

D.3. Transfer Pricing Practices and Challenges in India

D.3.1. Introduction

D.3.1.1. Transfer pricing provisions were introduced in the Indian Income-tax Act in 2001. The provisions were broadly aligned with the OECD guidelines on transfer pricing. Over the last 15 years, transfer pricing audits in India have thrown up a number of issues and challenges. Administration of the transfer pricing law has also resulted in a number of disputes and protracted litigation. With a view to reducing transfer pricing disputes, a number of initiatives have been introduced by the tax administration in the recent past. Some of the initiatives have included the introduction of an Advance Pricing Agreement (APA) Scheme, inclusion of Safe Harbour provisions, utilisation of the MAP provision in bilateral tax treaties to resolve TP disputes, migration from a quantum of transaction based selection to risk-based selection of TP cases for audit, and issuance of various Circulars and Instructions on transfer pricing matters to provide clarity on TP issues, etc.

D.3.1.2. Due to these initiatives, there has been an impact on the number of cases under audit as well as the number of disputes arising from such audits which have both shown a downward trend. Transfer pricing tax administration can now focus on high risk cases and at the same time provide a reasonable degree of certainty to low risk taxpayers. The new approach is expected to raise the quality of transfer pricing audits without creating an environment of tax uncertainty and protracted litigation.

D.3.1.3. India, as a member of the G-20, has participated in the Base Erosion and Profit Shifting (BEPS) Project on an equal footing with the OECD and other non-

D.3.2.1. The Indian Transfer Pricing Regulations are based on the 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.

D.3.2.2. The ALP is to be determined by any of the prescribed methods. The methods prescribed for the determination of an arm's length price are: Comparable Uncontrolled Price Method, Resale Price Method, Cost Plus Method, Transactional Net Margin Method, Profit Split Method and a residual method known as "any other method" to determine the arm's length price under the statute. The regulations do not provide any hierarchy of the methods and support the concept of the "most appropriate method" which provides the most reliable measure of an arm's length result under a particular set of facts and circumstances.

D.3.2.3. The regulations prescribe mandatory annual filing requirements as well as maintenance of contemporaneous documentation by taxpayers if international transactions between associated enterprises cross a threshold, and they contain penalty implications in case of non-compliance. The primary onus of proving the arm's length price of a transaction lies with the taxpayer. In most cases, the Indian entity is taken as the tested party and Indian comparables are used. If the foreign associated enterprise is the lesser complex entity it is taken as the tested party.

D.3.2.4. In order to provide uniformity in the application of transfer pricing law, there are specialised Commissionerates under the supervision of a Principal Chief Commissioner of Income-tax (International Taxation) at Delhi and two Chief Commissioners of Income-tax (International Taxation) stationed at Mumbai and Bengaluru. Transfer Pricing Officers (TPO) are vested with powers of inspection, discovery, enforcing attendance, examining a person under oath, on-the-spot enquiry/verification and compelling the production of books of account and other relevant documents during the course of a transfer pricing audit. The mechanism of the dispute resolution panel (DRP) is also available to taxpayers to resolve disputes relating to transfer pricing.

D.3.2.5. The government of India has a dedicated website which contains comprehensive information about the latest provisions of tax law and related rules, Circulars and Instructions including on transfer pricing. The website has a user friendly interface. It can be accessed at <http://www.incometaxindia.gov.in>

Core functions, key responsibilities, key decision-making and levels of individual responsibility for the key decisions are important factors to identify the party which has control over the risks. Besides, financial capability to bear the risk is also important in establishing whether a party actually bears or controls the risk.

D.3.4.3. In India, MNEs make claims before the transfer pricing officers that related parties engaging in contract R&D or other contract services in India are risk-free entities. Accordingly, these related parties are said to be entitled to only routine (low) cost plus remuneration. MNEs also contend that the risks of R&D activities or services are being controlled by them and Indian entities being risk-free entities are only entitled to low cost plus remuneration.

D.3.4.4. The notion that risks can be controlled remotely by the parent company and that the Indian subsidiary engaging in core functions, such as carrying out research and development (R&D) activities or providing services, is a risk free entity has not been found acceptable. India believes that in many cases the core function of performing R&D activities or providing services is located in India, which in turn requires important strategic decisions to be taken by the management and employees of the Indian subsidiaries. These strategic decisions could be in terms of designing the product or the software; the direction of R&D activities or providing services; and the monitoring of R&D activities. Accordingly, the Indian subsidiary exercises control over the operational and other risks. In these circumstances, the ability of the parent company to exercise control over the risks remotely from a place where core functions of R&D and services are not located is very limited.

D.3.5. Arm's Length Range

4.5.1. In order to align the Indian transfer pricing law to the best international practices, the law was amended recently to introduce a 'Range' concept for determining the ALP, which is applicable for international transactions undertaken on or after the 1st April 2014 (i.e., effective from assessment year 2015-16). The salient features of the 'Range' concept are as follows:

- A dataset of the results/profit margins of six or more comparable companies are to be arranged in an ascending order and an arm's length range beginning with the thirty-fifth percentile of the dataset and ending with the sixty-fifth percentile of the dataset (the "Middle 30" of the dataset) is to be constructed;
- If the price at which the international transaction has actually been undertaken is within the range referred to above, then the price of the transaction shall be deemed to be the arm's length price;

- If the price at which the international transaction has actually been undertaken is outside the range referred to above, then the arm's length price shall be the median of all the values included in the dataset (i.e. the 50th percentile);
- However, if the range is not used due to the non-availability of at least six comparable companies, the arithmetic mean shall continue to be used to determine the ALP.

D.3.6. Comparability Adjustment

As with many other countries, the Indian transfer pricing regulations require “reasonably accurate comparability adjustments”. The onus to prove a “reasonably accurate comparability adjustment” is on the taxpayer. The experience of the Indian transfer pricing administration indicates that it is possible to provide capacity utilisation and working capital adjustments. However, the Indian transfer pricing administration finds it difficult to make risk adjustments in the absence of any reliable, robust and internationally agreed methodology to provide risk adjustment.

D.3.7. Location Savings

D.3.7.1. The concept of “location savings”, i.e. cost savings in a low-cost jurisdiction such as India, is one of the aspects taken into account while carrying out comparability analysis during transfer pricing audits. The expression “location savings” has a much broader meaning; it goes beyond the issue of relocating a business from a “high-cost” to a “low-cost” location and relates to any cost advantage that a jurisdiction can provide. MNEs continuously search for options to lower their costs in order to increase their profits. In this respect, India provides various operational advantages to the MNEs, such as availability of low-cost labour or skilled employees, lower raw material cost, lower transaction cost, reasonably priced rental space, lower training costs, availability of infrastructure at a lower cost, various direct and indirect tax incentives, etc.

D.3.7.2. In addition to the above cost advantages, India provides the following Location-Specific Advantages (LSAs) to MNEs:

- Highly skilled, specialised and knowledgeable workforce;
- Access and proximity to large and growing local/regional markets;
- Large customer base with increased spending capacity;
- Superior information networks;
- Superior distribution networks;
- Various policy incentives; and
- Market premium.

D.3.7.3. The incremental profit from LSAs is known as “location rents”. The main issue in transfer pricing is the quantification and allocation of location savings and location rents

among the associated enterprises. Using an arm's length pricing approach, the allocation of location savings and rents between associated enterprises should be made by reference to what independent parties would have agreed in comparable circumstances. It is possible to use the Profit Split Method to determine arm's length allocation of location savings and rents in cases where comparable uncontrolled transactions are not available. In these circumstances, it is considered that the functional analysis of the parties to the transaction (functions performed, assets owned and risks assumed), and the bargaining power of the parties (which at arm's length would be determined by the competitiveness of the market, availability of substitutes, cost structure, etc) should both be considered as appropriate factors.

D.3.7.4. However, in situations where comparable uncontrolled transactions are available, the comparability analysis and benchmarking by using the results/profit margins of such local comparable companies will determine the arm's length price of a transaction with a related party in a low-cost jurisdiction. If good local comparables are available, the benefits of location savings can be said to have been captured in the ALP so determined. However, if good local comparables are not available that could capture the benefits of location savings or where the overseas associated enterprise (AE) is chosen as the tested party, the issue of capturing the benefits of location savings would remain an issue in determining the ALP.

D.3.8. Intangibles

General

D.3.8.1. Transfer pricing of intangibles has been a difficult area of work for tax administrations across the world. The n Tw 0. 0 TdsisurÍ nbln lo(g)10.9 -13.5 (n)-4.6 ((va)-1.>>BDC

D.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 made as a lump sum or by way of periodic payments or a combination of both types of payment. Intellectual property, which is owned by one entity and used by another entity, generally requires a royalty payment as consideration for the use. However, the important issue in this regard has been the determination of the arm's length rate of royalty. The main challenge in determining the arm's length royalty rate is to find comparables in the public domain with sufficient information for comparability analysis. Further, it is difficult to find comparable arm's length prices in most cases. The use of the Profit Split Method as an alternative is generally not a feasible option due to the lack of requisite information.

D.3.8.5. Serious difficulties have been encountered in determining the rate of royalty charged for the use of brands and trademarks in certain cases. In some cases, the user had borne significant costs in promoting the brand/trademark, and to promote and develop customer loyalty for the brand/trademark in a new market. In these cases, the royalty rate charged by the MNE should depend upon the following factors:

brand by co-branding it with a popular Indian brand and therefore increasing market recognition.

D.3.9. Intangibles generated through R&D activities

D.3.9.1. Several global MNEs have established subsidiaries in India for research and development activities on a contract basis to take advantage of the large pool of skilled manpower which is available at a lower cost. These Indian subsidiaries are generally compensated on the basis of routine and low cost plus mark-ups. The parent MNEs of these R&D centres justify low cost plus mark-ups on the ground that they control all the risks and their subsidiaries or related parties are risk free or limited risk bearing entities. The claim of the parent MNEs that they control the risk and are entitled to a major part of the profits from R&D activities is typically based on the contention that they:

- Design and monitor all the research programmes of the subsidiary;
- Provide the funds needed for the R&D activities;
- Control the annual budget of the subsidiary for R&D activities;
- Control and take all the strategic decisions regarding the core functions of R&D activities of the subsidiary; and
- Bear the risk of unsuccessful R&D activities.

D.3.9.2. In transfer pricing audits of certain contract R&D centres, the following facts have emerged:

- Most parent companies of MNEs were not able to file relevant documents to justify their claim of controlling the risk of core functions of R&D activities and assets (including intangible assets), which are located in the country of their subsidiary;
- Contrary to the claims made by the parent companies, it was found that day-to-day strategic decisions and monitoring of R&D activities were carried out by personnel of the subsidiary who were engaged in actual R&D activities and bore relevant operational risks;
- The management of the Indian subsidiary also took decisions concerning the allocation of budget to different streams of R&D activities and Indian management also monitored the day-to-day performance of R&D activities; and
- While it was true that funds for R&D activities were provided by the MNE parents that bore the financial risk of the R&D activities, the other important aspects of R&D activities, such as technically skilled manpower, know-how for R&D activities, etc. were developed and owned by the Indian subsidiaries. Accordingly, control over risks of R&D activities lay both with the MNE parent

and the Indian subsidiary but the Indian subsidiary controlled more risks as compared to its MNE parent.

D.3.9.3. Thus, it has been inferred that

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Wherever a mark-up is to be paid or received, the determination of an arm's length mark-up is also a challenge.

D.3.11.6. In view of the above facts, transfer pricing of intra-group services is considered a high risk area in India. India considers the payment for such intra-group services to be base-eroding in nature and, accordingly, attaches great importance to the transfer pricing of such payments. Further, even if an arm's length result is achieved in respect of such payments from India, an additional protection in the form of an overall ceiling on the amount of such

the benchmark rate to arrive at the ALP. The Indian tax administration also uses the interest rate prevalent in the rupee bond markets in India for bonds of different credit ratings. The

D.3.13.3. The Indian tax administration is aware of the problem of increasing transfer pricing disputes and the impact on the investment climate in India. Therefore, the Government of India has taken several steps to reduce litigation and the time needed to resolve tax disputes. Some of the steps taken in this direction are the following:

- Risk-based selection of cases for transfer pricing audit instead of selecting all cases above a particular monetary limit of the value of international transactions for audit;
- Introduction of the 'Range' concept in the Transfer Pricing Law along with the use of multiple-year data ;
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pre-filing consultation between the taxpayer and the APA team before filing a formal application. Such consultation can be on anonymous basis. The application is to be filed along with the specified fee. The Indian APA Scheme also provides for a rollback of the APA for a period of 4 years prior to the first year of the APA period. Therefore, the combined impact of an APA with rollback provisions is tax certainty for 9 years. Rollback is not available for a year in which the Income Tax Appellate Tribunal (ITAT) has pronounced its decision on the issues proposed to be covered under the APA/Rollback. All the procedures relating to the APA Scheme have been prescribed in detail under the APA Scheme in the Income-tax Rules and certain issues have also been clarified by the CBDT through various Circulars and Frequently Asked Questions (FAQs).

D.3.14.3. The Indian APA program has been well received by the taxpayers and more than 700 applications have been filed in the first 4 years. Almost 100 APAs have already been entered into by the CBDT. The APAs entered into so far cover various sectors of the Indian economy including information technology, automobiles, telecommunications, steel, shipping, general trading, banking, pharmaceuticals, etc. It is expected that the robust APA program in India would go a long way in reducing transfer pricing disputes and providing certainty to MNEs in such matters.

D.3.15. Safe Harbour

D.3.15.1. India has introduced safe harbour provision in its legislation in 2009. Rules for administering the provision were subsequently notified. Safe harbour provisions are intended to reduce the compliance burden for small taxpayers with regard to transfer pricing issues. Sectors/transactions covered under safe harbour rules are the following:

- Software Development;
- IT Enabled Services;
- Knowledge Process Outsourcing Services;
- Outbound Intra-Group loans;
- Corporate Guarantees;
- Contract R&D Services in Software;
- Contract R&D Services in Pharmaceuticals;

D.3.16.1. India has endorsed the final report of the BEPS project on Actions 8, 9 and 10 dealing with various transfer pricing issues. Some of the issues addressed in the BEPS reports, such as the broad objective of aligning transfer pricing outcomes with value creation; giving importance to the Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) functions in respect of intangibles for remunerating the group entities of MNEs; testing of contractual allocation or contractual assumption of risk on the parameters of exercising control over risk and/or the financial capacity to bear the risk, and disregarding such contractual allocation or assumption of risk; harmonising contracts with the conduct of parties; identifying and accurately delineating the transaction (i.e., identifying the “real deal”) by analysing the economically relevant characteristics; preventing the capital-rich but low-functioning entities (the “cash box” entities) from contributing to base-erosion or profit-stripping; non-recognition of commercially irrational transactions that cannot be seen between independent parties; etc. are in conformity with the long standing views of the Indian transfer pricing administration. Accordingly, the Indian tax administration is of the view that the guidance flowing from the final report of the BEPS project on Actions 8, 9 and 10 should be utilised by both the TPOs and the taxpayers in situations of ambiguity in interpretation of the law. However, India has not endorsed the guidance in the BEPS report pertaining to Low Value Adding Intra Group Services (LVAIGS) under Action 10 and has not opted for the simplified approach.

D.3.16.2. India has also endorsed the recommendations contained in the BEPS final report on Action 13, which attempts to completely change the transfer pricing documentation standards. India has supported the three-tiered documentation regime comprising a Local File, a Master File and a Country-by-Country (CbC) Report and has already carried out legislative changes in its domestic law.