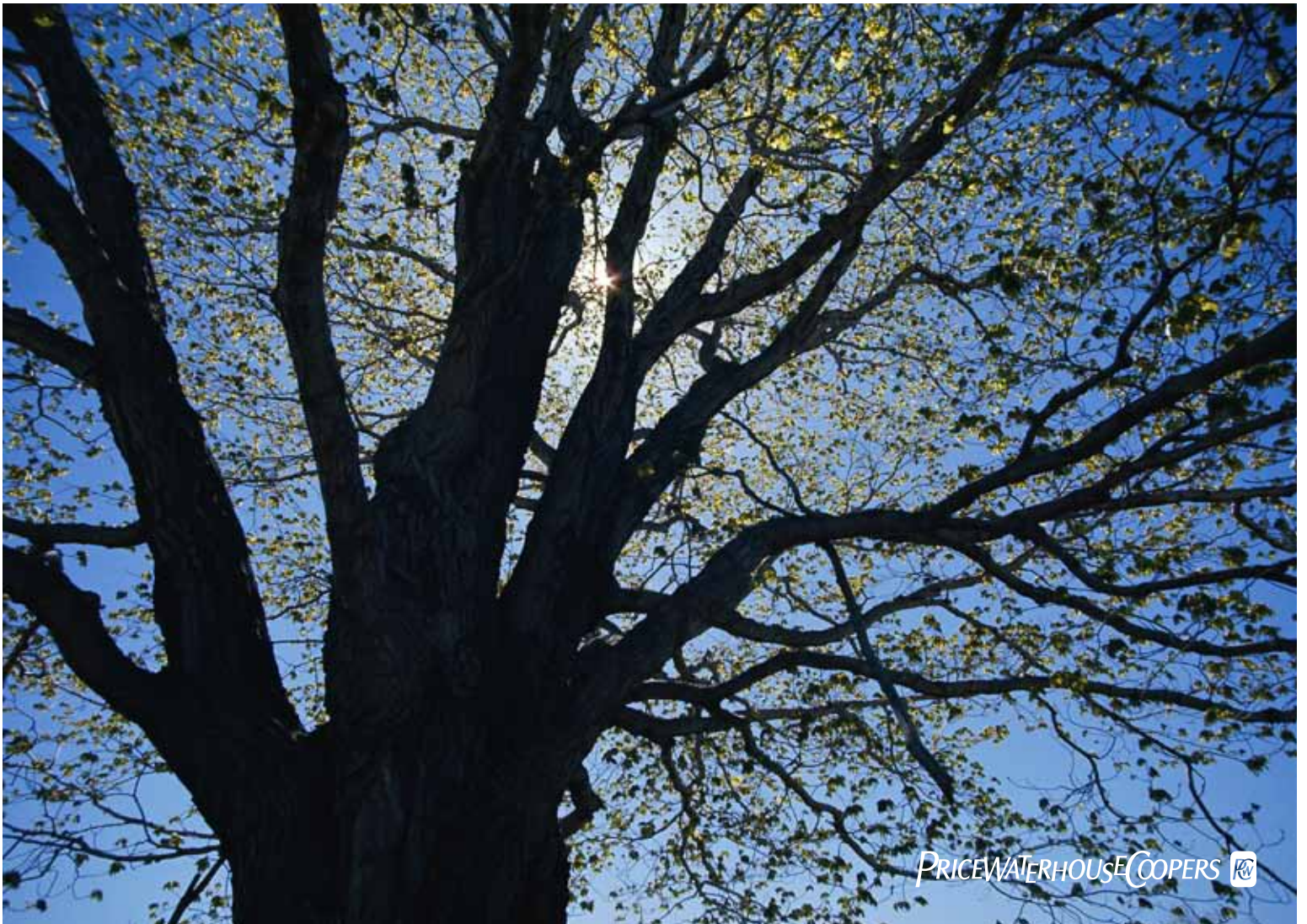


India transfer pricing audits—
Challenges and emerging trends

Transfer pricing perspectives

Re:solutions
moving towards certainty



India transfer pricing audits— Challenges and emerging trends

By Shyamal Mukherjee (PwC India) and Tarun Arora (PwC India)

Globalisation and the inherent advantages enjoyed by India including a large consumer base, low production costs, and a huge skilled work force led numerous multinational enterprises to establish large India operations. Accordingly, India introduced a comprehensive transfer pricing (TP) code into its tax laws in 2001. The code prescribes detailed documentation requirements, stringent penalty provisions, and a procedure for audit of TP cases by specialised revenue officers, known as transfer pricing officers (TPO).

TP audits in India have been characterised by intense scrutiny and aggressive positions by transfer pricing officers. Over the years, the TP challenges faced by multinational enterprises operating in India have undergone a significant change. Controversies arose in the initial years of audit over fundamental issues such as time period (single- vs. multiple-year data) for comparability analysis, choice of TP methodology, application of arm's length range, and other procedural matters. Today, although some of these issues are nearing settlement through rulings of appellate bodies and courts, newer, more complex challenges are emerging.

This article examines major audit issues for taxpayers and emerging areas of focus of Indian TP authorities.

Transfer pricing audit issues

Data for comparability analysis

India's TP rules require the use of "current year" data (data pertaining to the year in which the taxpayer has transactions with group concerns) for transfer pricing analysis.²⁴ The use of prior data (up to two years) is permitted only in certain circumstances when it reveals facts that could influence the determination of current transfer prices.²⁵

Where profit-based methods are used for TP analysis, taxpayers generally compute the margins of functionally comparable companies from publicly available data/databases. Although these databases are updated regularly, the current-year data is usually not available before taxpayers file their tax return and finalise their TP analysis. Taxpayers thus use the past two years' average data to support the transfer prices.

However, by the time the case comes up for a TP audit, current-year data has become available. Then TP officers request that data and test a taxpayer's transfer prices based on the updated results. The practice of conducting fresh searches for comparables and using current-year data causes undue hardship to taxpayers. Even though they may have undertaken a thorough contemporaneous TP analysis while setting transfer prices, the taxpayers face the risk of TP adjustments and harsh penalties from 100 to 300% of the tax on the adjustment amount. Therefore, taxpayers should keep constantly updated about

²⁴ Rule 10B(4) of the Income Tax Rules, 1962 (Rules)

²⁵ Proviso to Rule 10B(4) of the Rules

prevailing industry/market trends and undertake comparables selection and economic analysis with utmost care.

Use of ‘nonpublic’ comparables

In some cases, TPOs seek pricing information from competitors of the taxpayers (for computing the arm’s length price of the taxpayer’s transactions) by exercising the powers granted to them under the tax laws of India.²⁶ The use of competitor data not in the public domain is not only unjust from the taxpayer’s point of view, but may also harm the business interests of the competitor once such strategic pricing information is shared with the taxpayer. Such information is also not enough to undertake a detailed comparability or functional analysis of the enterprises/transactions, thus leading to an inappropriate TP analysis.

The issue requires careful handling and analysis, from a legal/tax as well as an economic viewpoint.

Business strategies and comparables selection

The Indian rules prescribe a comprehensive list of TP documentation that a taxpayer needs to maintain,²⁷ which includes a broad description of the industry; a record of economic and market analysis; assumptions, policies, price negotiations, etc. In accordance with the requirements, most taxpayers undertake comprehensive TP studies that contain an in-depth industry analysis and set out their business strategies and commercial practices.

However, the tax authorities primarily look at the profit margins of the taxpayer, ignoring the company’s business strategies. For example, some companies voluntarily make losses part of a bigger strategy (entry strategy, loss leaders, cross-subsidisation across products, etc). The general tendency of revenue authorities has been to reject any losses reported by taxpayers and substitute a so-called “arm’s length” profit. It is a commercial reality that even in an arm’s length situation, each and every independent enterprise cannot make profits. In many cases, the authorities tend to ignore the market situation, industry dynamics, business considerations, and strategies of the companies, imposing fictitious profits

Even in the comparable sets prepared by taxpayers, the authorities tend to challenge independent loss-making companies and “cherry-pick” profitable companies for comparison. Companies need to select comparables and do related economic analysis with utmost caution and after a comprehensive functional, assets, and risk analysis of both the taxpayer and the comparables. Since the Indian TP provisions do not evaluate a taxpayer’s transfer prices based on a range of outcomes (unlike international practice), the choice of comparables assumes greater significance. The inclusion of outliers, loss-making companies, etc., is one of the common audit issues taxpayers face during TP audits. Taxpayers should analyse any loss-making comparables in significant detail.

²⁶ Section 133(6) of the Income Tax Act, 1961

²⁷ Rule 10D of the Rules

In the Indian context, risk adjustments may be necessary for evaluating the transfer prices of not just captive Indian service set-ups, but also manufacturing or other operations of multinational enterprises having risks significantly different from those of the chosen comparables.

Global arrangements determining India transactions

Under the Indian TP legislation, a taxpayer's transaction with a third party is also covered by the TP code if such transaction is a part of an arrangement that the third party has with a group concern of the taxpayer. Indian TP authorities have started evaluating such transactions in detail to test them from an Indian TP perspective.

High-value services—location savings

India has emerged as the hub for outsourced services such as software development, research and development, engineering design, and business processes. These typically are undertaken on a contract service provider model, which insulates the Indian captive unit against most business risks. However, increasingly, some Indian entities have started taking on higher-end, intangible creating functions.

The evolution and ongoing discussions around the new US regulations, from the concept of “high-value” services to the suggestion of using the profit-split method for “non-routine” contributions, have not escaped the attention of Indian TP authorities. Even though the US regulations as finalised may have moved away from these concepts and suggestions, Indian TP authorities have started nurturing the thought of treating high-end intangible development services as non-routine contributions, and applying the profit-split method for these intangible-generating services. The location savings argument has already been put forward by some officers during TP audits to claim significantly high margins for such services.

Given the widespread extent of outsourced services in India, it becomes imperative to carefully structure and implement clear TP arrangements and contracts for such Indian set-ups, and to undertake and document an in-depth, on-ground functional analysis to counter any such argument put forward by the authorities during TP audits. Comparables selection and adjustments (including risk adjustments) by such entities also require careful attention. Indian entities undertaking entrepreneurial, intangible-creating services and making valuable, non-routine contributions to the crown jewels of the group need to set their transfer prices carefully based on a robust TP analysis.

Risk adjustment

In the Indian context, risk adjustments may be necessary for evaluating the transfer prices of not just captive Indian service set-ups, but also manufacturing or other operations of multinational enterprises having risks significantly different from those of the chosen comparables. The issue of risk adjustment assumes more significance in view of the huge TP adjustments undertaken by transfer pricing officers in the information technology/IT enabled services/business process outsourcing sectors, where captive service units bearing limited risk have been compared with companies having different business and revenue models and bearing full entrepreneurial risks.

The requirement for comparability adjustments (including risk adjustments) is an integral part of the Indian regulations. Recent rulings of appellate authorities have reinforced the need for such adjustments. However, neither the regulations nor the rulings provide any guidance on the methodology to be adopted for computing such adjustment.

Any such risk adjustment needs to be undertaken based on a detailed and well-documented analysis. Companies can use various economic theories/methods as well as statistical tools for making a sound risk adjustment. Globally accepted TP techniques can be utilised for undertaking this adjustment on a rational and scientific basis.

In the absence of a robust technical and well-documented risk adjustment, the revenue/appeal authorities may not permit the adjustment during audit/appeal proceedings or may allow an ad-hoc adjustment that may not be appropriate or adequate. Accordingly, in the absence of specific guidance under law, it is imperative for taxpayers to focus on this issue and make a strong case upfront for computing and claiming the risk adjustment.

Royalties/management charges

The payment of a royalty for the use of intellectual property such as trademarks, know-how, brand names, etc., is a significant focus of the revenue authorities. In many cases, the authorities have rejected the taxpayer's analysis and disallowed payments for use/transfer of intellectual property, on the grounds that the taxpayer has failed to commensurately demonstrate the following:

- Need for sourcing such intellectual property and its actual receipt
- Appropriate documentation evaluating and describing such intellectual property
- Fulfilment of the benefits test by the Indian entity
- Whether the royalty is embedded in the import price of goods, etc.

Similarly, management charges paid by Indian taxpayers invite significant attention from tax authorities. Extensive documentation is sought by the revenue authorities to justify the management charges paid by Indian enterprises. Such documentation includes composition of costs allocated, methodology of cost allocation, benefits derived from each constituent of the costs, need for procuring such services, actual receipt of services, etc.

Taxpayers are required to satisfy the above parameters through extensive documentation, failing which they could face significant adjustments on account of intellectual property or services fee payments made to group concerns.

Indian TP authorities have also started focusing on issues such as disposition of intangibles and consequential exit charges required for implicit or deemed migrations of intellectual property as part of acquisitions, reorganisations, conversions, or business restructurings.

Emerging areas of focus

In recent years, Indian TP authorities have started examining more subtle and complex issues such as remuneration or cost sharing for marketing intangibles created by Indian taxpayers, migration of intangibles in business restructurings, and profit splits and sharing of “locations savings” resulting from intangible-creating R&D services. Some of these newer challenges are discussed below.

Business restructuring

TP issues relating to business restructuring have recently started attracting the attention of tax authorities across the globe. The 2008 OECD discussion draft on the subject, the recent rules introduced by Germany on cross-border transfer of functions, and the ruling of the Norwegian Appeal Court in the case of *Cytec Norge KS*, are clear indicators of international thinking on this complex TP issue.

Indian TP authorities have also started focusing on issues such as disposition of intangibles and consequential exit charges required for implicit or deemed migrations of intellectual property as part of acquisitions, reorganisations, conversions, or business restructurings.

Such restructuring could include conversion of an entrepreneurial manufacturer to a contract or toll manufacturer, conversion of a full-fledged product developer to a contract R&D service provider, or conversion of a distributor to a commission agent. The issue requires detailed analysis of intricate matters, such as whether it involves a transfer of valuable, protected or unprotected intellectual property (including identification of it); a loss or migration of profit potential; a required exit charge and, if so, how to quantify such charge, and similar issues. Therefore, the restructuring necessitates a detailed analysis of contracts, financial and functional analyses, and industry/market structure review, followed by preparation of robust, related TP documentation, economic analysis, written agreements, and the like.

Marketing intangibles

Another issue that has started receiving significant attention during TP audits in India is marketing intangibles. This issue is particularly relevant for Indian group concerns of multinational enterprises that undertake significant local marketing in India.

In recent audits, the TP authorities have examined the marketing activities and spending by Indian subsidiaries developing local market intangibles that are legally owned by overseas parents or other affiliates. For instance, where the Indian entity undertakes significant marketing expenditure above the industry average or comparables levels, transfer pricing authorities have reduced the transfer prices (of goods or other transactions) paid by the Indian subsidiary to its group concerns. In certain cases, the authorities have imputed a cost reimbursement to be received by the Indian entity, and in other cases, they have simply disallowed the “excessive” marketing expenditure incurred by the Indian entity. In all such cases, the intention has been to compensate the Indian subsidiary for its contribution toward development of marketing intangibles.

It needs to be evaluated whether the local marketing efforts contribute to the increase in value of marketing intangibles owned by a group concern or enhance only the value of the contributing entity's own rights under a long-term license or distribution arrangement. Further, it also needs to be evaluated whether the compensation for such contributions is already embedded within another transaction or requires a separate service fee.

In the absence of detailed upfront TP economic analysis as well as robust documentation (including explicit contracts), such Indian operations could be exposed to significant issues during TP audits. Indian TP authorities are closely following international developments including case law and overseas regulations on this matter.

Attribution of profits to permanent establishments

The allocation of profits between a head office and its permanent establishment has been the centre of numerous discussions between taxpayers and Indian revenue authorities. Some countries follow traditional allocation and apportionment techniques for attributing profits to permanent establishments, while others adopt TP principles. Indian TP law has defined a permanent establishment as an "enterprise"²⁸ and has applied the "functionally separate entity" approach authorised by the OECD for attributing profits to permanent establishments.

Further, the courts in India have upheld the application of TP principles for attributing profits to permanent establishments in India. The Supreme Court of India and other courts have held that where the functions, assets, and risks of the permanent establishment have been appropriately captured while remunerating the enterprise which created the permanent establishment, attribution of profits to the permanent establishment stands subsumed in such remuneration and there can be no further attribution.

In the light of this, a sound TP analysis could be an effective, practical solution for any permanent establishment exposure that multinational enterprises operating in India face.

Conclusion

It is critical for multinational enterprises with operations in India to receive updates about ongoing audit issues and to plan their transfer prices as well as audit/appeal strategy based on such information. In the absence of an advance price agreement mechanism in India, taxpayers need to be well-prepared, from the initial stage of planning transfer prices to maintaining comprehensive documentation and having a robust and holistic strategy for audits as well as dispute resolution.

The dispute resolution strategy should evaluate the mutual agreement procedure under relevant Indian tax treaties. This effective alternative mechanism for dispute resolution can also be used in some cases to avoid upfront deposit of substantial TP-related tax demands raised by Indian revenue authorities.

²⁸ Section 92F(iii) of the Income Tax Act

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers does not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2009 PricewaterhouseCoopers. All rights reserved. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

BS-BS-09-0537-A.1009.DvL