Genesis of Domestic TP regime

► Supreme Court decision in CIT v Glaxo SmithKline Asia (P) Ltd [195 Taxman 35 (SC)]

► Recognized “revenue neutrality” of domestic transactions other than in exceptional cases (e.g. tax holiday, loss making situations)

► Suggested that Finance Ministry should consider making Transfer Pricing (TP) provisions applicable to aforesaid transactions as well

► Key extracts

“In order to reduce litigation, we are of the view that certain provisions of the Act, like s. 40A(2) and s. 80-IA(10), need to be amended empowering the AO to make adjustments to the income declared by the assessee having regard to fair market value of the transactions between the related parties. The Assessing officer may thereafter apply any of the generally accepted methods of determination of arm’s length price, including the methods provided under Transfer Pricing Regulations.”
Explanatory Memorandum to Finance Bill, 2012

“The application and extension of scope of transfer pricing regulations to domestic transactions would provide objectivity in determination of income from domestic related party transactions and determination of reasonableness of expenditure between related domestic parties. It will create legally enforceable obligation on assessee’s to maintain proper documentation. However, extending the transfer pricing requirements to all domestic transactions will lead to increase in compliance burden on all assessee’s which may not be desirable.”

Applies to all entities including firms
Object of Domestic TP

Payments to related parties u/s. 40A(2)(b)

Discourage excessive payments to associates

Profit linked tax holiday units

Inter unit transactions

Should not lead to shifting of excessive profits to qualifying unit

Transactions with outsiders

Should be at ALP

Other transactions to be notified
Broad concept of Arm’s Length Price (ALP)

- ALP is the price at which two unrelated parties would undertake a “similar transaction” in “similar circumstances”

- Find answers to questions:
  - Would the selling / provider firm agree on the price if it were dealing with an unrelated firm?
  - Would the purchasing / availing firm agree to purchase or avail if it were dealing with an unrelated firm?
ALP linked computation – S. 92(2A)

Section 92(2A)

“Any allowance for an expenditure or interest or allocation of any cost or expense or any income in relation to the specified domestic transaction shall be computed having regard to the arm's length price”

In relation to Specified Domestic Transaction (SDT), the provision covers:

- Allowance for an expense or interest
- Allocation of cost or expense
- Any income

Cost contribution arrangements also covered [s.92(2)]

The Chapter permits adjustment to income favorable to the revenue on item to item basis

The Chapter neither permit downward adjustment nor set-off of one item against another nor corresponding adjustment in hands of other party

Allocation of cost or expense is not SDT in itself
“Specified Domestic Transaction" means any transaction, not being an international transaction, namely:—

i. any expenditure for which payment is to a person referred to in s.40A(2)(b);

ii. any transaction referred to in s. 80A;

iii. any transfer of goods or services referred to in s. 80-IA(8);

iv. any business transacted between the assesse and other person under s. 80-IA(10);

v. any transaction, under Chapter VI-A or s.10AA, if s. 80-IA(8) or s. 80-IA(10) is applicable; or

vi. any other transaction as may be prescribed,

and the aggregate of such transactions entered into in the previous year exceeds INR 5 Crores
Intricacies of value threshold INR 5 Cr.

- Threshold of INR 5 Cr. on aggregate basis for all six limbs
  - Value to be adopted as per books – [Form 3CEB]
  - Relief from documentation and ALP benchmarking
  - Book value to be adopted even if transactions are ALP compliant

Illustration

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Value as per books</th>
<th>ALP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Scenario I</td>
</tr>
<tr>
<td>40 (A)(2)(b) payments</td>
<td>3.00 Cr.</td>
<td>3.00 Cr.</td>
</tr>
<tr>
<td>Inter-unit payment by</td>
<td>1.50 Cr.</td>
<td>2.25 Cr.</td>
</tr>
<tr>
<td>qualifying unit</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>4.50 Cr.</strong></td>
<td><strong>5.25 Cr.</strong></td>
</tr>
</tbody>
</table>
Intricacies of value threshold INR 5 Cr.

- Transaction between two qualifying units to be counted once or twice!!
- Evaluate exclusion of expenditure disallowed (say for TDS default)!!
- Evaluate exclusion of expenditure of a disallowable nature
- Consistent with method of accounting in relation to taxes and levies
Domestic TP not restricted to transaction with residents

- S. 92BA excludes International Transaction from within its scope
- Trigger for AE relationship different for International and Domestic TP
- Illustrative examples where transactions with non-resident may be covered under Domestic TP
  - Remuneration paid by an Indian company to a non-resident director
  - Remuneration paid by a FC having PE to non resident director
  - Payment by Indian Co to Foreign Co. where Foreign Co. holds 20 to < 26% in Indian Co.
No notional imputation of Income

► Section 40A(2) covers transactions in the nature of ‘expenditure’ and not’ income’.
  
  ► Illustrative transactions not covered.
    
    ► Grant of interest free loan to an associate
    
    ► Corporate guarantee on behalf of subsidiaries
    
    ► Sale of goods at less than FMV
    
    ► Allowing use of trade mark or know-how or common services by group entities at NIL or nominal charge
    
    ► Gratis lease of machinery to associates
  
► S. 40A(2) inapplicable if expense is lower

► TP adjustment by AO w.r.t. s. 80A(6)/s. 80-IA(8)/s.80-IA(10) cannot lead to higher income of tax holiday qualifying unit.
Determining years of eligibility of incentive

► Applicability of Domestic TP vis-à-vis commencement of ‘initial year’
  ► Provisions apply from year of effective claim
    ► No choice available to Taxpayer (e.g. 80-IC, 80-IE etc.)
    ► Choice available to Taxpayer (e.g. 80-IA, 80-IAB)
  ► Provisions to apply in year of tax holiday – though, in loss

► Applicability of Domestic TP to presumptive basis of taxation (e.g. Life Insurance companies, Tonnage Tax, etc.)
Transfer Pricing vs. Exempt Income

► Arguable that TP provisions being computational provisions should not apply if income wholly exempt.
  ► Entity having Agricultural Income
  ► S.25 company enjoying unconditional exemption u/s 10(23C)
► Conditional exemption may need review
  ► Standalone SEZ unit enjoying 100% tax holiday u/s 10AA
Transfer Pricing and TDS

Case study:

- XCo makes rent payment of INR 2 Lacs to YCo (related party)
- ALP is determined at INR 1.5 Lacs
- XCo defaults in TDS compliance

<table>
<thead>
<tr>
<th>Disallowance</th>
<th>Whether Domestic TP applies</th>
</tr>
</thead>
<tbody>
<tr>
<td>40(a)(ia)</td>
<td>40A(2)(a)</td>
</tr>
<tr>
<td>View 1</td>
<td>2 Lacs</td>
</tr>
<tr>
<td>View 2</td>
<td>1.5 Lacs</td>
</tr>
</tbody>
</table>
Scope of s.40A(2) r. w. s. 92BA
Scope of s. 40A(2)(b)

► Domestic TP applies to expenditure for which payment is made or is to be made to a person referred to in s. 40A(2)(b)
  ► Coverage is wide; conceptually different from AS-18

► Applies to transactions on or after 1 April 2012
  ► Will not apply on basis of payment on or after 1 April 2012

► Applies to ‘payment’ which results in ‘expenditure’
  ► Arguably includes constructive payment
  ► Dividends/DDT not covered since not an expenditure
  ► Payment of loan or share capital is not an expenditure

► “Payment” should be to independent entity; Inter unit transaction of same taxpayer not covered
Scope and coverage of s. 40A(2)

- Introduced by Finance Act, 1968 to disallow excessive or unreasonable payments to taxpayer’s relatives or associate concerns.

- Unreasonableness to be judged vis-a-vis
  - Fair market value of goods or services or facilities
  - Legitimate needs of the business or profession
  - Benefit derived or accruing to the taxpayer

- Conditions are cumulative from taxpayer’s perspective (Refer Coronation Flour Mills v. ACIT (2009) 314 ITR 1 (Guj))

- Proviso inserted by Finance Act 2012 provides no disallowance vis-a-vis FMV if transaction is SDT and is at ALP
## Illustrative coverage of s. 40A(2)(b) relationship

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Illustrative coverage</th>
</tr>
</thead>
</table>
| **Individual** | ▶ Relatives  
                ▶ Firm in which he is partner  
                ▶ Company in which he is director / has more than 20% shareholding |
| **Firm** | ▶ Partners/ relatives  
                ▶ Company/ firm in which partner / relative has substantial interest (>20%) |
| **Company** | ▶ Director/ relatives  
                ▶ Company/firms in which director / relatives have substantial interest (> 20%)  
                ▶ Parent (> 20%)  
                ▶ Sister subsidiary (common parent holding > 20%) |
Payments to related parties - Illustration

- Any payment towards expenditure by
  - ACo to its own directors as remuneration, salary, bonus etc
  - ACo to XCo (Parent Company)
  - ACo to directors of XCo
  - ACo to relatives of directors of A Co and X Co
  - ACo to BCo
- Any payment towards expenditure by
  - XCo to ACo/BCo
S. 40A(2)(b) scope – Indirect Holding

- S. 40A(2) refers to ‘beneficial’ ownership of shares

**Issue:**
- Whether Y Co can be considered as related party to A Co since A Co indirectly controls more than 20% of Y Co.
- Circular 6 P dated 6 July 1968 explaining S.40A(2)(a) refers to expression “direct or indirect” substantial interest.

- Arguable: Indirect shareholding is not covered
  - Distinguishable from s. 92A (definition of AE) which uses the expression ‘directly or indirectly’ and “through one or more intermediaries”.
  - Separate legal entity; Corporate veil cannot be lifted
S. 40A(2)(b) – Aggregation of holding

► Whether shareholding needs to be aggregated to determine substantial interest?

Are A Pvt. Ltd. and B Pvt. Ltd. related concerns?
► Substantial holding is to be determined qua individual.
► Preference shareholding to be excluded
► For entities other than companies, beneficial share in profits is relevant; share in corpus not relevant
S. 40A(2)(b) – controversial transactions

- Inter-linking of S.40A(2) (a) and S.40A(2)(b)
- Benchmarking of remuneration
  - Remuneration to partners regulated by s.40(b) (Circular 636)
  - Directors remuneration regulated under Company Law (1968 Circular 6-P)
- Payment to related parties covered under non-business heads
  - Interest payment to related party claimed as deduction u/s 57; s.58 (2) extends s. 40(A)(2) to Income from other sources.
  - Cost of capital asset acquired from related party
- Payments for capital assets under business head
  - Depreciation claimed u/s. 32
  - Full deduction claimed u/s. 35(1)(iv)
Canvas of Incentive provisions and Domestic TP
Transaction covered under s. 80-IA (10)

- Needs to be a “transaction” with “other person”
- Ingredients which trigger invocation of s. 80-IA(10):
  - Assessee carrying on eligible (tax holiday) business
  - If it appears to AO
  - Owing to close connection or otherwise
  - Course of business arranged
  - Transaction produces more than ordinary profit in tax holiday unit
- No need to report transaction unless conditions for invocation established
  - Scope not restricted to goods or services
  - Scope not restricted to S.40A(2) persons
- Revenue >ALP does not per se imply existence of more than ordinary profits.
- If conditions fulfilled
  - Transaction qualifies as SDT → adopt ALP,
  - Transaction not SDT → AO to impute reasonable profits
### Popular Incentive provisions under TP Lens

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>10AA</td>
<td>Newly established units in SEZ</td>
</tr>
</tbody>
</table>
| 80-IA     | ► Infrastructure development  
            | ► Production / Distribution of power  
            | ► Telecom service  
            | ► Industrial park development |
| 80-IAB    | Development of SEZ                                                          |
| 80-IB(11C)| Operating and maintaining a hospital located anywhere in India.             |
| 80-IC     | Industrial undertakings or enterprises in special category states           |
| 80-IE     | Undertakings in North-Eastern states                                        |
Coverage of s. 80-IA (10)

- For A Co
  - Domestic TP not applicable – transaction is of income receipt, 40A(2) not triggered

- For B Co
  - Covered by s. 40A(2)(b) and hence SDT. But, payment is at < FMV, no TP adjustments required.
  - S. 80-IA(10) may still be invoked on the ground that arrangement leads to more than ordinary profits?

- A Co
- Related Parties
- B Co (WOS)
- Tax Holiday Unit

- Sale of goods at cost < FMV
- Corporate Guarantee: NIL cost
- Free use of TM and KHW or HO resources
S. 80A(6)/80-IA(8) coverage

- Contextually covers intra division transfers not being a transaction
- Influences a case where taxpayer is entitled to deduction u/s. 10A or s.10AA or s.10B or s.10BA or Chapter VI-A in respect of undertaking or unit or Enterprise, where:
  - Goods or services held for the purpose of eligible business are transferred to "any other business",
  - Goods or services held for the purpose of "any other business" transferred to eligible business,
  - Consideration recorded in books does not correspond to market value of such goods
- Inter unit transfer between two non-eligible units has no TP implications.
- Section requires "any other business" carried on by assessee and dealings between businesses
  - Restricted to goods and services of ‘marketable’ nature
  - Restricted to transfer
Activities which are not carried on as business
- HO expenses including IT support, accounts, law compliance etc
- Use of corporate resources, including IPR
- HO finance out of capital or accumulated profits
- Temporary use of funds

Allocation of actual expenses and challenges around allocation keys
- Research cost, finance cost, HO overheads, sales promotion

Provides for a “two-way” adjustment (both favorable as well as adverse)

Restricted to core activity
- Supply of power by captive power unit to the manufacturing unit
- Supply of intermediate goods to the unit manufacturing final goods

If SDT, adjustment w.r.t. ALP; if not SDT, adjustment w.r.t FMV
Pre-requisite of ‘any other business’

- Head Office (HO)
  - Audit Fees
  - Directors’ fees
  - Payroll processing
  - H.O. rent, etc.

- Treasury Operations
  - Eligible Unit 1
  - Eligible Unit 2
  - Non eligible unit

- Typical H.O. expenses need fair and commercial allocation
  - If not a super specialty / commercial function no mark up needed

- Marketable services rendered by inter unit will need to be at ALP
### Significant Investment-Linked incentive provisions

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>35(2AB)</td>
<td>Weighted deduction on approved in-house R&amp;D facility</td>
</tr>
<tr>
<td>35AD¹</td>
<td>Accelerated/weighted deduction on capital expenditure incurred in relation to specified business</td>
</tr>
<tr>
<td>35(1)(iv)</td>
<td>Capital expenditure on scientific research related to business</td>
</tr>
</tbody>
</table>

Whether capital assets acquired from related parties covered by s. 40A(2) ?

¹ Fifth limb of s. 92BA vis-à-vis s.80-IA(8)/(10) covers only income linked tax holiday provisions
Inter unit transfers – Interplay of eligible and non-eligible unit

**Facts:**
- Power unit is eligible for Tax holiday deduction.
- Power unit transfers power to non-eligible Manufacturing unit at INR 100.

**Issue**
Will there be any adverse tax implications if Domestic TP is invoked by the AO?

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Income</th>
<th>GTI</th>
<th>Deduction</th>
<th>Total Income</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Unit P</td>
<td>Unit M</td>
<td>Unit P</td>
<td>Unit M</td>
</tr>
<tr>
<td>AS returned by the taxpayer</td>
<td>100</td>
<td>100</td>
<td>200</td>
<td>100</td>
</tr>
<tr>
<td>If AO enhances income of Unit P</td>
<td>120</td>
<td>80</td>
<td>200</td>
<td>100</td>
</tr>
<tr>
<td>If AO reduces income of Unit P</td>
<td>80</td>
<td>120</td>
<td>200</td>
<td>80</td>
</tr>
</tbody>
</table>
Applicability of Domestic TP - Inter unit transfers

**Facts:**
- Both units of A Co are tax holiday qualifying units @ 100%
- Power unit transfers power to the Manufacturing unit.

**Issue:**
Whether application of Domestic TP can result in adverse impact for taxpayers despite there being no potential for tax arbitrage between two units?

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Income</th>
<th>GTI</th>
<th>Deduction</th>
<th>Total Income</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Unit P</td>
<td>Unit M</td>
<td>Unit P</td>
<td>Unit M</td>
</tr>
<tr>
<td>AS returned by the taxpayer</td>
<td>100</td>
<td>100</td>
<td>200</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>If AO enhances income of Unit P</td>
<td>120</td>
<td>80</td>
<td>200</td>
<td>120</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(100?)</td>
</tr>
<tr>
<td>If AO reduces income of Unit P</td>
<td>80</td>
<td>120</td>
<td>200</td>
<td>80</td>
</tr>
</tbody>
</table>
Voluntary TP adjustment in ROI

- Taxpayer is benefited by voluntary TP adjustment in Domestic TP if it is 40A(2)(b) transaction which impacts GTI and Taxpayer is eligible for s. 10AA / Chapter VI-A deduction (Refer illustration).

- Where s. 10AA / Chapter-VI-A deduction is not available and / or adjustment is to deductible profits, voluntary TP adjustment may lead to additional income but mitigates interest and concealment penalty.

<table>
<thead>
<tr>
<th></th>
<th>Taxpayer (Eligible Unit)</th>
<th>Taxpayer Post Vol. TP</th>
<th>AO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase from related party</td>
<td>100</td>
<td>80</td>
<td>80</td>
</tr>
<tr>
<td>GTI</td>
<td>200</td>
<td>(200+20)</td>
<td>(200+20)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>220</td>
<td>220</td>
</tr>
<tr>
<td>Less: Deduction u/s10AA</td>
<td>200</td>
<td>220</td>
<td>200</td>
</tr>
<tr>
<td>Taxable income</td>
<td>Nil</td>
<td>Nil</td>
<td>20</td>
</tr>
</tbody>
</table>

► Taxpayer is benefited by voluntary TP adjustment in Domestic TP if it is 40A(2)(b) transaction which impacts GTI and Taxpayer is eligible for s. 10AA / Chapter VI-A deduction (Refer illustration).

► Where s. 10AA / Chapter-VI-A deduction is not available and / or adjustment is to deductible profits, voluntary TP adjustment may lead to additional income but mitigates interest and concealment penalty.
Consequences of TP adjustment
Consequences of TP adjustment

► S.40A(2)(b) disallowance leads to enhancement of income and consequential tax /interest levy

► No consequential enhancement of s.10AA/Chapter VI-A deduction. (First proviso to s.92C(4))

► S.80A(6) /s.80-IA(8) /s.80-IA(10) adjustment leads to curtailment of tax holiday deduction leading to additional income and consequential tax, interest levy

► No co-relative adjustment in the hands of the recipient

► Penal consequences
## Penal provisions

<table>
<thead>
<tr>
<th>Section</th>
<th>Trigger</th>
<th>Quantum of penalty</th>
</tr>
</thead>
<tbody>
<tr>
<td>271(1)(c)</td>
<td>Post assessment adjustment regarded as concealment of income [r.w. Explanation 7]</td>
<td>100-300% of the tax on amount of adjustments</td>
</tr>
<tr>
<td>271AA</td>
<td>Failure to maintain TP documentation, failure to report the transaction, maintenance or furnishing of incorrect information/document</td>
<td>2% of the value of transactions</td>
</tr>
<tr>
<td>271BA</td>
<td>Failure to furnish Form 3CEB</td>
<td>INR 100,000</td>
</tr>
<tr>
<td>271G</td>
<td>Failure to furnish TP documentation with the tax officer</td>
<td>2% of the value of the transactions</td>
</tr>
</tbody>
</table>

- Not leviable where taxpayer acted in ‘good faith’ and exercised ‘due diligence’
- TP documentation serves as a good basis to demonstrate good faith and due diligence
- Following adjustments held to be debatable and not warranting penalty levy
  - Not reckoning provision for bad debts as operating cost while applying TNMM
  - Substitution of TNMM by CUP method
Methodology of Determining ALP
Determination of Arm’s Length Price (ALP)

- ALP is the price at which two unrelated parties would undertake a "similar transaction" in "similar circumstances"
- Deviation of ALP from actual price has consequences
- Find answers to questions:
  - Would the selling / provider firm agree on the price if it were dealing with an unrelated firm?
  - Would the purchasing / availing firm agree to purchase or avail if it were dealing with an unrelated firm?
Challenges around ALP exercise

- ALP determination is not an exact science

- ALP is an economic concept:
  - FAR analysis the prime driver
  - Evaluate the comparable with similarity of FAR

- Determination has subjective considerations

- Valuation excluded from scope of AAR

- Determination based on Herd analysis
## Permissible deviation range from ALP

<table>
<thead>
<tr>
<th>Particulars</th>
<th>W. e. f. 1.4.12</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfer price</td>
<td>100</td>
</tr>
<tr>
<td>ALP (Arithmetic mean)</td>
<td>120</td>
</tr>
<tr>
<td>Permissible Range</td>
<td>Not exceeding $\pm$ 3% of transaction value (97-103)</td>
</tr>
<tr>
<td>Tolerance limit for TP adjustment</td>
<td>1% for wholesale traders</td>
</tr>
<tr>
<td></td>
<td>3% for other taxpayers</td>
</tr>
</tbody>
</table>
Prescribed Benchmarking Methods

- Any other method prescribed by the Central Board of Direct Taxes
- Indian rules have no guidance on preference for any particular method
- CUP is the most preferred method; TNMM is the most frequent method
Most Appropriate Method Rule

- ALP to be determined by adopting the most appropriate method. (i.e. Best method Rule)
  - The method best suited to the facts and circumstances of the case
  - Which provides most reliable measure of ALP
Comparables: Determining uncontrolled price

- Transaction price is determined commercially
- Transfer price is tested using data of comparable transactions
- Demonstration of comparables is uniform requirement in almost all methods
- Onus of establishing ALP is on taxpayer
- Comparison should be with independent uncontrolled (unrelated party) transactions
  - Enterprises with predominant AE business are generally disqualified
  - In any case, transactions with AEs do not qualify to be comparable
Comparable Uncontrolled Price Method

- **Internal CUP**

  Manufacturer A
  
  Sale to related party B
  
  Sale to non-related party C

- **External CUP (Unrelated parties)**

  Non-related party P
  
  Non-related party Q

Adjustments permitted for volume discount, geographical differences, etc
Comparable Uncontrolled Price Method

► Preferred method, if available
  ► As applicable to product / service

► Requires high degree of comparable

► Parameters of non comparison
  ► Geographical difference
  ► Intangible
  ► Market share
  ► Bargaining strength
  ► Quality segment of product / service

► Adjustments for
  ► Discounts
  ► Market penetration
**Resale Price Method (RPM)**

- Compares the resale gross margin earned by AE, with gross margin of comparable independent distributors

  - Comparable need not be in very same product
    - Software distributor compared with FMCG distributor
  - Concept of tested party [Tax holiday unit of Mfg: Resale by Distributors]
Eligible unit – Distributor model

Facts

► A Ltd. sells entire production of its qualifying unit to related party B Ltd. who is sole distributor for A Ltd.
► B Ltd. has no other activity
► Sale price to B Ltd. is fixed so as to leave a fixed margin for B Ltd. on onward sale price to unrelated parties

Issues

► Can A Ltd. justify ALP of sale price to B Ltd. by benchmarking B Ltd.’s margin using TNMM method?
Cost Plus Method (CPM) ( C+)

► Used predominantly when AE works for another AE as contract manufacturer.

\[
\text{ALP} = \left\{ \frac{\text{Direct & Indirect Cost of Production / service}}{\text{Comparable Margin}} \right\} + \text{Comparable Margin}
\]

► Typically applied to a contract manufacturer who:
  ► Does not bear risk of marketing
  ► Does not “normally” undertake high skill work
  ► May apply to contract manufacture, BPO, call centre, software developer, etc.
Eligible unit – Toll manufacture

**Facts**
- A Ltd. gets goods manufactured from related party B Ltd. on toll manufacture basis
- B Ltd. is compensated on cost plus basis
- B Ltd. does not have any other activity
- Goods are sold to unrelated parties.
- Purchases of A Ltd. are from unrelated parties

**Issues**
- Can A Ltd. justify reasonableness of profits by making B Ltd. as ‘tested party’
Transactional Net Margin Method (TNMM)

- Comparable Net profit adopted in relation to:
  - Costs incurred, or
  - Sales effected, or
  - Assets employed; or
  - Any other relevant base. (eg. PBDIT, gross margin, operating margin)
Profit Split Method (PSM)

- Generally applicable in case of transaction involving
  - Transfer of unique intangibles
  OR
  - Multiple transactions which are interrelated not permitting separate evaluation
- Split global profit according to contribution of each AE
- Avoids vice of unilateral entity level adjustment which may lead to overall distortion
Unspecified method – Rule 10AB

▶ Other method – Rule 10AB

“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 a 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-associated enterprises, under similar circumstances, considering all the relevant facts.”
Documentation

<table>
<thead>
<tr>
<th>Entity related</th>
<th>Price related</th>
<th>Transaction related</th>
<th>Supporting documents</th>
</tr>
</thead>
<tbody>
<tr>
<td>► Profile of industry</td>
<td>► Transaction terms</td>
<td>► Agreements</td>
<td>► Official publications, reports by Government, institutions of repute, Stock exchanges</td>
</tr>
<tr>
<td>► Profile of group</td>
<td>► Functional analysis (functions, assets and risks)</td>
<td>► Invoices</td>
<td>► Financial statements</td>
</tr>
<tr>
<td>► Profile of unit of the entity claiming tax holiday</td>
<td>► Economic analysis (method selection, comparable, benchmarking)</td>
<td>► Pricing related correspondence (letters, emails etc)</td>
<td></td>
</tr>
<tr>
<td>► Profile of related parties</td>
<td>► Forecasts, budgets</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

► Documentation to be contemporaneous

► Due date for maintenance of TP documentation for FY 2012-13 is November 30, 2013
Taxpayer driven ALP Benchmarking

1. Identify Specified Domestic Transaction and Base Level Documentation including FAR
2. Identify potential comparables internally (or), and in public domain
3. Process of ‘accept/reject/filtration criteria with reasons as per identified appropriate method
4. Receipt of report in form 3CEB before due date of ROI
   - Has taxpayer maintained TP documentation?
   - Correctness of particulars
5. Determine arithmetic mean of adjusted price and validate TP
6. Make adjustments for differences on account of volume, geographies, intangibles, research and development, working capital, etc etc.
TP Audit process

- TPO provides opportunity of hearing if referred by A.O with approval of CIT
- TPO order binding on A.O
- A.O. prepares draft order
- Taxpayer has alternative remedy of DRP
- Taxpayer cannot avail APA or safe harbour

Taxpayer in distress finds his way to safe hands of BCAS Member!!!
Thank You