Centre for Tax Laws (CTL)
Directorate of Distance Education
NALSAR University of Law, Hyderabad
In collaboration with
TAXMANN

<u>Course Material</u>

M.A. (INTERNATIONAL TAXATION)

1.2.7. TRANSFER PRICING AND ALLOCATION OF BUSINESS PROFITS

Prepared by TAXMANN

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Module – I Basics of Transfer Pricing

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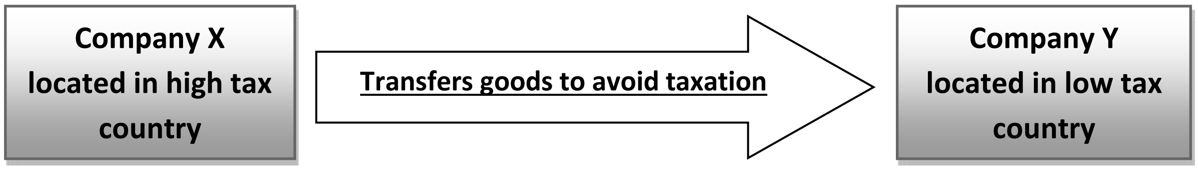
1. Introduction

With the advent of globalization, multinational companies (MNCs) have established presence in all parts of the world. They can enjoy the privileges of doing business with related parties whereas companies which deal with unrelated party in an open market are not able to exploit such benefits. Therefore, in order to ensure safe and fair dealings among all companies and markets, the need to introduce regulations for transfer pricing was felt.

In addition to price related benefits, (such as price concessions, extended credit period, reduced interest rates, etc.) MNCs may also bear in mind the goal of minimizing tax burden and maximizing profits but the two tax countries also need to ensure that they are not losing their fair share of tax revenue in such cases.



This has given rise to an internationally accepted practice "Transfer Pricing" which is governed by the Arm's Length Principle (ALP) and the transfer price should be the price applicable in case of a transaction of arm's length. We can say that the transaction between associates should be priced in the same way as a transaction between independent enterprises.

Note: Two enterprises are "associated enterprises" if one of the enterprises participates directly or indirectly in the management, control or capital of the other or if both enterprises are under common control.

2. What is Transfer Pricing?

The expression "transfer pricing" generally refers to prices of transactions between associated enterprises which may take place under conditions differing from those taking place between independent enterprises. It refers to the value attached to transfers of goods, services and technology between related entities. It also refers to the value attached to transfers between unrelated parties which are controlled by a common entity.

Accordingly, the term has evolved to mean <u>the price which is charged between two or more entities of MNC [associated enterprises (AEs)] operating in different countries.</u>

Examples of common business transaction between the AEs are purchase and sale of assets, raw materials, finished goods and provision of services. The MNC is basically able to steer and manage its book profit and influence tax burden, by structuring these types of transactions in a way which is most beneficial to the MNC from a tax perspective.

Following are the objectives of the transfer pricing:

- True and fair reporting of financial statements
- Better estimation of profits generated by entities from associated transfers

- Avoidance of **double taxation** and avoiding **tax evasion** by entities
- Promoting competitiveness among the associated enterprises.

From the given below example, we can understand how transaction with related parties can help company to manipulate the profits and avoid taxation.

Example:

KAI Limited, a trader of goods, purchases and sells goods as below:

Particulars	Related Parties/ Associated Enterprises	Unrelated Parties
Purchase	7,00,000	4,00,000
Sale	9,00,000	9,00,000
Profit	2,00,000	5,00,000

By increasing the costs of purchases from related parties, KAI Ltd. has reduced its taxable profits in its jurisdiction.

Moreover, the principles governing the taxation of MNCs are embodied in the OECD Model Tax Convention of Income and Capital (OECD Model Convention), which serves as the basis for the bilateral income-tax treaties between Organization of Economic Cooperation and Development (OECD) member countries and between OECD member and non-OECD member countries. According to these guidelines, **"Transfer prices"** are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises.

3. Arm's Length Price Concept

The Arm's Length Price (ALP) of a transaction between two associated enterprises is the price that would be paid if the transaction had taken place between two comparable independent and unrelated parties, where the consideration is only commercial.

In simple words, we can state that *arm's length price means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.*

The OECD transfer pricing guidelines provides guidance on the application of the arm's length principle in order to arrive at the proper transfer pricing range between associated enterprises. Market forces determine business relations between independent parties. The arm's length principle seeks to adjust the profits between two associated enterprises by comparing the same as if the transaction is carried out between two independent enterprises. It treats each enterprise as a separate independent entity rather than as inseparable parts of a single unified business.

4. Significance of Arm's Length Price Principle (ALP)

There are several reasons as to why the OECD member countries and other countries have adopted the arm's length principle.

- A major reason is that the ALP provides broad parity of tax treatment for MNCs and independent enterprises. Since the ALP puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages and disadvantages that would otherwise distort the relative competitive positions of these entities.
- An 'arm's length' price – a price two independent firms operating at arm's length would agree on – is needed to determine real taxable profits earned in each country. The arm's length doctrine permits the taxing authorities to rectify the accounts of the enterprise so as to reflect correctly the income that the establishment would have earned if it were an independent enterprise.
- If the ALP is not followed, an MNC will sell goods/ provide services to a controlled entity in a high tax regime at a high price (which exceeds the market price) and to an entity in a low-tax regime or a tax haven at a low price (which is lower than the market price). This would result in extreme price distortion of goods and services in the international market. Thus ALP is needed for reduction of artificial price distortion.
- The ALP is international concept so the potential for double taxation is minimized, since in international transfer pricing, adjustment to the transfer price in one tax jurisdiction requires a corresponding adjustment in the other tax jurisdiction.
- The ALP provides accurate measurement of the fair market value of the economic contribution units of an MNC. The focus of the ALP is to ensure that the proper amount of income is attributed to where it is earned.

5. Indian Provisions for Transfer Pricing

In India, the Finance Act, 2001 introduced Transfer Pricing Regulations for curbing tax avoidance and manipulation of intra-group transactions by abusing transfer pricing.

Accordingly, **Sections 92 to 92F** had been included in Chapter X of the Income-tax Act, 1961, through the Finance Act, 2001, providing for a transfer pricing mechanism based on computation of income from cross-border transactions. The provisions of Chapter X apply to international transactions entered into with effect from 1st April, 2001.

These sections and rules of the Income-tax Act, 1961 and the Income-tax Rules, 1962 respectively, will affect all non-corporate and corporate assessees who have dealings with non-residents for import or export of goods, properties or services. In other words, price paid for import of goods, properties or services and price received for export of goods, properties or services will be subject to scrutiny by the Assessing Officer.

All assessees who have such dealings with non-residents will have to keep detailed records as prescribed under the Rules and will have to furnish audit report every year with the return of income about their international transactions.

6. Computation of Income from Transaction with Non-Resident [Section 92]

Section 92 provides that any income arising from an "international transaction" shall be computed having regard to "the arm's length price".

As per this section, The section further provides that in an international transaction between two or more 'associated enterprises" when there is a mutual agreement or arrangement for the allocation of any cost or expenses in connection with a benefit, service or facility provided to any one or more of such enterprises, the allocation of cost, expenses etc. shall be determined having regard to arm's length price of such benefit, service or facility.

The objective of transfer pricing provisions is to protect the tax base of India and to ensure that due to inter-company transactions, there is no reduction in the taxable profits or the taxes paid by the Indian taxpayer.

> Note:
>
> In simple words, as per section 92, any income, expenditure, interest and allocation of cost in relation of international transaction or specified domestic transaction shall be computed having regards to **arm's length price.**

7. Associated Enterprise [Section 92A]

Section 92A defines the term 'Associated Enterprises' for the purpose of provisions relating to transfer pricing.

As per section 92A (1), associated enterprise refers to:

1. An enterprise which participates, directly or indirectly, or through one or more intermediaries, in:
    - Management of the other enterprise, or
    - Control of the other enterprise, or
    - Capital of the other enterprise.
2. If one or more persons participates, directly or indirectly, or through one or more intermediaries in:
    - Management of the two different enterprises

- Control of two different enterprises
- Capital of two different enterprises

then, those two enterprises are associated enterprises.

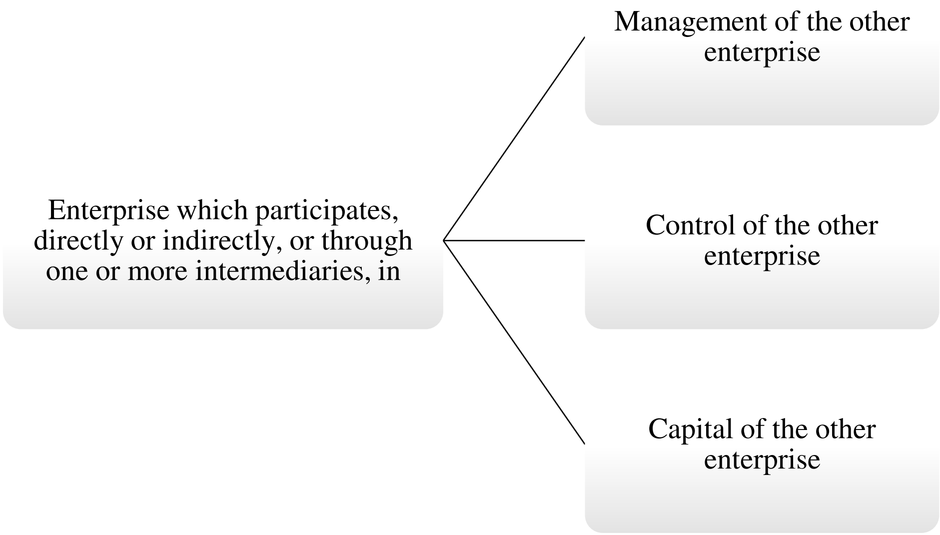


Fig. Meaning of Associated Enterprise

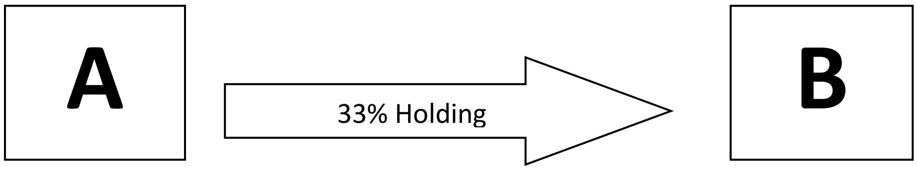
8. <u>Deemed Associated Enterprise</u>

Two enterprises are deemed to be associated enterprises if they fall under any one or more of the situations contained in section 92A (2).

Two enterprises are deemed to be associated enterprise if:

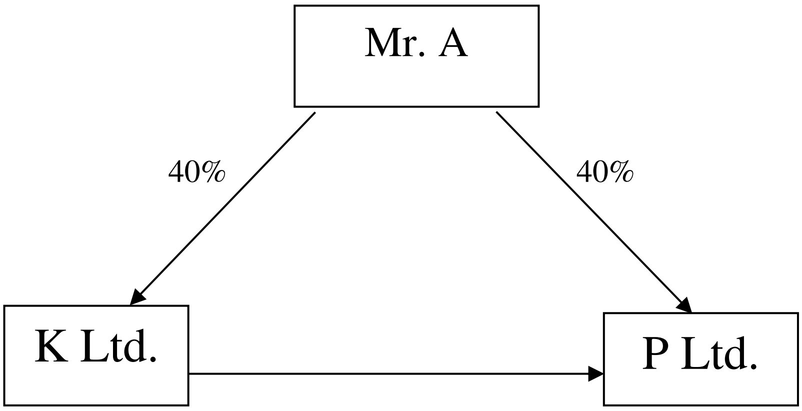
1) **Enterprise ownership -** One enterprise holds 26% or more of the voting power, directly or indirectly, in the other enterprise.

   For example, A Ltd. holds 33% of voting power in B Ltd. In this situation, A Ltd. holds 26% or more voting power in B Ltd., so B Ltd. is deemed associated enterprises of A Ltd.



2) **Substantial voting power in two entities by common person -** Any person or enterprise holds 26% or more of the voting power, directly or indirectly, in each of two different enterprises.

For example, Mr. A holds 40% of voting power in both K Ltd. and P Ltd. where neither K Ltd. has any holding in P Ltd. nor P Ltd. has any holding in K Ltd. In this situation, since Mr. A directly holds 40% of voting power in both K Ltd. and P Ltd., K Ltd. and P Ltd. will be deemed associated enterprises.



3) One enterprise **advances loan to the other enterprise** of an amount of 51% or more of the book value of the total assets of such other enterprise.

   For example, book value of total assets of DK Ltd. is Rs. 200 crores. PK Ltd. advances loan of Rs. 120 crores to DK Ltd.
   Since, in this case, PK Ltd. advances loan of Rs.120 crores to DK Ltd, which is 60% of the book value of total assets of DK Ltd., hence, DK Ltd. & PK Ltd. are deemed associated enterprises.

4) One enterprise **guarantees** 10% or more of the total borrowings of the other enterprise.

   For example, ABC Ltd. has total loan of 1 million dollars from Bank of America. Out of that, KBC Ltd., an Indian company, guarantees 25% of total borrowings in case of any default made by ABC Ltd.
   In such scenario, since KBC Ltd. guarantees 25% of total borrowings of ABC Ltd., ABC Ltd. and KBC Ltd. are deemed associated enterprises.

5) One enterprise **appoints 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 another enterprise.

   For example, DC Ltd. has 17 directors on its Board. Out of that, AB Ltd. has appointed 9 directors. In such case, DC Ltd. and AB Ltd. are deemed associated enterprises.

6) **Appointment of majority directors** of two different enterprises by same persons: 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.

7) The **manufacture or processing of goods** or articles or business carried out by one enterprise is **wholly dependent** (i.e. 100%) on the know-how, patents, copyrights, trade-marks, licenses, 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 entity is the owner or in respect of which the other enterprise has exclusive rights.

8) **Dependence on raw material**: 90% or more of raw materials and consumables required for the manufacture or processing of goods or articles or business carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, where the prices and other conditions relating to the supply are influenced by such other enterprise.

9) **Dependence on sale:** 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.

10) Where one enterprise is **controlled by an individual** (common individual), the other enterprise is also controlled by such individual or his relative or jointly by such individual and his relatives.

    For example, Mr. A and Mr. B are relatives. Mr. A has control over X Ltd. and Mr. B has control over Y Ltd. Therefore, both X Ltd. and Y Ltd. will be deemed associated enterprises.

11) **Control by Hindu Undivided Family** or member thereof: Where one enterprise is controlled by a Hindu Undivided Family (HUF) and the other enterprise is controlled by a member of such HUF or by relative of a member of such HUF or jointly by such member and his relative.

12) Where one enterprise is a firm, association of persons or body of individuals, the other enterprise **holds 10% or more interest in firm/AOPs/BOIs**.

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

Meaning of Enterprise: The term “enterprise” is defined in section 92F(iii) to mean a person (including its certain specified Permanent Establishment) who is or has been engaged in any activity,

- relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or know-how, patents, copy rights, 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

- the provision 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 enterprise is located or at a different place or places.

9. International Transaction [Section 92B]

As per section 92B, an international transaction means:

i. A transaction between two or more associated enterprises, either or both of whom are non-residents; and
ii. transaction in the nature of:
   a. Sale/ purchase/ lease of tangible property; or
   b. Sale/ purchase/ lease of intangible property; or
   c. Provision of services; or
   d. Lending/ borrowing money; or
   e. Any other transaction having a bearing on profits, income, losses or assets of such enterprises; or
   f. Mutual agreement or arrangement between two or more associated enterprise 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.

Deemed International Transaction [Section 92B(2)]

Where, in respect of a transaction entered into by an enterprise with a person other than an associated enterprise (hereinafter referred to as “other person”),

- there exists a prior agreement in relation to the relevant transaction between the other person and the associated enterprise **or**,
- where the terms of the relevant transaction are determined in substance between such other person and the associated enterprise; **and**
- either the enterprise or the associated enterprise or both of them are non-residents,

then such transaction entered into between the enterprise and the other person shall be **deemed to be an international transaction** entered into between two associated enterprises, **whether or not such other person is a non-resident.**

Meaning of Transaction: As per section 92F(v) of the Act, "transaction" includes an arrangement, understanding or action in concert –

a) whether or not such arrangement, understanding or action is formal or in writing; or
b) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceeding.

Explanation:
The scope of **"international transaction"** shall include**:**

- Purchase, sale, transfer, lease or use of **tangible property**, where, tangible property includes building, transportation vehicle, machinery, equipment, tools, plant, furniture, commodity or any other article, product or thing;
- Purchase, sale, transfer, lease or use of **intangible property**, including transfer of ownership or the provision of use of certain rights;
- **Capital financing**: 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;
- **Provision of services**, such as provision of market research, market development and management, administration, technical service, repairs, design, consultancy, agency, scientific research, legal and accounting service;
- **Business restructuring or reorganization** entered into by an enterprise with an associated enterprise.

10. Computation of Arm's length Price [Section 92C]

"Arm's length price" is defined in section 92F(ii) to mean price which is applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions.

Section 92C provides the method for determining arm's length price and describes the factors which are to be considered for applicability or non-applicability of a particular method to a given situation.

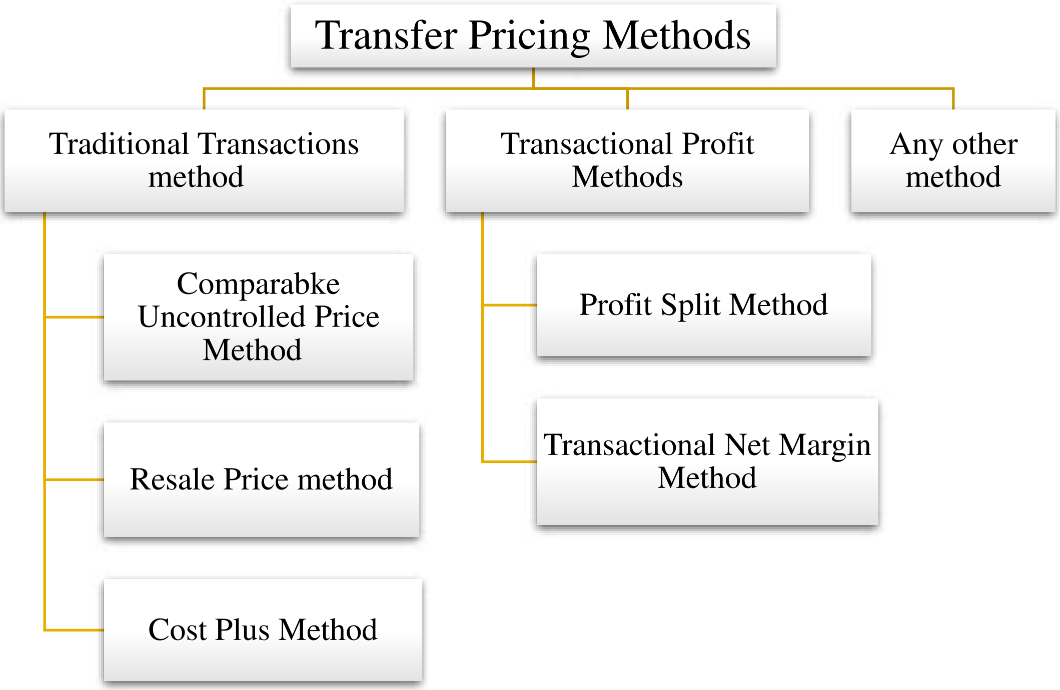


Fig. Transfer Pricing Methods

1) **Comparable Uncontrolled Price Method (CUP) Method:**
   Comparable uncontrolled price is the price agreed between unconnected parties for the transaction of goods or services under similar circumstances.
   Calculation of Arm's Length Price (ALP) under this method is as under:

Particulars	**Amount**
Price charged/ paid in comparable uncontrolled transaction	-------
(+)/(-) Adjustment for difference between international transaction & comparable uncontrolled transaction	-------
ALP	-------

Where, **uncontrolled transaction** means a transaction between enterprises other than associated enterprises, whether resident or non-resident.

Note:

Normally CUP Method is applicable when comparable uncontrolled transaction is available.

Illustration:

UK Ltd., a UK company has a subsidiary, IND Ltd. in India. UK Ltd. sells computer monitors to IND Ltd. for resale in India. UK Ltd. also sells computer monitors to PMI Ltd., another computer reseller. It sells 40,000 computer monitors to IND. Ltd. at Rs. 10,000 per unit. The price fixed for PMI Ltd. is Rs. 8,000 per unit. The warranty in case of sale of monitors by IND Ltd. is handled by IND Ltd. However, for sale of monitors by PMI Ltd., UK Ltd. is responsible for the warranty for 2 months. Both UK Ltd. and IND Ltd. offer extended warranty at a standard rate of Rs. 1,000 per annum. On these facts, how is the assessment of IND Ltd. going to be affected?

Answer:

UK Ltd., the foreign company and IND Ltd., the Indian company are associated enterprises since UK Ltd. is the holding company of IND Ltd. UK Ltd. sells computer monitors to IND Ltd. for resale in India. UK Ltd. also sells identical computer monitors to PMI Ltd., which is not an associated enterprise. The price charged by UK Ltd. for a similar product transferred in comparable uncontrolled transaction is, therefore, identifiable. Therefore, Comparable Uncontrolled Price (CUP) method for determining arm’s length price can be applied.

For sale of monitors by PMI Ltd., US Ltd. is responsible for warranty for 2 months. The price charged by UK Ltd. to PMI Ltd. includes the charge for warranty for 2 months. Hence, arm's length price for computer monitors being sold by UK Ltd. to IND Ltd. would be:

Particulars	No.	Rs.
Sale price charged by UK Ltd. to PMI Ltd.		8,000
Less: Cost of warranty included in the price charged to PMI Ltd. (Rs. 1,000 * 2/12)		200
Arm’s length price		**7,800**
Actual price paid by IND Ltd, to UK Ltd.		10,000
Difference per unit		2,200
No of units supplies by UK Ltd. to IND Ltd.	40,000	
Addition required to be made in the computation of total income of IND Ltd. (Rs. 2,200 * 40,000)		8,80,00,000

2) **Resale Price Method:**

The resale price method (RPM) is a method which compares the gross margins (i.e. gross profit over sales) earned in transactions between related and unrelated parties for the determination of the ALP.

The RPM requires high level of functional comparability and is mainly applicable where the controlled party is a distributor.

RPM can be computed as follows:

Particulars	**Amount**
Price charged for goods sold to unrelated enterprise (Resale Price)	-------
Less: Normal G.P. Margin in similar transaction (i.e. uncontrolled transaction)	-------
Less: Purchase related expense	-------
This price may be adjusted to account for functional and other differences, if any, including differences in accounting practices which could materially affect the gross profit margin in the open market.	-------
ALP	-------

RPM is generally used to test transactions involving distribution function, i.e. when the tested party purchases products/ acquires services from related party and resells the same to independent parties. The use of RPM is appropriate where the reseller does not add substantially to the value of the product/ services.

Illustration:

Earth Ltd., Delhi is engaged in trading of electronic goods. It purchased goods from its associated enterprise Sun Ltd., Singapore, and also from unrelated party, Moon Ltd., US. For the F.Y. 2021-22, the gross profit margin was 15% on the sale of goods of Sun Ltd., whereas it was 20% in the case of Moon Ltd. After-sales warranty of 6 months was provided by Sun Ltd. whereas Moon Ltd. gave after-sales warranty of 1 year. The cost of warranty may be taken as 2% of the sale price. The Sun Ltd.'s brand value is internationally known and the benefit of the brand value can be taken as 1% of sale price. During the F.Y. 2021-22, it sold goods of Sun Ltd. for Rs. 10 crores and of Moon Ltd. for Rs. 8 crores. As regards transport cost of the goods purchased, there was no difference between related and unrelated party. Compute the ALP of the transaction between Earth Ltd. and Sun Ltd., Singapore by applying the Resale Price Method, considering the facts of the case.

Answer:

As per section 92B, the transactions entered into between Earth Ltd., an Indian company, and Sun Ltd., Singapore, being associated enterprises, for purchase of electronic goods would be international transaction.

Since Earth Ltd. purchased similar electronic goods from Moon Ltd., an unrelated entity, and sold the same to unrelated parties, this transaction can be considered as uncontrolled transaction and the gross profit margin of 15% earned on sale of such goods can be considered for the purpose of determining the arm's length price.

Particulars	Amount
Resale price of goods purchased from Sun Ltd.	10,00,00,000
Less: Normal G.P. Margin in uncontrolled transaction between earth Ltd and Moon Ltd. (20% on sale)	2,00,00,000
	8,00,00,000
Add: Adjustment for benefit of brand value of Sun Ltd. [Sun Ltd. has its brand value internationally. Therefore, adjustment of benefit of brand value has to be carried out to arrive at ALP (1% of sale price)]	10,00,000
Less: Adjustment of cost of warranty [Sun Ltd. provides warranty for 6 months whereas unrelated party has provided warranty of 12 months. Therefore, adjustment for the cost of such warranty has to be carried out to arrive at arm's length price (2% of sale price x 6/12)]	(10,00,000)
Arm's length price	**8,00,00,000**

3) **Cost Plus Method:**
The cost plus method ('CPM') determines an arm's-length price by adding an appropriate gross profit margin to an associated entity's costs of producing goods or services. The gross profit margin should reflect the functions performed by an entity and should include a return for capital used and risks assumed by the entity.

CPM can be computed as follows:

Particulars	Amount
Direct cost + Indirect cost of production incurred by the enterprise	-------
Add: Normal G.P. mark-up in similar transaction (i.e. uncontrolled transaction) [The normal gross profit mark-up determined above is adjusted to account for functional and other differences, if any, which could materially affect such profit mark-up in the open market.]	-------
ALP	-------

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

Illustration:

Bazel Ltd., Canada holds 35% shares in JIL Ltd. India. JIL Ltd. develops software and does both onsite and offsite consultancy services for the customers. JIL Ltd. during the year billed Bazel Ltd. Canada for 3500 man-hours at the rate of Rs. 5,000 per man hour. The total cost (direct and indirect) for executing this work amounted to Rs. 1,50,00,000.

However, JIL Ltd. billed XYZ Ltd., India at the rate of Rs. 6,800 per man hour for the similar level of manpower and earned a Gross Profit of 50% on its cost.

The transactions of JIL Ltd. with Bazel Ltd. and XYZ Ltd. are comparable, subject to the following differences:

(i) Bazel Ltd gives research and development support to JIL which can be valued at 6% of the normal gross profit. XYZ Ltd does not provide any support.
(ii) As Bazel Ltd. gives business in large volumes, JIL Ltd. offered to Bazel Ltd., a quantity discount which may be valued at 18% of normal gross profits. No such discount was given to XYZ Ltd.
(iii) JIL Ltd. offered 60 days credit to Bazel Ltd. The cost of providing such credit may be valued at 4% of the gross profits. No such credit was given to XYZ Ltd.

Compute ALP and the amount of increase in total income of JIL Ltd.

Answer:

Computation of arm's length gross profit mark up:	%	%
Normal GP Mark-up		50.0
Less: Adjustment for difference		
R & D support from Bazel Ltd 6% of Normal GP [6% of 50%]	3.0	
Quantity discount 18% of Normal GP [18% of 50%]	9.0	(12.0)
		38.0
Add: Cost of credit period to Bazel Ltd. 4% of normal bill [4% of 50%]	2.0	2.0
Arm's length gross profit mark up		**40.0**

Computation of increase in total income of JIL Ltd.	Amount
Cost of service provided to Bazel Ltd.	1,50,00,000
Arm's length billed value	
[Cost / (100 – Arm's length mark-up) [1,50,00,000 / 100% - 40%]	2,50,00,000
Less: Amount charged (3,500 * Rs. 5,000)	1,75,00,000
Therefore, increase in total income of JIL Ltd.	**75,00,000**

4) Profit Split Method:

This is a 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.

The Profit Split Method (PSM) evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is at arm's length with reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most prominently identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions (relevant business activity).

Profit split method is applied by following steps:

Steps	Particulars
1	Determination of combined net profit of the associated enterprises arising out of international transaction in which they are engaged.
2	Evaluation of relative contributions by each enterprise to the earning of such combined net profit on the basis of functions performed, risks assumed and assets employed by each enterprise.
3	Splitting of combined net profit amongst the enterprises in proportion to their relative contributions, as evaluated above.
4	Profit, thus apportioned to the assessee, is taken into account to arrive at the arm's length price in relation to the international transaction.

Allocation of profits must be made in accordance with one of the following allocation methods:

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

B) Residual profit split - Following the two-step process:
   (i) Allocate income to routine contributions
   (ii) Allocate residual profit

Illustration:

MM Ltd incorporated in UK, received an order to develop a software for Nano Inc. USA and consideration for the same is $2,00,000. MM Ltd. executed such order in joint venture with BB Ltd. and AA Ltd. India-based companies. AA Ltd. holds 30% equity shares of BB Ltd. and 27% equity shares of MM Ltd. Consideration of $2,00,000 is distributed amongst MM Ltd., BB Ltd. and AA Ltd., $1,00,000, $50,000 & $50,000 respectively.

Cost incurred to develop a software is $1,60,000. Relative contribution by MM Ltd., BB Ltd. & AA Ltd. to the earning of such combined profit on the basis of function performed, risk assumed and asset employed by each enterprise is 40:40:20. This evaluation is to be made on the basis of reliable external market data which can indicate how such contribution would be evaluated by unrelated enterprise performing comparable functions in similar circumstances. Cost incurred by BB Ltd. is $42,000. Calculate ALP for BB Ltd.

Answer:

Total Profit from Joint Venture ($2,00,000 – $1,60,000) = $40,000
Distribution of profit on relevant contribution ratio:
MM Ltd.: $40,000 * 40% = $16,000
BB Ltd.: $40,000 * 40% = $16,000
AA Ltd.: $40,000 * 20% = $8,000

Calculation of ALP for BB Ltd:

Particulars	**Amount**
Cost incurred by BB Ltd.	$42,000
Add: Profit distribution	$16,000
ALP	$58,000
Profit to be increase of BB Ltd. : $58,000 – $50,000	$8,000

Suppose in the above example, allocate $30,000 profit on routine contribution ratio i.e. 40:40:20 and balance $10,000 profit based on each party's ownership of non-routine intangibles & ratio of the same is equal.
So, $30,000 shall be distributed in the ratio of 40:40:20 and balance $10,000 shall be distributed in 1:1:1.

Distribution of profits for BB Ltd.	**Amount**
Distribution of $30,000 (40:40:20)	$12,000
Distribution of $10,000 (1:1:1)	$3,333.33
Profit For BB Ltd.	**%15,333.33**

5) **Transactional Net Margin Method:**
Under the transactional net margin method (TNMM), an arm's-length price is determined by comparing the net profit margin in relation to an appropriate base (example costs, sales, assets) of the tested party with the net profit margin in relation to the same base, of an uncontrolled party engaged in comparable transactions.

The following steps are required to determine ALP using TNMM:

Steps	Particulars
1	Computation of net profit margin realized by the enterprise from the international transaction with an AE.
2	Computation of net profit margin realized by the enterprise or an unrelated enterprise in a comparable uncontrolled transaction.
3	Net profit margin realized from uncontrolled transaction is adjusted to account for differences, if any, which could materially affect the net profit margin in the open market.
4	The net profit margin realized by the enterprise referred in (1) above is established to be the same as net profit margin referred in (3) above.
5	The net profit margin thus established is taken into account to arrive at an arm's length price for the international transaction.

Illustration:

Amber Corporation, having its business in Malaysia, has advanced a loan of MD 1,70,000 to Amber Ltd, India. Book value of total assets of Amber Ltd. was Rs. 150 lakhs. Amber Ltd. provides software backup support to Amber Corporation. Amber Ltd. has spent 60,000 man hours during the financial year 2021-22 for the services rendered to Amber Corporation. The cost for Amber Ltd. is MD 75/manhour. Amber Ltd. has billed Amber Corporation at MD 90/manhour.

Gama Ltd. in India which has a similar business model, provides software backup support to Olive Ltd. in Penang, Malaysia. Gama Ltd.'s cost and operating profits are as hereunder:

Particulars	Rs. in lakhs
Direct costs	500
Indirect costs	300
Operating profits	200

1. Calculate Arm's Length Price for the transaction between Amber Ltd. and Amber Corporation based on the above data of Gama Ltd. using the Transactional Net Margin Method. Assume 1 MD = Rs. 48.
2. Explain, if there is any adjustment to be made to the total income of Amber Ltd.

Answer:

Two enterprises are deemed to be associated enterprises where one enterprise advances loan constituting not less than 51% of the book value of the total assets of the other enterprise.

In this case, since Amber Corporation, a foreign company, has advanced loan to Amber Ltd., an Indian company, and such loan constitutes 54.4% [Rs. 48 x 1,70,000 x 100/1,50,00,000] of the book value of total assets of Amber Ltd., Amber Corporation and Amber Ltd. are deemed to be associated enterprises.

Since the transaction of provision of software backup support by Amber Ltd. to Amber Corporation is an international transaction between associated enterprises, the provisions of transfer pricing would be attracted in this case.

Determination of Operating Margin of transaction of provision of software backup support by:

Particulars	**Rs.**
Billing per manhour [MD 90/hour * Rs. 48]	4,320
Cost per man hour [MD 75/hour * Rs. 48]	3,600
Operating profit per manhour	720
Operating profits to cost (%) [720*100/3,600]	20%

Determination of Operating Margin of Comparable Uncontrolled Transaction i.e., provision of software backup support. by Gama Ltd. to Olive Ltd.:

Particulars	Rs. in lakhs
Direct costs	500
Indirect costs	300
Total cost	800
Operating profits	200
Operating profits to cost (%) [200*100/800]	25%

Computation of Arm's Length Price of provision of software backup support provided by Amber Ltd. to Amber Corporation by applying TNMM:

Particulars	Rs.
Cost for Amber Ltd. (per man hour) [MD 75 * Rs. 48]	3,600
Add: Arm's length operating profit margin as % of cost (25% of 3,600)	900
Arm's length price (per man hour)	4,500
Arm's length price of total manhours spent by Amber Ltd. for providing software backup support to Amber Corporation [Rs. 4,500 x 60,000 man hours] = Rs. 27,00,00,000	

Adjustment to be made to the total income of Amber Ltd.

Particulars	Rs.
Arm's length price of total manhours spent by Amber Ltd. for providing software backup support to Amber Corporation	27,00,00,000
Less: Amount actually billed [90 MD * Rs. 48/MD * 60,000 man hours]	25,92,00,000
Arm's length adjustment to be made to the total income of Amber Ltd.	1,08,00,000

6) **Any other method** as may be prescribed by the CBDT:
The other method allows the use of 'any method' which takes into account
   a) the price which has been charged or paid or
   b) would have been charged or paid for the same or similar uncontrolled transactions with or between non-associated enterprises, under similar circumstances.

The various data which may possibly be used for comparability purposes under this method could be third party quotations, valuation reports, tender/bid documents, documents relating to the negotiations, standard rate cards, commercial and economic business models, etc.

Methods for Computing ALP & its application		
No.	**Methods**	**Application**
1	CUP Method	This method is applied where there are similar transaction(s) between unconnected parties.
2	Resale Price Method	This method is applied where item obtained from AE is resold to unrelated party.
3	Cost Plus Method	This method is generally applied where semi-finished goods are sold to AEs.
4	Profit Split Method	This method is applied where there is transfer of unique intangibles or in multiple international transactions.
5	Transactional Net Margin Method	Compute Net Profit (NP) margin of the enterprise from International Transaction with AE having regard to cost incurred/sales effected/assets employed.

11. Selection of Tested Party

Concept of tested party does not find any specific mention in Indian transfer pricing regulations. The concept of tested party has been explained in detail in the transfer pricing guidelines issued by OECD and Practice Manual issued by United Nations from time to time.

The tested party will be the participant in the controlled transaction whose profitability/ pricing attributable to the controlled transactions can be verified based on the most appropriate data and requiring the fewest & most reasonable adjustments, and for which reliable data regarding uncontrolled comparables can be located.

Consequently, in most cases, the tested party will be the "least complex" of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.

12. <u>Documentation and Compliances under Income Tax Act, 1961</u>

Transfer pricing documentation is the documentation maintained to review transfer pricing arrangements for transactions taking place between different entities of the same group (also known as intra-group transactions). The primary objective of the transfer pricing documentation is to review the arm's length nature of the transactions taking place between different entities of an multi-national company.

- **Persons responsible for keeping and maintaining prescribed information and document:** Section 92D imposes responsibility on every person,
  - (i) who <u>*enters into an international transaction*</u> to keep and maintain such information and documents in respect thereof as may be prescribed;
  - (ii) being a <u>*constituent entity of an international group*</u>, to keep and maintain the prescribed information and document in respect of an international group.

    The constituent entity is required to keep and maintain the information and document irrespective of the fact **whether or not any international transaction is undertaken** by such constituent entity.
- **Information and documents to be kept and maintained for prescribed period** - The CBDT is empowered to prescribe the period for which the information and documents shall be kept and maintained.
- The Assessing Officer or the Commissioner (Appeals) may, in the course of any proceedings under the Income-tax Act, require any person who has entered into an international transaction to furnish any such prescribed information or documents within a period of **30 days** from the date of receipt of a notice issued in this regard.
- **Audit Report [Section 92E]:** Under section 92E, every person who enters into an international transaction during a previous year is required to obtain a report from a chartered accountant and furnish such report on or before the specified date in the prescribed form.
  - Rule 10E provides that the auditor's report shall be in Form No. 3CEB.
  - It requires the auditor to state that he has examined the accounts and records of the assessee relating to the international transactions entered into by the assessee during the relevant year.
  - He has also to give his opinion whether the prescribed information and documents relating to the above transactions have been kept by the assessee.

13. <u>Secondary Adjustment [Section 92CE]</u>

Meaning of Primary Adjustment and Secondary Adjustment

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

"Secondary adjustment" means an adjustment in the books of accounts of the assessee and its associated enterprise to reflect that the actual allocation of profits between the assessee and its associated enterprise are consistent with the transfer price determined as a result of primary adjustment, thereby removing the imbalance between cash account and actual profit of the assessee.

14. <u>Safe Harbour Rules</u>

Section 92CB provides that determination of

- income referred to in section 9(1)(i); or
- arm's length price under section 92C or Section 92CA

shall be subject to Safe Harbour Rules. Section 92CB(2) empowers the CBDT to prescribe safe harbour rules.

'Safe Harbour' means circumstances in which the income-tax authorities shall accept the transfer price or income, deemed to accrue or arise under section 9(1)(i), as the case may be, declared by the assessee.

15. <u>Advance Pricing Agreements (APA)</u>

An APA is an agreement between a tax payer/ applicant and the CBDT, which determines the arm's length price of future inter-company transactions. It can also be used for existing inter-company transactions. The tax payer/applicant mutually agree on the transfer pricing methodology to be applied and its application, in relation to the taxpayer's international transactions for certain future period of time.

A) **Types of APA:** The APA scheme can be divided in three types of APA's, viz.
   - Unilateral APA – Agreement between the assessee and CBDT.
   - Bilateral APA – Agreement between the assessee and CBDT subsequent to and based on agreement between competent authorities of India with the competent authority in the other country regarding appropriate transfer pricing method or the ALP.
   - Multilateral APA - Agreement between the assessee and CBDT subsequent to and based on agreement between competent authorities of India with the competent authorities in the other countries regarding appropriate transfer pricing method or the ALP.

B) **Advantages of APA program:** The APA program is designed to:
   - Provide certainty with regard to determination of ALP of the international transaction;
   - Impart flexibility in developing practical approaches for complex transfer pricing issues;
   - Reduce the risk of potential double taxation through bilateral and multi-lateral APA;
   - Reduce compliance costs by eliminating the risk of transfer pricing audit and resolving long drawn and time consuming litigation;

- Reduce the burden of record keeping, as the taxpayer knows in advance the required documentation to be maintained to substantiate the agreed terms and conditions of the agreement.

C) Applicability of APA:

Section 92CC enables the CBDT (with the approval of the Central Government), to enter into an APA with any person determining the –

(i) arm's length price or specifying 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;

(ii) income referred to in section 9(1)(i), or specifying the manner in which said income is to be determined, as is reasonably attributable to the operations carried out in India by or on behalf of that person, being a non-resident.

D) Purpose of APA: The APA shall relate to an international transaction to be entered into by such person. The APA shall be entered into for the purpose of determination of the

a) arm’s length price or specifying the manner in which arm’s length price shall be determined, in relation to such international transaction.

b) income referred to in section 9(1)(i), or specifying the manner in which said income is to be determined, as is reasonably attributable to the operations carried out in India by or on behalf of that person, being a non-resident.

E) Manner of determination of Arm’s Length Price in APA: The manner of determination of arm’s length price or the income referred above may include methods referred to in section 92C(1) or any other method provided by rules made under the Act with necessary adjustments or variations.

F) Validity of APA: The APA shall be valid for such period as specified in the agreement, which shall in no case exceed five consecutive previous years.

G) Binding nature of APA: The APA so entered into shall be binding on:

(i) the person in whose case, and in respect of the transaction in relation to which, the APA has been entered into; and

(ii) the Principal Commissioner or Commissioner and the income-tax authorities subordinate to him, in respect of the said person and the said transaction.

The <u>APA shall not be binding</u> if there is any change in law or facts having bearing on such APA.

Test Your Knowledge

QUESTIONS	
1.	Mr. Hani holds 35% of voting power in KK Ltd., a company incorporated under the laws of Country A. For the purpose of expansion of business, the said company enters into an agreement with JB Ltd., a company incorporated under the Indian laws. As per one of the clauses of the agreement, KK Ltd. has the power to appoint 6 directors of JB Ltd. which has 12 directors on the board. Further, total purchases by JB Ltd. for the F.Y. 2021-22 is estimated to be Rs. 400 crores, out of which, purchases of Rs. 40 crores has been sourced locally and the balance shall be supplied by KK Ltd. The price for entire purchase has been fixed in the agreement and the conditions for supply are determined by KK Ltd. Advise Mr. Hani as to whether KK Ltd and JB Ltd are Associated Enterprises, on the basis of the provisions of the Income-tax Act, 1961.
2.	King Inc, a US company having its place of effective management also in the USA, has advanced a loan equivalent to Rs. 150 crores to Gagan Ltd., an Indian company on 10-4-2021. The total book value of assets of Gagan Ltd. is Rs. 250 crores. The market value of the assets, however, is Rs. 350 crores. Gagan Ltd. repaid Rs. 25 crores before 31-3-2022. Whether the two enterprises referred to can be deemed to be associated enterprises under Indian transfer pricing regulations?
3.	Examine whether transfer pricing provisions under the Income-tax Act, 1961 would be attracted in respect of the following cases – 1. Transfer of process patents by R Ltd., an Indian company, to CC Inc., a US company, which guarantees 15% of the total borrowings of R Ltd. 2. Purchase of machinery by Beta Ltd., an Indian company, from Papa Jo, a German company. Beta Ltd. is the subsidiary of Papa Jo.

<table>
<tr><th colspan="2">SOLUTIONS</th></tr>
<tr><td>1.</td><td>Two enterprises shall be deemed to be associated enterprises if, at any time during the previous year, more than half of the board of directors or members of the governing board, or one or more of the executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise.

In the present case, the power to appoint is only for half the number and not more than half. Hence, KK Ltd. and JB Ltd. are not associated enterprises under this criteria.

Moreover, two enterprises shall be deemed to be associated enterprises, if 90% or more of the raw materials and consumables required for the manufacture or processing of goods or article 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.

In this case, KK Ltd. supplies more than 90% of the requirements of purchases of JB Ltd. Further, the price is controlled by the former by way of written agreement. Also, the conditions for supply are determined by KK Ltd. Hence, the two entities would be deemed to be associated enterprises under this criterion.</td></tr>
<tr><td>2.</td><td>Kings Inc, a foreign company, has advanced loan of Rs. 120 crores to Gagan Ltd., an Indian company, which amounts to 60% of book value of assets of Gagan Ltd. Since the loan advanced by King Inc. is 51% or more of the book value of assets of Gagan Ltd, King Inc. and Gagan Ltd. are deemed to be associated enterprises under the Indian transfer pricing regulations.

The deeming provisions would be attracted even if there is a repayment of loan during the same previous year which brings down the said percentage below 51%.</td></tr>
<tr><td>3.</td><td>1. The scope of the term “intangible property” includes, inter alia, process patents, which is a technology related intangible asset. Transfer of intangible property falls within the scope of the term “international transaction”. Since CC Inc., a US company, guarantees not less than 10% of the total borrowings of R Ltd., an Indian company, CC Inc. and R Ltd. are deemed to be associated enterprises under section 92A(2). Therefore, since transfer of process patents by R Ltd., an Indian company, to CC Inc., a US company, is an international transaction between associated enterprises, the provisions of transfer pricing are attracted in</td></tr>
</table>

	this case. 2. Purchase of tangible property falls within the scope of “international transaction”. Tangible property includes machinery. Papa Jo and Beta Ltd. are associated enterprises under section 92A, since Papa Jo is a holding company of Beta Ltd. Therefore, purchase of machinery by Beta Ltd, an Indian company, from Papa Jo, a German company, is an international transaction between associated enterprises, and consequently, the provisions of transfer pricing are attracted in this case.

Transfer Pricing and Allocation of Business Profits

Module II Attribution of Profits

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3.	Functional Analysis in Highly Integrated Value Chains	
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9.	Alternative Transfer Pricing Rules (African Countries)	
	Test Your Knowledge	

1. Introduction

Transfer prices are valuations of products within a firm and represent a common and important instrument of managerial accounting, financial accounting, and taxation. Most of the objectives ascribed to transfer prices are captured by the functions of coordination and profit allocation.

The definition of permanent establishment (PE) included in tax treaties is crucial in determining whether a non-resident enterprise must pay income tax in another State. To prevent the use of certain common tax avoidance strategies that have been used to circumvent the existing PE definition, the Report on *Preventing the Artificial Avoidance of Permanent Establishment Status* (Action 7 Report, OECD 2015) recommended changes to the definition of PE in Article 5 of the OECD Model Tax Convention, which is widely used as the basis for negotiating tax treaties, as a result of the work on Action 7 of the BEPS Action Plan.

In particular, that Report contained changes to tackle arrangements through which a non-resident enterprise makes sales in a jurisdiction through a commissionnaire or a dependent agent that does not formally conclude contracts in the jurisdiction, thereby avoiding taxation in the jurisdiction despite having the type of economic nexus that justifies the recognition of a taxable presence.

The OECD has recommended changes to Tax Treaties to prevent Artificial Avoidance of Permanent Establishment (PE) Status. Those changes will be made through Multi-Lateral Instrument (MLI). Among other things, the changes make the criteria for formation of Dependent Agency PE stricter.

2. Role of Transfer Pricing Rules in Business Profit Allocation

The role of Transfer Pricing Rules in allocation of business profits among different profit units of an entity is directly linked to the computation of Arm's Length Price. The various roles played by transfer pricing rules in allocation of business prfit are as follows:

(i) **Establishes parity between MNCs and independent enterprises** – A major reason is that the Transfer Pricing provides broad parity of tax treatment for MNCs and independent enterprises. Since it puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages and disadvantages that would otherwise distort the relative competitive positions of these entities. Thus, it promotes the growth of international trade and investment by removing these tax considerations from economic decisions.

(ii) **Determination of real taxable profits -** The transfer price adopted by a multinational has a direct bearing on the proportional profit it derives in each country in which it operates. If inadequate or excessive consideration is paid for the transfer of goods, services or intangible property between the members of an MNC group, the income calculated for each of those members will be inconsistent with their relative economic contributions. An 'arm's length' price – a price two independent firms operating at arm's length would agree on – is needed to determine taxable profits earned in each country. The arm's length doctrine permits the taxing authorities to rectify the accounts of the enterprise so as to reflect correctly the income that the establishment would have earned if it were an independent enterprise.

(iii) **Reduces artificial price distortion -** If transfer pricing is not followed, an MNC will sell goods/ provide services to a controlled entity in a high tax regime at a high price (which exceeds the market price) and to an entity in a low-tax regime or a tax haven at a low price (which is lower than the market price). This would result in extreme price distortion of goods and services in the international market.

(iv) **Minimization of double taxation** – Transfer Pricing is an international concept and it represents the international norm. The potential for double taxation is minimized, since in international transfer pricing, adjustment to the transfer price in one tax jurisdiction requires a corresponding adjustment in the other tax jurisdiction.

(v) **Accurate measurement of economic contribution** – Transfer Pricing provides accurate measurement of the fair market value of the economic contribution units of an MNC. The focus of transfer pricing is to ensure that the proper amount of income is attributed to where it is earned. This result in each unit of the MNC earning a return commensurate with its economic contribution and risk assumed.

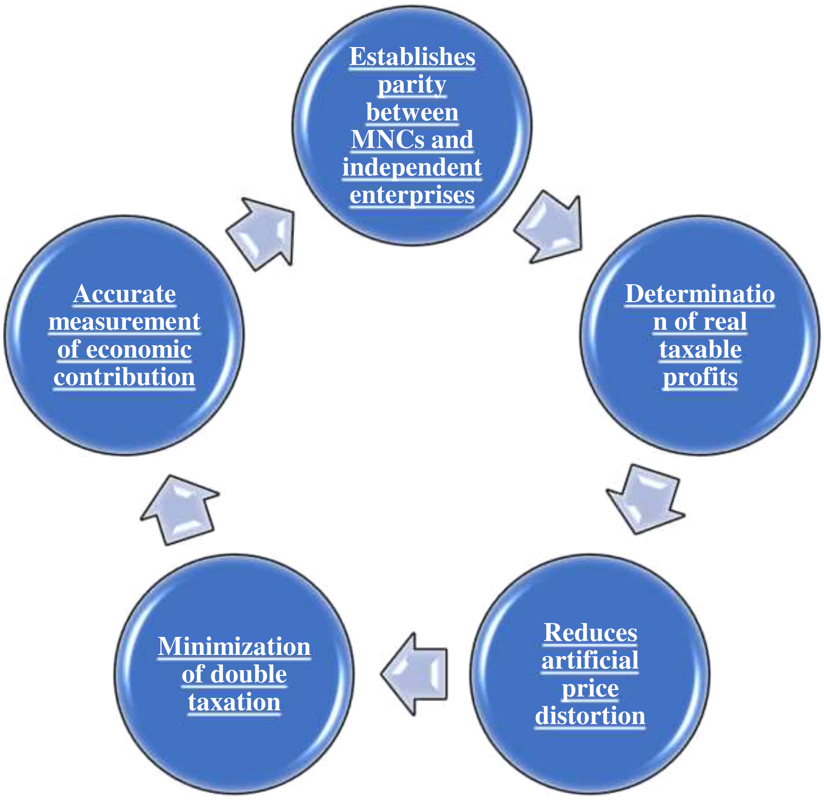


Fig. Role of Transfer Pricing Rules in Business Profit Allocation

3. Functional Analysis in Highly Integrated Value Chains

The Organisation for Economic Co-operation and Development (OECD) 2017 edition of the Transfer Pricing Guidelines provides an explanation of what a functional analysis is, where it states that the functional analysis is used for transfer pricing purposes and it analyses the functions performed (taking into account assets used and risks assumed) by associated enterprises in a transaction.In order to determine arm's length transfer pricing, multinational enterprises (MNEs) must identify, by means of a functional analysis, which members of the MNE group perform or exercise control over functions, provide assets and assume risks associated with the transaction.

For transactions between two independent enterprises, the compensation will usually depend on the functions that each enterprise performs.The functional analysis is important as it provides an overview of value creation within the supply chain in general and the related party transaction in particular. It provides an understanding of the relative contributions of the parties to the transaction and their roles in overall value creation.

In determining, whether controlled and uncontrolled transactions or entities are comparable, a functional analysis is necessary. This functional analysis seeks to identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions.It will also be relevant to determine the legal rights and obligations of the taxpayer in performing its functions.

The functions carried out (taking into account the assets used and the risks assumed) will determine to some extent the allocation of risks between the parties, and therefore the conditions each party would expect in arm's length dealings.

4. Information Asymmetry

Information asymmetry is referred to as the extensive information available to the taxpayer and the absence of information available to the tax administration, other than what the taxpayer may present. Such information asymmetry restricts the ability of tax administrations to establish or verify, at an early stage, the developments or events that might be considered relevant for the pricing of a transaction involving the transfer of intangibles or rights in intangibles, as well as the extent to which the occurrence of such developments or events, or the direction they take, might have been foreseen or reasonably foreseeable at the time the transaction was entered into.

Information asymmetry between the taxpayer and the tax administration, including the information taken into account by the taxpayer in the pricing transaction, can be acute and the tax administration may face difficulty on the extent to which the pricing is determined.

As a result, it will prove difficult for a tax administration to conduct a risk assessment for transfer pricing purposes, to evaluate the reliability of the information on which pricing has been based by the taxpayer, or to consider whether the intangible or rights in intangibles have been transferred at undervalue or overvalue compared to the arm’s length price, until ex post outcomes are known in years subsequent to the transfer.

5. Hard-to-value Intangibles (HTVI)

The hard-to-value-intangibles (HTVI) approach is the outcome of the work done under BEPS Action 8, and is aimed at preventing base erosion and profit shifting by moving intangibles among group members. The HTVI approach protects tax administrations from the **negative effects of information asymmetry between tax administration and taxpayers** by ensuring that tax administrations can consider ex post outcomes as presumptive evidence about the appropriateness of ex-ante pricing arrangements by determination of the arm’s length pricing arrangements that would have been made between independent enterprises at the time of the transaction.

However, the ex post evidence should not be used without considering whether the information on which the ex post results are based could or should reasonably have been considered by the associated enterprises at the time the transaction was entered into.

The hard-to-value intangibles (HTVI) recommendations included in the final report on BEPS Actions 8-10 are intended to address perceived information asymmetries between tax administrations and taxpayers whereby tax administrations may,

1. lack access to information.
2. too reliant on "specialized knowledge, expertise, and insight" provided by the taxpayer.
3. incapable of determining whether the differences between projected results used to set the transfer pricing (ex-ante) and the actual results (ex-post) were due to unforeseen developments or faulty transfer pricing.

HTVI are defined as intangibles or rights in intangibles for which, at the time of the transaction, no reliable comparable existed, and projections of future cash flows expected to be derived from the transferred intangible or assumptions used in valuing the intangibles were highly uncertain.

5.1 Characteristics of HTVI

HTVI possess one or more of the following characteristics:

1. The intangible is only **partially developed** at the time of the transfer.
2. It is **not** expected to be **exploited commercially** until several years following the transaction.
3. It is **integral to the development of othe**r hard-to-value intangibles.
4. It is expected to be **exploited in a novel manner**, making reliable projections from past developments unavailable.
5. It is transferred to an associated enterprise for a **lump sum payment.**
6. It is used in connection with, or developed under, a **cost contribution arrangement** or similar arrangements.

Given these broad features, many intangibles will be included under the proposed HTVI analysis. The **new guidance uses actual financial outcomes** to evaluate intangible transfers or license arrangements related to HTVI under certain conditions.

5.2 Presumption

It is presumed barring unforeseen events, that the transfer pricing is not at arm's length if there are material differences between the forecasts used to price the transaction and the actual results.

5.2.1 Exemption from Presumption

The taxpayer has the possibility to rebut such presumptive evidence by demonstrating the reliability of the information supporting the pricing methodology adopted at the time the controlled transaction took place.

Additional exemption based on one of the following exemptions:

1. The taxpayer documented how the original projections were determined, including how reasonably foreseeable events and risks were considered and the probabilities assigned to those events. In addition, the taxpayer must provide reliable evidence that any significant difference between the financial projections and the actual outcome is due to unforeseeable events, or that the probability of the occurrence of foreseeable outcomes at the time of the transactions was not significantly overestimated or underestimated. An unforeseeable event is a low-probability event that could not be foreseen, such as a natural disaster.

2. The transfer of the HTVI was covered by a bilateral or multilateral advance pricing arrangement.

3. Any significant differences between the financial projections and the actual outcomes do not cause the projected compensation for the HTVI to deviate by more than 20 percent.

4. The HTVI has generated unrelated party revenues for the transferee for a five-year commercialization period, and any difference between the financial projections and the actual outcomes was less than or equal to 20 percent of the forecasts for that period.

Some of the practical ways in which the approach to HTVI can be applied are illustrated in the examples provided ahead. The application of the approach to HTVI should be underpinned by the following principles:

- Where the HTVI approach applies, tax administrations can consider ex post outcomes as presumptive evidence about the reasonableness of the assumptions of the ex ante pricing arrangements.

- The ex post outcomes inform the determination of the valuation that would have been made at the time of the transaction; however, it would be incorrect to base the valuation on the actual income or cash flows without taking into account whether the associated enterprises could or should reasonably have known and considered, at the time of the transfer of the HTVI, the information related to the probability of achieving such income or cash flows.

- Where a revised valuation shows that the intangible was transferred at an undervalue or overvalue compared to the arm’s length price, the revised price of the transferred intangible may be assessed to tax taking into account price adjustment clauses and/or contingent payments, irrespective of the payment profiles asserted by the taxpayer.

- Tax administrations should apply audit practices to ensure that presumptive evidence based on ex post outcomes is identified and acted upon as early as possible.

Example 1

Para 1: Company A, a resident of Country A, has patented a pharmaceutical compound. Company A has concluded pre-clinical tests for the compound and has successfully taken the compound through Phases I and II of the clinical trials. Company A transfers in Year 0 the patent rights to an affiliate, Company S, a resident of Country S. Company S will be responsible for the Phase III trials following the transfer. In order to determine the price for the patent on the partially developed drug, the parties made an estimation of expected income or cash flows that will be obtained upon exploitation of the drug once finalised over the remaining life of the patent. Assume the price so derived at the time of the transfer was 700 and that this was paid as a lump sum in Year 0.

Para 2: In particular, the taxpayer assumed sales would not exceed 1,000 a year and that commercialisation would not commence until Year 6. The discount rate was determined by referring to external data analysing the risk of failure for drugs in a similar therapeutic category at the same stage of development. Even if the tax administration of Country A had been aware of these facts relating to the transfer of the patent rights in Year 0, it would have had little means of verifying the reasonableness of the taxpayer's assumptions relating to sales.

Scenario A

In Year 4, the tax administration of Country A audits Company A for Years 0-2 and obtains information that commercialisation in fact started during Year 3 since the Phase III trials were completed earlier than projected. Sales in Years 3 and 4 correspond to sales that were projected, at the time of the transfer, to be achieved in Years 6 and 7. The taxpayer cannot demonstrate that its original valuation took into account the possibility that sales would arise in earlier periods, and cannot demonstrate that such a development was unforeseeable.

The tax administration uses the presumptive evidence provided by the *ex post* outcome to determine that the valuation made at the time the transaction took place did not consider the possibility of sales occurring in earlier years. The taxpayer's original valuation is revised to include the appropriately risk-adjusted possibility of earlier sales resulting in a revised net present value of the drug in Year 0 of 1,000 instead of 700. The revised net present value also takes into account the functions performed, assets used and risks assumed in relation to the HTVI by each of the parties before the transaction and reasonably anticipated, at the time of the transaction, to be performed, used or assumed by each of the parties after the transaction. Therefore, assume for the purposes of the example that the arm's length price anticipated in Year 0 should have been 1,000. Note that the value of 1,000 is not necessarily the net present value of the transferred rights based solely on the actual outcome.

In accordance with the approach to HTVI, the tax administration is entitled to make an adjustment to assess the additional profits of 300 in Year 0.

Scenario B

The tax administration uses the presumptive evidence provided by the *ex post* outcomes to determine that the valuation made at the time the transaction took place, did not consider the possibility of sales occurring in earlier years. The taxpayer's original valuation is revised to include the appropriately risk-adjusted possibility of sales occurring in earlier years resulting in a revised net present value of the drug in Year 0 of 800 instead of 700. Therefore, assume for the purposes of the example that the arm's length price anticipated in Year 0 should have been 800. Note that the value of 800 is not necessarily the net present value of the transferred rights based solely on the actual outcome (see paragraph 6 of this guidance).

In accordance with the approach to HTVI, the tax administration is entitled to make an adjustment to assess the additional profits of 100 in Year 0. However, in this example, the exemption provided by item (iii) in paragraph 6.193 applies since the adjustment to the compensation for the transfer is within 20% of the compensation determined at the time of the transaction.

Example 2

The facts are the same as in paragraphs 1-2 above in Example 1. Based on those facts, assume that in Year 7, the tax administration of Country A audits Company A for Years 3-5 and obtains information that sales in Years 5 and 6 of the product to which the patent relates were significantly higher than those projected. In the original valuation, the taxpayer had not projected sales any higher than 1,000 in any year, but outcomes in each of Years 5 and 6 show sales of 1,500. The taxpayer cannot demonstrate that its original valuation took into account the possibility that sales would reach these levels, and cannot demonstrate that reaching that level of sales was due to an unforeseeable development.

The tax administration uses the presumptive evidence provided by the *ex post* outcomes to determine that the possibility of higher sales should have been taken into account in the valuation. The taxpayer's original valuation is revised to include the appropriately risk-adjusted possibility of sales occurring in earlier years, resulting in a revised net present value of the drug in Year 0 of 1300 instead of 700. The revised net present value also takes into account the functions performed, assets used and risks assumed in relation to the HTVI by each of the parties before the transaction and reasonably anticipated, at the time of the transaction, to be performed, used or assumed by each of the parties after the transaction. Therefore, assume for the purposes of the example that the arm's length price anticipated in Year 0 should have been 1300. Note that the value of 1300 is not necessarily the net present value of the transferred rights based solely on the actual outcome.

In accordance with the approach to HTVI, the tax administration is entitled to make an adjustment to assess the additional profits of 600. Assume for the purposes of this example that none of the exemptions listed in paragraph 6.193 of Chapter VI of the Guidelines applies. One way to implement the adjustment is to re-assess the price paid in Year 0. However, the significant revision of the lump-sum payment highlights the risks posed by the high uncertainty in valuing the intangible and gives rise to consideration, in light of this significant uncertainty, of whether adjustments consistent with an alternative payment structure might be more consistent with what unrelated parties would have done.

Evidence of pricing arrangements for the transfer of intangibles in comparable circumstances to address high valuation uncertainty may point to appropriate alternatives to making the adjustment in Year 0. For example, assume that in the pharmaceutical sector it is common to transfer patent rights to independent parties through a combination of an initial lump sum payment and additional contingent payment arrangements based on the successful completion of development phases or regulatory approvals in a particular market. In this case, assume that the first market approvals were obtained in Year 3. The tax administration may, therefore, determine that it is consistent with arm's length practices in comparable circumstances to recover the underpayment through a further payment in Year 3. Note that this paragraph is not intended to, and does not, imply that modification of the payment form can only occur when there is a common practice in the relevant business sector regarding the form of payment for the transfer of a particular type of intangible.

The principles illustrated by this example apply irrespective of whether the tax administration in fact carries out an audit for Years 0-2 and then a second audit for Years 3-5, or whether it audits only for Years 3-5. In both scenarios, a revision to the original valuation is justified based on *ex post* evidence emerging in Year 7, and, subject to any treaty or domestic law limitations, the undervaluation may be recovered based on the HTVI approach.

6. OECD Transfer Price Report

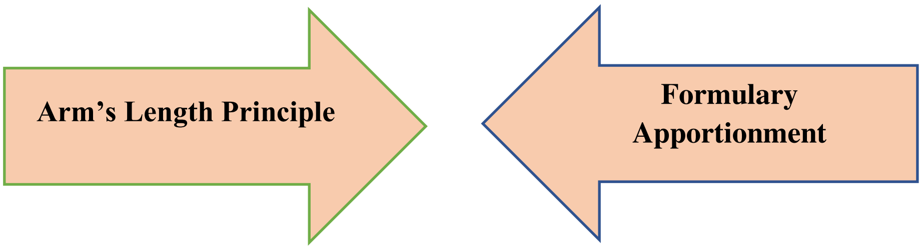
The growth of MNEs presents increasingly complex taxation issues for both tax administrations and the MNEs themselves since separate country rules for the taxation of MNEs cannot be viewed in isolation but must be addressed in a broad international context. The need to comply with laws and administrative requirements that may differ from country to country creates additional problems.

In a global economy where MNEs play a prominent role, governments need to ensure that the taxable profits of MNEs are not artificially shifted out of their jurisdiction and that the tax base reported by MNEs in their country reflects the economic activity undertaken therein. For taxpayers, it is essential to limit the risks of economic double taxation.

To ensure the correct application of the separate entity approach, OECD member countries have adopted the “arm’s length principle”. The Committee on Fiscal Affairs, which is the main tax policy body of the OECD, has issued a number of reports relating to the application of Treaty Articles to MNEs and to others.

In applying the foregoing principles to the taxation of MNEs, one of the most difficult issues that has arisen is the establishment for the tax purposes of appropriate transfer prices. The OECD Transfer Pricing Guidelines provide guidance on the application of the “arm’s length principle”, which is the international consensus on the valuation of cross-border transactions between associated enterprises. The OECD Transfer Pricing Guidelines were approved by the OECD Council in their original version in 1995.

7. Approaches to Transfer Pricing



7.1 The Arm's Length Principle

"The arm's length principle is an international standard that compares the transfer pricing charged between related entities with the price of similar transactions carried out between independent entities at arm's length. An adjustment may be made to the extent that profits of a related party differ from those that would be agreed between independent entities in similar circumstances."

- *United Nations Practical Manual on Transfer Pricing for Developing Countries (2017)*

Well recognized and accepted international principle which is the foundation of modern transfer pricing laws.

7.2 Formulary Apportionment

Apportioning profits proportionately based on global sales and Function, Asset and Risk (FAR) factors. It can work only when it is implemented globally in a standardized manner across jurisdictions. It is an approach to allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined formula.

7.2.1 How would Formulary Apportionment Work?

- Under the current global system, multinational firms determine their profits separately in each tax jurisdiction in which they operate.
- An alternative system would allocate a firm's worldwide income across countries using a formula based on some combination of its sales, assets, and payroll in each jurisdiction.
- An alternative formula would base a corporation's taxes only on the fraction of its worldwide sales destined for domestic consumers, a so-called "destination-based" corporate profits tax.

7.2.2 Advantages

1. Removes current artificial incentive for multinationals to shift reported income to low-tax locations.
2. Tax liabilities, instead, would be allocated by a measure (or measures) of their real economic activity in each location.
3. Reduce the tax system's complexity and the administrative burden it imposes on entities.
4. There would be no need for transfer-pricing rules for intra-group transactions, which would remove a major source of dispute between corporations and tax authorities.
5. Controlled Foreign Corporation (CFC) rules would be redundant since all profits assigned to foreign activities would be exempt. For this reason, there would also no longer be a need for foreign tax credits.
6. Shift to formulary apportionment can be made revenue neutral by reducing corporate tax rates.
7. It would make a multinational corporation's tax liability independent of both its legal residence and its legal form (for example, branch or subsidiary).
8. It would remove any incentive for corporate inversions in which firms from two countries merge and establish their residence in a low-tax country to reduce their tax liabilities.

7.2.3 Disadvantages

1. Difficult in designing and implementing a global formulary apportionment system.
2. Such a system would create new incentives for tax avoidance and could increase the incentive to shift real investments to low-tax countries.
3. It would require an agreement among the major economies to scrap the current separate-entity system and to agree on how to allocate corporate income among jurisdictions.
4. It would also require agreement on common accounting methods for measuring corporate profits.
5. A unilateral move by any country to formulary apportionment would result in double taxation of some multinationals' income and exemption of other income.
6. Introduces new boundary problems between high-tax and low-tax activities.
7. Creates incentives to shift profits between multinationals and separately owned firms - For e.g. if physical assets help determine the location of a multinationals' profits, a firm might well have an incentive to contract its low-margin manufacturing activities in high-tax jurisdictions to independently owned firms instead of establishing a manufacturing subsidiary within the firm to reduce its share of capital assets allocated to high-tax countries.
8. Could worsen the incentive to shift real activities to low-tax countries because intangible assets — a large share of value for many leading multinational companies — are part of a firm's total profits but are absent from the allocation formula.

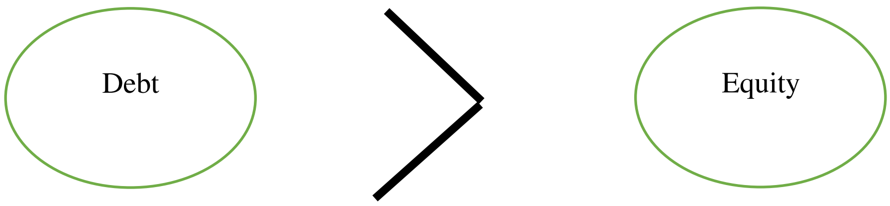
9. Some analysts and commentators favor sales or destination-based allocation of corporate profits because firms are least likely to reduce sales in a jurisdiction simply to reduce tax liability.
10. Documentation and compliance requirements for an application of global formulary apportionment would generally be more burdensome than under the separate entity approach of the arm's length principle.

7.3 Thin Capitalisation Rules - Limitation on Interest Expenses

7.3.1 Introduction

Multinational entities (MNEs) often borrow funds both externally and internally. This could be in the form of external loans or leveraging internally on the funds available within the group to increase their investments and meet their business requirements. MNEs are generally seen at an advantage vis-à-vis local businesses, due to their access to global debt and equity markets, with varying interest rates and borrowing terms.

Debt and equity are two primary sources of finance for any company. A mix of debt and equity in the capital structure of any commercial organisation is dependent on various factors such as capital intensity of the industry they operate in, risk appetite, ability to raise funds through debt, and legal, commercial and tax considerations. **In general, an entity financed through comparatively higher amount of debt as compared to equity is regarded as a thinly capitalised entity**.



While the compensation for debt and equity is interest and dividend respectively, their tax implications are quite different. Dividends are not deductible as an expense for the taxpayers and are generally taxable in the hands of the recipient. On the other hand, in case of debt, interest payments are generally tax-deductible for the taxpayer and taxable in the hands of the recipient. In case a company has high debt, an issue may arise whether the capital structures are devised in a manner that could result in potential claim of higher deduction of interest payment on debts from taxable income.

Simply put, in a situation where a business is financed through relatively higher level of debt as compared to equity contribution from its owners, the taxpayer can claim excessive deduction of interest payment owing to such high debt. Such arrangements may be questioned during revenue audits and taxpayer could be required to substantiate the debt-equity combination, which otherwise may be treated as tax base erosion.

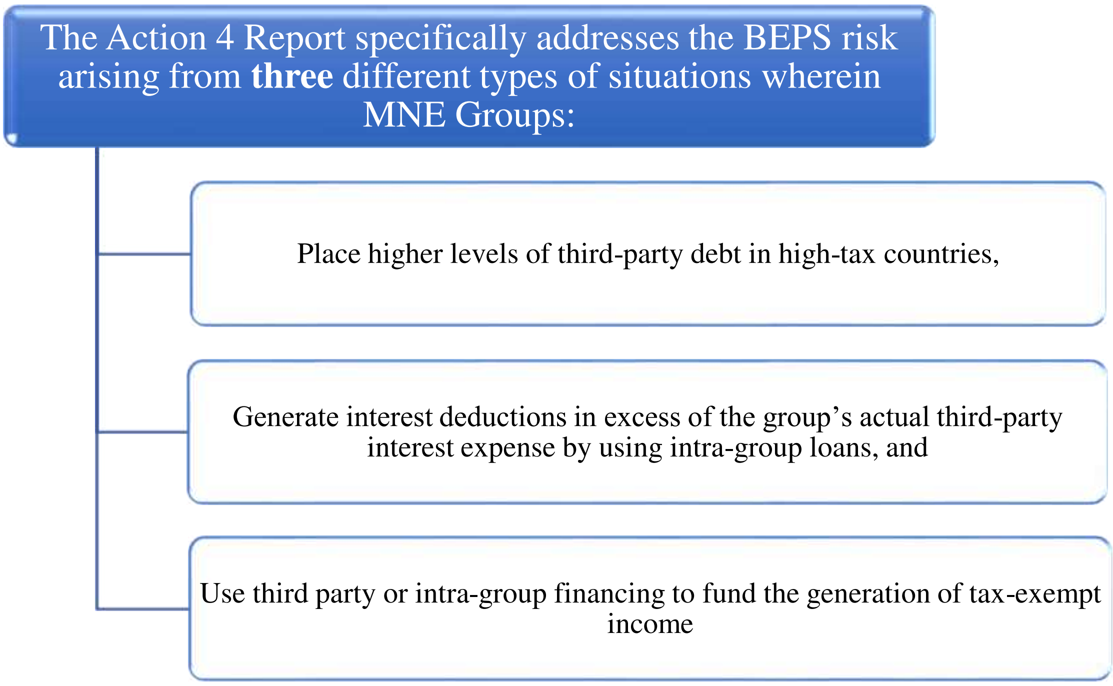


Fig. BEPS Risk Addressed by Action 4 Report

7.3.2 Global Backdrop

The Organisation for Economic Co-operation and Development (OECD) has expressed that multinationals may have certain thinly capitalised entities achieving favourable tax results, which is now a global concern. To counter this issue, called base erosion and profit shifting (BEPS), an initiative of the OECD and the G20 nations adopted the **Action 4 Report titled 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments'.**

Accordingly, the OECD recommended that tax jurisdictions should implement a mechanical rule to limit interest deductions, which may have been undertaken as an instrument for excessive tax deductions.

The following are the methods adopted by some jurisdictions to curb thin capitalisation:

- **Fixed Ratio:** These are the rules that limit the level of interest expenses or debt in a company or an entity, concerning a fixed ratio of debt or equity, interest or earning, etc.
- **Specified Percentage:** These are the rules that disallow a specified percentage of the interest expenses in a company or an entity, regardless of the nature of the payment or to whom the payment is made.
- **Arm's Length Basis:** These are the rules that compare the level of interest or debt in a company or an entity with the position, had the company been dealing entirely with third parties.

- **Anti-Avoidance Rules:** These are targeted anti-avoidance rules that disallow interest on particular transactions.

7.3.3 Implementation of BEPS Action 4 Report in Indian legislation

The Government of India, through Finance Act, 2017, introduced anti-abuse provisions in the Indian tax laws that provides for limitation on interest deduction in certain cases, which is broadly in line with the recommendations as per BEPS Action 4 Report.

❖ **Requirements of Section 94B**

- Section 94B of the Income Tax Act, 1961 provides the provisions for the restriction of interest payments made by a company in India or a foreign company that is permanently set up in India to its Associated Enterprise that is established abroad.
- Interest Payments should be restricted to a 30 per cent of the revenue before any interests, taxes, depreciation and amortisation or interests paid to an Associated Enterprise, whichever may be less. A period of 8 years is permitted to carry the disallowed potion forward. Moreover, the provisions offered by the Section would be applicable if an interest payment exceeds INR 1 Crore only.
- The following example will help to understand this better. Suppose, the Earnings before interest, tax, depreciation and amortisation (*EBITDA*) of an Indian Company is INR 200 Crores. The total interest payment would be INR 65 Crores which would be split as INR 45 Crores to Non-Associate Enterprise and INR 20 Crores to Associate Enterprise.
- The disallowance would be calculated as lower of 30% of the amount of tax sought to be evaded, or 20% of the sum totally payable to the associated enterprise. For example, out of Rs. 5 crores, INR 20 lakhs would be payable as a penalty to the Income Tax Department.

❖ **Applicability:**

As per the provisions provided in Section 94B, this section would apply under the following conditions.

- If the borrower is either an Indian Company or a permanent establishment for a foreign company in India.
- If the lender is a company that is located abroad and is an Associate Enterprise within the aspects mentioned under Section 92A of the Income Tax Act.
- If the expense is deductible under the head Profits and Gains of Business or Profession.
- If the expense is like interest, discount or any other similar finance charges and includes the debt in the form of a loan, financial lease, financial instrument,

financial derivative or other arrangements that give rise to the expenses mentioned above.

It should be noted that if the borrowing is not from an Associate Enterprise directly, the debt shall also be termed to from an associate enterprise for the section. This also included when the lender, in turn, has borrowed from an associated enterprise of the borrower entity and has in turn on-lent.

- **Exceptions**

Banking and Insurance companies are not included under the rules of the Thin Capitalisation Rules. Non-Banking Financial Companies have not been involved in the exemptions.

- **Impact on A Non-Banking Financial Company**

The provisions of the Section has dramatically affected the Non-Banking Financial Companies and the same has been summarised below for a quick reference.

- Section 94B applies to Non-Banking Financial Companies as the interest expenses of the respective company will be subject to disallowance from the income tax perspective if the threshold limits prescribed by the section are breached.
- One of the major cost components of a non-banking financial company happens to interest expense. These companies take money from investors and provide funds to the earn interest income. Therefore, there happens to be a greater outflow for tax if the company is funded by an Associate Enterprise and exceeds the threshold limit.
- If the parent of a non-banking financial company happens to be a FOCC, the provisions of this section would be applicable apart from the whole transfer pricing provisions and rules, which would add to the cost burden of the company.
- Furthermore, this section has a clause that states so much interest as by an Indian company which has been implicitly or explicitly guaranteed by the Associate Enterprise would be disallowed.
- Similarly, it would be difficult for core investment companies having funds from associated enterprises to survive.
- The purposes of leveraging are to increase the return on equity, reduce tax burdens and maintain the cost of funds facilitating the viability of a business. The disallowance of the interest expenses under this section would force companies to create a sort of balance between the debt and the equity, such that the disallowance may be negated, which would further have an impact on the cost of the funds as well.

- ### Impacts on other sectors

After scrutinising the opinions received from various quarters, the Central Board of Direct Taxes (CBDT) has arrived at the conclusion that this section would have a significant effect on the following sectors, which are listed below.

- **Impact on Start-ups:** Most start-ups are funded by foreign companies that hold significant stakes in the company they are supporting. According to the broad definition of Associated Enterprises in the Section, it may seem like start-ups would have to face hurdles. Furthermore, a start-up procures funding on a guarantee provided by the Associated Enterprise that holds stakes and a guarantee of being covered under the ambit of the provisions will also affect the operations of start-ups.
- **Impact on Infrastructure Companies:** Given that substantial funding is required for an Infrastructure Company, it is primarily funded by an Associated Enterprise, and the provision under the Section is likely to impede operations of an Infrastructure Company. While the regulatory aspects of banks and non-banking financial companies may seem equal, non-financial banking companies are not involved in the exclusion list for the applicability of this section. This certainly has a negative impact on the funds costs and the ability to do business.

- ### Global experience

Many countries have implemented interest limitations rules in various forms, including a) arm’s length rule, by establishing the arm’s length debt amount that an independent party is willing to lend and further the arm’s length interest rate that an independent party is willing to charge; b) general rules, which disallow certain percentage of interest expense or limit the level of interest expense or debt with reference to a fixed ratio like interest to earnings or debt to equity at an entity level or at a group level; and c) targeted rules, to address specific planning risks and limit interest deduction on specific transaction.

Different tax jurisdictions have implemented interest limitation rules by applying various parameters, which are aligned with their objective of implementing such rules. Brazil, Canada, China, Indonesia, Mexico, Russia, and Switzerland have prescribed threshold ratios of debt to equity, which ranges from 1.5:1 to 4:1. On the other hand, India, Germany, Luxembourg, Malaysia, the Netherlands, US and UK have prescribed an upper cap for interest expense deduction in the form of interest to Ebitda ratio, which ranges from 10% to 50%. France, Korea, and Japan have adopted a hybrid approach by implementing both parameters to test thresholds using debt to equity and interest to Ebitda approach.

- **Conclusion**

  In a growing number of countries, tax administrations deem it necessary to include such thin capitalisation rules in their tax legislations, to limit interest deductions to regulate the alleged profit shifting by MNEs. Subject to commercial considerations, this would necessitate MNEs to consider the deductibility of interest expense while obtaining an interest-bearing debt. The inclusion of third-party borrowings guaranteed by the non-resident associated enterprise under the ambit of thin capitalisation could have serious repercussions on the fundraising efforts of taxpayers, especially those operating in capital-intensive sectors or sectors having longer gestation periods. Further, it could impact certain start-ups who generally face a loss situation in their initial years and usually need support in the form of guarantees from their related parties to leverage their third-party borrowings, which could be deemed as related-party debt under these provisions.

  The challenges faced by taxpayers under the thin capitalisation rules have further aggravated on account of the hardships faced during the covid-19 pandemic. Some entities would have incurred huge losses due to varied reasons. To ensure the survival of such entities and ensuring sufficient working capital requirements, MNE groups may extend support by lending funds. Such increased debts combined with losses (or insignificant profits) may adversely impact the interest deductibility for several taxpayers.

  MNEs may navigate the complexities of interest deductibility by determining an optimal capital structure, especially during the initial or low profit phases of their operations, or exceptional circumstances faced during the pandemic.

8. Country-by-Country Reporting

8.1 Introduction

India entered into Double Tax Avoidance Agreement (DTAA) with various countries with the aim to ensure that none of the taxpayers are harassed because of double taxation in both the countries (one where the income is earned and other where he is resident). However later on all the countries realized that these DTAA's are used by various entities for tax evasion and avoidance by various means, one of which is by shifting profits to a lower tax jurisdiction.

Under BEPS Action 13, all large multinational enterprises (MNEs) are required to prepare a country-by-country (CbC) report with aggregate data on the global allocation of income, profit, taxes paid and economic activity among tax jurisdictions in which it operates. This CbC report is shared with tax administrations in these jurisdictions, for use in high level transfer pricing and BEPS risk assessments.

The BEPS report recommends that countries adopt a standardised approach to transfer pricing documentation; it mandates the following three tier structure :

Sr. No.	Document	Information
1	Master File	Standardised information relevant for all multinational enterprises (MNE) group members.
2	Local File	Specific reference to material transactions of the local taxpayer.
3	Country-by-Country Report	Information relating to the global allocation of the MNE’s income and taxes paid;and Indicators of the location of economic activity within the MNE group.

The Finance Act, 2016 introduced provisions relating to Country by Country Report (CbCR) and Master File pursuant to adoption of OECD’s BEPS Action Plan-13 in India. On 31st October 2017, CBDT released the Final Rules with respect to maintenance and furnishing of Master File and CbCR.

8.2 Key Requirements for MF and CbCR – India Perspective

The key requirements for MF and CbCR from an India perspective are explained in the subsequent paragraphs:

- ***Master File Threshold for Master File***

The MF will be applicable to every constituent entity (CE) of an international group (whether inbound [having a parent entity resident in a jurisdiction other than India] or outbound [having a parent entity resident in India]), subject to the following two conditions:

- Consolidated revenue of such international group as reflected in its consolidated financial statements (CFS) for the accounting year exceeds INR 6.4 billion; and
- The aggregate value of international transactions of the CE:
  - during the accounting year (as per the book of accounts) exceeds INR 500 million, or
  - in respect of purchase, sale, transfer, lease, or use of intangible property during the accounting year (as per the book of accounts) exceeds INR 100 million.

Observation: For inbound groups, the prescribed consolidated group revenue threshold is quite low and could result in some groups being required to prepare a MF only for India.

Information and documents to be kept and maintained

The documentation prescribed in respect of the MF is largely in line with OECD's final BEPS Action 13 report, but with the following additional requirements of the functions performed, assets employed, and risks assumed by CEs of the international group that contribute to at least 10 percent of revenues *or* assets *or* profits taken on an individual basis. By contrast, the OECD requires a description of principal contributions to value creation by individual entities of the group.

- List and address of all entities of the international group (rather than that of 'operating entities').
- List of all entities of the international group engaged in development and management of intangibles along with their addresses.
- Names and addresses of the top ten unrelated lenders.
- The Indian MF has, in several instances, warranted the need for 'detailed' information as against 'general description' required by the OECD.

Observations: With respect to the description of functions performed, assets employed, and risks assumed, the financial metric of 10 percent provides a definitive *de minimis* threshold, which the OECD Action 13 report does not. However, it could create a greater compliance burden for groups, since this documentation requirement differs from what is specified under Action 13, where the requirement is only to provide a brief functional analysis describing the principal contributions to value creation by individual entities in the group. In addition, revenue, assets, and profits may not have consistent definitions across jurisdictions, which may lead to inconsistent results when applying the 10-percent threshold.

With respect to intangibles, the focus seems to be not only on legal ownership of intangibles, but also on their economic ownership.

With respect to financing arrangements, clarity is needed on the term 'lenders.'

Overall, since the Indian rules prescribe MF requirements over and above the OECD template, the compliance burden will be higher, because globally prepared MFs will need to be customized for India.

Filing specifications

- The MF is to be filed electronically, and the procedures to do so will be specified.
- The prescribed form contains two parts: Part A and Part B. Part A requires generic information about the CEs in India, and Part B relates to the content of the MF.
- Where there are multiple CEs in India of the same group, the rules provide an option to designate a CE resident in India to undertake the MF compliance on behalf of the group. The designated CE must furnish the MF to the specified Indian Revenue Authority.

Observations: The option of having only the designated entity to undertake the MF-related compliances instead of all CEs of the group is a welcome move, as it will provide administrative relief with respect to filing of MF for groups that have multiple entities operating in India.

However, by referring to CEs 'resident in India', the rule seems to inadvertently not cover non-resident CEs of an international group (that are required to undertake tax and transfer pricing compliances in India), who will have to file both Part A and Part B of the form for furnishing the MF on an individual basis, thereby increasing their compliance burdens.

Security of information filed in the MF

Specified income-tax authorities shall be responsible for developing and implementing appropriate security, archival and retrieval policies in relation to the information furnished in the MF.

Observation: Various stakeholders had raised concerns about the confidentiality and security of information filed as part of the MF. It is a significant positive that the rules have specifically spelled out that the responsibility for holding security of such information lies with the Indian income-tax authorities.

Snapshot of the Indian MF compliance requirements

Who	***What***	***When***	***To Whom***
A constituent entity (irrespective of: ❘❘ whether the entity has entered into an international transaction ❘❘ threshold applicability ❘❘ whether the entity is resident or not)	Part A of Form No. 3CEAA	By due date of furnishing Return of Income (ROI) i.e. for **AY 2021-22, it is 30 November 2021** except for FY 2016-17, for which the deadline is on or before March 31, 2018 (Refer Note 1 below)	Director General of Income-Tax, Risk Assessment (DGIT, RA)
A constituent entity passing the prescribed thresholds	Part B of Form No. 3CEAA	By due date of furnishing ROI, i.e. for **AY 2021-22, it is 30 November 2021** except for FY 2016-17, for which the deadline is on or before March 31, 2018	DGIT, RA

The designated entity, where there are multiple CEs resident in India	Form No. 3CEAA (Part A and Part B) Form No. 3CEAB	Form No. 3CEAA (Part A and Part B) - by due date of furnishing ROI, except for FY 2016-17, for which the deadline is on or before March 31, 2018 Form No. 3CEAB - at least 30 days before the due date of filing Form No. 3CEAA, except for FY 2016-17, for which the deadline is on or before March 1, 2018	DGIT, RA

Note 1: The MF filing due date has been aligned to the due date for filing the ROI. It also seems that the MF filing has been contemplated for a reporting accounting year that is the same as the Indian FY (i.e., April to March).

Observations: While the above filing rules may work well for an Indian outbound group, they may not for an inbound CE resident in India. This is because there is a high likelihood that the parent entity of an inbound CE resident in India will have a different reporting accounting year and have a filing deadline that does not coincide with the Indian ROI filing deadline. Accordingly, at least for the first year of implementation, the filing timeline for a MF for an inbound CE resident in India could have been made concurrent with filing timelines in the jurisdiction of the parent entity.

Also, practically speaking, inbound CEs resident in India will not have access to the MF unless it has been filed or made available by the parent entity in the first place. Thus, the abovementioned alignment of filing timelines would go a long way in easing compliance by inbound CEs resident in India.

Master File: Objective and Features

- The master file would provide an overview of the MNE group business including;
    - The nature of its global business operations
    - Its overall transfer pricing policies, and
    - Its global allocation of income and economic activity

in order to assist tax administrations in evaluating the presence of significant transfer pricing risk.

- The master file is intended to provide a high level overview in order to place the MNE group's transfer pricing practices in their global economic, legal, financial and tax context.
- The master file shall contain information which may not be restricted to transaction undertaken by a particular entity situated in particular country.
- Thus, information in master file would be more comprehensive than the existing regular transfer pricing documentation.
- The master file shall be furnished by each entity to the tax authority of the country in which it operates.

❖ ***Country-by-Country (CbC) report - Threshold for CbC report***

The CbC report provisions apply where the total consolidated group revenue of the international group is INR 55 billion (approximately USD 846 million) or more in the CFS of the preceding accounting year. The rules also provide clarity on the foreign exchange conversion date and rate to be used to compute threshold of INR 55 billion of the international group.

Observation: Although many countries have followed the Euro 750 million threshold, India has established its threshold in local currency. This may not fully align with the Euro 750 million threshold, due to exchange rate movements or because of rounding.

Information requested

The details of the CbC report are consistent with the OECD's final BEPS Action 13 report. The CbC report and related forms are to be filed electronically, procedures for which will be specified.

Security of information filed in the CbC report

The specified income tax authorities shall be responsible for developing and implementing appropriate security, archival, and retrieval policies for the information furnished in the CbC report.

Snapshot of the Indian CbC report compliance requirements

Who	***What***	***When***	***To Whom***
CE resident in India, which is part of an international group and whose parent is a non-resident (*Refer Note 1 below*)	Form No. 3CEAC (Notification)	on or before **December 31, 2021**, against previous deadline of November 30, 2021, except for FY 2016-17, for which the deadline is on or	DGIT, RA

		before January 31, 2018	
Parent entity, or alternate reporting entity, that is: ❘❘ resident in India; and ❘❘ part of an international group, the consolidated group revenue of which exceeds the prescribed threshold	Form No. 3CEAD (CbC report)	AY 2020-21 has extended from November 30, 2020 to **January 31, 2021** vide Press Release, dated 24-10-2020. Due date to exercise option of safe harbour rules for specified domestic transaction by furnishing Form 3CEFB. By due date of furnishing ROI, except for FY 2016-17, for which the deadline is on or before March 31, 2018	DGIT, RA
CE resident in India, that is part of an international group and whose parent is non-resident [and if conditions of section 286(4) of the Indian Income-tax Act ('the Act') are satisfied]	Form No. 3CEAD (CbC report)	Filing date will be contingent to the provisions of section 286(4) of the Act	DGIT, RA
The designated entity, where there are multiple CEs resident in India that are part of the same international group and whose parent is non-resident [and if conditions of section 286(4) of the Act are satisfied] (*Refer Note 2 below*)	Form No. 3CEAE (Intimation)	Not specified, as the filing date will be contingent to the provisions of section 286(4) of the Act	DGIT, RA

Note 1: The notification allows the inbound CE resident in India to disclose upfront for which period its group's CbC report will be prepared. This information should help Indian

Revenue Authorities to track CbCR reporting requirements in the parent entity's jurisdiction with respect to inbound groups.

Note 2: The Indian Regulations provide for filing of the CbC report by an inbound CE resident in India in the following situations:

- The parent entity of the international group is a resident of a country with which India does not have an agreement providing for exchange of CbC report; or
- There is an exchange framework with that country but there has been a systemic failure in exchanging information.

In those situations, the CbC report shall be furnished by the inbound CE resident in India within the specified time. Where there are multiple CEs resident in India that are part of the same international group, the designated CE needs to file the CbC report and file an intimation to that effect in Form No. 3CEAE with the specified Indian revenue authority.
The due date of filing the CbC report by an inbound CE resident in India has not yet been explicitly notified.

The Takeaway
Some aspects of the Indian rules appear to require more data than the OECD requirements. There is a need to strike a balance between the provision of more data on the one hand (which will carry a higher compliance burden), versus data that is sufficient for a risk assessment.

With the new rules, both inbound and outbound entities operating in India will need to maintain and disclose a significant amount of information. This will require entities to ensure they have the capability to execute, especially from the perspective of human resources and technology.

For the MF, considering the additional Indian requirements, groups could consider preparing an India supplement to the MF which captures the additional information prescribed under the Indian rules. This would allow the group's 'OECD compliant' MF to remain intact.

After the rules are issued, we hope that, like in the past, the GoI will release FAQs to clarify some aspects and provide further guidance on the implementation of the rules. For example, guidance on whether an inbound CE resident in India is required to file a CbC report in the absence of a CbC report being prepared or required globally would provide much needed clarity around CbC report filing requirements for those groups and would help ease compliance burdens.

9. Alternative Transfer Pricing Rules (African Countries)

Africa with 54 countries and 10 dependent territories, holds a diverse range of jurisdictions at varying stages of economic development. With significant foreign investment and rapid growth, many African countries are taking steps to shore up their tax systems and ensure their ability to tax a share of profits attributable to their jurisdictions.

This geopolitical tussle has pushed transfer pricing to the top of the agenda. Many countries in Africa have recently adopted or updated transfer pricing rules in line with the Organisation for Economic Co-operation and Development's (OECD) guidelines. At the same time, companies face intense scrutiny from tax authorities, investors and other stakeholders about their approach to tax and where they pay it, and the number of transfer pricing audits in Africa has increased dramatically.

Africa's transfer pricing reforms and their key practice in managing compliance and mitigating transfer pricing risk:

❖ **Joining in the global project to address BEPS**

The OECD's global project to prevent Base Erosion and Benefit Transfer (BEPS) is perhaps the biggest driver of transfer price change in Africa and globally. Many African countries are changing to new international tax rules and tax treaties in line with OECD recommendations.

28 countries in Africa are among the 135 members of the OECD's Inclusive Framework. These and other countries have been keen to implement the BEPS minimum standards. For example:

- **South Africa, Nigeria** and **Gabon** have implemented country-by-country tax reporting.
- Many African countries are taking part in the global transfer pricing debates, especially regarding requirements for service transactions, capital-rich and low-function entities, and analyses of intangibles based on development, enhancement, maintenance, protection and exploitation (DEMPE).
- Many African countries are also taking steps to implement the OECD's recommendations for countering harmful tax practices through coordinated international tax rules and enforcement efforts. Beyond the BEPS minimum standards, countries in Africa, such as **Uganda, Benin** and **Zambia,** are imposing the OECD's new limitations on interest deductibility as a percentage of earnings before interest, deductions, taxes and amortization (EBITDA).
- Some countries are also exploring the adoption of safe harbor regimes.

❖ **Recent Transfer Pricing Reforms: Selected African Jurisdiction**

Below are snapshots of new and revised transfer pricing rules and practices being put in place in selected African jurisdictions.

Nigeria

Nigeria's transfer pricing regulations were revised in 2018, primarily to align with the OECD's BEPS recommendations.

Other key transfer pricing reforms announced by Nigeria include

- Adopted the OECD's three-tiered approach of transfer pricing documentation (i.e. country-by-country reports, master and local files) with the threshold for country-by-country reporting set at 160 billion Nigerian naira (about 750 million euros).
- new requirements on procurement and intra-group service transaction
- introduction of guidelines on pricing of commodities
- a limitation of deduction on royalty payment
- clarification that only pricing arrangements approved by the tax authority (and not other government agencies) qualify for a safe harbor
- strict penalties for non-compliance.

Since these rules were introduced, the number of transfer pricing audits has steadily increased and the Nigerian tax authority is penalizing taxpayers found to be in default.

Since these rules were introduced, the number of transfer pricing audits has steadily increased and the Nigerian tax authority is penalizing taxpayers found to be in default. The tax authority now has more knowledge of the global activity of multinational enterprises, and is also taking an aggressive approach towards revenue generation and collection. Consequently, the volume of transfer pricing audits in Nigeria is expected to increase in the future.

Tanzania

- The new Tax administration (Transfer pricing) Regulations, 2018 replace the previous Regulations issued in 2014.
- Regulations issued in 2018 require taxpayers with related party transactions of TZS 10 Billion (USD 4.35 Mil) or more must now file their transfer pricing documentation together with their tax returns.
- Penalties may be imposed of up to 100 percent for adjusted transfer pricing amounts and approximately up to USD 23,000 for failing to maintain contemporaneous documentation.
- Elimination of royalties for locally developed intangibles that are transferred and then licensed for use in Tanzania
- Rejection of service transactions where remuneration is based on a percentage (i.e. remuneration must be based on cost)
- Restriction on use of ‘tested parties’. Use of a tested party located outside of Tanzania will only be permitted when the party’s financial statements are provided
- The comparable uncontrolled price (CUP) method is now the designated method to test commodity transactions.

Kenya

- Kenya's draft income tax bill for 2018 expanded the scope of the country's transfer pricing rules to cover transactions with parties in beneficial tax regimes as well as both associated and unrelated parties in preferential tax regimes offered by foreign countries. Transactions with non-resident persons that lack economic substance will also be considered for transfer pricing adjustments. Other new rules require annual contemporaneous documentation, use of a prescribed method for commodity transactions, rejection of negative transfer pricing adjustments and acceptance of secondary transfer pricing adjustments.
- A penalty for failing to maintain documentation may be imposed of 2 percent of the controlled transaction's value.
- Introduction of Country-by-Country reports: CbyC reporting will result in additional transfer pricing documentation and reporting requirements for MNEs. In addition, this will lead to increased compliance costs. The change is effective from 1 July 2021.

Rwanda

- On 14 December 2020, Rwanda's new general rules on transfer pricing ("New TP Rules") which are in line with the key aspects of the 2017 OECD guidelines.
- The New TP Rules apply to transactions between related (known as controlled transactions) where one of the parties is a Rwanda tax resident, as well as transactions between non-resident related persons if the transaction concerns the permanent establishment of one of those persons in Rwanda.
- The New TP Rules permits both **transaction-based** (CUP, RPM, CPM) and **transactional profit** (TNMM, PSM) transfer pricing methods, as opposed to the repealed transfer pricing rules which only provided for transaction-based methods.
- The New TP Rules also allow the use of alternative methods where none of these five methods can be reasonably applied to achieve an arm's length outcome.

Uganda

Uganda's transfer pricing rules have been in place since 2011 and cover both cross-border and domestic transactions. Where provisional tax paid is less than 90 percent of the actual tax assessed, a penalty of 20 percent of the shortfall may apply. For documentation purposes, only a local file is required, and, for in-country transactions, a filing threshold of USD 135,000 applies. Unilateral, bilateral and multilateral APAs are available.

Ethiopia

Ethiopia is not an OECD member, but its transfer pricing regulations are influenced by the OECD's guidelines. A 2015 directive requires related resident taxpayers with annual turnover of over USD 22,000 to maintain transfer pricing documentation. The directive also details the concept of comparability based on the OECD's provisions, allows the use of other methods when justified, and prohibits the use of secret comparables. Transactions that are assessed as outside the arm's length range are adjusted to the median. Taxpayers can also apply for APAs under the directive.

South Africa

South Africa's transfer pricing legislation was overhauled as of April 2012 to align more with the OECD's guidelines. Although South Africa is not an OECD member, the country has been actively involved in the OECD Working Party processes around BEPS. South Africa is therefore expected to release new transfer pricing guidance in the near future.

The South African Revenue Services (SARS) now has a full team of transfer pricing specialists and increased audit activity has been observed. With the recently introduced transfer pricing documentation requirements, more relevant information is being provided to the tax authority, and their use of risk assessment and other IT tools has further improved capabilities.

As a result, taxpayers have seen significantly increased focus on transfer pricing since mid-2019, and SARS has announced that it will focus on transfer pricing reviews to combat base erosion and profit shifting. Evidence of these efforts was seen in the national budget for 2020-2021 presented on 26 February 2020 which proposed a significant change to the interest limitation provisions in respect of cross-border loans, introduced for years of assessment commencing on or after 1 January 2021.

Botswana

Botswana's transfer pricing regulations took effect in July 2019, setting out a new framework for enforcing the arm's length principle. Among other things, the regulations:

- Prescribe five approved methods of transfer pricing, prioritizing use of the comparable uncontrolled price method (CUP) when other methods equally apply, and use of a traditional method when a traditional method and a transactional method are equally applicable.
- Provide for the use of the median in the arm's length range in making adjustments
- Set out factors to consider when determining arm's length prices in transactions involving intangible property.
- The regulations require selected taxpayers to prepare an annual transfer pricing local file and submit the local file when filing their tax return.
- In addition, affected taxpayers with a transaction or transactions exceeding BWP 5 million with a connected person within a multinational entity group are required to provide to the commissioner general a transfer pricing master file upon written request.
- Authorize the making of corresponding adjustments, provided certain conditions are met.
- Prescribe rules for maintaining contemporaneous documentation.

Test Your Knowledge

QUESTIONS	
1	According to Section 286 of Income Tax Act, 1961, which taxpayers are subject to country-by-country reporting requirements in India?
2	Company X is incorporated in Singapore and has a subsidiary Company Y in India. Company X has invested INR 600 crores by way of equity shares and INR 1600 crores by way of debt. Company Y has revenues of INR 1500 crores and an EBIDTA of INR 600 crores. Company Y is required to make interest payment of INR 160 crores to Company X and INR 150 crores to other domestic creditors. Based on the above facts, examine the tax implications in the hands of Company X and Company Y respectively in respect of the interest payments that it is made by Company Y to Company X.

SOLUTIONS	
1.	Under section 286 of the Income Tax Act, 1961, the country by country report (CbCr) filing requirement in India would arise in the case of the following entities: (i) The parent entity of an international group (which has been defined to include two or more enterprise including a permanent establishment which are resident of different countries or territories having total consolidated group revenue in the preceding accounting year of more than INR 5500 crore), if it is resident in India (ii) An entity in India belonging to an international group, if the parent entity of the group is resident: • In a country where the parent entity is not obligated to file the report of the nature referred to in section 286(2); or • In a country with which India does not have an arrangement for exchange of the CbC reporting; or • Such country is not exchanging information with India even though there is an agreement; and this fact has been intimated to the constituent entity by the Indian tax administration. Provisions in the connection with CbCr also provide that if an international group, with a parent entity which is not resident in India, has designated an alternate entity for filing its report with the tax jurisdiction in which the alternate entity is resident, then the entities of such group operating in India would not be required to furnish a CbC report if the same can be obtained under the agreement of exchange of CbC reports the Indian tax administration.
2.	There are two different tax consequences that will have to be examined in this case. First, in the hands of Company X and second in the hands of Company Y. **In the hands of Company X**, the interest payments received will be taxable under the provisions of the Act as well as under the India Singapore DTAA. Under the Act, Section 9(1)(v) provides that income by way of interest payable by a person who is a resident, except where the interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of business or profession carried on by such person outside India or earning income from any source outside India; shall be deemed to accrue or arise in India. Since Company X has revenues only from business activities carried on in India, the interest income will be taxable under the provisions of the Act. The applicable rates that will apply for such withholding will be restricted to 5 per cent due to the application of section 194LC. Under the provisions of the India Singapore DTAA, Article 11 para 2 also provides a right to the source state, provided that the tax so charged shall not exceed 10 per cent of the gross amount of interest payable if the interest is paid on a loan granted by a bank or similar financial institution and 15 per cent in other cases. **In the hands of Company Y**, apart from withholding tax implications, the thin capitalization provisions will also be relevant. Section 94B has been inserted to

	provide for thin capitalization rules in India. As per the provisions, where an Indian company pays more than one crore which is deductible in computing income under the head 'profits and gains of business or profession' in respect of debt issued by a non-resident, being an associated enterprise of such borrower, the interest shall not be deductible in computation of income under the said head to the extent it arises from excess interest. Excess interest has been defined under Section 94B to mean an amount of total interest paid or payable in excess of 30% of EBIDTA of the borrower in the previous year or interest paid or payable to the associate enterprise, whichever is less. Company X and Company Y will qualify as associated enterprises. Therefore, any interest in excess of 180 crores (600*30/100) shall be treated as excess interest and shall not be available deduction in the hands of the Company Y. Company Y can however carry forward the excess interest for a period of up to 8 years and offset the same in future years.

Module II Attribution of Profits

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1. Introduction

Transfer prices are valuations of products within a firm and represent a common and important instrument of managerial accounting, financial accounting, and taxation. Most of the objectives ascribed to transfer prices are captured by the functions of coordination and profit allocation.

The definition of permanent establishment (PE) included in tax treaties is crucial in determining whether a non-resident enterprise must pay income tax in another State. To prevent the use of certain common tax avoidance strategies that have been used to circumvent the existing PE definition, the Report on *Preventing the Artificial Avoidance of Permanent Establishment Status* (Action 7 Report, OECD 2015) recommended changes to the definition of PE in Article 5 of the OECD Model Tax Convention, which is widely used as the basis for negotiating tax treaties, as a result of the work on Action 7 of the BEPS Action Plan.

In particular, that Report contained changes to tackle arrangements through which a non-resident enterprise makes sales in a jurisdiction through a commissionnaire or a dependent agent that does not formally conclude contracts in the jurisdiction, thereby avoiding taxation in the jurisdiction despite having the type of economic nexus that justifies the recognition of a taxable presence.

The OECD has recommended changes to Tax Treaties to prevent Artificial Avoidance of Permanent Establishment (PE) Status. Those changes will be made through Multi-Lateral Instrument (MLI). Among other things, the changes make the criteria for formation of Dependent Agency PE stricter.

2. Role of Transfer Pricing Rules in Business Profit Allocation

The role of Transfer Pricing Rules in allocation of business profits among different profit units of an entity is directly linked to the computation of Arm's Length Price. The various roles played by transfer pricing rules in allocation of business prfit are as follows:

(vi) **Establishes parity between MNCs and independent enterprises** – A major reason is that the Transfer Pricing provides broad parity of tax treatment for MNCs and independent enterprises. Since it puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages and disadvantages that would otherwise distort the relative competitive positions of these entities. Thus, it promotes the growth of international trade and investment by removing these tax considerations from economic decisions.

(vii) **Determination of real taxable profits -** The transfer price adopted by a multinational has a direct bearing on the proportional profit it derives in each country in which it operates. If inadequate or excessive consideration is paid for the transfer of goods, services or intangible property between the members of an MNC group, the income calculated for each of those members will be inconsistent with their relative economic contributions. An 'arm's length' price – a price two independent firms operating at arm's length would agree on – is needed to determine taxable profits earned in each country. The arm's length doctrine permits the taxing authorities to rectify the accounts of the enterprise so as to reflect correctly the income that the establishment would have earned if it were an independent enterprise.

(viii) **R**

educes artificial price distortion - If transfer pricing is not followed, an MNC will sell goods/ provide services to a controlled entity in a high tax regime at a high price (which exceeds the market price) and to an entity in a low-tax regime or a tax haven at a low price (which is lower than the market price). This would result in extreme price distortion of goods and services in the international market.

(ix) **Minimization of double taxation** – Transfer Pricing is an international concept and it represents the international norm. The potential for double taxation is minimized, since in international transfer pricing, adjustment to the transfer price in one tax jurisdiction requires a corresponding adjustment in the other tax jurisdiction.

(x) **Accurate measurement of economic contribution** – Transfer Pricing provides accurate measurement of the fair market value of the economic contribution units of an MNC. The focus of transfer pricing is to ensure that the proper amount of income is attributed to where it is earned. This result in each unit of the MNC earning a return commensurate with its economic contribution and risk assumed.

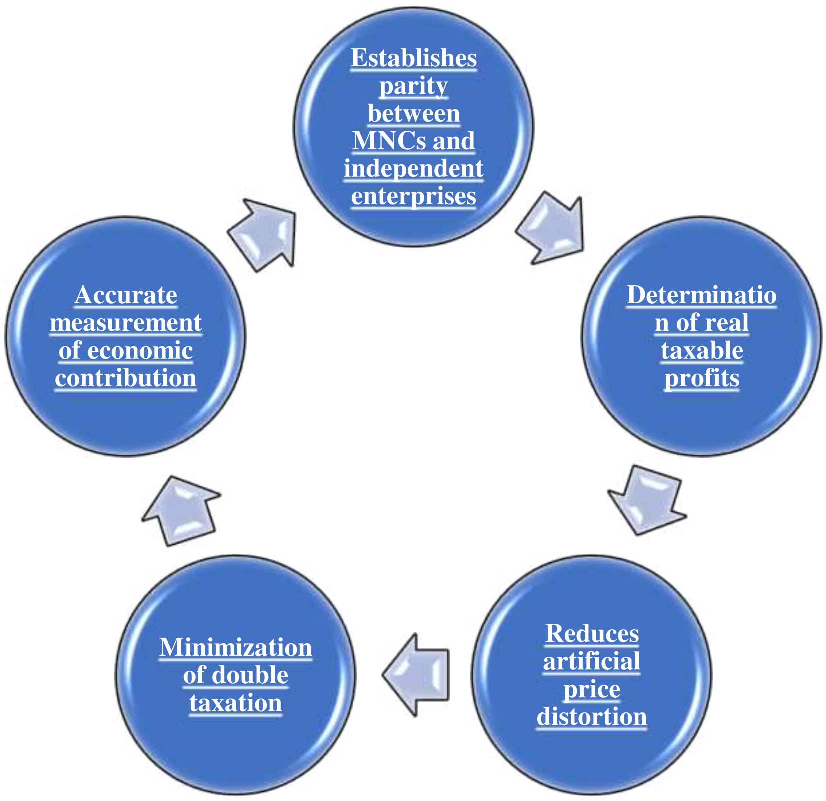


Fig. Role of Transfer Pricing Rules in Business Profit Allocation

3. Functional Analysis in Highly Integrated Value Chains

The Organisation for Economic Co-operation and Development (OECD) 2017 edition of the Transfer Pricing Guidelines provides an explanation of what a functional analysis is, where it states that the functional analysis is used for transfer pricing purposes and it analyses the functions performed (taking into account assets used and risks assumed) by associated enterprises in a transaction.In order to determine arm's length transfer pricing, multinational enterprises (MNEs) must identify, by means of a functional analysis, which members of the MNE group perform or exercise control over functions, provide assets and assume risks associated with the transaction.

For transactions between two independent enterprises, the compensation will usually depend on the functions that each enterprise performs.The functional analysis is important as it provides an overview of value creation within the supply chain in general and the related party transaction in particular. It provides an understanding of the relative contributions of the parties to the transaction and their roles in overall value creation.

In determining, whether controlled and uncontrolled transactions or entities are comparable, a functional analysis is necessary. This functional analysis seeks to identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions.It will also be relevant to determine the legal rights and obligations of the taxpayer in performing its functions.

The functions carried out (taking into account the assets used and the risks assumed) will determine to some extent the allocation of risks between the parties, and therefore the conditions each party would expect in arm's length dealings.

4. Information Asymmetry

Information asymmetry is referred to as the extensive information available to the taxpayer and the absence of information available to the tax administration, other than what the taxpayer may present. Such information asymmetry restricts the ability of tax administrations to establish or verify, at an early stage, the developments or events that might be considered relevant for the pricing of a transaction involving the transfer of intangibles or rights in intangibles, as well as the extent to which the occurrence of such developments or events, or the direction they take, might have been foreseen or reasonably foreseeable at the time the transaction was entered into.

Information asymmetry between the taxpayer and the tax administration, including the information taken into account by the taxpayer in the pricing transaction, can be acute and the tax administration may face difficulty on the extent to which the pricing is determined.

As a result, it will prove difficult for a tax administration to conduct a risk assessment for transfer pricing purposes, to evaluate the reliability of the information on which pricing has been based by the taxpayer, or to consider whether the intangible or rights in intangibles have been transferred at undervalue or overvalue compared to the arm’s length price, until ex post outcomes are known in years subsequent to the transfer.

5. Hard-to-value Intangibles (HTVI)

The hard-to-value-intangibles (HTVI) approach is the outcome of the work done under BEPS Action 8, and is aimed at preventing base erosion and profit shifting by moving intangibles among group members. The HTVI approach protects tax administrations from the **negative effects of information asymmetry between tax administration and taxpayers** by ensuring that tax administrations can consider ex post outcomes as presumptive evidence about the appropriateness of ex-ante pricing arrangements by determination of the arm’s length pricing arrangements that would have been made between independent enterprises at the time of the transaction.

However, the ex post evidence should not be used without considering whether the information on which the ex post results are based could or should reasonably have been considered by the associated enterprises at the time the transaction was entered into.

The hard-to-value intangibles (HTVI) recommendations included in the final report on BEPS Actions 8-10 are intended to address perceived information asymmetries between tax administrations and taxpayers whereby tax administrations may,

4. lack access to information.
5. too reliant on “specialized knowledge, expertise, and insight” provided by the taxpayer.
6. incapable of determining whether the differences between projected results used to set the transfer pricing (ex-ante) and the actual results (ex-post) were due to unforeseen developments or faulty transfer pricing.

HTVI are defined as intangibles or rights in intangibles for which, at the time of the transaction, no reliable comparable existed, and projections of future cash flows expected to be derived from the transferred intangible or assumptions used in valuing the intangibles were highly uncertain.

5.1 Characteristics of HTVI

HTVI possess one or more of the following characteristics:

7. The intangible is only **partially developed** at the time of the transfer.
8. It is **not** expected to be **exploited commercially** until several years following the transaction.
9. It is **integral to the development of othe**r hard-to-value intangibles.
10. It is expected to be **exploited in a novel manner**, making reliable projections from past developments unavailable.
11. It is transferred to an associated enterprise for a **lump sum payment.**
12. It is used in connection with, or developed under, a **cost contribution arrangement** or similar arrangements.

Given these broad features, many intangibles will be included under the proposed HTVI analysis. The **new guidance uses actual financial outcomes** to evaluate intangible transfers or license arrangements related to HTVI under certain conditions.

5.2 Presumption

It is presumed barring unforeseen events, that the transfer pricing is not at arm’s length if there are material differences between the forecasts used to price the transaction and the actual results.

5.2.1 Exemption from Presumption

The taxpayer has the possibility to rebut such presumptive evidence by demonstrating the reliability of the information supporting the pricing methodology adopted at the time the controlled transaction took place.

Additional exemption based on one of the following exemptions:

5. The taxpayer documented how the original projections were determined, including how reasonably foreseeable events and risks were considered and the probabilities assigned to those events. In addition, the taxpayer must provide reliable evidence that any significant difference between the financial projections and the actual outcome is due to unforeseeable events, or that the probability of the occurrence of foreseeable outcomes at the time of the transactions was not significantly overestimated or underestimated. An unforeseeable event is a low-probability event that could not be foreseen, such as a natural disaster.

6. The transfer of the HTVI was covered by a bilateral or multilateral advance pricing arrangement.

7. Any significant differences between the financial projections and the actual outcomes do not cause the projected compensation for the HTVI to deviate by more than 20 percent.

8. The HTVI has generated unrelated party revenues for the transferee for a five-year commercialization period, and any difference between the financial projections and the actual outcomes was less than or equal to 20 percent of the forecasts for that period.

Some of the practical ways in which the approach to HTVI can be applied are illustrated in the examples provided ahead. The application of the approach to HTVI should be underpinned by the following principles:

- Where the HTVI approach applies, tax administrations can consider ex post outcomes as presumptive evidence about the reasonableness of the assumptions of the ex ante pricing arrangements.

- The ex post outcomes inform the determination of the valuation that would have been made at the time of the transaction; however, it would be incorrect to base the valuation on the actual income or cash flows without taking into account whether the associated enterprises could or should reasonably have known and considered, at the time of the transfer of the HTVI, the information related to the probability of achieving such income or cash flows.

- Where a revised valuation shows that the intangible was transferred at an undervalue or overvalue compared to the arm’s length price, the revised price of the transferred intangible may be assessed to tax taking into account price adjustment clauses and/or contingent payments, irrespective of the payment profiles asserted by the taxpayer.

- Tax administrations should apply audit practices to ensure that presumptive evidence based on ex post outcomes is identified and acted upon as early as possible.

Example 1

Para 1: Company A, a resident of Country A, has patented a pharmaceutical compound. Company A has concluded pre-clinical tests for the compound and has successfully taken the compound through Phases I and II of the clinical trials. Company A transfers in Year 0 the patent rights to an affiliate, Company S, a resident of Country S. Company S will be responsible for the Phase III trials following the transfer. In order to determine the price for the patent on the partially developed drug, the parties made an estimation of expected income or cash flows that will be obtained upon exploitation of the drug once finalised over the remaining life of the patent. Assume the price so derived at the time of the transfer was 700 and that this was paid as a lump sum in Year 0.

Para 2: In particular, the taxpayer assumed sales would not exceed 1,000 a year and that commercialisation would not commence until Year 6. The discount rate was determined by referring to external data analysing the risk of failure for drugs in a similar therapeutic category at the same stage of development. Even if the tax administration of Country A had been aware of these facts relating to the transfer of the patent rights in Year 0, it would have had little means of verifying the reasonableness of the taxpayer’s assumptions relating to sales.

Scenario A

In Year 4, the tax administration of Country A audits Company A for Years 0-2 and obtains information that commercialisation in fact started during Year 3 since the Phase III trials were completed earlier than projected. Sales in Years 3 and 4 correspond to sales that were projected, at the time of the transfer, to be achieved in Years 6 and 7. The taxpayer cannot demonstrate that its original valuation took into account the possibility that sales would arise in earlier periods, and cannot demonstrate that such a development was unforeseeable.

The tax administration uses the presumptive evidence provided by the *ex post* outcome to determine that the valuation made at the time the transaction took place did not consider the possibility of sales occurring in earlier years. The taxpayer's original valuation is revised to include the appropriately risk-adjusted possibility of earlier sales resulting in a revised net present value of the drug in Year 0 of 1,000 instead of 700. The revised net present value also takes into account the functions performed, assets used and risks assumed in relation to the HTVI by each of the parties before the transaction and reasonably anticipated, at the time of the transaction, to be performed, used or assumed by each of the parties after the transaction. Therefore, assume for the purposes of the example that the arm's length price anticipated in Year 0 should have been 1,000. Note that the value of 1,000 is not necessarily the net present value of the transferred rights based solely on the actual outcome.

In accordance with the approach to HTVI, the tax administration is entitled to make an adjustment to assess the additional profits of 300 in Year 0.

Scenario B

The tax administration uses the presumptive evidence provided by the *ex post* outcomes to determine that the valuation made at the time the transaction took place, did not consider the possibility of sales occurring in earlier years. The taxpayer's original valuation is revised to include the appropriately risk-adjusted possibility of sales occurring in earlier years resulting in a revised net present value of the drug in Year 0 of 800 instead of 700. Therefore, assume for the purposes of the example that the arm's length price anticipated in Year 0 should have been 800. Note that the value of 800 is not necessarily the net present value of the transferred rights based solely on the actual outcome (see paragraph 6 of this guidance).

In accordance with the approach to HTVI, the tax administration is entitled to make an adjustment to assess the additional profits of 100 in Year 0. However, in this example, the exemption provided by item (iii) in paragraph 6.193 applies since the adjustment to the compensation for the transfer is within 20% of the compensation determined at the time of the transaction.

Example 2

The facts are the same as in paragraphs 1-2 above in Example 1. Based on those facts, assume that in Year 7, the tax administration of Country A audits Company A for Years 3-5 and obtains information that sales in Years 5 and 6 of the product to which the patent relates were significantly higher than those projected. In the original valuation, the taxpayer had not projected sales any higher than 1,000 in any year, but outcomes in each of Years 5 and 6 show sales of 1,500. The taxpayer cannot demonstrate that its original valuation took into account the possibility that sales would reach these levels, and cannot demonstrate that reaching that level of sales was due to an unforeseeable development.

The tax administration uses the presumptive evidence provided by the *ex post* outcomes to determine that the possibility of higher sales should have been taken into account in the valuation. The taxpayer's original valuation is revised to include the appropriately risk-adjusted possibility of sales occurring in earlier years, resulting in a revised net present value of the drug in Year 0 of 1300 instead of 700. The revised net present value also takes into account the functions performed, assets used and risks assumed in relation to the HTVI by each of the parties before the transaction and reasonably anticipated, at the time of the transaction, to be performed, used or assumed by each of the parties after the transaction. Therefore, assume for the purposes of the example that the arm's length price anticipated in Year 0 should have been 1300. Note that the value of 1300 is not necessarily the net present value of the transferred rights based solely on the actual outcome.

In accordance with the approach to HTVI, the tax administration is entitled to make an adjustment to assess the additional profits of 600. Assume for the purposes of this example that none of the exemptions listed in paragraph 6.193 of Chapter VI of the Guidelines applies. One way to implement the adjustment is to re-assess the price paid in Year 0. However, the significant revision of the lump-sum payment highlights the risks posed by the high uncertainty in valuing the intangible and gives rise to consideration, in light of this significant uncertainty, of whether adjustments consistent with an alternative payment structure might be more consistent with what unrelated parties would have done.

Evidence of pricing arrangements for the transfer of intangibles in comparable circumstances to address high valuation uncertainty may point to appropriate alternatives to making the adjustment in Year 0. For example, assume that in the pharmaceutical sector it is common to transfer patent rights to independent parties through a combination of an initial lump sum payment and additional contingent payment arrangements based on the successful completion of development phases or regulatory approvals in a particular market. In this case, assume that the first market approvals were obtained in Year 3. The tax administration may, therefore, determine that it is consistent with arm's length practices in comparable circumstances to recover the underpayment through a further payment in Year 3. Note that this paragraph is not intended to, and does not, imply that modification of the payment form can only occur when there is a common practice in the relevant business sector regarding the form of payment for the transfer of a particular type of intangible.

The principles illustrated by this example apply irrespective of whether the tax administration in fact carries out an audit for Years 0-2 and then a second audit for Years 3-5, or whether it audits only for Years 3-5. In both scenarios, a revision to the original valuation is justified based on *ex post* evidence emerging in Year 7, and, subject to any treaty or domestic law limitations, the undervaluation may be recovered based on the HTVI approach.

6. OECD Transfer Price Report

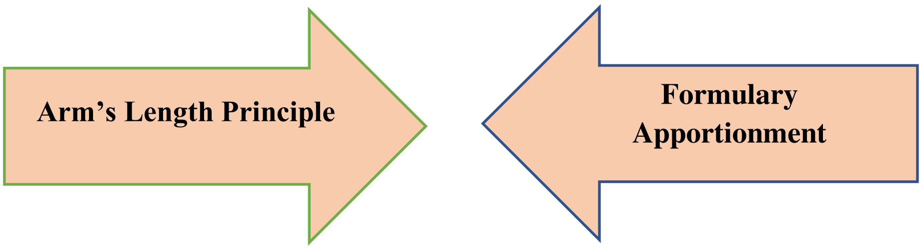
The growth of MNEs presents increasingly complex taxation issues for both tax administrations and the MNEs themselves since separate country rules for the taxation of MNEs cannot be viewed in isolation but must be addressed in a broad international context. The need to comply with laws and administrative requirements that may differ from country to country creates additional problems.

In a global economy where MNEs play a prominent role, governments need to ensure that the taxable profits of MNEs are not artificially shifted out of their jurisdiction and that the tax base reported by MNEs in their country reflects the economic activity undertaken therein. For taxpayers, it is essential to limit the risks of economic double taxation.

To ensure the correct application of the separate entity approach, OECD member countries have adopted the “arm’s length principle”. The Committee on Fiscal Affairs, which is the main tax policy body of the OECD, has issued a number of reports relating to the application of Treaty Articles to MNEs and to others.

In applying the foregoing principles to the taxation of MNEs, one of the most difficult issues that has arisen is the establishment for the tax purposes of appropriate transfer prices. The OECD Transfer Pricing Guidelines provide guidance on the application of the “arm’s length principle”, which is the international consensus on the valuation of cross-border transactions between associated enterprises. The OECD Transfer Pricing Guidelines were approved by the OECD Council in their original version in 1995.

7. Approaches to Transfer Pricing



7.1 The Arm's Length Principle

"The arm's length principle is an international standard that compares the transfer pricing charged between related entities with the price of similar transactions carried out between independent entities at arm's length. An adjustment may be made to the extent that profits of a related party differ from those that would be agreed between independent entities in similar circumstances."

- *United Nations Practical Manual on Transfer Pricing for Developing Countries (2017)*

Well recognized and accepted international principle which is the foundation of modern transfer pricing laws.

7.2 Formulary Apportionment

Apportioning profits proportionately based on global sales and Function, Asset and Risk (FAR) factors. It can work only when it is implemented globally in a standardized manner across jurisdictions. It is an approach to allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined formula.

7.2.1 How would Formulary Apportionment Work?

- Under the current global system, multinational firms determine their profits separately in each tax jurisdiction in which they operate.
- An alternative system would allocate a firm's worldwide income across countries using a formula based on some combination of its sales, assets, and payroll in each jurisdiction.
- An alternative formula would base a corporation's taxes only on the fraction of its worldwide sales destined for domestic consumers, a so-called "destination-based" corporate profits tax.

7.2.2 Advantages

9. Removes current artificial incentive for multinationals to shift reported income to low-tax locations.
10. Tax liabilities, instead, would be allocated by a measure (or measures) of their real economic activity in each location.
11. Reduce the tax system's complexity and the administrative burden it imposes on entities.
12. There would be no need for transfer-pricing rules for intra-group transactions, which would remove a major source of dispute between corporations and tax authorities.
13. Controlled Foreign Corporation (CFC) rules would be redundant since all profits assigned to foreign activities would be exempt. For this reason, there would also no longer be a need for foreign tax credits.
14. Shift to formulary apportionment can be made revenue neutral by reducing corporate tax rates.
15. It would make a multinational corporation's tax liability independent of both its legal residence and its legal form (for example, branch or subsidiary).
16. It would remove any incentive for corporate inversions in which firms from two countries merge and establish their residence in a low-tax country to reduce their tax liabilities.

7.2.3 Disadvantages

11. Difficult in designing and implementing a global formulary apportionment system.
12. Such a system would create new incentives for tax avoidance and could increase the incentive to shift real investments to low-tax countries.
13. It would require an agreement among the major economies to scrap the current separate-entity system and to agree on how to allocate corporate income among jurisdictions.
14. It would also require agreement on common accounting methods for measuring corporate profits.
15. A unilateral move by any country to formulary apportionment would result in double taxation of some multinationals' income and exemption of other income.
16. Introduces new boundary problems between high-tax and low-tax activities.
17. Creates incentives to shift profits between multinationals and separately owned firms - For e.g. if physical assets help determine the location of a multinationals' profits, a firm might well have an incentive to contract its low-margin manufacturing activities in high-tax jurisdictions to independently owned firms instead of establishing a manufacturing subsidiary within the firm to reduce its share of capital assets allocated to high-tax countries.
18. Could worsen the incentive to shift real activities to low-tax countries because intangible assets — a large share of value for many leading multinational companies — are part of a firm's total profits but are absent from the allocation formula.

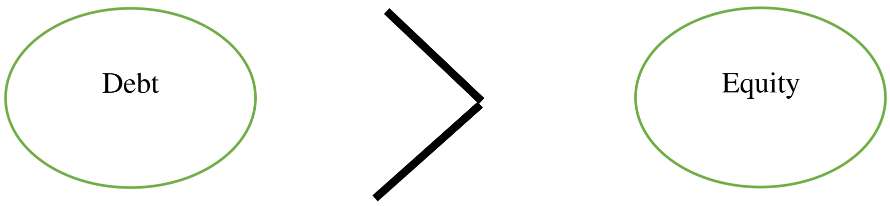
19. Some analysts and commentators favor sales or destination-based allocation of corporate profits because firms are least likely to reduce sales in a jurisdiction simply to reduce tax liability.
20. Documentation and compliance requirements for an application of global formulary apportionment would generally be more burdensome than under the separate entity approach of the arm's length principle.

7.3 Thin Capitalisation Rules - Limitation on Interest Expenses

7.3.1 Introduction

Multinational entities (MNEs) often borrow funds both externally and internally. This could be in the form of external loans or leveraging internally on the funds available within the group to increase their investments and meet their business requirements. MNEs are generally seen at an advantage vis-à-vis local businesses, due to their access to global debt and equity markets, with varying interest rates and borrowing terms.

Debt and equity are two primary sources of finance for any company. A mix of debt and equity in the capital structure of any commercial organisation is dependent on various factors such as capital intensity of the industry they operate in, risk appetite, ability to raise funds through debt, and legal, commercial and tax considerations. **In general, an entity financed through comparatively higher amount of debt as compared to equity is regarded as a thinly capitalised entity**.



While the compensation for debt and equity is interest and dividend respectively, their tax implications are quite different. Dividends are not deductible as an expense for the taxpayers and are generally taxable in the hands of the recipient. On the other hand, in case of debt, interest payments are generally tax-deductible for the taxpayer and taxable in the hands of the recipient. In case a company has high debt, an issue may arise whether the capital structures are devised in a manner that could result in potential claim of higher deduction of interest payment on debts from taxable income.

Simply put, in a situation where a business is financed through relatively higher level of debt as compared to equity contribution from its owners, the taxpayer can claim excessive deduction of interest payment owing to such high debt. Such arrangements may be questioned during revenue audits and taxpayer could be required to substantiate the debt-equity combination, which otherwise may be treated as tax base erosion.

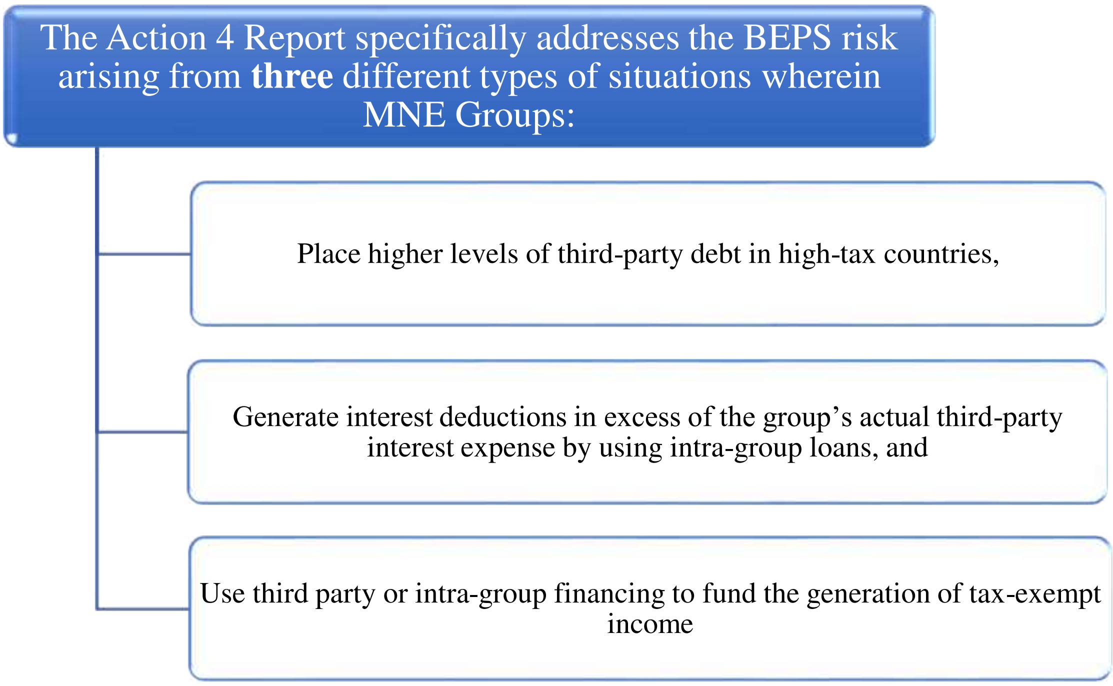


Fig. BEPS Risk Addressed by Action 4 Report

7.3.2 Global Backdrop

The Organisation for Economic Co-operation and Development (OECD) has expressed that multinationals may have certain thinly capitalised entities achieving favourable tax results, which is now a global concern. To counter this issue, called base erosion and profit shifting (BEPS), an initiative of the OECD and the G20 nations adopted the **Action 4 Report titled 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments'.**

Accordingly, the OECD recommended that tax jurisdictions should implement a mechanical rule to limit interest deductions, which may have been undertaken as an instrument for excessive tax deductions.

The following are the methods adopted by some jurisdictions to curb thin capitalisation:

- **Fixed Ratio:** These are the rules that limit the level of interest expenses or debt in a company or an entity, concerning a fixed ratio of debt or equity, interest or earning, etc.
- **Specified Percentage:** These are the rules that disallow a specified percentage of the interest expenses in a company or an entity, regardless of the nature of the payment or to whom the payment is made.
- **Arm's Length Basis:** These are the rules that compare the level of interest or debt in a company or an entity with the position, had the company been dealing entirely with third parties.
- **Anti-Avoidance Rules:** These are targeted anti-avoidance rules that disallow interest on particular transactions.

7.3.3 Implementation of BEPS Action 4 Report in Indian legislation

The Government of India, through Finance Act, 2017, introduced anti-abuse provisions in the Indian tax laws that provides for limitation on interest deduction in certain cases, which is broadly in line with the recommendations as per BEPS Action 4 Report.

❖ **Requirements of Section 94B**

- Section 94B of the Income Tax Act, 1961 provides the provisions for the restriction of interest payments made by a company in India or a foreign company that is permanently set up in India to its Associated Enterprise that is established abroad.
- Interest Payments should be restricted to a 30 per cent of the revenue before any interests, taxes, depreciation and amortisation or interests paid to an Associated Enterprise, whichever may be less. A period of 8 years is permitted to carry the disallowed potion forward. Moreover, the provisions offered by the Section would be applicable if an interest payment exceeds INR 1 Crore only.
- The following example will help to understand this better. Suppose, the Earnings before interest, tax, depreciation and amortisation (*EBITDA*) of an Indian Company is INR 200 Crores. The total interest payment would be INR 65 Crores which would be split as INR 45 Crores to Non-Associate Enterprise and INR 20 Crores to Associate Enterprise.
- The disallowance would be calculated as lower of 30% of the amount of tax sought to be evaded, or 20% of the sum totally payable to the associated enterprise. For example, out of Rs. 5 crores, INR 20 lakhs would be payable as a penalty to the Income Tax Department.

❖ **Applicability:**

As per the provisions provided in Section 94B, this section would apply under the following conditions.

- If the borrower is either an Indian Company or a permanent establishment for a foreign company in India.
- If the lender is a company that is located abroad and is an Associate Enterprise within the aspects mentioned under Section 92A of the Income Tax Act.
- If the expense is deductible under the head Profits and Gains of Business or Profession.
- If the expense is like interest, discount or any other similar finance charges and includes the debt in the form of a loan, financial lease, financial instrument, financial derivative or other arrangements that give rise to the expenses mentioned above.

It should be noted that if the borrowing is not from an Associate Enterprise directly, the debt shall also be termed to from an associate enterprise for the section. This also included when the lender, in turn, has borrowed from an associated enterprise of the borrower entity and has in turn on-lent.

❖ **Exceptions**

Banking and Insurance companies are not included under the rules of the Thin Capitalisation Rules. Non-Banking Financial Companies have not been involved in the exemptions.

❖ **Impact on A Non-Banking Financial Company**

The provisions of the Section has dramatically affected the Non-Banking Financial Companies and the same has been summarised below for a quick reference.

- Section 94B applies to Non-Banking Financial Companies as the interest expenses of the respective company will be subject to disallowance from the income tax perspective if the threshold limits prescribed by the section are breached.
- One of the major cost components of a non-banking financial company happens to interest expense. These companies take money from investors and provide funds to the earn interest income. Therefore, there happens to be a greater outflow for tax if the company is funded by an Associate Enterprise and exceeds the threshold limit.
- If the parent of a non-banking financial company happens to be a FOCC, the provisions of this section would be applicable apart from the whole transfer pricing provisions and rules, which would add to the cost burden of the company.
- Furthermore, this section has a clause that states so much interest as by an Indian company which has been implicitly or explicitly guaranteed by the Associate Enterprise would be disallowed.
- Similarly, it would be difficult for core investment companies having funds from associated enterprises to survive.
- The purposes of leveraging are to increase the return on equity, reduce tax burdens and maintain the cost of funds facilitating the viability of a business. The disallowance of the interest expenses under this section would force companies to create a sort of balance between the debt and the equity, such that the disallowance may be negated, which would further have an impact on the cost of the funds as well.

- **Impacts on other sectors**

  After scrutinising the opinions received from various quarters, the Central Board of Direct Taxes (CBDT) has arrived at the conclusion that this section would have a significant effect on the following sectors, which are listed below.

  - **Impact on Start-ups:** Most start-ups are funded by foreign companies that hold significant stakes in the company they are supporting. According to the broad definition of Associated Enterprises in the Section, it may seem like start-ups would have to face hurdles. Furthermore, a start-up procures funding on a guarantee provided by the Associated Enterprise that holds stakes and a guarantee of being covered under the ambit of the provisions will also affect the operations of start-ups.
  - **Impact on Infrastructure Companies:** Given that substantial funding is required for an Infrastructure Company, it is primarily funded by an Associated Enterprise, and the provision under the Section is likely to impede operations of an Infrastructure Company. While the regulatory aspects of banks and non-banking financial companies may seem equal, non-financial banking companies are not involved in the exclusion list for the applicability of this section. This certainly has a negative impact on the funds costs and the ability to do business.

- **Global experience**

  Many countries have implemented interest limitations rules in various forms, including a) arm's length rule, by establishing the arm's length debt amount that an independent party is willing to lend and further the arm's length interest rate that an independent party is willing to charge; b) general rules, which disallow certain percentage of interest expense or limit the level of interest expense or debt with reference to a fixed ratio like interest to earnings or debt to equity at an entity level or at a group level; and c) targeted rules, to address specific planning risks and limit interest deduction on specific transaction.

  Different tax jurisdictions have implemented interest limitation rules by applying various parameters, which are aligned with their objective of implementing such rules. Brazil, Canada, China, Indonesia, Mexico, Russia, and Switzerland have prescribed threshold ratios of debt to equity, which ranges from 1.5:1 to 4:1. On the other hand, India, Germany, Luxembourg, Malaysia, the Netherlands, US and UK have prescribed an upper cap for interest expense deduction in the form of interest to Ebitda ratio, which ranges from 10% to 50%. France, Korea, and Japan have adopted a hybrid approach by implementing both parameters to test thresholds using debt to equity and interest to Ebitda approach.

- ❖ **Conclusion**

  In a growing number of countries, tax administrations deem it necessary to include such thin capitalisation rules in their tax legislations, to limit interest deductions to regulate the alleged profit shifting by MNEs. Subject to commercial considerations, this would necessitate MNEs to consider the deductibility of interest expense while obtaining an interest-bearing debt. The inclusion of third-party borrowings guaranteed by the non-resident associated enterprise under the ambit of thin capitalisation could have serious repercussions on the fundraising efforts of taxpayers, especially those operating in capital-intensive sectors or sectors having longer gestation periods. Further, it could impact certain start-ups who generally face a loss situation in their initial years and usually need support in the form of guarantees from their related parties to leverage their third-party borrowings, which could be deemed as related-party debt under these provisions.

  The challenges faced by taxpayers under the thin capitalisation rules have further aggravated on account of the hardships faced during the covid-19 pandemic. Some entities would have incurred huge losses due to varied reasons. To ensure the survival of such entities and ensuring sufficient working capital requirements, MNE groups may extend support by lending funds. Such increased debts combined with losses (or insignificant profits) may adversely impact the interest deductibility for several taxpayers.

  MNEs may navigate the complexities of interest deductibility by determining an optimal capital structure, especially during the initial or low profit phases of their operations, or exceptional circumstances faced during the pandemic.

<u>8. Country-by-Country Reporting</u>

8.1 Introduction

India entered into Double Tax Avoidance Agreement (DTAA) with various countries with the aim to ensure that none of the taxpayers are harassed because of double taxation in both the countries (one where the income is earned and other where he is resident). However later on all the countries realized that these DTAA's are used by various entities for tax evasion and avoidance by various means, one of which is by shifting profits to a lower tax jurisdiction.

Under BEPS Action 13, all large multinational enterprises (MNEs) are required to prepare a country-by-country (CbC) report with aggregate data on the global allocation of income, profit, taxes paid and economic activity among tax jurisdictions in which it operates. This CbC report is shared with tax administrations in these jurisdictions, for use in high level transfer pricing and BEPS risk assessments.

The BEPS report recommends that countries adopt a standardised approach to transfer pricing documentation; it mandates the following three tier structure :

Sr. No.	Document	Information
1	Master File	Standardised information relevant for all multinational enterprises (MNE) group members.
2	Local File	Specific reference to material transactions of the local taxpayer.
3	Country-by-Country Report	Information relating to the global allocation of the MNE's income and taxes paid;and Indicators of the location of economic activity within the MNE group.

The Finance Act, 2016 introduced provisions relating to Country by Country Report (CbCR) and Master File pursuant to adoption of OECD's BEPS Action Plan-13 in India. On 31st October 2017, CBDT released the Final Rules with respect to maintenance and furnishing of Master File and CbCR.

8.2 Key Requirements for MF and CbCR – India Perspective

The key requirements for MF and CbCR from an India perspective are explained in the subsequent paragraphs:

- ***Master File Threshold for Master File***

The MF will be applicable to every constituent entity (CE) of an international group (whether inbound [having a parent entity resident in a jurisdiction other than India] or outbound [having a parent entity resident in India]), subject to the following two conditions:

- Consolidated revenue of such international group as reflected in its consolidated financial statements (CFS) for the accounting year exceeds INR 6.4 billion; and
- The aggregate value of international transactions of the CE:
  - during the accounting year (as per the book of accounts) exceeds INR 500 million, or
  - in respect of purchase, sale, transfer, lease, or use of intangible property during the accounting year (as per the book of accounts) exceeds INR 100 million.

Observation: For inbound groups, the prescribed consolidated group revenue threshold is quite low and could result in some groups being required to prepare a MF only for India.

Information and documents to be kept and maintained

The documentation prescribed in respect of the MF is largely in line with OECD's final BEPS Action 13 report, but with the following additional requirements of the functions performed, assets employed, and risks assumed by CEs of the international group that contribute to at least 10 percent of revenues *or* assets *or* profits taken on an individual basis. By contrast, the OECD requires a description of principal contributions to value creation by individual entities of the group.

- List and address of all entities of the international group (rather than that of 'operating entities').
- List of all entities of the international group engaged in development and management of intangibles along with their addresses.
- Names and addresses of the top ten unrelated lenders.
- The Indian MF has, in several instances, warranted the need for 'detailed' information as against 'general description' required by the OECD.

Observations: With respect to the description of functions performed, assets employed, and risks assumed, the financial metric of 10 percent provides a definitive *de minimis* threshold, which the OECD Action 13 report does not. However, it could create a greater compliance burden for groups, since this documentation requirement differs from what is specified under Action 13, where the requirement is only to provide a brief functional analysis describing the principal contributions to value creation by individual entities in the group. In addition, revenue, assets, and profits may not have consistent definitions across jurisdictions, which may lead to inconsistent results when applying the 10-percent threshold.
With respect to intangibles, the focus seems to be not only on legal ownership of intangibles, but also on their economic ownership.
With respect to financing arrangements, clarity is needed on the term 'lenders.'
Overall, since the Indian rules prescribe MF requirements over and above the OECD template, the compliance burden will be higher, because globally prepared MFs will need to be customized for India.

Filing specifications

- The MF is to be filed electronically, and the procedures to do so will be specified.
- The prescribed form contains two parts: Part A and Part B. Part A requires generic information about the CEs in India, and Part B relates to the content of the MF.
- Where there are multiple CEs in India of the same group, the rules provide an option to designate a CE resident in India to undertake the MF compliance on behalf of the group. The designated CE must furnish the MF to the specified Indian Revenue Authority.

Observations: The option of having only the designated entity to undertake the MF-related compliances instead of all CEs of the group is a welcome move, as it will provide

administrative relief with respect to filing of MF for groups that have multiple entities operating in India.
However, by referring to CEs ‘resident in India’, the rule seems to inadvertently not cover non-resident CEs of an international group (that are required to undertake tax and transfer pricing compliances in India), who will have to file both Part A and Part B of the form for furnishing the MF on an individual basis, thereby increasing their compliance burdens.

Security of information filed in the MF

Specified income-tax authorities shall be responsible for developing and implementing appropriate security, archival and retrieval policies in relation to the information furnished in the MF.

Observation: Various stakeholders had raised concerns about the confidentiality and security of information filed as part of the MF. It is a significant positive that the rules have specifically spelled out that the responsibility for holding security of such information lies with the Indian income-tax authorities.

Snapshot of the Indian MF compliance requirements

Who	***What***	***When***	***To Whom***
A constituent entity (irrespective of: • whether the entity has entered into an international transaction • threshold applicability • whether the entity is resident or not)	Part A of Form No. 3CEAA	By due date of furnishing Return of Income (ROI) i.e. for **AY 2021-22, it is 30 November 2021** except for FY 2016-17, for which the deadline is on or before March 31, 2018 (Refer Note 1 below)	Director General of Income-Tax, Risk Assessment (DGIT, RA)
A constituent entity passing the prescribed thresholds	Part B of Form No. 3CEAA	By due date of furnishing ROI, i.e. for **AY 2021-22, it is 30 November 2021** except for FY 2016-17, for which the deadline is on or before March 31, 2018	DGIT, RA

The designated entity, where there are multiple CEs resident in India	Form No. 3CEAA (Part A and Part B) Form No. 3CEAB	Form No. 3CEAA (Part A and Part B) - by due date of furnishing ROI, except for FY 2016-17, for which the deadline is on or before March 31, 2018 Form No. 3CEAB - at least 30 days before the due date of filing Form No. 3CEAA, except for FY 2016-17, for which the deadline is on or before March 1, 2018	DGIT, RA

Note 1: The MF filing due date has been aligned to the due date for filing the ROI. It also seems that the MF filing has been contemplated for a reporting accounting year that is the same as the Indian FY (i.e., April to March).

Observations: While the above filing rules may work well for an Indian outbound group, they may not for an inbound CE resident in India. This is because there is a high likelihood that the parent entity of an inbound CE resident in India will have a different reporting accounting year and have a filing deadline that does not coincide with the Indian ROI filing deadline. Accordingly, at least for the first year of implementation, the filing timeline for a MF for an inbound CE resident in India could have been made concurrent with filing timelines in the jurisdiction of the parent entity.

Also, practically speaking, inbound CEs resident in India will not have access to the MF unless it has been filed or made available by the parent entity in the first place. Thus, the abovementioned alignment of filing timelines would go a long way in easing compliance by inbound CEs resident in India.

Master File: Objective and Features

- The master file would provide an overview of the MNE group business including;
  - The nature of its global business operations
  - Its overall transfer pricing policies, and
  - Its global allocation of income and economic activity

in order to assist tax administrations in evaluating the presence of significant transfer pricing risk.

- The master file is intended to provide a high level overview in order to place the MNE group's transfer pricing practices in their global economic, legal, financial and tax context.
- The master file shall contain information which may not be restricted to transaction undertaken by a particular entity situated in particular country.
- Thus, information in master file would be more comprehensive than the existing regular transfer pricing documentation.
- The master file shall be furnished by each entity to the tax authority of the country in which it operates.

❖ ***Country-by-Country (CbC) report - Threshold for CbC report***

The CbC report provisions apply where the total consolidated group revenue of the international group is INR 55 billion (approximately USD 846 million) or more in the CFS of the preceding accounting year. The rules also provide clarity on the foreign exchange conversion date and rate to be used to compute threshold of INR 55 billion of the international group.

Observation: Although many countries have followed the Euro 750 million threshold, India has established its threshold in local currency. This may not fully align with the Euro 750 million threshold, due to exchange rate movements or because of rounding.

Information requested

The details of the CbC report are consistent with the OECD's final BEPS Action 13 report. The CbC report and related forms are to be filed electronically, procedures for which will be specified.

Security of information filed in the CbC report

The specified income tax authorities shall be responsible for developing and implementing appropriate security, archival, and retrieval policies for the information furnished in the CbC report.

Snapshot of the Indian CbC report compliance requirements

Who	***What***	***When***	***To Whom***
CE resident in India, which is part of an international group and whose parent is a non-resident (*Refer Note 1 below*)	Form No. 3CEAC (Notification)	on or before **December 31, 2021**, against previous deadline of November 30, 2021, except for FY 2016-17, for which the deadline is on or	DGIT, RA

		before January 31, 2018	
Parent entity, or alternate reporting entity, that is: ǀ ǀ resident in India; and ǀ ǀ part of an international group, the consolidated group revenue of which exceeds the prescribed threshold	Form No. 3CEAD (CbC report)	AY 2020-21 has extended from November 30, 2020 to **January 31, 2021** vide Press Release, dated 24-10-2020. Due date to exercise option of safe harbour rules for specified domestic transaction by furnishing Form 3CEFB. By due date of furnishing ROI, except for FY 2016-17, for which the deadline is on or before March 31, 2018	DGIT, RA
CE resident in India, that is part of an international group and whose parent is non-resident [and if conditions of section 286(4) of the Indian Income-tax Act ('the Act') are satisfied]	Form No. 3CEAD (CbC report)	Filing date will be contingent to the provisions of section 286(4) of the Act	DGIT, RA
The designated entity, where there are multiple CEs resident in India that are part of the same international group and whose parent is non-resident [and if conditions of section 286(4) of the Act are satisfied] (*Refer Note 2 below*)	Form No. 3CEAE (Intimation)	Not specified, as the filing date will be contingent to the provisions of section 286(4) of the Act	DGIT, RA

Note 1: The notification allows the inbound CE resident in India to disclose upfront for which period its group's CbC report will be prepared. This information should help Indian

Revenue Authorities to track CbCR reporting requirements in the parent entity's jurisdiction with respect to inbound groups.

Note 2: The Indian Regulations provide for filing of the CbC report by an inbound CE resident in India in the following situations:

- The parent entity of the international group is a resident of a country with which India does not have an agreement providing for exchange of CbC report; or
- There is an exchange framework with that country but there has been a systemic failure in exchanging information.

In those situations, the CbC report shall be furnished by the inbound CE resident in India within the specified time. Where there are multiple CEs resident in India that are part of the same international group, the designated CE needs to file the CbC report and file an intimation to that effect in Form No. 3CEAE with the specified Indian revenue authority.
The due date of filing the CbC report by an inbound CE resident in India has not yet been explicitly notified.

The Takeaway
Some aspects of the Indian rules appear to require more data than the OECD requirements. There is a need to strike a balance between the provision of more data on the one hand (which will carry a higher compliance burden), versus data that is sufficient for a risk assessment.

With the new rules, both inbound and outbound entities operating in India will need to maintain and disclose a significant amount of information. This will require entities to ensure they have the capability to execute, especially from the perspective of human resources and technology.

For the MF, considering the additional Indian requirements, groups could consider preparing an India supplement to the MF which captures the additional information prescribed under the Indian rules. This would allow the group's 'OECD compliant' MF to remain intact.

After the rules are issued, we hope that, like in the past, the GoI will release FAQs to clarify some aspects and provide further guidance on the implementation of the rules. For example, guidance on whether an inbound CE resident in India is required to file a CbC report in the absence of a CbC report being prepared or required globally would provide much needed clarity around CbC report filing requirements for those groups and would help ease compliance burdens.

9. Alternative Transfer Pricing Rules (African Countries)

Africa with 54 countries and 10 dependent territories, holds a diverse range of jurisdictions at varying stages of economic development. With significant foreign investment and rapid growth, many African countries are taking steps to shore up their tax systems and ensure their ability to tax a share of profits attributable to their jurisdictions.

This geopolitical tussle has pushed transfer pricing to the top of the agenda. Many countries in Africa have recently adopted or updated transfer pricing rules in line with the Organisation for Economic Co-operation and Development's (OECD) guidelines. At the same time, companies face intense scrutiny from tax authorities, investors and other stakeholders about their approach to tax and where they pay it, and the number of transfer pricing audits in Africa has increased dramatically.

Africa's transfer pricing reforms and their key practice in managing compliance and mitigating transfer pricing risk:

❖ **Joining in the global project to address BEPS**

The OECD's global project to prevent Base Erosion and Benefit Transfer (BEPS) is perhaps the biggest driver of transfer price change in Africa and globally. Many African countries are changing to new international tax rules and tax treaties in line with OECD recommendations.

28 countries in Africa are among the 135 members of the OECD's Inclusive Framework. These and other countries have been keen to implement the BEPS minimum standards. For example:

- **South Africa, Nigeria** and **Gabon** have implemented country-by-country tax reporting.
- Many African countries are taking part in the global transfer pricing debates, especially regarding requirements for service transactions, capital-rich and low-function entities, and analyses of intangibles based on development, enhancement, maintenance, protection and exploitation (DEMPE).
- Many African countries are also taking steps to implement the OECD's recommendations for countering harmful tax practices through coordinated international tax rules and enforcement efforts. Beyond the BEPS minimum standards, countries in Africa, such as **Uganda, Benin** and **Zambia,** are imposing the OECD's new limitations on interest deductibility as a percentage of earnings before interest, deductions, taxes and amortization (EBITDA).
- Some countries are also exploring the adoption of safe harbor regimes.

❖ **Recent Transfer Pricing Reforms: Selected African Jurisdiction**

Below are snapshots of new and revised transfer pricing rules and practices being put in place in selected African jurisdictions.

Nigeria

Nigeria's transfer pricing regulations were revised in 2018, primarily to align with the OECD's BEPS recommendations.

Other key transfer pricing reforms announced by Nigeria include

- Adopted the OECD's three-tiered approach of transfer pricing documentation (i.e. country-by-country reports, master and local files) with the threshold for country-by-country reporting set at 160 billion Nigerian naira (about 750 million euros).
- new requirements on procurement and intra-group service transaction
- introduction of guidelines on pricing of commodities
- a limitation of deduction on royalty payment
- clarification that only pricing arrangements approved by the tax authority (and not other government agencies) qualify for a safe harbor
- strict penalties for non-compliance.

Since these rules were introduced, the number of transfer pricing audits has steadily increased and the Nigerian tax authority is penalizing taxpayers found to be in default.

Since these rules were introduced, the number of transfer pricing audits has steadily increased and the Nigerian tax authority is penalizing taxpayers found to be in default. The tax authority now has more knowledge of the global activity of multinational enterprises, and is also taking an aggressive approach towards revenue generation and collection. Consequently, the volume of transfer pricing audits in Nigeria is expected to increase in the future.

Tanzania

- The new Tax administration (Transfer pricing) Regulations, 2018 replace the previous Regulations issued in 2014.
- Regulations issued in 2018 require taxpayers with related party transactions of TZS 10 Billion (USD 4.35 Mil) or more must now file their transfer pricing documentation together with their tax returns.
- Penalties may be imposed of up to 100 percent for adjusted transfer pricing amounts and approximately up to USD 23,000 for failing to maintain contemporaneous documentation.
- Elimination of royalties for locally developed intangibles that are transferred and then licensed for use in Tanzania
- Rejection of service transactions where remuneration is based on a percentage (i.e. remuneration must be based on cost)
- Restriction on use of ‘tested parties’. Use of a tested party located outside of Tanzania will only be permitted when the party’s financial statements are provided
- The comparable uncontrolled price (CUP) method is now the designated method to test commodity transactions.

Kenya

- Kenya's draft income tax bill for 2018 expanded the scope of the country's transfer pricing rules to cover transactions with parties in beneficial tax regimes as well as both associated and unrelated parties in preferential tax regimes offered by foreign countries. Transactions with non-resident persons that lack economic substance will also be considered for transfer pricing adjustments. Other new rules require annual contemporaneous documentation, use of a prescribed method for commodity transactions, rejection of negative transfer pricing adjustments and acceptance of secondary transfer pricing adjustments.
- A penalty for failing to maintain documentation may be imposed of 2 percent of the controlled transaction's value.
- Introduction of Country-by-Country reports: CbyC reporting will result in additional transfer pricing documentation and reporting requirements for MNEs. In addition, this will lead to increased compliance costs. The change is effective from 1 July 2021.

Rwanda

- On 14 December 2020, Rwanda's new general rules on transfer pricing ("New TP Rules") which are in line with the key aspects of the 2017 OECD guidelines.
- The New TP Rules apply to transactions between related (known as controlled transactions) where one of the parties is a Rwanda tax resident, as well as transactions between non-resident related persons if the transaction concerns the permanent establishment of one of those persons in Rwanda.
- The New TP Rules permits both **transaction-based** (CUP, RPM, CPM) and **transactional profit** (TNMM, PSM) transfer pricing methods, as opposed to the repealed transfer pricing rules which only provided for transaction-based methods.
- The New TP Rules also allow the use of alternative methods where none of these five methods can be reasonably applied to achieve an arm's length outcome.

Uganda

Uganda's transfer pricing rules have been in place since 2011 and cover both cross-border and domestic transactions. Where provisional tax paid is less than 90 percent of the actual tax assessed, a penalty of 20 percent of the shortfall may apply. For documentation purposes, only a local file is required, and, for in-country transactions, a filing threshold of USD 135,000 applies. Unilateral, bilateral and multilateral APAs are available.

Ethiopia

Ethiopia is not an OECD member, but its transfer pricing regulations are influenced by the OECD's guidelines. A 2015 directive requires related resident taxpayers with annual turnover of over USD 22,000 to maintain transfer pricing documentation. The directive also details the concept of comparability based on the OECD's provisions, allows the use of other methods when justified, and prohibits the use of secret comparables. Transactions that are assessed as outside the arm's length range are adjusted to the median. Taxpayers can also apply for APAs under the directive.

South Africa

South Africa's transfer pricing legislation was overhauled as of April 2012 to align more with the OECD's guidelines. Although South Africa is not an OECD member, the country has been actively involved in the OECD Working Party processes around BEPS. South Africa is therefore expected to release new transfer pricing guidance in the near future.

The South African Revenue Services (SARS) now has a full team of transfer pricing specialists and increased audit activity has been observed. With the recently introduced transfer pricing documentation requirements, more relevant information is being provided to the tax authority, and their use of risk assessment and other IT tools has further improved capabilities.

As a result, taxpayers have seen significantly increased focus on transfer pricing since mid-2019, and SARS has announced that it will focus on transfer pricing reviews to combat base erosion and profit shifting. Evidence of these efforts was seen in the national budget for 2020-2021 presented on 26 February 2020 which proposed a significant change to the interest limitation provisions in respect of cross-border loans, introduced for years of assessment commencing on or after 1 January 2021.

Botswana

Botswana's transfer pricing regulations took effect in July 2019, setting out a new framework for enforcing the arm's length principle. Among other things, the regulations:

- Prescribe five approved methods of transfer pricing, prioritizing use of the comparable uncontrolled price method (CUP) when other methods equally apply, and use of a traditional method when a traditional method and a transactional method are equally applicable.
- Provide for the use of the median in the arm's length range in making adjustments
- Set out factors to consider when determining arm's length prices in transactions involving intangible property.
- The regulations require selected taxpayers to prepare an annual transfer pricing local file and submit the local file when filing their tax return.
- In addition, affected taxpayers with a transaction or transactions exceeding BWP 5 million with a connected person within a multinational entity group are required to provide to the commissioner general a transfer pricing master file upon written request.
- Authorize the making of corresponding adjustments, provided certain conditions are met.
- Prescribe rules for maintaining contemporaneous documentation.

Test Your Knowledge

QUESTIONS	
1	According to Section 286 of Income Tax Act, 1961, which taxpayers are subject to country-by-country reporting requirements in India?
2	Company X is incorporated in Singapore and has a subsidiary Company Y in India. Company X has invested INR 600 crores by way of equity shares and INR 1600 crores by way of debt. Company Y has revenues of INR 1500 crores and an EBIDTA of INR 600 crores. Company Y is required to make interest payment of INR 160 crores to Company X and INR 150 crores to other domestic creditors. Based on the above facts, examine the tax implications in the hands of Company X and Company Y respectively in respect of the interest payments that it is made by Company Y to Company X.

SOLUTIONS	
1.	Under section 286 of the Income Tax Act, 1961, the country by country report (CbCr) filing requirement in India would arise in the case of the following entities: (i) The parent entity of an international group (which has been defined to include two or more enterprise including a permanent establishment which are resident of different countries or territories having total consolidated group revenue in the preceding accounting year of more than INR 5500 crore), if it is resident in India (ii) An entity in India belonging to an international group, if the parent entity of the group is resident: • In a country where the parent entity is not obligated to file the report of the nature referred to in section 286(2); or • In a country with which India does not have an arrangement for exchange of the CbC reporting; or • Such country is not exchanging information with India even though there is an agreement; and this fact has been intimated to the constituent entity by the Indian tax administration. Provisions in the connection with CbCr also provide that if an international group, with a parent entity which is not resident in India, has designated an alternate entity for filing its report with the tax jurisdiction in which the alternate entity is resident, then the entities of such group operating in India would not be required to furnish a CbC report if the same can be obtained under the agreement of exchange of CbC reports the Indian tax administration.
2.	There are two different tax consequences that will have to be examined in this case. First, in the hands of Company X and second in the hands of Company Y. **In the hands of Company X**, the interest payments received will be taxable under the provisions of the Act as well as under the India Singapore DTAA. Under the Act, Section 9(1)(v) provides that income by way of interest payable by a person who is a resident, except where the interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of business or profession carried on by such person outside India or earning income from any source outside India; shall be deemed to accrue or arise in India. Since Company X has revenues only from business activities carried on in India, the interest income will be taxable under the provisions of the Act. The applicable rates that will apply for such withholding will be restricted to 5 per cent due to the application of section 194LC. Under the provisions of the India Singapore DTAA, Article 11 para 2 also provides a right to the source state, provided that the tax so charged shall not exceed 10 per cent of the gross amount of interest payable if the interest is paid on a loan granted by a bank or similar financial institution and 15 per cent in other cases. **In the hands of Company Y**, apart from withholding tax implications, the thin capitalization provisions will also be relevant. Section 94B has been inserted to

	provide for thin capitalization rules in India. As per the provisions, where an Indian company pays more than one crore which is deductible in computing income under the head ‘profits and gains of business or profession’ in respect of debt issued by a non-resident, being an associated enterprise of such borrower, the interest shall not be deductible in computation of income under the said head to the extent it arises from excess interest. Excess interest has been defined under Section 94B to mean an amount of total interest paid or payable in excess of 30% of EBIDTA of the borrower in the previous year or interest paid or payable to the associate enterprise, whichever is less. Company X and Company Y will qualify as associated enterprises. Therefore, any interest in excess of 180 crores (600*30/100) shall be treated as excess interest and shall not be available deduction in the hands of the Company Y. Company Y can however carry forward the excess interest for a period of up to 8 years and offset the same in future years.