



**Submission of Comments to the Central Board of Direct Taxes (CBDT)**

**on**

**Draft scheme of the proposed rules for computation of Arm's Length Price (ALP) of an International Transaction or Specified Domestic Transaction on or after 01.04.2014**

**1. Background**

The Finance Minister in his budget speech, while introducing the Finance (No. 2) Bill, 2014 had made an announcement for introduction of a “range concept” for determination of Arm's Length Price (ALP) in the Indian transfer pricing (TP) regime, and use of “multiple year data” for undertaking comparatively analysis.

Consequent to the announcement, sub-section (2) to section 92C of the Income Tax Act, 1961 was amended vide Finance (No.2) Act, 2014, to provide that where more than one price is determined by application of the most appropriate method, ALP in relation to an international transaction or specified domestic transaction undertaken on or after April 1, 2014 shall be computed in such manner as may be prescribed.

Pursuant to this, the Central Board of Direct Taxes (“CBDT” or “the Board”) has developed a draft scheme<sup>1</sup>, containing detailed provisions as regards the application of “range concept” and the use of “multiple year data”. Further, the Board, in order to take into consideration views of various stakeholders, invited comments and suggestions of interested stakeholders and general public on the draft scheme.

Consumer Unity & Trust Society (CUTS, [www.cuts-international.org](http://www.cuts-international.org)) is a vigilant institution working in the area of economic regulation, financial sector, consumer protection, competition, trade, and investment since last 30 years. CUTS' comments on the draft scheme are set out in the following sections:

**2. Applicability of the Proposed Scheme**

As mentioned above, the Finance Minister, while delivering his budget speech in July 2014, announced that the “range concept” would be introduced in the Indian TP regime. It was also announced that use of “multiple year data” would be permitted for undertaking comparative analysis. However, it took almost a year for the CBDT to frame rules containing provisions with respect to the “range concept” and “multiple year data” for determination of ALP. Further, considering the proposed scheme would be effective from a back date, i.e., April 1, 2014 (applicable for financial years (FYs) 2014-15 and onwards), there would have

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<sup>1</sup> F.No. 134/11/2015-TPL

been greater clarity in executing international transactions or specified domestic transactions in FY 2014-15, should these rules were in place at the time such transactions actually undertook.

### 3. Application of Range Concept

The draft scheme provides that a minimum 9 comparables would be needed, based on an analysis of functions, assets and risks. Further, the weighted average of 3-year data of these 9 comparables would be considered to construct the data set, except in certain cases where 2 years data can be used. The ALP would be defined as the data points between the 40<sup>th</sup> and 60<sup>th</sup> percentile of the data set (which would have a minimum of 9 data points as stated above).

Practically, nine comparable companies may be difficult to find in all cases. In addition, it is not clear that whether 9 comparables would be those which the tax payer uses, or those which the tax officer arrives at. In a scenario, where the tax payer uses 9 comparables and the tax officer subsequently reduces them to less than 9, the question that arises is whether the tax payer loses its right to apply the “range concept” and consequently, forced to apply the “arithmetic mean” at the time of audit. Such a situation would create significant uncertainty, not only from a compliance point of view, but also from the perspective of price setting/pricing policy.<sup>2</sup>

Moreover, compared to the range prescribed by CBDT (i.e., the range of 40<sup>th</sup> to 60<sup>th</sup> percentile), the Organisation for Economic Co-operation and Development (OECD) and United Nations Transfer Pricing Guidelines prescribes the adoption of an “inter-quartile range” (i.e., the range from 25<sup>th</sup> to the 75<sup>th</sup> percentile of the results derived from the comparable set). Consequently, most countries including all developed nations, use the concept of inter-quartile range.<sup>3</sup>

The range proposed by the CBDT for Indian TP framework would present quite a narrow range of margins/results of comparables. From commercial view point as well, this limited set comparables might not be true representative of margins prevailing in the industry. As a result, this might entice tax authorities to deliberately reject cert comparables, initially selected by the tax payer, so as to push the case towards the rigours of arithmetic mean.<sup>4</sup>

Therefore, it is imperative for CBDT to consider adopting the classical concept of inter-quartile range, and provide flexibility to the tax payers to adopt the “range concept” even if the number of comparables is less

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<sup>2</sup> “CBDT prescribes draft scheme for use of ‘Arm’s Length Range’ and ‘Multiple Year Data’”, available at [http://www.pwc.in/en\\_IN/in/assets/pdfs/news-alert-tax/2015/pwc-news-alert-22-may-2015-cbd-t-prescribes-draft-scheme.pdf](http://www.pwc.in/en_IN/in/assets/pdfs/news-alert-tax/2015/pwc-news-alert-22-may-2015-cbd-t-prescribes-draft-scheme.pdf), last visited on May 26, 2015

<sup>3</sup> “CBDT Draft Rules on “range concept” and “multiple year data” – A boon or bane?”, available at <http://www.tp.taxsutra.com/expertprint?sid=209>, last visited on May 26, 2015

<sup>4</sup> “CBDT Draft Rules on “range concept” and “multiple year data” – A boon or bane?”, available at <http://www.tp.taxsutra.com/experts/column?sid=211#content-bottom>, last visited on May 26, 2015

than 9, if the CBDT seriously wishes to mitigate TP litigation around comparability analyses. In addition, the regulations should provide guiding principles on how to select the comparables including rights of the tax payer and powers of the tax officer in this regard.

#### **4. Use of Multiple Year Data**

The CBDT has proposed that multiple year data should mandatorily comprise the data of three years including the current year (i.e., the year in which the transaction has taken place). However, the use of data of 2 out of relevant 3 years shall be permitted in the following situations:

- Unavailability of current year data at the time of filing of return of income,
- A comparable fails to clear a quantitative filter in any 1 out of the three years, and
- A comparable may have commenced operations only in last 2 years or may have closed down operations during the current year.

Thus, one of the exceptions to the use of three year data is when a comparable fails to satisfy the quantitative filter in one out of the three years. There is, however, no exception provided for a comparable not passing any of the qualitative filters like change in functional profile, for any of the three years.

#### **5. Common Issues**

Adoption of range concept and use of multiple year data may create complexities and ambiguities with respect to reconciliation with previous years' data. In cases where tax payers apply for advance pricing agreement (APA) for financial year 2014-15 onwards and roll back for financial years prior to that, i.e., financial year 2013-14 and before (when range concept/ multiple year options were not available), it would be interesting to see how the tax authorities reconcile the application of "range concept" and "multiple year data" in the regular APA years *vis-à-vis* the existing "arithmetic mean" in the roll back years.<sup>5</sup>

In addition, the proposed scheme allows the use of "range concept" and "multiple year data" only in case the method used for determination of ALP is Transactional Net Margin Method (TNMM), Resale Price Method (RPM) or Cost Plus Method (CPM). This has the potential to limit the application of "range concept" and "multiple year data", and consequently, leading to a risk of not meeting the inherent objective of curbing TP litigation. Accordingly, in line with global best practices, the Government should

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<sup>5</sup> Supra Note 2

allow the use of the “range” and “multiple year data” also in cases where the Comparable Uncontrolled Price Method (CUP) and Profit Split Method are used.<sup>6</sup>

## 6. Need for impact assessment of regulatory requirements

The Government has issued a Pre-legislative Consultation Policy to ensure efficient pre-legislative scrutiny of a legislative proposal, in consultation with the stakeholders. It includes publishing/ placing in public domain:<sup>7</sup>

- the draft legislation or at least the information that may *inter alia* include brief justification for such legislation, essential elements of the proposed legislation, its broad financial implications, and an estimated assessment of the impact of such legislation on environment, fundamental rights, lives and livelihoods of the concerned/ affected people, etc;
- an explanatory note explaining key legal provisions of the draft legislation or rules, in a simple language;
- summary of feedback/comments received from the public/other stakeholders.

In addition, the Department/Ministry concerned is required to include a brief summary of the feedback received from stakeholders (including Government Departments and the public) along with its response in the note for the Cabinet along with the draft legislation. The summary of pre-legislative process is also required to be placed before the Department Related Parliamentary Standing Committee by the Department/Ministry concerned when the proposed legislation is brought to the Parliament and is referred to the Standing Committee.

Similarly, as per the Resolution of Financial Stability and Development Council (comprising financial sector regulators) dated October 24, 2013, it was decided that all regulations after October 31, 2013 and all other subordinate legislations (including circulars, notices, guidelines, letters, etc.) issued after December 31, 2013 must comply with the following requirements<sup>8</sup>:

- No subordinate legislation may be published without a Board resolution determining the need for such subordinate legislation.
- All draft subordinate legislations should be published with statement of objectives, the problem it seeks to solve, and a cost-benefit analysis (using best practices).

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<sup>6</sup> “CBDT Draft Rules on “range concept” and “multiple year data” – A boon or bane?”, available at <http://www.tp.taxsutra.com/experts/column?sid=211#content-bottom>, last visited on May 26, 2015

<sup>7</sup> Pre-Legislation Consultation Policy, 05 February 2014

<sup>8</sup> Department of Economic Affairs, Handbook on adoption of governance enhancing and non-legislative elements of the draft Indian Financial Code, December 26, 2013

- Comments should be invited from the public and all comments should be published on the web site of the regulator.

While the CBDT<sup>9</sup> has invited comments from public on the proposed changes in TP rules, specifically no statement objective, or cost-benefit analysis of regulations seems to have been undertaken.

Therefore, cost-benefit analysis of proposed changes in the TP regulations needs to be undertaken. Further, there is a need to review the (intended and unintended) impact/ consequences of the proposed amendment.

CUTS has been implementing projects on undertaking regulatory impact assessment (through cost-benefit analysis) of select legislations in energy (<http://www.cuts-ccier.org/ADB-RIA/>) and financial (<http://www.cuts-ccier.org/BHC-RIA/>) sectors. We would be happy to work with the CBDT to undertake cost benefit analysis of the proposed and other rules/regulations.

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<sup>9</sup> While the above policy/resolution is not specifically applicable on CBDT, it should also adopt best practices in policy/regulation making.