tax notes international
Volume 71, Number 12 ■ September 16, 2013

Tripping Over Transfer Pricing Regulations in India

by Mihir Naniwadekar and T.P. Janani

Reprinted from *Tax Notes Int'l*, September 16, 2013, p. 1127

PRACTITIONERS' CORNER

Tripping Over Transfer Pricing Regulations in India

by Mihir Naniwadekar and T.P. Janani

Mihir Naniwadekar and T.P. Janani are associates with Nishith Desai in Mumbai.

The amount locked up in litigation in direct tax cases in India on September 30, 2012, was INR 1.002 trillion (about $15.4 billion).[1] The transfer pricing adjustments made in 2012-2013 alone were INR 700 billion (about $10.8 billion).[2] In the recent past, a large majority of direct tax disputes have been decided initially in favor of the tax authorities but later in favor of the taxpayer at appellate levels in tribunals and courts.[3] The taxpayer is required to deposit the whole or a significant portion of the disputed amount before pursuing appellate proceedings, and any refund of deposits on reversal of the judgment appealed against must be made with 6 percent interest per annum. Therefore, the tax authorities are leading the Indian government into a debt trap.

Much of the analysis of transfer pricing litigation in India has concentrated on the adoption of the right method for determining the arm's-length price (ALP). This article attempts to explore issues beyond those questions, particularly the issues at the very root of the regulation — the extent to which the transfer pricing regulations are fair, just, and reasonable (according to article 21[4] read with article 265[5] of the Constitution of India).

Transfer pricing regulations are provisions to determine income arising from transactions carried out between associated enterprises such that the income would be equivalent to the income that would have arisen had the enterprises not been associated. The objective of the determination is to prevent artificial profit shifting to enterprises situated in jurisdictions with relatively lower tax rates or that are otherwise taxed at lower rates by virtue of exemptions, special deductions, setoff of losses carried forward from previous years, and so forth.

In 2001 transfer pricing regulations were introduced in India in an amendment to the Income Tax Act, 1961. The following table captures some of the important provisions of the transfer pricing regulations (along with comparison of the position in other countries whenever possible), the analysis of which is vital to understanding whether the Indian transfer pricing provisions are fair, just, and reasonable.

---

[1] "Enough: Govt May Choose to Draw the Line on Tax Litigation With Firms," *The Indian Express* (Apr. 25, 2013), *available at* http://www.indianexpress.com/news/enough-govt-may-choose-to-draw-the-line-on-tax-litigation-with-firms/1107372/0.

[2] Ministry of Finance, "Tax Evasion by Foreign Companies," Press Information Bureau, Government of India (Aug. 30, 2013), *available at* http://pib.nic.in/newsite/erelease.aspx?relid=99349.

[3] In 2011-2012, in appeals cases filed by the taxpayer at the tribunal, High Court and Supreme Court level, 36 percent, 38 percent, and 33 percent, respectively, have been decided wholly in favor of the taxpayer, compared to 35 percent, 36 percent, and 14 percent, respectively (that is, slightly less), decided wholly in favor of the tax authorities. For the same period, in case of appeals filed by the tax authorities, only 19 percent, 20 percent, and 10 percent, respectively, were decided wholly in favor of the tax authorities, compared to 52 percent, 62 percent, and 39 percent, respectively (almost triple), decided wholly in favor of the taxpayer (Report of the Standing Committee on Finance on Demand for Grants (2013-2014) of the Ministry of Finance (Department of Revenue), dated Apr. 16, 2013).

[4] Article 21 reads: "Protection of Life and Personal Liberty: No person shall be deprived of his life or personal liberty except according to procedure established by law"; in *Maneka Gandhi v. Union of India* (AIR 1978 SC 597), the Supreme Court of India held that the procedure prescribed by "law" referred to in article 21 should be one that is fair, just, and reasonable.

[5] Article 265 reads: "Taxes not to be imposed save by authority of law: No tax shall be levied or collected except by authority of law."

Background	Position in India	Contrasting Position in Other Prominent Jurisdictions
a) Burden of Proof		
Many countries with transfer pricing regulations have made it mandatory for associated enterprises to prepare and submit documentation on the determination of ALP in respect of the various transactions they enter into among themselves. Leaving apart such documentation, countries differ with respect to whether they impose the burden of proof on the taxpayer or the tax officials so as to arrive at an ALP which is different from the one reflected in the documentation submitted by the taxpayer.	The concerned tax official merely has to form an opinion that the ALP determined by the taxpayer is not in accordance with statutory provisions, or that the information used for computation thereof is not reliable/correct (*instead of having to substantiate the same*). It is the taxpayer who has to show why the ALP suggested by the tax official is not correct. While it has been judicially interpreted[a] that once a taxpayer presents a reasonable argument and evidence to suggest that its transfer pricing was at arm's length, the burden of proof shifts to the tax officials to establish why the taxpayer's transfer pricing was not at arm's length, the tax officials, particularly lower level officials, reject the taxpayer's determination of ALP as a matter of routine without assigning reasons and shift the burden of proof to the taxpayer by asking the taxpayer to show cause as to why the determination made by the tax officials should not be adopted. The harshness of the imposition of such burden of proof on the taxpayer becomes more prominent when seen in light of: (i) judicial interpretation[b] that absence of motive to avoid tax or to shift profits outside India is not a defense against applicability of the transfer pricing provisions; and (ii) *the difficulty in treating transfer pricing regulations as charging provisions*[c] (compared with mere rules of evidence, for the application of which requires some real evidence of tax evasion).	**U.K.** — If the taxpayer's transfer pricing position is reasonable and well documented, the tax authorities will have to demonstrate that it is wrong before an adjustment can be imposed. **Australia** — If the tax office's view of the relevant ALP is materially different to that adopted by the taxpayer, a position paper is issued by the Australian Taxation Office (ATO) *setting out the basis for the ATO's determination*. The taxpayer has an opportunity to respond to the position paper before the ATO makes a final decision. **Japan** — The *tax authorities bear the burden of proof* for the allegation that the transfer pricing method applied by the tax authorities accords with one of the methods provided for under Japanese tax law. **U.S.** — While the taxpayer has to bear the burden of proof in showing both that the tax authorities' determination of ALP is arbitrary, capricious, and unreasonable, and that the ALP determined by it is accurate, the tax authorities are required to provide the taxpayer with an explanation as to how their adjustment was determined.
b) Reciprocity — Whether Both Upward and Downward Adjustments Are Made?		
Where tax officials determine the ALP with respect to a transaction (different from the one determined by the taxpayer) and make an adjustment with respect to the income of one of the associated enterprises to the transaction, there could be double taxation of such additional income if a corresponding adjustment (or downward adjustment) is not made with respect to the income of the other associated enterprise(s).	In cases where tax is required be deducted at source according to the Indian Income Tax Act, 1961, by way of a withholding/similar procedure and an upward adjustment is made in case of the payer, *downward adjustment is not permissible* in case of the payee.	**U.S. and U.K.** — When an ALP adjustment is made, the corresponding downward adjustment is also *allowed*. **South Africa** — When an ALP adjustment is made, the corresponding downward adjustment is also *allowed, if the enterprise in question is resident in a jurisdiction with which South Africa has a tax treaty*. **Canada** — The tax officials allow corresponding adjustments *in accordance with the provisions of the relevant tax treaty*, subject to the tax officials being satisfied that the primary adjustment made by the treaty partner's tax officials is in order.

Background	Position in India	Contrasting Position in Other Prominent Jurisdictions
c) Quantum of Penalty		
It is a widely accepted principle that determination of ALP is not an exact science, is undertaken by way of a subjective analysis, and is largely dependent on data integrity, which is difficult (if not impossible) to determine. It is merely the determination of an estimate. Penalty imposed by transfer pricing regulations, though treated as a civil penalty, is nothing but punishment for wrongdoing and thereby has an element of criminal penalty. Therefore, the extent to which wrongdoing can be attributed with respect to a calculation, for an undertaking for which there is no objective/scientific method, is something that needs to be handled very carefully.	If ALP determined by the taxpayer differs from the one determined by the tax officials by a margin of more than 3 percent, *interest is levied at 12 percent per annum and penalty can be imposed up to 300 percent* of the additional income tax liability. There are no binding guidelines to determine the different factors that aggravate or reduce the quantum of penalty within the 300 percent limit. Moreover, in practice penalties are levied, particularly by lower level tax authorities, as a matter of routine whenever an additional tax liability is ascertained by the tax authorities and the burden of proof is on the taxpayer to show good and sufficient reasons for default and to prove non-concealment of income and particulars thereof.	**U.S.** — In case of transfer pricing, the maximum penalty that could be imposed is 40 percent. There are clear rules prescribed regarding the quantum of penalty that could be imposed.[d] **U.K.** — *Maximum penalty imposed is 60 percent* of the additional tax liability, except in cases involving deliberate and/or unconcealed action. **Australia** — The tax officials may impose interest as well as penalties. Penalty could *range from 10 to 50 percent* of the additional tax liability. **Japan** — The penalty for understatement *range from 10 to 15 percent* of the corporation tax additionally imposed. The delinquency tax (equivalent to interest) is currently 4.3 percent per annum (four percentage points above the Central Bank's interest rate of 0.3 percent per annum). **Canada** — *Maximum penalty up to 10 percent* of the additional tax liability is levied. **South Africa** — Differing quantum of penalty has been prescribed depending on the levels of culpability involved and on whether there is voluntary disclosure post-audit. The *maximum understatement penalty (except in case of repeat offense) is 75 percent* of the additional tax imposed. **Brazil** — In the absence of fraud and/or nonadherence with notifications issued during investigation by the tax officials, *penalty up to 75 percent* of the additional tax liability could be levied.
d) Advance Pricing Agreement		
A lot of uncertainty arises in relation to compliance with transfer pricing provisions by virtue of the fact that determination of the ALP is an exercise involving subjective analysis and is not an exact science. Therefore, to reduce uncertainty and avoidable litigation, many countries have introduced advance pricing arrangements, whereby the taxpayers can enter into an agreement with the tax officials in advance (that is, prior to a dispute arising) on the determination of ALP. Such agreements can be classified into unilateral, bilateral, and multilateral, depending on the number of countries whose tax officials are involved. Agreement involving tax officials from two or more countries is sought by a taxpayer where there is a possibility of double or higher taxation arising from different ALP determination by tax officials in different countries with respect to the same transaction. This is generally carried out in accordance with the mutual agreement procedure (MAP) prescribed in the bilateral tax treaties between such countries. A large majority of APA proceedings that have taken place in the world are bilateral.	The APA was introduced in India in 2012. The following are some of its important characteristics: • valid for a maximum period of five years; • contract binding on the taxpayer and the relevant tax officials; • would cease to be binding if there is a change in law; • *no relief from compliance with mandatory documentation* requirements for determination of ALP; • pending APA, *no relief from regular proceeding* for ALP determination; • in bilateral and multilateral APAs, *neither is an applicant permitted to be part of the discussions between the tax officials nor are the tax officials bound to communicate with or consult the applicant* on APA negotiations; and • for an applicant to be able to enter into an APA with the tax officials, the agreement as approved by the tax officials is also required to be approved by the central government, thereby *necessitating approval by multiple authorities.*	**U.S., Canada, U.K., and Japan** — The transfer pricing method agreed upon for the term of the APA can be sought by the taxpayer to be extended for a period immediately prior to the commencement of such term (the *rollback period*), unless the functions performed, risks undertaken, and assets used by the applicant are significantly different from those during the term of the APA. **Japan** — While an APA is in progress, *no tax examination of transfer pricing issues will be conducted for the years to be covered* by the APA application (including rollback years). **Australia** — While the taxpayer is not entitled to be directly involved in the APA process in the case of bilateral and multilateral APAs, the *taxpayer could seek to be kept informed of the progress of the negotiations and the issues that emerge.* **Japan** — Although a MAP is a government-level negotiation procedure, taxpayers that file APA requests are *permitted to participate in some sessions to provide factual information*. **Australia** — The APA process is managed by the tax officials without the involvement of any other government agencies in Australia.

Background	Position in India	Contrasting Position in Other Prominent Jurisdictions
e) Miscellaneous		
(i) Expanding the Scope of the Nature of Transactions Covered Retrospectively		
Certainty (including coherence with established principles) is key to bringing about taxpayer compliance, and is moreso relevant in subjective fields like transfer pricing.	In 2012 the definition of the term ''international transaction'' was introduced in the Income Tax Act, 1961, with *retrospective effect* from 2001, to enumerate the types of transactions that are covered within the ambit of the transfer pricing regulations. The definition overrules judicial interpretation rendered with respect to the applicability of the term in specific circumstances like extension of credit/existence of a continuing debit balance,[e] group restructuring activities,[f] and so forth. The definition also includes within the scope of its provisions transactions which are simple capital receipts,[g] with *no element of income or gain* (a basic requirement for taxability under the Income Tax Act, 1961).	
(ii) Applicability of Transfer Pricing Provisions in Case of Tax-Exempt Transactions		
Applicability of transfer pricing regulations to tax-exempt transactions is a futile exercise where the exemption is based on the nature of the transaction and does not vary with the value/price of the transaction.	The transfer pricing regulations do not expressly exclude tax-exempt transactions from the applicability of transfer pricing provisions. It has been judicially interpreted[h] that transfer pricing regulations (including maintenance of documentation) would apply to such transactions, *though on a final analysis there would be no tax payable*.	
(iii) Choosing a Method for ALP Determination		
There are various methods prescribed in various countries for determination of ALP (such as the comparable uncontrolled price method, resale price method, cost plus method, profit-split method, transaction net margin method, and so forth).	With respect to a transaction, India requires the *most appropriate method* to be followed, which is to be determined having regard to the nature of transaction, class of transaction, class of associated persons, functions performed, and so forth.	**Brazil** — The transfer pricing law allows the taxpayer to rely on *whichever method results in the smallest adjustment* (instead of a best-method approach).
(iv) Alternate Dispute Resolution		
	Leaving apart the existence of a settlement commission (which is more relevant with respect to making disclosures and avoiding penalty for undisclosed income), in transfer pricing matters, there is *no alternative dispute resolution mechanism*.	**South Africa** — The tax officials can enter into settlements using alternative dispute resolution procedure. To date, no transfer pricing case has been taken to court, and all disputes have been settled by negotiation.

Background	Position in India	Contrasting Position in Other Prominent Jurisdictions
(v) Taxpayer Rights		
	There is no clear-cut/comprehensive recognition of taxpayer rights.	**Australia** — It has a *taxpayers' charter*, which is a policy guide to provide information to taxpayers on their legal rights.[i] Although the charter is not legally binding, taxpayers have a legitimate expectation that it will be followed.

[a]*Deputy Commissioner of Income Tax v. Indo American Jewellery Ltd.*, [2010] 41 SOT 1 (Mum); *Dresser-Rand India (P.) Ltd. v. Additional Commissioner of Income-tax*, [2011] 13 taxmann.com 82 (Mum); *Aztec Software & Technology Services Ltd. v. Assistant Commissioner of Income Tax*, [2007] 107 ITD 141 (Bang).
[b]*Coca Cola India Inc. v. Assistant Commissioner of Income Tax*, 309 ITR 194 (P&H); *Aztec Software and Technology Service Ltd. v. Assistant Commissioner of Income Tax*, [2007] 294 ITR 32 (Bang); *Assistant Commissioner of Income Tax v. MSS India*, ITA No. 393/PN/07.
[c]Under the Income Tax Act, 1961, tax is only chargeable on income that is either accrued/received in India or deemed to have been accrued or received in India (as against income that ought to have accrued in India).
[d] For example, a penalty of up to 20 percent and 40 percent could be imposed only if the ALP determined by the tax authorities is more than twofold and fourfold or less than one-half and one-quarter, respectively, of the determination by the taxpayer. Further, the total adjustment must also be beyond certain absolute and relative thresholds.
[e]*Patni Computer Systems v. Deputy Commissioner of Income Tax*, [2011] 16 ITR 533 (Pune); *Nimbus Communications Limited v. Assistant Commissioner of Income Tax*, ITA No. 6597/Mum/09.
[f]*Dana Corporation v. Director of Income Tax*, [2010] 321 ITR 178 (AAR).
[g]An instance of application of this provision is the recent issue of a draft assessment order to *Shell India Markets Private Limited* adding INR 150 billion to the taxable income of the company by alleging underpricing in relation to issue of shares to an overseas group entity.
[h]*In re Castleton Investment Limited*, [2012] 348 ITR 537 (AAR).
[i]Taxpayers' rights include the right to be treated fairly and reasonably by the tax officials; to be presumed to be telling the truth unless their actions indicate otherwise; to have their privacy respected and the confidentiality of documentation maintained; and to obtain professional advice and representation.

While courts in India may be slow in striking down fiscal provisions for violation of fundamental rights, clearly they would be determinative factors in developing or hampering local and international investor confidence, which at the moment appears to be at an all-time low and cannot be corrected by adopting quick fixes targeting only the symptoms of structural fault lines. Transfer pricing is relatively new in India and it is not too late to make the difficult choices without incurring too much transitional cost. ◆