Transfer Pricing – Practical Issues and Controversies

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As the globalisation of Indian business continues to accelerate, transfer pricing will remain foremost on the agenda of Indian income-tax authorities into the foreseeable future. This article takes stock of issues and controversies in Indian transfer pricing particularly in the light of assessment experiences of taxpayers.

With the rapid globalisation, multinationals see national boundaries as increasingly less relevant to how they conduct business. Revenue authorities on the other hand do not see things in quite the same way and zealously guard the tax base of their respective countries. As a result transfer pricing has become one of the most important and complex tax issues facing modern businesses today. Revenue authorities worldwide are investigating transfer pricing arrangements with increased vigour.

Transfer pricing generally being the first tax consideration of any cross border transaction between related parties, developed countries such as USA and UK have had transfer pricing law for decades. In India, the void in the Income-tax Act, 1961 ('the Act') relating to detailed transfer pricing regulations was finally filled with Finance Act, 2001 introducing detailed transfer pricing provisions as an anti-avoidance measure into Chapter X of the Act with effect from 1 April 2001. Prior to this amendment, a limited provision existed in the Act[1], 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 rules were prescribed for implementing the erstwhile Section 92 and it was almost never invoked in practice. The legislative intent behind the introduction of detailed transfer pricing provisions is brought out in para 55.6 of CBDT Circular No. 14 / 2001 on provisions relating to Finance Act, 2001, which *inter-alia* states:

"The basic intention underlying the new transfer pricing regulations is to prevent shifting out of profits by manipulating prices charged or paid in international transactions, thereby eroding the Country's tax base."

Indian transfer pricing regulations ('Indian TP Regs') are exhaustive in many respects and broadly based on the OECD[2] Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ('OECD Guidelines') and prescribe methodologies to be followed, documentation to be maintained, and penalties to be levied, though in some respects they have their own peculiar flavour. The central theme of the Indian TP Regs, like in most regulations, is the arm's length principle, which requires charging of an arm's-length price for all international transactions between associated enterprises, supported as such by appropriate documentation.

The regulatory framework of Indian TP Regs encompasses (i) Provisions of the Act viz. anti-avoidance provisions - Sections 92-92F; and penalty provisions – Sections 271(1)(c), 271AA, 271BA, 271G; (ii) Provisions contained in the Income-tax Rules, 1962 ('the Rules') – Rules 10A to 10D; and (iii) Administrative guidance by way of CBDT Circular No. 12/2001, dated 23 August 2001 and Instruction No. 3 of 2003, dated 20 May 2003.

Notwithstanding the fact that Indian transfer pricing law is still in its infancy, assessments for the very first year of transfer pricing (AY 2002-03) are widely reported to have yielded incremental taxes of over Rs. 600 crores[3], stemming from transfer pricing adjustments. These figures strongly point towards transfer pricing becoming a key focus area for income-tax authorities in years to come. As the globalisation

[1] Section 92

[2] Organisation for Economic Co-operation and Development

[3] Reported in Economic Times, Mumbai edition on Saturday, 2nd April 2005

of Indian business continues to accelerate, transfer pricing will remain foremost on the agenda of Indian income-tax authorities into the foreseeable future.

Issues relating to the application of the (+/-) 5% safe harbour

(a) Eligibility for (+/-) 5% safe harbour where there is a single arm's length price

The proviso to Section 92C(2) which states *"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 per cent of such arithmetical mean"* provides the taxpayer a safe harbour to the extent that the value of the international transaction is within a range of (+/-) 5 per cent of the arm's length price.

Assessment experience indicates that taxpayers have been given the benefit of the (+/-) 5 per cent safe harbour only in cases where more than one price has been determined by the most appropriate method and arithmetical mean of such prices has been taken as the arm's length price. In cases where there is a single arm's length price, the benefit of the (+/-) 5 per cent safe harbour has been denied to the taxpayers. The injustice caused by such a literal interpretation is illustrated by way of a numerical example below:

A taxpayer imports a product from its associated enterprise at Rs. 104 per unit. Under Scenario 1, the taxpayer imports one consignment of an identical product from an unrelated party at Rs. 100 per unit. Under Scenario 2, the taxpayer imports four consignments of an identical product from an unrelated party priced at Rs. 98, Rs. 99, Rs. 101 and Rs. 102 per unit. It is important to note that in both Scenarios the taxpayer has imported products from its associated enterprise at a price higher (albeit within +/- 5 per cent) than the price paid for an identical import from unrelated parties. Assuming that the Comparable Uncontrolled Price Method (CUP Method) is the most appropriate method, the arm's length price is calculated as follows:

The arm's length price in both cases is Rs. 100. However, under Scenario 1, in assessment proceedings the taxpayer has been denied the benefit of the (+/-) 5 per cent safe harbour, and hence been subjected to a transfer pricing adjustment of Rs. 4. On the other hand, under Scenario 2, the taxpayer in assessment proceedings has been granted benefit of the (+/-) 5 per cent safe harbour and has not been subjected to a transfer pricing adjustment.

Uncontrolled Transactions	Scenario 1 (Rs. per unit)	Scenario 2 (Rs. per unit)
Third party import 1	100	98
Third party import 2	n.a.	99
Third party import 3	n.a.	101
Third party import 4	n.a.	102
Arithmetical Mean	n.a.	100
Arm's Length Price	100	100

As can be seen from the above example, adoption of a strict literal interpretation of the law leads to an absurd result that is unlikely to have been intended by the legislature. It is a well-understood principle of jurisprudence that while interpreting a provision in a taxing statute, a construction, which would preserve the purpose of the provision, must be adopted. This principle is well supported by the Hon'ble Supreme Court's judgments *[State of Tamil Nadu v M.K. Kandaswami* (1975) 36 STC 191 (SC); *Rajkot Municipal Corporation v Manjula Jayantilal Nakum* (1997) 9 SCC 552, 565 (SC)]. Having regard to the legislative intent, this would be a fit case for applying the rule of reasonable construction for avoiding an absurd result.

(b) Application of (+/-) 5 per cent safe harbour where a margin method is the most appropriate method

The manner in which the (+/-) 5 per cent safe harbour is to be applied in cases where the most appropriate method is not the CUP Method is not entirely free from doubt. Where Transactional Net Margin Method ('TNMM') is the most appropriate method, the margins of the taxpayer are benchmarked with the margins earned by broadly comparable independent companies, using an appropriate profit level indicator ('PLI') such as return on sales / return on costs / return on assets. In other words, the tested party margin i.e. taxpayer's margin (in percentage terms) is compared with the arm's length margin i.e. arithmetical mean of the margins (in percentage terms) earned by comparable companies.

In such a case, should the (+/-) 5 per cent safe harbour is calculated (i) as (+/-)

5 per cent of the arm's length margin; or (ii) as a range of (+/-) 500 basis points of the arm's length margin; or (iii) in relation to a derived arm's length 'price'? Such value of the international transaction as would result in an arm's length margin is the derived arm's length price. Based on a reading of Rule 10B(1)(e) and proviso to Section 92C(2), it would appear that the (+/-) 5 per cent safe harbour would apply in relation to the derived arm's length price. This can be elucidated with the help of an example.

Example

In this example the taxpayer is a routine service provider rendering services to its associated enterprises as well as to unrelated parties. The taxpayer earns revenues from associated enterprises as well as unrelated parties from the provision of services. The international transaction is the provision of services. Costs incurred by the taxpayer in rendering the services are all local third party costs. TNMM is selected as the most appropriate method and Net Cost Plus Margin[4] ('NCP') is selected as the profit level indicator. Brief financials of the

Rs. (000)	Column 1	Column 2	Column 3	Column 4
	Financials of the Tested Party (i.e. taxpayer) under various scenarios			
Profit & Loss Account	**At Actuals**	**At arm's length price**	**At + 5% of arm's length price**	At - 5% of arm's length price
Revenue				
From AEs[5] (international transaction)	39,000	(ALP[6]) 40,341	(+5%) 42,358	(-5%) 38,324
From unrelated parties	1,000	1,000	1,000	1,000
Total Revenue	40,000	41,341	43,358	39,324
Total Cost	37,500	37,500	37,500	37,500
Operating Profit	2,500	3,841	5,858	1,824
Actual Net Cost Plus Mark-up	6.67			
NCP % (based on arithmetical mean of NCPs of comparable independent companies)		10.24		
Range of NCPs that would be considered to be at arm's length based on the (+/-) 5% variation			15.62	4.86

Note:(i) Operating profit in Column 2 is a derived figure by applying arm's length mark-up of 10.24% to the tested party's total operating expenses of Rs. 37,500. (ii) Revenue from AEs (international transaction) in Column 2 is the balancing figure considering operating profit as derived in (i) above and the total operating expenses remaining unchanged at Rs. 37,500. This revenue figure is the Arm's Length Price (ALP). (iii) Revenue from AEs (international transaction) in Column 3 represents the upper limit of the range permissible under the Proviso to Section 92C(2). (iv) Revenue from AEs (international transaction) in Column 4 represents the lower limit of the range permissible under the Proviso to Section 92C(2). (v) The Net Cost Plus Mark-up earned by the tested party (Column 1) is higher than the arm's length mark-up (Column 2), accordingly the international transaction complies with the arm's length principle

[4] The Net Cost Plus Margin is the ratio of Net Operating Profit to Total Operating Expenses. Net Operating Profit is calculated as Total Operating Income (i.e. aggregate of total operating income and other income excluding interest income, dividend income and non-recurring income) less Total Operating Expenses (i.e. aggregate of operating, selling, distribution and administrative expenses, depreciation and amortizations excluding non-recurring expenses, interest and financial charges)

[5] Associated Enterprises

[6] Arm's Length Price

taxpayer ('tested party') are given in Column 1. As can be seen, the taxpayer has earned an NCP of 6.67 per cent. The arithmetical mean of NCPs earned by comparable independent companies (i.e. arm's length margin) is 10.24 per cent (bottom row of Column 2). Would the tested party's margins comply with the arm's length principle? In the absence of specific guidance, the (+/-) 5 per cent safe harbour may be applied either

- as a percentage of the arm's length margin of 10.24 per cent, resulting in a safe harbour range extending from 9.73 per cent to 10.75 per cent; or
- as a range of (+/-) 500 basis points of the arm's length margin of 10.24 per cent, resulting in a safe harbour range extending from 5.24 per cent to 15.24 per cent; or
- in relation to the derived arm's length price (refer working below). As discussed earlier, based on a reading of Rule 10B(1)(e) and proviso to Section 92C(2), it would appear plausible to apply the (+/-) 5 per cent safe harbour in relation to the derived arm's length price.

As can be seen in the example table, the arithmetical mean of the comparables' NCPs (10.24 per cent) is applied to the costs of the tested party (Rs. 37,500) to derive the arm's length price of the international transaction [refer Column 2 – figure indicated as ALP (Rs. 40,341) is a balancing figure and is the derived arm's length price of the international transaction]. The (+/-) 5 per cent variation is applied to the ALP to give the range of values that would be considered compliant with the arm's length principle. Since the international transaction entails export of services, the lower end of the range (95 per cent of ALP) viz. Rs. 38,324 (Column 3) represents the least transaction value that would be considered compli-

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ant with the arm's length principle from an Indian perspective. Since the tested party's transaction value (Rs. 39,000) exceeds 95 per cent of ALP, it is compliant with the arm's length principle.

The intention of the (+/-) 5 per cent safe harbour is to allow the taxpayer a certain flexibility having regard to business exigencies and commercial practicalities. A number of overseas jurisdictions allow taxpayers the flexibility of an arm's length range, a concept adopted by the OECD Guidelines as well. In contrast, Indian TP Regs have the concept of an arithmetical mean. Considering the impracticality of targeting a single point benchmark (arithmetical mean), the (+/-) 5 per cent safe harbour gives the taxpayer a certain amount of flexibility. There however remains an issue as to how the (+/-) 5 per cent safe harbour is to be applied where there are multiple international transactions e.g. import of raw material, export of finished goods, payment of royalty etc. The practical approach in such cases would be to apply the (+/-) 5 per cent variation to the most significant international transaction value-wise. However, there is no clarity on this at present.

1. Adjustments by tax authorities

The taxpayer is required to compute the arm's length price of an international transaction in accordance with sub-sections (1) and (2) of Section 92C i.e. by applying the most appropriate method from amongst the five prescribed methods viz. Comparable Uncontrolled Price Method ('CUP'), Resale Price Method ('RPM'), Cost Plus Method ('CPLM'), Profit Split Method ('PSM') and Transactional Net Margin Method ('TNMM') in accordance with Rule 10B. The Assessing Officer is empowered under certain circumstances to independently compute the arm's length price [also in accordance with sub-sections (1) and (2) of Section 92C]. By virtue of sub-section (4) of section 92C, where the arm's length price is determined by the Assessing Officer under sub-section (3), the Assessing Officer may compute the total income of the assessee having regard to the arm's length price so determined. In doing so, the Assessing Officer would 'adjust' the transaction value of the international transaction as recorded in the taxpayer's books of account to the arm's length price. As discussed earlier, the taxpayer is entitled to a (+/-) 5 per cent safe harbour in the determination of the arm's length price. However, assessment experience shows that tax authorities have extended the benefit of the (+/-) 5 per cent safe harbour to the taxpayer only in cases where the transaction value of the international transaction as recorded in the taxpayer's books of account is within (+/-) 5 per cent of the arm's length price as determined by the Assessing Officer under Section 92C(3). Where the transaction value as recorded in the books of account of the taxpayer is outside a range of (+/-) 5 per cent of the arm's length price as determined by the Assessing Officer under Section 92C(3), the revenue authorities have proceeded in making adjustments to the arm's length price without giving the benefit of the (+/-) 5 per cent safe harbour to the taxpayer. This practice has led to the denial of a safe harbour specifically provided by the law for allowing taxpayers certain flexibility considering that transfer pricing is not an exact science.

2. Voluntary adjustments by taxpayers

A taxpayer can make a voluntary transfer pricing adjustment in its tax return in a situation where the taxpayer determines after the close of its books of account for a financial year that the transaction value of its international transaction does not comply with the arm's length principle. The voluntary transfer pricing adjustment results in an increase in the taxable income of the taxpayer in the same manner and to the same level as if the international transaction were recorded in the books of account at an arm's length price. As discussed earlier, by virtue of the proviso to Section 92C(2), the law has provided the taxpayer with a (+/-) 5 per cent safe harbour. An issue arises whether the taxpayer is entitled make the voluntary transfer pricing adjustment taking the benefit of the (+/-) 5 per cent safe harbour. The issue is illustrated by way of an example.

International transaction with AE (import of raw materials)	Rs. 120
Most appropriate method	CUP
Arithmetical mean of prices of uncontrolled transactions	Rs. 100
Maximum permissible transaction value [applying (+/-) 5 per cent safe harbour of the proviso to Section 92C(2)]	Rs. 105

In the given situation, the taxpayer realises (after close of books of account) that the transaction value of its international transaction does not meet the arm's length standard and makes a voluntary transfer pricing adjustment in its tax return. In this situation the issue is the quantification of the transfer pricing adjustment. Can the taxpayer make an adjustment of Rs. 15 [(i.e. Rs. 120 less Rs. 105; applying the proviso to Section 92C(2)] or does the taxpayer need to make an adjustment of Rs. 20 (i.e. Rs. 120 less Rs. 100)?

Practically, tax authorities have been taking the view that the taxpayer would have to make an adjustment of Rs. 20 and not Rs. 15, thereby denying the taxpayer the benefit of the (+/-) 5 per cent safe harbour. It is pertinent to note that if the transaction value in the normal course of business were to have been Rs. 105, in such a case, applying the proviso to Section 92C(2), the transaction value of Rs. 105 would have been considered compliant with the arm's length principle. Is there any difference from the perspective of the income-tax authorities between a situation where the taxpayer makes a voluntary transfer pricing adjustment taking the benefit of the (+/-) 5 per cent safe harbour and a situation where the taxpayer's transaction value in the normal course happens to be within the (+/-) 5 per cent safe harbour, particularly since under both the situations the taxpayer would report the same taxable income in its tax return? Admittedly, in the given example, the value of the transaction recorded in the books of account is Rs. 120, however, by virtue of making a voluntary transfer pricing adjustment to the extent of Rs. 15 in its tax return and paying income-tax on the additional amount, from a Revenue perspective, transaction value recorded in the books of account stands revised to Rs. 105, which is within (+/-) 5 per cent of the arm's length price. Denying the taxpayer the benefit of the (+/-) 5 per cent safe harbour in such a situation does not appear to be in accordance with the intent of the law.

3. Benchmarking of royalty payments/interest on ECBs

Benchmarking royalty payments and interest payments on External Commercial Borrowings ('ECBs') remains controversial. Royalty/interest payments are made either under the Approvals route (in accordance with specific approval granted by an arm of the Government of India FIPB/SIA/RBI) or the Automatic Route (based on applicable ECB guidelines for interest payments and prescribed limits[7] in the case of royalty payments).

Benchmarking these transactions pose certain practical issues. The RPM, CPLM and PSM methods by definition cannot be applied. The CUP method can in theory be applied for benchmarking 'rates' of royalty/interest.

The CUP method can be applied where associated enterprises buy or sell similar goods or services in comparable transactions with unrelated enterprises or when unrelated enterprises buy or sell similar goods or services, as is being done between the associated enterprises. For application of CUP method there should be no material differences between a controlled transaction and an uncontrolled transaction.

Applying the CUP method, the arm's length price of the rate of royalty/rate of interest could be determined as follows:

- Using External CUP, i.e. rates of royalty/interest underlying knowhow/lending arrangements entered into between independent third parties; or
- Using Internal CUP, i.e. rates of royalty/interest underlying knowhow/ending arrangements of the Company/associated enterprises with independent unrelated parties.

In the context of royalty, generally, an internal CUP would not exist as a multinational is unlikely to grant its proprietary know-how to a third party. Although periodic newsletters available on the SIA website do contain some details of royalty rates approved by the FIPB/SIA/RBI in specific cases, these cannot be used as external CUPs since details such as the period of payment, nature of technology transferred and other contractual terms, which are essential for judging comparability for applying CUP method are not available. Similarly in the case of ECBs, getting proper CUPs is generally not possible. Parameters such as ge ographical region, amount of loan, currency of loan, tenor of loan, underlying security and creditworthiness of the borrower are relevant factors in determining interest rate. A quotation given by a third party e.g. a banker has some persuasive value, however it does not constitute a CUP since it is a quotation and not an actual uncontrolled

[7] 8 per cent of exports / 5 per cent of domestic sales

"transaction". Similarly using domestic Prime Lending Rate (PLR) as a benchmark is not appropriate having regard to the geographic and economic differences.

Using TNMM as the most appropriate method, it may be possible to benchmark royalty by comparing net operating margins of the taxpayer (calculated after considering royalty expense) with net operating margins earned by comparable independent companies. In case the taxpayer has earned higher net operating margins as compared to comparable independent companies (despite having paid royalty), the royalty expense can be said to be compliant with the arm's length standard. However this is an indirect way of justifying royalty and payments as the international transaction itself is not being tested.

It is however not possible to justify interest[8] by even applying the indirect testing method using TNMM, since it is the net operating profit (i.e. without considering interest, financing and other non-operating/extraordinary items) that is benchmarked under TNMM.

On the basis that none of the methods prescribed under Section 92C(1) of the Act, viz. CUP, RPM, CPLM, PSM and TNMM can be applied for benchmarking royalty and interest, the taxpayer could contend that since none of the prescribed methods can be applied, the machinery provisions laid down by the Act for computation of arm's length price fail and applying the ratio of the Supreme Court decision in *B C Srinivasa Shetty (1981) 128 ITR 294 (SC)*, arm's length price cannot be computed for international transaction relating to payment of royalty and interest owing to failure of the machinery provisions of the Act for computation of arm's length price.

Assessment experience suggests that the transfer pricing authorities are reluctant to accept the arm's length nature of the arm's length nature of the transactions on the strength of a specific government approval or on the basis of the taxpayer having complied with the relevant policy guideline. In this situation authorities should take a more reasonable view in the matter and should declare publicly by way of a binding Circular that where the payment is in accordance with a specific Government approval or is within the limits prescribed by relevant guidelines laid down by any Government body (FIPB / SIA / RBI / SEBI etc.), it should be considered compliant with the arm's length principle. The view is backed by the rationale that if a transaction has been blessed by one arm of the Government, or is completely compliant with the policy guideline laid down by it, the same should be acceptable to another arm of the Government. Admittedly the FIPB/SIA/RBI looks at the transactions from a foreign exchange perspective, however in doing so they also examine the economic substance and commercial need for these transactions and hence specific approvals / compliance with relevant guidelines is a strong indication that the transaction is on an arm's length basis. This view also finds support in the Rules as well as the OECD Guidelines. Rule 10B(2), which lays down certain criteria that are relevant for determining the comparability of an international transaction with an uncontrolled transaction *inter-alia* specifies "laws and Government orders in force" as a relevant criterion [Clause (d) Rule 10B(2)]. Even the OECD Guidelines include 'the nature and extent of government regulation of the market' as one of the factors determining comparability. (Para 1.30 of the OECD Guidelines)

4. Captive units

The recognition of India as a global outsourcing destination coupled with the unprecedented advances in convergence technologies has led to an exponential growth in the number of multinationals setting up captive units in India that undertake services such as software development, back office support, call centers etc. Similarly in the manufacturing sector (e.g. pharmaceuticals / automotive), captive units have been set up as sourcing hubs for global requirements.

Captive units by definition operate in a virtually risk free environment. Generally significant business risks such as market risk, price risk, product risk, idle-time risk, credit risk etc. are borne by the overseas group company thereby insulating the captive unit from losses on account of any of the above risks actually materialising. Following robust economic logic, captive units are therefore generally remunerated with a mark-up over total operating costs.

For purposes of benchmarking the margins of the captive units, comparable independent companies are

[8] Unless lending and borrowing is part of the operating activity

entrepreneurial enterprises undertaking the full range of economic risks such as market risk, price risk, credit risk, idle-time risk, infrastructure risk, interest rate fluctuation risk and currency fluctuation risk etc. Other captive units cannot be considered for purposes of benchmarking since these units would be "controlled" and not independent units and hence by definition cannot be considered as uncontrolled comparables for benchmarking purposes.

Since comparable independent companies undertake a significantly wider range of risks, their profitability outcomes are subject to greater uncertainties; as such they could earn super normal profits as well as incur significant losses. On the other hand, the captive units usually are expected to continue to earn a mark-up over operating costs.

The real issue which one encounters while benchmarking such captive units is to objectively determine and demonstrate what adjustments can be made to margins of entrepreneurial uncontrolled comparables account for these significant differences in risk profile. Debtors' adjustment and working capital adjustment can be quantified fairly accurately, however this adjustment does not take account of the differences due to significant business risks which *inter-alia* can lead to higher than normal profitability as well as lower than normal profitability / losses.

Rule 10B(1) prescribes the manner in which arm's length price is to be determined in relation to an international transaction for each of the prescribed methods. Clause (iii) of sub-rule (1)(e), which deals with TNMM, states *"the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market"*. Rule 10B(2), which lays down criteria for judging the comparability of an international transaction with an uncontrolled transaction inter-alia specifies 'risks assumed' and 'contractual terms' as relevant criteria for judging comparability.

The main difference in the profile of the captive units vis-à-vis comparable companies is on account of the difference in risk profile insofar as the tested party is a limited risk captive service provider while comparable companies are entrepreneurial enterprises undertaking the full range of economic risks.

For a proper comparison, the difference in risk profile, which results into higher uncertainties and consequent profitability fluctuations for independent companies, should be adjusted in terms of clause (iii) of sub-rule (1)(e) of Rule 10B. However, there is presently no clarity on what type of 'adjustments' would be permissible for adjusting the outcomes of entrepreneurial comparable companies for benchmarking captive units. A possible approach which is based on sound economic logic is to eliminate companies that are 'outliers' i.e. companies earning higher than normal profits as well as those earning lower than normal profits by applying a statistical measure such as the interquartile range. It would have to be seen whether the transfer pricing authorities would accept such an adjustment in terms of clause (iii) of sub-rule (1)(e) of Rule 10B.

5. Exercise of powers u/s 133(6)

Sub-section (7) of Section 92CA states *"The Transfer Pricing Officer may, for the purposes of determining the arm's length price under this section, exercise all or any of the powers specified in clauses (a) to (d) of sub-section (1) of section 131 or sub-section (6) of section 133"*. During the course of transfer pricing adjustments, transfer pricing authorities have exercised their powers under Section 133(6) of the Act in order to gather comparable data for determining the arm's length price. For instance, income-tax authorities have by the exercise of powers under Section 133(6) obtained the profit & loss accounts of private limited companies for calculating their margins and benchmarking them as comparables. It is well known that the profit & loss accounts of private limited companies are not publicly available by virtue of the second proviso to Section 220 read with Section 610 of the Companies Act, 1956. Private companies are entitled to file their balance sheets and profit & loss statements separately with the Registrar of Companies so that only the balance sheet is available for public inspection. Accordingly, it is not possible for a taxpayer to have information on the profit & loss statements of private companies. Use of such information obtained by exercise of special powers tantamounts to use of a secret comparables by the tax authorities, since the taxpayer has no legal access of being privy to such data while planning its business dealings. This creates an inequitable position for the taxpayers, insofar as they are challenged with information not available

in the public domain.

A related issue also arises in the context of the party from whom the information has been called for, in case the information called for is critical business information or is confidential or sensitive if disclosed to competitors.

6. Use of one-year comparable financial data

Rule 10B(4) stipulates that the data to be used in analysing the comparability of an uncontrolled transaction with an international transaction shall be the data relating to the financial year in which the international transaction has been entered into. Accordingly, for purposes of benchmarking international transactions relating to the current financial year (FY 2005-06), comparable data relating to the FY 2005-06 has to be used. This poses practical difficulties since financial data of comparables for FY 2005-06 would be publicly available only around June/ July 2006. In order to overcome this practical difficulty, taxpayers, relying on the proviso to Rule 10B(4), which states *"data relating to a period not being more than two years prior to such financial year may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared"*, have used three-year data for benchmarking international transactions relating to a financial year i.e. data for the financial year to the extent available (interim / unaudited / audited) as well as data for the two immediately preceding financial years.

Internationally, developed jurisdictions allow taxpayers to properly plan for and comply with transfer pricing regulations by using data for multiple years. The purpose of using multiple-year data is to ensure that the outcomes for the relevant year are not unduly influenced by abnormal factors. In attempting to determine an arm's length outcome for international dealings between associated enterprises, the results of any one-year may be distorted by differences in economic or market conditions and the features and operations of the enterprise affecting the controlled or uncontrolled dealings. Participants in an industry may not be uniformly affected by business and product cycles, and therefore differences between dealings may reflect differences in circumstances, and not the effects of non-arm's length dealings. The use of multiple-year data smoothens the effects of yearly aberrations and provides a more stable benchmark. This approach of using multiple-year data is consistent with the OECD Guidelines as well as transfer pricing regulations of several developed jurisdictions.

During the course of transfer pricing assessments, tax authorities have considered only single year comparable data for the relevant previous year for determination of the arm's length price i.e. for determination of arm's length results for FY 2001-02, income-tax authorities have only considered FY 2001-02 comparable data on a single-year basis. This approach is not consistent with the OECD Guidelines and ignores the conceptual advantages of using multiple-year data as described above. Further the approach is unfair vis-à-vis taxpayers, as the taxpayer's results are compared with comparable data, which may not even have been in existence at the time the transfer prices were set! It needs to be appreciated that while an assessment or audit is a post-facto exercise, taxpayers are required to fix transfer prices during the relevant financial year. It is *inter-alia* for this very reason that the law permits use of data relating to two preceding years. Accordingly, it would be appreciated that use of single year data by tax authorities at the time of assessment, is inequitable and due cognizance should also be given to data relating to the two years preceding the relevant financial year.

7. Whether the assessing officer is bound by the order of the transfer pricing officer?

Under the prevailing scheme of transfer pricing assessments, for all cases where the value of international transactions exceed a prescribed threshold (currently Rs. 5 crores), the assessing officer is required to make a reference under Section 92CA(1) to a transfer pricing officer, referring the computation of the arm's length price of the international transaction to the transfer pricing officer. The transfer pricing officer passes an order under Section 92CA(3) determining the arm's length price in relation to the international transaction. Section 92CA(4) provides *"On receipt of the order*

under sub-section (3), the Assessing Officer shall proceed to compute the total income of the assessee under sub-section (4) of section 92C having regard to the arm's length price determined under sub-section (3) by the Transfer Pricing Officer". An issue arises whether the assessing officer is bound by the order of the transfer pricing officer.

By virtue of Section 92CA(4) of the Act it is the assessing officer who has to compute the total income of the taxpayer under Section 92C(4), albeit having regard to the arm's length price determined by the transfer pricing officer under Section 92CA(3). This clearly shows that the recommendation of the transfer pricing officer is not binding on the assessing officer. Moreover, this has also been clarified by the CBDT's instruction: No. 3 of 2003, dated 20-5-2003, which specifically explains the role of the assessing officer as follows:

iii) Role of the Assessing Officer after receipt of "arm's length price" - Under sub-section (4) of section 92C, the Assessing Officer has to compute total income of the assessee having regard to the arm's length price so determined by the TPO. While sub-section (4) of section 92CA clearly provides that such computation of income will be made having regard to the arm's length price so determined by the TPO, it is imperative that a formal opportunity is given to the taxpayer before making adjustments to the total income. The opportunity with regard to the determination of arm's length price has already been given by the TPO and, therefore, opportunity by the Assessing Officer, for final determination of income under sub-section (4) of section 92C read with sub-section (4) of section 92CA is to be given by the Assessing Officer—

Based on the foregoing, the plausible view would be that the final determination of the arm's length price is to be made by the assessing officer. However, in practice, assessing officers have not independently evaluated the arm's length price computed by the transfer pricing officers.

Conclusion

When the transfer pricing regulations were introduced in 2001, this subject was completly unknown. The onerous documentation requirements and stringent penalties prescribed by the regulations were a cause of concern for any taxpayer with international transactions, particularly as there was no basis of knowing how the law would be implemented.

With the first transfer pricing assessments having been completed, certain controversies as detailed above have emerged even as the income-tax department and practitioners have made a lot of efforts to move up the learning curve within a relatively short span of time. A time has come to relook at the provisions and settle these controversies so that there is more certainty and fairness in the manner in which the law will be applied.

Moreover, the introduction of measures such as Advance Pricing Arrangements (APAs) and Safe harbour benchmarks for certain activities, aligning our transfer pricing regulations to OECD guidelines and other international best practices coupled with a drastic reduction in the penalties would go a long way in enhancing India's reputation as an attractive foreign direct investment destination – a goal which successive governments have sought to achieve. ❐