India

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Proposal on Determination of the Arm's Length Price Using the Range Concept

While presenting the Union Budget 2014-15, the Finance Minister proposed the introduction of the concepts of "range" and "multiple-year data" in Indian transfer pricing, with the objective of reducing transfer pricing litigation in India. The Central Board of Direct Taxes has developed a draft scheme, which contains detailed provisions as regards the application of "range concept" and the use of "multiple year data" for transactions undertaken for financial years 2014-15 and onwards.

1. Introduction of Transfer Pricing Provisions in India

The liberalization of trade and foreign exchange policy began in 1991 and has helped the Indian economy to integrate with the global economy. With the increase in trade and commerce, it became imperative for the Indian tax authorities to take cognisance of issues relating to transfer pricing as regards cross-border transactions within a multinational group. The Ministry of Finance, after considering all the issues, introduced detailed transfer pricing regulations in India in 2001 with new sections 92A to 92F of the Income-tax Act 1961 (the ITA) and Rules 10A to 10E in the Income-tax Rules 1962 (the Rules), with effect from assessment year[1] 2002-03. These provisions were to be applied to all cross-border transactions entered into between related parties (i.e. associated enterprises) from 1 April 2001.

The transfer pricing provisions were enacted with a view to providing a statutory framework that can lead to the computation of reasonable, fair and equitable consideration (i.e. the arm's length price) of international transactions (i.e. related party transactions between associated enterprises). This would result in a reasonable and fair profit to be chargeable to tax in India, so that such profit would not be diverted elsewhere by alterations in intra-group transactions, leading to a reduction of the Indian tax base.

The transfer pricing provisions require that the international transactions entered into by the taxpayer with its associated enterprises reflect the conditions and circumstances of transactions between two independent or unrelated enterprises. The objective is to prevent the shifting of profit by multinational enterprises with a presence across the globe, and the reduction of India's share of taxes. Thus, the aim of the law is that all the international transactions reflect an arm's length consideration.

2. Determination of the Arm's Length Price

Section 92(1) of the ITA provides that any income arising from an international transaction is to be computed having regard to the arm's length price. Section 92C provides for the determination of the arm's length price for an international transaction by applying one of the specified methods, whichever is the most appropriate method. The initial burden of determining the arm's length price is to be discharged by the taxpayer, bearing in mind the factors of comparability and by applying the most appropriate method from the methods specified under section 92C. The methods specified under section 92C are the comparable uncontrolled price (CUP) method, resale price method, cost-plus method, profit split method, transactional net margin method (TNMM) and the so-called other method[2] as prescribed by the Central Board of Direct Taxes (CBDT) (which is akin to CUP method, but has more flexibility, e.g. even quotations may be used as uncontrolled transactions).

The proviso to section 92C(2) of the ITA, as it stood originally before its amendment by the Finance Act 2002, provided that where more than one price is determined by applying the most appropriate method, the arm's length price is to be taken to be the arithmetical mean of such prices. This would have resulted into an addition to the total income on account of a transfer pricing adjustment in all cases wherever there was even a marginal variation between the arm's length price determined by the Assessing Officer[3] or Transfer Pricing Officer[4] (also known as the tax authorities) and the transfer price of the international transaction as recorded on the books of the taxpayer.

With a view to avoiding hardship to Indian taxpayers in the initial years of implementation of the transfer pricing provisions, the government, through a press note issued by the Ministry of Finance (Department of Revenue) on 22 August 2001, expressed its intention to not make any adjustment if the price adopted by the taxpayer was up to 5% less or up to 5% more than the arm's length price deter-

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1. The income earned in a fiscal year (financial year), which is a 12-month period from 1 April to 31 March, is taxed in the succeeding fiscal year, known as the assessment year. For example income earned in financial year 2001-02 is taxed in assessment year 2002-03.

2. IN: Income-tax Rules, 1962, Rule 10AB.
3. The Assessing Officer is the income tax officer.
4. The Transfer Pricing Officer is the first income tax officer looking into transfer pricing assessments.

Example 1		(INR)	
		Scenario 1	Scenario 2
Operating income (international transaction)	A	10,000,000	10,000,000
Operating expense	B	9,500,000	9,500,000
Operating margin of comparable companies (on cost)	C	*15.00%*	*10.75%*
Arm's length income	D = (B * C) + B	10,925,000	10,521,250
Variation between arm's length price and operating income (international transaction)	E = D – A	925,000	521,250
5% of arm's length price	F = D * 5%	546,250	526,063
Amount of adjustment*	**D – A**	**925,000**	**nil**
* No adjustment if F > E, because variation between international transaction and arm's length price is within (+/-) 5%.			

mined by the tax authorities. Immediately thereafter, the CBDT issued Circular 12[5] dated 23 August 2001, specifying that the tax authorities are not to make any adjustment to the price shown by the taxpayer if such price was up to 5% less or up to 5% more than the arm's length price as determined by the tax authorities and in such cases, the price declared by the taxpayer is to be accepted as being at arm's length.

In effect, the transfer price shown by the taxpayer was not to be altered if it was within a (+/-) 5% range i.e. up to 5% less (i.e. in the case of income) or up to 5% more (i.e. in the case of expenses) than the arm's length price determined based on the arithmetical mean of the prices. If the transfer price shown by the taxpayer was less than 5% (in the case of income) or more than 5% (in the case of expenses) of the arithmetical mean arm's length price (i.e. mean arm's length price) determined by the tax authorities, the transfer price declared by the taxpayer was not to be accepted and an adjustment was required to be made for the difference between (i) the arm's length price determined by the tax authorities based on the arithmetical mean of the prices and (ii) the transfer price shown by the taxpayer. The same was also reiterated by means of an Instruction[6] issued by the CBDT to tax authorities.

Example 1 illustrates the calculation of this adjustment.

The flexibility as regards transfer pricing adjustments as provided by the above-mentioned CBDT Circular was clearly intended to alleviate hardship to taxpayers in cases where the variation between the declared transfer price and the determined arm's length price was only marginal (i.e. within 5% of the arm's length price).

3. Periodic Changes to the Concept of Determination of the Arm's Length Price

Subsequently, the flexibility extended by the Circular was, in substance, brought into law by the Finance Act 2002 through the amendment of the proviso to section 92C(2) of the ITA (quoted below) with retrospective effect from 1 April 2002. Under this proviso, besides the arithmetical

mean of the prices, the arm's length price may be a price that varies from the arithmetical mean by up to 5%.

Thus, in effect, there would be no addition on account of a transfer pricing adjustment in cases of marginal variation of up to 5% between the transfer price declared by the taxpayer and the arm's length price determined by the transfer pricing officer:

> Provided that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices, or, at the option of the assessee, a price which may vary from the arithmetical mean by an amount not exceeding five per cent of such arithmetical mean.[7]

However, in the decision of the Delhi bench of the Income-tax Appellate Tribunal in the *Sony India*[8] case, the Tribunal held that the calculation of the transfer pricing adjustment must be made after deducting the applicable 5% marginal benefit available to the taxpayer, as a standard deduction. This interpretation had been agreed upon by various other benches of the Income-tax Appellate Tribunal (ITAT) across India.

Nevertheless, the tax authorities believed that this flexibility was not intended to be provided to taxpayers in those cases where the variation between the actual price and the determined arm's length price exceeded the permissible 5% range. Thus, in order to overcome this, Finance Act (No. 2) 2009[9] amended the proviso to section 92C(2) to mean that if the variation between the arm's length price determined by the taxpayer and the price at which the international transaction was actually undertaken does not exceed 5% of such international transaction, the price at which the international transaction was actually undertaken by the taxpayer will be deemed to be the arm's length price.

> Provided that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices.

> Provided further that if the variation between the arm's length price so determined and price at which the international transaction has actually been undertaken does not exceed five per cent

5. IN: Circular 12/2001 of 23 August 2001.
6. IN: Instruction 3 of 20 May 2003.

7. IN: Income-tax Act, 1961, proviso to sec. 92C(2).
8. IN: ITAT Delhi, *Sony India Private Limited v. DCIT*, (2009) 315 ITR 150 (Delhi ITAT).
9. IN: Finance (No. 2) Act, 2009, with effect from 1 October 2009

Example 2					
				(INR)	
Particulars		Old proviso	Sony India (Delhi ITAT)*	New proviso (Finance Act 2009)	
				Scenario 1	Scenario 2
Operating income (international transaction)	A	10,000,000	10,000,000	10,000,000	10,000,000
Operating expense	B	9,500,000	9,500,000	9,500,000	9,500,000
Operating margin of comparable companies (on cost)	C	15.00%	15.00%	*15.00%*	*10.75%*
Arm's Length Revenue	D = (B*C)+B	10,925,000	10,925,000	10,925,000	10,521,250
Variation between arm's length price and operating income	E = D – A	925,000	925,000	925,000	521,250
5% of arm's length price (old proviso) / 5% of operating income (new proviso)	F	*546,250*	546,250	*500,000*	*500,000*
Amount of adjustment**	D – A	925,000	378,750	925,000	521,250
* Calculation of adjustment = B – A – D.					
** No adjustment if F > E because variation between international transaction and arm's length price is within (+/-) 5%.					

of the latter, the price at which the international transaction has actually been undertaken shall be deemed to be the arm's length price.[10]

There has been a slight distinction in the methodology for calculating the arm's length price by the amendment introduced by Finance Act 2009. Previously, the benefit of 5% range was calculated on the arm's length price, while the amendment to Finance Act 2009 states that the calculation of benefit of the 5% range is to be made on the contracted price of the international transaction, instead of the arm's length price. Example 2 illustrates this distinction.

Thus, the distinction between the calculation methodology brought about by the amendment, can be seen in scenario 2 of Example 1 and Example 2 respectively, where under one scenario the adjustment is nil, whereas after the amendment the amount of the adjustment comes to INR 521,250.

Furthermore, Finance Act 2011 (effective from assessment year 2012-13) introduced an amendment that replaced the phrase "5 per cent" with "such percentage as notified by the government". However, the long delay in issuing the notification after the 2011 amendment created continued uncertainty for taxpayers as to the percentages that would be prescribed.

The CBDT issued a Notification[11] dated 17 August 2012 which stipulated that where the variation between the arm's length price determined under section 92C and the price at which the international transaction was actually undertaken does not exceed 5% of the price of the international transaction, the price at which the international transaction was actually undertaken will be deemed to be the arm's length price for assessment year 2012-13.

Thereafter, Finance Act 2012 further amended the proviso for assessment year 2013-14 such that the upper limit may

not exceed 3%, i.e. transactions were to be considered at arm's length if the difference between the transfer price and arithmetic mean did not exceed the number as notified by the government, subject to an upper limit of 3%.

The Finance Ministry, by means of Finance Act 2012, extended the applicability of transfer pricing provisions to certain domestic transactions executed between related parties. These provisions became effective from assessment year 2013-14 for transactions exceeding an aggregate value of INR 50 million. In June 2013, the CBDT, by means of a Notification,[12] amended the Rules so as to include specified domestic transactions as regards the application of various methods, comparability, etc. Additionally, the Accountant's Report was also amended (new Form 3CEB) to include specified domestic transactions, such that all compliance requirements for international transfer pricing provisions are now applicable to those specified domestic transactions.

The CBDT then issued a Notification[13] for assessment year 2013-14 which specified that where the variation between the arm's length price determined and the price at which the international transaction or specified domestic transaction which was actually undertaken does not exceed 1% of the transaction value for wholesale traders and 3% of the transaction value in all other cases, the arm's length price will be the price at which the international transaction or specified domestic transaction was actually undertaken. However, there was no clarification provided in the Notification as to which taxpayers would be classified as "wholesale traders". The term "wholesale trader" had a wide connotation in common commercial parlance, and therefore required clarification.

The CBDT thus issued a Notification[14] specifying that the variation range applicable for assessment year 2014-15 for purposes of section 92C(2) of the ITA continues to be 1%

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10. IN: Amendment to the Proviso to sec. 92C(2) brought by the Finance (No. 2) Act, 2009, with effect from 1 October 2009.
11. IN: Notification 31/2012 of 17 Aug. 2012, F.500/185/2011-FTD I.

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12. IN: Notification 41/2013/ of 10 June 2013, F.142/42/2012-TPL.
13. IN: Notification 30/2013 of 15 April 2013, F.500/185/2011-FTD-I.
14. IN: Notification 45/2014 of 23 September 2014.

for wholesale trading and 3% for others. That Notification also defines the term "wholesale trading" as an international transaction or a specified domestic transaction of trading in goods which fulfils the following conditions:

– purchase cost of the finished goods is 80% or more of the total cost pertaining to such trading activities; and

– the average monthly closing inventory of such goods is 10% or less of sales pertaining to such trading activities.

A definition of "wholesale trading" was introduced with the aim of avoiding litigation regarding different interpretation of the term by taxpayers and by the tax authorities. The two conditions mentioned above must be met cumulatively for the application of the lower 1% variation range for "wholesale traders". The definition seems to indicate that the higher 3% variation range could also apply to taxpayers engaged in trading, but which perform a significant "inventory management function" measured on the basis of the level of inventory being managed by them; and which also perform the functions of a trader, which is represented by operating costs of higher value and would therefore not fulfil the twin financial parameters noted above. The commercial nature of trade carried out (i.e. "wholesale" or "retail") may not be really relevant, as the twin financial parameters have been prescribed which may mimic the functional profile of a wholesale trader.

4. Introduction of the Concept of Range

The Finance Minister, in his speech while introducing the Finance Bill 2014, proposed the introduction of the concepts of "range" and "multiple-year data", with the objective of reducing transfer pricing litigation in India. In this speech, the Finance Minister stated as follows:

> In order to align Transfer Pricing regulations in India with the best available practices, I propose to introduce range concept for determination of arm's length price. However, the arithmetic mean concept will continue to apply where number of comparable is inadequate. The relevant data is under analysis and appropriate rules will be prescribed.
>
> As per existing provisions of Transfer Pricing Regulations, only one year data is allowed to be used for comparable analysis with some exception. I propose to amend the regulations to allow use of multiple year data.[15]

However, no details regarding its implementation were provided in Finance Act 2014, nor in Finance Act 2015.

This wait is finally over, as the CBDT has announced draft rules that contain detailed provisions on the application of the range concept and the use of multiple-year data. Through this Notification,[16] the CBDT has proposed to make the draft rules effective from 1 April 2014, i.e. applicable for assessment year 2015-16. The CBDT invited comments and suggestions from professionals, stakeholders and the general public on the proposed rules by 31 May 2015. However, to date, the final notification for the Rules has not been issued.

The proposed conditions/steps for the use of the range, as proposed by the CBDT are as follows:

– the range is applicable only when the cost-plus method, resale price method or TNMM is used to determine the arm's length price;

– it is necessary to use financial data of at least nine comparable companies. Further, such companies must have data for at least two out of the three relevant financial periods (i.e. current financial year and previous two financial years);

– the weighted average is to be computed for these nine companies. This is to be computed by aggregating the numerator and denominator of all the years of every comparable company; and

– a total of nine weighted averages will represent nine data points. Thus, points falling between the 40th and 60th percentile will constitute the range.

It is proposed that if the transfer price falls outside the above-prescribed range, a transfer pricing adjustment will be made considering the median of the range to be the arm's length price (i.e. 50th percentile of the series). Needless to say, no transfer pricing adjustment will be made if the transfer price falls within the prescribed range.

The current provisions on the use of the arithmetic mean will continue to apply in cases where the arm's length price is determined by using the CUP method, profit split method or the so-called other method, or where there are less than nine comparable companies that have been identified for the purpose of benchmarking the international transaction.

5. Use of Multiple-Year Data

Current transfer pricing provisions[17] specify that the data to be used in analysing a comparable company are to be the past data relating to the financial year in which the transaction took place. However, if data influence the determination of the transfer prices of the transaction, data of two previous years are allowed for comparison.

Rule 10B(4) of the Rules states as follows:

> The data to be used in analysing the comparability of an uncontrolled transaction with an international transaction shall be the data relating to the financial year in which the international transaction or the specified domestic transaction has been entered into.
>
> Provided that data relating to a period not being more than two years prior to such financial year may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared.

Accordingly, existing provisions do not generally permit the use of multiple-year data of comparable companies. Jurisprudence on this subject has also decided and accepted the use of only financial data of comparable companies which relate to the financial year in which the taxpayer entered into the international transaction.

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15. Speech of Arun Jaitley, Finance Minister, on the floor of the Parliament while proposing the Finance Budget 2014-15, dated 10 July 2014.
16. IN: Draft Scheme of 21 May 2015, F.134/11/2015-TPL.
17. Rule 10B(4).

Table 1: Range vs. arithmetic mean	
Arithmetic mean	**Range**
Meaning/concept	
It is the average of a set of numerical values, as calculated by adding them together and dividing by the total number of terms in the set (i.e. simple average).	It is a measure of central tendency which divides the data set based upon its dispersion from the median. The inter-quartile range is a measure that indicates the extent to which the central 50% of values within the data set are dispersed. It is based upon, and related to, the median.
Properties/advantages	
It is often used to report central tendencies; it is not a robust statistic, meaning that it is greatly influenced by outliers (values that are significantly larger or smaller than most of the values). Notably, for skewed distributions, such as the distribution of income for which a few people's incomes are substantially greater than most people's, the arithmetic mean may not accord with one's notion of "middle", and robust statistics (such as the median) may be a better description of central tendency.	Compared with the arithmetic mean, one advantage of the range is that it indicates the spread or concentration for the middle of the distribution, ignoring the extremes of the distribution. This is worthwhile for statistical analysis when the extremes are of less interest and more consideration of the middle part of the distribution is required. That is, in the case of the inter-quartile range, the difference between the 75th and 25th percentiles provides a good indication of the range of the values for the middle, or more typical cases, of the distribution.
Limitations	
– It is highly affected by extreme values. – It cannot average the ratios and percentages properly. – It is not an appropriate average for highly skewed distributions. – Sometimes, the mean does not coincide with any of the values in the set.	One of its defects as a measure of variation is that it is based on only two specific percentiles, and does not take other values of the variable into account. This occurs because the range is a positional measure, indicating only the difference between two other positional measures.

The above-mentioned draft rules have proposed the use of multiple-year data. The conditions in the draft rules are as follows:

– multiple-year data may be used only when the method for determining the arm's length price is a profit-based method, i.e. cost-plus method, resale price method or TNMM;
– the multiple-year data must include three years, i.e. the current year in which the transaction took place and the two previous years;
– when data from three years are not available, the use of data from any two years out of the three years is permitted if:
  – the data of the current year are not available in databases at the time of filing the return of income;
  – a comparable fails to qualify for a quantitative filter in any one year; or
  – a comparable has commenced operations in the last two years or closed down operations during the current year; and
– current year data may be used by the income tax department and/or the taxpayer if the same become available subsequently, at the time of assessment.

6. Continued Use of Arithmetic Mean

In cases where the range concept does not apply, the arithmetic mean concept will continue to be used in the same manner as it applied earlier, along with the benefit of the tolerance range. Furthermore, in cases where multiple-year data are to be used, the same would apply in both cases, whether the arm's length price is computed based on a range or the arithmetic mean, as the use of multiple-

year data is dependent on the application of a profit-based method.

7. Range vs. Arithmetic Mean

The arithmetic mean and range are statistical measures, used to analyse dispersion variability in a distribution, which – from a transfer pricing perspective – would mean the margin of comparable companies. Dispersion and central tendency are the often characterized properties of distributions. They are used to derive a central or typical value that can represent the distribution/population. The authors have enumerated certain points of distinction that will further an understanding of the concepts, as in Table 1.

Example 3

Consider the following example of a set with the following nine data points, where the three-year weighted average margin of the comparable companies is shown in percentages:

Serial No.	1	2	3	4	5
Margin (%)	10	15	16	-4	5
Serial No.	6	7	8	9	
Margin (%)	25	30	6	13	

This set in ascending order is as follows:

-4, 5, 6, 10, 13, 15, 16, 25, 30

The arithmetic mean or the simple average of the above distribution is 12.89%, whereas the range of the same set of distributions comes to 10% to 15% (i.e. 40th and 60th percentile, specifically the fourth and sixth term of the series arranged in ascending order).

Thus, when benchmarking the sale of products or services to its associated enterprises, if the taxpayer has earned 9.75%, the taxpayer's transfer price would fall outside the range given above; however if the taxpayer would have opted for the arithmetic

mean, the taxpayer would have been at arm's length, considering the +/-3% allowable under the proviso to section 92C(2) (i.e. 9.5%).

Example 4

This example tweaks one data point, such that serial number 6 is changed from 25 to 40. The three-year weighted average margin of comparable companies is shown in percentages.

Serial No.	1	2	3	4	5
Margin (%)	10	15	16	-4	5
Serial No.	6	7	8	9	
Margin (%)	40	30	6	13	

The above set in ascending order is as follows:

-4, 5, 6, 10, 13, 15, 16, 30, 40

The arithmetic mean or simple average of the above distributions is 14.56%, whereas the range of the same set of distribution continues be 10% to 15% (i.e. 40th and 60th percentile, specifically the fourth and sixth term of the series arranged in ascending order).

Thus, when benchmarking the sale of products or services to its associated enterprises, if the taxpayer has earned 10.50%, the transfer price of the taxpayer will fall within the range given above and it will be deemed to be at arm's length; however if the taxpayer would have opted for the arithmetic mean, the taxpayer would have been subject to an adjustment, even after considering +/-3% allowable under the proviso to section 92C(2) (i.e. 11.12%).

Thus, there is a wide deviation between the results derived from the arithmetic mean and the range of the 40th to 60th percentile.

However, it is evident from the above examples that the arithmetic mean deviated from 12.89% to 14.56% when a smaller data point (i.e. 25) was replaced with a higher data point (i.e. 40), whereas the range remained static at 10% to 15% under both the scenarios. This illustrates that the arithmetic mean reacted to the extreme values, whereas the range remained indifferent. As a result, compared with the arithmetic mean, one advantage of the range is that it indicates the spread or concentration from the middle of the distribution, ignoring the extremes of the distribution.

8. Issues and Limitations on the Implementation of the Draft Rules

Since the recent announcement of the proposed rules, the following issues have been raised.

US transfer pricing regulations[18] have provided for an acceptable inter-quartile range, namely the 25th to 75th percentile. While the OECD Guidelines for Multinational Enterprises and Tax Administrations are silent on the issue of quantifying a particular range to be applied, the Guidelines provide that where the range comprises results of relatively equal and high reliability, it could be argued that any point in the range satisfies the arm's length principle.[19] However, the CBDT has not clarified the rationale behind the proposed range of the 40th to 60th percentiles.

In practice, the situation could arise where the taxpayer uses nine comparables and the tax officer rejects one of

them, reducing the final set to merely eight comparables. It will be interesting to see whether, in such a scenario, the concept of range will be accepted, or whether the tax authorities will now apply the arithmetic mean once again. Understandably, this would lead to much toggling between the two approaches, without a certainty

Although the Draft Rules were framed on 21 May 2015, the proposed rules are set to be applied retrospectively to all international and specified domestic transactions undertaken on or after 1 April 2014.

While the Draft Rules propose the application of the range concept for the resale price method, cost-plus method and TNMM, there is no explanation as to why the benefit of the range is not extended to economic analysis using other specified methods under section 92C. The concept of arithmetic mean was, however, applied universally without any discrimination between methods or availability of comparable data.

There does not seem to be any clarification as to why the range concept is inter-linked to the multiple-year concept, as it narrows the application of direct methods.

Although the Draft Rules discuss quantitative filters, there is no definite explanation as to what is covered under the term "quantitative filter". Whether sales turnover filter, related party filter or employee cost filter will be covered under the quantitative filters, remains to be seen. The Draft Rules have clarified that if the data of a comparable company are not available in databases due to the specified reasons, comparable data from two out of the three years will be allowed to be used. However, among the reasons specified for such non-availability of data, non-acceptance of comparable companies due to qualitative comparable analysis is not included. Considering that quantitative filters have not been defined, it will be imperative to include the rejection of companies using qualitative analysis in the final rules, for, in essence, the application of a quantitative filter actually stems from a qualitative comparable analysis.

Also, the Draft Rules seem to ignore the basic realities of various types of industries where it is very difficult to obtain quality data in the public domain on comparable companies. It would be difficult to apply the range concept to such industries where the number of comparable companies available in the public domain may not be nine or more.

Where the transfer price of the tested party falls outside the range, the median of the range would be taken as the arm's length price in order to make an adjustment to the transfer price. Thus, there would be a classification of taxpayers for which the calculation of the adjustment would be made from the arithmetic mean, and those where the adjustment would be calculated from the median. The Draft Rules envisage two different averages, one for testing and one for making adjustments.

The CBDT has not specified the methodology for calculating the 40th and 60th percentile of a data set. For instance effecting the computation using Microsoft Excel

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18. US: Treasury regulation sec. 1.482-1(e)(3).
19. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010), para. 3.62, International Organizations' Documentation IBFD.

would provide a different result as compared to traditional statistical techniques. In the methodology followed by Microsoft Excel, the lower limit and upper limit of the range are hypothetical figures, obtained by application of formulae for arriving at the 40th and 60th percentile. However, statistically, the lower limit and upper limit of the range should be the items from the distribution itself. For instance in Example 3, above, the range calculated by applying the formula under Microsoft Excel comes to 10.6% to 14.6% (which is not a part of the series at all), as opposed to 10% to 15% calculated statistically from the series. This variation in the methodology for calculating the percentiles may lead to diversified results and wide variations in arriving at a universally accepted range. The better approach would seem to be to adopt the statistical method to arrive at the range. The CBDT needs to clarify this matter.

Finally the Draft Rules specifically state that the use and application of the range is to be based on the weighted average of the comparable companies. However, the proposed rules are silent on whether the weighted average or simple average should be used for the application of multiple-year data (in the manner as explained in the rules relating to the range). A clarification is required from the CBDT in this regard.

9. Text of the Draft Rules

Draft scheme of the proposed rules for computation of Arm's Length Price (ALP) of an International Transaction or Specified Domestic Transaction undertaken on or after 01 April 2014

F. 134/11/2015-TPL[20]

Government of India

Ministry of Finance

Department of Revenue

Central Board of Direct Taxes

Dated: May 21, 2015

1. Section 92C of the Income Tax Act, 1961 (the "Act") provides for computation of Arm's Length Price (ALP) of an international transaction or specified domestic transaction.

2. The Finance Minister in his Budget speech, while introducing the Finance (No. 2) Bill 2014, had made an announcement that "range concept" for determination of ALP would be introduced in the Indian transfer pricing regime however, the arithmetic mean concept will continue to apply where the number of comparables is inadequate. Further, it was announced that use of multiple year data would be permitted for undertaking comparability analysis. Consequent to the announcement, section 92C (2) of the Act was amended by the Finance (No. 2) Act, 2015 to provide that where more than one price is deter-

mined by application of the most appropriate method, the arm's length price in relation to an international transaction or specified domestic transaction undertaken on or after the 1st day of April, 2014 shall be computed in such manner as may be prescribed.

3. Therefore, the manner of computation of ALP is proposed to be provided through the amendment of Income-tax Rules. The proposed mechanism and conditions under which the multiple year data and "range" concept would be used for determination of ALP shall be as under:

A. Adoption of the Range Concept

i. The "range" concept shall be used 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).

ii. The following steps would be required to construct the range:-
   a) A minimum of 9 entities are required to be selected as comparable entities of the tested party, based on the similarity of their functions, assets and risks (FAR) with that of the tested party;
   b) 3-year data of these 9 entities (or more) would be considered and the weighted average of such 3-year data of each company would be used to construct the data set. In certain circumstances, data of 2 out of 3 years could also be used. Thus, the data set or series would have a minimum of 9 data points;
   c) For calculating the weighted average, the numerator and denominator of the chosen Profit Level Indicator (PLI) would be aggregated for all the years for every comparable entity and the margin would be computed thereafter; and
   d) The data points lying within the 40th to 60th percentile of the data set of series would constitute the range.

iii. If the transfer price of the tested party falls outside the range as constructed above, the median of the range would be taken as ALP and adjustment to transfer price shall be made. If the transfer price is within the range no adjustment shall be made. There shall not be two different data sets – one for testing and one for making adjustments.

B. Use of Multiple Year Data

i. The multiple year data would be used only in case determination of ALP is by Transactional Net Margin Method (TNMM), Resale Price Method (RPM) or Cost Plus Method (CPM);

ii. The multiple year data should comprise three years including the current year i.e. (year in which transaction has been undertaken) and its use for above mentioned methods shall be mandatory;

iii. In case of non-availability of data for 3 years for any of the following reasons:

   – Data of the current year of the comparables may not be available on the databases at the time of filing of returns of income by taxpayers;

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20. Central Board of Direct Taxes, *Draft scheme of the proposed rules for computation of Arm's Length Price (ALP) of an International Transaction or Specified Domestic Transaction* (21 May 2015).

– A comparable may fail to clear a quantitative filter in any one out of the three years; and

– A comparable may have commenced operations only in the last two years or may have closed down operations during the current year.

the use of data of two out of relevant three years shall be permitted.

iv. The data of the current year, however, can be used during the transfer pricing audit by both the taxpayer and the department if it becomes available at the time of audit.

C. Continued use of Arithmetic Mean

In cases where "range" concept does not apply, the arithmetic mean concept shall continue to apply in the same manner as it applied before the amendment to section 92C (2) by the Finance (No. 2) Act 2014 alongwith benefit of tolerance range. Further, in cases where multiple year data is to be used, the same would apply whether "range" concept is used or arithmetic mean is used for determining the ALP. Therefore, in such cases the arithmetic mean of the multiple year data of comparable will be considered for computation of ALP.

10. Conclusion

Transfer pricing is not an exact science and the determination of an arm's length price requires the exercise of good judgement. The availability of relevant data on comparable uncontrolled transactions is also a limitation in the transfer pricing analysis that leads to the arm's length price. While the Draft Rules issued by the CBDT regarding the use of a range of results vis-à-vis the arithmetic mean may reduce the rigours of the law, the practical implications of the Draft Rules can be determined only upon the implementation of the Draft Rules by both taxpayers and tax authorities.

The range concept inherently aims to bring flexibility to the computation of the arm's length price as mandated under section 92(1) of the ITA. However,

whether the quantitative parameters laid down by the Draft Rules (e.g. a minimum of nine comparable companies) will achieve the avowed purpose as stated by Finance Minister in his speech of Finance Bill 2014 remains to be seen.

However, the aim of the Draft Rules to introduce the concepts of a range and multiple-year data seems to be in the right direction, as it seeks to make the transfer pricing process more flexible and amenable to economic changes. Furthermore, this should assist in reducing potential litigation on transfer pricing matters and creating an environment conducive to doing business in India.

The CBDT will likely need to flesh out the finer points before the final rules are issued so that these concepts will be certain and plausible in practice.