CBDT prescribes draft scheme for use of "Arm's Length Range" and "Multiple Year Data"

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In brief

For almost a decade, the corporate community and transfer pricing (TP) professionals had been relentlessly putting forth pre-budget recommendations for introduction of the range concept (instead of the stringent arithmetic mean), and for allowing the use of multiple year data.

The plea was finally heard in the Budget 2014, when the Finance Minister in his speech proposed the introduction of a "range" and "multiple year data" with the objective of reducing TP litigation. The details were, however, not spelt out and the rules were to be prescribed.

The wait is finally over, as the Central Board of Direct Taxes (CBDT) has developed a draft scheme, containing detailed provisions as regards the application of "range concept" and the use of "multiple year data". These would be effective 1 April 2014, i.e., applicable for financial years (FYs) 2014-15 and onwards.

The CBDT has invited comments and suggestions of stakeholders and general public on the proposed scheme by 31 May 2015.

In detail

The proposed scheme[1] prescribes that the use of "multiple year data" and application of "range concept" shall be possible only in cases where the method used for determination of Arm's Length Price (ALP) is the Transactional Net Margin Method, Resale Price Method or Cost Plus Method.

The contents of the proposed scheme has been provided as follows:

Application of Range Concept:

- A minimum of 9 comparables would be needed, based on an analysis of functions, assets and risks;
- 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 (refer ensuing section for details of these exceptional cases);
- For determining the weighted average, the numerator and denominator of the selected Profit Level Indicator would be aggregated for all the years, for each comparable company, and margins would be computed (refer illustration below):

[1] F. No. 134/11/2015-TPL

Particulars	Year 1	Year 2	Year 3	Total
Operating profit	250	300	350	900
Total cost	1700	1800	1900	5400
Weighted Average Profit				**=900/5400 i.e. 16.7%**

- The arm's length range would be defined as the data points between the 40th and 60th percentile of the data set (which would have a minimum of 9 data points as stated above);
- If the transfer price falls outside the prescribed range, the adjustment shall be made with reference to the Median of the range;
- In cases where the number of comparables is inadequate (i.e., less than 9), the "arithmetic mean" shall continue to apply as before for arriving at the ALP (along with the benefit of the tolerance range).

Use of Multiple Year Data:

Multiple year data is proposed to be applied regardless of whether "range" is used or "arithmetic mean" is used.

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). The use of data of 2 out of the relevant 3 years shall be permitted only in the following circumstances:

- Unavailability of current year data at the time of filing return of income;
- A comparable fails to clear a quantitative filter in any 1 out of the 3 years;
- A comparable may have commenced operations only in last 2 years or may have closed down operations during current year.

The CBDT has further proposed that the data for the current year, however, can be used during TP audit both, by the taxpayer and the Revenue, if it becomes available at the time of audit.

The takeaways

The introduction of the range concept and use of multiple year data in the Finance Budget 2014, in principle, had gone down extremely well with the industry. The intent of the Government to reduce TP litigation was evident.

Further, the current approach adopted by the Government of seeking stakeholder and general public comments on the prescribed rules is clearly inclusive and collaborative. It is certainly a positive trend and in line with best practices followed globally, which would help build trust and enhance taxpayer confidence.

Having said that, it is important that the new scheme translates into actually reducing the current litigation challenges "on-ground". It would therefore be in order for the Government to take into account the following practical and implementation difficulties that may possibly arise, while finalising the subject rules:

- Allowing the use of current year data available at the time of audit revives the perennial concern of TP documentation becoming a nullity, and may as well be specifically done away with rather than being specifically included. In any case, the financial data of comparable companies which is not available in the public domain on or before the specified date[2], but which becomes available subsequently by the time of audit, is strictly speaking not in line with the contemporaneous documentation requirement under the Indian TP provisions.
- Nine comparable companies may simply be difficult to find at all times – in fact in most cases! The number of comparable companies is an economic outcome (a blend of functional analysis and number of industry players available in the public domain) which cannot, and should not, be controlled.

  Moreover, it is not clear whether 9 comparables are those which the taxpayer uses, or those which the assessing officer arrives at – in a situation where the taxpayer uses 9 comparables and the assessing officer reduces them to, say, 7 – the question that arises is whether the taxpayer loses its right to apply the "range" and moves back to "arithmetic mean" at the time of audit.

  Consider the following situation: let's say the taxpayer could not find 9 comparables at the time of price setting or developing the TP policy, but found 9 or more comparables at the time of the year-end

[2] Due date for filing of the income tax return for the relevant tax year.

transfer pricing documentation study – however, at the time of the TP audit, the tax officer disputed the comparables and reduced the set to less than 9 comparables.

Such situations could create significant uncertainty and reconciliation difficulties, not only from a compliance standpoint, but also from the perspective of price setting (pricing policy).

- The proposed range of 40th to 60th percentile is undoubtedly quite narrow when compared to the typically (globally) followed 25th to 75th percentile range (i.e., inter-quartile range). Most of the 9 comparables (or more) would anyway become redundant when using this range as only 20% of the set of finally selected comparables will eventually fall within the range. Apart from the mathematics – more importantly from a commercial standpoint – would such a limited set of comparables truly be representative of the margins prevailing in the industry?
- The proposed scheme in its current form may not find acceptance by Competent Authorities of other countries during a bilateral advance pricing arrangement (APA), multilateral APA or a mutual agreement procedure (MAP) negotiation – this would be a critical point for consideration, given the Government's current focus and proposed headway on MAPs and APAs.

  On a separate note, in cases where taxpayers apply for APAs for FY 2014-15 onwards and roll back for financial years prior to FY 2014-15, i.e., FY 2013-14 and before (when range/ multiple year options were not available) – it would be interesting to see how the authorities reconcile the application of "range" in the regular APA years *vis-à-vis* the existing "arithmetic mean" in the roll back years.
- 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 for any of the three years. For instance, in a case where a comparable could not be selected in one of the three years on account of a change in its functional profile or the non-availability of segmented profit and loss account, there seems to be no apparent logic for why the financial data of the remaining two years should not be used, although the proposed rules would require the taxpayer to consider only single (current) year data of such a comparable.

Quite evidently, the proposed scheme could lead to complexities and ambiguities, which may create and proliferate more litigation – although now of a different variety! There is a risk that the inherent and laudable objective of the Government to curb TP litigation may eventually not be met.

However, thanks to the Government's flexible approach, the scheme is still a draft, and a turnaround is possible. A simplified approach of broadening the range (to a full inter-quartile range, or at the very minimum, a range that is larger than the middle 20% data points), not prescribing the number of comparables, and not allowing use of current year data at the time of audit, would go a long way in meeting the objective that the Government has set out for itself. In addition, in line with global best practices, if the Government allows the use of the range also in cases where the Comparable Uncontrolled Price Method or the Profit Split Method is used - that would be the icing on the cake!

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Tax & Regulatory Services – Transfer Pricing

Gautam Mehra, *Mumbai*
+91-22 6689 1155
gautam.mehra@in.pwc.com

Indraneel R Chaudhury, *Bangalore*
+91-80 4079 6064
indraneel.r.chaudhury@in.pwc.com

Our Offices

Ahmedabad
President Plaza
1st Floor Plot No 36
Opp Muktidham Derasar
Thaltej Cross Road, SG Highway
Ahmedabad, Gujarat 380054
+91-79 3091 7000

Bangalore
6th Floor
Millenia Tower 'D'
1 & 2, Murphy Road, Ulsoor,
Bangalore 560 008
Phone +91-80 4079 7000

Chennai
8th Floor
Prestige Palladium Bayan
129-140 Greams Road
Chennai 600 006
+91 44 4228 5000

Hyderabad
Plot no. 77/A, 8-2-624/A/1, 4th Floor, Road No. 10, Banjara Hills,
Hyderabad – 500034,
Andhra Pradesh
Phone +91-40 44246000

Kolkata
56 & 57, Block DN.
Ground Floor, A- Wing
Sector - V, Salt Lake
Kolkata - 700 091, West Bengal
+91-033 2357 9101/
4400 1111

Mumbai
PwC House
Plot No. 18A,
Guru Nanak Road(Station Road),
Bandra (West), Mumbai - 400 050
+91-22 6689 1000

Gurgaon
Building No. 10, Tower - C
17th & 18th Floor,
DLF Cyber City, Gurgaon
Haryana -122002
+91-124 330 6000

Pune
7th Floor, Tower A - Wing 1,
Business Bay, Airport Road,
Yerwada, Pune – 411 006+91-20
4100 4444

For more information
Contact us at
pwctrs.knowledgemanagement@in.pwc.com

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