Transfer Pricing Directives, 2024 (2081 BS)

Government of Nepal

Ministry of Finance

Inland Revenue Department

2024 October

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Chapter- 1

Introduction

1.1 Introduction

With the wave of economic liberalization and globalization, economic activities are also spreading across the world without boundaries. The development of information technology has further accelerated this trend. Along with this, companies are expanding the scope of their operations globally. As a result, the establishment and expansion of multinational companies is gradually increasing.

With the adoption of a liberal economic policy, Nepal has opened up to direct foreign investment. To ensure the country's economic development and prosperity, there is a need to further promote such investment. As foreign investment increases, the number of multinational companies in Nepal is also growing. As a result, there is a rise in economic activities, and the scope of employment opportunities is expanding as well.

The objective of private companies is to maximize profits and enhance shareholder value. In the case of multinational companies, their network is spread globally, but control typically lies with the parent company. Due to this centralized control, transactions within the group of multinational companies may not always occur at market prices. This creates the possibility of transferring profit from one jurisdiction to another within the same corporate group. As a result, a country may fail to obtain its fair share of tax revenue, leading to the erosion of its national tax base. Therefore, it is essential to ensure that transactions between related multinational companies are conducted at market prices and properly documented. This directive has been drafted with the aim of encouraging such companies to carry out their intercompany transactions at arm's length prices, thereby ensuring the country receives its fair share of tax revenue.

In this directive, definitions have been presented in sequential order. The titles of the definitions and the relevant sections of the Act have been highlighted using **Bold Letters** and Rules have been highlighted using ***Bold Italic Letters***, while the explanations and other examples are presented in regular text. While interpreting the provisions of the Act, Rules, and matters related to transfer pricing, efforts have been made to provide clarity through the use of examples where necessary. The names and transactions mentioned in such examples are fictional. Any resemblance of these names or transactions to real individuals or entities is purely coincidental. This directive must be applied while implementing, practicing, and interpreting Section 33 of the Income Tax Act, 2002 and Rule 15 of the Income Tax Rules, 2002. In the context of implementing provisions related to transfer pricing, this directive shall be considered subsidiary to the Income Tax Act, 2002 and the Income Tax Rules, 2002. In case of any amendment or replacement made in the Income Tax Act, 2002 or the Income Tax Rules, 2002, or through any subsequent Finance Act, the amended or newly introduced provisions of the Act or Rules shall prevail over any conflicting provisions in this directive.

1.2 Legal Provisions Related to Transfer Pricing Determination:

Section 33 of the Income Tax Act, 2002 contains provisions related to transfer pricing and other arrangements between associated persons. According to this section, the Inland Revenue Department (IRD) may distribute, appropriate or allocate amounts included or excluded in the calculation of income based on transactions between associated persons to reflect the income in accordance with the arm's length principle, to determine taxable income and assess the applicable tax. The Department also has the authority to re-characterize such distributed, appropriated or allocated amounts if necessary. Furthermore, the valuation of transfer prices in transactions between related parties must be carried out in accordance with the methods specified by the Department. Since the implementation of this section requires the specification of documents, details, and methods and procedures for determining the arm's length price, this directive has been prepared and issued by exercising the authority granted under Sections 33 and 139 of the Income Tax Act, 2002.

Provision under Section 33 of the Income Tax Act, 2002:

1) **Price transferring and other arrangements between associated persons**: (1) If any provision is made between the associated persons and the provision is operated as per arm's length, the Department may, by issuing a notice in writing, distribute, appropriate or allocate the amounts to be included or deducted in computing the income between those persons in such a manner as to reflect the taxable income or the payable tax that could be set for them.

(2) In carrying anything mentioned in sub-section (1), the Department may do as follows:

(a) To re-characterize any income, loss, amount or source and type of payment, or

(b) Where various expenses including main office expenses which any person had to incur to operate any business have yielded benefits to the associated person or persons, to allocate such expenses between the associated persons on the comparative basis of the turnover of the business.

(3) As per this section, the valuation of transfer in transactions between associated persons shall be conducted in accordance with the methods prescribed by the Department.

Provision under Rule 15 of the Income Tax Rules, 2002:

Fixation of value in advance: (1*) In cases where any one or more than one person makes a request in writing to become clear as to the distribution, allocation or allotment to be made by the Department on the basis of arm's length in respect of the amounts to be included or deducted in computing the income of any person pursuant to Subsection (1) of Section 33 of the Act, the Department may issue a notice in writing as follows:*

(a) In a manner that the period of the notice in writing does not exceeds five income years at a time,

(b) In a manner that the notice in writing can be renewed notwithstanding anything contained in Clause (a).

(2) The notice in writing referred to in sub-rule (1) shall be binding to the Department and the party making such request.

Provided that, in cases where the Department agrees to the request made by the concerned applicant, the notice in writing shall be invalid.

1.3 Transactions, Entities, and Jurisdiction Covered by the Directive

1. This directive shall apply to cross-border transactions between associated persons.
2. It shall be applied in the course of implementation, practice, and interpretation of the Income Tax Act, 2002 and the Income Tax Rules, 2002. In matters related to taxation, this directive shall have a subordinate position to the Income Tax Act, 2002 and the Income Tax Rules, 2002.

1.4 Short Title and Commencement:

1. The name of this directive is "Transfer Pricing Directive, 2024."
2. This directive shall come into effect from the income year 2024/2025.

Chapter- 2

Definition

For the purpose of this directive, the terminology defined in the Income Tax Act, 2002 shall carry the same meaning as provided in the Act. However, other terminologies have been separately defined and explained as necessary. Matters not defined under the definition section have been explained in other relevant parts of the directive as required.

2.1 Definition and Explanation

(a) **“Act”** means Income Tax Act, 2002.

(b) **"Income year"** means a period from the first day of Shrawan (15th of July) of any one year to the last day of Ashad (14th of July) of the following year

(c) **Company**

"Company" means any company incorporated under the prevailing company law, and for the purpose of tax the following institutions shall also be treated as if they were companies:

(1) Any corporate body established under the laws in force;

(2) Any unincorporated union, board, association or society or sole proprietorship whether incorporated or not and any group of persons or trust except a partnership;

(3) Any partnership firm, retirement fund, cooperative institution, unit trust, joint venture, consisting of twenty or more partners whether registered or not under the law in force;

(4) Foreign company;

(5) Any other foreign institution as specified by the Director General

(d) Resident entity controlled by a tax-exempt organization

For any income year, a "resident entity controlled by a tax-exempt organization" means a resident entity in which, at any time during that year, one or more of the specified persons or entities held at least 25 percent of vested ownership or control.

i. Tax-exempt organization and its associated persons
ii. Any person exempts from tax under Section 11 of the Act or any person associated to such a person during that income year,
iii. A non-resident person or person associated to such non-resident person, or
iv. Any combination of the persons mentioned in clauses (i), (ii), and (iii)

Illustration

A situation where a resident person has been provided a loan by a non-resident person

In the context mentioned above, Extap Limited, a non-resident person, provides a loan to Ganesh Limited, a resident person in Nepal. Extap Limited holds more than 25 percent vested ownership (33% x 80% = 26.4%) in Ganesh Limited. In such a situation, Ganesh Limited is considered a controlled entity of Extap Limited. Accordingly, the interest amount paid by Ganesh Limited to Extap Limited must be accounted for in accordance with Subsection (2) of Section 14 of the Income Tax Act.

(e) Comparability Analysis

"Comparative Analysis" means the analysis conducted to determine whether comparable transactions are comparable or not, for the purpose of comparing controlled transactions with transactions between independent persons.

(f) Comparable Uncontrolled Transaction

"A comparable uncontrolled transaction" means a transaction between two independent persons that has been selected, based on comparable analysis, for comparison with a controlled transaction.

(g) Relative

"Relative" means an individual's husband, wife, son, daughter (adopted son, daughter as well), father, mother, grand-father, grand-mother, elder brother, younger brother, sister-in-law, daughter-in-law, elder sister, younger sister, father-in-law, mother-in-law, brother-in-law, elder brother-in-law, wife's sister, elder mother-in-law, uncle, aunt, nephew, niece, grand-son and granddaughter.

(h) Entity

"Entity" means the following organization or body:

(1) A partnership, trust or company,

(2) Rural Municipality, Municipality or District Coordination Committee,

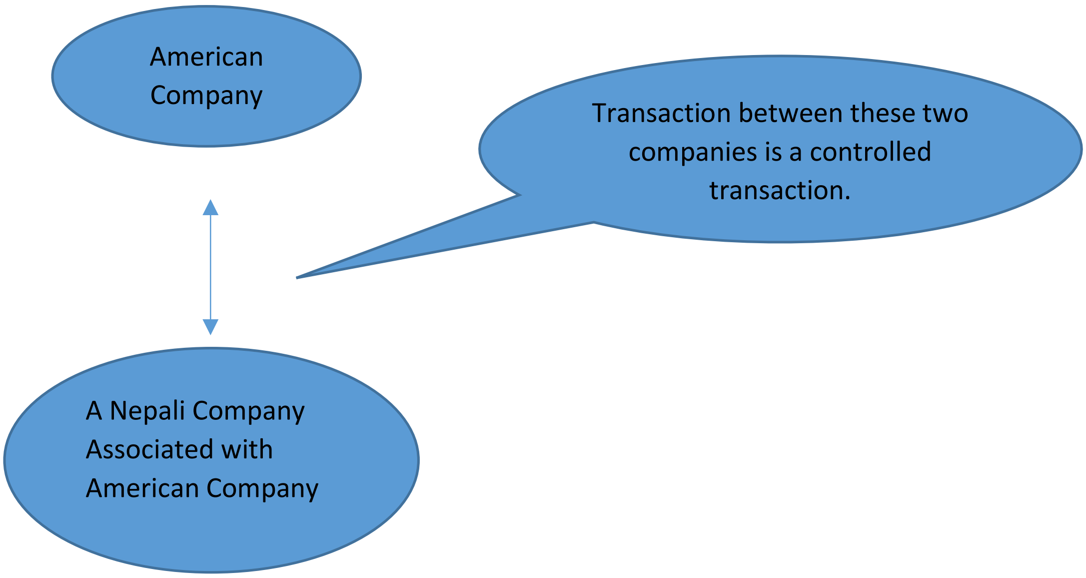
(3) Government of Nepal, Provincial Government or Local Level,

(4) Any foreign government or provincial or local government under that government or a public international organization established by any treaty, or

(5) A permanent establishment of the organization or body referred to in clauses (1), (2) (3) and (4), which is not situated in a country of which it is a resident.

(i) Controlled transaction

"A Controlled Transaction" means the transaction of goods, services, assets, or loans between associated persons. It also includes any other business activities or financial transactions between such persons that may affect their income, profit.



(j) "Regulations" means the Income Tax Regulations, 2002.

(k) Vested ownership

"Vested ownership" means the following ownership:

(1) In the case of any entity, ownership created on the basis of the interest which any individual or any entity in which an

individual has no interest has in that entity directly or indirectly through one or more interposed entities, or

(2) In the case of the assets owned by any entity, ownership of the assets as determined in proportion to the ownership of the persons who have vested ownership in that entity.

(l) Tested Party

"Tested party" means the associated person whose financial indicators are used as the basis when determining the arm's length price using the Comparable Uncontrolled Price (CUP) Method, Resale Price Method, Cost Plus Method, and Transactional Net Margin Method. However, an associated person outside Nepal shall not be considered the tested party if the necessary and reliable data and information required for authentication are not available.

(m) Market value

"Market value" means ordinary transaction value of any property or service in the ordinary course of trade between unrelated persons in respect of such property or service.

(n) Multinational Company

"Multinational company" means a company or a group of companies that conducts business operations in more than one country. This also includes permanent establishments located in more than one country.

(o) Resident person

"Resident person" means the following person in respect of any income year:

(1) In respect of an individual,-

(a) Whose normal abode is in Nepal,

(b) Who has resided in Nepal for 183 days or more during a continuous period of 365 days, or

(c) Who is deputed by the Government of Nepal to a foreign country in any time of the income year,

(2) A partnership firm,

(3) In respect of a trust, such trust, -

(a) Which is established in Nepal,

(b) The trustee of which is a resident person in an income year, or

(c) Which is controlled by a resident person or by a group of persons comprising such a person, directly or through one or more interposed entities.

(4) In respect of a company, such company,-

(a) Which is incorporated under the law of Nepal, or

(b) Management of which has been effective in Nepal in any income year.

(4a) Government of Nepal or Provincial Government,

(5) Rural Municipality, Municipality, or District Coordination Committee,

(6) In respect of an entity of any foreign government or provincial or local government under that government, such entity,-

(a) Which is established under the laws of Nepal, or

(b) Management of which is effective in Nepal in any income year.

(7) An organization or entity established under any treaty or agreement, and

(8) A foreign permanent establishment of a nonresident person situated in Nepal.

(p) Individual

"Individual" means a natural person or an entity.

(q) Arrangement

"Arrangement" means any action, agreement, or conduct whether carried out individually by a person or jointly by two or more persons, directly or indirectly including rules of mutual dealings, contracts, understandings, promissory notes, or documentation. Such an arrangement or schemes are of two types that may or may not be legally enforceable.

(r) Department

"Department' means the Inland Revenue Department.

(s) Cross-border business

"Cross-border business" means the trade of goods, services, assets, or loans between two or more countries. Additionally, the term also includes any business or financial activities that affect the income, profit, loss, assets, or liabilities of an entity.

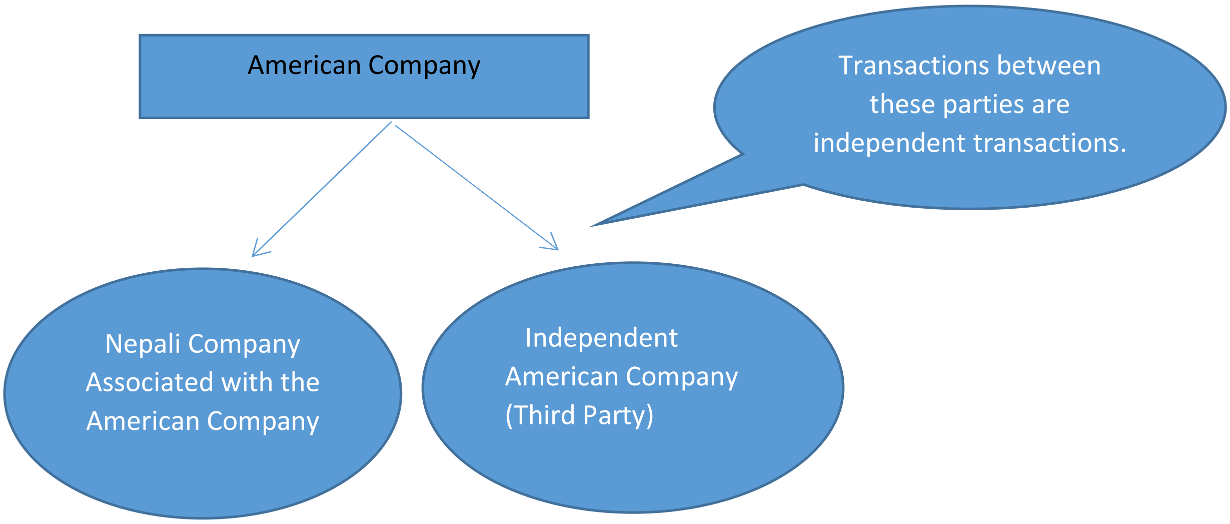
(t) Cross-border controlled business

"Cross-border controlled business" refers to cross-border transactions between associated persons of two or more different countries.

(u) Independent Business

"Independent business" means transactions that take place according to Arm's Length value.

Diagram:



(v) Permanent Establishment

"Permanent establishment" means a place where any person carries on a business fully or partly, and the term includes the following place:-

(1) A place where any person carries on a business fully or partly, through any agent (except a general agent) who acts independently in the ordinary course of carrying on business,

(2) A place where any person's main equipment or main machinery is situated or used or installed,

(3) One or more than one place in any country where any person has delivered technical, professional or consultancy service through an employee or in any other manner for more than ninety days at one or several times in a period of any twelve months, or

(4) A place where any person is involved in a construction, installation or establishment project and has carried out supervisory works of that project for a period of ninety days or more.

(5) A place outside Nepal that has a digital presence in Nepal as specified, and if it has operated data or service transactions in Nepal for at least 90 days within the past 12 months while hosting its server outside Nepal.

(w) Associated person

"Associated person" means any one or more than one person or group of persons who act as per the intention of each other, and the term also includes the following persons: -

(1) An individual and relative of that person or any person or a partner of that person,

(2) A foreign permanent establishment and a person having ownership in that establishment, and

(3) Any entity which by itself or jointly with any other person related with it or with an assisting entity or any other person or entity related with such assisting entity controls fifty percent or more of the income, capital or voting right of any entity or derives benefits therefrom.

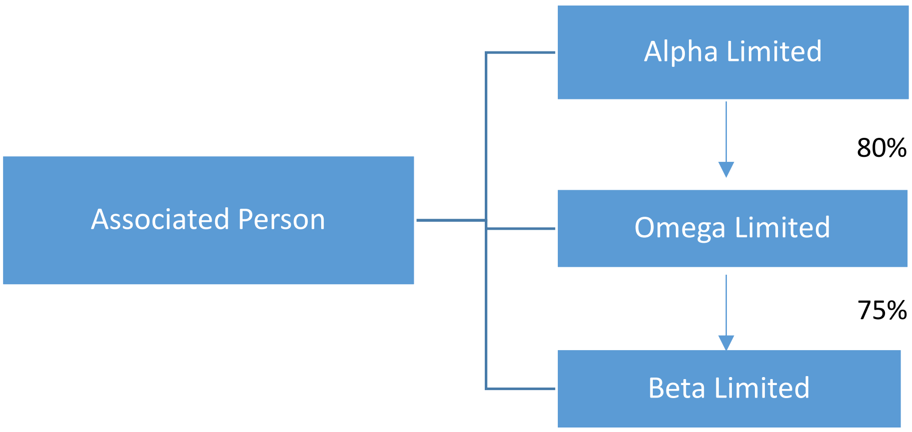
Provided that the following person shall not be an associated person: -

(1) An employee,

(2) A person specified by the Department as a non-associated person.

Illustration- 1

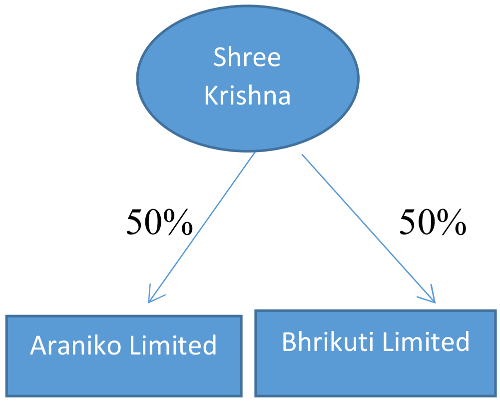
A situation where one person holds, directly or indirectly, more than 50 percent ownership of another person.



According to the above diagram, Alpha Limited holds 80 percent direct ownership in Omega Limited, and Omega Limited holds 75 percent direct ownership in Beta Limited. In this situation, Alpha Limited has direct ownership in Omega Limited and an indirect vested ownership in the capital of Beta Limited (80×75÷100 = 60%). Based on the circumstances mentioned above, both Omega Limited and Beta Limited are associated persons of Alpha Limited. Similarly, Omega Limited and Beta Limited are also associated with each other, as they act in accordance with each other's intention.

Illustration-2

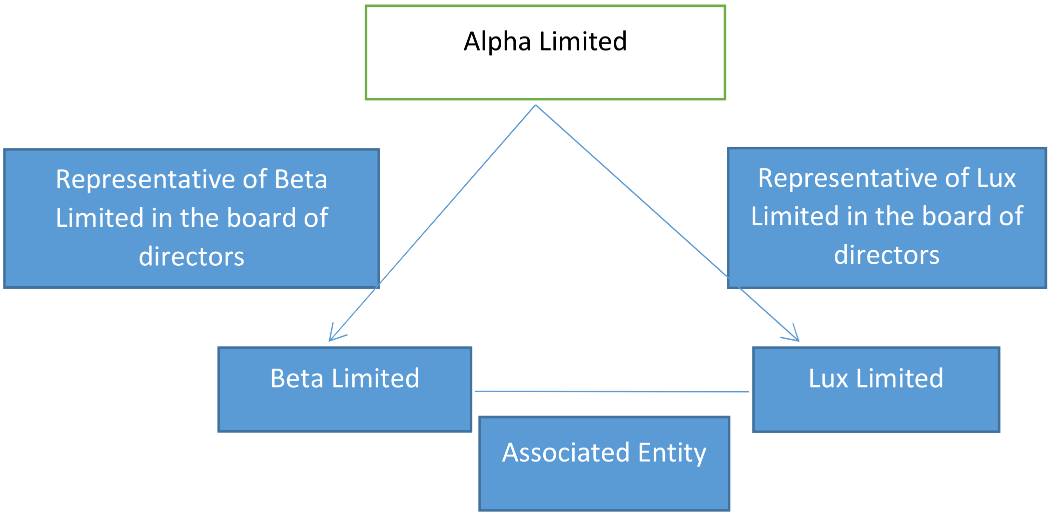
A situation where a person or persons, by holding ownership of shares directly or indirectly, acquire 50 percent voting rights of that person



Shri Krishna holds 50 percent voting rights in both Araniko Limited and Bhrikuti Limited. Araniko Limited and Bhrikuti Limited does not hold ownership in each other. Since Shri Krishna has the right to exercise 50 percent of the voting rights in both companies, Araniko Limited and Bhrikuti Limited are considered associated persons in this situation.

Illustration 3

A situation where a person represents more than 50 percent of the members in the board of directors or executive committee of another person.



Beta Limited has a provision for a board of directors consisting of 7 members, out of which 4 directors represent Alpha Limited. Similarly, Lux Limited has an executive committee with 5 members, and Alpha Limited nominates 3 of them.

As per the above diagram, since Alpha Limited holds the majority representation in both the board of Beta Limited and the executive committee of Lux Limited, both companies are considered associated entities of Alpha Limited. Likewise, since Alpha Limited holds majority control in the management bodies of both companies, Beta Limited and Lux Limited are also regarded as associated persons of each other.

(x) Arm's length transaction

"Arm's length transaction" means a purchase, sale or transaction, dealing, or exchange of any property or service conducted at market value between unrelated persons.

(y) Transfer pricing determination

"Transfer pricing determination" means the pricing of cross-border controlled transactions between associated persons. It also includes the process of distributing, appropriating or allocating amounts in a manner that reflects the taxable income or tax liability that would have arisen had the arrangement between the associated persons been conducted in accordance with arm's length principles.

Chapter- 3

Transfer Pricing and Arm's Length Principle

3.1 Transfer pricing

Transfer pricing refers to the price determined for transactions conducted between associated persons. Such transactions may include the purchase and sale of goods or services, financial dealings, cost-sharing arrangements, and other forms. Transfer pricing determination refers to the pricing of goods or services in transactions between associated persons. While the price of economic transactions between independent persons is determined by the market, transactions within a multinational group may not be solely guided by market forces but can also be influenced by the collective interests of the group. However, tax obligations are not determined collectively for the group, but separately according to the tax jurisdiction in which each company operates. The way transactions are priced within a group can affect the profit allocated to each group member, which in turn may result in each tax jurisdiction receiving a different amount of tax than what is actually due. Companies can increase the overall profit of the group by setting transfer prices in such a way that lower profits are shown in countries with higher tax rates and higher profits are shown in countries with lower tax rates for intra-group transactions. In such situations, countries with higher tax rates may not receive their fair share of tax revenues. Therefore, it has been widely accepted that transactions within a multinational group should follow the principle of arm's length pricing.

This principle has been incorporated into international tax treaties as well as into the domestic laws of many countries.

The price set for transactions between associated parties may differ from the market price. In such transactions, businesses often aim to reduce their tax burden. Manipulating prices in a favorable manner is primarily done for shifting income from high-tax jurisdictions to low-tax jurisdictions.

Diagram:

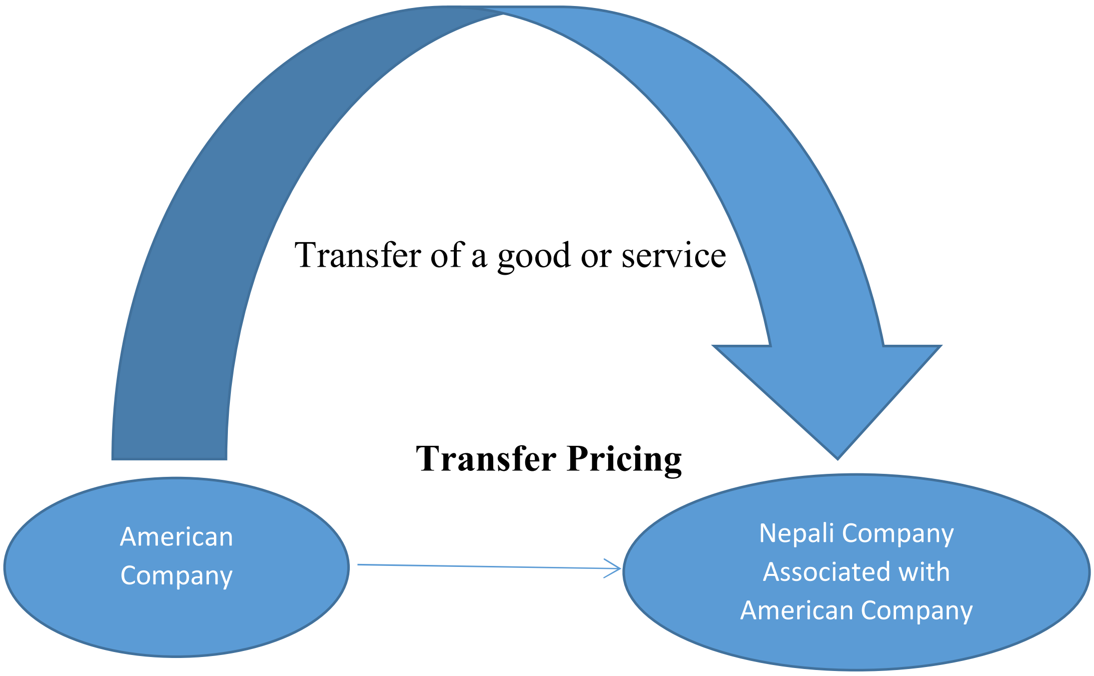


Illustration 3.1

A company 'Kha' from Country 'Ka' sells a product to its associated company 'Gha' located in Country 'Ga' for NPR 100/-. The market value of the product is NPR 150/-. Company 'Gha' adds some value to the product and sells it to an independent party in another country for NPR 200/-. Company 'Kha' had purchased the product from an unrelated party at a cost of only NPR 50/-. The tax rate in both Country 'Ka' and Country 'Ga' is the same, i.e., 30%

Table

Details	Company 'Kha'	Company 'Gha'	Total
Selling price	100/-	200/-	300/-
(-) Purchase cost	50/-	100/-	150/-
Net profit/taxable income	50/-	100/-	150/-
30% applicable tax	15/-	30/-	45/-
Profit after tax	35/-	70/-	105/-

Effective Tax Rate- 30% (45/150*100)

The market value of the goods sold by company "Kha" to "Gha"= 150/-

In the above situation, manipulating the price does not benefit the taxpayer. However, the tax that should be collected by Country 'Ka' is effectively shifted to Country 'Ga'. In such cases, Country 'Ka' must make price adjustments to recover the actual tax revenue due to it.

Illustration 3.2

In the aforementioned scenario, Company 'Kha' from Country 'Ka' establishes another associated company 'Cha' in Country 'Nga', where the tax rate is only 5%. Company 'Kha' sells the product to Company 'Cha', and Company 'Cha' sells it to Company 'Gha'. The transaction values between them are as follows:

Table

Details	Company "Kha"	Company "Cha"	Company "Gha"	Total
Sale	80/-	180/-	200/-	460/-
Purchase Cost (Value)	50/-	80/-	180/-	310/-
Net Profit (Taxable Income)	30/-	100/-	20/-	150/-
Tax Rate (%)	30	5	30	
Tax	9	5	6	20/-
Profit After Tax	21/-	95/-	14/-	130/-

The effective tax rate is 13.33% (20/150 × 100).

Market price of the product sold by Company 'Kha' to Company 'Cha' = 150

Market price of the product sold by Company 'Cha' to Company 'Gha' = 200

By setting up an associated company in a country with a lower tax rate, Company 'Kha' has significantly reduced its global tax liability from 30% to 13.33%. To counter such tax behaviors by multinational companies, the transfer pricing mechanism has been developed to ensure that the appropriate share of tax revenue is allocated to the correct tax jurisdiction.

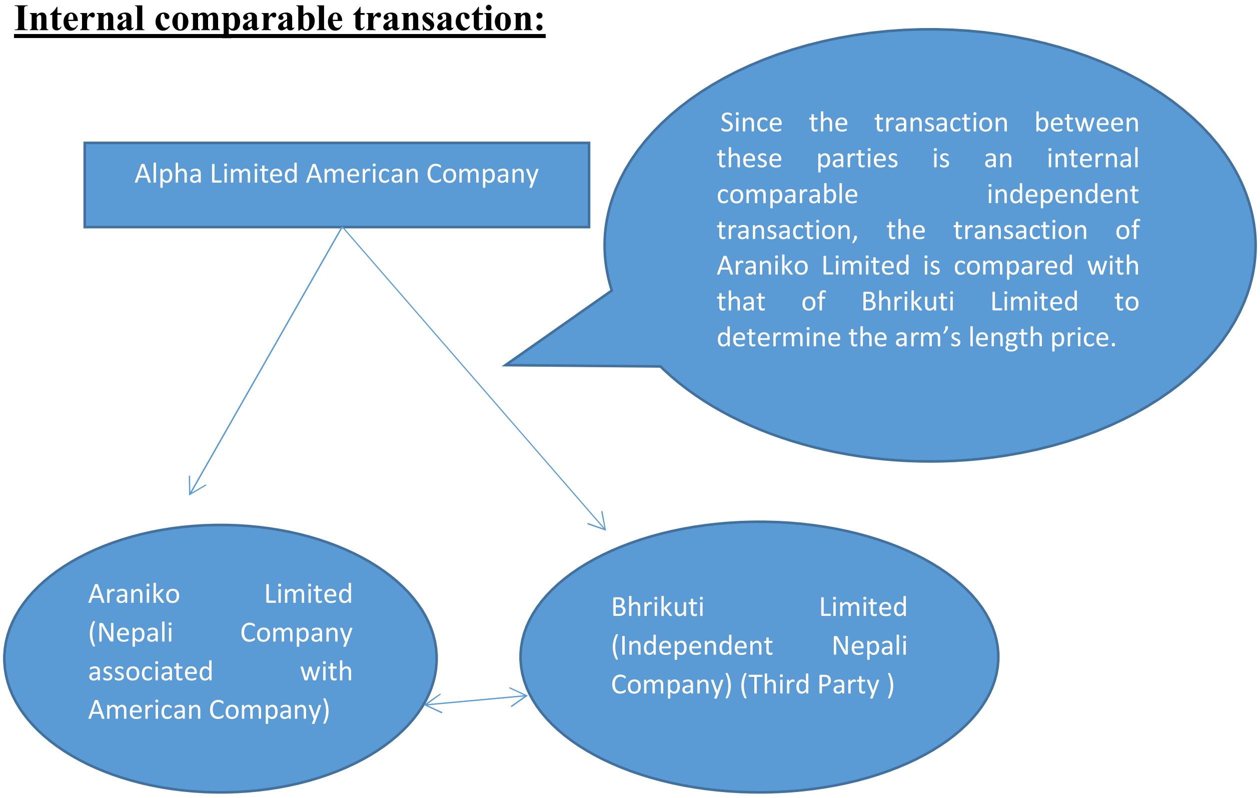
3.2 Arm’s Length Principle

The prevalent standard applied for transfer pricing is to determine the price of controlled transactions between associated persons by comparing them with prices of comparable transactions between independent persons. Internationally, this arm’s length principle is the basis for pricing transactions between related parties. The objective of this principle is to ensure that controlled transactions between associated persons are conducted according to market behavior, so that tax revenues are fairly allocated among all relevant tax jurisdictions. Only through transactions conducted at arm’s length can each country where a multinational company resides receive its rightful share of tax revenue.

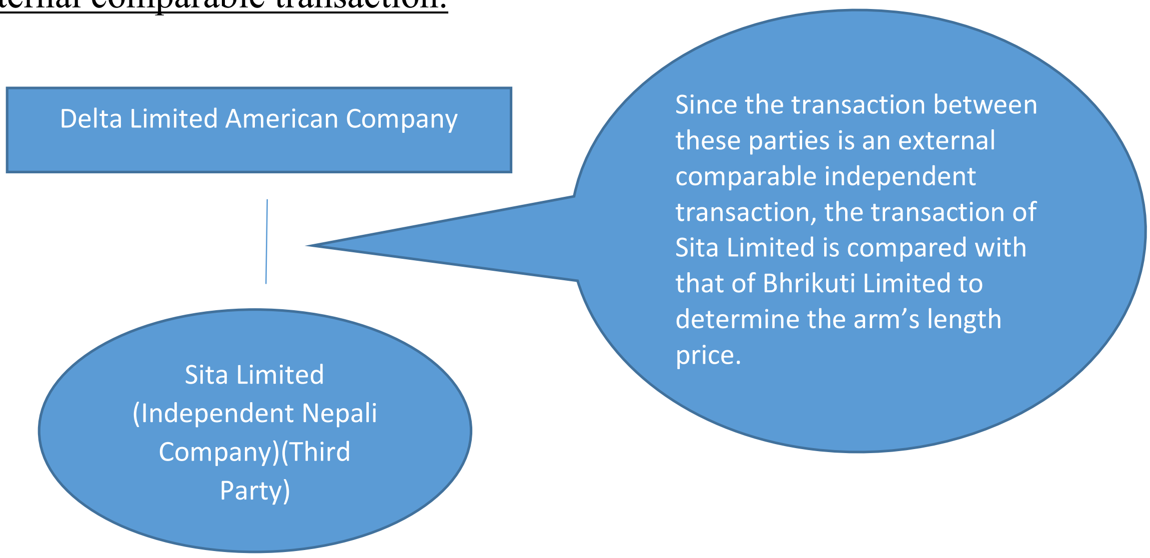
For example, if both Alpha Limited and Delta Limited are U.S.-based companies engaged in similar businesses, in normal condition, the controlled transactions between them will be priced by comparing with comparable independent transactions, as illustrated in the diagram below, to determine the arm’s length price.

Diagram:

Internal comparable transaction:



External comparable transaction:



Article 9 of the Model Double Taxation Avoidance Agreements (DTAA) of the Organization for Economic Co-operation and Development (OECD) and the United Nations (UN) provides that if a transaction between associated persons residing in different tax jurisdictions is conducted in a manner different from that between independent persons, resulting in reduced profits for the person resident in the taxing jurisdiction, the taxing jurisdiction may include the reduced amount in the income and impose tax accordingly. This provision has also been incorporated into Nepal's various double taxation avoidance and financial fraud prevention agreements with different countries.

Article 9 of the OECD Model Tax Convention contains the following provisions regarding transactions conducted at arm's length.

> Where an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Section 33 of the Income Tax Act, 2058 (2002) also provides that if transactions between associated persons are not conducted in accordance with the arm's length principle, the tax authority may adjust the reduced income through allocation, apportionment, or re-characterization.

Provision under Section 33 of the Income Tax Act, 2002:

Transfer pricing and other arrangements between associated persons:

(1) If there is any arrangement between associated persons, and such arrangement is conducted in accordance with the arm's length principle, the Department may, by issuing a written notice, distribute, appropriate or allocate the amounts to be included in or deducted from the income of such persons in a manner that reflects the taxable income or tax payable that would have been generated.

(2) While doing anything as mentioned in Subsection (1), the Department may take the following actions:

(a) Re-characterize the source and nature of any income, loss, amount, or payment; or

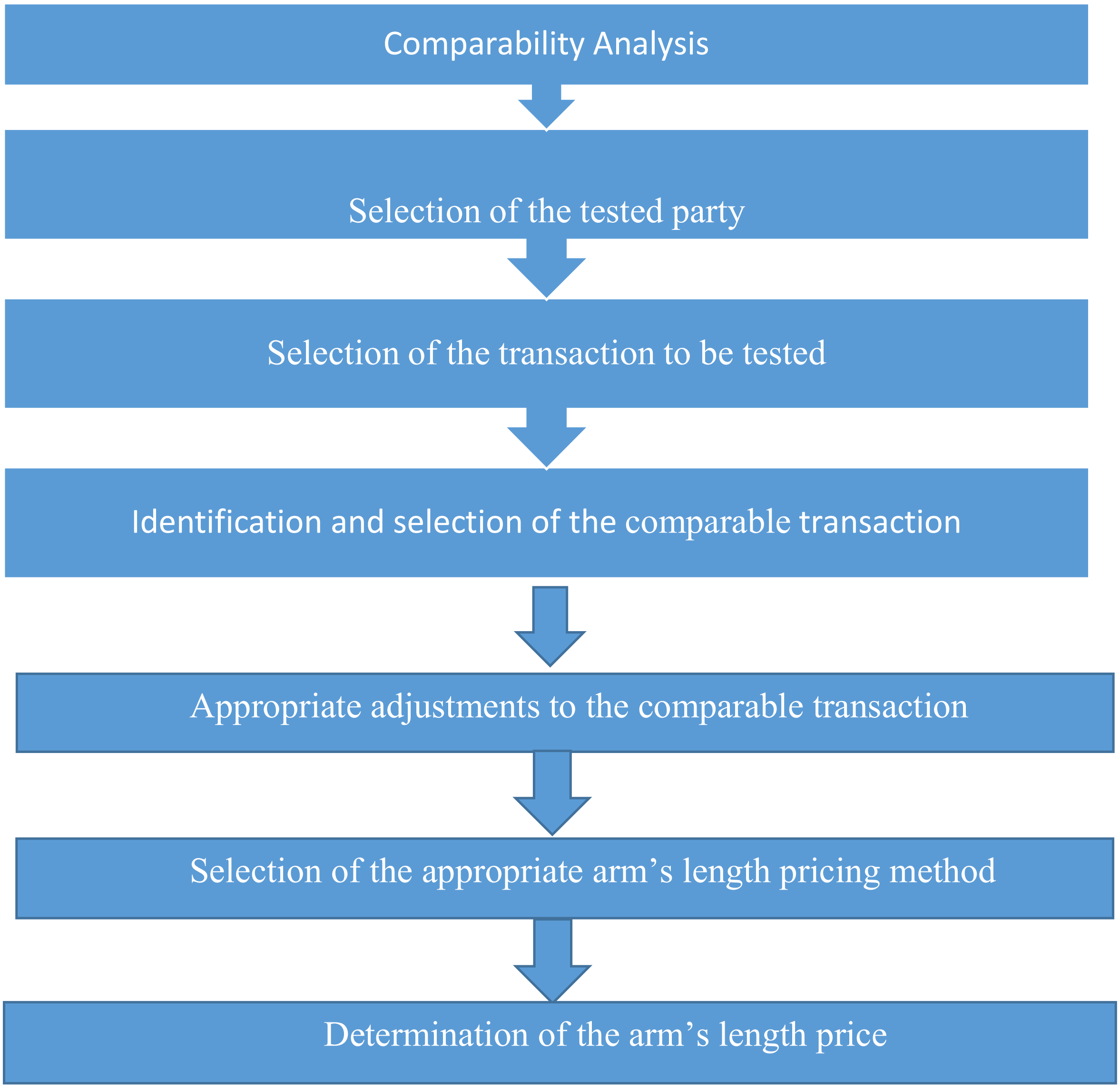
(b) If any person incurs expenses, including head office expenses, for the operation of a business that benefits an associated person or persons, allocate such expenses among the associated persons based on the comparative nature of the business transactions.

(3) The valuation method for determining the transfer price between associated persons under this section shall be as prescribed by the Department.

3.3 Procedures for Arm's Length Price Determination

Controlled transactions between associated persons are compared with transactions conducted independently to determine the arm's length price. For such pricing to be determined, the transactions being compared must also be comparable. Therefore, while determining the arm's length price, it is necessary to analyze all the factors that can influence the transaction price. This requires adherence to established methods and procedures, along with the application of sound judgment. Only when these elements are in place can the determination of the arm's length price be considered accurate and acceptable.

The general procedures for determining the arm's length price are sequentially outlined below. A detailed explanation and analysis of these procedures is provided in Chapters 4 and 5.



Chapter- 4

Comparability Analysis

The arm's length price of a controlled transaction between associated persons is determined by comparing it with a transaction between independent persons. The price of a transaction is influenced by various factors of the business. When comparing a controlled transaction with an independent transaction, all factors affecting the pricing of the transaction must be analyzed. Factors such as the nature of the transaction, the business operations, the external economic environment, and the terms of the contract influence the pricing of the transaction. Only by analyzing all these factors can an appropriate comparable transaction and method be selected for determining the arm's length price. This enables the determination of a suitable arm's length price.

The comparability analysis mainly includes the following tasks:

a) Analyzing the controlled transaction between associated persons.

b) Conducting a functional analysis (Function, Asset, and Risk (FAR) Analysis) of the associated persons.

c) Comparing the controlled transaction with an independent transaction based on the above analyses.

Certain procedures are required for comparability analysis. Generally, comparability analysis should be conducted based on the following procedures. However, depending on the nature of the transaction, the sequence of these procedures may vary, and in some cases, not all procedures may be necessary.

Steps of Comparability Analysis

The procedures for determining the arm's length price are explained in detail as follows:

4.1 Analysis of Economically Significant Characteristics of Business and Transaction

In the first stage of comparability analysis, it is necessary to analyze the nature and key characteristics of the controlled transactions carried out by the associated persons, as well as the nature and features of the businesses involved in such transactions. This includes the following tasks:

4.1.1 Collection of Basic Information about the Persons Involved in the Transaction

In the first step of comparability analysis, it is essential to collect and analyze the necessary data and information related to the controlled transactions and the business. To gather the basic information of the taxpayer, sources such as the annual report, group company's annual report, brochures providing details about the manufactured products, and articles published in newspapers and journals should be utilized. The following tasks are included in this process:

a) Industry Analysis

When analyzing industries within any sector, the following aspects must be considered:

- **Analysis of the Value Chain:** This involves analyzing the stages and levels involved in the taxpayer's business operations and supply chain. Each industry has its own unique value chain. Since differences in the value chain can affect the pricing of goods, it is essential to analyze the supply chain of the industry while conducting the industry analysis.

- **Analysis of Profit Drivers:** Every business has its own strengths. These strengths are the reasons a business can sustain itself and generate profit. Not all activities of a business may significantly contribute to profit generation. Therefore, while analyzing an industry, it is necessary to examine factors such as location, operational efficiency, and customer satisfaction that play a significant role in profit generation.
- **Market Trends:** In today's world, people's lifestyles are rapidly changing. Along with these changes, people's needs, preferences, and interests are also evolving. These changes directly influence the supply of goods or services in the market. Therefore, the industry analysis must include a study and assessment of market trends, technological developments, advertising styles, customer behavior, and so on.
- **Competitive Environment:** Competition plays a major role in determining the price of goods. In industries with low competition, profit margins may be higher, whereas in highly competitive industries, profits may be low or even nonexistent. Hence, while conducting industry analysis, it is necessary to examine the taxpayer's competitive position, number of employees, and details about the products.

(b) Analysis of the Taxpayer's Business Environment

The policies, laws, regulatory provisions, capabilities, and economic conditions of the country in which a business operates play a significant role in determining the pricing of transactions. Therefore, this includes the analysis of the regulatory environment and the economy of the jurisdiction where the taxpayer carries out business operations.

(c) Identification of Associated Persons

The arm's length price is determined based on the controlled transactions between associated persons. Hence, among the many parties involved in a transaction, it is important to identify which ones are associated persons. Only after identifying the associated persons can the transactions between them be considered as controlled transactions between associated persons.

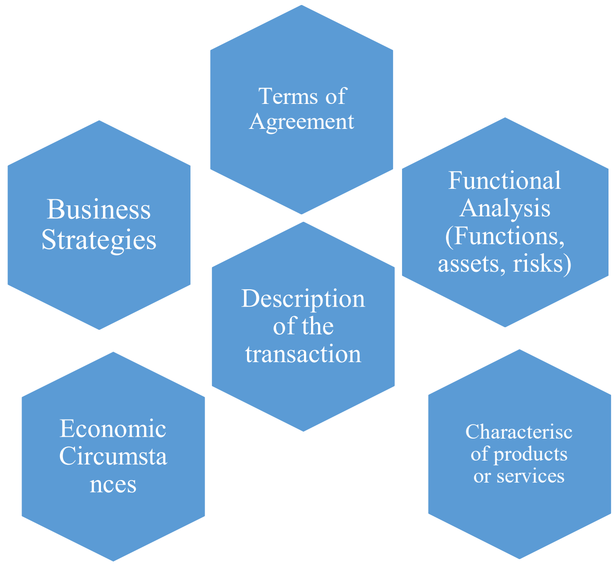
(d) Identification of Controlled Transactions

Since the main objective of comparability analysis is to examine the transactions between associated persons, it is essential to gather detailed information about such controlled transactions. This includes analyzing what goods or services are involved, whether intangible assets are included, the terms of the transaction, and the prevailing economic conditions.

4.1.2 Clear Characterization of the Transaction

To determine the market behavior of any transaction, it is necessary to obtain clear and comprehensive information about all aspects related to that transaction. Only when all elements of the transaction are clearly defined can the price be determined in accordance with market behavior. Based on the terms stated in the contract, an analysis of the economically significant features must be conducted to clearly define the transaction. Therefore, the first step is to analyze the terms of the contract. It must be examined whether the terms mentioned in the contract are consistent with the actual performance functions of the parties involved.

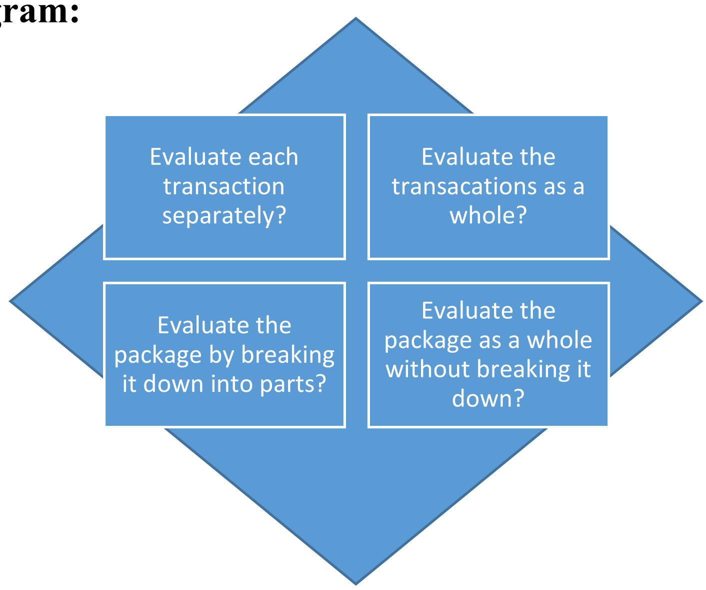
Factors to be Analyzed While Characterizing a Transaction:



4.1.3 Selection of Whether to Evaluate Transactions Separately or on an Aggregate Basis

After identifying the controlled transactions, it must be determined whether each transaction should be evaluated separately, on an aggregate basis, or if included in a package deal, broken down and evaluated individually.

Diagram:



4.2 Examination of Comparability Factors of the Controlled Transaction

The nature of the goods or services involved in a transaction, along with various aspects of the business, can influence the pricing of the transaction. Therefore, after identifying the controlled transaction, the following factors that affect comparability must be analyzed for the purpose of comparability analysis: -

- Characteristics of property or service transferred,
- Contractual terms of transaction,
- Functional analysis,
- Economic circumstances of transaction,
- Business strategies.

4.2.1 Characteristics of property or service transferred

Due to the differing characteristics of the assets (tangible or intangible) or services involved in a transaction, the market value of goods and services can vary. Therefore, for comparability analysis, differences arising from the characteristics of goods or services in independent and controlled transactions must be analyzed. The following are the key features of assets (tangible or intangible) or services that should be examined for determining the arm's length price:

- **In the case of tangible property:** visible attributes such as physical composition, quality, reliability, availability, and volume of supply.
- **In the case of services:** the nature of the service, its quality, and the duration of service availability.

- **In the case of intangible property:** the status of the transaction (whether licensed or sold), type or status of the property, duration of use, level of protection, and the benefits that can be derived from it.

4.2.2 Contractual Terms of the Transaction

There may be a contract between the associated persons involved in the transaction. Such contracts usually contain various provisions and terms related to the transaction. These terms may lead to differences in the transaction price between the parties. Therefore, while determining the arm's length price, the contractual terms must be taken into consideration. If there are significant differences in pricing due to the terms of the contract, necessary adjustments must be made during the comparability study.

Key points to consider while analyzing contractual terms:

- Since the persons involved are associated, not all terms may be explicitly stated in the contract, the terms may not be genuine, or the contract may not be legally enforceable.
- The terms relating to responsibilities, allocation of risks, and sharing of benefits as mentioned in the contract should be confirmed by comparing against the actual functions performed by the parties.
- If the terms of the contract result in material differences between the controlled transaction and the comparable transaction under review, those differences must be evaluated and necessary adjustments made to eliminate such differences.

4.2.3 Functional, Asset & Risk -FAR Analysis

FAR analysis is considered the most important part of comparability analysis. It involves analyzing the functions performed, assets employed, and risks assumed by the related parties involved in a controlled transaction. FAR analysis helps identify and compare the significant economic activities of the related parties and potentially comparable independent transactions. Since the pricing of transactions between independent parties is based on the functions performed, assets used, and risks borne, these factors also play a crucial role in determining the arm's length price for transactions between related parties.

a) Functions Performed

The economic activities carried out by each party in a transaction are referred to as the functions performed. In FAR analysis, the functions performed by each party must be thoroughly examined. Since the return from a transaction is generally based on the performance of economically significant functions, the focus of FAR analysis should be on identifying those significant economic functions rather than listing all economic functions performed.

Some of the economically significant functions can be listed as follows: -

- Functions related to the production of goods or services,
- Transportation and inventory management,
- Product design,
- Research and development,
- Sales, distribution, and advertising functions.

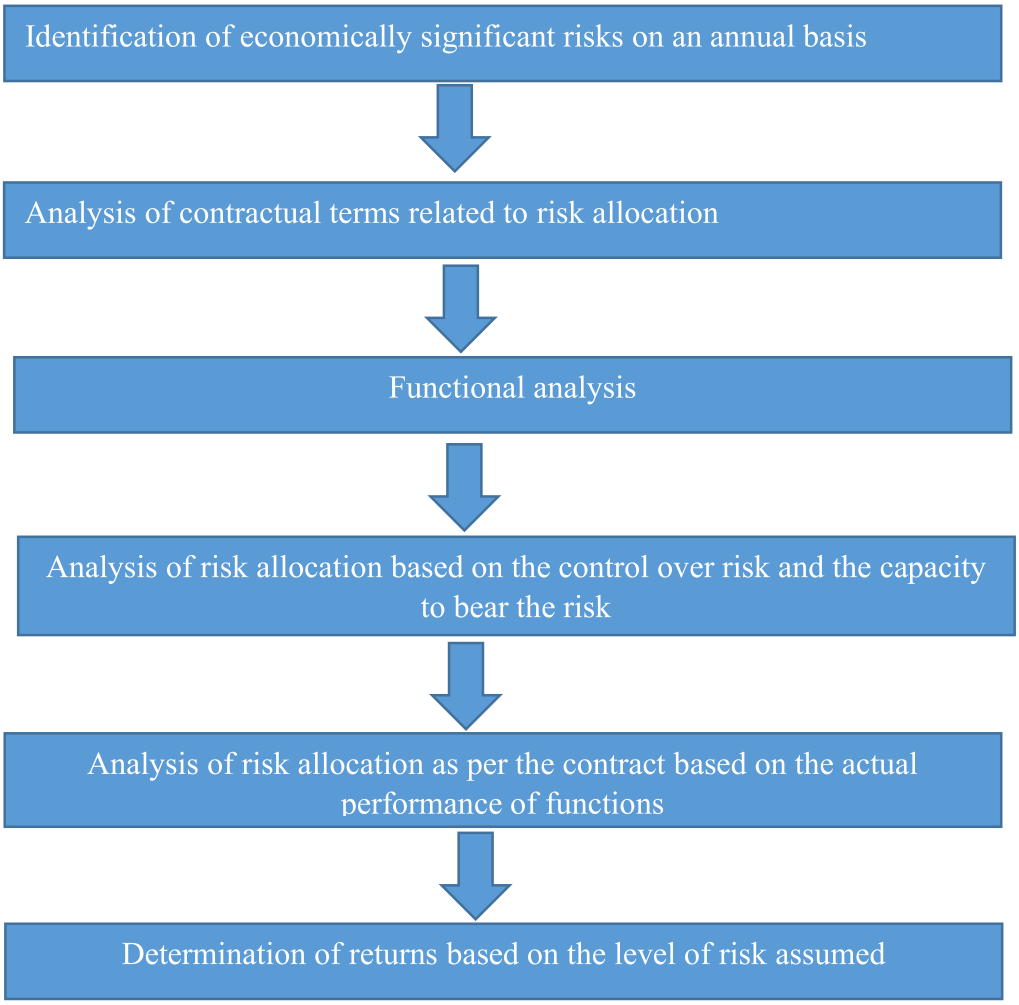
b) Assets Utilized

In a Functional Analysis (FAR Analysis), the tangible and intangible assets used by the related parties involved in the controlled transaction must be identified and analyzed. Since the significant assets utilized by the parties are considered a key basis in determining the transaction price between independent parties, the significant assets utilized by the parties should be considered for determining the arm's length price of transactions between related parties as well. The analysis of economically significant assets requires a detailed examination of factors such as the type of asset, duration, ownership rights, location, protection, and market value.

Some economically significant tangible assets may include land, buildings, plants, machinery, office equipment, vehicles, computers, and other assets depending on the nature of the business. Similarly, intangible assets may include economically significant assets such as intellectual property, technology, brands, and trademarks.

c) Risks Assumed

Risk analysis is an important component of Functional Analysis (FAR Analysis). Risk is an integral part of any economic activity and serves as a key factor in profit determination. A business assumes higher risks only when there is the potential for higher profits. Since risk plays a significant role in determining the market price of independent transactions, it must also be analyzed when determining the arm's length price of controlled transactions. Although a business may assume many types of risks, FAR Analysis focuses only on those economically significant risks that materially impact pricing. The steps for identifying economically significant risks can be outlined as follows:



1) **Identification of Economically Significant Risks**

   Various types of risks are present in the operation of a business. However, not all risks may be economically significant. Only those risks that have a material impact on the pricing of goods or services and the profitability of the business should be analyzed during the Functional Analysis (FAR Analysis). The key functions performed by the business and the analysis of the business environment help in identifying the economically significant risks assumed by the business.

Some economically significant risks are shown in the chart below.

Nature of Risk	**Description of Risk**
Financial Risk	Methods of raising financial resources
	Changes in interest rates
	Financing under loss conditions
	Foreign Exchange Risk
Production Risk	Product Design and Development
	Product standardization
	After-Sales Service
	Inventory-Related Risk
	Research and Development Related Risk
Market Risk	Capturing market share
	Price and demand fluctuations
	Business cycles
	Quantitative Risk
Risk related to revenue collection	Credit Risk
	Bad debts
Business Risk	Risks related to capital investment
	Risk related to limited customers
	Human resource-related risks
Country and region-	Political Risk

Nature of Risk	Description of Risk
related risk	Security-related risks
	Regulatory Risk
	Risks related to government policies
Other Business Risks	Ownership-related risks
	Inflation-related risks

2) **Analysis of Contractual Terms Related to Risk Allocation**

In the course of business transactions, parties involved enter into contracts. These contracts specify the extent to which each party assumes risk. Since there is an interdependent relationship between risk and profit, the proportion of risk borne also affects the profit from the transaction. Therefore, when analyzing risk in comparability analysis, attention must be paid to the provisions regarding risk allocation mentioned in the contracts between the parties.

3) **Functional Analysis (FAR Analysis) in the Context of Risk Assumption**

Any party involved in a transaction assumes risk only in proportion to the functions they perform. They cannot bear risks beyond their capacity or those unrelated to the functions they carry out. Therefore, when analyzing risk assumption in comparability analysis, the analysis should assess whether the risks assumed by the parties correspond to the functions they perform, based on the following risk analysis criteria.

i. **Control over Risk**

The economically significant risks borne by any business determine its success or failure. For this reason, a business only assumes risks that it is capable of managing. Therefore, when analyzing control over risk, it is necessary to assess the capacity of the parties involved in the transaction to bear, address, and mitigate the risks.

ii. **Financial Capacity to Bear Risk**

When any party assumes risk, it considers the financial burden that may arise from bearing that risk. The party only assumes risks within its financial capacity. Therefore, it is also necessary to analyze whether the risks borne by the parties correspond to their financial capacities.

4) **Analysis of Risk Allocation in the Contract Based on Work Performance**

At this stage, the allocation of risk in the contract must be analyzed to determine whether it is confirmed or contradicted by the functions performed by the parties. If the work performance confirms the assumption of risk, then the control over risk and the financial capacity to bear the risk must be analyzed. For transactions that pass both of these tests, the fifth stage of analysis is skipped, and the valuation is done based on risk allocation according to the sixth stage.

5) **Analysis of Risk Allocation Based on Control over Risk and Financial Capacity to Bear Risk**

If the transaction fails the analysis in the fourth stage, it must be analyzed according to this stage. If the contract's risk allocation does not align with the work performed, control over risk, and financial capacity to bear risk, then risk must be reallocated based on the work performed, control over risk, and financial capacity to bear risk. After that, according to the sixth stage, an analysis should be conducted to determine whether the transaction pricing reflects the arm's length principle based on the allocated risks.

6) **Transaction Pricing Based on Risk Assumed**

After completing the mentioned stages, it is determined how much risk each party has assumed. Since the transaction price and profit of the parties depend on the proportion of risk assumed, the risk borne by the parties must also be taken into account when determining the arm's length price.

4.2.4 Economic Circumstances of Business and Transaction

a) General Conditions

The economic environment in which a business operates influences the pricing of transactions. Therefore, in comparability analysis, special attention must be given to the business environment of the associated persons as well as comparable independent persons. Generally, the economic environment of a transaction can be classified as follows:

- Global economic developments related to the business and their trends,
- Economic development of the country where the taxpayer conducts business and its trends,
- Market share held by the business and the economic conditions of the business environment.

An independent transaction with an economic environment significantly different from that of the taxpayer should not be considered a comparable independent transaction. When selecting comparable independent transactions, priority should be given to businesses operating in the same geographical area. If comparable independent transactions are not available in the same geographical area and of the same nature, transactions from different geographical areas may be considered as comparable independent transactions in the following cases:

- Where the geographical difference does not result in a significant difference in the transaction price.
- Where the difference in price due to geographical variation can be adjusted.

b) Other Factors to Consider in the Analysis of Business and Economic Environment

Apart from the factors mentioned in the analysis of the business's economic environment, the following conditions may also arise. If such conditions exist, they must also be analyzed and adjusted accordingly.

a) Benefits Arising from the Location of Business Operations (Location Benefits)

Multinational companies transfer their business operations from high-cost tax jurisdictions to low-cost tax jurisdictions to enhance overall economic benefits. Generally, businesses relocate to places where the cost of production factors is lower. Such locations may bring advantages as well as disadvantages. Therefore, the net benefit is calculated by subtracting potential disadvantages from potential advantages. When determining the arm's length transfer price according to general market behavior, such location-related benefits must also be analyzed.

The benefits arising from the location of the business should be allocated as follows:

- Calculate the net benefit derived from the location,
- Analyze whether the benefit has been passed on to the customer or not,
- If the benefit has not been passed on to the customer, allocate that benefit among the related parties based on the allocation of similar benefits in other independent transactions.

b) Other Aspects of Business Environment Analysis

Apart from the environments mentioned above, the following conditions can also cause differences in the transaction price between the parties: -

- Multinational companies generally have large global operations. When dealing with third parties, their bargaining power may increase, leading to economic benefits. If such benefits exist, they should be fairly allocated among the related parties.

- Government policies of the location where the business operates can also affect pricing. Examples include price controls, interest rate regulation, foreign exchange controls, exemptions and subsidies, anti-dumping duties, etc. If such conditions exist, the benefits or disadvantages arising from government regulations should also be considered in determining the arm's length price for the parties.
- The level or type of company conducting the transaction can also affect the market price. For example, wholesalers may earn less profit than retailers. Other market-related factors such as the availability of substitute goods, transportation costs, market size, and competitive conditions can also influence market prices and should therefore be analyzed as well.

4.2.5 Business Strategy

Every business adopts different strategies to expand their operations. A business in its initial stage may have a strategy to capture market share, while an established business may focus on maintaining its existing market share. To gain market share, a business might sell goods or services at discounted prices at lower rates, or it might spend heavily on advertising and distribution to build its brand. Therefore, these factors must also be given special attention when determining the arm's length transfer price based on normal market behavior.

Business strategies can be categorized as follows:

- Market entry strategy,
- Market expansion strategy,
- Market share maintenance strategy.

Depending on the strategy adopted, market expansion might involve significant price reductions through discounts on goods or services, or increased expenses on sales distribution and advertising. Hence, while calculating the arm's length transfer price, the mentioned strategies and the associated expenses must also be evaluated.

4.3 Selection of Tested Party

After the comparability analysis, one party among the related parties involved in the transaction must be selected for comparison with comparable uncontrolled transactions. This party is called the Tested Party. The selection of the Tested Party is required when applying methods such as the Resale Price Method, Cost Plus Method, and Transactional Net Margin Method. The financial indicators of the Tested Party should be compared with the financial indicators of comparable uncontrolled transactions. Among the two related parties, the one with the less complex transaction should be chosen as the Tested Party. Additionally, when selecting the Tested Party, consideration must be given to whether data on comparable uncontrolled transactions in the same environment is available or not. If the taxpayer selects a related party outside Nepal as the Tested Party, it must be ensured that the tax administration has access to the necessary information and data relating to that related party and the comparable uncontrolled transactions.

Illustration

Suppose Company A produces two types of products, P1 and P2. It sells its products to a related party, Company B, located in another country. Company A manufactures product P1 according to technical specifications determined by Company B, which owns a specialized intangible asset with high value. In this transaction related to product P1, Company A performs only routine functions without making any significant additional contribution. In this case, Company A is the tested party for the transaction involving product P1. Suppose Company A uses its own valuable specialized intangible assets, such as patents and trademarks, to produce product P2, while Company B acts only as a distributor in this transaction. In the transaction related to product P2, Company B performs only routine functions without any significant additional contribution. In this case, Company B is the tested party for the transaction involving product P2.

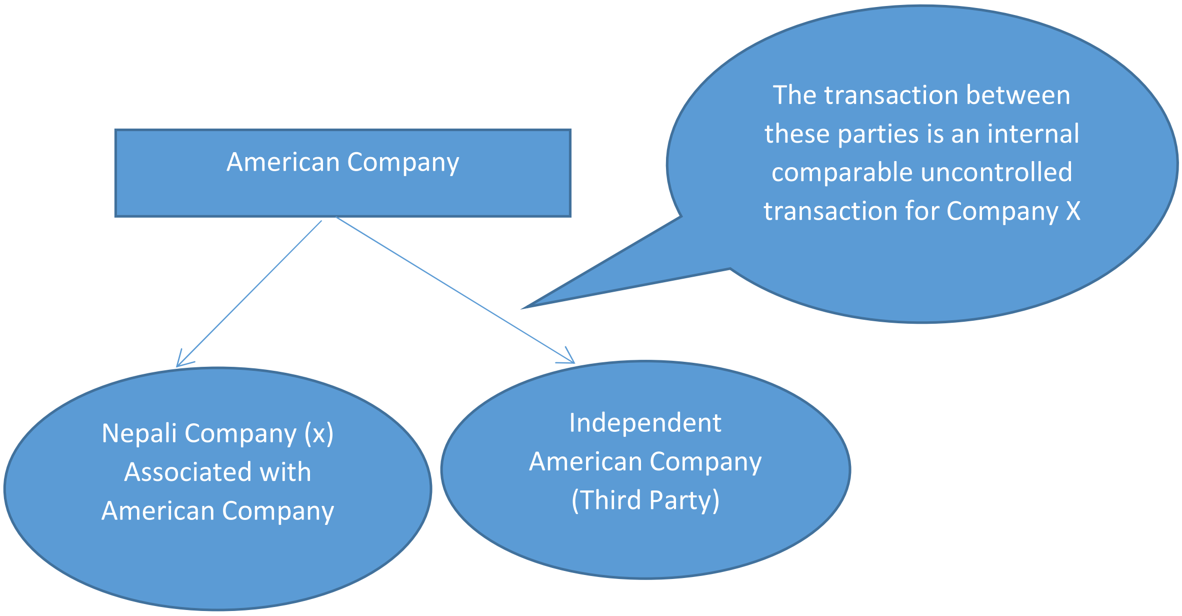
4.4 Identification and Selection of Comparable Transactions

After selecting the tested party, based on the comparability analysis, comparable uncontrolled transactions must be selected to compare with the financial indicators of the tested party. Comparable uncontrolled transactions are of two types: internal and external, as described below:-

4.4.1 Internal Comparable Uncontrolled Transactions

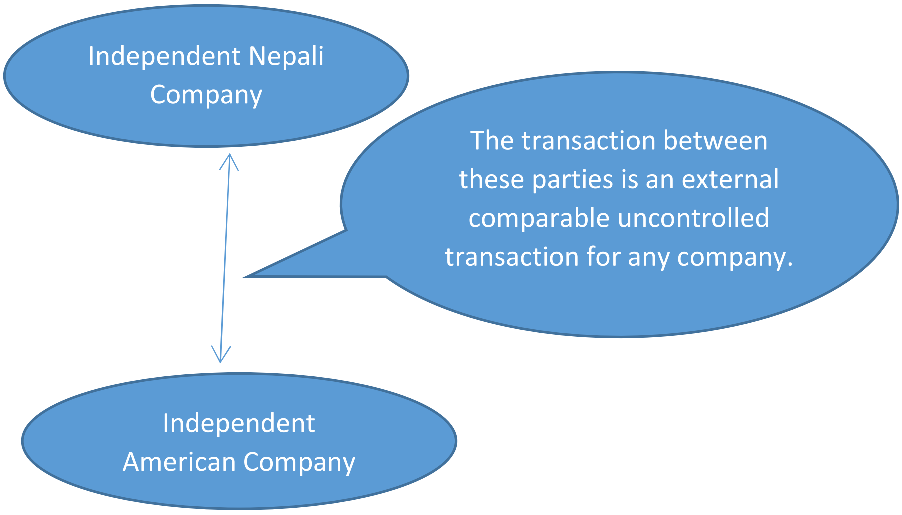
The tested party may have conducted transactions with both related parties and independent parties. Transactions that the tested party has conducted with independent parties are considered internal comparable uncontrolled transactions. Since these transactions involve the same party, internal comparable uncontrolled transactions are regarded as more comparable. However, if the terms and conditions differ when transacting with different parties, necessary adjustments must be made to eliminate those differences. When internal comparable transactions are available, the comparable uncontrolled price method should be used. Even when using other methods for determining the arm's length price, internal comparable uncontrolled transactions should be used. If internal comparable transactions are not available, external comparable uncontrolled transactions must be examined.

Diagram: Company X



4.4.2 External Comparable Uncontrolled Transactions

Transactions between independent third parties that have no transactions with the tested party are considered external comparable uncontrolled transactions. Generally, since internal comparable uncontrolled transactions are often not available in practice, external comparable uncontrolled transactions must be used as the basis. For the application of the comparable uncontrolled price method, the transaction prices between the two independent persons are used as the basis, whereas for the use of other profit-based methods, financial indicators and results are taken as the basis. To compare with transactions between independent third parties, complete, accurate, and reliable information is required. For this purpose, various sources of information must be utilized.



a) Sources of Information for External Comparable Transactions

There are various external sources available to obtain information related to comparable independent transactions. Using such sources, data can be gathered for conducting comparability analysis. Some major sources of information for external comparable transactions are as follows:

1) Internal Revenue Department

Taxpayers submit income details along with other statistics to the department. Based on the information submitted, potential comparable transactions can be identified. Similarly, under the provisions of double taxation avoidance and financial fraud prevention agreements, data exchanged with various countries can also be used as a source of information.

2) **Various Government Agencies**

Associated parties and independent traders submit data related to their economic transactions to government and regulatory bodies such as the Office of the Company Registrar, Department of Industry, Department of Commerce, Supplies and Consumer Protection, Customs Department, etc. This information can also be used as a source of data for comparability analysis.

3) **Data available in Trade-related Organizations and Other International Organizations**

Chamber of Commerce and industry and trade related other professional organizations may also maintain business data. Likewise, institutions such as the World Bank, International Monetary Fund (IMF), international development, and aid organizations can also serve as sources of information.

4) **Commercial Databases**

Various entities may provide commercial databases. These organizations may maintain commercial databases for the purpose of selling business data. Data can be purchased from such databases through membership or other means. These can also be used as important sources of information. However, when using data from such sources, its reliability must be verified.

B) Methods of selecting external comparable transactions

Data may be available in sufficient quantity for comparability analysis. Selecting a comparable transaction from the available data is challenging. The following methods are mainly adopted for this:

1) Additive approach

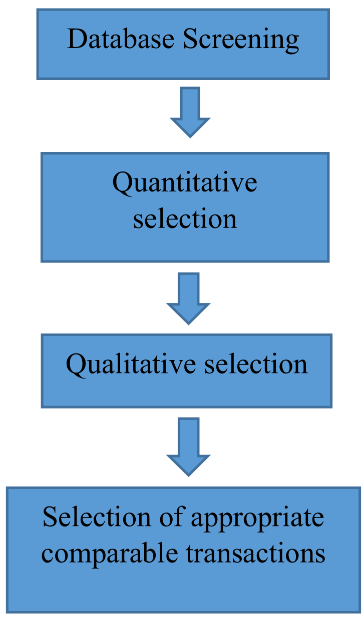
According to the additive approach, a possible comparable transaction is selected based on assumptions. The transaction selected in this way is analyzed on the basis of various criteria to determine whether it is comparable or not and a decision is made whether to use it as a comparable transaction or not.

2) Deductive Approach

According to this method, the most suitable comparable transaction is selected from a large database based on various criteria, narrowing the selection range and selecting the most suitable comparable transaction with the party being tested.

C) Procedures for selecting comparable transactions

The following procedures should be followed for selecting suitable comparable transactions from the database.



1) Database Screening

Criteria should be prepared for selecting suitable comparable transactions from the database based on facts and indicators that match the basic economic characteristics of the party being tested. The following bases can be taken for preparing criteria:

- Industry related code,
- Geographical area or market,
- Business related terminologies,
- Available financial information,
- Business size,
- Business ownership type,
- Financial accounting type.

2) Quantitative selection

In this stage, the scope is narrowed down by further narrowing down the business based on various financial indicators and other criteria that can be used to measure the business. Various financial ratios can be taken as a basis for this. Such as the ration of sales to inventory, the ratio of sales to fixed assets indicators etc.

3) Qualitative selection

Some aspects of the business may not be measurable quantitatively. In such a situation, qualitative selection alone may not be the right choice of comparable business. Therefore, the qualitative aspects of the resulting comparisons should also be examined.

4) Selection of appropriate comparable transactions

Aftermath the aforementioned process, appropriate comparable transactions should be selected.

4.5 Appropriate adjustment to comparable transaction

It is practically difficult to find comparable free transaction that are exactly the same as the ones being tested. The financial indicators of the test party should be adjusted to compare them with the financial indicators of the selected independent comparable transactions on the same basis. By adjusting and comparing the different bases, a general market transaction value that is acceptable to all can be determined.

The following should be taken into consideration for comparability adjustment:

- Adjustments cannot be made in the selection of comparable transactions in cases where there is a significant economic impact. Adjustments should be made only for the purpose of increasing the reliability and quality of the data.
- No adjustment should be made on matters that do not materially affect the value and profit.
- In cases where the accuracy and reliability of the adjustment cannot be maintained, adjustments should not be made on an estimated basis.
- The adjustment should be made on the basis of objective and verifiable data.

Adjustments for comparability can be made on the following subjects:

a) Adjustment of accounting

The tested party and the person doing comparable free transaction may have different accounting policies. This may affect the financial indicators and results. When comparing transactions, the financial indicators and results that differ due to such accounting should be adjusted to make the transactions comparable. Examples of different accounting systems are as follows:

- Discounts on sales may be shown in the adjusted cost of goods sold. This may again affect the net profit of the selling price method. For the same reason, necessary adjustments should be made.
- Research and development expenses may be shown directly or indirectly in the accounting. This may affect the cost plus rate derived from the cost plus method.
- Since there may be differences in net profit due to accounting practices, accounting adjustments may be necessary even when using the net profit method in a transaction. For example, differences in depreciation rate may varies per the business.

b) Adjustment of current and working capital

The balance sheet of a comparable transaction may differ, such as the amount of money to be received and paid in the balance sheet. Due to such differences, there is a difference in the amount of working capital. Due to such differences in the amount of working capital, there may be variations in interest expenses. Entities requiring higher working capital may have lower profits, whereas those requiring lower working capital tend to have higher profits. Therefore, necessary adjustments must be made to account for such differences.

c) Other adjustments

In addition to the above, necessary adjustments can be made based on the performance level of the parties, risk bearing status, economic environment, etc.

4.6 Selection of appropriate arm's length method

After completing the above procedures, the transfer price of the controlled transaction between the concerned parties is determined according to the arm length practice based on various indicators of comparable free transactions. For this, there are various methods to determine the price according to the arm length practice. The methods for determining the price according to the arm length practice are mentioned in Chapter-5 of this Directive. Among those methods, the most appropriate method should be used based on the comparability analysis.

Chapter-5

Method of Arm's Length Price Determination

The party and the comparable free transaction are selected on the basis of comparability analysis. After this, the party's controlled transaction is compared with the comparable free transaction to determine the arm's length price. For such comparison, price or certain financial indicators such as gross profit, net profit are taken as the basis. Depending on the nature of the transaction, the arm's length price determination method should be selected on the basis of which price or financial indicator is to be taken as the basis. Related parties involved in cross-border transactions should determine the arm's length price by selecting the appropriate method from the following methods based on a comparative analysis, subject to this Directive:

- Comparable Uncontrolled Price Method,
- Resale Price Method,
- Cost Plus Method,
- Transactional Net Margin Method,
- Transactional Profit Split Method.

5.1 Comparable Uncontrolled Price Method (CUP)

According to the method of comparing the price of a controlled transaction of a good or service with an free transaction in the same environment, the arm's length price should be calculated. In making such a comparison, the transfer price of the good or service transferred between related parties should be taken as the basis. When using this method, both internal and external comparable transactions can be considered.

Example 5.1.1

Suppose a Nepali company Manakamana Pvt. Ltd. purchased a packing machine from its affiliate Alaska Ltd. for NPR.20 lakhs (including freight and insurance). Another Nepali company Vindhabasini Pvt. Ltd. purchased a similar type of packing machine from its unrelated company Pennsylvania Ltd. for NPR.18 lakhs (excluding freight and insurance), for which the freight and insurance cost was NPR.1,00,000. In this case, the arm length transaction value of the company Manakamana Pvt. Ltd. should be calculated as follows.

Since the company Vindhavasini Pvt. Ltd. purchased the same type of packing machine from the company Pennsylvania Ltd. in Nepal and both are independent enterprises, it is appropriate to use the comparative uncontrolled price (CUP) rule in such a situation to simulate arm length.

Details	**Price(NPR.)**
Purchase price for company Vindhavasini Pvt. Ltd.	18,00,000
Insurance and rent	1,00,000
Arm length transaction price	1,900,000
Actual purchase price for company Manakamana Pvt. Ltd	20,00,000
Transfer pricing(TP) Adjustment	100,000

Example 5.1.2

Suppose Arizona Ltd. sells some goods to Bageswari Ltd. (an affiliate of Arizona Ltd.) at FOB (Free on Board) for NPR.3,000 per unit. Similarly, Arizona Ltd. sells the same goods to an unaffiliated entity, Taleju Ltd. at CIF Value (Cost, Insurance and Freight) of NPR.6,000 per unit for 10,000 units, where Taleju Ltd. pays NPR.500 per unit for insurance and freight. Taleju Ltd. gets a discount of NPR.200 per unit because it has a large stock.

In the said sale, Taleju Ltd. is also given a credit facility of 3 months, while Bageswari Ltd. is sold only on cash payment and the credit cost is 1% per month. In the above example, the arm length transaction value should be calculated as follows using the CUP method.

Details	Price(Rs)
Purchase price of Taleju Ltd.	NPR.6000 per unit
(+) Discount	NPR.200
(-) Insurance and Freight cost	NPR.500
(-) Three months credit facility (6000×3%)	NPR.180
Arm length transaction price	NPR.5520 per unit
Transfer pricing adjustment (TP Adjustment)	NPR.2520 per unit

a) When using the price comparison method with an free transaction, an free transaction that meets one of the following conditions should be selected as a comparable transaction:-

- There should be no element that makes a material difference in the price of the comparable transaction, Or,
- in case of a difference, necessary adjustments should be made.

b) If the following differences are found in controlled transactions and free transactions, necessary adjustments can be made:

- Type and quality of goods such as - unbranded tea from Ilam and unbranded tea from Darjeeling.
- Conditions related to freight, such as a situation where a transaction may have a price including freight price, or a factory price.
- Quantity based discounts, For example, if a calculator manufacturing company has set a selling price of NPR.100/- per unit on a purchase order of up to 10000 units of calculators and If a purchase order of more than 10,000 units of calculators is made at a discount of NPR.10 per unit and the selling price is fixed at NPR.90, then the discount of NPR.10 per unit on the selling price is called a quantity discount.
- Geographical factors such as transactions between related parties in Nepal and transactions between independent parties in India for similar goods and services.
- Contractual terms such as the credit period in related transactions and the credit period in free transactions.
- In a risk-sharing situation, it is as if the US-based Monalisa multinational company decides to produce a smart watch and does the research and development of the watch itself, assigns the responsibility of production to Shanghai Ltd. in China, and appoints Monica Pvt. Ltd. in Nepal for global distribution. In this situation, the US-based Monalisa

multinational company seems to have spread the risk of production and distribution.

c) The necessary adjustment cannot be made if the following differences exist between controlled transactions and free transactions:

- If there is a brand and trademark that affects the transaction price, for example, a mobile phone of the Orange brand cannot be compared with a mobile phone of the Mango brand with the same features. .
- If the goods traded are fundamentally different.

d) It is appropriate to use the price comparison method with free transactions in the following transactions:

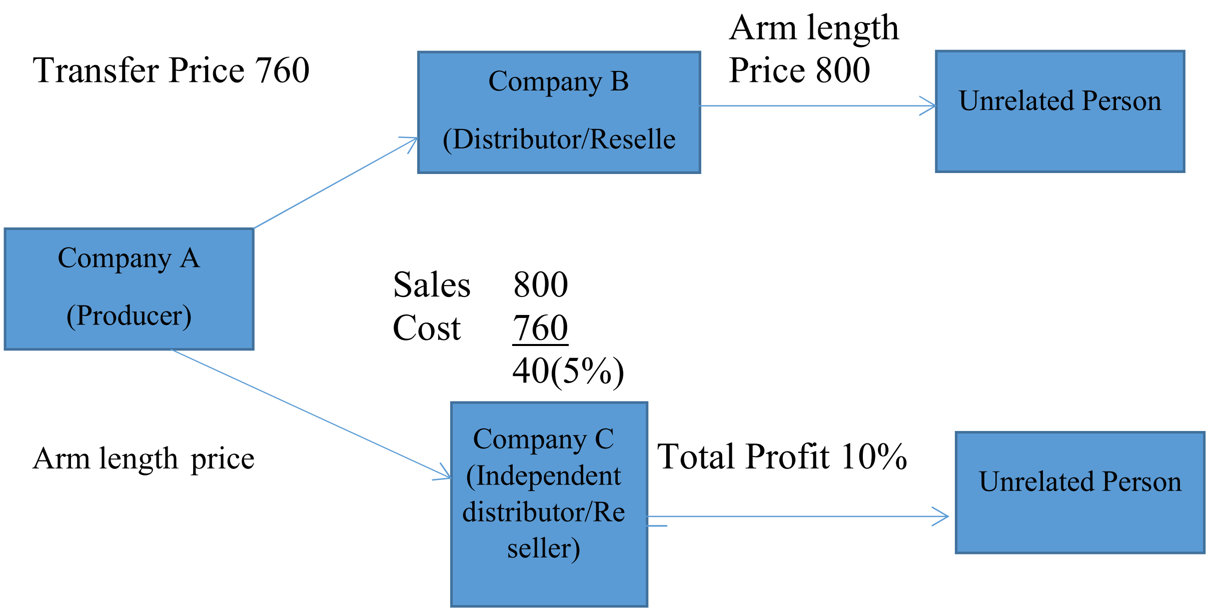
- If there is a similar item with a common brand that does not have a market price,
- And if internal comparable transactions are available.

5.2 Resale Price Method

Under the resale price method, the purchase price that should have been made by the related party in an free transaction with the arm length price is calculated by deducting the total profit made by the related party in a comparable free transaction from the arm length price. The sale price made by the tested party to an independent person is taken as the resale price, while the total profit percentage of the comparable free transaction is taken as the total profit made in an Arm's length transaction. The total profit is reduced based on the total profit percentage made from the comparable transaction from the resale price made by the tested party to an independent person. If additional expenses are incurred during the purchase, the purchase price that should have been made by the tested party in an ordinary market transaction is calculated by deducting the expenses related to the purchase.

Example 5.2.1

A subsidiary of a company 'A' located in Malaysia has a taxpayer named 'B' as a distributor in Nepal. B distributes high-quality goods produced by A. A sells similar low-quality goods to an independent distributor located in Malaysia. The cost of goods purchased by B from A is NPR.760 per unit. B resells the goods to an unrelated person for NPR.800. From the functional analysis, it is seen that B and C are conducting similar activities. The total profit of firm C is 10%.



In this example, when comparing controlled and independent market transactions, it is important to take into account the difference in quality of the goods. However, comparing on the basis of profit is not as realistic as comparing on the basis of the difference in price that would occur. Also, since B and C are conducting the same business activity (C is another reseller in the market), B's purchase from A should be taken as the basis.

The free market transaction value of the goods purchased = NPR.800-(800*10%) = 720

Example 5.2.2

Suppose that a Nepali company, Arun Ltd, is involved in the business of machinery used in the manufacture of steel utensils. The company imports the required machinery from its main company in the US for NPR.200,000 per unit and sells it in Nepal for NPR.350,000 per unit.

Another Nepalese company, Barun Ltd., is involved in the business of similar machinery. Barun Ltd. imports the required machinery from the UK for NPR.180,000 per unit and sells it for NPR.300,000 per unit.

In the above example, assuming that both the contractual obligations of the machine and the other are equal, the fair market value is calculated as follows:

Details	Amount (in NPR.lakhs)
Selling price of Barun Ltd.	3.00
(-) Purchase price	1.80
Total profit (per machine)	1.20
Total profit ratio	40%
Selling price of Arun Ltd.	3.50
(-) Total profit (40%)	1.40
Arm's length purchase price	2.10
Actual purchase price	2.00
Transfer price adjustment per machine	0*

***Since the actual purchase price per machine is less than the arm's length price, no transfer price adjustment is required.**

a) While selecting a comparable free transaction for using the resale price method, the following should be considered-

- The transaction to be compared should not have a factor that fundamentally changes the gross profit.
- In case of a difference in gross profit, necessary adjustments should be made.

b) For a comparability study in the resale price method, the following should be considered-

- Expenses included in the cost price calculation that change the gross profit, accounting method, management efficiency, level of maturity of the business.
- If the seller has done any work that significantly increases the value of the goods, such as: - Creation of intangible assets such as trademarks, brands, if additional processing work is done before sale. .
- Levels of activity performed by the seller such as distributor, street vendor, retailer.
- Whether there is an exclusive right to sell or not.

c) Resale price method is suitable for use in the following transactions -

- Transactions related to the sale and distribution of goods with limited risk without intangible assets such as trademarks, brands.
- In cases where comparable free transactions that can be compared on the basis of cost/expenses are available.

5.3 Cost plus Method

According to the cost plus method, the transfer price according to arm length practice is derived from the direct costs incurred by the party supplying the goods or services in the transaction between related parties, plus the percentage of cost plus in the comparable transaction. In this method, the total cost of the party being tested is taken as the base price. The cost plus (Cost Plus) in the comparable uncontrolled transaction on that base price is taken as the cost plus that should be made even in a controlled transaction. The cost plus that should be made to the base price is added to the cost plus that should be made to the base price, plus the cost plus that should be made to the related party for the goods and services supplied to the related party.

Example-

Service providing Nepali Company → Independent US company (Service Recipient)

Cost plus Transaction Amount- Cost/ Expenses = NPR.200-150 = 50

Cost plus Percentage- 50/150= 33.33%

US Affiliated Nepali Company Providing Services → US Parent Company (Service Recipient

Cost Expenses = NPR.300

Transfer Price = Cost /Expenses x (1+ Cost plus Percentage)

=NPR.300 x (1+ 33.33%)

Therefore, Transfer Price = NPR.400

Example 5.3.1

Janaki Nepal Ltd. (a subsidiary of Georgia Ltd.) provides call center services to other companies, including its parent company, Georgia Ltd., located in the United States. The company invoices its parent company, Georgia Ltd., at a rate of US$60 per hour.

The company provides similar services to Texas Ltd. and invoices it at a rate of US$80 per hour. Georgia Ltd. pays the service immediately, while Texas Ltd. receives a 60-day credit facility. Janaki Nepal Ltd. incurs a total cost of US$30 per person per hour to provide the service, including indirect costs of US$6. The financial cost of the credit period at the time of the transaction is US$6 per month. Janaki Nepal incurs an additional 30% manpower cost when providing services to Georgia Ltd. In this case, the arm's length price should be calculated as follows.

Details	**Price (In US $)**
Invoiced Price per Hour for Texas Ltd.	80
Cost Expense	
Total Expense	30
(-) Indirect Cost	6
Direct Cost	24
(+) Credit Period Finance Cost at rate US$ 6 per month	12
Cost after adjustment	36
Cost plus Cost (Cost after Invoice Price Adjustment)	44
Cost plus Ratio	122.23%
Expense Cost for Georgia Ltd	
Direct Cost (30% more) (24+ 30%)	31.20

Cost plus (122.22%)	38.14
Arm’s Length Price	69.34
Actual Price for Georgia Ltd.	60
Transfer Price Adjustment *	9.34

***Therefore: Since the actual invoice price issued to Georgia Ltd. is less than the arm’s length price, a transfer price adjustment is required.**

Example 5.3.2

Suppose Kasthamandap Pvt. Ltd. (a subsidiary of New York Incorporation) provides software development and database management services to New York Incorporation (head office) located in the United States. Kasthamandap Pvt. Ltd. has incurred a cost of US$ 10,000 to provide the said service. Kasthamandap Pvt. Ltd. has mutually agreed that when issuing an invoice to New York Incorporation, it will issue the invoice by adding 15% to the cost incurred in Nepal.

Similarly, when providing services between independent persons involved in a business, the invoice is issued by adding 50% to the cost incurred. The following is the calculation of the arm length price using the Cost Plus Method:

Details	Amount (in US$)
Cost of Expense for Kasthamandap Pvt.Ltd.	10,000
Cost plus 15%	1,500
Income	**11,500**

Arm length price = Expense × (1+ Cost plus

Percentage between Independent Persons)	**15,000**
= 10,000 x (1+50%) =	3,500
Transfer Price Adjustment*	

Therefore: Kasthamandap Pvt.Ltd. (a subsidiary of New York Incorporation) should make a transfer price adjustment since the actual invoice price issued by New York Incorporation (head office) is less than the arm length price.

a) The following points should be considered while selecting a comparable free transaction for the use of the cost plus method:

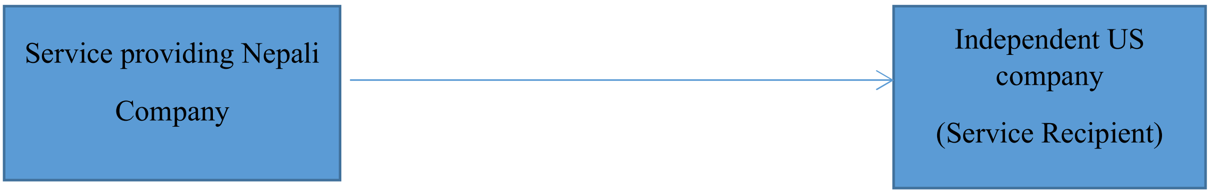
- The comparable transaction should not have a factor that fundamentally changes the cost plus.
- In case of a difference in cost plus, necessary adjustments should be made.

b) The cost plus method is suitable for use of the following transactions:

- Transactions between related parties producing goods or services with limited level of production work.
- Manufacturers, co-producers, and assembly industries producing goods on a contract basis to bear minimum risk.

5.4 Transactional Net Margin Method

According to the transactional net margin method, the percentage net profit obtained by dividing the operating profit of the party being tested by the appropriate basis (cost, sales, and assets) is compared with the profit ratio of the operating profit of the comparable free transaction to the same basis, and the transaction value is derived according to arm length practice. Generally, such a ratio is derived on the basis of cost. If the purchase of the tested party is made by a related party, the purchase price is calculated according to arm length practice by deducting the net profit from the sale price made to an independent person, while if the purchase is made by a related party, the purchase price is calculated according to Arm length price practice by adding the net profit to the purchase and direct and indirect expenses. Operating profit is the profit after deducting direct and indirect expenses from income, but excluding interest and taxes.



Net Cost plus = Transaction Amount -(Direct Expenses + Operating Expenses)

=NPR.550- (450+50)=50

Net Cost plus Percentage as per Expenses = 50/500 =10%

Direct Expenses = NPR.900

Operating Expenses = NPR.100

Transfer Price = (Direct Expenses + Operating Expenses) x (1+ Net Cost plus Percentage as per Expenses)

=(NPR.900 + NPR.100) x (1+ 10%)

Therefore: Transfer Price = NPR.1100

Example 5.4.1

Kasthamandap Ltd. (a subsidiary of California Inc.) provides information technology services to its parent company, California Inc., located in the United States. The net operating profit of the company, including the services provided to the parent company, is 15%.

In this context, a search in two recognized databases found five comparable independent companies providing similar services near the business location of Kasthamandap Ltd. and the average operating profit of these companies was 17%.

The comparable independent companies have been providing such services for a long time. For this reason, they claim to provide more effective services and generally charge up to 34 times more profit than other companies providing similar services.

The average net profit of the comparable independent companies is adjusted using the Transactional Net Margin Method as follows: When comparing the net profit of Kasthamandap Ltd., the net profit ratio is higher, so no transfer price adjustment is required.

Details	Net Profit Ratio
Operating Profit of Five Comparable Companies	17%
(-)Adjustment for profit that is higher than that of general	3%
companies	14%
Net profit for comparison	15%
Net profit of Kasthamandap Ltd	0*
Transfer price adjustment	

*Since Kasthamandap Ltd.'s net profit is higher than the adjusted average net profit ratio of five comparable independent companies, there is no

need to adjust the transfer price.

a) Indicators to be taken for the net profit method of business:

In the net profit method of business, the result obtained by comparing operating profit with sales, costs and assets is generally taken as the basis. In using this method, the following indicators are taken as the basis.

Indicators	**Method of Calculation**	**Appropriateness**
Return on Assets	Operating profit/Operating Assets	Production work and leasing work
Return on Capital employed	Operating profit/ Capital employed	Production work and leasing work
Operating Margin	Operating profit/Sales	Sales distribution activities
Return on total cost	Operating profit/Total cost	Manufacturing industry
Berry ratio	Gross profit/Operating expenses	Service Distributor
Return on Cost of goods sold	Gross profit/Cost of Goods sold	Manufacturing industry

b) Issues to consider for comparability analysis in the net profit method of trading:

- Consideration should be given to factors that affect net profit (such as barriers to entry, competitive landscape, management effectiveness, business strategy, challenges from substitutes, cost structure, and business experience).

- If there are elements that significantly differ in the net profit, necessary adjustments should be made.

c) The net profit method of the transaction is suitable for use in the following transactions:

- When data on the total profit cannot be obtained and the resale price method and the cost plus method cannot be used.
- When the total profit differs due to differences in accounting.
- If one of the parties, a licensed manufacturer, bears the high risk and sales and distribution costs of carrying out all the work related to the product, or a related party has the right to the intangible asset
- This method is also used to check whether the results of the resale value and cost plus methods are appropriate.

5.5 Transactional Profit Split Method (TPSM)

As per the Transactional Profit Split Method, the profits or losses of persons engaged in controlled transactions are computed jointly and then split among the associated persons based on the ratio in which independent comparable persons would have earned profits, considering the significant economic contributions made. If no comparable transactions are available, the profit is split based on the relative value of the functions performed, assets used, and risks assumed, as analyzed in the comparability study. In cases involving more than two associated parties, the less complex party — one that does not own intangible assets — is allocated a routine return based on other transfer pricing methods reflecting arm's length principles. The remaining profit is then allocated among the parties using this method.

Example 5.5.1

Florida Incorporation, located in the United States, entered into a contract worth USD 200 million with one of its clients to develop a customized accounting software designed to streamline and simplify the client's accounting system.

Since developing this software solely within the U.S. would be more expensive, Florida Incorporation decided to carry out the work with the help of its subsidiary companies. Florida Incorporation itself would handle 50% of the work, while its subsidiaries in India and Nepal would carry out 30% and 20% of the work, respectively, under separate agreements.To complete its 20% share of the work, the Nepal-based subsidiary incurred a cost of USD 10 million in Nepal and issued an invoice of USD 15 million to its parent company, Florida Incorporation, for the services rendered.

Upon selling the completed software to the client, after deducting all expenses, Florida Incorporation earned a total profit of USD 60 million.

Using the Transactional Profit Split Method (TPSM) to determine the Arm's Length Price, it was found that the invoice value issued by the Nepalese subsidiary to the parent company is less than the Arm's Length Price. Therefore, a transfer pricing adjustment is deemed necessary.

Calculation of Arm's Length Price Based on Available Details:

Description	**Amount (in USD million)**

Total profit earned by Florida Incorporation (parent company)	60
Contribution of Nepalese subsidiary	20%
Independent arm’s length profit for Nepalese subsidiary (i.e., 20% of total profit)	12
Actual cost incurred by Nepalese subsidiary	10
Arm’s Length Price	22
Actual invoice value raised by Nepalese subsidiary	15
Transfer Pricing Adjustment Required	**7** *

Since the invoice value raised by the Nepalese subsidiary to its parent company is lower than the Arm’s Length Price (USD 22 million), a Transfer Pricing Adjustment required to comply with arm's length standards.

(a) When no comparable free transactions are available, profit allocation under the Transactional Profit Split Method (TPSM) should be based on certain indicators related to the creation of unique and valuable intangibles, such as:

- **Asset-based Allocation:** This method uses the relationship of tangible and intangible assets involved in asset creation as the basis for profit split.

- **Cost-based Allocation:** This method allocates profit based on the contribution of costs to value creation. For example:
    - If market-related intangibles (like brand value) are involved, profits can be allocated based on sales and distribution expenses.
    - If royalties or technical intangibles are involved, profits can be allocated based on research and development expenses.

(b) The Profit Split Method is appropriate for transactions with the following characteristics:

- When each related person involved in the controlled transaction makes unique and significant contributions, this method ensures a fair distribution of profits that reflects each party's role in the value creation process.
- If the transactions between the associated persons are so integrated that they cannot be separated,
- If both parties have borne economically significant risks,
- If both parties have used business-related intangible asset.

5.6 Determination of Arm's Length Price

Based on a comparability analysis, appropriate comparable transactions are selected, and necessary financial indicators for comparison are derived using a suitable method for determining the arm's length price. Among the indicators thus derived, it is necessary to identify which one, or to what extent, reflects the arm's length principle. For this purpose, the following methods must be used:

(a) Interquartile Range Method:

When there are seven or more comparable transactions, the interquartile range method must be used. For the purpose of this method, the 35th percentile to the 65th percentile is considered as the arm's length range. According to this method, if the financial indicators of the tested party fall within the range determined by the 35% to 65% percent of comparable free transactions, or within 5% above or below the minimum or maximum financial indicator falling within that range, the transaction is considered to be at arm's length. If the financial indicators fall outside this range, the transaction is considered not to be at arm's length, and necessary adjustments must be made.

If the transaction of the tested party does not fall within the above-mentioned range, the median of the comparable transactions' indicators shall be taken as the basis. The difference between this median and the financial indicator of the tested party shall be calculated, and the amount equivalent to that difference shall be adjusted accordingly for the purpose of tax assessment.

Example 5.6.1

Let's assume that Api Ltd. is engaged in the business of software development. The head office of Api Ltd. is Adobe Inc., located in the United States. Api Ltd. provides software-related services to its head office. In the economic analysis, a total of 8 comparable companies have been included for this year.

The operating profit margins of these eight companies are as follows:

S.N.	Operating Profit margin
Company 1	12.44%
Company 2	6.00%
Company 3	9.86%
Company 4	10.87%
Company 5	36.13%
Company 6	7.71%
Company 7	21.30%
Company 8	5.32%

Step 1

Company	8	2	6	3	4	1	7	5
Operating profit margin	5.32%	6	7.71	9.86	10.87	12.44	21.30	36.13

Step 2

Lower Range = Total number of data points in the dataset × (35/100)

Upper Range = Total number of data points in the dataset × (65/100)

35th percentile data point: $8 \times 0.35 = 2.8$

The operating profit at the 3rd position = 7.71%

65th percentile data point: $8 \times 0.65 = 5.2$

The operating profit at the 6th position = 12.44%

Therefore,

The arm's length range will be from 7.71% to 12.44%.

Step 3

(a) If the operating profit margin in the international transaction lies between 7.71% or more and 12.44% or less, then it shall be considered to fall within the arm's length range.

(b) However, if the international transaction falls outside the arm's length range by more than 5%, the median of the dataset shall be used to determine the arm's length price.

Case 1: Suppose the company's operating profit margin in the said transaction is 8%. In that case, it shall be considered to be within the arm's length range and hence at arm's length price.

Case 2: Suppose the company's operating profit margin is 7.5%. Since this is within 5% of the lower bound of the arm's length range, it shall also be considered at arm's length price.

Case 3: Suppose the company's operating profit margin is 4%. Since this falls outside the 5% deviation from the lower range, an adjustment needs to be made as follows:

Median of the dataset: (8+1)/2 = 4.5

Therefore, median value = (9.86% + 10.87) / 2 = 10.37%

Hence, the arm's length price is 10.37%, and the adjusted price should be calculated as follows:

10.37% – 4=6.37%

b) Average Method

If there are six or fewer comparable transactions, the average method must be used. Under this method, the average of the financial indicators determined according to the appropriate arm's length pricing method of the comparable transactions is calculated.

If the tested party's financial indicator is within 5 percent above or below the average financial indicator of the comparable uncontrolled transactions, it shall be considered to be at arm's length. If the difference exceeds this range, the transaction shall be considered not to be at arm's length. In such cases, the tested financial indicator shall be adjusted by comparing it with the average financial indicator of the comparable uncontrolled transactions, and the difference shall be used for adjustment and tax determination.

Example 5.6.2

Let's assume that Alpha Ltd. is engaged in the business of software development. The head office of Alpha Ltd. is located in Adobe Inc., United States. Alpha Ltd. provides software-related services to its head office. This year, operating profit data of only 5 comparable companies engaged in similar transactions as Alpha Ltd. is available. The comparative operating profit margins of those companies are as follows:

S.N.	Operating Profit margin
Company 1	12.44%
Company 2	6.00%
Company 3	9.86%

Company 4	10.87%
Company 5	36.13%

Step 1

The average operating profit margin
of the five comparable companies=

$$\frac{12.444\%+6.00\%+9.86\%+10.87\%+36.13\%}{5}$$

=15.06%

Step 2

Case 1:

If Alpha Ltd.'s operating profit is (15.06*95%=14.3%) or more than it, it shall be considered to be within the arm’s length range.

Case 2:

Suppose Alpha Ltd.'s actual operating profit is only 10%,
Difference with Arm length price= (15.06%-10%) = 5.06%
Hence, an adjustment of 5.05% % must be made to bring Alpha Ltd.'s operating profit in line with the arm’s length standard.

Chapter- 6

Transfer Pricing Documentation

6.1 Recording and Documentation of Transactions

Section 77 of the Act provides that, for the implementation of the Income Tax Act and the rules made under the Act, the Department may prescribe the format of necessary documents incorporating the information, details, and data as required. Pursuant to this provision, taxpayers are required to maintain records of cross-border controlled transactions conducted with associated persons, along with additional documents as specified in Schedule-1 and Schedule-2 of this Directive. However, this requirement shall not be mandatory for taxpayers whose annual cross-border controlled transactions amount to less than NPR 100 million.

Following provisions relating to the Format of Documents are enlisted under Section 77 of the Act:

Subsection (1) For the effective implementation of this Act and the rules made under it, the Department may, from time to time, prescribe the necessary formats for documents, income statements, tax withholding details, the method and format of filing such details, and the format of records to be maintained, incorporating the information, particulars, and data as required under this Act.

Subsection (2) The Department shall make the formats prescribed under Subsection (1) publicly available at the Department

and other locations designated by the Department, as well as through other means.

Subsection (3) The Department may require that any person submit the information, particulars, or documents to be filed with the Department in electronic form.

As per Section 81 of the Act, taxpayers are required to maintain in Nepal the necessary documents prescribed by the Department. Therefore, the documents specified in Schedule-1 of this Directive must be prepared by the taxpayer and securely maintained in such a way that they are readily available for inspection when requested or reviewed by the Department. Failure to maintain such documents in Nepal shall result in the imposition of a fee in accordance with the provisions of the Act.

Following provisions relating to Records and Information are enlisted under Section 81 of the Act:

Subsection (1) Each person who is liable to pay tax pursuant to this Act has to maintain in Nepali the following necessary documents, in addition to the documents required to be maintained in the format or type as prescribed by the Department or to be certified or authenticated by audit or in other manner:

(a) Necessary information and documents supporting the income returns or any other documents required to be submitted to the Department pursuant to this Act,

(b) Documents assisting to assess the tax payable by him,

(c) Documents supporting the deduction of expenses.

Subsection (2) Except as otherwise specified by the Department by issuing a notice in writing, the documents referred to in this Section have to be safely retained for five years from the date of expiration of the concerned income year.

Subsection (3) If any document referred to in subsection (1) is not in the Nepali or English language, the Department may, by issuing a notice in writing, require the related person to submit the translated version of such document in the Nepali language done, at such person's own cost, by a recognized translator under the law in force.

Subsection (4) The Department may, upon prescribing the standards and procedures, give approval to any person to issue invoices through electronic means and to keep the documents required to be kept under subsection (1) through electronic means.

6.2 Certification by Auditor

Taxpayers carrying out cross-border controlled transactions with related parties must have the documents specified in Schedule-1 of this Directive certified by an auditor in the format prescribed in Schedule-2.

6.3 Qualifications of Auditor

6.3.1 Only individuals who are registered with the Institute of Chartered Accountants of Nepal under Chapter-4 of the Nepal Chartered Accountants Act, 1996, and have obtained a professional certificate under Section 28 of the same Act, shall be eligible to certify the documents as prescribed in this Directive.

6.3.2 In cases where the cross-border transactions of goods, services, or both between related parties exceed NPR 500 million, the certification must be done by an auditor other than the one conducting the financial/tax audit. Such an auditor must have at least five years of experience working in the field of auditing.

6.4 Submission of Details

Section 96 of the Act requires every person to submit an income return. While submitting such return, if the Department prescribes the inclusion of additional information or documents beyond what is specified in that section, such information must also be submitted as prescribed. Therefore, any person required to comply with this Directive must submit the details certified by an auditor as per Schedule-2 of this Directive along with their income return. Failure to submit the documents in the format prescribed in Schedule-2 of this Directive along with the income return shall be subject to fees as provided by the Act.

The provisions related to income return under Section 96 of the Act are as follows:

Subsection (1) each person shall, within three months of expiration of an income year, and subject to Sections 97, 98 and 100, submit an income return of that year in the place as specified by the Department.

Subsection (2) the income return referred to in subsection (1) shall be as follows:

(a) It has to be prepared in the manner and format as specified by the Department, setting out the following matters:

(1) Assessable income earned by that person from each employment, business or investment in that year and source of such income,

(2) Taxable income of that person in that year and the tax to be imposed on the person referred to in clause (a) of Section 3 in respect of that income,

(3) Income sent abroad in that income year by a non-resident person's foreign permanent establishment situated in Nepal, and the tax imposable in that income,

(4) ………

(5) ………..

(6) Such other information and details as specified by the Department.

Subsection (3) if any person, except in capacity of an employee, prepares or assists in preparing the income return of any other person or the documents or details to be accompanied with the income return in lieu of any payment, such a person has to certify the following matters:

(a) Having examined the documents maintained by other person pursuant to Section 81, and

(b) Having the circumstances in question been actually reflected from the details or information.

Subsection (4) if the person required to certify the return pursuant to subsection (3) refuses to certify, information, setting out the reasons for such refusal, has to be given to the person whose income return is to be certified.

Subsection (5) The Department may, in the following circumstances, require any person to submit the income return of an income year or any part of the income year within the time-limit mentioned in the written notice given by it to such person subject to Section 100 prior to the due time-limit for submission of the income return of the income year pursuant to subsection (1):

(a) If that person becomes bankrupt, insolvent or is dissolved,

(b) If that person is to leave Nepal for an uncertain period of time,

(c) If that person is leaving the act being carried out by him in Nepal, or

(d) If the Department otherwise thinks it proper.

Subsection (6) If any person wishes to amend his or her income return submitted to the Department within the time-limit for its being otherwise, that person may amend the income return within thirty days of the date of its submission in accordance with the process specified by the Department.

Chapter-7

Transfer Pricing Administration

7.1 Provisions Related to Transaction Audit

Section 101 of the Act provides for reassessment of tax by the Department. If the Department believes that the transfer pricing determined by the taxpayer is not consistent with arm's length principles or general market practices, it may reassess the tax and make necessary adjustments pursuant to Sections 33 and 101 of the Act.

The process of reassessment shall be conducted in accordance with Sections 101 and 102 of the Act, the Income Tax Rules, 2009 (with amendments), and the circulars and directives issued by the Department.

Under listed are Provisions Related to Reassessment of Tax under Section 101 of the Act:

Subsection (1) The Department may reassess the tax liability of a person whose tax has been assessed under Section 99 or 100 in order to make a fair and reasonable adjustment in line with the objectives of this Act.

Subsection (2) if deemed necessary, the Department may further revise the reassessed tax made under subsection (1), as many times as required, on a fair and reasonable basis.

Subsection (3) The Department must complete any reassessment under subsection (1) or (2) within four years from the following dates:

(a) In the case of tax assessed under Section 99 — the date on which the income return was required to be submitted;

(b) In the case of tax assessed under subsection (2) of Section 100 — the date on which the tax assessment notice was issued to the person under Section 102;

(c) In the case of reassessment under subsections (1) or (2) — the date referred to in clause (a) or (b) related to the original assessment being revised.

Subsection (4) notwithstanding anything written in subsection (3), if a person's tax assessment is found to have been made improperly due to fraud, the Department may revise such assessment at any time. However, such reassessment must be completed within one year from the date on which the fraud or the fraudulent submission of details or assessment comes to the knowledge of the Department.

Subsection (5) notwithstanding anything mentioned in subsection (3), if the tax assessment has been revised or the assessed tax has been reduced by the Revenue Tribunal or any other competent court, the Department shall not revise the assessment to that extent. However, if an order for re-investigation is issued, it shall not be considered a restriction on making such a revision.

Subsection (6) while revising a tax assessment under this section, the Department must clearly state the grounds for such revision and provide written notice to the concerned person, allowing them a period of fifteen days to submit evidence or clarification related to the assessment.

Under listed are the Provisions Related to Notice of Tax Assessment under Section 102 of the Act

Section 102: The Department must provide a written notice of tax assessment made under subsection (2) of Section 100 or under Section 101 to the person whose tax has been assessed, clearly stating the following:

(a) The outstanding tax payable, as per Section 3(a) and (b), for the relevant income year or period;

(b) The method used to calculate the tax as mentioned in clause (a);

(c) The reasons for which the Department has made the tax assessment;

(d) The deadline by which the outstanding tax must be paid; and

(e) The timeframe, venue, and procedure for filing an appeal if dissatisfied with the tax assessment.

7.2 Fees, Interest, and Penalties

If a taxpayer fails to maintain the documents prescribed by the Act or as required by the Department under the Act, or fails to submit the necessary details, a fee shall be levied under Section 117 of the Act.

Similarly, if a taxpayer who is required to pay tax in installments fails to pay such installment on time, interest shall be levied under Section 118. Likewise, if any tax due under this Act is not paid within the prescribed time, interest shall be charged under Section 119. If it is found that the tax declared and paid by the taxpayer is less than what is actually due, a fee shall also be levied under Section 120.

Under listed are the provisions related to fees for failure to maintain documents or to submit details or income returns, as per Section 117 of the Act:

Subsection (2) **If a person fails to maintain the documents required under Section 81 for any income year, a fee shall be charged for that particular year. In such cases, while calculating the assessable income, any amount that would otherwise be deductible shall not be deducted, and any amount that should be included shall be added. The fee shall be the higher of either 0.1 percent of the assessable income calculated after making such adjustments or NPR 1,000.**

Section 118 – Interest to be charged where person making payment in installment makes lesser payment of estimated tax:

Subsection (1) Where a person pays an installment amount pursuant to Section 94 for any income year that is less than the amount prescribed under clause (b) below, interest shall be imposed on the difference as provided under subsection (2). For the purposes of this provision,

(a) Denotes the amount actually paid by the person for each installment during the income year; and

(b) denotes the total amount required to be paid as installments for each installment period of the income year, based on the estimated or revised estimated tax liability, if such estimation is accurate; failing which, the amount shall be calculated as ninety percent of the tax payable for each installment period by the persons referred to under Section 3(a) and (b) of the Act.

Subsection (2) Interest at the prevailing monthly rate shall be charged on the shortfall amount from the due date for payment of the installment until the following periods:

(a) In the case of a person whose tax assessment has been made under subsection (1) of Section 99, until the date for submission of the income return;

(b) In the case of a person whose tax was not assessed under subsection (1) of Section 99 and for whom the Department has made the first reassessment under Section 101, until the date on which the notice of such reassessment is delivered as per Section 102.

<u>Explanation:</u> For the purposes of this section, the term "amount to be paid in installments" means the installment amount calculated as those who have submitted an estimate once and do not submit a revised estimate thereafter, or for those who have not submitted any estimate and the Department has made an estimate under subsection (7) of Section 95, the installment amount shall be calculated pursuant to subsection (1) of Section 94 based on such Department estimate. For those

who submit a revised estimate, or for whom the Department is not satisfied with the submitted estimate or revised estimate and has made an estimate under subsection (7) of Section 95, the installment amount shall be calculated according to the provisions of subsection (5) of Section 95.

Under listed are Provisions Related to Interest to be charged if tax is not paid under section 119:

Subsection (1) If any person does not pay tax on the prescribed due date for payment of tax, an interest by the normal rate of interest, for each month and portion of the month, in the amount due and payable shall be imposed on the person for the period during which tax is so due and payable.

Subsection (2) For the purpose of computing the interest to be paid pursuant to subsection (1), interest shall not be exempted in the extended time-limit given pursuant to Section 98.

Section 119(A) Charge to be imposed:

Except as otherwise provided in this Act, there shall be imposed a charge of five thousand to twenty-five thousand rupees on a person who does not comply with any provision of this Act or the Rules framed under this Act

Under listed are Provisions Related to Charge to be imposed on the person who submits false or misleading statement under Section 120:

If any person submits to the Department a false or misleading statement on any matter or the information mentioned in the

statement becomes misleading as a result of concealing information of any matter or thing required to be submitted or removing such information from the statement, the following charge shall be imposed on such a person:

(a) If it has become false or misleading not by knowingly or recklessly but by mistake, fifty percent of the amount less resulted therefrom.

(b) If it has become false or misleading knowingly or recklessly, one hundred percent of the amount less resulted therefrom.

Explanation: For the purposes of this Section, "statement submitted to the Department" means any statement submitted in writing to the Department or to the officer authorized by the Department in the course of performing the duty pursuant to this Act and includes the statement submitted as follows:

(a) Application, notice, complaint, description, deposition, or other document submitted, prepared, given or furnished pursuant to this Act,

(b) Document submitted to the Department or any officer of the department except under this Act,

(c) Reply to any question asked by the Department or any officer to any person, or

(d) Information given by any person who has reasonable knowledge of the matter to be informed to the Department or any officer through any other person.

7.3 Advance Pricing Agreement

Pursuant to Section 33 of the Act and Rule 15 of the Rules, provisions are made for advance pricing agreements based on the arm's length price.

Subsection (1) Where one or more persons submit a written request to the Department seeking clarity regarding the allocation, apportionment, or distribution of amounts to be included or deducted in calculating income under subsection (1) of Section 33 of the Act, based on the arm's length price, the Department may issue a written notice specifying the following:

(a) The period of the written notice shall not exceed five income years at a time;

(b) Notwithstanding clause (a), the written notice may be subject to renewal.

Subsection (2) The written notice issued under sub-rule (1) shall be binding on both the Department and the requesting party. However, if the Department agrees to the request of the concerned applicant, such written notice shall be rendered inactive.

Rule 15 of the Regulations provides for advance pricing agreements in relation to the determination of transfer prices based on the arm's length principle under subsection (1) of Section 33 of the Act. Under the said regulation, taxpayers may submit an application to the Department concerning methods and procedures for transfer pricing and transaction price determination. To implement the provisions related to advance pricing agreements, the Department shall issue notices specifying the methods, procedures, and other necessary arrangements for price determination.

7.4 Administrative Review

A taxpayer who is dissatisfied with the reassessment of tax made under Sections 33 and 101 of the Act and in accordance with this Directive may file an application for administrative review with the Department pursuant to Section 115 of the Act.

The provisions regarding the eligibility and procedure for filing an application for administrative review are provided as follows under Section 115 of the Act:

Subsection (1) **A person dissatisfied with the decision on administrative review under Section 114 may file an application with the Department against such decision within thirty days from the date of receipt of the notice of that decision.**

Subsection (2) **The application submitted under subsection (1) must clearly state the reasons and grounds for requesting the review.**

Subsection (3) **If the deadline for submitting the application under subsection (1) has expired, the Department may, upon receiving an application for extension within seven days from the expiry date, take the following actions:**

(a) If reasonable cause is shown, grant an extension of up to thirty days from the original deadline for submission; and

(b) Provide written notice of the Department's decision regarding the application to the applicant.

Subsection (4) **The submission of an application under subsection (1) shall not be deemed to affect the implementation of the decision referred to in subsection (1) of Section 114.**

Subsection (5) **Notwithstanding anything stated in subsection (4), until the application submitted under subsection (1) is finally disposed of, the Department may hold the decision made under subsection (1) of Section 114 in abeyance or otherwise suspend or affect it.**

Subsection (6) **The person submitting the application under subsection (1) shall pay the full amount of undisputed tax and one-fourth of the disputed tax amount as determined.**

Subsection (7) **The Department may, in relation to the application submitted under subsection (1):**

(a) Accept or reject, wholly or partly, the matters stated in the application; and

(b) Provide written notice of the decision on the application to the person concerned.

Subsection (8) **If the Department fails to provide a decision notice to the applicant within sixty days from the date of submission of the application under subsection (1), the applicant may file an appeal with the Revenue Tribunal pursuant to Section 116.**

Subsection (9) **Upon filing such appeal under subsection (8), the appellant shall, within fifteen days from the date of filing the**

appeal, submit a copy of the appeal petition along with written notification to the Department.

7.5 Appeal

A taxpayer who is dissatisfied with the revised tax assessment made under Section 101 of the Act based on transfer pricing adjustment pursuant to Section 33 may file an application for administrative review with the Department under Section 115 of the Act.

If the taxpayer is not satisfied with the decision made by the Department on such application, they may file an appeal with the Revenue Tribunal in accordance with Section 116 of the Act and the Revenue Tribunal Act, 2031 (1974).

The provisions relating to appeals before the Revenue Tribunal under Section 115 of the Act are as follows:

Subsection (1) **A person dissatisfied with the decision of the Department on the application filed under Section 115 may file an appeal before the Revenue Tribunal in accordance with the Revenue Tribunal Act, 2031 (1974).**

Subsection (2) **The appellant shall submit a copy of the appeal notice to the Department within fifteen days of filing the appeal.**

Subsection (3) **The filing of an appeal under subsection (1) shall not be deemed to affect the implementation of the decision referred to in subsection (1) of Section 114.**

Subsection (4) **Notwithstanding anything stated in subsection (1) of Section 114, if the Director General has made a decision allowing administrative review under that subsection, the**

matter shall be subject to appeal before the Revenue Tribunal.

Subsection (5) **When filing an appeal before the Revenue Tribunal under subsection (1), the appellant shall deposit the undisputed tax amount in full, and fifty percent of the disputed tax amount, penalties, and fines as bail or provide an equivalent bank guarantee.**

Subsection (6) while calculating the amount of bail or bank guarantee under subsection (5), twenty-five percent of the tax amount submitted to the Internal Revenue Department for administrative review shall also be included.

Schedule-1

<u>List of Documents to Be Maintained by Taxpayers Regarding Transfer Pricing</u>

(a) Documents Related to Information about the Entity:

(1) Organizational structure of the Group Company and general information about the company

(2) General information about the taxpayer, including:

- Ownership structure, management structure, organizational chart
- General information about the taxpayer's business and business strategy
- Detailed information about any business restructuring of the taxpayer in the current and previous income years
- Information about main competing companies

(b) Documents Related to Cross-Border Transactions between related Persons:

(1) Details revealing the nature, quantity, and value of transactions between associated persons

(2) Basic information about the associated persons involved in the transactions

(3) Documents related to any written agreements entered into between associated persons for such transactions

(4) Information about transactions conducted under abnormal circumstances (if any)

(c) Documents Related to Pricing Based on the Arm’s Length Price:

(1) Detailed functional analysis of the taxpayer and associated companies along with a comprehensive comparability analysis.

(2) The criteria used for selecting the tested party.

(3) If a foreign party is chosen as the tested party, relevant data pertaining to that party.

(4) Details of comparable uncontrolled transactions selected for comparison, including the source of data and the method of selection.

(5) Details of any comparability adjustments made.

(6) The method selected for determining the arm’s length price and the reasons for choosing that method.

(7) Calculation details of the arm’s length range.

Schedule-2

Details to Be Certified by the Auditor and Submitted Along with the Income Statement

1. Basic Information of the Taxpayer-

Name		Permanent Account Number	
Address		Fiscal Year	
Type of Business		Total Amount of International Cross-Border Transactions between related Persons	

2. Details of the organizational structure (Organizational Tree) revealing the taxpayer's beneficial ownership of related persons, including all levels between them. (Organizational tree)-

3. Details of person related to cross border trading-

S.N.	Name of related Person	Address of related Person	Relation between the related person	Brief details of business of related person

4. In case of purchase and sale of trading goods with related persons, the details shall include-

S. N.	Name and address of related person	Name of Goods	Nature of Goods (Raw material, Semi-finished or finished goods)	Quantity of Goods and unit	Total value of transactions NPR.			Method of determining Arms' length price	Tested party
					As per the record of taxpayer	As per Arms' length price	Adjusted Price Based on Transfer Pricing		

5. In case there has been any purchase or sale of tangible assets other than trading goods with related parties, the details are as follows:

S.N	Name and address of related person	Name of the Assets	Nature of Assets	Quantity and unit of assets	Total value of transactions NPR.			Method of determining Arms' length price	Tested party
					As per the record of account of taxpayer	As per Arms' length price	Adjusted Price Based on Transfer Pricing		

6. In case there has been any purchase or sale service with related parties, the details are as:

S.N	Name and address of related person	Name of the service	Nature of service	Quantity and unit of service	Total value of transactions NPR.			Method of determining Arms' length price	Tested Party
					As per the record of account of taxpayer	As per Arms' length price	Adjusted price based on transfer price		

7. Details of Purchase and Sale of Other Intangible Assets with Related Parties

S.N	Name and address related person	Name of the Assets	Nature of Assets (Royalty, management Charge etc)	Quantity and unit of Assets	Total value of transactions NPR.	Method of determining Arms' length price	Party tested

					As per the record of account of taxpayer	As per Arms' length price	Adjusted price based on transfer price		

8. Details of Loans Taken from or Given to Related Parties

S.N	Name and address of related person	Nature of financial Agreement	Currency of transaction	Loan Amount	Total value of transactions NPR.			Method of determining Arms' length price	Party tested
					As per the record of account of taxpayer	Method of determining Arms' length price	Adjusted price based on transfer price		

9. Details of Share Transactions with Related Parties

(Including information on any change in beneficial ownership)

S.N	Name of the buyer and seller of shares	Nature of share transaction (purchase or sale)	No of share purchase and sale	Currency of transaction	Total value of transactions NPR.			Method of determining Arms' length price	Tested party
					As per the record of account of taxpayer	As per Arms' length price	Adjusted price based on transfer price		

10. Details of Other Transactions (if any) with Related Parties Not Covered under Points 1 to 9

S.N	Name of the related person	Details of transaction	Nature of Transaction	Quantity and unit of transaction	Total value of transactions NPR.		Method of determining Arms' length price		Tested party
					As per the record of account of taxpayer	As per Arms' length price	Adjusted price based on transfer price		

11. Declaration of an Auditor

I/We have examined the accounts and records related to the cross-border transactions between related parties of the taxpayer ....… for the income year……. Based on my/our examination, it is found that the records maintained by the taxpayer regarding transactions with related parties are in accordance with the provisions of the Income Tax Act, 2001 and the Transfer Pricing Directives, 2024. Based on the information and documents provided by the taxpayer, I/We hereby certify that the details mentioned in Points 1 to 10 of this schedule are true and complete.

Details of the certifying auditor:

Signature:

Name:

Address:

Contact No.:

Membership No.:

Professional Certificate No.:

Permanent Account Number (PAN):

Note: The auditor must affix signature and stamp on each page.