TRANSFER PRICING IN INDIA - AN OVERVIEW

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Introduction

Transfer Pricing was introduced vide Sections 92 to 92F of the Indian Income TaxAct, 1961 (the Act) which covers intra-group cross-border transactions. The sections became applicable from 1st April 2001 for cross border transactions and from 1st April 2012 for specified domestic transactions.

After the introduction of these sections, transfer pricing has become the most significant international tax issue affecting multinational enterprises operating in India. The regulations are broadly based on the Organisation for Economic Co-operation and Development (OECD) Guidelines. It describes the various transfer pricing methods, imposing far-reaching annual transfer pricing documentation requirements, and contains severe penal provisions for non-compliance of the rules and regulations.

Statutory rules and regulations

The rules prescribe that income arising from cross border transactions or specified domestic transactions between associated enterprises should be computed having regard to the arm's-length price.

Further, it goes on to specify that any allowance for an expenditure or interest or allocation of any cost or expense arising from an cross border transaction or specified domestic transaction also shallbe determined having regard to the arm's-length price. The Income Tax Act defines the terms 'international transactions', 'specified domestic transactions', 'associated enterprises'and 'arm's-length price'.

Type of transactions covered

Section 92B of the Act defines the term 'international transaction' to mean a transaction between two (or more) associated enterprises involving the sale, purchase or lease of tangible or intangible property; provision of services; cost-sharing arrangements; lending/borrowing of money; or any other transaction having a bearingon the profits, income, losses or assets of such enterprises. The associated enterprises could be either two non-residents or a resident and a non-resident; furthermore, a permanent establishment (PE) of a foreign enterprise also qualifies as an associated enterprise. Accordingly, transactions between a foreign enterprise and its Indian PE are within the ambit of the code.

Even the term "Intangible property" has been explained to include marketing intangible, customer-related intangible, human capital intangible, location-related intangible, etc.

Till the sections were not notified in the Act, transfer pricing regulations were not applicable to domestic transactions. However, the Finance Act 2012 has extended the application of transfer pricing regulations to 'specified domestic transactions', being the following transactions with certain related domestic parties, if the aggregate value of such transactions exceeds INR 5 crore:

- Any expenditure with respect to which deduction is claimed while computing profits and gains of business or profession.

- Any transaction related to businesses eligible for profit-linked tax incentives, for example, infrastructure facilities (Section 80-IA) and SEZ units (section 10AA).
- Any other transactions as may be specified.

Associated enterprises

The relationship of associated enterprises (AEs) is defined by Section 92A of the Actto cover direct/ indirect participation in the management, control or capital of an enterprise by another enterprise. It also covers situations in which the same person(directly or indirectly) participates in the management, control or capital of both the enterprises.

For the purposes of the above definition, certain specific parameters have been laid down based on which two enterprises would be deemed as AEs. These parameters include:

- Direct/indirect holding of 26% or more voting power in an enterprise by the other enterprise or in both the enterprises by the same person.
- Advancement of a loan, by an enterprise, that constitutes 51% or more of the totalbook value of the assets of the borrowing enterprise.
- Guarantee by an enterprise for 10% or more of total borrowings of theother enterprise.
- Appointment by an enterprise of more than 50% of the board of directors or one or more executive directors of the other enterprise or the appointment of specified directorships of both enterprises by the same person.
- Complete dependence of an enterprise (in carrying on its business) on theintellectual property licensed to it by the other enterprise.
- Substantial purchase of raw material/sale of manufactured goods by an enterprisefrom/to the other enterprise at prices and conditions influenced by the latter.
- The existence of any prescribed relationship of mutual interest.

Furthermore, in certain cases, a transaction between an enterprise and a third partymay be deemed to be a transaction between AEs if there exists a prior agreement in relation to such transaction between the third party and an AE or if the terms of such transaction are determined in substance between the third party and an AE.

The arm's-length principle and pricing methodologies

The term 'arm's-length price' is defined by Section 92F of the Act to mean a price that is applied or is proposed to be applied to transactions between persons other than AEs inuncontrolled conditions. The following methods are prescribed by Section 92C of the Act for determination of arm's-length price:

- Comparable uncontrolled price (CUP) method.
- Resale price method (RPM).
- Cost plus method (CPM).
- Profit split method (PSM).
- Transactional net margin method (TNMM).
- Such other methods as may be prescribed.

In this regard, the Central Board of Direct Taxes [CBDT] has notified that the 'other method' for determination of the arm's-length price in relation to an international transactionshall be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts.

The most appropriate method for a particular transaction would need to be determined havingregard to the nature of the transaction, class of transaction or associated persons and functions performed by such persons, as well as other relevant factors.

The regulations provides that where more than one arm's-length price is determined by applying the most appropriate transfer pricing method, the arithmetic mean (average) of such prices shall be the arm's-length price of the international transaction or specified domestic transactions.

However, some flexibility has been extended to taxpayers by allowing a range benefit which would be notified by the Government, not exceeding 3%. Accordingly, if the variation between the arm's-length price and the price at which the transaction has actually been undertaken does not exceed the specified range of the latter, the price at which the transaction has actually been undertaken shall be deemed to be the arm's-length price.

This, in turn, would have the effect of disallowing the benefit to a taxpayer where variation between the arm's-length price and transfer price of the taxpayer exceeds the

specified range, leading to a transfer pricing adjustment even though the transfer price is only marginally outside the range benefit.

In addition, transfer pricing provisions will not apply if the arm's-length price wouldresult in a downward revision in the income chargeable to tax in India.

Documentation requirements

Assessee/Taxpayers are required to maintain, on an annual basis, a set of broad information and documents relating to international transactions undertaken with AEs or specifieddomestic transactions. Rule 10D of the Income Tax Rules, 1962 prescribes detailed information and documentation that has to be maintained by the taxpayer. Such requirements can broadly be divided into two parts :

First Part

The first part of the rule lists mandatory documents/ information that a taxpayer must maintain. The extensive list under this part includes information on ownership structure of the taxpayer, group profile, business overview of the taxpayer and AEs, prescribed details (nature, terms, quantity, value, etc.) of international transactions or specified domestic transactions and relevant financial forecasts/estimates of the taxpayer.

The rule also requires the taxpayer to document a comprehensive transfer pricing study. The requirement in this respect includes documentation of functions performed, risks assumed, assets employed, details (nature, terms and conditions) of relevant uncontrolled transactions, comparability analysis, benchmarking studies, assumptions, policies, details of adjustments and explanations as to the selection of the most appropriate transfer pricing method.

Second Part

The second part of the rule requires that adequate documentation be maintained that substantiates the information/ analysis/ studies documented under the first part of the rule. It also includes :

(a)	*official publications, reports, studies and data bases from the Government of the country of residence of the associated enterprise, or of any other country;*
(b)	*reports of market research studies carried out and technical publications brought out by institutions of national or international repute;*
(c)	*price publications including stock exchange and commodity market quotations;*
(d)	*published accounts and financial statements relating to the business affairs of the associated enterprises;*
(e)	*agreements and contracts entered into with associated enterprises or with unrelated enterprises in respect of transactions similar to the international transactions or specified domestic transactions, as the case may be*
(f)	*letters and other correspondence documenting any terms negotiated between the assessee and the associated enterprise;*
(g)	*documents normally issued in connection with various transactions under the accounting practices followed.*

All prescribed documents and information have to be contemporaneously maintained (to the extent possible) and must be in place by the due date of the tax return filing. Companies to whom transfer pricing regulations are applicable are currently required to file their tax returns on or before 30 November following the close of the relevant tax year. The prescribed documents must be maintained for a period of nine years from theend of the relevant tax year, and must be updated annually on an ongoing basis.

The documentation requirements are also applicable to foreign companies deriving income liable to Indian withholding tax.

Accountant's report

It is mandatory for all taxpayers, without exception, to obtain an independent accountant's report in respect of all international transactions between associated enterprises or specified domestic transactions. The report has to be furnished by the due date of the tax return filing (i.e. on or before 30 November). The form of the report has been prescribed. The report requires the accountant to give an opinion on the proper maintenance of prescribed documents and information by the taxpayer. Furthermore, accountant is required to certify correctness of an extensive list of prescribed particulars.

Tax audit procedure

A certain percentage of tax returns are selected for detailed audit. A notice to this effect has to be statutorily dispatched to the taxpayer within six months from the end of the financial year in which the return is furnished. Such notice specifies the records,documents and details that are required to be produced before the tax officer.

Once an audit is initiated, the corporate tax assessing officer (AO) may refer the case to a specialist transfer pricing officer (TPO) for the purpose of computing the arm's- length price of the international transactions or specified domestic transactions. Such reference may be made by the AO wherever he or she considers it necessary. However, this can be done only with the prior approval of the Commissioner of Income tax.

In accordance with prevailing internal administrative guidelines of the Revenue, all taxpayers having an aggregate value of international transactions or specified domestictransactions with AEs in excess of INR 50 million are referred to a TPO for detailed investigation of their transfer prices. The threshold of INR 50 million may be reviewed on an ongoing basis.

The TPO would then send a notice to the taxpayer requiring the production of necessary evidence to support the computation of the arm's-length price of the international transactions or specified domestic transactions. The prescribed documentation/ information maintained by the taxpayer in respect of its transfer pricing arrangements would have to be produced before the tax authorities during the course of audit proceedings within 30 days after such request has been made. Theperiod of 30 days can be extended to 60 days at most.

The TPO would scrutinise the case in detail, taking into account all relevant factors such as appropriateness of the transfer pricing method applied and correctness of data. TPOs are vested with powers of inspection, discovery, enforcing attendance, examininga person under oath and compelling the production of books of account and other relevant documents and information. Further, TPOs have been empowered to conduct surveys for spot inquiries and verification for subsequent investigation and collation of data.

After taking into account all relevant material, the TPO would pass an order determining the arm's-length prices of the taxpayer's international transactions or specified domestic transactions. A copy of the order would be sent to the AO and the taxpayer. On receipt of the TPO's order, the AO would compute the total income of the taxpayer by applying the arm's-length prices determined by the TPO and pass a draft order within the time limit prescribed for completion of scrutiny assessments.

Appeals procedure

A taxpayer that is aggrieved by an order passed by the AO may appeal to the Commissioner of Income Tax, also called the Appellate Commissioner, within 30 days of the date of receipt of the scrutiny assessment order. The office of the Appellate Commissioner is a type of quasi-judicial authority, where the taxpayers make representations in support of their claims to rebut the order passed by the AO. The decision of the appellate commissioner is reflected in an appellate order.

Additional tax and penalties

The following stringent penalties have been prescribed for noncompliance with the provisions of the transfer pricing code:

- For failure to maintain the prescribed information/ document: 2% oftransaction value.
- For failure to furnish information/documents during audit: 2% oftransaction value.
- For failure to disclose any transaction in Accountant's report: 2% oftransaction value.
- For adjustment to taxpayer's income: 100% to 300% of the total tax on the adjustment amount.
- For failure to furnish an accountant's report: INR 100,000.

Further, taxable income enhanced as a result of transfer pricing adjustments does not qualify for various tax concessions/holidays prescribed by the Act.

Advance pricing agreements (APAs)

There are no monetary or other conditions prescribed under the Indian APA rules for a taxpayer to be eligible for applying for an APA. However, the APA mechanism is not available for specified domestic transactions. The validity of an APA (once entered into) shall not exceed five consecutive years and shall be binding on the taxpayer as well as the Revenue authorities in respect of the international transactions for which the APA is sought. APA fees would range between INR 1 millionto 2 million, based on the value of international transactions.

Resources available to the tax authorities

A special transfer pricing team within the Indian tax authorities deals with transfer pricing issues. The team comprises of trained TPOs who deal with transfer pricing issues arising during an audit. Indian tax authorities are actively training their staff to increase competency in handling transfer pricing issues.

Use and availability of comparables' information

Taxpayers are required to maintain information on comparables as part of their transfer pricing documentation to demonstrate that the pricing policy complies with the arm's-length principle. Comparable information is a crucial element for defending transfer pricing in India. Indian revenue officials have indicated that, to the extent possible, Indian comparables should be used. Use of foreign comparables is generally not acceptable, unless the tested party is located overseas. In some cases, the TPOs have exercised their power to obtain private information from other taxpayers and used it against the

taxpayer undergoing an audit.

The quality of comparable information available in Indian databases is reasonable. The tax authorities use a couple of electronic databases giving detailed financial and descriptive information for companies. Taxpayers also usually rely on these databases. It is also possible to obtain information about Indian public companies from the Registrar of Companies upon payment of statutory fees.

Risk transactions or industries

No transactions or industries are excluded from the possibility of a transfer pricing investigation. Software development, business process outsourcing, banking, telecommunications, pharmaceutical, FMCG and automobile (and ancillary) are some of the industries that have been subject to intense transfer pricing audits in recent times.

Outsourcing companies rendering core/high-value services to AEs need to carefullyanalyse and set their transfer prices. Furthermore, specific situations such as sustained losses, business strategies, business restructurings, transactions with entities in tax havens, and royalties and management charges paid should be sufficiently documented.

Management services

Under India's exchange control rules, charging management service fees to Indian residents in certain situations could require regulatory approval. It may be possible to obtain regulatory approval for such a charge based on transfer pricing documentationproving its arm's-length nature. Management service fees charged to Indian taxpayersare tax-deductible if charged on an arm's-length basis. Management charges to Indian taxpayers are generally scrutinised in detail during transfer pricing audits. To mitigate the risk of disallowance, the charges should be evidenced by extensive supporting documentation proving that the services were rendered and were necessary to the business of the recipient of the services (the benefit test).

Where an Indian taxpayer is providing such services, the taxpayer should be compensated on an arm's-length basis.

Limitation of double taxation and competent authority proceedings

The competent authority provisions/mutual agreement procedure (MAP) is an alternate dispute resolution mechanism that companies are increasingly beginning to use, especially in cases where the tax amount in dispute is significant. MAP settlementstypically have been sought on issues relating to transfer pricing, PE matters and profit attribution.

Most Indian tax treaties contain an 'associated enterprises' article, which contains relieving provisions that require one country to reduce the amount of tax charged to offset the enhanced tax liability imposed by the other country to reflect the arm's- length standard. This article refers to competent authority provisions (contained in the relevant MAP article of the treaty) for consultation between authorities of both countries to prevent double taxation on taxpayers. MAP/competent authority provisions are an integral part of India's extensive treaty network.

The MAP route can be pursued by taxpayers simultaneously with the domestic dispute resolution process. In the event the MAP route is invoked, the competent tax authorities of the countries involved negotiate until they reach an agreement on the transfer prices acceptable to both the authorities. To facilitate the MAP, the Indian government has introduced rules and also has entered into memorandum of understanding (MoU) with the competent authorities of the United Kingdom and United States. An advantage of applying for the MAP under the MoUs mentioned is that Revenue will suspend the collection of tax, where the taxpayer has an adjustment in relation to transactions with the associated enterprises. Under the MoUs, the collection of tax is deferred while the MAP is in process. However, taxpayers need to provide appropriate bank guarantees in support of the potential tax payable prior to resorting to the MAP.

The increasing use of MAPs by taxpayers in seeking effective resolution of transfer pricing disputes is an encouraging step in the Indian scenario.

OECD issues

India is not a member of the OECD. However, India has been invited to participate as an observer in the OECD's Committee on Fiscal Affairs, which contributes to setting international tax standards, particularly in areas such as tax treaties and transfer pricing. India's transfer pricing regulations broadly adopts the OECD principles. Tax offices have also indicated their intent of broadly following the OECD Guidelines during audits, to the extent the OECD Guidelines are not inconsistent with the Indian Transfer Pricing Code.

Joint investigations

There is no evidence of joint investigations having taken place in India. However, almost all Indian tax treaties contain provisions for the exchange of information and administrative assistance, under which the Indian tax authorities may exchange information with other countries for transfer pricing purposes. Furthermore, with transfer pricing awareness increasing and India

signing agreements/renegotiating double tax avoidance agreements with various countries for exchange of information, joint investigations may be undertaken by the Indian tax authorities in the future.

Anticipated developments in law and practice

Revenue officials have indicated the possibility of introducing rules on safe harbour, cost contribution arrangements and thin capitalisation.

In the recent budget, the Government has proposed to introduce the General Anti-Avoidance Rule (GAAR) but as of now it has been deferred to April 2013. Current discussions indicate that the Government may further defer the implementation of GAAR by another three years. Under the GAAR provisions, Revenue authorities are empowered to disregard/combine/recharacterise the whole or any part of any impermissible avoidance arrangement. An arrangement may be regarded as an impermissible avoidance arrangement if the main purpose of the same or any part thereof is the availing of any tax benefit and is not at arm's length or is not for bonafide purpose or lacks commercial substance or results in the abuse of any provisions of the code.

Payment of royalty

The Government of India has permitted lump-sum fees for transfer of technology and royalty payments for use of trademarks/ brand names and technology under the automatic route without any restrictions. The objective of this change in policy is to freely promote the transfer of high-end technology into India.

This amendment in the exchange control regulations could have implications on the intercompany royalty arrangements that multinational enterprises have with their Indian affiliates. Because of exchange control limitations, multinational enterprises may have in the past restricted the royalty charge to their Indian affiliates in line with the limits prescribed under the automatic approval route. With the removal of such a restriction, multinational enterprises may consider revisiting their royalty arrangements with their Indian affiliates to align them with the arm's-length standard.

With this change in policy, a robust transfer pricing documentation for supporting the arm's-length nature of royalty payments would be of utmost importance to defend the deductibility of such payments before Revenue.