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REPRESENTATION ON

DRAFT TRANSFER PRICING RULES IN RELATION TO

'RANGE CONCEPT' AND 'MULTIPLE YEAR DATA'

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INITIAL REMARKS

There is no doubt that the release of the long-awaited rules on the 'Range concept' and use of 'Multiple Year Data' is a very welcome step and is in the right direction. It is hoped that the revenue authorities not only at the field level but also during the course of APA/MAP negotiations will consider the rules on Range concept and use of Multiple Year Data for determination of Arm's Length Price. In order to achieve the desired objectives of reducing litigation on various issues, bringing the Indian Transfer Pricing at par with international best practices in Transfer Pricing and to attract the foreign investors by setting the right tax environment in India, it would be appreciated if the Draft Rules incorporate the recommendation of the various stakeholders and industry representatives so as to attain the desired objectives.

We have provided herein our suggestions /recommendations on the aspects that matter to the taxpayers/stakeholders who intend to opt for the Range concept as provided in the Draft Transfer Pricing Rules issued by Hon'ble Central Board of Direct Taxes ('CBDT') vide Circular F No. 134/11/2015-TPL dated May 21, 2015.

ISSUE 1 – RESTRICTION ON THE USE OF RANGE CONCEPT TO THE SELECTED METHODS:

- The first bullet of the circular provides that the Range concept is proposed to be available for the taxpayers /assesses that determine /establish the arm's length price ('ALP') considering any of the following method:

    a. Transaction Net Margin Method ('TNMM')

    b. Resale Price Method ('RPM')

    c. Cost Plus Method ('CPM')

- The Indian Transfer Pricing law provides the computation of ALP based on either of the six methods whichever turns out to be the most appropriate method based on the functions performed, risks assumed and assets utilized by the associated enterprises in a controlled transaction viz. (i) TNMM, (ii) RPM, (iii) CPM, (iv) Comparable Uncontrolled Price Method ('CUP'), (v) Profit Split Method ('PSM') and (vi) Other Method.

- As mentioned above, the current draft scheme has taken cognizance of only first three methods for the purpose of Range concept. However, the rationale of limiting /restricting the benefit /applicability of Range concept to aforesaid three methods is not understandable.

- It is worthwhile to note that Range concept can equally be useful where ALP is determined using the Residual PSM ('PSM') and CUP Method.

- Under Residual PSM approach, various associated enterprises would be remunerated based on the contributions made by them to the business. In the PSM analysis, as a first step, out of the Group system profit/loss, each associated enterprise would be remunerated with a normal return for the routine activities performed by it. Post compensating with the routine return, as a second step, the residual super normal return (profit/loss) is required to be distributed between the various jurisdictions/Group entities based on the key value drivers of the business.

- The compensation/remuneration to the associated enterprises for their routine activities is generally set up with reference to third party arrangements/comparables benchmarking done using local/global databases. –The balance /left-out global profit of a Multinational Enterprise ('MNE') is then allocated between the various associated enterprises in the ratio of their contribution.

- It can be seen that the ALP determination even using the PSM method may require the consideration of independent /third party comparables data. Since the basic/underlying premise for applicability of Range concept as provided in the draft rules on Range concept is availability /use of the comparables, non-applicability of said Range concept to PSM, which also uses the comparables for determination of ALP, may not be considered as positive step specifically when the revenue authorities historically in several cases required the use of Profit Split Method for determination of ALP.

- Similarly, the Range concept may be equally essential for determination of ALP using the CUP method. The CUP method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of price the parties would have agreed to had they resorted directly to a market alternative to the transaction. Therefore, even the CUP method requires the use of comparables for the purpose of determining the ALP as per the Transfer Pricing norms.

- Let's assume that an Indian Parent Company, who is engaged in rendition of software development services to its overseas AE (on a contract service provider basis) who is the marketing entity of the Indian parent, establishes the ALP by undertaking an independent search for comparable data on hourly rates for Indian software developers. The aforesaid benchmarking and establishment of ALP is done using the CUP method. As per the extant rules proposed in the draft scheme, the Indian Parent, who has considered the CUP method for the ALP determination, is not allowed to avail the benefit of Range concept and rather it is mandatorily required to consider the arithmetic mean for the Transfer Pricing analysis. While on the other hand, if the Indian Parent establishes the ALP let's assume considering the TNMM, in that case, even though there is no change in the FAR profile of both the entities, it is allowed to use the Range concept. This would not be fair.

RECOMMENDATION:

In view of the above discussion, it is humbly suggested that the Hon'ble CBDT should allow the use of Range concept for CUP and PSM (residual) methods provided in the Indian TP regulations so that the Assessee would be motivated to consider the most appropriate method from the Transfer Pricing point of view for determining the ALP of its controlled transactions

rather than moving to opt for a most appropriate method from the "Range concept" point of view.

ISSUE 2 – RESTRICTION ON USE OF RANGE CONCEPT UNLESS MINIMUM NUMBER OF NINE COMPARABLES ARE SELECTED:

- The draft scheme provides that minimum nine (9) comparable entities to be selected for the purpose of comparability analysis.

- Use of Range of results is meant to exclude potential outliers and consequently increase the reliability of the comparison of the results. In this regard, the OECD on Transfer Pricing provides that not all the comparable transactions examined will have relatively equal degree of comparability. It further provides that if the Range includes *the sizeable number of observations* (comparables in the context of Indian Transfer Pricing regulations*), statistical tools that take account of central tendency to narrow the Range (eg. Inter quartile Range or other percentiles) might help to enhance the reliability of analysis.*

- It is to be noted that the OECD does not specify the minimum number of comparables to be considered for the applicability of the Range concept. Rather it has simply mentioned that "sizeable" number of comparables assist/can be useful to enhance the comparability analysis. Based on the aforesaid, an inference can be drawn that even OECD while drafting the rules in its wisdom does not specify the number of comparables rather left it to the best judgment of the taxpayers to consider the sizeable number of comparable entities based on facts and circumstances of the specific case.

- Further, as per international guidance available in terms of US Transfer Pricing law, etc, there is no such minimum number of comparables for the applicability of Range concept.[1]

- On the practical front as well, such a threshold may not find favour with the taxpayers specifically those which are engaged in rendition of uncommon services in respect of which large /significant number of comparables may not be easily available. In such a scenario, the taxpayer may choose certain comparables (in order to avail the Range concept) that may not strictly coincide with the functions performed by the tested party as a result of which the functional comparability may be diluted and as a consequence, the same may lead to litigation with the tax authorities and the whole purpose of Range concept may be defeated.

- Another downside of retaining the provision/rule on minimum number of comparables is the flip side of the above discussed scenario. In this situation, the taxpayer may be able to select minimum number of nine (9) or more comparables assuming without any dilution in the functional comparability, however, it is not necessary that the revenue authorities accept all the comparables selected by the taxpayer in its TP documentation and may challenge (without going into the reason on which the said comparable might be challenged) few of the comparables, (the probability of which is there in view of the historic experience) consequent to which the number of comparables would reduce to less than nine (9). Such a situation opens up another Pandora box of litigation whereby the revenue authorities not only contest

[1] Arithmetically, for computing the inter-quartile range, minimum four number of comparables are required.

the comparables selected by the taxpayer rather the applicability of the Range concept itself (in absence of minimum number of comparables).

- Further, the selection of number of comparables is a subjective issue specifically in the cases where overseas entity (i.e. entity outside India) is selected as tested party for the Transfer Pricing analysis, and due to the complexity involved in the selection of comparables from the global databases, the subjectivity may be exaggerated to an unpredictable extent. In a such situation if the minimum number of comparables (the limit of which is currently placed at 9) are not available post completion of benchmarking analysis, the taxpayer may be required to fall back on the traditional arithmetic method which has its own inherent limitations and has already faced criticism including internationally.

RECOMMENDATION:

Given the above discussion, there is a need to re-look at requirement of minimum number of comparabiles to be considered for the applicability of Range concept. It is suggested that following the guidance available in the OECD as well as the international guidance, the requirement of minimum number of comparables should be done away with, which may not only provide enough space to the taxpayers to consider the appropriate comparables for the benchmarking analysis rather the same would also assist the revenue authorities in undertaking the objective assessment /audit of taxpayers rather than contesting the applicability of Range concept based on number of comparables.

ISSUE 3 – THE DATA POINTS LYING WITHIN 40TH TO 60TH PERCENTILE OF THE DATA SET OF SERIES WOULD CONSTITUTE THE RANGE:

- The draft scheme provides that margin/price that would fall within 40th to 60th percentile of the data set of comparables would constitute the arm's length range i.e. the said margin/price would constitute the ALP from the Transfer Pricing point of view.

- Globally, the Range concept has been widely used and accepted on a worldwide basis. Since the Transfer Pricing is not an exact science and in substantial number of cases, the benchmarking analysis could result in a Range of prices which may all be at arm's length, the aforesaid concept is known as Range concept.

- In contrast to the Range concept, the arithmetic mean result in narrowing down the range to single price /margin which result in distorted picture of ALP since the arithmetic mean is vulnerable to extreme values by inclusion of outliers. Therefore, the proposed introduction of Range concept is certainly a positive step towards acceptance of internationally accepted principles to the Indian Transfer Pricing Law.

- Having said the above, the current Range proposed in the draft scheme is only with 40th percentile to 60th percentile which is presumably a very narrow Range at least when compared to the expectation of the various stakeholders and also from the practical application point of view.

- For the sake of better understanding of the concept, let us assume that there are eight comparable companies having operating margins varying from 1% to 11%.

Comparable	Margin OP/TC
1	1%
2	3%
3	4%
4	5%
5	5%
6	6%
7	7%
8	10%
9	11%
40th Percentile	**5.00%**
60th Percentile	**5.80%**

Considering the above example, as per the draft rules on Range concept, if the margin of the tested party falls within 5.00% to 5.80% the same would be considered to be at arm's length. Without dwelling into whether the Range proposed is narrow or the same should be broader, let us consider the above example for the purpose of computing arm's length margin considering the arithmetic mean concept along with the tolerance band of +/-3% for the service providers.

Comparable	Margin OP/TC
1	1%
2	3%
3	4%
4	5%
5	5%
6	6%
7	7%
8	10%
9	11%
Average	**5.78%**
+3% Range	**8.95%**
-3% Range	**2.61%**

From the above it is evident that the establishment of ALP by considering the arithmetic mean concept provides a Range of 2.61% to 8.95% (using a tolerance band of +/-3%) which is much wider as compared to the Range concept proposed to be allowed under the new regime.

It is imperative to note that though the Draft Rules may be able to achieve the first objective by addressing the concerns of various stakeholders which is to eliminate the outliers which otherwise distort the comparability analysis for the establishment of the ALP through the introduction of Range concept, however, the proposed Range of 40th to 60th percentile may not

be useful in the accomplishment of the primary objective of reducing litigation specifically the dispute on arm's length margin between the revenue authorities and the taxpayers.

RECOMMENDATION:

In view of the above discussion, as well as in accordance with the international guidance in terms of the OECD, UN, and US, UK and other Regulations that follow the Range concept, it humbly suggested that the Range should be broadened to bring it at par to international platform/standards wherein the data points between 25th and 75th percentile (referred to as the inter-quartile Range) is considered as a Range from the Transfer Pricing perspective. The inter quartile Range is used in most developed countries like Australia, Denmark, France, Germany, Italy, Netherlands, Israel, Portugal, Singapore, Spain, Sweden, UK and USA as well as by developing nations such as Argentina, Columbia, China, Korea, Malaysia, South Africa, Thailand, etc.

ISSUE 4 – RESTRICTION ON THE USE OF MULTIPLE YEAR DATA TO THE SELECTED METHODS:

- The Draft Rules as provided in the circular provides that the use of multiple year data is available for determination of ALP using the TNMM, RPM and CPM Method.

RECOMMENDATION:

In view of the above discussion in the earlier paragraphs of this paper, it is recommended that the use of Multiple Year data should be allowed for determination of ALP using the Residual PSM.

ISSUE 5 – MANDATORY USE OF 'MULTIPLE YEAR DATA' AT THE TIME OF TP DOCUMENTATION VERSUS DISCRETION FOR USE OF 'CURRENT YEAR DATA' AT THE TIME OF AUDIT PROCEEDINGS:

- It is imperative to note that the Draft Rules have mandated the use of Multiple Year Data (three years data with exception to consider the two years data in the specified circumstances) for the purpose of preparation of TP documentation by the taxpayer. However, the said Draft Rules also contain a provision that provides that Current Year Data can be used both by the taxpayer and the revenue authorities at the time of audit proceedings.

- The above referred provision is not very clear and does not provide the conditions/ situations/ circumstances under which the current year data can be considered by both the parties and in the absence of the same, it appears to provide a discretionary power to the tax authorities to consider the current year data (of course to the taxpayer as well but the probability of being discretionary in nature for the taxpayer is less/remote who has already established the ALP of the controlled transaction(s) using the 'Multiple Year Data').

- Further, the above referred provision of allowing the use of Current Year Data during the transfer pricing audits, once again leaves the space for dispute between the taxpayers and the revenue authorities bringing the entire dispute back to the same square.

- Further, the Draft Rules provide that if any of the three conditions as provided therein would be met, in that scenario, the taxpayer would be allowed to use the two year data out of all the three years. The said conditions are:

  - Data for current year is not available in the public domain at the time of preparation of TP documentation;

  - Any comparable company has commenced operations in last two years only;

  - Any comparable company fails to clear a quantitative filter in any one out of the three years.

- Though the mention of the above conditions in order to allow the use of two year data is appropriate, however, there are many questions which have been left unanswered as of now.

  - One such question is what would happen if a comparable is rejected by the taxpayer at the time of preparation of TP documentation due to non-availability of data (for two years) at that point of time, however, the data (either for two years or all the three years) of said comparable becomes available at the time of TP audit. In such a case, whether the tax officer would have the discretion to select that comparable (may be as a result of fresh search undertaken by him) for determining the ALP or whether the tax officer can only challenge the comparable set of the TP documentation (by rejecting certain comparables or by introducing certain new comparables) based on qualitative reasons /functional comparability.

  - Another situation is where a comparable is selected by the taxpayer and the data of two years is considered for the purpose of TP documentation, however, the data of third year becomes available to the tax officer at the time of TP audit. In such a case, whether the tax officer would be allowed to consider the current year (third year) data along with the earlier year data of the comparable or not.

  The above listed scenarios are just illustrative for highlighting the relevant issue to the tax administration.

RECOMMENDATIONS

- Though a step towards bringing the regulation on introduction of Multiple Year Data is a welcome step by the Hon'ble CBDT, however, it is suggested that the above referred provision related to use of Current Year Data at the time of TP audits should be appropriately/carefully customized to provide for the exceptional reasons under which such a provision could be triggered so that the taxpayers would be confident enough that the TP documentation prepared by them would not be rejected /contested by the tax authorities for no good reason.

- It is to be noted that for the exceptional reasons to be recorded in writing by the Transfer Pricing Officer, the use of current year data should be allowed during the course of TP audit proceedings. Some guidelines should be given to TPO regarding which exceptional reasons would permit the use of Current Year Data.

- It is to be noted that where businessman/ entrepreneur who transacts the business with the associated enterprise(s) determines the ALP with bonafide intention, he would do so based

on the data available at the time of entering into the transaction – the said data could be the relevant data for just the current year or upto the time of transaction where available. In view of the aforesaid, an option to Transfer Pricing Officer of determining the ALP using the Current Year Data at the time of preparation of TP audit is not fair as it was not available to the assessee.

- It is humbly recommended to the tax administration that the proposed rules should be robust and specifically consider the obvious scenario/ situations that could lead to dispute between the taxpayer and the revenue authorities so that the resources and efficiency of tax administration can be utilized for value based audits.

CONCLUDING REMARKS:

The step towards introduction of the Range concept and the use of Multiple Year Data is a very positive development. If carefully re-drafted, this should assist in overcoming much potential TP litigation and create a right environment for the foreign investors globally. It is a wish that the Government should provide appropriate clarification, on the many questions as may be highlighted by numerous stakeholders, by considering the suggestions and recommendations from the industry at large and incorporate appropriate provisions in the concluding version /law on Range concept and use of Multiple Year Data.