

# Transfer Pricing - a born baby

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Technological innovation has provided the pivot through which trade has transcended geographical limitations. Trade has enhanced its scope to encompass resources from around the world, giving rise to a variety of issues from commercial, business and tax perspectives.

Globalization has brought with it the advantage of, greater utilization of resources from around the world. Multinational corporations have expending their activities on a large scale through the incorporation of subsidiaries and joint ventures in various jurisdictions, globally.

A company can no longer survive on a stand alone basis, but needs to grow as a conglomerate of companies – A synergised Group. Intra group transfers of goods and services are increasing significant, as a result of these cross-border transactions between subsidiaries and joint ventures partners have caught the attention of the tax authorities in all tax jurisdictions across the globe. Therefore, legislations have introduced transfer pricing regulations to restrict intra group companies from shifting profits from high tax jurisdictions to low tax jurisdictions.

The draconian effect of transfer pricing can be felt not only by multinational corporations but also by the small and medium sized enterprises with ambitious growth plans, which have come under the powerful grip of the regulation.

India has completed four years of transfer pricing assessments in 2008 after implementing the transfer pricing regulations in 2001. Transfer pricing is a key cornerstone of the Finance Authorities compliance program. The Indian taxpayers and authorities alike have from the first round of litigations, gained invaluable experience after having faced various complicated issues. India is now ready to accept the new techniques in transfer pricing already implemented in most of the developed tax jurisdictions like USA and UK alike. Internationally



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accepted methods of determining the Arm's Length Price (ALP), reliable statistical tools, Advance Pricing agreements (APA) and applicability of range vis-à-vis an arithmetic mean are some illustrative developments. The increasing numbers of transfer pricing cases, has caused the Central Board of Direct Taxes to suggest the implementation of APA's to mitigate litigation and strengthening the administration of the law. The change in India's international tax regime is inevitable in order for it to move from an emerging economy to a developed economy on the global platform.

Multinational companies resident in other tax jurisdictions can seek relief under the Mutual Agreement Procedure (MAP) provisions if they incur any transfer pricing additions for their operations in India. The MAP provisions are covered in the Double Tax Avoidance Agreements that India has with various countries. Most companies are hesitating to take advantage of the MAP due to some inherent limitations in the provisions. Namely, the MAP process is time consuming in nature and the Indian MAP officers do not have enough authority to decide the matter as compared to their counterparts in the United States, United Kingdom and Australia etc. This makes companies hesitant.

The Indian Tax authorities usually take an aggressive stand on transfer pricing issues, especially on the transfer of intangibles. Such a strict approach of the revenue department may restrict MNC's from showing interest in the Indian markets even though the global research studies show that the BRIC (Brazil, Russia, India and China) countries are the emerging markets of the world. The expected increase in the FDI which will flow into the country over the next 5 years, needs good governance, which requires a reform in the tax system and the incorporation of transfer pricing regulations, which are based on the globally accepted OECD guidelines or other guidelines followed by developed countries, to enable the adoption of international norms, which would provide legal certainty to the foreign investor.

We also have the first round of judgments available as precedents from the Income Tax Tribunals, High Courts and the Supreme Court of India on transfer

pricing. The Income Tax Appellate Tribunals all over India have pronounced some orders on transfer pricing which are considered as ground breaking judgments laying down the law of transfer pricing in India namely Aztec Software V/s. ACIT, Sony India (P) Ltd. V/s. Central Board of Direct Taxes (CBDT) (2006), Mentor graphics (Noida) Pvt. Ltd. V/s. DCIT (Delhi), Ranbaxy Laboratories Ltd. Vs. Addl. CIT and Cargill India Ltd. Vs. DCIT.

The recent orders of the Indian Tax Authorities also show that the Transfer Pricing Officer takes different views on similar situations when they reoccur, each time in favour of revenue. The CBDT should frame regulations which restrict the TPO's from cherry picking. Recently, due to the increasing number of litigational cases and the subsequent increase in the collection of revenue from this new area, the income tax department has enlarged its international taxation department to enable a speedy settlement of the litigation.

It is suggested that, before issuing notices for more information than is filed mandatorily, there should be a system of a pre-audit meeting with the taxpayer to determine which elements are relevant to ascertain the transfer price of the taxpayer so that only the relevant information and documentation is requested from the taxpayer in the interest of time and resources available.

A practical problem faced by the companies in India is finding comparable data for documentation as required by the Indian regulations. The lack of acceptable comparable data restricts the companies to comply with the transfer pricing regulations in the most efficacious way. Therefore, in the absence of transactional information of the third parties, the comparison between the transactions of the third parties and taxpayer under review is next to impossible as is the mandate of the Indian Tax Regulations.

The key to a good transfer pricing policy is documentation. Companies should give due attention to be able to show a well structured documented transaction. This will produce greater results in terms of saving time and resources at the time of revenue audit (if any).

Normally companies appoint transfer pricing experts to generate a transfer pricing report after the international transaction has already taken place to confirm that the transaction was indeed at an arm length price at the end of the year. This practice often leads to some mis-matches between the commercial price of a transaction and the arm's length price of the same transaction. This is because the prices have been negotiated at the time of transaction based on commercial prudence and the management together with the commercial team can support the price at which the transaction was actually done. But in some cases the divergence between the commercial price and the arm's length price is not easily justifiable to the tax authorities and unrelated parties therefore it is suggested that, advice should be sought from experts before the prices are determined for transactions with Associated Enterprises. This view is also supported by the famous landmark judgment in US transfer pricing history - DHL Corporation and subsidiaries Vs. Commissioner of Internal revenue.

The Indian transfer pricing regime has the advantage of learning from the experiences of other tax jurisdictions, which have more than two decades of transfer pricing experience, and incorporate similar provisions in its regulations to enable the country to attain new heights of competence in the highly competitive global platform.

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