

Should new "range" and "multiple year data" be optional for FY 2014-15?

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1. Introduction

To bring into operation the amended Sec. 92C (2) which was amended by the Finance (No. 2) Act, 2015 the CBDT brought out on 21st May 2015 a Draft Scheme for computation of ALP. The Draft Scheme has been extensively analysed by the Professional Community. In this write up, *among other things*, we focus on the following issues:

- (i) Should the Proposed New Scheme be made mandatory for FY 2014-15, an year for which the Taxpayers have already set their Transfer Prices under the old Rule?
- (ii) Can an acceptable Arm's Length Range be formed with less than 9 data-points of Comparable Entities?
- (iii) Is it appropriate to compare *Multiple Year Data* of Comparable Entities with *Single Year Data* of Tested Party?
- (iv) Do we need to have two different data sets – one for comparison or testing, and the other for making TP Adjustment?

2. The New Scheme should be optional for FY 2014-15

For FY 2014-15 the Taxpayers have already benchmarked their controlled transactions, while setting the prices of those transactions, under the arithmetic mean rule, with the use of single year data. While it may be true that in most cases the Range Concept and the use of Multiple Year Data – recommended in the Draft Scheme of CBDT - would favour the Taxpayers, it is not necessarily true in each and every case.

So, for the International Transactions and Specified Domestic Transactions undertaken during FY 2014-15 the application of the Range Concept, as well as the use of Multiple Year Data, may be made optional. The Taxpayers may be allowed to choose –

- (i) either the Arithmetic Mean or the Range Concept, or
- (ii) the Multiple Year Data or Single Year Data,

for the transition year of FY 2014-15.

3. The requirement of minimum of 9 comparable entities is not practical - Range can be formed even with a minimum of 2 comparable entities

The Draft Scheme proposes that the Arm's Length Range Concept will apply only with a minimum of 9 comparable entities. It is no secret that in our Country there is not enough data of comparable transactions in the public domain. In most cases 9 comparable entities would not be available, except in IT and ITeS sectors. And that will render the Range Concept redundant in a majority of cases.

To avoid such a situation, constitution of Range with 2 comparable entities may be allowed, along with the 25th and 75th percentiles (Inter-Quartile Range). Statistically, a Range of data-set can be constituted even with a minimum of 2 data-points.

For example, let us take two numbers of ALP, say 100 and 110. Then the Inter-quartile Range will work out to 102.50 to 107.50.

Indeed the US TP Regulations do allow only 2 comparable uncontrolled transactions for forming the Inter-Quartile Range [US Regulations 1.482 – 1 (e) (2) (i): “The arm’s length range is ordinarily determined by applying a single pricing method selected under the best method rule to **two or more** uncontrolled transactions of similar comparability and reliability.”]

Allowing the constitution of Range with a minimum of 2 data-points of comparable entities will make the application of Range Concept relatively independent of the number of data-points of comparable entities. And that will have a benefit of immense practical value: it will insulate the Range Concept from disputes between the TPOs and the Taxpayers on the set of comparables to be selected for arm’s length benchmarking.

4.1 Step I – Testing: Use of Multiple Year Data (Tested Party’s Multiple Year Data should be compared with the Comparable Entities’ Multiple Year Data)

The proposed rules envisage comparison of *Multiple Year Data* of Comparable Entities with *Single Year* (the relevant year) data of the Tested Party. This is faulty and unreliable comparison. It does not meet the standard of like-to-like comparison. If data relating to uncontrolled comparables from multiple years is used, data relating to the controlled taxpayer (Tested Party) for the same years ordinarily must be considered. So, for comparison that is reliable and meaningful the Tested Party’s Multiple Year Data should be compared with the Comparable Entities’ Multiple Year Data.

That will result in appropriate comparison of the effect of economic cycles and business cycles in the Tested Party’s industry, or the effects of life-cycles of the product or intangible being examined, over a reasonable period of time viz. 3 years.

In fact, the *UN Practical Manual on TP* has given examples (in Para 6.3.5.1 to 6.3.5.3 on Pages 228 – 232) illustrating comparison of *Multiple Year Data (over a period of 3 years)* of Uncontrolled Comparables with the *Multiple Year Data (over the same period of 3 years)* of the Tested Party. Besides, the *US Regulations 1.482 – 1 (f)(2)(iii)(D)* also recommend comparing a Controlled Taxpayer’s average result over a multiple year period with the average results of Uncontrolled Comparables over the same period, to reduce the effect of short-term variations that may be unrelated to transfer pricing.

And the OECD TP Guidelines also suggest use of Multiple Year Data of the Controlled Taxpayer in order to obtain a complete understanding of the facts and circumstances surrounding the controlled transaction. [Para 3.76 of the OECD TP Guidelines].

4.2 Step II – Making TP Adjustment: Once comparison or testing is done, the Transfer Pricing Adjustment, if required, should be computed only with reference to the Relevant Year’s Data, of both the Comparable Entities as well as the Tested Party

The Proposed Rules state that there shall not be two different data sets – one for testing and one for making adjustments [Para A (iii) of the Draft Scheme]. Such an approach will lead to TP Adjustment – on Single Year Data of Tested Party - worked out on basis of Multiple Year Data of Comparable Entities.

As discussed above in *Para 4.1*, for testing - whether the Controlled Transaction Price is within the Arm’s Length Range - Multiple Year Data of both the Comparable Entities and the Tested Party should be taken into account. But if the Controlled Transaction Price falls outside the Arm’s Length Range, then the TP Adjustment should be computed with reference to only the Relevant Year’s Data of both the Tested party and the Comparable Entities. This means that, after comparison or testing, the TP Adjustment, if the Controlled Transaction Price is not within the ALP Range, should be computed on basis of the difference between –

'the median of the PLIs (or Prices) of Comparable Entities *for the relevant FY alone*' and 'the PLI (or Price) of the Tested Party for the same relevant FY'. Why?

Because it is not accurate to apply the 3 year average data of PLI or Prices of Comparable Entities (or Comparable Transactions) to a single year (the relevant year) data of the Tested Party. The effect of short-term variations - like economic cycles, business cycles and product-life cycles, etc. - over a period of time (viz. 3 years) that may be unrelated to transfer pricing would stand reflected in the financial results or PLIs or Prices of the Comparable Entities (or Comparable Transactions); but the same effect will not be reflected in the single year's data of the Tested Party.

Moreover, for computing the TP Adjustment, the 3 year average data of Comparable Entities (or Comparable Transactions) cannot be applied to the 3 year average data of Tested Party, because then the *years other than the relevant year get roped in*, while making the TP Adjustment. And that violates the principle that each assessment year is a separate and distinct unit of assessment.

On this point the *UN Practical Manual on TP* suggests making TP Adjustment only with reference to the results of the Tested Party and Comparable Entities for the relevant year; even though comparison for testing is to be made between 3 year average data of comparable entities and 3 year average data of Tested Party. [Para 6.3.5.2 (Example 2 on Pages 230 and 231) and Para 6.3.5.3 (Example 3 on Pages 231 and 232) of the UN Practical Manual on TP].

Also, the *US TP Regulations* recommend comparison of a controlled taxpayer's average result over a multiple year period with the average results of uncontrolled comparables over the same period. But for making TP Adjustment, when the Controlled Transaction Price is not within the Inter-Quartile Arm's Length Range, the *US TP Regulations 1.482 -1 (f) (2) (iii) (D)* provide that the US Revenue Authorities may make TP Adjustment equal to the difference between the Controlled Taxpayer's result for the Taxable Year (Single Year) and the median of the results of the Uncontrolled Comparables for the same Taxable Year. [*Example 2 and 3 of US TP Regulations 1.482-5(e)*].

4.3 Summing up - There is need for two different data sets: one for testing and one for making TP Adjustments

To sum up the discussion made above in *Para 4.1 and 4.2*, two different data sets may be used for testing and for TP Adjustment. For testing, the Multiple Year Data of Comparable Entities, along with the Multiple Year Data of the Tested Party, should be considered. But for TP Adjustment, only the Relevant Single Year Data, of both the Comparable Entities and the Tested Party, should be considered.

5. Conclusion

The Range Concept and the use of Multiple Year Data, proposed in the Draft Scheme, is a significant step towards aligning India's Transfer Pricing Regulations with the Global Standards. In that sense it is heart-warming to the Taxpayers. But to make the Scheme practically relevant certain modifications are required.

The Range Concept may be permitted with minimum of 2 data-points of Comparable Entities. And instead of Range constituting of 40th and 60th percentiles, Range constituting of 25th and 75th percentiles (Inter-Quartile Range) may be allowed for arm's length benchmarking.

Besides that, the Multiple Year Data of both the Tested Party and the Comparable Entities should be taken for testing or comparison. And if the Tested Party's transaction price falls outside the Arm's Length Range, the Transfer Pricing Adjustment should only be made vis-à-vis the median of uncontrolled prices for the relevant year.

One earnestly hopes that the CBDT will consider the Comments and Suggestions of the Taxpayers and other Stakeholders and come up with a truly fine Final Scheme of Computation of ALP.