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TAX IMPLICATIONS OF TRANSFER PRICING IN INDIA

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Abstract

Transfer pricing holds significant implications for taxation in the Indian regulatory landscape, presenting a complex web of challenges and compliance strategies for businesses. This research paper looks at the Indian perspective of transfer pricing, with a primary focus on its profound impact on tax assessments, revenue collection, and the broader implications for both corporate entities and Indian tax authorities.

The paper elucidates the essential principles of transfer pricing within India's regulatory framework, underlining its pivotal role in determining taxable income. It examines the intricate challenges specific to India, including evolving tax regulations, stringent documentation requirements, and increasing scrutiny by tax authorities.

A central theme explored in this paper is the critical role of transfer pricing in influencing tax liabilities and assessments. It highlights how businesses in India strategically navigate these challenges by employing various transfer pricing methods and documentation practices to ensure compliance and optimize their tax positions, such as the Comparable Uncontrolled Price (CUP) method and the use of Advance Pricing Agreements (APAs).

In conclusion, this research paper underscores the paramount importance of transfer pricing in shaping taxation in India. By scrutinizing the challenges, compliance strategies, and taxation

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lawsin India, it provides valuable insights for businesses operating in India and Indian tax authorities grappling with the intricate dynamics of transfer pricing within the tax framework.

1. Introduction

In today's world where business happens across the globe at the touch of the fingertips, it is vital for companies to ensure they get the maximum benefits, especially when it comes to taxation and revenue generation, to have an edge over their competitor. The concept of transfer pricing comes into play here when there is a Multi-National Corporation (MNC) or Associated Entities (AEs) operating across the world. These companies try to gain an upper hand by fixing prices between themselves that are lower than market prices, thus ensuring they all benefit from the transactions. This fixing of price between related entities is known as transfer pricing.

Transfer pricing refers to the fixing of prices between related entities that are all a part of the same MNC, or divisions of one company, across the world, when they are transacting with each other. These prices are used to determine and save costs, helping companies get resources from each other at lower prices than they would get when transacting with an unrelated entity or a third party.

The advantage of transfer pricing for MNEs is lowering the tax liability incurred as a group, as tax rates vary in each country. This advantage is gained by setting prices in such a way that the profits in a country with high tax rates are minimal, while higher profits are earned by the entities operating in countries with lesser tax rates. For instance, if country AZ sets high tax rates while country BY sets low rates, companies operating in both the countries will prefer to have manufacturing units in AZ, while selling their products to the related entity in BY, thus gaining more profits in BY and incurring lesser tax rates. Fixing rates and supply of goods among entities also helps companies ensure that their flow or supply of goods doesn't get disrupted.

2. Transfer pricing in India

Transfer pricing has become one of the most significant international tax issue affecting multinational enterprises operating in India. While the term transfer pricing is used in Indian law,

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particularly in Sections 92CB and 92CE of the Income Tax Act, 1961, (hereinafter referred to as "the Act") the term has not been specifically defined.

Transfer pricing in India was introduced from Sections 92 to 92F of the Income Tax Act, 1961 which deals with computation of income from international transactions, with reference to the arm's length principle via regulations introduced in 2001. These are broadly based on the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines. India aligns its regulations with international standards,and has even been an active part of theBare Erosion and Profit Shifting (BEPS) Actions which is the OECD's project, even though India is not a member of OECD. Some of the specific components of Indian law and regulations are enumerated below.

2.1. Arm's Length Price (ALP):

The cornerstone of India's transfer pricing laws is the arm's length concept, defined under Section 92F of the Act (Definitions of certain terms relevant to computation of arm's length price, etc.). This is based on the international arm's length principle. ALP states that linked entities should price their transactions as though they were carried out between unrelated parties in comparable circumstances. So related entities find other comparable transactions between independent entities, and fix their transfer price based on these comparable independent transactions, which are called comparable uncontrolled transactions. The basis and justification for the arm's lemgth principle is that a group of companies is not to be taxed as a whole but as separate entities. So transactions are to be seen as though they are conducted between independent entities, not related entities.[2]This notion is essential because it guarantees accuracy and fairness in international business.The principle is also rooted in the need to stop profit shifting and ensure equitable tax allocation between jurisdictions.

The OECD lays down five factors that are to be considered when searching a comparable[3]:

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[2]RaffaelePetruzzi, Chapter 1: The Arm's Length Principle, "Transfer Pricing in a Post-BEPS World", 2016
[3] Chapter III paragraph 1.36, Transfer Pricing Guidelines 2017, Organisation for Economic Co-operation and Development (OECD)

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a. contractual terms
b. functions performed, taking into account assets used and risks assumed, including how these relate to the wider value generation of the MNE
c. characteristics of goods or services provided
d. economic circumstances of the companies and the market
e. business strategies of the companies

In Development Consultants (P) Ltd. v. Dy. CIT[4], it was held that where an assessee has entered into various types of international transactions basis with associated enterprises, arm's length price should be determined on a transaction by transaction basis rather than on an aggregate basis.

2.2. Advance Pricing Agreements (APA)[5]:

APAs were introduced through the insertion of sections 92CC and 92CD into the Act, through the Finance Act of 2012. These are agreements that taxpayers can enter into with tax authorities to reduce transfer pricing disputes while offering the assessee's assurance. These agreements give companies and authorities the opportunity to agree in advance on transfer pricing methodology and pricing, which acts as an assurance against any possible disagreements in the future.

2.3. Transfer Pricing Methods:

There are various methods that are prescribed under Section 92C of the Act. All of the methods are defined under Rule 10B (Determination of arm's length price under section 92C) of the Income Tax Rules, 1962, (hereinafter referred to as "the Rules"). They are briefly explained below:

2.3.1. Comparable Uncontrolled Price method: The comparable uncontrolled price method (CUP) is the most direct method of determining ALP. Under this method, a comparison is taken

[4] DevelopmentConsultants (P) Ltd. v. Dy. CIT, (2008) 115 TTJ 0577
[5] Annual Report of APA Programme of India, 2022-23, Central Board of Direct Taxes

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up between a transaction done with related entities, or a controlled transaction, and a transfer between unrelated entities, called as an uncontrolled transaction. The terms and conditions of these transactions are to be comparable, in identical or similar circumstances. The CUP method can be used for both internal and external transactions of an MNE – all those that are comparable. The price of the controlled transaction is deemed to be at arm's length if that price is same as the price of the uncontrolled, comparable transaction. But a disadvantage of this method is that even if a few variables are changed, or in addition, in either of the transactions to differentiate them, it will render the CUP method inoperative.

2.3.2. Resale Price Method (RPM): Under the RPM, a comparison is made between the resale prices of a product or service sold by a related party and the resale price of the product or service sold to an unrelated entity. Here, the related party must buy the goods or services from an unrelated party, and then resell them to an unrelated entity. The product must be identical or similar in nature. The markup added to the resold product, markup being the addition made to the cost of a product to arrive at the selling price, must be comparable to the markups added in unrelated transactions between parties.

2.3.3. Cost Plus Method (CPM): The Cost Plus Method uses the cost of producing a product or service by a related entity to compare it to the cost of production of an identical product or service by an unrelated entity. This method can be used when there are no products in the market that an enterprise can make a comparison to. A condition that has to be satisfied to apply this method is that the enterprise must produce the goods or service and then charge a markup while selling it to an unrelated party. But a drawback of this method is its sensitivity to cost allocation. Differences in cost accounting methods, or the comprisal or absence of certain costs, can impact how reliable the results of this method will be.

2.3.4. Profit Split Method (PSM): The Profit Split Method is one of the two transactional profit methods prescribed by OECD, the other method being the Transactional Net Margin Method. The PSM is used when there are two or more parties working together, dependent on each other, in the creation of a utility or service. In cases where it is not possible to differentiate each party's contribution separately, this approach is used. The first step is to determine how profits will be split in a similar transaction between unrelated or independent entities. Based on this

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determination, profits are split between the two related entities. Using this, an arm's length price can be arrived at.

There are two methods that can be used for splitting the profits, after the initial analysis:

(i) Contribution analysis: The total profits earned by both entities are split between them in the ratio of their contribution to the output. Their contribution can be calculated by taking into account the assets utilised, and the relative value of the functions performed by each entity.

(ii) Residual analysis: There are two steps under this method. First, the profits are shared between the entities on the basis of the arm's length price for its contributions and functions. Then, the residual profit, if any, is divided between the entities based on an analysis of the transaction.

2.3.5. Transactional Net Margin Method (TNMM): In the Transactional Net Margin Method, also known as the Comparable Profits Method (CPM), the transfer price is determined by looking at the net profit in a controlled transaction between related entities, and comparing that to the net profit in a comparable uncontrolled transaction between third parties. The net profit indicator is calculated as a ratio of the net profit to a relevant base, such as sales or costs.

2.3.6. Such other method as may be prescribed by the Board: The meaning of "other method" is dealt with under Rule 10AB (Other Method Transfer Pricing) of the Rules, and is meant to broaden ALP's scope. Other method, as given under Rule 10AB, "shall be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts."

Section 92(2) of the Act states that the most appropriate method among these will be followed. It was also held in Serdia Pharmaceuticals (India) (P.) Ltd. v. CIT[6] that there is no particular order or priority of methods which the assessee must follow. No method can invariably be considered to be more reliable than others.

[6]Serdia Pharmaceuticals (India) (P.) Ltd. V. CIT [2011] 44 SOT 391 (Mum)

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2.4.Documentation requirement:

Assesses are required to maintain extensive documentation and information pertaining to international transactions done with AEs, or certain domestic transactions, as specified. The documentation requirements are listed under Rule 10D of the Rules (Information and documents to be kept and maintained under section 92D), which can be seen as two parts. The first part deals with mandatory documents or information to be maintained, while the second part requires further documentation to substantiate the information or studies, done under part one of the Rule.

2.5.Availability of Comparable Data:

Under Rule 10B of the Rules, it is given that the data to be used in analyzing the comparability of an uncontrolled transaction with an international one must be from the financial year that the transaction has occurred in, or the current year. The rule also provides for an exception to allow data from the preceding two years if there are any facts that could have exerted an influence on determining the arm's length price. The rule of allowing multiple year data came in to effect in 2014.

The previous approach was to only allow data from the same year of the transaction, and if there was no data available from a company, it made the company ineligible for comparable analysis. This approach resulted in a lot of difficulties for companies because it was not possible to obtain current year data while determining the transfer price. The OECD guidelines, under which one of the topics dealt with is multiple year data with regard to comparability analysis, state that:

In order to obtain a complete understanding of the facts and circumstances surrounding the controlled transaction, it generally might be useful to examine data from both the year under examination and prior years. The analysis of such information might disclose facts that may have influenced (or should have influenced) the determination of the transfer price. For example, the use of data from past years will show whether a taxpayer's reported loss on a transaction is part of a history of losses on similar transactions, the result of particular economic conditions in a prior year that increased costs in the subsequent year, or a reflection of the fact that a product

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is at the end of its life cycle. Such an analysis may be particularly useful where a transactional profit method is applied.[7]

Thus, the allowance of multiple year data makes it easier for companies, while also ensuring that India aligns with international standards in transfer pricing and its documentation.

2.6.Base Erosion and Profit Shifting (BEPS):

BEPS Actions 8 to 10 are part of the OECD initiative to deal with concerns in international transfer pricing, especially the shifting of profits to jurisdictions with lower tax rates, or tax havens across the world. BEPS Action 8 deals with intangibles, which deals with intangible assets and the allocation of profits to these by MNEs. BEPS Action 9 deals with Risk and Capital, which deals with risk allocation in MNEs, including risk-free and risk-adjusted returns and the use of capital. BEPS Action 10 is Other High-Risk Transactions, which focuses on the transfer pricing aspects of cross-border commodity transactions. These Actions help prevent the erosion of tax bases and shifting of profits to avoid tax by MNEs, as the name suggests.

3. Challenges and Issues in Transfer Pricing in India

Challenges arise from a combination of legal, economic and practical factorsand in some cases, due to ambiguity in the law. Transfer pricing in itself is a complex subject, where there are many transactions between various companies with different business models operating in different parts of the world. To deal with all these, while ensuring legal compliance with the laws of the country, results in some challenges for both tax authorities and tax payers. The following are some of the issues dealt with by companies in transfer pricing in India.

3.1. Comparability Analysis and Adjustment:

Companies have to undertake detailed comparability analyses of various transactions to find two comparable transactions that they can use for the purpose of transfer pricing. But this analysis undertaken, which helps ensure the pricing and the transaction is in line with the arm's length principle, is very lengthy and expensive. To shorten this, companies instead undertake

[7] Chapter III paragraph 3.76, Transfer Pricing Guidelines 2017, OECD

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comparability adjustment. Here, companies aim to reduce the differences and effects that arise between different transactions. These differences may arise due to differences in jurisdictions, economic factors or any factors that may or may not be in the control of the companies, but a comparability adjustment helps mitigate them. According to the OECD, "to be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined… or that reasonably accurate adjustments can be made to eliminate the effect of any such differences"[8].

Adjustments must be made to ensure compatibility between comparables, so they must only be undertaken if they lead to more reliable and accurate results of the comparability analysis.[9] These adjustments must also be made on a case to case basis and not in a generalized manner, and are not mandatory but are rather improvements made. The line between an acceptable number of adjustments which increase the reliability, and an excessive amount of adjustments which point out that the transaction is not sufficiently comparable is hard to determine – in fact, as hard as finding out the comparable transactions in the initial stage.

Adjustments between the assessee and the comparables are broadly of two types[10]:

a. Adjustments to eliminate differences in accounting or financial risks
b. Adjustments to eliminate differences in strategic or market adjustments

But there are various drawbacks associated with comparability analysis, such as[11]:

(i) Lack of reliable comparables: This is one of the most frequent problems faced in transfer pricing. This may be caused due to an absence in data, which can happen when the industry that the company is operating may be new, or there may not be many players. In cases of niche products and markets where there may not be many players, it will almost be impossible to find

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[8] Chapter III paragraph 3.47, Transfer Pricing Guidelines 2017, OECD
[9] Chapter III paragraph 3.50 Transfer Pricing Guidelines 2022, OECD
[10] Comparability Adjustments: A Literature Review, Stefanie Chroustovsky and Matthias Petutschnig, WU International Taxation Research Paper Series No. 2018-08, October 2018
[11] Comparability Analysis, United Nations Geneva Meeting, October 2012

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comparables, so here adjustments must be made to the available data to arrive at arm's length price, based on an acceptable degree of compatibility.

(ii) Global economic factors: Global market factors such as economic downturns and recessions can play a major role in the profits and losses of companies. The regions that companies operate in can be a deciding factor too. For instance, the profits of an oil company in Venezuela, where the economic situation is poor and the currency is highly devalued, will be vastly different to that of its subsidiary or competitor operating in the United Arab Emirates, where oil is a resource that is highly valued. Other economic factors may be disruption of supply chain, changes in exchange rates and interest rates in countries, andchanges in governmental regulations and global trade policies.

3.2. Location Savings:

Location savings refers to the savings made by a company on its cost, thanks to the jurisdiction that it operates in. This is one of the major factors considered while undertaking comparability analysis. This does not just include relocating from a high cost to a low cost area, for tax benefits and resources at lower prices, etc. but also includes any cost advantage that can be derived from a location. India is a major hub for MNEs seeking such advantages, as it provides various benefits such as skilled and specialised labour at lower costs, access to a large regional market and customers with varied and growing needs, and various production incentives. The profits derived from these locations are known as location rents.

The major issue is the allocation of location savings and rent among the AEs. If comparables are not available, the Profit Split Method can be used to determine prices. This is based on functions performed, assets used and risks assumed, and the power of the entities, based on the markets they function in and its competitiveness and so on.

When comparables are available, using the arm's length method, entities should arrive at prices based on what independent parties would have agreed upon. When the local comparables are available, the benefits of location saving can be subsumed in the arm's length price. But the issue arises when good local comparables are not available – this means the benefit of the location

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cannot be captured in the ALP. An overseas AE can be chosen as a comparable, but this means that the most important factor in the ALP, the chosen location and its benefit, cannot be appropriately expressed in the ALP.

3.3. Determining arm's length price using range concept:

The determination of the arm's length price based on the arm's length range was newly introduced in order to align with international standards. This is given under Section 10CA (Computation of arm's length price in certain cases) of the Act. The usage of the range method helps to accommodate the complexities and uncertainties involved in determining transfer prices, since there are many factors involved in their determination, that are outside the control of companies. The range concept is only applicable when the most appropriate method is one of the following: CUP Method, RPM, CPM or TNMM, and when the dataset has six or more comparables.

The range method comprises first arranging the dataset arrived at in an ascending order, which is to include the earnings margins or outcomes of a minimum of six comparable entities. In this order, the range is to start from the thirty fifth percentile and end with the sixty fifth percentile. In cases where the concept is applicable but the price of a controlled transaction does not fall within the range, then the median is to be considered to determine the arm's length price.

In the application of range price, when the transaction falls within the range, no adjustments can be made to the assessee's profits. A point of contention between tax authorities and companies is where this adjustment should fall within the range, to create a basis for profit calculation, since there is no specific guideline to guide to any one point within the range. In CIT v Mentor Graphics (Noida) Pvt Ltd.[12], the Delhi High Court ruled that ALP can be determined using arithmetic mean if more than one price is determined by using the most appropriate method.

But in comparison, the German Federal Court inGermany vs "Clothing Distribution Gmbh"[13]after considering all the possible adjustments, took a different approach and stated that

[12]CIT v Mentor Graphics (Noida) Pvt Ltd. ITA No. 1114/2008
[13]Germany vs "Clothing Distribution Gmbh", October 2001, BFH Urt. 17.10.2001, IR 103/00

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adjustment which is most beneficial to the taxpayer could be made, and that choosing the higher or lower limit would not be punished.

Thus the range concept remains an issue at large in India, and it is a major bone of contention under transfer pricing regulations in India as entities believe they must be allowed to make favourable adjustments, which is present in other countries such as Germany.

4. Conclusion

The intricate legal landscape of transfer pricing in India poses many challenges for companies, but is also filled with opportunities. The many regulatory and documentary requirements mean that companies must proactively and meticulously work to ensure compliance, and make sure their strategies are well-planned and effectively implemented to ensure they reap the maximum benefits. As India constantly improves legal standards and aligns with global standards and requirements, companies must also equip themselves internally to optimize their operations.

There are a plethora of challenges like location savings, but the right strategy and a thorough understanding of the regulatory framework can help overcome this and ensure there are benefits for the tax payers. It may be argued that the tax laws in India are unfavourable to taxpayers and there is no ease of doing business, unlike in some other countries but companies must take advantage of the existing laws, like use of multiple year data and the use of contemporaneous data, to stay ahead of their competitors. Companies can also insure themselves against possible disputes by working along with the tax authorities, and use strategies such as Advance Pricing Agreements in their favour.

In this dynamic environment, as the law constantly evolves as tax authorities ensure there is no tax evasion and erosion, companies must stay informed and embrace technology and take a proactive stance in dispute resolution, which will all go a long way in contributing to an effective transfer pricing policy. While there are challenges such as the lack of comparable data, increasing documentation requirements and global factors like economic depression and inflation that are outside the control of companies, companies must undertake a proper understanding of the law to not only comply with it, but ensure they make the most of their global profits and tax

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positions. As India's role in the global economy grows, so do the legal requirements and complexities. Tackling these firmly will put businesses in a position of strength in an environment that requires adaptability, precision and foresight.

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