Exploring Provisions

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Transfer Pricing Manual

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PREFACE

This document tutors the Transfer pricing regulations, its application of prices to transactions that are steered within the precincts or structure of an enterprise and how effective it is in preventing the menace of transfer pricing manipulation. With an incessant annual surge in intra-firm transactions, transfer pricing regulations can only acquire greater, not lesser attention

Purpose of this Document

This document aims to edify how the transfer pricing regulations in India, OECD and other countries function.

Intended Audience

This document is intended for use by the companies and for the public users.

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I. Introduction

Transfer pricing is becoming increasingly significant in the modern economic context. Apart from these transactions being unavoidable and fundamental to the economic survival of a transnational organization, an interesting dimension is the ability of a firm to drastically reduce its tax incidence by using transfer pricing. The mechanism by which this is put into effect is simple: prices for intra-firm transactions are fixed in such a manner that low profits are reflected in jurisdictions having a high tax rate while higher profits are shown in those jurisdictions having a low tax rate.

A sizeable portion of tangible and intangible global trade is intra-firm i.e. it is conducted within the enterprise itself. The OECD observer opines that as much as 60% of world trade takes place within multinational enterprises. This has at least two different implications. Firstly, a multinational corporation (hereinafter: MNC) may be subject to double taxation on the same profits. Secondly, an MNC may use transfer pricing to

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reduce the overall tax burden by "trading"
with production units or subsidiaries in different tax jurisdictions. The effect of these transfers is that governments are often deprived of revenue, and in some cases, the effect may be so severe as to trigger distortions in the Balance of Payments situation of a country.

Prior to the evolution of the arm's length price (ALP), trade within an enterprise could subsist between two related units at an arbitrarily determined price. The Government of India introduced law relating to transfer pricing for the first time by amending the Income Tax Act, 1961 (ITA) through the Finance Act, 2001. The amended Act included sections 92 to 92F as part of Chapter 10 related to Special Provisions Relating to Avoidance of Tax. Additionally, the Organization for Economic Co-operation and Development (OECD) has revised a set of guidelines related to transfer pricing in 2009.

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There has always been confluence and conflict between India, the OECD and other countries guidelines and legislations with regards to transfer pricing regulations.

II. Associated Enterprises

The term 'associated enterprise' is defined in section 92A of the Act as an enterprise which participates directly or indirectly or through one or more intermediaries, in the management or control or capital of the other enterprise. In commercial parlance, an arm's length price is the price at which independent enterprises deal with each other, where the conditions of their commercial and financial relations ordinarily are determined by market forces. Section 92F(ii) of the Act, however, defines the arm's length price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.

The Central Board for Direct Taxes (CBDT) issued a circular with regard to the transfer pricing legislation stating that the

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provisions have been enacted with a view
to ensure that the profits chargeable to tax in India do not get diverted elsewhere by altering the prices charged and paid in intra-group transactions leading to erosion of our tax revenues. The ITA functions in a manner that, subject to s. 92B (2), only transactions between associated enterprises fall within the regulations contained in Chapter X. As per the law, at least one of the parties require to be a non-resident i.e. if the parties to a transaction can prove that they are both residents, they would be saved from the application of arm's length pricing.
The amended ITA seeks to identify and regulate intra-firm transactions so as to not to lose government revenue. To achieve this, s. 92A of the ITA, 1961 accords an extensive definition to Associated Enterprises. As per the statute, it includes an enterprise which participates in the management or control or capital of another enterprise.

Furthermore, the statute provides thirteen specific instances wherein two enterprises will be deemed to be associated

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enterprises. These instances include voting power (≥ 26%), loan value(≥ 51% of the book value of the total assets), guarantees total borrowings(≥10%), appointment of the Board or governing council, dependence on intellectual property of an enterprise, supply of raw materials and consumables (≥90%) , sale of products, controlling authority or related party or mutual interest.

A holds at least 26% of the voting power of B; or,	(A & B are AEs)
A holds at least 26% of the voting power of B & C; or	(B & C are AEs)
A advances a loan to B, constituting at least 51% of the book value of total assets of B; or	(A & B are AEs)
A guarantees at least 10% of the total borrowings of B; or	(A & B are AEs)
A appoints, more than half the directors of B; or, one or more executive directors of	(A & B are AEs)

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B; or	
A appoints, more than half the directors of B & C; or, one or more executive directors of B & C; or	(B & C are AEs)
The manufacture or processing of goods or articles or business carried on by A is wholly dependent on the use IPRs (know how's etc.) belonging to B or in respect of which B has exclusive rights; or	(A & B are AEs)
At least 90% of the raw materials and consumables required for the manufacturing or processing of goods or articles carried out by A, are supplied by B or by persons specified by B, and the prices and other conditions relating to the supply are influenced by B; or	(A & B are AEs)
The goods manufactured or processed by A are sold to B or persons specified by B,	(A & B are AEs)

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and the prices and other conditions relating thereto are influenced by 'B'; or	
Where A is controlled by B (an individual) a transaction between A and C, if C is controlled by B or his relative or jointly by B and his relative; or	(A & C are AEs)
Where A is controlled by B HUF, a transaction between A and C, if C is controlled by a member of B HUF or by a relative of a member of B HUF or jointly by such member and his relative; or	(A & C are AEs)
Where A is a firm, AOP or BOI and B holds at least 10% interest in A; or	(A & B are AEs)
There exists any relationship of mutual interest between A and B as may be prescribed.	(A & B are AEs)

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Moreover, clause (iii) of s. 92F describes "enterprise" to mean a person (including the permanent establishment of such person) who is, or is proposed to be, engaged in any activity related to, inter alia, production, distribution, supply or control or articles or goods, or intellectual property or provision of services of which [another] enterprise is the owner or has exclusive rights.

III. Comparative analysis of different jurisdictions

It is important to see whether the understanding of associated enterprises as prescribed by Indian law is in sync with legal meanings given by other tax jurisdictions. This exercise has important ramifications with respect to clarity and consistency in law. To understand this better, consider a situation where one tax jurisdiction identifies an enterprise as a related party but another tax jurisdiction does not. MNCs are thus in a position to exploit the differential with the result that governments are faced with losses in revenue.

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The OECD Model Convention on Tax, 2005

forms the basis of most tax treaties. It has been adopted by most OECD members and some non- OECD members as well. As part of the Convention, Article 9 gives meaning to Associated Enterprises. Article 9 identifies Associated Enterprises on the basis of participation in management, control or capital of an enterprise of a contracting State. Further the Article provides for an appropriate adjustment to be made by a contracting State in the event of double taxation i.e. where profits have been taxed in two contracting States but would have accrued to the enterprise of only one of these contracting States, had the two enterprises been independent.

Regardless of definition, the law across jurisdictions must function so as to govern a wide range of transactions and to prevent transfer pricing manipulation.

IV. International Transaction

Arm's length pricing would administrate only those transactions between associated enterprises which have been described by

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the law.

Connotations of international transaction under Indian law

The ITA, 1961 functions on two tiers and will impose arm's length pricing only on certain transactions i.e. international transactions between certain parties i.e. associated enterprises. The reasoning behind introducing ss. 92 to 92F by amending the ITA in 2001 is its application to a wider set of transactions including payment of royalty and other individual transactions that do not constitute a part of the regular business carried on between a resident and a non-resident. Furthermore, the new provisions prescribe the documentation required to be maintained by the taxpayer. Such provisions did not exist in the previous editions of Chapter X of the Act.

As per the s. 92B, international transaction refers to a transaction between two associated enterprises, both or either of whom are non-residents, that includes the purchase, sale or lease of intellectual property, provision of services, lending or

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borrowing of money, or any transaction
that has a bearing on the profits, incomes, assets and losses of the enterprise. Further, an international transaction goes on to include any mutual agreement between associated enterprise with regard to the allocation or apportionment of, or contribution to, any cost or expense incurred in relation to any benefit, service or facility to be provided by either of the enterprises.

Not only this, Where the transaction is entered into between parties who are not associated enterprises within the meaning of the law, it will be deemed to be a transaction entered into between two associated enterprises if there exists a prior agreement in relation to the relevant transaction or the terms of the relevant transaction are determined in substance by the two parties. (Sec 92B (2))

Cross-jurisdictional connotations of transaction

It is imperative to ensure consistency and clarity in law across tax jurisdictions. Failure to do so causes the emergence of a

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differential, liable to be exploited by transnational firms. Consider the case where a particular transaction comes within the purview of transfer pricing regulation under one jurisdiction but not under a second jurisdiction. Enterprises would be tempted to conduct transaction through parties situated in the second jurisdiction culminating in the accrual of revenue losses to the first jurisdiction.

While the OECD Model Convention on Tax does not specifically address the concept of transaction, when Article 7 (relating to business profits) is read with (r/w) Article 9 (relating to associated enterprises), it may be deduced that transactions resulting in profits to business enterprises would fall within the tax net.

V. Arm's length price (ALP)

Transfer pricing rules in most countries are based on what is referred to as the "arm's length principle" – that is to establish

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transfer prices based on analysis of pricing
in comparable transactions between two or more unrelated parties dealing at arm’s length. The OECD has published guidelines based on the arm's length principle, which are followed, in whole or in part, by many of its member countries in adopting rules. The United States and Canadian rules are similar in many respects to the OECD guidelines, with certain points of material difference. A few countries, such as Brazil and Kazakhstan, follow rules that are materially different overall.

Prices actually charged are compared to prices or measures of profitability for unrelated transactions and parties. The rules generally require that market level, functions, risks, and terms of sale of unrelated party transactions or activities be reasonably comparable to such items with respect to the related party transactions or profitability being tested

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Section 92C(1) stipulates that the arm's length price is to be determined by adopting any one of the following methods, being the most appropriate method:

- Resale Price Method (RPM)
- Cost Plus Method (CPM)
- Profit Split Method (PSM)
- Transactional Net Margin Method (TNMM)
- Comparable Uncontrolled Price Method (CUP method)

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The law is subject to two conditions –

i) where the application of the most appropriate method results in more than one price, the ALP shall be calculated as a mean of the prices and

ii) Where the variation between the ALP and the price of the international transaction does not exceed 5% of the latter, the latter price will be deemed to be the ALP.

VI. Factors affecting the selection of the most appropriate method

Computation of ALP under s. 92C has to be r/w Rule 10B and 10C of the ITR. The ITR prescribes that the method examines:

- the nature and class of the international transaction,
- class or classes of associated enterprises entering into the transaction,
- the availability, coverage and reliability of data necessary for application of the method,
- the degree of comparability existing between the international transaction and
- the uncontrolled transaction,
- contractual terms
- Economic circumstances of different markets and business strategies
- the extent to which reliable and accurate adjustments can be made to account for differences and the nature, extent and

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- Reliability of assumptions required to be made in the application of the method.

VII. Traditional Transaction Methods

The Traditional Transaction Methods include the

- CUPM

Under the CUPM, determination of ALP requires the identification of the price of property transferred or service provided in a comparable uncontrolled transaction or a series of such transactions. Following this, prices are to be adjusted for differences (if any) with the prices in international transactions.

- RPM and

Under the RPM, the price at which property obtained from an associated enterprise is resold or services provided by an associated enterprise are provided to an independent entity is taken as the base price. The normal gross profit margin which could be earned by an enterprise in the same or similar uncontrollable transaction as well as any expenses incurred in

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connection with the purchase of property
or services are deducted from the base price. The price arrived at is adjusted to take into account the functional and other differences with the international transaction prices

- CPM

The CPM may be considered a reversal of the RPM. Here, the direct and indirect costs incurred in respect of the property transferred or service provided to an associated enterprise is determined. Further, a normal gross profits margin reflecting a same or similar uncontrolled comparable transaction is added. The price arrived at is adjusted to factor functional and other differences with the price of the international transaction price.

VIII. Transactional Profit Methods

The Transactional Profits Methods include

- PSM and

Under the PSM, the combined net profits of all the associated enterprises arising from an international transaction are calculated and then divided among the associated enterprises

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on the basis of relative contribution of
each of the enterprises with regards to functions performed, assets employed and risk assumed. This data is weighed against reliable external market data which indicates how such contributions would be evaluated by unrelated entities partaking in an international transaction. The ALP is computed as against the profits apportioned to the various associated enterprises

- TNMM

The TNMM is accorded the status of being the method of the last resort. Under this method, the net margin of an international transaction is computed in relation to costs incurred, sales affected or assets employed or any other base. Further, the net margin realized by the enterprise or unrelated enterprise on an uncontrolled comparable transaction is computed with respect to the same base and adjusted to account for differences between the international transaction and the uncontrolled comparable transaction.

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IX. Hierarchical preference of ALP computation methods

OECD guidelines have historically favored the former over the latter. Accordingly, CUPM, RPM and CPM have enjoyed hierarchical precedence over PSM and TNMM. The transactional profit methods were accorded the status of being methods of the last resort and member countries were advised to use it only where data compiled from the application of traditional transactional methods were inappropriate or unreliable.

Revisions to the 2009 Guidelines removed this hierarchical construction of the computation methods and traditional methods no longer assumed preference over the profit methods. It acknowledges that certain facts and circumstances may be better assessed using transactional methods, however, the CUPM is exempted from this theory so it may be understood that the CUPM retains its status as being the method of choice.

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X. Issues relating to record keeping

The issues related to maintenance of records are not limited to tax administrations; they greatly affect the tax planning exercises of MNCs.

From the perspective of tax administrations, enterprises must be able to documentarily establish that all their international transactions have been conducted in conformity to the arm's length principle. Accordingly, most of the world's major trading nations have evolved detailed requirements for the documentation of transfer pricing matters.

Documentation Requirements in India

Under Indian law, s. 92D of the amended ITA provides for the maintenance and keeping of information and documents by persons entering into an international transaction. Furthermore, s. 92E provides that the report of an accountant is to be furnished by persons entering into an international transaction

As per Rule 10D (1), the necessary documents are mentioned. However, Rule 10D (2) further states that where the books of account of the assessee enterprise show that the aggregate value of the international transactions entered into by it does

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not exceed fifteen crore rupees, the assessee would not be required to maintain information and documents as prescribed under sub-section (1)

The ITR also specifies that the documentation produced under sub-section (1) and (2) must be contemporaneous and should exist latest by the date specified under s. 92F (iv) as well as the time period for which the information and documentation must be maintained under this Rule i.e. eight years after the relevant assessment year.

Documentation Standards under the OECD Guidelines

With regard to specific documents, the OECD Guidelines state that it is useful to refer to information pertaining to an outline of the business, the structure of the organization, ownership linkages with the MNC group, the amount of sales and operating margins in the years preceding the transaction, the level of taxpayer's transactions with foreign associated enterprises, etc. In addition to this information, the OECD Guidelines also suggest that it may be useful to procure information relating to factors that influenced the establishment of any pricing policy within an MNC, management strategy, general commercial and industry conditions affecting the taxpayer, possibility of risk and documents showing the process of negotiations culminating in

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the determination or revision of prices in controlled transactions.

XI. Case references – TP Glitches

International transaction	F Y	Assessee	Operating Margin Earned/ paid	Average Mean Margin Quotient/ PLI i.e. operating profit as a percentage of operating costs as determined by TPO	Comparable /Non comparable Companies
BPO Services-Provision of IT enabled services (ITES) &Charges	2001-02	American Express (India) P Ltd.(70DTR330) Del Trib	Cost plus 5%	8.78%	1. Ace Software Export Ltd. 2. Allsec Technologies Ltd.

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for SDN/CPU and technology		Method: TNMM			3. MCS Ltd. 4. Max Healthscribe Ltd.
Software developme nt and ITES/BPO	2005-06	Genisys Integratin g Systems (I) P Ltd. (15ITR(Tri b) 475 (Bang) Method: TNMM	7.96%	19.80	Loss making companies excluded and additional comparables selected
R&D Services	2002-03	SAP Labs India P Ltd. (6ITR Trib.81 read with 15ITR Trib. 506 (Bang) Method:	Cost plus 6%	19.62%	1. satyam excluded 2. all comparables having margin less than 6 per cent excluded 3. loss making

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		TNMM			companies excluded
1.R&D services; 2. IT support services; 3. Corporate shared services (back office support services); 4. Global sourcing services	2003-04	Timken Engineering & Research India (P) Ltd. (21taxmann.com 160(Bang) Method: TNMM	Cost plus 5%	R&D- 31.73% IT/ITES- 25.35%	1. to consider operating revenue and the operating cost of the transactions relating to associated enterprises only; (b)Comparables having the turnover of more than 1.00 crore but less than 200.00 crores only shall be taken into consideration; (c) To allow standard deduction of 5%

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					under the proviso to s. 92C(2) (d) following companies excluded as these are giant and command premium pricing- i. I-Power Solutions India Ltd. ii. Igate Global Solutions Ltd. (Mascot Systems) iii. Infosys Technologies Ltd.-premium pricing iv. Larsen and Toubro

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					InfoTech Ltd. v. Satyam Computer Services Ltd.- falsified financials vi. VMF Soft Tech Ltd.
ITES/BPO or back office services & software development	2003-04	Deloitte Consulting India P Ltd. – 15ITR Trib. 573 Method: TNMM	Cost plus 7%	Back office-31% Software development-13.05%	1. Following companies excluded for want of export earnings or giant in size: a. C S Software Enterprise Ltd.

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					b. Idea space Solutions Ltd. c. MCS Ltd. d. Tata Share Registry Ltd. e. Vakrangee Softwares Ltd. f. Wipro BPO 2. Following additional companies included: a. North Gate BPO/North Gate Technologies Ltd. b. Vishal

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					Information Technologies Ltd. c. Fortune Infotech Ltd. d. Tricom India Ltd.
Software development services	2005-06	Kodiak Networks (India) Ltd./15ITR Trib 610 Method: TNMM	Cost plus 10.70%	15.61%	Only companies having turnover of 1 cr to 200 cr alone qualify for comparison
Low Consulting and and back office support	2003-04	Frost & Sullivan (I) P. Ltd./50SOT517	Cost plus 10%	20.42%	The bench however directed exclusion of both:

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services		(Mum) Method: TNMM			a. Loss making companies b. High/upper profit making /turnover companies such as Tata Sons Ltd., Sonata Technology, L&T Infotech, Infosys, Birlasoft, Polaris, Wipro, I-Flex , Satyam etc.
Business support	2003-04	BP India Services	Cost plus	20.55%	1. Two set of loss making

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/advisory services		(P) Ltd./133ITD255 (Mum) Method: TNMM	2.5%-personnel costs /7.5% -shared costs/reimbursements		comparable cases in assessee list of comparables excluded when bulk of the transaction are found to be with related parties. 2. NO uniform principle that loss making companies to be excluded unless of course for different profile. 3. Exclusion of extreme profit rate companies (75.6% and 68.7%) declined once these

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					form part of comparable list of cases given by assessee for arithmetic mean calculation.
Courier service	2005-06	DHL Express (India) P Ltd./12ITR Trib 658 Method: TNMM	7.34%	10.28%	1. small sized business with less than 20% turnover excluded- 20% turnover filter found acceptable 2. segmented results of TCI not considered since direct comparable were available 3. interest income, rent receipts,

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					dividends, penalties collected, rent deposits returned back, forex fluctuations, profit on sale of fixed assets not to be considered as part of operating profits for comparison
Cranes manufacturing-imports	2005-06	Demag Cranes & Components (India) (P) Ltd./66DTR (Trib) 217 Method:	11.70%- entity level taking multi – year data 2.41 % - manufa	7.18% - entity level PLI taking current year data	1. six comparables identified and accepted by TPO 2. Working capital adjustment allowed since

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		TNMM	cturing segment level		TPO compared entity level margins/arithmetic mean with manufacturing segment margins to work out the variance. Also high import cost contributed to an adjustment as part of working capital adjustment factor.
Royalty payment	2005-06	Sona Okegawa Precision Forgings Ltd./49SOT410 Method: CUP	3% of sales	1.Not justified since separate payment is made for technical	CUP method justified on the basis of a) RBI approval for payment of royalty in case of an associate, b) DIPP Press Note issued in

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				know how 2.Not justified in case of contract/captive manufacturing	2003 for ceiling on payment of royalty.
Royalty & advertisement	2001-02	McDonald's India (P) Ltd./49SOT415 Method: Royalty-CUP Advertising- cost plus mark up of 8.37%	Royalty- 5% of gross domestic sales plus USD 45000 initial franchise fee For Advertising charge incurre	TPO accepted comparables and operating margins in rule 10-D documentation. 1. For royalty CUP accepted by TPO. 2. TPO	The Delhi bench held a view that TPO is not justified in adding return on advertisement as such transaction was not referred to him. However after 1.6.2011 even advertisement expenditure incurred by

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			d but not recovered	desired return on advertisement expenses at cost plus 8.37%.	Indian outfit has to be suitably apportioned among global outfits as the benefits of such advertisements are shared among all.
Call center and back office operations or customer care services	2004-05 & 2005-06	Vodafone India Services (P.) Ltd./12taxmann.com 412 TNMM-6.93%	Cost plus 7% mark up. & net margin 11.63%	29.38%	1. Chronically loss making and negative net worth companies excluded. 2.Cases with related party transactions with foreign parent hence not considered as uncontrolled transaction 3.Higher end

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					ITES segment companies included by TPO

Flag points:

1. Wide gaps in margins offered and margins compared by TPO/CIT(A). Therefore the method of selection of a comparable is to be highly scientific and full proof on the basis of following key factors viz a viz comparables:

   a. Extent of related party transactions

   b. Extent of export/import transactions

   c. Scale and size of operations/turnover giving different economies of scale

   d. Turnover of relevant activity and its materiality

   e. Do not exclude loss making companies from select comparable list

   f. Exclude high profit and high turnover companies

   g. Other factors to be considered for inclusion or exclusion are character /profile of service provider, assets employed, risks assumed, contractual terms and

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conditions prevailing, geographical location, size of market, costs of labour, cost of capital etc.

h. Use only current year data

XII. Direct tax code

In the 2009-10 Budget, the Finance Minister of India announced that there would be a new Direct Taxes Code. When the DTC comes into effect, it would amend parts of the law relating to transfer pricing in India

Under the DTC, the amount of any income or expense arising from an international transaction shall be determined having regard to the ALP. Both the ITA and the proposed DTC begin their analysis of transfer pricing through associated enterprise

Under s. 92B (2), where certain transactions are deemed to be international transactions, there is no specification as to whether either of the parties must be non-residents or not. However, this confusion has been cleared by the DTC. Under the current and proposed statutory language, the meaning of international transaction is founded upon the concept of associated enterprise. It is our suggestion that the where the law reads "a transaction between two or more associated

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enterprises", it should read "a transaction
between two parties either or all of whom is a non-resident including a permanent establishment of the nonresident". This change would bring Indian law in sync with Division 13 under the Australian ITAA and would significantly increase the coverage of transactions.

XIII. Computation of ALP and the Advance Pricing Agreement

The earlier ITA did not make any provision for an Advance Pricing Agreement (APA), though in Finance Bill 2012 sec 92CC (sub clauses 1-10) is inserted after sec 92CB for APA. However the DTC has introduced an APA clause. Under the DTC, the Board, with prior approval of the Central Government, may enter into an APA with any person in respect of ALP in relation to an international transaction which may be entered into by that person on the basis of the prescribed method being the most appropriate for a period of five consecutive financial years. Further it provides that the ALP for such transactions shall be determined in the manner provided in ss. 106(1) – (4) of the DTC

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XIV. Insertion of chapter X-A- general Anti Avoidance Rule

Although originally forming a part of the Direct Taxes Code ("DTC"), however, given the postponement of DTC, GAAR is a part of the tax reforms proposed to be introduced through the Union Budget 2012. The Revenue authorities will be bestowed with widespread powers to disregard and re-characterize any tax avoiding transaction and income accruing therefrom. Further, the Finance Bill 2012 proposes the introduction of sub-section 2A to section 90 which would enable the provisions of GAAR (proposed to be introduced through Chapter X-A in the Income-tax Act, 1961) to override the provisions of the tax treaties signed by India. However, the provisions are to apply from A Y 2013-14.

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GAAR – Jurisdictional analysis

Some of the key provisions of the Indian GAAR can be analyzed with respect to the anti-avoidance rules existing in other international jurisdictions. The complexity of GAAR varies depending on the economic growth, infrastructure and the complexity of domestic tax statute of a particular jurisdiction. Some jurisdictions which have evolved anti-avoidance measures in the form of GAAR are Australia, France, Germany,

Spain, Italy, Canada, South Africa and the United States of America.

XV. Alternate dispute resolution mechanism

As the TP law marches ahead, the government is concerned about the rising TP disputes, arising due to increasing cases of adjustments to ALP. The Finance (No. 2) Act, 2009, has thus put in the following amendments:-

- Safe Harbour rules (Section 92CB) for determining the ALP. The rules would provide the circumstances under which the income tax authorities would automatically accept the TP declared by the assessee.
- A Dispute Resolution Panel (DRP), (Section 144C) consisting of a collegiums of 3 commissioners of income tax for dealing with complex matters relating to TP or the tax disputes of foreign companies

The DRP is collegiums of three Commissioners of Income Tax based in eight major cities in India having distributed jurisdiction across the country. These Commissioners will have this added responsibility in addition to the respective revenue administrative charge they hold.

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The tax payer is required to file his/her objections or otherwise to the draft order proposed by the field level tax officer (assessing officer or AO), within 30 days of the receipt of such draft order. The DRP would then have the time frame of 9 months to consider the facts and arguments of the AO as well as the taxpayer, and issue directions to the AO. Such directions issued by the DRP are binding on the AO and the AO is required to pass the final order based on such directions within 30 days of receipt of such directions. The DRP has wide powers as vested in a Court and can either confirm, reduce or enhance the additions proposed by AO. It, however, has to pass a definitive order and cannot remand the matter back to the AO. If the tax payer does not get the relief as desired, s/he has the option to file an appeal with the Income Tax Appellate Tribunal (ITAT).

XVI. Finance Act 2012 amendments:

In sections 92C, 92CA, 92D and section 92E of Chapter X of the Income-tax Act, for the words "international transaction" wherever they occur, the words "international transaction or specified domestic transaction" shall respectively be substituted with effect from the 1st day of April, 2013

XVII. How to survive a transfer pricing audit in India

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The Indian process of selecting cases for a transfer pricing audit is procedural and apparently does not deal with the qualitative aspects of the case. The Central Board of Direct Taxes has, vide an instruction, notified that should the gross value of its international transaction exceeds RS. 15 crores the case should be compulsorily audited. This process has led to a large number of cases having selected, which does not leave the TPOs with adequate time to scrutinize the case.

In the past couple of years, the TPOs have made significant adjustments. The fact pattern of adjustments indicates that one in every four cases picked-up for audit, is adjusted

The typical scenarios which would attract the attention of the TPOs for a transfer pricing audit would be:

- Consistent losses of the taxpayer attributable to inter-company transactions;
- Significant changes in the profitability of the taxpayer and its associated enterprises;
- Unjustifiably large payment of management charges not passing the 'benefit test';
- Losses incurred by routine distributors; and
- Low mark-ups for services.

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It is important that a taxpayer regularly monitors and regulates its transfer prices to survive a transfer pricing audit in India. Some of the key aspects which could help a company survive a transfer pricing audit process are discussed as under:

- Strong and robust transfer pricing documentation
- Due recognition of the economic circumstances
- Establishing control of the audit process

It is worthwhile to mention that the Indian transfer pricing regulations do not provide for a process of negotiation with the taxpayers. Under the Indian scenario, when a transfer pricing audit is completed, an order is passed either accepting or rejecting the arm's length price of the taxpayer. The adjustment made by the TPO becomes final and the income tax officer shall proceed to raise a tax demand on that basis. The transfer pricing order, per se, is not an appealable order but the assessment order by the income tax officer based on which a tax demand has been raised is an appealable order.

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Appendix 1

Article 9 of the OECD Model Convention on Tax

ASSOCIATED ENTERPRISES

1. Where

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an nterprise of the other Contracting State, or
b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State —and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the

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first-mentioned State if the conditions
made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

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Appendix 2

*Article 7 of the OECD Model Convention on Tax

BUSINESS PROFITS

1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.

2. For the purposes of this Article and Article [23 A] [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise. 4

3. Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been

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charged to tax in the other State, the other
State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.

4. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

* THE 2010 UPDATE TO THE MODEL TAX CONVENTION

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