

# Transfer Pricing

Porus Kaka  
Sr. Advocate

# What is Transfer Pricing?

- Ascertaining the price charged in transaction between related enterprises / entities of
  - Tangible assets
  - Intangible assets
  - Controlled services
  - Financial arrangements

# What is Transfer Pricing?

- Three key concepts:
  - International transaction or Specified domestic transactions
  - Associated Enterprise (AE)
  - Arm's Length Price (ALP)

# Why is important?

- Deterrence to international transactions resulting into shifting of profit and over all low tax payment by MNE's in various jurisdictions
- Sharing of pie between jurisdictions

# Stakes Involved.. (*..allegedly*)

## [INR figures in crore]

- FY 2004-05 – 1,220
- FY 2005-06 – 2,287
- FY 2006-07 – 3,432
- FY 2007-08 – 1,614
- FY 2008-09 – 6,140
- FY 2009-10 – 10,908
- FY 2010-11 – 23, 237
- FY 2011-12 – 44,531
- FY 2012-13 – 70,000 approx\*
- FY 2013-14 – 60,000 approx\*

# Methods of Transfer Pricing

- Comparable Uncontrolled Price Method (CUP)
- Resale Price Method (RPM)
- Cost Plus Method (CPM)
- Profit Split Method (PSM)
- Transactional Net Margin Method (TNMM)
- Any other method that may be prescribed by the Board
- Rule 10AB inserted by Finance Act, 2012 w.r.e.f. 1-4-2012 prescribed the Sixth method

# Sixth Method

- *Rule 10AB. For the purposes of clause (f) of sub-section (1) of section 92C, the other method for determination of the arms' length price in relation to an international transaction 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.**"*

# Income attribution

Two step process:

1. Functions Assets Risk (FAR) Analysis of the entity
2. Comparability Analysis in order to find out the Arm's Length Price of the transaction in an Uncontrolled manner



# Sources of Literature

- OECD Transfer Pricing Guidelines
- UN Transfer Pricing Guidelines
- US IRS Transfer Pricing Guidelines

# Internationally Existing Methods

- Globally accepted Arm's length principle
- Formulary apportionment – Used by Brazil

# History of OECD TP Guidelines

- 1979 & 1984 – Reports on transfer pricing
- 1995 – Transfer Pricing guidelines
- 2010 – Amended TP guidelines
- October 2014 – Action Plans 8-10 under BEPS project

# Intangibles

- Intangibles – Whether any exists?
- What is that intangible?
- Who has developed / created that intangible?
- Who owns that intangible?
- What is the correct value of that intangible?

# Major Issues of Dispute in Transfer Pricing

- Associated Enterprise?
- International transaction?
- Most appropriate method
- Comparability Analysis
- Availability of Uncontrolled transaction
- Availability of proper comparable
- Function
- Asset
- Risk

# Associated Enterprise?

- Meaning of Associated Enterprise
- Meaning of “deemed associated enterprise” u/section 92A(2)
- Whether Section 92A (1) and (2) are independent of each other?
- Veer Gems [2017] 183 TTJ 588 (Ahd).
  - Section 92A(1) and (2), are required to be read together.
  - Revenue’s SLP against Gujarat HC judgement affirming the above dismissed by SC in [2018] 256 Taxman 298 (SC)

# International transaction?

- Meaning of “international transaction” u/section 92B(1)
- Meaning of “deemed international transaction” u/section 92B(2)
- Whether Section 92B (1) & (2) are independent of each other?



# Reference to Transfer Pricing Officer

- Is the reference automatic?
- What is 'Necessary or expedient'?
- Approval
- CBDT Instruction No. 3 of 2016 on 10 March 2016
- Indorama Synthetics (India) Limited Vs. ACIT dated 25-7-2016 [2016] 386 ITR 665 (Delhi HC) has held that the above Instruction, being procedural and beneficial to the taxpayer, has to be given retrospective effect
- Nikon India Pvt Ltd dated 15.7.2016 [2016] 182 TTJ 870 (Del ITAT), earlier had taken a contrary view by holding the above Instruction being prospective in nature
- Tata Consultancy Services Ltd dated 4-11-2015 [2015] 174 TTJ 570 (Mum ITAT) even prior to above Instruction, has held that AO erred in not himself examining the issue of TP and with the approval of the Id. CIT, made a reference to the TPO u/s 92CA(1) of the Act

# Use of contemporaneous data

- Mckinsey Knowledge Centre India Pvt Ltd [ITA 217/2014] (DEL)
  - Comparable cannot be rejected if data available for 9 months can be extrapolated to make a reasonable comparability analysis
- PTC Software India P. Ltd [2017] 395 ITR 176 (BOM)
  - Dismissed Revenue's appeal against the removal of a comparable having June year ending as Rule 10B(4) warrants the data to be for the same financial year.
- Maersk Global Services Centre (I) P. Ltd. (Mum)
  - Distinguishes PTC Software to decide in favour of the assessee

# Who should be the Tested Party?

- Foreign AE can be a tested party
  - Development Consultants [2008] 23 SOT 455 (Kol)
  - Ranbaxy [2008] 110 ITD 428 (Del)
  - Mastek [2012] 53 SOT 111 (Ahd)
  - General Motors [2014] 146 ITD 559 (Ahd)
  - Ranbaxy [2016] 68 taxmann.com 322 (Del) - follows APA principle
  - WNS Global Services India Pvt Ltd [2018] ITA 2318 & 1886/Mum/2009 (Mum)
- Foreign AE cannot be a tested party
  - Onward Technologies Ltd. [2014] 44 taxmann.com 295 (Mum)
  - AT & S India (P.) Ltd. [2016] 72 taxmann.com 324 (Kol)

# Relevant Cost Base to calculate Net profit margin

- Li & Fung India Pvt Ltd [2014] 361 ITR 85 (DEL)
  - Issue: Relevant cost to calculate net profit margin under TNMM
  - The ALP can't be determined on the basis of FOB value
  - IT Act draws heavily from the OECD Model Tax Convention interpretation under article 9.
  - The study carried out by the assessee must first be rejected, for any further alterations to take place
  - Once TNMM was deemed as the most appropriate method, the distortions, if any, had to be addressed within its framework

# Issuance of shares

- Vodafone India Services Private Limited (Bom HC) [2014] 50 taxmann.com 300
  - The issue of shares at a premium is a capital account transaction and not income
  - Issue of shares does not give rise to any income from an admitted International Transaction. Thus, no occasion to apply Chapter X of the Act can arise in such a case
- CBDT Instruction No. 2/2015, dated 29 January 2015

# Marketing intangibles

- AMP expenses were treated as an international transaction with Associated Enterprise and thus held to be subject to TP regulations in India in
  - LG Electronics (Delhi ITAT-SB) &
  - Sony Ericsson Mobile Communication India Pvt. Ltd. [2015] 374 ITR 118 (DEL)
- Maruti Suzuki India Limited [2016] 381 ITR 117 (DEL) holds that incurrence of AMP expenditure cannot be considered as an international transaction

# Location savings

- Watson Pharma [2015] 168 TTJ 281 (Mum) / [2018] 257 Taxman 65 (BOM)
  - Further returns on account of location savings are not warranted where operating margin earned by the taxpayer is at arm's length based on local market comparables operating in similar economic circumstances as the taxpayer;
  - Location savings are not regarded as an intangible asset unless specific advantages are capable of being owned or controlled by an individual enterprise
- GAP International Sourcing (India) Pvt. Ltd [2012] 149 TTJ 437 (Del)
  - The advantage of location savings is passed onto the end-customer.
  - Benchmarking with comparables in the jurisdiction of tested party does not warrant any separate/additional allocation on account of location savings

# BPO v/s KPO classification

- Maersk Global Centres (India) (P.) Ltd. [2014] 43taxmann.com100 (Mum - SB)
  - Classification of ITES into low-end BPO services and high-end KPO services for comparability analysis would not be fair and proper
- Rampgreen Solutions (P.) Ltd. 377 ITR 533 (DEL)
  - Data Processing is BPO
  - High Court expressed reservations on the methodology for selection of comparables on a broad ITeS level as advocated in the Special Bench ruling in case of Maersk Global
  - Tribunal view that there can be no sub-classification of services falling under ITeS is difficult to be accepted and is contrary to the fundamental rationale of determination of arm's length price (ALP)
  - Functional comparability is the key criteria for the selection of comparable companies
  - Broad functionality test is inappropriate as not being in accordance with transfer pricing principles. However, in case of a mixed bag i.e. a taxpayer rendering a mix of BPO and KPO services, broad functionality test can first be performed and then materially dissimilar companies can be eliminated
  - Functionally dissimilar companies cannot be considered as comparable taking recourse to TNMM, which is less sensitive to functional differences
- McKinsey Knowledge Centre India Pvt Ltd [2018] 96 taxmann.com 237 (DEL)
  - Data processing is KPO



# Funding transactions (guarantee)

- Bharti Airtel Ltd [2014] 64 SOT 50 (Del) –
  - Issuance of corporate guarantee is not an ‘international transaction’ under section 92B of the Act, since the transaction does not have any bearing on profits, income, losses or assets of the enterprise.
- Advanta India Limited [2016] 156 ITD 286 (B’lore) –
  - Taxpayer had incurred costs on issuance of the guarantee, therefore the issuance of guarantee indeed had a bearing on the profits and income of such enterprise, and hence, it cannot be said that the issuance of guarantee did not constitute an 'international transaction'
- Everest Kento Cylinders Ltd. [2015] 378 ITR 57 (BOM) –
  - No comparison can be made between guarantees issued by commercial banks as against a corporate guarantee issued by holding company for benefit of its AE, a subsidiary company.
  - Thus, the higher rate of 3% as guarantee commission was thereby not justified, and a rate of 0.5%, as charged by the taxpayer, was ultimately upheld.

# Intra-group Services and Commercial Expediency

- S.A. Builders Ltd. vs. CIT [2007] 289 ITR 26 (SC)
  - Tax authorities cannot justifiably claim to place itself in the arm chair of businessman or in the position of the Board of Directors and assume the role to decide how much is the reasonable expenditure having regard to the circumstances of the case
- EKL Appliances Limited [2012] 345 ITR 241 [DEL]
  - The tax authorities cannot question the commercial rationale of legitimate business expenses incurred by the taxpayer as long as it is demonstrated that the transaction is at arm's length
- Knorr-Bremse India (P) Ltd. [2016] 380 ITR 307 (P&H HC)
  - The tax authorities cannot go in the commercial expediency of availing the services
- Cushman & WakeField India Pvt Ltd 46 Taxmann.com 317(Del)
  - Authority of the TPO was limited to conducting transfer pricing analysis for determining the ALP of an international transaction and not to decide if such services exist or benefits accrues to assessee
- CLSA India Ltd [2014] 148 ITD 421 (Mum); TNS India (P) Ltd. (Hyd); Ingersoll Rand (India) (Bang); Castrol India Ltd. (Mum.); N L C Nalco India Ltd. (Kol)
  - Rejected the arguments on the basis of benefit test to apply CUP method for determining 'NIL' value as no comparable uncontrolled transaction existed

# Sogo Sосha Companies

- Mitsubishi Corporation India Private Limited [2015] 67 SOT 83 (AY 2007-08) (Del) & ITA No. 332/2014 (AY 2006-07) (DEL)
  - Cannot be equated with activities of a normal trader
  - Rejected the inclusion of FOB value of the goods in the cost base for service fee / commission segment
  - Berry Ratio can be used as PLI in cases where the business does not assume any significant inventory risk or perform any functions to add value to the goods traded
- Sumitomo Corporation India Private Limited [2016] 387 ITR 611 (DEL)
  - Indenting functions cannot be re-characterised as trading function
  - Berry ratio can only be applied in cases of stripped down distributors, i.e. distributors that have no financial exposure and risks in respect of goods distributed by them

# Application of the sixth method

- The Delhi Tribunal, has held that the ‘Other Method’ is applicable retrospectively from the date of inception of Indian TP regulations, i.e., April 1, 2002.
  - Toll Global Forwarding India Private Limited [2015] 152 ITD 283 (Del)
  - Geodis Overseas Private Limited [2015] 67 SOT 220 (Del)
- Hon’ble Delhi HC in Toll Global Forwarding India Private Limited [2016] 381 ITR 38 – has upheld the findings of ITAT though no direct observation has been made on retrospectivity of Rule 10BA

# Role of ITAT

- Final fact finding authority
- Disputes in Transfer Pricing mostly revolve around comparables
- Analysis of Function Asset and Risk

# Comparables – A question of fact..

- Softbrands India (P.) Ltd [2018] 94 taxmann.com 426 (KAR)
  - Existence of a “substantial question of law” was sine qua non (i.e. essential) for maintaining an appeal before the HC u/section 260A of the Act
  - A finding of “fact” might give rise to a substantial question of law only if it is “perverse”.
  - Determination of “arm’s length price” as laid down in Chapter X of the Act, essentially involves selecting the most appropriate method, applying the appropriate filters, selecting comparable companies, etc.
  - Such an exercise does not fit within the parameters of a “substantial question of law,” as the entire exercise of making TP adjustments on the basis of comparables is an estimate of the broad and fair guess work of the lower authorities.
  - Even, inconsistent views taken by the Tribunal in different cases also could not lead to the formation of a substantial question of law to determine the aspects of arriving at the arm’s length price
  - Therefore, the HC categorically held that the appeals on whether the right comparables have been selected or the correct filters have been applied, do not give rise to a substantial question of law.

# Comparables – A question of fact..

- Carlyle India Advisors P. Ltd. 357 ITR 584 (Bom HC); General Atlantic (P.) Ltd 384 ITR 271 (BOM)
  - Tribunal had in its ruling held that an investment advisor could not be compared to a merchant banker
  - HC held that finding of the comparable to be adopted to determine the ALP as the basis of the activity conducted by the respondent-assessee is essentially a finding of fact



Thank you!