




TRANSFER PRICING IN INDIA – A REVENUE PERSPECTIVE

A PRESENTATION BY
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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
- ◆ DTAAAs 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