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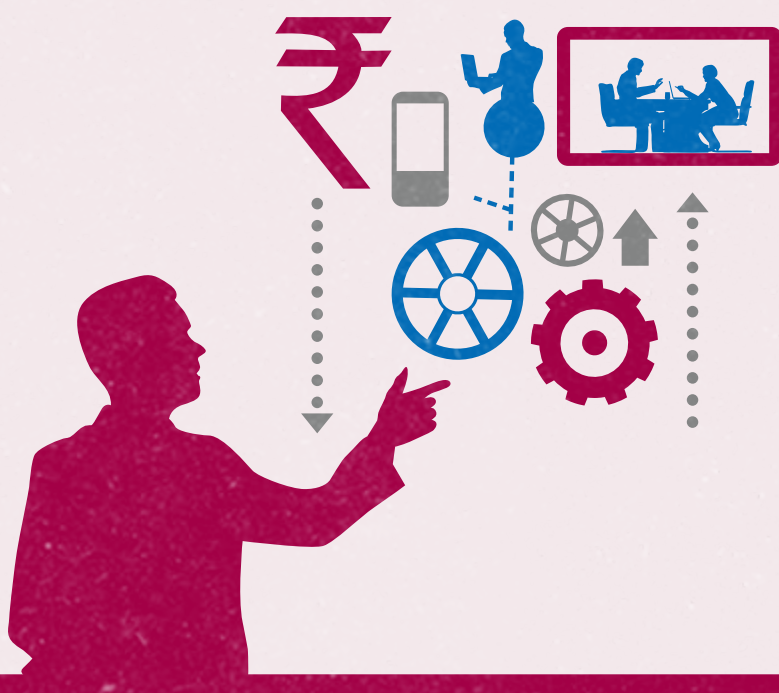
A spectrum of transfer pricing issues

Quarterly Edition: April-June 2016



Contents

Foreword	3
Perspective	4
Our experience	10
From the judiciary	11
Tracker	16
Global corner	17
Citations	19
Glossary	20



Foreword



Arun Chhabra
Director
Grant Thornton Advisory Pvt. Ltd.

Dear Readers,

We are glad to present to you our quarterly newsletter- TP Niche. This edition of the newsletter marks the second phase of this publication. We have improved our already well received publication to include more analysis and practical experience.

This issue covers a broad range of topics relating to Transfer Pricing under five sections namely 'Perspective', 'Our experience', 'From the judiciary', 'Tracker' and 'Global corner'. The Perspective section covers analysis of key transfer pricing issues. In this edition, we have covered two very interesting issues: The first of which relates to 'outstanding receivables', which is at the centre of transfer pricing disputes and the second is an analysis of multiple year data and range concept for IT/ITeS industry.

In 'Our Experience' section, we share our experience through the stages of the Advanced Pricing Agreement ('APA') programme. The readers should be able to get a practical insight into the APA process.

With so many decisions on Transfer Pricing issues every day, it is difficult to keep track of what is important. With this in mind, we have captured some key rulings reported in the last quarter in 'From the judiciary' section to give our readers a snapshot of important judicial pronouncements.

'Tracker' section lists key developments in the form of notifications, circulars and other publications which touches different arena of transfer pricing which readers may want to read in detail.

'Global Corner' is a section which is designed to throw spotlight on TP regimes of some key jurisdictions. In this edition, readers get to know of recent development in China's TP regime.

We hope that you find the format and content engaging and informative. In case you have any comment or query, please reach out to us. Your feedback is important to us. We look forward to receiving it.

Perspective

This section focuses on issues disputed on outstanding receivables from international transaction with associated enterprises (“AEs”) and analyses related Indian rulings and trends in India. The section further gives a quantitative outlook to the range and multiple year concepts introduced in India

I. Outstanding receivables

What is the issue?

Extending credit period to customers is a common business practice. The transfer pricing officers (“TPOs”) in India allege that outstanding receivables from the AEs is an international transaction. The TPOs re-characterise the receivables due from AEs as interest free loan offered to the AEs and impute notional interest on the outstanding amount and make an upward adjustment to taxpayer’s income. This issue first surfaced in the case of Logix Micro Systems Ltd. v/s. ACIT [ITA No. 425 & 524/Bang/2009].

Whether outstanding receivables are international transactions?

The definition of international transaction as per section 92B of the Income-tax Act, 1961 (“the Act”) was amended by Finance Act 2012 to specifically include receivables or any other debt arising during the course of business. In light of the amended definition, outstanding receivables arising from an international transaction purportedly become an international transaction liable to be reported in accountant’s report (“AR”) in Form 3CEB.

The amendment coupled with numerous case laws pronounced on this subject has given new outlook to the issue that orbits around the following:

Whether outstanding receivables are separate transactions requiring arm’s length price (ALP) determination?

The outstanding receivables cling to the occurrence of principal transaction. They are not independent transaction in the sense that they are not undertaken between parties on a standalone basis unlike a loan or advance.

In the rulings tabulated below, the Income tax Appellate Tribunal (“ITAT”) is of the view that outstanding receivables cannot be considered as a separate international transaction as they are a result of the commercial transaction. Moreover, section 92B of the Act has defined ‘sales’ and ‘lending money’ as distinctive transaction and one transaction cannot be benchmarked twice under different heads.

Outstanding receivables is not a separate transaction
Kusum Healthcare Pvt. Ltd
Goldstone Jewellery Limited
Avnet India Private Limited
Dell International Services Limited
Det NorskeVeritas
Information Systems Resource Centre Private Limited
Micro Inks Limited
Goldstar Jewellery Limited
Indo American Jewellery Limited
Rushabh Diamonds
Hiraco Jewellery (India) Private Limited
Gitanjali Exports Corporation Limited
Det NorskeVeritas

Contrary to the above, certain benches of ITAT have ruled that outstanding receivables are a financial result of transaction conducted with AE(s) and income arising through deemed interest on late payment of such receivables, shall affect the determination of ALP. Thus, there is need to benchmark the interest transaction separately to make sure the sales transaction is at arm’s length.

Outstanding receivable is a separate transaction
Golawala Diamonds
Tecnimont
Logix Micro Systems Ltd.
Techbooks International Private Limited
Ameriprise India Private Limited

Do outstanding receivables require a separate ALP analysis?

The price at which the related party transaction (“RPT”) is undertaken takes into consideration the related terms of payment that includes the credit period extended to the AE. Therefore, determination of ALP of the sale price automatically determines the ALP of the incidental outstanding balances.

This approach is commensurate with the principle of aggregation of closely linked transactions for the purpose of TP analysis. The concept of clubbing or aggregating such closely linked transactions finds backing in Indian TP Regulations vide rule 10A(d) of the Rules and paragraph 3.9 of the organisation for the economic corporation and development (“OECD”) TP Guidelines 2010.

Some benches of ITAT advocate that no separate analysis is required for receivables outstanding on the ground that they arise out of credit sales transactions for which payments have not been received from AEs. Therefore, the amount of interest is inseparable from the sales, thus for the purpose of ALP analysis, interest amount can be aggregated with sales transaction as both are closely linked. Some of the rulings on this matter are as follows:

No separate analysis required for outstanding receivables
Hiraco Jewellery (India) Private Limited
Gitanjali Exports Corporation Limited
Det NorskeVeritas
Nimbus Communications Limited
Micro Ink Limited
Avnet India Private Limited
Pegasystems Worldwide India Pvt. Ltd
Tecnimont
Information Systems Resource Centre Private Limited
Kusum Healthcare Pvt. Ltd.
Goldstar Jewellery Limited

On the other hand, some argue that interest that accrues up to credit period as per the agreement or any judicial precedence may be adjusted in the sale price. However, non-realisation of dues beyond the said period shall be stipulated as a separate international transaction of interest income warranting separate analysis.

Separate analysis required for outstanding receivables
Ameriprise India Pvt. Ltd.
Techbooks International Pvt. Ltd.
iGate Computer Systems Ltd.

If one vies that ALP for outstanding receivables is to be separately determined then the following aspects that are specific to a particular case can be evaluated.

Working capital (WC) Adjustment

WC adjustment takes into account the impact of outstanding receivables on profitability. If the profitability of the taxpayer is higher than the WC adjusted profitability of the comparable companies then no further adjustment by the tax authority is justified.

Several benches of ITAT have held that a WC adjustment nullifies the effect of excess funds being blocked towards WC requirement. Excessive receivables that accrue on account of liberal credit policy gets accounted for while undertaking the said adjustment.

Some of the rulings on this aspect are following:

WC adjustment takes account of outstanding receivables
Information Systems Resource Centre Private Limited
Kusum Healthcare Pvt. Ltd.

WC adjustment does not take account of outstanding receivables
Ameriprise India Pvt. Ltd

Comparable uncontrolled price (CUP) of outstanding receivables

The TPOs while applying notional interest on delayed payments impute interest (using State Bank of India (“SBI”) rates or rates on government bond) and benchmark the said transaction separately under CUP method.

However, various ITATs have held that ideal CUP would be to analyse the credit policy followed by the taxpayer in case of AEs and non-AEs.

Some rulings on this issue are as below:

Credit policy followed with AE vis-à-vis non-AE a valid CUP	Credit policy followed with AE vis-à-vis Non AE not a valid CUP
Hiraco Jewellery (India) Private Limited	Techbooks International Pvt. Ltd
Gitanjali Exports Corporation Limited	iGate Computer Systems Ltd.
Det NorskeVeritas	
Bechtel India Pvt. Ltd.	
Satyam Venture Engg Services Pvt. Ltd.	
Golawala Diamonds	
Evonik Degussa Pvt. Ltd.	
Indo American Jewellery Limited	

Pre and post 2012 outstanding receivables

The amendment in the definition of international transaction which aimed at bringing outstanding receivables within the purview of transfer pricing (TP) provisions was introduced with retrospective effect from 1 April 2002. However, the taxpayers argued that TP provisions were anti-avoidance rules which aimed at guiding the behaviour of taxpayers. Thus, making retrospective amendment in such provisions is against the principle of natural justice.

In the following rulings of the ITAT, the Hon’ble bench has upheld the view taken by the taxpayers that amendment in the definition of international transaction in relation to inclusion of outstanding receivables is to be considered as prospective and not retrospective. Accordingly, the outstanding receivables which relate to a period before assessment year 2012-13 would fall outside the ambit of TP provisions:

Rushabh Diamonds
Hiraco Jewellery (India) Private Limited
Gitanjali Exports Corporation Limited
Firestone Diamond Pvt. Ltd

Pre and post 2012 outstanding receivables

The TPOs invariably treat the outstanding receivables as extended loan facility to the AE and charge a lending rate i.e. SBI prime lending rate (“PLR”) and relevant mark-up on such rates based on certain adjustment relevant for the assessment year (“AY”) to increase taxpayer’s income.

Though, the higher authorities such as the dispute resolution panel (“DRP”) or the Commissioner of Income tax appeals (“CIT (A)”), on the face of it agree to the stand of the TPOs, however, they advocate the use of LIBOR + certain basis points.

In practice, if one were to impute interest on the same, the following needs to be considered:

- Currency of outstanding receivables – for e.g. if the receivables are in USD it does not make sense to benchmark them using an Indian lending rate
- Given that taxpayer’s business is not that of lending or borrowing, hence the receivables realised before the due date would have invested on some risk free schemes. Accordingly, short term deposit rates may serve as a rational benchmark.

Some rulings on this issue are as below:

LIBOR upheld as comparative interest rate	Deposit rates upheld as comparative interest rate
CIT vs. Cotton Naturals (I) Pvt Ltd	Goldstar Jewellery Limited
Golawala Diamonds	Logix Micro Systems Ltd.
Tecnimont ICB House	
iGate Computer Systems Ltd.	
Siva Industries Limited	
Everest Kanto Cylinder Limite	
Tata Autocomp Systems Ltd.	

Increasingly various benches of ITAT have pronounced decisions in detail to address one of the most litigated issues of outstanding receivables. These decisions are not mere favourable or unfavourable judgements but are also guiding precedents for a taxpayer. A taxpayer may take into consideration the factors discussed above so that one can apply the best available solution during assessment proceedings.

II. Multiple year data and range concept – Industry analysis

Final rules for application of multiple year data and range concept for determination of Arm’s length price (ALP) were notified by the Central board of direct taxes (“CBDT”) on October 19, 2015. The new rules are applicable to international transactions and specified domestic transactions (“SDT”)s entered on or after April 1, 2014.

As per the said rules, taxpayer’s profit margin is said to be at arm’s length if it is within the 35th and 65th percentile of margins (computed using multiple year data as prescribed) earned by a comparable set of companies (provided there are six or more companies in the said set). In case taxpayer’s margins are outside the prescribed range, ALP shall be determined using the median of the set.

In the instant Section a hypothetical example of dataset has been considered to assess the impact of multiple year data and range concept for information technology (“IT”)/ information technology and enabled services (“ITES”) industry had the same been used during the most recent round of TP scrutiny concluded for AY 2012-13.

To get a detailed outlook on the rules [Click Here](#)

1. Taxpayer engaged in IT/software ¹development¹

For a taxpayer engaged in rendering software development services to its overseas parent company, the summary of the economic analysis undertaken in its TP documentation for determining ALP is as below:

PLI	Taxpayer’s margin	MAM	No. of comparables	Comparables’ mean margin
OP/TC	15%	TNMM	5	12.90%

¹ The example is for illustration purpose only; the applicability of range concept is for transactions entered on or after 1st April 2014.

During assessment, the TPO was in disagreement with the comparables selected by taxpayer and came up with a new set of companies (including few companies selected by the taxpayer) to determine ALP. Summary of TPO's economic analysis is as below:

PLI	Taxpayer's margin	MAM	No. of comparables	Comparables' mean margin
OP/TC	15%	TNMM	15	21.23%

Based on the above, TPO made an adjustment based on the arm's length margin computed at 21.23% as regards 15% margin earned from the international transaction.

To understand the effect on taxpayer's ALP, the new rules as described above were applied to the comparable companies finally selected by the TPO in his/her order. The result of the said analysis is as below:

S.No	Company Name	Margins
1	ABC Ltd.	3.02%
2	BCD Ltd.	7.98%
3	CDE Ltd.	10.28%
4	DEF Ltd.	11.89%
5	EFG Ltd.	13.23%
6	FGH Ltd.	13.97%
7	HIJ Ltd.	14.23%
8	IJK Ltd.	14.98%
9	JKL Ltd.	15.27%
10	KLM Ltd.	20.85%
11	LMN Ltd.	25.93%
12	MNO Ltd.	26.55%
13	NOP Ltd.	27.14%
14	OPQ Ltd.	28.86%
15	PQR Ltd.	43.71%

Source:1 Comparables' profit margins computed as weighted average of data for FY 2009-10, FY 2010-11 and FY 2011-12 (to the extent available)

Source: 2 Comparables' profit margins computed as weighted average of data for FY 2009-10, FY 2010-11 and FY 2011-12 (to the extent available)

Source: 3 Comparables' profit margins computed as weighted average of data for FY 2009-10, FY 2010-11 and FY 2011-12 as prescribed in the new rules

Computation of prescribed range is as below:

35th percentile	5.25	Next highest place (6th place)	13.97%
Median	7.5	Next highest place (8th place)	14.98%
65th percentile	9.75	Next highest place (10th place)	20.85%

As is evident from the above analysis, taxpayer's margin of 15% falls within the 35th and 65th percentile of the comparable set i.e. 13.97% and 20.85%. Therefore, in cases similar to one discussed above, if range and use of multiple year data were allowed back in FY 2011-12, the assessee's margin would have been accepted at arm's length

2. Taxpayer engaged in ITes

Similar to the analysis undertaken in case of IT services, let us now analyse the effect of application of multiple year and range in lieu of arithmetic mean in case of a taxpayer engaged in rendering ITES. Summary of the economic analysis undertaken in its TP documentation is as below:

PLI	Taxpayer's margin	MAM	No. of comparables	Comparables' mean margin
OP/TC	15%	TNMM	7	12.93%

Summary of TPO's economic analysis is as below:

PLI	Taxpayer's margin	MAM	No. of comparables	Comparables' mean margin
OP/TC	15%	TNMM	9	28.96%

Based on the above TPO made an adjustment based on the arm's length margin computed at 28.96% as regards 15% margin earned from the international transaction.

Application of new rules on the set of companies selected by TPO is as below:

S.No	Company Name	Margins (in %)
1	LMN	8.23
2	MNO	8.87
3	NOP	11.19
4	PQR	27.92
5	QRS	28.68
6	RST	31.83
7	STU	39.04
8	TUV	57.65
9	UWW	59.62

Accordingly the range comes out to be the following:

35th percentile	3.15	Next highest place (4th place)	27.92%
Median	4.5	Next highest place (5th place)	28.68%
65th percentile	5.85	Next highest place (6th place)	31.83%

The above analysis indicates that even if range and use of multiple year data were allowed back in FY 2011-12, the assessee would still have had an adjustment. However, the silver lining in this case would be that the adjustment amount would be marginally lower as the same would be calculated on 28.68% (being the median of the set) instead of 28.96% (as computed by TPO).

Ultimately one can conclude that the use of multiple year data and range concept introduced by the Indian Government is not entirely a smooth curve, but is sure easy to take. Introduction of such changes is yet another action of the government to pave a smooth path for multinational corporations to Indian market. However, percentile concept is not in line with global practices and may have dispute during APA and MAP. The TP fraternity expects the introduction of new rules to reduce TP disputes and make TP computations less complex for taxpayers.

Nevertheless, it cannot be ignored that applicability of new rules is highly sensitive to availability of data and number of comparable companies for undertaking economic analysis. Inclusion or exclusion of even one company from the set has a significant effect on the range available to the assessee for seeking relief from adjustments.

Source 5: Comparables' profit margins computed as weighted average of data for FY 2009-10, FY 2010-11 and FY 2011-12 (to the extent available)

Source 6: Comparables' profit margins computed as weighted average of data for FY 2009-10, FY 2010-11 and FY 2011-12 (to the extent available)

Source 7: Comparables' profit margins computed as weighted average of data for FY 2009-10, FY 2010-11 and FY 2011-12 as prescribed in the new rules

Experience

This section narrates our stage wise experience in the field of advance pricing agreements (“APA”) and aims to give an outlook to the APA regime from the perspective of APA authorities and clients.

Provisions	Grant Thornton experience
Step 1- Pre filing consultations (“PFC”)	
<ul style="list-style-type: none"> PFC may be requested by any taxpayer by filing an application in Form 3CEC Option available for filing this application on an anonymous basis It is intended to identify TP issues, determine scope of agreement and discuss broader terms of APA PFC does not bind a taxpayer to enter into an APA 	<ul style="list-style-type: none"> PFC on anonymous basis is preferred only by taxpayers willing to enter APA for complex/unique transactions. Taxpayers with non-unique business model did not practice anonymous PFC. PFC is actually very effective in laying down the broad parameter for designing the final APA application Positive atmosphere provided by APA authorities in terms of providing time to present case, offering valuable feedback to the client’s confidence
Step 2- APA Application	
<ul style="list-style-type: none"> APA application to contain general information, FAR analysis, industry analysis, financial information, critical assumptions and forecasts, litigation related documents, etc. Every application filed is processed to ensure completeness Without above step no application is processed for negotiation 	<ul style="list-style-type: none"> At Grant Thornton, we experienced that a robust APA application, which is seamlessly aligned with the facts of the case and the overall ecosystem in which the tax payers operates, goes a long way in building trust with the APA authorities.
Step 3- Negotiation with APA authorities	
<ul style="list-style-type: none"> APA authority will undertake main processing in consultation and discussion with the applicant. This would typically include the following: <ul style="list-style-type: none"> Meetings/hearings Visit to the business premises of the taxpayer Call for additional information and documents The negotiation phase also includes discussion around the benchmarking and critical assumption with the APA 	<ul style="list-style-type: none"> Review of the final APA application would involve discussion/negotiation around transactions i.e. FAR and business operation of taxpayer and its group. This would be undertaken by way of hearings, site visits or written submissions. Site visits are regarded by APA Authorities as significant means to evaluate the nature and extent of business activities and to validate the FAR analysis undertaken by the taxpayer. Process of negotiation though extensively consumes time and effort; it acts as an effective mechanism for both parties to put their best foot forward to reach at a consensus ALP
Step 4-Withdrawal and roll back options	
<ul style="list-style-type: none"> APA application can be withdrawn/amended at any time before the finalisation of the terms of the agreement Roll-back for a maximum period of four immediately preceding years: the first of which is the year from which APA is sought to be applied 	<ul style="list-style-type: none"> Roll back provisions opted by clients to insure itself from any potential litigation We experienced that the clients after applying for APA generally tend to prefer to apply for roll back also since such application does not require enormous effort and which in turn may provide an additional four years of certainty. Certainty for a total of nine years was the key motivation of opting roll back
Step 5- Finalisation of APA	
<ul style="list-style-type: none"> The formal agreement is based on the negotiation carried out between the taxpayer and the tax authorities or between CAs in case of bilateral and multilateral APAs. The agreement shall be entered into after the approval of Central Government 	<ul style="list-style-type: none"> The negotiation process involves some back and forth between the APA authorities/Ministry of Law and the clients’ legal team.

From the judiciary

This section focuses on some recent issues disputed at the Income-tax Appellate Tribunal (Tribunal) and High Court (HC) in the last quarter i.e. April– June 2016

1. Comparability adjustments

Rule 10B(3) of the Rules provides that if there are differences between the AE transaction and an uncontrolled transaction which would materially affect the price, cost or profit, then the latter can be taken as a comparable only if adjustments can be undertaken to eliminate material effects of such differences. Adjustments for a variety of differences are more or less a settled practice amongst taxpayers and TPOs. Recent court rulings have upheld adjustments on following matters:

Rulings on Adjustments	Case laws
Risk adjustment allowed for the difference in the risk borne by the taxpayer as well as the comparable entities	<ul style="list-style-type: none"> Rolls Royce India Pvt Ltd
Foreign exchange risk adjustment to be allowed on the account that no foreign exchange loss incurred by the taxpayer	<ul style="list-style-type: none"> McDonald's India (P) Ltd
Working capital - adjustment to be allowed on annual basis with the average of closing and opening figures	<ul style="list-style-type: none"> Sony Mobile Communications International AB
Working capital adjustments to be allowed to neutralise the differences on net working capital and to bring the taxpayer at par with the other functionally comparable entities	<ul style="list-style-type: none"> Federal Mogul Automotive Products India Ltd. Syngenta Biosciences Private Limited Tata McGraw Hill Education
Working capital adjustment allowed on the basis of average credit/debit period for the year and commercial rate of interest	<ul style="list-style-type: none"> Starent Networks India Pvt Ltd
Capacity adjustment to be allowed if the comparable selected are operating since long and taxpayer is in the initial stages of operation	<ul style="list-style-type: none"> MGE UPS System India P Ltd
Depreciation Adjustment: is justified if excess/lesser depreciation is charged by the taxpayer because of adopting a different method of charging depreciation as compared to method of charging depreciation by the comparables.	<ul style="list-style-type: none"> AMD Far East Limited – Indian Branch office

2. Advertisement marketing and promotion (AMP) expenses

The TP aspect of marketing intangibles has been the focus of the Indian TP authorities over the last couple of years. Many Indian taxpayers have witnessed large TP adjustments on the issue. While issues related to AMP expenses continue to occur, by large the most fundamental question of whether AMP expense even accounts for as an international transaction was addressed in the HC decision of Maruti Suzuki. Consequent to the same many more cases spun before the appellate authorities. A brief of the case is given below:

Rulings on AMP expenses	Case laws
AMP expenses not incurred for the benefit of AE. Hence not an international transaction following the judgments of the HC decision in Maruti Suzuki	<ul style="list-style-type: none"> Heinz India Private Limited Diageo India Private Limited Thomas Cook (India) Limited Mondelez India Foods Private Limited
The HC decision of Maruti Suzuki India Ltd is not only limited to manufactures but also applicable to distributors	<ul style="list-style-type: none"> Toshiba India Pvt Ltd Fujifilm India Private Limited

3. Interest on loan / advances

Lending and borrowing of loans and advances falls within the ambit of international transactions and the same is benchmarked by justifying the interest rates charged on such loans/advances. The issue here is the comparable rate that should be taken for benchmarking the interest rate at which such loan or advances are given/received to/from AEs. Recent court rulings on this aspect are as below:

Rulings on loans and advances	Case Laws
LIBOR plus 2% is the appropriate arm's length interest for benchmarking the transactions for providing interest free loan to the AE	<ul style="list-style-type: none"> S B & T International Ltd.
interest rate charged by the taxpayer @ 6% is more than the LIBOR hence adjustment computed by the TPO deleted	<ul style="list-style-type: none"> Hinduja Global Solutions Ltd

4. Corporate guarantee

Finance Act 2012 introduced an explanation to sec 92B of the Act by virtue of which corporate guarantee was brought under the ambit of TP and hence was considered as a qualified transaction. Thus, post this amendment the Indian authorities have considered corporate guarantee to be an international transaction and have ruled with the above presumption. However, the issue in this case is whether remuneration should be paid for the guarantee given? And if paid what should be the appropriate ALP? Recent court rulings in this aspect are as follows:

Rulings on corporate guarantee	Case Laws
Remuneration should be charges. Rate of Corporate guarantee cannot be compared with bank guarantee	<ul style="list-style-type: none"> Godrej Consumer Products Ltd Thomas Cook (India) Limited
There is a subtle difference in 'impact on' and 'influence on' the profits. The issuance of a corporate guarantee may have an influence on the profits, incomes, losses and assets of an entity, in whose favour the guarantee is issued, but it has, no impact on the same as long as it is issued without a consideration and as long as the guarantee is not invoked by the beneficiary.	<ul style="list-style-type: none"> Manugraph India Limited

5. Royalty

Royalty means sum paid towards use of anything which is not publicly available. Many MNCs being a conglomerate of group companies are often seen paying royalties to each other for use of brand, technology and the likes. However simple, this aspect has been baffling both taxpayers and revenue authorities alike and questions such as whether royalty payment was at all required, rate of royalty to be paid have often sprung up. Recent court rulings in this aspect are as follows:

Rulings on royalty	Case laws
TPO cannot question the business and commercial expediency	<ul style="list-style-type: none"> Frigoglas India Pvt. Ltd
Royalty rates approved by RBI can only be persuasive and not conclusive.	<ul style="list-style-type: none"> Gruner India Pvt Ltd
TNMM covers within its ambit royalty transactions as well	<ul style="list-style-type: none"> Frigoglas India Pvt. Ltd

6. Penalty

TP space is not immune to the hefty additions being lashed on taxpayers on the premise of being engaged in wilful shifting of profits. To top it the AOs frequently levy penalties to add to the dismay of the taxpayers. Finance Act 2016 has introduced more penalties to motivate taxpayers to follow newly enacted provisions on documentation. Recent rulings on this aspect are as below:

Rulings on Penalty	Case Laws
Penalty under section 271G of the Act – if it was presumed that details furnished by taxpayer were delayed, it had not prejudiced Revenue because TPO had duly considered those details and was fully satisfied with the details furnished by the taxpayer	<ul style="list-style-type: none"> Mayar India Limited
Explanation 7 to section 271(1) of the Act states an exception for levy of penalty, that no penalty will be imposed pursuant to TP addition, if the taxpayer proves to the satisfaction of the authority that the price charged or paid in such a transaction was in accordance with the provisions of section 92C of the Act and such price was computed as per the manner prescribed under that section in good faith and with due diligence	<ul style="list-style-type: none"> Mitsui Prime Advanced Composites India Pvt Ltd
Penalty under section 271(1)(c) of the Act deleted as TP documentation containing fundamental & economic analysis prescribed under Rule 10D had been made available by the taxpayer before passing of TPO's order. Also, there was no such nomenclature as 'TP Study Report' in Rule 10D, however, explaining that the combined information mentioned in Rule 10D is generally called 'TP Study Report'.	<ul style="list-style-type: none"> Worlds Window Impex (India) Pvt Ltd

7. Profit Level Indicator (“PLI”) calculations

PLI are ratios that measure relationships between profits and costs incurred/sales achieved/capital employed. Since the PLI provides a reliable basis for comparing operating profits of the tested party and uncontrolled comparable, it is important to have clarity of term “operating” as a slight variation may lead to material differences. There are numerous litigations on the term “operating” as the TP regulations do not define the same. Some of the court rulings on this topic are as follows:

Rulings on operating heads	Case Laws
Foreign exchange gain / loss	<ul style="list-style-type: none"> Rolls Royce India Pvt Ltd Ameriprise India Pvt Ltd. Gillete Diversified Operations Pvt Ltd NEC Technologies India Ltd
Provision for doubtful debts	<ul style="list-style-type: none"> Rolls Royce India Pvt Ltd
Provisions revenue in nature	<ul style="list-style-type: none"> Gillete Diversified Operations Pvt Ltd
Bad debts	<ul style="list-style-type: none"> Thomas Cook (India) Limited
loss on account of rains and insurance claim received for such loss would be included while computing the operating profit	<ul style="list-style-type: none"> Asahi Glass Ltd
Reimbursement of expenses received by the taxpayer from its AE should be included in the cost base as well as income for the purpose of computing the profits. As the taxpayer had performed substantial functions in relation to marketing support services and building a market for the AE's products	<ul style="list-style-type: none"> Seagram Manufacturing Pvt. Ltd
Reimbursement costs should not be included in operating costs as they do not involve any function to be performed	<ul style="list-style-type: none"> International Merchandising Corporation

Rulings on non- operating heads	Case Laws
Pass through cost	<ul style="list-style-type: none"> McDonald's India (P) Ltd
If the income was excluded, the expenditure for earning the income also needs to be excluded.	<ul style="list-style-type: none"> Vestas Wind Technology India Pvt. Ltd

8. Filters in selection of comparable

For carrying out a robust benchmarking exercise it is imperative to eliminate companies which are not comparable to us. Hence, to do away with inappropriate comparables quantitative filters are applied. Since the application of filters differs from case to case it provides ample ground for litigation where court judgments lay the foundation for further action. Recent court rulings on application of filters are as below:

Ruling on filters	Case laws on comparability issues
RPT filter at 15% instead of 25%	<ul style="list-style-type: none"> Kshema Technologies Limited
Turnover filter - does not have an impact in the service industry if the company is functionally similar	<ul style="list-style-type: none"> NTT Data Global Delivery Services Ltd
Application of Rs 1-100 crores turnover filter	<ul style="list-style-type: none"> Starent Networks India Pvt Ltd
Application of Rs 1-200 crores turnover filter	<ul style="list-style-type: none"> Arcot R&D Software P Ltd
Turnover filter is not an appropriate filter hence if company is functionally comparable then even though it fails the turnover filter it should be accepted.	<ul style="list-style-type: none"> Tata McGraw Hill Education

9. Comparability issue

The analysis of controlled and uncontrolled transactions with the functions undertaken, assets employed and risks borne by the companies involved is critical to determining whether or not prices and/or margins are at arm's length. There is lot of subjectivity on this matter, which has resulted into numerous litigations. Recent case laws are:

Ruling – grounds on which certain companies held not comparable	Case laws on comparability issues
Companies with high brand value, owns the intangible economies of scale, etc., having bearing on profits	<ul style="list-style-type: none"> • COWI India Private Limited • VFS Global Services Pvt Ltd • FIL India Business Services Pvt Ltd • Visteon Engineering Center (India) Pvt Ltd • Arcot R&D Software P Ltd
Continuous loss making	<ul style="list-style-type: none"> • Siemens Technology Services Pvt Ltd
Differential profitability earned from year to year	<ul style="list-style-type: none"> • Aptara Technologies Pvt Ltd
Engaged in diversified business and segmental data not available	<ul style="list-style-type: none"> • Arcot R&D Software P Ltd
Exceptional financial results due to mergers / de-mergers /acquisition	<ul style="list-style-type: none"> • Accentia Technologies Limited • COWI India Private Limited • Sony Mobile Communications International AB • Vertex Customer Services India Pvt Ltd • FIL India Business Services Pvt Ltd • Aptara Technologies Pvt Ltd

Unreliable financials	<ul style="list-style-type: none"> • M/s. Emerson Process Management • Arcot R&D Software P Ltd
Giant company – in terms of profits, turnover and risk	<ul style="list-style-type: none"> • NTT Data Global Delivery Services Ltd • Vertex Customer Services India Pvt Ltd
if the assessee wrongly reports an incomparable company and later on claims that it should be excluded, then such a claim cannot be forbidden	<ul style="list-style-type: none"> • Sopra India Pvt Ltd • Sony Mobile Communications International AB • Arcot R&D Software P Ltd
Non availability of segmental data	<ul style="list-style-type: none"> • FIL India Business Services Pvt Ltd
Insufficient financial data	<ul style="list-style-type: none"> • Principal Global Services Private Ltd.
Consistent change in operating margins due to revenue recognition method followed	<ul style="list-style-type: none"> • Arcot R&D Software P Ltd
Captive service provider cannot be compared with giant companies	<ul style="list-style-type: none"> • Sony Mobile Communications International AB

Ruling – grounds on which functionally comparable companies were held comparable	Case Laws
Abnormal growth	<ul style="list-style-type: none"> • COWI India Private Limited
company having negative net worth	<ul style="list-style-type: none"> • Gillette Diversified Operations Pvt Ltd
Loss making company and the losses are not on account of some extra ordinary circumstances.	<ul style="list-style-type: none"> • Asahi Glass Ltd • International Merchandising Corporation
If because of the merger and de-merger or amalgamation the company does not became functionally different	<ul style="list-style-type: none"> • NTT Data Global Delivery Services Ltd
100% EOU cannot be the reason for exclusion of a comparable as 100% EOU only gives it benefit with respect to indirect and direct taxation and nothing else. It does not change the functional profile of the comparable	<ul style="list-style-type: none"> • Rolls Royce India Pvt Ltd
mere high profits/loss/ turnover does not ipso facto lead to exclusion of comparable	<ul style="list-style-type: none"> • Sopra India Pvt Ltd • Asahi Glass Ltd • VFS Global Services Pvt Ltd
company treated as comparable in one case does not per se become comparable in all other cases and vice versa	<ul style="list-style-type: none"> • Sony Mobile Communications International AB • NTT Data Global Delivery Services Ltd

10. FAR Analysis

A FAR analysis of the controlled and uncontrolled transactions is a pre-requisite to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results. It is not hard to find a case where the difference between FAR of the tested party and that of comparables leads to twisted benchmarking. Recent court rulings distinguishing between various industry segments is given below:

Rulings on FAR	Case Laws
<ul style="list-style-type: none"> KPO segment is not comparable with ITeS activities 	<ul style="list-style-type: none"> COWI India Private Limited C3i Support Services P Ltd Genpact Services LLC Vertex Customer Services India Pvt Ltd
Engineering design services which are high end in nature and constitute KPO service	<ul style="list-style-type: none"> COWI India Private Limited
Software development services different from software product services	<ul style="list-style-type: none"> NTT Data Global Delivery Services Ltd FIL India Business Services Pvt Ltd Arcot R&D Software P Ltd
Medical transcription services cannot be compared with ITes	<ul style="list-style-type: none"> VFS Global Services Pvt Ltd
ITes is not comparable with software development services	<ul style="list-style-type: none"> Bruno's Computer Solutions & Software Pvt Ltd
BPO activities are different from KPO activities	<ul style="list-style-type: none"> Principal Global Services Private Ltd. Aptara Technologies Pvt Ltd
Provision of business support services cannot be distinguished from ITES	<ul style="list-style-type: none"> VFS Global Services Pvt Ltd
Marketing support services is different from payroll activity	<ul style="list-style-type: none"> LG Chemical India Pvt Ltd

11. Others

There are a plethora of issues which still have no clarity and contribute to the adverse tax environment. With the rules being ambiguous we depend heavily on the various court pronouncements. Recent court rulings addressing some of the issues are as under:

Rulings	Case Laws
<p>Intra group services</p> <p>Benefit test, need test, redundancy test and rendition test needs to be satisfied in relation to intra group services</p> <p>If the services are shareholder activity for safeguarding the benefit of ownership it cannot be remunerated by the independent parties. However if it is not a shareholder's services, other conditions are satisfied, they needs to be remunerated.</p> <p>In the case of services received by the taxpayer they are satisfying the need test, rendition test and also benefit test and therefore these services cannot be said to be shareholder activities</p> <p>In relation to application of benefit test, mere profitability cannot be considered as a criteria of benefit</p>	<ul style="list-style-type: none"> GE Money Financial Services Pvt Ltd
<p>Rule of consistency - If wrong path was followed last year won't mean that incorrect path shall be followed. Also, if appeal did not come to ITAT in previous year so no judgement was made by ITAT last year thus there is no question of consistency.</p>	<ul style="list-style-type: none"> Gruner India Pvt Ltd
<p>The principle of res judicata do not apply to income tax proceeding but rule of consistency shall hold forth if the fact and circumstances remain same.</p>	<ul style="list-style-type: none"> Thomas Cook (India) Limited 3M India Ltd
<p>The authority of the TPO is limited to conducting TP analysis for determining the ALP of an international transaction and not to decide if such services exist or benefits did accrue to the taxpayer</p>	<ul style="list-style-type: none"> Goodyear India Ltd
<p>Revenue has no power to re-characterise the transaction</p>	<ul style="list-style-type: none"> Sun Pharmaceuticals Ind Ltd
<p>TPO cannot question the commercial expediency and business needs of the taxpayer</p>	<ul style="list-style-type: none"> Frigoglas India Pvt. Ltd. Mondelez India Foods Private Limited
<p>If the criteria filter applied by the taxpayer or TPO is rejected or relaxed, the matter should go back to the TPO for fresh analysis is not tenable.</p>	<ul style="list-style-type: none"> NTT Data Global Delivery Services Ltd
<p>DRP being an appellate authority has all the powers as that of the CIT(A). The proceedings before the DRP is an extension of the assessment proceedings and admitting additional evidence is part of the powers of the DRP</p>	<ul style="list-style-type: none"> Rolls Royce Marine India Pvt Ltd

Tracker

I. Notifications/circulars/amendments

- **CBDT Instruction no. 3/2016 issued on 10 March 2016**

The instruction mentions specific circumstances wherein AO has to mandatorily make a reference to the TPO for ALP determination. It also lays down that AO will now refer cases to TPO for TP audit only after recording satisfaction in certain cases. Additionally, it limits the number of cases to be handled by TPOs (AdCIT and JCIT) up to 50, and also specifies the role of a TPO in compliance audit in APA and safe harbour provisions.

- **Partial modification of Instruction no 1914 dated 21.03.1996**

CBDT on 29th February 2016 issued partial modifications to the existing instruction no 1914 dated 21.03.1996, wherein if an outstanding demand is disputed before the CIT (A), the AO shall grant a stay of demand till the disposal of the first appeal, on payment of 15% of the disputed demand with a few exceptions.

II. Grant Thornton thought leadership

- **Cbc Outlook paper**

A white paper on the recently amended documentation requirement under country-by-country reporting was released by Grant Thornton on 19th April 2016. The document thoroughly captures the amendments made in the existing law and its implications. Additionally it also provides guidance on how one must prepare for the future.

III. Articles published

- **CBDT Instruction no. 3/2016: A game-changer for TP audits?**

The article highlights the changes proposed by CBDT regarding assessment procedures

- **CIT(A) or DRP – An inevitable muddle**

The article highlights notable differences between the CIT(A) route and the DRP route and brings about the pros and cons of the two routes to provide guidance on suitable route to be accepted depending upon the priorities.

- **Indian Court Upholds Constitutionality of Anti avoidance Provision**

The article focuses on a recent case at Madras HC wherein the constitutional validity of section 94A was challenged and was subsequently quashed.

However as we write, India- Cyprus has successfully renegotiated the treaty. India would revoke Cyprus from being classified as notified jurisdiction. This news will become more formal with days to come.

- **Advance pricing agreement not time limited**

This article discusses a tribunal ruling of Ranbaxy Laboratories Ltd. v. ACIT (ITA 196/Del/2013), wherein it was held that an APA can apply to periods that are not covered even if the taxpayer does not apply for a rollback of the APA provisions.

Global corner

This section highlights the TP environment worldwide to give a wider perspective on what is happening around the world. For this issue we have selected China, wherein our counterparts in China have summarised the regulations prevailing in China along with the impact of base erosion and profit shifting (“BEPS”) action plans on their existing provisions.

China

Circular 2

China passed its first ever transfer pricing (“TP”) ruling back in 1999. However, it was the mega ruling issued in 2009 (i.e., 2009 Circular 2) that created an advanced and comprehensive TP legislation in China.

Circular 2 lays out the following three levels of compliance requirements for Chinese entities with intercompany dealings –

- **Level 0 – Arm’s Length Principle**

China endorses the arm’s length principle for intercompany transactions. Failure to comply with this principle could result in TP assessment as well as penalties, regardless of the quantum of the transactions;

- **Level 1 – TP Annual Filing**

Chinese entities are legally obliged to lodge a set of TP filing forms that are embedded in the annual income tax filing package.

- **Level 2 – Contemporaneous Documentation**

Contemporaneous documentation is also a legal obligation, and with di minimis –

1. annual amount of intercompany buy-sell transactions no less than RMB 200 mn;
2. annual amount of intercompany non-buy-sell transactions no less than RMB 40 mn;
3. single-functioned manufacturer, distributor or contract R&D service provider incurring loss under intercompany dealings.



TP Litigation

The TP assessment regime of China is one of the most aggressive worldwide, covering both foreign investment into China and Chinese outbound businesses. The averaged amount of tax adjustment under each single case crossed RMB 30 mn in 2015. And tax examiners are expanding their horizon to more complicated transactions such as equity transfer and intangible sub-licensing, in addition to their continuous focus on more conventional transactions such as intercompany buy-sell and services.

China also has CFC ruling and thin-capitalisation clauses, while on the other hand, both APA and MAP are available to offer taxpayers higher level of legal certainty as well as relief from double taxation in case of TP adjustment.

BEPS – Action 13 CbC Reporting

Starting 2013, BEPS has always been a topic that invites heated discussion, if not controversy, in a global context. China was one of the pioneers during the drafting of action plans, and planned to continue this momentum by becoming one of the countries of the first batch to codify the essence of BEPS into local legislation. In this context, a fully revamped version of Circular 2 was released by China SAT in September of 2015 for public consultation purposes. It targeted formal release towards the end of 2015 or early 2016. This target of timeline has now been postponed, due to the prolonged review and discussion of the draft ruling at the National Treasury. However, a glimpse into the draft reveals all the key elements of BEPS – CbCR, value creation concept, legal vs. economic ownership of intangibles – to name just a few. Authors anticipate that these elements will be retained in the final codification.

Automatic exchange of information

On 12th May 2016 the People's Republic of China alongwith five other signatories (including India) signed the Multilateral Competent Authority agreement for the automatic exchange of CbC reports bringing the total number of signatories to 39 countries. The signing ceremony took place in Beijing, China.

OECD approves incorporation of BEPS amendments into the TP Guidelines for Multinational Enterprises and Tax Administrations

In response to a request made by G-20 countries to issue guidelines to counter tax erosion OECD in 2015 released BEPS action plans. On 23rd May 2016, the OECD Council approved the amendments to the TP Guidelines, as set out in the actions 8-10 and 13 to provide further clarity and legal certainty about the status of the BEPS changes to the TP Guidelines.

The amendments approved by the Council translate these BEPS TP measures into the TP Guidelines. Specific changes include:

- deletion of chapter I section D and
- provisions of chapters V-VIII relating to documentation, intangibles, intra-group services and cost contribution agreements
- addition of new paragraphs in Chapter II.

Further, work is being undertaken to make conforming amendments to the remainder of TP-Guidelines, in particular to Chapter IX. Such changes are expected to be approved later in 2016, until then, provision of TP-Guidelines should be interpreted to be consistent with the amended provisions and in case of perceived inconsistencies, modified provisions will prevail.

Citations

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Visteon Engineering Center (India) Pvt Ltd	ITA No.331/PN/2014
Worlds Window Impex (India) Pvt Ltd	ITA No.3721/Del/2014

Glossary

Abbreviations	Full name
AE	Associated enterprises
ALP	Arm's length price
AM	Arithmetic mean
AMP	Advertising, marketing and promotional
APA	Advance price agreement
AO	Assessing officer
AR	Accountant's report
AY	Assessment year
BEPS	Base erosion and profit shifting
BPO	Business process outsourcing
CBDT	Central Board of Direct Taxes
CbC	Country by country
CIT(A)	Commissioner of Income Tax (Appeals)
CPM	Cost plus method
CUP	Comparable uncontrolled price
DRP	Dispute resolution panel
FAR	Functions, assets and risks
FLCP	Fully loaded cost plus
FY	Financial year
HC	High Court
ITAT	Income Tax Appellate Tribunal
IT	Information technology

Abbreviations	Full name
ITES	Information technology enabled services
KPO	Knowledge process outsourcing
LIBOR	London interbank offered rate
MAM	Most appropriate method
New rules	Final rules for application of multiple year data and range concept
OECD	Organisation for Economic Cooperation and Development
PFC	Pre- filing consultations
PLI	Profit level indicator
PLR	Prime lending rate
PSM	Profit split method
RPM	Resale price method
SBI	State bank of India
SDT	Specified domestic transactions
The Act	Indian Income-tax Act, 1961
The Rules	Indian Income-tax Rules, 1962
TNMM	Transactional net margin method
TP	Transfer pricing
TPO	Transfer pricing officer
WC	Working capital

Contact us

To know more, please visit www.grantthornton.in or contact any of our offices as mentioned below:

NEW DELHI

National Office
Outer Circle
L 41 Connaught Circus
New Delhi 110001
T +91 11 4278 7070

AHMEDABAD

BSQUARE Managed Offices
7th Floor, Shree Krishna
Centre
Nr. Mithakali Six Roads
Navrangpura
Ahmedabad 380009
T +91 76000 01620

BENGALURU

5th Floor, 65/2, Block A,
Bagmane Tridib, Bagmane
Tech Park,
C V Raman Nagar,
Bengaluru - 560093
T +91 80 4243 0700

CHANDIGARH

B-406A, 4th Floor
L&T Elante Office Building
Industrial Area Phase I
Chandigarh 160002
T +91 172 4338 000

CHENNAI

Arihant Nitco Park,
6th Floor, No. 90,
Dr. Radhakrishnan Salai
Mylapore
Chennai 600004
T +91 44 4294 0000

GURGAON

21st Floor, DLF Square
Jacaranda Marg
DLF Phase II
Gurgaon 122002
T +91 124 462 8000

HYDERABAD

7th Floor, Block III
White House
Kundan Bagh, Begumpet
Hyderabad 500016
T +91 40 6630 8200

KOCHI

7th Floor, Modayil Centre
point
Warriam road junction
M. G. Road
Kochi 682016
T +91 484 406 4541

KOLKATA

10C Hungerford Street
5th Floor
Kolkata 700017
T +91 33 4050 8000

MUMBAI

16th Floor, Tower II
Indiabulls Finance Centre
SB Marg, Elphinstone (W)
Mumbai 400013
T +91 22 6626 2600

MUMBAI

9th Floor, Classic Pentagon
Nr Bisleri factory, Western
Express Highway
Andheri (E)
Mumbai 400099
T +91 22 6176 7800

NOIDA

Plot No. 19A, 7th Floor
Sector – 16A
Noida 201301
T +91 120 7109 001

PUNE

401 Century Arcade
Narangji Baug Road
Off Boat Club Road
Pune 411001
T +91 20 4105 7000

For more information or for any queries, write to us at contact@in.gt.com



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