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Transfer Pricing in India

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Commercial transactions between related entities of multinational corporations (“MNC”) increasingly dominate the sphere of world trade. The pricing of these transactions between related parties, which is known as ‘transfer pricing’, may differ from those that take place between unrelated parties. Such pricing divergence from prevailing market forces are also attributable to the fact that these transactions are all encompassing, ranging from goods and services to intangible property or by way of exchange of goods for services and so on.

Where tax rates are different between the countries, there is a strong incentive to shift income to a lower tax country and deductions to a higher tax country so that the overall tax effect is minimised.¹ Accordingly, as the aggregate tax payable by MNCs is reduced, tax authorities across the world incur significant losses. To guard against such losses, many countries have introduced transfer pricing legislation to govern the pricing of cross border transactions between related parties. So also, India has introduced rules and regulations on transfer pricing as of 2001.

I. Regulatory Framework

In India, the transfer pricing regulations (“Regulations”) are contained in sections 92 to 92F of the Income Tax Act, 1961 (“ITA”).² The Regulations provide for a transfer pricing mechanism based on computation of income arising out of cross-border transactions having regard to the arm’s length price (“ALP”). The arm’s length principle as codified in the Regulations has its roots in the Organisation for Economic Co-operation and Development (“OECD”) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The “ALP” is defined to mean a price, at which transactions between persons other than associated enterprises, in uncontrolled circumstances are carried out.³ Exhaustive definitions have been provided in the Regulations for the terms “associated enterprise” and “international transactions” to which the Regulations apply. Apart from the Regulations, the Indian Government has also notified rules⁴ in relation to transfer pricing, which have been inserted in the Income Tax Rules, 1962 (“ITR”).⁵

A. Overriding Effect

The Regulations override the provisions relating to the tax holiday available to Export Oriented Units (“EOUs”), units in Software Technology Parks (“STPs”), Special Economic Zones (“SEZs”), Export Processing Zones (“EPZs”) under sections 10A, 10B, 10AA and 80HHE/80HHC of the ITA. Therefore, if the income of companies set up as EOUs or in STPs, SEZs and EPZs which is otherwise not subject to tax, is determined by the tax authorities to be understated, then the differential amount (*i.e.*, the difference between the amount disclosed by the tax payer and the amount assessed by the tax authorities) would be added to the income of the tax payer and would be taxed accordingly.

II. Important Definitions

The term “associated enterprise” has been defined⁶ to mean an enterprise which:

- participates directly or indirectly in the management or control or capital of another enterprise; or
- has one or more persons who participate directly or indirectly in its management or control or capital and also in that of another enterprise.

The Regulations also include deeming provisions as regards “associated enterprise”. Accordingly, two enterprises will be deemed to be associated enterprises if, at any time during the tax year certain conditions exist. These include equity ownership or common equity holding in excess of the prescribed limits, granting or guaranteeing of loans or borrowings by one enterprise for another enterprise in excess of the prescribed limits, business interdependence, *etc.*

The term “international transaction” is defined to mean a transaction between two or more associated enterprises, either or both of which are non-residents.⁷ The following transactions are covered:

- purchase, sale or lease of tangible or intangible property;
- provisions of services;
- lending or borrowing of money;
- mutual agreement or arrangement for the allocation or apportionment of costs or expenses incurred or any contribution made; or
- any other transaction, which has a bearing on the profits, income, losses or assets of an enterprise.

The term ‘international transaction’ for this purpose means any arrangement, understanding or action in concert whether formal or in writing and whether enforceable or not.

III. Calculation of ALP

Different methods have been specified to determine the ALP in relation to an international transaction, which are as follows:⁸

1. Comparable uncontrolled price method (“CUP”);
2. Resale price method;
3. Cost plus method;
4. Profit split method;
5. Transactional net margin method; and
6. Such other method as may be prescribed by the Central Board of Direct Taxes (“CBDT”).

The Regulations require a taxpayer to consider all the prescribed methods as listed above in order to select the most appropriate method. However it is also stated that where more than one price is determined by any of these methods, the ALP shall be taken to be the arithmetical mean of such prices. The ITR prescribe the manner in which an ALP in relation to an international transaction is to be determined by the “most appropriate method”, the factors to be considered in selecting the most appropriate method, and the information and the documents required to be maintained and furnished by the taxpayer. Further, the transfer price can be within a range of plus or minus five percent of the ALP determined.

The following in particular is prescribed under the ITR:

- a. In analysing the comparability of an uncontrolled transaction with an international transaction, the taxpayers have been allowed the use of data relating to the financial year in which the international transaction was entered into. The data relating to a period of two years prior to the financial year may also be considered if such data reveals facts, which could have an influence on the determination of transfer prices in relation to comparable transactions.
- b. Taxpayers are free to select the most appropriate method as long as their selection is made taking into account the factors prescribed.
- c. Documentation requirements are limited to maintaining only such information as is relevant to the transactions entered into.
- d. All the prescribed requirements for documentation are not applicable in cases where the aggregate value of international transactions entered into during a year is limited to INR 10 million (approximately U.S.\$230,000). However, the taxpayer shall nonetheless be required to substantiate that income so arising from such international transactions has been computed in accordance with the Regulations.

IV. Transfer Pricing Officer

As the verification or determination of ALP requires specialised knowledge and expertise, specified officers called Transfer Pricing Officers (“TPOs”) have been appointed by the Tax Department to deal with transfer pricing cases.⁹ Technically, it is provided that the Assessing Officer, whenever he considers it necessary or expedient to do so, may with the previous approval of the Commissioner refer computation of ALP in

relation to the relevant ‘international transaction’ under Section 92C to the TPO. However, the CBDT has issued Instructions¹⁰ directing Assessing Officers to refer all cases involving determination of ALP to the TPOs where the aggregate value of ‘International Transactions’ entered into by the tax payer exceeds INR 150 million¹¹ (approximately U.S.\$3,362,470).

V. Documentation and Penalties

The taxpayer who falls within the ambit of the Regulations is required to maintain a record of the details of the international transactions entered into with its associated enterprises.¹² Such requirement is mandatory where the value of the transaction exceeds INR 10 million. The concerned authorities may require any person who has entered into an international transaction to furnish any of the information and documents specified under the ITR,¹³ within a period of thirty days from the date of receiving the notice issued in this regard. Further, every person who has entered into an international transaction is required to obtain a report from a qualified accountant.¹⁴ The report is required to be submitted to the Indian tax authorities by October 31 of the tax year by corporates and by July 31 of the tax year by other taxpayers.

Failure by the taxpayer to comply with the Regulations may attract severe penalties as summarised below:

- failure to furnish the accountants report – INR 100,000 (approximately U.S.\$2,241).
- concealment of income or furnishing of inaccurate particulars of income – Penalty of 100 percent to 300 percent of the amount of tax sought to be evaded in addition to the additional tax determined to be payable.
- failure to maintain prescribed information and documents – Penalty of two percent of the value of the international transaction.
- failure to furnish any such information or document as may be required by the tax authorities – Penalty of two percent of the value of the international transaction.

VI. ALP – Comparability

The central point of all methods used to determine the ALP is ‘comparability’. Under the CUP Method, the focus is on the comparability of products and under the resale and cost-plus methods, it is on the comparability of functions. The objective of comparability analysis is always to seek the highest practicable degree of comparability, recognising that there will be unique situations (which could be the result of business complexity) and cases where any method cannot be applied or relied upon. The standard of comparability that is practicable will be determined by the availability and the extent of the reliable data on which to make comparisons with uncontrolled situations and dealings for the particular case.¹⁵

VII. Drawbacks of the Regulations

Advance Pricing Agreements (“APA”) which are written agreements between a business enterprise and the tax authorities of the State in which it is a resident, are used to determine a method for determining the ALP in advance of filing returns for a limited period of time. Several countries such as the U.S., Canada, Australia and Japan allow for APAs and have brought APAs within the ambit of their transfer pricing

regulations. However, the Regulations in India do not provide for an APA mechanism.

Further, the Regulations do not envisage more unique situations such as intangibles, e-commerce, global trading derivatives and so on. Also, matters such as intra-group services and cost-sharing arrangements are not dealt with comprehensively.

VIII. Recent Advance Ruling on Transfer Pricing in India

The Advance Ruling mechanism in India is a mechanism available to non-residents (and residents in certain circumstances) under which a determination of the tax liability in India of the non-resident is sought for. The Authority for Advance Ruling ("AAR"), a quasi-judicial authority that operates like a tribunal or court in respect of the matters before it recently pronounced a ruling on the subject of transfer pricing. In the case of *Instrumentarium Corporation*,¹⁶ a Finnish company ("Applicant") sought a ruling as to whether the grant of interest free loan to its wholly owned subsidiary in India, would be subject to the Regulations and whether the applicant is required to charge interest to its Indian subsidiary as per the ALP.

As regards the first issue on the applicability of the Regulations, the AAR ruled that the Applicant must comply with the arm's length principle and other transfer pricing requirements in connection with granting a loan to its Indian subsidiary, even if such compliance reduces tax revenues for India. The AAR did not make any pronouncements on the determination of an arm's length interest rate as it is prohibited from ascertaining fair market value of any property as per the ITA.¹⁷

This Ruling stresses the need for an APA mechanism to provide clarity on tax obligations in international transactions between related entities.

IX. Emerging Issues From Recent Transfer Pricing Audits

The key issues / observations concerning recent transfer pricing audits by the tax authorities are as listed below:

- the tax authorities are more comfortable with the CUP Method as compared to the other four methods for determining the ALP.
- cost sharing arrangements are challenged, if proper documentation is not maintained and furnished for establishing the cost-benefit analysis arising from such cost sharing arrangements.
- the tax authorities are generally not comfortable with the use of foreign companies as comparables.
- the tax payers and tax authorities have experienced difficulty in obtaining "exact comparables" on account of difference in risk levels with uncontrolled functionally comparable companies.
- the tax authorities are more comfortable with a transaction wise analysis as opposed to aggregate company wide analysis for determining the ALP.
- in certain cases, the tax authorities have also used secret comparables for determining the ALP.

X. Conclusion

As described above, the Regulations are exhaustive in many respects and for the most part conform to international standards with regard to methodologies, documentation requirements and penalties. However, the Regulations are silent on APAs and do not specifically prescribe methods for determining ALP for intangibles, e-commerce transactions, global trading derivatives, intra-group services and so on. Thus, the Regulations would require certain amendments in order that they may be brought in line with recent developments on transfer pricing that have taken place internationally.

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- 1 D.P. Mittal, 'Law of Transfer Pricing' (2nd Ed.) (2006) at p. 3.
- 2 As introduced by the Finance Act, 2001.
- 3 Section 92F (ii) of the ITA.
- 4 *Vide* notification No.S.O.808 (E) dated 21.8.2001.
- 5 Rule 10A to 10E of the ITR.
- 6 Section 92A of the ITA.
- 7 Section 92B of the ITA.
- 8 Sub-section (1) of Section 92C of the ITA.
- 9 Explanation to Section 92CA.
- 10 Instruction No. 3 of 2003 (261 ITR (St.) 0051).
- 11 Bombay Chartered Accountants' Society, 'Transfer Pricing Manual', (1st Ed) (2005) at p. 21.
- 12 Section 92F of the ITA.
- 13 Rule 10D of the ITR.
- 14 Section 92E of the ITA.
- 15 D.P. Mittal, 'Law of Transfer Pricing' (2nd Ed.) (2006) at p. 175.
- 16 (2005) 194 CTR 302 (AAR).
- 17 Proviso (ii) of Section 245 R (2) of the ITA.