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Introduction

A separate code on transfer pricing under Sections 92 to 92F of the Indian Income Tax Act, 1961 (the Act) covers intra-group cross-border transactions which is applicable from 1 April 2001 and specified domestic transactions which is applicable from 1 April 2012. Since the introduction of the code, transfer pricing has become the most important international tax issue affecting multinational enterprises operating in India. The regulations are broadly based on the Organisation for Economic Co-operation and Development (OECD) Guidelines and describe the various transfer pricing methods, impose extensive annual transfer pricing documentation requirements, and contain harsh penal provisions for noncompliance.

Statutory rules and regulations

The Indian Transfer Pricing Code prescribes that income arising from international transactions or specified domestic transactions between associated enterprises should be computed having regard to the arm's-length price. It has been clarified that any allowance for an expenditure or interest or allocation of any cost or expense arising from an international transaction or specified domestic transaction also shall be determined having regard to the arm's-length price. The Act defines the terms 'international transactions', 'specified domestic transactions', 'associated enterprises' and 'arm's-length price'.

Type of transactions covered

Section 92B of the Act defines the term 'international transaction' to mean a transaction between two (or more) associated enterprises involving the sale, purchase or lease of tangible or intangible property; provision of services; cost-sharing arrangements; lending/borrowing of money; or any other transaction having a bearing on the profits, income, losses or assets of such enterprises. The associated enterprises could be either two non-residents or a resident and a non-resident; furthermore, a permanent establishment (PE) of a foreign enterprise also qualifies as an associated enterprise. Accordingly, transactions between a foreign enterprise and its Indian PE are within the ambit of the code.

An explanation having an inclusive list of transactions has been inserted in the definition of 'international transaction' by the Finance Act 2012, to specifically cover certain transactions/ arrangements such as purchase, sale, transfer, lease or use of intangible property, provision of guarantees, deferred payments or receivables, business restructuring or reorganisation etc. Intangible property has been explained to include marketing intangible, customer-related intangible, human capital intangible, location-related intangible, etc. These clarifications have been inserted retrospectively with effect from 1 April 2001.

Until financial year (FY) 2011-12, transfer pricing regulations were not applicable to domestic transactions. However, the Finance Act 2012 has extended the application of transfer pricing regulations to 'specified domestic transactions', being the following transactions with certain related domestic parties, if the aggregate value of such transactions exceeds INR 5 crore:

- Any expenditure with respect to which deduction is claimed while computing profits and gains of business or profession.
- Any transaction related to businesses eligible for profit-linked tax incentives, for example, infrastructure facilities (Section 80-IA) and SEZ units (section 10AA).
- Any other transactions as may be specified.

This amendment will be applicable for FY 2012-13 and subsequent years.

Associated enterprises

The relationship of associated enterprises (AEs) is defined by Section 92A of the Act to cover direct/ indirect participation in the management, control or capital of an enterprise by another enterprise. It also covers situations in which the same person (directly or indirectly) participates in the management, control or capital of both the enterprises.

For the purposes of the above definition, certain specific parameters have been laid down based on which two enterprises would be deemed as AEs. These parameters include:

- Direct/indirect holding of 26% or more voting power in an enterprise by the other enterprise or in both the enterprises by the same person.
- Advancement of a loan, by an enterprise, that constitutes 51% or more of the total book value of the assets of the borrowing enterprise.
- Guarantee by an enterprise for 10% or more of total borrowings of the other enterprise.
- Appointment by an enterprise of more than 50% of the board of directors or one or more executive directors of the other enterprise or the appointment of specified directorships of both enterprises by the same person.
- Complete dependence of an enterprise (in carrying on its business) on the intellectual property licensed to it by the other enterprise.
- Substantial purchase of raw material/sale of manufactured goods by an enterprise from/to the other enterprise at prices and conditions influenced by the latter.
- The existence of any prescribed relationship of mutual interest.

Furthermore, in certain cases, a transaction between an enterprise and a third party may be deemed to be a transaction between AEs if there exists a prior agreement in relation to such transaction between the third party and an AE or if the terms of such transaction are determined in substance between the third party and an AE. Accordingly, this rule aims to counter any move by taxpayers to avoid the transfer pricing regulations by interposing third parties between group entities.

Also, as per Section 94A of the Act, if a taxpayer enters into a transaction in which one party is a person located in a notified jurisdictional area, then all the parties to the transaction shall be deemed to be AEs, and any transaction with such party(ies) shall be deemed to be an international transaction. This regulation aims to specify countries

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or territories outside India having lack of effective exchange of information as notified jurisdictional areas. To date no jurisdiction has been notified.

The arm's-length principle and pricing methodologies

The term 'arm's-length price' is defined by Section 92F of the Act to mean a price that is applied or is proposed to be applied to transactions between persons other than AEs in uncontrolled conditions. The following methods have been prescribed by Section 92C of the Act for the determination of the arm's-length price:

- Comparable uncontrolled price (CUP) method.
- Resale price method (RPM).
- Cost plus method (CPM).
- Profit split method (PSM).
- Transactional net margin method (TNMM).
- Such other methods as may be prescribed.

In this regard, the Central Board of Direct Taxes has notified that the 'other method' for determination of the arm's-length price in relation to an international transaction shall be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts. The 'other method' shall apply to FY 2011-12 and subsequent years.

No particular method has been accorded a greater or lesser priority. The most appropriate method for a particular transaction would need to be determined having regard to the nature of the transaction, class of transaction or associated persons and functions performed by such persons, as well as other relevant factors.

The regulations require a taxpayer to determine an arm's-length price for international transactions or specified domestic transactions. It further provides that where more than one arm's-length price is determined by applying the most appropriate transfer pricing method, the arithmetic mean (average) of such prices shall be the arm's-length price of the international transaction or specified domestic transactions. Accordingly, the Indian regulations do not recognise the concept of arm's-length range but requires the determination of a single arm's-length price.

However, some flexibility has been extended to taxpayers by allowing a range benefit which would be notified by the Government, not exceeding 3%. Accordingly, if the variation between the arm's-length price and the price at which the transaction has actually been undertaken does not exceed the specified range of the latter, the price at which the transaction has actually been undertaken shall be deemed to be the arm's-length price. Therefore, the benefit of the range would be available only if the arm's-length price falls within the specified range of the transfer price. This, in turn, would have the effect of disallowing the benefit to a taxpayer where variation between the arm's-length price and transfer price of the taxpayer exceeds the specified range, leading to a transfer pricing adjustment even though the transfer price is only marginally outside the range benefit.

The government will notify the range benefit percentage from FY 2012-2013 and onwards which would be industry specific. For FY 2011-12, the government has continued with the 5% range which is available to all taxpayers.

In addition, transfer pricing provisions will not apply if the arm's-length price would result in a downward revision in the income chargeable to tax in India.

Documentation requirements

Taxpayers are required to maintain, on an annual basis, a set of extensive information and documents relating to international transactions undertaken with AEs or specified domestic transactions. Rule 10D of the Income Tax Rules, 1962 prescribes detailed information and documentation that has to be maintained by the taxpayer. Such requirements can broadly be divided into two parts.

The first part of the rule lists mandatory documents/ information that a taxpayer must maintain. The extensive list under this part includes information on ownership structure of the taxpayer, group profile, business overview of the taxpayer and AEs, prescribed details (nature, terms, quantity, value, etc.) of international transactions or specified domestic transactions and relevant financial forecasts/estimates of the taxpayer. The rule also requires the taxpayer to document a comprehensive transfer pricing study. The requirement in this respect includes documentation of functions performed, risks assumed, assets employed, details (nature, terms and conditions) of relevant uncontrolled transactions, comparability analysis, benchmarking studies, assumptions, policies, details of adjustments and explanations as to the selection of the most appropriate transfer pricing method.

The second part of the rule requires that adequate documentation be maintained that substantiates the information/ analysis/ studies documented under the first part of the rule. The second part also contains a recommended list of such supporting documents, including government publications, reports, studies, technical publications/ market research studies undertaken by reputable institutions, price publications, relevant agreements, contracts, and correspondence.

Taxpayers having aggregate international transactions below the prescribed threshold of INR 10 million and specified domestic transactions below the threshold of INR 50 million are relieved from maintaining the prescribed documentation. However, even in these cases, it is imperative that the documentation maintained should be adequate to substantiate the arm's-length price of the international transactions or specified domestic transactions.

All prescribed documents and information have to be contemporaneously maintained (to the extent possible) and must be in place by the due date of the tax return filing. Companies to whom transfer pricing regulations are applicable are currently required to file their tax returns on or before 30 November following the close of the relevant tax year. The prescribed documents must be maintained for a period of nine years from the end of the relevant tax year, and must be updated annually on an ongoing basis.

The documentation requirements are also applicable to foreign companies deriving income liable to Indian withholding tax.

It should be noted that, with effect from April 2009, the Central Board of Direct Taxes (CBDT) has been empowered to formulate safe harbour rules. These rules will specify the circumstances in which the tax authorities will accept the arm's-length price as declared by a taxpayer, without detailed analysis. The basic intention behind the introduction of these rules is to reduce the impact of judgmental errors in determining the transfer prices of international transactions or specified domestic

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transactions. To date, no safe harbour rules have been issued by the CBDT. However, the adaptation of these rules might help relieve taxpayers of the burden of carrying out detailed comparability analysis and benchmarking studies in support of their intercompany transactions.

Accountant's report

It is mandatory for all taxpayers, without exception, to obtain an independent accountant's report in respect of all international transactions between associated enterprises or specified domestic transactions. The report has to be furnished by the due date of the tax return filing (i.e. on or before 30 November). The form of the report has been prescribed. The report requires the accountant to give an opinion on the proper maintenance of prescribed documents and information by the taxpayer. Furthermore, the accountant is required to certify the correctness of an extensive list of prescribed particulars.

The Authority for Advance Rulings (AAR)¹ has delivered a ruling in the case of Vanenburg Group B.V. and Dana Corporation, wherein it was held that the provisions relating to the determination of the arm's-length price are machinery provisions which would not apply in the absence of liability to pay tax, and accordingly, a taxpayer would not be required to comply with the transfer pricing regulations in respect of income that is not chargeable to tax in India.

Based on these rulings, a possible view exists that where it is established that the income is not subject to tax in India (under the provisions of the Act/ double taxation avoidance agreement), the taxpayer should not be required to comply with the regulations relating to the maintenance of transfer pricing documentation and furnishing of an accountant's report.

It is relevant to note that although the ruling is binding only on the applicant that had sought it, it does carry a degree of persuasive value.

In this context, it is important to note that entities enjoying a tax holiday in India still need to comply with transfer pricing provisions and would need to demonstrate that their international transactions have been carried out at arm's length. In addition, such entities would not be entitled to a tax holiday on any upward adjustment made to their transfer prices in the course of an audit.

Burden of proof

The burden of proving the arm's-length nature of a transaction primarily lies with the taxpayer. If the tax authorities, during audit proceedings on the basis of material, information or documents in their possession, are of the opinion that the arm's-length price was not applied to the transaction or that the taxpayer did not maintain/ produce adequate and correct documents/ information/ data, the total taxable income of the taxpayer may be recomputed after a hearing opportunity is granted to the taxpayer.

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¹ A scheme of Advance Rulings has been introduced under the Act in order to provide the facility to non-residents and certain categories of residents, of ascertaining their income tax liability, planning their income tax affairs well in advance and avoiding long drawn and expensive litigation, an Authority for Advance Rulings has accordingly been constituted. The non-resident/ resident can obtain binding rulings from the Authority on question of law or fact arising out of any transaction/ proposed transactions which are relevant for the determination of his tax liability.

Tax audit procedure

A certain percentage of tax returns are selected for detailed audit. A notice to this effect has to be statutorily dispatched to the taxpayer within six months from the end of the financial year in which the return is furnished. Such notice specifies the records, documents and details that are required to be produced before the tax officer.

Once an audit is initiated, the corporate tax assessing officer (AO) may refer the case to a specialist transfer pricing officer (TPO) for the purpose of computing the arm's-length price of the international transactions or specified domestic transactions. Such reference may be made by the AO wherever he or she considers it necessary. However, this can be done only with the prior approval of the Commissioner of Income tax. In accordance with prevailing internal administrative guidelines of the Revenue, all taxpayers having an aggregate value of international transactions or specified domestic transactions with AEs in excess of INR 50 million are referred to a TPO for detailed investigation of their transfer prices. The threshold of INR 50 million may be reviewed on an ongoing basis.

The TPO would then send a notice to the taxpayer requiring the production of necessary evidence to support the computation of the arm's-length price of the international transactions or specified domestic transactions. The prescribed documentation/ information maintained by the taxpayer in respect of its transfer pricing arrangements would have to be produced before the tax authorities during the course of audit proceedings within 30 days after such request has been made. The period of 30 days can be extended to 60 days at most.

The TPO would scrutinise the case in detail, taking into account all relevant factors such as appropriateness of the transfer pricing method applied and correctness of data. TPOs are vested with powers of inspection, discovery, enforcing attendance, examining a person under oath and compelling the production of books of account and other relevant documents and information. Further, with effect from 1 June 2011, TPOs have been empowered to conduct surveys for spot inquiries and verification for subsequent investigation and collation of data. In addition, TPOs have been instructed to seek opinions of technical experts in the relevant field to enable them to analyse technical evidence in complex cases.

After taking into account all relevant material, the TPO would pass an order determining the arm's-length prices of the taxpayer's international transactions or specified domestic transactions. A copy of the order would be sent to the AO and the taxpayer. On receipt of the TPO's order, the AO would compute the total income of the taxpayer by applying the arm's-length prices determined by the TPO and pass a draft order within the time limit prescribed for completion of scrutiny assessments.

Normally, scrutiny assessments are required to be completed within an upper time limit of 36 months from the end of the relevant tax year. However, scrutiny assessments involving transfer pricing audits would have to be completed within 48 months from the end of the relevant tax year. It is important to note that India completed its seventh round of transfer pricing audits in October 2011.

Appeals procedure

A taxpayer that is aggrieved by an order passed by the AO may appeal to the Commissioner of Income Tax, also called the Appellate Commissioner, within 30 days

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of the date of receipt of the scrutiny assessment order. The office of the Appellate Commissioner is a type of quasi-judicial authority, where the taxpayers make representations in support of their claims to rebut the order passed by the AO. The decision of the appellate commissioner is reflected in an appellate order.

An alternative dispute resolution mechanism has been instituted by the Finance Act (2009) to facilitate expeditious resolution of disputes in all cases involving transfer pricing and foreign company taxation. It has introduced the concept of draft assessment orders, which would be issued by the AO pertaining to the order of the TPO that is prejudicial to the taxpayer. In cases involving foreign companies or companies suffering transfer pricing adjustments, the AO is required to forward a draft assessment order to the taxpayer which would ordinarily include the order of the TPO. A dispute resolution panel (DRP), comprising a collegium of three Commissioners of Income Tax, is constituted to which the taxpayer would have recourse on receiving the draft assessment order from the AO.

At this stage, the taxpayer has two choices: It could either accept the draft order as it is, or seek to refer the matter to the DRP. The taxpayer has to communicate its decision to the AO within 30 days of the receipt of the draft order. If the order is accepted by the taxpayer as it is, the draft would be finalised by the AO and served to the taxpayer. If the matter is referred to the DRP, the panel would have nine months from the time of referral to decide the matter taking into consideration the draft order of the AO, the order of the TPO and the taxpayer's objections and evidence. The draft assessment order would be finalised after the DRP has rendered its decision to the AO. If the taxpayer does not communicate its decision to refer the draft order to the DRP within 30 days, the AO would finalise the assessment order without modification of the draft assessment order.

However, an order of the AO that is based on the direction of the DRP would be appealable directly to the Income Tax Appellate Tribunal (Appellate Tribunal). All orders passed by the AO before 30 June 2012 pursuant to the directions of the DRP were binding on Revenue. However, with respect to objections filed on or after 1 July 2012, the Revenue can appeal against the direction passed by the DRP.

It is also clarified that the taxpayer would have to decide whether to opt for the dispute resolution mechanism based on the draft assessment order or file an appeal in the normal course with the appellate commissioner against the assessment order. Thus, the order of the AO can be agitated before the appellate commissioner in the ordinary course (i.e. if it is not referred to the DRP).

Taxpayers that still feel aggrieved by the order of the appellate commissioner or, as the case may be, the order of the AO passed in conformity with the directions of the DRP have the right to appeal to the Appellate Tribunal, thereafter to the jurisdictional High Court, and finally to the Supreme Court. A similar right to appeal also rests with the Revenue, in cases where objections before the DRP have been filed on or after 1 July 2012.

Additional tax and penalties

The following stringent penalties have been prescribed for noncompliance with the provisions of the transfer pricing code:

- For failure to maintain the prescribed information/document: 2% of transaction value.
- For failure to furnish information/documents during audit: 2% of transaction value.
- For failure to disclose any transaction in Accountant's report: 2% of transaction value.
- For adjustment to taxpayer's income: 100% to 300% of the total tax on the adjustment amount.
- For failure to furnish an accountant's report: INR 100,000.

Further, taxable income enhanced as a result of transfer pricing adjustments does not qualify for various tax concessions/holidays prescribed by the Act.

Advance pricing agreements (APAs)

The Indian authorities have introduced unilateral, bilateral and multilateral APAs with effect from 1 July 2012. There are no monetary or other conditions prescribed under the Indian APA rules for a taxpayer to be eligible for applying for an APA. However, the APA mechanism is not available for specified domestic transactions. The validity of an APA (once entered into) shall not exceed five consecutive years and shall be binding on the taxpayer as well as the Revenue authorities in respect of the international transactions for which the APA is sought. APA fees would range between INR 1 million to 2 million, based on the value of international transactions. There are four phases in an APA which is in line with global practice, as follows:

- Pre filing phase: 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.
- Formal submission phase: 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.
- Negotiation phase: 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).
- Finalisation phase: 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

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return for that year, or within ninety days of entering into an agreement, whichever is later.

Resources available to the tax authorities

A special transfer pricing team within the Indian tax authorities deals with transfer pricing issues. The team comprises of trained TPOs who deal with transfer pricing issues arising during an audit. Indian tax authorities are actively training their staff to increase competency in handling transfer pricing issues.

Use and availability of comparables' information

Taxpayers are required to maintain information on comparables as part of their transfer pricing documentation to demonstrate that the pricing policy complies with the arm's-length principle. Comparable information is a crucial element for defending transfer pricing in India. Indian revenue officials have indicated that, to the extent possible, Indian comparables should be used. Use of foreign comparables is generally not acceptable, unless the tested party is located overseas. In some cases, the TPOs have exercised their power to obtain private information from other taxpayers and used it against the taxpayer undergoing an audit.

The quality of comparable information available in Indian databases is reasonable. The tax authorities use a couple of electronic databases giving detailed financial and descriptive information for companies. Taxpayers also usually rely on these databases. It is also possible to obtain information about Indian public companies from the Registrar of Companies upon payment of statutory fees.

Liaison with customs authorities

The Indian Ministry of Finance had constituted a joint working group, comprising officers from Income Tax and Customs, to suggest measures for cooperation between the Income Tax and Customs departments. Based on the recommendations of the working group, the Ministry of Finance has laid down that periodic meetings should be held between Income Tax and Customs personnel to discuss joint issues requiring attention.

The Ministry of Finance also has decided that exchange of information in specific cases would be done, and for this purpose, officers from the two departments would be nominated at each of the four metros. Furthermore, officers from the two departments would make databases available to one another, relating to related parties/AEs on a need-to-know basis. The Ministry of Finance also has decided to develop and organise training programmes to train the officials of both departments to familiarise them with the treatment of transfer pricing matters in the other department.

The above action by the Ministry of Finance can be seen as the first clear statement of intent of the government of India towards addressing transfer pricing matters in a harmonious manner between the Customs and Income Tax departments (as transfer pricing officers have, in the past, expressed a view that the price accepted by other authorities is not conclusive evidence for determining the arm's-length price for transfer pricing purposes). This also suggests that going forward, Customs and Income Tax authorities could coordinate and exchange information with one another on transfer pricing matters. Such an increase in liaison between the two departments makes it imperative for companies operating in India to plan and document their transfer prices comprehensively based on valuation principles contained in Customs

as well as Income Tax laws and also deal with both authorities in a harmonious and seamless manner.

Risk transactions or industries

No transactions or industries are excluded from the possibility of a transfer pricing investigation. Software development, business process outsourcing, banking, telecommunications, pharmaceutical, FMCG and automobile (and ancillary) are some of the industries that have been subject to intense transfer pricing audits in recent times.

Outsourcing companies rendering core/high-value services to AEs need to carefully analyse and set their transfer prices. Furthermore, specific situations such as sustained losses, business strategies, business restructurings, transactions with entities in tax havens, and royalties and management charges paid should be sufficiently documented.

Thin capitalisation

The arm's-length principle applies to loans and interest charges. However, at present, there are no rules that specifically deal with thin capitalisation and no set permissible debt-to-equity ratios in the Act or the transfer pricing code. However, the Indian government has put forward a proposal for a new direct tax code that will replace the existing Income tax Act with effect from 1 April 2012². A draft of the new direct tax code has been circulated for public comment and includes thin capitalisation provisions.

The proposed regulations do not prescribe any capital gearing ratio unlike typical thin capitalisation regulations, but instead provide for recharacterisation of debt as equity and vice versa upon identification of an impermissible avoidance arrangement – in other words, where the arrangement among parties is (1) not at arm's length, (2) lacks commercial substance, or (3) adopts means that are ordinarily not adopted for bona fide purposes. The absence of a specified capital gearing ratio allows subjectivity and discretion at the hands of Revenue while it evaluates whether a given capital structure is an impermissible avoidance arrangement.

The proposed thin capitalisation provisions are now becoming an area of concern – it is therefore desirable that multinational enterprises operating in India should review their respective capital structures in light of appropriate and acceptable benchmarks.

Management services

Under India's exchange control rules, charging management service fees to Indian residents in certain situations could require regulatory approval. It may be possible to obtain regulatory approval for such a charge based on transfer pricing documentation proving its arm's-length nature. Management service fees charged to Indian taxpayers are tax-deductible if charged on an arm's-length basis. Management charges to Indian taxpayers are generally scrutinised in detail during transfer pricing audits. To mitigate the risk of disallowance, the charges should be evidenced by extensive supporting documentation proving that the services were rendered and were necessary to the business of the recipient of the services (the benefit test).

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2 Provided the implementation of the new Direct Tax Code is not deferred by the Government.

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Where an Indian taxpayer is providing such services, the taxpayer should be compensated on an arm's-length basis.

Limitation of double taxation and competent authority proceedings

The competent authority provisions/mutual agreement procedure (MAP) is an alternate dispute resolution mechanism that companies are increasingly beginning to use, especially in cases where the tax amount in dispute is significant. MAP settlements typically have been sought on issues relating to transfer pricing, PE matters and profit attribution.

Most Indian tax treaties contain an 'associated enterprises' article, which contains relieving provisions that require one country to reduce the amount of tax charged to offset the enhanced tax liability imposed by the other country to reflect the arm's-length standard. This article refers to competent authority provisions (contained in the relevant MAP article of the treaty) for consultation between authorities of both countries to prevent double taxation on taxpayers. MAP/competent authority provisions are an integral part of India's extensive treaty network.

The MAP route can be pursued by taxpayers simultaneously with the domestic dispute resolution process. In the event the MAP route is invoked, the competent tax authorities of the countries involved negotiate until they reach an agreement on the transfer prices acceptable to both the authorities. To facilitate the MAP, the Indian government has introduced rules and also has entered into memorandum of understanding (MoU) with the competent authorities of the United Kingdom and United States. An advantage of applying for the MAP under the MoUs mentioned is that Revenue will suspend the collection of tax, where the taxpayer has an adjustment in relation to transactions with the associated enterprises. Under the MoUs, the collection of tax is deferred while the MAP is in process. However, taxpayers need to provide appropriate bank guarantees in support of the potential tax payable prior to resorting to the MAP.

The increasing use of MAPs by taxpayers in seeking effective resolution of transfer pricing disputes is an encouraging step in the Indian scenario.

OECD issues

India is not a member of the OECD. However, India has been invited to participate as an observer in the OECD's Committee on Fiscal Affairs, which contributes to setting international tax standards, particularly in areas such as tax treaties and transfer pricing. India's transfer pricing regulations broadly adopts the OECD principles. Tax offices have also indicated their intent of broadly following the OECD Guidelines during audits, to the extent the OECD Guidelines are not inconsistent with the Indian Transfer Pricing Code.

Joint investigations

There is no evidence of joint investigations having taken place in India. However, almost all Indian tax treaties contain provisions for the exchange of information and administrative assistance, under which the Indian tax authorities may exchange information with other countries for transfer pricing purposes. Furthermore, with transfer pricing awareness increasing and India signing agreements/renegotiating

double tax avoidance agreements with various countries for exchange of information, joint investigations may be undertaken by the Indian tax authorities in the future.

Anticipated developments in law and practice

Revenue officials have indicated the possibility of introducing rules on safe harbour, cost contribution arrangements and thin capitalisation.

In the recent budget, the Government has proposed to introduce the General Anti-Avoidance Rule (GAAR) but as of now it has been deferred to April 2013. Current discussions indicate that the Government may further defer the implementation of GAAR by another three years. Under the GAAR provisions, Revenue authorities are empowered to disregard/combine/recharacterise the whole or any part of any impermissible avoidance arrangement. An arrangement may be regarded as an impermissible avoidance arrangement if the main purpose of the same or any part thereof is the availing of any tax benefit and is not at arm's length or is not for bonafide purpose or lacks commercial substance or results in the abuse of any provisions of the code.

Payment of royalty

The Government of India has permitted lump-sum fees for transfer of technology and royalty payments for use of trademarks/ brand names and technology under the automatic route without any restrictions. The objective of this change in policy is to freely promote the transfer of high-end technology into India.

This amendment in the exchange control regulations could have implications on the intercompany royalty arrangements that multinational enterprises have with their Indian affiliates. Because of exchange control limitations, multinational enterprises may have in the past restricted the royalty charge to their Indian affiliates in line with the limits prescribed under the automatic approval route. With the removal of such a restriction, multinational enterprises may consider revisiting their royalty arrangements with their Indian affiliates to align them with the arm's-length standard.

With this change in policy, a robust transfer pricing documentation for supporting the arm's-length nature of royalty payments would be of utmost importance to defend the deductibility of such payments before Revenue.

Legal cases

Since the enactment of the transfer pricing regulations took effect from 1 April 2001, Indian tax authorities have completed seven rounds of transfer pricing audits. There have been a few noteworthy judicial cases, which have established certain important transfer pricing principles, such as preference for transaction-by-transaction analysis over the aggregation of transactions approach, importance of functional similarity between tested party and comparables and disregard of comparables having controlled transactions. Also, while the common issues such as availability of contemporaneous data and use of secret comparables remain unsolved, the tax authorities have increased their focus on complex issues including intangibles, procurement models and cost allocations. Certain recently concluded eminent cases that have marked the transfer pricing landscape in India are summarised below:

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Quark Systems Pvt. Ltd.

The taxpayer is engaged in providing customer support services to an AE. In the transfer pricing documentation, TNMM was applied as the most appropriate method for determining the ALP. During the scrutiny audit, the Revenue rejected one company selected as a comparable by the taxpayer on the grounds that the said company was in a start-up phase and had made losses for consecutive years.

Before the Appellate Tribunal, the taxpayer contested that once functional comparability is established, the comparable should not be rejected on grounds such as start-up phase, negative net worth, etc. In addition, the taxpayer argued for the rejection of one high-margin comparable company on the basis that the company had significant controlled transactions.

In its ruling, remanding the order back to Revenue, the Appellate Tribunal upheld the need for a proper functional analysis of the tested party and the comparables in determination of ALP and objected to the selection of comparables merely on the basis of business classification provided in the database. The Appellate Tribunal also highlighted the need to follow principles of substantial justice, where the taxpayer should be given an opportunity to rectify a bona fide mistake when it is based on facts on record.

The ruling emphasised that selection of comparables rests on a proper functional analysis and principle of substantial justice to be considered in applying the burden of proof. In addition, the Appellate Tribunal held that the taxpayer may reject its own comparable selected in the transfer pricing study on merits, in light of additional/substantive facts available at the time of a transfer pricing audit.

Schefenacker Motherson Limited

Schefenacker Motherson Limited (SML) is a joint venture company engaged in the manufacture of rear-view mirrors and cable assemblies for rear-view mirrors for automobile manufacturing companies. The rear-view mirrors were supplied to automobile manufacturing companies in India, and the cable assemblies were exported outside India to group entities.

SML applied the TNMM to substantiate the arm's-length pricing and used cash profit to sales as the profit level indicator (PLI) to remove the effect of differences in capacity utilisation, technology used, age of assets used in production and depreciation policies between SML and comparable companies. The TPO rejected the use of cash profit to sales as the acceptable PLI.

The Appellate Tribunal opined that the elements that constitute operating income should be decided on a case-by-case basis depending on the facts, circumstances and nature of business involved. The ruling highlights that the fundamental principle of comparability analysis is to compare like with like. For this purpose, adjustments should be made for material differences to make transactions/entities comparable to each other. Furthermore, the ruling creates a precedent in support of the use of cash profit to sales or cash profit to cost as a PLI in applying the TNMM in certain circumstances.

Skoda Auto India Private Limited

The key international transactions of the taxpayer involved the purchase of kits and payment of royalties, the pricings of which were justified using TNMM as the most

appropriate method. In addition, CUP data (in the form of transaction price between the parent company and other group companies) was used as a corroborative analysis for the transaction of purchase of kits. The TPO rejected the application of the CUP and further made an adjustment by disregarding certain comparables selected by the taxpayer. At the Appellate Tribunal level, the taxpayer argued on the following issues:

- Differences in business models of comparable companies (full-fledged manufacturers) vis-à-vis the company (operating as an assembler).
- Low-capacity utilisation of the taxpayer as it was in the start-up phase.

The Appellate Tribunal laid down that:

- wherever necessary, economic adjustments (for capacity utilisation, unusual high start-up costs) should be made
- the taxpayer cannot be expected to get detailed information, which is not available in the public domain
- in the absence of information in the public domain for making the adjustments, approximations and assumptions can be relied upon
- the benefit of the +/-5% range should be allowed to the taxpayer.

The principle of adjustment for high start-up costs enunciated in the judgment holds significant value for companies that are in their initial stage of operations. The ruling reemphasises the fact that a comparison should be made after economic adjustments whenever necessary.

Fulford (India) Limited

The taxpayer imported Active Pharmaceutical Ingredients (APIs) for secondary manufacturing of formulations. The TPO rejected the TNMM analysis undertaken by the taxpayer and considered the CUP method as the most appropriate method. The TPO compared the purchase price of APIs imported by the taxpayer from an AE with the price for which generic APIs were purchased by the taxpayer's competitors.

The taxpayer contended that the CUP method requires stringent comparability and any differences in the third party price and the international transaction price which could materially affect the price in the open market, warrant appropriate adjustment to such third party prices. In the pharmaceutical world, APIs may have similar properties but still could be different on quality, efficacy and levels of impurities present in the drug amongst other things. Therefore, the two products cannot be compared. Further, the assessee imported the APIs from the AEs and performed secondary manufacturing functions converting the APIs into formulations and marketed and sold the formulations in the Indian market, and therefore, was akin to a value added distributor. It was therefore entitled to a return for its distribution functions and secondary manufacturing functions commensurate to its level of involvement for the relevant product. The selection of the method should be based on functional analysis and the characterisation of the transactions and the entities. CUP method cannot be applied here as the application of the CUP method is blatantly absurd. By applying the CUP method and reducing the import price, the TPO was expecting the assessee to earn an operating margin of 32.09% in the manufacturing AE segment as compared to 11.37% earned in that segment. The profit earned in the AE segment was higher than the operating margin of 8.69% earned by the assessee in its non-AE segment.

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Therefore, the assessee made several arguments rejecting CUP as the most appropriate method and distinguished the prior *Serdia Pharmaceutical* ruling on a similar issue. In the said ruling, the Appellate Tribunal had stated that the arm's-length price of generic APIs can be computed using the CUP method, as long as comparables for application of CUP are available.

However, in this ruling, the Appellate Tribunal did not make any adverse observations in relation to any of the arguments placed by the assessee. The Tribunal observed that the assessee's submission that it acted as a secondary manufacturer, which was akin to a 'value added distributor', was not made before the lower authorities. Accordingly, the Tribunal opined that in the interest of justice, they deem it proper to restore the issue to the file of the Assessing Officer for fresh adjudication.

IL Jin Electronics (I)(P) Ltd.

The taxpayer is engaged in the manufacture of printed circuit boards for one of its group companies in India. The taxpayer imported 45.51% of its raw materials from its AE in Korea, while the balance of 54.49% was procured locally. The AE in Korea purchased these raw materials from unrelated vendors and charged a mark-up for its procurement services. The taxpayer adopted the TNMM and used the operating margin results of a set of comparable companies to demonstrate the arm's-length nature of the import transaction. During the audit, the TPO rejected certain high-loss-making comparable companies identified by the taxpayer and made an upward adjustment to the taxpayer's import prices by applying a higher arm's-length operating margin to the total turnover of the taxpayer.

The taxpayer contested before the Appellate Tribunal that in arriving at the arm's-length price for the import transaction, it is important to consider the actual purchase price paid by its AE to the unrelated vendors as well as the mark-up charged by its AE for its procurement services. In addition, the taxpayer argued that working capital differences between the taxpayer and the comparable companies needs to be considered in arriving at the arm's-length operating margin under the TNMM. Finally, the main contention of the taxpayer was that because only 45.51% of the total raw materials were imported from its AE, any upward adjustment to the import price should be based only on 45.51% of the taxpayer's turnover, not the total turnover.

The Appellate Tribunal observed that an alternative methodology for TP analysis taking a foreign AE as a tested party by applying the resale price method or CPM would have been the ideal approach to determine the arm's-length price in the present case. However, in the absence of any supporting analysis/information presented in relation to the details of prices of the raw material purchased by the AEs from the third-party vendors by the taxpayer, the Appellate Tribunal held that the adoption of alternative methodology was not possible and hence, only TNMM could be used as the most appropriate method.

The Appellate Tribunal agreed with the taxpayer that transfer pricing adjustment should be made based only on 45.51% of the turnover, not the total turnover.

This ruling is important in the context of application of the TNMM, when the method has been applied on an entity-level basis where segmented financial data is not available with the taxpayer for transactions with its AEs. In such a case, any transfer pricing adjustment is to be made only on a proportionate basis and not on the basis of

the total turnover of the taxpayer. The Appellate Tribunal also commented on use of foreign AEs as the tested party to determine the arm's-length price.

Cheil Communication India Private Ltd.

The taxpayer is primarily engaged in the business of rendering advertising services to its AEs against payment of commission. The taxpayer applied the TNMM to confirm the arm's-length price of the international transactions and selected operating profit/value-added expenses as the profit level indicator (PLI). As part of its business of providing consultancy services related to advertisement, the taxpayer also facilitates placement of such advertisements in the print/electronic media. For this purpose, the taxpayer makes payment to third parties including advertisement agencies and printing presses for booking of advertising space/time slots, etc. on behalf of its customers, namely its AEs, and recovers them from its AEs.

In its audited accounts, the taxpayer recognises revenue on a net basis (i.e. it recognises the commission received as 'revenue' and treats the 'gross media spends' passed on to the customers/AEs as 'pass-through costs', thereby not including such third-party costs in its profit and loss account and operating margin computation).

The TPO held that the PLI for comparability purposes should be taken as OP/total cost where total cost includes the costs of placing advertisements on behalf of the AEs, which costs were reimbursed by the AEs to the taxpayer on an actual basis.

The Appellate Tribunal accepted that the gross media spends paid to the media agencies do not represent the taxpayer's value-added activity and accordingly, mark-up is to be applied on the cost incurred by the taxpayer in performing the agency functions and not on the gross media spends. The Appellate Tribunal endorsed the OECD's view that while applying the TNMM, the costs to be considered should be the costs incurred in relation to the value-added activity (i.e. the costs relating to the agency function in the taxpayer's case).

This is the first Appellate Tribunal ruling in India on the treatment of pass-through costs. The ruling extensively relies on the OECD guidelines and establishes the principle that in applying a cost-based remuneration model, a return or mark-up is appropriate only for the value-added activities.

Maruti Suzuki India Ltd.

The taxpayer manufactures and sells cars and trades in spares and components of vehicles. The taxpayer had entered into a license agreement with its AE for use of licensed information and a licensed trademark for the manufacture and sale of the products and parts in specified territories. The taxpayer paid composite royalties for the licensed trademark as well as for the technology license. The TPO proposed to make an adjustment by disallowing the royalty paid by the taxpayer to its AE for use of the trademark and imputing as reimbursement with mark-up on the non-routine advertising, marketing and promotion expenses incurred in promoting the AE's brand name.

The taxpayer filed a writ petition with the High Court against the proposed addition by the TPO. The High Court, while disposing of the writ petition, referred the case back to the TPO with certain observations/directions. One of these was that if there is an agreement between the AE and the taxpayer which carries an obligation on the taxpayer to use the trademark owned by the AE, such agreement should be

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accompanied either by an appropriate payment by the AE or by a rebate provided to the taxpayer. Appropriate payment should be made on account of benefit derived by the AE in the form of marketing intangibles obtained from such mandatory use of the trademark. However, if the agreement between the AE and the taxpayer for the use of the trademark is discretionary, no payment is required to be made by the foreign entity. The High Court also directed application of the concept of 'bright line' in the context of the taxpayer. Aggrieved by the order of the High Court, the taxpayer filed a special leave petition before the Supreme Court. The Supreme Court has directed the TPO to proceed in accordance with law 'uninfluenced' by the observations/directions given by the High Court in the impugned order on merits.

This is a landmark case on the issue of marketing intangibles in the Indian transfer pricing landscape. If the licensed manufacturer contributes to creation of and also economically owns marketing intangibles arising out of advertising and marketing expenses, then it would be entitled to rewards arising out of such spend and thus not required to be compensated by the foreign licensor for any part thereof. The bright line concept is generally applied in cases of distributors and not entrepreneurial licensed manufacturers such as the taxpayer. Further, import of components from group company suppliers needs to be ideally benchmarked in the hands of the foreign suppliers as tested parties, if such components are not embedded with significant intangibles. This approach would ideally be the situation in the majority of the cases where the licensees carry out significant localisation.

Gemplus India Pvt. Ltd.

The taxpayer is a part of the Gemplus group, which is engaged in providing smart card solutions for the telecommunications industry, financial services industry and other e-businesses. The taxpayer entered into a management services agreement with its AE for receipt of services in marketing and sales support, customer service support, finance, accounting and administration support and legal support.

The TPO observed that there was no clear proof that such services had actually been rendered by the AE. There was no specific benefit derived by the Indian entity. The taxpayer had not established the necessity for availing these services from the AE and had already incurred expenses towards professional and consultancy services and employed qualified personnel in India for rendering similar services. The volume and quality of services were disproportionate to the amount paid, and the charge was based on cost apportionment amongst the group entities on a mutually agreed basis and not on the basis of actual services rendered.

The Appellate Tribunal decided the case in favour of Revenue. This ruling has laid down some critical principles applicable for service transactions, which would in fact apply to any transactions involving intra group services or intangibles. Simply put, to satisfy the arm's-length standard, a charge for intra group services or intangibles must at least meet the following conditions:

- The need for intra group services or intangibles is established.
- The intra group services or intangibles have actually been received.
- The benefit from intra group services or intangibles is commensurate with the charge.

It may be noted that in the case of Dresser Rand India Private Limited, the Tribunal held that commercial wisdom of the taxpayer cannot be questioned in deciding the

necessity for availing such services. However, a few principles that are common in both the rulings are documentary evidences to establish actual receipt of services and cost incurred must be commensurate with expected benefits.

Logix Micro Systems Ltd.

The taxpayer is a software developer. It entered into a product development services agreement and a professional service agreement with one of its AEs. During audit proceedings, the TPO upheld that all the transactions of the taxpayer with the AE were compatible with the ALP but proposed an adjustment for notional income to be earned by the taxpayer relating to large receivables outstanding with its AEs.

The Appellate Tribunal has considered the concept of charging interest only on the overflowing interest-free period and has clarified that any interest loss on non-receipt of funds on time should form the basis of computing the notional income.

It should be noted that in the explanation added to definition of International transactions by the Finance Act 2012, receivables or any debts arising in course of business are considered as international transactions.

Reliance Industries Ltd.

The taxpayer hired a vessel from its AE and paid time charter hire charges based on a per day rate (PDR). In order to establish the ALP of the transaction, the taxpayer relied on the approval received by the Director General of Shipping (DG Shipping) and contended the same as comparable uncontrolled price (CUP). Further, the taxpayer also relied on monthly charter hire rate indicated in Drewry Monthly Report by contending that the PDR paid by the taxpayer was reasonable taking into account that the vessel provided by the AE was of less capacity i.e. 2,242 cubic meters, as against the rate published in Drewry Monthly Report which was for a capacity of 3,000 cubic meters.

The TPO considered published prices in the shipping publications, the Shipping Intelligence Weekly and the Drewry Monthly Report and arrived at their arithmetic mean. Further, the TPO made a prorated adjustment for the difference in capacity and determined the ALP, without considering any technical and commercial factors.

The Appellate Tribunal held that in the absence of comparable transactions (i.e. in view of the unique vessel, with no comparable ships available), the matter should be set aside to the file of the Assessing Officer for the limited purpose of re-computing the ALP by taking the data available in the public domain in the form of publication of Shipping Intelligence Weekly and Drewry Monthly as a 'comparable price', and adjusting it for differences in weight, capital cost, risk, etc.

The ruling reiterates the important principle that in the absence of actual transaction which can be considered as CUP, the data available in the public domain can be considered as a 'comparable price' after making adjustment for the differences.

Li & Fung (Trading) Ltd.

Li & Fung (Trading) Ltd., Hong Kong (AE) entered into contracts with its global third party customers for provision of sourcing services with respect to products to be sourced by such global customers directly from third party vendors in India. For the sourcing services, the AE received a commission from these global customers at 5% of the FOB value of goods sourced. The taxpayer was engaged in providing sourcing

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support services to its AE, and was remunerated by the AE at cost plus 5 percent mark-up for provision of these services. The TPO alleged that a cost plus form of remuneration did not take into account substantial intangible assets such as supply chain management and human capital owned by the taxpayer. Based on above, the TPO ascertained that the taxpayer ought to have earned a commission of around 5% on the free on board (FOB) value of the goods sourced from India.

The Appellate Tribunal, in principle, rejected the cost plus remuneration model in favour of a commission based remuneration model (i.e. percentage of value of goods sourced). The Tribunal held that the compensation received by the AE (i.e. 5% of the FOB value of goods sourced) should be distributed between the taxpayer and the AE in the ratio of 80:20 based on the functional profiles of the AE and the taxpayer.

This decision of the Tribunal was based on its conviction regarding the following aspects of the functional profiles of the AE and the taxpayer:

- The taxpayer had actually performed all critical functions, assumed significant risks and had also developed unique intangibles over the years.
- AE did not have either any technical expertise or manpower to carry out the sourcing activities.

GAP International Sourcing (India) Pvt. Ltd.

The taxpayer was engaged in facilitating the sourcing of apparel from India for its group companies. The primary activity of the taxpayer comprised of assistance in identification of vendors, provision of assistance to vendors in procurement of apparel, inspection and quality control and coordination with vendors to ensure delivery of goods to group companies. The necessary technical and intellectual inputs for the discharge of these services were provided by the group companies. The taxpayer adopted the TNMM to benchmark the service fee determined at full cost plus 15% from the foreign group company for its transfer pricing documentation. During the TP audits, TPO disregarded the functional profile and characterisation of the taxpayer by assuming that the functional profile of taxpayer was substantially higher than those of limited risk support service providers.

The TPO alleged that a cost plus form of remuneration did not take into account substantial intangible assets owned by the taxpayer. These intangibles were primarily construed by the TPO to be in the nature of human asset intangibles, supply chain intangibles and location savings. Based on above, the TPO ascertained that the taxpayer ought to have earned a commission of around 5% on the free on board (FOB) value of the goods procured by the group companies.

The Tribunal has stated that for determining the ALP of every international transaction, it is imperative to take the characterisation of the taxpayer and its AEs into consideration through functional analysis of international transactions. While stating this, the Tribunal has observed the following specifically for the taxpayer's case:

- No significant business risks were borne by the taxpayer.
- The taxpayer did not have capacity to assume business risks.
- No human resource intangibles were developed by the taxpayer.
- No supply chain intangibles were developed by the taxpayer.
- Location savings could not be attributed to the taxpayer.

In view of all of the above, the Tribunal held that the arm's-length cost plus mark-up for the taxpayer should be 32%, as opposed to the exorbitant numbers (830% and 660% for the two years under consideration) imputed by the TPO in a derived manner, by resorting to a commission based model of 5% on the FOB value of goods procured by the AE directly from Indian vendors.

The Appellate Tribunal has acknowledged that procurement companies may have different remuneration models based on their functional profiles (e.g. cost plus, commission or buy-sell margin), therefore it is important to ensure that the ALP is determined using the appropriate PLI and suitable benchmarking method. The ALP as determined by either the taxpayer or Revenue cannot lead to manifestly absurd or abnormal financial results, as had happened in the present case.

L'oreal India Pvt. Ltd.

The taxpayer is engaged in manufacturing and distribution of cosmetics and beauty products. In respect of the distribution segment, i.e. the international transaction of purchase of finished goods; the taxpayer had applied the RPM by benchmarking the gross margin of the taxpayer at 40.80% against that of comparables at 14.85%. The TPO rejected application of RPM by the taxpayer on the basis that the taxpayer was consistently incurring losses and the gross margins cannot be relied upon because of product differences in comparables. Accordingly, the TPO adopted Transactional Net Margin Method (TNMM).

The taxpayer contended that it was following market penetration strategy since the commencement of its distribution segment while the comparables had been present in the Indian market since long and had established themselves firmly in the Indian market.

The Appellate Tribunal observed that the taxpayer buys products from its AEs and sells to unrelated parties without any further processing and as per OECD Guidelines, in such a situation, RPM is the most appropriate method. The taxpayer had also produced certificates from its AEs that margin earned by AEs on supplies to the taxpayer was 2% to 4% or even less. The Revenue had not disputed these certificates. Therefore, the TPO's contention that the AEs have earned higher profit was not based on facts. On the other hand, profit earned by the AEs was also reasonable and hence there was no shifting of profits by the taxpayer to its AEs.

In this ruling, the impact of business strategies has been appreciated and operating losses were not attributed to non-arm's-length nature of international transactions.