ARTICLES

Transfer Pricing Rules and Practice in India

by Samir Gandhi
Minal Sharma and
Rakesh Alshi
Deloitte
Mumbai, India

INTRODUCTION

General Overview of the Investment Climate

India remains one of the world's fastest growing economies, ranking among the top 10 industrialized nations and enjoying abundant natural resources. Prior to 1991, India was a highly regulated economy, with exchange controls, prohibitive tariffs, and quantitative barriers to the process of integration with the world economy. Since then, the objective of the government has been to build a modern democratic, socialist, prosperous, and forward-looking India, maintain a sustained growth in productivity, create gainful employment, and attain international competitiveness. In this regard, one of the initiatives is to promote foreign investment and technical collaborations to bring attendant advantages of technology transfer and marketing expertise.

General Overview of the Tax System

Excise duties and customs duties are the principal central indirect taxes, forming a major part of the revenues of the central government. These are administered by the Central Board of Excise and Customs.

The Central Board of Direct Taxes (CBDT) administers various direct taxes. For this purpose, the country is divided into geographical areas, each headed by a Chief Commissioner aided by Commissioners who in turn are aided by Assessing Officers. The Assessing Officers are directly responsible for administration, collection of tax, and determining and issuing tax assessments.

Corporate entities liable to income tax include Indian companies and corporate bodies incorporated abroad. An ''Indian company'' is a public or private limited company formed and registered in India, an Indian statutory corporation, or any body that is declared by the Board to be such a company. Every company is a separate entity for tax purposes. The income of group companies or controlled companies is not consolidated for the purpose of tax assessment.

The taxable year in India, known as the ''assessment year,'' is the period of 12 months beginning on April 1 of each year. Income tax is levied for an assessment year, at the rates prescribed for that year, on the previous year's income. The ''previous year'' in relation to an assessment year is the financial year (year ending March 31) immediately preceding the assessment year for all taxpayers.

Taxable income of a company is determined by aggregating the income of four different categories. Different computation rules apply to each category. A loss in one category may be set off against income in another, except in the case of capital loss, which can be set off only against capital gains. Corporate tax is payable on the entity's profits as shown by its financial statements, after adjustment for various items that are treated differently for tax purposes.

The effective rate of tax (including surcharge) in the case of companies incorporated in India (domestic companies) is 33.99%; in the case of foreign companies, it is 42.23%. The surcharge on income is levied only where the income exceeds 10 million rupees (US$200,000). Further, special tax rates apply to specified types of income of foreign companies.

On August 12, 2009, Indian Finance Minister Pranab Mukherjee released a 254-page draft tax code that would constitute a complete overhaul of India's 50-year-old Income Tax Act. The latter is seen by the government as extremely complex, hard to understand, and not generating sufficient revenue. The draft tax code would broaden the tax base, lower tax rates, and add tough tax evasion penalties, including high fines and prison terms of up to seven years. The corporate tax rate for both domestic and foreign companies would be reduced to 25% but foreign companies would pay an additional 15% branch profits tax. The government hopes to bring the new tax code into effect starting with the 2011 fiscal year.[1]

[1] Jackson, ''India Proposes New Direct Tax Code,'' 2009 *WTD* 154-3 (8/13/09); Lahiri, ''New Draft for India's Tax Code Would

Please send contributions to: Herman B. Bouma, Esq., or John P. Warner, Esq., Buchanan Ingersoll & Rooney PC, 1700 K Street, N.W., Suite 300, Washington, D.C. 20006. Materials in this edition of the *Tax Management International Journal* are current as of May 27, 2010.

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THE TRANSFER PRICING LEGISLATION

History of the Legislation

Prior to the introduction of the transfer pricing regime in 2001, some domestic tax law provisions in the Income Tax Act 1961 attempted to address the shifting of profits offshore.

Under the provisions of §92 (prior to its amendment in 2001) of the 1961 Act, a ''close connection'' between a resident and nonresident could lead to an income adjustment of the resident but not of the nonresident. However, the term ''close connection'' was not defined in the Act. Also, as per the provisions of §40A(2) of the Act, an excessive payment to a related party, compared to fair market value, could be disallowed. The definition of ''related party'' was narrow and required a direct equity holding of at least 20%. Direct or indirect control of management was not covered.

The arm's-length principle was not explicitly applied, although it was implicitly recognized in the concept of ''fair market value.'' It was accepted that business profits should normally be computed on the basis of the ''real income principle,'' i.e., what is actually realized, as per the prevailing business principles and market conditions.

The provisions of the Act were rarely invoked prior to the introduction of the transfer pricing regime and had a number of shortcomings. For example, they failed to:

- address isolated transactions;
- cover transfers of services or intangibles;
- cover transactions between two nonresidents (e.g., business transactions between a permanent establishment of a nonresident company and the parent were not covered);
- deal with profits instead of prices (where a taxpayer entered into several transactions, it was difficult to apportion expenses to each of them and arrive at the profit; this difficulty reduced the effectiveness of the law); and
- define what constitutes a ''close connection'' — therefore the application of the provisions was murky.

As India began to attract more foreign direct investment with the opening up of its economy, the tax authorities became concerned that the growth in international transactions presented possibilities for transfer pricing abuse. The government formed the Expert Group in November 1999 to suggest a framework for transfer pricing legislation. Transfer pricing rules were drafted in 2000 after considering the rules of several countries and the Organisation for Economic Co-operation and Development's (OECD's) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Although India is not an OECD member, the OECD rules were most likely given great weight because OECD members are India's major trading partners and India's rules needed to be in line with the international understanding. The recommendations of the Expert Group were the foundation for the comprehensive legislation enacted in 2001.

In April 2001, India's Parliament enacted the Finance Act 2001, the legislation establishing the nation's first comprehensive transfer pricing regime. Then existing §92 was deleted and new §§92 to 92F containing transfer pricing rules were substituted. In addition to providing an overall framework, the transfer pricing legislation gave India's tax authority broad powers to impose penalties for willful negligence in setting prices and for failing to maintain documentation.[2]

The Finance Bill 2001's explanatory memorandum said the legislation was introduced to curb transfer pricing abuse, and in particular stated that:

> . . . the increasing participation of multinational groups in economic activities in the country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in such intra-group transactions, thereby leading to erosion of tax revenues. With a view to providing a statutory framework which can lead to the computation of reasonable, fair, and equitable profits and tax in India in the case of such multinational enterprises, new provisions are proposed to be introduced in the Income Tax Act.

The objective of the statutory framework is to create a simple and equitable regime, one that will create a reasonable, fair, and equitable tax base and prevent the abuse of transfer pricing in cross-border transactions between associated enterprises.

Lower Rates, Broaden Base,'' 155 *BNA Daily Tax Rpt.* I-1 (8/14/09).

[2] See ''Legislature Passes Transfer Pricing Bill; Ministry May Ease Penalty, Other Provisions,'' 10 *Tax Mgmt. Transfer Pricing Rpt.* 15 (5/2/01).

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Overview of the Legislation

The legislation provides that any income arising from or expenses and interest payments relating to an international transaction shall be computed having regard to the arm's-length price. The term ''arm's-length price'' is defined by §92F(ii) as a price that is applied or proposed to be applied in a transaction between persons other than associated enterprises, under uncontrolled conditions (''uncontrolled transactions''). (The regulations have clarified that an uncontrolled transaction is a transaction between enterprises other than associated enterprises, whether resident or nonresident, and have clarified that a ''transaction'' includes a number of closely linked transactions.) The rules apply to cross-border transactions between two or more related parties, provided either or both of the parties are nonresidents. In other words, the rules are not applicable to domestic transactions or transactions between two residents.

The terms ''enterprise'' and ''permanent establishment'' are defined in §92F. An ''enterprise'' is a person (including a permanent establishment of such person) that is, or has been, or is proposed to be, engaged in any activity, whether relating to articles or goods, or to know-how, patents, copyrights, trademarks, licences, franchises, or any other business or commercial rights of a similar nature, or to any data, documentation, drawing, or specification relating to any patent, invention, model, design, secret formula, or process, or to the provision of services of any kind, or to providing loans, or to acquiring, holding, underwriting, or dealing with shares, debentures, or other securities of any other body corporate, whether such activity is carried on directly or through one or more of its units or divisions or subsidiaries or whether such unit or division or subsidiary is located at the same place where the enterprise is located or at a different place or places. A ''permanent establishment'' includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.

The definition of ''international transaction'' as per §92B is very wide and attempts to cover every transaction that may take place between associated enterprises. The definition is as follows:

> (1) For the purposes of this Section and Sections 92, 92C, 92D, and 92E, ''international transaction'' means a transaction between two or more associated enterprises, either or both of whom are nonresidents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

Thus, all possible commercial transactions have been covered under the law.

Transactions need not be formal or in writing. It is notable that, as per the provisions of subsection (2) of §92B, a transaction through an interposed entity, which has the effect of a transaction between the associated enterprises in substance, is also considered an international transaction.

The term ''associated enterprises'' is defined in §92A(1). Direct or indirect participation in the management or control or capital of another enterprise or such participation by the same persons in two enterprises will result in associated enterprises. This definition is similar to the definition given in Article 9 (Associated Enterprises) of the OECD Model Convention (which definition is also followed in the income tax treaties entered into by India).

Section 92A(2) contains the following illustrations of control that results in two enterprises being considered associated enterprises:

- an equity holding of at least 26%;
- control of the board of directors;
- advancing loans constituting 51% of assets or providing guarantees on 10% of total borrowings;
- dependence on the use of intangibles, such as patents, licenses, business or commercial rights, etc.;
- franchisor-franchisee relationship;
- effective influence over the supply of raw materials, e.g., one enterprise purchases 90% of its raw materials from another enterprise for the purpose of manufacturing and the price or other related conditions are influenced by the supplier enterprise;
- effective influence over the sale of finished product, e.g., an enterprise carrying on the business of manufacturing sells its manufactured goods to another enterprise, or to an enterprise specified by another enterprise, and the price and related conditions are influenced by such other enterprise; and
- appointment of more than half of the board members of an enterprise.

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THE TRANSFER PRICING REGULATIONS

Following enactment of the transfer pricing legislation in April 2001, the tax authority — the CBDT — finalized its first set of transfer pricing regulations in August 2001 (Rules 10A to 10E). The regulations require Indian taxpayers to maintain adequate transfer pricing documentation, use specific transfer pricing methods, and ensure that cross-border, related-party transactions produce arm's-length results.[3] The regulations also create certain safe harbors.

The final regulations are discussed in more detail below.

BURDEN OF PROOF

The primary onus is on the taxpayer to prove that transfer prices are in accordance with the arm's-length principle and determined by the most appropriate method. Where the taxpayer discharges the initial burden of proof, there can be no intervention by the revenue authorities unless they have material information or documents in their possession that may show that the price charged in the international transaction has not been determined by the taxpayer in accordance with the arm's-length principle. Thus, the burden of proof shifts to the tax authority once the taxpayer has discharged its initial burden of demonstrating that its arm's-length prices were computed as per the most appropriate method.

METHODS

Most Appropriate Method Rule

The regulations provide five methods for the determination of the arm's-length price, but do not provide for any hierarchy or preference of a method. Rather, they state that the most appropriate method (MAM) should be applied. The regulations state that the MAM is the method that, under the facts and circumstances of the transaction under review, provides the most reliable measure of an arm's-length result. Power has been conferred on the CBDT to prescribe other methods; however, so far no additional methods have been prescribed.

Rule 10C lists the following factors to be taken into account in selecting the MAM:

- nature and class of the international transaction;
- class or classes of associated enterprises;
- availability, coverage, and reliability of data;
- degree of comparability existing between the international transaction and uncontrolled transaction; and
- extent to which reliable adjustments can be made.

In the case of *UCB India Private Limited*,[4] the Mumbai Income Tax Appellate Tribunal (ITAT) disapproved of the use of the Transactional Net Margin Method (TNMM) on an entity-wide basis and observed that TNMM refers only to the net profit margin realized by an enterprise from an international transaction/class of such transactions, but not to operational margins of the enterprise as a whole. The class of transactions of an enterprise may be evaluated on an aggregate basis in cases where only similar transactions are undertaken. It held that if a taxpayer wants to adopt a particular method as the MAM, then it is the taxpayer's duty to maintain and furnish the required data. The ITAT also observed that the Comparable Uncontrolled Price (CUP) method requires a high degree of comparability, and product comparability is essential. It rejected the adoption of the CUP method by the Revenue on the basis that it suffered from many deficiencies and infirmities, specifically the lack of information and data on comparables.

In the case of *Development Consultants Private Limited*, it was held by the Kolkata ITAT that, in order to determine the MAM for determining the arm's-length price, it is first necessary to select the "tested party." It stated that the tested party will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.

Comparable Uncontrolled Price Method

The Comparable Uncontrolled Price (CUP) method uses a price charged by an entity to another independent entity in an uncontrolled transaction. Rule 10B(1)(a) of the regulations describes the application of the CUP method as follows:

1. The price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified;
2. Such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transac-

[3] See "Tax Board's Final Rules Provide Safe Harbor Instead of Range of Results," 10 *Tax Mgmt. Transfer Pricing Rpt.* 327 (9/19/01).

[4] Refer ITA Nos. 428 and 429 /MUM/2007.

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tions, which could materially affect the price in the open market; and

3. The adjusted price arrived at is taken to be an arm's-length price in respect of the property transferred or services provided in the international transaction.

Resale Price Method

The Resale Price Method (RPM) is generally applied when property purchased from an associated enterprise is resold to an unrelated enterprise. In that case, the resale price of the goods is reduced by the expenditure and the normal gross profit margin that would have been incurred or earned in an uncontrolled transaction by an unrelated enterprise in a similar transaction. Rule 10B(1)(b) of the regulations describes the application of the RPM as follows:

1. The price at which property purchased by the enterprise from an associated enterprise is resold to an unrelated enterprise is identified;
2. Such resale price is reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property in a comparable uncontrolled transaction, or a number of such transactions;
3. The price so arrived at is further reduced by the expenses incurred by the enterprise in connection with the purchase of the property;
4. The price then arrived at is adjusted to take into account the functional and other differences, including differences in accounting practices, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market; and
5. The adjusted price arrived at is taken to be an arm's-length price in respect of the purchase of the property by the enterprise from the associated enterprise.

Cost Plus Method

Cost plus is generally used with respect to the transfer of goods, intangible property, or services provided by one associated enterprise to another. The gross profit markup arising from the provision of the same or similar property or services by the taxpayer or by an unrelated enterprise in a comparable uncontrolled transaction is identified. Rule 10B(1)(c) of the regulations describes the application of the cost plus method as follows:

1. The direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise are determined;
2. The amount of a normal gross profit markup on costs arising from the provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions, and computed according to the same accounting norms as in the case of the controlled transaction, is determined;
3. That normal gross profit markup is adjusted to take into account the functional and other differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit markup in the open market;
4. The costs determined for the controlled transaction (in 1.) are increased by the adjusted gross profit markup; and
5. The sum so arrived at is taken to be an arm's-length price in relation to the provision of the property or services by the enterprise.

Profit Split Method

The profit split method generally is used for international transactions involving the transfer of unique intangibles or for multiple transactions among associated enterprises where the transactions are so interrelated that they cannot be valued separately for the purpose of determining the arm's-length price of any one transaction. Under this method, the combined net profit of all affiliated enterprises from all interrelated transactions is determined. Rule 10B(1)(d) of the regulations describes the profit split method as follows:

1. The combined net profit of the associated enterprises arising from the international transactions in which they are engaged is determined;
2. The relative contribution made by each of the associated enterprises to the earning of such combined net profit is then evaluated on the basis of the functions performed, assets employed or to be employed, and risks assumed by each enterprise, and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances;
3. The combined net profit is then split among the enterprises in proportion to their relative contributions; and

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4. The profit thus apportioned to the taxpayer is taken into account to arrive at arm's-length prices in relation to the international transactions.

The combined net profit referred to in 1. above may first be partially allocated to each enterprise to provide each with a basic return appropriate for the type of international transactions in which it is engaged, with reference to market returns achieved for similar types of transactions by independent enterprises. Thereafter, the residual net profit remaining after such allocation may be split among the enterprises in proportion to their relative contribution in the manner specified in 2. and 3. above. In such a case, the aggregate of the net profit allocated to the enterprise in the first instance together with the residual net profit apportioned to that enterprise on the basis of its relative contribution is the net profit derived by that enterprise from the international transactions.

Transactional Net Margin Method

The general application of the Transactional Net Margin Method (TNMM) involves the computation of the net profit margin realized by an associated enterprise from an international transaction in relation to a particular factor, such as costs incurred, sales, or assets utilized. The net profit margin realized by the associated enterprise, or an unrelated enterprise, from a comparable uncontrolled transaction is then computed, having regard to the same factor, and adjustments are made to the net profit margin to take into account the differences between the international transaction and the uncontrolled transaction. The net profit margin realized by the associated enterprise in the international transaction is then established, in conformity with the net profit margin of the uncontrolled transaction, to arrive at the arm's-length price.

Rule 10B(1)(e) of the regulations describes the TNMM as follows:

1. The net profit margin realized by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;

2. The net profit margin realized by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;

3. The net profit margin referred to in 2. above arising in the comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;

4. The net profit margin realized by the enterprise (initially determined in 1. above) is established to be the same as the net profit margin referred to in 3. above; and

5. The net profit margin thus established is then taken into account in arriving at an arm's-length price for the international transaction.

COMPARABLE DATA

Tested Party

Generally, the tested party should be the Indian taxpayer. However, data limitations mean that in many cases more reliable information will be available about the overseas associated enterprise. In this regard, there is no prohibition under the regulations on the overseas associated enterprise being considered the tested party if it will provide a more reliable measure of an arm's-length price. However, if the overseas associated enterprise is considered the tested party, the results obtained need also to be considered from the perspective of the Indian tax authorities to ensure that the method selected provides an appropriate return for the Indian entity.

In selecting the tested party, the key is to select the enterprise that is the least complex of the associated enterprises for which reliable comparable data are easily available. This has been made clear by the ITAT in recent cases.

In the case of *Ranbaxy Laboratories Limited*,[5] the Delhi ITAT held that the tested party normally should be the enterprise for which reliable data for comparison are easily and readily available and for which fewer computational adjustments are needed. In that case, the taxpayer selected a foreign entity as the tested party, but it was found that reliable data for comparable companies were not available.

In the case of *Development Consultants Private Ltd.*,[6] it was held by the Kolkata ITAT that the tested party would be the one that had the least complex transactions and did not own valuable intangible property or unique assets. Based on the facts of that case, the foreign entity was accepted as the tested party.

Availability of Comparable Data

Comparable company information is gathered from various sources, including financial databases avail-

[5] Refer 110 ITD 428.

[6] Refer 2008-TIOL-150-ITAT-KOL.

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able in the market. Two widely used databases are *Prowess* and *Capitaline*. Information may also be available from financial statements filed in the office of Registrar of Companies, and on websites of relevant companies.

The regulations provide that an uncontrolled transaction (enterprise) is comparable to an international transaction (enterprise) if none of the differences between the two is likely to materially affect prices or profits. In addition, two transactions (enterprises) may be considered comparable if reasonably accurate adjustments can be made to eliminate the material effects of such differences.

In a landmark judgment in the case of *Mentor Graphics (Noida) Private Limited*,[7] the Delhi ITAT considered the important issue of selecting reliable comparables and made the following important observations:

- Comparables are to be selected considering the specific characteristics of the controlled transaction — functions performed and assets deployed (including intangibles) — rather than a broad comparison of activities.
- ‘‘The greater the risks, the greater the expected return’’ is a sound economic principle. Risk can be borne in many varied forms and a sound risk analysis comparing the risk profile of the taxpayer and that of comparables is necessary when selecting comparables.
- If there are material differences in the functions, assets, and risk profiles of the taxpayer and the comparables, then adjustments (e.g., for working capital, risk and growth, and R&D expenses) must be made. If the differences between the companies are so major that adjustment is not possible, then the ‘‘comparables’’ must be rejected.

In the case of *Ranbaxy Laboratories Limited*, the Delhi ITAT held that comparable companies should ideally operate in the same geographical area as the tested party. If foreign comparables are chosen, then there must be very good data to establish functional similarity.

In the case of *E-Gain Communication Private Limited*,[8] the Pune ITAT also issued a decision on the selection of reliable comparables. It stated that parameters such as nature or line of business, products/services, market, assets employed, size and scope of operations, and stage of business or product cycle should be considered in determining comparability.

With regard to differences in risk profile, working capital, and accounting policies, in the case of *Philips Software Centre Private Limited* [9] the Bangalore ITAT accepted the need to make adjustments to the margins of comparables in order to eliminate the impact of such differences.

In the case of *Skoda Auto India Private Limited*,[10] the Pune ITAT dealt with the issue of comparability and adjustments required for enhancing comparability. Adjustments are required to be made on account of functional differences between the tested party and the comparable companies. The Pune ITAT observed that the business models of the comparable companies had import contents ranging from 26% to 56.83% and thus were fundamentally different from the business model of the tested party, which was essentially an assembly of imported knocked-down units, thus having an import content as high as 98.55%. In order to increase comparability, the impact of the divergent import contents had to be eliminated. The Pune ITAT further stated that, even if the business models were considered similar, an adjustment was still required because the tested party could be regarded as having incurred unusually high costs on account of the initial stages of its business.

The Pune ITAT also observed that, for the purpose of making comparability adjustments, it is inevitable that approximations and reasonable assumptions must be used where there is non-availability, or insufficient availability, of information in the public domain. The court stated that a taxpayer cannot be expected to obtain details and particulars that are not in the public domain.

Multiple-Year Data

Rule 10B(4) of the regulations states that the taxpayer is required to rely on data relating to the relevant financial year for benchmarking. However, taxpayers have been given the option to use data relating to the earlier two years in cases where such data had an influence on the determination of transfer prices. However, Transfer Pricing Officers (TPOs) have given a strict interpretation to the provisions of Rule 10B(4) and have insisted that only data for the year of audit be used in determining comparables.

Use of Overseas Data

Though there is no prohibition in the regulations, the tax authorities are not inclined to accept the use of overseas comparable data. However, courts have accepted such use.

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[7] Refer (2007) 109 ITD 101.

[8] Refer ITA No.1685/PN/2007.

[9] Refer ITA No. 218(BNG)/08.

[10] Refer ITA No. 202/PN/2007.

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ARITHMETICAL MEAN VS. RANGE OF PRICE

The regulations require the computation of an arithmetical mean in case more than one price is determined in applying one of the prescribed methods. However, a tolerable range of +/– 5% is allowed for determining an arm's-length price. By allowing this tolerable range, the concept of arithmetical mean has been diluted, and the concept of a range of price is being accepted in principle.

In the case of *Mentor Graphics*,[11] the ITAT implicitly accepted the concept of an arm's-length range of results rather than one result. It observed that the arm's-length price does not mean the maximum price or maximum profit in the range. It is not necessary for the taxpayer to satisfy all points in the range; if one point is satisfied, the taxpayer can be taken to have established its case.

In the case of *Skoda Auto India Private Limited*, the Pune ITAT directed the revenue to consider providing the benefit of the +/– 5% range to the taxpayer.

CONTEMPORANEOUS DOCUMENTATION

Legal Requirement

The regulations require maintaining extensive documentation concerning international transactions. The documentation, as far as possible, must be contemporaneous and available to the taxpayer. The documentation must include both general information about the transacting parties as well as specific information relating to the international transactions. The rules provide that the documentation is to be prepared and maintained by the due date for filing the annual income tax return. It is not necessary to file the required documentation with the return of income; however, the documentation is required to be furnished within 30 days of request by the tax authorities, which period is further extendable by another 30 days. Documentation must be maintained for eight years.

The regulations require foreign enterprises receiving royalties and technical fees from Indian affiliates to comply with the documentation requirements. This is quite burdensome and in fact contrary to the principles followed by other countries regarding transfer pricing compliance because both the Indian related party and the foreign related party involved in the cross-border transaction must comply with India's transfer pricing regulations. Even though the transaction reported by the foreign affiliate is a mirror image of the transaction reported by the Indian taxpayer, both are subject to India's transfer pricing regulations.

In the case of *Philips Software*, the Bangalore ITAT held that the TPO should provide the reason for deviating from the approach in the taxpayer's transfer pricing documentation (including the most appropriate method, the databases used, etc.). The court stated that the TPO's action of conducting a fresh comparability study with data from periods after the due date for filing the tax return was not in conformity with the provisions of:

- Rule 10B(4), which states that the data used for a comparability analysis must be data relating to the financial year in which the international transaction was entered into; and
- Rule 10D(4), which states that the information and documentation to be kept and maintained by the taxpayer pursuant to the provisions of Section 92D and Rule 10D should be as far as possible contemporaneous with the international transaction and should exist by the due date for filing the annual tax return.

The ITAT held that the provisions of the above two rules are ''cumulative in nature'' and should be read harmoniously.

Nature of Documentation

The information required in the documentation can be classified as general information, transaction-specific information, and supporting documentation.

General Information. The general information required is as follows:

1. A description of the ownership structure of the taxpayer with details of shares or other ownership interests held therein by other enterprises;
2. A profile of the multinational group of which the taxpayer is a part along with the name, address, legal status, and country of tax residence of each of the enterprises comprised in the group with whom international transactions have been entered into by the taxpayer, and ownership linkages among them; and
3. A broad description of the business of the taxpayer and the industry in which it operates, and of the business of the associated enterprises with whom it has transacted business.

Transaction-Specific Information. The transaction-specific information required is as follows:

1. The nature and terms (including prices) of international transactions entered into with each asso-

[11] Refer (2007) 109 ITD 101.

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ciated enterprise, details of property transferred or services provided, and the quantum and the value of each such transaction or class of such transaction;

2. A description of the functions performed, risks assumed, and assets employed or to be employed by the taxpayer and by the associated enterprises involved in the international transaction;

3. A record of the economic and market analyses, forecasts, budgets, or any other financial estimates prepared by the taxpayer for the business as a whole and for each division or product separately, which may have a bearing on the international transactions entered into by the taxpayer;

4. A record of uncontrolled transactions taken into account for analyzing their comparability with the international transaction entered into, including a record of the nature, terms, and conditions relating to any uncontrolled transactions with third parties, which may be of relevance to the pricing of the international transaction;

5. A record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction;

6. A description of the methods considered for determining the arm's-length price in relation to each international transaction or class of transaction, the method selected as the most appropriate method along with explanations as to why such method was selected, and how such method was applied in each case;

7. A record of the actual analysis carried out for determining the arm's-length price, including details of the comparable data and financial information used in applying the most appropriate method, and adjustments, if any, that were made to account for differences between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions;

8. The assumptions, policies, and price negotiations, if any, which have critically affected the determination of the arm's-length price;

9. Details of the adjustments, if any, made to transfer prices to align them with arm's-length prices determined under these rules and consequent adjustments made to the total income for tax purposes; and

10. Any other information or data that may be relevant to the determination of the arm's-length price.

Supporting Documentation. The information stated above shall be supported by authentic documents, which may include the following:

1. Official publications, reports, studies, and databases from the government of the country of residence of the associated enterprise, or any other country;

2. Market research studies and technical publications produced by institutions of national or international repute;

3. Price publications, including stock exchange and commodity market quotations;

4. Published accounts and financial statements relating to the business affairs of the associated enterprises;

5. Agreements and contracts entered into with associated enterprises or with unrelated enterprises in transactions similar to the international transaction;

6. Letters and other correspondence documenting any terms negotiated between the taxpayer and the associated enterprise; and

7. Documents normally issued in connection with various transactions under the accounting practices followed.

TAX RETURN DISCLOSURE (ACCOUNTANT'S REPORT)

Section 92E of the Income Tax Act requires the taxpayer to obtain from a chartered accountant (a practicing CPA), or any other person qualified to be appointed as an auditor, a report, on prescribed Form 3CEB, relating to international transactions entered into by the taxpayer. The report is required to be furnished by the taxpayer to the tax authorities on or before the due date for filing the annual tax return.

Form 3CEB requires, for various categories of transactions, disclosure of the transaction value, the arm's-length price, and the method applied to justify the same.

After examination of the accounts and records of the taxpayer, the accountant has to certify that in his opinion proper information and documents, as prescribed by law, have been kept by the taxpayer. The particulars required to be furnished are given in the annex to Form 3CEB. These particulars are similar to the information required by the U.S. Internal Revenue Service's Form 5472 and the Australian Taxation Office's Schedule 25A.

PENALTIES

In India, the penalty provisions concerning transfer pricing issues are in §§271, 271AA, 271BA, 271G,

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and 273B of the Act (discussed below). The penalties are independent of each other and can be levied concurrently. Double taxation can be avoided by applying for relief through India's Mutual Agreement Procedure (MAP) but no penalty relief can be given by the Indian Competent Authority. Section 273B of the Act clarifies that penalties will not be imposed if the taxpayer can establish reasonable cause for the failure to comply.

Comment: It may be difficult to prove reasonable cause to the tax official who is also making the transfer pricing adjustment. India should consider creating a ''Penalty Oversight Committee,'' a committee of senior tax officials who would determine whether a penalty should be levied under the facts of a particular case.

Adjustment to Transaction Price

Section 271(1)(c) provides for penalties that can range from a minimum of 100% to a maximum of 300% of the tax due to a transfer pricing adjustment. While the scale provided is the same as that for disallowances or additions in the case of domestic transactions, the penalties are stringent in light of the fact that transfer pricing is not an exact science and it may not always be possible to arrive at an acceptable arm's-length price. (Although the regulations follow the concept of an arithmetical mean and appear to presume only one arm's-length price for a transaction, clearly this is unrealistic.) However, penalties cannot be levied if the taxpayer demonstrates that the transaction price was determined in accordance with §92C in good faith and with due diligence, as prescribed.[12]

The scale of penalties provided is high compared to those of other countries, and no monetary threshold has been provided, as in the case of a ''net section 482 transfer price adjustment'' in the United States.

Failure to Maintain or Submit Documentation

Sections 271AA and 271G contain penalties, equal to 2% of the value of the international transaction entered into, for:

- Failure to keep and maintain information and documentation on the international transaction; and
- Failure to furnish information and documentation pursuant to §92D.

[12] *See Dy. Comr. of Income Tax v. Vertex Customer Services (India) Pvt. Ltd.*, New Delhi ITAT, ITA No. 1506/Del/2008, decision filed 9/25/09 (reversal of transfer pricing adjustment penalty, holding that transfer pricing officer imposing penalty provided no evidence that taxpayer acted in bad faith).

Failure to Submit Accountant's Report

Section 271BA provides for a penalty of 100,000 rupees (US$2,000) for failing to furnish an accountant's report pursuant to §92E.

TRANSFER PRICING AUDIT PROCESS

The Directorate for Transfer Pricing

A separate Directorate of the Income Tax Department was created in 2001 to administer the transfer pricing rules. It is headed by the Director General of Income Tax (International Taxation) in Delhi, and had Directors of Income Tax (International Taxation) in five locations, i.e., Mumbai, Delhi, Bangalore, Chennai, and Kolkata. Each location has one or more TPOs with supporting staff. Each TPO has the rank of Additional Commissioner of Income Tax. Indicating the importance accorded by the Revenue Department to transfer pricing, the Directorate was expanded in 2007 by increasing the number of TPOs from 18 to 70 in all jurisdictions, with 20 officers in Delhi, 22 in Mumbai, and six in Bangalore. In addition, the jurisdiction of the Directorate was extended to the cities of Pune and Ahmadabad. Thus, taxpayers in Pune and Ahmadabad are now subject to audits in their respective jurisdictions.[13]

Selection of Taxpayers for Audits

Under the regulations, the Assessing Officer (AO) is required to refer the computation of arm's-length prices for international transactions to the TPO. The AO cannot audit the correctness of the transfer prices charged in international transactions, and his power is limited to making a referral to a TPO in cases having aggregate international transactions of more than 150 million rupees (US$3.18 million). Though the guidelines provide a quantitative parameter for an audit target, the Central Board of Direct Taxes so far has not fixed any qualitative criteria for selecting a case for a transfer pricing audit.

Review by the TPO

The TPO, after reviewing the evidence produced by the taxpayer and after taking into account all relevant materials he may have gathered, has to put in writing his basis for determining an arm's-length price. The TPO is required to then send a copy of this document, the §92CA ''order,'' to the AO and also to the tax-

[13] CBDT notification nos. 231, 232 and 233 dated 22 August 2007.

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payer. The AO then computes the total income of the taxpayer on the basis of the order.

The results of transfer pricing audits undertaken by TPOs for five taxable years are summarized in the table below. These figures are approximations.

Taxable Year	No. of Audit Cases	Total TP Adjustments in US$ Millions
31 March 2002	1,081	305
31 March 2003	1,501	572
31 March 2004	1,768	858
31 March 2005	1,479	1,100
31 March 2006	1,717	2,165

Under the transfer pricing regulations, the TPO is expected to consider all relevant facts and information in determining the appropriate arm's-length price for a transaction. The regulations mandate that TPOs provide an opportunity for the taxpayer to submit evidence regarding the arm's-length price. TPOs are expected to consider the appropriateness of the method selected and applied by the taxpayer, the reliability of data used, and other facts and circumstances in determining the arm's-length price. The quality of the taxpayer's documentation and the commercial realism of the taxpayer's arm's-length price are also to be considered.

So far, TPOs generally have been conducting audits from their desks—they normally do not conduct onsite visits to the premises of taxpayers. TPOs have collected information from:

1. Taxpayers — asking them for their global transfer pricing policy and for information regarding other companies in their global group; in some cases, however, TPOs have requested extensive information regarding each international transaction;

2. Third parties — for information that is not available in public databases;

3. Indian Customs officials to cross-check the import prices of goods against their transaction value; and

4. Other regulatory authorities, such as the Director General of Foreign Trade and the Central Bank of India.

In the event the TPO wants to propose adjusting a transaction price, he is required to issue the taxpayer a notice directing it to explain why tax officials should not redetermine the arm's-length price. Thus, the taxpayer is afforded an opportunity to state reasons why an adjustment should not be made.

The TPO is then required to prepare an order (whether with or without a transfer pricing adjustment) that contains his basis for determining an arm's-length price. The order must contain details regarding the data he used, the application of the method he chose, and reasons for arriving at a given price. He must then send a copy of the order to the AO and also to the taxpayer. On receiving the order, the AO computes the total income of the taxpayer and issues a final assessment order to the taxpayer. The AO must rely upon the TPO order, which is merged with the assessment order issued by the AO.

The Finance Act 2007 amended the rules to provide sufficient time to TPOs as well as to AOs to complete an assessment where a referral has been made to the TPO for determining an arm's-length price for an international transaction. The revised time limit is 43 months after the close of the taxable year for the transfer pricing order and 45 months after the close of the taxable year for the main assessment order. Accordingly, in the case of a taxable year ended March 31, 2006, the transfer pricing order must be completed by October 31, 2009, and the main assessment order must be completed by December 31, 2009.

A transfer pricing order is subject to judicial review. Writ petitions were filed in the Delhi High Court by Moser Baer India Ltd.,[14] HCL Technologies Ltd., HCL Technologies BPO Services Ltd., Haier Appliances (I) Pvt. Ltd., Global Logic (I) Pvt. Ltd., and Kamla Dials and Devices Ltd. challenging transfer pricing orders on the following grounds:

- the TPO did not grant an oral hearing before determining arm's-length prices for international transactions entered into by the petitioners with their associated enterprises; and

- the documents and information filed by the petitioners were not considered by the TPO and the TPO failed to disclose documents and information used by him in determining the arm's-length prices.

The Court held that the transfer pricing rules require a TPO to grant a personal hearing to the taxpayer before issuing a transfer pricing order. The argument of the tax authorities that the taxpayer did not demand an oral hearing was rejected. The Court further held that the show cause notice issued by the TPO just before the determination of the arm's-length prices should have: (1) referred to all related documents and information in the possession of the TPO; (2) given the taxpayer the opportunity to inspect the material available and submit additional material or

[14] Refer WP(C) 6974/2008.

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evidence; and (3) given the taxpayer the opportunity to seek a personal hearing in the matter.

APPROACHES TAKEN BY TPOs IN TRANSFER PRICING AUDITS

Services

Services, such as research and development, marketing, and technical services, rendered by an Indian subsidiary or branch of a multinational company to its overseas affiliates have been scrutinized by TPOs to determine the adequacy of the compensation received by the Indian subsidiary or branch. In many cases, the TPOs have taken the position that the Indian subsidiary or branch was not compensated on an arm's-length basis for the services and, accordingly, adjustments were necessary.

Composition of Cost Base

In some cases, TPOs have required the taxpayer to apply a markup not only on the direct costs incurred but also on significant indirect costs. In some cases, pass-through costs incurred by the Indian enterprise, which were reimbursed on a cost-to-cost basis by the foreign affiliate, were also included in the cost base.

High-End vs. Low-End Services

In some cases involving Business Process Outsourcing (BPO) services in the software technology sector, services relating to research and development in the chemicals sector, and services relating to clinical trials in the pharmaceutical sector, TPOs have concluded that the services rendered by the Indian enterprise were in fact high-end services, rather than low-end services as claimed by the taxpayer, and thus a higher markup was required.

Application of Industry Rates

Particularly in the case of the software technology sector, TPOs have sought to apply the CUP method by using general man-hour rates or hourly rates prevailing in the industry, the data pertaining to which was gathered from industry associations, journals, and economic dailies.

Captive Service Providers

With regard to an Indian enterprise rendering services only for its foreign affiliates, TPOs have taken the position that the Indian enterprise is not expected to incur losses. Accordingly, if the enterprise incurred business losses in the initial years of its operations and was not able to explain the economic and business reasons for the same, it was subject to a transfer pricing adjustment.

Given the functional and risk profiles of these Indian enterprises, they are often compensated on a cost-plus basis. That is, all their direct and indirect costs of providing the services are reimbursed by the parent company with a markup. However, the TPOs in some cities, e.g., Bangalore and Hyderabad, have proposed markups ranging from 25% to 40%, resulting in large income adjustments for these entities. It is important to note that, though most of these entities enjoy the benefits of tax holidays under the Income Tax Act, these incentives are not available for income attributable to a transfer pricing adjustment made in the course of an assessment.

These adjustments may result in double taxation because they are likely not deductible in the other tax jurisdictions as expenses. It is generally felt that these adjustments are not founded on sound economic principles, and do not meet the test of "reasonableness."

Head Office Expenses

The allocation of head office expenses (mainly expenses for information technology, marketing, and budgeting) to an Indian entity has been accepted if: (1) the allocation was made on a reasonable basis; (2) the allocation approach was applied on a uniform basis to all related entities; and (3) the Indian entity satisfied the "benefit test," i.e., it produced evidence showing it actually benefited from the head office expenses.

Manufacturers

Taxpayers having multiple transactions with affiliates (e.g., import of raw materials, export of finished goods, payment of royalties, etc.) have applied the concept of "aggregation of transactions" and "single entity approach," thereby making application of the TNMM possible. Initially, TPOs have required the taxpayers to demonstrate compliance with the arm's-length principle for each category of international transaction. However, though the initial emphasis of the TPOs was on identifying internal comparable transactions, gradually they have accepted the reality that the application of the CUP method is not always possible, and hence application of the TNMM may be permissible.

In some situations, TPOs:

- have preferred "product comparability" rather than "functional comparability" while applying the TNMM;
- were not inclined to use foreign comparables, thus resulting in the Indian entity being the tested party for the analysis; and
- were reluctant to include loss-making companies in the comparables set.

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The application of the TNMM in the case of a taxpayer engaged in diversified activities, like manufacturing, trading, and services, has posed problems with respect to the proper allocation of indirect costs to the different business segments.

Distributors

In the case of distributors, TPOs are taking the position that losses are normally not acceptable. The argument that a distributor also bears ''entrepreneurial risk'' is usually strongly contested by a TPO.

Adjustments have also been made in the case of distributors earning high gross margins, but suffering losses on a net basis due to significant operating and distribution expenses. In the case of a distributor, normally the appropriate transfer pricing method is the resale price method, especially in light of the OECD guidelines. However, in these cases, TPOs have rejected the application of the resale price method and have applied the TNMM in making adjustments.

Intangibles

Using the TNMM to justify payments for inbound intangibles (such as know-how, brand names), along with the argument that the payments were in accordance with the exchange control regulations, have not been accepted by TPOs, and taxpayers have been required to substantiate the receipt of know-how, including updates, and to show evidence of negotiations concerning the amounts to be charged.

The arm's-length prices for intangibles have been determined to be zero in cases where the taxpayers could not submit details of payments made by other group entities for the use of similar intangibles. In addition, TPOs have not allowed payments for the use of brand names or trademarks when no such payments were made in earlier years, and thus, according to the TPOs, there is no business or commercial reason for making such payments now.

Location Savings

As multinational companies increasingly outsource their manufacturing/service functions to captive centers in India, an economic factor gaining attention in determining arm's-length prices is the ''location savings'' that arise by virtue of the relatively lower costs of Indian operations. While neither the regulations nor the OECD transfer pricing guidelines provide any guidance on the issue of location savings, they do acknowledge geographic conditions as relevant to comparability.

The Indian tax authorities are increasingly recognizing the concept of location savings and attributing high returns to location savings, particularly in the BPO and IT sectors. During the course of audits, TPOs have been adjusting captive subsidiary income upwards due to location savings. Though the standard markup for captive service providers is normally in the range of cost plus 10%–16%, in some cases TPOs have been raising the markup to 25%–34% on the grounds that the Indian entity is realizing location savings.

APPEALS

In General

The different levels at which a tax assessment can be challenged in India are summarized in the chart below:

Type	Authority
Assessment (Audit)	Assessing Officer
Appeals	Commissioner of Income Tax (Appeals) / Income Tax Appellate Tribunal (ITAT) / High Court
Revisions	Commissioner of Income Tax / Director of Income Tax
Stays	Assessing Officer / Joint Commissioner of Income Tax / Commissioner of Income Tax
Other	Settlement Commission / National Tax Tribunal / Authority for Advance Rulings / Supreme Court

AOs are responsible for administration, collection of tax, and determining and issuing tax assessments. Pursuant to the amendment made by the Finance Act 2007, an AO must compute the total income of the taxpayer in conformity with the arm's-length prices determined by the TPO.

A taxpayer aggrieved by an AO's assessment can file an appeal with a Commissioner of Income Tax (Appeals) (CIT(A)). (AOs and CIT(A)s are both appointed by the CBDT.) The taxpayer can file an appeal if it claims exemption from assessment under subsection (3) of §143 or §144, or if it objects to the amount of income assessed, the amount of loss computed, the amount of tax determined, or the status under which it was assessed.

Because there are different CIT(A)s for different locations, taxpayer appeals of arm's-length prices determined for international transactions are currently being heard before different CIT(A)s. However, one option being considered is the centralization of appeals involving the determination of arm's-length prices.

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The CIT(A)'s authority extends to adjusting the taxpayer's income based on information disclosed in the return or considered in the audit. The Commissioner can, therefore, traverse the whole range of the assessment order and direct the AO to do what he had failed to do at the time of issuing the order. The CIT(A) can also remand the case to the AO and direct the officer to inquire into items that were not the subject of the appeal.

If the taxpayer or the AO does not agree with the CIT(A)'s decision, he may appeal to the Income Tax Appellate Tribunal (ITAT), the final fact-finding authority. The ITAT is a quasi-judicial authority independent of the revenue authorities.

Under §260A, an appeal may be made to the High Court if the High Court is satisfied that the case involves a substantial question of law. Thus, on a substantial question of law, a right of direct appeal to the High Court is provided by the section's provisions. The High Court will determine any issue that has not been determined, or has been wrongly determined, by the ITAT. It will not consider questions of fact because the finding of facts falls outside its purview. Again, only questions of law that are substantial in nature will be considered.

The Commissioner of Income Tax and the Director of Income Tax have jurisdiction over revisions, while an AO, the Joint Commissioner of Income Tax, and the Commissioner of Income Tax may grant stays of assessment orders issued by the lower authorities or stays of demands arising from such orders.

Alternative Dispute Resolution Mechanism

The 2009 Finance Act created a new alternative dispute resolution mechanism for transfer pricing. The mechanism is available to foreign companies facing increased tax liabilities as a result of transfer pricing adjustments. The mechanism consists of four stages:

1. The AO must make his draft tax assessment available to the taxpayer, who then has 30 days to accept it or object;
2. If the taxpayer objects, the matter is referred to a panel of three commissioners, who must provide a decision to the AO within nine months;
3. The AO then has one month to finalize the assessment; and
4. If the taxpayer still objects, it may appeal the assessment to the Income Tax Appellate Tribunal.

The 2009 Finance Act also authorizes the formulation of safe harbors in order to reduce the impact of judgmental errors by TPOs in determining arm's-length prices.

The new mechanism was introduced to improve India's investment climate. There was concern that tax uncertainty in India was adversely affecting foreign investment into India. Taxpayers had complained of "both aggressive and inconsistent enforcement on the part of transfer pricing officers and an untenable process for resolving double tax issues."[15] In presenting the proposals to Parliament, Indian Finance Minister Pranab Mukherjee stated as follows:

> In order to further improve the investment climate in the country, we need to facilitate the resolution of tax disputes faced by foreign companies within a reasonable time frame. This is particularly relevant for such companies in the Information Technology (IT) sector. I, therefore, propose to create an alternative dispute resolution mechanism within the Income Tax Department for the resolution of transfer pricing disputes. To reduce the impact of judgmental errors in determining transfer prices in international transactions, it is proposed to empower the Central Board of Direct Taxes (CBDT) to formulate "safe harbor" rules.[16]

COMPETENT AUTHORITY RELIEF

In General

For purposes of India's income tax treaties, the Indian Competent Authority has been defined as the Finance Ministry or any person delegated by such authority. At present, the Joint Secretary of the Foreign Tax Division in the Finance Ministry has been delegated to be the Competent Authority. The Competent Authority is authorized to negotiate with the Competent Authority of the treaty partner to settle issues of interpreting and applying the treaty, and also to relieve cases of taxation not in accordance with the treaty.

India has a Mutual Agreement Procedure ("MAP") article in its income tax treaties which is similar to Article 25 of the OECD Model Convention. Under the article, a taxpayer can request the Indian Competent Authority to engage in a MAP when it feels the tax authorities' action has resulted in or will result in taxation not in accordance with the treaty. Therefore, both actual and probable disputes can be settled under

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[15] McWilliams and Lahiri, "India's Budget Proposes ADR Mechanism Along with Safe Harbor for Transfer Pricing," 127 *BNA Daily Tax Rpt.* I-4 (7/7/09).

[16] *Id.* See also Lahiri, "India's Industry Applauds Tax Reform Plans, Dispute Resolution Process, New Deductions," 128 *BNA Daily Tax Rpt.* I-3 (7/8/09).

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the procedure. The procedure can be invoked without depriving a taxpayer of its ordinary legal remedies, such as appeals and revisions available under domestic law.

The MAP can be used to negotiate corresponding adjustments in transactions between affiliated companies where transfer pricing adjustments have been made in one of the countries. The MAP is useful for this purpose because, even though the purpose of income tax treaties is to avoid double taxation, it is unusual for a treaty partner to make corresponding adjustments unilaterally. The treaty partner will normally want to be assured that the transfer pricing adjustments made by the other country are arm's-length before making corresponding adjustments, and thus the MAP provides a procedure for arriving at mutually agreed transfer pricing adjustments.

Under India's income tax treaties, a taxpayer residing in a Contracting State may request Competent Authority relief from its Competent Authority within three years from the date of notification of action giving rise to taxation that the taxpayer feels is not in accordance with the treaty. On receipt of the application, the Competent Authority will try to arrive at a satisfactory solution on its own. However, if it is not possible to arrive at a solution, the Competent Authority may then communicate with the Competent Authority of the other state and try to resolve the case by mutual agreement. There is no prescribed time limit for the Competent Authorities to arrive at an agreement.

Treaties empower the Indian Competent Authority to develop through consultation appropriate bilateral procedures, conditions, methods, and techniques in the implementation of the MAP. In addition, the Competent Authority is empowered to devise appropriate unilateral procedures to facilitate the above-mentioned bilateral actions.

Under India's income tax treaties, once an agreement is reached under the MAP, it must be implemented notwithstanding any time limit or other procedural limitation under the domestic law of India. One of the matters that needs to be addressed in this regard is the extension of the statute of limitations for completing the assessment, and suspension of recovery proceedings with regard to completed assessments, where the Competent Authorities are engaged in a MAP. In September 2002, a significant step was taken when the U.S. and Indian Competent Authorities agreed, under the provisions of the India-U.S. Income Tax Treaty, to defer assessment or suspend collection of taxes, including interest and penalties, during the negotiation of transfer pricing adjustments under a MAP.[17] Similar arrangements have been entered into with the United Kingdom.

Procedures for a MAP

In February 2003, the CBDT issued the nation's first operating procedures for a MAP. Although India has a comprehensive network of income tax treaties that contain MAP provisions for resolving double taxation, no operating rules for India existed before the procedures were issued.[18] The procedures state that a taxpayer may request the Indian Competent Authority to invoke a MAP to resolve double taxation. The procedures also create for the first time a specific form — Form 34F — for requesting double taxation relief.

ADVANCE PRICING AGREEMENTS

Indian law does not currently recognize the concept of an Advance Pricing Agreement (APA). However, the draft tax code released by Indian Finance Minister Pranab Mukherjee on August 12, 2009, would authorize the granting of APAs. Section 107 of the draft tax code provides that the CBDT may, with the approval of the central government, enter into an APA with any taxpayer concerning the arm's-length price for an international transaction. The APA would be binding only on the CBDT and the taxpayer, and could not apply to more than five consecutive years.[19]

Under current law, advance rulings can be obtained from the Authority for Advance Rulings (a quasi-judicial body) (the AAR), but advance rulings have limited application as far as transfer pricing disputes are concerned because the AAR is precluded from ruling on property valuations. The AAR was formed as an alternate dispute resolution mechanism by the Finance Act 1993, with effect from June 1, 1993. The expression "advance ruling" means the determination, by the AAR, of a question of law or fact (not involving the determination of the value of property) in relation to a transaction undertaken or proposed to be undertaken by a nonresident applicant or a resident applicant with a nonresident. The AAR's rulings are binding on the applicant as well as the revenue au-

[17] See "U.S., India to Defer, Suspend Collections for Cases Accepted by Competent Authorities," 11 *Tax Mgmt. Transfer Pricing Rpt.* 475 (10/2/02).

[18] See "Indian Central Board of Taxes Prescribes MAP Rules for Double Taxation Disputes," 11 *Tax Mgmt. Transfer Pricing Rpt.* 871 (2/19/03).

[19] Wright, "India's 2009 Proposed Tax Code Includes APA Program, Risk-Based Approach to Audits," 154 *BNA Daily Tax Rpt.* I-1 (8/13/09); Lahiri, "New Draft for India's Tax Code Would Lower Rates, Broaden Base," 155 *BNA Daily Tax Rpt.* I-1 (8/14/09).

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thorities, and cannot be appealed. Advance rulings have persuasive value in similar cases, but a High Court judgment on the same issue takes precedence over an advance ruling. Changes in law may render an advance ruling inapplicable after the effective date of the law.

In *Instrumentarium Corporation, Finland* (A.A.R. No. 609 of 2003), the issue referred to the AAR was whether Instrumentarium's interest-free loan to an associated enterprise in India had to adhere to the principles of arm's-length pricing, even if it resulted in lower tax revenue for India.[20] The AAR observed that the determination of an arm's-length price involves the determination of a fair market rate of interest, and thus it could not issue any ruling on the applicability of subsection (3) of §92 of the Income Tax Act. However, while answering another question referred to it, the AAR stated that the Instrumentarium loan had to comply with §§92 to 92F of the Act. Accordingly, interest for purposes of those provisions had to be chargeable in accordance with the arm's-length principle.

BENEFIT OF TAX HOLIDAY UNDER §10A

Section 10A of the Income Tax Act provides that, under specified conditions, income earned by software or service exporters qualifies for exemption from tax (by means of a credit for the amount of tax otherwise due). However, if a transfer pricing adjustment is made under the regulations, then that benefit is denied with respect to the tax attributable to the adjustment.

In the case of *I Gate Global Solutions Limited*, [21] the taxpayer, when filing its return of income, made an upward adjustment to its total income as a result of a transfer pricing adjustment it made, and claimed a credit under §10A of the Act with respect to the tax on the enhanced income. The taxpayer contended that the additional income was not due to an adjustment by the revenue authorities and consequently was eligible for the credit under §10A. The Bangalore ITAT accepted the taxpayer's argument on the grounds that this was not a case where there was an enhancement of income due to the determination of an arm's-length price by the revenue authorities and hence the taxpayer was entitled to the credit.

This issue was also dealt with by the Bangalore ITAT in the case of *Philips Software*.[22] The court stated that as the basic reason for the denial of a tax holiday for tax attributable to a transfer pricing adjustment is to deter taxpayers from shifting profits outside of India, the denial should not apply when a taxpayer has on its own increased its income through a transfer pricing adjustment.

CONCLUSION

Every tax authority around the world, just like every taxpayer and advisor, changes its views regarding how best to manage transfer pricing as it gains more experience. When first implementing a transfer pricing regime, tax authorities invariably develop some positions that, after a few years experience, evolve toward globally accepted ''best practices.'' Indian transfer pricing authorities appear to be no exception in this regard. Some of the issues arising from the implementation of the transfer pricing regime are normal, but the challenge is to administer it in a fair and practical manner. As the tax authorities take positions regarding technical transfer pricing issues, the CBDT should issue administrative rulings on certain aspects, including the selection of methods and comparables, in order to promote transparency and a sense of fairness among taxpayers.

The government appears set to usher in major reforms with respect to its international tax rules, including its transfer pricing rules, in order to bring them into sync with the best international practices and to bring about uniformity in audits and assessments. A working group on reforms in international taxation and transfer pricing, chaired by the Director General (International Taxation), was formed and it has considered the views of the OECD on legislative changes that India should consider in these areas. The proposed direct tax code referred to earlier, released by Indian Finance Minister Pranab Mukherjee on August 12, 2009, would make the following changes to the transfer pricing regime in addition to the introduction of an APA procedure, discussed earlier: (1) add new risk assessment procedures that focus more on qualitative criteria, such as whether a taxpayer consistently reports losses and has low-quality documentation; (2) create more stringent penalty provisions, including possible criminal prosecution and imprisonment for noncompliance; (3) consolidate the transfer pricing assessment procedure; (4) change the definition of ''associated enterprise''; and (5) provide broader definitions of ''royalties'' and ''fees for tech-

[20] See ''Indian Advance Ruling Authority Decision on Applying Transfer Pricing Laws,'' 13 *Tax Mgmt. Transfer Pricing Rpt.* 967 (2/2/05).

[21] Refer 112 TTJ 1002.

[22] 2008 TIOL 471 ITAT Bangalore.

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nical services,'' terms that have led to tax disputes in the past.[23]

[23] Wright, ''India's 2009 Proposed Tax Code Includes APA Program, Risk-Based Approach to Audits,'' 154 *BNA Daily Tax Rpt.* I-1 (8/13/09); Lahiri, ''New Draft for India's Tax Code Would Lower Rates, Broaden Base,'' 155 *BNA Daily Tax Rpt.* I-1 (8/14/09).

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