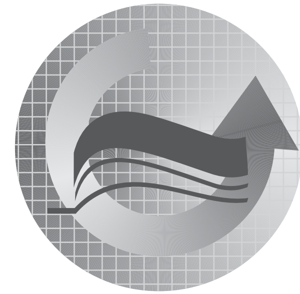

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Broad Overview of Transfer Pricing Provisions in India and Current Key Issues faced by Tax-payer

INTERNATIONAL TRANSFER PRICING PROVISIONS

Introduction

Transfer pricing ('TP') provisions were introduced in India in the year 2001 (i.e. w.e.f. A.Y. 2002-03) by way of an amendment to the Income-tax Act, 1961 ('the Act'), essentially to put a systematic check on India's tax base erosion on account of dealings/transactions between related parties (i.e. 'associated enterprises' or 'AEs')[1]. The requirements of law being that the transactions between AEs would be a mirror image of transactions between two non-associated enterprises i.e. independent enterprises. The objective is to prevent 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, set-off of losses carried forward from previous years, and so forth. The law, thus aims that all controlled transactions should be at arm's length price (ALP).

For example, an Indian company may buy goods at inflated prices from its overseas subsidiary which has a lower tax rate than India to portray higher expenditure and consequently pay lower taxes in India.

Thus, TP provisions were introduced to provide a detailed statutory framework [*vide* Sections 92 to 92F of the Act read with Rules 10A to 10TG of the Income-tax Rules, 1962 (the Rules)] and assist in computation of reasonable, fair and equitable profits and tax in India and resulting tax payments in India, in case of multinational enterprises (MNEs). The basic framework of the provisions has been modelled from the Organization for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

Applicability

Section 92(1) of the Act provides that any income arising from an international transaction shall be computed having regard to the ALP. Further, the Explanation to Section 92(1) clarifies that the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the ALP. Section 92(2) also provides that when two or more AEs enter into any arrangement or agreement for allocation or apportionment of any cost or expenses, the same also need to be apportioned/allocated at ALP. The said arrangement/agreement may be in connection with a benefit, service or facility to be provided to any or all of the enterprises.

International transaction

As per Section 92B(1) of the Act, an international transaction means a transaction between two

1 Refer CBDT Circular No. 14/2003

or more AEs, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more AEs for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

The Finance Act, 2012, inserted an Explanation to Section 92B with retrospective effect from 1 April, 2002, expanded the definition of the term 'international transaction' to include purchase, sale, transfer, lease and use of tangible and intangible property, capital financing (including any type of long-term or short-term borrowing, lending or guarantee, etc., provision of various services and transaction of business restructuring or reorganisation (even though such transaction may not have any bearing on profits, income, losses or assets of the relevant year). Further, the said Finance Act also expanded the definition of the expression 'intangible property' to bring within its ambit almost every kind of intangible property.

Deemed international transaction

Section 92B(2) of the Act provides that a transaction entered into between two unrelated enterprises may also be treated as an international transaction, if such a transaction has been undertaken by virtue of a prior agreement/ understanding between one of such unrelated enterprises and an AE of the other party to the transaction.

Until 2013, taxpayers refuted applicability of TP provisions in such cases if the transaction was between two resident enterprises, based on the proposition that as per Section 92B(1) of the Act, at least one of the parties to the transaction needs to be a non-resident and hence, TP provisions i.e. Section 92B(2) could not be applied in cases where both parties to the transaction were resident enterprises. However, the Finance Act, 2014 has clarified that Section 92B(2) shall apply even if both parties to the transaction are residents.

Associated enterprise/AE

As per sub-section (1) of Section 92A of the Act, two enterprises can be regarded as AE if one enterprise participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or same persons participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of both the enterprises. Sub-section (2) of Section 92A provides a list of cases when the two enterprises shall be deemed to be regarded as AE for the purpose of sub-section (1). The said section uses the criteria of voting power, amount of loan, guarantee provided, dependence on intangible assets, amount of purchase/sale as compared to the total purchase/sale, composition of board of directors etc. for determining participation of control, management or capital between the two enterprises. Even if the relevant criteria are satisfied at any time during the year the enterprises can be regarded as AEs.

The words "at any time during the previous year" used in Section 92A hold significance. It means that even if two enterprises become AEs for even one day in a year, they will be construed as AEs for the full year and transactions undertaken between them during the entire year would need to be benchmarked as per TP provisions of the Act.

Methodology to be followed

Transactions between AEs need to be benchmarked by following the methods specified in the Act, to establish that the controlled transactions are at ALP.

Benchmarking methodologies specified under the Act

Section 92C of the Act specifies six methods that can be applied, depending upon the nature of the transaction, or class of transactions, class of AEs, functions performed by such persons or such other relevant factor as Board may prescribe[2] to justify ALP. The same have been briefly explained as under:

Comparable Uncontrolled Price (CUP) method

CUP method evaluates the 'price' charged in a controlled transaction with reference to the 'price' charged in a comparable uncontrolled transaction(s), which could be identified either through internal or external comparable companies. For example, the same product is being sold by an enterprise to both, its AE as well as third parties (internal comparable) or the same product is freely available in the market of which prices can be compared (external comparable).

Since comparison is done at price level, the CUP method is considered to be the most direct and reliable method for comparison purposes.

Resale Price Method (RPM)

RPM is applicable in a resale situation, where the property or services purchased from an AE are sold to an unrelated enterprise without any value addition. The RPM is applied on either a transactional or a comparable-company basis, and it mostly applies to distributors/ marketers.

Cost Plus Method (CPM)

CPM is generally applied by comparing gross profit mark-up (on direct and indirect costs of production) in relation to supply of products or provision of services to AE. CPM is most useful where semi-finished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.

Profit Split Method (PSM)

PSM could be applied mainly in international transactions involving transfer of unique intangibles or in multiple international transactions, which are so interrelated that they cannot be evaluated separately for the purpose of determining the ALP of any one transaction. The PSM is therefore, appropriate for integrated transactions with more than one enterprise.

Transactional Net Margin Method (TNMM)

TNMM is generally appropriate for the provision of services/sale of goods etc., where CPM or RPM cannot be adequately applied. It compares the net level profitability in relation to an appropriate base like sales, costs or assets employed, etc. TNMM is based on the principle that differences in the operating level, capacity etc. get neutralised by the difference in the level of operating expenditure and hence, profitability of companies belonging to the same industry/ category can be compared.

The "Other Method" as prescribed by Rule 10AB (Other Method)

The Other Method refers to "price which has been charged or paid, or would have been charged or paid" for same or similar uncontrolled transactions, with non AEs, under similar circumstances, considering all the relevant facts. This method seems to be akin to the CUP method.

For instance: The "Other Method" may be applicable for transactions which can be benchmarked using "prices" (rather than margins). Also the words "would have been charged or paid" could cover transactions such as valuation of shares, intangible property, etc. It could sanction the use of "quotations" rather than prices "actually" charged or paid.

2 Refer Rule 10B

It is provided that when more than one price is determined by following a method, arithmetical mean of such prices should be regarded as ALP. It is also provided that if the ALP so determined is within the range of the prescribed percentage (i.e. one per cent for wholesale trade and three per cent for others) of the transaction price, the transaction price should be accepted as ALP.

However, in respect of transaction entered into after April 1, 2014, if more than one price is determined by following a method, ALP is required to be computed in a prescribed manner. The manner is yet to be prescribed, it may take into account a concept of range together with use of multiple year data.

Advance Pricing Agreement (APA)

The Finance Act, 2012 introduced provisions relating to Advance Pricing Agreement (APA). The following are the salient features of the APA scheme:

- It is an agreement between a taxpayer and the tax authorities for either specifying ALP or the manner in which the ALP is to be determined in relation to an "international transaction";
- The ALP shall be determined on the basis of prescribed methods or any other method;
- The APA is binding on tax authorities as well as taxpayers unless there is a change in the law or facts of the case.
- Valid for a maximum of consecutive 5 years and preceding 4 years
- In case APA covering a particular year is obtained after filing the return of income, modified return needs to be filed based on the APA and assessment or reassessment to be completed based on such modified return;
- APA to be declared void *ab initio* if obtained by fraud or misrepresentation of facts;
- Rules 10F to 10T governs the detailed procedure for application, annual compliance report, compliance audit etc.

Safe Harbour Rules

Rules 10TA to 10TG were introduced in September 2013 providing rules for Safe Harbour. 'Safe Harbour' means circumstances in which the Income Tax authorities shall accept the transfer price declared by the taxpayer. The Rules among other things provide for the circumstances under which the transfer price declared by the taxpayer (margin declared by the assessee) would be accepted by the authorities for prescribed eligible international transactions i.e. software development services and other IT related services, provision of loans and guarantee, provision of contract research and development services, manufacture and export of core/noncore auto components etc.

Further, following are some of the typical issues faced by the taxpayers as regards the TP provisions in the Act:

Use of TNMM

There seems to be a preference for determining the arm's length nature of international transactions, based upon the overall profitability of an enterprise under the TNMM as opposed to other direct methods, irrespective of whether the international transactions have a bearing on such profitability or not.

For example, a taxpayer may have sold goods to its AE on which it earned a reasonable/ acceptable gross margin, but still suffered a loss at net level on account of higher operating cost that it had to incur to make sales to third party customers, e.g. marketing costs. Such marketing expenditure, though may not be functionally related to the international transaction of sales to AE, often becomes a reason for an adverse TP adjustment in the case of the taxpayer when its net level profitability is compared by the Transfer Pricing Officer (TPO) with its peers. Other examples leading to losses at a net level could include high proportion of bad debts, high employee cost compared to peers, heavy discounts offered to clear stocks at the year-end, etc.

This is one of the most common issues faced by taxpayers in India. While the OECD TP

Guidelines suggest that appropriate adjustments should be made to neutralise the effect of an enterprises' business strategies on its profitability, transfer pricing analysis in India is still in its nascent phase to give due weightage to such aspects.

Characterisation as low-end or high-end service providers

Having regard to the low-cost base of India, it is known that many MNEs have set up back-end centres in India to assist in carrying out routine functions such as accounting, invoicing, payment processing, etc. Such back-end centres are usually remunerated on a cost plus mark-up basis.

One of the most common area of disputes between taxpayers and revenue authorities in such cases is use of appropriate comparable companies for benchmarking the taxpayer's profitability. While taxpayers insist on benchmarking their profits vis-à-vis companies providing routine low-end services, revenue authorities tend to include certain high end service providers in the list of comparables. Obviously, such service providers earn higher margins than routine service providers, due to various economic reasons like established presence in the market, more sophisticated processes, brand value, etc.

Reasons for such disputes in the choice of comparables could be attributed to the difference in the taxpayer's functional, asset and risk (FAR) analysis pertaining to the transaction of provision of services, inappropriate drafting of the relevant agreement for provision of services between the taxpayer and the MNE, non-maintenance of adequate records by the taxpayer to substantiate the routine nature of the services, etc.

Payments for centralised services

MNEs often set up centralised centres in one jurisdiction to carry out certain common services such as IT services, R&D services, etc. for all group members. Further, in many cases, the core function in a MNE viz. conceptualisation, design, product development, marketing strategies, framing of high level business policies, etc. are centralised. The objective may be to establish globally seamless methodology to do business throughout the globe, to achieve economies of scale, to reap benefits of specialisation, etc. Such centralisation ensures standardisation in procedures followed and products/ services provided by all group enterprises globally, ultimately leading to satisfaction of the customer that he will be getting the same product/ service across the globe. MNEs charge out costs incurred for such centralised activities to their group enterprises across the globe, either with or without an administrative mark-up.

The key areas of disputes between taxpayers and TP revenue authorities in such cases are as under:

- Categorisation of costs into stewardship and other allocable costs – division of costs incurred between share holder costs and allocable costs has been a frequent challenge between taxpayers and revenue authorities.
- Substantiation of benefits received by the taxpayer from such services – In many cases, taxpayers are faced with the challenge of putting together tangible evidence for services/ benefits availed. For example a high level management team may have been involved in assisting the taxpayer in negotiating a deal with a customer, in respect of which the MNE may have charged the taxpayer for his time cost. It is likely that in such cases, the taxpayer may not have sufficient evidence to substantiate that services were actually availed by it, if most of the assistance provided by the management committee personnel was through conference calls, etc., and sufficient documentation may not be available. The assistance lent by the AE is intangible in nature as it revolves around the experience and the expert skills of such a team.

Taxpayers are also faced with the challenge of proving that services availed by them from the MNE are not duplicative in nature i.e. they have not availed similar services locally also. The best example for this is IT services where it is likely that the taxpayer avails certain day-to-day services by a local third party service provider while the broad IT framework is provided by the MNE for which a cross-charge is made.

– Arm's length compensation for services – Since such cases mostly involve provision of proprietary services, finding a comparable third party price has always been a challenge.

No rational basis for inclusion/ exclusion of comparable companies

Transfer pricing in India being at a nascent stage, the comparability analysis is more often guided by a company's high/low profitability or loss situation as against its actual functional comparability factors.

Payment towards Royalty

Intra group payment for use of intangibles is always difficult to benchmark. Firstly, the intangible is developed over a period of time and unique to that group. Obviously, such a transaction is never entered into by the company with the outsiders. The revenue authorities generally do not accept the contribution of the intangible in the business of the taxpayer and hence they find it difficult to understand the business rationale for such payment and may view such payment as a tool to shift profits from India.

Capital account transactions

In the recent past, revenue authorities have determined ALP adjustments for typical transactions, such as taxing a transaction of issue of shares by an Indian company to its overseas AE (in the case of Vodafone, Shell, Essar, etc.). It has been alleged that the taxpayer charged a lower price for the shares issued than the ALP for such shares. Further, to the extent of the alleged short receipt of premium, notional interest was also attributed on a deemed loan given by the Indian entity.

One needs to appreciate that the taxpayer, for e.g. instead of issuing 100 shares at a premium of ₹ 10 could have issued 10 shares at a premium of ₹ 100. In any case, such a transaction has no bearing on the income or expense of the taxpayer as per Section 92(1) of the Act so as to attract TP provisions.

Recently, the Hon'ble Bombay High Court (HC) in the case of Vodafone India Services Pvt Ltd.[3] held that the transaction of issue of shares at a premium by the assessee to its non-resident holding company, does not give rise to any income from international transaction, and hence is not covered under the TP provisions.

Others

Tax authorities have also been imputing notional income in cases of guarantees provided by Indian MNEs on behalf of their overseas subsidiaries/AEs free of cost, interest free loans provided to its subsidiaries, etc. While taxpayers contend such activities to be in the nature of share holder functions not warranting any considerations, tax authorities tend to ignore the business rationale and by treating both entities as independent enterprises, impute notional income in the hands of the taxpayer.

Domestic transfer pricing provisions

The Finance Ministry has, *vide* Finance Act, 2012, extended the applicability of TP provisions to specified local transactions executed between related parties. These provisions became effective from A.Y. 2013-14 for transactions exceeding an aggregate value of ₹ 50 million.

3. V*odafone India Services Pvt. Ltd. v. Union of India, Addl. CIT, Dy. CIT, DRP-III* [Writ Petition No. 871 of 2014]

The genesis of the above amendment i.e. extending applicability of TP to specified domestic transactions lies in the Hon'ble Supreme Court's observation in the case of GlaxoSmithKline wherein the Hon'ble Supreme Court suggested to the Ministry of Finance to consider making TP provisions applicable to domestic related party transactions involving determination of "fair market value". For example, transactions covered under Section 40A(2), Section 80-IA(8)/ (10) etc. Consequent to the above amendment, the following transactions are covered within the ambit of domestic transfer pricing (DTP) regulations:

- Expenditure under Section 40A(2) paid to specified persons;
- Transfer of goods and services between the tax holiday undertaking and other undertakings of the taxpayer;
- Business transacted between the tax holiday undertaking and other 'closely connected entities'; Any other notified transaction.

Clause (b) of Section 40A(2) list various persons that can be regarded as related party with reference to a particular assessee i.e. when the assessee is an individual, Hindu Undivided Family (HUF), Firm, Company etc. Generally, it covers relatives of the individual, member of the HUF, partner of the firm, director of the company, relatives of member, partner, director, various concerns in which said persons have substantial interest etc.

Some of the key issues of domestic transfer pricing provisions are listed below:

- ***Meaning/coverage of beneficial ownership for purposes of Section 40A(2)***

  Whether indirect holding is covered by Section 40A(2) i.e. whether beneficial ownership covers indirect ownership? For example, if A Co. holds more than 50% in B Co. and B Co. holds more than 50% in D Co, can A Co. be regarded as having substantial interest in D Co.?

- ***Benchmarking requirement for Remuneration / other payments to Director / Chairman / Key management personnel***

  In case of a company, specified person as per Section 40A(2)(b) includes directors, key management personnel and their relatives. It will be very difficult for the companies / groups to benchmark the payment made to their directors / chairman.

Concluding remarks

The assessment after the introduction of the DTP provisions will commence in 2016. The taxpayer will eagerly look forward to how the revenue authorities deal with the audit report while completing the assessment. For the revenue authorities also this is going to pose a challenge considering their staff strength and infrastructure.

The OECD is currently working on a Base Erosion and Profit Shifting (BEPS) project. It has recently finalised its guidance on documentation on transfer pricing. It has suggested three tiered approach to the documentation i.e. a master file, a local file and country by country report. This will significantly change the way currently MNEs prepare their transfer pricing documentation and the content and information of the document. OECD is also working on the transfer pricing aspect of the intangibles. Although a significant progress has been made, some of the aspects especially the ownership of the intangibles and transactions relating to the development, enhancement, maintenance, exploitation, protection, etc. of the intangibles has not been finalised because of its close link to the BEPS project. The development in this front and other action points of the BEPS project when implemented is aimed at reducing the compliance cost of the taxpayer and help the revenue authorities in their TP audit. The same should hence reduce the litigation in TP matters.