

Transfer Pricing Issues in India

A Practitioner View

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Agenda

- Transfer Pricing (TP) audits
- Application of TP principles for attributing profits to Permanent Establishments (PE)

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Data for Comparability Analysis

- Contemporaneous documentation required [Rule 10D(4)]
- Preference for current year data for comparability analysis [Rule 10B(4)]
- Use of past 2 years data permitted – only in certain circumstances
- Multiple year analysis more relevant - allowed globally
- Paras 1.49 and 1.50 of the OECD Guidelines
- Use of past years data should be permitted unconditionally

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Data for Comparability Analysis

- Fresh search for updated data at the time of audit - such data not available with the taxpayer while computing arm's length prices (Paras 5.3 and 5.9 of the OECD Guidelines)
- Issue assumes more relevance on account of limited tolerance band of (+/-) 5% in the Indian Rules
- Globally - Use of Inter Quartile Range (IQR) permitted
- Data available with taxpayer at the time of documentation should be acceptable and used in audits
- Indian rules should recognize the concept of IQR and replace “mean” with “median”

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Other data issues

- Indian regulations should allow use of average of taxpayer's data (2/3 year average)
 - Better comparability analysis
 - Evens out seasonal variations/business cycle
- In most cases, TNMM (more like a CPM analysis) used by taxpayer
- Data limitations should be recognized and accepted in any TP analysis/audit

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Application of 5% range

- 5% range should be permitted even if prices used by taxpayer are outside the tolerance band of (+/-)5%.
- How to apply the 5% range in case of multiple transactions?
- Guidance required on above

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Secret Comparables & Confidentiality of Information

- Information obtained by tax authorities u/s 133(6) - not part of public domain and not known to the taxpayer while computing Arm's Length Price (Paras 5.3, 5.9 and 5.10 of OECD Guidelines)
- Information relating to comparables used by authorities to determine Arm's Length Price needs to be shared with the taxpayer
- Safeguards to ensure secrecy of information of strategic importance
- Data not available in public domain should not be used during audit proceedings

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Business Strategies and economic principles

- Acceptability of business strategies adopted by taxpayer:
 - Start-up companies
 - Loss leaders
 - Use of budgets and forecasts
 - Other business and commercial practices
 - Set-off transactions
- Reliance on economic techniques and methods
- Acceptability of OECD Guidelines and principles laid down in overseas case laws
- Business realities and commercial considerations should be recognized and accepted

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Absence of residuary TP Method

- Application of other non-specified pricing methods which are in accordance with arm's length principle for transactions like:
 - Transfer of intangibles
 - Cost contribution agreements
 - Other transactions
- Use of a variant of specified method (e.g. Cost Plus)
- Introduce a residuary method - any other method that complies with the arm's length standard

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Transactions between an Indian Entity and an Indian PE of the Group

- PE subject to tax in India on 'net profits' basis
- Transactions between an Indian entity and PE of a foreign group Company
 - “domestic transaction”, no “cross border” transaction
- Such transactions may be excluded from TP regulations

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Double Taxation of group profits

- Refund of withholding tax not allowed in case of expense adjustment
[second proviso to Section 92C(4)]
- Results in double taxation of group profits – against basic principles of taxation
- Corresponding adjustments should be permitted

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Advance Pricing Arrangement

- “Arm’s Length” – an abstract concept
- APA’s – allowed globally
- Need for comprehensive procedure to obtain APA
- Adequate mechanism for negotiating bilateral and multilateral
APA’s required
- Participation may be possible under MAP article of relevant tax treaty
- Introduce APA mechanism in domestic tax law

**Application of TP principles
for attributing profits to a PE**

Application of TP principles for attributing profits to PE

- Lack of international consensus on interpretation of Articles 7(1) and 7(2) of tax treaties
- OECD draft prefers the “functionally separate entity approach” over the “relevant business activity approach”
- Indian TP code defines a PE as an “Enterprise” and applies the TP code to Indian PEs (functionally separate entity approach)
- Rule 10 (ii) of domestic tax law continues to apply a procedure similar to the “relevant business activity approach” for determining non-resident profits to be taxed in India
- Disconnect needs to be resolved, TP principles should always be applied to determine business profits of non-residents liable to India tax

Some challenges in applying TP to PE attribution

- Use of intangibles (deductibility of notional royalties etc.)
- Capital allocation and internal funding
- Internal services (cost vs. mark-up)
- Use of capital assets and changes in asset allocation
- Withholding tax and related compliance issues
- Recent ruling of second appellate authority (ITAT)

Thank You

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