution of clearly stating in his report that the figures from the audited general purpose financial statements have been used and relied upon. The Accountant may obtain a written representation from the Assessee on the reconciliation between the figures appearing in his report and the figures appearing in the general-purpose financial statements (as provided in the “Guidance Note on Reports and Certificates for Special Purposes” (Revised 2016)). Further, the Accountant can clearly state that he has relied upon the work performed by the other auditors.

9.8 In conducting the review and examination the Accountant will have to use his professional skill and expertise and apply such audit tests as the circumstances of the case may require. He may apply such tests/sampling techniques as may be deemed proper depending on the internal control procedures followed by the Assessee. The Accountant will also have to keep in mind the concept of materiality depending on the circumstances of each case. He would be well advised to refer to Standards on Auditing as well as the guidance notes issued by the Institute.

9.9 Ensuring completeness of the listing of international transactions and specified domestic transactions is the responsibility of the Assessee. The Assessee should maintain a comprehensive detail of every international transaction and specified domestic transaction. The Accountant should use his professional skill and expertise and apply such tests as the circumstances of the case may require to examine whether the same meets the requirement of law. Further, in relation to the deemed international transactions, the primary responsibility of identification / analyzing such transaction rests with the assessee. It is worthwhile to note that w.e.f. FY 2014-15, transactions of the assessee with an Indian company are also

Scope of Examination under Section 92E

covered within the ambit of 'deemed international transaction'. The Accountant should obtain a representation from the management of the Assessee as to completeness of the listing of such transactions. However, the Accountant should exercise his professional judgment in this regard.

9.10 The Accountant should obtain a written representation from the Assessee providing him with the name, address, legal status and country of tax residence of each of the enterprises with whom international transactions and the specified domestic transactions have been entered into by the Assessee, and association linkages among them.

9.11 Maintenance of proper information and documents

"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".

9.12 In paragraph 2 of the report the Accountant is required to give his opinion on the Assessee's compliance with the documentation requirements prescribed under Rule 10D. The Accountant should review the documents and records pertaining to international transactions and the specified domestic transactions of the Assessee and compare the same with those prescribed under Rule 10D to form an opinion.

9.13 If the Accountant is satisfied that specified records have been properly maintained by the Assessee then the certification may be done without any qualification. If any document is not maintained or if any qualification or a note as part of emphasis on matter is given in the financial statement by the statutory auditor of the Assessee, then the Accountant should suitably qualify his report or disclose the same in his report depending upon the facts and circumstances of each case. The Accountant should state the qualification in the report making it comprehensive and self-explanatory. In this regard the Accountant should follow principles enshrined in the SA 700(Revised) "Forming an Opinion and Reporting on Financial Statements", SA 705 (Revised) Modifications to the Opinion in the Independent Auditor's Report and SA 706 (Revised) Emphasis of Matters Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report.

9.14 An Assessee in whose case the aggregate value of international transaction as recorded in the books of account does not exceed INR1 crore in aggregate, there is a relief provided under sub-rule (2) of Rule 10D from

Guidance Note on Report under Section 92E of the Income-tax Act, 1961

maintaining the specified information and documents. However, the proviso thereunder necessitates such an Assessee to substantiate that income or expense as the case may be arising from international transactions has been computed in accordance with section 92 on the basis of material in his possession. Therefore, the Accountant should verify in such cases whether there is any material available with the Assessee in this regard and if available the details thereof needs to be examined. The Accountant shall, in such cases, express his opinion with or without qualification by exercising his professional judgement after verification of the material produced for such examination.

The said rule does not provide any such relief by way of monetary threshold for the purposes of maintaining the information and documents in respect of the specified domestic transactions. Accordingly, where the aggregate of the specified domestic transactions during a previous year exceeds Rs. 20 crores, there would be an obligation to maintain specified information and documents as per sub rule (1) of Rule 10D.

9.15 Certification regarding particulars in Annexure

“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”.

9.16 Paragraph 3 of Form No.3CEB provides that the particulars required to be furnished under section 92E are given in the Annexure to this Form and whether in the Accountant's opinion and to the best of his information and according to the explanations given to him, they are true and correct. As mentioned above, the particulars should be obtained from the Assessee, duly authenticated, which should be reviewed by the Accountant. In case of any negative remark or qualification about this matter, the same should be properly reported.

9.17 The Accountant must limit his scope of work and the review procedures to the extent certified in Form No.3CEB. For e.g. in the Annexure the method which has been used to determine the arm's length price needs to be stated. In this context the Accountant is only required to ensure that the method stated as being used to determine the arm's length price by the Assessee has actually been used and it is not the Accountant's responsibility

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to ensure that the method so used is the most appropriate method as prescribed by the Board.

9.18 The Accountant may mention in the report, wherever necessary, that the correctness has been ensured only to the extent that the Accountant has carried out an examination and further that the certificate is subject to the notes stated against the relevant clauses or Annexure to Form No.3CEB.

9.19 The statutory auditor of the Assessee has to report that the financial statements audited by him give a 'true and fair' view. The requirement in paragraph 3 of Form No.3CEB relating to particulars in Annexure to Form No.3CEB is that the Accountant should report that these particulars are "true and correct". The terminology "true and fair" is widely understood though not defined even by the Companies Act, 2013. On the other hand, the words "true and correct" lay emphasis on factual accuracy of the information. In this context reference is invited to AS-1 and AS(IT)-I relating to disclosure of accounting policies. These standards recognise that the major considerations governing the selection and application of accounting policies are (i) prudence, (ii) substance over form and (iii) materiality. Therefore, while examining the particulars in the Annexure to Form No.3CEB these aspects should be kept in view. In particular, considering the nature of particulars to be examined in the Annexure to Form No.3CEB, the aspect of materiality should be considered. In other words qualifications may be given only in respect of material items as envisaged by the Accountant.

Other aspects

Online filing of Form 3CEB

9.20 From AY 2012-13, CBDT has made it mandatory for enterprises to file their Form 3CEB online, with a view to make the process faster and less error prone. However, the online filing mode does not provide for a facility for documenting notes by the Accountant in each of the relevant clauses or Annexure to Form No.3CEB.

9.21 In order to document the position adopted while certifying the Form 3CEB, the Accountant may issue a memo / written document to the enterprise presenting his/ her notes against the relevant clauses or Annexure to Form No.3CEB.

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The Assessee thereafter at his discretion may consider filing the Form 3CEB along with the notes applicable to the relevant clauses or Annexure to Form No. 3CEB, with the Indian tax department to support the position adopted while filing Form No. 3CEB online by an Accountant.

Form 3CEB in case of a permanent establishment of an overseas enterprise

9.22 In the case of an permanent establishment of an overseas enterprise, the clauses of Rule 10D(1) would apply to the extent relevant. Data which is not relevant may not be required to be maintained. The Accountant should rely on his professional judgement to verify the relevance and the extent of details available with the permanent establishment as per Rule 10D(1) in order to establish the arm's length price.

Annexure to Form No.3CEB

9.23 The statement of particulars given in the Annexure to Form No.3CEB contains twenty five clauses. The Accountant has to report whether the particulars furnished in Form No.3CEB are true and correct.

9.24 As stated earlier, the Accountant should obtain a duly authenticated statement of particulars in Annexure to Form No.3CEB from the Assessee. It would be advisable for the Assessee to take into consideration the following general principles while preparing the Annexure:

- (a) He can rely upon the judicial pronouncements while taking any particular view about inclusion or exclusion of any items in the particulars to be furnished under any of the clauses specified in the Annexure.
- (b) If there is a conflict of judicial opinion on any particular issue, he may refer to the view, which has been followed while giving the particulars under any specified clause.
- (c) The Accounting Standards (AS), Guidance Notes, Standards on Auditing (SA) issued by the Institute from time to time should be followed, to the extent applicable.

9.25 While verifying the truth and correctness of the particulars in Annexure to Form No.3CEB it would be advisable for the Accountant to consider the following:

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- (a) If a particular item is covered in more than one of the specified clauses in the Annexure, care should be taken to make a suitable cross reference to such items at the appropriate places.
- (b) If there is any difference in the opinion of the Accountant and that of the Assessee in respect of any information furnished in the Annexure, the Accountant should state both the view points and also the relevant information in order to enable the tax authority to take a decision in the matter.
- (c) If any particular clause in the Annexure is not applicable, the Accountant should state that the same is not applicable.
- (d) In examining the particulars furnished in the Annexure, the Accountant should keep in view the law applicable in the relevant year, even though the form of report may not have been amended to bring it in conformity with the amended law.
- (e) The information in the Annexure should be based on the books of account, records, documents, information and explanations made available to the Accountant for his examination.
- (f) The Annexure should be signed by the Accountant after he has completed his procedures on the particulars given/to be given in the Annexure.

9.26 Particulars to be furnished in the Annexure

PART A

1. **Name of the Assessee :**
2. **Address :**
3. **Permanent account number :**
4. **Nature of business or activities of the Assessee***
5. **Status :**
6. **Previous year ended :**
7. **Assessment year :**
8. **Aggregate value of international transactions as per books of accounts**
9. **Aggregate value of specified domestic transactions as per books of accounts**

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**Code for nature of business to be filled in as per instructions for filing Form ITR 6*

9.27 Under clause (1) the name of the Assessee whose accounts and records are being examined under section 92E should be given. However, if the examination is in respect of a branch, name of such branch should be mentioned along with the name of the Assessee (in case a separate branch certificate is done).

9.28 The address to be mentioned under clause (2) should be the same as has been communicated by the Assessee to the Income-tax Department for assessment purposes as on the date of signing of the Form. If the examination is in respect of a permanent establishment of an overseas enterprise including branch or a unit, the address of the branch or the unit should be given. In the case of a company, the address of the registered office should also be stated. In the case of a new Assessee, the address should be that of the principal place of business.

9.29 Under clause (3) the permanent account number (PAN) allotted to the Assessee should be indicated. If the Assessee has not been allotted the permanent account number as on the date of signing of the Form, that fact should be indicated. Where PAN is not known/allotted but the general index register number (GIR) is available, the same may be given.

9.30 Under clause (4) the code for nature of business is to be provided as per the instructions for filling form ITR 6.

9.31 Under clause (5) the status of the Assessee is to be mentioned. This refers to the different classes of Assessee included in the definition of "person" in section 2(31) of the Act, namely, individual, Hindu undivided family, company, firm, an association of persons or a body of individuals whether incorporated or not, a local authority or artificial juridical person. Furthermore, a person has been defined as 'including a permanent establishment of such person', i.e. even a branch or a project office. In case of any violations by a liaison office it may come under the purview of this clause and hence, the same should be disclosed. Further, in case of disputes regarding status of the Assessee, the full facts should be mentioned.

9.32 Under clause (6), since the previous year under the Act uniformly ends on 31st March, the relevant previous year should be mentioned.

9.33 Under clause (7) the assessment year relevant to the previous year for which the accounts and records are being examined should be mentioned.

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9.34 Under clause (8) & (9), the aggregate value of international transactions and specified domestic transactions as per books of accounts should be mentioned.

PART B

9.35 10. List of associated enterprises with whom the Assessee has entered into international transactions, with the following details:

- (a) **Name of the associated enterprise.**
- (b) **Nature of the relationship with the associated enterprise as referred to in section 92A(2).**
- (c) **Brief description of the business carried on by the associated enterprise.**

9.36 The Assessee is required to furnish by way of an attachment, a complete list of associated enterprises, duly certified by the authorised person (partner, trustee, managing director etc. depending on the definition of Assessee) with whom the Assessee has entered into international transactions during the previous year. The terms 'associated enterprises' and 'international transactions' have been defined in detail in sections 92A and 92B of the Act, respectively. If an enterprise was 'associated' with the Assessee for a part of the previous year, details should be furnished with respect to that period of the previous year.

In this connection, the Assessee has to maintain a register with the list of the transactions and the relevant details. The Accountant can rely on the information provided in the register of associated enterprise for completing his work.

9.37 The particulars in this clause should be examined on test check basis from an instrument or agreement or any other document evidencing the association of enterprises including any supplementary documents related thereto. In this connection the Accountant has to, based on his best judgement, determine the sampling approach and design the nature and timing of the audit tests.

9.38 In preparing the list of the associated enterprises, it is possible that the extent of association may not be precisely ascertainable during the previous year, i.e. it may be indeterminate or unknown, resulting in a situation whereby the Assessee is not in a position to conclude as to whether any particular entity is covered under the definition of 'associated enterprise',

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as detailed in section 92A of the Act. In such circumstances, it is advisable both from the viewpoint of the Assessee and the Accountant's perspective that the relevant fact be stated in the Annexure or in the notes, as the case may be, and reference to same be made, if considered significant, in the Accountant's report. The Assessee could source required data from the master file or CbC report, wherever applicable.

9.39 In certain cases the enterprises may be associated in more than one manner. Since there is no different treatment for any particular form of association, it may be sufficient if the Assessee details any particular relationship with the associated enterprise under clause 10(b). Although the Assessee may be advised to detail all the relationships, disclosure of any one relationship is considered sufficient from a compliance perspective.

9.40 The Accountant should obtain a written representation from the Assessee detailing the business of the associated enterprises with whom the Assessee has transacted. Further, since the completeness of the list of the associated enterprises and transactions with them is the primary responsibility of the Assessee, the Accountant should obtain suitable written representation from the management (Board of directors or its equivalent).

9.41 The Accountant may be advised to use his professional skill and expertise, in determining the scope of work to be performed with respect of getting reasonable comfort on the Assessee's list of international transactions with associated enterprises. The Accountant should, however, be aware of the possibility that transactions with associated enterprises may have been influenced in large measure by conditions similar to the following :-

- (a) Lack of sufficient working capital or credit to continue the business;
- (b) An urgent desire for a continued favorable earnings record in the hope of supporting the price of the Assessee's share price, if any;
- (c) An overly optimistic earnings forecast;
- (d) Dependence on a single or relatively few products, customers, or transactions for the continuing success of the venture;
- (e) A declining industry characterised by a large number of business failures;
- (f) Excess capacity;
- (g) Significant litigation, especially litigation between stockholders and management; or

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- (h) Significant obsolescence dangers because the Assessee is in a high-technology industry.

9.42 The Accountant should place emphasis on test checking material transactions with enterprises associated to the Assessee. Certain relationships, such as parent-subsidiary or investor-investee, may be clearly evident. Determining the existence of others requires the application of certain procedures, which may include the following:

- (a) Evaluate the Assessee's procedures for identifying and properly accounting for international transactions;
- (b) Request from appropriate management personnel the names of all associated enterprises and inquire whether there were any transactions with these enterprises during the period;
- (c) Review filings by the reporting entity with regulatory agencies for the names of associated enterprises and for other businesses in which officers and directors occupy directorship or management positions; (example director's representations on transactions under sections 297, 299 etc.);
- (d) Review stockholder listings of closely held companies to identify principal stockholders;
- (e) Enquire, where possible and considered essential of predecessor, principal, or other Accountants/Accountants of associated enterprises concerning their knowledge of existing relationships and the extent of management involvement in material transactions;
- (f) Review material investment transactions during the period under review to determine whether the nature and extent of investments during the period create associated enterprises; and
- (g) Review the mandatory related party disclosure in the audited financial (AS 18) [The definition of Associated Enterprise u/s. 92A in relation to the International Transactions is different than the definition of related party under AS 18 and therefore the Accountant should review the Associated Enterprises for the purpose of section 92A independently].

9.43 Although it is the responsibility of the Assessee to furnish a complete list of associated enterprises and international transactions, the Accountant must exercise reasonable care to ensure that prima facie and, based on the information that is made available to him, the list of associated enterprises

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and list of international transactions furnished by the Assessee is reasonably complete based on financial statements and books of accounts. Further, in order to ascertain whether the Assessee has entered into any transactions coming within the scope of sub-section (2) of section 92B, the Accountant should obtain appropriate management representation. For the purpose of furnishing the list of associated enterprises and international transactions, as envisaged in para 9.42 above, the Assessee may place reliance on the Master file / CbCR report as applicable.

9.44 11. Particulars in respect of transactions in tangible property :

A. Has the Assessee entered into any international transaction(s) in respect of purchase / sale of raw material, consumables or any other supplies for assembling / processing / manufacturing of goods/articles from/to associated enterprises?

Yes/No

If 'yes', provide the following details in respect of each associated enterprise and each transaction or class of transaction:

- (a) Name and address of the associated enterprise with whom the international transaction has been entered into.**
- (b) Description of transaction and quantity purchased/sold.**
- (c) Total 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.**
- (d) Method used for determining the arm's length price. [See section 92C(1)].**

9.45 Under this clause, the Assessee has to furnish details of international transactions in respect of inputs used in the course of assembling, processing and manufacturing. The items referred to in this clause are essentially materials worked upon or used in the course of the Assessee's business, namely, raw materials, components, assemblies and sub-assemblies, consumables, etc.

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When any of the aforesaid materials are sold before their consumption during the normal course of business, the details of these sales are also to be reported under clause 11A.

At times owing to practical difficulties quantitative details of the purchases and sales of raw materials/ consumables/ other supplies may not be available. In such a case, the Accountant should provide suitable clarificatory note.

B. *Has the Assessee entered into any international transaction(s) in respect of purchase / sale of traded / finished goods?*

Yes/No

If 'yes' provide the following details in respect of each associated enterprise and each transaction or class of transaction:

- (a) *Name and address of the associated enterprise with whom the international transaction has been entered into.*
- (b) *Description of transaction and quantity purchased/sold.*
- (c) *Total 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.*
- (d) *Method used for determining the arm's length price[See section 92C(1)]*

9.46 Under this clause, the Assessee has to furnish details of international transactions in respect of purchase/sales of traded goods and purchase/sales of finished goods.

C. *Has the Assessee entered into any international transaction(s) in respect of purchase, sale, transfer, lease or use of any other tangible property including transactions specified in Explanation (i)(a) below section 92B(2)?*

Yes/No

If 'yes' provide the following details in respect of each associated enterprise and each transaction or class of transaction :

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- (a) *Name and address of the associated enterprise with whom the international transaction has been entered into.*
- (b) *Description of the property and nature of transaction.*
- (c) *Number of units of each category of tangible property involved in the transaction.*
- (d) *Amount paid/received or payable/ receivable in each transaction of purchase/sale/transfer/use, or lease rent paid/ received or payable/receivable in respect of each lease provided/entered into:*
 - (i) *as per books of account.*
 - (ii) *as computed by the Assessee having regard to the arm's length price.*
- (e) *Method used for determining the arm's length price. [see section 92C(1)].*

9.47 Under this clause, the Assessee has to furnish details of purchase, sale, lease or use of any other tangible property.

12. Particulars in respect of transactions in intangible property:

Has the Assessee entered into any international transaction(s) in respect of purchase, sale, transfer, lease or use of intangible property including transactions specified in Explanation (i)(b) below section 92B(2)? Yes/No

If 'yes' provide the following details in respect of each associated enterprise and each category of intangible property:

- (a) *Name and address of the associated enterprise with whom the international transaction has been entered into.*
- (b) *Description of intangible property and nature of transaction.*
- (c) *Amount paid/received or payable/ receivable for purchase/sale/transfer/lease/use of each category of intangible property:*
 - (i) *as per books of account.*

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(ii) *as computed by the Assessee having regard to the arm's length price.*

(d) *Method used for determining the arm's length price. [see section 92C(1)].*

9.48 Under this clause, the Assessee has to furnish details about transaction involving not only commercial/business intangibles such know-how, patent, copyrights, marketing related, technology related, contract related, customer related intangibles but, where applicable even personal intangibles such as literary and artistic copyrights. Intangibles would also include human capital related, location related and goodwill related intangibles. Any other similar item that derives its value from its intellectual content rather than its physical attributes would also be included as an intangible. As all the intangibles referred to Explanation (ii) to Section 92B may not be separately accounted in the books of accounts the Accountant may need to rely on the transfer pricing documentation maintained by the Assessee under Rule 10D as well as obtain adequate representations from the management stating that all the international transactions relating to intangibles have been disclosed to the Accountant.

13. Particulars in respect of providing of services:

Has the Assessee entered into any international transaction(s) in respect of Services including transactions as specified in Explanation (i)(d) below section 92B(2)? Yes/No

If 'yes' provide the following details in respect of each associated enterprise and each category of service:

(a) *Name and address of the associated enterprise with whom the international transaction has been entered into.*

(b) *Description of services provided/availed of/ from the associated enterprise.*

(c) *Amount paid/received or payable/ receivable for the services provided/ taken.*

(i) *as per books of account.*

(ii) *as computed by the Assessee having regard to the arm's length price.*

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- (d) **Method used for determining the arm's length price. [See section 92C(1)].**

9.49 Under this clause, the Assessee has to furnish details about transactions that are in the nature of providing services to associated enterprises. The services contemplated under this clause include provision of market research, market development, marketing management, administration, technical, commercial, repairs, design, scientific research, legal or accounting service, etc. For example, if A Inc., USA (associated enterprise) out-sources its entire accounting function to B Ltd. (Indian subsidiary), such transaction needs to be reported under this clause.

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)?

Yes/No

If 'yes' provide the following details in respect of each associated enterprise and each loan/advance :

- (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.**

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(f) Method used for determining the arm's length price. [See section 92C(1)].

- 9.50 Under this clause, the nature of the financing arrangements i.e. term loan, medium term loan, short term loan, project finance, working capital arrangement, fixed asset financing facility, trade advances, non-convertible preference shares, etc. should be clearly mentioned. The currency denomination of the loan account should be clearly indicated in the form along with any conversion options and any forward cover contracts taken. The Assessee should disclose the interest rate applicable.

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? **Yes/No**

If Yes, please 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 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)].**

- 9.51 Under this clause, the nature of the guarantee i.e. whether corporate guarantee, etc. should be clearly mentioned. The compensation charged / paid should also be stated.

16. Particulars in respect of international transactions of purchase or sale of marketable securities, issue and buy back of equity shares, optionally convertible/ partially convertible/ compulsorily convertible debentures/ preference shares:

Has the Assessee entered into any international transaction(s) in respect of purchase or sale of marketable securities or issue of equity shares including transactions specified in Explanation (i)(c) below section 92B(2)? **Yes/No**

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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 transaction*
- (c) *Currency in which the transaction was undertaken*
- (d) *Consideration charged/ paid in respect of the transaction*
- (e) *Method used for determining the arm's length price [See section 92C(1)]*

9.52 Under this clause, the Assessee has to furnish details about transactions that are in nature of purchase or sale or marketable securities (for example commercial paper, banker's acceptances, treasury bills and other money market instruments) issue and buy back of equity shares, convertible debentures/ preference shares. Further, the Assessee is required to furnish details such as nature of transaction, currency, consideration charged/ paid as per books and method used for determination of arm's length price. The Government of India vide Instruction No. 2/2015 dated 29.01.2015 has accepted the decision of the Bombay High Court in the case of Vodafone India Service Private Limited [TS-308-HC2014(BOM)-TP-Vodafone India Services]. According to the said Instruction, the premium arising on issue of shares is a capital account transaction and does not give rise to income and, hence not liable to transfer pricing adjustment. However, it is noteworthy that explanation to section 92B and clause 16 of Form No 3CEB continue to require the assessee's to disclose the transaction relating to issue of shares.

Since as per the said Instruction, issue/ allotment of equity shares including at premium to non-resident does not give rise to income under section 92 of the Act, this transaction may not be required to be reported under section 92E read with Rules.

17. *Particulars in respect of mutual agreement/ arrangement:*

Has the Assessee entered into any international transaction with an associated enterprise or enterprises by way of a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be

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incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises? Yes/No

If 'yes' provide the following details in respect of each agreement/arrangement:

- (a) *Name and address of the associated enterprise with whom the international transaction has been entered into.*
- (b) *Description of such mutual agreement or arrangement.*
- (c) *Amount paid/received or payable/ receivable in each such transaction:*
 - (i) *as per books of account.*
 - (ii) *as computed by the Assessee having regard to the arm's length price.*
- (d) *Method used for determining the arm's length price. [See section 92C(1)]*

9.53 Under this clause, the Assessee has to furnish the details of international transactions pertaining to cost contribution/sharing agreements and mutual arrangements for cost allocation or apportionment thereof.

18. Particulars in respect of international transactions arising out/ being part of business restructuring or reorganizations:

Has the Assessee entered into any international transaction(s) arising out/being part of any business restructuring or reorganization entered into by it with the associated enterprise or enterprises as specified in Explanation (i) (e) below section 92B (2) and which has not been specifically referred to above?

Yes/No

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 transaction*
- (c) *Agreement in relation to such business restructuring/ reorganization*

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- (d) **Terms of business restructuring/ reorganization**
- (e) **Method used for determining the arm's length price [See section 92C(1)]**

9.54 Under this clause, the Assessee has to furnish the details of international transaction with respect business restructuring or reorganization. The Assessee is required to furnish details such as details of AE with whom such transaction has been entered into, nature of transaction and method used for determination of arm's length price.

19. Particulars in respect of any other transaction including the transaction having a bearing on the profits, incomes, losses, or assets of the Assessee:

Has the Assessee entered into any other international transaction(s) including a transaction having a bearing on the profits, income, losses or assets, but not specifically referred to above, with associated enterprise? Yes/No

If 'yes' provide the following details in respect of each associated enterprise and each transaction:

- (a) **Name and address of the associated enterprise with whom the international transaction has been entered into.**
- (b) **Description of the transaction.**
- (c) **Amount paid/received or payable/ receivable in each such transaction:**
 - (i) **as per books of account.**
 - (ii) **as computed by the Assessee having regard to the arm's length price.**
- (d) **Method used for determining the arm's length price. [see section 92C(1)].**

9.55 Under this clause, the Assessee is required to furnish details of any other transaction having a bearing on profits, losses, income or assets i.e. it is a residual clause to cover any transaction which has not been covered in the preceding categories. Examples of these transactions could be reimbursement transactions or transactions which do not involve any charge (i.e. free of cost services or goods).

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These transactions should be identified and further notes could be provided to explain their nature.

20. Particulars of deemed international transaction:

Has the Assessee entered into any transaction with a person other than an AE in pursuance of a prior agreement in relation to the relevant transaction between such other person and the associated enterprise? Yes/No

If 'yes' provide the following details in respect of each of such agreement:

- (a) Name and address of the person other than the associated enterprise with whom the deemed international transaction has been entered into.***
- (b) Description of the transaction.***
- (c) 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.***
- (d) Method used for determining the arm's length price. [see section 92C(1)].***

9.56 Under this clause, the Assessee is required to furnish details with respect to the deemed international transactions. A discussion on what constitutes a deemed international transaction has already been provided in Para 4.5 and Para 4.6 above. The Assessee is required to furnish details such as description of the transaction, amount paid/ payable or received/ receivable, and the method used for determination of arm's length price.

9.57 The Accountant should examine the information provided by the Assessee, with the documents as he considers essential in connection with the details of nature and terms (including prices) of international transactions entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction.

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9.58 The Accountant should examine the information provided in the annexure by the Assessee, by using standard examining practices from the books of account maintained by the Assessee and from information and explanations obtained. He should also verify the information provided by the Assessee in the context of the understanding that he has of the Assessee's business. Further, in conducting the examination the Accountant will have to use his professional skill and expertise and apply such tests, based on materiality and sampling, as the circumstances of the case may require.

9.59 For verifying the correctness of the:

- (i) 'name and address of the associated enterprise with whom the international transaction has been entered into', and
- (ii) 'description of transaction and quantity purchased/sold'

the Accountant may examine any instrument or agreement or any other document (invoices, correspondence etc.) evidencing the transaction and may also verify the books of account of the Assessee.

9.60 For determining the correctness of the, 'total amount paid/ received or payable/receivable in the transaction as per books of account' the Accountant may, in addition to examining the information/documents detailed above, obtain a confirmation for material international transactions from each associated enterprise, if considered essential. Such confirmation may be undertaken to obtain evidence from third parties about assertions made by the Assessee in the annexure. In general, it is presumed that when evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent examination than that secured solely within the entity.

9.61 Confirmation requests can be designed to elicit evidence that addresses the completeness assertion: that is, if properly designed, confirmations may provide evidence to aid in assessing whether all transactions, accounts and amounts that should be included in the annexure are included. The Accountant may require the identified associated enterprise to seek confirmation from associated parties, the following with respect to the transactions entered into with the Assessee:

- (a) description of transaction and quantity purchased/sold;
- (b) total amount paid/received or payable/receivable in the transaction; and

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- (c) listing of all transactions without consideration, if any.

Additionally, obtaining of a confirmation from the associated enterprise would be more advisable in the event that the financial statements / books of account of the Assessee are yet to be audited.

9.62 With regard to the, 'total amount paid/received or payable/ receivable in the transaction as computed by the Assessee having regard to the arm's length price', the Accountant should get an authenticated declaration from the Assessee along with a computation statement regarding the total amount paid/received or payable/receivable in the transaction as well as the arm's length price as computed by the Assessee.

9.63 With regard to the, 'method used for determining the arm's length price', the Accountant is at no point of time required to suggest the most appropriate method to determine the arm's length price nor is he required to assign any value to any transaction. As stated earlier, the computation of the arm's length prices and the selection of the most appropriate method is the responsibility of the Assessee and the Accountant only needs to verify the same to ensure that they are in accordance with the accounts and records maintained by the Assessee and that the same are true and correct.

9.64 Clauses 11 to 18 and clause 20 of Annexure to Form No.3CEB list typical transactions that generally take place. However, these are not exhaustive and if there are any international transactions that are not specifically covered by these clauses, the particulars as required under clause 19 (in case of any other international transactions) should be furnished in respect of such international transactions.

Further, in case the Assessee has entered into transactions involving cost reimbursements or transfer of assets, free of cost receipts of services, free of charge, it is recommended that the Accountant may identify these transactions in the Form No.3CEB and provide notes to explain their nature.

9.65 It may be noted here that though the Accountant is required to make specific inquiries he is not responsible to ensure completeness of the list of international transactions / specified domestic transactions entered into by the Assessee. Further, it is advisable to take a representation from the management stating that all international transaction / specified domestic transactions, whether specifically stated in the Form No.3CEB or not, have been disclosed to the Accountant.

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9.66 Form No. 3CEB requires the Accountant, who signs the report, to indicate his membership number. As such, the Accountant should give his membership number and firm's registration number with ICAI and indicate the status, such as proprietor or partner of a firm, in which he has signed the report.

PART C

9.67 21. List of associated enterprises with whom the Assessee has entered into specified domestic transactions, with the following details:

- (a) Name, address and PAN of the associated enterprise.**
- (b) Nature of the relationship with the associated enterprise.**
- (c) Brief description of the business carried on by the said associated enterprise.**

9.68 The Assessee is required to furnish a complete list of associated enterprises, with whom the Assessee has entered into specified domestic transactions during the previous year. The list of associated enterprises must be duly certified by the authorised person (partner, trustee, managing director etc. depending on the definition of Assessee). The term 'associated enterprises' has been defined in detail in Rule 10A of the Rules. If an enterprise was 'associated' with the Assessee for a part of the previous year, details should be furnished with respect to that period of the previous year.

In this connection, the Assessee has to maintain a register with the list of the transactions and the relevant details. The Accountant can rely on the information provided in the register of associated enterprise for completing his work.

9.69 The particulars in this clause should be examined on test check basis from an instrument or agreement or any other document evidencing the association of enterprises including any supplementary documents related thereto. In this connection the Accountant has to, based on his best judgement, determine the sampling approach and design the nature and timing of the audit tests.

9.70 In preparing the list of the associated enterprises, it is possible that the extent of association may not be precisely ascertainable during the previous year, i.e. it may be indeterminate or unknown, resulting in a situation whereby the Assessee is not in a position to conclude as to whether any particular entity is covered under the definition of 'associated enterprise', as detailed in Rule 10A. In such circumstances, it is advisable both from the

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viewpoint of the Assessee and the Accountant's perspective that the relevant fact be stated in the Annexure or in the notes, as the case may be, and reference to same be made, if considered significant, in the Accountant's report.

9.71 In certain cases the enterprises may be associated in more than one manner. Since there is no different treatment for any particular form of association, it may be sufficient if the Assessee details any particular relationship with the associated enterprise under clause 21(b). Although the Assessee may be advised to detail all the relationships, disclosure of any one relationship is considered sufficient from a compliance perspective.

9.72 The Accountant should obtain a written representation from the Assessee detailing the business of the associated enterprises with whom the Assessee has transacted. Further, since the completeness of the list of the associated enterprises is the primary responsibility of the Assessee, the Accountant should obtain suitable representation from the management (Board of directors or its equivalent).

9.73 The Accountant should use his professional skill and expertise, in determining the scope of work to be performed with respect of getting reasonable comfort on the Assessee's list of specified domestic transactions with associated enterprises.

9.74 The Accountant should place emphasis on test checking material transactions with enterprises associated to the Assessee. Certain relationships, such as parent-subsidiary or investor-investee, may be clearly evident. Determining the existence of others requires the application of certain procedures, which may include the following:

- (a) Evaluate the Assessee procedures for identifying and properly accounting for specified domestic transactions;
- (b) Request from appropriate management personnel the names of all associated enterprises and inquire whether there were any transactions with these enterprises during the period;
- (c) Review filings by the reporting entity with regulatory agencies for the names of associated enterprises and for other businesses in which officers and directors occupy directorship or management positions; (example director's representations on transactions under sections 184, 188, 189 etc.);

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- (d) Review stockholder listings of closely held companies to identify principal stockholders;
- (e) Enquire, where possible and considered essential of predecessor, principal, or other Accountants/Accountants of associated enterprises concerning their knowledge of existing relationships and the extent of management involvement in material transactions;
- (f) Review material investment transactions during the period under review to determine whether the nature and extent of investments during the period create associated enterprises; and
- (g) Review the mandatory related party disclosure in the audited financial (AS 18). [The definition of Associated Enterprise in Rule 10A is different than the definition of related party under AS 18 and therefore the Accountant should review the Associated Enterprises for the purpose of section 92BA independently]
- (h) Review the income tax return of Assessee to determine any tax holiday status claimed by Assessee.

9.75 Although it is the responsibility of the Assessee to furnish a complete list of associated enterprises and specified domestic transactions, the Accountant must exercise reasonable care to ensure that prima facie and, based on the information that is made available to him, the list of associated enterprises and list of specified domestic transactions furnished by the Assessee is reasonably complete.

9.76 *Particulars in respect of transactions in the nature of any expenditure:*

Has the Assessee entered into any specified domestic transaction(s) being in respect of which payment has been made or is to be made to any person referred to in section 40A(2)(b)?

Yes/No

If 'yes', provide the following details in respect of each of such person and each transaction or class of transaction:

- (a) ***Name of person with whom the specified domestic transaction has been entered into.***
- (b) ***Description of transaction along with quantitative details, if any***

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- (c) **Total amount paid or payable in the transaction-**
 - (i) **as per books of account.**
 - (ii) **as computed by the Assessee having regard to the arm's length price.**
- (d) **Method used for determining the arm's length price. [See section 92C(1)].**

9.77 Under this clause, the Assessee has to furnish details of specified domestic transactions in respect of expenditure for which payment has been made or to be made to any person referred in section 40A(2)(b). However, in light of amendment in section 92BA of the Act vide Finance Act 2017 (effective from assessment year 2017-18), transactions with persons referred to section 40A(2)(b) are not within the ambit of specified domestic transactions.

22. Particulars in respect of transactions in the nature of transfer or acquisition of any goods or services:

- A. Has any undertaking or unit or enterprise or eligible business of the Assessee [as referred to in section 80A(6), 80IA(8) or section 10AA] transferred any goods or services to any other business carried on by the Assessee?**

Yes/No

If 'yes' provide the following details in respect of each unit or enterprise or eligible business:

- (a) **Name and details of business to which goods or services have been transferred.**
- (b) **Description of goods or services transferred.**
- (c) **Amount received / receivable for transferring of such goods or services -**
 - (i) **as per books of account.**
 - (ii) **as computed by the Assessee having regard to the arm's length price.**
- (d) **Method used for determining the arm's length price [See section 92C(1)]**

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9.78 Under this clause, the Assessee has to furnish details of specified domestic transactions respect of sale of goods/services from the Assessee's eligible business to Assessee's other business.

B. *Has any undertaking or unit or enterprise or eligible business of the Assessee [as referred to in section 80A(6), 80IA(8) or section 10AA] acquired any goods or services from another business of the Assessee?* Yes/No

If 'yes' provide the following details in respect of each unit or enterprise or eligible business:

- (a) *Name and details of business from which goods or services have been acquired.*
- (b) *Description of goods or services acquired.*
- (c) *Amount paid / payable for acquiring of such goods or services -*
 - (i) *as per books of account.*
 - (ii) *as computed by the Assessee having regard to the arm's length price.*
- (d) *Method used for determining the arm's length price [See section 92C(1)]*

9.79 Under this clause, the Assessee has to furnish details of specified domestic transactions respect of purchase of goods/services by the Assessee's eligible business from Assessee's other business.

23. *Particulars in respect of specified domestic transactions in the nature of any business transacted:*

Has the Assessee entered into any specified domestic transaction(s) with any associated enterprise which has resulted in more than ordinary profits to an eligible business to which section 80IA(10) or section 10AA applies? Yes/No

If 'yes' provide the following details:

- (a) *Name of the person with whom the specified domestic transaction has been entered into*
- (b) *Description of the transaction including quantitative details, if any*

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(c) **Total amount received/receivable or paid/payable in the transaction-**

(i) **as per books of account.**

(ii) **as computed by the Assessee having regard to the arm's length price.**

(a) **Method used for determining the arm's length price [See section 92C(1)]**

9.80 Under this clause, the Assessee has to furnish details of specified domestic transactions which has enabled Assessee to earn more than ordinary profits for a business to which section 80IA(10) or section 10AA is applicable. In case the Assessee is of the opinion that a transaction under Section 80IA(10) or Section 10AA does not result in more than ordinary profits to the Assessee, the Assessee does not have to disclose such transaction as specified domestic transaction under clause 24. However, the Assessee has to maintain robust documentation as prescribed under Rule 10D of the rules to substantiate that such transaction has not resulted in more than ordinary profits to the Assessee.

24 Particulars in respect of specified domestic transaction in the nature of any business transacted between the persons referred to in sub-section (6) of section 115BAB:

Has the assessee entered into any specified domestic transaction(s) with any persons referred to in sub-section (6) of section 115BAB which has resulted in more than ordinary profits expected to arise in such business?

If "yes", provide the following details:

(a) **Name of the person with whom the specified domestic transaction has been entered into**

(b) **Description of the transaction including quantitative details, if any.**

(c) **Total amount received/receivable or paid/payable in the transaction-**

(i) **Price as per books of account;**

(ii) **Price as computed by the assessee having regard to the arm's length**

Guidance Note on Report under Section 92E of the Income-tax Act, 1961**(d) Method used for determining the arm's length price [See section 92C(1)]**

9.81 Under this clause, the Assessee has to furnish details of specified domestic transactions, the Assessee entered into any specified domestic transaction(s) with any persons referred to in sub-section (6) of section 115BAB. With respect to the reporting requirements in above mentioned clauses such as details of the person, description of the transaction, amount paid/payable or received/receivable, method for computing the arm's length nature of the transaction, the Accountant can refer to the guidance elaborated in the previous paragraphs which are relevant for international transactions.

25. Particulars in respect of any other transactions:

Has the Assessee entered into any other specified domestic transactions(s) not specifically referred to above, with an associated enterprise? Yes/No

If 'yes' provide the following details in respect of each associated enterprise and each transaction:

- (a) **Name of the associated enterprise with whom the specified domestic transaction has been entered into:**
- (b) **Description of the transaction.**
- (c) **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.**
- (d) **Method used for determining the arm's length price [See section 92C(1)]**

9.81 Under this clause, the Assessee has to furnish details of other specified domestic transactions, which are not superficially covered in the above discussed clauses. With respect to other reporting requirements in above mentioned clauses such as details of the person, description of the transaction, amount paid/payable or received/receivable, method for computing the arm's length nature of the transaction, the Accountant can refer to the guidance elaborated in the previous paragraphs which are relevant for international transactions.