Transfer Pricing Compliance-Revenue Perspective

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- International Tax Conference-2008

Structure of Transfer Pricing Directorate in India

- Separate division in the department to deal with the TP Audits
- Division is headed by Director General (International Tax) at all India Level
  - Transfer Pricing directorate are located in 7 main cities in India
  - These offices are headed by Director of Income Tax (TP). In all, there are 9 directors. They supervise the work of Transfer Pricing Officers who conducts actual TP audits
  - There are 70 Transfer Pricing Officers in India.

Structure of Transfer Pricing Directorate in India

- The Transfer Pricing officers are Senior Officers of the department having minimum 8 to 9 years of work experience in the department
- On an average a Transfer Pricing Officer audits 65 TP cases
- Normal tenure of a Transfer Pricing Officer ranges from on an average of 3 years to 5 years
- Extensive training on transfer pricing is imparted to the IRS officers at National Academy of Direct Taxes at the entry level. This training is further supplemented by various specialized training courses held for the officers at regular intervals at national and regional training institutes

Initiative taken to streamline TP audit in India:

- All the directorate are equipped with two national (Prowess & Capitaline) and two foreign data base (orbis and one source)

- Time period for conducting TP audit is increased from 21 months to 33 months w.e.f. 01.06.2007 (refer second proviso to section 153 r.w.s. 92 CA(3A).

- Most of the TPO are being sent to participate in Workshop /Seminars at various OECD centers for better exposure and to broaden their outlook.

Current status of T.P.Audit

- India introduced comprehensive transfer pricing legislation in 2001 based on arm's length principle.
- Indian transfer pricing legislation is broadly in line with OECD guidelines.
- In India Department has completed transfer pricing audit for 3 years and the transfer pricing audit for the 4th year has just concluded.
- In four years audit 5829 cases have been audited and adjustments have been made in 1680 cases.
- The total amount of adjustments in four years audit is approximately Rs. 13093 crore.

Current status of T.P.Audit

- The percentage of adjusted cases is 28%.
- The percentage of adjustment in India is in line with the global trends (based on year 2001).
  - USA 30%
  - UK 37%
  - Australia 19%
  - Netherlands 18%
  - Germany 39%
  - Sweden 21%
  - Poland 28%
  - Denmark 25%

How People rate us?

- Recently TP week, Transfer Pricing website has conducted a survey to compile top ten toughest tax authorities for transfer pricing. Such tax authorities have been rated as under:
  - Japan
  - Germany
  - USA
  - Australia
  - France
  - India
  - Korea
  - China
  - Canada
  - UK

Most of the transfer pricing adjustments are as under:

- Change in tested party
- Adjustment to the operating profit of tested party
- Change of certain criteria chosen by tax payer for selection of comparable -on account of rejection and modification of search parameter
- Application of fresh search parameter and search of additional comparables from updated database (new database available to TPO at the time of audit)
- Use of comparables-make use of data relating to comparable companies which are not in commercial database but are available with TPO from such companies u/s 133(6) of the Act.

Most of the transfer pricing adjustments are as under:

- Rejection of claim of comparability adjustment-the adjustment is claimed mostly for difference in risk, capacity adjustment and for certain income alleged to be non-operating.
- Adjustment so as to arrive at correct amount of operating profit margins of tested party or of comparable enterprises
- Change in profit level indicators (PLI) under TNMM : PLI is ratio of operating profit margins to an appropriate base which may be total operating cost or total sales or assets or any other relevant base. In most of the cases, the PLI adopted by the taxpayers is ratio of operating profit margin to total cost (OP/TC) or operating profit margin to total sales (OP/Sales). In some cases, the denominator base adopted by taxpayer is found to be representing the controlled transaction. Consequently, TPO changes PLI ratio.
- Rejection of claim for +- 5% adjustment in ALP determination

Status of most preferred method by taxpayers

- A study on most preferred method for determination of arm's length price has revealed that the transactional net margin method (TNMM) was the most appropriate method for determination of arm's length price. The status of most preferred method in F.Y. 2006-07 is depicted as under:

TNMM	72%
CUP	19%
CPM	06%
RPM	03%
PSM	0.1%

Sectoral Analysis:

Sectoral analysis of margins of profit level indicators (PLI) under the transactional net margin method (TNMM) has been made in certain select sectors. The sectors selected for the analysis are Software sector, ITES sector, Auto ancillary sector, Marketing support services sector, Pharmaceutical sector, Diamond sector, Jewellery sector and Chemical sector. The analysis of various sectors reveals that PLI margins in each sector vary significantly from case to case and no definite trend of PLI margin is indicated in any sector

Summary of Sectoral analysis of Delhi, Mumbai and Bangalore is as under

Sectors	PLI	Delhi		Mumbai		Bangalore	
		No. of Cases	Range of Margins	No. of Cases	Range of Margins	No. of Cases	Range of Margins
Software	OP/TC	33	5 to 74	24	8 to 52	112	4 to 74
ITES	OP/TC	21	5 to 35	14	7 to 30	16	26 to 39
Auto Ancillary	OP/Sales	14	3 to 22				
Marktg Support Services	OP/TC	19	5 to 40				
Pharmaceutical	OP/Sales			11	11 to 38		
Diamond	OP/Sales			26	3 to 23		
Jewellery	OP/Sales			15	4 to 22		
Chemical	OP/Sales			22	3 to 25		

Challenges before Us:

- Integrated global economy in 20th century has given rise to large number of MNEs.
- Two-third volume of international trade among the MNEs across the globe
- Huge volume of intra group transaction may be used as a mechanism for profit shifting from one tax jurisdiction to another through pricing of cross border intra group transactions, dispute settlement act US$ 3.4 billions in case of M/s Glaxo Smith Kline Holdings is one of recent examples. A study conducted by Simon J.Pak of Pennsylvania state university and John S. Zdanowicz of Florida state university found that US certification used manipulative pricing scheme to avoid over US$ 53 billion taxes in the year 2001 alone.

Challenges before Us:

- Based on US import and export data, the authors found several examples of abnormally priced transactions such as toothbrushes imported from the UK into the US for a price of $5,655 each, flash lights imported from Japan for $5,000 each, cotton dish towels imported from Pakistan for $153 each, briefs and panties imported from Hungary of $739 a dozen, car seats exported to Belgium for $1.66 each, and missile and rocket launchers exported to Israel for just $52 each.

Challenges before US:

- Lack of comprehensive database: Most of databases are designed primarily for stock market analysis and other economic research activities. There databases are ill equipped for effective FAR analysis.
- Lack of adequate information required for use of CUP, RPM or CPM. By default TNMM has become most favoured method.
- Even though AS-17 provide for maintenance of segmental account in practice either segmental account are not maintained or inadequate information on segmental accounts are available which make application of TNMM also difficult.
- There is need to study feasibility of developing TP specific database through public-private partnership.

Challenges before US:

- Poor documentation/lack of detailed FAR analysis as well as lack of in depth_comparability analysis.
- Reluctance of the taxpayer to part with information on price setting mechanism as well as information on their associated enterprises in countries abroad.
- Transfer pricing of intangibles.
- Transfer pricing of cobranded trademarks.
- Valuation of intangibles

Certain Issues for Consideration

- Emphasis should be on quality of analysis rather than on mechanical comparisons of financial indicia.
- OECD committee on fiscal affair which is working on revision of transfer pricing guidelines recognizes a need to follow a procedure that evaluates comparability characteristics between controlled and uncontrolled transaction rather than immediately relying on data base and financial indicia.

Certain Issues for Consideration

- Given that we live in an imperfect world, the OECD and international transfer pricing experts have now started realizing the practical difficulties in apples to apples comparison. However, in India tax authorities are expected to perform impossibility of High Standard of Comparability in the name of FAR analysis.
- Many of us still believe that FAR analysis means identification of functions performed, assets used and risk assumed. Whereas this is one of several steps involved in FAR analysis.
- What is range of arm's length price range? Is it so vide that even +/-5% margin is also fall within range? One should never forget that large number of business transaction are earning margin of 5% .

Certain Issues for Consideration

- Conflicting judgments of ITAT on various issues for examples:
- Issue of related party transaction
  - *"For purpose of comparability, companies with even single rupee of transaction with associated enterprises cannot be considered as comparables"* Refer para 5.71 of Philips Software centre Pvt. Ltd. V ACIT.
  - *" We are further of view that an entity can be taken as uncontrolled if its related party transaction do not exceeds 10 to 15 percent of total revenue. Within the above limit, transactions can not be held to be significant to influence the profitability of comparable".* Refer para 115.3 of Sony India Ltd. V DCIT (2008)114 ITD 448 (Delhi).

Certain Issues for Consideration

- Whether Assessing Officer is required to prove that there is under statements of price or avoiding of tax for acting under transfer pricing provision?
  - *"22. In the light of above discussion, we hold that although chapter X has title 'Special provisions relating to avoidance of tax' and aim of various sections under Chapter X is to check avoidance of taxes, diversion of income and funds by non-residents from India, it is not necessary that Assessing Officer must demonstrates such avoidance and diversion of tax before invoking the provisions of sections 92C and 92CA."* Refer para 22 of Aztec Software and Technology Services Ltd. [2007] 294 ITR (AT)32
  - *" i) Since the basic intention behind introducing the transfer pricing provisions in the Act is to prevent shifting of profits outside India, and the assessee is claiming benefit under section 10A of the Act, the transfer pricing provisions ought not to be applied to the assessee".* Refer para 5.71 of Philips Software Centre Pvt. Ltd.

Certain Issues for Consideration

- Section 92C(3)
  - *"iv) The TPO or the A.O. needs to satisfy and communicate to the taxpayer the relevant clause under section 92C(3) which has been triggered by the assessee, which has necessitated the application of provisions of the transfer pricing provisions, in the instant case, since this was not demonstrated to the assessee, the transfer pricing order is void."* Refer para 5.71 of Philips Software Centre Pvt. Ltd.
  - *"Rival submissions of the parties have been considered carefully. After giving our deep thoughts to the submissions of the parties, we are of the view that the Assessing Officer is not required to demonstrates the existence of the circumstances set out in clauses (a) to (d) sub-section (3) of section 92C of the Act before referring the case of the assessee to the TPO for determining the ALP under section 92CA(1) of the Act for the reason given hereafter…………28.The view taken by us is also fortified by the decision of Hon'ble Delhi High Court in case of Sony India (P) Ltd. V CBDT (2006) 288 ITR 52,where in the court considered the similar question."*Refer para 26 and 28Aztec Software and Technology Services Ltd. [2007] 294 ITR (AT)32

Certain Issues for Consideration

- Whether order of TPO is binding on the AO?
  - *"The finance Act, 2007, has amended section 92CA(4) to replace the words 'having regard to' with 'in conformity with'. This amendment has been made effective from 1 June, 2007. Since the amendment is effective only from 1 June, 2007, it would not be relevant for A.Y. 2003-04, and accordingly, the provisions prior to the amendment would apply in the instant case."* Refer para 5.60 of Philips Software Centre Pvt. Ltd.
  - *"53. Now words "having regard to" have been replaced by words "in conformity with". So now Assessing Officer after introduction of sub-section (4) above is required to pass assessment order in conformity with the order of the Transfer Pricing Officer determining arm's length price. Now the order of the TPO has been expressly made binding on the Assessing Officer. From the above it is clear that there was a lacuna in the Act as appropriate language was not used earlier. This has been modified and with effect from 01.06.2007, the order of TPO is binding on the Assessing Officer who now has no choice but to pass an order in conformity with the order of the TPO".* Refer para 53 of Aztec Software and Technology Services Ltd. [2007] 294 ITR (AT)32