Transfer Pricing Regulation and Practical Issues and Updates

Introduction of Transfer Pricing Regulation is one of the best internal controls to ensure that the Indian entity having associate enterprise (as defined in Act) outside India is not paying low taxes by manipulating the prices paid or received for transaction encounter with AE. Indian Government has introduced Rules and Sections in Finance Act 2001 to regulate this activity. This article tries to summaries the important aspects of transfer pricing study and some practical issues co-related with the same. As in the process of globalisation, Indian entities now have too many international transactions with Associated Enterprise (AE) so its scope is very wide. There was a news in Economic Times dated 5th December 2011 that "More than ₹40,000 crore demand is raised in Mumbai from assessment of MNCs which "mispriced" their cross border transactions". So this article tries to focus on whether determining the ALP by applying the Transfer Pricing Regulations is either not easy because of practical issues discussed or assessees need to take care while entering into transaction with AE. The idea behind to have discussion on these issues is to find out the ways or to know the solutions available to tackle the same.

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Introduction of Transfer Pricing Provisions

The Finance Act 2001 has introduced the Transfer Pricing Regulation (TPR) in the Income-tax Act, 1961 by enacting new Section 92 to 92 F in the Income-tax Act, 1961 (IT Act) in substitution of the earlier Section 92. Hence, TPR are effective from Assessment Year 2002 to 2003 and would be applicable to "International transactions", which take place on or after 1st April 2001.

These new provisions apply to "International Transactions" that take place between "Associated Enterprises". It is relevant to notice that, as per these new provisions, where an Assessing Officer is of the opinion that the transactions between Associated Enterprises are not at an arm's length, he can compute profits from such transactions at an arm's length price.

Further, it has been provided that where the total income of an Associated Enterprise is so varied on account of applicability of TPR, the other enterprise may not be permitted to make correlative adjustments. There is no threshold limit for Transfer Pricing Audit and its compliance. Therefore, any Indian entity having signal transaction of any amount is required to submit Transfer Pricing Audit Report in 3CEB format and documentation is compulsory only if transaction value is more than ₹1 crore. Therefore, practicing Chartered Accountants have a lot of scope in this activity as now-a-days cross border transactions are necessary to expand the business.

Gist: By applying the provisions and rules introduced by Revenue authorities, assessee has to prove that his transactions with Associated Enterprise are at Arm's Length.

Transfer Pricing - Documentation

Transfer Pricing Study Report plays an important role. It is one of the documents which are required to be maintained as per Rule 10D of Income Tax Act. OECD (Organisation for Economic Co-Operation and Development) Guidelines also define documentation process and its role in transfer pricing study.

The decision of the Special Bench of Bangalore Tribunal in the case of *Aztech Software and Technology Services Ltd Vs. ACIT* (2007) 107 ITD 141 ITAT held that when the primary responsibility is discharged by the taxpayer by conducting the appropriate transfer pricing study, then responsibility shifts to revenue and the tax authorities are required to prove that the said comparables are not in fact comparables. Tax authorities cannot exclude the comparable cases given by the assessee as per their opinion or selection

AND

Extracted para from Bear Text of Circular 12/2001

"721. Clarification on provisions governing transfer price in an international transaction

The Finance Act, 2001, has substituted the existing Section 92 of the Income-tax Act by new Sections 92 and 92A to 92F. These new provisions lay down that income arising from an international transaction between associated enterprises shall be computed having regard to the arm's length price. The term "associated enterprise" has been defined in Section 92A. Section 92B defines an "international transaction" between two or more associated enterprises. The provisions contained in Section 92C provide for methods to determine the arm's length price in relation to an international transaction, and the most appropriate method to be followed out of the specified methods. While the primary responsibility of determining and applying an arm's length price is on the assessee, sub-section (3) of Section 92C empowers the Assessing Officer to determine the arm's length price and compute the total income of the assessee accordingly, subject to the conditions provided therein. Section 92D provides for certain information and documents required to be maintained by persons entering into international transactions, and Section 92E provides for a report of an accountant to be furnished along with the return of income."

Transfer Pricing Study Report is the base document which helps to understand how the Arms Length Price is determined. Preparation of Study Report includes the following many steps, including: Understanding of Business profile of the tasted party and Associated Enterprise, and, Identification and analysis of International transactions with AEs.

Therefore, accuracy in Transfer Pricing Study report can relieve the assessee from controversies with tax authorities and addition in total income.

Let's understand the process and other details in relation to Transfer Pricing Study Report after knowing the importance of the same.

Transfer Pricing Study Report is the base document which helps to understand how the Arms Length Price (ALP) is determined. Preparation of Study Report includes the following steps:

-Understanding of Business profile of the tasted party and Associated Enterprise (AE)

-Identification and analysis of international transactions with AEs

-Industry and Market analysis

-Functional, Asset and Risk analysis

-Selection and Characterisation of entities

-Economic Analysis

-Selection and application of most appropriate method

Methods are prescribed in Rule 10B. The prescribed Methods are (a) Cost Plus Method; (b) Transactional Net Margin Method; (c) Profit Split Method; (d) Resale Price Method; (e) Comparable uncontrolled Method. Assessee has to select an appropriate method, while selecting the most appropriate method as specified in sub-rule (1) of Rule 10C, the following factors shall be taken into account, namely:—

(*a*) the nature and class of the international transaction;

(*b*) the class or classes of associated enterprises entering into the transaction and the functions performed by them taking into

account assets employed or to be employed and risks assumed by such enterprises;

(*c*) the availability, coverage and reliability of data necessary for application of the method;

(*d*) the degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;

(*e*) the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;

(*f*) the nature, extent and reliability of assumptions required to be made in application of a method.

Selecting appropriate method after considering the above factors, the required data and information for carrying out the real analysis be obtained and thereafter following two steps can be carried.

-Data Analysis and Market research

-Final list of comparable companies

Functional, Asset and Risk Analysis

Having reference to above steps, in transfer pricing study, analysis of functions, risk and asset (FAR) is of prime importance. Rule 10D clause (e), which also requires the taxpayer to document a description of the functions performed, risks assumed and assets employed or to be employed by the assessee and by the Associated Enterprises involved in the international transaction.

This helps to

-provide the blue print of business model between Assessee and AE

-provide the risk assumed by Assessee and AE

-select the comparable companies from data available in public domain

In transfer pricing study, analysis of functions, risk and asset (FAR) is of prime importance. Rule 10D clause (e), which requires the taxpayer to document a description of the functions performed, risks assumed and assets employed or to be employed by the assessee and by the Associated Enterprises involved in the international transaction. This helps to provide the blue print of business model between Assessee and AE, and, provide the risk assumed by Assessee and AE.

The OECD also emphasises the importance of the functional analysis in determining the arm's length price and identifying suitable entities for comparison purpose as under:

Therefore, after carrying out the FAR analysis, assessee should select the comparable companies considering the functions, risks and assets assumed by tested party. In this process first assessee will require to obtain data of all companies falling in his industry e.g. software, automobile, infrastructure. Then applying the filter of function, risk and asset it will select the comparable companies. However, it is rare possibility to available identical comparable companies like tested party, hence there will be always difference in functions, risk and asset employed by comparable companies and tested party. Therefore, there is a need to make adjustment for difference in functions, risk and asset to determine the ALP. Rule 10B also allows making adjustment for difference in FAR. However, it asks to make adjustment to comparable companies instead of tested party. Quantification of risk adjustment is the biggest challenge in this respect. And in most of the cases TPO rejects adjustment to tested party because Rule 10B does not allow. However, assesses have difficulty to obtain data in public domain about comparable companies to make adjustment to their margin or price to determine ALP.

Summary of Case laws where adjustment made to margin of tested party is accepted:

- **Pune Tribunal (ITAT) in the case of** *Skoda Auto India* ITA No. 202/PN/07 where the Tribunal allowed adjustment to the assessee's PLI
- ***ITO Vs CRM Services India (p) ltd*** decided by **Delhi ITAT ITA No. 4796(Del)/2010** where Claim for capacity utilisation adjustments allowed for additional capacity of building created on behalf of the AE, but not used.

To date only few tribunal rulings have ventured into the quantification of risk adjustment. Risk adjustment is more important in case of captive companies, because in case of captive units most of the functions like identifying the business, marketing, debtors collection, handling customer complaints, proving after sale service are handled by AE instead of tested party which is captive unit. However the comparable companies selected from Public domain are exposed to all the above functions and risk. Therefore they expect high returns as they assume high risk, but as captive units assume less risk, therefore, they will earn return consistent with risk assumed.

Another issue faced by small and medium assesee is to get comparable companies in public domain.

The transfer pricing rules apply when one of the parties to the transaction is a non-resident, even if the transaction takes place within India. There is no need to find out the legislative intent behind the transfer pricing provision when the provisions were unambiguous. The existence of actual cross border transactions or motive to shift profits outside India or to evade taxes is not a pre-condition for transfer pricing provisions to apply.

Because mainly these small and medium assessee have turnover ranging from ₹5 crore to ₹25 crore. Companies available in public domain mainly are having large economics of scale, so the availability of pool of companies is very less, so sometimes study can be lopsided.

Example:
ABC Pvt Ltd (tested party) is subsidiary of PQR LLC (AE). ABC Pvt Ltd is captive unit, therefore PQR LLC has assumed most of the functions and risks, i.e. identification of business, business planning, billing to end customer, collection from end customer, after sale service, handling customer complaints. Therefore, ABC Pvt Ltd is only required to execute the business by deploying the required resources.

Price Mechanism: Agreement with AE is Cost Plus 10% mark-up, Cost should exclude Direct tax and foreign exchange gain\loss.

In my opinion as the Subsidiary is going to charge for the services with cost plus, then the risk of idle capacity, risk of incurring business\cash loss is transferred to AE. However, in transfer pricing study we are unable to identify the price mechanism of comparable companies. Now while selecting comparable companies, care is taken that there should be less or nil transactions with AE so that our study will be based on uncontrolled transactions. Hence comparable companies having transactions with third party (i.e. Non-AE entities) will be factoring in, this cost in the sale price for risk of idle capacity, risk of marketing, risk of collection, because risk and reward go hand in hand (high risk high reward).

Also these comparable companies will have wide variable results in different financial years, but as in case of tested party the risk of business\cash loss is avoided by AE. Stability in net results also play an important role in selection of comparable companies.

Practical Issues:
1) Availability of data or basis for adjustment of functions and risk
2) Selection of comparable companies with same risk and functions
3) Adjustment for stability of result and un-even result of comparable companies

Also where assessees make adjustment for risk, the tax officials may not agree on working or basis, so it is becoming more judgmental. Hence some rules or guidelines for making these adjustments should be designed so that these adjustments can be carried out which will make it easy to determine the Arm's Length Price.

Lower Profitability of AE and Its Impact on Indian Entity

It has been observed that the argument that our AE is earning lower profits hence margin in Indian entity are also low is not accepted.

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Intention of introducing the regulation has been clarified. Let's go through the same.

The Revenue authorities have issued Circular No. 14 of 2001 ('Circular 14') containing the notes explaining the provisions of the Finance Act, 2001, whereby Para 55 of the said Circular lays down the rationale for introduction of TPR.

Bear text *"55.5A The new provision is intended to ensure that profits taxable in India are not understated (or losses are not overstated) by declaring lower receipts or higher outgoings than those which would have been declared by persons entering into similar transactions with unrelated parties in the same or similar circumstances. 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. The new Section 92 is, therefore, not intended to be applied in cases where the adoption of the arm's length price determined under the regulations would result in a decrease in the overall tax incidence in India in respect of the parties involved in the international transaction."*

Therefore, entities earning lower profit are facing problem to prove that their low margin is not because of shifting of profits but real commercial terms depicting ALP.

So here we have to clear the thin line of difference, i.e. we accept that transfer pricing regulation will be applicable to every Indian entity having cross-border transaction but it is able to demonstrate that no profits are shifted outside India then whether authorities adding in total income as per ALP determined by selecting comparable companies will be within the intention of the law.

The reason to raise this point is to clarify whether entities earning low profits should not carry on its business in India or should demonstrate that they have not shifted profits from India to outside India to evade taxes.

Possibility of Amendment in Methods or Introduction of New Methods be Explored

(A) Available Option

Profit Split Method is best to work out the profit on over-all group level and to ensure that no profit is shifted from India to any other countries. But the practical difficulty is that Rule specify the conditions when this method can be applied, therefore, assessee which does not fall into those criteria can not apply the same and demonstrate that prices determined are not with intention of shifting the profits from India to other country.

Rule 10B has specifically spelt out the methods out of which one appropriate method should be selected to calculate the ALP. However, considering above issues, the Finance Department should either introduce few more methods or assessee be given some free hand to demonstrate the ALP by method other than given in Rule 10B.

(B) Available Options:

Consolidated Financial statement of Group:

Assessee can prepare the consolidated financial statements to present true and fair result of group, so that tax authorities can compare the result of Indian companies with Group to ensure that there is no shifting of profits. For applying this method, the necessity is that the accounting policy followed by all group companies should be same. This method will be more beneficial for small groups where low economies of scale and business model play an important role to determine profitability. Getting comparable companies for such tested party becomes difficult. These consolidated financial statements can be audited or certified by management.

This method could be based on non-arms length approach: Global formulary apportionment defined in OECD. However, this approach has been rejected by members of OECD because of difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation.

However, at least this method can ensure the tax authorities that transaction with associated enterprise are not designed to shift the profits from India. Limitation is that this could not be applied in case of large group where preparing the financial statement with similar accounting policies is difficult. Here we can think to make adjustment to consolidated financials to the extent of difference in accounting policies applied by companies group, because getting the data for this adjustment in group companies can be easier than calculating the adjustment for risk and functions in case of comparable companies. These consolidated results can have disclosure of segmental results.

Finance Act 2009, proposed to introduce "Safe Harbor" rules to Income-tax Act 1961. The Finance Minister in his budget speech stated the objective "to reduce the impact of judgmental errors n determining transfer price in international transaction". The conditions for qualifying for the safe harbour with reference to transfer pricing will be different i.e. total relief to certain identified taxpayers from compliance with country specific transfer pricing laws and regulations or, at the least, the obligation to comply with country specific procedural rules.

Safe Harbour Rules:

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The Guidelines clearly differentiate the 'safe harbour' provisions from 'advance pricing arrangements', the latter are decided in advance by the taxpayer and the tax administration.

Pros and Cons of Safe harbour provisions:

Some of the factors in favour of having safe harbour provisions to the taxpayers are simplified compliance with arm's length principle, affords flexibility in cases where there are no matching or comparable companies or transactions, advance information or knowledge about the range of profits or prices to qualify for the safe harbour helps in better planning of intra-group transactions, substantial reduction in time and efforts involved in search for comparables in external databases, reduction in cost in terms of simplified procedures for compliance and record maintenance. Certainty about acceptance of the transfer prices by tax authorities in transfer pricing assessments or even the taxpayer may be spared of a detailed scrutiny, if the transfer prices fall meet the specified mark-up or pricing. For the tax authorities, the safe harbour provisions substantially reduce the administrative burden involved in terms of minimal examination (or limited number of companies being picked up for detailed scrutiny) of the transfer pricing compliance by the taxpayers. They can choose to concentrate their time and resources on larger taxpayers, transactions or issues and be more lenient to the small taxpayers.

Hence, the structure of safe harbour provisions can give relief to assessee requiring compliance with transfer pricing regulations. Therefore, all assesses are waiting for blue print of these rules.

TPR Can Enhance to Domestic Transactions

Recently, in the case of *Commissioner of Income Tax & Anr. Vs. Glaxo Smithkline Asia (P) Ltd. (2010) 236 CTR (SC) 113 : (2010) 195 Taxman 35 : 47 DTR 65,* the Supreme Court took up the issue as to whether transfer pricing regulations should be limited to cross-border transactions or whether the transfer pricing regulations be extended to domestic transactions too? The Court observed that in the case of domestic transactions, the under-invoicing of sales and over-invoicing of expenses ordinarily would be revenue neutral except in two circumstances involving tax arbitrage:

(i) If one of the related companies is loss making and the other is profit making and profit is shifted to the loss making concern; and

(ii) If there are different rates for two related units (on account of different status, area bases incentives, nature of activity, etc.) and if profit is diverted towards the unit on the lower side of tax arbitrage.

The Apex Court suggested amendments for consideration by the Finance Ministry in certain provisions like Sections 40a(2) and 80-IA(10) to empower the AO to apply any of the generally accepted methods of determination of arm's length price, including the methods provided under the transfer pricing regulations to domestic transactions between related entities. The court also capitulated on maintenance of books of accounts and other documents reflecting transactions between such entities and audit of such transactions by chartered accountants. The court has reiterated the legal position regarding non-applicability of transfer pricing provisions to domestic transactions. The court has also accepted that domestic transactions are by its nature revenue neutral. Therefore, the burden of proof would lay on the department to draw any conclusion on the contrary. The intent of the Supreme Court behind making this suggestion is to decrease the litigation relating to allowance and disallowance of expenditures and adjustment of incomes by providing a well defined price determination regime and bringing in objectivity to domestic transactions. However, experience relating to transfer pricing regulations in international transactions indicates to the contrary. The lack of comparables and uniqueness in the business of each company would only make the matter more complex and perhaps a rise in transfer pricing litigations relating to domestic transactions would become inevitable. In addition, it would also increase the compliance cost for the assessee and oversight cost for the department. The matter, therefore, requires a cost-benefit-analysis before taking any further steps. However, considering so many tax arbitrage avenues available to domestic units, one would be surprised why provisions similar to transfer pricing adjustments have not been put in place till date. From the Department's point of view, this would provide level playing field to both domestic and transnational units and would also plug the leak of revenues from domestic entities.

Conclusion

Transfer Pricing Regulations are vital for Indian tax kitty. However, can we have some mechanism for entities which are earning lower profits but have not either understated or overstated their prices to shift the profits from Indian to overseas, so that the intention of the law, tax authorities and assessee all should have win-win situation. Now in case of this mechanism the prime responsibility will be on assessee to prove because it should be able to extract the information and data required from AE to assure tax authorities that the price is genuine and not misleading to avoid taxes in India. ■