SEBI – An ALP Approach

1. Introduction

- The note below covers the ambit of arm's length pricing principles under the Income Tax Act, 1961, Companies Act, 2013 and Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 ('SEBI LODR'). It briefly explains why transfer pricing methods adopted in the Income Tax Act, 1961 can be accepted under other Acts/Regulations for determining the arm's length price.

2. SEBI LODR (existing and proposed) – Arm's length perspective

- On perusal of the SEBI LODR, it is understood that only approval from the audit committee/shareholder is required for Related Party ('RP') transactions. Regulation 23(3) provides the conditions for granting omnibus approval by the audit committee which includes specifying the indicative ***base price / current contracted price and the formula for variation in the price***, if any. However, the regulations do not have any reference to the arm's length price ('ALP') principles.
- Further, The SEBI Report of the Working Group on RP transactions, has proposed changes to the definitions of related parties and related party transactions, but have not brought in the concept of ALP for the RP transactions.

3. ALP concept for related party transactions in other Act/regulations

<u>Income Tax Act, 1961 ('ITA)</u>

- 'Arm's length' as a concept in India, was first introduced in the ITA about two decades back in 2001 as an anti-abuse provision. Section 92 to 92F of the ITA which provides that the related party transactions (for a certain category of RPs) are required to be at arm's length. The ITA has laid down detailed rules and methods for the determination of ALP. These methods and rules are comparable with global best tax practices around the world and largely aligned with guidelines recommended by international bodies like OECD and UN.
- The ITA, inter alia, provides that if an income transaction with a non-resident RP is less than ALP, then the shortfall being difference of ALP value and the actual transaction value shall be additionally taxed as income of the taxpayer in India. Similarly, if an expense transaction with non-resident RP is more than ALP, then the excess shall be disallowed and not allowed as deduction for the taxpayer in India. But this is subject to 'no base erosion' rule in terms of which if actual income is more than ALP or actual expense is less than ALP, then no adjustment is made since there is no base erosion.
- Further, after the introduction of Secondary adjustment rules in 2017, the excess amount due to an adjustment in the transaction with an RP is required to be repatriated to India within a prescribed time limit. This is to ensure that taxpayers do not get away with one-time tax payment on TP adjustment and India actually receives the revenue which it deserves. Any default in actual remittance within specified period triggers a year on year notional interest imputation till there is actual remittance to India.
- In fact, pursuant to recommendation from Supreme Court in the case of CIT v. Glaxo Smithkline Asia Pvt Ltd (2010) (195 Taxman 35), the TP rules for international cross border transactions were also extended from 2012 onwards to domestic transactions involving related party payments and taxpayers availing tax holiday under different incentive provisions. To reduce compliance costs for taxpayers, the requirement has been removed from 2017 for domestic related party payments but retained for taxpayers availing tax holiday.
- The rules for maintaining TP documentation are well defined. Further, taxpayers are required to obtain and furnish annual TP audit report from CA for which there is extended time made available for filing income tax returns with TP audit reports. Also, the Institute of

Chartered Accountants of India (ICAI) has published a Technical Guidance for its members for discharging the function of TP audit. This Guidance has been recently revised and updated in August 2020 (Copy attached herewith)

- Although the introduction of TP for international transactions increased tax litigation in India, the Government has been taking several measures over years to reduce TP litigation, bring certainty and improve ease of doing business through measures like safe harbour rules, unilateral advance pricing agreements, bilateral advance pricing agreements, reference of TP dispute to Dispute Resolution Panel before raising final demand, identification of cases for TP scrutiny through computerised risk management criteria. etc.
- Having regard to experience of almost two decades in TP compliance in tax matters, the industry is well accustomed to various TP methods to compute ALP with expert guidance of tax professionals. There are robust databases available in the market which are designed to facilitate TP benchmarking under different TP methods for both compliance by the taxpayers and verification by the Tax Department. The Tax Department also has specialised cell to deal with Transfer Pricing matters with experienced and trained officers.
- The TP litigation in India has also helped develop a body of legal jurisprudence through rulings of different Tribunals, High Courts and Supreme Court on various TP principles like parameters for comparison and benchmarking.
- Thus, the concept of ALP and TP methods have evolved and matured under income tax law providing a very good reference point, if required, to be implemented under other statutes.

<u>Companies Act, 2013</u> (‘Cos. Act’)

- Section 188 of the Cos. Act states that RP transactions will require the approval of Board/Shareholder, as applicable, if they are not in the ordinary course of business ***or not at arm’s length.*** Category of RP transactions which qualifies to be tested for the above-mentioned criteria is given below:
    - Sale, purchase or supply of any goods or materials
    - Leasing of property
    - Availing/ rendering of services
    - Appointment of agent for purchase / sale of good / service/ property
    - Availing/ rendering of services
    - Appointment of related party to office or place of profit
    - Underwriting the subscription of any securities/ derivatives

  Explanation (b) to Section 188 of the Cos. Act defines arm’s length transaction as: *“…a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest”*

- However, there is no further guidance in Cos. Act on how such ALP will be determined, unlike the ITA. Therefore, for the purpose of compliance to ALP in Cos. Act, companies have actually drawn reference from the transfer pricing methods prescribed under Section 92C of the ITA to compute the ALP of the transactions.
- The “Guidance Note on Related Party Transactions” issued by The Institute of Company Secretaries of India In March 2019, has also referred to the methods prescribed by ITA for determining the arm’s length basis. Furthermore, it recommends that the Audit Committee may use the TP guidelines under the Income tax Act (Refer page 14 of the attached ICSI Guidance Note)
- A common set of methods and documentation between ITA and Cos Act reduces complexity and compliance/administration cost for industry as well as regulators.

4. **Transfer Pricing Methods to determine ALP as per ITA**

- It is important to highlight that the methods and way of computation of ALP of the ITA have been derived from the transfer pricing guidelines of the Organisation for Economic Co-operation and Development (OECD) which is a globally accepted guideline and recently revised/updated pursuant to Base Erosion and Profit Shifting (BEPS) Actions to address abusive tax practices adopted by multinational enterprises..
- ITA provides various methods to determine the ALP of a transaction under different business situations with criteria for selection of 'most appropriate method' in a given situation. Reference may be made to Rules 10A to 10CA of Income tax rules which are extracted in separate Annexure. Each method is described in brief as under:

A. Comparable Uncontrolled Price Method ('CUP')

- CUP method requires a comparison of the price of property or services transferred in a controlled transaction (RP transactions) to the price charged for property or services transferred in a comparable uncontrolled transaction (third party transaction) in comparable circumstances. Appropriate adjustments can be made to such price for product quality, contractual terms, geographic market, embedded intangibles and foreign exchange fluctuation risks to ensure better comparability.

B. Resale Price Method ('RPM')

- RPM is applicable in a resale situation, where the property or services purchased from a related party is sold to an unrelated enterprise. It is a preferred method (if CUP is not available) for distributors buying finished goods from a group company and selling to third parties without any value addition.
- The gross margin retained by a company from a trading transaction undertaken with RP is compared with the gross margin that would have been earned in an unrelated scenario.

C. Cost Plus Method ('CPM')

- The CPM compares gross profits to the cost of sales. It begins with the costs incurred by the supplier of property (or services) in a controlled transaction to the RP. An appropriate arm's length mark-up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions.
- The arm's length mark-up can be determined based on the margin earned by the supplier from third parties (internal CPM) or margin earned by independent enterprises (external CPM) for a similar transaction.

D. Profit Split Method ('PSM')

- PSM is applicable in transactions involving the transfer of unique intangibles or in multiple transactions, which are so interrelated that they cannot be evaluated separately for determining the arm's length price of any one transaction.
- The combined net profit from a transaction is determined, then the relative contribution made by each RP to the earning of such combined net profit is evaluated on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances. Accordingly, the net profit is split in the ratio of the RP's contribution.

E. Transactional Net Margin Method ('TNMM')

- TNMM uses net profitability levels from comparable transactions to establish an arm's length result against the entity whose net profitability is tested. The net profit margin in relation to an appropriate base, i.e., cost, sales, assets, etc., from a controlled transaction is compared with the net profit margin on the similar base from an uncontrolled transaction of, the taxpayer, or between two independent third parties.
- When functional analysis of the parties in controlled transaction and uncontrolled transactions result in any differences, necessary adjustments are required to be made to establish reliable results.
- TNMM can be internal or external. Internal TNMM refers to a transaction between RPs and unrelated parties whereas External TNMM refers to transactions between third parties.

F. Other Method

- Where the application of the five specific methods is not possible due to difficulties in obtaining comparable data or due to uniqueness of transactions, any other method can be used.
- Any method that takes into account the price that has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-related parties, under similar circumstances considering all the facts, shall be regarded as one of the recognized methods for determining the ALP.
- Transactions where this method can be applied, are intangibles or business transfers, transfer of unlisted shares, sale of fixed assets, guarantees provided and received, etc.
- Possible methods of determining ALP under Other Method are third party quotations, valuation reports, commercial and economic models etc.

It may be reiterated that the above referred methods are well entrenched in the industry and accepted by the Government for income tax purposes.

5. Conclusion

- The SEBI LODR currently provides for taking approval from the Audit Committee (shareholder in case of Material RP transactions) and specifying the price of the transaction. However, it does not provide any basis for granting approval.
- Therefore, to make such approvals more robust and enhance corporate governance, the concept of arm's length pricing can be introduced (similar to Cos. Act), wherein if the transaction is not at ALP, then further approvals of the Board and shareholders may be required.
- SEBI LODR may also explicitly place its reliance on the arm's length principle and related methods mentioned in the ITA. Given the transfer pricing methods explained in the ITA is tried and tested in various courts of law in India as well as in international guidance/ international legal forums, therefore the ITA can also be relied upon to determine the ALP of the related party transactions.
- The above may help the companies to achieve consistency in their approach in relation to the relevant RP regulations while entering into an RP transaction, avoid duplication, reduce compliance costs and avoid complexity of divergence between income tax and corporate law compliances.