HOW WELL DO YOU UNDERSTAND TRANSFER PRICING?

It is a well known fact that Multi-National Enterprises (MNEs) have found India conducive to set up their operations, largely because of the availability of a skilled work force at reasonable costs.

Investments into India result in transactions between the Indian and the parent company as also between the Indian company and other foreign group companies. Such transactions could encompass sale of goods, provision of services, licensing of intangibles, to give a few examples. These transactions give rise to transfer pricing issues.

Transfer prices are important for both tax payers and tax authorities because they determine, in large part, the income, expense and taxable profits of the associated (group) enterprises in different tax jurisdictions.

Effective April 1, 2001, India introduced a comprehensive TP legislation as an anti-avoidance measure. The Indian TP regulations are broadly based on the transfer pricing guidelines issued by the Organisation for Economic Co-operation and Development (OECD), but are unique in some respects.

The Indian TP regulations mandate that international transactions with related parties shall be determined having regard to the arm's length price, i.e. the price that would be charged by enterprises in an uncontrolled transaction. In India, not only are taxpayers selected for compulsory audits based on quantitative parameters i.e. international transactions in excess of INR 50 million in a fiscal year (proposed to be increased to INR 150 million), but further, Indian tax authorities are seen as adopting an increasingly aggressive approach on TP related issues.

In several cases, in the recent past, taxpayers faced significant challenges in defending their transfer prices. Taxpayers typically defend their transfer prices as being at arm's length by conducting a transfer pricing study and comparing their net margins with those earned by comparable uncontrolled enterprises. Therefore, whether a particular transfer price is accepted as being at arm's length or not depends to a large extent on the process of selecting comparable data for the analysis. The lack of quality comparable data in public domain is a challenge faced by the taxpayers while preparing their documentation.

This challenge is further compounded by the approach adopted the Transfer Pricing Officers (TPOs) during audits. In addition to using comparable data which was not available at the time of preparing the documentation, TPOs have also resorted to "cherry-picking" of comparables (especially by eliminating loss making/ low turnover comparables) rather than adopting an objective approach to identifying and screening the comparable companies.

This approach creates a bias in favor of profitable companies in the comparable data, resulting in transfer pricing adjustments for the taxpayers. The worst affected were captive service providers, which bear little or no risks as they deal with parent or group companies as compared to comparable uncontrolled transactions undertaken by other companies which cater to third parties and bear a range of risks including recovery of the price from the third party customers. However, in a number of instances, TPOs have largely ignored the importance of risk in a transfer pricing analysis and determined high mark ups on costs, to be the arm's length margin for captive service providers. It is a fundamental economic principle that entities which do not undertake risks can expect to earn a lower rate of return.

Recently The Delhi Income Tax Appellate Tribunal (ITAT) has revived the hopes of tax payers in India. This decision was given in the case of a captive service provider, Mentor Graphics (Noida) Private Limited, engaged in rendering software services to its US parent. The decision has laid down certain broad principles that could have a significant influence on transfer pricing in India.

Background:

Mentor Graphics, a company engaged in rendering software development services to its group entities, was being remunerated on charge out rate basis. To establish the arm's length nature of its pricing, the profit margin (7% on cost) was compared by the company with average operating profit of similar software service providers. The TPO rejected the company's analysis and based on his own analysis, determined the arm's length price of the software services rendered by the company far in excess of its actual price. Placing reliance on the TPO's order, the Assessing Officer adjusted the taxable income of the company by Rs. 14.5 million which was upheld by the Commissioner (Appeals).

Tribunal's order:

The ITAT, in its order, has emphasised that an important step in the determination of Arm's Length price (ALP) is to analyse the specific characteristics of the controlled transaction whether it relates to transfer of goods, services or intangible. Also, an analysis of the functional and risk profile of the comparable companies and an adjustment for differences in the same vis-à-vis the functions and risks undertaken by the Taxpayer was considered imperative by the ITAT.

The observations of ITAT are critical to the extent that these relate to importance of functional and risk analysis and adjustment for various differences while determining ALP. The ITAT observed that selecting companies with extreme results may not be appropriate since such extreme results indicate non-comparability of these companies. They have explicitly rejected high profit and high loss making companies for the economic anlaysis.

Another critical aspect emphasised in the Order is on the need to undertake economic adjustments to eliminate the differences in functional and risk levels. While, in view of the principles of economics, the greater the risk, the greater the expected return, the ITAT stressed on the importance of adjustment for differences in risk, it also strongly advocated adjustment for differences in working capital and R&D expenditure.

The ITAT further held that if the differences between the Taxpayer and comparable companies are material, and if adjustment is not possible, then comparables are required to be rejected. A look back on the transfer pricing audit experience till date would clearly highlight the reluctance of Revenue Authorities to allow economic adjustments either principally or by sighting lack of proper data. Also, TPOs have proposed that a net margin analysis takes care of all economic differences and no such adjustments would be required in case of a net margin analysis. This view was severely criticised by the ITAT. The ITAT has taken cognisance of the OECD guidelines and the Income Tax Rules to contend that adjustments for working capital, risk and growth and R&D expenses need to be made to eliminate differences between the taxpayer and the comparables.

The ITAT also observed that the TPO can undertake a new comparable search only if there is some deficiency in the Taxpayer's approach (which, in the Tribunal's opinion, was not sufficiently discharged by the TPO in the present case).

Conclusion

While the ruling has provided some guidance on the contentious issue of selecting comparable data for a transfer pricing analysis it has not addressed a number of other controversial issues. Primary among them is the fact that while the ruling acknowledges that risk differences could have significant impact on a transfer price no guidance has been provided on the approach to be adopted for making adjustments.

Nevertheless, this verdict should make it more comfortable for taxpayers and transfer pricing practitioners to deal with TP audits and litigation and would certainly chart out the way for transfer pricing in India, at least in the short term.