

contemporaneous data which may be available to the taxpayer and tax administration at the time of filing of the tax return or conducting ex post facto analysis of transfer pricing studies cannot be held as use of hindsight.

2. Issue relating to risks

- a. A comparison of functions performed, assets employed and risks assumed is basic to any comparability analysis. India believes that the risk of a MNE is a by-product of performance of functions and ownership, exploitation or use of assets employed over a period of time. Accordingly, risk is not an independent element but is similar in nature to functions and assets. In this context, India believes that it is unfair to give undue importance to risk in determination of arm's length price in comparison to functions performed and assets employed.
- b. Identification of risk and the party who bears such risks are important steps in comparability analysis. India believes that the conduct of the parties is key to determine whether the actual allocation of risk conforms to contractual risk allocation. Allocation of risk depends upon ability of parties to transaction to exercise control over risk. Core functions, key responsibilities, key decision making and level of individual responsibility for the key decisions are important factors to identify party which has control over the risks.
- c. In India, MNEs are making claims before the transfer pricing auditor that related parties engaged in contract R&D or other contract services in India are risk free entities. Accordingly, these related parties are entitled to only routine (low) cost plus remuneration. MNEs also contend that the risks of R&D activities or services are being controlled by them and Indian entities being risk free entities are entitled to (low) cost plus remuneration.
- d. The Indian transfer pricing administration does not agree with the notion that risk can be controlled remotely by the parent company and that the Indian subsidiaries or related party engaged in core functions, such as carrying out research and development activities or providing services are risk free entities. India believes that core function of R&D or services are located in India which in turn require important strategic decisions by management and employees of Indian subsidiaries or related party to design, direction of R&D activities or providing services and monitoring of R&D activities etc. Accordingly, the Indian subsidiary exercises control over the operational and other risks. In these circumstances, the ability of the parent company to exercise control over the risk - remotely and from a place where core functions of R&D and services are not located - is very limited. In these circumstances, allocation of risk to the parent MNE is not only questionable but is devoid of logical conclusion.
- e. India believes that the subsidiary carries out core functions and by taking strategic operational decisions controls a substantial part of risk. India believes that the parent company should be entitled to appropriate returns for provision of funds and overall direction to R&D activity or services. The Indian subsidiary should also similarly be entitled to returns on their core function including strategic decisions and control on risk related to operation of R&D activities. In this context, Indian tax administration is of the view that allocation of routine cost plus return in these cases will not reflect a true arm's length price of the transaction.

3. Arm's length range

Application of most appropriate method may set up comparable data which may result in computation of more than one arm's length price. Where there may be more than one arm's length price, mean of such prices is considered. Indian transfer pricing regulations provide that in such a case the arithmetic mean of the prices should be adopted as arm's length price. If the variation between the arithmetic mean of uncontrolled prices and price of international transaction does not exceed 3% or notified percentage of such transfer pricing, then transfer price will be considered to be at arm's length. In case transfer price crosses the tolerance limit, the adjustment is made from the central point determined on the basis of arithmetic mean. Indian transfer pricing regulation do not mandate use of inter quartile range.

4. Comparability adjustment

- a. Like many other countries, Indian transfer pricing regulations provide for “reasonably accurate comparability adjustments”. The onus to prove “reasonably accurate comparability adjustment” is on the taxpayer. The experience of Indian transfer pricing administration indicates that it is possible to address the issue of accounting difference and difference in capacity utilization and intensities of working capital by making comparability adjustments. However, Indian transfer pricing administration finds it extremely difficult to make risk adjustments in absence of any reliable and robust and internationally agreed methodology to provide risk adjustment. In some cases taxpayers have used Capital Asset Pricing Method (CAPM). However, the methodology was found flawed for the reasons outlined in the following paragraphs
- b. The CAPM model assumes that most assets rate of return within a portfolio are normally distributed (meaning rates of return do not deviate too much from the mean). However, historically speaking, equities have been prone to large deviations from the mean much more frequently than it is generally assumed under the CAPM model. So, if an asset is actually prone to large swings in either direction from its mean, then it stands to reason that its risk aspect may not be correctly captured by the CAPM calculation.
- c. Capital asset pricing model is not able to capture all variations in equity returns in same industry segment. Past empirical studies have demonstrated that some stocks, although they had lower beta and implied lower risk vs. return ratio, still managed to pull off higher returns than the CAPM model would have assumed initially.
- d. On a more practical level, one of the shortfalls of CAPM is that the model assumes all investors have the same ideas of what constitutes risk and required rates of return, as well as the fact that the model excludes the impact of taxes and transaction costs which, in reality, have adverse impact on the expected rate of return.
- e. The CAPM assumes the application of the market portfolio, which is supposed to consist of all risky assets in all markets. The CAPM also assumes that investors have no individual preference as to which risky assets they wish to invest in and in which markets. Yet, investors have been known to depart from assets ‘risk vs. return profiles often and particularly at times when markets were not normally distributed.
- f. The CAPM accepts the concepts of the market portfolio, which theorizes inclusion of literally all asset classes, including real estate, art intellectual property etc. However, in reality such a market portfolio is impossible to construct which is why it is often equated with various composites. However, limiting the market portfolio in such a manner could and it indeed has created fallacies within the CAPM model, thus rendering it at the very least empirically inconsistent.
- g. An important flaw relating to the computation of risk adjustment by the taxpayer is use of the “Beta” concept. It is important to remember that computation of beta is based on a presumption that high-beta shares usually give the highest returns. Over a long period of time, however, high beta shares are the worst performers during market declines (bear market) which are more common phenomena in Indian stock exchange. While someone might receive high returns from high beta shares, there is no guarantee that the CAPM return is realized. It is worthwhile to mention here that the computation of beta in this case is based on seven year average price of comparables and tested party shares; the methodology of taking an average of such a long period is highly questionable in existing volatile world market conditions.
- h. The Indian tax administration has also experienced difficulties in getting reliable data for computation of comparability adjustments like capacity and working capital adjustments, where methodology to provide comparability adjustment is more or less internationally agreed.

5. Location Savings

- a. It is view of the Indian transfer pricing administration that the concept of “location savings” - which refer

to cost savings in a low cost jurisdiction like India – should be one of the major aspects to be considered while carrying out comparability analysis during transfer pricing audits. Location savings has a much broader meaning; it goes beyond the issue of relocating a business from a ‘high cost’ location to a ‘low cost’ location and relates to any cost advantage. MNEs continuously search options to lower their costs in order to increase profits. India provides operational advantages to the MNEs such as labour or skill employee cost, raw material cost, transaction costs, rent, training cost, infrastructure cost, tax incentive etc. It has also been noticed that India also provides following Location Specific Advantages (LSAs) to MNE in addition to location savings:

- Highly specialized skilled manpower and knowledge
 - Access and proximity to growing local/regional market
 - Large customer base with increased spending capacity
 - Superior information network
 - Superior distribution network
 - Incentives
 - Market premium
- b. The incremental profit from LSAs is known as “location rents”. The main issue in transfer pricing is the quantification and allocation of location savings and location rents among the associated enterprises. Under arm’s length pricing, allocation of location savings and rents between associated enterprises should be made by reference to what independent parties would have agreed in comparable circumstances. The Indian transfer pricing administration believes it is possible to use the profit split method to determine arm’s length allocation of location savings and rents in cases where comparable uncontrolled transactions are not available. In these circumstances, it is considered that the functional analysis of the parties to the transaction (functions performed, assets owned and risks assumed), and the bargaining power of the parties (which at arm’s length would be determined by the competitiveness of the market - availability of substitutes, cost structure etc) should both be considered appropriate factors.
- c. Comparability analysis and benchmarking by taking local comparables will determine the price of a transaction with a related party in a low cost jurisdiction. However, it will not take into account the benefit of location savings which can be computed by taking into account cost difference between cost of low cost country and high cost country from where the business activity was relocated. In view of this, the price determined on the basis of local comparables is not consistent with arm’s length price because any arm’s length transaction between two unrelated parties would not be possible without benefiting both parties to the transaction.
- b. Hypothetically, if an unrelated third party had to compensate another party to the transaction in a low cost jurisdiction that was equal to the cost savings and location rents attributable to the location, there would be no incentive for the unrelated third party to relocate business to a low cost jurisdiction. Thus, arm’s length compensation for cost savings and location rents should be such that both parties would benefit from participating in the transaction. In other words, it should be not less than zero and not greater than the value of cost savings and locations rents; it should also reflect an appropriate split of the cost savings and location rents between the parties.

6. Intangibles

- a. Transfer pricing of intangibles is well known as a difficult area of taxation practice. However, the pace of growth of the intangible economy has opened new challenges to the arm’s length principle. The transactions involving intangible assets are difficult to evaluate because of the following reasons:

- Intangibles are seldom traded in the external market and it is very difficult to find comparables' in the public domain.
 - Intangibles are often transferred bundled along with tangible assets. They are difficult to be detected.
- b. A number of difficulties arise while dealing with intangibles. Some of the key issues revolve around determination of arm's length price of rate of royalties, allocation of cost of development of market and brand in a new country, remuneration for development of marketing, Research and Development intangibles and their use, transfer pricing of co-branding etc. Some of the Indian experiences in this regard are discussed below.
- With regard to payment of royalties, MNEs often enter into agreements allowing use of brands, trademarks, know how, design, technology etc. by their subsidiaries or related parties in India. Such payments can be in a lump sum, periodical payments or a combination of both types of payments. It is an internationally agreed position that intellectual property which is owned by one entity and used by another entity generally requires royalty payment. However, the important issue in this regard is determination of the rate of royalty. The main challenge in determination of arm's length price of royalty rate is to find comparables in the public domain with sufficient information required for comparability analysis. The Indian experience suggests that it is impossible to find comparable arm's length prices in most cases. The use of profit split method as an alternative is generally not a feasible option due to lack of requisite information.
 - The Indian tax administration has noticed serious difficulties in determining the rate of royalty charged for use of brand and trademark in certain cases. In some cases the user had borne significant costs on promotion of the brand/trademark, and to promote and develop customer loyalty for brand/trademark in a new market. In these cases, royalty rate charged by the MNE will depend upon the cost borne by the subsidiary or related party to promote the brand and trademark and to develop customer loyalty for brand and product. In many cases no royalty may be charged under uncontrolled environment and the subsidiary would require arm's length compensation for economic ownership of marketing intangible developed by it and for enhancing the value of brand and trademark owned by parent MNEs in the new emerging market like India.
 - In many cases, Indian subsidiaries which use technical know-how of their parent company have incurred significant expenditure to customize such know-how and to enhance its value by their R&D efforts. Costs on activities, such as R&D activities which have contributed in enhancing the value of know-how owned by parent company is generally considered by Indian transfer pricing officer while determining arm's length price of royalty for use of technical know-how.
 - The Indian transfer pricing administration has also noted significant transfer pricing issues in cases of co-branding of new foreign brand of parent MNE (which is unknown to new market like India) with popular Indian brand name. Since the Indian subsidiary has developed valuable Indian brand in the domestic market over a period of time, incurring huge expenditure on advertisement, marketing and sales promotion, it should be entitled for arm's length remuneration for contributing to the value of foreign little known brand through market recognition by co-branding it with a popular Indian brand.

7. R&D activities

- a. Several global MNEs have established subsidiaries in India for research and development activities on contract basis to take advantage of the large pool of skilled manpower which are available at a lower cost. These Indian subsidiaries are generally compensated on the basis of routine and low cost plus mark up. The parent MNE of these R&D centres justify low cost plus markup on the ground that they control all the risk and their subsidiaries or related parties are risk free or limited risk bearing entities. The claim of parent

MNEs that they control the risk and are entitled for major part of profit from R&D activities is based on following contentions:

- Parent MNE designs and monitors all the research programmes of the subsidiary.
 - Parent MNE provides fund needed for R&D activities.
 - Parent MNE controls the annual budget of the subsidiary for R&D activities.
 - Parent MNE controls and takes all the strategic decisions with regards to core functions of R&D activities of the subsidiary.
 - Parent MNE bears the risk of unsuccessful R&D activities.
- b. The Indian transfer pricing administration always undertakes a detailed enquiry in cases of contract R&D centres. Such an enquiry seeks to ascertain correctness of the functional profile of subsidiary and parent MNE on the basis of transfer pricing report filed by the taxpayers, as well as information available in the public domain and commercial databases. After conducting detailed enquiries, the Indian tax administration often reaches the following conclusions:
- Most parent MNEs were not able to file relevant documents to justify their claim of controlling risk of core functions of R&D activities and asset (including intangible assets) which are located in the country of subsidiary or related party.
 - Contrary to the above, it was found that day to day strategic decisions and monitoring of R&D activities were carried out by personnel of subsidiary who were engaged in actual R&D activities and bore relevant operational risks.
 - The management of Indian subsidiary also took decision of allocation of budget to different streams of R&D activities and Indian management also monitored day to day performance of R&D activities.
 - It was true that in most of the cases funds for R&D activities were transferred from the MNE parent and they bore the risk of such fund. However, in addition to “capital” other important assets like technically skilled manpower, know how for R&D activities etc were developed and owned by the Indian subsidiary. Accordingly, control of risk of the asset lies both with the MNE parent and Indian subsidiary but the Indian subsidiary controls more risks as compared to the MNE parent.
- c. On the basis of above functional analysis, the Indian transfer pricing administration decided in most of the cases that Indian subsidiaries were not risk free entities but bore significant risk. Accordingly Indian subsidiaries were entitled to an appropriate return for their function including the strategic decision, monitoring, use of their assets and control over the risk. In view of these facts, routine cost plus compensation model was not held at arm’s length price.
- d. Most of these R&D centres in India were actually found to be engaged in creation of unique intangibles, legal ownership of which was transferred to their parent MNEs under agreement. Such transfer took place without any appropriate compensation and patents for these intangibles were registered in the name of parent MNE. In these cases the Indian transfer pricing administration allocated additional arm’s length compensation for transfer of such intangibles in addition to arm’s length compensation for R&D activities.

8. Marketing Intangibles

- a. Transfer pricing aspect of marketing intangibles has been a focus area for the Indian transfer pricing administration. The issue is particularly relevant to India due to its unique market specific characteristics such as location advantages, market accessibility, large customer base, market premium, spending power

of Indian customers etc. The Indian market has witnessed substantial marketing activities by the subsidiary/related party of the MNE groups in recent past, that have resulted in creation of local marketing intangibles. For Indian transfer pricing administration first important step is to identify marketing intangibles. The marketing intangibles are generally identified on the basis of the efforts of Indian subsidiary/related party on:

- Enhancing the value of foreign trade mark/brand unknown to Indian market by incurring huge advertisement, marketing and sale promotion expenditure.
 - Creation of brand and product loyalty in the minds of customers.
 - Creation of efficient supply chain.
 - Establishing distributor network in the country.
 - After sale services support network in the country.
 - Conducting customer and market researches.
 - Establishing customer list etc.
- b. Since Indian subsidiaries/related parties (which are claimed as no risk and limited risk bearing distributors by parent MNE in order to justify low cost plus return) have incurred and borne huge expenditure on development of marketing intangibles. These entities generally incur huge losses or disclose very nominal profit as evident from their return of income. Determination of ALP in cases of marketing intangibles generally involves following steps:
- Functional analysis of profile of the Indian and parent MNE to ascertain whether the Indian taxpayer is a risk free, limited risk bearing or risk bearing entity?
 - Identification of nature, types and stages of development of marketing intangibles. The Indian entity may be engaged in different stages of development of marketing intangibles. For example if an MNE is new entrant in Indian market, the related party in India will incur substantial expenditure:
 - to create awareness about trade mark, brand and product or services of MNE group in India.
 - customer loyalty for brand and products/services for dealer network.
 - after sale services network.
 - market and customer research for creation of customer list.
- c. After some years of operation, the cost on developing and sustaining marketing intangible may be reduced.
- Identification of expenditure on launch of new products in India and to ascertain who had borne such expenditure.
 - to ascertain who had borne the cost of development of marketing intangibles.
 - examination of remuneration model to Indian related party.
- d. The Indian tax administration computes the ALP in the cases involving marketing intangibles following the concept of bright line i.e., no risk or limited risk distributor will bear the cost of only routine expenditure on advertisement, marketing and sale promotion. However, the tax administration faces following challenges in determination of the ALP:
- Whether parent MNE should reimburse the cost incurred by the Indian related party on development of marketing intangibles with or without mark-up.
 - Lack of uniform accounting codes creates a significant challenge in identification of advertisement, marketing and sales promotion (AMP) expenditure in comparable companies and tested party.

- The developer of marketing intangibles who has economic ownership in the intangibles is entitled to additional returns. However, the difficult question is what should be the arm's length price of such returns.
- e. The important issue in the determination of ALP in these cases is to examine who benefits from the extraordinary AMP expenditure. Taxpayers generally claim that such extraordinary expenditure helps the business of the Indian entity also in addition to parent MNE. However, the tax authorities in India have found that Indian distributors are claimed to be no risk or low risk bearing entities and are getting fixed and routine return on cost plus basis. They do not get a share in the excess profit relatable to local marketing intangibles. Accordingly, extra-ordinary AMP expenditure does not enhance the profitability of Indian subsidiary or related party. This conclusion of the tax authorities is further supported by the fact that these so called risk-free or limited risk distributors have disclosed huge losses even when they are entitled for fixed return on cost plus basis and should not have incurred losses.
- f. In this context, the Transfer Pricing administration have taken a view that such Indian entities which incur excessive AMP expenses, bear risks and perform functions beyond what an independent distributor with similar profile would incur or perform for the benefit of its own distribution activities should be compensated for return on intangibles. Such compensation would be in the form of reimbursement of the excess AMP expenditure along with mark-up. Alternatively, the Indian entity should be allowed to share profit related to marketing intangibles. If no reimbursement is made in these type of cases along with mark-up, or the related party does not get an arm's length return for development of marketing intangibles in the form of its entitlement to share profits, the Indian tax administration makes adjustment on account of reimbursement of excess AMP expenditure along with a mark-up for the functions undertaken by the subsidiary/related party.

9. Intragroup Services

- a. Globalization and the drive to achieve efficiencies within MNE groups have encouraged sharing of resources to provides support between one or more location by way of shared services. Since these intra group services are the main component of “tax efficient supply chain management” within an MNE group, the Indian transfer pricing authorities attach high priority to this aspect of transfer pricing. The tax administration has noticed that some of the services are relatively straight forward in nature like marketing, advertisement, trading, management consulting etc. However, other services may be more complex and can often be provided on stand-alone basis or to be provided as part of the package and is linked one way or another to supply of goods or intangible assets. An example can be agency sale technical support which obligates the licensor to assist the licensee in setting up of manufacturing facilities, including training of staff. The Indian transfer pricing administration generally considers following questions in order to identify intra group services requiring arm's length remuneration:
 - Whether Indian subsidiaries have received any related party services i.e., intra group services? Nature and detail of services including quantum of services received by the related party.
 - Whether services have been provided in order to meet specific need of recipient of the services? What are the economic and commercial benefits derived by the recipient of intra group services?
 - Whether in comparable circumstances an independent enterprise would be willing to pay the price for such services?
 - Whether an independent third party would be willing and able to provide such services?
- b. The answers to above questions enable the Indian tax administration to determine if the Indian subsidiary has received or provided intra group services which requires arms' length remuneration. Determination of the arm's length price of intra-group services normally involve following steps:
 - Identification of the cost incurred by the group entity in providing intra group services to the related party.

- Understanding the basis for allocation of cost to various related parties i.e., nature of allocation keys.
 - Whether intra group services will require reimbursement of expenditure along with markup.
 - Identification of arm's length price of markup for rendering of services.
- c. Identification of the services which require an arm's length remuneration is one of the main challenges before the Indian transfer pricing administration. India believes that shareholder services, duplicate services and incidental benefit from group services do not give rise to intra group services requiring arm's length remuneration. However, such conclusion would need a great deal of analysis. The biggest challenge in determination of the arm's length price is allocation of cost by using allocation keys. The nature of allocation keys generally varies with the nature of services. However, it is difficult to reach agreement between the tax administration and taxpayer on the nature of allocation of keys.
- d. The next challenge before the transfer pricing administration is a most commonly asked question whether or not it is necessary for services provider to make a profit. Typical example of this would include treatment of pass through cost. Another important question is how to determine a percentage of mark up and to fix the benchmark of markup are tedious processes. The fixing up of the cost base to compute the markup is another complex issue and it is a difficult decision to include or not to include various types of overhead.
- e. A brief review of cases where adjustments have been made by Indian transfer pricing administration has revealed that most of MNE parents do not allow any profit markup on the services rendered by Indian subsidiaries to them. However, in some exceptional cases a low markup of 5% to 10% is allowed on some services with a restricted cost base. On the other hand, where Indian subsidiaries or related parties receive intra group services, parent MNEs generally charge mark up on all the services provided to such entities, including duplicate services, shareholding services and services which provide only incidental benefits to the Indian entities. The rate of markup charged on such intra-group services is also mostly on the higher side. The Indian transfer pricing administration has also noticed that in several cases, the claim of rendering services was found to be incorrect or the services were found not to be intra-group services which required arm's length remuneration.
- f. In view of the above facts, transfer pricing of intra-group services is a high risk area for the Indian transfer pricing administration.

10. Financial Transactions

- a. Intercompany loans and guarantees are becoming common international transactions between related parties due to management of cross border funding within group entities of a MNE group. Transfer pricing of inter-company loans and guarantees are increasingly being considered some of the most complex transfer pricing issues in India. The Indian transfer pricing administration has followed a quite sophisticated methodology for pricing inter-company loans which revolves around:
- comparison of terms and conditions of loan agreement.
 - determination of credit rating of lender and borrower.
 - Identification of comparables third party loan agreement.
 - suitable adjustments to enhance comparability.
- b. The Indian transfer pricing administration has come across cases of outbound loan transactions where the Indian parent has advanced to its associated entities (AE) in a foreign jurisdiction either interest free loans or loans at LIBOR/EURIBOR rates. The main issue before the transfer pricing administration is benchmarking of these loan transactions to arrive at the ALP of the rates of interest applicable on these loans. The Indian transfer pricing administration has determined that since the loans are advanced from India and Indian currency has been subsequently converted into the currency of the geographic location of the AE, the Prime Lending Rate (PLR) of the Indian banks should be applied as the external CUP and not the LIBOR or EURIBOR rate.

- c. A further issue in financial transactions is credit guarantee fees. With the increase in outbound investments, the Indian transfer pricing administration has come across cases of corporate guarantees extended by Indian parents to its associated entities (AEs) abroad, where the Indian parent as guarantor agrees to pay the entire amount due on a loan instrument on default by the borrower. The guarantee helps an AE of the Indian MNE to secure a loan from the bank. The Indian transfer pricing administration generally determines the ALP of such guarantee under the comparable uncontrolled price method. In most cases, interest rates quotes and guarantee rate quotes available from banking companies are taken as the benchmark rate to arrive at the ALP. The Indian tax administration also uses the interest rate prevalent in the rupee bond markets in India for bonds of different credit ratings. The difference in the credit ratings between the parent in India and the foreign subsidiary is taken into account and the rate of interest specific to a credit rating of Indian bond is also considered for determination of the arm's length price of such guarantees.
- d. However, the Indian transfer pricing administration is facing a challenge due to non-availability of specialized database and transfer price of complex cases of inter-company loans in cases of mergers and acquisitions which involve complex inter-company loan instruments as well as implicit element of guarantee from parent company in securing debt.

Solved Case

Terabyte Inc. of France and R Ltd. of India are associated enterprises. R Ltd. imports 6,000 compressors for Air Conditioners from Terabyte Inc. at ₹ 6,700 per unit and these are sold to Refresh Cooling Solutions Ltd at a price of ₹ 10,000 per unit. R Ltd. had also imported similar products from Gold Inc. Poland and sold outside at a Gross Profit of 20% on Sales. Terabyte Inc. offered a quantity discount of ₹ 1,000 per unit. Gold Inc. could offer only ₹ 500 per unit as Quantity Discount. The freight and customs duty paid for imports from Gold Inc. Poland had cost R Ltd. ₹ 1,200 per piece. In respect of purchase from Terabyte Inc., R Ltd. had to pay ₹ 200 only as freight charges.

On the basis of aforesaid information, you are requested to choose correct options for the following:

1. What will be considered as arm's length price per unit?
2. State the amount of addition required to be made in the computation of R Ltd.?

Solution:

Computation of Arm's Length Price

Particulars	Amount (₹)
Resale Price of Goods Purchased from Terabyte Inc.	10,000
Less: Adjustment for Differences –	
a) Normal Gross Profit Margin at 20% of Sale Price [20% × ₹ 10,000]	2,000
b) Incremental Quantity Discount by Terabyte Inc. [₹ 1,000 – ₹ 500]	500
c) Difference in Purchase related expenses [₹ 1,200 – ₹ 200]	1,000
Arms Length Price	6,500

Computation of Increase in Total Income of R Ltd

Particulars	Amount (₹)
Price at which actually bought from Terabyte Inc. of France	6,700
Less: Arms Length Price per unit under Resale Price Method	6,500
Decrease in Purchase Price per unit	200
No. of units purchased from Terabyte Inc.	3,000 units
Increase in Total Income (6,000 units × ₹ 200)	₹ 12,00,000

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. The provisions of sec. 92 will apply only if the aggregate value of specified domestic transactions entered into by the taxpayer during the year exceeds a sum of ₹ _____.
 - a. 100 crore
 - b. 5 crore
 - c. 10 crore
 - d. 20 crore
2. As per section _____ when any specified domestic transaction is carried out between associated enterprises, the said transaction should be carried out at arm's length price.
 - a. 90
 - b. 91
 - c. 92
 - d. 90A
3. Section _____ deals with methods of computation of arm's length price.
 - a. 94
 - b. 93
 - c. 92C
 - d. 91
4. Arm's length price is to be determined by applying _____.
 - a. Resale Price Method
 - b. Fair Market Value Method
 - c. Stamp Duty Value Method
 - d. Indexed Cost of Acquisition Method
5. Advance Pricing Agreement shall be valid for such period not exceeding _____ consecutive previous years as may be specified in the agreement.
 - a. 5
 - b. 3
 - c. 10
 - d. 2
6. As per sec. 94B, interest expenses claimed by an entity to its associated enterprises shall be restricted to _____ of its earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid or payable to associated enterprise, whichever is less.
 - a. 30%
 - b. 25%
 - c. 20%
 - d. 50%

7. If any person fails to keep and maintain any such information and document as required by sec. 92D in respect of an international transaction or specified domestic transaction, the Assessing Officer or Commissioner (Appeals) may direct that such person shall pay, by way of penalty, a sum equal to _____
- ₹ 5,00,000
 - 2% of the value of each international transaction or specified domestic transaction entered into by such person
 - ₹ 1,00,000
 - 1% of the value of each international transaction or specified domestic transaction entered into by such person
8. Uncontrolled transaction means a transaction between _____, whether resident or non-resident
- enterprises other than associated enterprises
 - associated enterprises
 - any enterprises
 - none of the above
9. Information and documents required to maintained u/s 92D shall be kept and maintained for a period of _____ from the end of the relevant assessment year.
- 8 years
 - 5 years
 - 10 years
 - 16 years
10. When an assessee fails to furnish any information relating to a specified domestic transaction, the quantum of penalty as a percentage of value of the transaction would be —
- 2%
 - 1%
 - 5%
 - 3%

[Answer : 1-d; 2-c; 3-c; 4-a; 5-a; 6-a; 7-b; 8-a; 9-a; 10-a]

Short Essay Type Questions

1. What do you mean by advance pricing agreement?
2. What is thin capitalisation?
3. State the provisions relating to secondary adjustments.

B. Numerical Questions

Comprehensive Numerical Problems

On the basis of following information, you are requested to compute disallowance u/s 94B

Particulars	Case I	Case II	Case III
	₹ in lakhs		
Net Profit after deduction of the following items:	1,000	1,000	1,000
Interest to SBI	70	50	200
Interest to associated enterprise	200	110	320
Interest to unrelated parties	500	190	300
Depreciation	90	80	110
Provision for taxation	340	170	70
Proposed dividend	300	150	100

[Ans: Nil]

Case Studies - Unsolved

Question: 1

Bharat Cellphones Ltd. (BCL) of Mumbai and Japan Mobiles Ltd. (JML) of Tokyo are associated enterprises. BCL imported 10,000 mobile handsets from JML for ₹ 15,000 per handset which are sold to unrelated parties in India for ₹ 20,000 per handset. BCL also imported similar mobile sets from Europe Ltd. (EL) of London which was sold with a gross profit margin of 25% on cost. JML offered quantity discount @ ₹ 2,000 per unit and whereas EL offered discount @ ₹ 800 per unit as quantity discount. The freight and customs duty paid for imports from EL had cost BCL ₹ 1,500 per unit. In respect of purchases from EL, the expenditure towards freight and customs duty was ₹ 500 per unit.

On the basis of aforesaid information, you are require to answer the following questions:

- Suggest which method shall be considered as most appropriate method for computation of arm's length transaction.
- Calculate the arm's length price per mobile handset.
- State the amount of increment required to be made in the total income on account of transfer pricing.

[Hint: (i) Resale Price Method; (ii) ₹ 13,800; (iii) ₹ 120 lakhs]

Question: 2

S Limited, an Indian Company supplied billets to its holding company, G Limited, Germany during the previous year 2025-26. S Limited also supplied the same product to another German-based company, Z Limited, an unrelated entity. The transactions with G Limited are priced at Euro 500 per MT (FOB), whereas the transactions with Z Limited are priced at Euro 900 per MT (CIF). Insurance and Freight amounts to Euro 300 per MT.

During the year, 10,000 MT were supplied to G Limited.

Assume an exchange rate of 1 Euro = 90 INR

On the basis of aforesaid information, you are require to answer the following questions:

- (i) Suggest which will be considered as the most appropriate method for computing arm's length price in this case
- (ii) Calculate the arm's length price for the transaction with G Limited
- (iii) Calculate the effect of the change in the ALP on the profits of S Limited
- (iv) If export profits of the Indian company are covered by exemption u/s 10AA (seventh year), will there be any increase in the quantum of exemption u/s 10AA?

[Hint: (i) Comparable Uncontrolled Price; (ii) Euro 600; (iii) Total income will be increased by ₹ 9 crore; (iv) Nil]

Question: 3

X Ltd., a resident Indian Company, on 01-04-2025 has borrowed ₹ 100 crores from M/s. A Inc, a Company incorporated in US, at an interest rate of 9% p.a. The said loan is repayable over a period of 10 years. Further, loan is guaranteed by M/s B Inc incorporated in US. M/s. K Inc, a non-resident, holds shares carrying 30% of voting power both in M/s X Ltd. and M/s B. Inc. M/s K Inc has also deposited ₹ 100 crores with M/s A Inc.

Other information

Net profit of M/s. X Ltd. was ₹ 10 crores after debiting the above interest, depreciation of ₹ 5 crores and income-tax of ₹ 3.40 crores.

Based on the above information, you are require to answer the following questions:

- (i) State the amount of addition required to be made u/s 94B.
- (ii) Calculate the taxable income of the assessee.

[Hint: (i) ₹ 78 lakhs; (ii) ₹ 1,418 lakhs]

Question: 4

U Ltd., a US company has a subsidiary, B Ltd., in India. U Ltd. sells computer monitors to B Ltd. for resale in India. U Ltd. also sells computer monitors to K Ltd., another computer reseller. It sells 50,000 computer monitors to B Ltd. at ₹ 11,000 per unit. The price fixed for K Ltd. is ₹ 10,000 per unit. The warranty in the case of sale of monitors by B Ltd. is handled by B Ltd. However, for sale of monitors by K Ltd., U Ltd. is responsible for the warranty for 3 months. Both U Ltd. and B Ltd. offer extended warranty at a standard rate of ₹ 1,000 per annum. On these facts, answer the following questions:

- (i) Calculate the arm's length price per computer monitor.
- (ii) State the amount of increment required to be made in the total income on account of transfer pricing.

[Hint: (i) ₹ 9,750; (ii) ₹ 625 lakhs]

Question: 5

I Ltd. is an Indian Company in which Z Inc., a US company, has 28% shareholding and voting power. Following transactions were effected between these two companies during the financial year 2025-26:

- a. I Ltd. sold 1,00,000 pieces of T-shirts at \$ 2 per T-Shirt to Z Inc. The identical T-Shirts were sold to unrelated

party namely Kennedy Inc., at \$ 3 per T-Shirt.

- b. I Ltd. borrowed \$ 2,00,000 from a foreign lender based on the guarantee of Z Inc. For this, I Ltd. paid \$ 10,000 as guarantee fee to Z Inc. To an unrelated party for the same amount of loan, Z Inc. collected \$ 7000 as guarantee fee.
- c. I Ltd. paid \$15,000 to Z Inc. for getting various potential customers details to improve its business. Z Inc. provided the same service to unrelated parties for \$ 10,000.

Assume the rate of exchange as 1 \$ = ₹ 82

I Ltd. is located in a Special Economic (SEZ) and its income before transfer pricing adjustments for the year ended 31st March, 2026 was ₹ 1,200 lakhs.

On the basis of above information, answer the following questions:

- (i) State the amount of increment required to be made in the total income of I Ltd. on account of transfer pricing.
- (ii) State the amount of incremental deduction u/s 10AA available to I Ltd. on account of addition made due to transfer pricing provisions.

[Hint: (i) ₹ 88,56,000; (ii) Nil]

References

<https://www.incometaxindia.gov.in/>

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