

WIRC

International Tax and Transfer Pricing Refresher Course

Transfer Pricing: Concepts and Issues

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Transfer Pricing: Concepts and Issues

Discussion Paper

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1. Tested Party

1.1 Introduction

When applying a Cost Plus Method, Resale Price Method or Transactional Net Margin Method, we have to choose the party (one of the AEs) to the transaction for which a Profit Level Indicator (mark-up on costs, gross margin, or net profit ratio) is tested to profitability of uncontrolled internal or external comparables. The Tested Party is that AE whose profitability is analyzed and benchmarked for establishing arm's length price of the international transaction (or the specified domestic transaction).

The choice of the Tested Party should be consistent with the functional analysis of the transaction. As a general rule, the Tested Party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found, i.e. 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 will most often be the one that has the less complex functional analysis. The choice of the Tested Party should be consistent with the functional analysis of the transaction, and the characterisation of the entities.

What about Comparable Uncontrolled Price Method? 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.

1.2 Example

Assume that AE1 is manufacturing products for which it owns and uses valuable unique intangibles such as valuable patents and trademarks, and for which AE2 acts as a distributor. Assume that in this transaction, AE2 only performs distribution functions and does not make any valuable, unique contribution, in the form of marketing intangibles. The Tested Party for this transaction (sale of products by AE1, the manufacturer to AE2, the distributor) would most often be AE2; because data of comparable distributors will be more easily and reliably available for the purpose of benchmarking.

1.3 Principles to keep in mind while selecting the Tested Party

The following principles would need to be kept in mind while selecting the Tested Party:

- (i) The party that is the least complex in terms of functions performed, assets employed and risks undertaken should be selected as the 'Tested Party' (i.e., the party to the international transaction whose functions are simpler to evaluate, which does not own valuable non-routine intangible assets and does not undertake substantial risk). Invariably, Least complex entity would be that party in

the transaction flow, whose profitability would bear maximum correlation to the price of international transaction and is least influenced by other factors

- (ii) Reliable information about the 'Tested Party' must be available.
- (iii) Reliable information about the 'comparables' must be more easily and readily available and should be capable of being verified independently

1.4 Foreign AE as the Tested Party

- a) Where the Foreign AE is least complex entity, and reliable information about the Foreign AE is available, and reliable information about the 'comparables' is also more easily and readily available, then can we select the Foreign AE as the Tested Party?
- b) There are various judicial precedents in India wherein Foreign AE has been accepted as Tested Party; also, there several precedents wherein based on factual consideration Foreign AE as Tested Party has been rejected, however it's been concurred that in suitable cases there is nothing against selecting Foreign AE as Tested Party. So, more often than not, Indian judiciary has been receptive to accept Foreign AE as Tested Party if certain pre-requisite factors are present.
- c) But, the Pune Tribunal, in recent orders in *Carraro India Private Limited [TS-124-ITAT-2019(PUN)-TP]* and *Bekaert Industries Private Limited [TS-347-ITAT-2019(PUN)-TP]*, has ruled that the concept of Foreign AE as Tested Party has no statutory sanction under the Indian TP Regulations.
- d) On the adverse decisions of Pune Tribunal, there are two views, as can be gauged through myriad of judicial precedents available on this issue.

One school of opinion, based on constructive study and interpretation of Indian TP Regulations and Indian TP Regulation alone, affirmatively asserts that the concept of Foreign AE as Tested Party is foreign to Indian TP Regulation and has no statutory sanction. This view hinges upon the premise or understanding that the word Enterprise, as has been used in Rule 10B of Income Tax Rules 1962, implies Indian Assessee and 'Associated Enterprise' implies overseas group entity.

The other school of opinion, although agrees that apparently Indian TP Regulation has not expressly specified that Foreign AE can be taken as Tested Party, argues that these regulations have not specified anything against such construction. According to the other opinion, when Indian TP Regulation is looked at alongside OECD and UN Guidelines, India Chapter in UN Guidelines and ICAI Guidelines, it becomes a foregone conclusion that there is nothing against considering a Foreign AE as Tested Party in appropriate circumstances.

This is also fortified by the commonly accepted judicial position that unless aforementioned guidelines run contrary to the specific provisions of Indian TP Regulation, they invariably prove and have often been used as accepted tool for interpreting Indian TP Regulation. The Indian TP Regulation does not qualify or restrict the meaning of word Enterprise to only include Indian Assessee. In fact, this opinion is based upon the premise that Enterprise as well as AE could interchangeably mean both Indian Assessee as well as the Foreign AE, as may be suitable based on the facts and circumstances of the case.

- e) On reading the provisions of Section 92F (iii) (Definition of 'Enterprise'), Section 2 (31) (Definition of 'Person'), Section 2 (17) (Definition of 'Company'), Section 92A (Definition of 'Associated Enterprises') and Section 92B (Definition of 'International Transaction') apparently the term "Enterprise" would include all persons engaged in the specified activity and term "Person" as defined in the Act, *inter alia*, includes a Company within its definition. Moreover, Company, as has been defined in the Act, includes both Indian as well as overseas companies.
- f) So, one can infer from combined reading of the provisions mentioned above that the term Enterprise (as used in rule 10B to describe the entity whose profitability is benchmarked or in other words is to be considered as the Tested Party) can be both, an Indian Entity or a Foreign Entity.
- g) Further, there is nothing in Section 92A to indicate that AE can only be a Foreign Entity and an Indian Entity cannot be an Associated Enterprise. Also, the definition of International Transaction includes the phrase "*two or more associated enterprises, either or both of whom are nonresidents*". It can be derived from this phrase that it is accepted that Associated Enterprise could be a Resident Entity as well as a Non-Resident Entity. In this back ground reading a different and restrictive meaning in the term Associated Enterprise for the purpose of Rule 10B (determination of arm's length price and making comparability analysis), without there being any specific provision as such, would be inappropriate.
- h) The view of Indian Tax Administration, expressed as part of the India Chapter in UN TP Manual, unequivocally establishes that Indian Revenue Department does not find Foreign AE as Tested Party a legal concept repugnant to provisions of Indian TP Regulation, and have apparently indicated that Foreign AE could be considered a Tested Party in appropriate circumstance.
- i) Such view is further reinforced by the view expressed in The ICAI Guidance Note on Report Under Section 92E (2019):

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, we should check if detailed information and analysis is maintained by the Company.

1.5 Cases - Rejection of Foreign AE as Tested Party

Following are the adverse decisions on the point of selection of Foreign AE as the Tested Party. In these decisions the Tribunal held that we *cannot* select Foreign AE as the Tested Party.

Decision	Rationale for rejection of Foreign AE as Tested Party
<ul style="list-style-type: none"> • <i>Bekaert Industries Private Limited</i> [TS- 347-ITAT-2019(PUN)-TP] 	<p>The profit margin of the Indian enterprise and not that of the foreign AE, which should be compared with the comparables to see if any increase in the total income of the enterprise chargeable to tax in India, is warranted on account of transfer pricing adjustment</p>
<ul style="list-style-type: none"> • <i>Carraro India Private Limited</i> [TS-124-ITAT-2019(PUN)-TP] 	<p>None of the factors under the Transfer Pricing Regulations require to consider whether the AEs would have incurred or earned more or less; but it is always considered whether the assessee had earned more or less by doing a similar transaction with an unrelated party Indian taxation law can neither call for also roping in and taxing in India the margin from the activities undertaken by the foreign AE nor can it curtail the profit arising out of transaction between the Indian and foreign AE at arm's length Under Rule 10B, the term 'enterprise' under the TNM method, and for that matter all other methods, has been used to indicate the assessee in whose hands the benchmarking of the international transaction is done and the term 'associated enterprise' has been used to denote the foreign/AE, being the other related party to the international transaction.</p>
<ul style="list-style-type: none"> • <i>GE Money Financial Services Pvt Ltd</i> [TS-457- ITAT-2016(DEL)-TP] 	<p>Even under Rule 10B of the IT Rules, the factors prescribed for inclusion or exclusion of comparables (these factors are listed below, for ready reference) to determine the ALP are also based on the comparison of the assessee with the chosen entities and the AE has no role in the exercise of selecting the comparables</p>
<ul style="list-style-type: none"> • <i>Onward Technologies Limited</i> TS-94-ITAT-2013(Mum)-TP] 	<p>1. The specific characteristics of the property transferred, or services provided in either transaction;</p>
<ul style="list-style-type: none"> • <i>Aurionpro Solutions Ltd</i> [TS-75-ITAT-2013(Mum)-TP] 	
<ul style="list-style-type: none"> • <i>AT & S India Pvt Ltd</i> 	

<p>[TS- 539-ITAT-2016(Kol)-TP]</p>	<ol style="list-style-type: none"> 2. The functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions 3. The contractual terms 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; 4. Conditions prevailing in the markets in which the respective parties to the transactions operate <p>Consideration of foreign AE as Tested Party would result in making substantive section 92 otiose and the definition of international transaction u/s 92B and rule 10B redundant Borrowing a contrary mandate of the TP provisions of other countries (i.e. wherein Foreign AE as Tested Party is accepted) and reading it into our provisions is not permissible</p>
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1.6 Cases - Acceptance of Foreign AE as Tested Party

Following are the contrary decisions on the point of selection of Foreign AE as the Tested Party. In these decisions the Tribunal held that we *can* select Foreign AE as the Tested Party.

Decision	Rationale for acceptance of Foreign AE as Tested Party
<ul style="list-style-type: none"> • <i>Prothious Engineering Services</i> [TS-933-ITAT-2019(Mum)-TP] 	<ol style="list-style-type: none"> 1. Tested Party is least complex entity and does not own valuable intangible property or unique assets
<ul style="list-style-type: none"> • <i>Capsugel Healthcare (Formerly Bharti Healthcare Limited)</i> [TS-828-ITAT-2019(DEL)-TP] 	<ol style="list-style-type: none"> 2. It is not appropriate on the part revenue authorities to contend that comparable companies selected by the assessee doesn't fall within the ambit of TPO's jurisdiction and, thus, he can neither call for any additional information nor scrutinize their books of accounts
<ul style="list-style-type: none"> • <i>Almatis Alumina Pvt. Ltd</i> [TS-302-ITAT-2019(Kol)-TP] 	<ol style="list-style-type: none"> 3. The revenue can get relevant particulars by using the latest technology/database or direct the assessee to furnish the same
<ul style="list-style-type: none"> • <i>IDS Infotech Ltd</i> [TS-58-ITAT-2019(CHANDI)-TP] 	<ol style="list-style-type: none"> 4. Reliance on International guidelines (UN, OECD) considered
<ul style="list-style-type: none"> • <i>Moser Baer India Ltd</i> [TS-334-ITAT-2018(DEL)-TP] 	

<ul style="list-style-type: none"> • <i>IDS Infotech Ltd [TS-184-ITAT-2017(CHANDI)-TP]</i> • <i>TNT India Pvt Ltd [TS-920-ITAT-2016(Bang)-TP]</i> • <i>Landis Gyr Limited [TS-518-ITAT-2016(Kol)-TP]</i> • <i>Royal Canin India Private Limited [TS-294-ITAT-2016(Mum)-TP]</i> • <i>Ranbaxy Laboratories Ltd [TS-173-ITAT-2016(DEL)-TP]</i> • <i>GE Money Financial Services Pvt Ltd [TS-216-ITAT-2016(DEL)-TP]</i> • <i>Tata Motors European Technical Centre Plc [TS-440-ITAT-2014(Mum)-TP]</i> • <i>General Motors India Pvt. Ltd. [TS-215-ITAT-2013(Ahd)-TP]</i> • <i>Development Consultants (P.) Ltd [TS-5263-ITAT-2008(KOLKATA)-O]</i> 	<p>5. The onus is upon the Assessee to submit irrefutable/verifiable document in relation to comparable data</p> <p>6. Entity wide margin of Assessee is not indicative of pricing of international transaction, profitability of lesser complex overseas AE is a better candidate</p> <p>7. It is noteworthy that in number of adjacent rulings the contrarian view, wherein it was suggested that foreign AE could not be a Tested Party as per India TP regulation was specifically discussed and was distinguished with (e.g. Almatiss Alumina Pvt. Ltd, Ranbaxy Laboratories Ltd, Landis Gyr Limited etc.)</p>
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1.7 Documentation to select Foreign AE as the Tested Party

In light of the Tribunal decisions listed above, to select Foreign AE as the Tested Party, we should to maintain the following documents:

- Robust FAR (Functions, assets, risk) analysis - To demonstrate Foreign AE as the least complex or simpler entity and Assessee as the more complex entity
- Financial Statements including Segmental results of the Foreign AE

- Search matrix and benchmark result in relation to Foreign AE- Foreign database search needs to be appropriately and adequately documented to facilitate proper examination by tax authorities
- Financial information including Business description, of comparables
- Available information on 'Tested Party' and 'comparables' shall be sufficient to carry out reliable adjustments for material differences, if any

1.8 Other Relevant facts and Parting Thoughts

Below are some of other pertinent trends in this regard:

- Currently there is no Supreme court or High Court judgement on this issue - High court has admitted this issue in several cases and have also remanded back this issue for consideration by lower authorities (*GE Money Financial Services Pvt. Ltd [TS-697-HC-2016(DEL)-TP]*), however no substantive reported judgement is available as on date. Also, no Special Bench judgment is available on this issue - Request for Special Bench was raised by Assessee and rejected by Ahmedabad Tribunal in the case of *General Motors India Pvt. Ltd*. In that case the Tribunal held that as the matter is admitted, and pending for final adjudication, by Hon'ble Gujarat High Court in Assessee's own case, there is no need for constitution of Special Bench on the same issue.
- Revenue Authorities, during APA proceedings, have considered Foreign AE as Tested Party in certain cases. Also, it is pertinent to note that positions agreed under APA on this issue could carry reference value in normal litigation route – E.g. in the case of *Ranbaxy Laboratories Ltd vs ACIT [TS-173-ITAT-2016(DEL)-TP]*, while deciding upon the issue that whether Foreign AE could be considered as Tested Party, Delhi Tribunal placed reliance on the fact that for the concerned transaction under APA, the Foreign AE was considered as the Tested Party based on availability of reliable financial and comparable data.
- Several countries like USA, EU, Malaysia, etc. expressly allow selection of Foreign AE as Tested Party under their TP Regulations.

In the above backdrop and considering the fact that there is an increased emphasis on ensuring universally accepted consistent norms of TP compliance requirements across the globe, it is necessary that concerned jurisdictions, including India, unequivocally specify their positions on acceptable norms and compliance requirements; every endeavor should be made to root out unnecessary confusions and irregularities. MNCs are invariably confronted with the challenge of establishing the ALP of same or different

facets of similar transactions in multiple jurisdictions, and confusions and inconsistencies such as the above issue add to their agony.

So, the Revenue Department may issue appropriate clarification to provide much needed tax certainty. However, in the meantime, MNCs facing the above issue are increasingly more inclined, and quite understandably so, to place their bet on preemptive measures of Dispute Resolution such as Advance Pricing Agreement (APA).

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2. Deemed International Transaction

2.1 Introduction

Below is the provision of Sub-section (2) of Sec. 92:

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

Section 92B (1) of the Act defines the term 'international transaction' as the transaction between two or more AEs either or both of whom are non-residents. The said definition makes it crystal clear that at least one of the transacting entities must be non-resident in India for the transaction to qualify as an 'international transaction'.

Section 92B (2) of the Act creates a deeming fiction which extends the ambit of the term international transaction to include those transactions which an entity enters into with other entities which are not its AEs (hereinafter referred to as 'third party') provided either of the two conditions mentioned below are fulfilled:

- (i) There exists a prior agreement in relation to the subject transaction between the Third Party and the AE of the entity, or
- (ii) Terms of the relevant transaction are determined in substance between AE of Indian taxpayer and such Third Party.

The rationale behind this clause was to prevent the taxpayers from escaping the rigours of TP provisions in situations where the transaction appears to be between independent parties when viewed in isolation, however, in substance is influenced by the AE.

Unlike section 92B (1) of the Act which clearly states that at least one of the transacting entities should be non-resident, there was an ambiguity and uncertainty on the applicability of the of section 92B (2) when both the transacting entities were resident in India. With a view to clarifying the intention of the law, the Finance Act 2014 made specific amendments to section 92B(2), to include within a deemed international

transaction a transaction between a taxpayer and an unrelated party (whether resident or non-resident), if following conditions are satisfied:

- a. There is a Transaction between an Enterprise and a Non-Associated person or Third Party.
- b. The transaction can be traced to a prior agreement between the Third Party and the AE or is in substance between the Third Party and the AE.
- c. Either the Enterprise or the AE or both must be a non-resident.
- d. The Third Party may be a resident or a nonresident.

Thus, a transaction which an entity enters into with an unrelated resident person would be deemed as an international transaction provided if it fulfils the conditions highlighted above.

2.2 Implication

It is a usual practice for multinational groups to enter into global supply agreements for all its group entities across the globe. The essence of such agreements is to get better prices, volume discounts and standardised quality products and services for all its group companies by identifying vendors through a centralised agreement. The vendors supply goods and services to all the group entities of the multinational group through their local counterparts. The price which those local counterparts demand from the group entities may or may not be decided on the basis of the global supply agreement.

2.3 Triangular and Quadrangular arrangements

In triangular or tri-party agreements, the transaction between the taxpayer company and the other entity is governed by way of a tri-party agreement between the taxpayer company (A), its AE (B) and the 'other entity' (C). Thus, it can be reasonably assumed that the pricing and other terms of the transaction between A and C are in effect determined by B.

On the other hand in a quadrangular agreement, the AE (A) of the taxpayer (B) enters into an agreement with an independent third party (C) (hereinafter referred to as 'first agreement'). In pursuance of the first agreement, B enters into an agreement with a local counterpart of C in India (D) (hereinafter referred to as 'second agreement'). Thus, the transaction between B and D, both of whom are resident in India and are not AEs are governed by two separate agreements.

If B & D do not enter into second agreement for the said transaction, or terms of the agreement between B & D are in substance determined by first agreement, then the transaction between B & D would be deemed as an international transaction.

However, if B & D enter into an independent agreement to independently determine the terms of the transaction between them, the transaction would fall outside the scope of deemed international transaction.

2.4 Case Law

i. Kodak India Pvt Ltd v. ACIT TS-471-HC-2016 (BOM)-TP

- Mumbai ITAT gave a categorical finding that the terms of transaction between Kodak India, the taxpayer, and independent third party in India with whom Kodak India had entered into transaction with was not governed by the agreement which the parent entity of Kodak India had entered into with AE of the third party.
- The Hon'ble Bombay HC rejected the appeal of the tax authorities against the above order on the premise that the tax authorities had not controverted the factual finding of Mumbai ITAT that the terms of the transaction between Kodak India and the independent third party have not been determined in substance by the AE of Kodak India.

ii. Thomson Reuters India Pvt Ltd v. ACIT (ITA No. 901/Mum/2014)

- On similar facts, the Mumbai ITAT set aside the case to the file of the TPO to analyse the terms of the agreement between the Thompson Reuters, the taxpayer, and the Indian entity transacting with the taxpayer to see whether the terms of the agreement are in effect governed by the global agreement entered into by the AE of the taxpayer.

iii. Novo Nordisk India Pvt Ltd v. DCIT [2015-TII-233-ITAT-BANG-TP]

- Novo Nordisk India Pvt Ltd (Novo India) was a subsidiary of Novo Investments Pte. Ltd, Singapore, which, in turn, was a subsidiary of Novo Nordisk A/S Denmark (Novo Denmark). Novo India was in the business of trading in high-purity insulin formulations, insulin delivery systems and other pharmaceutical products. Novo India and Novo Denmark were AEs in terms of the Act.
- Novo India purchased finished goods from Novo Denmark, as well as from a third party Indian contract manufacturer, Torrent Pharmaceuticals Ltd (Torrent). Torrent manufactured finished products using raw materials procured from Novo Denmark. Further, Novo India had the right to use trademark and know-how

intangibles granted by Novo Denmark on a license basis and sub-licensed them to Torrent.

- Other important aspects with respect to the overall arrangement were:
 - the raw material supply agreement between Novo Denmark and Torrent included a clause giving exclusive supply of finished goods (which were manufactured using the raw materials purchased from Novo Denmark) to Novo India;
 - a facility establishment agreement between Novo India and Torrent stated that Torrent would create a facility exclusively for production of finished goods for Novo India; and
 - a quality control testing agreement between Novo Denmark and Novo India provided that Novo Denmark would carry out quality testing of products manufactured by Torrent for Novo India.
- Amongst other issues, the Tribunal was required to determine whether or not the transactions between Torrent and:
 - Novo Denmark for the purchase of raw materials by Torrent from Novo Denmark; and
 - Novo India for the sale of finished goods by Torrent to Novo India were international transactions.
- The Tribunal took cognizance of the overall arrangement and the agreements entered into between the three parties, and noted that, in essence, all of the agreements referred to each other: reference to one agreement was clearly made in another agreement. The Tribunal held that, in substance, the purchase of raw materials by Torrent from Novo Denmark was in effect an international transaction between Novo Denmark and Novo India.
- The Tribunal referred to the definition of “transaction”, defined in section 92F of the Act, and found that it was a concerted action or arrangement which was brought out in a form that was apparently intended and framed in such a manner so as not to attract the provisions of section 92B of the Act. However, in substance, it was a transaction of supply of raw materials for manufacture of finished goods.
- Therefore, the Tribunal held that the provisions of section 92B (1) of the Act were satisfied, since one of the entities (viz. Novo Denmark) was a non-resident.
- Although, this case pertained to the AY 2008-09, which pre-dated the 2014 amendment to section 92B, the decision, which was pronounced by the Tribunal on 30 June 2016 (i.e. post-amendment), also referred to the 2014 amendment.

- The Tribunal observed that the amendment to Section 92B (2) was only by way of abundant caution. The Tribunal held that the concept of a transaction between two residents being regarded as international transaction was implicit in the scheme of transfer pricing provisions if it impacted or eroded the tax base in India.

iv. Renault India Pvt Ltd v. DCIT (ITA No.1078/Mds/2017)

- The assessee (Renault India - RI) bought cars from a resident vendor entity (Vendor Co.) and further sold them to dealers. RI was a wholly owned subsidiary of R.Co, France, which also held 30% stake in Vendor Co. Thus, there was no doubt RI, Vendor Co. and R.Co. France were associated enterprises. RI purchased cars from Vendor Co. in terms of a Master Supply Agreement between them, though there was no agreement as regards price and it was to be settled by mutual negotiation.
- Vendor Co. had in turn entered into a Master Licensing Agreement with R.Co France in terms of which Vendor Co. was to supply cars to specified AEs of R.Co. France. Even this agreement did not contain any stipulation as to the price at which Vendor Co. will sell the cars to the AEs. Vendor Co. paid royalty to R.Co. France.
- RI incurred heavy losses in the first year of operations and the Department contended that the losses had been incurred on instructions of the foreign parent (R.Co. France), who was in a position to control the pricing of cars. The Department also argued that the said arrangement for sale of cars in India was in existence even prior to the signing of agreements and the substance behind the arrangement and action in concert was to be seen. The assessment year in question was prior to the amendment of Section 92B(2) in the Act w.e.f. 1-4-2015.
- RI argued that the transaction between two resident entities (viz. RI and Vendor Co.) could not be brought within the ambit of deemed international transaction in terms of section 92B (1).
- The Tribunal agreed with this argument and held that amended Section 92B (2) was not applicable in the assessment year in question.
- The Tribunal further held that even if the amended provision of section 92B (2) was applicable, since there was no finding that the non-resident AE (R.Co. France) did in fact control the price, the transaction of purchase of cars cannot be said to be a deemed international transaction.

v. Shilpa Shetty v. ACIT [2018-TII-472-ITAT-MUM-TP]

- The Department invoked Section 92B (2) contending that Ms. Shilpa Shetty (SS) had promoted an event for Jaipur IPL Cricket P Limited (JICPL) without accepting any fee.
- SS didn't have any relationship with JICPL. However, the holding company of JICPL was K Co., in which SS's husband had substantial shareholding.
- The Department contended that such abstinence from charging fee for promotion by SS was influenced by the "relationship" between SS, JICPL and K Co. Interestingly, when K Co (represented by SS's husband) had acquired controlling stake in JICPL from the earlier shareholder (M Co), in terms of the Share Purchase Agreement (SPA) between shareholders, SS agreed to provide sponsorship service free of charge to JICPL.
- The Department contended that SS, JCIPL (the enterprise controlled by K. Co.) and K Co. (the company controlled by SS's husband) were AEs in terms of Section 92A(1) of the Act and the transaction of SS providing sponsorship services benefitted K Co, which did not pay any consideration for shares acquired from M. Co.
- As per the Department, the transaction between SS and JICPL (Non-AEs) would be a deemed international transaction in terms of Section 92B (2) and on this count also a transfer pricing adjustment was warranted.
- However, the Tribunal found force in the argument of the assessee that 'profession' by itself was not a person and that an enterprise in terms of Section 92F has to be a person.
- Further, it was held that in order to invoke Section 92B(2) there must a prior agreement between a third person and an AE. In this case, no agreement existed between SS and JICPL or SS and M. Co. T
- Thus, while the element of influence was visible in various parts of the transaction of share purchase, the elements did not quite fit into provisions of the statute.

2.5 ICAI Guidance Note on Report under Section 92E

In the said Guidance Note the ICAI has provided following guidance:

“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 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.”

“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.”

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3. Cost Contribution Arrangements

3.1 Statutory Provision

Section 92 (2). *Where in an international transaction or specified domestic transaction, two or more associated enterprises enter into a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises, the cost or expense allocated or apportioned to, or, as the case may be, contributed by, any such enterprise shall be determined having regard to the arm's length price of such benefit, service or facility, as the case may be.*

3.2 What is a Cost Contribution Arrangement? What are its essential features?

- A Cost Contribution Arrangement (CCA) is a contractual arrangement between associated enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights, and to define the interests of each participant in those assets, services or rights - this is how CCA is defined in the OECD TP Guidelines.
- CCAs may exist for any joint funding or sharing of costs and risks for acquiring property or obtaining services. CCAs are most common in relation to research & development (R&D) and development of intellectual property (IP) including IP use & ownership.
- Under a CCA, each participant's proportionate share of the overall contributions to the arrangement should be consistent with the participant's proportionate share of the overall expected benefits to be received from the arrangement.
- Thus, each participant in the arrangement, in return for agreeing to make a specified contribution towards the activity performed under the arrangement ('the CCA activity'), acquires a specified interest in the results of that activity.
- A participant's rights to exploit its interest, on successful completion of R & D, are free of obligation to pay royalties or other consideration additional to its contribution.
- To satisfy the arm's length principle, a participant's contribution must be consistent with what an independent enterprise would have agreed to contribute under comparable circumstances given the mutual benefits it reasonably expects to derive from the arrangement.
- It is essential that all parties to a CCA have the expectation of mutual benefit resulting in either cost savings or risk minimising. The expectation of mutual

benefit is what differentiates contributions to a CCA from ordinary intra-group transfers of property and/or services.

- Contributions under a CCA are determined (in cash or in kind) and allocated on the basis of the participant's shares of expected benefits (allocation key).
- Balancing payments may be required to adjust participants' proportionate share of contributions to constantly reflect the overall benefits received.
- Buy-in payments are necessary when a participant obtains an interest in an already existing CCA, or the parties own existing property which will form a part of the CCA.
- Buy-out payments are necessary when a participant disposes of its interest in an existing CCA to the other participants.
- Buy-in and buy-out payments should be determined based upon the arm's length value of the rights being obtained or rights being withdrawn.
- Where arm's length principles have not been followed, tax authorities are entitled to adjust the participant's contribution and/or payments. The tax authorities may also adjust or disregard a CCA under the following circumstances:
 - Facts and circumstances indicate that the reality differs from the terms purportedly agreed by participants
 - Substantial discrepancy or disproportion between purported contribution and benefits over time
 - The CCA is not based on a sharing of costs, i.e. in service situations
 - Non-commerciality - CCA designed just for tax purposes

3.3 Key Documentation Requirements

The OECD - in the guidelines issued under BEPS Action Plan 8 - suggests the following information would be relevant and useful to include while documenting the CCA:

- a) a list of participants
- b) a list of any other associated enterprises that will be involved with the CCA activity or that are expected to exploit or use the results of the subject activity
- c) the scope of the activities and specific projects covered by the CCA, and how the CCA activities are managed and controlled
- d) the duration of the arrangement
- e) the manner in which participants' proportionate shares of expected benefits are measured, and any projections used in this determination

- f) the manner in which any future benefits (such as intangibles) are expected to be exploited
- g) the form and value of each participant's initial contributions, and a detailed description of how the value of initial and ongoing contributions is determined (including any budgeted vs actual adjustments) and how accounting principles are applied consistently to all participants in determining expenditures and the value of contributions
- h) the anticipated allocation of responsibilities and tasks, and the mechanisms for managing and controlling those responsibilities and tasks, in particular, those relating to the development, enhancement, maintenance, protection or exploitation of intangibles or tangible assets used in the CCA activity
- i) the procedures for and consequences of a participant entering or withdrawing from the CCA and the termination of the CCA
- j) any provisions for balancing payments or for adjusting the terms of the arrangement to reflect changes in economic circumstances.

Further, over the duration of the CCA term, the following information could also be useful:

- i. any change to the arrangement (e.g. in terms, participants, subject activity), and the consequences of such change
- ii. a comparison between projections used to determine the share of expected benefits from the CCA activity with the actual share of benefits
- iii. the annual expenditure incurred in conducting the CCA activity, the form and value of each participant's contributions made during the CCA's term, and a detailed description of how the value of contributions is determined.

3.4 Written CCA Agreement – Contents

Considering the documentation requirements laid down by the OECD, the Agreement for CCA should specify the following:

- a list of participants
- an explanation of economic interest of each participant
- a description of the benefit of the project
- a description of resources at the disposal of each participant to contribute - it should provide for the reconciliation of MNE's transfer pricing policy with services including the CCA
- the benefit expected by each participant and way to measure them

- the type of services included in CCA
- the form and value of each participant's contribution
- the allocation of responsibilities and tasks between participants and indicating which company eventually centralizes the R & D activity performed
- the confidentiality clauses
- the access to subcontractors, and
- the duration of the agreement

3.5 OECD Guidelines on CCA

Under BEPS Action Plan 8 recommendations, the OECD has issued fresh guidance on CCA.

i. Control over risk

Under the New 2015 Guidance control has become a pre-requisite for an enterprise to be considered as a CCA participant.

Every participant in a CCA must have the functional capacity to exercise control over the risks it assumes under the CCA, and the financial capacity to assume those risks. This means that they must be capable of (and actually perform) making the decision to take on the initial risk of participation in the CCA, and have the ongoing decision-making capacity (and actually perform it) to decide on whether or how to respond to the risks associated with the CCA.

ii. Measuring the value of contributions to a CCA

A further aspect of the New 2015 Guidance is that the value of the contributions made by CCA participants must be in proportion to their reasonably anticipated benefits from the CCA. Where contributions are not in proportion to reasonably anticipated benefits, true-up payments may be required.

The value of each participant's contribution should be determined in line with the value that would be placed on it by independent enterprises in comparable circumstances.

iii. Balancing payments

A balancing payment may be necessary where the value of a participant's share of overall contributions under a CCA at the time the contributions are made is not consistent with the expected benefit to be received by the participant. The Final BEPS Report states that a balancing payment may be necessary where the value of a participant's proportionate contribution at the time of contribution was incorrectly determined, or where the participant's proportionate expected benefits were incorrectly assessed.

iv. Return to an AE providing only funding

If a CCA participant's primary role is funding of R & D (carried on under the CCA), then the new Guidelines limit the return to such participant unless the funder also manages and controls the risks associated with Development, Enhancement, Maintenance, Protections and Exploitation (DEMPE) of CCA intangibles.

3.6 Reporting Requirement

The new Transfer Pricing documentation standard requires reporting - under the Master File - of important service arrangements and important agreements related to intangibles, including CCAs.

The Local File requires transactional information including a description of the transactions, the amounts of payments and receipts, identification of the associated enterprises involved, copies of material intercompany agreements, and pricing information including a description of reasons for concluding that the transactions were priced on an arm's length basis.

It would be expected that in order to comply with these documentation requirements, the participants in a CCA will prepare or obtain materials about the nature of the subject activity, the terms of the arrangement, and its consistency with the arm's length principle.

Implicit in this is that each participant should have full access to the details of the activities to be conducted under the CCA, the identity and location of the other parties involved in the CCA, the projections on which the contributions are to be made and expected benefits determined, and budgeted and actual expenditures for the CCA activity, at a level of detail commensurate with the complexity and importance of the CCA to the taxpayer.

All this information could be relevant and useful to tax administrations in the context of a CCA and, if not included in the master file or local file, taxpayers should be prepared to provide it upon request. The information relevant to any particular CCA will depend on the facts and circumstances.

4. Management Service Fees

4.1 Background

The payment of Management Service Fees ('MSF') is a necessary modern day feature of Multinational Companies ('MNCs'). Centrally coordinated services are required by MNC Group entities in order to maintain global standards, quality, competitive edge, confidentiality, etc. and also to reduce cost.

Transfer Pricing Officers ('TPO') and Assessing Officers ('AO') view the payments of MSF with suspicion. They routinely disallow the MSF payments by determining the Arm's Length Price ('ALP') as Nil on various grounds, such as, no services were received, no benefits were received, duplicative services were received, the services were in nature of shareholder activity, or only incidental benefits were received. According to the TPO no independent third parties would be willing to make payment for availing management services, and so the ALP is determined as Nil.

4.2 What Documents and Evidences should you maintain in order to demonstrate that management services were indeed rendered by the Associated Enterprises ('AEs') and received by the Taxpayer Entity?

Ideally, the following documents and evidences should be maintained.

- a. Agreements – Clauses of the Agreement should specifically include the below mentioned information:
 - Capability and Infrastructure of the AE to provide management services
 - Why the Taxpayer Entity needs to avail the management services?
 - Detailed description of various services, and nature of services received from AE
 - Mode of rendering and receiving of services
 - Fees for the services and the basis of arriving at the fees
 - Working of costs-allocations (Direct as well as Indirect charges), including allocation keys. Some examples of allocation keys are given below:
 - IT: number of PCs
 - Business management software (e.g. SAP): number of licences
 - Human Resources: headcount
 - Health and safety: headcount
 - Management development: headcount
 - Tax, Accounting, etc.: turnover or size of balance sheet
 - Marketing services: turnover
 - Vehicle fleet management: number of cars

- The Agreement should clearly state these aspects: What exactly is provided by the AE? In what manner? And at what cost?
- b.** Wherever feasible, the following record of services received during the year may be maintained. Such record should preferably be contemporaneous i.e. as and when the services are received.
- Visits of AE's Personnel
 - Trainings, Workshops, Seminars, etc. conducted by the AE
 - Research Reports made available by the AE
 - Expert Presentations shared by the AE
 - Access to IT Systems, Websites, Databases, Intranet, etc.
 - Screenshots of login by users of taxpayer entity
 - Logbook of users of IT Systems, ERP, Accounting Systems, E-learning, etc.
 - Certificates of Experts of AE
 - Certificates from AE's Management
- c.** Evidence of the AE's Capabilities, Cost Centre, Infrastructure, etc.
- AE's Profit and Loss Account and Balance Sheet
 - Certificate from AE's Auditors
 - Certificate from AE's Management
- d.** Proof that Services were rendered by the AE
- Record of Personnel employed by the AE
 - Costs incurred by the AE
 - Assets and Infrastructure deployed by the AE
 - Mode through which services were rendered by the AE. For example, emails, expert presentations, research reports, conference-calls, workshops, trainings, site-visits, recommendations, access to databases, etc.
 - Document it all: Details of services rendered by the AE? When? In what manner?
 - Services rendered by the AE to other group entities
- e.** Proof that the services were received by the Taxpayer Entity
- Invoices
 - Ledger of AE
 - Benefits that accrued due to services
 - No corresponding Expenditure of the same or similar nature debited to the Taxpayer's Profit and Loss account
 - No corresponding Assets in the Balance Sheet
 - Emails and Correspondence, linked up with the Invoices.

- Conference calls
 - Visits of AE's personnel
 - Screenshots of websites, databases, Intranet, etc.
 - Expert Presentations and Research Reports provided by the AE
 - Certificates from AE's Personnel, AE's Management, or AE's Auditors
- f. Detailed Chart showing description of services, mode of receipt of services and proof of receipt of services
- g. *TP Study Report - Following details must be included in the TP Study Report:*
- Detailed description of services, benefits from services and rationale for availing services from the AE
 - ALP Benchmarking of the MSF paid to the AE

4.3 How should you benchmark the payment of MSF?

- a. To determine the ALP you can benchmark the payment of MSF by performing aggregated Transactional Net Margin Method ('TNMM') analysis. That is, you can bunch or combine MSF with other internal transactions (sales, purchases, etc) and apply TNMM in a combined manner. Thus, all international transactions, including MSF, can be benchmarked together, by way of comparison of Taxpayer's Profit Level Indicator ('PLI') at entity level, with the PLI's of comparable companies. This approach was approved by the High Court and the ITAT in following cases:
- *N L C Nalco India Ltd vs DCIT [TS-36-ITAT-2016(Kol)-TP] (ITAT Kolkata)*
 - *Ingersoll Rand (India) Ltd vs DCIT IT (TP) [TS-190-ITAT-2015(Bang)-TP] (ITAT Bangalore)*
 - *DCIT vs Payne (India) Pvt Ltd, [TS-346-ITAT-2015(Bang)-TP] (ITAT Bangalore)*
 - *Knorr-Bremse India (P) Ltd vs ACIT [2015] 63 taxmann.com 186 (Punjab & Haryana)*
 - *McCann Erickson India (P) Ltd vs Addl CIT [2012] 24 taxmann.com 21 (ITAT Delhi)*
 - *DCIT vs Danisco (India) (P) Ltd [2015] 63 taxmann.com 174 (ITAT Delhi)*
 - *Fosroc Chemicals India (P) Ltd vs DCIT [2015] 58 taxmann.com 85 (ITAT Bangalore)*
 - *AWB India (P) Ltd vs DCIT [2014] 50 taxmann.com 323 (ITAT Delhi)*
- b. The benchmarking under TNMM can further be corroborated by using the Other Method (the 6th Method) by using quotations of third party suppliers providing same or similar kind of services.

- c. Cost Plus Method - or TNMM - can also be applied by taking the Service Provider AE as the Tested Party. Of course, to do that you will have to identify Foreign Comparables using Foreign Databases. This approach was approved by the ITAT in the following cases:
- *AWB India (P) Ltd vs Addl CIT, ITA No. 4454/Del/2011, dated 22 March 2013 (ITAT Delhi)*
 - *Gillette India Ltd vs ACIT [2015] 62 taxmann.com 57 (ITAT Jaipur)*

4.4 Relevant Case Law – Cases decided by the High Court and the ITAT

In a large number of cases the High Court and the ITAT have decided the Issue of MSF in favour of the Taxpayers. Below we highlight the principles laid down by the High Court and the ITAT:

- i. Evidence filed by the Taxpayer should not be ignored
- ii. Necessity to avail of Services from AE cannot be questioned by the TPO and the AO
- iii. Taxpayer's Business Judgement and Commercial Expediency cannot be Questioned
- iv. Whether the Taxpayer received any Benefit from the Services is not a relevant consideration
- v. TPO cannot compute ALP of services at NIL
- vi. Burden is initially on the assessee to determine the arm's length price
- vii. It is the Taxpayer's burden to prove receipt of Service from the AE
- viii. Cost-Allocations are acceptable; direct-charge is not required in all cases
- ix. What are the Elements of TPO's Authority?
- x. TPO cannot determine ALP of services under CUP method without bringing on record comparable transaction
- xi. The Taxpayer can Benchmark the Management Services by applying Entity Level TNMM, by aggregating management service transactions with other transactions
- xii. The Management Services can also be Benchmarked by taking AE as the Tested Party
- xiii. Division of Authority between the AO and the TPO
- xiv. Management Service Fee should not be taken as Expenditure to compute Assessee's PLI
- xv. Principle of Year-to-Year Consistency does not allow authorities to take view which is different from the view taken in earlier or later years

4.5 Landmark High Court Judgements

i. Knorr-Bremse India (P) Ltd vs ACIT [2015] 63 taxmann.com 186 (Punjab & Haryana High Court)

- The TPO held that the assessee had sufficient local help to allow it to overcome the legal challenges at the local level. The TPO held that there was no reason to believe that the AEs provided assistance that the assessee could not obtain at the local level in India.
- That, however, cannot be a ground for rejecting a claim for deduction. Nor can that be a ground for assuming that the consideration paid for the same is not the genuine arm's length price. In absence of any law, an assessee cannot be compelled to avail the services available in India. It is for the assessee to determine whose services it desires availing of and whose goods it intends purchasing. It is certainly understandable if the assessee prefers to deal with its Group Entities/AEs. This is for a variety of reasons which are far too obvious to state. So long as there is no bar in law to the assessee availing the services of a particular party, the authorities under the Act must determine whether the consideration paid for the same is at an arm's length price or not.
- The assessee's claim of payment of service fee to AEs cannot be disallowed, even if the assessee fails to establish that it has benefited from the services provided by the AEs.
- The answer to the issue whether a transaction is at an arm's length price or not is NOT dependent on whether the transaction results in an increase in the assessee's profit. This would be contrary to the established manner in which business is conducted by people and by enterprises. Business decisions are at times good and profitable and at times bad and unprofitable. Business decisions may and, in fact, often do result in a loss. The question whether the decision was commercially sound or not is not relevant. The only question is whether the transaction entered into was bona fide or not or whether it was sham and only for the purpose of diverting the profits.

ii. Hive Communication (P.) Ltd. v. CIT [2011] 201 Taxman 99 / 12 taxmann.com 287 (Delhi High Court)

- The legitimate business needs of the company must be judged from the view point of the company itself and must be viewed from the point of view of a prudent businessman. It is not for the Assessing Officer to dictate what the business needs of the company should be. He is only to judge the legitimacy of the business needs of the company from the point of view of a prudent

businessman. The benefit derived or accruing to the company must also be considered from the angle of a prudent businessman. The term "benefit" to a company in relation to its business, it must be remembered, has a very wide connotation and may not necessarily be capable of being accurately measured in terms of pound, shillings and pence in all cases.

iii. CIT vs Cushman and Wakefield (India) (P) Ltd [2014] 46 taxmann.com 317 (Delhi High Court)

- The authority of the TPO is to conduct a transfer pricing analysis to determine the ALP and not to determine whether there is a service or not from which the assessee benefits. That aspect of the exercise is left to the AO.
- The AO can determine under Section 37 that the expenditure claimed was not for the benefit of the business, and thus, disallow that amount. This does not restrict or in any way bypass the functions of the TPO. Quite to the contrary, it represents the correct division of jurisdiction between the two entities.

iv. CIT vs EKL Appliances Ltd [2012] 24 taxmann.com 199 (Delhi High Court)

- It is not necessary for assessee to show that any legitimate expenditure incurred by him was also incurred out of necessity. It is also not necessary for assessee to show that any expenditure incurred by him for the purpose of business carried on by him has actually resulted in profit or income either in the same year or in any of the subsequent years. The only condition is that the expenditure should have been incurred "wholly and exclusively" for the purpose of business and nothing more.
- Whether or not to enter into the transaction is for assessee to decide. The quantum of expenditure can no doubt be examined by the TPO as per law but in judging the allowability thereof as business expenditure, he has no authority to disallow the entire expenditure or a part thereof on the ground that assessee has suffered continuous losses. The financial health of assessee can never be a criterion to judge allowability of an expense; there is certainly no authority for that.
- So long as the expenditure or payment has been demonstrated to have been incurred or laid out for the purposes of business, it is no concern of the TPO to disallow the same on any extraneous reasoning.

4.6 TPO cannot compute ALP of services at NIL

In the following cases the Tribunal has held that TPO cannot compute Arm's Length Price (ALP) of management services at NIL.

- *Tudor India Private Limited (formerly known as Tudor India Limited) [TS-458-ITAT-2018(Ahd)-TP]*
- *Schneider Electric India Pvt Ltd [TS-433-ITAT-2017(Ahd)-TP]*
- *Essentra India Pvt Ltd vs DCIT, ITANo.446/Bang/2012, dated 24/7/2015 (ITAT Bangalore)*
- *DCIT vs Payne (India) Pvt Ltd, [TS-346-ITAT-2015(Bang)-TP] (ITAT Bangalore)*
- *Castrol India Ltd vs ACIT [2013] 29 taxmann.com 62 (ITAT Mumbai)*
- *Castrol India Ltd vs Addl CIT [2014] 45 taxmann.com 330 (ITAT Mumbai)*
- *Festo Controls (P) Ltd vs DCIT [2013] 30 taxmann.com 16 (ITAT Bangalore)*
- *Dresser-Rand India (P) Ltd vs Addl. CIT [2011] 47 SOT 423/13 taxmann.com 82 (ITAT Mumbai)*
- *N L C Nalco India Ltd vs DCIT [TS-36-ITAT-2016(Kol)-TP] (ITAT Kolkata)*
- *DCIT vs. Diebold Software Services (P) Ltd [2014] 48 taxmann.com 26 (ITAT Mumbai)*
- *DQ Entertainment (International) Ltd vs ACIT [2015] 64 taxmann.com 360 (ITAT Hyderabad)*

4.7 Summing Up

Payment of Management Service Fee (MSF) is widely prevalent in MNC Groups. That is because centralisation of management services provides distinct advantages, in the form of global best practices and competitive edge. Despite sound commercial rationale, TPO's and AOs routinely disallow the payment of MSF on various grounds, as discussed in this Article. The Taxpayers can, however, defend the claim of MSF, by maintaining appropriate documentation; and by presenting their case in a persuasive manner with the help of sound arguments supported by favourable case laws. There are a number of ITAT and High Court cases that have decided the issue of MSF in favour of the Taxpayers.

5. Value Chain Analysis

5.1 What is a Value Chain Analysis (VCA)? How can a VCA help companies?

Value Chain Analysis (VCA) tells the 'value creation story' of a group: how and where economic value is created, and by which parties within a multinational group.

VCA is really an answer to the question 'how does a business create value', with value being the difference between what a business is able to sell its goods and services for, and the cost of creating them. The value chain is the overall complete overview of all the activities of a company. Every function, every business, every activity is part of the value chain. A value chain as a concept is distinct from a supply chain, which typically focuses on the "flows of goods and services.

VCA is important both for disclosure in the updated transfer pricing documentation standard recommended by the OECD, but also as a way to test and corroborate the alignment of transfer pricing outcomes with economic value creation.

Consider this example. A MNC earns profit of 100 from final sale of goods to the end-customer. How that profit is to be divided among, or allocated to, different entities of the MNC in different countries? Profit is to be divided based on Functions performed, Assets deployed and Risks borne (FAR) i.e. the value contributed. The BEPS Action Plan 8-10 provides that risks should be allocated to different group entities properly, and the contractual and actual realities must be in harmony. That will lead to proper determination of value contributed by different group entities. And on basis of such value, profit can be allocated to different group entities. The determination of value contributed by different group entities participating in the chain of activities (like R & D, Manufacturing, Distribution, etc.) can be done by undertaking a VCA.

When we conduct a VCA, we start the process by making a snapshot of the total company, the as-is situation. Interviewing key people is important to determine the key contributions made by entities across the group. We start by reviewing all the existing documentation (financial statements, tax returns, policies, transfer pricing documentation, CbCR and so forth).

During this review a lot of things come up that should be addressed (primarily risks). Companies should look at the VCA as a tool to assess how the company deals with transfer pricing. Is everything up-to-date? During this process, it frequently becomes clear that the transfer pricing documentation is not what it should be. This is because local consultants often prepare documentation without looking at the whole picture.

The next step is to come up with recommendations on how to optimise the value chain. That means revisiting the existing tax-business model, as our first step was identifying where value was created. As such, we can use the outcome of this process to propose

a revised tax-business model to optimise that value creation. By sitting down with management, we can discuss whether the proposed model or the proposed changes to the model fit the company.

The result of performing a VCA is often that companies want to change their current transfer pricing documentation set-up by taking responsibility and applying a more centralised transfer pricing documentation approach.

5.2 Transfer Pricing Disclosure Requirements for Value Chain Analysis

The OECD report Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 updates chapter V of the OECD guidelines. There is now detailed specification as to the three tier approach and what is required to be included in a master file and local file, as well as setting out country by country reporting requirements.

- A master file (the group 'blueprint'), sets out an overview of the group's business including important drivers of business profit and description of principal contributions to value creation by individual entities within the group, its intangible assets, important service arrangements, intercompany financial activities and overviews of financial and tax positions.
- A local file is the transactional record for the year and supporting analysis for each entity. It should set out entity specific details and more detailed financial and operational information on specific intercompany transactions and include both comparability analysis and explain why the transfer pricing methodologies used are the most appropriate. It needs to be calibrated at the entity level although files for different entities may be aggregated.
- A country-by-country report.

The master file requires two key areas of information relating to a value chain analysis:

- i. Drivers of business profit; and
- ii. Principal contributions to value creation by individual entities, i.e. with reference to key functions performed, important risks assumed and important assets used.

The purpose of this is to provide an overview of the group and to enable a relation to the value creation as a whole by the granular local file economic analysis and support for material categories of controlled transactions.

The local file requires detailed, entity level functional analysis - the functional analysis should make reference to value creation.

5.3 Tax Planning and VCA

Say, a group entity owning manufacturing plants is structured as a contract manufacturer or a group entity owning R & D facilities is structured as a contract R & D service provider. By doing so substantial profit can be booked in the hands of the entrepreneurial entity, while nominal profit can be booked in the hands of the contract manufacturer and the contract R & D service provider. This way of tax planning can be done by locating the entrepreneurial entity in a low-tax jurisdiction when the contract manufacturer and the contract R & D service provider are located in a high-tax jurisdiction. That is high FAR is allocated to entrepreneurial entity in low-tax countries; and low FAR is allocated to contract manufacturer and the contract R & D service provider in high-tax countries. This is a common way of tax planning. But, in the Post-BEPS era and in the era of GAAR one has to substantiate any tax planning with adequate substance. The profit allocated to different group entities must be aligned with value contributed by those entities across the value chain of the MNC.

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6. Typical Business Models

6.1 Business Model for Outsourcing vs. Captive Operations (Captive Service Provider)

The most common approaches nowadays are either working with a third party outsourcing provider or establishing captive operations in lower cost locations. Engagement models can be bifurcated based upon customer organization's need for management control, costs of operation, risks and other factors.

6.1.1 Third-party Outsourcing

Third-party outsourcing is classic client-vendor relationship governed by contractual obligations and service level agreements. It is mostly driven by tactical reasons such as short-term cost savings and staffing flexibility. Non-core or non-critical activities are typical candidates for outsourcing.

Traditional third-party outsourcing comes in two main forms:

- i) Project-based outsourcing* is considered to be the most appropriate for development of software with well-defined requirements and deliverables. It is suitable for irregular but on-going or one-off projects. On-site presence may be required to facilitate estimating, specification and relationship management. Typical pricing models are Time and Materials (T&M) and Fixed Price.
- ii) Dedicated development center model* caters for software with changing requirements, maintenance and support of large systems, research and development, testing as well as other types of complex ongoing medium- or long-term tasks. In this type of engagement vendor provides necessary facilities and allocates a team that works only on account's projects and is managed by customer representative. This option is usually preferred when resource requirements are low. The customer is charged fixed monthly fee per full-time employee (FTE).

6.1.2 Captive Operations (Captive Service Provider)

When considering how to organize the remote delivery of software development services, captive subsidiary option often does not receive full consideration in comparison to outsourcing. While it is generally accepted to outsource certain non-critical activities, in certain cases this approach is inappropriate for core functions and critical activities. Decision to take work offshore/near-shore doesn't necessarily mean that you have to outsource it. Use of remote resources for the delivery of functions close to core business while retaining operational control and benefiting from real cost

advantages can be achieved by means of setting up captive facility, thus keeping work within the company.

Captive model means that customer organization makes strategic decision to create its presence in the lower cost location and conduct work there as a part of its own operations. The activities are performed remotely, but they are not outsourced to the vendor. Thus the customer is able to retain full control and mitigate respective risks associated with intellectual property and other sensitive business information.

Organizations that want to establish captive centers have similar goals as those deploying traditional enterprise or shared services operations. In the first place captives are supposed to lower cost through labor arbitrage. But recent research shows that buyers are seeking not only cheaper but skilled labor at offshore/nearshore locations. They want to obtain competitive advantage and gains from process improvements. In order to avoid risks of underutilizing captive capacities, organizations must thoroughly assess their long-term operational requirements and predict service needs that may arise in the future.

The most common approaches to setting up captive operations are the following:

i) *Creating Captive Center from scratch (do-it-yourself captive)* can be successful when customer organization has necessary resources, local expertise and market knowledge. Decision to set up own captive center may evolve organically through growth. Organization can either perform extensive due diligence on its own or buy existing company with operations in the chosen location.

ii) *Build-Operate-Transfer (BOT)* approach means partnering with third-party vendor to establish and stabilize center. Vendor is responsible for initial setup, staffing and operations of the captive center during the predefined period of time. At the end of the contract period the ownership is transferred to the customer. Thus organization takes over the turnkey captive center tailored to its specific needs. BOT option best suits organizations that do not have local expertise or extensive resources available. In this type of engagement only logistics associated with setup of the captive center is outsourced. Build-Operate-Transfer optimally combines control element of the pure captive model with flexibility of outsourcing. Essentially it provides maximum control at minimal risk.

Both outsourcing and captive operations have similar driving forces (cost reductions and competitive pressures in the first place) and particular advantages, but main factors for choosing one or another vary.

Both approaches will deliver benefits in terms of improved focus, optimization of processes, reduction of operational costs, faster time-to-market etc. But companies must thoroughly evaluate each option to identify one that represents the best fit for their specific requirements, business culture and strategic goals.

In determining ALP of Indian Captive Service Provider there has been controversy about comparing BPOs with KPOs. However, Courts have held that BPOs cannot be compared with KPOs for benchmarking.

6.2 Different Models of a Distributor

An entity's profitability is typically related to the functions, risks, and intangible assets associated with its activities. Therefore, it is important to define the business model selected, as it will drive the type and amount of compensation that can be determined under arm's length principles and will define which country will enjoy the largest portion of the profits. Some of the common business models used by sales and distribution organizations today are:

- i) Limited Risk Distributor
- ii) Full Fledged Distributor (Marketer/Distributor)

The key characteristics of these two popular business models are as follows.

i) Limited Risk Distributor (LRD)

In general, an LRD is a buy/sell organization that performs all sales and distribution functions and has limited risk profile.

The limited-scope distributor undertakes many of the same activities as a marketer/distributor; however, the primary distinction between the two entities is the degree of involvement in strategic marketing decisions. In many industries, a limited-scope distributor has little or no strategic marketing responsibility, but may undertake the day-to-day risks delegated by the manufacturer whose products the limited-scope distributor purchases and resells. Because the distributor does not undertake responsibility for these functions, it also avoids the associated risks, including some market risk, and typically does not develop the associated marketing intangibles.

Local revenue is recorded on the books of the LRD as well as the cost of goods sold. In some cases the intellectual property (IP) is bundled in the product price paid to the Principal, who is the IP owner. In other cases, especially for a more mature company, there is a separate service fee for the use of intangibles. This fee or royalty is charged in addition to the purchase price of the product/offering.

For an LRD, the resale price method or the comparable profits method (CPM) can be utilized to determine the amount of the payment to be received. Various algorithms can be used to determine a targeted distribution return, such as a Return on Sales (ROS) or the Berry Ratio (i.e. the ratio of gross profits to operating expenses).

ii) Full Fledged Distributor (FFD)

In general, a FFD undertakes all of the sales and distribution functions as well as the typical risk incurred in performing this function. It buys, holds and sells product/offerings, as appropriate.

Additionally, the FFD (marketer/distributor) holds some strategic and operational marketing responsibility. These marketing functions include: (i) conducting market research, such as building sales forecasts and consumer profiles; (ii) developing advertising materials or campaigns or hiring independent advertising professionals; and (iii) developing strategic marketing plans. Because the FFD undertakes both operational and entrepreneurial functions relating to the marketing, distribution, and sales activities, the marketer/distributor bears the risks associated with these activities, such as credit, inventory shrinkage, and market risk. It also develops the associated marketing intangibles, including (i) customer relationships, (ii) recognition of a trademark/trade name, (iii) a third-party dealer network, and/or (iv) expertise in either technical or customer assistance.

As with the LRD, local revenue is recorded on the books of the FFD and in addition to the purchase price of the goods/offering, there is a separate charge/royalty for the Principal's IP.

6.3 Principle-to-Principle vs Agent Relationship

A Principal is the enterprise that provides goods to the customer, through an intermediary that is either another Principal or an Agent.

In Principle-to-Principle transactions the Foreign Principal sells goods to the Indian Principal and then the Indian Principal sells the goods to customers. So, a Principle-to-Principle transaction is a buy-sell transaction. The Indian Principal buys goods from the Foreign Principal on its own account. The title to the goods passes over from the Foreign Principal to the Indian Principal.

All related risks like inventory risk, credit risk, market risk, etc. are taken over by the Indian Principal who functions like a Full Fledged Distributor.

An agent is the entity arranging, on behalf of the Principal, the goods to be sold by the Principal to the customer. An agent acts on behalf of the principal and normally will receive a commission for its services. The title to the goods does not pass to the Agent.

An Agent generally operates as a sales representative, who does not purchase products for resale, but receives a commission on the sale of products to customers. The Agent contacts customers on behalf of a manufacturing or distribution entity. An Agent is responsible for typical sales functions, such as:

- (a) identifying potential customers;
- (b) calling on active and potential customers;
- (c) introducing new products;
- (d) taking customer orders;
- (e) maintaining customer relations; and
- (f) providing limited technical assistance.

An Agent might constitute a Dependent Agent Permanent Establishment of the Foreign Principal if the conditions prescribed in the Tax Treaty are met.

Article 5 (Permanent Establishment) of the OECD Model Tax Treaty contains the following provisions:

Article 5.5 - Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are

- a) in the name of the enterprise, or
- b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
- c) for the provision of services by that enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

Article 5.6 - Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.

Similar provision is also made in Explanation 2 of Sec.9 (1)(i) of the Act.

So, if the Foreign Principal or the Foreign Enterprise sells goods in India through an Agent then there is a risk that the Agent might constitute Permanent Establishment of the Foreign Principal. But selling goods in India under a buy-sell model in a Principle-to-Principle transaction will mitigate that risk.

6.3.1 FAR Profile

The Function, Asset and Risk (FAR) Profile of Principal-to-Principal Entity vs An Agent is laid out below –

Functions, Assets and Risks	Principal-to-Principal Entity	Agent
Marketing	Yes	No
Sales	Yes	No
After sales Services	Yes	No
Inventory Management	Yes	Yes
Customer List	Yes	Yes
Warehousing Facilities	Yes	Yes
Marketing Intangibles	Yes	No
Furniture/Fixtures/Communication Facilities	Yes	Yes
Market Risk	Yes	No
Price Risk	Yes	No
Inventory Risk	Yes	No
Product Liability Risk	Yes	No
Credit Risk	Yes	No
Warranty Risk	Yes	No

Relevant recent Tribunal cases -

- i. Nokia Networks OY v JCIT - [2018] 94 taxmann.com 111 (Delhi - Trib.) (SB)
- ii. HITT Holland Insitute of Traffic Technology BV vs. DCIT (2018) 52 CCH 0280
Kolkata Tribunal - ITA No. 390/Kol/2015 dated Apr 4, 2018

6.4 Different Models for Manufacturing Goods

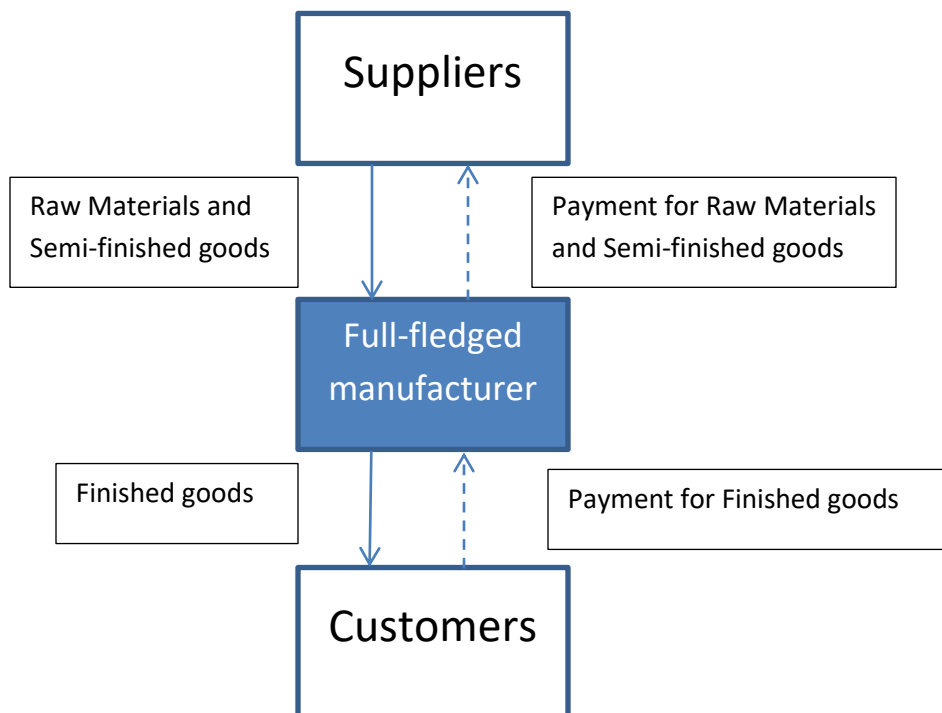
Manufacturers' operating structures are often described by the following commonly used terms according to their risk profiles and economic characterisations:

- (i) Full-fledged Manufacturer or entrepreneur;
- (ii) Licenced manufacturer;
- (iii) Contract manufacturer; and
- (iv) Toll manufacturer.

Although the boundaries between these terms are sometimes unclear and they may oversimplify complex manufacturing profiles, these terms summarising manufacturer risk and functional profiles are often useful in describing typical transfer pricing issues associated with the manufacturing sector.

Below mentioned are the practical illustrations of these four operating structures and associated intercompany transactions.

i) Full-fledged Manufacturer or Entrepreneur - An entrepreneur, or a full-fledged manufacturer, may be responsible for activities such as production planning, input procurement, supply chain management, quality control, long-term capacity utilisation planning and potentially selling to third-party customers. A full-fledged manufacturer possesses routine intangibles it bears a range of risks associated with those activities, such as product liability, warranty, capacity utilization, market demand and pricing risks. A full-fledged manufacturer/entrepreneur also may be engaged in significant R&D activities, bearing risks associated with development, maintenance and protection of valuable intangible property that may result from the R&D activities. An entrepreneur manufacturer earns returns on routine functions (including routine manufacturing operations) and on its contribution toward valuable intangibles.

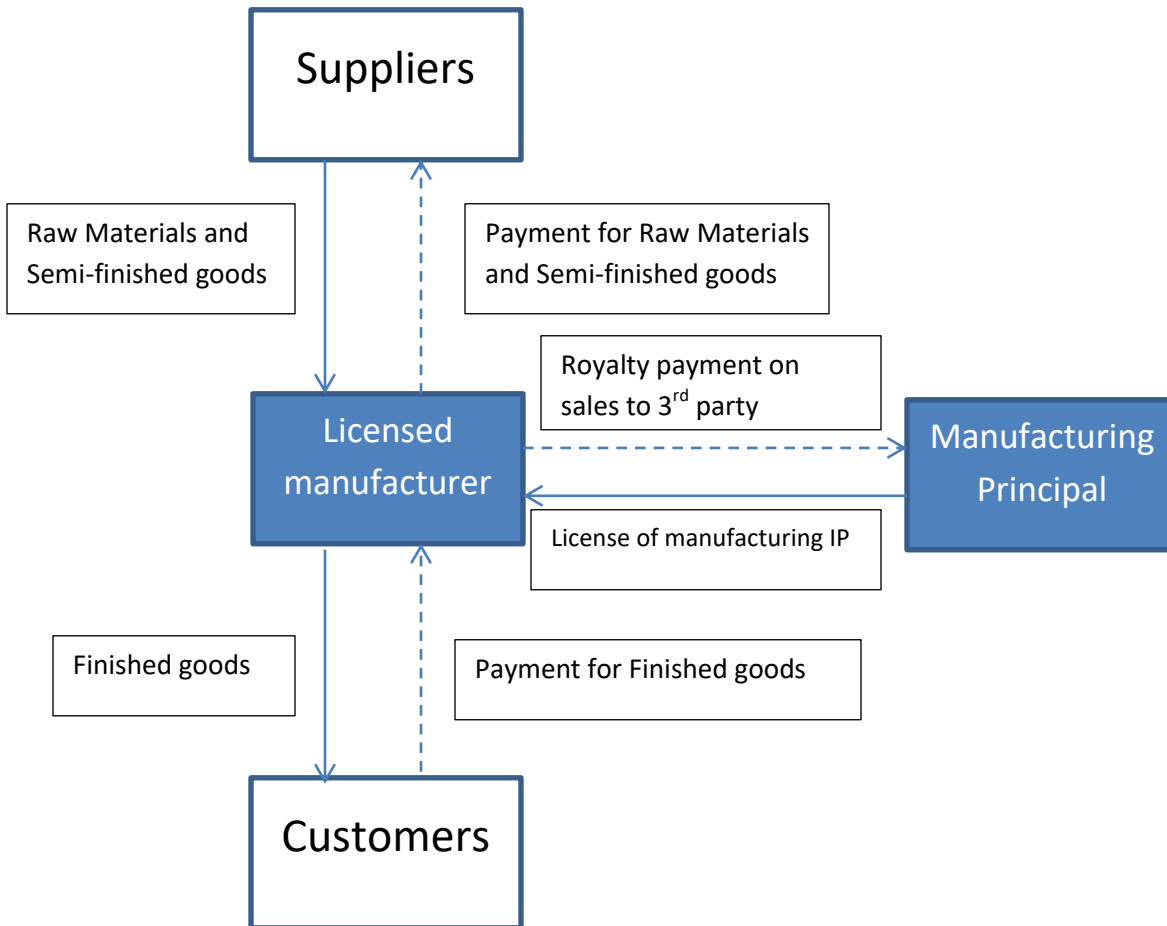


For example, in a simplified model, with one entrepreneur and many non-entrepreneurial entities in an MNE group's value chain, non-entrepreneurial entities (such as limited risk entities) earn returns on routine functions based, for example, on benchmark profitability established from functionally comparable companies. The entrepreneur receives all residual profits or losses from the value chain. In this system, the non-entrepreneurial entities' profitability tends to be relatively stable, as it is subject to a fixed benchmark profitability range, whereas the entrepreneur manufacturer's profitability can vary significantly (reflecting the entrepreneur's higher risk profile) in line with the group's aggregated profit level.

ii) Licenced Manufacturer - A licensed manufacturer produces goods under a licence agreement, using manufacturing intangibles owned by the licensor, such as patents, product designs, manufacturing process and knowhow. The licenced manufacturer pays royalties for the use of the licenced intangibles, typically buys raw materials and semi-finished goods on its own account and holds inventories of the raw materials and finished goods. Therefore, it bears the risks associated with both holding inventories and selling products, including demand and pricing risk. The licenced manufacturer typically owns plant and equipment necessary for manufacturing operations and invests in training its labour force.

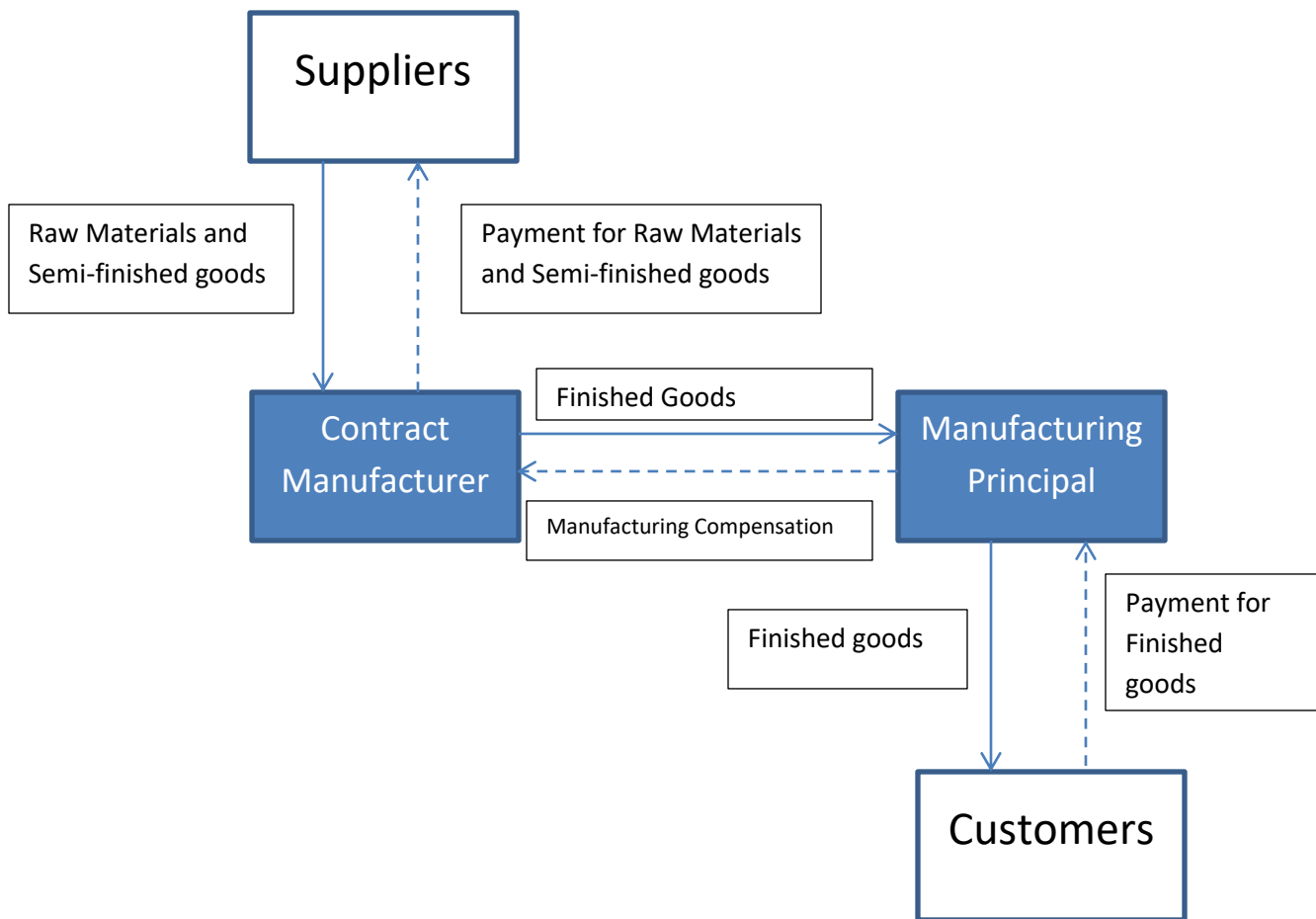
Intercompany transactions under this framework often include tangible property transactions, intangible property transactions and services transactions that may be highly interrelated. For example, in its manufacturing operations, a licenced manufacturer may use specially designed equipment purchased from the licensor, high-quality components supplied by the licensor, valuable production process knowhow developed and owned by the licensor, valuable testing services, technical support and quality assurance protocols provided by the licensor. The licenced manufacturer's operating profits, therefore, are driven by value derived from tangible property, licenced intangible property and services. In profit based transfer pricing analysis, in particular, it is important to recognise the potentially interdependent nature of multiple intercompany transactions and consider review of results aggregating several categories of intercompany transactions. Compensation for a licenced manufacturer is often best determined as a limited risk return in line with industry benchmarks established from functionally comparable manufacturing companies' operating results.

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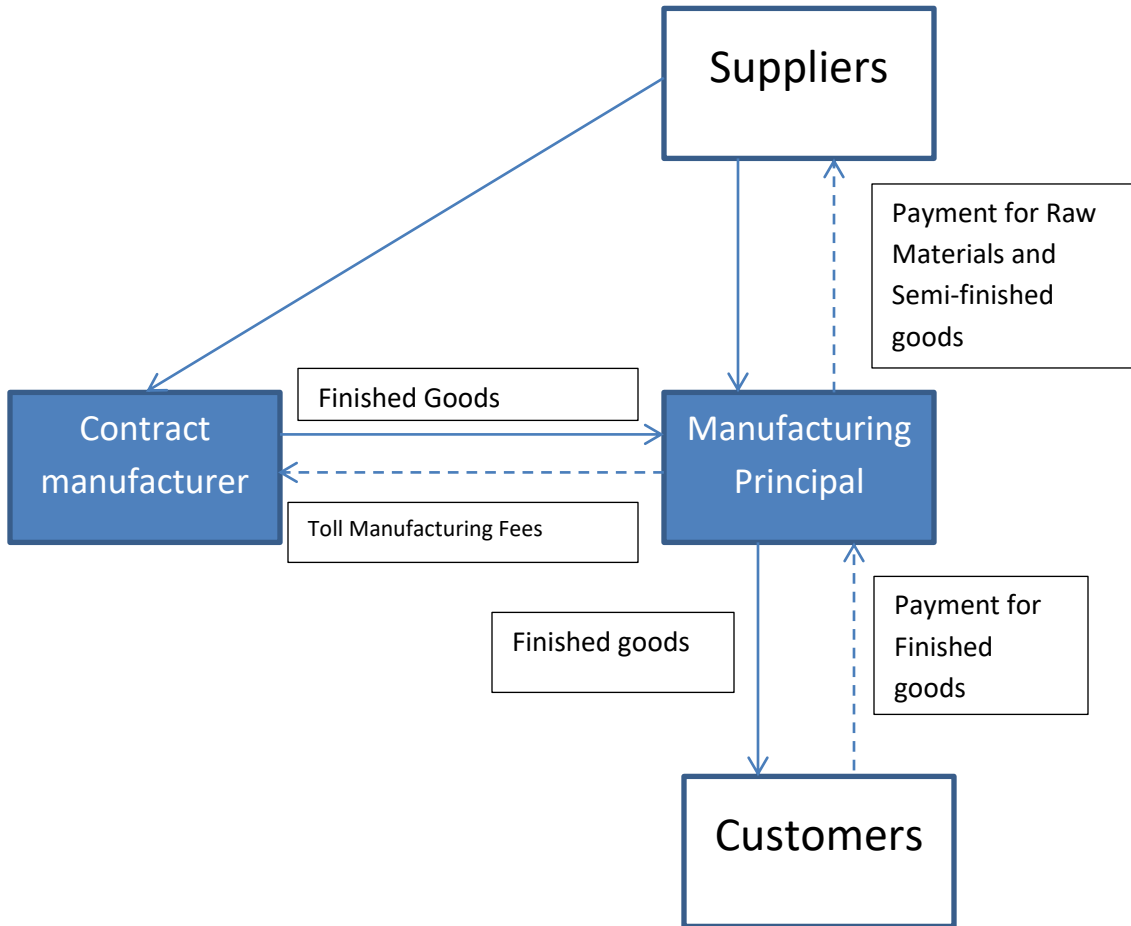
iii) Contract Manufacturer - A contract manufacturer is generally thought of as less risky than a typical licenced manufacturer. The contract manufacturer produces goods for a manufacturing principal that directly bears demand risk and final customer pricing risk. Provided the products made by the contract manufacturer comply with the principal's product and quality specifications, the principal may guarantee to purchase the goods. *Therefore, the contract manufacturer may bear relatively limited risks associated with holding finished goods and selling them, compared with a licenced manufacturer.* The contract manufacturer typically owns plant and equipment and procures/owns raw materials, and thus still bears the risks associated with holding fixed assets and raw material inventory.

A typical intercompany transaction between a manufacturing principal and a contract manufacturer is the contract manufacturer's sale of manufactured goods to the principal. The contract manufacturer is compensated by the principal typically through a return to enable the contract manufacturer to earn an arm's length mark-up on total costs, that is, a return on value added manufacturing services reflecting a return on its capital investments and investments in raw material inventory.



You may refer to the case decided by Ahmedabad Tribunal in *Sun Pharmaceutical Industries Limited vs ACIT, TS-596-ITAT-2017 (Ahd)-TP*. It is an instructive case where nuances of Contract Manufacturing vis-à-vis Full-fledged Manufacturing are discussed.

iv) Toll Manufacturer - Under a toll manufacturer framework, the principal retains title to the raw materials, work in process and final products during the manufacturing process. The related party manufacturing principal owns raw materials and makes them available to the toll manufacturer for processing (that is, the toll manufacturer does not take title to raw materials). The toll manufacturer performs processing services, and is compensated by the manufacturing principal through a toll manufacturing fee that is typically calculated as a mark-up on processing costs. The manufacturing principal bears the risks associated with holding raw materials and finished goods inventory, as well as final demand and price risks.



6.4.1 Functions, Assets and Risks (FAR Analysis)

Functions, Assets and Risks (FAR Analysis)	Contract Manufacturer	Toll Manufacturer	Full-fledged Manufacturer or entrepreneur	Licensed manufacturer
Manufacturing	For Principal	For Principal	For itself	For Principal
Research & Development	No	No	Yes	No
Advertisement & Marketing	No	No	Yes	Yes
Distribution	No	No	Yes	Yes
Procurement	Generally Does Itself	No	Yes	Yes
Production Scheduling	No	No	Yes	Yes
IP	Licensee; no exploitation rights	Licensee; no exploitation rights	Yes	Licensee; no exploitation rights

Inventory	Owner*	Does Not Own	Owner	Owner
Market & Price Risk	Does not bear	Does not bear	Does bear	Does bear
Technology Risk	Does not bear	Does not bear	Does bear	Does bear
Inventory Risk	Bears (but the risk is very low)	Does not bear	Does bear	Does bear
Capacity Risk	Does not bear (Unless not captive)	Does not bear	Does bear	Does bear
Product/Service Risk	Does bear (Service)	Does bear (Service)	Does bear	Does bear

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7. How to Attribute Profits to a Permanent Establishment?

7.1 Introduction

In BEPS Action 7 the OECD has recommended changes to Tax Treaties to prevent Artificial Avoidance of Permanent Establishment (PE) Status. Those changes are being made through Multi-Lateral Instrument (MLI).

So now, Post-BEPS and Post-MLI, we are more likely to be confronted with the formation of PE in Host Country (e.g. India), whereas in earlier times we were able to plan for avoidance of PE. When a PE gets formed it becomes necessary to attribute taxable profits to the PE. How do we attribute profits to a PE?

7.2 Attribution of Profits to a PE: Authorised OECD Approach

Under Article 7(2) of Tax Treaties the PE is hypothetically treated as a distinct and separate enterprise dealing independently with the Head Office (HO) or the Parent Enterprise (of which PE is a part). This is a hypothesis because actually a PE is not legally and economically separate - like a Subsidiary is - and a PE, not being a separate legal entity, actually does not deal independently with the HO.

7.2.1 Step I: Functional and Factual Analysis

Because the PE is actually not a separate and independent entity, first we need to construct the PE as a hypothetical distinct and separate enterprise dealing independently with its HO. To do that the Authorised OECD Approach ('Step I + Step II' prescribed in OECD 2010 Report on Attribution of Profits to PEs) guides us that in Step I we should undertake a Functional and Factual Analysis (FFA), leading to:

- i. The attribution to the PE of the contractual Rights and Obligations arising out of transactions (evidenced by contracts between the enterprise and external parties) between the enterprise of which the PE is a part and separate external enterprises;
- ii. The identification of Significant People Functions relevant to the attribution of economic ownership of Assets to the PE;
- iii. The identification of Significant People Functions relevant to the assumption of Risks, and the attribution of Risks to the PE;
- iv. The identification of other Functions (or Activities) - in addition to the Significant People Functions relevant to the attribution of economic ownership of Assets and Significant People Functions relevant to the assumption of Risks - of the PE;

- v. The recognition and determination of internal Dealings between the PE and other parts of the same enterprise (HO and other parts) that can appropriately be recognised; and
- vi. The attribution of Capital based on the Assets and Risks attributed to the PE.

7.2.2 Step II: Determining the Profits of the PE as a Hypothesised Separate and Independent Enterprise based upon a Transfer Pricing Comparability Analysis

After constructing or setting up the PE as a Hypothetical Separate Enterprise we can then move to Step II of the Authorised OECD Approach to determine the Arm's Length Price of Internal Dealings (e.g. purchase of goods from HO for resale, sale of goods to HO, rendering service to HO, etc.) between the PE and the HO or Parent Entity (of which PE is a part).

In Step II the Internal Dealings, between the PE and the HO, recognized in step I, is priced at arm's length, assuming the PE and the HO (or rest of the enterprise of which it the PE is a part) to be independent of one another, as if the PE is an Associated Enterprise (AE) of the HO. The arm's length price of Internal Dealings is determined using Comparability Analysis applying the Most Appropriate Transfer Pricing Method.

We must keep in mind that in addition to the Internal Dealings with HO the PE may have transactions with other unrelated external enterprises as well as transactions with other related enterprises (AEs). In the case of transactions with unrelated enterprises (Arm's Length Parties) the PE's profits (or losses) attributable to its participation in those transactions (Arm's Length Transactions) can be computed directly. And the pricing on an arm's length basis of any transactions with AEs (other than HO), attributed to the PE, can be done separately by performing Transfer Pricing analysis.

The attribution of profits to a PE of an enterprise on an arm's length basis will follow from the calculation of the profits (or losses) from all its activities, including transactions with other unrelated external enterprises, transactions with related enterprises (with separate TP analysis) and internal dealings with other parts (HO) of the enterprise (under Step II of the Authorised OECD Approach). So, profits attributable to the PE from all its activities will be –

- Income and Expense with regard to dealings with third parties;
- Income and Expense with regard to dealings with AEs (other than HO) at ALP determined by making a TP analysis; and
- Income and Expense with regard to Internal Dealings with HO/Parent Entity (at ALP by virtue of Article 7 of Tax Treaties and determined by following Steps I and II of the Authorised OECD Approach).

7.3 Indian Scenario

7.3.1 Case of Daikin Industries Ltd decided by Delhi Tribunal

In this case the Delhi Tribunal held Daikin Air-conditioning India Pvt Ltd (DAIPL) as Dependent Agent PE of Daikin Industries Ltd - Japan, and examined the attribution of profits to such PE.

The Delhi Tribunal observed -

“Although the Hon'ble Supreme Court in *Morgan Stanley* (DIT (International Taxation v. Morgan Stanley & Co [2007] 162 Taxman 165/292 ITR 416 (SC)) has held that once a transfer pricing analysis is undertaken, there is no further need to attribute profits to a PE as, in such cases, nothing further would be left to be attributed, yet, their Lordships carved out an exception to the above general rule by laying down that:

'The situation would be different if transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a situation, there would be a need to attribute profits to the PE for those functions/risks that have not been considered.'

Therefore, in each case the data placed by the taxpayer has to be examined as to whether the transfer pricing analysis placed by the taxpayer is exhaustive of attribution of profits and that would depend on the functional and factual analysis to be undertaken in each case'.

The extant case falls within the ambit of the exception spelt out by the Hon'ble Supreme Court inasmuch as transfer pricing analysis in the hands of DAIPL captured only two functions, whereas it actually carried out several others functions as well, which have been itemized above. *'In such a situation, there would be a need to attribute profits to the PE for those functions/risks that have not been considered.'*”

The Delhi Tribunal went on to hold that the first step of finding out 'the amount of profit which would have been earned by the Foreign Enterprise from direct sale to end-customers in India' involves two sub-steps. First is determining the amount of total net profit earned by the Foreign Enterprise from direct sales to end-customers and the second is to work out that part of total profit, as determined in the first sub-step, which relates to the operations carried out in India.

In case of *Daikin Industries Ltd* the Delhi Tribunal determined that 10% Net Profit had been derived by the Non-Resident Japanese Principal from sales in India, and then attributed 30% of those profits to DAPE.

Finally, the Delhi Tribunal held that there can be no hard and fast rule of determining the rate of profit attributable to marketing activities carried out in India. It is a fact based exercise, depending upon the role played by the PE in the overall generation of income. Such activities carried out by a PE in India resulting in generation of income, may vary

from case to case. Attribution of income has to be in line with the extent of activities of PE in India.

7.3.2 Rule 10 of Indian Income Tax Rules 1962

We have the following provision in Rule 10 of Indian Income Tax Rules 1962.

If the Assessing Officer is of opinion that the actual amount of the income accruing or arising to any non-resident person whether directly or indirectly, through or from any business connection in India or through or from any property in India or through or from any asset or source of income in India or through or from any money lent at interest and brought into India in cash or in kind cannot be definitely ascertained, then this Rule enables the Officer to compute such income –

- (i) at such percentage of the turnover so accruing or arising as the Officer may consider to be reasonable, or
- (ii) on any amount which bears the same proportion to the total profits and gains of the business of such person (such profits and gains being computed in accordance with the provisions of Indian Income-Tax Act 1961), as the receipts so accruing or arising bear to the total receipts of the business, or
- (iii) in such other manner as the Officer may deem suitable.

This Rule under the Domestic Law of India enables the Officer to compute taxable income in India. Of course, PE is not explicitly mentioned in the Rule but PE will generally be included in a Business Connection.

Recently the Central Board of Direct Taxes (CBDT) brought out a proposed draft to replace the existing Rule 10 with the new Rule, recommending a simple, uniform and consistent method of profit attribution under Rule 10, to bring more clarity, predictability and objectivity to the process of attribution of profits.

The Draft New Rule 10 contains formula based rules based on factors like employees, assets, sales and users (in case of digital industry).

7.3.3 Does proposed New Rule 10 create any conflict with the Tax Treaties?

The proposed New Rule 10 does not seem to be creating any conflict. The tax treaty distributes taxing rights in favour of the source country when a PE exists in the source country. The source country is authorised to tax the profits attributable to the PE and such profits are to be determined in terms of the provisions of the domestic law i.e. Rule 10.

But where a taxpayer has access to a DTAA, most of tax treaties mandate the attribution of income to a PE on the basis that the PE is a 'single, distinct and separate'

enterprise [Article 7(2)]. However, the treaty further states that nothing in paragraph 7(2) will preclude attribution to a PE based on a country's customary approach [Article 7(4)] and the result of such apportionment is in conformity with principle of Article 7. In India, whether this customary approach is the apportionment based Rule 10 or, after the introduction of Transfer Pricing provisions in the Act in 2001, it is the 'arm's length principle' is a matter of debate which requires a careful consideration.

7.3.4 Sec. 44C of Indian Income Tax Act 1961

Section 44C defines head office expenses and lays down limit to which such expenses can be claimed as deduction from profits of the PE. The limit of deduction is 5% of adjusted total income even if the expenses actually incurred and attributable to the PE are higher.

Section 44C covers all executive and general administration expenses including rent, rates, taxes, insurance, salary, travelling etc. incurred outside India. Usually, the executive and general administrative expenses include expenses that are related to the overall management of the enterprise and, in addition to the specific expenses included in the inclusive definition, it can cover depreciation, expenses related to office equipment, expenses on periodic meetings, training and skill enhancement, market research and analysis, expenses on standard operating procedures, marketing costs for the overall enterprise, etc.

a. Interplay of limit imposed by Sec. 44C with Tax Treaties

Article 7(3) of the Treaties generally provides that all expenses including executive and general administrative expenses incurred for the purpose of PE should be considered for determining PE profits.

So, the expenses restricted by Section 44C can find shelter under this Article. Of course, the fact of expenses' actual incurrence and its connection to the business of the PE must be established. It is believed that since the expenses are general and for benefit of the overall enterprise, a direct benefit of the PE is not a prerequisite for the deductibility. Rather the test is the connection between the expense and the business of the PE.

Most Indian Treaties have Article 7(3) similar to OECD MC. But some Treaties, like India-USA Treaty, India-UAE Treaty and India-Canada Treaty, include in Article 7(3) the restriction imposed by Sec. 44C.

7.3.5 Sec. 92F (iii)

An Indian PE and its Foreign Head Office are considered as AEs by virtue of the Definition of 'Enterprise' which includes a PE - [see *Aithent Technologies Pvt. Ltd [TS-752-ITAT-2016(DEL)-TP]*

8. Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) Concept for Pricing of Transactions involving Intangibles

8.1 Introduction

DEMPE concept is designed to ensure that allocation of the returns from the exploitation of intangibles, and also allocation of costs related to intangibles, is made by compensating MNE group entities for functions performed, assets used, and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles.

DEMPE was introduced in the BEPS Actions 8-10 Report of the Transfer Pricing Aspects of Intangibles ('Aligning Transfer Pricing Outcomes with Value Creation'). The concept is that multiple entities within an MNE – not just the intangible's legal owner – may have been involved in the creation of an intangible's value. They may have performed functions, used assets, or assumed risks that are expected to contribute to the value of the intangible. As such, those various entities within an MNE should receive a portion of the profits that were gained from the exploitation of the intangible in question.

Before the DEMPE concept was introduced, the legal owner of an intangible was entitled to essentially all the returns generated by that particular intangible (e.g. intellectual property (IP), such as a patent, brand name or logo). This meant that, in practice, a MNE could set up operating (or manufacturing) company – for example, in India – but hold and register its patents, brand and trademark in a low-tax environment – such as Ireland or Cyprus – so that the IP holding entity could charge royalties to the Indian business for any income related to the IP registered in the low-tax environment. With the old model, the IP owner would be entitled to the income effectively generated by the Indian entity.

Now, under the DEMPE concept, any income that is generated as a result of that IP is owned by all the parties that perform the DEMPE functions. So, rather than the IP owner receiving the full amount of the returns generated by the intangible, the returns instead have to be divided between the group entities, in line with each entity's contribution to the value of the IP.

It is worth noting that in the case of the India–Ireland/Cyprus example mentioned above, if no DEMPE functions are performed by the Ireland/Cyprus entity (legal owner of IP), then under the new approach the Indian tax authorities would likely disallow the payments of royalty to Ireland/Cyprus entity especially if the DEMPE functions are performed by the Indian entity.

For transfer pricing purposes, legal ownership of intangibles, by itself, does not confer the right to retain returns derived by the MNE group from exploiting the intangible. As a result of the contractual arrangement between the MNE entities, these returns may initially accrue to the legal owner. However, if the legal owner performs no DEMPE functions, but acts only as a holding entity, the legal owner will not be entitled to any portion of the returns, other than compensation for the holding activities, if any.

DEMPE has significantly changed the way in which MNEs should determine arm's length conditions for controlled IP transactions between related parties. Appropriate compensation of entities that have performed DEMPE functions that contribute towards the profit generating value of an intangible is now a key consideration in establishing arm's length transfer pricing.

8.2 The DEMPE Functions: An Example

It is important to look at each of the DEMPE functions individually, in order to understand the overall intention and significance of DEMPE. Below is an explanation of each of the functions, for clarification. The functions will be discussed in the context of an example, to highlight what each function may entail and how profits may be divided.

The example is as follows. A premium Italian clothing brand has entities in Italy, India and Switzerland. The group develops a new product line for professional sporting goods, which is owned and promoted by the Italian entity. The Italian entity acquires the manufacturing technology licenses, which are needed to make the sporting goods, from third parties. The sporting goods are manufactured to the highest standards in India, by the Indian entity. The Indian entity also distributes the sporting goods, and launches an online platform where customers can connect with the brand and receive support to complement their purchase. Meanwhile, the Swiss entity enhances, revises and updates the product line.

Across the Italian, Indian and Swiss entities, different DEMPE functions are carried out – each of which contributes to the overall value of the intangibles of the sporting goods product line.

Based on the example scenario, the possible DEMPE functions and contributions of different entities are described below.

i. Development

The development of intangibles refers to everything that is associated with coming up with ideas for the brand and products, and putting plans and strategies in place for their creation.

In the above example, a number of different processes and ideas went into creating the intangibles for Italian brand's sporting goods product line. Each of the brand's entities was responsible for various parts of the development process, with some functions overlapping, so that multiple entities carried them out. For example, while the Italian entity was solely responsible for the initial brand development and the acquisition of technology licenses, it had a limited input in comparison to the Indian entity when it came to establishing quality standards for the manufacturing process. Likewise, the Swiss entity was instrumental in terms of establishing an enhancement strategy for the product line.

Indeed, it was up to the Indian entity to set up the sales process, refine the user experience and create the client platform.

ii. Enhancement

The term 'enhancement', in the context of DEMPE, involves continuing to work on aspects of intangibles to make sure they can perform well at all times and be constantly improved.

Just like with the development stage, in the example, the enhancement functions were divided between the three entities. Italian entity was mainly responsible for promoting the brand and enhancing its awareness, though it also provided inputs (to a lesser degree) on searching for the latest technologies to enhance the professional characteristics of the product. The Indian entity made contributions to enhancing the manufacturing process and improving the client purchase experience, and had sole responsibility when it came to encouraging client interaction. It was up to the Swiss entity to enhance the existing technology that the sporting goods product line was using.

iii. Maintenance

Maintaining intangibles involves doing everything that is possible to ensure they continue to perform well and generate revenue for a business.

In the case of the Italian clothing brand, maintenance was all about making sure clients were happy and that the quality of the products was consistently high. The majority of the responsibility for this fell with the Indian entity, which was in charge of nurturing client connections, monitoring client feedback, and quality control. The Indian entity also had input on making sure the purchase experience was consistent. The Italian entity was responsible for monitoring brand health and maintaining the brand's legal license agreements. The Swiss entity collected the client feedback and made sure that any performance issues were addressed through constant enhancements, revisions and updates.

iv. Protection

Brand protection is important for ensuring that the value of a brand's assets remains strong. It involves securing IP legal rights, making sure nobody can copy the ideas, and monitoring competitor's activities.

The processes for protecting the sporting goods brand were mainly divided between the Italian and Indian entities, with the Swiss entity just handling the legal registration of the technology enhancement patents. The Italian entity took care of enforcing brand protection and legally registering the brands, and, to a lesser degree, monitoring the technology license agreements.

The Indian entity developed the brand's online support systems and kept track of competition, while also handling aspects of patenting the business's manufacturing know-how and ensuring client privacy protection.

v. Exploitation

In relation to intangibles, the term 'exploitation' refers to the way in which intangibles are used to generate profits. For the Italian clothing brand example, the majority of responsibility for exploitation fell with the Indian entity, which was in charge of the following: introducing the brand to market; implementing the licensed and developed technology during the manufacturing process; selling the products; connecting with customers online; and helping customers benefit from the products.

The Italian entity showcased the brand along with its other brands, while the Swiss entity built on current technology and feedback.

The outcome of DEMPE Analysis

As you can see from the example above, the three entities contributed in varying degrees to the intangibles' value at different points of the revenue-generating process. Before DEMPE, all the residual income generated from the activities of the intangibles would have gone to the Italian entity, as it legally owns the brand IP and the contractual rights to the technology.

However, now that DEMPE has been introduced, each of the three entities outlined above is entitled to a proportionate share of the income generated by the particular intangibles that they helped to Develop, Enhance, Maintain, Protect or Exploit.

The share that the different entities within the value chain receive is determined in accordance with the importance of their contributions to the value of the intangible. This can be measured by assessing the performance of the different functions. However, this is only the first step of the analysis.

The DEMPE functions have different degrees of contribution to the value creation. Before any distribution of returns is estimated, one would need to assess the level of contribution of the different functions to the value-creation process.

Finding third-party DEMPE data

The BEPS Actions 8-10 report clarifies that taxpayers should carry out a DEMPE analysis to ensure that they are complying with the OECD BEPS guidance with regards to determining appropriate arm's length compensation for functional contributions towards intangibles.

DEMPE functions are integral to the value of intangibles, so they need to be analyzed in detail when assessing transactions between related entities. This can be facilitated by accessing data on third-party DEMPE functions and comparable uncontrolled transactions through a royalty rate database. With this data, taxpayers can ensure that their transfer pricing is at arm's length.

8.3 Framework prescribed by the OECD for TP analysis of Intangibles

OECD has prescribed a six-step framework to identify commercial or financial relations in the context of intangibles, which is discussed below:

Step 1: Identify unique and valuable intangibles and economically significant risks associated with the DEMPE of the intangibles;

Step 2: Identify full contractual arrangements and determine legal ownership;

Step 3: Conduct detailed functional analysis to identify the parties performing functions, using assets and assuming risks related to DEMPE of the intangibles;

Step 4: Confirm the consistency between the terms of the relevant contractual arrangements and the actual conduct of the parties;

Step 5: Delineate the actual controlled transactions related to the DEMPE of intangibles; and

Step 6: Where possible, determine arm's length prices for controlled transactions consistent with each party's contribution.

As summarized above, the BEPS Action Plan provides a detailed step-by-step process to identify parties involved in the DEMPE of intangibles of MNE group, to arrive at the arm's length compensation that should be awarded to the parties performing DEMPE functions.

8.4 BEPS - Key Recommendations under Action Plan 8 on Transactions involving Intangibles

Below are the key recommendations of OECD in BEPS Action Plan 8 on DEMPE concept -

1. Legal ownership of intangibles by an Associated Enterprise by itself does not entitle that Associated Enterprise to returns from the exploitation of intangibles. Associated Enterprises performing important value-creating functions related to the Development, Maintenance, Enhancement, Protection and Exploitation (DEMPE) of the intangibles, and controlling economically significant risks, will be entitled to appropriate arm's length return reflecting the value of their contributions.
2. An associated enterprise assuming risk in relation to the Development, Maintenance, Enhancement, Protection and Exploitation of the intangibles must exercise control over the risks and have the financial capacity to assume the risks.
3. Entitlement of any member of the MNC Group to profit or loss relating to differences between actual and expected profits will depend on which entity or entities assume(s) the risks that caused these differences, and whether the entity or entities are performing important functions in relation to the Development, Enhancement, Maintenance, Protection or Exploitation of the intangibles, or contributing to the control over the economically significant risks.
4. An associated enterprise providing funding and assuming the related financial risks, but not performing any functions relating to the intangible, can generally only expect a risk-adjusted return on its funding. And if the associated enterprise providing funding does not exercise control over the financial risks associated with the funding, then it is entitled to no more than a risk-free return.
5. A rigorous transfer pricing analysis by Taxpayers is required to ensure that transfers of hard-to-value intangibles are priced at arm's length.

9. Mutual Agreement Procedure

9.1 Introduction

Mutual Agreement Procedure (MAP) is an alternative available to taxpayers for resolving disputes giving rise to double taxation whether juridical or economic in nature.

When the domestic tax authorities interpret the DTAA in an inconsistent manner, in addition to the option of litigation available to the taxpayer under the domestic tax laws (filing objections before DRP, appeal to CIT (A), appeal to ITAT, etc.), DTAA also provide MAP as an additional option.

The DTAA between the countries authorizes assistance of Competent Authorities in the respective jurisdiction under MAP. In the context of OECD Model Convention for the Avoidance of Double Taxation, Article 25 provide for assistance of Competent Authorities under MAP.

MAP is a codified set of rules between nations to resolve disputes resulting in double taxation. It is one of the means of Alternate Dispute Resolutions provided for in the DTAA, wherein the aggrieved party may approach the Competent Authority (the Authority enabling Map under DTAA) of the Contracting State wherein he is a resident.

MNEs commonly approach Competent Authorities for resolution of the following issues under MAP:

- Adjustment made in the course of transfer pricing audit;
- Issues in relation to existence of Permanent Establishment and
- Attribution of profits to Permanent Establishment;
- Characterisation of income; etc.

9.2 Global perspective

Article 25 of the Organisation of Economic Co-operation and Development ('OECD') Model Tax Convention, which is the basis for Article on MAP for most of the DTAA provides for the following:

- Where the action of the tax authorities is not in accordance with the convention, resident of a contracting state may approach Competent Authority of either of the contracting states - both for economic and juridical double taxation;
- There is three years' time limit provided for presenting a case for MAP - from the date of first notification resulting in taxation not in accordance with the Convention.

Further, it is not necessary to exhaust the remedies available under the domestic tax provisions, to approach under MAP;

- If the Competent Authority believes that a case has merits, but cannot reach a unilateral solution, then the Authority seeks agreement with the other contracting state. For cases of elimination of double taxation that are not provided for in the DTAA, a mutually consulted solution may be arrived at;
- The taxpayer should be given right to make representations, in person or through a representative;
- Mutual agreement should be made subject to the acceptance of the agreement by the taxpayer and withdrawal of appeal concerning the points settled in mutual agreement.

BEPS Action Plan 14 has recommended that dispute resolution mechanism, including MAP, should be made more effective.

9.3 Who can apply for assistance of Competent Authorities under MAP?

The taxpayer of the country having to bear the incidence of double taxation can apply for assistance of Competent Authorities under MAP to resolve the issue of such double taxation.

Example: ABC Co Ltd is an Indian subsidiary of ABC Inc in US. ABC Co Ltd provides contract software development services to ABC Inc and is compensated on a 'cost plus' basis for the contractual services. During a Financial Year the international transaction of ABC Co Ltd were scrutinized by the Transfer Pricing Officer in India and an upward adjustment to income was made. The upward adjustment to the income, due to higher transfer price, in the hands of ABC Co Ltd would give rise to double taxation to ABC Inc., US. In such cases, under the India - US Tax Convention, ABC Inc can apply for assistance of Competent Authorities under MAP to resolve such incidence of double taxation.

9.4 Does the taxpayer have to exhaust the appeal options available under the domestic litigation route to apply for assistance under MAP?

Option of resolution under MAP is an additional dispute resolution option available to the taxpayer. It can be pursued simultaneously with the dispute resolution options available under domestic regulation.

If the taxpayer accepts the resolution arrived at under MAP, a letter indicating the acceptance of resolution under MAP, and withdrawal of appeal (to the extent of the issues covered under the MAP resolution) need to be made to the Assessing Officer

and the Appellate Authorities before whom an appeal is filed under domestic litigation provisions.

9.5 Can a taxpayer participate in the negotiation process between the Competent Authorities?

The negotiation process between the Competent Authorities of countries under MAP, are generally a 'closed door' event. Thus, the taxpayer would not have access to and cannot participate in the negotiation process between the Competent Authorities.

Taxpayers can, however, work with the Competent Authorities to explain their own case and positions prior to the negotiation meetings between the Competent Authorities.

9.6 MAP provisions under Indian Tax Laws

The enabler of MAP benefit for a taxpayer is the relevant DTAA. Under the provisions of the Income-tax Act, 1961 (the Act) read with Income-tax Rules, 1962 (the Rules), erstwhile Rule 44G detailed the application for initiating MAP and Rule 44H provided for the actions of the Indian Competent Authority. These rules were amended by the Central Board of Direct Taxes ('CBDT') vide notification dated 6 May 2020.

Broadly the following changes were made in the procedure by the amendment:

- i. Rule 44G and Rule 44H was consolidated into single rule 44G;
- ii. Where reference is received from Competent Authority outside India, the Competent Authority of India shall convey his or her acceptance or otherwise of the MAP reference;
- iii. The Competent Authority of India shall not just call for additional details, but also hold discussions with such authorities or the assessee or representative, to understand the actions taken by the income-tax authorities;
- iv. The Competent Authority in India shall endeavour to arrive at a mutually agreeable resolution of the tax disputes in accordance with relevant DTAA within an average time period of 24 months;
- v. The resolution arrived at shall not result in decreasing the income or increasing the loss, as the case may be, of the assessee in India, as declared by him in the return of income of the said year;
- vi. The resolution arrived at shall be communicated to the assessee in writing;
- vii. Assessee may accept or reject the MAP resolution in writing to the Competent Authority in India within thirty days of receipt of the communication. Further,

communication of acceptance shall be accompanied by proof of withdrawal of appeal;

- viii. Within one month from the end of the month in which the communication was received by the Assessing Officer about acceptance of MAP by the assessee, an order may be passed determining the amount of tax liability;
- ix. Further, copy of order shall be sent to the Assessee and Competent Authority.

In addition to the above, Form 34F (Form of application seeking to invoke MAP) is also amended providing for inclusion of detailed reasons of the order/ action of the Tax Authority of the Treaty Partner, and remedy sought in the other country or specified territory, if any, with documentary evidence.

Commitment shown by the CBDT to resolve MAP cases within 24 months and providing detailed procedures for invoking MAP, placing reliance on OECD Model Tax Convention, and BEPS Action Plan 14, is likely to lead MNEs to choose MAP as a preferred option to solve tax and transfer pricing disputes.

However, it is desirable that procedural clarity is provided in respect of domestic Courts/ITAT dealing with cases that are also covered under MAP. The present practice of Courts/ITAT adjourning *sine dine* matters which have been referred for MAP is a negative factor. It goes against the established principles that the assessee has the right to choose both the processes: the process under domestic law as well as the MAP process under DTAA - as held in the landmark judgement in the case of *CIT v. Visakhapatnam Port Trust (1983) 144 ITR 146 (AP)*.

Another negative factor is India not providing an option for arbitration in case the Competent Authorities cannot come to an agreement.

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10. Advance Pricing Agreement

10.1 Introduction

An Advance Pricing Agreement (APA) is a mechanism to resolve transfer pricing issues in advance, i.e., before the cross-border related party transaction actually takes place or, at least, before a dispute arises in respect of such cross-border transaction. In an APA the transfer price of goods and services transacted between group entities is decided in advance by the tax authorities and the taxpayers, so as to prevent any dispute arising from such transfer pricing. The primary goal of such programmes is to provide certainty to taxpayers in respect of the transfer price of the transactions undertaken by such taxpayers with their group entities.

The APA programme in India was launched in 2012 vide the Finance Act, 2012 through the insertion of Sections 92CC and 92CD in the Income-tax Act, 1961. These statutory provisions provide the legal basis for the CBDT to enter into APAs with taxpayers for a maximum period of 9 years (5 years forward and 4 years backwards i.e. rollback).

The Rules 10F to 10T lay down the APA Scheme. These rules lay down the detailed procedures for Pre-filing Consultation; Payments of Fees; Filing of APA Application; Processing of APA Application; Withdrawal of APA Application; Terms and Conditions of APA; Filing of Annual Compliance Report; Compliance Audit; Revision, Cancellation and Renewal of APA; etc.

Under the Indian APA programme, APAs can be multilateral or bilateral (involving CBDT and the tax authorities of one or more countries) or unilateral (involving the CBDT only). Over the last 7 years, more than 1150 applications have been filed in India. Majority of these applications (about 82%) are for unilateral APAs between the Indian taxpayer and the CBDT. Till 31st March, 2019, 271 Agreements have been entered into (240 unilateral and 31 bilateral).

10.2 What are the key benefits of an APA?

An APA provides certainty on the pricing and the TPM to be adopted for covered intercompany transactions. Further, a bilateral or multilateral APA also eliminates the risk of potential double taxation arising from controlled transactions.

The key advantages of APA can be summarised as:

- Certainty with respect to the outcome of covered transactions during the APA term
- Agreement as to information to be kept for annual report, low annual reporting cost
- Reduction in risk and cost associated with audits and appeals over the APA term
- Imparts flexibility in developing practical approaches for complex transfer pricing issues

- APA renewal provides an excellent leverage of time and efforts expended during negotiating the original APA

The Indian APA rules also provide for all the above benefits that are experienced under APA programmes in other countries. Moreover, the rules exhibit significant amount of flexibility in the process. Besides allowing for withdrawal, revision, amendment, etc., the Indian APA rules also allow the taxpayer to convert a unilateral into bilateral and vice versa in case of need. It also allows a 4 year roll-back under certain conditions.

10.3 APA – 5 Phase Process

Process	What happens during the Process?
Pre-Filing Consultation (Form 3CEC)	Explores suitability of an APA with the APA Teams Provides opportunity to discuss upfront the process, scope of covered RPTs, documents / data potentially required for the APA negotiations
APA Evaluation	Post the pre-filing consultation the APA Team evaluates the APA request made by the taxpayer and confirms its acceptance of the request for an APA by a written intimation
Main Filing (Form 3CED)	Detailed application containing information on the entity, AEs, RPTs, industry, TP method, critical assumptions, etc. to be filed
Negotiation & Finalisation	<ul style="list-style-type: none"> • Submission reviewed by APA Team • Site visits, discussions, joint meetings to gain a better understanding • After review, analysis & evaluation stage, positions of the APA team is discussed and agreed with the taxpayer • After the preparation of a mutually agreed draft, the taxpayer and the CBDT sign the APA
Annual Compliance	<ul style="list-style-type: none"> • Annual Compliance Report and Compliance Audit for the APA term

10.4 APA – Prefiling Consultation

Before making an application for APA, Taxpayers may choose to seek a Pre-filing consultation from the APA Cell of the Department. Pre-filing consultation is optional. Pre-filing can be done on anonymous basis.

The request for pre-filing consultation shall be made in Form No. 3CEC to the Director General of Income-tax (International Taxation). The relevant rule is Rule 10H of the Income Tax Rules 1962.

10.4.1 Process

- Request to be made in Form 3CEC to the Director General of Income Tax (International Taxation) ('DGIT')
- APA team shall hold pre-filing consultation with the applicant
- Competent Authority ('CA') in India/ representative shall be associated in pre-filing consultation (for bilateral or multilateral agreement)

10.4.2 Main Objectives

- Determine the scope of the agreement
- Identify TP issues
- Determine the suitability of international transaction for the agreement
- Discuss the broad terms of the agreement

10.4.3 Prefiling Consultation is Non-Binding

Pre-filing Consultation shall:

- Not bind the Board or the Taxpayer to enter into an agreement
- Not be deemed to mean that the Taxpayer has applied to enter into an agreement

10.5 Main APA Application- Form 3CED

- The APA Application in Form 3CED is to primarily amplify the information provided at the pre-filing consultation stage
- A detailed analysis of the Functions performed, Assets utilised and the Risks undertaken by the taxpayer and all relevant AEs should be included
- Business strategies, projections, etc. for Controlled Transactions should be included
- A detailed Industry / Market Analysis of all countries involved is also required to be included
- The Application should include historical information of:
 - Transfer pricing methodologies / policies for Controlled Transactions followed by all parties for past 3 years
 - Indian and Foreign Audits / Appeals / Proceedings before Competent Authorities
- A detailed analysis of transfer pricing methods including any Secondary Methods should be provided
- Impact of proposed transfer pricing methods on Controlled Transaction for past 3 years and for the period covered in the APA

- The APA Main Application can be withdrawn, at any time before finalisation of the terms of the APA, by filing request for withdrawal in Form 3CEE

Application for Rollback of an Advance Pricing Agreement is to be made in Form 3CEDA.

10.6 CBDT clarifies on APA Rollback Provisions

The Finance (No. 2) Act, 2014, provided for rollback mechanism in the APA program for a period of four years preceding the first previous year for which the APA is applied, subject to prescribed conditions. Thereafter, in March 2015, CBDT announced the rules and the procedure to give effect to the rollback provisions, following which the CBDT received several requests for clarifications in this regard. With a view to address concerns and clarify, the CBDT has in a unique question and answer format provided clarifications (Circular No. 10/2015).

The clarifications are:

Sr. No.	FAQ	Clarification
1.	Whether applicants who have filed return of income ('return') under Section 139(4) or 139(5) of the Income-tax Act, 1961 ('the Act') would be eligible for rollback?	<ul style="list-style-type: none"> • Rollback provisions will be available even in case of revised return filed under Section 139(5) of the Act, because the revised return replaces the original return. • Rollback provisions will not be available for a belated return filed under Section 139(4) of the Act, because it is a return not filed within the specified due date
2.	What is the meaning of the term 'same international transaction' referred to in the rollback provisions? Whether APA applicant can apply for rollback provisions if there is a change in the Functions, Assets, Risks ('FAR') analysis?	<ul style="list-style-type: none"> • It has been clarified that the term 'same' implies transaction of the same nature undertaken with the same associated enterprise(s) ('AEs') in respect of which the APA has been reached. • It is also clarified that the rollback provisions would apply only if the FAR analysis of the rollback year does not diverge materially from the FAR validated for the purpose of reaching an APA with regard to the international transaction(s) to be undertaken in the future years. Further, the term 'materially' will mean a material change of facts and circumstances which could reasonably have resulted in an APA with significantly different terms and conditions
3.	Whether rollback has to be requested for all 4 years or applicant can choose any	<ul style="list-style-type: none"> • An applicant has to choose all the 4 years for rollback, unless: <ol style="list-style-type: none"> a. the relevant international transaction was not

	year(s) out of the block of 4 years?	<p>undertaken in any of the 4 years; or</p> <p>b. the applicant fails the prescribed rollback conditions in any of the 4 years. In such cases, the applicant can still apply for rollback for the other years.</p>
4.	Whether there is a bar in case of the year where an order in appeal is passed by the Tribunal in respect of the determination of ALP for the international transaction?	<ul style="list-style-type: none"> • Rollback provisions would not be applicable for the international transaction for which the Tribunal has passed an order disposing of an appeal, since the Tribunal is the final fact finding authority, and hence on factual issues the matter would be assumed to have reached finality in that year. • On the other hand, if the Tribunal has not decided the matter and has only set aside the order for fresh consideration by the lower authorities with full discretion at their disposal, the matter shall not be treated as one having reached finality. Thereby rollback provisions would be applicable.
5.	Whether the rollback provisions can be applied in a manner to ensure that the returned income/loss is accepted as the final income/loss after applying the rollback provisions?	<ul style="list-style-type: none"> • In case the terms of rollback provision contain specific agreement between the CBDT and the applicant that the agreed determination of ALP is subject to the condition that the rollback benefit would be limited to the extent of declared income and not reduce the total income or increase the total loss.
6.	In the event the applicant fails to take required action for claiming a rollback benefit for some years after signing of the APA, whether the entire APA would stand cancelled or only those rollback years will be affected in which the applicant has failed to take the required action?	<ul style="list-style-type: none"> • Rule 10RA is to be followed which specifies action to be taken by the applicant to effectuate the rollback provision. • If rollback provisions are not given effect to in accordance with the prescribed rules, then the entire APA agreement would stand cancelled.
7.	What would be the view of the APA authorities if Mutual Agreement Procedure ('MAP') is pending or has already been concluded for a rollback year?	<ul style="list-style-type: none"> • If MAP has been concluded for any international transaction(s) in any of the rollback years under APA, rollback provisions would not be allowed for those international transaction(s) for that year but could be allowed for other years or for other international transactions for that year. • If MAP request is pending for any of the rollback years under APA, the APA applicant can exercise an

		option to pursue MAP or the rollback application.
8.	How would the ALP be determined?	<ul style="list-style-type: none"> • ALP could be different for different years. However, the manner of determination of ALP (including choice of method, comparability analysis and tested party) would need to be the same as that agreed in the APA.
9.	Whether compliance audit for rollback is required? Would critical assumptions need to be validated during compliance audit?	<ul style="list-style-type: none"> • ALP for rollback years would be agreed after full examination of all the facts including validation of critical assumptions. • Accordingly, compliance audit for the rollback years would be required, to check if the agreed price or methodology has been applied in the modified return.
10.	Can the rollback application be withdrawn?	<ul style="list-style-type: none"> • Applicant has an option to withdraw its rollback application even while maintaining the APA application for the future years. • However, the applicant cannot accept the rollback results without accepting the APA for the future years.
11.	In case of already concluded APAs, whether new APAs would be signed for rollback or the earlier APAs could be revised?	<ul style="list-style-type: none"> • Already concluded APAs may be revised to include rollback provisions.
12.	In case of already concluded APAs, where the modified return has already been filed for the first year of the APA term, how will the time-limit for filing modified return for rollback years be determined?	<ul style="list-style-type: none"> • Time to file modified return for rollback years will start from the date of signing the revised APA incorporating the rollback provisions.
13	In case of merger / de-merger of companies which company can claim the benefit of the APA?	<ul style="list-style-type: none"> • The APA is between the CBDT and a person (company). The principle to be followed is that the company who makes the APA application would be the company entitled to enter into an APA and claim the benefit of rollback in respect of the international transaction(s) undertaken by it in the rollback years. • Other companies that have merged with the applicant company later or have demerged from the applicant company would not be eligible for the rollback provisions under the APA.

10.7 APA Application - Other Points

Revision

- APAs can be revised by the Board either on its own or on the request of the taxpayer in case of change in critical assumptions; failure to meet conditions subject to which the agreement has been entered into

Acceptance

- The applicant taxpayer needs to communicate acceptance or otherwise to an APA agreed within 30 days

Cancellation

- An APA may be cancelled in case of failure of the taxpayer to comply with the terms of the agreement; or failure to file the annual compliance report in time; or if the annual compliance report filed contains material errors; or if the applicant does not agree for revision of the APA

Renewal

- Renewal is permissible, however no pre-filing consultation would be required in case of a renewal

10.8 Budget 2019 clarifications

Secondary Adjustment provisions shall only be applicable to APAs, which have been signed on or after 1 April 2017; however, no refund of the taxes already paid till date under the pre amended section would be allowed.

In cases where assessment or reassessment has already been completed and modified return of income is filed by the taxpayer, tax officers shall pass an order of the assessment or reassessment to only modify the total income of the taxpayer to the extent of terms of APA.

10.9 Other Important Points

i. Who would the APA team comprise of?

Generally, the APA team (revenue) would comprise of a team leader who is an expert in international tax and transfer pricing who can take help of an economist and other industry experts as necessary. The APA team for bilateral and multilateral APA would also include the competent authority office. The Indian APA rules provide for the constitution of an APA team (team) which will consist of an income tax authority and experts from economics, statistics, law and other necessary fields. For unilateral APAs, the Director General of Income Tax (International Tax and Transfer Pricing) [DGIT (Intl

Tax and TP)] would be responsible, who will be supported by the Commissioner of Income Tax (APA). For bilateral or multilateral APAs, the competent authority of India would be responsible, supported by the Director APA. Further, there are teams reporting to the Commissioner (APA) in three major cities of Delhi, Mumbai and Bangalore to facilitate the process.

ii. Who is eligible to apply for an APA?

There are no monetary or other conditions prescribed under the Indian APA rules for a taxpayer to be eligible to apply.

However, the APA mechanism is not available for domestic controlled transactions.

Per the Indian APA rules, the APA filing fees are set at relatively high amounts. Also, one of the objectives of pre-filing consultation is stated as 'to determine the suitability of international transaction for the agreement'. Therefore, it appears that while there is no express limitation on eligibility, the government is possibly looking for taxpayers to use the programme for complex and high stake transactions. The past two seasons of APA filing has not shown too many cases of application rejection at pre-filing consultation stage.

iii. What are the transactions that can be covered under an APA? Can I apply for certain specific international transactions instead of all my international transactions?

Any type of international transaction can be covered under an APA, e.g., transactions involving transfer of tangible and intangible properties, cost sharing, provision and receipt of services, etc.

APAs are also possible for international transactions with permanent establishments.

Further, similar to APA programmes in other countries, the Indian rules allow the taxpayer to selectively apply for an APA only for certain international transactions. In such cases, the taxpayer is required to disclose all other international transactions to the APA team.

It is also pertinent to note that an APA can be applied for both continuing as well as proposed transactions.

iv. Whether an APA is restricted to the determination of methodology only or if a specific price or rate can also be determined in an APA?

Generally, under an APA, the most appropriate TPM is determined upon negotiation and finalisation between the taxpayer and the tax authorities involved. Following agreement on the TPM, the APA may also agree on the transfer price or the outcome of the TPM over the APA term.

The Indian APA rules also provide for agreeing on the TPM alone, as well as the outcome of the TPM and transfer price over the APA term.

v. What are critical assumptions?

Critical assumptions refer to a set of taxpayer related facts and macro economic criteria (such as industry, business, economic conditions, etc.), the continued existence of which are material to support the concluded position under an APA. A material change in any of the critical assumptions may result in the revision of the APA, or even termination in extreme circumstances.

Critical assumptions form an integral part of the Indian APA programme as well. However, the rules do provide for sufficient flexibility to amend and revise an APA following a change in critical assumptions.

vi. For how long would an APA remain valid? Is renewal possible after expiry of the APA term?

The Indian APA rules provide for an APA term up to five years in addition it can also cover upto four preceding years in case of a roll-back.

Unilateral, bilateral or multilateral APAs may be renewed with the consent of all the parties to it, including the tax treaty partner who is a party to a bilateral or multilateral APA. A request for renewal of the APA would follow the same procedures that apply to an initial APA request.

It is essential for taxpayers to seek renewal early enough to allow the renewal to be negotiated and put in place prior to the expiration of the earlier APA. If the facts and circumstances are largely similar, a renewal can be completed in a relatively shorter timeframe.

vii. Whether there can be a roll back of the concluded APA to cover past open years which are not yet audited?

Usually, APAs cover prospective years, and if they provide reasonably agreed basis for resolving open issues, the agreed TPM / outcome can also be applied to resolve prior

year issues. The Indian APA rules permit roll-back upto four years prior to the APA period.

viii. What is the statutory fee for filing an APA application?

The APA filing fee, i.e. fee to be paid while filing the formal APA application depends upon the amount of the proposed covered transactions over the proposed APA term, as below:

- 1 million INR for international transactions up to 1 billion INR
- 1.5 million INR for international transactions up to 2 billion INR
- 2 million INR for international transactions greater than 2 billion INR

However, there is no fee prescribed for the pre-filing consultation process.

ix. What is the key information required for filing or negotiating an APA? Can I submit the required information documents later during the analysis and negotiation process?

In addition to the information required at the pre-filing consultation stage, documents containing the following information, among others, are required to be filed along with the APA submission:

- Details of proposed covered transactions
- Disclosure of other controlled transactions
- Transfer pricing background
- Financial statements, for past years and forecasts or financial projections
- Industry analysis (description of the taxpayer's core activities in the relevant industry)
- Business structure (description of the main business arrangements within the group of companies to which the taxpayer belongs)
- Detailed functional analysis (analysis of the functions performed by the taxpayer in relation to the controlled transactions, assets used to perform these functions and related business and commercial risks)
- Relevant economic analysis including impact of the proposed TPM

As can be seen, the prescribed form (Form No 3 CED) provides for detailed information to be filed with the APA application. While one may observe that several of these documents and information are generally available as part of the transfer pricing documentation maintained by the taxpayer, APA requires a deeper dive in to the facts, and the financial data.

The rules at present provide for upfront filing of the above documents. Further, the applicant may, if considered necessary, provide additional documents and information for consideration of the APA team, or the competent authority in India, or his or her representative.

It is observed that the APA team has been considerate in allowing sufficient time to provide some of these information following filing of the formal application.

x. As part of the APA process, will the authorities visit my office for investigation or verification of facts?

A well drafted and thorough APA application helps significantly reduce the questions from the tax administrations as well as the overall time in execution. Upon filing of the formal APA application, the tax administration will review it in detail.

Once the APA team starts reviewing the formal APA application, there will be rounds of questions raised by the APA team to obtain clarification and additional information as may be needed. In addition to the rounds of questions, the APA team normally visits the applicant's business premises. It may be helpful to organise site visits, especially in cases involving complex manufacturing operations, heavy use of fixed assets, intangible assets, etc. This is a common practice observed in other countries.

The site visits provide the APA team with a firsthand feel of the actual operations underlying the covered transactions and make it easier for them to better understand and appreciate the business realities. The taxpayer can suggest the relevant people to be interviewed to provide the APA team with better understanding of its business.

xi. Can I revise my application once it has been filed?

The taxpayer may request in writing for an amendment to an application at any stage, before the finalisation of the terms of the agreement. In this regard, the applicant needs to also provide the circumstances requiring the changes and submit supporting documentation with a proposed course of action as early as possible.

The DGIT (Intl Tax and TP) (for unilateral APAs) or the competent authority in India (for bilateral or multilateral APAs) may allow the amendment to the application, if such an amendment does not have the effect of altering the nature of the application as originally filed. Further, an amendment to the application may require an additional fee to be paid.

xii. How much time does it take to negotiate and conclude an APA (unilateral and bilateral)?

In most cases unilateral APA takes one to two years to finalise, and a bilateral APA takes two to three years. None of the countries have a specific timeline to finalize an APA, though they are guided by tentative target timelines. The Indian APA rules also do not specify any timeline to complete the entire process.

It will depend on a number of factors such as - (i) complexity of the transactions to be covered; (ii) availability or relative workload of the examiners and officers; (iii) whether it is a unilateral or bilateral APA; and (iv) the time taken by the treaty partners to review the bilateral and multilateral APA requests.

xiii. Is it possible to withdraw an APA application filed with the APA Authorities? Can I get the refund of application fees?

The taxpayer may withdraw itself from the APA process at any time before final agreement is reached. If the taxpayer opts to withdraw from the APA process, the APA filing fees would not be refunded.

xiv. How would the compliances be done (e.g., Return of Income, Form 3CEB etc.) in the interim period when the APA is under negotiation?

Per the Indian regulations, the annual transfer pricing compliances and income tax return filing should be carried out by the taxpayer in the regular manner until the APA is concluded.

Once an agreement is reached, the taxpayer would be required to file revised return (for the covered years that has elapsed) within 3 months from the end of the month in which the agreement is entered into. Further, in case the assessment of the year under APA is completed or is pending, the same has to be completed giving regard to the APA.

xv. What are the annual compliance obligations of the taxpayer once an APA is agreed with the revenue authorities?

The taxpayer will be required, as part of the APA, to prepare an annual compliance report ('ACR'), for each year of the APA, containing sufficient information to detail the actual results for the year, and to demonstrate compliance with the terms of the APA.

The ACR need to be furnished within thirty days of the due date of filing the income tax return for that year, or within 90 days of entering into an agreement, whichever is later.

The details of the ACR are provided in form 3CEF. It contains information on the actual results for the year to demonstrate compliance with the terms of the APA, and the

necessary information and computation to ascertain the outcome of the application of the TPM for the covered transactions. As required in many countries, the taxpayer is required to declare whether there are any changes in the business model, functional and risk profile, critical assumptions and organizational structure.

Information to be included in ACR also forms part of APA agreement and as such reflect the result of discussions and negotiation with APA team.

Following the filing of the ACR, the jurisdictional TPO would carry out a compliance audit for each of the years under the APA term. The TPO would provide a report to the DGIT (Intl and TP) (for unilateral APAs) or the competent authority in India (for bilateral and multilateral APAs).

It is important to note that the APA can be cancelled for not filing the ACR in time and also for furnishing the same with material errors.

xvi. In case litigation is pending before tax authorities and ITAT, will my application be accepted?

There is no restriction for filing an APA in respect of transactions which are in litigation before tax authorities and ITAT. Accordingly, even if litigation in relation to the covered transactions is pending before tax authorities and ITAT, an APA application could be accepted.

That said, the prescribed form for applying for pre-filing meeting does require the taxpayer to provide information in relation to history of transfer pricing audits, assessments and present status of appeals.

xvii. Can the documents submitted during the APA process be shared with tax authorities for initiating and concluding other tax proceedings?

While negotiating APAs the taxpayers may have to submit sensitive information such as future business projections, marketing strategy, audited financials of associated enterprises, etc. It is important to consider the issue of sharing information filed by the taxpayer during an APA process, by the APA team with the on-field audit officers.

In this regard, most developed jurisdictions have rules governing sharing of such information, in the sense that either the sharing of such information is not allowed or only facts can be shared, without holding the taxpayer against any analysis submitted during the APA process.

At this point, the Indian APA rules are silent on this matter. It is believed that since most taxpayers to whom transfer pricing requirements apply, are subjected to regular audits, similar information would be accessible by the on-field audit officers as well during the audit process.

That said, some clarification in this regard is required from the government in order to dispel the apprehensions of the taxpayers.

xviii. Whether confidentiality of information filed during the APA process will be maintained? Will the revenue department publish details of the APA cases in the public domain?

It is highly expected that in order to ensure the success of an APA programme the APA authorities maintain strict confidentiality of taxpayer's data. During the pre-filing stage and subsequently in the APA application, a lot of critical and confidential data are discussed and shared with the APA authorities. In most cases classified information not only for Indian entities but also information pertaining to overseas associated entities may be provided with respect to the margins earned, basis of pricing, etc. Such information should be used only for negotiation purpose and arriving at the agreed TPM.

Since, APA is a client specific private agreement between that taxpayer and the governments of two or more states, the details of the agreement should not be ideally published in the public domain. This is unlike an advance ruling which is published in the public domain. Also, the Indian income-tax act provides for maintaining confidentiality of the information, which should be respected in this process.

Although not on case specific basis, the APA authorities of many countries publish annual reports on APA statistics which can provide guidance to taxpayers. However, the identity of the taxpayers involved is not revealed in such annual reports. It may be helpful for the taxpayers in the coming years, if the Indian APA office publishes such statistics after the programme is well established.

xix. If there is a significant change in law or facts, would the APA still be valid? Can I apply for an amendment to the APA or do I have to file a fresh application once again?

In the event of a change in law or facts it is most likely that the 'critical assumptions' would be impacted. These critical assumptions, as discussed earlier, are the bedrock on which the APA would stand. It is advisable to apply for a revision of the APA, which is permissible under the Indian APA rules. The APA authorities may agree on revision of the APA if there has been a material change in circumstances of the case instead of cancelling the APA and asking for a fresh application.

However, if the change in law is such that it renders the APA non-binding, a revision may not be possible.

xx. How best I can prepare myself for an APA?

It takes a significant amount of time to prepare the strategy, roadmap, alternative options available, etc which is very important for being prepared to take on the discussions with the APA team.

The following parameters are important in order to “get the house in order”:

- Preparation of a robust transfer pricing policy
- Aligning transfer pricing policy with commercial substance
- Having intercompany agreements aligned to business substance and transfer pricing policy
- Adherence to transfer pricing policy with strong back up documentation
- Deciding on the information and documentation to be shared
- Availability of financial projections
- Having alternative plan of actions in case APA does not work

10.10 APA - Experience so far

Over the last 7 years (FY 2012-13 to FY 2018-19) 1155 applications for APAs were filed in India. Majority of these applications (about 82%) were for unilateral APAs between the Indian taxpayer and the CBDT. Till 31st March, 2019, 271 APAs have been entered into (240 Unilateral and 31 Bilateral).

The International Transactions covered in these APAs, inter alia, include the following, -

- ❖ contract manufacturing
- ❖ provision of software development services
- ❖ back office engineering support service
- ❖ provision of back office (ITeS) support services
- ❖ provision of marketing support services
- ❖ payment of royalty for use of technology and brand
- ❖ trading
- ❖ payment of interest

11. Safe Harbour Rules

11.1 Introduction

Introduced in 2009, safe harbour provide for circumstances in which a certain category of taxpayers can follow a simple set of rules and rates under which transfer prices that are aligned to such rules are automatically accepted by the revenue authorities. It aims to provide an element of certainty to taxpayers. A safe harbour regime will, in particular, benefit taxpayers in the services sector by adopting a transfer pricing mark-up at the rate prescribed to avoid protracted litigation.

Profit margin rates specified under the Safe Harbour Rules provide arm's length price issued by the CBDT for specified international transactions. In case a taxpayer undertakes, or declares, certain specific international transactions at the specified safe harbour rates, it will be acceptable by the Income tax authorities and no further transfer pricing audit, and consequent adjustment, will be made for those international transactions.

Post 2009, first round of Safe Harbour Rule provisions were introduced in August 2013 for a period of 3 years, followed by revision in 2017 in the Safe Harbour Rule which were applicable till Financial Year (FY) 2019.

11.2 Extension of Safe Harbour Rules for FY 2019-20

The Central Board of Direct Taxes (CBDT), vide issue of Income Tax (9th Amendment) Rules, 2020 has notified Safe Harbour Rules for FY 2019-20. As per the notification, rates applicable from FY 2016-17 to 2018-19 will continue to apply for FY 2019-20 without any change.

The CBDT issued a gazette notification on 20 May 2020, to specify the safe harbour rates applicable for FY 2019-20, for determining arm's length rates for certain specified international transactions. The gazette notification states that the same rates as were applicable during the last three financial years, i.e., FY 2016-17 to FY 2018-19, would be applicable for FY 2019-20, as well. Unlike earlier safe harbour notifications by the CBDT in 2013 and 2017, which gave safe harbour rates for 5 years and 3 years, respectively, the current notification provides safe harbour rates for only one year, i.e., for FY 2019-20.

We expect the government to rationalise the rate under Safe Harbour Rules for FY 2020-21. This would go a long way in making this scheme more attractive for the taxpayers at large and provide tax certainty to business on the crucial aspect of transfer pricing.

11.3 Safe Harbour rates applicable for FY 2019-20

Sr. No.	International transactions	Monetary Threshold	Safe Harbour Rate
1.	Software development services and information technology enabled services	Up to Rs. 100 crore	Operating Profit Margin of 17%
		Rs. 100 crores to Rs. 200 crores	Operating Profit Margin of 18%
2.	Knowledge process outsourcing services	Up to Rs. 200 crores and employee cost to total cost ratio is:	
		Up to 40%	Operating Profit Margin of 18%
		40% to 60%	Operating Profit Margin of 21%
		Greater than 60%	Operating Profit Margin of 24%
3.	Contract Research and Development services relating to software development	Up to Rs. 200 crores	Operating Profit Margin of 24%
4.	Contract Research and Development services relating to generic pharmaceutical drugs	Up to Rs. 200 crores	Operating Profit Margin of 24%
5.	Intra group loans denominated in Indian currency	CRISIL rating of AE:	One year marginal cost of funds lending rate of SBI as on 1 st April, 2019 plus
		AAA to A or its equivalent	175 bps
		BBB-, BBB, BBB+ or Equivalent	325 bps
		BB to B or its equivalent	475 bps
		C to D or its equivalent	625 bps
		Credit rating of AE not available and the aggregate sum of loan advanced to AEs as on March 31, 2020 does not exceed Rs. 100 crore	425 bps
6.	Intra group loans denominated in foreign currency	CRISIL Rating of AE:	Six month's LIBOR of the relevant currency as on 30 September, 2019 plus

		AAA to A or its equivalent	150 bps
		BBB-, BBB, BBB+ or Equivalent	300 bps
		BB to B or its equivalent	450 bps
		C to D or its equivalent	600 bps
		Credit rating of AE not available and the aggregate sum of loan advanced to AEs as on March 31, 2020 does not exceed Rs. 100 crore.	400 bps
7.	Provision of corporate guarantee	No threshold	1% of the amount guaranteed
8.	Manufacture and export of core auto components	No threshold	Operating cost plus Mark up of 12%
9.	Manufacture and export of non- core auto components	No threshold	Operating cost plus Mark up of 8.5%
10.	Receipt of low value adding intra group services (IGS)	Total value of IGS does not exceed Rs 10 crores.	Operating Cost plus Mark up of up to 5%

Taxpayers opting for the Safe Harbour Rules for FY 2019-20 will need to file Form 3CEFA with the Assessing Officer, on or before the due date of furnishing return of income for FY 2019-20, i.e., by 30 November, 2020 – this due date for filing return is prescribed by the Indian Government vide its Press Release dated 13 May 2020.

11.4 Conclusion

- The safe harbour rates for FY 2019-20 were long awaited. Taxpayers who wanted to opt for safe harbour rates for FY 2019-20, had no clarity regarding the applicable safe harbour rates for the year, and were not able to close their financial statements accordingly. Now that the safe harbor rates have been announced the taxpayers can make an informed decision.
- It may be useful to mention here that the Finance Act, 2020 had amended safe harbour provisions in the Income-tax Act, 1961, to cover profit attribution for permanent establishment. The CBDT's gazette notification, however, does not specify profit attribution for permanent establishments.

THE END