

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

(Revised-Edition August, 2013)



**The Institute of Chartered Accountants of India**  
*(Set up by an Act of Parliament)*  
**New Delhi**

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

**[Based on the law as amended by the Finance Act, 2013]**



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

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## **Foreword to the Fourth Edition**

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Third edition of the Guidance Note on Report under section Sec. 92 E of the Income Tax Act, 1961 (Transfer Pricing) (Based on the Law as amended by the Finance Act, 2012) was approved by the Council on 11th February, 2013.

Under this Guidance note, Chapter 4A related to Specified Domestic Transaction mentioned that if and when a new revised format of Form No. 3CEB is notified, contents of this Guidance Note may need to be reviewed, and an addendum issued, or separate or amended Guidance Note issued.

Subsequent to this, there is a change in Form No. 3CEB for reporting International Transactions between Associated Enterprises. Further Part C of 3CEB has been inserted to report Specified Domestic Transactions u/s 92 BA.

Therefore, urgent need to update the third edition of Guidance Note was widely felt. The Guidance Note is mainly revised to give guidance to the members for reporting the transaction between Associated Enterprises u/s 92E of Income Tax Act, 1961.

I express my appreciation to CA. Dhinal A Shah, Chairman, Committee on International Taxation of ICAI for the initiative taken to revise the publication.

I thank to CA. Vijay Iyer, Mr. Ashwin Vishwanathan, CA. Nehal Sheth, CA. Pradeep A for contribution in giving a concrete shape to this publication.

I am sure that as in the case of the earlier edition, this revised edition of the Guidance Note will be immensely useful to the members in discharging their responsibilities.

**Place: New Delhi**  
**Date: 1<sup>st</sup> August, 2013**

**CA. Subodh Kumar Agrawal**  
**President, ICAI**



## **Preface to the Fourth Edition**

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With the increase in Cross Border transactions, particularly between Associated Enterprises, the applicability of transfer pricing provisions under Income Tax Act & other statutes gained importance. Further, Finance Act, 2012 also introduced similar transfer provisions for domestic transactions.

This Guidance Note was revised in February, 2013. However no form was prescribed for reporting specified domestic transactions u/s 92BA.

Now, rules relating to Transfer Pricing Provisions & reporting Form no. 3CEB has been amended by Income Tax (Sixth amendment) Rules, 2013. Part-C to Form no. 3CEB has also been inserted by this rule. Further, from Financial Year 2013-14, Form no. 3CEB is required to be filed through e-filing before the due date.

In view of above substantial reporting amendments, this Guidance Note is again revised (Amendments made till 26/07/2013 have been considered) to incorporate these changes & to provide guidance to members to their reporting responsibility.

I am happy to state that CA. Vijay Iyer, Mr. Ashwin Vishwanathan, CA. Nehal Sheth and CA. Pradeep A has readily accepted our request to revise the edition. I place on record our sincere appreciation of the contribution made by each of them.

I express my gratitude to CA. Subodh Kumar Agrawal, President and CA. K. Raghu, Vice-President for their motivation and guidance. I thank CA. Sanjiv Kumar Chaudhary Vice-Chairman, CA. Jay Ajit Chhaira, CA. Tarun Jamnadas Ghia, CA. Nihar Niranjana Jambusaria, CA. Sanjeev Maheshwari, CA. Shiwaji Bhikaji Zaware, CA. S. Santhana Krishnan, CA. G. Sekar, CA. J. Venkateswarlu, CA. Manoj Fadnis, CA. Sanjay Agarwal, CA. Naveen N.D. Gupta, CA. Vijay Kumar Gupta, Shri Manoj Kumar, Shri Bhaskar Chatterjee, CA. T.P. Ostwal, CA. Gurunath Kanathur, CA. Mahesh P. Sarda, CA. Vivek Newatia, CA. Kuntal Dave, CA. Rajneesh Agarwal, CA. Sachin Vasudeva and CA. (Dr.) Girish Ahuja who have contributed by giving valuable inputs in revising this Guidance Note.

I appreciate the efforts made by Mr. Ashish Bhansali, Secretary, Committee on International Taxation for co-ordination and Mr. Govind Agarwal for rendering secretarial assistance.

I am sure that this revised Guidance Note will be immensely helpful to members in discharging their responsibilities.

**Place: New Delhi**  
**Date: 1st August, 2013**

**CA. Dhinal A. Shah**  
**Chairman,**  
**Committee on International Taxation, ICAI**

## **Foreword to the Third Edition**

The law relating to transfer pricing is dynamic and the members of the Institute are getting acquainted with the practical implications of the law and the rules relating to transfer pricing. The Finance Act, 2012 has made major Amendments such as Advance Pricing Agreement (APA), Specified Domestic Transaction, Expansion of TPO Power etc.

Guidance has been introduced with regard to how the accountant should exercise due diligence while inspecting international transactions in view of the increased scope of the definition of International Transactions.

Therefore, the Committee on International Taxation decided to bring out this revised edition Guidance Note on Report under Section 92E of the Income-Tax Act, 1961 (Transfer Pricing) for its members.

The legal, Financial and accounting aspects relating transfer pricing are highly complex and have global ramifications. It is indeed a matter of honour to chartered accountants who have been given the onerous responsibility of reporting on International as well as specified domestic transactions. I am sure that the members will discharge this responsibility to the satisfaction of the government.

I express my gratitude and appreciation to CA. Mahesh P. Sarda, Chairman, Committee on International Taxation of ICAI for the initiative taken to revise the publication. I thank CA. Sanjay Agarwal, Chairman, Direct Taxes Committee and CA. Dhinal Shah, Vice-Chairman, Direct Taxes Committee and convener for this publication for immense support provided by them.

I thank to CA. Vijay Iyer, Mr. Ashwin Vishwanathan, CA. Nehal Sheth, CA. Pradeep A, CA. Manoj Pardarsani and CA. Esha Tuteja for contribution in giving a concrete shape to this publication.

I am sure this book will be immensely useful and benefit all its readers by providing an insight into the complex aspects of Transfer Pricing with due clarity on the subject matter and in a simplified manner.

Place: New Delhi

**CA. Jaydeep Narendra Shah**

Date: 11th February, 2013

**President, ICAI**





## **Preface to the Third Edition**

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In the era of globalization, when multinational Enterprises (MNEs) have branches, divisions, subsidiaries and offices operating across the globe; it is common for them to transact goods and services from one jurisdiction to an associated enterprise in another tax jurisdiction.

The Finance Act, 2012 has made significant changes such as Advance Pricing Agreement (APA), expansion of Transfer Pricing Officer's (TPO's) Power, amendments relating to penalties, etc. Also, the Finance Act, 2012 introduced a new section 92BA in the Income-tax Act. Such provisions deal with the meaning of Specified Domestic Transaction. The proposed new section 92BA provides the meaning of "specified domestic transaction" with reference to which the income is computed under section 92 having regard to the arm's length price.

The members of our profession are expected to do the examination of the information and documentation so maintained and expresses an opinion thereof in Form No.3CEB as to the compliance of the legal requirements. The report also requires opinion to be expressed about the truth and correctness of the particulars given in the annexure to Form No. 3CEB.

Therefore, urgent need to update the publication was widely felt.

I am happy to state that CA. Dhinal Shah readily accepted our request to revise the edition and who has been actively supported by CA. Vijay Iyer, Mr. Ashwin Vishwanathan, CA. Nehal Sheth and CA. Pradeep A. I place on record our sincere appreciation of the contribution made by each of them. I thank CA. Manoj Pardarsani, for carrying out thorough vetting process and who has been supported by CA. Esha Tuteja.

I thank CA. Sanjay Agarwal, Chairman, Direct Taxes Committee and its Committee members for immense support provided by them.

I appreciate the efforts made by Mr. Ashish Bhansali, Secretary, Committee on International Taxation and CA. Mukta K. Verma, Secretary, Direct Taxes Committee for co-ordination and CA. Govind Agarwal for rendering secretarial assistance.

I believe the efforts in bringing out this publication will get amply rewarded if it proves to be useful to members of the Institute. It will be our endeavor to revise the edition more frequently.

Place: New Delhi  
Date: 11th February, 2013

**CA. Mahesh P. Sarda**  
**Chairman,**  
**Committee on International Taxation, ICAI**

## **Foreword to the Second Edition**

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The first edition of the Guidance Note on Report on International Transactions under section 92E of the Income-tax Act, 1961 (Transfer Pricing) was published in the year 2002. Subsequent Finance Acts made some significant amendments to the law relating to transfer pricing.

The globalization of the Indian economy has resulted in considerable increase in foreign institutional investments, a huge expansion in the production and service base and also a multiplicity of international transactions. As a result of this development international taxation is assuming great importance. The subject of international transaction covers a wide spectrum like cross border transactions, e-commerce, Double Taxation Avoidance Agreement, transfer pricing etc. Members of the Institute are more and more required to deal with many issues related to transfer pricing.

Since the law relating to transfer pricing is in the process of development, several new issues would naturally arise during the implementation of the requirements of the legislation. Further, this branch of law is relatively new to the Income-tax Act and it would take some time before the law gets settled down.

During the course of about five years the members have gained experience in dealing with the requirements of the law and the rules relating to transfer pricing. It was thought fit that these insights could be incorporated in the guidance note for the benefit of our members.

The Fiscal Laws Committee of the Institute constituted Study Groups in Delhi, Chennai and Bangalore to analyse all the practical issues in-depth and bring out the revised edition of the Guidance Note. I compliment the Chairman, Fiscal Laws Committee CA. G. Ramaswamy for his initiatives in getting the Guidance Note revised. I also record my appreciation for CA. Padam Chand Khincha, Convenor of the Bangalore Study Group, CA. R. Bupathy, Convenor of the Chennai Study Group and CA. Vijay Iyer, Convenor of the Delhi Study Group for their sincere efforts in bringing out this Guidance Note.

Date: 3.2.2008  
Place: New Delhi.

**Sunil Talati**  
**President**



## **Preface to the Second Edition**

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Following the enactment of sections 92A to 92F in the Income-tax Act, 1961 providing for the computation of income from an international transaction having regard to arm's length price, by the Finance Act, 2001, some significant amendments were made by the subsequent Finance Acts. These amendments were made to address the issues arising out of the practical implementation of the transfer pricing regulations.

The law relating to transfer pricing is in the process of evolution and the members of the Institute are getting acquainted with the practical implications of the law and the rules relating to transfer pricing. Out of their practical experience some important issues relating to determination of arm's length price, responsibilities of the Assessing Officer to determine the total income of the assessee in conformity with the arm's length price determined by the Transfer Pricing Officer and maintenance and keeping of information and documents relating to international transactions have arisen.

The Fiscal Laws Committee thought it fit to consider the above developments in their proper perspective and incorporate them in the revised edition of the Guidance Note. Accordingly, Study Groups were constituted in Delhi, Chennai and Bangalore under the Convenorship of CA. Vijay Iyer, CA. R. Bupathy and CA. Padam Chand Khincha respectively. The Study Groups considered the matter in-depth and came out with their valuable inputs. I must compliment CA. K. K. Chythanya, CA. Murali Mohan, CA. Nitin Garg, CA. Shikha Gupta and CA. Tarun Arora, for their excellent contributions in the preparation of this Guidance Note.

I express my gratitude to CA. Sunil Talati, President and CA. Ved Jain, Vice-President for their motivation and guidance. I thank CA. K. Raghu, Council Member, CA. Mahesh P. Sarda, Vice-Chairman and other members of the Fiscal Laws Committee who have contributed in giving a concrete shape to this Guidance Note.

I also appreciate CA. R. Devarajan, Secretary, Fiscal Laws Committee and his team comprising Ms. Mukta Kathuria, Sr. Executive Officer and Mr. Y. S. Rawat, Private Secretary for coordinating this project.

I am sure that as in the case of the earlier edition, this revised edition of the Guidance Note will be useful to the members in discharging their responsibilities.

Date: 3.2.2008  
Place: New Delhi

**G. Ramaswamy**  
**Chairman**  
**Fiscal Laws Committee**

## **Foreword to the First Edition**

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The Finance Act, 2001 has introduced sections 92 to 92F in the Income-tax Act, 1961 with effect from Assessment Year 2002-2003. These provisions are commonly referred to as transfer pricing regulations.

Such provisions deal with the methods of computation of income from international transactions, the documentation to be maintained by the enterprises, certification by a chartered accountant and penalty for non-compliance thereof. Every person who has entered into an international transaction during a previous year shall obtain a report from a chartered accountant and furnish such report on or before the specified date in the prescribed form.

The legal, financial and accounting aspects relating to transfer pricing are highly complex and have global ramifications. It is indeed a matter of honour to chartered accountants who have been given the onerous responsibility of reporting on international transactions. I am sure that the members will discharge this responsibility to the satisfaction of the government.

The Fiscal Laws Committee has closely involved itself with transfer pricing right from the stage of drafting of transfer pricing rules. It has constituted study groups in Delhi and Bangalore, got the issues closely examined and brought out this guidance note.

I record my appreciation for the initiatives taken by the Fiscal Laws Committee and more particularly I thank Mr. T.N. Manoharan, Chairman of the Committee, Mr. Ved Jain, Convenor of the Delhi Study Group and Mr. Padam Chand Khincha, Convenor of the Bangalore Study Group for their excellent efforts in bringing out this guidance note. I also appreciate Mr. R. Devarajan, Secretary, Fiscal Laws Committee for his coordination of the project.

New Delhi  
2.4.2002

**Ashok Chandak**  
**President**





## **Preface to the First Edition**

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The Finance Act, 2001 has substituted a new section 92 and inserted sections 92A to 92F with a view to compute income from an international transaction having regard to arm's length price. These provisions are intended to facilitate determination of proper income arising from international transactions where either or both the parties involved happen to be non-resident(s). These provisions read with relevant rules 10A to 10E stipulate the maintenance and keeping of information and documents by persons entering into an international transaction. Further, an obligation is cast under section 92E on every such person to obtain and furnish a report from a Chartered Accountant.

The members of our profession are expected to do the examination of the information and documentation so maintained and kept with effect from assessment year 2002-03 and express an opinion thereof in Form No.3CEB as to the compliance of the legal requirements. The report also requires opinion to be expressed about the truth and correctness of the particulars given in the annexure to Form No.3CEB.

The Fiscal Laws Committee has considered it appropriate to bring out this Guidance Note for the benefit of the members so as to enable them to perform their attest function under section 92E of the Income-tax Act in an effective manner.

The inputs for this Guidance Note have been received from the Study Group constituted in Bangalore with Shri Padamchand Kincha as the Convener and from the Study Group constituted in Delhi with Shri Ved Jain as the Convener. I must compliment Sarvshri Arjun Vaidyanathan, K. K. Chythanya, D. Devaraj, S. Ramasubramanian, Rajendra Rao, Sandeep Dinodia, Sanjiv K. Choudhary, K. R. Sekar, Tarun Arora, Vijay Iyer, H. Vishnumoorthi, and the Conveners but for whose contributions the preparation of this Guidance Note could not have fructified. Their devotion to the task has enabled the bringing of the Guidance Note in a timely manner.

I express my gratitude to Shri Ashok Chandak, President and Shri R. Bupathy, Vice-President for their motivation and guidance. I thank Mrs. Bhavna G. Doshi, Vice Chairperson, Shri Sunil Goyal, Shri Jayant Gokhale, Shri Gopal Dokania, members of the Fiscal Laws Committee, and the co-opted members who have contributed in giving a final shape to this Guidance Note. My sincere thanks are due to all the other Council Members, more

particularly, Shri N.V. Iyer for the valuable suggestions given. Many members across the country have also sent in their comments and views for which I remain thankful to them.

I will be failing in my duty if I do not acknowledge the initiative taken by Shri N.D. Gupta, Immediate Past President in ensuring the constitution of study groups during 2001 and for the periodical guidance and persistent follow-up on the progress of the guidance note till date.

Finally, my appreciation is due in abundance to Shri R Devarajan, Secretary, Fiscal Laws Committee and his team comprising of Mrs. Ishita Sengupta, Assistant Director of Studies and Shri Y. S. Rawat, Steno-typist for the methodical and efficient manner in which the bringing out of the guidance note was co-ordinated.

It is fervently desired that this effort of the Fiscal Laws Committee will prove to be of immense use to the members in enabling them to discharge their responsibility justifying the faith and confidence reposed on the profession by the Government.

9th April, 2002.  
New Delhi

**T. N. Manoharan**  
**Chairman,**  
**Fiscal Laws Committee**

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## **Clarification Regarding Authority Attached to the Documents Issued by the Institute**

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*"Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary".*

(Volume I of the Handbook of Auditing Pronouncements - Compendium of Standards and Statements (4th Edition, 2007), page I - 5, Para 5)





# Chapter 1

## Introduction

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### Legislative Framework

1.1 In an era of liberalization and globalization of trade and investment and the emergence of e-commerce, the perceptible results have been increase in the number of cross-border transactions, the complexity, speed and lack of transparency with which global business can be transacted. There is a general belief that multi-national corporations, in an effort to manage and minimize their global tax outflows, have employed creative transfer pricing approaches in the context of flow of goods, services, funds, intangibles, etc.

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

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

1.4 In India, the Act had hitherto not dealt with this problem in a detailed manner. The erstwhile section 92 sought to determine the amount of profits which may reasonably be deemed to have been derived from a business carried on between a resident and a non-resident which, owing to the close connection between them is so arranged that it produced, to the resident, either no profits or less than the ordinary profits which might be expected to arise in that business. Besides, sections 40A(2); 80IA(10) and 80IB(13) of

## **Guidance Note – Transfer Pricing**

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the Act provide powers to the Assessing Officer to interfere with the pricing or costing of certain transactions in certain cases in order to determine the correct quantum of deduction permissible.

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

1.6 The relevant provisions contained in Chapter X (sections 92 to 92F) of the Act and the provisions dealing with the levy of penalties for non-compliance thereof are reproduced in **Annexure I**. The Finance Act, 2002 made certain changes to the provisions contained in sections 92A, 92C, 92F and 271F. The Finance Act, 2006 further amended section 92C. Further, the Finance Act, 2007 inserted sub-sections (3A) and (4) in section 92CA. Finance Act 2009 amended the proviso to section 92C, provided for constitution of the dispute resolution panel and empowered the Board to formulate safe harbor rules. Finance Act 2011 amended the allowable variation as per second proviso to section 92C(2) to be notified by the Central Government, and made changes to Section 92CA. The Finance Act 2012 has introduced significant amendments including inter alia clarifying the coverage of the term 'international transactions', expanding the scope of transfer pricing provisions to specified domestic transactions (Section 92BA) and providing a Advance Pricing Agreement framework (Section 92CC and Section 92CD). These amendments are also included in the said Annexure. The Rules 10A to 10E prescribed in this regard by the Central Board of Direct Taxes are reproduced in **Annexure II**. The relevant extracts from the Memorandum explaining the provisions of the Finance Act, 2001, Finance Act, 2002, Finance Act, 2006, Finance Act, 2007 and the Finance Act 2012 are given in **Annexure III**. The Central Board of Direct Taxes has issued Circulars explaining the provisions and clarifying certain related aspects. These circulars are given in **Annexure IV**.

## Terms and abbreviations used

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

**(a) Act**

The Income-tax Act, 1961.

**(b) Accountant**

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

**(c) Arm's Length Price (ALP)**

Arm's length price as defined under section 92F(ii) of the Act.

**(d) AS**

The Accounting Standards issued, prescribed and made mandatory by the ICAI or the Accounting Standards notified under section 211(3C) of Companies Act, 1956 and the Companies (Accounting Standards) Rules, 2006.

**(e) AS (IT)**

Accounting Standards notified by the Central Government under section 145(2) of the Act.

**(f) AAS**

Auditing and Assurance Standards prescribed and made mandatory by the Institute of Chartered Accountants of India.

**(g) Associated enterprise (AE)**

An associated enterprise as defined under section 92A of the Act.

**(h) APA**

Advance Pricing Agreement

**(i) Board**

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

## **Guidance Note – Transfer Pricing**

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**(j) Circular**

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

**(k) CUT**

Comparable Uncontrolled transaction

**(l) Enterprise**

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

**(m) ICAI**

The Institute of Chartered Accountants of India.

**(n) International transaction**

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

**(o) OECD**

Organisation for Economic Co-operation and Development.

**(p) Report**

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

**(q) Rules**

The Income-tax Rules, 1962.

**(r) Specified date**

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

**(s) Specified domestic transaction**

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

**(t) Transaction**

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

**(u) Transfer Pricing Officer (TPO)**

An officer as defined in explanation to section 92CA.

## **Objective of the guidance note**

1.8 The provisions relating to computation of income from international transactions between associated enterprises having regard to arm's length price are applicable with effect from assessment year 2002-03. According to

section 92E of the Act, every person who has entered into an international transaction or a specified domestic transaction<sup>1</sup> during a previous year shall obtain a report from an accountant and furnish such report on or before the specified date in the prescribed form. An accountant is required to discharge his function in this regard from assessment year 2002-03.

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

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

### **Applicability of the provisions**

1.10 The provisions contained in Chapter X of the Act would apply based upon certain criteria. Firstly, there must be an international transaction. Secondly, such international transaction must be between two or more associated enterprises either or both of whom are non-residents. Further, a specified domestic transaction, not being an international transaction has to fulfill the conditions outlined in section 92BA of the Act in order to attract these provisions.

1.11 Such international transactions should involve in the incurring of any cost or expenses or interest or it should involve in purchase, sale or lease of tangible or intangible property or in the lending or borrowing of money or any other transaction having a bearing on the profits and income, losses or assets of such enterprises. In respect of the above items the transaction may effect the allocation or apportionment or contribution on the basis of a mutual

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

## **Guidance Note – Transfer Pricing**

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agreement or arrangement between two or more associated enterprises. Such allocation etc. may be in connection with a benefit; service or facility provided or to be provided to any one or more of such associated enterprises, which have a bearing on the profits, incomes, losses or assets of such enterprises. The expression 'international transaction' has been clarified vide Finance Act 2012 with retrospective effect from 1 April 2002 to include a wide variety of arrangements.

1.12 According to section 92B (2) even if a transaction entered into between an enterprise with a person other than an associated enterprise, it shall be deemed to be a transaction between 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. Consequently the provisions of this chapter shall apply even in such cases.

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

### **A. New developments**

#### *A.1 Safe Harbours (Section 92CB of the Act)*

The Finance Act 2009 empowered the Board to frame safe harbor rules. Safe harbor means circumstances in which the tax authorities shall accept the transfer price as declared by the assessee. As of now no safe harbor rules have been notified.

#### *A.2 Advance Pricing Agreements (APA) (Section 92CC of the Act)*

Finance Act 2012 introduced APAs wherein the Board, with the approval of the Central Government may enter into APAs with any person to determine the arm's length price or specify the manner in which the arm's length price is to be determined, in relation to an international transaction to be entered into by that person.

## Chapter 2

# Responsibility of an Enterprise and the Accountant

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### Responsibility of an Enterprise

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

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

2.3 The obligation of an enterprise to keep and maintain records and documents vis-a-vis the duty of revenue authorities to verify about the compliance with the arm's length principle has been succinctly stated by the OECD in their Transfer Pricing Guidelines:

*"Taxpayers should make reasonable efforts at the time the transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the arm's length principle. Tax administrations should have the right to obtain the documentation prepared or referred to in this process as means of verifying compliance with the arm's length principle. However, the extensiveness of this process should be determined in accordance with the same prudent business management principles that would govern the process of evaluating the business decision of a similar level of complexity and importance. Moreover, the need for the documents should be balanced by the costs and the administrative burdens, particularly where this process suggests the creation of documents that would not otherwise be prepared or referred to in the absence of tax considerations. Documentation requirements should not impose on tax payers' costs and burdens disproportionate to the circumstances. Taxpayers should nonetheless recognise that adequate record-keeping practices and*



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*production of documents facilitates examination and resolution of transfer pricing issues that arise".*

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

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

2.6 By virtue of sub-section (2) of section 92D the Board is empowered to prescribe the period for which the assessee must maintain the prescribed information and records. Pursuant thereto, the Board has stipulated that the prescribed information and documents be kept and maintained for a period of eight years from the end of the relevant assessment year - Rule 10D (5).

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

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

2.9 Under section 92E, every person who has entered into an international transaction or specified domestic transaction during a previous year shall obtain a report from an accountant and furnish such report on or before the specified date in the prescribed form duly signed and verified in the prescribed manner by such accountant and setting forth such particulars as may be prescribed. "Specified date" shall have the same meaning as assigned to due date in *Explanation 2* below subsection (1) of section 139.

## Responsibility of an Enterprise and the Accountant

The above-mentioned Explanation reads as under:

*"In case of an assessee being a company, which is required to furnish a report referred to in section 92E, the due date means the 30th day of November of the assessment year."*

### **Accountant's responsibility**

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

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

The above-mentioned Explanation reads as under:

*"Accountant means a chartered accountant within the meaning of Chartered Accountants Act, 1949 (38 of 1949) and includes, in relation to any State, any person, who by virtue of the provisions of sub-section (2) of section 226 of the Companies Act, 1956 (1 of 1956), is entitled to be appointed to act as an Accountant of companies registered in that State."*

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

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

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

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the examination in the earlier year. Attention of the members is invited to the detailed discussion in the publication of ICAI, "Code of Ethics" under clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949 vide **Annexure V**.

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

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

*"Normally, the joint auditors are able to arrive at an agreed report. However, where the joint auditors are in disagreement with regard to any of the matters to be covered by the report, each of them should express his own opinion through a separate report. A joint auditor is not bound by the views of the joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement"."*

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

2.16 Under section 92E, the appointment to the position of an "accountant" will be considered as an appointment to an office of profit. Therefore, the provisions of section 314 of the Companies Act, 1956 will be attracted when a relative of a director is appointed as an accountant of the company, if the remuneration thereof exceeds the limits prescribed in the aforesaid section. The necessary formalities will be required to be complied with as required under section 314.

## Responsibility of an Enterprise and the Accountant

2.17 The Act does not prohibit a relative or an employee of the assessee being appointed as an accountant under section 92E. It may, however, be noted that as per a decision of the Council (reported in the Code of Ethics under clause (4) of Part I of Second Schedule), a chartered accountant who is in employment of a concern or in any other concern under the same management cannot be appointed as an auditor of that concern. Therefore, an employee of an assessee or an employee of a concern under the same management cannot examine the accounts and records of an assessee under section 92E.

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

2.19 Similarly, an internal auditor of the assessee cannot conduct the examination if he is an employee of the assessee. If the internal auditor is working in his professional capacity (as an independent accountant not being an employee of the assessee), he can conduct the examination. However, an accountant or a firm of accountants appointed as tax consultants of the assessee can conduct the examination under section 92E.

2.20 No separate guidelines have been prescribed for fees under section 92E. The Institute has recommended fees for professional services on the basis of time devoted by the accountant and his assistants. The scale of fees effective from 12.5.2006 recommended by the Institute for "professional services" is given in **Annexure VI**. The Council has also clarified that the scale does not include fees chargeable in respect of non-qualified assistants and that the chartered accountants are free to negotiate the terms in respect of such assistants with the clients.

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

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2.22 A question may arise whether an accountant appointed under section 92E can be held responsible if he does not complete the examination and give his report before the specified date. The answer to this question will depend on the facts and circumstances of the case. Normally, it is the professional duty of a chartered accountant to ensure that the examination accepted by him is completed before the due date. If there is any unreasonable delay on his part, he is answerable to the Institute if a complaint is made by the client. However, if the delay in the completion of examination is attributable to his client, the accountant cannot be held responsible. In view of the fact that the Act does not give any discretion to the tax authorities to extend the time limit for furnishing of the report, the examination has to be completed within the time limit provided in the Act. It is, therefore, necessary that a chartered accountant should not accept assignments which he cannot complete within the specified date.

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

2.24 Section 227 of the Companies Act gives certain powers to the auditors to call for the books of account, information, documents, explanations, etc. and to have access to all books and records. The accountant is advised to obtain all the books of accounts, information, documents, explanation etc. from the enterprise to enable him to discharge his responsibility under the Act in a satisfactory manner. If, however, the assessee does not produce any particular record or fails to provide any specific information or explanation called for, the accountant will be required to report the same and accordingly qualify his report.

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

## **Responsibility of an Enterprise and the Accountant**

also maintain all his working papers. Such working papers should include his notes on the following, amongst other matters:

- (a) work done while conducting the examination and by whom;
- (b) explanations and information given to him during the course of the examination and by whom;
- (c) decision on the various points taken;
- (d) the judicial pronouncements relied upon by him while making the report;
- (e) certificates issued by the client/management letters; and
- (f) annexure to Form No.3CEB duly filled in and authenticated by the client.

2.26 Attention is also invited to the "SA 230 - Audit Documentation" which provides that the accountant should document matters which are important in providing evidence that the examination was carried out in accordance with the basic principles.

2.27 While test checks may suffice in the conduct of a statutory audit for the expression of the accountant's opinion as to whether the accounts depict a true and fair' view, the accountant may be required to apply reasonable tests on the total information to be prepared by the assessee in respect of certain items in the prescribed form. While the entity may have to prepare the details for the entire year, the accountant may have to ensure that no items have been omitted in the information furnished and a reasonable test check would reveal whether or not the information furnished is correct.

2.28 The extent of check undertaken would have to be indicated by the accountant in his working papers. The accountant would be well advised to so design his program of examination as would reveal the extent of checking and to ensure adequate documentation in support of the information being certified.

2.29 The accountant may rely upon the audit conducted by an internal auditor or by an outside professional firm appointed as internal auditor, by using his own judgement as to the degree of reliance which he wishes to place on the work of the internal auditor relevant to the examination. The degree of reliance would depend on the areas of work covered by the internal auditor and relevant for purposes of the examination, particularly by reference to working papers/documents of the internal auditor and ensuring

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that reasonable checks/tests have been applied to transactions covered by the internal auditor, to satisfy himself about the authenticity of the ultimate information.

2.30 It would be in the interest of the accountant to obtain and scrutinise the programme of work and procedures adopted and the relevant working papers and documents obtained by the internal auditor in evidence of the work carried out by him. Reference may be made to the Standards on Auditing: Using the work of Internal Auditors (SA 610) – vide **Annexure VII**. Primarily it would, be necessary for the accountant to ensure that in expressing his opinion, he has adequately satisfied himself as to the authenticity of the information contained in the relevant form and that, his working papers and documents are adequate to enable him to certify the particulars. Reference may be made to the Standards on Auditing: Risk Assessments and Internal Control (SA-400) and Analytical Procedures (SA-520).

2.31 The accountant must ensure that he receives a standard Management Representation Letter in respect of all oral representations explicitly or implicitly given to him. The letter should indicate and document the continuing appropriateness of the representations made to him and reduce the possibility of any misunderstanding concerning the matters which are the subject of the representations. However, it may be noted that in respect of matters that may be directly verified by the accountant, mere obtaining of a management representation letter will not be sufficient compliance with the Generally Accepted Auditing Standards.

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

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

## **Responsibility of an Enterprise and the Accountant**

2.34 In case the prescribed particulars are given in part or piecemeal to the accountant or the relevant form is incomplete and the assessee does not give the information against all or any of the clauses, the accountant should not withhold the entire report. In such a case, he can qualify his report on matters in respect of which information is not furnished to him. In the absence of relevant information, the accountant would have no option but to state in his report that the relevant information has not been furnished by the assessee.

### **Professional misconduct**

When any question relating to professional misconduct in connection with the examination arises, the accountant would be liable under the Chartered Accountants Act, 1949 and the ICAI's disciplinary jurisdiction will prevail in this regard.



## Chapter 3

# Associated Enterprises

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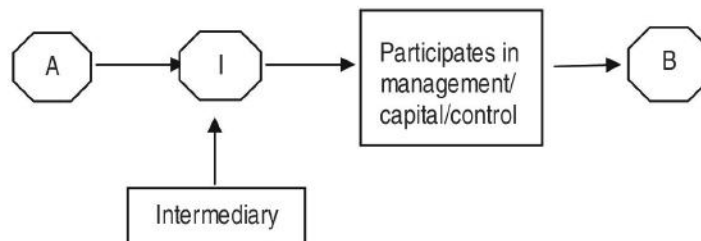
### Associated enterprises and deemed associated enterprises

3.1 The term 'associated enterprise' is defined in section 92A of the Act. According to sub-section (1), an enterprise which participates directly or indirectly or through one or more intermediaries, in the management or control or capital of the other enterprise shall be regarded as an associated enterprise. This can be understood as follows:

**Situation 1 - Direct Participation:**

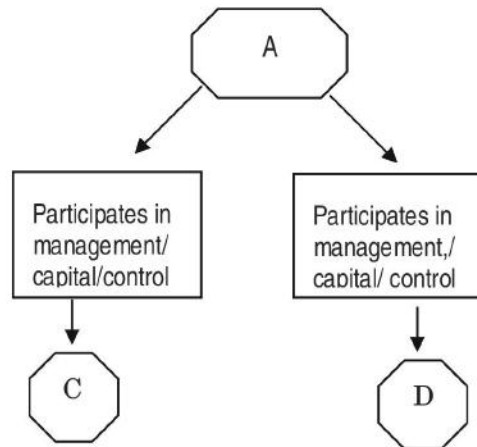


**Situation 2 - Participation through Intermediary**

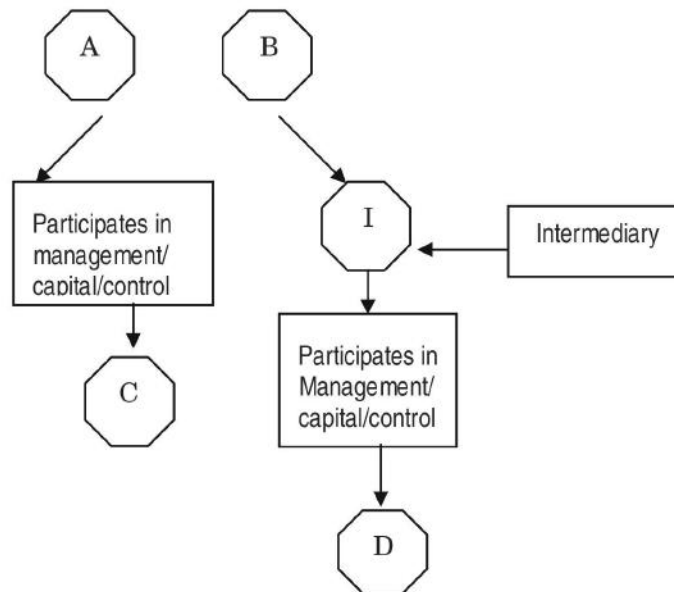


In both the situations detailed above, B will be an associated enterprise of A.

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



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



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

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3.3 The Finance Act, 2002 has amended sub-section (2) of section 92A to the effect that for the purposes of sub-section (1), two enterprises shall be deemed to be associated enterprises if, at any time during the previous year any of the conditions mentioned in clauses (a) to (m) are satisfied. The provisions of sub-section (2) of section 92A supplements the definition of associated enterprise given in sub-section (1) by enlisting various situations under which two enterprises shall be deemed to be associated enterprises. Each of these situations specified in clauses (a) to (m) of sub-section (2) of section 92A are discussed here below with suitable illustration, wherever considered necessary. It may be noted that for the purposes of these clauses, two enterprises would be associated enterprises if the conditions stipulated therein are fulfilled at any time during the previous year. Besides, in clauses (c) to (m) the words 'directly' or 'indirectly' have not been used which indicates the intention of the legislature that indirect control is not envisaged in these clauses. Therefore, direct relationship between two enterprises is relevant for the purposes of clauses (c) to (m) in order to determine whether they are associated enterprises.

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

**[Section 92A(2)(a)]**

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

As the terms used are "shares" and "voting power", it is apparent that this clause applies only to those cases where the investee enterprise is a company. This is further supported by the fact that clause (j) refers to individuals, clause (k) to Hindu undivided families and clause (l) to firms, association of persons and body of individuals.

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

**[Section 92A(2)(b)]**

Under this clause, two enterprises are deemed associated enterprises, even though one enterprise may not hold any shares in the other enterprise. This

## Associate Enterprises

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clause comes into play when one person or enterprise simultaneously holds shares carrying not less than twenty-six per cent voting power in each such enterprise. For example, if AA of UK holds 26% voting power in BB of Germany and also in CC of India, then BB and CC shall be deemed to be associated enterprises. Even for this clause, shareholding may be direct or indirect holding.

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

**[Section 92A(2)(c)]**

Where the lender enterprise's loans to the borrower enterprise constitute more than 51% of the 'book value' of the total assets of the borrowing enterprise, then both the lender and the borrower enterprises would be treated as 'associated enterprises'.

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

**[Section 92A(2)(d)]**

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

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

**[Section 92A(2)(e)]**

Where one enterprise has appointed

- (a) more than one-half of the board of directors or members of the governing board; or
- (b) one or more executive directors or executive members of that board in another enterprise the two enterprises shall be deemed to be associated enterprises.

This clause refers to "board of directors" and "governing board". As per section 2(6) of the Companies Act, 1956, the term "board of directors" would refer to the board of directors of a company. The term "governing board",

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correspondingly, would refer to a body or council that has the executive authority to manage the affairs of the enterprise to which it relates. These enterprises could be artificial juridical non-corporate bodies.

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

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

**[Section 92A(2)(f)]**

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

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

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

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

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

**[Section 92A(2)(g)]**

Two enterprises are deemed to be associated, if one is wholly dependent on the other for the use of know-how, patents, copyrights etc. for the

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

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

**[Section 92A(2)(h)]**

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

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

or

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

and

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

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

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

**[Section 92A(2)(i)]**

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

- (i) to another enterprise (say, enterprise B)  
or
- (ii) sold to another enterprise (say, enterprise C) specified by enterprise B,  
and  
the prices and other conditions relating thereto are influenced by enterprise B, then enterprises A and B shall be associated enterprises.

While in clause (h), a minimum criteria of 90% has been mentioned, no such quantification has been done in clause (i). This clause covers only sale of goods manufactured or processed and not the sale of traded goods.

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

**[Section 92A(2)(j)]**

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

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

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

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

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

**3.14 *Where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided***

*family, or by a relative of a member of such Hindu undivided family, or jointly by such member and his relative.*

**[Section 92A(2)(k)]**

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

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

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

**[Section 92A(2)(l)]**

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

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

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

**[Section 92A(2)(m)]**

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

3.17 It requires mention that the term 'enterprise' is defined under clause (iii) of section 92F of the Act. Accordingly, "enterprise" means a person (including a permanent establishment of such person) who is, or has been, or is proposed to be, engaged in any activity, relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret



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formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights, or the provisions of services of any kind, or in carrying out any work in pursuance of a contract, or in investment, or providing loan or in the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate, whether such activity or business is carried on, directly or through one or more of its units or divisions or subsidiaries, or whether such unit or division or subsidiary is located at the same place where the enterprises is located or at a different place or places. While the term is defined to mean a person engaged in the past, present or in the future in any activity relating to tangibles, intangibles, facilities or services with widest possible modes, forms or pattern of operation, it also includes a permanent establishment of such person. Permanent Establishment” referred to in clause (iii) of section 92F of the Act, includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.

## Chapter 4

# International Transaction

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### Definition

4.1 Before proceeding to analyse the expression “international transaction”, it would be useful to take note of the definition of the term “transaction”. The term ‘transaction’ has been defined in clause (v) of section 92F as under:-

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

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

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

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

“For the purposes of this section and sections 92, 92C, 92D and 92E, “international transaction” means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money or any other transaction having a bearing on the profits, income, losses or assets of such enterprises and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service, facility provided or to be provided to any one or more such enterprises - section 92B(1)”.

“A transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purposes of sub-section (1), be deemed to be a transaction entered into between two associated enterprises, if there exists a prior arrangement in relation to the relevant transaction between

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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 - section 92B(2)".

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

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

- (i) the purchase, sale, transfer, lease or use of tangible property including building, transportation vehicle, machinery, equipment, tools, plant, furniture, commodity or any other article, product or thing; or
- (ii) the purchase, sale, transfer, lease or use of intangible property, including the transfer of ownership or the provision of use of rights regarding land use, copyrights, patents, trademarks, licences, franchises, customer list, marketing channel, brand, commercial secret, know-how, industrial property right, exterior design or practical and new design or any other business or commercial rights of similar nature ; or
- (iii) capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business.; or
- (iv) provision of services, including provision of market research, market development, marketing management, administration, technical services, repairs, design, consultation, agency, scientific research, legal or accounting service; or
- (v) a transaction of business restructuring or reorganization, entered into by an enterprise with an associated enterprise, irrespective of the fact that it has a bearing on the profits, income, losses, or assets of such enterprises at the time of transaction or at any future date.

It shall also include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any

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contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service, facility provided or to be provided to any one or more such enterprises.

It is relevant to note that a transaction of business restructuring or reorganization has been clarified to be an international transaction irrespective of whether it has a bearing on the profits, income, losses or assets of the enterprise. However, the Act does not define business restructuring. In this respect, guidance may be drawn from the OECD guidelines which defines business restructuring as cross border redeployment by a multinational enterprise of functions, assets or risks. A business restructuring may also involve cross border transfers of valuable intangibles or alternatively involve the termination or substantial renegotiation of existing arrangements.

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

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

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

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

4.6 For example, enterprise X of India and enterprise Y of Australia are associated enterprises. Enterprise Z of Singapore is not an associated enterprise of enterprise X. Enterprise Y and enterprise Z enter into an agreement for determining the terms of transactions between enterprise X

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and enterprise Z. The transaction as may be entered between enterprise X and enterprise Z which is governed by such an agreement existing between Y and Z shall be deemed to be a transaction between two associated enterprises.

### **Tangible and intangible property**

4.7 Tangible property has an existence in physical form. Any property other than tangible is intangible property. OECD guidelines include right to use industrial assets such as patents, trademarks, names, designs or models as intangible properties. It also includes literary and artistic property. OECD guidelines focus on “business rights” associated with commercial activities including marketing activities.

4.8 The expression “intangible property” for purposes of the Indian transfer pricing regulations has been clarified to include-

- (i) marketing related intangibles assets, such as, trademarks, trade names, brand names, logos; or
- (ii) technology related intangibles assets, such as, process patents, patent applications, technical documentation such as laboratory notebooks, technical know-how; or
- (iii) artistic related intangible assets, such as, literary works and copyrights, musical compositions, copyrights, maps, engravings ; or
- (iv) data processing related intangible assets, such as proprietary computer software, software copyrights, automated databases, and integrated circuit masks and masters; or
- (v) engineering related intangible assets, such as industrial design, product patents, trade secrets, engineering drawing and schema-tics, blueprints, proprietary documentation; or
- (vi) customer related intangible assets, such as, customer lists, customer contracts, customer relationship, open purchase orders; or
- (vii) contract related intangible assets, such as, favourable supplier, contracts, licence agreements, franchise agreements, non-compete agreements; or
- (viii) human capital related intangible assets, such as, trained and organised workforce, employment agreements, union contracts; or

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- (ix) location related intangible assets, such as leasehold interest, mineral exploration rights, easements, air rights, water rights; or
- (x) goodwill related intangible assets, such as, institutional goodwill, professional practice goodwill, personal goodwill of professional, celebrity goodwill, general business going concern value; or
- (xi) methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; or
- (xi) any other similar item that derives its value from its intellectual content rather than its physical attributes.

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

### **Services, finances and costs etc.**

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

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

The basis to decide whether a service has been provided is set out in the guidelines as 'whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself. If the activity is not one for which the independent enterprise would

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have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's length principle'. Services benefiting a group of enterprises as a whole should be allocated amongst the group in a way that matches the benefit received.

4.10 The associated enterprises often enter into transactions of capital financing including borrowing, lending, guarantee arrangements, etc. The pricing of these arrangements will have a bearing on the profits or losses of the associated enterprises and hence are included as part of the definition of 'international transaction'. These transactions of capital financing including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business are expressly covered as international transactions vide Finance Act 2012. The accountant will need to carefully identify and report such transactions and particularly equity and preference capital, debentures, guarantees provided or received, etc. Advance payments received or made and debts arising during the course of business shall need to be carefully considered and reported by the accountant however ensuring that there is no duplication or overlap with reporting of the principal transactions to which such advances or debts relate to, unless the accountant identifies factors which cause such advances or debts as separate transactions.

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

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

## Cross-border transactions

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

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

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

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

4.16 In alternative, assume that there is an Indian company which is the holding company of two Indian (subsidiary) companies. The two Indian companies are associated enterprises since they are subsidiaries of a common holding company. If one such Indian subsidiary company enters into a transaction with the foreign branch of the other Indian subsidiary company, such transaction shall not be regarded as an international transaction. In this case, even though the transaction is between two associated enterprises, both the parties to the transaction are residents. For a transaction to be regarded an international transaction, either or both the parties must be non-residents. An important aspect to be noted here is that even though the above mentioned transaction is not an international transaction but it would be covered under domestic transfer pricing as per the amendements made vide Finance Act 2012 and the ALP would have to be determined having regard to transfer pricing provisions.

4.17 Even where a transaction is between two non-resident associated enterprises, the provisions of chapter X of the Act shall apply so long as the income arising therefrom is assessable within the perview of the Act. It is



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possible that an international transaction between two associated enterprises, both of whom are non-residents, may not attract the provisions of chapter X of the Act if the income from such transaction is not taxable in India and falls outside the scope of total income assessable under the Act.

## Chapter 4A

# Specified Domestic Transactions

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

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

### Definition

4A.3 Section 92BA defines Specified Domestic Transaction (SDT) which is covered by TP regulations. Section 92BA as under:

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

any expenditure in respect of which payment has been made or is to be made to a person referred to in clause (b) of sub-section (2) of section 40A;

any transaction referred to in section 80A;

any transfer of goods or services referred to in sub-section (8) of section 80-IA;

any business transacted between the assessee and other person as referred to in sub-section (10) of section 80-IA;

any transaction, referred to in any other section under Chapter VI-A or section 10AA, to which provisions of sub-section (8) or sub-section (10) of section 80-IA are applicable; or

any other transaction as may be prescribed,

and where the aggregate of such transactions entered into by the assessee in the previous year exceeds a sum of ₹ 5 crore.’

## **Threshold Limit**

4A.4 The above referred transactions will be regarded as SDT only if the aggregate value of all the above specified transactions exceeds the threshold limit of ₹ 5 crore. All the transactions covered under the six limbs as mentioned above will be regarded as SDT only if the aggregate value of all transactions exceeds threshold of ₹ 5 crore. If the threshold limit is crossed, the taxpayer will be required to comply with TP requirements with reference to all the transactions regardless of the fact that that the value of transactions under one of the limbs may be very small or nominal. Thus, there is no internal threshold for each limb of the definition.

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

### **Expenditure in respect of payments made to persons referred to in section 40A(2)(b)**

4A.6 Section 92BA(i) refers to ‘any expenditure in respect of which payment has been made or is to be made to a person referred to in clause (b) of sub-section (2) of section 40A;’

#### **Section 40A(2)(a) lays down**

*‘Where the assessee incurs any expenditure in respect of which payment has been or is to be made to any person referred to in clause (b) of this sub-section, and the Assessing Officer is of opinion that such expenditure is excessive or unreasonable having regard to the fair market value of the goods, services or facilities for which the payment is made or the legitimate needs of the business or profession of the assessee or the benefit derived by or accruing to him therefrom, so much of the expenditure as is so considered by him to be excessive or unreasonable shall not be allowed as a deduction.’*

**The following proviso has been inserted in sub-section (2)(a) of section 40A by the Finance Act, 2012, w.e.f. 1-4-2013 :**

*‘Provided that no disallowance, on account of any expenditure being excessive or unreasonable having regard to the fair market value, shall be*

## Specified Domestic Transactions

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*made in respect of a specified domestic transaction referred to in section 92BA, if such transaction is at arm's length price as defined in clause (ii) of section 92F.'*

**4A.7 The transactions included in the ambit of this section would include expenditure transactions like (*illustrative only*):**

- Expenditure on buying goods
- Expenditure on procurement of services
- Expenditure on interest payments
- Expenditure on salary, training services, marketing expenses
- Expenditure on purchase of tangible and intangible property
- Director's remuneration, commission, sitting fees
- Group charges
- Reimbursement expenditure
- Guarantee fee expenditure

4A.8 This provision operates only on the expenditure side and would not have any impact in the hands of the recipients of such payments. Thus only the persons/entities incurring such expenditure would be subject to SDT under this provision and would be required to comply with the relevant transfer pricing compliances.

4A.9 The persons/entities receiving such income will not be subject to SDT under this provision and would not be required to comply with the relevant transfer pricing compliances.

4A.10 These provisions are applicable to expenditures claimed as deduction under 'income from other sources' head on account of specific direction in section 58(2) which states that provisions of section 40A are also applicable for computation of taxable income under "income from other sources".

### **Section 58 (2)**

*"The provisions of section 40A shall, **so far as may be**, apply in computing the income chargeable under the head "Income from other sources" as they apply in computing the income chargeable under the head "Profits and gains of business or profession"*

4A.11 These provisions are also applicable to expenditures which are in capital in nature and fully claimed as deduction under other provisions(eg.

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Sec 35(2AB), 35 or 35AD) since any expenditure is covered under the scope of sec 40A (2)(b).

### **4A.12 Sections 40A(2)(b) lays down the list of persons who would be covered under this section**

Sections 40A(2)(b) reads as under:

The persons referred to in clause (a) are the following, namely:—

- (i) *where the assessee is an individual - any relative of the assessee;*
- (ii) *where the assessee is a company, firm, association of persons or Hindu un-divided family - any director of the company, partner of the firm, or member of the association or family, or any relative of such director, partner or member;*
- (iii) *any individual who has a substantial interest in the business or profession of the assessee, or any relative of such individual;*
- (iv) *a company, firm, association of persons or Hindu undivided family having a substantial interest in the business or profession of the assessee or any director, partner or member of such company, firm, association or family, or any relative of such director, partner or member [or any other company carrying on business or profession in which the first mentioned company has substantial interest];*
- (v) *a company, firm, association of persons or Hindu undivided family of which a director, partner or member, as the case may be, has a substantial interest in the business or profession of the assessee; or any director, partner or member of such company, firm, association or family or any relative of such director, partner or member;*
- (vi) *any person who carries on a business or profession,—*
  - A. *where the assessee being an individual, or any relative of such assessee, has a substantial interest in the business or profession of that person; or*
  - B. *where the assessee being a company, firm, association of persons or Hindu undivided family, or any director of such company, partner of such firm or member of the association or family, or any relative of such director, partner or member, has a substantial interest in the business or profession of that person.*

## Specified Domestic Transactions

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**Explanation.**—For the purposes of this sub-section, a person shall be deemed to have a substantial interest in a business or profession, if,—

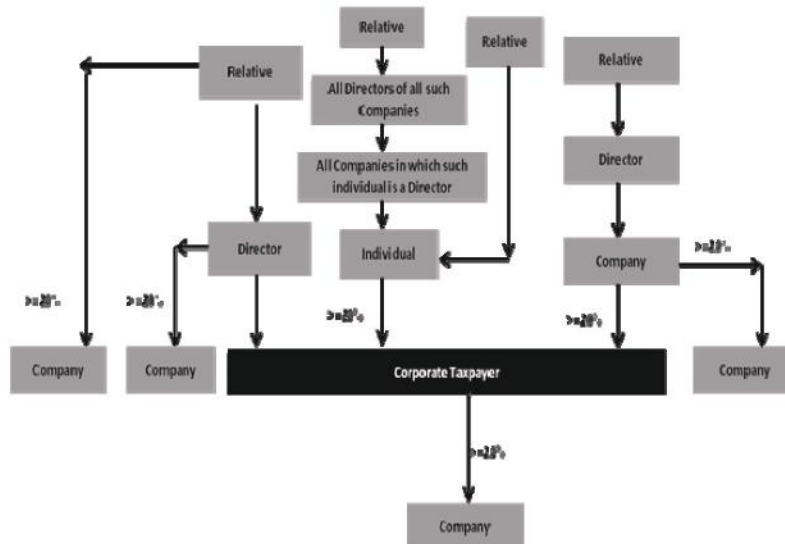
- a) *in a case where the business or profession is carried on by a company, such person is, at any time during the previous year, the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) carrying not less than twenty per cent of the voting power; and*
- b) *in any other case, such person is, at any time during the previous year, beneficially entitled to not less than twenty per cent of the profits of such business or profession.*

4A.13 Further, the list of specified persons as per section 40A(2)(b) has also been amended by Finance Act 2012 to cover transactions amongst persons/companies wherein another person/company has substantial interest in both such transacting persons/companies.

4A.14 The threshold for substantial interest to qualify as 'specified persons' (relevant for domestic transfer pricing) is 20% or more, as compared to the threshold of 26% or more applicable for 'associated enterprises' (relevant for international transfer pricing). For example, where an Indian company purchases goods from a US company in which it has a 23% equity stake (substantial interest), such an expenditure transaction will not qualify as an international transaction amongst associated enterprises, but will qualify as a specified domestic transaction and thus subjected to arms length price requirements, transfer pricing documentation, accountant's report, etc.

4A.15 Given below is an illustrative (only) chart of specified persons as per section 40A(2)(b) in case of a corporate taxpayer:

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4A.16 As in the case of section 92A(2)(a) and (b) (which defines the term 'associated enterprise' for the purposes of international transactions) the phrase "directly or indirectly" is not used in Section 40A(2)(b). However, in this regard, reference should be made to the Central Board of Direct Taxes' Circular number 6-P dated 6 July 1968 explaining the then newly inserted provisions in section 40A(2). This circular sets out the categories of the persons, payments to whom fall within the purview of section 40A(2). It mentions that such persons would include inter alia –

"(c) persons in whose business or profession the taxpayer has a substantial interest directly or indirectly".

However, Explanation to Section 40A(2) deems a person to have substantial interest if such person is 'beneficial owner' of shares carrying not less than twenty per cent of voting power. The expression "beneficial owner" needs to be construed in contrast to "legal owner" and not in the context of determining indirect ownership of shares. Hence, the emphasis is on covering the real owner of the shares and not the nominal owner. This proposition is also supported by legal jurisprudence which states that in a multi-tier structure, a parent cannot be regarded as the beneficial owner of shares in a downstream subsidiary merely because it owns the shares of the intermediate subsidiary companies. It is important to respect the fact that the entities are separate legal entities.

## **Specified Domestic Transactions**

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Consequently, in a situation where A Ltd. holds 50% in B Ltd. and B Ltd. holds 50% in C Ltd., under ordinary circumstances, A Ltd. cannot be regarded as having beneficial interest in C Ltd. In other words, for purposes of Section 40A(2)(b), it may be appropriate to consider only direct shareholding and not derivative or indirect shareholding.

4A.17 The coverage of section 40A(2)(b) is very wide and covers persons related to the assessee under several relationships. Thus the assessee and the accountant should ensure that all relevant expenditure transactions with all specified persons as mentioned in section 40A(2)(b) should be carefully identified and included in transfer pricing documentation and accountant's report. With regard to ensuring completeness of such information, the accountant should obtain a written representation from the assessee detailing the list of persons specified in section 40A(2)(b) and expenditure transactions with them.

### **4A.18 Transactions covered under section 80A, 80-IA and 10AA**

Section 92BA further extends transfer pricing provisions to:

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

### **4A.19 Transactions covered under section 80A**

The second limb of section 92BA refers to any transaction referred to in section 80A.

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



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

### 4A.20 Section 80A (6) of the Act provides that

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

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

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

4A.21 This provision requires that the inter unit transfer of goods or services between eligible and other units of the same taxpayer should be recognized at market value of such goods or services on the date of transfer for the

## **Specified Domestic Transactions**

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purpose of computing deduction admissible to the taxpayer under specified sections of Chapter VI-A. The provision covers income as well as expenditure of the eligible unit. Further, if threshold of ₹ 5 crore is not crossed, the same will continue to be governed by un-amended provisions of section 80A(6) of the Act and FMV will be computed on general principles

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

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

### **4A.22 Transfers referred to in section 80-IA(8)**

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

**Section 80-IA(8) reads as under:**

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

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*shall be computed as if the transfer, in either case, had been made at the market value of such goods or services as on that date”*

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

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

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

4A.23 The above provision entitles the assessing officer to compute profits and gains of eligible business based on market value of goods and services transferred between an eligible and a non-eligible business only if the consideration for such transfer (if any) as recorded in the books of accounts of the eligible business does not correspond to the market value of the goods or services. By virtue of the amendment made to the above explanation vide Finance Act 2012, on lines of extension of Explanation to section 80A(6) defining market value, the Explanation under this provision has also been expanded to provide that the market value shall be computed at arm's length price if the inter unit transfer constitutes specified domestic transaction.

### **4A.24 Transfers referred to in section 80-IA(10)**

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

4A.25 Section 80-IA(10) reads as under:

*“Where it appears to the Assessing Officer that, owing to the close connection between the assessee carrying on the eligible business to which this section applies and any other person, or for any other reason, the course of business between them is so arranged that the business transacted between them produces to the assessee more than the ordinary profits which might be expected to arise in such eligible business, the Assessing Officer shall, in computing the profits and gains of such eligible business for the*

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*purposes of the deduction under this section, take the amount of profits as may be reasonably deemed to have been derived therefrom.”*

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

4A.26 Section 80-IA (10) applies to transactions between the assessee and any other person which results in excessive profits in the hands of the assessee:

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

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

### **4A.27 Transactions in other provisions to which section 80-IA(8)/(10) apply**

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

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

- 80-IAB- Deductions in respect of profits and gains by an undertaking or enterprise engaged in development of Special Economic Zone.
- 80-IB- Deduction in respect of profits and gains from certain industrial undertakings other than infrastructure development undertakings
- 80-IC- Special provisions in respect of certain undertakings or enterprises in certain special category States
- 80-ID- Deduction in respect of profits and gains from business of hotels and convention centres in specified area
- 80-IE- Special provisions in respect of certain undertakings in North-Eastern States

## Chapter 5

# Arm's Length Price

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### Meaning and determination

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

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

- (i) identification of the "international transaction" or specified domestic transaction;
- (ii) identification of an "uncontrolled transaction" - Rule 10A (a);
- (iii) identification and comparison of specific characteristics embodied in international transactions or specified domestic transactions and uncontrolled transactions - Rule 10B (2);
- (iv) finding out whether uncontrolled transactions and international transactions or specified domestic transactions can be compared by reconciling/resolving differences, if any - Rule 10B (3);
- (v) ascertaining the most appropriate method by applying the tests laid down - Rule 10C;
- (vi) determination of the arm's length price by applying the method chosen - Rule 10B (1).

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

- Comparable Uncontrolled Price method (CUP method)
- Resale Price Method (RPM)
- Cost Plus Method (CPM)

- Profit Split Method (PSM)
- Transactional Net Margin Method (TNMM)
- Other Method (OM) as prescribed by the Board and provided in Rule 10AB<sup>2</sup>.

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

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

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

5.6 Rule 10C, inter alia, specifies that the availability, coverage and reliability of data and whether reasonably accurate and reliable adjustments could be made as the relevant considerations in selecting the most appropriate method. In actual practice, the choice of most appropriate method depends not only on the nature and character of international transaction or specified domestic transaction but also on the availability of comparable transactions and data. Hence, the selection of most appropriate method is a process of applying both the criteria. It may happen that what

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<sup>2</sup> Rule 10AB vide Notification No. 18/2012 [F. NO. 142/5/2012-TPL] dated 23 May 2012, applicable for assessment year 2012-13 and onwards

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appears to be most appropriate method on the basis of nature of international transaction or specified domestic transaction may not be eventually selected because of non-availability of comparable data. The following example would clarify. An enterprise may buy from its AE and resell in India. The transaction itself suggests that the most appropriate method is Resale Price Method (RPM). There may not be any internal comparable transaction available. Even an external comparable may not be available. Even if an external comparable is available, the available data may not be sufficient to determine the Arm's length Gross Profit. Therefore, RPM may not be most appropriate method and some other method is to be chosen. The selection of most appropriate method is a process of continuously evaluating the nature and characteristics of international transactions or specified domestic transactions and the comparable transactions.

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

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

as the most appropriate method covering all the above transactions as the same are closely linked.

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

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

5.11 Section 92C(2) provides that most appropriate method referred to in section 92C(1) shall be applied, for determination of arm's length price, in the manner as prescribed in Rule 10B. The first proviso to section 92C(2) provides that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices. The second proviso to section 92C(2) provides that with effect from previous year 2012-13 (assessment year 2013-14) and onwards, if the variation between the arm's length price, so determined and price at which the transaction has actually been undertaken does not exceed such percentage (not exceeding 3 percent) as may be notified, the price at which the international transaction has been undertaken will be deemed to be the arm's length price. The notification relating to the quantum of variation permissible for various industries and business activities and transactions is awaited. The variation is to be computed with reference to the actual price at which the international transaction has been undertaken.

5.12 The aforesaid amended second proviso refers to arms length price (and not 'arithmetic mean' – as was the case in Finance Act 2002), and hence is applicable to any 'arms length price' determined (whether as a single comparable price, or as arithmetic mean of multiple comparable prices). Notably, only one method out of the 6 methods can be identified as the most appropriate method for a given transaction. Such most appropriate method may lead to a single comparable price or multiple prices. The arm's



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length price is the single comparable price or arithmetic mean of multiple comparable prices arrived at by application of the most appropriate method.

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

A. ALP determined by assessee		₹
CUT1	ALP1	7.600
CUT2	ALP2	7.380
CUT3	ALP3	7.320
Arithmetic mean as per proviso		7.433
ALP determined	7,433	

Assuming that the Indian taxpayer sells a product to its AE, in the above example, if the transfer price is equal to or above ₹ 7,433, it would be treated as being arm's length from an Indian transfer pricing perspective. For AY 2013-14, if the transfer price was less than ₹ 7,433, then it could vary from ALP only to the extent of the notified percent (not exceeding 3 percent). An example to illustrate this is as follows:

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

(-) 3% variation from transfer price	97%*7,000	6,790
(+)3% variation from transfer price	103%*7,000	7,210
ALP is greater than 3percent variation from Transfer Price		Transaction is not at arm's length

Scenario 2: Transfer Price is ₹ 7,200 and ALP is ₹ 7,433

(-) 3% variation from transfer price	97%*7,200	6,984
(+)3% variation from transfer price	103%*7,200	7,416
ALP is within 3 percent variation from Transfer Price		Transaction is at arm's length

## Uncontrolled transaction

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

An uncontrolled transaction can be between:

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

## Comparable uncontrolled transactions

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

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

## Distinctive nature of the property and services

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

- quality of product/services;
- quantity and value of the transactions;
- presence of intangibles like brand name, trade marks etc.;
- material/physical features.

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

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

Whether the transactions as illustrated in the aforesaid examples can be taken as comparable transactions or not would depend on the availability of data for making the reasonably accurate adjustments.

### **Analysis of functions performed**

5.17 Some of the important functions performed in a transaction are:

- design and development of product
- sourcing of materials
- manufacturing
- warehousing
- sales and distribution
- technical services
- conceptualisation and specifications of services performed
- customer support

Under this process, first a functional analysis of the transaction is carried out to identify the roles performed by each party thereto. Only the material or important functions are considered, while insignificant or irrelevant functions are ignored. What is important to consider is not the number of functions performed but their criticality.

### **Analysis of assets employed**

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

- a) Whether assets are owned or leased
- b) Whether activity is capital or labour intensive
- c) Presence or absence of intangibles

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

### **Analysis of risks assumed**

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

<b>Nature of risks</b>	<b>Particulars</b>
1. Financial risk	a. Capital contribution b. Method of funding c. Funding of losses d. Bad debts
2. Product risk	a. Design and development of product b. Up-gradation of product c. After Sales Service d. Risks associated with R & D e. Product liability risk f. Intellectual property risk if any
3. Market risk	a. Development of market including advertisement and product promotion etc. b. Business volume risk c. Assured sales risk d. Fluctuations in demand and prices. e. Credit and collection risk

### **Contractual terms**

5.20 The important contractual terms of the transactions should be ascertained to determine whether transactions are comparable or not. Some of the contractual terms that need to be examined are:

- terms of delivery
- CIF, C&F, FOB

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- terms of payment
- discount, if any
- credit period
- warranty period
- installation services

### **Market conditions**

5.21 The market conditions in which uncontrolled transactions and international transactions are conducted must be evaluated to judge their comparability. Some of the different market conditions are:

- geographical location and size
- regulatory laws and government orders
- cost of labour and capital
- level of competition
- nature of market whether wholesale/retail
- overall economic development

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

### **Business strategies, commercial considerations and economic principles**

5.22 Economic principles and prevailing business conditions are fundamental to any transfer pricing evaluation. Therefore, business strategies adopted by enterprises and market conditions faced by taxpayers are relevant factors for determining comparability with uncontrolled transactions/margins, and must be carefully considered during the comparability analysis.

Some examples where business strategies/ economic realities could be relevant are:

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

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

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

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

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

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

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

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

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

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

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

5.28 A question arises as to what should be the number of comparable uncontrolled transactions to be selected. In other words, is it sufficient to have just one CUT or is it necessary that a reasonable number of CUTs should be selected? Both the Act and the Rule do not prescribe the number of CUTs to be chosen. An analysis of section 92C(2) read with the proviso thereto and Rule 10B(1) would show that selection of even one CUT is permissible. The proviso to section 92C(2) uses the expression “provided that where more than one price is determined by the most appropriate method.....”. This indicates that selection of multiple CUTs is not required as a rule and if an assessee adopts multiple CUTs the proviso would be applicable. This is further strengthened by the language adopted in Rule 10B(1) which clearly permits adoption even a single CUT. For example, Rule 10B(1)(a)(i) uses the expression “.....in a comparable uncontrolled

transaction, or a number of such transactions..." (emphasis supplied). Similar expression is used in other clauses of Rule 10B(1). It is possible to have a single most appropriate CUT. Therefore, it may be said that if one most appropriate CUT is selected, such CUT would represent ALP. However, if more than one CUT is available the proviso to section 92C(2) would be applicable.

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

5.30 The proviso to Rule 10B(4), further states that data relating to a period of not more than 2 years preceding such financial year may also be considered, if such data reveals facts which could have an influence on the determination of the transfer prices in relation to transactions being compared.

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

### **Power of Assessing Officer**

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

- (i) the price charged or paid in an international transaction or specified domestic transaction has not been determined on the basis of the most appropriate method.
- (ii) any information and document relating to an international transaction or specified domestic transaction has not been kept and maintained as mandated.
- (iii) the information or data used in computation of the arm's length price is not reliable or correct.



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- (iv) the assessee had failed to furnish, within the specified time, any information or document which he was required to furnish.

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

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

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

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

5.37 The income of one of the associated enterprise may be recomputed by substituting the actual price paid/charged to another associated enterprise for any property or service with the arm's length price. When this substitution takes place it results in a re-computation of the total income of such associated enterprise. This re-computation would, however, not entitle the other associated enterprise to demand a re-computation of its total income. Consequently, it would not be entitled to a refund of any tax. For example, if XYZ Ltd. has paid royalty of ₹ 100 to its associated enterprise ABC Ltd., it would have deducted ₹ 20 as tax under section 115A read with section 195

### **Arm's Length Price**

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and remitted the balance of ₹ 80 to ABC Ltd. If the Assessing Officer computes the arm's length price of royalty to be ₹ 75 and substitutes it for the actual amount paid, i.e. ₹ 100, ABC Ltd., will not be able to demand either a re-computation of the royalty income received by it or a refund of tax in excess of what is due on the basis of the arm's length price.

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

## Chapter 6

# Methods of Computation of Arm's Length Price

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### Meaning of relevant terms

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

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

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

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

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

### Comparable Uncontrolled Price Method (CUP Method)

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

- (i) *the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified;*

## Methods of Computation of Arm's Length Price

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

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

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

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

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

"The CUP method is a particularly reliable method where an independent enterprise sells the same product as is sold between two associated enterprises."

"The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. If there is any difference between the two prices, this may indicate that the conditions of the commercial and financial relations of the associated enterprises are not arm's length, and that the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction."

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

- (i) Identify the price charged or paid in comparable uncontrolled transactions;

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

6.8 The application of the comparable uncontrolled price method can be understood with the following example:

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

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

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

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

#### Analysis of the international transaction with comparable uncontrolled transaction

	International transaction (with AE2 Ltd.)	Comparable uncontrolled transaction (with M Ltd.)	
Price	FOB	CIF	Freight and insurance ₹ 550
Quantity discount	Yes	No	One CD of ₹ 10 each for every CD writer plus ₹ 20 per CD writer
Credit	One month	Cash and carry	Cost of credit 1.25% per month
Warranty	No warranty	Six months warranty	Cost of warranty is ₹ 250 per unit

### **Methods of Computation of Arm's Length Price**

Factors to be considered while determining ALP:

- (a) In the CUP method, one has to start from the price charged in the case of the comparable uncontrolled transaction.
- (b) In this illustration one has to start with the price charged by AE1 Ltd., to M Ltd.
- (c) The price charged to AE3 Ltd., cannot be considered as AE3 Ltd., is itself an associated enterprise of AE1 Ltd.
- (d) The price charged to M Ltd., will have to be increased by the value of credit which is at the rate at 1.25% p.m. (i.e. 15% p.a.). If the similar credit were offered to M Ltd., the price charged to M Ltd. would have been higher, after factoring this cost.
- (e) The price charged to M Ltd., will have to be reduced by the following;
  - (i) ₹ 550 representing the freight and insurance –This is for the reason that if the price to M Ltd., had been on FOB basis, it would have been less by ₹ 550.
  - (ii) ₹ 250 per unit representing the estimated cost of warranty execution for a period of six months on the basis of a technical analysis and past experience - This is for the reason that if the warranty was not given, the price to M Ltd. would have been lower, without factoring this cost.
  - (iii) ₹ 10 representing the cost of each CD – This is for the reason that if similar gift had been offered to M Ltd., the effective price to M Ltd., would have been less.
  - (iv) ₹ 20 representing a quantity discount - This is for the reason that if similar discount had been offered to M Ltd., the effective price to M Ltd., would have been less.

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

The following points are to be noticed:

- (i) All adjustments in the course of applying this method are to be made to the price charged in the uncontrolled transaction. The presence or absence of any specific features in the uncontrolled transaction as compared to the international transaction is to be adjusted for. These

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features are to be evaluated in monetary terms. This is a subjective process based on objective facts.

- (ii) Only differences that would materially affect the price in the open market are required to be adjusted. Two points may be noted. Firstly, materiality would have to be judged in the light of various circumstances. If there are numerous adjustments, which are individually not material but collectively material, the necessary adjustments are required to be made. Secondly, the term 'open market', though not defined, would mean a transaction between a knowledgeable and a willing purchaser and a knowledgeable and willing seller where neither of them is influenced or compelled to act in a particular manner.

## **Resale Price Method (RPM)**

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

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

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***or obtaining of the services by the enterprise from the associated enterprise.***

6.10 Typical transactions where the resale price method may be adopted are distribution of goods involving little or no value addition.

6.11 The OECD in its Transfer Pricing Guidelines has observed as under:

“An appropriate resale price margin is easiest to determine where the reseller does not add substantially to the value of the product. In contrast, it may be more difficult to use the resale price method to arrive at an arm's length price where, before resale, the goods are further processed or incorporated into a more complicated product so that their identity is lost or transformed (*e.g.* where components are joined together in finished or semi-finished goods). Another example where the resale price margin requires particular care is where the reseller contributes substantially to the creation or maintenance of intangible property associated with the product (*e.g.* trademarks or trade names) which are owned by an associated enterprise. In such cases, the contribution of the goods originally transferred to the value of the final product cannot be easily evaluated.

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

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

- (i) identify the international transaction of purchase of property or services;
- (ii) identify the price at which such property or services are resold or provided to an unrelated party (resale price);
- (iii) identify the normal gross profit margin in a comparable uncontrolled transaction whether internal or external. The normal gross profit margin is that margin which an enterprise would earn from purchase of the similar product from an unrelated party and the resale of the same to another unrelated party.
- (iv) deduct the normal gross profit from the resale price.
- (v) deduct expenses incurred in connection with the purchase of goods;



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- (vi) adjust the resultant amount for the differences between the uncontrolled transaction and the international transaction. These differences could be functional and other differences including differences in accounting practices. Further these differences should be such as would materially affect the amount of gross profit margin in the open market;
- (vii) the price arrived at is the arm's length price of the international transaction;

6.13 The application of the resale price method can be understood with the following example:

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

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

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

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

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

### Analysis of the sales transactions

	Sales to A Ltd.	Sales to M Ltd.	
Price	Ex shop	FOR Destination with cost of freight and insurance estimated at 2% of GP	Impact of Freight and insurance on GP is 2% as the sale price increases but corresponding expenses are not debited to trading

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			account but to profit and loss account
Quantity discount	Yes - the cost of the same is estimated at 1% of GP	No	Impact of quantity discount on GP is 1%
Free gifts	No	One CD pack for every CD writer with no change in sale price	As cost of gift is not debited to trading account but to P & L Account, there is no impact on GP
Warranty	No	6 months warranty (without change in sale price) - cost of warranty is estimated at ₹ 250 per unit	As cost of warranty is not debited to trading account but to P&L Account, there is no impact on GP

**Analysis of the purchase transactions**

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

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Factors to be considered while determining ALP:

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



- (b) The comparable uncontrolled transaction is the purchase transaction entered into by AE1 Ltd., with K Ltd.



- (c) The starting point for arriving at the ALP of such purchase transaction is the resale price charged to A Ltd. viz. ₹ 3,000 [Rule 10B(1)(b)(i)].
- (d) From the said resale price, the normal gross profit margin which AE1 Ltd., would earn in a comparable uncontrolled transaction should be reduced. In this example, the actual gross profit margin earned by AE1 Ltd., in respect of its purchase from K Ltd, and its resale to M Ltd, is 15%.
- (e) The following adjustments are made to arrive at the normal GP;

Actual gross profit margin with M Ltd.	15%
Less :	
1. Difference between Ex-shop and FOR prices	2%
2. Difference due to quantity discount	1%      3%
Normal gross profit margin with M Ltd.	12%

**Note:** While arriving at normal gross profits from the actual gross profits, only the differences in the sale transactions of AE1 Ltd., with A Ltd., and M Ltd., have been taken. The differences in the purchase transactions of AE1 Ltd., with AE2 Ltd. and K Ltd., affecting the gross profits are taken separately as provided in sub rule (iv).

- (f) The resale price of ₹ 3000. to M Ltd., is reduced by the normal gross profit margin of 12%. The resultant cost of sales is ₹ 2640 (i.e. 3000-360) [Rule 10B(1)(b)(ii)].

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- (g) The cost of sales so arrived at is reduced by the expenses incurred in connection with the purchase (international transaction) i.e. freight of ₹ 10 and customs duty of ₹ 25. The resultant amount is ₹ 2605 (i.e. 2640-25-10) [Rule 10B(1)(b)(iii)].
- (h) The above amount is further adjusted to take into account functional and accounting differences between the international transaction and the comparable uncontrolled transaction with AE2 Ltd the purchase transaction with K Ltd., which will affect the amount of gross profit margin as explained below.
- (i) The aforesaid amount of ₹ 2605 should be increased by ₹ 10 being the freight incurred by AE1 Ltd., in the case of purchase from AE2 Ltd., but not incurred in case of purchase from K Ltd., This is for the reason that if a similar freight had been paid in respect of transaction with K Ltd, the gross profit margin from K Ltd., would have been lower and the resultant price would have been higher.
- (j) A decrease by ₹ 15 representing the quantity discount allowed by AE2 Ltd., is to be made. This is for the reason that if a similar discount had been allowed in respect of transaction with K Ltd, the gross profit margin from K Ltd., would have been higher and the resultant price would have been lower.

#### **Determination of arm's length price under resale price method**

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

Details	₹ /unit
Price paid to AE2 Ltd.(FOB)	2,900
Quantity	100
Purchases cost (actual) (A)	2,90,000
Actual GP Margin on sales to M Ltd.(%)	15
Normal GP Margin on sales to M Ltd.(%)	12
Price charged to A Ltd.	3,000

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Less: Normal GP margin	360
Balance	2640
Less: Expenses connected with purchase (freight & customs duty paid)	35
Price before adjustment	2,605
<b>Add:</b>	
Freight incurred in case of purchase from AE2 Ltd.	10
<b>Sub total</b>	10
<b>Less :</b>	
Quantity discount allowed by AE2 Ltd.	15
<b>Sub total</b>	15
Arm's length price	2,600
Adjusted purchase cost (B)	2,60,000
Income increases by (A-B)	30,000

The following points are to be noticed:

- (i) The resale price method is to be adopted only when goods purchased from an associated enterprise are resold to unrelated parties.
- (ii) As provided in Rule 10B(1)(b)(iii), the expenses incurred in connection with the purchase from AE are to be reduced from cost of sales. In resale price method, the arm's length purchase price is arrived at reducing the normal gross profit margin from the resale price as the first step. If the computation is stopped at this step itself, the derived purchase amount would be inclusive of the such expenses. It is therefore necessary to reduce such expenses in arriving at the arm's length purchase price.
- (iii) Adjustments have to be made also for accounting practices apart from functional and other differences. Differences in accounting practices may be because:
  - (a) sales and purchases have been accounted for inclusive of taxes or exclusive of taxes;
  - (b) method of pricing the goods namely, FOB or CIF;
  - (c) fluctuations in foreign exchange.
- (iv) In actual practice, the resale in any financial year may be also out of opening stock. Similarly, the goods purchased during the said year

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may remain in closing stock. Under the resale price method, the arm's length price of purchases from AE during the financial year should be determined. The process of determination under Rule 10B(1)(b) culminates in the cost of sales rather than value of purchase during the year. This 'cost of sales' should be converted into 'value of purchase'. For this purpose, the closing stock of goods purchased from AE should be added and the opening stock of purchases from AE should be deducted.

### **Cost Plus Method (CPM)**

**6.14 Rule 10B(1)(c) cost plus method, by which,-**

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

**6.15** Typical transactions where the cost plus method may be adopted are:

- (a) provision of services;
- (b) joint facility arrangements;
- (c) transfer of semi finished goods;

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(d) long term buying and selling arrangements.

6.16 The OECD in its Transfer Pricing Guidelines states as follows :

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

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

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

6.18 The application of the cost plus method can be understood with the following example:

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

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

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

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

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

#### **Analysis of transactions**

	<b>Transactions with AE2 Ltd.</b>	<b>Transactions with M Ltd.</b>
Technology support	Yes	No - value of technology support incurred by AE1 Ltd., is ₹ 17,500
Discount	Yes – Discount offered is ₹ 8,750	No
Business risks and marketing	Yes – Value of the same is estimated at ₹ 13,125	No
Credit	Yes – Cost of credit is estimated at ₹ 2,625	No

Factors to be considered while determining ALP:

- (a) In the CPM, one has to start with the gross profit mark up which the enterprise earned in a comparable uncontrolled transaction. In this example, the comparable uncontrolled transaction is between AE1 Ltd., and M Ltd.
- (b) Such gross profit (GP) mark up needs to be decreased by the following:
  - As AE1 Ltd., did not receive the technology support from M Ltd., it has priced its services higher resulting in its earning a higher GP with M Ltd.. The value of technology support of ₹ 17,500 received from AE2 Ltd. is 10% of cost. Therefore, the GP with M Ltd., has to be reduced by 10%.
  - AE1 Ltd. did not provide discount to M Ltd., as volume of business from M Ltd., was not as high as that from AE2 Ltd. Had AE1 Ltd., offered similar discount to M Ltd., the GP with M Ltd., would have been lower. The discount of ₹ 8,750



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offered to AE2 Ltd. is 5% of cost. Therefore, the GP with M Ltd., has to be decreased by 5%.

- AE1 Ltd., has incurred ₹ 15,000 towards marketing functions in respect of its transactions with M Ltd., which is 7.5% of its cost. However, in its transactions with AE2 Ltd. the said functions are assumed by AE2 Ltd. Had AE1 Ltd., not incurred similar expenses with M Ltd., it would have settled for a lower GP. Therefore, the GP with M Ltd., has to be reduced by 7.5%.
  - The cost of credit of ₹ 2,625 provided by AE1 Ltd., to AE2 Ltd. is 1.5% of its cost. However, in its transactions with M Ltd., such credit is not provided. Had AE1 Ltd., provided similar credit to M Ltd., it would have increased its price resulting in a higher GP. Therefore, the GP with M Ltd., has to be increased by 1.5%.
- (c) The resultant gross profit mark up is the arm's length gross profit mark up.
- (d) The costs of AE1 Ltd., in its transactions with AE2 Ltd. should be increased by the arm's length gross profit mark up to arrive at the arm's length income.

### Determination of arm's length price under costs plus method

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

### Determination of arm's length gross profit mark up

Details	
Gross profit mark up in case of M Ltd.	50.00%
<b>Less :</b>	
1. Technology support from AE2 Ltd.	10.00%
2. Quantity discount to AE2 Ltd not to M Ltd.	5.00%
3. Marketing functions performed by AE1 Ltd., in respect of M Ltd.	7.50%
<b>Sub total</b>	<b>22.50%</b>

### Methods of Computation of Arm's Length Price

<b>Add :</b>	
1. Cost of credit to AE2. Ltd.	1.50%
<b>Sub total</b>	1.50%
Arm's length gross profit mark up	29.00%

#### Determination of arm's length price

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

The following points are to be noticed:

- (i) In this method, the direct and indirect costs of production are to be determined. The terms 'direct' or 'indirect' costs are however not defined. A reference may therefore be made to the industry practice as well as the pronouncements of the ICAI
- (ii) In determining the direct and indirect cost, the following factors have to be borne in mind:
  - (a) if the plant has been under utilised the costs may have to be suitably adjusted;
  - (b) absorption costing method is normally to be preferred.
- (iii) This method is to be adopted only in cases of supply of property or services to an associated enterprise. This method is not to be applied when the enterprise is in receipt of property or services from an associated enterprise.

### Profit Split Method (PSM)

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

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

*Provided that the combined net profit referred to in sub-clause (i) may, in the first instance, be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of international transaction in which it is engaged, with reference to market returns achieved for similar types of transactions by independent enterprises, and thereafter, the residual net profit remaining after such allocation may be split amongst the enterprises in proportion to their relative contribution in the manner specified under sub-clauses (ii) and (iii), and in such a case the aggregate of the net profit allocated to the enterprise in the first instance together with the residual net profit apportioned to that enterprise on the basis of its relative contribution shall be taken to be the net profit arising to that enterprise from the international transaction.*

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

- (a) integrated services provided by more than one enterprise for e.g., in case of financial service sector, where the activities performed by Indian company and foreign AEs in relation of a merger and acquisition transaction are so interrelated that it may not possible to segregate them;*

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- (b) transfer of unique intangibles, for e.g. two associated enterprises contribute their respective intangibles to develop a new product or process and earn income from such product or process.

6.21 The observations of the OECD, in its Transfer Pricing Guidelines, on this method are as follows :

"This method aims to determine what division of total profits independent enterprise would expect in relation to the relevant transactions. The profits should be split on an economically valid basis that reflects the functions and risks of each of the parties. In order to apply this method, it is necessary to identify the total profit arising from the related party transactions and split that profit between the parties according to their respective contributions."

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

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

- (i) Determine the combined net profit of the associated enterprises arising from the international transactions in which they are engaged. Such profits represent the profits earned from third parties due to the combined efforts of the associated enterprises. It may be noted that the 'combined net profit' referred to in the rule is not the aggregate of entire profits earned by the associated enterprises. Example: AE1 may earn profits from certain transactions wherein there is no contribution by AE2 and vice versa. Such profits do not enter into the determination of combined net profit. Only those profits that are earned as a result of joint efforts of AE1 and AE2 should be taken as combined net profit.
- (ii) Evaluate relative contribution made by each entity involved in the transaction on the basis of:
  - (a) functions performed;
  - (b) assets employed;
  - (c) risks assumed;
  - (d) the reliable external market data indicating how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances. It may be noted that reference to 'external market data' indicates comparable uncontrolled transactions. The use of

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word 'external' does not preclude use of internal CUT. In the process of choosing CUTs, the function performed, assets used and risks taken (FAR) of the uncontrolled transactions would have been compared with the FAR of the international transactions. When the FAR of the international transaction and CUT are similar, the relative contribution adopted in the CUT should be applied to the international transaction. Any significant differences between the two should be suitably adjusted.

- (iii) Thereafter, split the combined net profit in proportion to the relative contribution determined as above.
- (iv) The profit so apportioned is taken to arrive at the arm's length price in relation to the international transaction. The profits so apportioned to the AE when added to the costs incurred by it in relation to international transaction would result in arm's length price.

### **Residual profit split approach**

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

6.24.1 Steps involved in this approach are as follows:

- (i) As detailed in paragraph 21.5(i), determine the combined net profit of the associated enterprises arising from the international transactions in which they are engaged.
- (ii) At the first stage, depending on functions performed, assets employed and risks assumed, determine the basic return appropriate to the respective activities. Allocate the combined net profit on the basis of above. This step results in a partial allocation of the combined net profit to each enterprise. For this purpose, the allocation is undertaken with reference to margins of comparable uncontrolled entities.
- (iii) the balance of the combined net profit is allocated on the basis of the evaluation of the relative contribution as discussed in paragraph 21.5(ii).

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- (iv) the total net profit from such two-tier allocation is taken to arrive at the arm's length price. The profits so apportioned to the AE when added to the costs incurred by it in relation to international transaction would result in arm's length price.

6.25 The application of the profit split-method can be understood with the following example:

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

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

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

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

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

Factors to be considered:

- (a) The normal basic return is ordinarily calculated as a percentage of the costs incurred or gross revenues or capital employed. In this example, it is assumed as a percentage of the cost.
- (b) Based on the FAR analysis, the basic return for AE1 Ltd., and AE3 Ltd., are determined to be 15% and 10% respectively. Accordingly, the normal basic return for AE1 Ltd. in India for the aforesaid operation is US\$ 3000. The similar returns for AE3 Ltd., US\$ 800. The total basic return, thus, is US \$ 3,800.

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- (c) On the basis of functions performed, risks assumed and assets employed, the relative contribution may be taken at 70%, 30% for AE1 Ltd. and AE3 Ltd., respectively.

#### Determination of arm's length price under profit split method:

##### First Approach: Total Profit Split Method

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

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

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

##### Second Approach: Residual profit split method

Details	US\$
Price charged by AE3 Ltd from M Ltd	50,000
AE3 Ltd share of revenue	20,000
AE1 Ltd share of revenue	30,000
Combined total profits	22,000
1. Basic return	

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AE1 Ltd : India return	3,000
AE3 Ltd : US return	800
Total	3,800
2. Residual net profit	18,200
AE1 Ltd: India return – 70%	12,740
AE3 Ltd: US return – 30%	5,460
Total	18,200
Total return for AE1 Ltd (12740 + 3000)	15,740
Total cost of AE1 Ltd.	20,000
Income of AE1 Ltd. on arm's length price (A)	35,740
Actual revenue (B)	30,000
Increased income (A-B)	5,740

The following points are to be noticed:

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



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price in the international transaction that an adjustment may be made to the income returned.

### Transactional Net Margin Method (TNMM)

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

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

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

- (a) provision of services;
- (b) distribution of finished products where resale price method cannot be applied;
- (c) transfer of semi finished goods where cost plus method cannot be applied;

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- (d) transactions involving intangibles where profit split method cannot be applied.

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

- (i) Identify the net profit margin realised by the enterprise from an international transaction. Where the assessee also has transactions, segments or businesses where the international transactions with associated enterprises are not relevant, then the net profit margin to be considered for the purposes of this TNMM method should be such net profit margin as is derived only from the transactions, segments or businesses related to the international transaction. The net profit margin may be computed in relation to costs incurred or sales effected or assets employed or any other relevant base.

For example,

- In case where the assessee acts as a distributor and the transaction pertains to import, the revenue may be used as base.
  - In case the transaction involves export of services/goods, costs may be taken as base.
- (ii) Identify the net profit margin from a comparable uncontrolled transaction or a number of such transactions having regard to the same base; In practice, net profit margin is ascertained at segment level where segment data are available. The unallocated expenses are allocated on a reasonable basis and the segmental net profit is determined. Where segment data are not available, net profit is normally determined at enterprise level. Where internal CUT is available transaction level net profit may be determined.
- (iii) In case internal CUT is not available, external CUT is taken. In such case, as discussed above, net profit margin should be taken at enterprise level (segmental or enterprise as a whole) of comparable companies. A search should be carried out to identify comparable companies on the basis of information and data available with the assessee. Where such information and data are not available, search may be carried out with reference to database in public domain.
- (iv) The net profit margin so identified is adjusted to take into account the transaction level and enterprise level differences if any. The

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differences should be those that could materially affect the net profit margin in the open market;

- (v) The adjusted net profit margin is taken into account to arrive at the arm's length price in relation to the international transaction.

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

AE1 Ltd., is an Indian company

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

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

	<b>No. of companies</b>
Search on the basis of following keywords:	
(a) Computer	800
(b) Computer hardware	250
(c) Computer peripherals	66
Sub total	1116
Elimination process :	
Companies with different activities	800
Companies with duplication when multiple database are used	75
Companies with no financials	90
Companies having significant operations like sales or purchases with related party	100
Companies reporting no operations	50
Sub total	1115
Company/companies selected – Z Ltd.	1

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

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

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

<b>Operating margin</b>	<b>AE1 Ltd. ₹ (in crores)</b>	<b>Z Ltd. ₹ (in crores)</b>
Sales	130	200
Gross revenue	130	200
Operating expenses	85	120
Interest	5	7
Depreciation	10	12
Total operating cost	100	139
Operating profit	30.00	61.00
Operating margin (before interest and depreciation)	52.94	66.67
Operating margin (after depreciation but before interest)	36.84	51.52

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

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

**(a) Working capital** – There may be differences in stock holding, debtors and creditors. Appropriate adjustment to eliminate the impact of above difference may be made by taking the prevailing interest rate. For this purpose, useful reference may be made to the guidelines issued by Internal Revenue Service of USA. However, in this example, it is assumed that the difference in the working capital is not significant requiring any adjustment.

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

**(c) Assets employed** – There may be difference in assets employed and the method of providing depreciation. In order that such difference does not impact the net profit, the operating margin on operating cost before depreciation is taken as profit level indicator.

**(d) Assured or risk bearing business** – There may be a difference in the customer/ revenue model of the assessee vis-à-vis the comparables. For example, the comparables identified may be entrepreneurs bearing the market risks of business volume, customer continuity, etc and the assessee's international transaction is in the nature of captive service provider or contract manufacturer with assured volumes and/or assured compensation and/or assured business period, etc. Such differences may be eliminated by making appropriate adjustment for low-risk or risk free business.

In the above table, the transaction level differences cannot be noticed. However, some transaction level differences may exist and the same may be adjusted if requisite information is available. Some of the common transaction level differences may be as follows;

- (a) Free gifts
- (b) Extended warranty (in addition to the normal one-year)
- (c) Marketing risks
- (d) Pricing - Ex-Shop or FOR-destination.
- (e) Quantity discount

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**Table 5: Computation of arm's length price under the transactional net margin method**

1. Associated enterprise	:	AE1 Ltd. and AE2 Ltd.	
2. International transaction	:	AE1 Ltd. and AE2 Ltd.	
3. Comparable uncontrolled company	:	Z Ltd.	
			%
Net profit margin of Z Ltd. - i.e. operating margin on cost before interest and after depreciation			51.52
Adjustments for transaction level differences			0.00
Arm's length net profit margin			51.52
			(₹ in crores)
Operating costs before interest and after depreciation			95.00
Arm's length sale revenue			143.94
Actual sales			130.00
Income increases by			13.94

The following points are to be noticed:

- (a) Different bases of determining the net profit margin [i.e. profit level indicators (PLI)] are recognised. The same basis of arriving at the net profit margin is to be adopted year after year, unless circumstances justify an alternate base;
- (b) Whichever base is selected in determining the net profit margin in an international transaction, the same basis is to be adopted for arriving at the net profit margin in the comparable uncontrolled transaction;
- (c) It is recommended that operating profit margin may be used instead of net profit margin. Operating profit margin would eliminate the non-operating items (the items of revenue and costs which do not result from routine business operations such as profit on sale of assets, dividend etc.).

Further, the operating profit margins should be computed on the basis of financial statements of the assessee and the comparable company.

- (g) The accounting treatment of expenses and depreciation is also a critical factor in computing the arm's length price. Unlike the

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preceding methods, the rule does not explicitly provide for adjustment on account of differing accounting practices. Nevertheless, such differing practices should also be factored in;

- (h) It is not uncommon to find purchase transaction being an international transaction where TNMM is used. TNMM requires the determination of the net profit margin from an international transaction and purchase transaction as such does not result in net profit. However, as purchase is inextricably linked to earning net profit, TNMM may be used for establishing arm's length purchase value. In such case, comparable operating margin should be appropriately used to work back the arm's length purchase cost. This may be illustrated as follows:

### Illustration 1:

1. Actual Profit and loss account of the assessee

	₹ in lakhs		₹ in lakhs
Opening stock-AE purchases	100	Sales of AE purchases	800
Opening stock-Non AE purchases	150	Sales of Non AE purchases	1200
Purchases from AE	500	Closing stock-AE purchases	120
Purchases from Non AE	1000	Closing stock-Non AE purchases	160
Gross profit	530		
	<u>2280</u>		<u>2280</u>
Expenses	200	Gross profit	530
Net profit	330		
	<u>530</u>		<u>530</u>

2. Comparable operating margin (PLI being operating profit on sale) 35%
3. Profit and loss account - recast to compute arm's length price of purchase

	(₹ in lakhs)		(₹ in lakhs)
Opening stock-AE purchases	100	Sales of AE purchases	800
Purchases from AE	460	Closing stock-AE	120

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(balancing figure)		purchases
Gross profit (brought back)	360	
	920	920
Expenses-allocated (in the ratio of sales)	80	Gross profit (worked back)
Net profits (applying TNMM margin on AE sales)	280	360
	360	360

4. Arm's length value of purchase is ₹ 460 as against actual value of ₹ 500. Therefore, income increases by ₹ 40.

**Illustration 2 :**

1. Profit and loss account of the assessee – Actual

	₹ in lakhs		₹ in lakhs
Opening stock of raw material (AE purchases)	100	Sale of finished goods	2500
Opening stock of raw material (Non-AE purchases)	150	Closing stock of raw material (AE purchases)	120
Purchases of raw material from AE	500	Closing stock of raw material (Non-AE purchases)	160
Purchases of raw material from Non-AE	1000	Closing stock of finished goods	500
Manufacturing costs	400		
Admin, selling and finance expenses	200		
Net profit	930		
	3280		3280

2. Comparable operating margin (PLI being operating profit on sale) 45%

3. Profit and loss account - recast:

	₹ in lakhs		₹ in lakhs
Opening stock of raw material (Non-AE purchases)	150	Sale of finished goods	2500
Cost of purchase from AE (net	405	Closing stock of raw	160



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of stock) (balancing figure)		material (Non-AE purchases)	
Purchases of raw material from Non AE	1000	Closing stock of finished goods	500
Manufacturing costs	400		
Admin, selling and finance expenses	200		
Net profit (arrived on basis of TNMM margin)	1125		
	<hr/>		<hr/>
	3280		3280
Arm's length Purchase value :			
Cost of purchase from AE (net of stock)			405
Add : Closing stock of Raw Material			120
Add : Closing stock of Raw Material in finished goods (see Note 1 below)			20
Less : Opening stock			<u>100</u>
Arm's length Purchase value			445
Actual purchase			500
Excess price paid			55

**Notes:** 1. In the above example, the raw material cost (of purchases from AE) built into closing stock of finished goods is assumed to be ₹ 20.

2. It is assumed that there is no opening stock of finished goods.

### Other Method (OM) of determination of arm's length price

6.31 The CBDT has inserted a new Rule 10AB by notifying the "Other Method" apart from the five methods already prescribed.

*For the purposes of clause (f) of sub-section (1) of section 92C, the Other Method for determination of the arms' length price in relation to an international transaction shall be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with*

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***or between non-associated enterprises, under similar circumstances, considering all the relevant facts.***

6.32 The introduction of the Other Method as the sixth method allows the use of 'any method' which takes into account (i) the price which has been charged or paid or (ii) would have been charged or paid for the same or similar uncontrolled transactions, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts. The various data which may possibly be used for comparability purposes could be:

- (a) Third party quotations;
- (b) Valuation reports;
- (c) Tender/Bid documents;
- (d) Documents relating to the negotiations;
- (e) Standard rate cards;
- (f) Commercial & economic business models; etc.

6.33 It is relevant to note that the text of Rule 10AB does not describe any methodology but only provides an enabling provision to use any method that has been used or may be used to arrive at price of a transaction undertaken between non AEs. Hence, it provides flexibility to determine the price in complex transactions where third party comparable prices or transactions may not exist. The wide coverage of the Other Method would provide flexibility in establishing arm's length prices, particularly in cases where the application of the five specific methods is not possible due to reasons such as difficulties in obtaining comparable data due to uniqueness of transactions such as intangibles or business transfers, transfer of unlisted shares, sale of fixed assets, revenue allocation/splitting, guarantees provided and received, etc. However, it would be necessary to justify and document reasons for rejection of all other five methods while selecting the 'Other Method' as the most appropriate method. The OECD Guidelines also permit the use of any other method and state that the taxpayer retain the freedom to apply methods not described in OECD Guidelines to establish prices, provided those prices satisfy the arm's length principle.

6.34 The application of the sixth method may be understood with the following example:

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### Illustration A

AE1 Ltd. is an Indian Company.

AE1 Ltd. owns certain registered patents which it has developed by undertaking research and development.

It is a subsidiary of AE2 Ltd., a foreign company.

AE1 Ltd. has sold its registered patents to AE2 Ltd., for ₹ 50 crores. The price has been determined based on a valuation report obtained from an independent valuer.

The sale of patents is a unique transaction and AE1 Ltd or AE2 Ltd. has not entered into similar transactions with third parties and hence no internal or external CUP is available.

AE1 Ltd. may select the Other Method as the most appropriate method and use the independent valuation report for comparability purposes.

### **Illustration B**

An Indian Company (I Co) buys back its equity shares issued to its foreign associated enterprise (AE Co). I Co obtains a valuation report from an external firm identifying the fair market value of these shares. I Co purchases the shares at the value determined in the valuation report. This value denotes a price that would have been charged if a third party would have bought the same shares. Hence, I Co could use Rule 10AB and rely upon the valuation report to demonstrate this transaction to be arm's length.

### **Illustration C**

Another example where this method could be used is in cases of cost allocation arrangements where a taxpayer benefits from certain services provided by a central entity of the group and has to pay a portion of the total cost incurred by the service provider. These costs are generally allocated on the basis of allocation keys like headcount, time spent, revenues etc. and a third party outside the group may not have the capability to provide identical services. Hence, in the absence of comparable prices or transactions, Rule 10AB may be applied and the cost allocation arrangement could be justified appropriately.

## **Most appropriate method**

**6.35 (1)** *For the purposes of sub-section (1) of section 92C, the most appropriate method shall be the method which is best suited to*

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*the facts and circumstances of each particular international transaction, and which provides the most reliable measure of an arm's length price in relation to the international transaction.*

**(2) In selecting the most appropriate method as specified in sub-rule (1), the following factors shall be taken into account, namely:-**

- (a) the nature and class of the international transaction;**
- (b) the class or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;**
- (c) the availability, coverage and reliability of data necessary for application of the method;**
- (d) the degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;**
- (e) the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;**
- (f) the nature, extent and reliability of assumptions required to be made in application of a method. [Rule 10C].**

6.36 No particular method is suitable in every possible situation. It is not possible to provide specific rules that will cover every case. While selecting the most appropriate method, the factors prescribed in section 92C of the Act and Rule 10C(2) should be considered.

Amongst these factors, the functions performed by associated enterprises (including assets employed and risks assumed) should be given due consideration. It is also important to ascertain the extent and reliability of the uncontrolled data that is available. The nature of the available data, and especially the amount and reliability of detail on the factors entering into a comparability analysis, are very important issues in the selection and application of a methodology.

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Although it is difficult to prescribe general principles for choice of most appropriate method, the following broad categorisation may be considered as already indicated under each of the respective methods:

- (i) Comparable uncontrolled price method may be used in case of loans, royalties, service fee, transfer of tangibles, etc.;
- (ii) Resale price method is most useful in case of marketing operations of finished products, especially in case of distributors not performing significant value addition to the product;
- (iii) Cost plus method is normally used where raw materials or semi-finished goods are sold; where joint facility agreements or long-term buy-and-supply arrangements, or the provision of services are involved;
- (iv) Profit split method is normally used in cases where the transactions involve provision of integrated services by more than one enterprise; and
- (v) Transactional net margin method could be used in majority of the cases including transfer of semi-finished goods; distribution of finished products where applicability of resale price method appears to be inappropriate and transaction involving provision of services.

6.37 For the purposes of sub-rule (1) of rule 10B, the comparability of an international transaction with an uncontrolled transaction shall be judged with reference to the following namely:-

- (a) the specific characteristics of the property transferred or services provided in either transaction;
- (b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;
- (c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;
- (d) conditions prevailing in the markets in which the respective parties to the transaction operate, including the geographical location and size of the markets, the laws and government orders in force, costs of

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labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

6.38 While evaluating each method the distinctive aspects of computation should be borne in mind. For instance, the Resale Price Method requires functional and other differences including accounting practices to be adjusted to the price whereas CPM and TNMM require such differences to be adjusted to the margin.

6.39 Different methods may be chosen as most appropriate method for different transactions of the assessee as long as the rationale for each of such choices are adequately documented. Also, different methods may be chosen for the same transaction in different years as long as the rationale for each such choice made in each year is adequately documented.

## Chapter 7

# Documentation and Verification

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### Type of information and documents

Rule 10D(1) lays down thirteen different types of information and documents that a person has to keep and maintain. Broadly, these information and documents may be classified into three types:

- (i) enterprise-wise documents – These are documents that describe the enterprise, the relationships with other associated enterprise, the nature of business carried out, etc. This information is, largely, descriptive [clauses (a) to (c)].
- (ii) transaction-specific documents – These are documents that explain the international transaction in greater detail. It includes information with regard to each transaction (nature and terms of the contract, etc.), description of the functions performed, assets employed and risks assumed by each party to the transaction, economic and market analyses, etc. This information is both descriptive and quantitative in nature [clauses (d) to (h)].
- (iii) Computation related documents – These are documents which describe and detail the methods considered, actual working assumptions, policies etc., adjustments made to transfer prices and any other relevant information, data, document relied for determination of arm's length price [clause (i) to (m)].

### Ownership, profile and business

**7.1 *A description of the ownership structure of the assessee enterprise with details of shares or other ownership interest held therein by other enterprises. [clause (a), Rule 10D(1)].***

7.2 It may be noted that the term "other enterprise" should refer to an associated enterprise. If this term were to be given the meaning provided in section 92F (iii), then it would virtually include every member in the register of members. No purpose would then be served by duplicating the contents of that register. Where the person is a company, the names of members who are associated enterprises, the number of shares held by each of them and the percentage of their holding to the total holding has to be stated.

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7.3 However, where the number of members is very large, a generic classification of the ownership structure may be given. For this purpose, the classification given in paragraph VIII, Part II, Schedule V to the Companies Act, 1956, may be used, namely, holdings by Government (Central, State), Government companies, public financial institutions, nationalised and other banks, mutual funds, venture capitalists, foreign holdings, bodies corporate, directors and relatives, others. The holdings of associated enterprises must, in any case, be shown separately.

7.4 Where the person is a firm or an association of persons, the names of the partners of the firm or members of the association of persons and their profit sharing ratios have to be stated. Similar details, to the extent applicable, need to be furnished when the person is a body of individuals, trust, Hindu undivided family, etc. The description of the ownership structure should be stated as at the day on which one person became an associated enterprise of another and as at every other day on which there was change in the ownership interest of that other enterprise.

7.5 For example, assume that A Ltd., India and X Inc., USA, are associated enterprises, and the holdings of X Inc. in A Ltd. were as under:

(a)	Total number of ₹ 10, fully paid equity shares, issued by and subscribed in A Ltd.	100,000
(b)	Total number of shares of ₹ 10, fully paid up, held by X Inc. on 1 <sup>st</sup> April, 2001	50,000
(c)	Total number of shares of ₹ 10, fully paid up, acquired by X Inc. on 24 <sup>th</sup> November, 2001 (by private purchase)	10,000
(d)	Total number of shares of ₹ 10, fully paid up, disposed off by X Inc. on 24 <sup>th</sup> February, 2002 (by private sale)	25,000

Under this clause, A Ltd. will have to report the holdings of its Associated Enterprise, as follows:

Details		Details of ownership structure					
		Period from 1.4.2001 to 23.11.2001		Period from 24.11.2001 to 23.2.2002		Period from 24.2.2002 to 31.3.2002	
		No. of shares	%	No. of shares	%	No. of shares	%
(a)	Directors, relatives	50,000	50	40,000	40	65,000	65



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	and others						
(b)	X Inc., USA (Associated Enterprise)	50,000	50	60,000	60	35,000	35

Where the ownership structure is complicated, the above tabular statement may be supplemented by a suitable diagrammatic representation of the ownership interest held by associated enterprises in the assessee.

7.6 The regulations require the assessee to maintain information regarding the shareholding pattern. Though there is no prescribed format for this information, following is the format that the accountant may suggest to the assessee.

S.No.	List of shareholders	Shareholding (%)

Further, ownership interest held by enterprises in the assessee enterprise, directly or indirectly through intermediaries, also needs to be maintained by the assessee.

7.7 The accountant shall verify that the assessee maintains information regarding enterprises having direct or indirect ownership interests, through intermediaries, in the assessee enterprise. The accountant may rely on representation from the management with regard to the veracity of the same.

**7.8 A profile of the multinational group of which the assessee enterprise is a part along with the name, address, legal status and country of tax residence of each of the enterprises comprised in the group with whom international transactions have been entered into by the assessee, and ownership linkages among them. [clause (b), Rule 10D(1)].**

7.9 As part of the profile of the multinational group, it may be advisable to maintain, amongst other things, corporate brochures, catalogues and other similar printed and / or electronic material that describe:

- The principal line(s) of business in which the group is engaged, such as manufacturing of electronic goods, trading in chemicals, wholesale trade in food grains, pharmaceuticals, etc.;
- Geographical areas in which the group one operates;

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- Summarised global financials and other details such as capital invested, assets employed, turnovers achieved, incomes earned, profits made / losses incurred, etc.

7.10 With respect to each of the associated enterprises in the group with whom the assessee has entered into international transaction, the following specific details must be maintained:

- Name;
- Address;
- Legal status (company, limited liability partnership, firm, etc.);
- Country of tax residence;
- Ownership linkages between the assessee and the associated enterprise.

Sometimes, the establishment of ownership linkages between the assessee and other associated enterprises is a problem for the reason that sufficient reportable information is not available. In such cases, the assessee will have to provide only the information that is available with him.

7.11 For example, A Ltd., India, is a 100% subsidiary of H Ltd., U.K., which itself is a 100% subsidiary of R Inc., USA. R Inc, also, has another subsidiary, C Ltd., Argentina. If, A Ltd. transacts with C Ltd., it will have to report the ownership linkage between itself and C Ltd. However, this information may not be available or even forthcoming from the ultimate holding company, R Inc.

7.12 The remarks of the OECD in their Transfer Pricing Guidelines on this issue merits reference:

"Tax administrators further should not require taxpayers to produce documents that are not in the actual possession or control of the taxpayer or otherwise reasonably available, e.g., information that cannot be legally obtained, or that is not actually available to the taxpayer because it is confidential to the taxpayer's competitor or because it is unpublished and cannot be obtained by normal enquiry or market data."

7.13 The assessee is required to maintain a document that describes the profile of the multinational group. The member may exercise his professional judgment to determine whether the profile prepared by the assessee provides sufficient information regarding the group, pertinent to transfer

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pricing. Some of the information that may be contained in the profile are as follows :

- the name and place of incorporation of the immediate parent company;
- the name and place of incorporation of the ultimate parent company;
- the major product lines, services offered by the group;
- a brief description of the technology, brands or other intangibles owned by the group;
- names of major competitors.

Any other information regarding the group that may be pertinent to the transfer pricing analysis.

7.14 The accountant has to verify if such a profile has been prepared and based on his understanding of the business of the assessee and a test check of the documents and records of the assessee, he is required to determine that the information contained in the profile is not incorrect.

7.15 The assessee is also required to provide a list of associated enterprises from within the group, with whom the assessee has entered into international transactions. The following details are required to be maintained by the assessee:

- name of the group entity (associated enterprise)
- address of the group entity
- legal status
- country of tax residence.

7.16 The assessee is not required to maintain this information in respect of other associated enterprises i.e. enterprises that are not its group entities but are deemed to be associated enterprises by virtue of provisions of clauses (c) to (m) of section 92A(2).

7.17 The accountant should obtain written representation from management providing him with name, address, legal status and country of tax residence of each of the enterprises comprised in the group with whom international transactions have been entered into by the assessee, and ownership linkages among them. He shall exercise his professional judgement and due diligence to verify that the same is *prima facie* correct.

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7.18 The accountant shall perform certain checks in regard to the various categories and situations in which the two enterprises are associated enterprises as provided in section 92A(1) and clause (a) and (b) of section 92A(2). He should check the register of members maintained by the assessee under section 150 of the Companies Act, 1956 and the voting rights corresponding to the shares of the associated enterprise.

**7.19 A broad description of the business of the assessee and the industry in which the assessee operates, and of the business of the associated enterprises with whom the assessee has transacted. [Clause (c), Rule 10D (1)].**

7.20 Under this clause, a general explanation of the business carried out by the assessee and the associated enterprise with whom it has transacted has to be stated. Where the assessee/ associated enterprise are engaged in more than one line of business, the explanation will have to cover all businesses.

7.21 This explanation could typically cover areas such as:

- the business model used;
- technologies employed;
- products manufactured/traded;
- markets addressed and competition faced;
- geographic dispersion of manufacturing facilities etc.

7.22 The broad description of the industry in which the assessee operates will include reports about the industry, which are available in the public domain. This could be material published in business newspapers, trade journals and magazines, etc. all of which provide a macro-economic perspective to the industry.

7.23 The assessee has to determine whether by virtue of clauses (c) to (m) of section 92A(2) certain enterprises shall be deemed as associated enterprises. The accountant shall conduct the following checks to verify if the assessee has conducted due diligence in determining whether an entity is an associated enterprise or not.

**Clause (c):** The accountant should check the register of loans and investments maintained by the assessee under section 372A of the Companies Act, 1956.

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**Clause (d):** The accountant shall obtain details of all the guarantees pertaining to the borrowing from the management and representation for its completeness thereof.

**Clause (e):** The accountant shall obtain a representation from management detailing composition and appointment of the members of board of directors or governing board, Executive Directors and Executive Member of the governing board. Further the member shall check the Register of Directors maintained by the company under section 303 of the Companies Act, 1956.

**Clause (f):** The accountant shall obtain a representation from the management detailing composition and appointment of the members of board of directors or governing board, Executive Directors and Executive Member of the governing board. Further the member shall check the Register of Directors maintained by the both companies under section 303 of the Companies Act, 1956.

**Clause (g):** The accountant shall obtain a representation from the management to the fact that enterprise is wholly dependent upon the intangible assets such as know-how, patents, copyrights, trademarks, licenses, franchises, or other commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or has exclusive right.

**Clause (h):** The accountant shall obtain the details of all the purchases of raw material and consumable requirement made by the assessee and compute the party wise share of business i.e. party-wise purchases. He shall obtain representation from the management to the fact that the information provided is correct and complete.

**Clause (i):** The accountant shall obtain a representation from the management to the fact that enterprise sold the goods or articles manufactured or processed by it, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise

**Clause (j) (Individual):** The accountant shall obtain a representation from management providing details of controlling interests in all the affiliated parties so as to determine the common controlling interest in two companies.

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**Clause (k) (HUF):** The accountant shall obtain a representation from management providing details of controlling interests in all the affiliated parties so as to determine the common controlling interest in two companies.

**Clause (l):** The accountant shall obtain the partnership/AOP/BOI agreement in order to determine whether any enterprise holds not less than ten per cent interest in other firm, association of persons or body of individuals.

**Clause (m):** The accountant shall obtain a representation from management to the effect that there exists or does not exist between the two enterprises, any relationship of mutual interest in case any such relationship is prescribed by CBDT. The accountant shall exercise his professional judgement and due diligence to verify that the same is prima facie correct.

7.24 The accountant should obtain written representation by management detailing the overview of the business of the assessee and a description of the business of the associated enterprises with whom the assessee has transacted.

7.25 Following is the illustrative checklist to carry out business analysis of the assessee:

- (a) year of establishment/incorporation;
- (b) name and residence of the parent company (holding company);
- (c) details of the place/s (units) from where services are rendered (including area occupied, infrastructure, etc.);
- (d) activity in brief (if there is more than one unit, details of activities in each unit);
- (e) stake-holding of the parent company;
- (f) legal environment of the industry;
- (g) key value drivers of the industry;
- (h) major players in the industry;
- (i) share of business in the industry;
- (j) trends in profitability, turnover, market share etc.

A similar description of the business of the associated enterprises with whom the assessee has undertaken international transactions, is also to be prepared by the assessee. The accountant shall verify if such description is also maintained.

## Details of international transactions

**7.26** *The nature and terms (including prices) of international transactions entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction. [clause (d), Rule 10D(1)].*

7.27 The list of individual international transactions entered into by the assessee with each of its associated enterprises is required to be stated here. For ease in comprehension and verification, the details may be compiled and presented in a tabular form giving the details required.

7.28 While the data may be classified in any convenient manner, for the purpose of facilitating the study of comparability, it is suggested that the nature of the property transferred or service provided be used as the primary key.

7.29 In addition to the standard inclusions such as name of associated enterprise, product transferred or service provided, quantity, price per unit of measurement etc., the data should, also, provide information on matters such as:

- form and time of payment;
- discounts;
- shipment;
- purchase commitments;
- product returns by the customer;
- supportive services; etc.

The listing should, also, include transactions where the property has been transferred or service has been provided “free of cost”.

7.30 The accountant should examine the details of nature and terms (including prices) of international transactions entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction. The accountant should verify the information provided by the assessee, by using standard examination procedures from the books of accounts maintained by the assessee and information/explanations obtained during the course of such examination.

**7.31** *A description of the functions performed, risks assumed and assets employed or to be employed by the assessee and by the associated enterprises involved in the international transaction. [clause (e), Rule 10D(1)].*

7.32 The assessee is required to undertake and describe the results of a detailed functional analysis of the business process involved in the transaction with the associated enterprise. In analysing of the business process, the study should not only cover the activities of the resident enterprise but, also, the activities of the non-resident enterprise. In other words, it is the business process that it analysed and not the enterprise.

7.33 The functional analysis should be made from the perspective of the "functions performed", "assets employed" and "risks assumed". Simply put, a 'functional analysis' is a study to determine what economically significant acts were performed in accomplishing the transactions in question and who performed them.

7.34 The role of functional analysis is to:

- (a) determine the facts with respect to a given transaction between the related parties; and
- (b) set the stage for the choice of pricing method by providing the framework within which comparable transactions may be determined

7.35 The assessee shall undertake a detailed functional analysis of the company and its associated enterprise in order to determine the functions performed, risks assumed and assets employed by the assessee and by the associated enterprises involved in the international transaction. A functional analysis is a method of finding and organizing facts about a business in terms of its functions, risks and intangibles in order to identify how these are divided up between the companies involved in the transaction under review. The functions and risks are analyzed to determine the degree of risks undertaken, the value of the intangibles provided and whether the profits (or losses) earned by the entities are appropriate to functions performed. However, the main purpose of performing a functional analysis is to identify comparable transactions or to serve as a basis for selecting comparable transactions or companies. Functional analysis is the basis of an economic analysis to arrive at the optimum transfer price.

7.36 A functional analysis attempts to identify all value added activities. The identification of the relevant value added activity helps in identifying the



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specific risks associated with the transaction. In addition, functional analysis identifies specialized business assets that increase the chances of success (such as key employees or marketing intangibles).

7.37 To conduct a full functional analysis, it is necessary to gather information from both within and outside the organization. To execute this, the company shall either interview or get questionnaires filled by the key personnel related to the various functions performed by the company.

7.38 The accountant shall obtain a representation from management to the effect that the functional analysis so done is complete and covers all the functions performed by the company.

### **Records having a bearing on international transaction**

***7.39 A record of the economic and market analyses, forecasts, budgets or any other financial estimates prepared by the assessee for the business as a whole and for each division or product separately, which may have a bearing on the international transactions entered into by the assessee. [clause (f), Rule 10D(1)].***

7.40 Whereas under clause (c), above, the study was of the business in which the assessee operated (macro), under this clause, the study is of the business which the assessee operates (micro).

7.41 Where assessees, in the normal course of their business, use general and financial and management tools (such as market analyses, marginal and absorption costing, capital and revenue budgeting, variance analysis, etc.) to control and run their business, the data captured in the process may be used to ascertain whether the arm's length principle has been complied with.

However, where these techniques are not in use, historical data cannot be used as a substitute.

7.42 The accountant shall obtain copies of budgets or forecasts, if any, from the management and shall exercise his professional judgement to ensure its correctness and validity. He shall also obtain the representation from management to the effect that all the budgets and forecasts prepared are being provided.

It may so happen that the company is not in the practice of preparing any forecast, budgets or other financial estimates. The accountant should then disclose this fact suitably.

**7.43 A record of uncontrolled transactions taken into account for analysing their comparability with the international transactions entered into, including a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the international transactions. [clause (g), Rule 10D(1)].**

7.44 This record is a compilation of the uncontrolled transactions that were identified and taken for analyzing whether they would pass the test of comparability. This is no more than raw data, prior to processing. In the process of creating this record, the enterprise has to prove the integrity of the following two critical parameters:-

- (i) The enterprise must establish that the uncontrolled transactions listed include transactions in only those products or services in respect of which the enterprise has dealt with associated enterprises.

Assume that the enterprise manufactures various types of caustic soda (e.g., industrial grade, commercial grade, membrane grade, etc.). Also, assume that transactions with associated enterprises have been in respect of only one type of caustic soda (say, membrane grade). Then, when the required list is being prepared, the enterprise must ensure that the uncontrolled transactions that have been included must be only of that membrane grade and not include other types, which are irrelevant.

- (ii) The enterprise must also confirm that the listing of uncontrolled transactions is complete and that no similar or identical transactions have been omitted.

7.45 For example, if the enterprise is dealing in electronic components (integrated circuits and printed circuit boards) and its transactions with associated enterprises have been conducted throughout the year, the enterprise must establish that the database from which the list has been compiled at least covers the period during which transactions with the associated enterprise took place.

7.46 In order to conduct an analysis the enterprise is required to collect data regarding comparable uncontrolled transaction or comparable company financials. The enterprise has to prepare a search memo detailing the process of identification of comparable uncontrolled transaction and/or comparable companies. The enterprise has to provide information regarding the databases used for the search and economic rationale for the

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selection/rejection of transaction/companies. The summary of the selection/rejection process has to be documented through a search matrix. In summary, the enterprise must prove that the rationale used by it in the process of searching for and including/excluding uncontrolled transactions is correct, logical and complete.

7.47 The accountant shall examine details of the comparable transactions/data compiled by the enterprise. Further, exercising his professional judgement, the accountant should verify that the data used to determine the price of the international transaction is in tune with the findings of the functional analysis. This would ensure the authenticity of the price so arrived on the basis of the data.

**7.48 *A record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction. [clause (h), Rule 10D (1)].***

7.49 The process to be described under this clause (record of analysis of data) is the naturally corollary to the process described in immediately preceding clause, clause (g) (record of compilation of data).

7.50 In trying to arrive at the comparability between uncontrolled transactions and international transactions, the enterprise has to, amongst other things, carryout the process of resolving any differences that may exist between them. These differences could be for the reasons stated in Rule 10B (2) or for any other reason also. Under this clause, the enterprise has to detail the analysis that he has conducted on each of the uncontrolled transactions in determining whether or not it is comparable to an international transaction.

7.51 The accountant shall examine whether the enterprise has prepared a thorough comparability analysis giving reasons for adjustments made to make the comparability more reliable.

## **Description of methods considered and working thereof**

**7.52 *A description of the methods considered for determining the arm's length price in relation to each international transaction or class of transaction, the method selected as the most appropriate method along with explanations as to why such method was so selected, and how such method was applied in each case. [clause (i), Rule 10D(1)].***

7.53 The OECD, in their Transfer Pricing Guidelines has set out the optimal conditions under which a particular method is more suited than another. For example, the cost plus method is “ probably is most useful where semi finished goods are sold between associated parties, where associated parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.”

By using these guidelines and analysing the intrinsic nature of the international transaction, it may be possible to determine which is the most appropriate method to be applied to each transaction.

7.54 In any case, when ascertaining the “most appropriate method”, the provisions of section 92C(1) and Rule 10C must be kept in mind. The guidelines provided by the OECD, after all, have only a persuasive value and cannot supersede the provisions of the Act and the Rules.

7.55 Under this clause, the assessee has to describe the nature of the international transaction, explain why the method chosen is the most appropriate method (may be, even, explaining why other methods were excluded) and then detail the manner in which the method was applied to the transaction under examination. In detailing the manner in which the method was applied, a numerical exercise is not expected. This is because the detailing of the arithmetic process is included under clause (j), infra.

7.56 This exercise has to be carried out once for:

- Every type of international transaction; and
- Every method chosen.

7.57 The accountant shall verify the method used to arrive at the arm's length price and reasons thereof for the choice of the method. The reasons may be either positive in favour of the method used or negative as to why other methods were not applied.

**7.58 *A record of the actual working carried out for determining the arm's length price, including details of the comparable data and financial information used in applying the most appropriate method, and adjustments, if any, which were made to account for differences between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions. [clause (j), Rule 10D (1)].***

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7.59 Once the enterprise has compiled the raw data [clause (g)], analysed the data for comparability [clause (h)] and chosen the most appropriate method [clause (i)], the next step would be to perform the actual exercise of arriving at the arm's length price. This is the process that is contemplated under this clause.

7.60 Here, the enterprise will have to detail all the mathematical iterations and arithmetic steps that have been undertaken to arrive at the arm's length price. Where any assumption have been made, or where any critical factors have affected the determination of the arm's length price, the numerical effect of these factors have not only to be stated but computed. The actual listing of these assumption, factors, etc. is required to be done under the provisions of clause (k), infra.

7.61 In assigning numbers to qualitative factors such as policies, price negotiations, etc. there may be an element of subjectivity. The enterprise may have to conclusively establish that no element of bias has entered the computational process.

7.63 The documentation on economic analysis shall also provide for the details of the data used and data rejected with reasons thereof. Also, different companies follow different accounting policies and there may be differences in respect of terms of sale etc, these variations call for certain adjustments in the financial to make the data comparable. The reasons and the adjustments so made should also be recorded.

7.64 The accountant should examine the correctness of such working and the adjustments made with reference to the relevant information and data.

**7.65 *The assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's length price. [clause (k), Rule 10D (1)].***

7.66 This part requires the enterprise to render a narrative description of the various assumptions, policies, price negotiations that have been considered in determining the arm's length price.

7.67 An example of an assumption affecting the determination of the arm's length price could be the buyer's commitment to purchase certain specified quantities of the product. An example of a policy affecting the determination of the arm's length price could be the enterprise's decision to make his borrowals in overseas markets (where the rates are lower than as compared

with indigenous banks) and reduce the interest component in his product cost sheet.

7.68 An example of a price negotiation affecting the determination of the arm's length price could be the manner in which the supplies are paid for. For example, a supply to an associated enterprise in China may get a better price if the payment is received in US Dollars instead of Chinese Yuan. Another example could be where an associated enterprise in Nigeria may get a better price if the letter of credit is accepted by a UK Bank rather than a local bank.

7.69 The accountant shall obtain information about the assumptions, policies and price negotiations, if any, which influenced the determination of the arm's length price by way of representation from management. The accountant shall examine the functional and economic analysis to determine the assumptions, policies and price negotiations that have been considered for determining the arm's length price and shall verify if the enterprise has maintained a document explicitly stating these assumptions, policies and price negotiations.

***7.70 Details of the adjustments, if any, made to transfer prices to align them with arm's length prices determined under these rules and consequent adjustment made to the total income for tax purposes. [clause (l), Rule 10D(1)].***

7.71 This process requires the enterprise to prepare a reconciliation statement detailing how the actual transaction value can be compared with the arm's length price. This is a two-stage process, detailed below.

7.72 Where the international transaction has certain characteristics that are absent in the uncontrolled transaction, the value of these characteristics has to be computed and reduced from the value of the international transaction.

7.73 Correspondingly, where the international transaction does not have certain characteristics that are present in the uncontrolled transaction, the value of these characteristics has to be computed and included in the value of the international transaction.

7.74 In case there is a difference between the transaction price and the arm's length price, the transaction price is required to be aligned to the arm's length price.

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7.75 The accountant shall verify the alterations made to transfer price of the company so as to align it with the arm's length prices, as determined under these rules and verify that consequent adjustment is made to the total income for tax purposes.

**7.76 Any other information, data or document, including information or data relating to the associated enterprise, which may be relevant for determination of the arm's length price. [clause (m), Rule 10D (1)].**

7.77 This is a residuary clause that allows the enterprise to use any other extraneous reasons that may have affected its judgement in the process of complying with the arm's length principle.

7.78 An example of such a situation could be when a loss-making enterprise sells goods to an associated enterprise at less than the "arm's length price" only because this is the only way in which the enterprise may be able to absorb fixed costs/ overheads.

7.79 Where any other information, data or document has been considered relevant for the determination of arm's length price by the assessee, the accountant shall verify the correctness of the same.

## **Relief from maintenance of specific records**

**7.80 Nothing contained in sub-rule (1) shall apply in a case where the aggregate value, as recorded in the books of account, of international transactions entered into by the assessee does not exceed one crore rupees:**

***Provided that the assessee shall be required to substantiate on the basis of material available with him, that income arising from international transactions entered into by him has been computed in accordance with section 92. [Rule 10D(2)]***

7.81 The ceiling limit of ₹ 1 crore is with reference to an assessee and not with reference to any undertaking or unit. The limit applies with reference to all the international transactions entered into during a previous year. The amount is reckoned on the basis of the aggregate value of international transaction as recorded in the books of account of the assessee. In case of assessee who fall within this category in a particular previous year, the relief given is from maintaining the specific records and documents prescribed in rule 10D. There is no exemption for such assessee in obtaining and furnishing audit report under section 92E of the Act.

7.82 It requires to be mentioned that even in such cases, the onus lies on the assessee to substantiate that income arising from international transaction has been computed on the basis of arm's length price. It is, therefore, necessary for those assesseees to maintain such materials or records as may enable them to discharge the burden of proof cast on them. The accountant, in such cases, is required to examine the records so maintained and satisfy himself that the material in the possession of the assessee is relevant and proper for the purpose of expressing his opinion in the report to be issued in Form No.3CEB.

### **Supporting documents**

**7.83** *The information specified in sub-rule (1) shall be supported by authentic documents, which may include the following:*

- (a) official publications, reports, studies and data bases from the Government of the country of residence of the associated enterprise or of any other country;*
- (b) reports of market research studies carried out and technical publications brought out by institutions of national or international repute;*
- (c) price publications including stock exchange and commodity market quotations;*
- (d) published accounts and financial statements relating to the business affairs of the associated enterprises;*
- (e) agreement and contracts entered into with associated enterprises or with unrelated enterprises in respect of transactions similar to the international transactions;*
- (f) letters and other correspondence documenting any terms negotiated between the assessee and the associated enterprise;*
- (g) documents normally issued in connection with various transactions under the accounting practices followed.*

*[Rule 10D(3)]*

7.84 Rule 10D(3) provides that the information compiled, kept and maintained by the enterprise, under clauses (a) to (m) of sub-rule (1), shall, to the extent possible, be further supported by "authentic" documents that



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provide additional information of the nature specified therein. Most of the information required to be provided is global or macro in nature.

7.85 The above documents are required to substantiate the functional and economic analysis performed by the enterprise. The accountant shall review the contents of the functional and economic analysis and shall verify whether the enterprise has maintained back-up data listed above to substantiate the facts and figures given in the documents listed in Rule 10D(1).

### **Contemporaneity of data**

**7.86** *The information and documents specified under sub-rules (1) and (2), should, as far as possible, be contemporaneous and should exist latest by the specified date referred to in clause (iv) of section 92F:*

*Provided that where an international transaction continues to have effect over more than one previous year, fresh documentation need not be maintained separately in respect of each previous year, unless there is any significant change in the nature of terms of the international transaction, in the assumptions made, or in any other factor which could influence the transfer price, and in case of such significant change, fresh documentation as may be necessary under sub-rules (1) and (2) shall be maintained bringing out the impact of the change on the pricing of the international transaction. [Rule 10D(4)]*

*The information and documents specified in sub-rules (1) and (2) shall be kept and maintained for a period of eight years from the end of the relevant assessment year. [Rule 10D(5)].*

7.87 The accountant shall have to design a questionnaire and conduct interviews with the client personnel to understand if the enterprise has taken due diligence with regard to maintaining documentation. The accountant should determine whether any changes have occurred in the business conditions under which the enterprise was operating. The enquires may cover the following areas :

- changes in business and pricing strategy;
- changes in market conditions [demand / supply] in India and in the country where the associated enterprise is located;
- changes in the “key” value drivers of the industry;

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- changes in the critical success factors that influence the company's position in the market;
- changes in competition;
- changes in terms of contract;
- changes in sales volumes / total revenues arising as a result of the international transactions.

7.88 Based on an understanding of the business of the assessee, the accountant should determine whether any of the above changes would significantly influence the economic analysis that had been conducted for the earlier year/years. In case the changes could have an influence on the arm's length price determined in the earlier year, the enterprise should conduct a functional and economic analysis again to determine the arm's length price.

7.89 In case the changes above, are not likely to influence the economic analysis conducted in the earlier year/years, the enterprise's role may be limited to the following :

- examine whether comparability analysis of the earlier year continues to be applicable [a comparable uncontrolled transaction in the earlier year may now have become a controlled transaction due to certain changes in the business conditions; a comparable company selected in the earlier year may now have started transacting with associated enterprises; etc.].
- update the financial analysis using the fresh list of comparables [after rejecting companies / transactions that are no longer comparable] and using the financial information for the current year [this is because, the Indian economy cannot still be considered a stable economy and prices and profit levels may fluctuate significantly from year to year].
- determine the arm's length price for the current year using the result of the financial analysis conducted in the current year.

7.90 Rule 10D (4) provides that the data, information and documents on the basis of which the arm's length price has been determined should, as far as possible, be contemporaneous. At any rate, they should exist by no later than the specified date by which the report under section 92E is required to be furnished. Where the international transaction has longevity that spans one or more previous years, the enterprise need not prepare fresh

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documentation in respect of the transactions conducted in every subsequent previous years.

7.91 However, when there is a significant change in the nature or terms of the international transaction, in the assumptions made, or in any other factor, which could influence the transfer price, then fresh documentation, as appropriate, should be made to bring out the impact of the changes on the pricing of the international transaction.

7.92 The information and documents required to be maintained under section 10D shall be preserved for a period of eight years from the end of the relevant assessment year. This provision assumes significance in view of the penal and other consequences attracted due to non-production of the information and documents kept and maintained. Reference is drawn to CBDT Circular No.12 dated 23.08.2001 (Annexure IV) relaxing this requirement for transactions entered into during the period from 1.4.2001 to 31.8.2001.

7.93 Supporting documentation in case of specific transactions like management fees/ royalties charges etc:

Detailed documentary back up to support payment by the assessee for such charges needs to be maintained by the assessee. Some of the documents/ details in this regard could be:

- inter-company agreements;
- global policy (if any);
- copy of invoices;
- independent auditors certificate on costs/charges of the overseas entity;
- copies of policies/manuals and other correspondences indicating the details of services/ benefits received by Indian assessee;
- basis of allocation of costs and charge;
- Other relevant records.

## Chapter 8

### Penalties

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#### **Penalty for concealment of income or furnishing inaccurate particulars thereof**

8.1 Section 271(1)(c)(iii) provides that if the Assessing Officer or the Commissioner (Appeals) or the Commissioner is satisfied that any person has concealed the particulars of his income or furnished inaccurate particulars of such income, he may direct that such person shall pay by way of penalty, in addition to any tax payable by him, a sum which shall not be less than, but which shall not exceed three times, the amount of tax sought to be evaded by reason of the concealment of particulars of his income or the furnishing of inaccurate particulars of such income.

8.2 A new Explanation, i.e. Explanation 7, has been inserted to the aforesaid section by Finance Act, 2001 with effect from April 1, 2002. This explanation is invoked only when any amount is added or disallowed in computing the total income under section 92C(4). The amount added/disallowed shall be deemed to be concealed income.

8.3 The explanation creates a rebuttable presumption of concealment or furnishing of inaccurate particulars. The burden of rebuttal is on the assessee and it does not shift to the Department. The assessee is required to prove that he has acted in good faith and with due diligence. If it is so proved, the addition/disallowance shall not be deemed to represent concealed income.

8.4 Section 273B states that no penalty shall be imposed if the assessee proves that there was a reasonable cause for the said failure. The provisions of section 273B do not apply to a penalty under section 271(1)(c). Therefore, the assessee must discharge the burden laid down in Explanation 7, only.

8.5 The explanation requires the assessee to prove that the price charged or paid was computed in good faith and with due diligence. Price charged or paid is to be broadly construed to mean even the methods of determining the arm's length price in respect of transactions not being in the nature of purchase or sale, like for example, cost sharing arrangements.

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8.6 The aforesaid section has been further amended with effect from AY 2013-14 to include therein the reference of specified domestic transactions.

### **Penalty for failure to keep and maintain information and documents in respect of international transaction or specified domestic transaction**

8.7 Section 271AA relates to penalty for failure to keep and maintain information and document in respect of international transactions.

Section 271AA has been substituted by a new section with effect from 1-7-2012. It provides that without prejudice to the provisions of section 271 or Section 271BA, if any person

- (a) fails to maintain prescribed documents and information *as required by sub-section (1) or sub-section (2) of section 92D*;
- (b) fails to report any international transaction which is required to be reported; or
- (c) maintains or furnishes any incorrect information or documents

the Assessing Officer or Commissioner (Appeals) may direct that such person shall pay, by way of penalty, a sum equal to two percent of the value of each international transaction entered into by such person.

8.8 The above provision is without prejudice to section 271 and Section 271BA and is invoked when 'any person' fails to keep and maintain any such information and document as required by section 92D (1) and (2) or fails to report any international transaction or maintains or furnishes any incorrect information or documents.

8.9 The aforesaid section has been further amended with effect from AY 2013-14 to include therein the reference of specified domestic transactions.

8.10 Thus, whether or not an international transaction or specified domestic transaction is determined at arm's length price, any person who has entered into such transaction, shall keep and maintain the information/document in respect of such transaction.

8.11 The penalty is invoked for failure to keep and maintain such information/documents or report the same. In other words, the person who has entered into international transaction or specified domestic transaction

should both keep as well as maintain such information/documents as well as report the same. Any failure in respect of the same attracts a penalty of 2% of the value of each international transaction or specified domestic transaction entered into by him.

### **Penalty for failure to furnish report under section 92E**

8.12 Section 271BA provides that if any person fails to furnish a report from an accountant as required by section 92E, the Assessing Officer may direct that such person shall pay, by way of penalty, a sum of one hundred thousand rupees.

8.13 This penalty is invoked if any person fails to furnish a report from an accountant and the same may be levied by the Assessing Officer. The penalty shall be a sum of one lakh rupees.

### **Penalty for failure to furnish information or document under section 92D**

8.14 Section 271G provides that if any person who has entered into an international transaction or specified domestic transaction fails to furnish any such information or document as required by sub-section (3) of section 92D, the Assessing Officer or the Commissioner (Appeals) may direct that such person shall pay, by way of penalty, a sum equal to two percent, of the value of the international transaction or specified domestic transaction for each such failure.

8.15 The aforesaid section has been further amended with effect from AY 2013-14 to include therein the reference of specified domestic transactions.

## Chapter 9

# Scope of Examination under Section 92E

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### Report under section 92E

9.1 According to section 92E every person who has entered into an international transaction or specified domestic transaction during a previous year shall obtain a report from an accountant and furnish such report on or before the specified date in the prescribed form duly signed and verified in the prescribed manner by such accountant and setting forth such particulars as may be prescribed. The report is to be given by an accountant in Form No.3CEB as prescribed under Rule 10E. Recently, the Income Tax rules have been amended to require the filing of the said report electronically. The scope of examination envisaged by section 92E is restricted to such examination of accounts and records of the assessee relating to the international transaction or specified domestic transaction entered into by the assessee during the previous year under examination.

9.2 Further, the accountant has to give his opinion whether “proper information and documents as are prescribed” have been kept by the assessee in respect of the international transactions or specified domestic transaction entered into by him. The examination under section 92E is not an audit requiring the opinion of the accountant on the true and fair view of the financial statements of the enterprise.

9.3 The report consists of three paragraphs dealing with distinct aspects as summarised hereunder:

The first paragraph contains the declaration about examination of the accounts and records of the assessee in order to review the international transaction(s) and the specified domestic transaction(s).

The second paragraph involves rendering of an opinion whether proper information and documents as are prescribed under Rule 10D are maintained by the assessee in respect of the identified international transactions and the specified domestic transaction(s), on the basis of the details furnished in Annexure to Form No.3CEB.

## Scope of Examination under Section 92E

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The third and the last paragraph requires expression of the opinion whether the particulars given in the Annexure to Form No.3CEB are true and correct.

### 9.4 Examination of accounts and records

#### Form No.3CEB

*\*I/we have examined the accounts and records of ..... (name and address of the assessee with PAN) relating to the international transaction(s) and the specified domestic transactions entered into by the assessee during the previous year ending on 31st March, .....*

*[Paragraph 1]*

9.5 The expression “accounts and records” appearing in the report should normally refer to those accounts and records which are to be examined solely in relation to the international transactions and the specified domestic transactions entered into by the assessee during the relevant previous year. As the expression “accounts and records” are limited to those pertaining to international transactions and the specified domestic transactions only, the said report does not require the accountant to certify the true and fair view of the financial statements of the enterprise. Therefore, he should restrict his examination to such details and matters that in his opinion are sufficient to determine whether proper documents have been maintained with respect to international transactions and the specified domestic transactions and whether the particulars disclosed in the annexure are true and correct.

The extent of examination of the said accounts and records is a matter of professional judgment of the accountant. However, while the accountant is expected to make specific inquiries as regards various matters that are the subject of the Form No 3CEB, his work often comprises checking, by the application of materiality principles and on a test basis, the evidence supporting the information presented in the Form No 3CEB. Particularly in cases where the accountant is relying on financial statements of the assessee audited by another auditor, it is reasonable to rely on the correctness of information contained in such audited financial statements, including as regards its completeness, unless there are any obvious or significant discrepancies. In the event of such discrepancies, the accountant would need to obtain necessary information, explanations and reconciliations as may be required from the assessee, and report on that basis.



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9.6 The accountant should obtain from the assessee a complete list of “accounts and records” maintained by him (both financial and non-financial records) and identify those that need to be produced before him for examination. He should further obtain suitable representation as regards the completeness of the “accounts and records” from the assessee.

9.7 Where the certifying accountant is not the statutory auditor of the assessee he should take the precaution of clearly stating in his report that the figures from the audited general purpose financial statements have been used and relied upon. He may also include in his report a reconciliation between the figures appearing in his report and the figures appearing in the general-purpose financial statements (as provided in the “Guidance Note on audit and reports and certificates for special purposes”). Further, the accountant can clearly state that he has relied upon the work performed by the other auditors. In this connection, reference can be taken from SA 600 – Using the Work of Another Auditor. Further, on using the work of other experts reference is invited to SA 620 – Using the Work of an Auditor’s Expert.

9.8 In conducting the review and examination the accountant will have to use his professional skill and expertise and apply such audit tests as the circumstances of the case may require. He may apply such tests/sampling techniques as may be deemed proper depending on the internal control procedures followed by the assessee. The accountant will also have to keep in mind the concept of materiality depending on the circumstances of each case. He would be well advised to refer to AASs as well as the guidance notes issued by the Institute.

9.9 Ensuring completeness of the listing of international transactions and specified domestic transactions is the responsibility of the assessee. The assessee should maintain a comprehensive register detailing every international transaction and the specified domestic transactions. The accountant should use his professional skill and expertise and apply such tests as the circumstances of the case may require to examine whether the same meets the requirement of law.

9.10 The accountant should obtain a written representation from the assessee providing him with the name, address, legal status and country of tax residence of each of the enterprises with whom international transactions and the specified domestic transactions have been entered into by the assessee, and association linkages among them.

**9.11 Maintenance of proper information and documents**

***“2. In my/our opinion proper information and documents as are prescribed have been kept by the assessee in respect of the international transaction(s) and the specified domestic transactions entered into so far as appears from my/our examination of the records of the assessee”.***

9.12 In paragraph 2 of the report the accountant is required to give his opinion on the assessee's compliance with the documentation requirements prescribed under Rule 10D. The accountant should review the documents and records pertaining to international transactions and the specified domestic transactions of the assessee and compare the same with those prescribed under Rule 10D to form an opinion. 9.13 If the accountant is satisfied that specified records have been properly maintained by the assessee then the certification may be done without any qualification. If any document is not maintained, then the accountant should suitably qualify his report or disclose the same in his report depending upon the facts and circumstances of each case. The accountant should state the qualification in the report making it comprehensive and self-explanatory. In this regard the accountant should follow principles enshrined in the SA 700 'Forming an Opinion and reporting on Financial Statements', SA 705 on Modifications to the Audit Report and SA 706 on Emphasis on Matters issued by the Institute.

9.14 An assessee in whose case the aggregate value of international transaction as recorded in the books of account does not exceed ₹ 1 crore in aggregate, there is a relief provided under sub-rule (2) of Rule 10D from maintaining the specified information and documents. However, the proviso thereunder necessitates such an assessee to substantiate that income arising from international transactions has been computed in accordance with section 92 on the basis of material in his possession. Therefore, the accountant should verify in such cases whether there is any material available with the assessee in this regard and if available the details thereof needs to be examined. The accountant shall, in such cases, express his opinion with or without qualification by exercising his professional judgement after verification of the material produced for such examination.

The said rule does not provide any such relief by way of monetary threshold for the purposes of maintaining the information and documents in respect of the specified domestic transactions. Accordingly, where the aggregate of the

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specified domestic transactions during a previous year exceeds Rs. 5 crores, there would be an obligation to maintain specified information and documents as per sub rule (1) of Rule 10D.

### **9.15 Certification regarding particulars in Annexure**

***“3.The particulars required to be furnished under section 92E are given in the Annexure to this Form. In \*my/our opinion and to the best of my/our information and according to the explanations given to \*me/us, the particulars given in the Annexure are true and correct”.***

9.16 Paragraph 3 of Form No.3CEB provides that the particulars required to be furnished under section 92E are given in the Annexure to this Form and whether in the accountant’s opinion and to the best of his information and according to the explanations given to him, they are true and correct. As mentioned above, the particulars should be obtained from the assessee, duly authenticated, which should be reviewed by the accountant. In case of any negative remark or qualification about this matter, the same should be properly reported.

9.17 The accountant must limit his scope of work and the review procedures to the extent certified in Form No.3CEB. For e.g. in the Annexure the method which has been used to determine the arm’s length price needs to be stated. In this context the accountant is only required to ensure that the method stated as being used to determine the arm’s length price by the assessee has actually been used and it is not the accountant’s responsibility to ensure that the method so used is the most appropriate method as prescribed by the Board.

9.18 The accountant may mention in the report, wherever necessary, that the correctness has been ensured only to the extent that the accountant has carried out an examination and further that the certificate is subject to the notes stated against the relevant clauses or Annexure to Form No.3CEB.

9.19 The statutory auditor of the assessee has to report that the financial statements audited by him give a ‘true and fair’ view. The requirement in paragraph 3 of Form No.3CEB relating to particulars in Annexure to Form No.3CEB is that the accountant should report that these particulars are “true and correct”. The terminology “true and fair” is widely understood though not defined even by the Companies Act, 1956. On the other hand, the words “true and correct” lay emphasis on factual accuracy of the information. In this context reference is invited to AS-1 and AS(IT)-I relating to disclosure of

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accounting policies. These standards recognise that the major considerations governing the selection and application of accounting policies are (i) prudence, (ii) substance over form and (iii) materiality. Therefore, while examining the particulars in the Annexure to Form No.3CEB these aspects should be kept in view. In particular, considering the nature of particulars to be examined in the Annexure to Form No.3CEB, the aspect of materiality should be considered. In other words qualifications may be given only in respect of material items as envisaged by the accountant.

### **Annexure to Form No.3CEB**

9.20 The statement of particulars given in the Annexure to Form No.3CEB contains twenty five clauses. The accountant has to report whether the particulars furnished in Form No.3CEB are true and correct.

9.21 As stated earlier, the accountant should obtain a duly authenticated statement of particulars in Annexure to Form No.3CEB from the assessee. It would be advisable for the assessee to take into consideration the following general principles while preparing the Annexure:

- (a) He can rely upon the judicial pronouncements while taking any particular view about inclusion or exclusion of any items in the particulars to be furnished under any of the clauses specified in the Annexure.
- (b) If there is a conflict of judicial opinion on any particular issue, he may refer to the view, which has been followed while giving the particulars under any specified clause.
- (c) The Accounting Standards (AS), Guidance Notes, Auditing and Assurance Standards (AAS) issued by the Institute from time to time should be followed, to the extent applicable.

9.22 While verifying the truth and correctness of the particulars in Annexure to Form No.3CEB it would be advisable for the accountant to consider the following:

- (a) If a particular item is covered in more than one of the specified clauses in the Annexure, care should be taken to make a suitable cross reference to such items at the appropriate places.
- (b) If there is any difference in the opinion of the accountant and that of the assessee in respect of any information furnished in the Annexure, the accountant should state both the view points and also the

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relevant information in order to enable the tax authority to take a decision in the matter.

- (c) If any particular clause in the Annexure is not applicable, the accountant should state that the same is not applicable.
- (d) In examining the particulars furnished in the Annexure, the accountant should keep in view the law applicable in the relevant year, even though the form of report may not have been amended to bring it in conformity with the amended law.
- (e) The information in the Annexure should be based on the books of account, records, documents, information and explanations made available to the accountant for his examination.
- (f) The Annexure should be signed by the accountant after he has completed his procedures on the particulars given/to be given in the Annexure.

### **9.23 Particulars to be furnished in the Annexure**

#### ***PART A***

1. ***Name of the assessee :***
2. ***Address :***
3. ***Permanent account number :***
4. ***Nature of business or activities of the assessee\****
5. ***Status :***
6. ***Previous year ended :***
7. ***Assessment year :***
8. ***Aggregate value of international transactions as per books of accounts***
9. ***Aggregate value of specified domestic transactions as per books of accounts***

*\*Code for nature of business to be filled in as per instructions for filing Form ITR 6*

9.24 Under clause (1) the name of the assessee whose accounts and records are being examined under section 92E should be given. However, if the examination is in respect of a branch, name of such branch should be

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mentioned along with the name of the assessee (in case a separate branch certificate is done).

9.25 The address to be mentioned under clause (2) should be the same as has been communicated by the assessee to the Income-tax Department for assessment purposes as on the date of signing of the Form. If the examination is in respect of a branch or a unit, the address of the branch or the unit should be given. In the case of a company, the address of the registered office should also be stated. In the case of a new assessee, the address should be that of the principal place of business.

9.26 Under clause (3) the permanent account number (PAN) allotted to the assessee should be indicated. If the assessee has not been allotted the permanent account number as on the date of signing of the Form, that fact should be indicated. Where PAN is not known/allotted but the general index register number (GIR) is available, the same may be given.

9.27 Under clause (4) the code for nature of business is to be provided as per the instructions for filling form ITR 6.

9.28 Under clause (5) the status of the assessee is to be mentioned. This refers to the different classes of assessee included in the definition of "person" in section 2 (31) of the Act, namely, individual, Hindu undivided family, company, firm, an association of persons or a body of individuals whether incorporated or not, a local authority or artificial juridical person. Furthermore, a person has been defined as 'including a permanent establishment of such person', i.e. even a branch or a project office. In case of any violations by a liaison office it may come under the purview of this clause and hence, the same should be disclosed. Further, in case of disputes regarding status of the assessee, the full facts should be mentioned.

9.29 Under clause (6), since the previous year under the Act uniformly ends on 31st March, the relevant previous year should be mentioned.

9.30 Under clause (7) the assessment year relevant to the previous year for which the accounts and records are being examined should be mentioned.

9.31 Under clause (8) & (9), the aggregate value of international transactions and specified domestic transactions as per books of accounts should be mentioned.

**PART B**

**9.32 10. List of associated enterprises with whom the assessee has entered into international transactions, with the following details:**

- (a) Name of the associated enterprise.**
- (b) Nature of the relationship with the associated enterprise as referred to in section 92A(2).**
- (c) Brief description of the business carried on by the associated enterprise.**

9.33 The assessee is required to furnish by way of an attachment, a complete list of associated enterprises, duly certified by the authorised person (partner, trustee, managing director etc. depending on the definition of assessee) with whom the assessee has entered into international transactions during the previous year. The terms 'associated enterprises' and 'international transactions' have been defined in detail in sections 92A and 92B of the Act, respectively. If an enterprise was 'associated' with the assessee for a part of the previous year, details should be furnished with respect to that period of the previous year.

In this connection, the assessee has to maintain a register with the list of the transactions and the relevant details. The accountant can rely on the information provided in the register of associated enterprise for completing his work.

9.34 The particulars in this clause should be examined on test check basis from an instrument or agreement or any other document evidencing the association of enterprises including any supplementary documents related thereto. In this connection the accountant has to, based on his best judgement, determine the sampling approach and design the nature and timing of the audit tests.

9.35 In preparing the list of the associated enterprises, it is possible that the extent of association may not be precisely ascertainable during the previous year, i.e. it may be indeterminate or unknown, resulting in a situation whereby the assessee is not in a position to conclude as to whether any particular entity is covered under the definition of 'associated enterprise', as detailed in section 92A of the Act. In such circumstances, it is advisable both from the viewpoint of the assessee and the accountant's perspective that the relevant fact be stated in the Annexure or in the notes, as the case

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may be, and reference to same be made, if considered significant, in the accountant's report.

9.36 In certain cases the enterprises may be associated in more than one manner. Since there is no different treatment for any particular form of association, it may be sufficient if the assessee details any particular relationship with the associated enterprise under clause 10(b). Although the assessee may be advised to detail all the relationships, disclosure of any one relationship is considered sufficient from a compliance perspective.

9.37 The accountant should obtain a written representation from the assessee detailing the business of the associated enterprises with whom the assessee has transacted. Further, since the completeness of the list of the associated enterprises and transactions with them is the primary responsibility of the assessee, the accountant should obtain suitable representation from the management (Board of directors or its equivalent).

9.38 The accountant may be advised to use his professional skill and expertise, in determining the scope of work to be performed with respect of getting reasonable comfort on the assessee's list of international transactions with associated enterprises. The accountant should, however, be aware of the possibility that transactions with associated enterprises may have been influenced in large measure by conditions similar to the following:-

- (a) Lack of sufficient working capital or credit to continue the business;
- (b) An urgent desire for a continued favorable earnings record in the hope of supporting the price of the assessee's share price, if any;
- (c) An overly optimistic earnings forecast;
- (d) Dependence on a single or relatively few products, customers, or transactions for the continuing success of the venture;
- (e) A declining industry characterised by a large number of business failures;
- (f) Excess capacity;
- (g) Significant litigation, especially litigation between stockholders and management; or
- (h) Significant obsolescence dangers because the assessee is in a high-technology industry.



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9.39 The accountant should place emphasis on test checking material transactions with enterprises associated to the assessee. Certain relationships, such as parent-subsidiary or investor-investee, may be clearly evident. Determining the existence of others requires the application of certain procedures, which may include the following:

- (a) Evaluate the Assessee's procedures for identifying and properly accounting for international transactions;
- (b) Request from appropriate management personnel the names of all associated enterprises and inquire whether there were any transactions with these enterprises during the period;
- (c) Review filings by the reporting entity with regulatory agencies for the names of associated enterprises and for other businesses in which officers and directors occupy directorship or management positions; (example director's representations on transactions under sections 297, 299 etc.);
- (d) Review stockholder listings of closely held companies to identify principal stockholders;
- (e) Enquire, where possible and considered essential of predecessor, principal, or other accountants/accountants of associated enterprises concerning their knowledge of existing relationships and the extent of management involvement in material transactions;
- (f) Review material investment transactions during the period under review to determine whether the nature and extent of investments during the period create associated enterprises; and
- (g) Review the mandatory related party disclosure in the audited financial (AS 18) [The definition of Associated Enterprise u/s. 92A in relation to the International Transactions is different than the definition of related party under AS 18 and therefore the accountant should review the Associated Enterprises for the purpose of section 92A independently].

9.40 Although it is the responsibility of the assessee to furnish a complete list of associated enterprises and international transactions, the accountant must exercise reasonable care to ensure that prima facie and, based on the information that is made available to him, the list of associated enterprises and list of international transactions furnished by the assessee is reasonably complete based on financial statements and books of accounts. Further, in

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order to ascertain whether the assessee has entered into any transactions coming within the scope of sub-section (2) of section 92B, the accountant should obtain appropriate management representation .

**9.41 11. Particulars in respect of transactions in tangible property :**

**A. Has the assessee entered into any international transaction(s) in respect of purchase / sale of raw material, consumables or any other supplies for assembling / processing / manufacturing of goods/articles from/to associated enterprises? Yes/No**

*If 'yes', provide the following details in respect of each associated enterprise and each transaction or class of transaction:*

- (a) *Name and address of the associated enterprise with whom the international transaction has been entered into.*
- (b) *Description of transaction and quantity purchased/sold.*
- (c) *Total amount paid/received or payable/ receivable in the transaction-*
  - (i) *as per books of account.*
  - (ii) *as computed by the assessee having regard to the arm's length price.*
- (d) *Method used for determining the arm's length price. [See section 92C(1)].*

**B. Has the assessee entered into any international transaction(s) in respect of purchase / sale of traded / finished goods?**

**Yes/No**

*If 'yes' provide the following details in respect of each associated enterprise and each transaction or class of transaction:*

- (a) *Name and address of the associated enterprise with whom the international transaction has been entered into.*
- (b) *Description of transaction and quantity purchased/sold.*
- (c) *Total amount paid / received or payable / receivable in the transaction-*

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- (i) *as per books of account.*
- (ii) *as computed by the assessee having regard to the arm's length price.*
- (d) *Method used for determining the arm's length price [See section 92C(1)]*

**C.** *Has the assessee entered into any international transaction(s) in respect of purchase, sale, transfer, lease or use of any other tangible property including transactions specified in Explanation (i)(a) below section 92B(2)?* **Yes/No**

*If 'yes' provide the following details in respect of each associated enterprise and each transaction or class of transaction :*

- (a) *Name and address of the associated enterprise with whom the international transaction has been entered into.*
- (b) *Description of the property and nature of transaction.*
- (c) *Number of units of each category of tangible property involved in the transaction.*
- (d) *Amount paid/received or payable/ receivable in each transaction of purchase/sale/transfer/use, or lease rent paid/ received or payable/receivable in respect of each lease provided/entered into:*
  - (i) *as per books of account.*
  - (ii) *as computed by the assessee having regard to the arm's length price.*
- (e) *Method used for determining the arm's length price. [see section 92C(1)].*

**12.** *Particulars in respect of transactions in intangible property:*

*Has the assessee entered into any international transaction(s) in respect of purchase, sale, transfer, lease or use of intangible property including transactions specified in Explanation (i)(b) below section 92B(2)?* **Yes/No**

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*If 'yes' provide the following details in respect of each associated enterprise and each category of intangible property:*

- (a) Name and address of the associated enterprise with whom the international transaction has been entered into.*
- (b) Description of intangible property and nature of transaction.*
- (c) Amount paid/received or payable/ receivable for purchase/sale/transfer/lease/use of each category of intangible property:*
  - (i) as per books of account.*
  - (ii) as computed by the assessee having regard to the arm's length price.*
- (d) Method used for determining the arm's length price. [see section 92C(1)].*

**13. Particulars in respect of providing of services:**

*Has the assessee entered into any international transaction(s) in respect of Services including transactions as specified in Explanation (i)(d) below section 92B(2)?* *Yes/No*

*If 'yes' provide the following details in respect of each associated enterprise and each category of service:*

- (a) Name and address of the associated enterprise with whom the international transaction has been entered into.*
- (b) Description of services provided/availed of/ from the associated enterprise.*
- (c) Amount paid/received or payable/ receivable for the services provided/ taken.*
  - (i) as per books of account.*
  - (ii) as computed by the assessee having regard to the arm's length price.*
- (d) Method used for determining the arm's length price. [see section 92C(1)].*

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**14. Particulars in respect of lending or borrowing of money:**

*Has the assessee entered into any international transaction(s) in respect of lending or borrowing of money including any type of advance, payments, deferred payments, receivable, non-convertible preference shares / debentures or any other debt arising during the course of business as specified in Explanation (i)(c) below section 92B(2)?* *Yes/No*

- (a) Name and address of the associated enterprise with whom the international transaction has been entered into.*
- (b) Nature of financing agreement.*
- (c) Currency in which transaction has taken place*
- (d) Interest rate charged/paid in respect of each lending/borrowing.*
- (e) Amount paid/received or payable/ receivable in the transaction-*
  - (i) as per books of account.*
  - (ii) as computed by the assessee having regard to the arm's length price.*
- (f) Method used for determining the arm's length price. [see section 92C(1)].*

**15. Particulars in respect of transactions in the nature of guarantee:**

*Has the assessee entered into any international transaction(s) in the nature of guarantee?* *Yes/No*

*If Yes, please provide the following details :*

- (a) Name and address of the associated enterprise with whom the international transaction has been entered into.*
- (b) Nature of guarantee agreement.*
- (c) Currency in which guarantee transaction was undertaken*
- (d) Compensation / fees charged / paid in respect of the transaction*
- (e) Method used for determining the arm's length price. [see section 92C(1)].*

16. *Particulars in respect of international transactions of purchase or sale of marketable securities, issue and buy back of equity shares, optionally convertible/ partially convertible/ compulsorily convertible debentures/ preference shares:*

*Has the assessee entered into any international transaction(s) in respect of purchase or sale of marketable securities or issue of equity shares including transactions specified in Explanation (i)(c) below section 92B(2)? Yes/No*

*If yes, provide the following details:*

1. *Name and address of the associated enterprise with whom the international transaction has been entered into*
2. *Nature of transaction*
3. *Currency in which the transaction was undertaken*
4. *Consideration charged/ paid in respect of the transaction*
5. *Method used for determining the arm's length price [See section 92C(1)]*

17. *Particulars in respect of mutual agreement or arrangement:*

*Has the assessee entered into any international transaction with an associated enterprise or enterprises by way of a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises? Yes/No*

*If 'yes' provide the following details in respect of each agreement/arrangement:*

- (a) *Name and address of the associated enterprise with whom the international transaction has been entered into.*
- (b) *Description of such mutual agreement or arrangement.*

18. *Particulars in respect of international transactions arising out/ being part of business restructuring or reorganizations:*

*Has the assessee entered into any international transaction(s) arising out/being part of any business restructuring or*

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*reorganization entered into by it with the associated enterprise or enterprises as specified in Explanation (i) (e) below section 92B (2) and which has not been specifically referred to above? Yes/No*

*If 'yes' provide the following details:*

- (a) Name and address of the associated enterprise with whom the international transaction has been entered into.*
- (b) Nature of transaction*
- (c) Agreement in relation to such business restructuring/ reorganization*
- (d) Terms of business restructuring/ reorganization*

*Method used for determining the arm's length price [See section 92C(1)]*

- (c) Amount paid/received or payable/ receivable in each such transaction:*
  - (i) as per books of account.*
  - (ii) as computed by the assessee having regard to the arm's length price.*
- (d) Method used for determining the arm's length price. [see section 92C(1)].*

- 19. Particulars in respect of any other transaction including the transaction having a bearing on the profits, incomes, losses, or assets of the assessee:**

*Has the assessee entered into any international transaction(s) including a transaction having a bearing on the profits, income, losses or assets, but not specifically referred to above, with associated enterprise? Yes/No*

*If 'yes' provide the following details in respect of each associated enterprise and each transaction:*

- (a) Name and address of the associated enterprise with whom the international transaction has been entered into.*
- (b) Description of the transaction.*

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- (c) **Amount paid/received or payable/ receivable in each such transaction:**

    - (i) **as per books of account.**
    - (ii) **as computed by the assessee having regard to the arm's length price.**
  - (d) **Method used for determining the arm's length price. [see section 92C(1)].**
- 20. Particulars of deemed international transaction:**
- Has the assessee entered into any transaction with a person other than an AE in pursuance of a prior agreement in relation to the relevant transaction between such other person and the associated enterprise? Yes/No**
- If 'yes' provide the following details in respect of each of such agreement:**
- (a) **Name and address of the associated enterprise with whom the international transaction has been entered into.**
  - (b) **Description of the transaction.**
  - (c) **Amount paid/received or payable/ receivable in each such transaction:**
    - (i) **as per books of account.**
    - (ii) **as computed by the assessee having regard to the arm's length price.**
  - (d) **Method used for determining the arm's length price. [see section 92C(1)].**

9.42 Under clause 11A, the assessee has to furnish details of international transactions in respect of inputs used in the course of assembling, processing and manufacturing. The items referred to in this clause are essentially materials worked upon or used in the course of the assessee's business, namely, raw materials, components, assemblies and sub-assemblies, consumables, etc. When any of the aforesaid materials are sold before their consumption during the normal course of business, the details of these sales are also to be reported under clause 11A.



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9.43 Under clause 11B, the assessee has to furnish details of international transactions in respect of purchase/sales of traded goods and purchase/sales of finished goods. Under clause 11C, the assessee has to furnish details of purchase, sale, lease or use of any other tangible property.

9.44 Under clause 12, the assessee has to furnish details about transaction involving not only commercial/business intangibles such know-how, patent, copyrights, marketing related, technology related, contract related, customer related intangibles but, where applicable even personal intangibles such as literary and artistic copyrights. Intangibles would also include human capital related, location related and goodwill related intangibles. Any other similar item that derives its value from its intellectual content rather than its physical attributes would also be included as an intangible. As all the intangibles referred to Explanation (ii) to Section 92B may not be separately accounted in the books of accounts (such as customer lists, human capital related intangibles, customer relationship, goodwill, etc), the accountant may need to rely on the transfer pricing documentation maintained by the assessee under Rule 10D as well as obtain adequate representations from the management stating that all the international transactions relating to intangibles have been disclosed to the accountant.

9.45 Under clause 13, the assessee has to furnish details about transactions that are in the nature of providing services to associated enterprises. The services contemplated under this clause include provision of market research, market development, marketing management, administration, technical, commercial, repairs, design, scientific research, legal or accounting service, etc. For example, if the A Inc., USA (associated enterprise) out-sources its entire accounting function to B Ltd. (Indian subsidiary), such transaction needs to be reported under this clause. Where the contract with the associated enterprise is a composite contract, involving both labour and materials, and the individual portions are indivisible, the details of such contract will have to be included under clause 11 and not under clause 13. The assessee may, however, make a suitable disclosure of the facts in both the paragraphs.

9.46 Under clause 14, the nature of the financing arrangements i.e. term loan, medium term loan, short term loan, project finance, working capital arrangement, fixed asset financing facility/deferred payments / receivables arrangements, trade advances, non-convertible preference shares, etc. should be clearly mentioned. Further, any security provided should also be clearly indicated along with the principal terms of repayment. The currency

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denomination of the loan account should be clearly indicated in the form along with any conversion options and any forward cover contracts taken. The assessee should disclose the interest rate applicable and along with any conditions applicable to a change in interest. The accountant should confirm the rate of interest from the loan agreement, any further correspondence between the assessee and the associated enterprise and verify the same from payment details. Further, if the interest is the sum of a fixed and variable component, e.g. LIBOR, the same should be clearly stated. The accountant should also disclose the rate of dividend payable to non-convertible preference shares.

9.47 Under clause 15, the nature of the guarantee i.e. whether corporate guarantee or letter of credit, etc. should be clearly mentioned. Further, the details of the loan for which the guarantee is received / provided, the currency denomination of the transaction should be clearly indicated in the form. The assessee should disclose the compensation charged / paid should also be stated.

9.48 Under clause 16, the assessee has to furnish details about transactions that are in nature of purchase or sale or marketable securities (for example commercial paper, banker's acceptances, treasury bills and other money market instruments) issue and buy back of equity shares, convertible debentures/ preference shares. Further, the assessee is required to furnish details such as the name and address of associated enterprise with whom the transaction has been undertaken, nature of transaction, currency, consideration charged/ paid as per books and method used for determination of arm's length price. In disclosing these transactions, it is important for the assessee to determine whether the said transactions have a taxable impact in India since the requirement to determine arm's length price would accordingly, be impacted.

9.49 Under clause 17, the assessee has to furnish the details of international transactions pertaining to cost contribution/sharing agreements and mutual arrangements for cost allocation or apportionment thereof. The Accountant should obtain and examine the copy of relevant agreements to support the details provided.

9.50 Under clause 18, the assessee has to furnish the details of international transaction with respect business restructuring or reorganization. The assessee is required to furnish details such as details of AE with whom such transaction has been entered into, nature of transaction and method used for determination of arm's length price. In disclosing such

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transactions, it is important to obtain a copy of the governing agreement that details the terms of the restructuring or reorganization.

9.51 Under clause 19, the assessee is required to furnish details of any other transaction having a bearing on profits, losses, income or assets i.e. it is a residual clause to cover any transaction which has not been covered in the preceding categories. Examples of these transactions could be reimbursement transactions or transactions which do not involve any charge (i.e. free of cost services or goods). These transactions should be identified and further notes could be provided to explain their nature.

9.52 Under clause 20, the assessee is required to furnish details with respect to the deemed international transactions. A discussion on what constitutes a deemed international transaction has already been provided in Para 4.5 and Para 4.6 above. The assessee is required to furnish details such as description of the transaction, amount paid/ payable or received/ receivable, and the method used for determination of arm's length price.

9.53 The accountant should audit the information provided by the assessee, with the documents as he considers essential in connection with the details of nature and terms (including prices) of international transactions entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction.

9.54 The accountant should examine the information provided in the annexure by the assessee, by using standard examining practices from the books of account maintained by the assessee and from information and explanations obtained. He should also verify the information provided by the assessee in the context of the understanding that he has of the assessee's business. Further, in conducting the examination the accountant will have to use his professional skill and expertise and apply such tests, based on materiality and sampling, as the circumstances of the case may require.

9.55 For verifying the correctness of the:

- (i) 'name and address of the associated enterprise with whom the international transaction has been entered into', and
- (ii) 'description of transaction and quantity purchased/sold'

the accountant may examine any instrument or agreement or any other document (invoices, correspondence etc.) evidencing the transaction and may also verify the books of account of the assessee.

## **Scope of Examination under Section 92E**

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9.56 For determining the correctness of the, 'total amount paid/ received or payable/receivable in the transaction as per books of account' the accountant may, in addition to examining the information/documents detailed above, obtain a confirmation for material international transactions from each associated enterprise, if considered essential. Such confirmation may be undertaken to obtain evidence from third parties about assertions made by the assessee in the annexure. In general, it is presumed that when evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent examination than that secured solely within the entity.

9.57 Confirmation requests can be designed to elicit evidence that addresses the completeness assertion: that is, if properly designed, confirmations may provide evidence to aid in assessing whether all transactions, accounts and amounts that should be included in the annexure are included. The accountant may require the identified associated enterprise to seek confirmation from associated parties, the following with respect to the transactions entered into with the assessee:

- (a) description of transaction and quantity purchased/sold;
- (b) total amount paid/received or payable/receivable in the transaction; and
- (c) listing of all transactions without consideration, if any.

Additionally, obtaining of a confirmation from the associated enterprise would be more advisable in the event that the financials statements / books of account of the assessee are yet to be audited.

9.58 With regard to the, 'total amount paid/received or payable/ receivable in the transaction as computed by the assessee having regard to the arm's length price', the accountant should get an authenticated declaration from the assessee along with a computation statement regarding the total amount paid/received or payable/receivable in the transaction as well as the arm's length price as computed by the assessee.

9.59 With regard to the, 'method used for determining the arm's length price', the accountant is at no point of time required to suggest the most appropriate method to determine the arm's length price nor is he required to assign any value to any transaction. As stated earlier, the computation of the arm's length prices and the selection of the most appropriate method is the responsibility of the assessee and the accountant only needs to verify the

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same to ensure that they are in accordance with the accounts and records maintained by the assessee and that the same are true and correct.

9.60 Clauses 11 to 24 of Annexure to Form No.3CEB list typical transactions that generally take place. However, these are not exhaustive and, if there are any transactions that are not specifically covered by these clauses, the particulars as required under clause 25 should be furnished in respect of such transactions. Further, in case the assessee has entered into transactions involving cost re-imburements or transfer of assets free of cost receipts of services free of charge, it is recommended that the accountant may identify these transactions in the Form No.3CEB and provide notes to explain their nature.

9.61 It may be noted here that though the accountant is required to make specific inquiries he is not responsible to ensure completeness of the list of international transactions entered into by the assessee. Further, it is advisable to take a representation from the management stating that all international transactions, whether specifically stated in the Form No.3CEB or not, have been disclosed to the accountant.

9.62 Often issues arise with respect to the services received or provided by the assessee free of cost to the associated enterprises. The assessee may not be able to attribute a cost or benefit from such services. However, the assessee should mention such services also under clause 25 in the annexure. These services could include the following:-

- (a) group marketing services on a global level the cost of which has not been allocated to the associated company even though the associated company may benefit from the same;
- (b) a group website operated by an associated company;
- (c) indirect recruiting services undertaken by an associated company.

9.63 Form No. 3CEB requires the accountant, who signs the report, to indicate his membership number. As such, the accountant should give his membership number and firm's registration number with ICAI and indicate the status, such as proprietor or partner of a firm, in which he has signed the report.

**PART C**

**9.64 21. List of associated enterprises with whom the assessee has entered into specified domestic transactions, with the following details:**

**(a) Name, address and PAN of the associated enterprise.**

**(b) Nature of the relationship with the associated enterprise.**

**(c) Brief description of the business carried on by the said associated enterprise.**

9.65 The assessee is required to furnish by way of an attachment, a complete list of associated enterprises, with whom the assessee has entered into specified domestic transactions during the previous year. The list of associated enterprises must be duly certified by the authorised person (partner, trustee, managing director etc. depending on the definition of assessee) The terms 'associated enterprises' has been defined in detail in Rule 10A of the Rules. If an enterprise was 'associated' with the assessee for a part of the previous year, details should be furnished with respect to that period of the previous year.

In this connection, the assessee has to maintain a register with the list of the transactions and the relevant details. The accountant can rely on the information provided in the register of associated enterprise for completing his work.

9.66 The particulars in this clause should be examined on test check basis from an instrument or agreement or any other document evidencing the association of enterprises including any supplementary documents related thereto. In this connection the accountant has to, based on his best judgement, determine the sampling approach and design the nature and timing of the audit tests.

9.67 In preparing the list of the associated enterprises, it is possible that the extent of association may not be precisely ascertainable during the previous year, i.e. it may be indeterminate or unknown, resulting in a situation whereby the assessee is not in a position to conclude as to whether any particular entity is covered under the definition of 'associated enterprise', as detailed in Rule 10A. In such circumstances, it is advisable both from the viewpoint of the assessee and the accountant's perspective that the relevant fact be stated in the Annexure or in the notes, as the case may be, and reference to same be made, if considered significant, in the accountant's report.

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9.68 In certain cases the enterprises may be associated in more than one manner. Since there is no different treatment for any particular form of association, it may be sufficient if the assessee details any particular relationship with the associated enterprise under clause 21(b). Although the assessee may be advised to detail all the relationships, disclosure of any one relationship is considered sufficient from a compliance perspective.

9.69 The accountant should obtain a written representation from the assessee detailing the business of the associated enterprises with whom the assessee has transacted. Further, since the completeness of the list of the associated enterprises is the primary responsibility of the assessee, the accountant should obtain suitable representation from the management (Board of directors or its equivalent).

9.70 The accountant should use his professional skill and expertise, in determining the scope of work to be performed with respect of getting reasonable comfort on the assessee's list of specified domestic transactions with associated enterprises.

9.71 The accountant should place emphasis on test checking material transactions with enterprises associated to the assessee. Certain relationships, such as parent-subsidiary or investor-investee, may be clearly evident. Determining the existence of others requires the application of certain procedures, which may include the following:

- (a) Evaluate the assessee procedures for identifying and properly accounting for specified domestic transactions;
- (b) Request from appropriate management personnel the names of all associated enterprises and inquire whether there were any transactions with these enterprises during the period;
- (c) Review filings by the reporting entity with regulatory agencies for the names of associated enterprises and for other businesses in which officers and directors occupy directorship or management positions; (example director's representations on transactions under sections 297, 299 etc.);
- (d) Review stockholder listings of closely held companies to identify principal stockholders;
- (e) Enquire, where possible and considered essential of predecessor, principal, or other accountants/accountants of associated enterprises concerning their knowledge of existing relationships and the extent of management involvement in material transactions;

**Scope of Examination under Section 92E**

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(f) Review material investment transactions during the period under review to determine whether the nature and extent of investments during the period create associated enterprises; and

(g) Review the mandatory related party disclosure in the audited financial (AS 18). [The definition of Associated Enterprise in Rule 10A r.w.s. 40A(2)(b) in relation to the specified domestic transactions is different than the definition of related party under AS 18 and therefore the accountant should review the Associated Enterprises for the purpose of section 92BA independently]

(h) Review the income tax return of assessee to determine any tax holiday status claimed by assessee.

9.72 Although it is the responsibility of the assessee to furnish a complete list of associated enterprises and specified domestic transactions, the accountant must exercise reasonable care to ensure that prima facie and, based on the information that is made available to him, the list of associated enterprises and list of specified domestic transactions furnished by the assessee is reasonably complete.

**9.73 22. Particulars in respect of transactions in the nature of any expenditure:**

***Has the assessee entered into any specified domestic transaction(s) being in respect of which payment has been made or is to be made to any person referred to in section 40A(2)(b)?***

**Yes/No**

***If 'yes', provide the following details in respect of each of such person and each transaction or class of transaction:***

- (a) Name of person with whom the specified domestic transaction has been entered into.***
- (b) Description of transaction along with quantitative details, if any***
- (c) Total amount paid or payable in the transaction-***
  - (i) as per books of account.***
  - (ii) as computed by the assessee having regard to the arm's length price.***



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(d) *Method used for determining the arm's length price. [See section 92C(1)].*

23. *Particulars in respect of transactions in the nature of transfer or acquisition of any goods or services:*

A. *Has any undertaking or unit or enterprise or eligible business of the assessee [as referred to in section 80A(6), 80IA(8) or section 10AA)]transferred any goods or services to any other business carried on by the assessee?*

**Yes/No**

*If 'yes' provide the following details in respect of each unit or enterprise or eligible business:*

(a) *Name and details of business to which goods or services have been transferred.*

(b) *Description of goods or services transferred.*

(c) *Amount received / receivable for transferring of such goods or services -*

(i) *as per books of account.*

(ii) *as computed by the assessee having regard to the arm's length price.*

(d) *Method used for determining the arm's length price [See section 92C(1)]*

B. *Has any undertaking or unit or enterprise or eligible business of the assessee [as referred to in section 80A(6), 80IA(8) or section 10AA)]acquired any goods or services to any other business carried on by the assessee?*

**Yes/No**

*If 'yes' provide the following details in respect of each unit or enterprise or eligible business:*

(a) *Name and details of business to which goods or services have been acquired.*

(b) *Description of goods or services acquired.*

(c) *Amount paid / payable for transferring of such goods or services -*

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- (i) as per books of account.
- (ii) as computed by the assessee having regard to the arm's length price.
- (d) Method used for determining the arm's length price [See section 92C(1)]

24. *Particulars in respect of specified domestic transactions in the nature of any business transacted:*

*Has the assessee entered into any specified domestic transaction(s) with any associated enterprise which has resulted in more than ordinary profits to an eligible business to which section 80IA(10) or section 10AA applies? Yes/No*

*If 'yes' provide the following details:*

- (a) Name of the person with whom the specified domestic transaction has been entered into
- (b) Description of the transaction including quantitative details, if any
- (c) Amount received/receivable or paid/payable for transferring of such goods or services -
  - (i) as per books of account.
  - (ii) as computed by the assessee having regard to the arm's length price.
- (e) Method used for determining the arm's length price [See section 92C(1)]

25. *Particulars in respect of any other transactions:*

*Has the assessee entered into any other specified domestic transactions(s) not specifically referred to above, with an associated enterprise?*

*Yes/No*

*If 'yes' provide the following details in respect of each associated enterprise and each transaction:*

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- (a) Name of the associated enterprise with whom the specified domestic transaction has been entered into:**
- (b) Description of the transaction.**
- (c) Amount paid/received or payable/receivable in the transaction -**
  - (i) as per books of account.**
  - (ii) as computed by the assessee having regard to the arm's length price.**
- (d) Method used for determining the arm's length price [See section 92C(1)]**

9.74 Under clause 22, the assessee has to furnish details of specified domestic transactions in respect of expenditure for which payment has been made or to be made to any person referred in section 40A(2)(b). The expenditure referred to in this clause includes all types of revenue transactions with related persons such as purchases of goods or services. Even when the payment is not made to the related person, the details of these transactions are required to be reported under clause 22.

9.75 Under clause 23A, the assessee has to furnish details of specified domestic transactions respect of sale of goods/services from the assessee's eligible business to assessee's other business.

9.76 Under clause 23B, the assessee has to furnish details of specified domestic transactions respect of purchase of goods/services by the assessee's eligible business from assessee's other business.

9.77 Under clause 24, the assessee has to furnish details of specified domestic transactions which has enabled assessee to earn more than ordinary profits for a business to which section 80IA(10) or section 10AA is applicable.

9.78 Under clause 25, the assessee has to furnish details of other specified domestic transactions, which are not superficially covered in the above discussed clauses.

9.79 With respect to other reporting requirements in above mentioned clauses such as details of the person, description of the transaction, amount paid/payable or received/receivable, method for computing the arms length nature of the transaction accountant can refer to the guidance elaborated in the previous paragraphs which are relevant for international transactions.

## Annexure I

# Statutory Provisions

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1. The Finance Act, 2001 has introduced with effect from A.Y. 2002-03 sections 92 to 92F in the Act. These provisions are commonly known as transfer pricing regulations.

2. The object behind introduction of the provisions as stated by the Finance Minister in his Budget Speech and as explained in the Memorandum explaining the provisions of the Finance Act, 2001 are reproduced below:

"The presence of multinational enterprises in India and their ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions has made the issue of transfer pricing a matter of serious concern, I had set up an Expert Group in November, 1999 to examine the issues relating to transfer pricing. Their report has been received proposing a detailed structure for transfer pricing legislation. Necessary legislative changes are being made in the Finance Bill based on these recommendations".

Vide the Finance Act 2012; specified domestic transactions have also been brought under the purview of transfer pricing provisions.

3. The relevant provisions of the Act dealing with the computation of income from international transactions/specified domestic transactions, certification by a chartered accountant and penalty for non compliance thereof are given below:

### **CHAPTER X**

#### **SPECIAL PROVISIONS RELATING TO AVOIDANCE OF TAX**

##### **3.1 Section 92 - Computation of income from international transaction having regard to arm's length price.**

(1) Any income arising from an international transaction shall be computed having regard to the arm's length price.

*Explanation.* For the removal of doubts, it is hereby clarified that the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arm's length price.

(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

### **Guidance Note – Transfer Pricing**

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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.

(2A) Any allowance for an expenditure or interest or allocation of any cost or expense or any income in relation to the specified domestic transaction shall be computed having regard to the arm's length price.

(3) The provisions of this section shall not apply in a case where the computation of income under sub-section (1) or sub section (2A) or the determination of the allowance for any expense or interest under that sub-section, or the determination of any cost or expense allocated or apportioned, or, as the case may be, contributed under sub-section (2) or sub section (2A) has the effect of reducing the income chargeable to tax or increasing the loss, as the case may be, computed on the basis of entries made in the books of account in respect of the previous year in which the international transaction or specified domestic transaction was entered into.

#### **3.2 Section 92A - Meaning of associated enterprise.**

(1) For the purposes of this section and sections 92, 92B, 92C, 92D, 92E and 92F, "associated enterprise", in relation to another enterprise, means an enterprise -

- (a) which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or
- (b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

(2) For the purposes of sub-section (1), two enterprises shall be deemed to be associated enterprises if, at any time during the previous year,

- (a) one enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise; or

- (b) any person or enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in each of such enterprises; or
- (c) a loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise; or
- (d) one enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise; or
- (e) more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise; or
- (f) more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons; or
- (g) the manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights; or
- (h) ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise; or
- (i) the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise; or

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- (j) where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or
- (k) where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or jointly by such member and his relative; or
- (l) where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association of persons or body of individuals; or
- (m) there exists between the two enterprises, any relationship of mutual interest, as may be prescribed.

#### **3.3 Section 92B - Meaning of international transaction.**

(1) For the purposes of this section and sections 92, 92C, 92D and 92E, "international transaction" means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

(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 a 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.

*Explanation—For the removal of doubts, it is hereby clarified that—*

- (i) *the expression "international transaction" shall include—*
  - (a) *the purchase, sale, transfer, lease or use of tangible property including building, transportation vehicle, machinery, equipment,*

## Annexure I

*tools, plant, furniture, commodity or any other article, product or thing;*

- (b) the purchase, sale, transfer, lease or use of intangible property, including the transfer of ownership or the provision of use of rights regarding land use, copyrights, patents, trademarks, licences, franchises, customer list, marketing channel, brand, commercial secret, know-how, industrial property right, exterior design or practical and new design or any other business or commercial rights of similar nature;*
- (c) capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business;*
- (d) provision of services, including provision of market research, market development, marketing management, administration, technical service, repairs, design, consultation, agency, scientific research, legal or accounting service;*
- (e) a transaction of business restructuring or reorganisation, entered into by an enterprise with an associated enterprise, irrespective of the fact that it has bearing on the profit, income, losses or assets of such enterprises at the time of the transaction or at any future date;*
- (ii) the expression "intangible property" shall include—*
  - (a) marketing related intangible assets, such as, trademarks, trade names, brand names, logos;*
  - (b) technology related intangible assets, such as, process patents, patent applications, technical documentation such as laboratory notebooks, technical know-how;*
  - (c) artistic related intangible assets, such as, literary works and copyrights, musical compositions, copyrights, maps, engravings;*
  - (d) data processing related intangible assets, such as, proprietary computer software, software copyrights, automated databases, and integrated circuit masks and masters;*
  - (e) engineering related intangible assets, such as, industrial design, product patents, trade secrets, engineering drawing and schema-tics, blueprints, proprietary documentation;*
  - (f) customer related intangible assets, such as, customer lists, customer contracts, customer relationship, open purchase orders;*