

Figuring out transfer pricing controversy in IT/ITeS sector

The Economic Times · 17 Jul 2008 · Vispi Patel

INCREASING globalisation has necessitated the offshoring phenomenon to preserve and enhance value for the multinational corporation (MNC). India has emerged as one of the most favoured outsourcing destinations due to its comparative cost advantage, and is the world's leading back office service provider. In India, the revenue authorities concluded with respect to transfer pricing (TP) assessments that Indian captive business process outsourcing companies were remunerated at a very low rate and should have been compensated on the basis of average return of comparable companies at cost plus 25% and more. This has created a lot of stress in the IT/ITeS space, as the increased tax adjustments results in huge tax outflow. This article tries to find a rationale for making economic adjustments so as to mitigate the rigours of such transfer pricing adjustments and create certainty in the tax environment for the industry.

Since the Indian (captive) company (selected as the tested party) generally is sheltered by the parent company as it does not take any strategic decision nor undertakes entrepreneurial risk, it is characterised as a low risk captive service provider. The comparable companies, however, generally are fullfledged entrepreneurs undertaking integrated functions and assume all inherent business risks (market risk, credit risk, foreign exchange risk, legal risk, technology risk etc).

The philosophy of TP is centred in seeing that controlled entities attain the arm's length standard (ALS) so that the country's tax base is protected. The ALS tries to equate the tested party's (controlled) transactions with that of independent comparable companies keeping in mind the differential economic factors (mainly reflecting differential risk profiles) affecting comparability analysis. Therefore, it is important to make adjustments to the risk profiles of comparable companies for the purposes of fair comparison. This is also emphasised by the OECD guidelines and the Indian transfer pricing regulations.

One of the prerequisites to do such risk adjustments is to establish the link between risk and capital. Due to uncertain economic environment faced by companies, capital and risk management have become critical in the business processes. The risk management is centred in the efficient use of capital, as capital and risks are closely interrelated. As discussed above, in order to make economic adjustments to comparable companies, the return of comparable companies should be adjusted for the market risk that they bear. This is best reflected in the financial theory by capital asset pricing model (CAPM).

The principal insight of CAPM is that the expected return on an asset is related to its risk, that is, risk taking is rewarded. The model demonstrates that the expected return of a security or a portfolio equals the rate of return on a risk-free security plus risk premium. The important

constituents of CAPM are thus, risk free rate of return, beta and stock market return. The CAPM derives that expected rate of return (ERR) equals risk free rate plus equity risk premium (stock market return less risk free rate) multiplied by beta.

The equity risk premium (ERP) which is the risk adjustment factor is derived by subtracting long-term average return on a risk-free asset, from long-term average stock market return. The stock market return in case of IT/ITeS industry gets best captured by the returns on CNX IT index, based on available NSE statistics or it is also possible to use generic indices which capture performance of overall market, including large cap and mid cap companies.

The usual methodology to demonstrate arms length dealings by the Indian captive companies is by applying transactional net margin method (TNMM) and using the profit level indicator as operating profit /total cost (cost plus at net level) under the transfer pricing regulations. Thus, economic adjustments due to differential risk profiles would be necessary to reduce risk return embedded in the comparables companies' returns on total costs so that the comparable companies returns are at par with tested party's returns to establish arm's length results.

Carrying out such economic adjustments is hence, critical for the Indian captive companies to justify their lower margins than comparable companies, and to demonstrate that their dealings with their affiliates are at arms length. This would enable such companies to mitigate transfer pricing risk, and preserve value in the group.