CBDT Draft Rules on "range concept" and "multiple year data" - A boon or bane?

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Transfer pricing continues to be one of the most significant area of litigation in India.The aggregate transfer pricing adjustment of Rs 46,400 crores made in the recent cycle ended on 31 January 2015 bear testimony to this fact.

The reforms in the last few years such as introduction of Advance Pricing Agreement scheme, Safe Harbour Rules and Roll-back provisions are clear indications that the Government is keen on reducing the litigation on this front. In furtherance to this, the Finance Minister in his Budget speech, while introducing the Finance (No. 2) Bill 2014 (FB 2014), had made an announcement that “range concept” for determination of Arm’s Length Price (ALP) would be introduced in the Indian transfer pricing regime.

Further, it was announced that use of multiple year data would be permitted for undertaking comparability analysis. Consequent to the announcement, the provisions of the Income-tax Act, 1961 (‘Act’) were amended by the FB 2014 to provide that where more than one price is determined 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 1 April, 2014 shall be computed in such manner as may be prescribed.

The Central Board of Direct Taxes (CBDT) should be lauded for releasing the draft scheme of the proposed rules for computation of ALP for public consultation. In the draft scheme, the manner of computation of ALP of an international transaction or specified domestic transaction undertaken on or after 1 April 2014,is proposed to be provided through the amendment of Income-tax Rules, 1962.

Current controversy:

The existing transfer pricing guidelines provide that where more than one ALPs are determined, the “arithmetic mean” of such prices shall be taken as the ALP. Such approach lead to a single point of ALP instead of a range and did not provide flexibility of exclusion of any comparable with abnormal result.

Further, the current guidelines provided that data only relating to the financial year in which theinternational transaction has been entered into shall be considered. The data of prior 2 years may also be considered only if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared.

Typically, taxpayers use multiple year analysis since data for the most recent financial year is generally not available in public domain at the time of filing of tax return. The tax department in most cases have disagreed with the use of multiple year data and has applied the data for the year in which the transaction is undertaken (single year data) since such data is generally available at the time of assessment proceeding.

The aforesaid concepts of “arithmetic mean” and use of “single year” data have been the cornerstone of most if not all the transfer pricing litigation cases in India.

Draft scheme issued by CBDT:

The proposed mechanism and conditions under which the “multiple year” data and “range” concept would be used for determination of ALP are summarised below:

The ‘range’concept

It is prescribed that 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). The methods excluded are Profit Split Method, Comparable Uncontrolled Price Method (CUP) and Other Prescribed Method. Even under the CUP method, there can be situations where there are multiple comparable transactions and the range concept may be applicableeven in such case. Accordingly, ‘range’ concept should be extended even to transactions where the CUP method is used for determination of ALP.

The draft scheme provides that 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) The data points lying within the 40th to 60th percentile of the data set of series would constitute the range.

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. It is prescribed that if the transfer price is within the range, no adjustment shall be made.

The above can be explained through the following illustration:

	Weighted average margin of comparable company
Comparable 1	-2.00%
Comparable 2	4.00%
Comparable 3	6.50%
Comparable 4	**8.50%**
Comparable 5	**12.00%**
Comparable 6	**15.50%**
Comparable 7	18.80%
Comparable 8	20.60%
Comparable 9	105.00%

n is the number of comparables. $x^1, x^2 \ldots x^n$ are the margins/values of comparables sorted from the lowest to the highest.

Arithmetic mean = $(x^1 + x^2 + \ldots x^n)/n$

Lower quartile = [40% *(n+1)] th data value in the data set = 4th observation in the above case

Upper quartile = [60% *(n+1)] th data value in the data set = 6th observation in the above case

m = number of observations in the range ie between 4th and 6th observations

Median (M) = [1/2 *(m+1) th data value in the data set = 5th observation in the above case

The Arithmetic Mean in the above case would be 20.99% and the range based on arithmetic mean would be 17.36% to 24.62% considering 3% variation.

The Median in the above case would be 12% and the 'range' would be 8.5% to 15.5% considering 40th and 60th percentile of data set.

In certain cases, the aforesaid formulae of quartile may result in a number with a decimal; for eg. where n = 10, the lower quartile would be 4.4 as per above formula. The draft rules do not prescribe whether an average of the 4th and 5th observations should be taken orthe same needs to be rounded off to the nearest integerie 4th in this case, or whether one should use a statistical interpolation to arrive at the quartile result.

In either case, it is evident from the above illustration that the 'range' concept is expected to provide greater flexibility to the taxpayers in respect of setting of transfer price as compared to the existing ‘arithmetic mean’ approach.

Compared to the above aforesaid ‘range’ prescribed by CBDT, the Organisation for Economic Co-operation and Development (OECD) prescribes the adoption of an “inter-quartile range”. Most countries, including all the developed nations, use the concept of inter-quartile range. The inter-quartile range is the range from the $25^{th}$to the 75^{th}percentile of the results derived from the comparable set.

The range of 40^{th} to 60^{th} percentile proposed by CBDT therefore would present a narrow range of margin/results of comparables. It appears that the requirement of minimum 9 comparables is prescribed for computing the range since the use of data between 40^{th} and 60^{th} percentile would result in atleast3 comparables. If less than 9 comparables are considered, the range of 40^{th} and 60^{th} percentile would result in less than 3 comparables.

There can be a scenario where the taxpayer may have selected 9 or more companies and adopted the range concept at the time of filing of the tax return. However, the transfer pricing officer may exclude some of comparables from the list resulting in the less than 9 comparables in the final list. In such a situation, the range concept would not apply and the ALP would be determined based on ‘arithmetic mean’ in the same manner as it applied before the amendment made by the FB 2014 alongwith benefit of tolerance range. The vice versa situation is also possible.

The CBDT could consider adopting the inter-quartile range and provide flexibility to the taxpayers to adopt the ‘range’ concept even if the number of comparables are less than 9.

Use of Multiple Year Data

It is proposed that 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).

The multiple year data would comprise of data of 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. The use of data of 2 out of relevant 3 years shall be permitted 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;
- 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.

It is observed that the draft rules, in their present form, are silent on the definition of quantitative filter. Further, there is no reference to any qualitative filter.

It is provided that the data of the current year can be used during the transfer pricing audit by both the taxpayer and the department if it becomes available at the time of audit.

In a scenario, where the data of current year is not available till the time of filing return and a particular company is not comparable in 1 out of 2 prior years, then such comparable would have to be excluded. However, the taxpayer and the department can use such comparable at a later stage if data for the 3rd or current year is available at the time of audit. This would result in the taxpayer having to refresh to transfer pricing study/documentation at a later stage for the most updated data of the current year. This approach does not provide the much needed certainty to the taxpayer at the time of filing the tax return.

It also remains to be seen whether the above rules are considered by APA/Competent Authorities during APA / MAP proceedings.

Use of range of results is amongst the globally accepted best practice and also closer to economic realities wherein prices, and or margins, are compared to those within a range and not at to a particular point. Further, the issue of ‘single year data vs multiple data’ has been a subject matter of a large debate and litigation so far. It is hoped that the aforesaid rules would go a long way in reducing transfer pricing disputes in the country and not create unnecessary controversy in the application of ‘range’ and ‘multiple year’ concepts.