

## Analysing the Sixth Transfer Pricing Method – Implications et al

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Recently vide Circular Dated May 23, 2012 the CBDT has prescribed the sixth Transfer Pricing method ('Sixth Method') for computation of the arm's length price. Since this entire article focuses on the Sixth Method, for ease of reference the relevant rule (Rule 10AB operative from April 1, 2012 and applicable from Assessment Year 2012-13) has been set out below:

*"10AB. For the purposes of clause (f) of sub-section (1) of section 92C, the other method for determination of the arms' length price in relation to an international transaction shall be **any method which takes into account the price which has been charged or paid, or would have been charged or paid,***

*for the same or similar uncontrolled transaction, with or **between non associated enterprises**, under similar circumstances, considering all the relevant facts."*

For analytical purposes, the new method may be split into two parts:

- (i) 'any method which takes into account the price **which has been charged or paid**; or
- (ii) 'any method which takes into account the price **which would have been charged or paid**

The first part refers to a price that has actually been charged or paid and in that sense necessitates the existence of a real or actual same or similar uncontrolled transaction. This is similar to the existing CUP method though broader in scope. The second part - 'or would have been charged or paid' - is more significant with wider ramifications.

### 1. Retrospective application

The Sixth Method applies retrospectively from financial year 2011-12 ie for assessment year 2012-13. This is pursuant to CBDT's power under section 295(4) of the Income-tax Act, 1961 to make rules retrospectively subject to the limitation that *no retrospective effect shall be given to any rule so as to prejudicially affect the interests of assessee*.

### 2. Open-ended and 'no-method' as such

The Sixth Method is really no method as such but simply an enabling provision to adopt any method that may be used (or would have been used) by third parties to arrive at the transaction price. The CBDT may well have provided an exclusive definition of the new method (or methods) spelling out precisely the scope and definition of each method. However, given the increasing complexity of inter-company transactions, there is no knowing how far such a list would have remained useful. One could say that an open-ended method cuts both ways. While one would never face the problem of lack of method for benchmarking a transaction, the open-endedness is bound to breed its own set of disputes and controversy.

### 3. Availability for Domestic Transfer Pricing

The newly inserted Rule 10AB states "*For the purposes of clause (f) of sub-section (1) of section 92C, the other method for determination of the **arms' length price in relation to an international transaction shall be...***". Based on a plain reading of the Rule it appears that the Sixth Method is available only for benchmarking 'international transactions' and not for 'specified domestic transactions'. At the same time for purpose of section 92C, the Finance Act, 2012 has substituted the phrase 'international transaction' with 'international transaction or specified domestic transaction'. It's not entirely clear whether such substitution would automatically extend to Rule 10AB as well. Hence, the availability of Sixth Method for domestic transfer pricing is somewhat shrouded in doubt. An administrative clarification here may be helpful if that's really the intention.

#### 4. Use of Valuation Methods

The new method provides a sweeping and unequivocal basis for 'Constructed' or 'Hypothetical CUP' approach wherein one may arrive at the comparable uncontrolled price based on logical reasoning and deduction even though there may not be an actual similar uncontrolled transaction. Hence, the new method would include all commonly used valuation methods such as discounted cash flow analysis, market capitalization method etc which depending upon the facts and circumstances may be used by third parties to arrive at the transaction price.

Interestingly, in a number of cases, the Tax Tribunal has adopted an expansive interpretation of 'CUP' method accepting reliance on valuation methods. In the case of *Tally Solutions* reliance on 'Excess Earnings Method' under CUP method was upheld for valuing the sale of 'intellectual property rights'. Similarly, in the case of *Intel Asia*, the Bangalore Tribunal also held that a valuation method could be relied upon under CUP method.

Going forward, it is crystal clear that any variant of a valuation method can be used as one of the prescribed methods for benchmarking an international transaction so long as the conditions of Rule 10AB are satisfied.

#### 5. Use of Quotations

Another interesting implication of the new method is clear validation of bonafide quotations for supporting transfer prices. If there was ever any doubt on use of bonafide quotations (as against actual transaction prices), the same is dispelled now. The express language of Sixth Method which refers to the '*price which would have been charged or paid*' puts it beyond doubt that bonafide quotations may be relied upon in view of the facts and circumstances of each case.

#### 6. Cost allocation agreements

Strictly speaking none of the hitherto prescribed methods covered cost allocation or sharing arrangements based on the use of allocation key (though historically allocation keys have been justified under CUP method, it could be said that this was more due to lack of any better method than for any other reason). The new method resolves this issue by providing a clear option on the choice of method in such cases.

#### 7. Coining of a new phrase - 'non-associated enterprise'

The new method uses a phrase 'non-associated enterprise' finding its place in the Indian Transfer Pricing regulations for the first time. Neither Rule 10AB nor do the Transfer Pricing regulations provide any definition of the said term. Prima-facie, any two enterprises that are not 'associated' within the meaning of Indian Transfer Pricing regulations (section 92A) could be understood as 'non-associated'. Such interpretation notwithstanding guidance from administrative authorities in this regard would be instructive.

#### 8. Two-pronged Test

The number of methods available outside the *hitherto* prescribed five methods is fairly large (or rather endless). Hence, it could be said that the test of 'most appropriate method' under the sixth method has a two-fold dimension. At first, one needs to determine the 'most appropriate method' amongst the six prescribed methods inter-se, and thereafter, if the sixth method is used – presumably the kind of sub-method used would also require justification considering the facts and circumstances of each case. Hence, quite like the 'choice of most appropriate method', the choice of sub-method within the sixth method shall not be free from litigation and challenge by Revenue Authorities.

#### 9. Sixth Method and the 'Bright line' test

In recent times, in a number of cases, the Revenue has challenged the huge advertising spend and marketing effort undertaken by Indian subsidiaries for promotion of foreign brands (legally owned by parent). In all such cases, significant Transfer Pricing adjustments have been made where the quantum of marketing expenditure was found to be in excess of the 'brightline' ie an estimate of marketing expenditure that would ordinarily be undertaken by any player in a given industry.

A common contention of taxpayer against the applicability of 'brightline' test has been that 'brightline' is not a prescribed method under Indian Transfer Pricing regulations. Without commenting on the appropriateness of this contention, given the introduction of sixth method, the lack of an accommodating method can surely not be a winning argument any more (from date of entry into force of Sixth Method).

#### 10. Parity between APA and Audit in terms of Method

Interestingly, the Advance Pricing Arrangement ('APA') mechanism introduced under the Finance Act, 2012 does not restrict taxpayers to the five prescribed methods. Under the APA, any method including those prescribed in the Act may be adopted with necessary adjustments or variations. The Sixth Method provides a similar leeway for Transfer Pricing documentation and audit.

#### Concluding Remarks

Post Finance Act, 2012 the scope of Indian Transfer Pricing regulations has been significantly expanded – business re-structuring, transfer of intangibles (including transfer of employees or workforce) and even domestic related party transactions have been expressly brought within the ambit of Transfer Pricing regulations. In the absence of the Sixth Method, a moot point could have been the choice of method for valuing such complex transactions. The introduction of the open-ended Sixth Method solves this problem in one stroke.

However, the open-endedness is not without its own share of problems and a lingering sense of unease. For example, under German Transfer Pricing regulations the transfer of functions such as production, distribution or procurement is treated as a taxable event and specific provisions/ methods exist for valuation of such transfers. With 'business re-structuring' expressly coming within the ambit of Transfer Pricing regulations and now with an open-ended Sixth Method the scope of Indian Transfer Pricing regulations appears all embracing adding to a heightened environment of uncertainty – for all that we know, despite the APA mechanism the adjustment curve may continue to move upwards with an unprecedented momentum.

*The views expressed in this article are personal.*