TRANSFER PRICING IN INDIA – A REVENUE PERSPECTIVE

A PRESENTATION BY

AKHILESH RANJAN

DIRECTOR OF INCOME TAX

(INTERNATIONAL TAXATION), NEW DELHI

02.12.2005

HISTORICALLY……

- Concept of transfer pricing always there in Indian Income-tax law

  - Section 40A(2) – empowers tax authorities to disallow payments to related parties if excessive or unreasonable– concept of 'substantial interest'

  - Section 92 (erstwhile) – allowed adjustment of profits accruing to resident from business with non-resident, if such profits less than ordinary due to 'close connection'

  - Tax holiday provisions – eligible profits can be adjusted if considered inflated due to close connection
- Limited scope of existing provisions

NEW REGULATIONS

- Need for a more comprehensive law:
  - Increasing presence of foreign businesses; new types of transactions
  - policy of integration and globalization
  - aggressive changes in US transfer pricing law in 1994; OECD update of 1995
- Comprehensive regulations introduced by Finance Act 2001

NEW REGULATIONS

- Based on internationally accepted principles, adapted to Indian context
- Income from international transactions (between associated enterprises) to be determined having regard to the arm's length price
- Regulations allow adjustments only to increase taxable income or reduce taxable losses

INTERNATIONAL TRANSACTION

- Defined to mean transaction between *associated enterprises* in all types of property, provision of services, finance, etc.
- At least one of the parties to the transaction should be non-resident
- Any transaction having a bearing on profits, losses or assets
- Includes:

  - transaction between two non-residents

  - mutual agreement or arrangement for allocation/apportionment of costs

INTERNATIONAL TRANSACTION

- Transaction with *unrelated party* also deemed to be international transaction between associated enterprises if:

  - prior agreement between unrelated party and associated enterprise in relation to the relevant transaction, or

  - terms determined in substance between unrelated party and associated enterprise

- 'Transaction' includes:

  - arrangement, understanding or action in concert

  - series of closely interlinked transactions

ASSOCIATED ENTERPRISES

- Definition of associated enterprises aligned with 'definition' in tax treaties
- Participation in management or control or capital
- Broad concept of control, suited to Indian context
- Apart from shareholding and appointment of decision-makers, regulations cover control through:
  - Loan advanced by one enterprise constituting 51% or more of book value of total assets of the other
  - Guarantee by one enterprise for 10% or more of total borrowings of the other

ASSOCIATED ENTERPRISES

- Business of one enterprise being wholly dependent on intangible property owned by the other, or in which exclusive rights held
- terms and conditions of purchase of 90% of raw materials/consumables of one enterprise controlled by the other
- terms of sale of manufactured/processed products by one enterprise entirely controlled by the other
- Kinship - control by same individual or relatives of such individual

ASSOCIATED ENTERPRISES

- Enterprises are associated if criteria met ‘at any time during the year’
- Additional criteria may be notified by CBDT
- ‘Enterprise’ defined to be a ‘person’ engaged in any of a wide range of activities
- “Permanent establishment" – defined as including a fixed place of business – deemed to be an ‘enterprise’

ARM’S LENGTH PRICE

- Five internationally recognised methods specified so far for computing ALP
    - CUP
    - Cost Plus
    - Resale Price Minus
    - Profit Split (including residual profit split)
    - TNMM
- Flexibility with CBDT to notify additional methods, as and when required

MOST APPROPRIATE METHOD

- Most appropriate method to be selected
- Factors prescribed for selecting most appropriate method
  - Nature of transaction
  - Functions performed
  - Availability, reliability of data necessary for applying a particular method
  - Degree of comparability
  - Extent to which reliable adjustments can be made to account for differences
  - Reliability and extent of assumptions required to be made in applying a method

COMPARABILITY ANALYSIS

- Well-recognised factors prescribed for judging comparability
- Prescribing business strategies not found feasible
- Use of contemporaneous data
- Multiple year data (earlier two years) may be used only if it reveals facts material to analysis

MEAN OF PRICES

- Arithmetical mean of prices obtained by most appropriate method to be taken as Arm’s Length Price
- Concept of Arm’s Length Range not found feasible
- Tolerance zone of 5 percent. allowed at taxpayer’s option.

AUDIT PROCEDURE

- Primary onus on assessee to compute ALP as per rules, supported by prescribed documentation
- Reference to TPO where ‘necessary or expedient’, with prior approval of Commissioner
- Intervention by TPO only if:
  - ALP not computed as per rules
  - documentation not maintained or not furnished
  - data used not correct or reliable
  - failure to furnish information or document called for
- Order of TPO only with regard to determination of arm’s length price - binding on Assessing Officer

OTHER FEATURES

- No requirement of balancing payments
- Tax incentives not applicable on amount of adjustment
- No compensatory adjustment where tax withheld
- DTAAs provide for corresponding adjustments
- Providing safe harbours not found feasible

DOCUMENTATION

- Prescribed documentation:
  - Nature of business environment.
  - Details of transaction.
  - Functions performed, risks assumed and assets employed.
  - Analysis to select most appropriate method and comparable transactions.
  - Actual working of ALP.
- Contemporaneous data required
- Relaxation for small value transactions – limited safe harbour

ACCOUNTANT'S REPORT

- Preliminary factual information to be furnished with return in Accountant's report.
- Details of international transaction, Associated Enterprises, method used and price adopted.
- Report not a certificate of arm's length price.

PENALTIES

- Strict penalty provisions for non-maintenance or non-furnishing of documentation – 2% of value of transaction
- Penalty for non-furnishing of accountant's report
- No penalty if reasonable cause shown
- No penalty on additions made if assessee shows good faith and due diligence

EXPERIENCE

- F.Y.2004-05 was the first year of transfer pricing audits
- Cases involving transactions above threshold value taken up
- Significant work done; learning experience
- Adjustments made in about 25% of cases

EXPERIENCE

Some typical grounds for adjustments:

- Rejection of method – taxpayer's method not found 'most appropriate' having regard to degree of comparability, availability of data
- Set of comparables modified –better comparables found through FAR analysis
- Interest free loans, free inter-company services

EXPERIENCE

- Operating margin recomputed by excluding non-operating income and including expenditure re-imbursed by parent
- Taxpayer's working in using CUP modified, rejecting adjustments not supported by documentation
- Choice of tested party

ROAD AHEAD

- Improving access to national and international databases
- Management of workload through more refined audit strategies, deployment of trained manpower
- Evolving specific methods for arrangements like CCAs
- Use of TP regulations in attribution of profits to PE
- Developing mechanism for APAs

THANK YOU

--