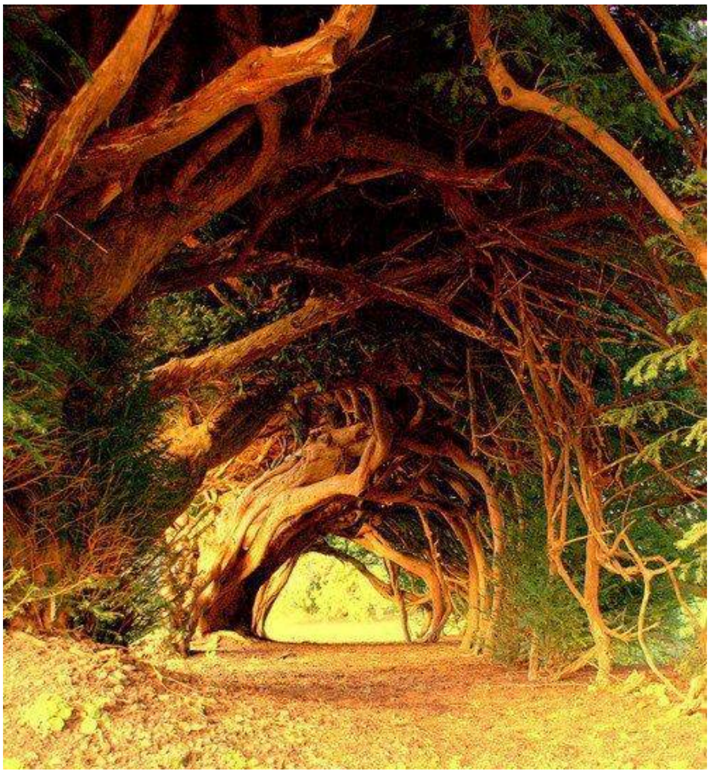
INTERNATIONAL TRANSFER PRICING REGULATIONS In INDIA



In a cross border transaction, countries on either side would like to ensure that it gets its due share of taxes. Transfer Pricing Regulations seek to achieve this objective. Transfer pricing means pricing of goods, services or intangibles when they are provided for use or consumption to a *related party* (e.g. subsidiary, associate). Since it's possible for these related parties to transfer profits or losses between tax jurisdictions they operate under, such intra group transactions could be guise for potential tax avoidance. This makes the tax authorities and businesses pay special attention to such transactions, as the tax authorities seek to detect tax avoidance and businesses seek to structure and price the transactions in a manner that are tax compliant and yet meet their group objectives. For global groups, this task is not only quite complex as they seek to minimise the total tax liability of the group as a whole.

Take an example of a subsidiary company in India receiving technical support services from its overseas associated enterprises for a charge. Now it is possible that the overseas associated enterprise may charge the Indian entity in a manner that will result in shifting of profits to an overseas jurisdiction say by charging a abnormally high price. This is only possible because a foreign enterprise is able to exercise control over the Indian associate. But, if they were unrelated then pricing would have been fixed by market forces without any influence by a group company.

Thus, whenever there is an international transaction between associated enterprises, the Indian transfer pricing regulations come into play.

Significance Meaning and Applicability

1) The Transfer Pricing provisions were brought under Indian income tax laws from financial year 2001-02.

2) With a view to provide a detailed statutory framework which, can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises, the Finance Act, 2001 substituted the then existing section 92 with sections 92A to 92F in the Income-tax Act, 1961, relating to computation of income from an international transaction having regard to the arm's length price, meaning of associated enterprise, meaning of information and documents by persons entering into international transactions and definitions of certain expressions occurring in the said section. The Central Board of Direct Taxes (CBDT) has come out with Transfer Pricing Rules - Rule 10A to Rule 10E.

3) Since that time the Central Board of Direct Taxes (CBDT) has only made the law more complex and carried out retrospective amendments to overrule determinations given by Tribunals and Higher Courts which were favourable to the tax payer.

4) The government has failed in its promise to make effective and useful rules in the areas of Safe Harbour Rules, Advance Price Agreements and making the Mutual Agreement Procedures more speedy and effective.

5) Consequently, India is the most litigious country in the Transfer pricing Area. The amount of Tax Demands done by revenue authorities has spiralled:

Year	Amounts in Rs.
2004-07	60,41,00,00,000
2007-08	16,21,00,00,000
2008-09	61,38,00,00,000
2009-10	1,09,07,00,00,000
2010-11	2,32,38,00,00,000
2011-12	4,45,36,00,00,000

6) Utmost importance is being given to transfer pricing by the Indian tax authorities. As per recent press reports, around 2500 cases were picked up for scrutiny by the Indian transfer pricing authorities and it is estimated that the finance ministry is attempting to raise Rs.80,000 crores from transfer pricing adjustment orders up to March 2011. The country has over 1,500 cases out of which 877

multinational cases from 25 countries are pending. Needless to say that, transfer pricing has become an important source of raising revenues for the Indian government hungry for more and more funds. Transfer pricing also continues to remain the topmost priority for the tax authorities worldwide. It is therefore critical that there are no loose ends while reviewing the intra-group transfer pricing policy.

7) The above figures show that transfer pricing is not a mere compliance exercise. It has to be used as an effective tax-planning tool to minimize the overall tax exposure and to optimize after tax cash flows for the group as a whole.

8) As per the provisions of section 92C the arms length price (ALP) in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe:

(a) Comparable Uncontrolled Price Method ("CUP")
(b) Resale Price Method ("RPM")
(c) Cost Plus Method ("CPM")
(d) Profit Split Method ("PSM")
(e) Transactional Net Margin Method ("TNMM")
(f) Any other method prescribed by CBDT

Under the ALP mechanism, a permissible tolerance band is defined.

9) Applicability of Transfer Pricing in India:

Transfer pricing provisions are applicable based on fulfilment of two conditions: Firstly, there must be an international transaction. Secondly, such an international transaction must be between two or more associated enterprises, either or both of whom are non-residents.

10) Associated Enterprises (AE) – How Identified?

The basic criterion to determine associated enterprises is the participation in management, control or capital (ownership) of one enterprise by another enterprise. The participation may be direct or indirect or through one or more intermediaries as defined in Section 92A(1) of Income Tax Act, 1961.
The above section is further supplemented by 13 clauses which enlist various situations under which two enterprises shall be *deemed to be Associated Enterprises* as per Section 92A(2) of Income Tax Act, 1961.

11) What is an International Transaction?

An international transaction is essentially a cross border transaction between AEs in any sort of property, whether tangible or intangible, or in the provision of services, lending of money etc. At least one of the parties to the transaction must be a non-resident entering into one or more of the following transactions:

i. Transactions relating to Purchase, sale or lease of Tangible or Intangible Property
ii. Transactions relating to provision of services
iii. Capital financing transactions such as lending/borrowing, guarantees, etc.
iv. Transactions relating to business restructuring irrespective of having a bearing on profits, income, losses or assets at the time of transaction/ future date.
v. Mutual agreement between AEs for allocation/apportionment of any cost, contribution or expense.

An illustration of a distant 'International Transaction' could be where a resident enterprise exports goods to an unrelated person abroad, and there is a separate arrangement or agreement between the unrelated person and an AE, which influences the price at which the goods are exported. In such a case the transaction with the unrelated enterprise will also be subject to TP Regulations (TPR). Therefore, the ambit of the TPR is very WIDE.

12) The **initial onus** of proof that its transfer pricing meets with the arm's length expectation lies on the taxpayer and it is the taxpayer who needs to discharge this onus based on comprehensive documents, if the tax enhancement, interest and penalties were to be avoided under the Indian regulations.

13) Reference to Transfer Pricing Officer (TPO)

Section 92CA of the Income Tax Act, 1961, states that where any person, being the assessee (taxpayer), has entered into an international transaction in any previous year, and the Assessing Officer considers it necessary or expedient so to do, he may, with the previous approval of the Commissioner, refer the computation of the arms length price in relation to the said international transaction under section 92C to the Transfer Pricing Officer.
This Officer is specially trained on International TP laws and practices and their number has been increased from 18 to 80 in recent times with the scrutiny audit time increased from 33 months to 45 months from the end of financial year.

14) Additionally, the customs officials and the TPOs are co-ordinating in recent times.

15) Documentation / Return

While there are certain relaxations in the maintenance of documentation in certain cases, the law requires detailed maintenance of documentation if the value of the international transaction with related parties was to exceed Rs 10 million per fiscal year.

Thirteen different types of documents are required to be maintained. These include –

i. Enterprise-wise documents:- Description of the enterprise, relationship with other associated enterprises, and nature of business carried out.
ii. Transaction-specific documents:- Information regarding each transaction, description of the functions performed, assets employed and risks assumed by each party to the transaction, Economic & Market Analysis etc.
iii. Computation related documents:- Describe in details the method considered, actual working assumptions, policies etc., adjustment made to transfer price, any other relevant information, data, documents relied for determination of arm's Length price etc.

A report from a Chartered Accountant in the prescribed form giving details of transactions is required to be submitted within a specific time limit.

16) The Company's case may be picked up for a compulsory transfer pricing audit by the Indian transfer pricing authorities if the value of the international transactions with its related parties would exceed Rs 150 million per annum. Consequently, it would be desirable to have proper documentation in place upfront so that transfer pricing audit subsequently becomes an easier affair

17) In practice, it may not always be possible to claim corresponding adjustment in the overseas country where the associate enterprise of the tax payer operates with the result that enhanced income pursuant to an adverse transfer pricing adjustment in India may result in double taxation for the group on the whole. It therefore becomes imperative to avoid all such enhancements in India based on suitable and contemporaneous documentation.

18) The transfer pricing provisions generally follow the OECD guidelines relating to the same. However, there are certain fundamental differences in that the Indian

provisions require the computation of an 'arms length price' as against the internationally accepted norm of arms length range. Further, the arms length price is to be computed as the 'arithmetic mean' of comparable results. A variance of around 5% of the mean may be opted for.

19) Safe Harbour Rule

With a view to reduce uncertainty on the taxpayers' front, the Finance (No. 2) Act, 2009 introduced Safe Harbour regulations in India effective form 1 April 2009. Safe Harbour has been defined to mean 'circumstances' in which the revenue authorities shall accept the transfer pricing declared by the taxpayer. But this rule has not been notified[1] by the Central Board of Direct Taxes(CBDT) as yet.

20) What is an Advance Pricing Agreement (APA)

An APA is an agreement between the Central Board of Direct Taxes and any person, which determines, in advance, the arm's length price or specifies the manner of the determination of arm's length price (or both), in relation to an international transaction. Hence, once APA has been entered in to with respect to an international transaction, the arm's length price with respect to that international transaction, for the period specified in the APA, will be determined only in accordance with the APA. The APA process is voluntary and will supplement appeal and other Double Taxation Avoidance Agreement (DTAA) mechanism for resolving transfer pricing dispute. The term of APA can be a maximum of five years.

Types of APA

The APA scheme makes available 3 types of APA: unilateral, bilateral and multilateral. The choice is on the applicant to choose a particular type of APA at the time of making the application. Unilateral APA is an agreement between the Board and the applicant and this process does not involve any agreement with the treaty partner. In bilateral and multilateral APA request, the applicant is required to make an application with the Competent Authority of India as well as the Competent Authority of the other country.

How will it work?

As is the international practice, before formally applying for the APA there will be a pre-filing consultation between the taxpayer and the Government to enable the applicant and the APA team to assess the possibility of entering into an APA.

[1] Giving it legal force

The formal APA application can be filed after the pre-filing consultation accompanied by the payment of fees as notified. In case of unilateral APA, the application is required to be furnished with the Director General of Income Tax (International Taxation), New Delhi and in case of bilateral / multilateral APA, the application is required to be furnished with the Competent Authority of India, i.e. Joint Secretary (FT&TR-I) in the Ministry of Finance. In case of bilateral / multilateral APA, the applicant must initiate the procedure for entering into APA with the other country as well and furnish evidence to the Competent Authority of India regarding the same.

Advantages

The APA scheme has many advantages. It will provide **tax certainty** with regard to determination of arm's length price of the international transaction with respect to which the APA has been entered into, reduce the risk of potential double taxation through bilateral or multilateral APA, reduce compliance cost by eliminating the risk of transfer pricing audit and resolving long drawn and time consuming litigation and other dispute resolution process and alleviate the burden of record keeping as the taxpayer knows in advance the required documentation to be maintained to substantiate the agreed terms and conditions of the agreement.
The Ministry of Finance has notified an Advance Pricing Agreement Scheme (Rules 10F to 10T of Income Tax Rules, 1962) vide notification No. 36 / 2012 dated 30-8-2012. The Finance Act, 2012 had inserted sections 92CC and 92CD in the Income Tax Act 1961 introducing the provisions of Advance Pricing Agreement (APA). The APA Scheme has come into effect from the date of its publication in the Official Gazette, i.e. from 30.08.2012. This is definitely a big step in the right direction to provide certainty to tax payers.

21) Adverse tax incidence due to PE implications

In recent past, Indian tax authorities have taken a stance that if a foreign company is having a subsidiary in India, such a subsidiary under certain circumstances may be regarded as a Permanent Establishment (PE) of the foreign company in India. In such a case, profits attributable to such direct sales might also be taxable in India. However, this exposure could be avoided and / or minimized subject to having a suitable transfer pricing policy.

22) Penalties are very high

Stringent penal provisions have been prescribed for non-compliance under the Indian transfer pricing regulations. Details of the various penalties that are prescribed for non-compliance with the various provisions of the transfer pricing regulations are summarized in table below:

Nature of penalty prescribed	Quantum of penalty
1) Addition to Income on account of concealment or furnishing of inaccurate details. *(section 271(1)(c))*	100% to 300% of tax on addition to Income.
2) Failure to maintain documentation / furnish documentation to tax authorities, when called for. *(section 271G)*	2% of value of the international transaction entered into between related parties (i.e. mainly the value of export billing recorded in the books).
3) Failure to furnish Accountants' Certificate *(section 271BA)*	INR 100,000/- (fixed)
4) Failure to maintain TP documentation, failure to report the transaction, maintenance or furnishing of incorrect information / document. *(section 271AA)*	2% of value of the international transaction entered into between related parties (i.e. mainly the value of export billing recorded in the books).

The above penalties can be avoided if the taxpayer proves that there was reasonable cause for such failures. Adjustment related penalty cannot be levied where it is proved that the taxpayer acted in 'good faith' and exercised 'due diligence'. **Penalties are not tax deductible but are discretionary.**

Issues and Challenges

Here are some of the challenges posed by the Indian TP Law:

a) Commercial Expediency / business necessity vs. Powers of the TPO
b) Can valid business expenditure paid to AE be disallowed if the tax payer is making losses?
c) How to work out payments for Intra Group services or cost contributions towards – IPR / IT / Management Fees / HR Support and other service charges.
d) Cost contribution for R&D Expenditure
e) Advertising, marketing and Promotion Expenses – can such expense result in Brand of the owner outside India and therefore does not relate to business in India.
f) Loans to Subsidiary and Corporate / Bank Guarantee – when there is no real income can a notional amount be taxed? Or Share holder investor function vs. Service.
g) What should be taken as Profit level Indicator – PBDIT or PBIT
h) How should adjustment for differences in risk assumed be quantified and factored in arriving at ALP?
i) Adjustment for depreciation on account of difference in method / difference in accounting system followed by comparable enterprises.
j) Capacity utilisation, initial period of operations where losses are forecasted or entry in new market.
k) Whether TPO can ignore the method used by tax payer and impose another method?

Objective of TP Assignment

The objective of the transfer pricing assignment would be to evaluate the existing transfer pricing policy of the group and the basis / methodologies for determining prices of international transactions with your associated enterprises. This analysis would be done keeping in mind commercial, tax and regulatory considerations. We shall also assist the company in maintenance of necessary transfer pricing documentation to justify intra-group transactions pricing for the financial year.

Lastly, it should be understood well that Indian tax department has almost limitless powers and have come up with innovative ways to challenge tax positions taken by the taxpayers. Additionally, they have little or no accountability towards taxpayers or to be fair in their judgement. Thus, if a wrong officer decides to proceed in an unfair manner, it could seriously harm taxpayer interests. It would be advisable therefore to take transfer pricing issues seriously and perhaps carry a lesser risk of future litigation.