



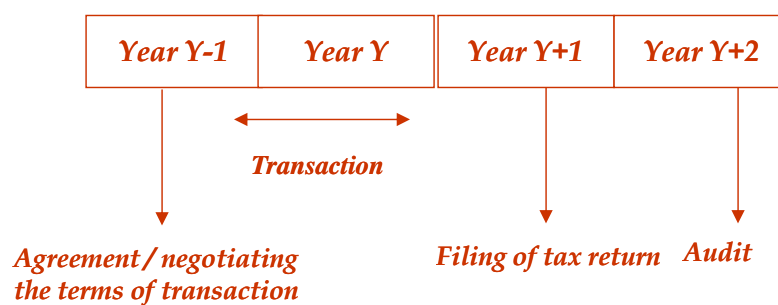
Arm's length principle in India: selected issues

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Timing issues – OECD perspective



Different country approaches: the “arm's length price setting” and the “arm's length outcome testing” approaches:



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Data for Comparability Analysis: multiple year data



- Average data analysis more robust
 - Better comparability analysis
 - Evens out product/ business life cycles, short term economic conditions etc.
- Indian Regulations should unconditionally permit use of past years data

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Comparability Adjustments



- Both Indian regulations and OECD require comparability analysis to be based on FAR. Adjustments to be made for material differences.
- OECD TPG Para 1.23: “in the open market, the assumption of increased risk will also be compensated by an increase in the expected return”
- Guidance for application/acceptance of adjustments in case of differences in market, entrepreneurial risks, viz.
 - Overall adjustment using various models like CAPM etc.
 - Use of IQR; remove outliers representing risk takers
 - Use of longer term average margins of comparables

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Comparability Adjustments



- Indian TP authorities have expected limited risk captives to earn margins comparable to entrepreneurs; disregard of the risk and asset profile of the taxpayer vis-à-vis comparables
- Indian authorities have in most cases accepted adjustment made to comparables primarily for working capital differences
- More guidance for application/ acceptance of other adjustments:
 - Excess capacity adjustments - Credit risk adjustments
 - Adjustment for non-comparable functions, pass through costs etc.
 - Adjustment for R&D activities - Other adjustments

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Acceptability of Business Strategies and Economic Principles - Losses



- Indian TP authorities do not appreciate business dynamics and strategies while conducting audits; profit position of the taxpayer is the prime focus
- General resistance to losses earned by taxpayers as well as loss comparables
- Cherry picking of profitable companies for comparison purposes
- Losses justified, if part of business strategy [para 1.52 and 1.54 of the OECD TPG]

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Transactional/ segment-level analysis



- **OECD TPG permit aggregated analysis if transactions are closely interlinked [paras 1.42 to 1.44]**
- **Indian TP authorities: preference for transactional or product-wise analysis over overall, aggregated company-level analysis disregarding:**
 - principles of aggregation and materiality of transactions
 - taxpayer may adopt basket of products approach to manage business dynamics and achieve sustainability on a consistent basis, organize their business into various baskets or product portfolios
- **Typically have sought “product-wise” profitability. Guidance needed.**

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Arm's Length Range



- **Indian regulations permit limited 5% variation from Arm's Length Price (ALP) [proviso to Section 92C(2)]**
- **ALP computed as mean of comparable prices**
- **OECD Guidelines permit use of complete arm's length range- entire range of outcomes obtained by application of most appropriate method; all such results are considered relatively equally reliable [para 1.45 of the OECD TPG]**

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Lack of guidance for certain transactions



- **Lack of guidance in the Indian TP regulations on transactions like:**
 - **Transfer of intangibles**
 - **Cost contribution agreements**
 - **Other complex transactions**
- **OECD TPG Chapters VI & VIII**
- **Guidance/ Rules required in Indian Regulations**

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Secondary adjustments



- **Refund of withholding tax not allowed in case of expense adjustments to paying Indian entities [second proviso to Section 92C(4)]**
- **Results in double taxation of group profits – against basic principles of taxation**
- **Corresponding adjustment should be permitted**

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Recent Audit Experience

- Major companies audited
 - 1,000/1,500 audits estimated
- Only Selection Criteria
 - International Transactions above INR 15 crores (US\$ 3 Million)
- Adjustments – INR 2500 crores (US\$ 500 Million) approx
 - Banks, FMCG, Software, Pharma etc
- TNMM method most commonly used by tax payers (approx. 80%)
- Reliance on precedents of tax year (s) March 2002 and 2003 but major departure for IT Sector
- Tax Authorities intend to develop case selection tools – more focused examinations in future years

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Industry Specific Issues

Software and BPO/ITES: High cost plus markups ranging from 25 to 45%

- Banking and Financial Services: Greater focus on marketing services (repatriation strategies)
- Distributors of products: Loss making companies usually unacceptable
- Manufacturers – Aggregation of transaction unacceptable
- Transaction Specific Issues
 - Management Charges: Subject to greater scrutiny
 - Royalties and Charges for Intangibles: Usually challenged and requires substantiation

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Summary of TPO approach:

- Rejected taxpayer's comparables based on unsound reasons
- "Cherry picking" of comparables with high margins
- No adjustments made for differences in functional or risk profile
- This is a hidden argument on Location Savings
 - Measurement issues
 - Who should be entitled to them?
"...even if the Indian service provider marks up his cost by 40%, still his price would be only around 27% of the US service providers price."
- Risk Adjustments
 - Working capital adjustments
 - Adjustments for entrepreneurial risk
 - Adjustments for differences in functions performed

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Management Charges

- Revenue Authorities contemplate disallowance based on:
 - No tangible benefit
 - Inadequate proof in rendering the services
 - Companies engaged in similar business does not pay such charges
 - Determination of allocated amount
 - Insist on mark-up even on reimbursements
 - "Benefit Test" critical
 - Determination of the cost allocation process
 - Cost reimbursement (with no markup) defensible if benefit is established

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AUDIT TRENDS - PHARMACEUTICALS



- Relying on customs databases, imported drugs taken as comparables for imported API (Active Pharmaceutical ingredient)
- Reliance on CUPs without regard to comparability factors
- Innovative features of taxpayer's drugs not considered
- Differences in market conditions, quality and pharmacopoeia standards ignored

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AZTEC SOFTWARE (BANGALORE TRIBUNAL)



Facts

- Aztec India has a wholly owned US subsidiary (Aztec US)
- Aztec US provides marketing and onsite services for Aztec India
- Aztec US receives cost-plus remuneration for marketing and onsite services

Issue

- Several procedural issues including validity of reference to TPO
- Whether arm's length price for services was correctly computed?

Decision

- CBDT circular (compulsory reference where transaction value exceeds INR 50 million) valid and binding on department
- No tax avoidance to be proved for reference
- Neither reference nor determination of arm's length price can be arbitrary (due consideration to principles of natural justice)
- Appellate body cannot reject price determined by taxpayer without itself determining arm's length price

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- Industry average can not be used as CUP
- Comparability requires that appropriate adjustments should be made
- Where cost plus model is used cost base too should be examined
- 10 comparable companies held not to be enough (on the facts of Aztec's case)
- Multiple year data not to be used unless influence of prior year's data on current year's data is demonstrated
- Revenue and taxpayer to equally share in burden of proof where transfer pricing methodology is changed
- OECD transfer pricing guidelines referred extensively
- US regulations referred to in case of CUP and cited as 'principles of universal application'
- Case remanded to jurisdictional officer with above guidance



Facts

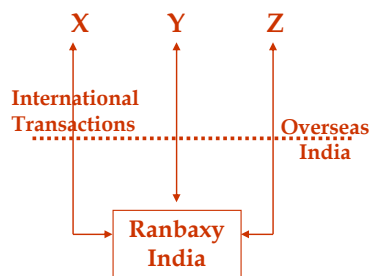
- Mentor Graphics India is a captive service provider providing software development support to its parent company in USA

Issues

- Choice of comparable companies for determining arm's length price

Tribunal Ruling

- Emphasis on comprehensive FAR analysis while applying TNMM
- Use of current year data for computing arm's length price
- Close scrutiny of high profit and loss making companies while benchmarking captive
- Computation of arm's length range based on several arm's length prices
- TPO can undertake a fresh search only if apparent deficiencies exist in taxpayer's documentation
- OECD guidelines and US Court Ruling relied upon
- Based on five comparable companies, MGI held to be within arm's length range



- Taxpayer manufactures and sells pharmaceutical products
- Transactions with overseas affiliates in different countries
- Methodology - TNMM PLI (operating profit / sales)
- Overseas affiliates chosen as tested parties
- Profitability benchmarked on aggregated basis
- Issues
 - Choice of tested party
 - Aggregation principles



Principles

- Least complexity; and
- Availability of reliable data
- Tested party must satisfy both conditions

Application

- Basic information on comparables (eg region of operation) not available
- Computation of margins not furnished

Tribunal rejected choice of overseas affiliate as tested party



Aggregation Principles

Principles

- Comparison on transaction by transaction basis
- Aggregation only where functions, risks and assets similar
- Closely linked nature of transactions to be demonstrated

Application

- Overseas affiliates in different countries with different market conditions
- Transactions undertaken were different in nature
- Substantial variation in operating margins of tested parties
- Closely linked nature not demonstrated

Tribunal rejected aggregation approach adopted by taxpayer

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Facts

- Three different international transactions entered into by taxpayer
- Transactional analysis undertaken
- Tested party - overseas entity
- Revenue rejected taxpayer's approach and aggregated transactions

Issues

- Choice of tested party
- Principles of aggregation

Tribunal Ruling

- Ranbaxy Ruling followed
- Taxpayer's documentation should be accepted unless revenue controvert's same
- Multiple year data allowed
- Allowance of (+/-) 5 percent benefit

Tribunal upholds taxpayer's documentation

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CARGILL INDIA PRIVATE LIMITED (DELHI TRIBUNAL)



Facts

- Transfer Pricing Officer (TPO) issued notice calling for information
- Taxpayer sought adjournment number of times before furnishing documents
- Revenue ruled that taxpayer failed to comply with documentation requirements
- Sufficient ground for initiation of penalties

Key Principles

- Revenue must call only for prescribed information
- Revenue should be specific in request for documents
- Notice imposing penalty must specify default and provision invoked
- Vague penalty notices are invalid

Held that documentation requirements were met and penalty notices were invalid

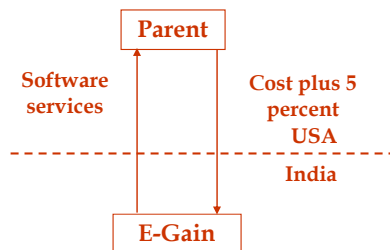
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E-GAIN COMMUNICATIONS (PUNE TRIBUNAL)



Facts

- Taxpayer is a captive software service provider
- Methodology – TNMM



Key Principles

- Importance of adjustments following earlier Rulings (Aztec and Mentor Graphics)
- Companies with extraordinary results need to be closely scrutinized
- Comparables to be rejected where no segmental results available
- Consistent accounting policies to be adopted across comparables and taxpayer
- Turnover screening criterion should be applied consistently

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Facts

- Taxpayer engaged in three distinct businesses
- Separate transfer pricing analysis for each business
- TPO insisted on combined analysis
- Assessing Officer (AO) disallowed license fee payments made to affiliates

Issues

- Aggregation of transactions

Tribunal Ruling

- Highlights importance of adjustments
- Followed Ranbaxy (Aggregation)
- Emphasis on robust analysis of functions, assets and risks
- In view of RBI's approval for license fee payments, AO should have closely examined transfer pricing analysis

With above guidance, Tribunal remanded case to AO

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Run up to Morgan Stanley (Supreme Court) Ruling

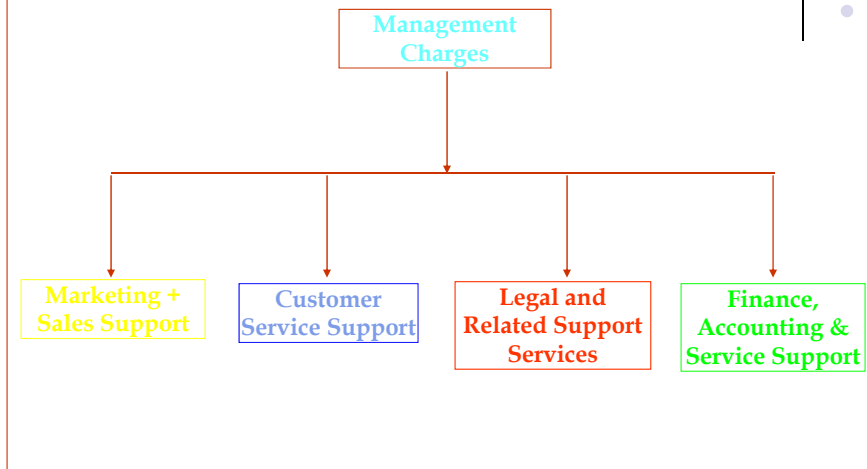
Administrative circulars of 1969 (Circular 23) and 2004 (Circular 5) :

Profit attribution to PE = Arm's length return

- **Morgan Stanley Ruling (Advance Ruling) (2006)**
 - Arm's length remuneration to an enterprise (constituting a PE) exhausts attribution of profits to PE
- **Sony Entertainment Tribunal decision (2007)**
 - Morgan Stanley decision (AAR) overruled
 - Profits attributed to a dependent agent PE over arm's length return to dependent agent
- **Hyundai Supreme Court Ruling (2007)**
 - Seemed to affirm Morgan Stanley principle but no categorical statement

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Management Charges - Meaning



Taxability : FTS / Make Available

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Transfer Pricing Officer's stand

- Contend that the payment of management charges were unjustifiable
- The broad premise for adopting such a stance are:
 - No "tangible" evidence of benefits accruing from such services;
 - Inadequate proof of "tangibility" in rendering the services;
 - None of the comparable companies identified pay such charges

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Justification for Management Charges



- Management fees are consideration for expertise availed by a business operating in a nascent market/niche segment
- Charges for services rendered by the parent for improving a subsidiary's prospects;
- Payments for lending skill sets unique to the business in question

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CONCLUSION



- Special Bench in Aztec settled procedural law on transfer pricing - Tribunal gradually laying down substantive law
- Alignment with international principles - greater reliance on OECD Guidelines and US regulations
- Recent Tribunal decisions have been practical and stress on application of fundamental transfer pricing principles (Robust FAR analysis and Comparability adjustments)
- Guidance available on
 - Aggregation of transactions
 - Choice of tested party
 - Selection of comparables
- Tribunal making up for lack of administrative guidance
- Post Morgan Stanley, fears of double taxation sorted out
- For taxpayer comprehensive documentation key to minimize transfer pricing risk

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