

10.3. Emerging Transfer Pricing challenges in India

10.3.1 Transfer Pricing Regulations in India

10.3.1.1. The Indian TP regulations are based on arm's length principle. The regulations came into effect from 1 April, 2001. The regulations provide that any income arising from an international transaction between associated enterprises shall be computed having regard to the arm's length price (ALP). The concept of associated enterprises has been defined in detail in the regulations.

10.3.1.2. The ALP shall be determined by any of the prescribed methods. The methods prescribed for the determination of arm's length price are the Comparable Uncontrolled Price method, Resale Price method, Cost plus method, Transactional Net Margin method, the Profit Split method and a residual method known as "any other method" appropriate to determine the arm's length price under the statute. The regulations do not provide any hierarchy of the methods and support concept of "most appropriate method" which provide the most reliable measure of an arm's length result under a particular set of facts and circumstances.

10.3.1.3. The regulation prescribes mandatory annual filing requirements as well as maintenance of contemporaneous documentation by the taxpayer in case international transactions between associated enterprises cross a threshold and contains stringent penalty implications in case of non compliance. The primary onus of proving arm's length price of the transaction lies with the taxpayer. Indian transfer pricing administration prefer Indian comparables in most of the cases and also accept foreign comparables in cases where foreign associated enterprises is less or least complex

determination of arm's length price. Some of these challenges and responses of Indian transfer pricing administration in dealing with these challenges have been analyzed below.

10.3.3.2. Use of contemporaneous data: Commodity price volatility, debt, recession and worries have brought volatility to world market. The volatility impede a stable business

direction

MNEs such as labour or skill employee cost, raw material cost, transaction costs, rent,

10.3.8.1. Transfer pricing of intangibles is well known as a difficult area of taxation practice. However, the pace of growth of the intangible economy has opened new challenges to the arm's length principle. Seventy five percent of all private R&D expenditure worldwide is accounted for by MNEs. World royalty and license fee receipts that were just US \$ 29 billion in the year 1990 has gone up to US \$ 191 billion in 2010.

10.3.8.2. The transactions involving intangible assets are difficult to evaluate because of the following reasons:

- Ø Intangibles are seldom traded in the external market and it is very difficult to find comparables in the public domain.
- Ø Intangibles are often transferred bundled along with tangible assets.
- Ø They are difficult to be detected.

10.3.8.3. A number of difficulties arise while dealing with intangibles. Some of the key issues revolve around determination of arm's length price of rate of royalties, allocation of cost of development of market and brand in a new country, remuneration for development of marketing, Research and Development intangibles and their use, transfer pricing of co branding etc. Some of the Indian experiences in this regard are discussed below.

10.3.8.4. With regard to payment of royalties, MNEs often enter into agreements allowing use of brands, trademarks, know how, design, technology etc. by their subsidiaries or related parties in India. Such payments can be in a lump sum, periodical payments or a combination of both types of payments. It is an internationally agreed position that intellectual property which is owned by one entity and used by another entity generally requires royalty payment. However, the important issue in this regard is determination of the rate of royalty. The main challenge in determination of arm's length price of royalty rate is to find comparables in the public domain with sufficient information required for comparability analysis. The Indian experience suggests that it is impossible to find comparable arm's length prices in most cases. The use of profit split method as an alternative is generally not a feasible option due to lack of requisite information.

10.3.8.5. The Indian tax administration has noticed serious difficulties in determining the rate of royalty charged for use of brand and trademark in certain cases. In some cases the user had borne significant costs on promotion of the brand/trademark, and to promote and develop customer loyalty for brand/trademark in a new market. In these cases, royalty rate charged by the MNE will depend upon the cost borne by the subsidiary or related party to promote the brand and trademark and to develop customer loyalty for brand and product. In many cases no royalty may be charged under uncontrolled environment and the subsidiary would require arm's length compensation for

10.3.8.7. The Indian transfer pricing administration has also noted significant transfer pricing issues in cases of co branding of new foreign brand of parent MNE (which is unknown to new market like

10.3.8.10. On the basis of above functional analysis, the Indian transfer pricing administration decided in most of the cases that Indian subsidiaries were not risk free entities but bore significant risk. Accordingly Indian subsidiaries were entitled to an appropriate return for their function including the strategic decision, monitoring, use of their assets and control including assets to

10.3.8.16. In this context, the Transfer Pricing administration have taken a view that such Indian entities which incur excessive AMP expenses, bear risks and perform functions beyond what an independent distributor with similar profile would incur or perform for the benefit of its own distribution activities should be compensated for return on intangibles. Such compensation would be in the form of reimbursement of the excess AMP expenditure along with mark up. Alternatively, the Indian entity should be allowed to share profit related to marketing intangibles. If no reimbursement is made in these type of cases along with mark up, or the related party does not get an arm's length return for development of marketing intangibles in the form of its entitlement to share profits, the Indian tax administration makes adjustment on account of reimbursement of excess AMP expenditure along with a mark up for the functions undertaken by the subsidiary/related party.

10.3.9. Intragroup Services

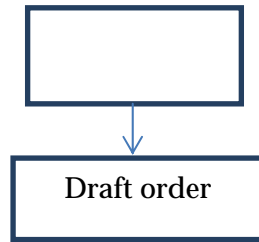
10.3.9.1. Globalization and the drive to achieve efficiencies within MNE groups have encouraged sharing of

- Ø Identification of the cost incurred by the group entity in providing intra group services to the related party.
- Ø Understanding the basis for allocation of cost to various related parties i.e., nature of allocation keys.
- Ø Whether intra group services will require reimbursement of expenditure along with markup or will be reimbursed on cost basis.

- Ø comparison of terms and conditions of loan agreement.
- Ø determination of credit rating of lender and borrower.
- Ø Identification of comparables third party loan agreement.
- Ø suitable adjustments to enhance comparability.

10.3.10.2. The Indian transfer pricing administration has come across cases of outbound loan transactions where the Indian parent has advanced to its associated entities (AE) in a foreign jurisdiction either interest free loans or loans at LIBOR/EURIBOR rates . The main issue before the transfer pricing administration is benchmarking of these loan transactions to arrive at the ALP of the rates of interest applicable on these loans. The Indian transfer pricing administration has determined that since the loans are advanced from India and Indian currency has been subsequently

10.3.11.2. The sequence and availability of dispute resolution forums to the taxpayer in India can be depicted as follows:



Ø International transactions below INR 150,000,000 (US\$ 3 Million) are not selected for transfer pricing audit.