# TRANSFER PRICING IN INDIA

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## CERTIFICATE

This is to certify that the dissertation entitled ***"Transfer Pricing in India"*** is a bonafide record of independent research work done by **SHRADDHA CHAUDHRI** *(R450210109)*, student of College of Legal Studies, University of Petroleum & Energy Studies, Dehradun, under my guidance and supervision for the partial fulfillment of the requirement of B.A., L.L.B. (Hons.) with specialization in Energy Laws degree at College of Legal Studies, University of Petroleum & Energy Studies, Dehradun.

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## DECLARATION

I declare that the dissertation entitled "***Transfer Pricing in India"*** is the outcome of my own work conducted under the supervision of Asst. Prof, Ms. Charu Srivastava, at College of Legal Studies, University of Petroleum & Energy Studies, Dehradun.

I declare that the dissertation comprises only of my original work and due acknowledgement has been made in the text to all other material used.

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# GLOSSARY

| | |
|---|---|
| AAR | Authority of Advance Ruling |
| AE | Associated Enterprises |
| ALP | Arm's Length Price |
| APM | Advertising, Marketing and Promotion |
| AO | Assessing Officer |
| APA | Advance Pricing Agreement |
| CBDT | Central Board of Direct Taxes |
| CIT(A) | Commissioner of Income Tax (Appeals) |
| CPM | Cost Plus Method |
| CUP | Comparable Uncontrolled Price Method |
| DRP | Dispute Resolution Panel |
| ITAT | Income Tax Appellate Tribunal |
| MAP | Mutual Agreement Procedure |
| MNE | Multi National Enterprise |
| OECD | Organisation for Economic Co – operation and Development |
| PE | Permanent Establishment |
| PSM | Profit Split Method |
| RPM | Resale Price Method |
| SDT | Specified Domestic Transaction |
| TNMM | Transaction Net Margin Method |
| TPO | Transfer Pricing Officer |
| TPR | Transfer Pricing Regulations |
| Tribunal | Income Tax Appellate Tribunal |
| Taxpayer | Assessee |
| Tax Authorities | Tax Administration/Revenue Authorities |

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# CHAPTER I – TRANSFER PRICING – AN INTRODUCTION

Today, transfer pricing is one of the most important issues faced by MNEs as they attempt to fairly allocate their profits amongst the companies within their group. A survey of the Global 1000 MNEs by Ernst &Young found that *"MNEs throughout the world regard transfer pricing as the most important international tax issue their organizations will face over the next two years".*[1] The tax authorities implement transfer pricing regulations and strengthen the enforcement in order to prevent a loss of revenue for each regime where these companies are incorporated.[2] The net result of this dichotomy is that transfer pricing has become a major tax issue for the companies.

Rapid advances in technology, transportation and communication have given rise to large number of MNEs (Multi National Enterprises) which have the flexibility to place their enterprises and activities anywhere in the world.[3]

Commercial transactions between the different parts of the multinational groups may not be subject to the same market forces shaping relations between the two independent firms.[4] When a party transfers goods or services to another party, for a price it is known as "transfer price".[5]

This price may be diverged from the market forces and hence can be termed as arbitrary in nature. But, the expression "transfer pricing" generally refers to prices of transactions between associated enterprises which may take place under conditions differing from those taking place between independent enterprises. It refers to the value attached to transfers of goods, services and technology between related entities. It also refers to the

[1] Ernest and Young (2003), Transfer Pricing 2003 Global Survey Practice, Perception and Trend in 22 Countries Plus Tax Authority Approaches in 44 Countries.
[2] World Transfer Pricing 2014 - the comprehensive guide to world's leading Transfer Pricing firms, also available at *www.tpweek.com*, last visited on 28 March, 2015.
[3] Background paper on Transfer Pricing, prepared by Members of the UN Tax Committee's Subcommittee on Practical Transfer Pricing Issues, para 1.2.
[4] Guidance Note on Report under Section 92E of the Income Tax Act, 1961by The Committee of International Taxation of The Institute of Chartered Accountants of India, Third Edition 2013.
[5] http://www.incometaxindia.gov.in/Pages/international-taxation/transfer-pricing.aspx

value attached to transfers between unrelated parties which are controlled by a common entity.

A significant volume of global trade nowadays consists of international transfers of goods and services, capital (such as money) and intangibles (such as intellectual property) within an MNE group; such transfers are called ‘intra-group transactions’.

Thus, the effect of transfer pricing is that the parent company or a specific subsidiary tends to produce insufficient taxable income or excessive loss on a transaction. For instance, profits accruing to the parent can be increased by setting high transfer prices to siphon profits from subsidiaries domiciled in high tax countries, and low transfer prices to move profits to subsidiaries located in low tax jurisdiction. As an example of this, a group which manufacture products in a high tax countries may decide to sell them at a low profit to its affiliate sales company based in a tax haven country. That company would in turn sell the product at an arm's length price and the resulting (inflated) profit would be subject to little or no tax in that country. The result is revenue loss and also a drain on foreign exchange reserves.[6]

As per OECD[7] Transfer Pricing Guidelines-

*“1.4 Factors other than tax considerations may distort the conditions of commercial and financial relations established between associated enterprises. For example, such enterprises may be subject to conflicting governmental pressures (in the domestic as well as foreign country) relating to customs valuations, anti-dumping duties, and exchange or price controls. In addition, transfer price distortions may be caused by the cash flow requirements of enterprises within the MNE group. A MNE group that is publicity held may feel pressure from shareholders to show high profitability at the parent company level, particularly if shareholder reporting is not undertaken on a consolidated basis. All of these factors may affect transfer prices and the amount of profits, accruing to associated enterprises within the MNE group.”*

[6] www.incometaxindia.gov.in
[7] http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm, accessed on 29th March, 2015.

It is often alleged by the tax authorities that MNEs may have the ability to resort to transfer pricing as a tool to shift profits from high tax jurisdiction to low tax jurisdiction, thereby saving the taxes payable.

Some of the related party transactions taking place in India, which may have the potential risk of diversion of funds are detailed as under:[8]

a) Purchase of goods or services from a related party at little or no cost or at inflated prices to the entity.
b) Payments for services never rendered or at inflated prices.
c) Sales at below market rates to am unnecessary 'middle man' related party, who in turn sells to the ultimate customer at a higher price with the related party (and ultimately its principals) retaining the difference.
d) Purchases of assets at prices in excesses of fair market value.
e) Use of trade names or patent rights at exorbitant rates even after their expiry or at a price much higher than the price, which can not be described as reasonable.
f) Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates prevailing at the time of the transaction.
g) Exchanging property for similar property in non monetary transaction.
h) Selling real estate at a price that differs significantly from its appraised value.
i) Accruing interest at a rate above the market rate on loans.

## PRE 2001 SCENARIO

Prior to the introduction of comprehensive transfer pricing regulations by the Finance Act, 2001, certain basic provisions existed under the income-tax and the customs and excise legislation. Further, the term 'related parties' also found mention under the company law and the anti-trust legislation.

In *Mazagaon Dock Ltd. v. CIT*[9], the concept of transfer pricing was considered by the Supreme Court with reference to Section 42 of the Indian Income Tax Act, 1922, when the law relating transfer pricing was in its rudimentary stage. The question before the

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[8] Report of the Expert Group on Transfer Pricing Guidelines submitted to the Government of India, Ministry of Finance and Company Affairs, Department of Company Affairs, August 2002.
[9] (1958) 34 ITR 368

Supreme Court was whether the transaction between the non-resident British companies and the Indian company were at arm's length. If not, whether, it is covered within the scope set out under section 42(2) of the Income Tax Act 1922. It was observed that section 42 states that it is not the question of the non-residents carrying on business in the abstract but of their carrying on business with the resident. The arrangement has to be looked into and decided on the taxability.

The Apex court rejected the contentions of the Indian company and held that profits, if any foregone, must be taxed. The court ecpressed the view with the fact, that the dealings were such as to yield no profit, was immaterial.

Section 42(2) in the Indian Income Tax Act, 1922 dealt with the situation concerning "Transfer Pricing". On the enactment of the Income Tax Act 1961, the provisions of section 42(2) were incorporated in this Act in the form of Section 92 with minor verbal changes to bring out the purport of the section more clearly. Section 92 was backed by the Rules 10 and 11 of the Income Tax Rules, 1962.

For invoking section 92, certain requisite conditions had to exist. These were:

i. The business was transacted between a resident and a non-resident.
ii. There was a close connection between the two.
iii. On the account, the course of business was so arranged that the business produces either no profit or less than normal profit to the resident.

If the conditions at (i) to (iii) were found to exist, the Asseessing Officer under the Act was empowered:

- To determine the amount of profits, which may reasonably be deemed to have been derived from such business;
- To include such amount in the total income of the resident.

Rules 10 and 11 provide the methodology for working out the normal profit to be included in the Income of the resident assesee in the circumstances mentioned earlier.

Section 92 as it existed prior to its amendment, was not sufficient to deal with complex cases of transfer pricing. Its primary shortcomings were:

i. The section applied only to 'business' between a resident and a non resident. Since business demands a continuity of relationship, isolated transactions were outside its purview.
ii. The section was not wide enough in its scope to cover cases of transfer of services or intangibles.
iii. The section was not applicable in the case where a non-resident entered into a transaction with another non-resident. Therefore, business transactions between a permanent establishment of a non-resident company and a non-resident were not covered.
iv. The section provided for adjustment of profits instead of adjustment of prices and the rules prescribed for estimating profits were not logical.
v. No detailed rules for necessary documentation were prescribed to defend actions by the Revenue authorities.

The need for Transfer pricing in India was felt by the authorities, upon the results of a study conducted by the *Zdanowicz et al (1996)*. Analyzing the capital outflow from India to USA, the survey concluded that the economic benefit of detecting and deterring capital outflow related to abnormal transaction prices can be very substantial.

A Standing Committee of experts was constituted in March, 1999 to look into a separate legislation for transfer pricing policy framework which is not effectively dealt with, in the present Income Tax Act, 1961.

In view of the above, the Central Board of Direct Taxes (CBDT) had set up an Expert Group on Transfer Pricing in November, 1999 to determine whether any amendments were necessary in the Income Tax Act, 1961 and if so to suggest a regulatory framework for the same.

The group submitted its report in January, 2001 to the CBDT. The Ministry of Finance after considering the report introduced exhaustive legislative framework to deal with transfer pricing issues *vide* the Finance Act, 2001.

## POST 2001 SCENARIO

Transfer pricing compliance has become mandatory with effect from 1 April 2001. Finance Act 2001 introduced Transfer Pricing Regulations for curbing tax avoidance and manipulation of intra-group transactions by abusing transfer pricing.

The memorandum stated as under:

*"The increasing participation of multinational groups in economic activities in the country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in such intra-group transactions, thereby, leading to erosion of tax revenues. With a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises, new provisions are proposed to be introduced in the Income Tax Act, 1961."*

A detailed circular[10] was also issued to familiarize the taxpayers who fall under the Transfer Pricing provisions apart from the Act and Rules laid down as per the constitutional statute governing the same.

As mentioned earlier, section 92 of the Income Tax Act, 1961 was substituted by eight sections in the Income Tax Act numbered 92, 92A, 92B, 92C, 92CA, 92D, 92E and 92F dealing with various aspects concerning transfer pricing. These provisions are extensively discussed in the Chapter II. The provisions were later explained in greater detail in Circular No. 14 dated 20th November, 2001 which provides a clear and detailed idea about the objective of the Revenue underlying the new provisions and their implementation.

Central Board of Direct Taxes vide the above circular containing Explanatory Notes on the provisions relating to Finance Act, 2001 (paragraph 55 to 55.23) brought out clearly the requirement of the Transfer Pricing legislation.

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[10] Circular No. 14 dated 20th November, 2001.

The Indian Legislation is not entirely aligned to the OECD transfer pricing guidelines. Since India is not a member of the OECD, it is not mandatory to follow OECD model tax code. However, India refers to OECD guidelines, which carries the persuasive value in the assessment proceeding.

# CHAPTER II – STATUTORY INTERPRETATION

Sections 92-92F have been introduced by Finance Act, 2001

## 1. ASSOCIATED ENTERPRISE

92A – associated enterprise

Section 92A defines “associated enterprise”, Enterprise is defined in Section 92F(iii)[11]. According to section 92A(1), associated enterprise is an enterprise-

(i) Which participates, directly or indirectly, or through one or more intermediaries, in the Management or control or capital of other enterprise, or,

(ii) In respect of one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management, or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

The terms participation, management, control or capital have not been defined in the Act. They have to be interpreted based on judicial precedents, definitions in other enactments, legal dictionaries and commercial practice.

Section 92A(2) gives various situations in which two enterprises can be deemed to be associated enterprises. Section 92A(2) stipulates that “if at any time during the previous year” the conditions envisaged in that section are satisfied, the ‘deeming’ provision will operate. This may create practical problems. Suppose a loan is advanced in the last month of the year, it will be

[11] Section 92F: Definitions of certain terms relevant to computation of arm's length price, etc.
(iii) "enterprise" means a person (including a permanent establishment of such person) who is, or has been, or is proposed to be, engaged in any activity, relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights, or the provision of services of any kind, or in investment, or providing loan or in the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate, whether such activity or business is carried on, directly or through one or more of its units or divisions or subsidiaries, or whether such unit or division or subsidiary is located at the same place where the enterprise is located or at a different place or places.

deemed that both the enterprises are associated enterprises for the whole year. Even the earlier transactions in the first eleven months when 'association' was not there, may have to satisfy 'arm's length price'. At that time, the enter[rise could not have anticipated 'association'.

Section 92A(1) and 92A(2) are not independent especially after the amendment of section 92A(2) by Finance Act, 2002.

The various situations mentioned in section 92A(2) are as under:

i. **Shareholding pattern –** control: holding shares directly or indirectly carrying voting control in excess of 26%. Since the section refers to holding shares with voting power, presumably it refers to companies. But there is no reason, why it should not refer to controlling interest, for example, in a firm with reference to profit sharing ratio.
ii. **Shareholding –** a common person or enterprise: a common person or enterprise holding shares directly or indirectly carrying voting power in excess of 26%in both the enterprises. Mere holding of shares is enough to invoke this clause. Capacity in which shares are held is immaterial. Significance of 26% emanates from section 189 of the companies act 1956. No special resolution can be passed without the approval of the enterprise holding 26% of shares.
iii. **Loan**: loan is advanced by one enterprise to the other enterprise and that constitutes not less that 51% of the book value of the total assets of the other enterprise. 'Loan' has not been defined in the Act. Even banks or financial institutions, who have advanced loans exceeding the 51% limit can also be treated as 'associate enterprises'!
iv. **Guarantee:** one enterprise guarantees at least 10% of the total borrowings of the other enterprise. The word used is 'borrowings' and not 'loans'. It is arguable whether items like advances from customers, amounts due to suppliers can be termed as 'borrowings'.
v. **Directors:** if one enterprise appoints any of the following of the other enterprise, the two enterprises will be deemed to be 'associated':

a. More than half of the members of the Board of Directors or the governing body of the other enterprise.
b. One or more executive directors of the other enterprise.
c. One or more executive members of the governing board refers to non-corporate enterprise.

vi. **Appointment by a third enterprise**: if a third enterprise appoints the following persons of two enterprises, then the two enterprises will be deemed to be associated:
    a. More than half of the members of the board of directors, or the governing Board.
    b. One or more executive director or executive member.

vii. **Know-how, patents, etc.:** if one enterprise carries on manufacture, or processing of goods or articles, or a business, which is wholly dependent on the use of intangibles such as patents, licenses etc., owned by another enterprise has exclusive rights, both the enterprises will be treated as 'Associated',
    The extent of dependency should be determined as the words used are "wholly dependent".

viii. **Purchase of raw materials and consumables**: if an enterprise purchases 90% of the raw materials and consumables required for manufacture or processing goods or articles from another enterprise, or from an enterprise specified by the other enterprise, and the price and related conditions are influenced by such other enterprises, the twoenterprises are deemed to be associated. It is not clear whether 90% should be applied to the quantity or the value of raw materials and consumables. It is also not clear what are the 'other conditions relating to the supply' which are influenced by the supplier enterprise.

ix. **Sale of goods or articles:** if an enterprise which manufactures or processes goods or articles sells the same to another enterprise or to an enterprise specified by the other enterprise and the piece and related conditions are influenced by such other enterprise, the two enterprises are deemed to be "associated". There is no restriction on the quantity sold. "other conditions relating to the sale" are not mentioned.

x. **Control by individual/relative:** if one enterprise is controlled by an individual, and the other is also controlled by the same individual and/or his relatives, the two enterprises will be deemed to be associated. The word 'control' has not been defined, but there are a large number of precedents, which may be seen under residence under section 6 (volume 1). 'relative' is defined in section 2(41) of the Act.

xi. **HUF as medium:** if one enterprise is controlled by a HUF and the other enterprise is controlled by-

   a. A member of the HUF
   b. A relative of a member of HUF
   c. Jointly by such member and his relative.

   The two enterprises will be deemed to be Associated.

xii. **Firm/AOP/BOI as control media:** if one enterprise holds at least 10% interest in the other enterprise being a firm, association of persons or body of individuals, the two enterprises will be deemed to be associated.

xiii. **Mutual interest to be prescribed:** id there exists any relationship of mutual interest as may be prescribed, between two enterprises, they will be deemed to be associated. Nothing has been prescribed so far.[12]

## 2. INTERNATIONAL TRANSACTION

**SECTION 92B-MEANING OF INTERNATIONAL TRANSACTION:** The definition of 'international transaction' is very wide. It includes-

i. Purchase, sale or lease of tangibles or intangible property
ii. Provision of services

[12] COMMENTARY [Sampath Iyengar's LAW OF INCOME TAX, 11TH Edition]

iii. Lending or borrowing money

iv. Any transaction having bearing on profits, income, losses or assets.

v. Mutual agreement or arrangements for the allocation or apportionment of, or any contribution to any cost or expense incurred in connection with a benefit, service oe facility provided to any one or more associated enterprises.

The term 'Transaction' is defined in section 92F(v)[13]. Section 92B deems certain transactions as 'international transactions'. It provides that a transaction entered into by an enterprise with a person other than an associated enterprise shall be deemed to be a transaction with an associated enterprise, if the following conditions are satisfied-

i. There exists a prior agreement in relation to the relevant transaction between such other person and the Associated Enterprise, or

ii. The terms of the relevant transaction are determined in substance between such other person and the Associated Enterprise.

## 3. ARMS LENGTH PRICE AND TRANSFER PRICING METHODS

***SECTION 92C- COMPUTATION OF ARM'S LENGTH PRICE:*** section 92C of the Income Tax act provides for adjustment in the transfer price of an international transaction with an associated enterprise if the transfer price is not equal to the arm's length price. As a result, a larger number of such transactions are being subjected to adjustment giving rise to considerable dispute.

The proviso to sub-section (2) of section 92C provides that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices, or, at the option of the assessee, a price which may vary from the arithmetical mean by an amount not exceeding five percent of such arithmetical mean.

[13] Section 92F(v): "transaction" includes an arrangement, understanding or action in concert,--

A. whether or not such arrangement, understanding or action is formal or in writing ; or
B. whether or not such arrangement, understanding or action is intended to be enforceable by legal proceeding.'.

The above provision has been subjected to conflicting interpretation by the assessee and the Income Tax Department. The assessee's view is that the arithmetical mean should be adjusted by 5 percent to arrive at the arm's length price. However, the department's contention is that if the variation between the transfer price and the arithmetical mean is more than 5 percent of the arithmetical mean, no allowance in the arithmetical mean is required to be made.

With a view to resolving this controversy, it is proposed to amend the proviso to 92C to provide that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such price.[14] However, if the arithmetical mean, so determined, is within five percent of the transfer price, then the transfer price shall be treated as the arm's length price and no adjustment is required to be made.

(the above amendment has been made applicable with effect from 1st April, 2009 and will accordingly apply in respect of assessment year 2009-10 and subsequent years)

Scope- this section gives the various methods of determining 'Arm's Length Price.' Income Tax rules 10A to 10E are relevant in this connection. Section 92C(2) provides that the most appropriate method should be applied. Rule 10C gives the guidelines in selecting the most appropriate method.

The methods given in Section 92C(1) are:

i. Comparable uncontrolled price method (CUP)
ii. Resale price method (RPM)
iii. Cost plus method (CPM)
iv. Profit split method (PSM)
v. Transactional Net Margin Method (TNMM)
vi. Any such method as may be prescribed by the board (so far nothing has been prescribed)

[14] white Paper on Transfer Pricing Consultation (Public Consultation), issued by OECD on 30th July, 2013.

Proviso to section 92C (i) provides the benefit of tolerance limit upto a margin of 5% of the Arithmetic mean to the tax payer. This proviso provides that if there is more than one price determined by the most appropriate method. The arithmetical mean of such prices should be calculated. The assessee has the option to adopt any price in this range as the Arm's Length Price.

Section 92C(3) gives the circumstances in which the Assessing Officer may proceed to determine Arm's Length Price. Proviso of this sub-section provides that reasonable opportunity should be given to the assessee before adopting the figure of Arm's Length Price calculated by the Assessing Officer (AO).

Assessee made an application to AAR for determination of Arm's Length Price, two days after approval for reference to Transfer Pricing Officer was given. AAR held that the question was already pending before the Assessing Officer and it has no jurisdiction and could not, therefore, entertain the application. [15]

Section 92C(4) gives the power to the Assessing Officer to finalise the assessment on the basis of Arm's Length Price as determined by him.

The first proviso to section 92C(4) provides that where there is enhancement of income by adopting Arm's Length Price calculated by the Assessing Officer, no deduction under section 10A, 10B or under chapter VIA shall be allowed from the income arising on account of enhancement. The second proviso to section 92C(4) prohibits corresponding adjustments in the case of the other associated enterprise/ if the income of an enterprise is determined on the basis of Arm's Length Price calculated by the Assessing Officer, no corresponding adjustment will be made in the case of the other associated enterprise.

For the calculation of Arm's Length Price, section 92C has prescribed 5 methods and also a residuary method which may be prescribed by the Board. The most appropriate method has to be chosen, where there is multiplicity of answers, the arithmetic mean of such prices should be calculated. The assessee has the option to adopt a value which is in the range of 5% of the Arithmetic Mean.

[15] Morgan Stanley and Co Inc. In re (2006) 284 ITR 260 (AAR) affirmed (2007)292 ITR 416 (SC).

For the purpose of five methods prescribed in section 92C, rules 10A to 10E are relevant. The Accountants' report for the purposes of Section 92E should be in the Form 3CEB.

i. Comparable uncontrolled price method (CUP) – Rule 10B(a) explains this method which reads as under
ii. Resale price method (RPM)- This is defined in rule 10B(b). the steps are
iii. Cost plus method (CPM)- Rule 10B(c) defines this method
iv. Profit split method (PSM)- This is defined in rule 10B(d)
v. Transactional Net Margin Method (TNMM)- Rule 10B(1)(e) describes the method.
vi. Any such method as may be prescribed by the board <u>(so far nothing has been prescribed)</u>

## 4. CHOICE OF METHODS

The main section and the rule provide that the method that is chosen should be best suited to the facts and circumstances of each particular international transaction and it should also provide the most reliable measure of arm's length price in relation to anh international transaction.

Sub-section (2) of section 92C[16] provides that the choice has to be made in the manner prescribed under the rules. It further contemplated possibility of more than one "most appropriate method", in which case, arithmetical mean could be adopted. But the reference to "more than one most appropriate method" which is in superlative tense does violence to the English language because there cannot be more than one "most appropriate method". What is referred is that may be more than one appropriate method both equally tenable.

[16] 92C(2): The most appropriate method referred to in sub-section (1) shall be applied, for determination of arm's length price, in the manner as may be prescribed :
Provided that where more than one price may be determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices.

The following factors are to be taken into consideration:

i. The nature and class of international transaction;
ii. The class or classes of associated enterprise and their function;
iii. The availability, coverage and reliability of data necessary, degree of comparability, extent of reliability and accurate adjustments to accounts for the differences between transaction price and comparable uncontrolled price and the assumptions made and reliability of such assumptions.

The requirements are of general nature and these are broadly to be read with the information and documents required under rule 10D read with section 92C. while Rule 10D would refer to the documents and information section 92C would expect the assessee to justify the choice of appropriate method with reference to the cover of information, accuracies and reliability of such information, again a task which is not easy and on final analysis may also be a matter of opinion.

In this context, the Press Release is more literal and should be treated as having watered down both the documentation that are required, and the possible errors in the choice of methods. When the section itself provides for the possibility of more than one appropriate method, choice of any method cannot be easily faulted. The Press Release concedes that "taxpayers are free to select the most appropriate method as long as their selection is made taking into account the factors prescribed." As regards documents, it is stated that they have been considerably scaled down and now require only such information as is relevant to the transaction entered into.

It is the view of the Institute of Charted Accountants of India,[17] that choice is that of the assessee and the certification would be with reference to such choice made by the assessee. Charted Accountants' responsibility is to ensure, that this method is correctly applied with reference to data furnished and available to him. But then, dispute with revenue often relates to appropriateness of the method adopted. Rule 10A defines the expressions, while rule 10B requires the computation of arm's length price according to any one of the methods appropriate to the purpose of determination of arm's length price.

[17] Supra 3.

**CUP METHOD [Rule 10B(1)(a)]**- The following three steps are required-

a. Ascertainment of price in a comparable uncontrolled transaction or transactions;
b. Adjust the same for differences, if any, between transaction under consideration and the transaction adopted for the comparison;
c. Taking the adjusted price as the arm's length price judging the variations.

The difference in character of the transaction, functions expected and the risks assumed, the difference in respect of responsibilities, risks and benefits with reference to contractual terms and prevailing market conditions taking into account difference, if any, in location, size of the market, laws, government orders imposed, cost of labor and capital in respective markets, overall economic development and the level of competition, nature of market, whether wholesale or retail have been indicated, though these items have not been listed in an exclusive fashion, they are comprehensive enough to cover every possible situation which would require adjustment.

Rule 10B(3), however, points out at that even uncontrolled transactions need not necessarily mean that it would be comparable listing out circumstances where they could not be so comparable , while defining, when it can be comparable. Comparable Uncontrolled Price (CUP) method is the favorite method for revenue, which attaches greater importance to this method. Rules in other countries also would give pre-eminence to this method. In India, the legacy of checking the accounts with reference to gross profit margin prevalent in comparable cases would indicate that this method has always been considered as a sound method, though there are many instances, where a different method would be more suitable and more reliable.

OECD report would consider this method preferable to other methods, where necessary data is available. It is sometimes possible that the same party engages itself from with associated parties and also with no so associated, so that information is available internally. Where it is not available, one has to seek information relating to competitors, bearing in mind adjustments that are necessary, broadly as under:

i. Identical product with same quality
ii. Terms of volume, credit terms, transport terms, etc.

iii. Whether wholesale, semi-wholesale, retail, etc.
iv. Geographical locations, market in which the transaction takes place
v. Date of transaction
vi. Intangible rights, if any, associated with the sale
vii. Foreign currency risks; and
viii. Alternatives available to the buyer and seller.

CUP method has been the subject matter of application in most cases as a more suitable method than others, though it involves number of problems in application, especially in identification of comparative cases. Six factors have been identified by Internal Revenue Service in U.S. as relevant in choice of a case for comparison. They are:

i. Quality of product
ii. Terms of sale
iii. Any intangible property associated with sale
iv. Time of sale
v. Level of market (retail or wholesale)
vi. Geographical market in which sales are made.

The U.S. Court in *Eli Lilly and Co v Commissioner*[18] in a transaction between a holding company in U.S. and a subsidiary company in Puerto Rico in export of painkillers, variables are identified as not only in respect of raw materials, but also containers, whether bottles or capsules, labels, credit terms, cost incurred for distribution of samples, packing, quality control necessary to be incurred at the other end and the quality difference. Reasonably ascertainable adjustments were required for these items before application. If such data are not available, the method itself will not be applicable. [19]

Where there is regulation as to price by an international cartel as in the matter of Saudi crude oil, it could not be sold at less than a pre-fixed international price. Arm's length price cannot be different and CUP method would have no relevance in such case as held in *Exxon Corporation and Affiliated Companies et al v. Commissioner of TC Memo*

[18] (1985)84 TC 996.
[19] *Sundstrand Corp. v Commissioner* (1991)96 TC 226.

1993-616. A similar view was taken by U.S. Supreme Court, where there was prohibition of payment of royalty, so that the Assessing Officer cannot adopt a different price as arm's length price with reference to transfer pricing rules in *Commissioner v First Security Bank of Utah*[20].

Where rent free equipment was supplied, transfer pricing rules were held to be justified by adoption of fair rental value in *Central De Gas De Chihuahua S.A. v Commissioner of Internal Revenue*, Doc. No. 18370-91. It is not unusual to adopt a markup over cost and justify the CUP method by establishing reasonableness of the mark-up. But such mark-up should be based upon comparable basis as decided in a Swedish case in Upjohn AB RA 1984.1.83.

The tribunal in recent decisions has held that all other things being equal, the CUP Method leads to more reliable results.[21]

In Arvind Mills Ltd v. ACIT[22], comparison between controlled and uncontrolled transactions under CUP Method, it was held, it is not appropriate and needs further investigations into functions performed, risks borne and assets employed to arrive at arm's length price of international transactions under scrutiny.

**RESALE PRICE METHOD [Rule 10B (1) (b)].** - Resale Price Method is relatively a simple one. While the transaction between associated concerns may be susceptible of variation because of the significant influence or control exercised by one over the other, the ultimate sale price in the open market cannot be questioned. It is this price, which is known as resale price. If the price paid for the purchases or services is commensurate with the value addition made before resale, there is no reason, why it should not be accepted as arm's length price.

Clause (i) of sub-clause (b) would require that where this method is adopted, resale price is the price in the open market to an unrelated enterprise and not to another associate enterprise. This is an obvious requirement. Where the sale is uncontrolled, it offers a

[20] 405 U.S.394 (1972)
[21] *Serdia Pharmaceuticals (I)Pvt Ltd v ACIT* (2011) 44 SOT 391 (Mum)
[22] (2011)11 Tanmann.com67 (Ahd-ITAT)

basis for which the transaction price could be worked out. Once the resultant price is identified adjustments are required to be made. Clause (ii) provides for such adjustments and the first step is reduction of the same by normal gross profit margin. It is recognized that resale price cannot be adopted as arm's length price because of the distribution cost and the distributor's margin. It is for this purpose normal gross profit margin is reduced from the sale price. If there is any value addition made, such value addition would also require to be adjusted and such amount as further reduced will be an amount, which should be treated as the arm's length price.

Rule 10B (1) (b)(iii) further provides reduction by way of expenses incurred by the party is connection with purchase of the property or obtaining the services. In other words sub-clause (ii) and (iii) together require deduction of profit margin and expenses at both ends, so that it would mean that value additions made at the sale point will be reduced from the resale price. But such amount as reduced by these items may not automatically mean that the net resale price is the arm's length price.

There may be various factors, which are functional or otherwise, which may lead to a further difference in price. Accounting practice or other factors may clearly affect gross profit margin in the open market. Mere reduction of resale price by gross profit and the cost does not necessarily give arm's length price. Further adjustments would be required to make them comparable or, in other words, one may look for an explanation, wherever the transaction price is different from the price calculated with reference to the resale price. Gross profit margin in the open market may not be a correct cure, because the actual gross profit could be influenced by parties. Subject to these, resale price may be the most appropriate method. One advantage of this method is the fact that information for arriving at this price is more readily available.

The resale method offers good evidence and it is more suitable method in some circumstances. In *E I Du Pont de Nemours*[23], the inference of U.S. authorities that the commission by the U.S. company to its Swiss distributor was under-charged as is evident from the abnormal profits of its Swiss subsidiary, bringing to tax the difference by adoption of normal commission.

[23] (1979) 608 F2d, 445

Resale price method was found appropriate in view of the comparability of gross margins with a foreign tested party rendering services in construction and engineering for core duties in high technology projects in respect of its transaction with the associated enterprises in Bahamas and USA. The comparability was in respect of foreign information data base as decided in *Development Consultants Pvt Ltd*. [24]

**COST PLUS METHOD [10B (1) (c)]-** Cost Plus Method involves determination of the cost to the associated enterprise and gross profit, which could be reasonably expected to be earned by the provider of the goods or service. This means that there should be adequate information as to the cost.

Cost can be both direct and indirect. Determination of the cost for a particular product involves allocation of common cost, an exercise which may not be too difficult under any costing system worth its name. Information relevant should be available. While direct cost can be more readily ascertainable, indirect cost may involve allocation of common cost. Cost of production involving materials and labor to convert such materials into saleable product could be direct cost, while indirect cost would involve allocation of cost or other costs including marketing. The rules do not spell out the manner in which this exercise has to be undertaken, except broadly stating that direct and indirect cost of production for the goods or services would have to be determined at the first stage in clause (1).

To this aggregate of direct or indirect cost of goods or services, addition has to be made for normal gross profit. Normal gross profit is one which is expected to be earned in a comparable uncontrolled transaction or a number of transactions. This is one factor which is less certain for ascertainment, compared to direct and indirect cost. Adjustments may be required to be made as to what is the normal gross profit. Normal gross profit in an uncertain market would require to be higher than, where the market is stable. Uniform gross profit may not be considered reasonable with reference to sale in different geographic locations. A potential expansion of the market may find a lower margin. Adjustments may have to be made for the same. The aggregate cost so arrived at, along

[24] 2008-ITOL-150-ITAT-Kol.

with the gross profit, which should take into consideration the possible variations, should be taken at arm's length.

While resale price method starts with sale price of goods purchased from associated concern, cost plus method adopts price of goods purchased. Cost plus method ultimately requires a fair mark-up on the basis of normal gross profit for determination of arm's length price. Comparison with competitors' facts is, therefore, unavoidable even in this method.

In Altair Engineering India P Ltd v DCIT[25], it was held, that cost plus method is acceptable only if the basis of mark-up is clearly demonstrated as justified failing which the Transfer Pricing Officer will resort to TNMM Method.

In a U.S. case, the parent company made available research and development services on a cost plus designated mark-up on a sliding scale dependent on the quantum of cost. Revenue argued that CUP method should be preferred on the basis of information related to 15 other companies. Expert witness of IRS besides its functional and risk analysis in support of CUP Method were not found acceptable.[26]

**PROFIT SPLIT METHOD [Rule 10B(1)(d)]-** Profit split method is probably the most scientific method in that it first identifies the total profit in the transaction and then the value addition made by the respective parties are taken as the basis for revenue sharing of the respective States. But then, there are two steps involved:

i. The ascertainment of combined net profit of the associated enterprises and
ii. The ascertainment of the relative contribution.

On the basis of above data, the aggregate book profits get split up, but both the steps require information, which may not be forthcoming and even if it does, verification will not be an easy task. Data required for relative contribution would be even more complex.

[25] ITA No. 1184 of 2010, dated 14.3.2011 (Bang.-ITAT)

[26] *Westreco Inc. v Commissioner T.C. Memo* 1992-561 (1992)

The sub-rule does not spell out the manner of ascertainment of combined net profit of associated enterprise, but tries to define the basis of ascertainment of relative contributions made by associate enterprises, the aggregate of which forms the combined net profit. Relative contributions are required to be ascertained with reference to the following indicia:

1. Functions performed
2. Assets employed or to be employed
3. Risk assumed by each enterprise with reference to reliable external market data.

Evaluation is required to be done with reference to the price that would have to be determined, if the transaction had been between unrelated enterprises performing comparable functions in similar circumstances. The profit split-up on the basis of the contributions would be more accurate, if the information constituting the basis are available and the method adopted for evaluation acceptable. Comparable data for evaluation of each component of value addition made by each associated enterprise would involve cumbersome procedure. In fact, it may involve all the other methods for ascertaining the value of each component.

OECD transfer pricing guidelines[27] would point out that the external market data for profit split method may be even more subjective than the other methods. Since external market data alone can determine the value addition with reference to what could have been the value, if the transaction had taken place as between independent enterprises, it should make the task of such ascertainment extremely difficult. In fact, it is possible; the tax authorities in the two participant states may arrive at a different combined profit and different ratio of the contribution in view of the greater role of estimate in profit-split method. It is for this reason that OECD guidelines would consider that this method has a number of weaknesses.

Is it necessary to find profits of each associated concerns and add up the same or estimate the normal profit in such a transaction, if both the associates were one? The rule is silent

[27] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2010, also available at http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm.

on the same. But there may be cases, where it may be possible to identify the combined profit as well as the contributions with the result, that this method may be most appropriate. It cannot, therefore, be discarded as a method inferior to any other method, since, in final analysis, what is appropriate, depends upon the availability of reliable data in connection with the rule.

While the rule does not mention the manner of arriving at the combined net profit, it does not mention the manner of arriving at the value addition with reference to market data available for similar types of transactions as between independent enterprises. It has to be done in respect of both the participant countries. The main task lies in ascertainment of the proportion for allocation of profits as between two countries.

The problem in this method is allocation of profit margin between associated concerns. This may ultimately have to be on a best judgment basis, which often becomes unavoidable not only for this method, but also for other methods in allocating the weight of each variable to draw overall inference. In *P P G Industries Inc. v. Commissioner*[28], the allocation of margin at 55% and 45% between the holding company and foreign subsidiary was considered justified, since the adoption of CUP method could not also lead to a result materially different. Such apportionment is more in vogue in U.S., where transfer pricing becomes necessary in transaction on which there is both State as well as Federal Tax, so that profit split method is relied upon more heavily, more often in proportion of payroll amounts in both these cases.

**<u>TRANSACTIONAL NET MARGIN METHOD [Rule 10B(1)(e)].</u>-** transactional net margin method is not essentially different from what Assessing Officer are prone to resort to, when they find that no accounts or accounts produced are reliable. The normal margin of profit that is expected in the line of trade forms the basis of turnover of either purchases or sales, whichever is considered more reliable. The following steps are contemplated:

i. The net profit margin of the associated enterprise is computed with reference to the sales, or the costs, or assets employed or any other relevant base.

[28] 55 TC 928 (1970)

ii. Net profit margin that would have been realized, if the transactions were between unrelated enterprises under uncontrolled conditions on the same basis is computed.

iii. The net profit margin as ascertained in Item 2 is adjusted for factors relevant for international transactions and materially affecting the profit as it would have otherwise been made in uncontrolled conditions as between independent persons.

Net profit margin is worked out after adjustments in 3 above will be treated as the actual margin of profit made by associated enterprise. Such margin will be added to the cost of the associated enterprise to arrive at the arms length price.

The task in computing the profit of the associated enterprise is not avoided, but such task is limited to the ascertainment of the profit of the associated enterprise situated in the country, where arm's length price is required to be determined, while in the case of profit split method, such ascertainment would have to be determined with reference to the data available in both the countries to arrive at combined profits with the result that this method is easier in some respects. The net profit spelt out in Rule 10B(1)(e) would have to be computed with reference to the cost incurred or sales effected or assets employed or required to be employed by the enterprise or having regard to any other relevant base indicating that determination of the net profit is not a matter which can be done on an *ad hoc* basis. Though there are as many as five steps indicated in the sub-rule, it may not be necessary to go through all the five steps. Even the first step may not be necessary if the objective of the tax collector is ascertainment of profit. The net profit margin for uncontrolled transactions can be arrived at and it is such profit which will be treated as earned by the non-resident subject to variations in other participating State for purposes of Section 9(1)(i) and the profit attributable to permanent establishment under double tax avoidance agreement.

The presumptive rate of profit can be said to be based upon expected margin in each line of business. Income-tax law already has a presumptive rate stipulated in the statute. Section 44B would adopt 7.5% for profits of shipping business, section 44B, a rate of 10% for computing profits in the business of exploration, etc. of mineral oil, and section 44BBB a rate if 10% with business of civil construction etc. in turnkey projects. Operation of aircraft, however, is presumed to earn 5% net profit as prescribed under section 44BBA. Royalty and technical fees are taxed at 20% now reduced to 10%, which is a rate lower than the ruling rate justified with reference to the lower net income therefrom, since the rate is on gross income. Double tax avoidance agreements may prescribe even a lower rate as a matter of mutual agreement for certain categories of income as it does for interest and dividend incomes.

Concessional rates of tax are prescribed for returns on capital not always with reference to principle of fair revenue-sharing, but as a matter concessions intended to encourage inflow of foreign capital. Hence, it would appear, that fundamentally the presumptive rate, which could be treated as a method of arriving at the nqaazjet profit margin. It can be no less reliable than any other method. In fact, such presumptive rate would lead to a certainty, which is considered necessary in tax matters. It is considered more preferable than what is considered to be fair in academic sense. Revenue sharing on presumptive basis may not be as fair as the most appropriate method. It is possible the rate may be oppressive, where it is not possible to earn matching profit as prescribed in the statute. But then, the rates, that are fixed are not permanent, since it is possible for alteration either way.

Transactional Net Margin Method (TNMM) was founded by Supreme Court to be more suitable in *DIT (International Taxation) v Morgan Stanley and Co. Inc*[29]. **However, the special bench**

Transactional Net Margin Method (TNMM) was found by the Supreme Court to be more suitable in *DIT (International Taxation) v Morgan Stanley and Co Inc*[30].

[29] (2007) 292 ITR 416 (SC).
[30] (2007) 292 ITR 416 (SC).

## 5. REFERENCE TO TRANFER PRICING OFFICER

Section 92CA is an afterthought to provide for specialization in view of the complexity of application in transfer pricing rules by delegating the function to a specially appointed Transfer Pricing Officer for ensuring proper implementation of law. Hopefully, it would be beneficial also to the taxpayer with better understanding expected of an officer because of greater familiarity to the rules in view of expertise, which is bound to be gained in dealing with most such cases. It should be possible for him to be equipped with information as to the precedents from other countries, so that there can be greater uniformity and harmonization in view of the fact that the transfer pricing rules are similar or even the same in most other countries.

Power of the Transfer Pricing Officer to go into the question of determination of transfer price for any transactions other than what has been referred to him was specifically recognized by sub-section (2A) inserted by the Finance Act, 2011 with effect from 1.6.2011. This amendment became necessary in view of the decision of the Tribunal[31] holding that there is no power for Transfer Pricing Officer to take up any matter other than what was referred to him.

Disputes arising out of Transfer Pricing are now to be decided by the Dispute Resolution Panel under section 144C even prior to assessment. Section 144C was inserted by the Finance Act, 2009 with retrospective effect from April 1, 2009. Any dispute pending with the Assessing Officer or Transfer Pricing Officer on or after April 1, 2009, should require a draft assessment order to be vetted by the Dispute Resolution Panel. A writ petition challenged the arm's length price as determined by the Transfer Pricing Officer for "representation service". The High Court dismissed the submission of the writ petitioner and held that all the objections posed by the assessee unsuccessfully before the TPO and raised before the High Court can be placed before the Dispute Resolution Panel, which is expected to pass order with supporting evidence for its conclusion.

[31] *Amadeus India P Ltd v ACIT* (2011) 8 ITR (Trib) 187 Del.

In *Vodafone Essar Ltd v Dispute Resolution Panel*[32] it was held that the DRP was a quasi judicial body and is bound to give cogent and germane reasons for its conclusions.

***ROLE OF TRANSFER PRICING OFFICER:*** a reference to the TPO can be made by the Assessing Officer. There is no need for Assessing officer to demonstrate avoidance of tax existence of circumstance mentioned in clauses (a) to (d) of section 92C(3) for making a reference to the Transfer Pricing Officer, Assessing Officer need not hear the assessee before making a reference to the TPO, but he should have some material to justify reference arm's length price. It can be determined, even if the assessee is entitled to exemption under section 10A or 10AA. Board's instruction to make reference only where international transactions cross Rs. 5 crores in value is valid and is binding on the Assessing Officer. The order of the Transfer Pricing Officer is not binding on the Assessing Officer, but he must have strong reasons not to accept it.- *Aztech Software and Technology Services Ltd. v ACIT*[33].

In *Sony India P Ltd v CBDT*[34], constitutional validity of Board's circular was upheld.

6. **POWER OF BOARD TO MAKE SAFE HARBOUR RULES**

The Power of the board to make Safe Harbour Rules was brought into the statute by the Finance Act (No. 2) 2009, with effect from 1.4.2009, but was made applicable with effect from 1st October 2009. Safe Harbour Rules would provide a blanket exception from the application of transfer pricing rules for certain classes of transaction. It may be in respect of turnovers falling below a certain limit or where the transaction is between a State undertaking or in such cases where the State feels that there is no scope of any significant additions on transfer pricing rules. However, these rules have not been provided and are still in the process of being framed.

7. **MAINTAINANCE, KEEPING OF INFORMATION AND DOCUMENT BY PERSONS ENTERING INTO AN INTERNATIONAL TRANSACTION-**

92D requires every person who has entered into an international transaction to maintain such information and documents as may be prescribed. Rule 10D prescribes the

[32] (2011) 196 Taxman 423 (Del)
[33] (2007) 294 ITR (AT) 32 (Bang)(SB)
[34] (2007)288 ITR 52 (Del)

information and documents to be kept and maintained. ‘Document’ is defined in section 2(22AA) of the Act and includes electronic data as defined in section 2(l)(t) of the Information Technology Act, 2000[35] .

The various types of information to be maintained in respect of an international transaction, the associated enterprise and the transfer pricing method used are prescribed in Rule 10D of the Income tax Rules, as under:

i. A description of the ownership structure of the enterprise and details of shares or other ownership interest held therein by other enterprises;
ii. A profile of the multinational group of which the taxpayer is a part and the name, address, legal status and country of tax residence of each of the enterprises comprised in the group with whom international transactions have been made by the taxpayer and the ownership linkages among them;
iii. A broad description of the business of the taxpayer and the industry in which it operates and the business of the associated enterprises;
iv. The nature, terms and prices of international transaction entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction;
v. A description of the functions performed, risks assumed and assets employed or to be employed by the taxpayer and by the associated enterprise involved in the international transaction;
vi. A record of the economic and market analyses, forecasts, budgets or any other financial estimates prepared by the taxpayer for its business as a whole or separately for each division or product which may have a bearing on the international transaction entered into by the taxpayer;
vii. A record of uncontrolled transactions taken into account for analysing their comparability with the international transaction entered into, including a record of the nature, terms sand conditions relating to any uncontrolled

[35] “(t) “electronic record” means data, record or data generated, image or sound stored, received or sent in an electronic form or micro film or computer generated micro fiche”

transaction with third parties which may be of relevant to the pricing of the internationals transactions;

viii. A record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction;

ix. A description of the methods considered for determining the arm's length price in relation to each international transaction or class of transaction, the method selected as the most appropriate method along with explanations as to why such method was so selected, and how such method was applied in each case;

x. A record of the actual working carried out for determining the arm's length price, including details of the comparable data and financial information used in applying the most appropriate method and adjustments, if any, which were made to account for differences between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transaction;

xi. The assumptions, policies and price negotiations if any which have critically affected the determination of the arm's length price ;

xii. Details of the adjustments, if any made to the transfer price to align it with arm's length price determined under these rules and consequent adjustment made to the total income for tax purposes;

xiii. Any other information data or document including information or data relating to the associated enterprise which may be relevant for determination of the arm's length price.

Rule 10D also prescribes that the above information is to be supported by authentic documents which may include the following:

i. Official publications, reports, studies and data bases of the government of the country of residence of the associated enterprise or of any other country;

ii. Reports of market research studies carried out and technical publications of institutions of national or international repute;

iii. Publications relating to prices including stock exchange and commodity market quotations;
iv. Published accounts and financial statements relating to the business of the associated enterprises;
v. Agreements and contracts entered into with associated enterprises or with unrelated enterprises in respect of transaction similar to the international transactions;
vi. Letters and other correspondence documenting terms negotiated between the taxpayer and associated enterprise;
vii. Documents normally issued in connection with various transaction under the accounting practices followed.

It is noteworthy that the information and documentation requirements referred to above are linked to the burden of proof laid on the taxpayer to prove that the transfer price adopted is in accordance with the arm's length principle. One of the conditions to be fulfilled for discharging this burden by the taxpayer is maintenance of prescribed information and documents in respect of an international transaction entered into with a associated enterprise. A default in maintaining information and documents in accordance with the rules is one of the conditions which may trigger a transfer pricing audit under Section 92C(3).

Any default in respect of the documentation requirement may also attract penalty of a sum equal to two percent of the value of the international transaction (Sec 271AA).

There is no reference in the provisions included either in the Income tax Act or the Income tax Rules about any requirement to submit the prescribed information and documents at the stage of initial compliance in the form of submission of report under section 92E. All that Section 92E requires is that the concerned taxpayer shall obtain a report from an Accountant in the prescribed form (Form 3CEB) and submit the report by the specified date. Form 3CEB contains a certificate from the Accountant that in his opinion proper information and documents as prescribed have been maintained by the taxpayer. It does not require their submission along with the report.

While there is no requirement for their submission along with the report, Rule 10D requires that the information and document maintained should be contemporaneous as far as possible and should exist latest by the specified date for filing the report under section 92E. Section 92D also provides that information and documentation may be requisitioned by the Assessing Officer or the Appellate Commissioner on a notice of thirty days which period may be extended by another period of 30 days.

Although the law has prescribed no monetary limit in respect of international transaction covered by the transfer pricing requirements, an exception is provided in para 2 of Rule 10D in respect of the information and document requirement in respect of transactions not exceeding INR 10 million. It is provided that the above requirement will not apply to such transactions. However the concerned taxpayer may be required to substantiate on the basis of available material that the income arising from the international transaction is computed in accordance with the arm's length rule.[36]

The prescribed information and documents are required to be maintained for a period of eight years. Rule 10D absolves a taxpayer entering into a international transaction which continues to have effect over more than one year from maintaining separate set of documents for each year. However separate documents are required for each year if there is any significant change in the terms and conditions of the international transaction which have a bearing on the transfer price.

As the transfer pricing provisions introduced by the Finance Act are effective from 1 April 2001, the above requirements will be applicable to all international transactions entered into by associated enterprises in India after that date. The first compliance date in respect of the new transfer pricing regulation would be 31 July 2002 for non-corporate and 31 October 2002 for corporate taxpayers in respect of international transactions entered into by them during the period 1 April 2001 to 31st March 2002. Taxpayers who are affected by the new transfer pricing regulation would thus have time till the above-mentioned dates to be ready with the required information and documents in respect of covered transactions.

[36] International Transfer Pricing 2013-2014, issued by PWC.

## 8. REPORT FROM AN ACCOUNTANT TO BE FURNISHING BY PERSONS ENTRING INTO INTERNATIONAL TRANSACTION:

Any person entering in an international transaction should furnish a report from an Accountant in Form 3CEB. Rules 10E is relevant in this connection and may be referred to. Rule 10E provides the format of certificate.

Filing of form is directory: the choice of appropriate method is that of the assessee. Part A of form 3CEB Annexure relates to particulars relating to assessee, while Part B in an elaborate questionnaire comprising all the relevant information for interference of associated enterprise, documentation, details of transaction and the arm's length price adopted, while the certification of the Charted Accountant only confirms that the particulars furnished in the Annexure are true and correct to the best of information of the Charted Accountant. Filing the form before the specified date, being the due date for filing return, could only be regulatory and not mandatory as has been found by the preponderant rulings of the courts under analogous provisions, where such certificates are prescribed.

Section 92E of the Act provides for report from an accountant to be furnished by persons entering into international transaction. In *Ravi Kumar Rawat v ITO*[37],the assessee was required to file a report from an accountant on or before the specified date. Due to non-filing of the report, a show cause notice was issues by the Assessing Officer and penalty was levied under section 217BA. It was held that, where the auditor of the assessee was himself not aware of the required compliance of filing auditor's report under section 92E and the assessee filed the same as soon as it became known to him, the default was technical one, so as to be not liable for penalty.

## 9. DEFINITIONS OF CERTAIN TERMS RELEVANT TO CUMPUTATION OF ARM'S LENGTH PRICE, ETC. –

Section 92F gives definitions of the legal terms used in context to Transfer Pricing, i.e understanding of those terms which becomes crucial in relevance to computation of arm's length price. Concept of arm's length price and enterprise have been considered under

[37] (2011) 10 Taxmann.com 248 (JP-ITAT).

section 92C and 92A. Permanent establishment is broadly the same as under the Agreements. Discussions under section 90 under the same title may be seen. Enterprise and transaction are also concepts discussed under section 90.

# CHAPTER III- ADMINISTRATIVE SET-UP, APPELLATE AUTHORITIES AND ADR MECHANISMS

This chapter provides an insight into the administrative set-up of the TP administration, the litigation hierarchy and the alternative dispute resolution mechanisms available under the Indian TPR. Apart from the administrative set-up, the critical issue in the TP administrative process is the interplay between the AO and the TPO, their relative roles and obligations.

## 1. ADMINISTRATIVE SET-UP

### ➢ *CBDT [CENTRAL BOARD OF DIRECT TAXES]*

The CBDT is a part of Department of Revenue in the Ministry of Finance. On one hand, CBDT provides essential inputs for policy and planning of direct taxes in India, at the same time it is also responsible for administration of direct tax laws through the Income Tax Department. The Central Board of Direct Taxes is a statutory authority functioning under the Central Board of Revenue Act, 1963. The officials of the Board in their ex-officio capacity also function as a Division of the Ministry dealing with matters relating to levy and collection of direct taxes.[38]

The CBDT as the Apex body of the department of Revenue being entrusted with the administration of taxes came into existence as a result of the Central Board of Revenue Act, 1924. Initially the Board was in charge of both direct and indirect taxes. However, when the administration of taxes became too unwieldy for one Board to handle, the Board was split up into two, namely Central Board of Direct Taxes and Central Board of Excise and Customs with effect from 1 January 1946. This bifurcation was brought by constitution of the two Boards u/s 3 of the Central Board of Revenue Act, 1963.

### ➢ *ORGANIZATIONAL STRUCTURE OF THE CENTRAL BOARD OF DIRECT TAXES*

The CBDT is headed by the Chairman and also comprises of six members, all of whom are ex-offico Special Secretary to Government of India.

[38] Dispute Resolution in Tax Matters : An Indian – U.K. Comparative Perspective by Sriram Govind and Samira Varanasi (Nishith Desai & Associates), International Taxation Volume 9 September 2013.

- Member (Income Tax)
- Member (Legislation and Computerisation)
- Member (Revenue)
- Member (Personnel & Vigilance)
- Member (Investigation)
- Member (Audit & Judicial)

The chairman and members of CBDT are selected from Indian Revenue Service (IRS) a premier civil service of India, whose members constitute the top management of the Income Tax Department.

There are as many as eight Directorates as attached officers of CBDT play a vital role by developing a positive liaison between the field formations and the CBDT. The following Directors General of Income Tax (DGIT) are directly under the administrative control of the Central Board of Direct Taxes:

1) DGIT (Administration)
2) DGIT (Systems)
3) DGIT (Vigilance)
4) DGIT Tax (Training)
5) DGIT (Legal and Research)
6) DGIT (Business Process Re-engineering)
7) DGIT (Intelligence)
8) DGIT (HRD)

In addition to above there are three more Directorates and also Chief Commissionerates at field level which are as follows:

1) DGIT (Investigation)
2) DGIT (Exemption)
3) DGIT (International Taxation)
4) 18 cadre controlling Chief Commissioners of Income Tax (CCIT)

Various Directorates, headed by Directors of Income Tax (DIT), have been placed under the Director Generals of Income Tax report the DGITs to the Central Board of Direct Taxes:

- ***FUNCTIONS OF DIRECTOR OF INCOME TAX (INTERNATIONAL TAXATION)***

There are five DITs (International Taxation) located at Delhi, Mumbai, Kolkata, Chennai and Banglore. The functions are:

- Supervision and control over the Directorate
- Statutory functions in respect of taxation of foreign companies and non-residents and withholding tax on remittances abroad.
- Vigilance and disciplinary matters.
- Computerization.

- ***FUNCTIONS OF DIRECTOR IF INCOME TAX (TRANSFER PRICING)***

In accordance with section 92CA of the Income Tax Act, 1961, a reference is made by the AO to DIT (TP) for determination of Arm's Length Price in relation to the international transaction(s). the transfer price is determined by the TPO in terms of section 92C. The price is determined by any one of the method stipulated in sub-section (1) of section 92 and by applying the most appropriate method referred to in sub-section (2) thereof. The TPO after taking into account all relevant facts and data available to him determines arm's length price and passes a speaking order after obtaining the approval of DIT transfer pricing.

Each major city has Director of Income Tax – Transfer Pricing (DIT-TP) who handles transfer pricing matters exclusively. Under DIT-TP, there will be Additional Commissioners, Joint Commissioners and Assistant Commissioners handling transfer pricing audits, being called as TPOs.[39]

Depending upon the value of the international transaction the file is processed by the concerned TPO.

- ***DIRECTOR GENERAL OF INCOME TAX (INTERNATIONAL TAXATION)***

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[39] *Ibid*

The Director General of Income Tax (International Taxation) performs the following functions:

- Supervision and control over the work of DIT (International Taxation)
- Vigilance and disciplinary matters
- Computerisation
- Statutory functions.

## 2. *JURISDICTION OF ASSESSING OFFICER (AO)/ TRANSFER PRICING OFFICER (TPO)*

Section 92C of the Act deals with the computation of the arm's length price. Section 92C(3) and section 92CA(3) of the Act give jurisdiction to the Assessing Officer (AO)/Transfer Pricing officer (TPO) to determine the arm's length price if, in the course of the assessment proceedings, on the basis of materials or information or documents in his possession, he is of the opinion that:

- The price charged or paid in an international transaction has not been determined in accordance with sub-sections (1) and (2);
- Any information or document relating to an international transaction has not been kept and maintained by the taxpayer in accordance with the provisions contained in section 92D (1) and the rules made in this behalf;
- The information or data used in the computation of the arm's length price is not reliable or correct;
- The taxpayer has failed to furnish, within the specified time, any information or document that he was required to furnish by a notice issued under section 92D (3).

In this regard, the CBDT has issued a circular[40], the relevant extract of which reads as under:

*(i)* ………

*(ii)* ………

[40] Circular 12/2001, of 23 August 2001.

(iii) *"It should be made clear to the concerned Assessing Officer that where an international transaction has been put to scrutiny, the Assessing Officer can have recourse to sub-section (3) of section 92C only under the circumstances enumerated in clauses (a) to (d) of that subsection. (…) In all other cases, the value of the international transaction should be accepted without further scrutiny."*

Based on circular 12 and section 92C(3), only in specific circumstances can the TPO proceed to determine the arm's length price of the international transaction and make adjustments to the income of the taxpayer.

Thus, the AO will make a reference, if he considers it necessary and expedient to do so, to the TPO after obtaining approval from the Commissioner of Income Tax[41]. The reference mechanism has been put in place by the CBDT through issuance of Instruction 3 of 2003, dated 20th May 2003.

Section 92CA was amended[42] to state that AO shall compute the total income of the Assessee in conformity with the order of the TPO.

Thus, post this amendment, the order of the TPO is binding on the AO.[43]

The AO is required to issue a notice for selecting a case for normal assessment within 6 months (12 months until tax year 31 March 2007) from the end of the financial year in which the return is furnished. In practice, the AO refers the case to the TPO within the above time limit. After receipt of the reference from the AO, the TPO is required to serve a notice on the taxpayer to substantiate the computation of arm's length prices in relation to its international transactions. The TPR mandate that TPOs should provide an opportunity to the taxpayer to submit evidence regarding the arm's length price. The TPOs are expected to consider the appropriateness of the method selected and applied by

[41] Section 92CA of the Income Tax Act, 1961.
[42] Finance Act, 2007.
[43] The Finance Act, 2011 has amended that (effective 1 June 2011) the jurisdiction of the TPO will extend to determination of the arm's length price in respect of other international transactions, which are noticed by him/her subsequently, in the course of proceedings before him/her. These international transactions would be in addition to the international transactions referred to the TPO by the AO.

the taxpayer, the reliability of data used and other facts and circumstances in determining the arm's length price, and are expected to document them in the order.

## 3. DISPUTE RESOLUTION

Where there is a disagreement between the tax payer and the tax authorities with regard to the arm's length price determined by the TPO, the taxpayer has two alternative remedies with effect from October, 2009:

- Objections filed with DRP
- Appeal to the commissioner – appeals

### ➢ *DISPUTE RESOLUTION PANNEL*

The Indian Government has introduced an alternative appellate procedure for the TP orders passed on or after 1st October, 2009 to approach DRP which will hear the case and pass orders. The passing of orders shall take place in nine months which is a quicker process than the commissioner – appeals which takes longer time. Therefore, now, the taxpayer has an option to appeal before DRP or CIT – Appeals.

### ➢ *DISPUTE RESOLUTION MECHANISM*

A comprehensive dispute resolution mechanism is available to the taxpayers in India facing transfer pricing adjustments. To facilitate the expeditious resolution of taxpayer disputes, including those related to transfer pricing, on a fast track basis, and to bring in certainty, the Finance Act, 2009 introduced an Alternate Dispute Resolution mechanism.

The Finance Act (No.2) Act, 2009 introduced an ADR mechanism[44] with an objective to facilitate expeditious resolution of disputes involving foreign companies and transfer pricing matters. The Memorandum to Finance (No. 2) Bill, 2009 highlights the fact that the dispute resolution mechanism presently in place is time – consuming and finality in high – demand cases is attained only after a long drawn litigation upto the level of Supreme Court. Considering this, the Act provides for an DRP mechanism with an objective to facilitate expeditious resolution of disputes on a fast track basis.

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[44] Under section 144C of the income Tax Act, 1961.

As a part of the legal process in all cases, the AO incorporates the order of the TPO in his order and issues a draft order to the tax payer. The taxpayer has the option to file an objection against the draft order before the DRP which is a panel comprising three commissioners of Income Tax. For cases referred to the DRP, the AO issues a final order in compliance of the directions of the DRP. In cases where taxpayer chooses not to file an objection before the DRP, the draft order by the AO incorporating the order of the TPO becomes final and the taxpayer may file an appeal before the Commissioner of Income Tax (Appeals). The transfer pricing administration is more than a old in India. However, disputes are increasing with each transfer pricing audit cycle, due to following factors:

- Cross border transactions have increased significantly in the last decade.
- Lack of international consensus on taxation of certain group cross – border transactions such as intangibles, financial transactions, intra – group services etc.
- Difficulty in applying the arm's length price method to complex transactions such as business restructuring.
- Taxpayers in India can postpone payment of tax liability by resorting to litigation; and
- Availability of multiple channels to resolve disputes in India.

The Indian tax authorities are aware of the problem of increasing disputes and has taken several steps to reduce litigation and the time needed to resolve tax disputes. The steps taken by the Indian tax authorities are as under:

- International transactions below INR 150,000,000 (US$ 3 Million) are not selected for transfer pricing audit;
- No adjustments are made in cases where the variation between the arm's length price determined and the price of international transaction does not exceed 3 percent or other notified percentage;
- Significant efforts have been made to provide certainty in the application of transfer pricing laws;

- There is a time limit for disposal of objection of the taxpayer by the DRP;
- Indicative time limits have been provided for various judicial forums;
- Direct appeal to the tax tribunal is provided against transfer pricing orders approved by the DRP;
- Dedicated and specialized appellate Commissioners and benches of tax tribunals have been put in place to deal with disputes of transfer pricing;
- The process for mutual agreement procedure has been put on fast track; and
- An Advance Pricing Agreement Scheme is put in place.

## 4. FIRST APPEAL – COMMISSIONER (APPEAL)

After the final order is passed by the AO (if the taxpayer does not prefer the DRP option) incorporating the TPO's order, the taxpayer can appeal against such order before the first level of appellate authority. Commissioner – Appeals, quasi judicial authority, will hear the taxpayer and pass orders representing himself as a representative of the tax authority.

The order passed by the CIT – Appeals is binding on both the parties and appealable by either of them, whoever is aggrieved before the Income – tax Appellate Tribunal.

## 5. INCOME TAX APPELLATE TRIBUNAL (ITAT)

This is the second level of Appellate forum which is governed by Ministry of Law. At this stage, the taxpayer or the tax authorities can appeal each other. The Headquarters of Income – tax Appellate Tribunal is situated in Mumbai, it has 63 branches at 27 places.

The following authorities have been created under the statutes and/or administrative orders who are vested with and exercise delegated powers:

(i) President
(ii) Senior Vice – President / Vice – Presidents
(iii) Member – Judicial and Accountant
(iv) Registrar

(v) Deputy Registrar

(vi) Assistant Registrar

The Income Tax Appellate Tribunal is not a court but is a tribunal exercising the judicial powers of the state. The tribunal's powers in dealing with the appeals are very wise and have in some cases been held similar to and identical with the powers of an appellate court under the Code of Civil Procedure.

The jury consists of two members, three member or more depending upon the intensity of the case. There shall be constituted special bench to discuss the specific legal issue, if required. ITAT shall discuss the factual matters placed before it and pass the necessary orders or directions to the jurisdictional lower authorities as the case may be. The orders passed shall be binding on both the parties and they have a right to appeal against the orders before the jurisdictional High Court.

### 6. HIGH COURT

The high courts are governed by the Ministry of Law and each State has a High Court. It shall discuss and decide on the 'issues of law' and not on 'issues of facts'.

Any person aggrieved by the orders of the High court has the right to appeal before the Supreme Court of India.

### 7. SUPREME COURT OF INDIA

This is the Apex court of India and the orders issued by this court is binding on all concerned in the country including the administrators. It protects the constitutional sovereignty of the country and discharges the legal disputes in accordance with the Supreme Court Rules.

The matter will be heard if the Special Leave Petition (SLP) is admitted for a hearing. Only if there is a legal case for argument, the same is allowed at SLP stage and thereafter if admitted, the matter will be adjudicated on the question of law.

## ADVANCE PRICING AGREEMENTS (APA)

The current global economic crisis and its impact on tax revenues are urging governments around the world to intensify their transfer pricing compliance efforts. Tax authorities are increasing audit activities to ensure that they are not disadvantaged in staking claims to taxable profits. In this environment, global companies face higher risk of disputes with tax authorities over their transfer pricing practices.[45] With material tax amounts at stake and looming uncertainty over tax positions during audit, many companies are opting to enter formal Advance Pricing Agreements (APAs) with one or more tax authorities.

An APA is a formal agreement for a specified period between a taxpayer and a tax authority specifying the pricing methodology and the arm's length price that the taxpayer will apply to its related – company transactions. Such arrangements are planned to help taxpayers voluntarily resolve actual or potential transfer pricing disputes in a proactive, cooperative manner, as an alternative to the traditional audit process.[46] Once entered, the APA is binding on both the taxpayer and the tax authority. The term of the APA varies and is usually in period of 3 to 5 years.

An APA (or 'arrangements') as referred to by the OECD in its 2010 transfer pricing guidelines is –

> *"An agreement that determines in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time".*[47]

The Internal Revenue Service (IRS) defines an APA as[48]:

> *"An APA is an agreement between a taxpayer and the Service in which the parties set forth , in advance of controlled transactions, the best Transfer Pricing Method (TPM) within the meaning of Sec. 482 of the Code and the regulations. The agreement specifies the controlled transactions or transfer (covered transactions), TPM, APA*

[45] Transfer Pricing 360 degrees, Volume 1 Issue 1, Apr – June 2014, issued by SKP team.
[46] Report on International Transfer Pricing by PWC. Also available at *www.pwc.com/internationaltp*.
[47] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010), paragraph 4.124.
[48] Internal Revenue Bulletin, section 482 – Allocation of Income and Deduction among Taxpayers, Rev.Proc. 2004 – 04, 19 July, 2004.Available *on http://www.irs.gov/irb/2004-29_IRB/ar13.html*, accessed on 28 March 2015.

*term, operational and compliance provisions, appropriate adjustments, critical assumptions regarding future events, required APA records, and annual reporting responsibilities."*

Advance pricing agreements usually involve pending transfer pricing issues from prior years and can provide an effective means of resolving existing transfer pricing audits and adjustments. Often involve the resolution of transfer pricing issues pending from prior years – and in some cases can provide an effective means for resolving existing transfer pricing audits or adjustments. An APA offers a company several other benefits. It provides greater certainty on the transfer pricing method adopted, mitigating, the possibility of disputes and facilitating the financial reporting of potential tax liabilities. Importantly, an APA also reduces the incidence of double taxation, and the costs associated with both audit defence and documentation preparation.

### ***TYPES OF APA***

There are three types of APAs – Unilateral, Bilateral and Multilateral. The taxpayer decides which type of an APA to enter.

Unilateral APA is an agreement between taxpayer and tax authority and doesn't include agreement with treaty partner. Hence, unilateral APA doesn't guarantee the arm's length price and transfer pricing methodology to be accepted in other countries.

In Bilateral APA, taxpayer reaches into an agreement with tax authority of two countries which are forming part of the international transaction. The competent authorities of the two countries are required to negotiate through Mutual Agreement Procedures.

In Multilateral APA, taxpayer reaches an agreement with tax authority of multiple countires which are forming part of the international transaction. The competent authorities of the countries are required to negotiate through mutual agreement procedures.

### ***SCOPE AND OBJECTIVE OF APA***

An APA can be applied for various international transactions, like purchase or sale of raw materials, finished goods, providing services, financing arrangements, transfer and use of tangible/intangible assets, etc. Considering the time and resources required for an APA it is generally preferred to enter into an APA in respect of complex/high value transactions. Certain countries exclude routine transactions from the scope of the APA. In some countries there is materiality threshold for entering into an APA.

Selecting of transactions for APA is up to discretion of the tax payer and there is no statutory obligation on a taxpayer to cover all the related party or inter – company transactions in an APA.

The scope of an APA also states the time period for which the APA shall be applied. Generally, an APA is entered into for duration of three to five years and may be renewed/ re-negotiated upon completion of the originally agreed term. Under the Indian APA rules, the APA term could be upto a period of five years with an option for renewal.[49]

In some countries even prior periods can be included in the APA. The Indian APA Rules do not enable roll back of APAs.

Hence, an APA is an agreement that sets transfer price of the covered transaction prospectively between the taxpayer and the tax authorities. The APA process follows a consultative and collaborative approach between the taxpayer and the tax authority.

### *ADVANTAGES OF APA*

An APA is designed to provide tax certainty with regard to arm's length price of the international transaction, which has been covered in the APA. Through bilateral or multilateral APA, risk of double taxation is avoided. The APA reduces the cost of compliance by reducing transfer pricing audit risk and risk prolonged litigations. Lastly, APA reduces the burden of record keeping as taxpayer knows in advance the documentation to be maintained for the period of APA.

### *APA PROCESS IN INDIA*

In India APA was introduced in 2012[50] and the tax authorities are in the first year of negotiating APAs with the applicants. The APA mechanism, covers only international transactions and doesn't cover specified domestic transactions in India. The validity of an

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[49] Guidance Note on Report under Section 92E of the Income Tax Act, 1961by The Committee of International Taxation of The Institute of Chartered Accountants of India, Third Edition 2013.page – 173-176.

[50] S.O. 2005 (E), Notification No. 36 of 2012, dated 20 August, 2012, Central Board of Direct Taxes.

APA shall not exceed five consecutive years and is binding on the taxpayer and the Revenue authorities for the international transactions covered in the APA. The fees range is between INR one million to two million based on the value if international transactions. In line with the global practice, there are four stages in an APA, which are as follows:

a) **Pre filing stage:** The process of an APA would start with a pre-filing consultation meeting. This meeting will be held to determine the scope of the agreement, understand the transfer pricing issues involved and to determine the suitability of the international transaction for the agreement. No fee is to be paid in this phase.

b) **Formal submission stage:** After the pre- filing meeting, if the taxpayer is desirous of applying for an APA, an application in the prescribed format would be required to be made containing specified information. The APA filing fee is payable at this stage. In the application, the taxpayer must describe critical assumptions. Critical assumptions refer to a set of taxpayer related facts and macroeconomic criteria (such as industry, business, economic conditions, etc.), the continued existence of which are material to support the position concluded under an APA. A material change in any of the critical assumptions may result in revision of the APA or even termination in extreme circumstances.

c) **Negotiation stage**: Once the application is accepted, the APA team shall hold meetings with the applicant and undertake necessary inquiries relating to the case. Post the discussion and inquiries, the APA team shall prepare a draft report which shall be provided to the Competent Authority in India (for unilateral/multilateral APA) or the Director General of Income Tax (International Tax and Transfer Pricing) (for Unilateral APA).

d) **Finalisation stage:** This phase involves exchange of comments on draft APA, finalisation of the APA, and giving effect to the initial years covered under the APA term that have already elapsed. The

> taxpayer will be required, as part of the APA, to prepare an annual compliance report (ACR) for each year of the APA, containing sufficient information to detail the actual result for the year and to demonstrate compliance with the terms of the APA. The ACR shall be furnished within thirty days of the due date of filing income tax return for that year, or within ninety days of entering into an agreement, whichever is later.

Globally, the APA process is largely similar to the one applied in India, with some unique features to that particular jurisdiction. In trying to secure a fair share of taxable profits, tax authorities to an extent compete with their counterparts from other transacting jurisdictions.[51] In order to avoid double taxation, there is an increasing trend towards tax authorities favouring the use of bilateral advance pricing agreements where they are available. The OECD also encourages the use of bilateral agreements where through the Mutual Agreement Procedure provisons of tax treaties[52]. In its first year (2013), there are about 150 APAs filed with Revenue in India, as per the information shared by the Revenue authorities during the APA road-shows.

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[51] Supra 2.
[52] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010), para 4.123.

# CHAPTER V- BASE EROSION AND PROFIT SHIFTING (BEPS) – A NEW LOOK AT TRANSFER PRICING

**Evolving scenario of BEPS**: globalization has resulted in a shift from country specific operating models, to global models based on matrix management organizations and integrated supply chains that centralize several functions at a regional or global level.[53]

Moreover, the growing importance of the service component of the economy, and of digital products that often can be delivered over the internet, has made it much easier for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers.

Base Erosion and Profit Shifting, refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes or to shift profits to locations where there is little or no real activity.[54]

At the request of G20 Finance Ministers, in July 2013, the OECD launched an Action Plan on BEPS, identifying 15 specific actions needed in order to quip governments with the domestic and international instructions to address this challenge.[55]

The BEPS initiative is an anti-avoidance measure designed to develop international consensus to tackle tax leakages due to lacuna in the current international tax concepts and regulations.

The plan recognizes the importance of addressing the borderless digital economy, and will develop a new set of standards to prevent double non-taxation. This will require closer international co-operation, greater transparency, data and reporting requirements. To ensure that the actions can be implemented quickly, a multilateral instrument to amend bilateral tax treaties will be developed.

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[53] Dealing effectively with the Challenges of Transfer Pricing , issued by OECD (2012)
[54] Prem Sikka and HughWillmott (2010) "The dark side of transfer pricing: Its role in tax avoidance and wealth retentiveness A Critical Perspective" on Accounting 21(2010) 342-356.
[55] Action Plan on Base Erosion and Profit Sharing, OECD publishing (2013)

*A realignment of taxation and relevant substance is needed to restore the intended effects and benefits of international standards, which may not have kept pace with changing business models and technological developments.*

Whilst bilateral tax treaties have been effective in preventing double taxation, there is a concern that they often fail to prevent double non-taxation that results from interactions among more than two countries. In particular, the involvement of third countries in the bilateral framework established by treaty partners puts a strain on the existing rules, in particular when done via shell companies that have little or no substance in terms of office space, tangible assets and employees.

The following is a pertinent extract from the frequently asked questions on BEPS:[56]

*Can BEPS be tackled without replacing the arm's length principle with formulary apportionment?*

*The current transfer pricing rule do not always properly address the way modern business operate in a globalised environment, and taxpayers have thus been able to use/misuse the rules to artificially shift profits. In particular, the arm's length principle faces challenges in addressing transfers in intangibles, risks and capital, and other high-risk transactions. The Action plan includes three major actions to address these cases, which may include special measures either within or beyond the arm's length principle. The Action Plan has been developed to fix the current system quickly and efficiently without preconceptions regarding the precise nature of the changes that may be required to address these critical transfer pricing issues. However, adoption of alternative transfer pricing methods like formulary appointment would require development of a consensus on a number of key issues and could also raise systematic problems which could result in even more damaging problems for countries' revenues. Accordingly, it is believed that it will be most productive to focus on addressing specific issues arising under the current arm's length system at the present time.*

At high levels, BEPS is designed to address the following concerns:

[56] http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm,accessed on 25 March, 2015.

- Aims to end use if shell companies used to stash profits offshore or unduly claim tax treaty protection and neutralize all schemes that artificially shift profit offshore.
- Use of two-tiered structure and transfer of intangibles under Cost Contribution Arrangement.
- Transfer of manufacturing operations together with a transfer of supporting intangibles under a cost contribution arrangement.
- Leveraged acquisition with debt push down and use of intermediate holding companies.
- Taxing rights between the source and resident states.

## KEY TAX PRINCIPLES AND OPPORTUNITIES FOR BASE EROSION AND PROFIT SHIFTING

### *KEY PRINCIPLES FOR TAXATION OF CROSS BORDER ACTIVITIES*

The set of rules that affect the tax treatment of cross-border activities, is constituted primarily by domestic tax law rules, and also by double tax treaties and other international law instruments, such as those applicable in the European Union (Regulations, Directives, etc.). It is possible to identify a number of principles contained in these rules that assume key relevance when examining issues related to BEPS. These key principles include jurisdiction to tax, transfer pricing, leverage and anti-avoidance.

### *JURISDICTION TO TAX*

The right to tax is traditionally based on the factor that determines connection to a jurisdiction. Jurisdiction to tax is exercised on an entity by entity basis, not on a group-wise basis, subject to the exception of the availability of domestic group consolidation regimes. In broad terms, tax systems are often divided into worldwide and territorial ones. A worldwide taxation system generally subjects to tax its residents in their worldwide income, i.e. derived from sources within and outside of its territory and non-resident on the income derived from its territory. On the other hand, a territorial system generally subjects to tax, both residents and non-residents only on the income derived from its territory. On the other hand, a territorial system is employed in a pure form and no two tax systems are exactly the same.

The interaction of domestic tax systems sometimes leads to an overlap, which means that an item of income can be taxed by more than one jurisdiction thus resulting in double taxation. The interaction can also leave gaps, which result in an item of income not being taxed anywhere thus resulting in so called 'double non-taxation'. Corporations have urged bilateral and multilateral co-operation among countries to address differences in tax rules that results in double taxation, while simultaneously exploiting difference that result in double non-taxation.

Treaty rules for taxing business profits use the concept of permanent establishment as a basic nexus/threshold rule for determining whether or not a country has taxing rights with respect to the business profits of a non-resident taxpayer. However, some categories of profits may be taxed in a country even though there is no permanent establishment therein. These include:

i. Profits derived from immovable property, which, in all or almost all treaties, may be taxed by the country of source where the immovable property is located;
ii. Profits that include certain types of payment which, depending on the treaty, may include dividends, interest, royalties or technical fees, on which the treaty allows the country of source to levy a limited tax based on the gross amount of payment (as supposed to the profit element related to the payment);
iii. Under some treaties, profits derived from collecting insurance premiums or insuring risks in the source country;
iv. Under some treaties, profits derived from the provision of services if the presence of the provider in the country of source meets certain conditions.

    The permanent establishment concept also acts as a source rule to the extent that, as a general rule, the only business profits of a non-resident that may be taxed by a country are those that are attributable to a permanent establishment.

## ***TRANSFER PRICING***

The issue of jurisdiction to tax is closely linked with one of the measurements of profits. Once it has been established that a share of an enterprise's profits can be considered to originate from a country and that the country should be allowed to tax it, it is necessary to have rules for the determination of the relevant share of the profits which will be subjected to taxation.

Transfer pricing rules perform this function. The internationally accepted principle underlying transfer pricing determination is the arm's length principle, which requires that for tax purposes, related parties must allocate income as it would be allocated between independent entities in the same or similar circumstances. *When independent enterprises transact with each other, the conditions of the transaction are generally determined by market forces*. When associated enterprises transact with each other, their relations may not be directly affected by market forces in the same way. The objective of the arm's length principle is for the price and other conditions of transactions between enterprises to be consistent with those that would occur between unrelated enterprises for comparable transactions under comparable circumstances. In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs, taking into consideration assets used and risks assumed. Therefore, in determining whether controlled and uncontrolled transactions or entities are comparable, a comparability analysis is needed to ensure that the economically relevant characteristics of the situations being compared are sufficiently comparable. One of the key factors in that comparability analysis is a functional analysis to identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions.

One of the underlying assumptions of the arm's length principle is that the more extensive the functions/assets/risks of one party to the transaction, the greater its expected remuneration will be and vice versa. This therefore creates an incentive to shift functions/asset/risks to where their returns are taxed more favorably. While it may be difficult to shift underlying functions, the risk and ownership of tangible and intangible assets may, by their very virtue, be easier to shift. Many corporate tax structures focus on allocating significant risks and hard-to-value intangibles to low-tax jurisdiction, where their returns may benefits from a favorable tax regime. Such arrangements may result in or contribute to BEPS. Shifting income through transfer pricing arrangements related to the contractual allocation of risks and intangibles often involves thorny questions. One basic question involves the circumstances under which a tax payer's particular allocation of risk should be accepted. Transfer pricing under the arm's length standard generally respects the risk allocations adopted by related parties. Such risk allocation and the income allocation consequences asserted to follow from them can become a source of controversy. The evaluation of risk often involves discussions regarding whether, in fact, a low-tax transferee of intangibles should be treated as having borne, on behalf of the MNE group, significant risks related to the development and use of the intangibles in commercial operations. Such arguments put stress on the ability of tax authorities to examine the substance of such arrangements, and determine whether the results of such arrangements, viewed in their totality, are consistent with policy norms (*i.e. avoidance of inappropriate base erosion*). Transfer pricing rules regarding the attribution of risks and assets within a group are applied on an entity-by-entity basis, thus facilitating planning based on the isolation of risks at the level of particular members of the group. There are a number of examples of risk allocations that can be undertaken under the arm's length principle between members of an affiliated group (e.g. low-key manufacturing and distribution, contract R&D and captive insurance).

A key challenge is determining the circumstances under which such arrangements result in or contribute to base erosion, and the principles under which the base erosion is addressed. Arrangements relating to risk shifting raise a number of difficult transfer pricing issues. At a fundamental level, they raise the question of how risk is actually distributed among the members of a MNE group and whether transfer pricing rules should easily accept contractual allocations of risk. They also raise issues related to the level of economic substance required to respect contractual allocations of risks, including questions regarding the managerial capacity to control risks and the financial capacity to bear risks. Finally, the question arises as to whether any indemnification payment should be made when the risk is shifted between group members.

# CHAPTER VI- OECD GUIDELINES ON TRANSER PRICING

The choice of a transfer pricing method depends, above all, on its accuracy and reliability, which itself depends on economic, methodological, and accounting factors. It is not dependent on the methods prescribed by the OECD and adopted by all the countries – members and non – members.

On 16 September 2014, the Organization for Economic Co-operation and Development ("OECD") issued **"Guidance on Transfer Pricing Aspects of Intangibles"** ("Intangibles Guidance"). The document contains

(i) interim draft revisions and

(ii) final revisions to parts of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010) ("Guidelines").

The interim draft revisions exclusively relate to the ownership of intangibles, hard to value intangibles, risk, and re-characterization. The OECD expects implementing these revisions in 2015. Although it is uncertain to which extent changes in the Guidelines will impact transactions that have clear third party benchmarks, it is an understanding that tax authorities already take positions in line with the final and interim draft revisions.

In July 2013, the OECD published its Action Plan on Base Erosion and Profit Shifting ("BEPS Action Plan"),[57] identifying the improper use of transfer pricing in relation to intangibles as one of the most important sources of BEPS concerns (Action 8). Under the BEPS Action Plan, the work to address a number of transfer pricing issues (Actions 8, 9, and 10) is divided into two phases. The first phase has been completed. The second phase is to be completed in 2015.

[57] Action Plan on Base Erosion and Profit Sharing, OECD publishing (2013)

## INTERIM DRAFT REVISIONS

In the interim draft revisions, the group member of the multinational group ("MNE Group") that

(i) performs the important functions in relation to the development, enhancement, maintenance, protection and exploitation of intangibles,

(ii) uses all assets, and

(iii) assumes all risks, is entitled to all intangibles related returns.

According to the OECD, this rule meets the intention of Action 8 of the BEPS Action Plan, which is aimed at ensuring that "profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation"

The interim draft revisions include new guidance on whether, and if so how, the profits or losses related to unexpected events (for example, a breakthrough technological development by a competitor) in relation to an intangible should be shared among members of a MNE Group.[58]

The OECD has partly adjusted its proposal following public concerns. It is no longer required that the party entitled to all or material part of the intangible related returns performs the important functions through its own employees. It is recognized that a legal owner not performing any significant functions may be entitled to share in the intangible related returns.

From the Intangibles Guidance, it however becomes clear that still a significant effort must be made by the OECD to finalize the Intangibles Guidance and to align the contents thereof with the other action points of the BEPS Action Plan.

The additional effort will focus on:

[58] OECD Guidance on Transfer Pricing Aspects of intangibles, Action 8: 2014 Deliverable

- Providing tax administrations with authority in appropriate instances to apply rules based on actual results to price transfers of hard to value intangibles and other assets (commensurate with income);
- Limiting the return to entities whose activities are limited to providing funding for the development of the intangibles and potentially other activities, for example by treating these entities as lenders rather than equity investors under some circumstances (low risk investor return);
- Requiring contingent payment terms and/or the application of profit split methods for certain transfers of hard to value intangibles;
- Requiring application of rules analogous to those applied under Article 7 and the Authorized OECD Approach to certain situations involving excessive capitalization of low function entities (allocation of risks and equity over group members irrespective of legal reality).

It is expected that this additional effort will lead to significant changes of the contents of the interim draft revisions.

## FINAL REVISIONS

The final revisions define intangibles, solely for purposes of transfer pricing, as *"something which is not a physical assets or a financial asset which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances."* Separate transferability is not a necessary condition. The final revisions do not categorizes the intangibles but the intangibles should be identified with specificity. Irrespective of this requirement, the final revisions confirm that the added value of a "going concern" should be considered.

The final revisions indicate that group synergies (e.g. as a result of streamlined management, duplication of effort, central purchasing power, etc.) are not considered an intangible as they cannot be owned or controlled by one party. It is however clarified that group synergies can have an effect on determining the price for controlled transactions.

Location savings and special market features can also not be considered an intangible, although they can have an effect on determining the price for controlled transactions. Local market comparables should preferably be used for the allocation of location savings and special market features. In the absence of such comparables, the comparability adjustments to account for location savings and special market features.

In addition to general supplemental guidance applicable to all intangibles transactions, specific supplemental guidance is provided on

(i) transactions involving the use of intangibles for sale of goods or the provision of services without transferring the intangible, and
(ii) transfers of intangibles (excluding those with a highly uncertain value).

It includes guidance on the use of valuation techniques based on the discounted projected cash flows derived from an intangible, the determination of an appropriate discount rate, and the tax effects. As already experienced under the previous draft revisions of the Intangibles Guidance, the final and interim draft revisions will impact the transfer pricing discussions with the tax administrations immediately. As the Guidelines are “merely” an explanation of the “at arm’s length standard” in many countries, no formal approval or implementation procedure is required. This Intangible Guidance however explores the “edges of the at arm’s length standard” as it suggests that certain transactions between third parties do not occur whereas day-to-day practice shows clear examples of such transactions between third parties. Whether the tax administrations and governments like it or not, in transactions between unrelated parties, capital is a very important value driver. Most likely the changes in the Guidelines will first impact transactions that do not have clear third party benchmarks. Currently, tax administrations already take positions in line with the final and interim draft revisions. Where possible we advise you to act in accordance with the OECD preferences included in this Guidance. Where this is impossible, we advise building even stronger transfer pricing documentation.

Hence, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations provide guidance on the application of the "arm’s length principle", which is the international consensus on transfer pricing, i.e. on the valuation, for tax purposes, of cross-border transactions between associated enterprises. In a global economy where multinational enterprises (MNEs) play a prominent role, transfer pricing is high on the agenda of tax administrators and taxpayers alike. Governments need to make certain that the taxable profits of MNEs are not artificially shifted out of their jurisdictions and that the tax base reported by MNEs in their respective countries reflect the economic activity undertaken therein. For taxpayers, it is essential to limit the risks of economic double taxation that may result from a dispute between two countries on the fortitude of an arm's length remuneration for their cross-border transactions with associated enterprises.

After having been originally published in 1979, the OECD Transfer Pricing Guidelines were approved by the OECD Council in their original version in 1995. A limited update was made in 2009, primarily to reflect the adoption, in the 2008 update of the Model Tax Convention, of a new paragraph 5 of Article 25 dealing with arbitration, and of changes to the observations on Article 25 on mutual agreement procedures to resolve cross-border tax disputes.[59] In the 2010 edition, Chapters I-III were substantially revised, with new guidance on: the selection of the most appropriate transfer pricing method to the circumstances of the case; the practical application of transactional profit methods (transactional net margin method and profit split method); and on the performance of comparability analyses. Furthermore, a new Chapter IX, on the transfer pricing aspects of business restructurings, was added. Consistency changes were made to the rest of the Guidelines.

[59] http://www.oecd.org/ctp/transfer-pricing/

# CHAPTER VII- LANDMARK CASES ON TRANSFER PRICING IN INDIA

## 1. VODAFONE CASE

Over the last couple of years, Indian subsidiaries of multinational companies have been faced with the major tax issue relating to the issuance of shares to their parent companies.[60] The tax department has questioned the valuation on which shares have been issued by the Indian subsidiaries and sought to apply the transfer pricing provisions under the Income Tax Act, 1961 (the Act) to impute additional tax burden through a re-characterization of the transactions. This has resulted in considerable litigation.

Of recent significance is the judgment of a division bench of the Bombay High Court on October 10, 2014 in *Vodafone India Services Pvt. Ltd. v. Union of India*[61], which is subject to a preliminary analysis in this post.

FACTS OF THE CASE:

i. Vodafone India (the subsidiary), a wholly owned subsidiary of Vodafone Tele-Services (India) Holdings Limited (the holding company) issued shares of a face value of Rs. 10 each at a premium of Rs. 8,509 per share to the holding company.
ii. The price was arrived at based on the methodology prescribed by the Controller of Capital Issues (CCI).
iii. However, the income tax department questioned the transaction on the ground that Vodafone India ought to have valued each share at Rs. 53,775, and on that basis there was a shortfall in premium to the extent of Rs. 45,256 resulting in an aggregate shortfall of Rs. 1,308.91 crores for all of the shares so issued.
iv. The income tax department treated the aggregate shortfall as income of Vodafone India as income, as a consequence of which the amount was to be treated as a deemed loan given by the holding company to Vodafone India upon which interest was chargeable as income.

[60] India's Value Shifting Regime by Rakesh Nangia.
[61] Vodafone India Services Pvt. Ltd. v. UOI [2014] 368 ITR 1 (Bom)

v. Vodafone India challenged the income tax department's position through a writ petition before the Bombay High Court on the principal ground that the shortfall does not constitute income and also that Chapter X of the Act relating to transfer pricing was not applicable to this case due to which the transfer pricing officer (TPO) did not possess jurisdiction.

vi. The High Court referred the jurisdictional issue to the dispute resolution panel (DRP) which was already seized of the matter. After consideration of the issues, the DRP passed an order dated February 11, 2014 holding that the income tax department had the jurisdiction to consider the issue of shares by Vodafone India to its holding company and also to tax the shortfall as income. It is against this order that Vodafone India preferred a writ petition to the Bombay High Court that resulted in its present judgment.

ISSUE:

The primary question before the Court related to the applicability of Chapter X of the Act.

This is because that chapter in certain circumstances permits the revenue to impute an "arm's length price" in case of an international transaction.

Hence, the narrow issue was ***whether the issue of shares by Vodafone India to the holding company gave rise to "income": whether the nature of the transaction made it one of a capital transaction or revenue transaction.***

JUDGMENT:

The Court began by observing that a "plain reading of Section 92(1) of the Act very clearly brings out that income arising from an International Transaction is a condition precedent for application of Chapter X of the Act".

On this basis, the Court embarked on an analysis of the meaning of "income", especially where it involved capital receipts. It found based on an interpretation of section 2(24) of the Income Tax Act that "income will not in its normal meaning include capital receipts unless it is so specified, as in Section 2(23)(vi) of the Act".

Since an issue of shares is a transaction on the capital account, the premium cannot be treated as income. The Court also drew a contrast with Section 56(2)(viib) of the Act where a capital transaction is deemed by legal fiction to amount to income. However, that provision applies only to premium received from a resident and that too where that premium is in excess of the fair market value of the shares.

The Vodafone case was far from that scenario because the premium was less than the alleged fair value of the shares, and that too received from a non-resident. One can glean from the analysis of the Court another difference which is that in Section 56(2)(viib) there is an actual receipt of the excess of amount, whereas in this case there is only an imputed amount of the difference without any actual receipt.

On this ground, the Court unequivocally concluded that neither the capital receipts in the form of the issue price (par value plus premium) nor the imputed difference with the fair market value could be considered income for the purpose of the Act.

Given the absence of "income", which expression was supplied with a narrow interpretation by the court (consistent with reading of tax statutes), the Court was able to quickly conclude on the inapplicability of Chapter X of the Income Tax Act relating to transfer pricing and arm's length determination of income from international transaction.

While a number of arguments were made by counsel representing both Vodafone India as well as the tax department on the interpretation of Chapter X (particularly the definition of International Transaction in Section 92B(1)), the Court dealt with those arguments in a more concise fashion given its conclusion as to the absence of "income", which is a prerequisite for the application of the Chapter.

This pronouncement of the Bombay High Court is welcome. First, from a legal perspective, issuance of shares and infusion of funds into companies constitute a capital transaction. In case such a transaction is to be taxed, the charging provision must be clear to extend to such. It is not permissible for the revenue to stretch the law to subsume such transactions within its fold.

Second, the judgment also induces a level of certainty in the taxability of such transactions. The ability of the revenue to tax them has caused consternation among foreign investors. As we have previously discussed on this Blog, the power of courts to recharacterize transactions must be exercised very carefully so as to preserve certainty to the extent feasible. If courts adopt a carefree approach to altering the substance of the transaction (for example in this case from equity to part-debt), that would affect a conducive atmosphere for business. It is only in cases where there is blatant abuse of policy that courts must embark upon such approach, that too in a careful and considered manner.

Although some clarity has emerged for share issuances by Indian subsidiaries of foreign parent companies, it may very well be temporary in case the tax department decides to prefer an appeal against the ruling to the Supreme Court. But, for now, the ruling may benefit several other companies that have found themselves in a similar predicament.

## 2. SHELL INDIA CASE:

Recently, the Bombay High Court in the case of Shell India Markets Pvt. Ltd.[62] (the taxpayer) dealt with the issue of share valuation and followed its earlier decision in the case Vodafone India Services Private Limited (Vodafone IV). The High Court observed that to apply Chapter X of the Income-tax Act, 1961 (the Act) income should arise from an international transaction. This income should be chargeable to tax under the Act. There is no charge in the Act on account of capital amounts received and/or arising on account of issue of shares by an Indian entity to non resident entity. Chapter X of the Act does not contain any charging provision but is a machinery provision to arrive at the Arm's Length Price (ALP) of a transaction between Associated Enterprises (AEs).

FACTS OF THE CASE:

[62](Writ Petition No. 1205 of 2013 – Bombay High Court)

i. The taxpayer is an affiliate of and belonging to Shell group of companies headquartered in Holland.
ii. In 2009, the taxpayer had issued 0.85 billion equity shares to its non-resident AE at a face value of INR 10 per share.
iii. In its Form 3CEB, the taxpayer disclosed various international transactions with its AEs. However, the taxpayer did not disclose the issue of equity shares to its AEs as the taxpayer was of the view that in the absence of income arising, it was not an international transaction.
iv. The Assessing Officer (AO) in terms of Sections 92CA(1) of the Act referred the international transaction disclosed by the taxpayer in Form 3CEB to the Transfer Pricing Officer (TPO).
v. The TPO issued a show cause notice to the taxpayer as to why the ALP should not be recomputed in respect of the equity shares issued to non-resident AE.
vi. In reply to the TPO's notice, the taxpayer pointed out that Chapter X of the Act would not apply as the transaction of issue of equity shares to the non- resident AE would not give rise to any income. The transaction was on capital account not giving rise to any income.
vii. However, the TPO held that in view of Chapter X of the Act, once a transaction between the parties is an international transaction, adjustment to transfer pricing can be done even on capital account (balance sheet items).
viii. The TPOs order held that shares were allotted to the AE at a price which was lower than the ALP of issue of shares which resulted in short receipt of consideration. Accordingly, the TPO on the basis of the ALP, computed enhancement of the issue price to INR 183,44 per share and also charged interest on the amount short received resulting in transfer pricing adjustment of INR 152.20 billion.

TAX DEPARTMENT'S CONTENTIONS

The High Court decision in the case of Vodafone IV should not be applied in this case in view of the following distinguishing features:

i. The taxpayer has an alternative remedy of prosecuting its grievances with the Dispute Resolution Panel (DRP). In fact the taxpayer had filed an application before the DRP raising an identical grievance. Therefore, this writ petition ought not to be entertained.

ii. The failure on the part of the taxpayer to disclose the transaction in Form 3CEB should disentitle the taxpayer to claim any relief from this court.

iii. The transaction between the taxpayer and the AE resulted in inter se change in shareholding amongst AEs which would be covered by the definition of international transaction under clause (e) in explanation to Section 92B of the Act. This would be so as it would amount to restructuring/reorganizing of the taxpayer.

VODAFONE IV- SUMMARY OF FINDINGS

The High Court summarised the findings in its earlier decision in the case of Vodafone IV where it was held that:

To apply Chapter X of the Act, income should arise out of an international transaction. This income should be chargeable under the Act.

The definition of income does not include within its scope capital receipts arising out of capital account transaction unless specified in Section 2(24) of the Act as income.

There is no charge in the Act to tax amounts received and/or arising on account of issue of shares by an Indian entity to non-resident entity in Section 4, 5, 15, 22, 28, 45 and 56 of the Act.

Chapter X of the Act does not contain any charging provision but is a machinery provision to arrive at ALP of a transaction between AEs.

Chapter X of the Act does not change the character of the receipts but only permits re-quantification of income uninfluenced by the relationship between AEs.

HIGH COURT'S RULING

In light of the above, in respect of the above three contentions of the tax department the High Court held:

- Regarding alternate remedy, since the tax department does not dispute that the issue on merit stands covered by the decision of Vodafone IV, it would serve no useful purpose by directing the taxpayer to prosecute its objections before the DRP and then the DRP disposing the same in accordance with the decision in the case of Vodafone IV. Further, the taxpayer had given an undertaking to withdraw its objection on the issue of jurisdiction before the DRP.
- The second distinguishing feature as contended by the tax department was that the taxpayer had not disclosed the transaction as an international transaction in Form 3CEB which was in fact done by the taxpayer in the case of Vodafone IV. The High Court held that the stand of the tax department was little curious as in the case of Vodafone IV they had contended that the petitioners therein had filed Form 3CEB in respect of the issue of shares and had submitted to the jurisdiction of Chapter X and cannot then contend that proceedings to tax such shortfall on Capital account was without jurisdiction. It was observed that in the Shells case, the tax department was taking an exactly opposite stand. The High Court observed that :*"The State is expected to be consistent and not change its stand from case to case"….*

  *"The fact that the petitioner chose not to declare issue of shares to its non-resident AEs in Form 3CEB as in its understanding it fell outside the scope of Chapter X of the Act………If the petitioner did not file a particular transaction in Form 3CEB when so required to be filed, the consequences of the same as provided in the Act would follow. However, the mere not filing of Form 3CEB on the part of taxpayer would not give jurisdiction to the tax department to tax an amount which it does not have jurisdiction to tax"*
- Regarding the scope of the clause (e) of the explaination to section 92B of the Act, the High court held that in the present facts, we need not examine whether a transaction would include restructuring or reorganization, for the reason that even if it is assumed that it is an international transaction, the jurisdictional requirement of Chapter X of the Act to be applicable is that income must arise. In this case, admittedly following Vodafone IV, no income has arisen. Accoedingly, the issue

in the present case has been decided in the case of Vodafone IV and would be binding on all authorities within the state till the Apex court takes a different view on it.

PERSONAL OPINION:

In my view, the Transfer Pricing Adjustment of 2 Billion U.S. Dollars was grossly erroneous. It is fundamental principle of Income tax law that, capital receipt are not chargeable to tax and capital expenditure cannot claimed as deduction while computing taxable income (subject to certain exceptions given in Act).Thus, capital receipt do not attract charging section of the Act.

Under income tax, only revenue receipts and capital gains (gains arising from transfer of ownership of capital asset by sale/relinquishment thereof) are taxable. Capital receipts are in nature of fixed capital account items, in contrast to revenue receipts which are circulating capital items.

In John Smith v Moore (12 TC 266 Uk House of Lords 1921 ), It was elucidated that, 'Fixed capital is what owner turns into profit by keeping it in his own possession, while circulating capital is what he makes profit by parting with it and letting it change masters.

Thus, stock in trade of business is circulating capital while machinery used for producing such stock in trade is fixed capital. Hence, it can be conveniently said after above analysis, that receipt of funds on issue of shares is capital account item. As issue of share capital is a capital receipt, the same is not chargeable to tax under section 4.The transfer pricing regulations under section 92 are machinery provisions.

The aim of transfer pricing (TP) regulations are to test whether transfer prices between AEs are having regards to arm's length price using prescribed methods viz. CUP, RPM, CPM, PSM and TNMM.

If actual prices are in conflict with transfer prices, the actual prices are adjusted by way of transfer pricing adjustment. However, such exercise by way of adjustment can only be in relation incomes which are chargeable to tax. This, is because, the TP adjustment does not have identity of its own. It either increases or decreases the transfer price which was subjected to TP evaluation.

In budget 2012, the Act was amended retroactively to provide that capital financing provisions should be evaluated from TP perspective. However, such amendment cannot transform capital receipt into revenue receipt or vice versa.

The interpretation which makes machinery provision in derogation to charging provision is patently illegal. Hence, issue of share capital whether of INR 1 or INR 100 million, is capital receipt and cannot be subjected to TP adjustment. Thus, adjustment of INR 15000 crore made by Indian Is grossly erroneous.

# CHAPTER VIII – CRITICAL ANALYSIS

In India a new transfer pricing regime has been introduced this year by the Finance Act 2001. Earlier a limited provision (Section 92) existed in the Income tax Act, which provided for making adjustment to the income of a resident taxpayer from a transaction with a non resident if the Assessing Officer was of the view that the income from such a transaction was understated in the hands of the resident due to the close connection between the two.

No other rules or obligations about maintenance of documents about such transaction existed under the old Section 92 which remained in the statute for a number of years though it was almost never invoked in practice.

The Finance Act 2001 has substituted a new section 92 and inserted sections 92A to 92F and certain other provisions in the Income tax Act which provide the statutory backbone of the new transfer pricing law. The procedural rules under these sections have been inserted in the Income tax Rules, by Notification S.O 808 (E) dated 21 August, 2001.

The new transfer pricing regime requires compliance with the principle of arm's length price in cases involving an 'international transaction' between associated enterprises (Section 92). The term 'associated enterprise' is defined in Section 92A which provides 13 parameters to determine if the enterprises concerned would constitute 'associated enterprises'. Section 92B defines the term 'international transaction' as a transaction between two or more associated enterprises when either or both them are non resident.

The transactions covered are transfer of tangibles, intangibles, services, lending and borrowing of capital and cost contribution agreements. Section 92 C lays down five methods for the determination of arm's length price. These are same as the transaction methods prescribed in the OECD guidelines [63]viz. comparable uncontrolled price method, resale price method, cost plus method, profit split method and transaction net margin method. Section 92C also lays down the provisions relating to transfer pricing audit which may be triggered if the administration is of the opinion that the transfer price

[63] http://www.oecd.org/ctp/transfer-pricing/

adopted does not reflect arm's length price, or if proper information or documents are not maintained. Provisions have also been made in respect of penalties for concealment of income by adopting non arm's length price, defaults relating to maintenance of prescribed information and documents and failure to furnish required information or documents during an audit or appellate proceedings.

India has been enjoying the benefit of large consumer base and high skilled work force. This has attracted multinational enterprises to set up their operations in India in the last two decades[64].

Transfer pricing is presently one of the most complex international tax issues faced by multinationals.[65] Apart from the difficulty in finding appropriate uncontrolled comparable transactions to benchmark the related party transactions, one of the reasons for dreading transfer pricing is that transfer prcing adjustments result in economic double taxation. Economic double taxation arises because cross-border transactions have tax implications in two or more jurisdictions. A taxable income in one jurisdiction (suppose country A) would have commensurate tax deductible expenses in another jurisdiction (say country B). A restatement of either the income in Country A or the expense in Country B would result in a reststement of the taxable profits in the other jurisdiction. Given the tax rates in developed and most developing countries are at comparable levels, most tax payers may be neutral to the split of profits in cross-border transactions. However, tax authorities are concerned about their respective revenues and therefore, even if the taxpayer has paid the same quantum of taxes on a aggregate basis, the tax authorities are interested in the share of profits taxed in their own jurisdiction.

Unfortunately, without considering this key aspect of transfer pricing, most tax legislations justify transfer pricing regulations on the basis that taxpayers have the objective of parking profits in low tax jurisdictions. Hence, it is presumed that the taxpayer evades taxes through creative inter-company pricing and that transfer pricing regulations are necessary to curb such ulterior motives. Transfer pricing, is not always an anti-avoidance mechanism and instead, may only be a revenue conservation/collection

[64]Report on International Transfer Pricing by PWC
[65] Ernst & Young Global Transfer Pricing Survey, 2013.

mechanism implemented by tax authorities to protect their fair share of tax revenues in cross-border transactions. Theoretically, the objective of the tax authorities to protect their revenue base is reasonable. However, practically, tax authorities may get overly aggressive and use transfer pricing as a mechanism for increasing revenue collections beyond their fair share and along with stringent penalty provisions make transfer pricing compliance a nightmare for taxpayers. In the 'tug of war' between tax authorities of two jurisdictions, the tax payer may be the one who suffers.

For instance, let's assume a transaction pertaining to import of finished goods by an Indian Company from its foreign associated enterprise. Lets assume the 'right price' for the goods is Rs.100 and the applicable customs duty on the product is 50 percent. In case the tax payer has the intention of evading taxes through transfer pricing and inflates the import price from Rs. 100 to Rs. 200, the impact of the same on the income tax would be that the purchase price in the profit and loss would be higher by Rs. 100 and hence, profits would be reduced by Rs. 100, thereby resulting in a reduced tax liability of approximately Rs. 33. However, as a consequence of the inflated price, the taxpayer would end up with a higher customs duty liability of Rs. 50. Clearly, there cannot be an intent to evade taxes through inflated import prices of goods where custom duty rates are higher than the marginal tax rates. Therefore, transactions involving import of tangible goods where custom duty rates are higher than income tax rates may be absolved from aggressive audits since the taxpayer, in the worst case scenario, may have ended up paying much higher revenues to the Government as customs duty as compared to the income tax avoided as a result of over-invoicing.

In real life, taxpayers are not looking for mechanism for tax evasion. In an attempt to curb tax evasion by exceptional taxpayers, there is a risk that the revenue authorties may get aggressive with all tax payers.

Apart from the economic double taxation and huge penalties, taxpayers are also burdened with significance compliance costs due to very aggressive transfer pricing administration. With tax authorities requiring taxpayers to carry out complex transfer pricing analysis of their related party cross-border transactions, the taxpayers are compelled to allocate resources for such compliance. The small and medium sized companies are thus burdened with significant costs for preparing detailed documentation. An aggressive and unstructured audit by the tax authorities also imposes additional costs on the tax payers to comply with the information request of the tax authorities.

Moreover, transfer pricing analysis being a very subjective exercise, may be viewed in different ways. Such transfer pricing analysis provides ample opportunity for the tax authorities to view the transaction in a way that may help them to raise more revenues. A pragmatic approach and a business perspective is imperative for a reasonable transfer pricing conclusion.[66]

The issue of economic double taxation cannot be addressed without a bilateral settlement if inter-company prices by the tax authorities of the countries where the parties to the transaction are resident. This is the reason that the taxpayers are very bullish about bilateral Advance Pricing Agreements (APAs). In case of APAs, the tax authorities of the two countries where the parties to the transaction are resident, sit together and fix the appropriate split of profits between the two jurisdictions at the time the transaction is entered into. The taxpayer therefore has clarity on his tax liability in both the jurisdictions with regard a particular transaction and is free from any risk of suffering adjustment to a tax payer from its authorities, in case its associated enterprise suffers a transfer pricing adjustment in another tax jurisdiction.[67] In practice, the tax authorities do not agree to allow a corresponding adjustment unilaterally and may get into discussions with the the tax authorities in the other jurisdiction to arrive at the optimum split of profits and hence, taxes. This process could be cumbersome and time consuming.[68] Further, the relatively high legal cost of such proceedings may be prohibitive where the quantum of transfer pricing adjustment is not high. Securing corresponding adjustment would help mitigate the issue of economic double taxation. However, the associated enterprise may continue to be liable to interests and penalties in its country of residence and hence would suffer an economic burden. Therefore, a bilateral APA is a better solution for prevention of economic double taxation.

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[66] Supra 4.
[67] Tax trends in emerging India by KPMG
[68] Navigating the choppy waters of international tax: 2013 Global Transfer Pricing Survey by Earnst and Young.

The requirement to maintain detailed transfer pricing documentation imposes a burden on small and medium taxpayers. An increase in the minimum threshold for maintenance of detailed documentation, may exempt some of these small and medium enterprises from the requirement to carry out complex analysis and maintain detailed documentation.

The use of safe harbors is another way to reduce compliance cost of taxpayers. In case of safe harbor provisions, transactions of a particular nature are exempt from the requirement to maintain detailed transfer pricing documentation and transfer pricing scrutiny if they meet a certain specified level of profitability. For instance, taxpayers engaged in rendering of software services may be exempt from transfer pricing audits in case they earn a net operating margin of 20 per cent.

The Indian tax department also should review its audit procedure for transfer pricing. The method of selection of cases for scrutiny based on value of international transactions undertaken by the taxpayer results in the same companies being subject to year-on-year audits. This results in duplication of efforts where facts and circumstances of business have remained more or less, constant and there are no material changes in the nature and terms of international transactions. This is more so in case where during an earlier audit, the tax authorities have found the transactions of the taxpayer to be complaint with the arm's length standard.

To reduce the ambiguity in the law, the Indian tax authorities may consider issuing clarifications and notifications. Detailed guidelines and more illustrations can be also introduced in the Indian transfer pricing legislation. The transfer pricing legislation should provide the auditors with the flexibility to view transaction with a business perspective and should not bind them to follow the quantitative basis under all circumstances. In the absence of robust comparable data and economic models for adjustment for differences in functions and risks between the taxpayer and the potential comparable companies, the taxpayer may be burdened with transfer pricing adjustments if the transfer pricing auditors do not take cognizance of business realities of the taxpayers.

Transfer pricing is a reality and is here to stay. However, tax authorities can ease the burden of the taxpayers through adequate guidance and by applying a business perspective to any transfer pricing review. Selective scrutiny of transfer pricing sensitive cases and qualitative evaluation of cases for selection for scrutiny, may help in a focused audit and catch the true transfer pricing violators and tax evaders. Tax authorities also need to take a liberal view on transfer pricing. Given the subjectivity involved in arm's length price determination, taxpayers and tax authorities can conveniently

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