Challenges and Way Forward for Implementation of Transfer Pricing Guidelines 2024

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Intra-group transactions

- Significant volume of global trade nowadays consists of international transfers of goods and services, capital (such as money) and intangibles (such as intellectual property) within an MNE group.
- Accounts for more than 30 per cent of all international transactions.

- In 2023, the US dollar value of
  - world merchandise trade was US$ 24.01 trillion
  - commercial services trade was US$ 7.54 trillion

Global value chains
(the international fragmentation of production)

OECD › Topics › Global value and supply chains

Global value and supply chains

About 70% of international trade involves global value chains (GVCs), as services, raw materials, parts, and components cross borders – often numerous times. A strong trend has emerged towards the international dispersion of value chain activities such as design, production, marketing, distribution, etc. This emergence of GVCs and increased interest in their sustainability and resilience requires analysing supply chains as a whole and developing policies around them.

Figure 6. The Nutella® global value chain

Source: Ferrero.

The food processing company Ferrero International SA is headquartered in Luxembourg and currently has ten factories producing Nutella

De Backer, K. and S. Miroudot (2013), "Mapping Global Value Chains", OECD Trade Policy Papers, No. 159, OECD Publishing

Definition

- Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises. (OECD TRANSFER PRICING GUIDELINES, 2022 , Chapter 1, para. 11)

- “Transfer pricing” is the general term for the pricing of cross-border, intra-firm transactions between related parties. Transfer pricing therefore refers to the setting of prices for transactions between associated enterprises involving the transfer of property or services. These transactions are also referred to as “controlled” transactions, as distinct from “uncontrolled” transactions between companies that are not associated and can be assumed to operate independently (“on an arm’s length basis”) in setting terms for such transactions. (United Nations Practical Manual on Transfer Pricing , para 1.1.6)

Why transfer pricing rules ???

- BEPS issues
- To avoid “mis-pricing”, “incorrect pricing”, “unjustified pricing” or non-arm’s length pricing
- Intra group transaction are no longer governed entirely by market forces, but driven by the common interests of the entities of a group. (may be tax or other interest)

		Case I	Case II	
Country A	Profit before tax	50	100	
CIT rate = 5%	tax	2.5	5	
	PAT	47.5	95	
			Shifting of profit from high tax to low tax jurisdiction	
Country B	Profit before tax	100	50	
CIT rate = 30%	Tax	30	15	
	PAT	70	35	
Group	Profit before tax	150	150	
	Tax	32.5	20	Less Tax
	PAT	117.5	130	High Group Profit

Profit shifted from high tax jurisdiction to low tax jurisdiction.
Aim is to maximize overall group cashflows.

स्वतंत्र
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Arm’s Length Price सामान्य बजार व्यवहार मूल्य

- Para 1 of Article 9 of OECD Model Tax Convention/ UN Model Double Tax Convention:

  [Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly

- Price of comparable uncontrolled transactions or Market Price स्वतंत्र व्यक्तिहरु बीच कारोवार हुँदा निर्धारण भएको मूल्य
- Separate entity approach rather than a unified single business
- Provides broad parity समान्ता/ निश्चितता of tax treatment
- The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm’s length.
- Closest approximation of the workings of the open market
- A move away from the arm’s length principle would abandon the sound theoretical basis of ALP and threaten the international consensus.

Is it tax avoidance/ tax fraud

३२७. कराधार क्षयीकरण, मुनाफाको स्थानान्तरण तथा आयको खण्डीकरण जस्ता अभ्यासबाट हुने करछलीको रोकथाम तथा न्यूनीकरणको लागि हस्तान्तरण मूल्यसम्बन्धी निर्देशिका तर्जुमा गरिनेछ।

- There may be a genuine difficulty in accurately determining a market price in the absence of market forces or when adopting a particular commercial strategy. It is important to bear in mind that the need to make adjustments to approximate arm’s length conditions arises irrespective of any contractual obligation undertaken by the parties to pay a particular price or of any intention of the parties to minimize tax.
- The consideration of transfer pricing should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes.

- Planning < Avoidance < Evasion

OAG 2079 60th Report

७०. **मूल्य हस्तान्तरण -** आयकर ऐन, २०५८ को दफा ३३ (१) अनुसार सम्बद्ध व्यक्तिहरूबीच कुनै व्यवस्था भएकोमा सो व्यवस्था सामान्य बजार व्यवहारअनुसार सञ्चालन गरिएको भए तिनीहरूका लागि कायम हुनसक्ने करयोग्य आय वा बुझाउनपर्ने कर प्रतिबिम्बित हुने किसिमले ती व्यक्तिहरूबीच आय गणना गर्दा समावेश वा कट्टी गरिने रकमहरू विभागले लिखित सूचना जारी गरेर वितरण, विनियोजन वा बाँडफाँड गर्न सक्ने व्यवस्था छ। नेपालमा बहुराष्ट्रिय कम्पनी वा अन्य करदाताहरूले सम्बद्ध कम्पनी, नियन्त्रित निकायहरूलाई कुनै सेवा लिई वा नलिई (अमूर्त रूपमा) समेत रोयल्टी, व्यवस्थापन शुल्क, परामर्श शुल्क, व्यवस्थापन सहयोग लगायत शीर्षकमा ठूलो रकम खर्च लेखे गरेका छन्। यसरी कम्पनीमा शेयर लगानी वा अन्य तरिकाले नियन्त्रण राख्ने निकायलाई गरिएको भुक्तानीमा अग्रिम करकट्टी गरेको उल्लेख गरी दाबी गरेको खर्चलाई कर प्रशासनले छुट दिने गरेको छ। यस्तो रकम कुन हदसम्म छुट दिने लगायतका मापदण्ड समेटेर विभागले मूल्य हस्तान्तरण (ट्रान्सफर प्राइसिङ) निर्देशिका तयार गरेको छैन। करदातालाई लाग्ने व्यावसायिक कर भन्दा अग्रिम करको दर कम भएकोले यस्तो खर्चहरू करदाताले कर नियोजन गर्ने उद्देश्यले समेत गरेको हुन सक्नेमा सोको छानवीन गर्ने गरेको पाईँदैन। यस्ता कारोबारमा व्यावसायिक कर र अग्रिम करको दर समान बनाउने र कर नियोजनलाई नियन्त्रण गर्ने गरी मूल्य हस्तान्तरण निर्देशिका बनाई लागू गर्नुपर्दछ।

Transfer Pricing Directive, 2081 (2024)

- Need for TP law stressed in Budget Speech 2024 (para. 327)
- Issued on 6th October, 2024
- In the form of Directive, rather than full fledged law (delegated legislation)
- Structure: Seven chapters and two annexures

Chapters

i) Introduction,

ii) Definition,

iii) Transfer pricing and arm’s length principle,

iv) Comparability analysis,

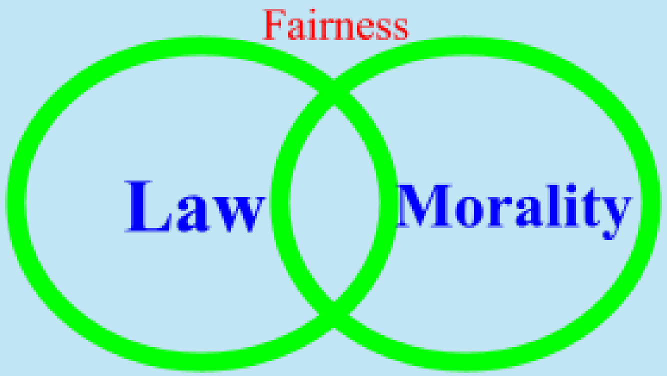
v) Method of arm’s length price determination,

vi) Transfer pricing documentation, and

vii) Transfer pricing administration

Chapter 1

- **Rationale**: This Directive has been formulated with the objective of receiving fair portion of tax (करको उचित हिस्सा) supposed to be received by the country by encouraging multinational companies to enter into international transactions at Arm’s length price (ALP).



- **Source**:
  - Section 33 of the Income Tax Act, 2002 (2058) and
  - Rule 15 of Income Tax Rules, 2003 (2059)
  - Section 139:

- **Hierarchy**
  - Income Tax Act, 2058
  - Income Tax Rules, 2059
  - TP Directive, 2081

Chapter 1 contd…

Section 33 of Income Tax Act

33. Transfer pricing and other arrangement between associated parties

- Sub-section (1) of Section 33 of the Act provides powers to IRD to distribute, appropriate or allocate the amount to be included or deducted in computing the income between associated enterprises in such manners as to reflect the [fair] taxable income or the [fair] tax payable.
- As per sub-section (2) of Section 33 of the Act, while taking action under section 33(1), the IRD has the power to re-characterize any income, loss, amount or source and type of payment.
- Sub-section (3) inserted in Section 33 of the Act by the Finance Act, 2024 provides that the transfer pricing methodology हस्तान्तरण मूल्यको मूल्याङ्कन विधि between the associated enterprises shall be as determined by the IRD.
- Rule 15 of the Income Tax Rules deals with advance pricing arrangements, which states that in cases where any one or more than one person makes a request in writing to IRD for the distribution, allocation or allotment on the basis of arm’s length in respect of the amounts to be included or deducted in computing the income of any person pursuant to Subsection (1) of Section 33 of the Act, the IRD may issue a notice in writing.

Chapter 2

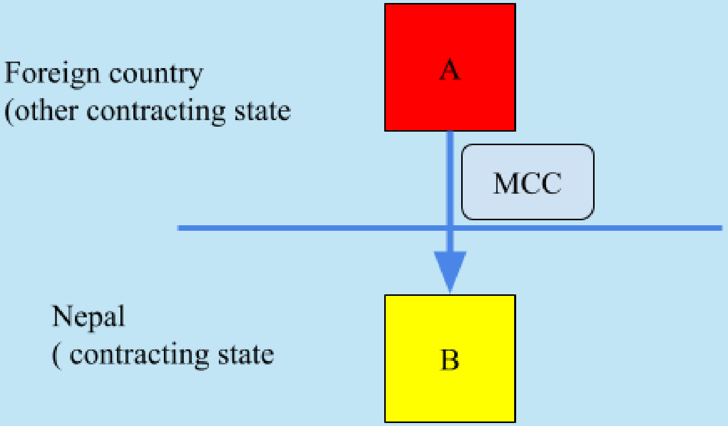
- defines key terms in the Directive
  - Comparability analysis,
  - Comparable uncontrolled transaction,
  - Controlled transaction,
  - Tested party,
  - Multinational company,
  - Arrangement,
  - Offshore transaction,
  - Foreign controlled transactions,
  - Un-controlled transactions,
  - Arm’s length transactions,
  - Transfer pricing determination

Associated Enterprise

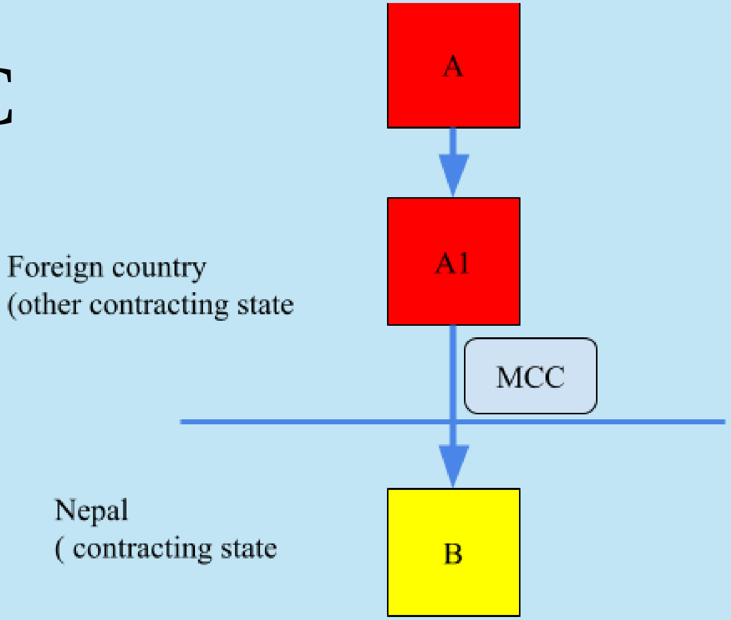
- is an enterprise that satisfies the conditions set forth in Article 9, sub-paragraphs 1a) and 1b) of the OECD Model Tax Convention Glossary page 19; UN Practical Manual on TP para 3.3.1.
- The degree of control as a threshold for triggering transfer pricing legislation has in effect been left to domestic legislation.

ARTICLE 9 ASSOCIATED ENTERPRISES - MCC

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

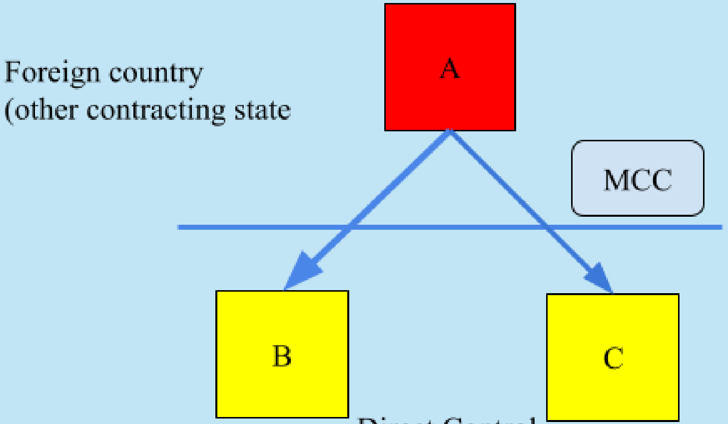


Direct Control

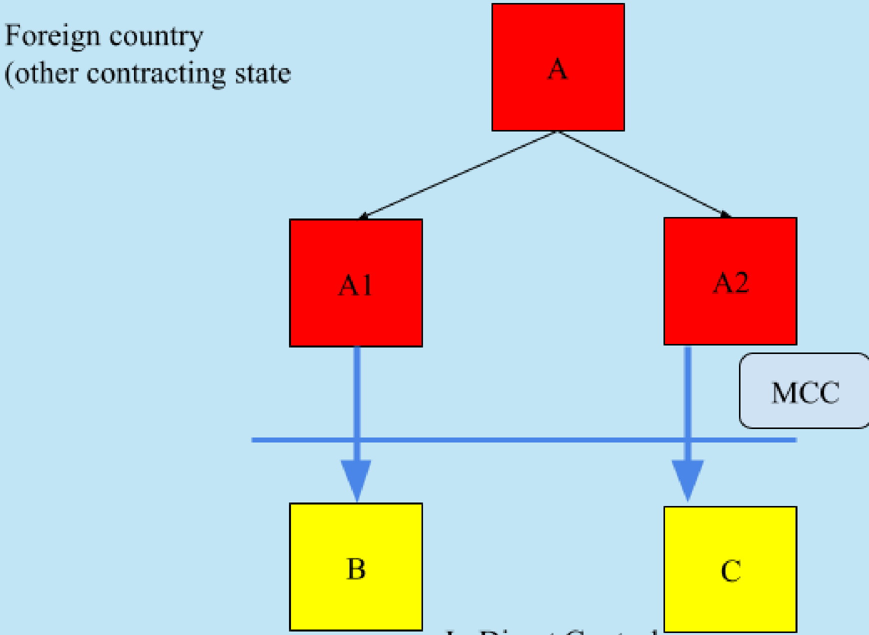


In Direct Control

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



Direct Control



In Direct Control

Definition as per ITA – broader than Article 9 1a & 1b

२(कन) 'सम्बद्ध व्यक्ति" भन्नाले एक अर्को व्यक्तिको मनसाय अनुसार काम गर्ने एक वा एकभन्दा बढी व्यक्ति वा त्यस्ता व्यक्तिहरूको समूह सम्झनु पर्छ र सो शब्दले देहायका व्यक्तिहरू समेतलाई जनाउँछः-

(१) प्राकृतिक व्यक्ति र सो व्यक्तिको नातेदार वा कुनै व्यक्ति वा सो व्यक्तिको साझेदार,

(२) विदेशी स्वायी संस्थापन र सो संस्थापनमा स्वामित्व भएको व्यक्ति, र

(३) कुनै निकाय आफै वा आफसँग सम्बन्धित अन्य व्यक्ति वा सहयोगी निकाय वा त्यस्ता सहयोगी निकायसँग सम्बन्धित अन्य कुनै व्यक्ति वा निकायसँग मिलेर कुनै निकायको आय, पुँजी वा मताधिकारको MCC पचास प्रतिशत वा सोभन्दा बढी हिस्सा नियन्त्रण गर्ने वा सोबाट फाइदा प्राप्त गर्ने निकाय। तर देहायका व्यक्ति सम्बद्ध व्यक्ति हुने छैनः-

(१) कर्मचारी,

(२) विभागले सम्बद्ध व्यक्ति होइन भनी तोकेको व्यक्ति ।

Whether intent is dominant or MCC is dominant test ??

Chapter 3: Transfer pricing and arm’s length principle

- Initially deals with principles of TP
- Arm’s length principle (internal comparables and external comparables.
- Principles of determination of ALP

Chapter 4: Comparability Analysis (Theory meets practice)

- Three steps in comparability analysis
  - Transactional analysis कारोबारको विश्लेषण (analysis of transaction between associated enterprises)
  - Functional Analysis (FAR test) कार्यात्मक विश्लेषण
  - Comparability analysis (comparison between controlled and uncontrolled transaction) स्वतन्त्र कारोबार सँग तुलना

Chapter 4: Comparability Analysis in operation

Six steps in comparability analysis

4.1
- Analysis of economically significant characteristics of business and transaction

4.2
- Examination of comparability factor of controlled transaction

4.3
- Selection of tested party

4.4
- Identification and selection of comparable

4.5
- Appropriate adjustment to comparable

4.6
- Selection of appropriate arm's length method

4.1 Analysis of economically significant characteristics of business and transaction (transactional analysis)

4.1.1 Gathering of basic information about the taxpayer

A. Analysis of Industry

- Value Chain (मूल्य श्रृङ्खला) Analysis
- Profit factor analysis
- Market trend
- Competitive Environment

B. Analysis of Business Environment of taxpayer

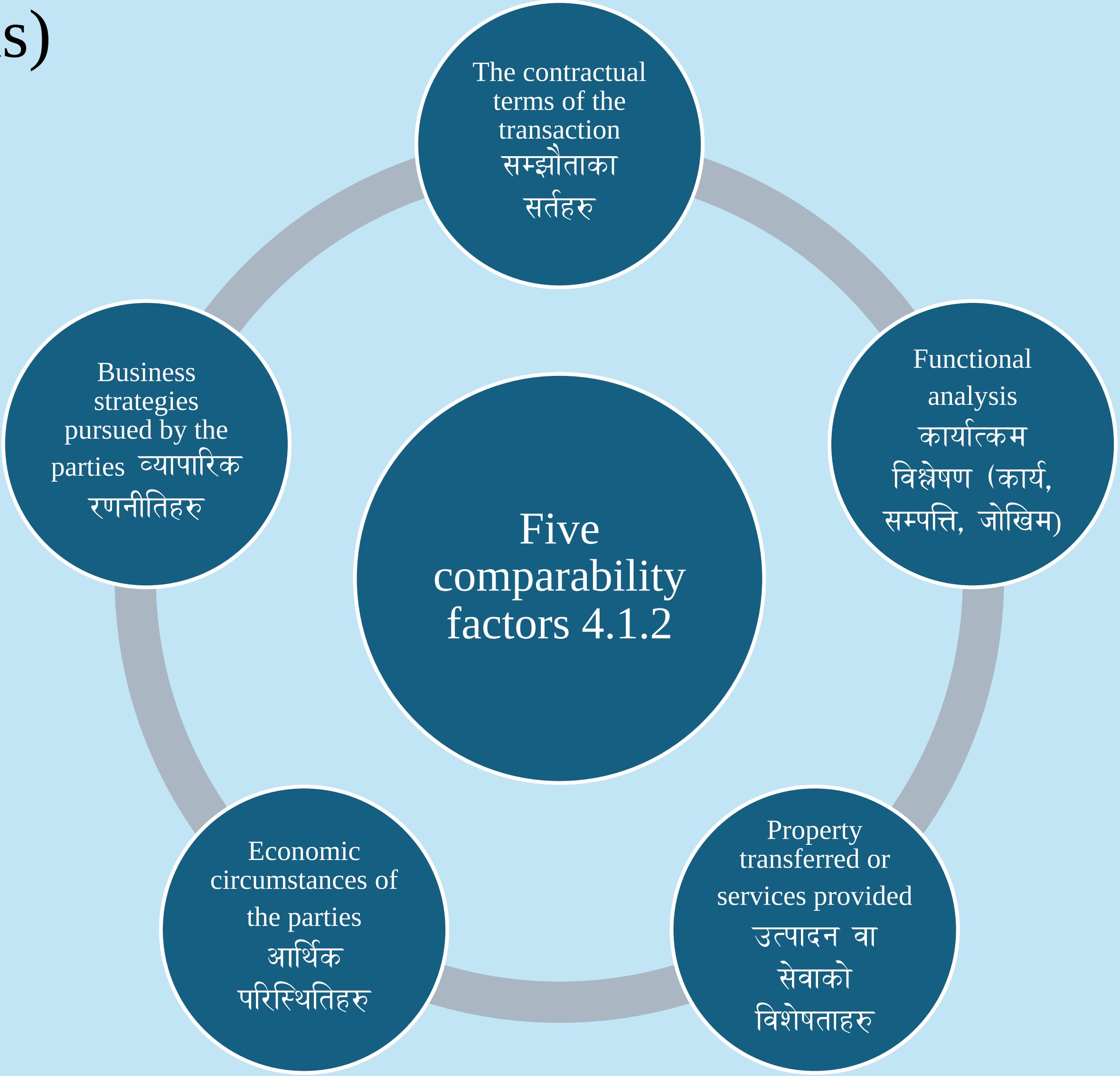
C. Identification of related parties

D. Identification of controlled transaction

4.1.2 Mapping of transaction – Transactional Analysis

4.1.3 Evaluation of separate and combined transactions

(package deals, aggregations etc.)



4.2 Examination of comparability factor of controlled transaction

- Five comparability factors are examined in detail
- Of them most important is Functional Analysis or FAR analysis कार्यात्कम विश्लेषण (कार्य, सम्पत्ति, जोखिम)

- **Functions performed**
- Functions performed are the activities that are carried out by each of the parties to the transaction. In conducting a functional analysis, economically significant functions are to be considered, as such functions add more value to the transactions and are therefore expected to fetch higher anticipated returns for the entity performing such functions.
  - Research and development; Product design and engineering; Manufacturing, production, process engineering and design work; Purchasing, materials management and other procurement activities; Manufacturing, production or assembly work; Transportation, warehousing and inventory; Marketing, advertising, publicity and distribution; Market intelligence on technological developments; and Intra-group services, for example managerial, legal, accounting and finance, credit and collection, training and personnel management services.
- **Assets Utilized:** Tangible as well as intangible assets that are used by, or transferred between, the associated enterprises in the course of an international controlled transaction need to be identified.
- **Risk Assumed:** Risk is associated with reward. 1) How is risk created? - by the ownership, exploitation or use of assets, or by the performance of functions over time2) Which entity bears the risk?
  - List of risk include: Financial risk, product risk, market risk, collection risk, entrepreneurial risk, general business risk, country/ regional risk.
  - Five Steps for analyzing risk in controlled transaction are stated in page 26-29

4.3 Selection of tested party

- In CPM, RPM or TNMM a party to the transaction should be chosen for which financial indicator is tested (mark-up on costs, gross margin, or net profit indicator).

- The tested party normally should be the less complex party to the controlled transaction and should be the party in respect of which the most reliable data for comparability is available. २(ठ)

4.4 Identification and selection of comparable

- Internal comparables
- Third party or external comparables: IRD, Various government bodies, Data base with trade institutions and organizations, Commercial Database
- Approach to identifying potential comparables: 1) Additive approach जोड्ने विधि 2) Deductive Approach घटाउने विधि

4.5 Appropriate adjustment to comparable: Certain adjustments may be needed in order to satisfy the requirements for accuracy and reliability of the comparables so that the financial results of the comparables are stated on the same basis as those of the tested party. Comparability adjustments can be divided into the following three broad categories: 1. Accounting adjustments; 2. Balance sheet/working capital adjustment; 3. Other adjustments.

4.6. Selection of appropriate arm's length method: Discussed in chapter 5 of the Directive

Chapter 5: Method of Arm's length price Determination

Five methods of transfer pricing

Traditional transaction methods **(when reliable comparable data exists for similar uncontrolled transactions)**	**Transactional profit methods** **(for complex transactions involving significant intangible assets;** **do not look at comparable uncontrolled transaction, or when not available; focus on specific transaction between related parties)**
i) Comparable uncontrolled price method (CUP) ii) Resale price method (RSM) iii) Cost plus method (CPM)	iv) Transactional net margin method (TNMM) and v) Transactional profit split method (TPSM)

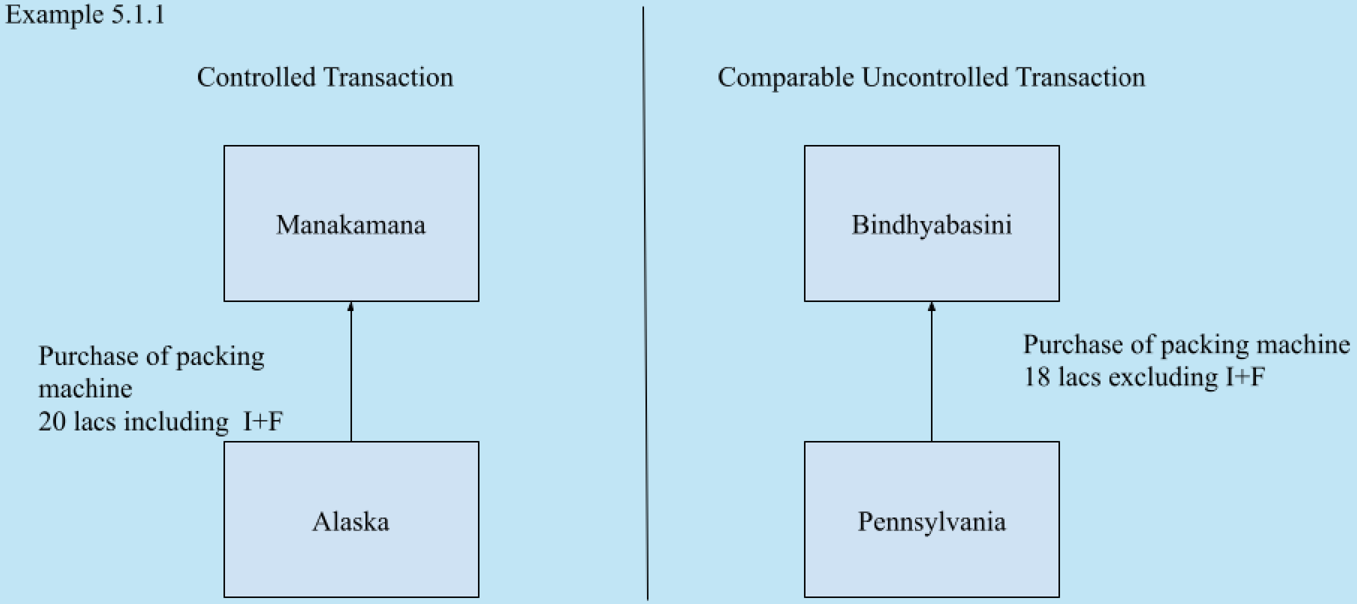
Comparable uncontrolled price method

- Most direct and reliable way to apply ALP

- CUP Method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances

Example 5.1.1

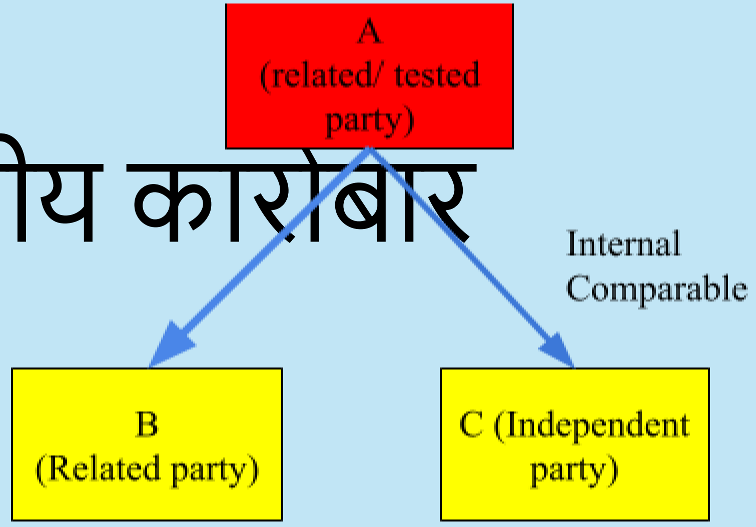
Example of External Comparable



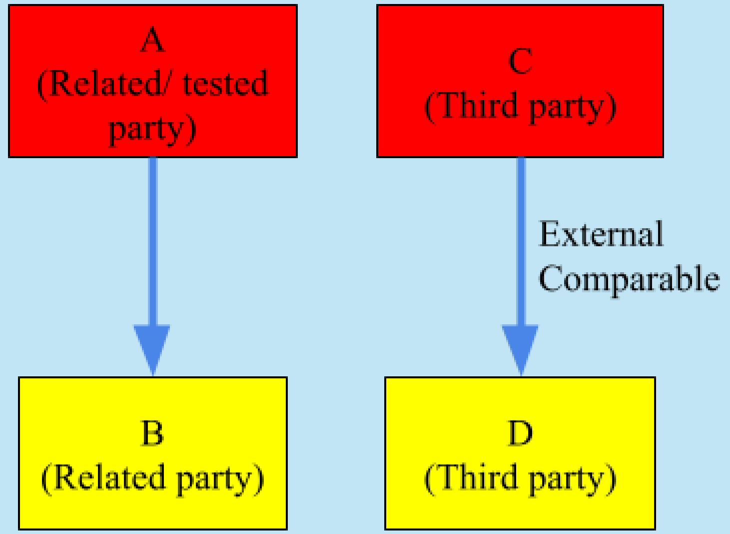
Particulars	Amount (Rs.)
Cost price for the Bindhavasini Pvt. Ltd.	18,00,000
Insurance and Freight	1,00,000
Arm's length price	19,00,000
Actual purchase price for the Manakamana Pvt. Ltd.	20,00,000
Transfer pricing (TP) adjustment (disallowance of excess expenditure)	1,00,000

Internal and external comparables
आन्तरिक तुलनीय कारोबार र बाह्य तुलनीय कारोबार

- Comparable uncontrolled transactions, which involve a transaction between the tested party (same party) and an uncontrolled party, are referred to as internal comparables. E.g. 5.1.1 of directive

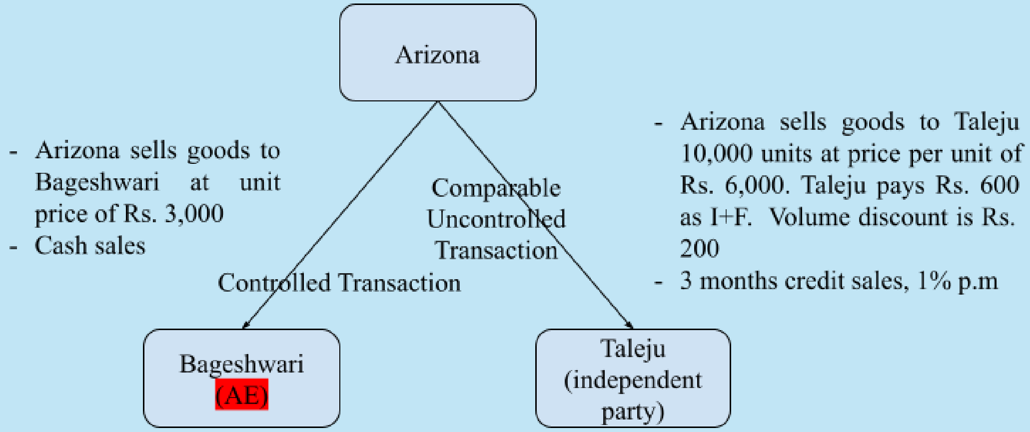


- Comparable uncontrolled transactions which involves a transaction between two parties neither of which is an associated enterprise, are called external comparables



Example 5.1.2

Example of Internal Comparable



Particulars	Amount (Rs.)
Cost price of Taleju Ltd.	Rs. 6,000 per unit
(+) Volume Discount	Rs. 200
(-) I+F	Rs. 500
(-) Three months' credit facility (6,000 X 3%)	Rs. 180
Arm's length price	Rs. 5,520 per unit
TP Adjustment	Rs. 2,520 per unit

Strength of CUP method

- it is two sided analysis as the price used reflects the agreed price between two unrelated parties to the transaction
- avoids the issue of which related party is to be treated as tested party
- involves direct transactional comparison

Weakness

- difficulty of finding comparable uncontrolled transaction

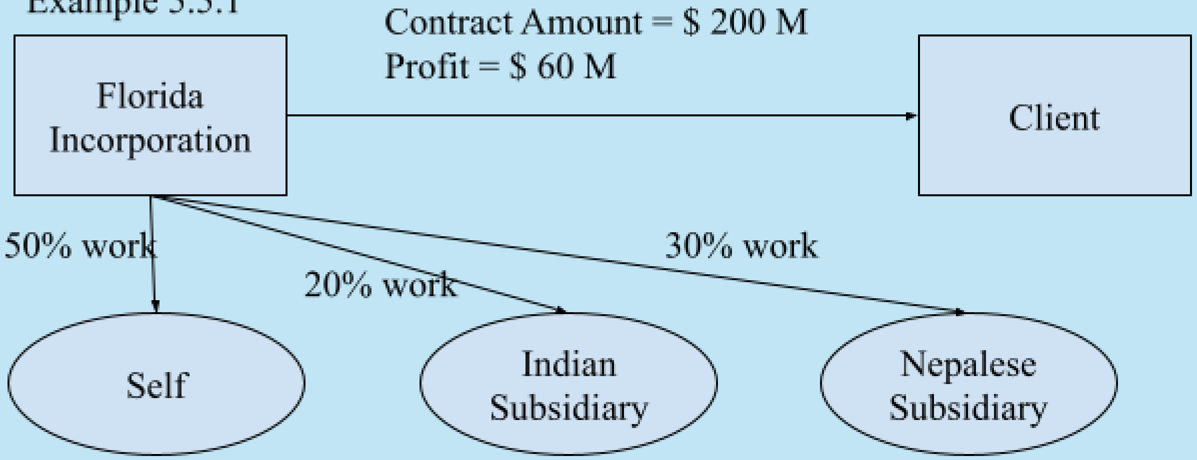
Tested Party (परीक्षण गरिने पक्ष) (२)(ठ) (2)(l)

- Tested party means that associated person whose financial indicator is taken as base (reference) while calculating ALP as per RSM, net profit method. *However, those associated persons outside of Nepal, whose data and information cannot be certified and whose fundamental and essential data is unavailable, shall not be considered a tested party.* (प्रमाणीकरण गर्न नसकिने एवं आधारभूत र आवश्यक तथ्याङ्क तथा सूचना उपलब्ध नरहेको नेपाल बाहिरको)
- The tested party is the party in relation to which a financial indicator (e.g. mark-up on cost, gross margin or net profit) is tested when using the Cost Plus Method, Resale Price Method or Transactional Net Margin Method.
- Financial indicator = / = sales
- Is the entity whose profit margin is taken up for comparison in profit –based comparability calculation (RSM, CPM, …..)
- For example, if the Resale Price Method is used, the related party sales company is the tested party in the transfer pricing analysis. If the Cost Plus Method is used, the related party manufacturer will be the tested party

Resale price method (RSM)

- The Resale Price Method focuses on the related sales company which performs marketing and selling functions as the tested party in the transfer pricing analysis.
- The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin on this price (the "resale price margin") representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm's length price for the original transfer of property between the associated enterprises

Example 5.5.1



Nepalese Company incurred cost of $ 10 M to complete its portion of work
Issued bill of $ 15M

Calculation of ALP

Particulars	$
Total profit of Florida Inc.	60
Contribution of Nepalese Subsidiary	20%
Profit as per Arm's Length	12
Cost incurred by Nepalese subsidiary	10
Arm's length price	22
Invoice amount	15
TP adjustment	7

Strength

- The method is based on the resale price, a market price, and thus represents a demand-driven method.
- The method can be used without forcing distributors to inappropriately “make profits.

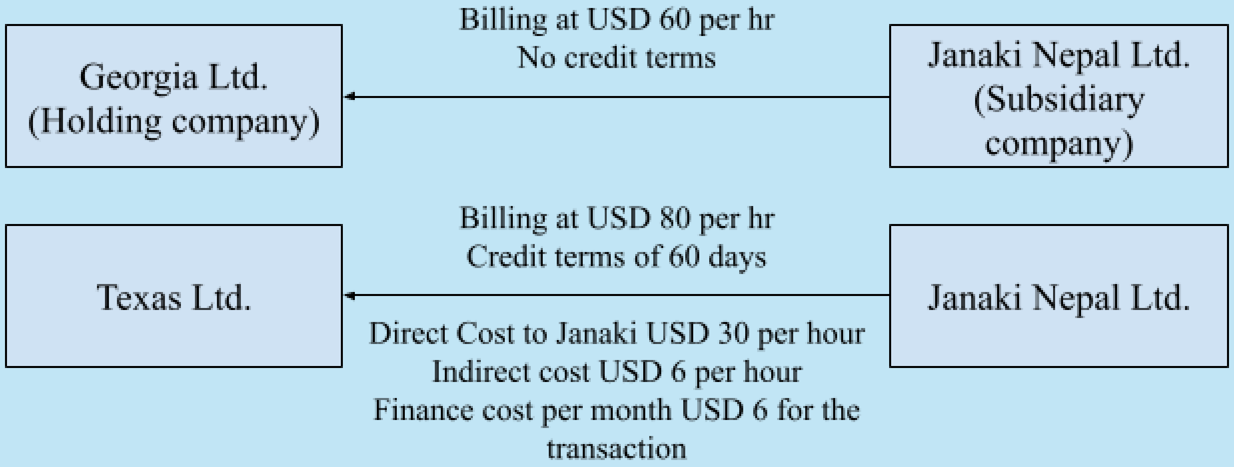
Weakness

- Difficult to find comparable data on gross margins due to accounting inconsistencies.
- The method involves a one-sided analysis, as its focus is on the related sales company as the tested party in the transfer pricing analysis.

Cost plus method (CPM)

- Cost Plus Method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate gross profit in light of the functions performed, risks assumed, assets used and market conditions.

Example 5.3.1



Suppose, if 30% extra manpower is needed to complete the work to Georgia Ltd. Arm's length price is calculated as follows:

Particulars	USD
Per hour billing rate to Texas Ltd.	80
Costs	
Total expenses	30
- Indirect Expenses	6
Direct costs	24
+ Financing cost during credit period (6*2)	12
Cost after adjustment	36
Mark-up (80-36= 44)	44
Markup % (44/36%)	122.23%
Costs to Georgia Ltd.	
Direct Expenses (30% extra)(24+30%)	31.2
Mark-up 122.23%	38.14
Arm's length price	69.34
Actual billing rate for Georgia Ltd.	60
Adjustment to be made	9.34

Strength

- method is based on internal costs, the information on which is usually readily available to the multinational enterprise.

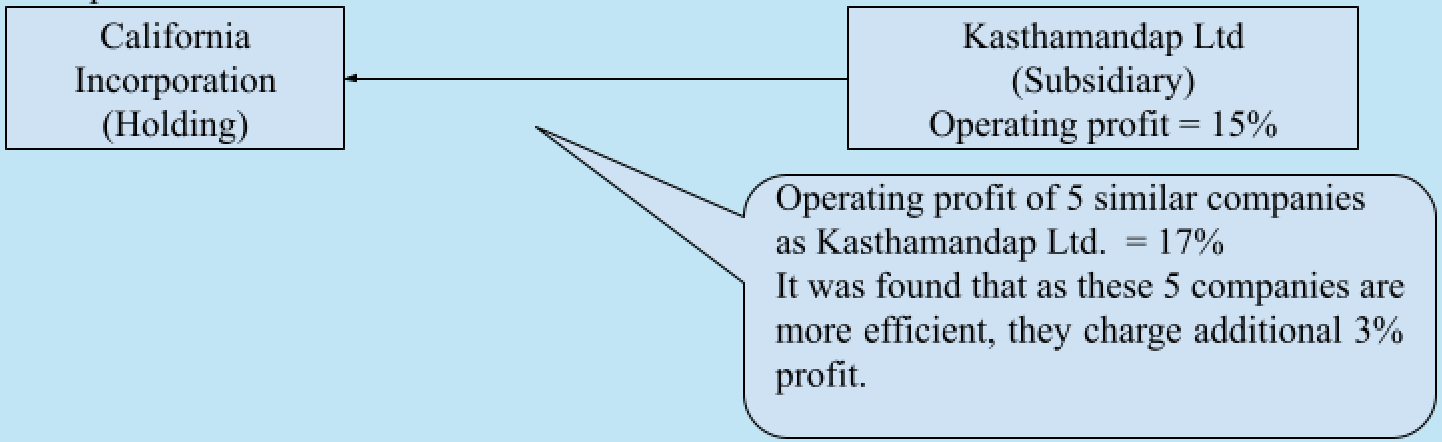
Weakness

- weak link between the level of costs and the market price
- accounting inconsistencies
- The analysis focuses only on the related party manufacturer
- Since the method is based on actual costs, there may be no incentive for the controlled manufacturer to control costs.

Transactional net margin method (TNMM)

- TNMM examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction.
- TNMM compares the net profit margin that the tested party earns in the controlled transactions to the same net profit margins earned by the tested party in comparable uncontrolled transactions or alternatively by independent comparable companies.

Example 5.4.1



Operating profit of 5 companies	= 17%
- Super profit earned due to efficiency	= 3%
Operating profit for comparability	= 14%
Operating % of Kasthamandap Ltd.	= 15%

As the profit % of Kasthamandap Ltd. is higher than the average profit of 5 similar companies, no TP adjustment needs to be made

PLI

- Several profit level indicators (PLIs) are allowed under the TNMM, typically based on operating profit.
- A PLI may express profitability in relation to (i) sales, (ii) costs or expenses, or (iii) assets.

Indicators	Method of calculation	Appropriateness
Return on Assets	Operating profit/Operating Assets	Production work and leasing work
Return on Capital employed	Operating profit/Capital employed	Production work and leasing work
Operating Margin	Operating profit/Sales	Sales Distribution activities
Return on total cost	Operating profit/Total cost	Manufacturing industry
Berry ratio	Gross profit/Operating expenses	Service Distributor
Return on Cost of goods sold	Gross profit/Cost of Goods sold	Manufacturing industry

Page 49 of the Directive

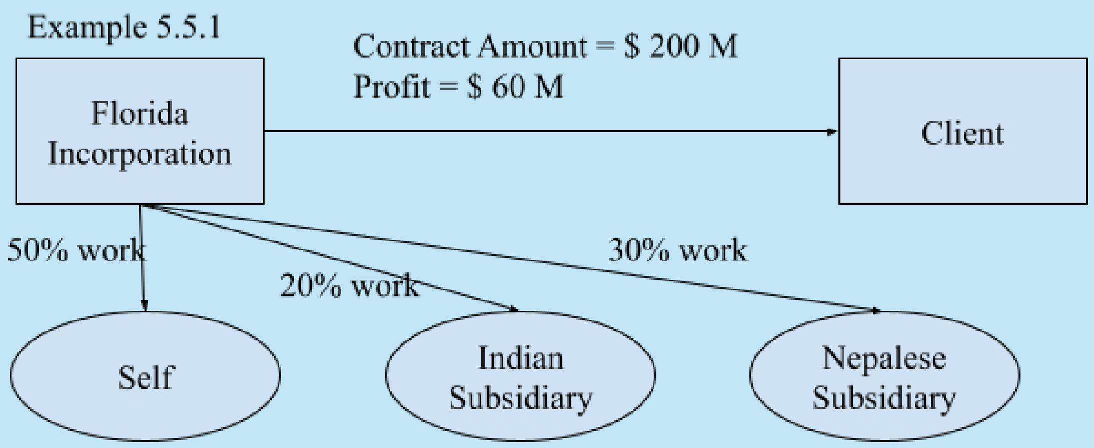
Transactional profit split method (TPSM)

Profit Split Method starts by identifying the profits to be divided between the associated enterprises from the controlled transactions. Subsequently, these profits are divided between the associated enterprises based on the relative value of each enterprise's contribution, which should reflect the functions performed, risks incurred, and assets used by each enterprise in the controlled transactions.

Methods to allocate profit:

a) Contribution Analysis:- Combined profits from the controlled transactions are allocated between the associated enterprises on the basis of the relative value of functions performed by those associated enterprises engaged in the controlled transactions

b) Residual Analysis:- Two-step approach
   a) Step 1: allocation of sufficient profit to each enterprise to provide basic arm's length compensation for routine contributions
   b) Step 2: allocation of residual profit (i.e. profit remaining after Step 1) between the associated enterprises based on the facts and circumstance



Nepalese Company incurred cost of $ 10 M to complete its portion of work
Issued bill of $ 15M

Calculation of ALP

Particulars	$
Total profit of Florida Inc.	60
Contribution of Nepalese Subsidiary	20%
Profit as per Arm's Length	12
Cost incurred by Nepalese subsidiary	10
Arm's length price	22
Invoice amount	15
TP adjustment	7

Most appropriate method principle

- Choose the method that best reflects the arm's length principle based on the specific transaction, functions performed, and risks assumed

If more than one price is determined, then the Directive guides that the price shall be determined on the basis of:

- Median range method - If the prices in the data set of price determined is equal to or more than seven. If pricing lies between 35th and 65th percentile, then no TP adjustment needed. - tolerable error 5%
- Average method - if the prices in the data set of prices determined is equal to or less than six.

Chapter 5: contd.. Median method

S.N.	Operating profit
Company 1	12.44%
Company 2	6.00%
Company 3	9.86%
Company 4	10.87%
Company 5	36.13%
Company 6	7.71%
Company 7	21.30%
Company 8	5.32%

- Example 5.6.1
- Suppose 8 comparable data have been identified, data set of company 1 to company 8 have been identified as stated in the figure
- Arrange data in ascending order

Company	8	2	6	3	4	1	7	5
Operating profit	5.32	6	7.71	9.86	10.87	12.44	21.30	36.13

- 35 percentile data point = 8*0.35 = 2.8 ~~3 (7.71%)
- 65 percentile data point = 8 * 0.65 = 5.2~~ 6 (12.44%)
- Arm's length range = 7.71% to 12.44%. (tolerable error 5%)

i) If operating profit is 8%, no adjustment is needed (falls within range)

ii) If operating profit is 7.5%, no adjustment is needed as it is within tolerable limit (7.7.-5%=7.3245)

iii) If operating profit is 4%, then adjustment is made to the median value of 10.365% (8+1/2=4.5th value, average of 4th (9.86) and 5th data (10.87). Therefore, adjustment is 10.65-4% = 6.37%.

Chapter 5: contd.. Average method

- Example 5.6.2:
- Suppose 5 comparable data have been identified as stated in the figure

S.N.	Operating Profit
Company 1	12.44%
Company 2	6.00%
Company 3	9.86%
Company 4	10.87%
Company 5	36.13%

- Average operating profit of 5 companies = $\frac{12.44\% + 6.00\% + 9.86\% + 10.87\% + 36.13\%}{5}$

  = 15.06%

- If operating profit is more than 14.3%(15.06*95%), it shall be deemed within the range. Else TP adjustment is made.

- If price between associated entrprises is 10%, then 5.06% (15.06-10) adjustment is to be made.

Chapter 6: Transfer Pricing Documentation

The list of documentation to be maintained is spelled out in Annex 1 of the Directive.

The basic documentation to be kept include

- documents regarding information of the entities,
- documents relating to offshore transactions between associated enterprise and
- documents regarding determination of price as per ALP.

WHO has to comply:

- TP documentation as mentioned in the Annex 1 of the Directive is to be maintained by taxpayers having controlled offshore transaction of equal to or more than one hundred million rupees रु १० करोड
- In case the amount of sale or purchase of goods or services between the associated enterprises exceeds five hundred million rupees, रु ५० करोड then a certification as per Annex 2 is to be done by an auditor who is not a tax or financial auditor and has experience of over five years.
- Annex 1 & 2

Chapter 7: Transfer Pricing Administration

This chapter revisits relevant section of the Act relating to:

- amended assessment (section 101),
- serving of notice of assessment (section 102),
- penalty for non-maintenance notified documents and non-filing of returns (section 117),
- penalty for non-payment of installment tax (section 118),
- penalty for non-payment of tax (section 119),
- residual penalty (section 119A) and
- penalty for furnishing of false or misleading statement (section 120).

Regarding appeal of the transfer pricing adjustment order, the appeal is to be made to Administrative Review (section 115), then to Revenue Tribunal.

➢ No new penalty provision have been introduced, or administrative body have been setup in ITA regarding TP implementation. TP regime is blended with current ITA.

ALP vs Global formulary apportionment
(Theory of Everything/ Unified field theory)

- Global formulary apportionment, allocation of global profits of an MNE group on a consolidated basis of a predetermined and mechanistic formula. Combination of cost, asset, payroll and sales.
- They argue that an MNE group must be considered on a group-wide or consolidated basis to reflect the business realities of the relationships among the associated enterprises in the group. They asset that the separate accounting method is inappropriate for a highly integrated groups because it is difficult to determine what contribution each enterprise makes to the overall profit of the MNE group.
- It is far from clear that jurisdictions would be willing to agree to a universal formula.
- This is only a theoretical alternative.

Corresponding adjustment 4.35

- Corresponding adjustment as per paragraph 2 of Article 9 to be made as per MAP Article 25.
- In absence of an arbitration decision arrived at pursuant to an arbitration procedure as per Para 5 of Article 25, corresponding adjustment are not mandatory, mirroring the rule that tax administrations are not obliged to reach agreement under MAP
- Only insofar as it considers the primary adjustment to be justified in principle and in amount.
- The non-mandatory nature of corresponding adjustment is necessary so that one tax administration is not forced to accept the consequences of an arbitrary or capricious adjustment by another State.
- Element 3.3 of the Action 14 of BEPS

Secondary Adjustments

- To make the actual allocation of profits consistent with the primary transfer pricing adjustment, some jurisdictions having proposed a transfer pricing adjustment will assert under their domestic legislation a constructive transaction (a secondary transaction), whereby the excess profits resulting from a primary adjustment are treated as having been transferred in some other form and taxed accordingly. Ordinarily, the secondary transactions will take the form of constructive dividends, constructive equity contributions, or constructive loans.

- Secondary adjustments attempt to account for the difference between the re-determined taxable profits and the originally booked profits.

- Secondary adjustment are rejected by some jurisdictions because of the practical difficulties they present. (hypothetical dividend)

Missing

Safe harbour

- A safe harbour in a transfer pricing regime is a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a jurisdiction's general transfer pricing rules.
- Simplified rules/ obligations

<u>Benefits</u>

- Compliance relief to taxpayers
- Certainty to taxpayers
- Administrative simplicity

<u>Concerns</u>

- Divergence from ALP
- Risk of double taxation, double non-taxation and mutual agreement concerns
- Possibility of opening avenues for tax planning
- Equity and uniformity issues

Missing

Advance Pricing Agreements (Rule 15)

- An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An advance pricing arrangement may be unilateral involving one tax administration and a taxpayer or multilateral involving the agreement of two or more tax administrations.
- Bilateral APA is preferable to reduce double taxation
- Action 14 of BEPS (More Effective Dispute Resolution Mechanisms)
- Consult and co-operate in non-adversarial spirit
- Prevent costly and time-consuming examination and litigation

Details Missing

Intangibles

- Trade intangibles
- Marketing intangibles
- DEMPE (Development, Enhancement, Maintenance, Protection, and Exploitation)

Details guidelines needed in this regard

AMP (Advertisement, Marketing and Publicity Expenses) Bright line test (BLT)

- Whether they are international transactions???

Pending final deliberation by the Supreme Court of India

FAR to FARM

- “Market” needs to be added in the equation.
- Taxation where value is created
- Current profit allocation rules only look at the production side factors not demand side factors.
- Whether value creation is by producers alone or whether consumers also create value???

Preparation for Tax Authority

- new terrain
- Identification of number and type of MNC operating
- transfer pricing risk

- prior experience
- scarcity of resources
- identifying, and maintaining database of comparable transactions

- assessing the current capabilities and gap
- Coordination between various Government Agencies

Preparation for businesses

- TP policies are normally harmonized across the countries
- uncertainty over double taxation risks and the documentation and compliance requirements to fit the law of land
- Maintaining contemporaneous documentation
- At initial state, handholding to comply with the documentation requirement as the local unit would lack the expertise
- MNC must strictly comply with the Directive and other best international practices

Reference Documents

- OECD TRANSFER PRICING GUIDELINES, 2022
- UNITED NATIONS PRACTICAL MANUAL ON TRANSFER PRICING
- TP Directives, 2081

Thank you !!!